***FRS 11 Construction Contract***

**Purpose of the Standard**

This Standard should be applied in accounting for construction contracts in the financial statements of contractors.

**Definitions**

**Construction contracts** are contracts specifically negotiated for:

1. The construction of an asset single asset such as a bridge, building, dam, pipeline, road, ship or tunnel or
2. Combination of assets that are closely interrelated in terms of design, technology and function for their purpose. For example, building of a refinery or complex equipment.

**Fixed price contract** is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

Example of escalation clause is in an RDC contract in Bangladesh where the cost of cement in fluctuates aggressively. RDC manage to include a variable price on the cost of cement at the point of use.

**Cost plus contract** is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

**Cost of construction** contracts do not include cost of construction alone but also:

1. Contracts for the rendering of services which are directly related to the construction of the asset, for example, services of project managers and architects; and
2. Contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

**When a Construction comprises of more than one asset**

When a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

1. separate proposals have been submitted for each asset;
2. each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
3. the costs and revenues of each asset can be identified.

A group of contracts, whether with a single customer or with several customers, should be treated as a single construction contract when:

1. the group of contracts is negotiated as a single package;
2. the contracts are so closely interrelated and as part of a single project with an overall profit margin; and
3. the contracts are performed concurrently or in a continuous sequence.

For Construction contracts accounting we must consider the following items:

* Contract Revenue
* Contract Cost
* Actual Cost incurred during the year
* Cost incurred in previous years
* Progress Billing

**Contract Revenue**

Contract revenue should comprise:

1. the initial amount of revenue agreed in the contract; and
2. variations in contract work, claims and incentive payments:
3. to the extent that it is probable that they will result in revenue; and

1. they are capable of being reliably measured.

Measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next. For example:

1. a contractor and a customer may agree variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

Definition of a variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. The amount of revenue can be reliably measured

1. the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;
2. the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or
3. when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

**Contract Cost**

Contract Cost should comprise of:

1. costs that relate directly to the specific contract and include:
2. site labour costs, including supervision;
3. costs of materials used in construction;
4. depreciation of plant and equipment used on the contract;
5. costs of moving plant, equipment and materials to and from the contract site;
6. costs of hiring plant and equipment;
7. costs of design and technical assistance that is directly related to the contract;
8. the estimated costs of rectification and guarantee work, including expected warranty costs; and
9. Claims from third parties.
10. costs that are attributable to contract activity in general and can be allocated to the contract and include;
11. insurance;
12. costs of design and technical assistance that is not directly related to a specific contract;
13. Construction overheads.

Construction overheads are to be allocated using a consistently applied method. Costs include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs.

1. Such other costs as are specifically chargeable to the customer under the terms of the contract which may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

1. general administration costs for which reimbursement is not specified in the contract;
2. selling costs;
3. research and development costs for which reimbursement is not specified in the contract; and
4. Depreciation of idle plant and equipment that is not used on a particular contract.

Contract costs may include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract.

Costs that relate directly to a contract and which are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained.

**Recognition of Contract Revenue and Expenses**

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 36 which state as follows:

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When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

The amount of such a loss is determined irrespective of:

1. whether or not work has commenced on the contract;
2. the stage of completion of contract activity; or
3. the amount of profits expected to arise on other contracts which are not treated as a

single construction contract defined under para 9.

Under fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

1. total contract revenue can be measured reliably;
2. it is probable that the economic benefits associated with the contract will flow to the enterprise;
3. both the contract costs to complete the contract and the stage of contract completion at the balance sheet date can be measured reliably; and
4. the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.

Under cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

1. it is probable that the economic benefits associated with the contract will flow to the enterprise; and
2. the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

This method of recognition of revenue and expenses is also referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period. Give Example.

Under the percentage of completion method, contract revenue is recognised as revenue in the income statement in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the income statement in the accounting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.

A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits associated with the contract will flow to the enterprise. However, when an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the income statement, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.

An enterprise is generally able to make reliable estimates after it has agreed to a contract which establishes:

1. each party's enforceable rights regarding the asset to be constructed;
2. the consideration to be exchanged; and
3. The manner and terms of settlement.

It is also usually necessary for the enterprise to have an effective internal financial budgeting and reporting system. The enterprise reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

The stage of completion of a contract may be determined in a variety of ways. The enterprise uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

1. the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;
2. surveys of work performed; or
3. Completion of a physical proportion of the contract work.

Progress payments and advances received from customers often do not reflect the work performed.

When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in costs incurred to date.

For examples of contract costs which are excluded are:

1. contract costs that relate to future activity on the contract, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made especially for the contract; and
2. Payments made to subcontractors in advance of work performed under the subcontract.

**When the outcome of a construction contract cannot be estimated reliably**

1. revenue should be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and
2. Contract costs should be recognised as an expense in the period in which they are incurred.

During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the contract costs incurred.

Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenues.

Contract costs that are not probable of being recovered are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may need to be recognised as an expense immediately include contracts:

1. which are not fully enforceable, that is, their validity is seriously in question;
2. the completion of which is subject to the outcome of pending litigation or legislation;
3. relating to properties that are likely to be condemned or expropriated;
4. where the customer is unable to meet its obligations; or
5. Where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.

When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance to the standard as presented above.

**Changes in Estimates**

The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate (see FRS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*). The changed estimates are used in the determination of the amount of revenue and expenses recognised in the income statement in the period in which the change is made and in subsequent periods.

**Disclosure**

*An enterprise should disclose:*

* 1. *the amount of contract revenue recognised as revenue in the period;*
	2. *the methods used to determine the contract revenue recognised in the period; and*
	3. *the methods used to determine the stage of completion of contracts in progress.*

*An enterprise should disclose each of the following for contracts in progress at the balance sheet date:*

* 1. *the aggregate amount of costs incurred and recognised profits (less recognised*

*losses) to date;*

* 1. *the amount of advances received; and*
	2. *the amount of retentions.*

Retentions are amounts of progress billings which are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified.

Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer.

Advances are amounts received by the contractor before the related work is performed.

*An enterprise should present:*

* 1. *the gross amount due from customers for contract work as an asset; and*
	2. *the gross amount due to customers for contract work as a liability.*

The gross amount due from customers for contract work is the net amount of:

* 1. costs incurred plus recognised profits; less
	2. the sum of recognised losses and progress billings for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.

The gross amount due to customers for contract work is the net amount of:

* 1. costs incurred plus recognised profits; less
	2. the sum of recognised losses and progress billings for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).

An enterprise discloses any contingent liabilities and contingent assets in accordance with FRS 37 Provisions, Contingent Liabilities and Contingent Assets. Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses

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