



LKAS 11

Construction Contracts

Construction Contracts LKAS 11: Overview

- ☐ **Definitions**
- ☐ **Combining and segmenting construction contracts**
- ☐ **Contract revenue**
- ☐ **Contract costs**
- ☐ **Recognition of contract revenue and expenses**
- ☐ **Recognition of expected losses**
- ☐ **Changes in estimates**
- ☐ **Disclosure**

LKAS 11: Construction Contracts

Why LKAS 11 - Construction contracts

The period of execution of most construction contracts extends to more than one accounting period, therefore the primary issue in accounting for construction contracts is the allocation of contract revenue and contract cost to the accounting period in which the construction work is performed.

A construction contract is ...

- ... a contract specifically negotiated ...
- ... for the construction of an asset, or a combination of assets ...
- ... that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

Combining Construction Contracts

A group of contracts should be treated as a single construction contract when:

- The group of contracts is negotiated as a single package;
- The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
- The contracts are performed concurrently or in a continuous sequence

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Segmenting Construction Contracts

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

- Separate proposals have been submitted for each asset;
- Each asset has been subject to separate negotiation with the possibility of separate rejection; and
- Costs and revenues of each asset can be identified

Separate Construction Contract

A contract to construct an additional asset at the option of the customer should be separated when:

- The additional asset differs significantly in design, technology or function from the asset(s) covered by the original contract; or
- The price of the additional asset is negotiated without regard to the original contract price

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Contract Revenue

Contract revenue comprises:

- Initial amount of revenue agreed in the contract, and
- Variations: Instruction for a change in the scope of the work
- Claims: Amount that the contractor seeks to collect from the customer
- Incentive Payment: Additional amounts paid to the contractor if specified performance standards are met

Measure at fair value of consideration received or receivable

Variation

- ☐ Instruction by the customer for a change in the scope of the work to be performed under the contract
- ☐ May lead to an increase or decrease in contract revenue
- ☐ Include in contract revenue when:
 - Probable that the customer will approve the variation and the amount of revenue arising from the variation, and
 - Amount of revenue can be reliably measured

Claims by Contractor

- ☐ **Amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. Causes include:**
 - Customer caused delays
 - Errors in specifications or design
 - Disputed variations in contract work
- ☐ **High levels of uncertainty, often depends on negotiations**
- ☐ **So only include in contract revenue when:**
 - Negotiations have reached an advanced stage such that it is probable that the customer will accept the claim, and
 - Amount that it is probable will be accepted by the customer can be measured reliably

Incentive Payments

- ☐ **Additional amounts paid to the contractor if specified performance standards are met or exceeded**
 - E.g. early completion
- ☐ **Included in contract revenue when:**
 - Contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded, and
 - Amount of the incentive payment can be measured reliably

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Contract Costs

Contract costs should comprise:

- Costs that **relate directly** to the specific contract
- Costs that are **attributable** to contract activity in general and can be **allocated** to the contract, and
- Such other costs as are **specifically chargeable** to the customer under the terms of the contract

Contract Costs

May be attributable to contract activity in general and can be allocated to specific contracts

- Insurance
- Costs of design and technical assistance that are not directly related to a specific contract
- Construction overheads
 - ◊ Preparation and processing of construction personnel payroll
- Borrowing costs (see LKAS 23)

Allocated using systematic and rational methods – applied consistently to all costs having similar characteristics

- Based on the normal level of construction activity

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Include 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 are incurred in securing the contract are also included as part of the contract costs

- If separately identifiable, can be measured reliably and probable that contract will be obtained
- When costs incurred in securing contract are recognised as an expense in period in which incurred, cannot subsequently be reinstated when the contract is obtained

Recognition of Contract Revenue and Expenses

- ☐ When outcome **can be** estimated reliably, contract revenue and costs shall be recognised as revenue and expenses by reference to the stage of completion of contract activity at the reporting date
- ☐ If the outcome of the contract **cannot be** estimated reliably
 - Revenue may be recognised only to the extent of contract costs incurred that will probably be recoverable
 - Contract costs shall be recognised as an expense in the period in which they are incurred
- ☐ An expected loss on the construction contract should be recognised as an expense immediately

Example

- ☐ A construction contractor has a fixed price contract for 9,000 to build a bridge.
- ☐ Initially agreed revenue is 9,000.
- ☐ initial estimate of contract costs is 8,000.
- ☐ Project duration 3 years
- ☐ Year 1, the contractor's estimate of contract costs has increased to 8,050.
- ☐ Year 2, the customer approves a variation to increase revenue by 200 and estimated additional contract costs of 150.
- ☐ Year 2, costs incurred include 100 for standard materials stored at the site to be used in year 3 to complete the project.
- ☐ The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs.

Example (*Continued....*)

A summary of the financial data during the construction period is as follows:

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation	—	200	200
Total contract revenue	9,000	9,200	9,200
Contract costs incurred to date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	—
Total estimated contract costs	8,050	8,200	8,200
Estimated profit	950	1,000	1,000
Stage of completion	26%	74%	100%

Example (*Continued...*)

The amounts of revenue, expenses and profit recognised in the statement of comprehensive income in the three years:

	To date	Recognised in prior years	Recognised in current year
Year 1			
Revenue ($9,000 \times .26$)	2,340	—	2,340
Expenses ($8,050 \times .26$)	2,093	—	2,093
Profit	<u>247</u>	<u>—</u>	<u>247</u>
Year 2			
Revenue ($9,200 \times .74$)	6,808	2,340	4,468
Expenses ($8,200 \times .74$)	6,068	2,093	3,975
Profit	<u>740</u>	<u>247</u>	<u>493</u>
Year 3			
Revenue ($9,200 \times 1.00$)	9,200	6,808	2,392
Expenses	8,200	6,068	2,132
Profit	<u>1,000</u>	<u>740</u>	<u>260</u>



LKAS 11: Construction Contracts

Classification



➤ Fixed Price Contracts

- Contractor and customer agreed to
 - a fixed price or
 - a fixed rate per unit of output



➤ Cost plus Contracts

- Contractor is reimbursed for
 - allowable or otherwise defined costs plus
 - a percentage of these costs or a fixed fees

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Fixed Price Contract

Outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:

- Total contract revenue can be measured reliably
- Probable that the economic benefits associated with the contract will flow to the entity
- Both the contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably, and
- 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

Cost Plus Contract

Outcome of a cost plus contract can be estimated reliably when all the following conditions are satisfied:

- Probable that the economic benefits associated with the contract will flow to the entity, and
- Contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably

Stage of Completion

Often referred to as ***percentage of completion*** method

- Contract revenue is matched with the contract costs incurred in reaching the stage of completion
- Results in reporting revenue, expenses and profit which can be attributed to the proportion of work completed
- Provides useful information on the extent of contract activity and performance during a period

Stage of Completion

- ☐ **Variety of ways to determine stage of completion; use the method that measures reliably the work performed**
- ☐ **Methods may include:**
 - Proportion that contract costs incurred for work performed to date bear to the estimated total contract costs
 - Surveys of work performed, or
 - Completion of a physical proportion of the contract work
- ☐ **Remember that progress payments and advances received from customers often do not reflect the work performed**
 - May have more to do with financing than rewarding performance

Stage of Completion

- ❑ **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
 - Examples of contract costs which are excluded are:
 - ◇ 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 specially for the contract
 - ◇ Payments made to subcontractors in advance of work performed under the subcontract

Reliable Estimates

Can usually make reliable estimates after entity has agreed to a contract which establishes:

- Each party's enforceable rights regarding the asset to be constructed
- Consideration to be exchanged, and
- Manner and terms of settlement

Usually necessary for the entity to have an effective internal financial budgeting and reporting system

- Reviews and revise estimates of contract revenue and contract costs as contract progresses
- Need for such revisions does not necessarily indicate that contract outcome cannot be estimated reliably

Changes in Estimates

Percentage of completion method applied cumulatively

Effect of a change in estimate of contract revenue or costs is accounted for as a change in accounting estimate under LKAS 8

- i.e. affects current and future periods, not retrospective
- Therefore the amounts recognised in a period won't necessarily only reflect activity in that period

LKAS 11: Construction Contracts: Example

In most cases the stage of completion is determined by reference to the costs already incurred compared to the total costs

Revenue of the period:

Costs incurred * Total revenues – PRR

Total costs

(PPR=Previously Recognised Revenue)

LKAS 11: Construction Contracts: Example

- ❑ ABC enters into a contract to build a road for Rs. 90 million. ABC's initial estimate of contract costs is Rs. 74 million. The contract starts early in 2013
- ❑ If, at the end of 2013, ABC can estimate reliably the outcome of the contract, it recognises revenue and expenses by reference to the stage of completion of the contract activity. Therefore, if the contract is half completed, ABC recognises revenue of Rs. 45 million and expenses of Rs. 37 million. The assessment that half the contract is completed would normally be made by one half the costs being incurred, that is Rs 37 million

LKAS 11: Construction Contracts: Example

	Year1	Year2
Contract Amount	90	90
Cost incurred to date	37	74
Total estimated cost	74	74
% of completion	50%	100%
Revenue recognized	45	45 (90- 45)
Cost recognized	(37)	(37) (74- 37)
Gross profit	8	8

LKAS 11: Construction Contracts: Example

- ❑ On the other hand, if at the end of 2013, ABC is unable to estimate reliably the outcome of the contract but has incurred costs of Rs. 30 million which it is probable will be recovered, ABC recognises revenue of Rs. 30 million and expenses of Rs. 30 million

LKAS 11: Construction Contracts: Example

Assume that ABC has been able reliably to estimate its costs and expenses for 2013 and has recorded revenue of Rs. 45 million and expenses of Rs. 37 million by reference to stage of completion (costs incurred method)

In 2014 ABC's total costs incurred are Rs. 74 million. The estimated total contract costs to build the road are now Rs. 80 million, therefore the contract will be finished during 2015.

Using a consistent stage of completion method, ABC will record revenue of $(74/80 * 90) - 45 = \text{Rs. } 38.25 \text{ million}$

ABC will record profit in 2014 of Rs. 1.25 million (revenue Rs38.25 million, costs Rs. 37 million) compared with a profit of Rs 8 million in 2013. The increase in total contract costs is not attributed to 2013, but recognised in 2014 (cumulative catch up)

LKAS 11: Construction Contracts: Example

	Y1	Y2	Y3
Contract amount	90	90	90
Cost incurred	37	74	80
Total est. cost	74	80	80
% of completion	50%	92.5%	100%
Rev. recognized	45	38.25	6.75
Cost recognized	(37)	(37)	(6)
Gross profit	8	1.25	0.75

LKAS 11: Construction Contracts: Example

- ❑ ABC enters into a contract to build a road for Rs. 90 million. ABC's initial estimate of contract costs is Rs. 74 million. The contract starts early in 2013 and will be finished at the end of 2014

- ❑ Before the contract starts, expected costs increase to Rs. 95 million, with no increase in contract revenue. ABC has to recognise the expected loss of Rs. 5 million immediately

- ❑ Cost incurred during 2013 is Rs. 37 million

LKAS 11: Construction Contracts: Example

	Y1	Y2
Contract amount	90	90
Cost incurred	37	95
Total est. cost	95	95
⇒loss=5		
% of completion	39%	100%
Rev. recognized	35	55
Cost recognized	(40)	(55)
Gross profit/(loss)	(5)	-

LKAS 11: Construction Contracts: Other Areas

- ☐ **Retention receivables and payables**
- ☐ **Advances from customers**
- ☐ **.Advances to sub contractors**
- ☐ **Due to and Due from Customers**
- ☐ **Liquidity damages**
- ☐ **Projects at early stages**

LKAS 11: Construction Contracts: Disclosure

- ☐ **Contract revenue recognised as revenue in the period**
- ☐ **Methods used to determine the contract revenue recognised in the period**
- ☐ **Methods used to determine the stage of completion of contracts in progress**
- ☐ **For contracts in progress at end of the period:**
 - Aggregate amount of costs incurred and recognised profits (less recognised losses) to date
 - Amount of advances received, and
 - Amount of retentions
- ☐ **Present**
 - Gross amount due from customers as an asset
 - Gross amount due to customers as a liability