

CONSTRUCTION CONTRACTS

RELEVANT TO ACCA QUALIFICATION PAPER F7

The correct timing of revenue (and profit) is crucial in order to faithfully represent the results shown in the income statement.

For many businesses, revenue and costs are easily divisible into a 12-month accounting period. For example, a retailer will recognise revenue when realised throughout the year, and match costs in accordance with the accruals concept. For some businesses, however, traditional revenue recognition methods (ie 'show revenue when realised') are not applicable. Many such organisations are in the construction industry and their business dealings involve contracts that are usually long-term in nature or span at least one accounting year end.

For example, a contractor has just won the bid to build a stadium in the new Olympic village in London for the 2012 Olympic Games. Work will commence on 1 January 2009 and it is anticipated that the stadium will be completed on 31 December 2011. If this type of contract were treated as a normal sale of goods, then revenue and profit would not be recognised until the stadium was completed at the end of the third year. This is known as the completed contracts basis and is an application of prudence, where profits should not be anticipated.

It can be argued that recognising the revenue at the end of the project would not faithfully present the situation under the construction contract, as in reality the revenue has been earned over the three-year period and not just when the stadium is completed. In addition, the fundamental accruals concept would not have been adhered to.

The problem with this type of industry, therefore, is to determine at what point revenue and costs should be recognised. For these businesses, the difficulties of accounting for both revenue and cost is remedied by the use of IAS 11, *Construction Contracts*, which prescribes the accounting treatment that should be followed.

IAS 11 – DEFINITION

When answering an exam question, it is necessary to know the definition of the relevant accounting standard. IAS 11 defines a construction contract as: *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 for their ultimate purpose or use.*

IAS 11 TREATMENT

Where possible, IAS 11 applies the accruals concept to the revenue earned on a construction contract. If the outcome of a project can be reasonably foreseen, then the accruals concept is applied by recognising profit on uncompleted contracts in proportion to the percentage of completion, applied to the estimated total contract profit. If, however, a loss is expected on the contract, then an application of prudence is necessary and the loss will be recognised immediately.

OUTCOME CAN BE RELIABLY MEASURED

IAS 11 only allows revenue and contract costs to be recognised when the outcome of the contract can be predicted with reasonable certainty. This means that it should be probable that the economic benefit attached to the contract will flow to the entity. If a loss is calculated, then the entire loss should be recognised immediately.

If a profit is estimated, then revenue and costs should be recognised according to the stage that the project has completed. There are two ways in which stage of completion can be calculated, and, in the exam, it is important to determine from the question scenario which method the examiner intends you to use, either the:

- work certified method** (sometimes referred to as the sales basis)
 - work certified to date
 - contract price
- cost method**
 - costs incurred to date
 - total contract costs

EXAM FOCUS

To answer an exam question on construction contracts, a step approach is required, which can be practised by looking at the following examples.

EXAMPLE 1

Profit-making contract

Lily is a construction company that prepares its financial statements to 31 December each year. During the year ended 31 December 2008, the

company commenced a contract that is expected to take more than one year to complete. The contract summary at 31 December 2008 is as follows:

	\$000
Progress payments	1,400
Contract price	2,736
Work certified complete	1,824
Contract costs incurred to 31 December 2008	2,160
Estimated total cost at 31 December 2008*	2,520

* The examiner sometimes presents information in this manner – 'estimated total cost' means costs incurred plus costs to complete.

The agreed value of the work completed at 31 December 2008 is considered to be equal to the revenue earned in the year ended 31 December 2008. The percentage of completion is calculated as the value of the work invoiced to date compared to the contract price.

Required:

Calculate the effect of the above contract on the financial statements at 31 December 2008.

Step approach

Step 1: Set up extracts of the financial statements and a working paper.

Step 2: Determine at W1 whether a profit or loss is expected on the contract.

Step 3: In this example a profit will be calculated, so determine the accounting policy from the question and calculate the stage of completion.

Step 4: Calculate how much profit should be shown this year from the stage of completion and include it in the income statement extract.

Step 5: 'Build' up the income statement. If it is a work-certified accounting policy, then the work certified for the year should be taken to the revenue line. If it is a cost-basis accounting policy, then the costs incurred should be taken to the cost of sales line.

Step 6: Depending on what approach was taken at step 5, you are now in a position to find the balancing figure to complete the income statement.

Step 7: Calculate the asset or liability outstanding on the construction contract.

Income statement extract – 31 December 2008

	\$000
Revenue (work certified)	1,824
COS (B)	<u>1,680</u>
Gross profit (W2)	<u>144</u>

Statement of financial position extract – 31 December 2008

Current assets	
Asset on a construction contract (W3)	904

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(W1) Expected outcome	\$000
Contract price	2,736
Total costs	<u>2,520</u>
Expected profit	<u>216</u>

(W2) Percentage of completion

Accounting policy = Work certified complete

Work certified to date	
Contract price	
$1,824 = 66.67\%$	
<u>2,736</u>	

(As a round percentage was not found, use the fraction to complete workings instead)

Profit to be recognised = \$216 (W1) x \$1,824 / \$2,736 = \$144

(W3) Asset on construction contract

Costs incurred to date	2,160
Profit recognised to date	144
Less: Progress payments	<u>(1,400)</u>
	<u>904</u>

EXAMPLE 2

Loss-making contract

Gladioli is a construction company that prepares its financial statements to 31 March each year. During the year ended 31 March 2008, the company commenced a contract that is expected to take more than one year to complete. The contract summary at 31 March 2008 is as follows:

	\$000
Progress payments	3,780
Contract price	4,500
Contract costs incurred to 31 March 2008	3,600
Estimated cost to complete at 31 March 2008	1,200

The percentage completion of this contract is to be based on the costs to date compared to the estimated total contract costs.

Required:
Calculate the effect of the above contract in the financial statements at 31 March 2008.

SOLUTION 1

Step 1: Set up extracts of the financial statements and a working paper.

Step 2: Determine at W1 whether a profit or loss is expected on the contract.

Step 3: A loss will be calculated in this example and should be recognised in the income statement immediately.

Step 4: 'Build' up the income statement. If it is a work-certified accounting policy, then the work certified for the year should be taken to the revenue line. If it is a cost-basis accounting policy, then the costs incurred should be taken to the cost of sales line.

Step 5: Depending on the approach taken at step 4, you are now in a position to find the balancing figure to complete the income statement.

Step 6: Calculate the asset or liability outstanding on the construction contract.

Income statement extract – 31 March 2008

	\$000
Revenue (B)	3,300
COS (costs incurred)	<u>(3,600)</u>
Gross loss (W1)	<u>(300)</u>

Statement of financial position extract – 31 March 2008

Current liabilities	
Liability on a construction contract	480

WORKING PAPER

(W1) Expected outcome	\$000
Contract price	4,500
Total cost (3,600 + 1,200)	<u>(4,800)</u>
Expected loss	<u>(300)</u>

(W2) Liability on construction contract

Costs incurred to date	3,600
Loss recognised to date	(300)
Less: Progress payments	<u>(3,780)</u>
Liability on construction	<u>(480)</u>

OUTCOME CANNOT BE RELIABLY MEASURED

In following prudence, where an outcome cannot be reliably measured, any costs incurred during the financial year should be expensed immediately and revenue recognised as equivalent to the contract costs expected to be recoverable.

EXAMPLE 3

Take no profit on contract

A welding company negotiated a two-year project that commenced in the latter half of the year. The project manager has been reviewing the contract and, at the year end, is unsure whether the contract will make a profit or a loss as there are uncertainties surrounding the project's completion. The project manager's records show that costs

during the year amount to \$700,000 and no cash had yet been received. What should the accounting entries be regarding the contract at the year end?

Solution

During the year, as costs have been incurred, the natural double entries occurring would have been:

Dr Purchases	\$700,000
Cr Bank/payables	\$700,000

As the outcome cannot be reliably measured, and assuming all costs are recoverable, revenue should be taken as equal to the costs incurred:

Dr Receivables	\$700,000
Cr Revenue	\$700,000

In processing the above journals, no profit will be taken on the contract during the financial year.

WHAT IS INCLUDED IN CONTRACT REVENUE AND COSTS?

Contract revenue will be the amount agreed in the initial contract, plus revenue from variations in the original contract work, plus incentive payments and claims that can be reliably measured, such as contract revenue which can be valued at the fair value of received or receivable revenue.

Contract costs are to include costs relating directly to the initial contract plus costs attributable to general contract activity, plus costs that can be specifically charged to the customer under the terms of the contract.

EXAM ADVICE

There are two common 'technical areas' that may feature in any exam question on construction contracts, and which could cause difficulties.

The first is when unplanned rectification costs are included within the question information. Rectification costs must be charged to the period in which they were incurred, and not spread over the remainder of the contract life. Therefore, such costs should not be added in when calculating the profit or loss to be shown on a contract.

The second difficulty is where a contract is already part way through, ie in its second year. If this is the second year of a contract, candidates must realise that some revenue and costs have previously been recognised. Candidates should take this into account in their calculations to make sure they show the current year revenue and costs.

CONCLUSION

IAS 11 could feature in the Paper F7 exam as part of Question 2 (on published accounts), or in its own right in Questions 4 or 5, for 15 marks and 10 marks respectively. It is therefore an extremely important accounting standard at this level and candidates are strongly advised to practise past questions relating to this area of the syllabus. ■

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