CONSTRUCTION CONTRACTS: IAS 11

Definition

- **construction contract** is a contract specifically negotiated for the construction of an asset or a combination of assets
- **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**
- **cost plus contract** is a construction contract in which the contractor is **reimbursed for allowable defined costs**, **plus a percentage of these costs or a fixed fee**

Combining and segmenting construction contracts

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

(a) **separate proposals** have been submitted for each asset; and
(b) 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
(c) the **costs** and **revenues** of each asset can be **identified**

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

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

A contract may provide for the **construction of an additional asset** at the option of the customer or may be amended to include the construction of an additional asset. The **construction of the additional asset is treated as a separate construction contract** when:

(a) the asset **differs significantly** in design, technology or function from the asset or assets covered by the original contract; **or**
(b) the price of the asset is negotiated without regard to the original contract price

Contract revenue

- Contract revenue includes:
  - (a) the initial amount of **revenue agreed** in the contract; and
  - (b) **variations** in contract work, **claims** and **incentive payments**:
    - (i) to the extent that it is **probable** that they will result in revenue; and
    - (ii) they are capable of being reliably **measured**
- **variation** is when customer requests a change (it can lead to an increase or decrease in revenue)
- **claim** is an amount contractor collects from the customer due to delays, unexpected costs, etc.
- **Incentive payments** additional amounts paid to contractor (i.e. for early completion of contract)

Contract costs

- Contract costs includes:
  - a) costs that relate **directly** to the specific contract;
  - b) costs that are **attributable** to contract activity in general and can be allocated to the contract; and

c) such other costs as are **specifically chargeable** to the customer under the terms of the contract.

- **Directly attributable costs**
  - site **labour** costs, including site supervision
  - costs of **materials** used in construction
  - **depreciation** of plant and equipment used on the contract
  - costs of **moving** plant, equipment and materials to and from the contract site
  - costs of **renting** plant and equipment
  - costs of **design** and **technical assistance** that is directly related to the contract
  - the estimated costs of **rectification** and guarantee work, including expected warranty costs
  - claims from third parties
- **general attributable costs**
  - insurance;
  - costs of design and technical assistance that are not directly related to a specific contract
  - construction overheads
  - borrowing costs
    - the allocation of overhead is based on **normal operating capacity**
- **costs that are specifically chargeable to the customer**
  - general administration costs and development costs for which **reimbursement is specified in the terms of the contract**
- **Costs that cannot be attributed or allocated to contract activity are excluded. Examples:**
  - general administration costs for which reimbursement is not specified in the contract;
  - selling costs (commission, advertisement)
  - research and development costs for which reimbursement is not specified in the contract;
  - depreciation of idle plant and equipment that is not used on a particular contract

Recognition of contract revenue and expenses

Fixed price contract

Revenues and costs associated with a fixed price contract are recognized when **all** of the following are met:

1. total contract revenue can be **measured reliably**;
2. it is **probable** that the economic benefits associated with the contract will flow to the entity;
3. 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
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.

Cost plus contract

Revenues and costs associated with a cost plus contract are recognized when **all** of the following are met:

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

Percentage of Completion Method

- **must** use the percentage of completion method for **fixed price contracts**

- revenues/expenses are recognized by reference to stage of completion
    - stage of completion can be determined by referring to:
        - the proportion that contract costs incurred for work performed in relation to the estimated total contract costs
        - surveys of work performed; or
        - completion of a physical proportion of the contract work
- the following **example** will help you understand the percentage of completion method

contract price	$	10,000
Total estimated contract costs		5,000
cost incurred to date		3,000
costs incurred in previous years		1,000

Revenue to date = (3000/5000)*10,000 = $6,000
Revenue already recognized in previous years = (1000/5000)*10,000 = $2,000
Revenue for current period = 6,000-2,000=$4,000

dr. construction in progress…………………2,000
cr. Cash/AP………………………………………..2,000

dr. Cost of goods sold……………………………2,000
dr. construction in progress………………..2,000
cr. Revenue………………………………………4,000

- only **costs that relate to current period activity** is recognized as cost of goods sold
- **costs that relate to future activity** are recognized in the construction in progress account (asset) – i.e. you may purchase materials to be used in the future
- When it is probable that total contract costs will exceed total contract revenue, the **expected loss shall be recognised as an expense immediately**
    - the recognised loss = expected loss (contract price less estimated costs) + all previously recognized profit (revenue less cogs – i.e. the $2,000 above)

- for **fixed price contracts**, if the criteria for **expense and revenue recognition is not met**
    - recognize contract costs based on the amount incurred
    - recognize revenue = costs incurred (i.e. the **cost recovery method**)
- for **cost plus contract**s there is **no need to use the percentage of completion** because the amount of revenue = cost + an additional amount

Changes in estimates

- changes to the contract price and contract costs are handled **prospectively**

Comparison to ASPE

- this material is covered in ASPE section 3400 – Revenues
- ASPE allows the completed contract method (under IFRS only percentage of completion allowed)