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IAS 11 – Construction Contract

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CONSTRUCTION CONTRACT
IAS 11

DEFINITION:

A construction contract is defined in IAS 11 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 or their ultimate purpose or use"

The standard distinguishes two types of construction contract, fixed price contract and cost plus contracts and defines each of these as follows:

"A 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.

A 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."

SCOPE:

Contracts within IAS 11’s scope may be for the construction of a single asset such as a bridge, a building, or a pipeline. A construction contract may be for a number of assets that are closely related or interdependent as to their design, technology and function or their ultimate purpose or use. Examples are the construction of refineries and other complex pieces of plant and equipment.

SEGMENTING CONTRACTS

When a contract covers the construction of a number of assets, the contract for construction of each asset shall be considered a separate contract when :

1. Separate proposals have been submitted for each asset.
2. Each asset has been subject to separate negotiation and both contractor and customer were able to accept or reject that part of the contract relating to each asset.
3. The cost and revenues of each asset are separately identifiable.

COMBINING CONTRACTS

A group of contracts, each with a single or even with different customers, shall be treated as a single contract when:

1. The group of contracts is negotiated as one single package.
2. The contracts are so closely interrelated that they are effectively (i.e., in substance) part of one project with one overall profit margin.
3. The contracts are performed either concurrently or in continuous sequence.

EXAMPLE- COMBINED CONTRACT

A contractor is negotiating two contracts with a single customer under IAS 11. The customer must either accept both contracts or reject both. The first contract will be for the design of a chemical plant and the second for the plant's construction. The planned profit margin on the design contract is 20% and the planned profit margin on constructing the plant is 10%.

The two contracts should be accounted for as a single contract. The contracts were negotiated as a single package as the customer must accept both or reject both. The contracts are closely related and will be performed in a continuous sequence. An overall profit margin should be recorded as work is performed on both contracts.

DEFINITION:

Contract Cost 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.
- Such other costs as are specifically chargeable to the customer under the contract's terms.

DETERMINATION OF COSTS:

Direct costs include:

- 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 hiring plant and equipment used on the contract.
- Costs of design and technical assistance that is directly related to the contract.
- Estimated costs of rectification and guarantee work, including expected warranty costs.
- Claims from third parties.

The standard lists categories of costs that cannot be allocated to contracts and which, therefore, are excluded from contract costs. These are:

- General administration costs for which reimbursement is not specified in the contract.
- Selling costs.
- 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.

Contract revenue comprises:

- The initial amount of revenue agreed in the contract.
- Variation in contract work, claims and incentive payments to the extent that it is probable that they will result in revenue and they are capable of being reliably measured.

Contract revenue may increase or decrease from one period to the next and gives the following examples of the potential causes:

- 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.
- The amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses.
- The amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in completing the contract.
- When a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

A 'Claim' is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, errors in the initial specifications, delays caused by the customer or disputed variations. The settlement of claims arising from circumstances not envisaged in the contract or arising as an indirect consequence of approved variations is subject to a high level of uncertainty relating to the outcome of future negotiations. In view of this, claims are included in contract revenue only when:

- Negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and
- The amount of the claim that the customer will probably accept can be reliably measured.

Variation or claim	Contract revenue recognised?
At the year end the following variation and claims occurred on a contract: (a) The customer approved changes to the contract's design specifications with a total cost of C5,000.	Yes, all criteria set out in paragraph 13 of IAS 11 are met. The C5,000 can be included in the contract price (revenue).
(b) Due to poor weather, the contract will overrun by 3 months. This will lead to an increase in costs of C3,000. The customer will probably not approve the amount of revenue arising from the variation.	No, the customer will probably not approve the variation amount. The additional costs already incurred should be included in the calculation of work-in-progress, if the contract is still profitable.

	However, a lower expected profit margin should be recognised because of the additional costs incurred. The total expected loss should be recognised immediately if the additional costs will result in a loss on the contract. For recognition of losses on contracts .
(c) Due to unforeseen circumstances the contractor incurred additional costs in the current year on the contract. Negotiations to obtain the customer's acceptance of these claims are in early stages.	No, negotiations have not reached an advanced stages where it is probable that the customer will accept the claim. The contractor should include the additional costs in the work in progress calculation and recognise a lower expected profit margin due to the additional costs incurred.

(d) The customer will probably accept a claim of C2,000 due to delays caused by the customer itself	Yes, all criteria set out in paragraph 14 of IAS 11 are met. The C2,000 can be included in the contract price (revenue).

‘Incentive payments’ are additional amounts that the customer pays to the contractor if certain specified performance targets or standards are met. An example is a payment for completing a contract ahead of schedule. Incentive payments are included in contract revenue when:

- The contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
- The amount of the incentive payment can be reliably measured.

PERCENTAGE OF COMPLETION METHOD

The recognition of revenues and expenses by references to the stages of completion of a contract is referred to as the percentage of completion method. The manner in which this method works is simple. The contract revenues are matched with the contract costs incurred in reaching the stage of completion. Such comparison results in the reporting of revenue, expenses, and profit that can be attributed to the proportion of the work completed.

RECOGNITION OF LOSSES:

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

Provision for an expected loss is made irrespective of :

- Whether or not work has commenced on the contract
- The stage of completion of the contract activity.
- The profitability of other contracts that are separately accounted for in accordance with the standard.

IFRIC 12

In certain countries construction or maintenance of infrastructure for public services (roads, bridges, water distribution facilities) is contracted out to private sector operators. The private sector operators are usually paid for their services over the term of the arrangements. Such arrangements are often described as “build-operate-transfer” (“BOT”) or “rehabilitate-operate-transfer” or a “public-to-private service concession arrangement.”

This IFRIC addresses the following issues:

1. Treatment of the operator's rights over the infrastructure.
2. Recognition and measurement of arrangement consideration.
3. Construction or upgrade services- The operator shall account for revenue and costs relating to construction or upgrade services in accordance with IAS 11.
4. Consideration given by the grantor to the operator- If the operator renders construction or upgrade services, the consideration received or receivable by the operator shall be recognized at its fair value. The consideration may be rights to a financial asset or an intangible asset.
5. Recognizing a "financial asset"- The operator shall recognize a financial asset to the extent that it has an unconditional contractual right to receive cash or any other financial asset from or at the direction of the grantor for the construction services.
6. Recognizing an "intangible asset"- The operator shall recognize an intangible asset to the extent that it receives a right or a license to charge users of the public service.

IFRIC 15:

Agreements for the construction of real estate may relate to residential, commercial, or industrial developments. Construction often spans more than one accounting period, may take place on land the buyer owns or leases before construction begins, and agreements may require progress payments. The objectives of IFRIC 15 are to clarify the definition of a construction contract and the articulation between IAS 11 and IAS 18 and to provide guidance on how to account for revenue when the agreement for the construction of real estate falls within the scope of IAS 18.

DISTINGUISHING FEATURES OF AGREEMENT TO CONSTRUCT REAL ESTATE WHETHER TO APPLY IAS 11 OR IAS18

When should the sale of real estate be treated as construction contract so as to apply IAS 11	when should the sale of real estate be treated as sale of goods so as to apply IAS 18
1. The buyer is able to specify major structural element in the design before and during the construction. The critical test is the ability to specify. It is not tested whether that is exercised or not.	1. The buyer has limited right to change the design. This is normally signified by the buyer’s ability to offer minor change in design or buyer’s option to select among alternative designs offered by the developer.

When should the sale of real estate be treated as construction contract so as to apply IAS 11	When should the sale of real estate be treated as sale of goods so as to apply IAS 18
2. Whether the buyer transfers the control, significant risk and reward of ownership to the buyer.	2. The negotiation between the buyer and seller relates primarily about the amount and timing of payment.
3. Indication of control: -Construction work is taking place in the land owned or leased-in by the buyer. -The buyer can take over the construction work. -If the contract is terminated, the buyer retains the construction work-in-progress whereas the seller has the right to get the payment.	3. If the contract is terminated, the seller retains the work-in-progress. This signifies that the buyer has not received risk and reward of ownership of the work-in-progress.

Disclosure

An entity shall disclose:

- the amount of contract revenue recognized as revenue in the period;
- the methods used to determine the contract revenue recognized in the period; and
- the methods used to determine the stage of completion of contracts in progress.

An entity shall disclose each of the following for contracts in progress at the end of the reporting period:

- the aggregate amount of costs incurred and recognized profits (less recognized losses) to date;
- the amount of advances received; and
- the amount of retentions.

Contd..

An entity shall present:

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

THANK YOU