

# IAS 11 – Construction Contracts



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# Purpose of Introduction of Standard- IAS 11

- Construction Contracts are generally long term in nature and the activity usually falls into different accounting periods. Thus the date on which the contract is entered and the date when the activity is completed fall into different accounting periods.
- Therefore an approach, different from 'as earned' approach as prescribed in **IAS 18** for revenue recognition, was required to account for long term construction contracts.

# Objective

- To Prescribe the Accounting Treatment of Revenue & Cost Associated with Construction Contracts.

and

- To provide practical guidance on the application of above

# Applicability of IAS 11

## Applicable

- In accounting for 'CONSTRUCTION CONTRACTS'
- In the financial statements of 'CONTRACTORS'

# Applicability of IAS 11

## ➤ Illustration 1- Long Term Contract

A company completes a construction contract soon after the year end, while a major part of the work is completed before the year end.

### **Answer:**

IAS 11 applies to this contract, as it might not give a true and fair picture if the revenue and cost are not attributed to the current period.

# Applicability of IAS 11

## ➤ Illustration 2 – Short Term Contract

A particular construction contract has taken only three months to complete

### **Answer:**

In this case there is no allocation of contract revenue and cost to different periods. Still, the disclosure requirements of IAS 11 is applicable

# Applicability of IAS 11- Inference

- IAS 11 accounting and disclosure requirements are applicable in the following cases
  - Long Term Construction Contracts – extend beyond one accounting period –
  - Short Term Construction Contracts – that extend beyond one accounting period

# Applicability of IAS 11- Inference

- IAS 11 only disclosure requirement is applicable
  - Short Term Construction Contracts – that do not extend beyond one accounting period

**Hence, IAS 11 applies to construction contracts irrespective of the time taken for executing the contract**



# Construction Contract - Definition

- A contract that is
  - Specially negotiated for
  - Construction of an asset or combination of assets
  - Such assets are interrelated or interdependent
  - In their design, technology and unction
  - Or in their ultimate use

# Construction contract - Definition

## includes:

- 1) Contract for rendering of services which are directly related to the construction of asset (e.g. Architect ).
- 2) Contract for destruction or restoration of assets, and the restoration of environment following the demolition of asset.

# Construction of Asset

➤ Examples of Construction of Asset are

- Bridge
- Building
- Dam
- Road
- Ship
- Tunnel

# Construction of Asset

- Construction does not amount to manufacturing
- Applicability of relevant Accounting Standards based on the **need** for construction of an asset
  - IAS 11- where the asset is constructed for a third party
  - IAS 2 – Sale of the asset so constructed
  - IAS 16 – Property, Plant and Equipment put to own use

# Definitions

- **A fixed price contract**

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**

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.

# Combining & Segmenting

- If a contract covers two or more assets, the construction of each asset should be accounted for separately if
  - (a) separate proposals were submitted for each asset,
  - (b) portions of the contract relating to each asset were negotiated separately, and
  - (c) costs and revenues of each asset can be measured.
- Otherwise, the contract should be accounted for in its entirety.

# Combining & Segmenting ....

- Two or more contracts should be accounted for as a single contract if they were negotiated together and the work is interrelated.
- If a contract gives the customer an option to order one or more additional assets, construction of each additional asset should be accounted for as a separate contract if either
  - (a) the additional asset differs significantly from the original asset(s) or
  - (b) the price of the additional asset is separately negotiated.

# Contract Revenue



Initial amount + Variations + Claims + Incentives



As agreed by customer and contractor



Due to instructions of customer for change in scope of work



Reimbursement for cost not included in contract price



Additional amount payable for meeting the standards



## Contract Cost



Directly Related + Attributable Cost + Specifically Chargeable



e.g. Labour cost, Supervision,  
Depreciation, Warranty etc.



e.g. Insurance, Construction Overhead,  
Borrowing cost as per IAS-23



e.g. Any Reimbursement Specified in  
the Contract.

# Recognition of Contract Cost and Contract Revenue

- Conditions for the Recognition of Contract Cost and Contract Revenue
  - Fixed Price Contracts
    - Contract Revenue can be reliably measured – it is probable that economic benefit will flow to the enterprises
    - Contract Cost and stage of completion can be reliably measured – actual cost can be identified and compared with prior estimates

# Recognition of Contract Cost and Contract Revenue

## ➤ Cost Plus Contracts

- It is probable that economic benefit will flow to enterprise
- Contract Cost can be clearly identified and reliably measured

## ➤ If the above said conditions are satisfied then, it means that the final outcome of the contract can be reliably measured

- Recognize revenue /cost with respect to stage of completion method

# Recognition of Contract Cost and Contract Revenue

➤ If the above conditions are not satisfied then

- Revenue equal to recoverable cost incurred will be recognized
- Contract cost will be recognized in the period they are incurred

Where it is probable that contract cost will exceed contract revenue, expected cost should be recognized immediately

# Accounting

Use the percentage of completion method if able to reliably estimate outcome of contract.

## Contract 1

Estimated total revenue	100
Costs to date	48
Costs to complete	<u>32</u>
Total estimated costs	80
Stage of completion	60%
Progress billings	58
Payments received	50

60%

## I/S

Revenue	60
Cost of sales	<u>(48)</u>
Profits	<u>12</u>

## Statement of financial position

Gross amounts due <u>from</u> customers for contract work	2
Trade receivables (58-50)	8

Gross amounts due from customers for contract work represents

- Costs incurred plus recognised profits (48+12); less
- The sum of recognised losses & progress billings (0+58).

# Accounting

If the outcome of a contract cannot be estimated reliably no profit should be recognised.

If a contract is expected to be loss making, the loss should be recognised immediately.

# Disclosure

- amount of contract revenue recognised; [IAS 11.39(a)]
- method used to determine revenue; [IAS 11.39(b)]
- method used to determine stage of completion; [IAS 11.39(c)] and
- for contracts in progress at statement of financial position date: [IAS 11.40]
  - aggregate costs incurred and recognised profit
  - amount of advances received
  - amount of retentions

# About the Author

- *CA. Rajkumar S Adukia is an eminent business consultant, academician, writer, and speaker. He is the senior partner of Adukia & Associates.*
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# About the Author

- *He has been coordinating with various Professional Institutions, Associations, Universities, University Grants Commission and other Educational Institutions.*
- *Authored more than 50 books on a vast range of topics including Internal Audit, Bank Audit, SEZ, CARO, PMLA, Anti-dumping, Income Tax Search, Survey and Seizure, IFRS, LLP, Labour Laws, Real estate, ERM, Inbound and Outbound Investments, Green Audit etc.*
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# Thank You