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 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:

- **work certified method** (sometimes referred to as the sales basis)
- **cost method**

The agreed value of the work completed at 31 December 2008 is calculated as the value of the work invoiced to date compared to the contract price.

**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:

<table>
<thead>
<tr>
<th></th>
<th>$000</th>
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<tbody>
<tr>
<td>Progress payments</td>
<td>1,400</td>
</tr>
<tr>
<td>Contract price</td>
<td>2,736</td>
</tr>
<tr>
<td>Work certified complete</td>
<td>1,824</td>
</tr>
<tr>
<td>Contract costs incurred to 31 December 2008</td>
<td>2,160</td>
</tr>
<tr>
<td>Estimated total cost at 31 December 2008*</td>
<td>2,520</td>
</tr>
</tbody>
</table>

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

**Step approach**

1. Set up extracts of the financial statements and a working paper.
2. Determine at W1 whether a profit or loss is expected on the contract.
3. In this example a profit will be calculated, so determine the accounting policy from the question and calculate the stage of completion.
4. Calculate how much profit should be shown this year from the stage of completion and include it in the income statement extract.
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.

In this example, we will use the Work certified complete accounting policy. The percentage completion of this contract is to be based on the costs to date compared to the estimated total contract costs.

The contract summary at 31 March 2008 is expected to take more than one year to complete.

The project manager's records show that costs expected to be recoverable.

Revenue (work certified) $1,824
COS (ß) $1,680
Gross profit (W2) $144

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.

Assets:

- Asset on a construction contract (W3) $904

Liabilities:

- Liability on a construction contract (W2) $480

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 recognized 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.

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 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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