Accounting Standard- 7

Construction Contracts

Construction contracts being of long durations normally start in one accounting period and end in another.The problem that arises in such cases is how much of revenue and costs related to the contract should beallocated at the end of each accounting period. AS- 7 addresses the issue of treatment of revenue and costs for a construction contract.

All contracts entered into on or after April 1, 2003 have to mandatorily adhere to this standard.

A construction contract is defined as a contract specifically negotiated for the construction of an asset or combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. Examples of an asset being constructed may be a flyover, bridge or tunnel while for interrelated or interdependent assets is a turnkey power project.

The outcome of a contract can be measured in any of the following ways:

- Fixed Price Contract
- Cost Plus Contract

Fixed Price Contract is one in which a price is fixed for the contract value or for a fixed rate per output. In certain cases an escalation clause is also included.

In the case of Cost plus Contract, the contractor is reimbursed an allowable cost or defined costs. In addition to this there is a fixed fee or a fee which is worked out as a percentage of allowable costs.

In reality however, there is a possibility of a combination of both where a Cost plus Contract has a maximum cap on the price.

When a contract is entered into, the following situations may arise:

- A group of assets are constructed but each asset can be distinguished separately, one is not interdependent on the other and price has been negotiated for each separately
- A group of assets are constructed that are interdependent on each other, part of a single project and must be performed in continuous sequence
- An additional asset is constructed to a main project

In the first instance, construction of each asset is treated as separate contract. In such cases revenue and costs can be tracked separately for each contract.

In the second instance even if multiple sub-contractors are involved, the contract is treated as a single one. This is primarily because the assets are interdependent on each other and the price is negotiated as one for the entire project.

When an additional asset is constructed, where the design and technology is different and price is negotiated separate from the original contract, the same is treated as a separate contract.

Recognition of revenue and costs related to a contract is determined by the stage of completion or percentage of completion method. Under this method the proportionate revenue and costs attributable to the stage of completion is accounted in the profit and loss account.

The following are the ways in which percentage of completion is determined:

- Proportion of costs incurred to the total cost of the contract
- Estimated based on a survey
- Physical proportion of work completed to total work outlay

Other than the initial agreed price on a contract, any additional claims or payments related to incentives or otherwise form part of revenue. Claims are generally in the nature of reimbursements which were agreed as per the contract. Incentives could be given for early milestones being achieved.

Costs include all direct and indirect costs attributable to the contract as per the terms of the contract. Costs that have been agreed to be allocable to a contract are also to be considered. However payments received from customer do not necessarily indicate extent of job completed.

Sometimes the defined scope of work as per the contract undergoes modification. This happens due to design change of an asset or change in the contract duration. These result in increase or decrease of the total contract value which results in variation of revenue and costs. At the end of an accounting period, all known variation to the contract has to be considered in determining the percentage of completion of a contract. Revenue, whether received or receivable have to be credited to the profit and loss account as per the stage of completion of the contract.

There may be a situation where the expenditure incurred on the contract is higher than the estimated percentage of completion. In such cases the cost that is attributable for the percentage of completion should be charged to the profit and loss account and the additional expenditure capitalized as a contract-in-progress.

In the early stage of a contract it may be difficult to determine the stage of completion. Revenue is then recognized to the extent of expenditure incurred and recoverable. In other words profit is not booked. During the tenure of the contract if a portion of the revenue recognized in the profit and loss becomes doubtful of recovery, the uncollectable amount is charged as expenditure in the contract and not reduced from the revenue.

When costs to a contract are doubtful of recovery, all incurred costs need to be charged of immediately. This can happen when the completion of the contract is linked to some pending litigation.

According to AS-7 guidelines the following must be disclosed in the final accounts:

- Amount of contract revenue recognized in the period
- The methodology adopted in determining revenue recognition for the period
- The method adopted for determining percentage of completion for the period

For contracts in progress disclosure guidelines as per AS-7 are:

- Aggregate amount of costs incurred and profit/loss recognized till reporting date
- Amount of advances received
- Amount of retentions

Retentions are amounts withheld by payer from the total bill for fulfilment of an obligation.

The amount due from customers for contracts should be shown on the asset side of the balance sheet and amount due to customers on the liability side. For any contingencies AS-4 has to be followed.

In summary, the life of a construction contract spills to more than one accounting period. AS-7 lays down the guidelines for recognition of revenue and costs related to such contracts.