

# Construction Contracts

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## < EXECUTIVE SUMMARY >

◆ The Institute of Chartered Accountants of India has issued Accounting Standard (AS) 7 relating to Construction Contracts (Revised). The revised AS 7 is effective for all contracts entered into during Accounting Periods commencing on or after 01-04-2003

and is mandatory in nature from that date. The article below highlights the major changes brought about by the revised AS 7, the method for recognition and measurement of Contract Revenue and Contract Cost and its disclosure requirements.

## 1.0 INTRODUCTION

- 1.1 The Council of the Institute of Chartered Accountants of India (ICAI) has issued Accounting Standard (AS) 7, Construction Contracts (revised). This was published in June 2002 issue of the journal 'The Chartered Accountant'. The revised AS7 is effective for all contracts entered into during accounting periods commencing on or after 01-04-2003 and is mandatory in nature from that date. Accordingly, Accounting Standard (AS)7 'Accounting for Construction Contracts' hereinafter referred to as 'the previous AS7', issued by the ICAI in December, 1983, is not applicable in respect of such contracts.
- 1.2 The nature of the activity undertaken in construction contracts is such that the date at which the contract activity is entered into and the date when the activity is complete (usually fall into different accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which the work is performed.

*The author is member of the Institute. The views expressed herein are the personal views of the author and do not necessarily represent the views of the Institute.*

## 2.0 MAJOR CHANGES

- 2.1 The revised AS 7 differs from the previous AS7 in respect of the following main issues :
- The revised AS7 applies in accounting for construction contracts in the financial statements of contractors. As against this the previous AS7 also applied to enterprises undertaking construction activities not as contractor but on their own account as a venture of commercial nature where the enterprise has entered into agreement for sale.
  - The previous AS7 recognized two methods of accounting for contracts viz the percentage completion method and the completed contract method. The revised AS7 recognizes only the percentage completion method.
- 2.2 The revised AS7 does not apply to the builders / developers. They will be required to recognize the revenue as per AS9 'Revenue Recognition'. A contractor has to necessarily follow the Percentage Completion Method in respect of all construction contracts entered into on or after 01-04-2003.

## 3.0 CONSTRUCTION CONTRACTS

- 3.1 A construction contract has been defined in the

revised AS7 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.

3.2 A construction contract includes :

- (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and
- (b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets. This is included in revised AS7 and was not finding place in the previous AS7.

3.3 A contract may involve supply of goods and supervision of installation, testing and training. Normally supply of goods is governed by AS-9 whereas contracts involving supervision of installation will be governed by AS7. Therefore in a composite contract the relative value of supervision work to the total value will have to be compared. In a particular case, the Expert Advisory Committee (EAC) of the ICAI held that where the value of supervision work not being significant in relation to the overall contract value, the contract was mainly for supply of material and may not be construed as a construction contract (Query No.. 44, Vol. No. XX).

3.4 The EAC has opined that the consultancy fees received only for design engineering and project management directly related to construction of an asset is to be recognized as per AS7. Whereas revenue from consultancy fees for design engineering and project management not directly related to construction of an asset would be recognized as per the principles in this regard enunciated in AS9 (EAC Query No. 20 Vol. No. XXI)

3.5 Construction contracts are formulated in a number of ways which, for the purpose of the revised AS7, are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and cost plus contract, for example, in the case of a cost plus contract with an agreed maximum price.

3.6 The requirements of the Standard are generally to be applied to each Construction Contract separately. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance

of a contract or a group of contracts.

3.7 A contract which covers the construction of a number of assets is treated as a separate construction contract for each asset when separate proposals are submitted for each asset, each such asset is subjected to separate negotiations and the costs and revenues of each asset can be separately identified.

3.8 A group of contracts, whether with a single customer or with several customers is treated as a single construction contract when the group is negotiated as a single package, the contracts are so closely inter related that they are, in effect, part of a single project with an overall profit margin and the contracts are performed concurrently or in a continuous sequence.

3.9 A construction 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 contract when the assets differ significantly in design, technology or function from the asset or assets covered by the original contract or the price of the asset is negotiated without regard to the original contract price.

## 4.0 RECOGNITION OF CONTRACT REVENUE AND CONTRACT COST

4.1 When the outcome of construction contract can be estimated reliably, the associated contract revenue and cost should be recognized by reference to the stage of completion of contract activity at the reporting date. In the previous AS 7 para 9.8 stated that normally, the profit is not recognized in fixed price contract unless the work on a contract has progressed to a reasonable extent. This test was ordinarily considered as not having been satisfied unless 20 to 25% of the work was completed. The revised AS7 does not prescribe the extent of work which should be completed. But it recognizes that in the early stages of a contract it is often the case that the outcome of a contract cannot be estimated reliably. It emphasizes the need to estimate reliably the contract revenue and the associated cost. The conditions which must be satisfied before it can be held that the outcome of construction contract can be estimated reliably are prescribed in para 22 and para 23 for fixed price contract and cost plus contract respectively. If these conditions are satisfied then

contract revenue and contract costs can be recognized irrespective of the degree of work completed.

- 4.2 In the case of fixed price contract, para 22 requires that all the following conditions must be satisfied :
- Total contract revenue can be measured reliably.
  - It is probable that the economic benefits associated with the contract will flow to the enterprise;
  - Both the contract costs to complete the contract and the stage of contract completion at the reporting date can be measured reliably; and
  - 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.
- 4.3 In the case of a cost plus contract, para 23 requires that all of the following conditions must be satisfied.
- It is probable that the economic benefits associated with the contract will flow to the enterprise; and
  - The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.
- 4.4 The condition regarding the probability of the economic benefits associated with the contract will flow to the enterprise is a new condition. All other conditions are similar to the conditions mentioned in the previous AS7.
- 4.5 Under the percentage completion method, the contract revenue is matched with the contract cost incurred in reaching the stage of completion. This results in reporting of revenue, expense and profit which can be attributed to the proportion of work completed. It may so happen that after recognizing revenue an amount may become uncertain of being collected. Such an amount is treated as an expense and is not to be adjusted to the contract revenue.
- 4.6 The stage of completion of a contract may be determined in a number of ways. No special weightage should be given to any single factor. All relevant factors should be taken into consideration. Para 29 of the revised AS7 suggests the following factors :
- The proportion that contract costs incurred for work performed upto the reporting date bear to the estimated total contract costs; or
  - Surveys of work performed; or
  - Completion of a physical proportion of the contract work.
- 4.7 The above factors should be considered as illustrative rather than exhaustive. However it is certain that progress payments or advances received from customers may not necessarily reflect the work per-

formed. If the stage of completion is to be determined by reference to the contract cost upto the reporting date then care should be taken to exclude advances paid, pre-paid expenses and closing inventory of material purchased but not consumed.

- 4.8 Para 31 of the revised AS 7 lays down the principles for recognizing contract revenue and contract costs when the outcome of construction cost cannot be ascertained reliably. The contract revenue is to be recognized only to the extent of contract costs incurred of which recovery is probable. The contract cost is recognized as an expense in the period in which it is incurred. As the outcome of the contract cannot be estimated reliably, no profit is recognized. Contract costs which are not recoverable are recognized as an expense immediately. Examples of such cost include :
- Which are not fully enforceable, that is, their validity is seriously in question;
  - The completion of which is subject to the outcome of pending litigation or legislation;
  - Relating to properties that are likely to be condemned or expropriated;
  - Where the customer is unable to meet its obligations; or
  - Where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.
- 4.9 It is necessary to appreciate a fine distinction between revenue i.e. turnover and profit. Where the outcome cannot be estimated revenue i.e. turnover may be recognized but not profit. The EAC had an occasion to bring out this fine distinction (Query No. 23 Vol. No. XXI). Although that opinion was expressed in context of the previous AS7, the principles enunciated therein are still valid.
- 4.10 Once the uncertainties that prevented the outcome to be estimated reliably cease to exist, the revenue and the costs should be recognized on the percentage completion method.
- 4.11 Irrespective of whether the outcome can be estimated reliably or not, any expected loss on construction contract is to be expensed immediately. Such a loss is to be booked whether or not the work has commenced.

## 5.0 MEASUREMENT OF CONTRACT REVENUE AND COSTS

- 5.1 The contract revenue includes the initial amount of

revenue and any variation in contract work, claims and incentive payment. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The estimates often need to be revised as events occur and uncertainties are resolved. Therefore the amount of contract revenue may increase or decrease from one period to the next. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. The Standard lays down that variation should be accounted for when there is reasonable degree of certainty that the variation will be approved and the amount of revenue can be reliably measured. 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 is to be included when it is probable that the customer will accept the claim and that such an amount can be reliably measured.

- 5.2 The use of the accounting estimates in measuring contract revenue and costs involves judgments based on the latest available information. Due to the uncertainties in the business activities many items of the financial statements cannot be measured with precision. The use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability. Where in a contract the terms provided that the actual payment made to the employees is billable and thus, the additional cost, if any, incurred on account of retrospective revision of pay scales will also be billable. Therefore, if a reasonable estimate of the amount of the additional cost can be made, there would be no insignificant uncertainty in determining the amount to be recovered from the clients. In such circumstances it was opined that it would not be unreasonable to expect the ultimate collection and hence the contract revenue should be recognized. (EAC Query No. 3, Vol. No. XVIII).
- 5.3 Contract costs include costs that relate directly to the specific contract, costs that are attributable to contract activity in general and can be allocated to the contract and such other costs as are specifically chargeable to the customer under the terms of the contract. The costs to be allocated to a contract are so allocated by using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is

based on the normal level of construction activity. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs are expensed off in the period when they are incurred.

- 5.4 Under the percentage of completion method, the turnover in respect of the uncompleted contract is recognized by reference to the stage of completion of the relevant contract at the reporting date. In case the turnover is calculated by reference to the proportion of costs incurred to the estimated total cost, only such costs should be considered for calculating such proportion, which reflect the work performed. The turnover achieved during a particular period on a contract should equal to the value of the work completed during that period (EAC Query No. 1.4 Vol. No. XIV).
- 5.5 In a construction company the employees rendered surplus on completion of a project were retained in employment for deployment to other construction projects. The salary was paid to these employees for the intervening period i.e. for the period after completion of one project and their transfer to some other project. In this case the EAC opined that the salary so paid was in the nature of a general expenditure and should be expensed off in the period in which it is incurred. (EAC Query No. 1.12 Vol. No. VIII).
- 5.6 The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. An estimate may have to be revised if change occur regarding the circumstances on which the estimate was based, or as a result of new information, more experience on subsequent developments. The revision of the estimate, by its nature, does not bring the adjustment within the definition of an extraordinary item or a prior period item.

## 6.0 DISCLOSURES

- 6.1 The financial statements of the contractor are required to disclose the amount of contract revenue recognized, the method used to determine the revenue and the stage of completion. Also the aggregate amount of costs incurred and recognized profits (less recognized losses), the advance received and the amount of retentions. 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 are also required to be disclosed.

## 7.0 SIGNIFICANT ACCOUNTING AND TAXATION ISSUES

7.1 The EAC had several occasions to issue opinions in relation to AS7. The principles enunciated still hold good. The gist of some of the opinions is mentioned hereunder :

- (a) The surplus construction material should be disclosed under the head "Current Assets" irrespective of whether the same are to be used for other projects or to be disposed off. Only on transfer of the material to another project, the same should be considered as "Capital work - in - progress" (EAC Query No. 27 Vol. XXI).
- (b) The provisions of AS7 and not AS2 would apply for the purpose of valuation of inventory of machines and ship equipments that can be used only in connection with a specific ship under construction and is intended to be used in that specific ship under construction (EAC Query No. 37 Vol. No. XXI).
- (c) The unconsumed material should be disclosed as closing stock in the financial statements of a company engaged in construction contracts. This is so even if the cost in respect of such unconsumed material is to be reimbursed by the company and the same is lying with the company to be returned to the client on completion of the contract. However, on completion of the project, the value of the material to be returned to the client may be disclosed after netting off the corresponding liability in this regard (EAC Query No. 1.5, Vol. No. XVII).
- (d) A company engaged in construction activities appoints contractors to whom certain advances were due to be paid under an agreement, but not so paid. No accounting entry is required to be passed in the books for the delay in the payment of advances. No liability should be created for an advance which is yet to be paid as at the balance sheet date (EAC Query No. 1.22, Vol. No. XV).
- (e) In case of contracts of manufacture and supply of long production cycle items which are com-

plex pieces of equipment, the recommendations contained in Accounting Standard (AS) 7 on 'Accounting for Construction Contracts', issued by the Institute of Chartered Accountants of India, should apply because the date at which the contract is secured and the date when the contract activity is completed fall into different accounting periods (EAC Query No. 1.26 Vol. No. X).

7.2 Section 211 (3A) mandates each company to prepare every profit and loss account and balance sheet of a company to comply with the accounting standards. Thus all companies will have to comply with the AS 7 (revised) and account for all the contracts entered into on or after 01.04.2003 on the percentage completion method basis. This will result in recognizing revenue and cost and consequently the profits on the basis of the work completed during the year. On such contracts the company will be required to pay advance tax, where ever applicable.

7.3 In *Amrapalli Mercantile. P Ltd. Vs. Asst. CIT (Delhi)* (1993) 43 ITD 386 it has been held that assessee cannot be permitted to maintain its accounts on cash basis for income tax purposes and on mercantile system for other purposes. The other view that it is not prohibited seems to have received a set back in view of Sec. 115 JB which requires the preparation of annual accounts including profit and loss account on the basis of the same accounting policies, Accounting Standards and the depreciation method and rates as have been adopted for the purpose of preparing such accounts including profit and loss account laid before the company at its AGM.

7.4 It is pertinent to note that the Accounting Standard prescribed under section 145 of the Income Tax Act do not include any standard on construction contracts. Therefore it is possible that a non corporate assessee may decide to adopt the completed contract method as its method of accounting. In *Madhuvana House Building Co-operative Society vs Asst. Comm. Income Tax (2002) 76 TTJ (Bang)* 948 it was held that in the line of civil construction and construction contracts where the duration of the project is spread over several years, the completed contract method of accounting is preferable. During the pendency of works, the income or loss cannot, be ascertained. The assessee was entitled to adopt the completed contract method of accounting for recognizing income from its project activity. ■