

Accounting Standard (AS) 7 *
(issued 1983)
Accounting for Construction Contracts

*(This Accounting Standard includes paragraphs 16-21 set in **bold italic** type and paragraphs 1-15 set in plain type, which have equal authority. Paragraphs in bold italic type indicate the main principles. This Accounting Standard should be read in the context of the Preface to the Statements of Accounting Standards¹.)*

The following is the text of the Accounting Standard (AS) 7 issued by the Institute of Chartered Accountants of India on 'Accounting for Construction Contracts'. The Standard deals with accounting for construction contracts in the financial statements of contractors.

In the initial years, this accounting standard will be recommendatory in character. During this period, this standard is recommended for use by companies listed on a recognised stock exchange and other large commercial, industrial and business enterprises in the public and private sectors. ²

Introduction

1. This Statement deals with accounting for construction contracts in the financial statements of enterprises undertaking such contracts (hereafter referred to as 'contractors'). The Statement also applies to enterprises undertaking construction activities of the type dealt with in this Statement not as contractors but on their own account as a venture of a commercial nature where the enterprise has entered into agreements for sale.

2. The feature which characterises a construction contract dealt with in this Statement is the fact that the date at which the contract is secured and the date when the contract activity is completed fall into different accounting periods. The specific duration of the contract performance is not used as a distinguishing feature of a construction contract. Accounting for such contracts is essentially a process of measuring the results of relatively long-term events and allocating those results to relatively short-term accounting periods.

3. For the purposes of this Statement, a construction contract is a contract for the construction of an asset or of a combination of assets which together constitute a single project. Examples of activity covered by such contracts include the construction of bridges, dams, ships, buildings and complex pieces of equipment.

4. Contracts for the provision of services come within the scope of this Statement to the extent that they are directly related to a contract for the construction of an asset. Examples of such service contracts are contracts for the services of project managers and architects and for technical engineering services related to the construction of an asset.

* This Standard has since been revised. The revised Standard comes into effect in respect of all contracts entered into during accounting periods commencing on or after 1-4-2003 and is mandatory in nature from that date. Accordingly, the prerevised standard is not applicable in respect of such contracts. The revised Standard is published elsewhere in this Compendium.

1 Attention is specifically drawn to paragraph 4.3 of the Preface, according to which Accounting Standards are intended to apply only to items which are material.

2 It may be noted that this Accounting Standard is mandatory. Reference may be made to the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium for a detailed discussion on the implications of the mandatory status of an accounting standard.

Explanation

5. The principal problem relating to accounting for construction contracts is the allocation of revenues and related costs to accounting periods over the duration of the contract.

6. Types of Construction Contracts

Construction contracts are formulated in a variety of ways but generally fall into two basic types:

- i. fixed price contracts-the contractor agrees to a fixed contract price, or rate, in some cases subject to cost escalation clauses;

- ii. cost plus contracts-the contractor is reimbursed for allowable or otherwise defined costs, and is also allowed a percentage of these costs or a fixed fee.

Both types of contracts are within the scope of this Statement.

7. Accounting Treatment of Construction Contract Costs and Revenues

- 7.1 Two methods of accounting for contracts commonly followed by contractors are the percentage of completion method and the completed contract method.
- 7.2 Under the percentage of completion method, revenue is recognised as the contract activity progresses based on the stage of completion reached. The costs incurred in reaching the stage of completion are matched with this revenue, resulting in the reporting of results which can be attributed to the proportion of work completed. Although (as per the principle of 'prudence') revenue is recognised only when realised, under this method, the revenue is recognised as the activity progresses even though in certain circumstances it may not be realised.
- 7.3 Under the completed contract method, revenue is recognised only when the contract is completed or substantially completed; that is, when only minor work is expected other than warranty obligation. Costs and progress payments received are accumulated during the course of the contract but revenue is not recognised until the contract activity is substantially completed.
- 7.4 Under both methods, provision is made for losses for the stage of completion reached on the contract. In addition, provision is usually made for losses on the remainder of the contract.
- 7.5 It may be necessary for accounting purposes to combine contracts made with a single customer or to combine contracts made with several customers if the contracts are negotiated as a package or if the contracts are for a single project. Conversely, if a contract covers a number of projects and if the costs and revenues of such individual projects can be identified within the terms of the overall contract, each such project may be treated as equivalent to a separate contract.

8. Costs to be Accumulated for Construction Contracts

- 8.1 Costs attributable to a contract are identified with reference to the period that commences with the securing of the contract and closes when the contract is completed.
- 8.2 Costs not specifically attributable to any contract incurred by the contractor before a contract is secured are usually treated as expenses of the period in which they are incurred. However, if costs attributable to securing the contract can be separately identified and either the contract has been secured or there is a clear indication that the contract will be obtained, the costs are sometimes treated as applicable to the contract and are deferred. As a practical measure, costs directly identifiable with a contract are sometimes deferred until it is clear whether the contract has been secured or not.
- 8.3 Costs attributable to a contract include expected warranty costs. Warranty costs are provided for when such costs can be reasonably estimated.
- 8.4 Costs incurred by a contractor can be divided into:
 - i. Costs that relate directly to a specific contract;
 - ii. Costs that can be attributed to the contract activity in general and can be allocated to specific contracts;
 - iii. Costs that relate to the activities of the contractor generally, or that relate to contract activity but cannot be related to specific contracts.
- 8.5 Examples of costs that relate directly to a specific contract include:
 - i. site labour costs, including supervision;

- ii. materials used for project construction;
 - iii. depreciation of plant and equipment required for a contract;
 - iv. costs of moving plant and equipment to and from a site.
- 8.6 Examples of costs that can be attributed to the contract activity in general and can be allocated to specific contracts include:
- i. insurance;
 - ii. design and technical assistance;
 - iii. construction overheads.
- 8.7 Examples of costs that relate to the activities of the contractor generally, or that relate to contract activity but cannot be related to specific contracts, include:
- i. general administration and selling costs;
 - ii. finance costs;
 - iii. research and development costs;
 - iv. depreciation of plant and equipment that cannot be allocated to a particular contract.
- 8.8 Costs referred to in paragraph 8.7 are usually excluded from the accumulated contract costs because they do not relate to reaching the present stage of completion of a specific contract. However, in some circumstances, general administrative expenses, development costs and finance costs are specifically attributable to a particular contract and are sometimes included as part of accumulated contract costs.

Basis for Recognising Revenue on Construction Contracts

9. Percentage of Completion Method

- 9.1 Under the percentage of completion method, the amount of revenue recognised is determined by reference to the stage of completion of the contract activity at the end of each accounting period. The advantage of this method of accounting for contract revenue is that it reflects revenue in the accounting period during which activity is undertaken to earn such revenue.
- 9.2 The stage of completion used to determine revenue to be recognised in the financial statements is measured in an appropriate manner. For this purpose no special weightage should be given to a single factor; instead, all relevant factors should be taken into consideration; for example, the proportion that costs incurred to date bear to the estimated total costs of the contract, by surveys which measure work performed and completion of a physical proportion of the contract work.
- 9.3 Progress payments and advances received from customers may not necessarily reflect the stage of completion and therefore cannot usually be treated as equivalent to revenue earned.
- 9.4 If the percentage of completion method is applied by calculating the proportion that costs to date bear to the latest estimated total costs of the contract, adjustments are made to include only those costs that reflect work performed. Examples of items which may need adjustment include:
- i. the costs of materials that have been purchased for the contract but have not been installed or used during contract performance; and

- ii. payments to subcontractors to the extent that they do not reflect the amount of work performed under the subcontract.
- 9.5 The application of the percentage of completion method is subject to a risk of error in making estimates. For this reason, profit is not recognised in the financial statements unless the outcome of the contract can be reliably estimated. If the outcome cannot be reliably estimated, the percentage of completion method is not used.
- 9.6 While recognising the profit under this method, an appropriate allowance for future unforeseeable factors which may affect the ultimate quantum of profit is generally made on either a specific or a percentage basis.
- 9.7 In the case of fixed price contracts, the conditions which will usually provide this degree of reliability are:
- i. total contract revenues to be received can be reliably estimated;
 - ii. both the costs to complete the contract and the stage of contract performance completed at the reporting date can be reasonably estimated; and
 - iii. the costs attributable to the contract can be clearly identified so that actual experience can be compared with prior estimates.
- 9.8 Normally, the profit is not recognised in fixed price contracts unless the work on a contract has progressed to a reasonable extent. Ordinarily, this test is not considered as having been satisfied unless 20 to 25% of the work is completed.
- 9.9 In the case of cost plus contracts, the conditions which usually provide this degree of reliability are:
- i. costs attributable to the contract can be clearly identified; and
 - ii. costs other than those that are specifically reimbursable under the contract can be reliably estimated.

10. Completed Contract Method

- 10.1 The principal advantage of the completed contract method is that it is based on results as determined when the contract is completed or substantially completed rather than on estimates which may require subsequent adjustment as a result of unforeseen costs and possible losses. The risk of recognising profits that may not have been earned is therefore minimised.
- 10.2 The principal disadvantage of the completed contract method is that periodic reported income does not reflect the level of activity on contracts during the period. For example, when a few large contracts are completed in one accounting period but no contracts have been completed in the previous period or are to be completed in the subsequent period, the level of reported income can be erratic although the level of activity on contracts may have been relatively constant throughout. Even when numerous contracts are regularly completed in each accounting period, and reported income may appear to reflect the level of activity on contracts, there is a continuous lag between the time when work is performed and the related revenue is recognised.

11. Selection of Method

- 11.1 The selection of a method of accounting for a construction contract depends on considerations discussed earlier. The contractor may use both methods simultaneously for different contracts depending upon circumstances.
- 11.2 When a contractor uses a particular method of accounting for a contract, then in respect of all other contracts that meet similar criteria, the same method is used.
- 11.3 The methods of accounting used by the contractor and the criteria adopted in selecting

the method/s represent an accounting policy. ³

3. Refer to AS 1.

12. Change in Accounting Policy

When there is a change in the accounting policy used for construction contracts, there is disclosure of the effect of the change and its amount. If the contractor changes from the percentage of completion method to the completed contract method, it is sometimes not possible to quantify the full effect of the change in the current accounting period. In such cases, there is disclosure of at least the amount of attributable profits reported in prior years, in respect of contracts in progress at the beginning of the accounting period. ⁴

4 Refer to AS 5.

13. Provision for Foreseeable Losses

- 13.1 When current estimates of total contract costs and revenues indicate a loss, provision is made for the entire loss on the contract irrespective of the amount of work done and the method of accounting followed. In some circumstances, the foreseeable losses may exceed the costs of work done to date. Provision is nevertheless made for the entire loss on the contract.
- 13.2 When a contract is of such magnitude that it can be expected to absorb a considerable part of the capacity of the enterprise for a substantial period, indirect costs to be incurred during the period of the completion of the contract are sometimes considered to be directly attributable to the contract and included in the calculation of the provision for loss on the contract.
- 13.3 If a provision for loss is required, the amount of such provision is usually determined irrespective of:
- i. whether or not work has commenced on the contract; and
 - ii. the stage of completion of contract activity; and
 - iii. the amount of profits expected to arise on other unrelated contracts.
- 13.4 The determination of a future loss on a contract may be subject to a high degree of uncertainty. In some of these cases, it is possible to provide for the future loss and in other cases only the existence of a contingent loss is disclosed ⁵.

5 Refer to AS 4 on 'Contingencies and Events Occurring After the Balance Sheet Date'. Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1-4- 2004, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by other Indian Accounting Standards. Reference may be made to Announcement XX under the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium.

14. Claims and Variations Arising Under Construction Contracts

- 14.1 Amounts due in respect of claims made by the contractor and of variations in contract work approved by the customer are recognised as revenue in the financial statements only in circumstances when, and only to the extent that, the contractor has evidence of the final acceptability of the amount of the claim or variation. ⁶
- 14.2 Claims or penalties payable by the contractor arising out of delays in completion or from other causes are provided for in full in the financial statements as costs attributable to the contract. Claims in the nature of contingency are treated as indicated in Accounting Standard 4 on 'Contingencies and Events Occurring After the Balance Sheet Date' .⁷

6 Refer to AS 4 on 'Contingencies and Events Occurring After the Balance Sheet Date'.

7 Pursuant to AS 29, Provisions, Contingent Liabilities and Contingent Assets, becoming mandatory in respect of accounting periods commencing on or after 1-4- 2004, all paragraphs of AS 4 that deal with contingencies stand withdrawn except to the extent they deal with impairment of assets not covered by

other Indian Accounting Standards. Reference may be made to Announcement XX under the section titled 'Announcements of the Council regarding status of various documents issued by the Institute of Chartered Accountants of India' appearing at the beginning of this Compendium.

15. Progress Payments, Advances and Retentions

- 15.1 Progress payments and advances received from customers in respect of construction contracts in relation to the work performed thereon are disclosed in financial statements either as a liability or shown as a deduction from the amount of contract-work-in-progress.
- 15.2 In case progress payments and advances received from customers in respect of construction contracts are not in relation to work performed thereon, these are shown as a liability.
- 15.3 Amounts retained by customers until the satisfaction of conditions specified in the contract for release of such amounts are either recognised in financial statements as receivables or alternatively indicated by way of a note.

Accounting Standard

16. *In accounting for construction contracts in financial statements, either the percentage of completion method or the completed contract method may be used. When a contractor uses a particular method of accounting for a contract then the same method should be adopted for all other contracts which meet similar criteria.*
17. *The percentage of completion method can be used if the outcome of the contract can be reliably estimated.*
- 17.1 *In the case of fixed price contracts this degree of reliability would be provided if the following conditions are satisfied:*
- i. total contract revenues to be received can be reliably estimated;*
 - ii. both the costs to complete the contract and the stage of contract performance completed at the reporting date can be reasonably estimated; and*
 - iii. the costs attributable to the contract can be clearly identified so that actual experience can be compared with prior estimates.*
- 17.2 *Profit in the case of fixed price contracts normally should not be recognised unless the work on a contract has progressed to a reasonable extent.*
- 17.3 *In the case of cost plus contracts this degree of reliability would be provided only if both the following conditions are satisfied:*
- i. costs attributable to the contract can be clearly identified; and*
 - ii. costs other than those that are specifically reimbursable under the contract can be reliably estimated.*
- 17.4 *While recognising the profit under percentage of completion method an appropriate allowance for future unforeseeable factors should be made on either a specific or a percentage basis.*
18. *The costs included in the amount at which construction contract work is stated should comprise those costs that relate directly to a specific contract and those that are attributable to the contract activity in general and can be allocated to specific contracts.*
19. *A foreseeable loss on the entire contract should be provided for in the financial statements irrespective of the amount of work done and the method of accounting followed.*

Disclosure

20. *There should be disclosure in the financial statements of*

- i. the amount of construction work-in-progress;*
- ii. progress payments received and advances and retentions on account of contracts included in construction work-in-progress; and*
- iii. the amount receivable in respect of income accrued under cost plus contracts not included in construction work-in-progress.*

If both the percentage of completion method and the completed contract method are simultaneously used by the contractor the amount of contract work described in (i) above should be analysed to disclose separately the amounts attributable to contracts accounted for under each method.

21. *Disclosure of changes in an accounting policy used for construction contracts should be made in the financial statements giving the effect of the change and its amount. However if a contractor changes from the percentage of completion method to the completed contract method for contracts in progress at the beginning of the year it may not be possible to quantify the effect of the change. In such cases disclosure should be made of the amount of attributable profits reported in prior years in respect of contracts in progress at the beginning of the accounting period.*

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