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A86045 Accounting and Financial Reporting (2017/2018)

Session 14

Construction contracts

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SESSION 14 OVERVIEW AND OBJECTIVES

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Course Overview

PGS	1. Financial reporting under IFRS	14. Construction contracts
	2. Financial analysis: Ratio analysis	15. Other Non-financial liabilities
	3. Financial analysis: Segments and EPS	16. Review session
	4. Review session	17. Mid term test (Mon April 16)
	5. Revenues	18. Financial Instruments 1
	6. Costs and expenses	19. Financial Instruments 2
	7. Taxation - Direct and Indirect	20. Review session
	8. Non-current assets - Intangible assets	21. Cash Flow Statement
	9. Non-current assets - Tangible assets	22. Group accounts/Business comb
	10. Financial leases	23. Review session
	11. Impairment of assets	24. Review session
	12. Review session	25. Final test
PT	13. Inventories	

PGS (14–20)

PT (21–24)

PGS (25)

Overview of Session 14

– IAS 11Construction contracts
  - Fixed price or cost plus contracts
  - Percentage-of-completion method
  - Completed contract method
– IFRS 15 Revenues from contracts with customers
  - Identify the contact
  - Identify the performance obligations
  - Determine the transaction price
  - Allocate the transaction price to the performance obligations
  - Recognize revenues as the performance obligations are satisfied

Session 14 Overview

	Mins
Session overview and objectives	5
Review of pre-work and session 13 recap	5
Construction Contracts	25
Research assignment RA 11 Construction contracts	10
Percentage of completion method	30
Presentation and disclosures	15
Class exercises	15
IFRS 15 What changes ?	15
Overview of session 15, required reading and assignment for next session	5
Summary and validation	10
	135

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Objectives of Session

At the end of this session students will be able to:

Illustrate the appropriate accounting and disclosures under IAS 11 for construction contracts using the percentage of completion method.

Understand the changes which will occur following the introduction of IFRS 15 effective from 01.01.2018

SESSION 13 RECAP AND PRE-WORK SESSION 14

Session 14 Pre-work

- Reading
  - Melville International Financial Reporting Under IFRS
    - Chapter 10 – Inventories and construction contracts (4th edition)
    - Chapter 13 – Revenues from contract with customers
  - IASB Statements
    - IAS 11 Construction contracts
    - IFRS 15 Revenue from contracts with customers
- Research
  - RA 11 Construction contracts: For your chosen company identify its accounting policy and disclosures in respect of construction contracts

Research Assignment RA 11 Construction Contracts

Company___________

Accounting policy

Disclosures

CONSTRUCTION CONTRACTS

Construction contracts

Fixed Price
or
Cost Plus

Definition – a construction contract is 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.

Generally long-term i.e. greater than 12 months

Construction Contracts

Revenues

- The initial amount of revenue agreed in the contract; and
- Variations in contract work and claims
  - If probable that they will result in revenue
  - They are capable of being reliably measured
- Incentives or penalties

Costs

- Costs that relate directly to the specific contract
- Costs that are attributable to contract activity
- Such other costs as are specifically chargeable to the customer.

Excluded costs include general administration or research and development costs for which reimbursement is not specified in the terms of the contract and selling costs.

Combining vs Segmenting contracts

Conditions for segmenting contracts	Conditions for combining contracts
• Separate proposals submitted for each asset • Each asset subject to separate negotiation • The costs and revenues of each asset can be identified	• The group of contracts is negotiated as a single package • Contracts are so closely interrelated • Performed concurrently or in a continuous sequence

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Recognition of contract revenue and expenses

IAS11 requires that contract revenue and expenses are recognised "*by reference to the stage of completion of the contract activity at the end of the reporting period*". The stage of completion may be determined by either:

- comparing the costs incurred for the work performed to date with the estimated total contract costs, or
- carrying out a survey of the work performed to date, or
- considering the physical proportion of the contract work completed.

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Recognition of expected losses

If at any stage it is probable that total contract costs will exceed total contract revenue, the expected loss must be recognised immediately.

Although expected profits are spread over the period of the contract, expected losses are accounted for as soon as they become probable.

Uncertainty as to outcome

Completed Contract Method

When the outcome of a construction contract cannot be estimated reliably:

a) Revenue shall be recognized only to the extent of contract costs incurred that it is probable will be recoverable; and
b) Contract costs shall be recognized as an expense in the period in which they are incurred.

An expected loss on the construction contract shall be recognized as an expense immediately.

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RESEARCH ASSIGNMENT RA 11
CONSTRUCTION CONTRACTS

Research Assignment RA 11
Construction Contracts

Company___________

Accounting policy

Disclosures

PERCENTAGE OF COMPLETION METHOD

Recognition of contract revenues and expenses

When the outcome of a construction contract can be estimated reliably, contract revenue and contract costa associated with the construction contract shall be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the end of the reporting period. An expected loss shall be recognized immediately.

The outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:

a) Total contract revenue can be measured reliably;
b) It is probable that the economic benefits associated with the contract will flow to the entity;
c) Both contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably
d) The contract costs attributable to the contract can be clearly identified and measured reliably.

	Contract price	Contract costs	Contract margin	%
Original contract	100	60	40	40%
Change orders	20	15	5	25%
Claims (in total 80)	20	20	0	
Additional costs to be incurred		20	(20)	
Revised contract	140	115	25	18%

Using the cost to cost method if costs incurred to date at the balance sheet date amount to 60 then 60/115 % of revenue and margin would be recognized

Determination of Contract revenues and expenses

A construction contractor has a fixed price contract for 9,000 to build a bridge. The initial amount of revenue agreed in the contract is 9,000. The contractor's initial estimate of contract costs is 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor's estimate of contract costs has increased to 8,050.

Costs incurred in year 1 were 2,093, year 2 6,167 and year 3 8,200

In year 2, the customer approves a variation resulting in an increase in contract revenues of 200 and estimated additional contract costs of 150.

	Year 1	**Year 2**	**Year 3**
Initial amount of revenue agreed in contract	9.000	9.000	9.000
Variation		200	200
Total contract revenue	9.000	9.200	9.200
Contract cost incurred to date	2.093	6.168	8.200
Contract cost to complete	5.957	2.032	
Total estimated contract costs	8.050	8.200	8.200
Estimated profit	950	1.000	1.000

Determination of Contract revenues and expenses – 2

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Total estimated contract costs	8.050	8.200	8.200
Estimated profit	950	1.000	1.000
Stage of completion	26%	75%	100%

	To date	**Recognized in prior years**	**Recognized in current year**
Year 1			
Revenue	2.340		2.340
Expenses	2.093		2.093
Profit	247		247
Year 2			
Revenue	6.920	2.340	4.580
Expenses	6.168	2.093	4.075
Profit	752	247	505
Year 3			
Revenue	9.200	6.920	2.280
Expenses	8.200	6.168	2.032
Profit	1.000	752	248

PRESENTATION AND DISCLOSURES

Disclosures required by IAS11

- the amount of contract revenue recognised during the accounting period
- the methods used to determine contract revenue
- the methods used to determine stage of completion
- for contracts in progress at the end of the reporting period:
  - the total costs incurred to date and total recognised profits/losses to date
  - the amount of any advances received
  - the amount of any retentions.

Presentation for construction contracts

Contractors must present in their statement of financial position the gross amount due *from* customers for contract work as an asset and the total amount due *to* customers for contract work as a liability. These amounts are equal to the difference between:

- contract costs incurred to date plus any recognised profits, and
- amounts billed to date ("progress billings") plus any recognised losses.

Gross amount due from customers

The gross amount due from customers for contract work is equal to:

1) costs incurred to date plus recognised profits;
2) less amounts billed to date (progress billings) and any recognised losses

for all contracts in progress at the end of the reporting period for which costs incurred to date plus recognised profits less recognised losses exceed progress billings.

Gross amount due to customers

The gross amount due to customers for contract work is equal to:

1) progress billings plus any recognised losses;
2) less costs incurred to date and recognised profits

for all contracts in progress at the end of the reporting period for which progress billings exceed costs incurred to date plus recognised profits less recognised losses.

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Contract disclosures

Disclosures required

	Contracts					
	A	B	C	D	E	Total
Contract revenue recognized in accordandance with para 22	145	520	380	200	55	1.300
Contract expenses recognized in accordance with para 22	110	450	350	250	55	1.215
Expected losses recognized in accordance with para 36				40	30	70
Recognized profits less recognized losses	35	70	30	-90	-30	15
Contract costs incurred in the period	110	510	450	250	100	1.420
Contract costs recognized as contract expenses in the period in accordance with para 22	110	450	350	250	55	1.215
Contract costs that relate to future activity recognized as an asset in accordance with para 27	0	60	100	0	45	205
Contract revenue	145	520	380	200	55	1.300
Progress billings	100	520	380	180	55	1.235
Unbilled contract revenue	45			20		65
Advances		80	20		25	125

Contract costs incurred	110	510	450	250	100	1.420
Recognized profits less recognized losses	35	70	30	-90	-30	15
	145	580	480	160	70	1.435
Progess billings	100	520	380	180	55	1.235
Due from customers	45	60	100		15	220
Due to customers				-20		-20

A contractor has reached the end of its first year of operations.

All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash.

Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date.

For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

T accounts

Contract WIP

1	1.420	1.235	2
5	15	200	7
	1.435	1.435	

Cash

2	1.235	1.420	1
6	125		
	1.360		

Contract Revenues

	1.215	1.235	
4	70	65	3
	1.285	1.300	
5	15		
	1.300		

Unbilled Revenues

3	65		

Billings in excess of Revenue

		20	7

Provision for losses

		70	4

Revenue in excess of billings

7	220		

Advances received

		125	6

Source IAS 36 Illustrative Examples

CLASS EXERCISE/EXAMPLES

Class exercise- construction contract

A company is engaged in a construction contract with an expected sales value of €10,000. It is the end of the accounting period during which the company commenced work on this contract and it needs to compute the amount of revenue to be reflected in the profit and loss account for this contract.

Scenario 1: The company has incurred and applied costs of €4,000. €3,000 is the best estimate of costs to complete.

Scenario 2. An independent surveyor has certified that at the period-end the contract is 55% complete and that the company is entitled to apply for cumulative progress payments of €5,225 (after a 5% retention).

Scenario 3. The company's best estimate of the physical proportion of the work it has completed is that it is 60% complete.

How much revenue should the company record?

Class exercise cont'd

Scenario 1: The company should recognize revenue of €5,714, being the appropriate proportion of total contract value, and computed thus: (4,000/7,000) x 10,000 = 5,714.

Scenario 2: In this case the company would record revenue of €5,500 being the sales value of the work done.

Scenario 3: The value of the work done and, therefore, the revenue to be recognized is €6,000.

IFRS 15 WHAT CHANGES?

5 Step Approach in IFRS 15

- 1. Identify the contract (s) with a customer
- 2. Identify the performance obligations in the contract
- 3. Determine the transaction price
- 4. Allocate the transaction price to the performance obligations in the contract
- Recognize revenue when (or as) the entity satisfies a performance obligation

IFRS 15 – What Changes ?

- Identify the contract – Issues if only partial payment expected
- Combining contracts – Fewer criteria to be met
- Contract modifications – evaluate as to whether distinct and commensurate with stand-alone selling prices
- Performance obligations – potential change in pattern of revenue recognition
- Variable consideration – may need to change process for determination

IFRS 15 What Changes ? Cont'd

Performance obligations satisfied over time

An entity transfers control of a good or service over time (rather than at a point in time) when **any** of the following criteria are met:

• The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.

• The entity's performance creates or enhances an asset (e.g., work in progress) that the customer controls as the asset is created or enhanced.

• The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

If an entity is unable to demonstrate that control transfers over time, the presumption is that control transfers at a point in time.

IFRS 15 What Changes ? Cont'd

Disclosures

IFRS 15 significantly increases the volume of disclosures required in entities' financial statements, particularly for annual financial statements.

For some E&C entities there may be no change in the timing of revenue recognition under IFRS 15, but the new disclosure requirements may, nonetheless, require significant additional effort (e.g., changes to systems, internal controls, policies and procedures) to collect and disclose the required information. In light of the expanded disclosure requirements and the potential need for new systems to capture the data needed for these disclosures, entities may wish to prioritise this portion of their implementation plans.

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OVERVIEW, REQUIRED READING AND ASSIGNMENT FOR NEXT SESSION

Overview of Session 15 Non-Financial Liabilities

- Provisions, contingent liabilities and contingent assets
  - Liabilities
  - Provisions
  - Contingent liabilities
- Restructuring provisions
- Onerous contracts
- Contingent assets

Session 15 Pre-work

- Reading
  - Melville International Financial Reporting Under IFRS
    - Chapter 10 – Inventories and construction contracts (4^{th} edition)
    - Chapter 13 – Revenues from contract with customers
  - IASB Statements
    - IAS 11 Construction contracts
    - IFRS 15 Revenue from contracts with customers
- Exercises
  - Melville Chapter 10 Ex1 – Ex4 (4^{th} edition)
  - Melville Multiple choice questions Chapter 13
  - EX 14 Construction contracts
- Research
  - RA 12 Provisions: Identify the disclosures in your chosen company in respect of provisions and contingencies.

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SUMMARY AND VALIDATION

Summary of Session 14

Construction contracts

- Types of contract
- Revenues and costs
- Percentage of completion method
- Completed contract method
- Disclosures
- IAS 11 vs IFRS 15

Session 14 Validation

- What is a construction contract?
- What are the two main types of contract'
- When should construction contracts be aggregated?
- What is the percentage of completion method?
- What should a company do if it anticipates an overall loss on the contract?
- If no reliable estimates are available for costs or revenues how should a contract be accounted for?
- What will change with IFRS 15?