AS – 7: CONSTRUCTION CONTRACTS

Contents

Applicability & Nature

Applicable	:	01-04-2002 (REVISED)
Nature	:	Mandatory for Contractors Only

Meaning of Construction Contracts

As per AS Construction means formation of asset or group of assets which are inter-related. For example construction of Building, Dam, Bridges, Roads, or any other similar assets.

As per AS the following additional points should also be considered for the understanding of meaning of construction.

(i) If any agreement has been entered into between the parties for formation or demolition of old assets then such agreement should also be covered in the meaning of construction contract.

(ii) If any contract has been entered into between the parties in relation to formation of design & specification, then such agreement should also be recognized as Construction Contract.

(The main objective of AS is to distribute the total contract price over the life of contract on accrual basis.)

Types of Contract

Fixed Price Contracts

Cost Plus Contracts

Meaning of Fixed Price Contracts

Under Fixed Price Contracts, Price of Construction is decided between Contractor & Customer on the date of agreement. It means that selling price of contractor is fixed which is to be compared with actual cost & difference will be loss or profit of the contractor.

Meaning of Cost Plus Contract

If any situation of construction can't be estimated by the contractor for the purpose of Fixed Price then Cost Plus Contract can take place under these contracts. Total cost is incurred by Contractor and Contractor receives a fixed percentage (%) of profit (Comm.) on the basis of cost incurred.

Contractor Profit = Total Cost Incurred x % of profit

There will be no loss to the contractor under Cost Plus Contract. (Recognition principles of AS are not applicable on Cost Plus Contract because objective of AS is to distribute total contract price over the life of contract and there is no contract price under these types of contract.)

Contract Revenue & Expenditure

Revenue:

Fixed Price Contract		Cost Plus Contract	
Contract Price	xxx	% of Profit on Cost	xxx
Claims	xxx	Claims	xxx
Incentive	xxx	Incentive	xxx
Cost Escalation	xxx	Less: Penalties	xxx
Less: Penalties	xxx	Total Revenue	xxx
Total Revenue	xxx		

Meaning of Claim

If any customer makes any default in providing necessary designs, guidance or other specification due to which extra cost is paid by contractor then such extra cost can be recovered by contractor from customer as per agreement. Such recovery of extra cost should be recognized as inflow for contractor in the name of claim.

Meaning of Incentive

If any customer has paid extra amount in addition to contract price for the performance of Contractor then extra payment should be recorded in the books of Contractor as additional inflow.

Meaning of Cost Escalation

It may be possible that prices of material & wages are expected to increase in future on the date of agreement. In such situation recovery of increased cost may be possible by cost escalation clause. The recovered cost should be recorded in the credit side of the P&L a\c as an income.

Penalties

Amount of penalties are decided between the penalties only to complete the work during specified period. If any delay in completion of work takes place the amount of penalty should be deducted out of contract price. Amount of penalty can be decided on per day basis, weak basis or month basis.

Contract Expenses

Direct Expenses | Common Expenses | Specific Expenses

Direct Expenses

If any expenditure is directly related to a contract then amount of related expenses should be debited to the related contract. Direct expenses may include Direct material, Direct wages, Depreciation on plant, Hire charges for the plant or any other similar cost.

Common Expenses

If any expenditure is incurred by contractor on behalf of all the contracts then such common expenses should be divided between the contracts on some reasonable basis.

Specific Expenditure

If any expenditure is incurred by contractor as per the requirement of customer in relation to a particular contract then the required cost should be allocated to the related contract.

Recognition Principles

As per AS, Recognition Principles are based on existence or non-existence of 'Outcome'. If Outcome is available, accounting should be made as per Para 22, 23 otherwise Para 31 will be applicable. The following conditions should be satisfied to prove the existence of Outcome.

(i) Contract price should be available.
(ii) Actual cost during the period should also be available.
(iii) Estimated cost to complete the contract should also be available.
(iv) Ultimate collection from customer should also be certain.

Para 22, 23

If any contractor is having existence of outcome, completion method can be applied for accounting purpose.

Step 1: First of all, % of completion of contract should be calculated.

$$\text{\% of Completion} = \frac{\text{Actual cost during the period}}{\text{Total Estimated Cost}} \times 100$$

Step 2: % of completion should be applied on total contract price for calculation of Revenue Recognition.

$$\text{Revenue} = \text{Contract Price} \times \text{\% of Completion}$$

Exception: There may be difference between calculated completion & physical completion. In such situation amount of revenue should be recognized as per Surveyor certificate.

Para 31

If any company or contractor is not having required information for completion method then income should be recognized equal to expenses. In such case no profit or loss will be recognized.

Para 35

Para 35 is not related to income recognition. Such provision is applicable only if total estimation cost is higher than contract price. In such situation provisions should be created for the expected loss from the contract on the date of higher estimation.

Change in Estimation

As per AS total estimated cost or contract price can be changed over the construction period. In such situation, adjustments should be made on prospective basis as per provisions of AS – 5, Changes in Estimates.

Ques 1 Contract Price = 900 Cr

Other information

	I	II	III
Actual Cost during the period (Cumulative)	161	574	820
Total Estimated Cost	805	820	-
Increase in Contract Price	-	20	-

Calculate Amount of Profit or Loss over construction period assuming that contract is completed in 3rd year.

Sol: Period I

W.N. Calculation of % of completion

% of Completion = 161 Cr / 805 Cr

Income Recognition (Profit/Loss)

Contract Price (900 x 20%)	=	180 Cr
Less: Expense	=	161 Cr
		19 Cr

Period II

% of Completion = 574/820 X 100 = 70%

Income Recognition (Profit/Loss)

Contract Price (920 x 70%-180)	=	464 Cr
Less: Exp of Current Year (574-161)	=	413 Cr
		51 Cr

Period III

Contract Price	=	920 Cr
Less: Total Contract Price		
(Already recognized)	=	644 Cr
		276 Cr
Less: Exp of 3rd year (820-574)	=	246 Cr
		30 Cr

Disclosures

(i) Accounting policies should be disclosed separately

(ii) Classification of contract under the heading of fixed price and cost plus contracts should also be made separately.

(iii) As per AS difference between actual sale & billing amount should be disclosed separately in Balance sheet.

(iv) Difference between billed and cash received should also be disclosed separately. (Such difference can also be recognized as retention money)

Ques 2 Contract Price = 5 Lakh

Additional information (in Lakh)

	I	II	III
Cumulative cost (actual)	1.50	3.60	4.05
Estimated Cost (further)	3.00	0.40	-
Billed Amount (Respective)	1.00	3.70	0.30
Collection Amount (Respective)	0.75	3.00	1.25

Calculate amount of profit / loss over the construction period and also calculate relevant disclosures as per the requirements of AS – 7.

Sol:

W.N.1 Calculation of % of Completion of Contract

	I	II	III
Actual Cost	1.50	3.60	4.05
Total Estimated Cost	4.50	4.00	-
% of Completion	33.33%	90%	100%

W.N. 2 Calculation of Contract Revenue to be Recognized

	I	II	III
Contract Price	5.00	5.00	5.00

	% of Completion	33.33%	90%	100%
	Contract Revenue	1.66	4.50	5.00
Less:	Previous Revenue	-	1.66	4.50
	Net Contract Revenue	1.66	2.84	0.50

Statement of Profit / Loss

		I	II	III
	Contract Revenue	1.66	2.84	0.50
Less:	Expenses	1.50	2.10	0.45
	Profit / Loss	0.16	0.74	0.05

Statement showing Retention Money

		I	II	III
	Amount Billed	1.00	3.70	0.30
Less:	Collection	0.75	3.00	1.25
	Retention Money	0.25	0.70	0.95

Comment: In the Balance Sheet of 1st year & 2nd year Retention money should be disclosed of Rs. 25,000 & Rs. 95,000

Statement showing Difference in Sales (Cumulative)

		I	II	III
	Sales (AS – 7)	1.66	4.50	5.00
Less:	Amount Billed	1.00	4.70	5.00
	Difference	0.66	(0.20)	0.00

Note: As per AS difference in sale should be calculated on cumulative basis because adjustment of period wise information will be made automatically.

Ques 3

Projects	X	Y
Contract Price	6 Lakh	8 Lakh
Date of Contract	01-04-05	01-04-05

Additional Information

(i) Completion period for Project X has been decided between the parties of 2 yrs. (Completion date 31-03-07).

(ii) To complete the project X during the decided time, there is a provision of penalty of Rs. 10,000 per day.

(iii) Completion time for project Y has been decided of 3 yrs.

(iv) Cost information

	X	Y
Period I		
Actual Cost	3.60 Lakh	4.10 Lakh
(Further) Estimated Cost	0.40 Lakh	4.10 Lakh
Period II		
Actual Cost (Cumulative)	4.50 Lakh	7.20 Lakh
(Further) Estimated Cost	-	1.80 Lakh

Calculate amount of profit/loss for project X and Y for the 2 different periods assuming that Project X is completed by the contractor in time but actual possession is given after 4 days.

Sol: Calculation of Profit / Loss of Project X

	I	II

Actual Cost (Cumulative)	3.60 Lakh	4.50 Lakh
Add: Estimated	0.40 Lakh	-
	4.00 Lakh	4.50 Lakh
% of Completion	90%	100 %

Statement of Profit / Loss

	I	II
Contract Price	6.00 Lakh	6.00 Lakh
Less: Penalty Amount		
(10000 X 4)	-	0.40 Lakh
Less: Previous Recognition	-	5.40 Lakh
	6.00 Lakh	0.20 Lakh

% of Completion	90%	100 %
Income Recognition	5.40 Lakh	0.20 Lakh
Less: Expense (Respective)	3.60 Lakh	0.90 Lakh
Profit / Loss	1.80 Lakh	(0.70 Lakh)

Project Y

Para 35

As per AS provision should be created if total estimated cost is higher than contract price. In the given situation total estimation is higher than contract price.

Statement of Expected Cost

	I	II

Contract Price	8.00 Lakh	8.00 Lakh
Total Estimated Cost	8.20 Lakh	9.00 Lakh
Provision Required	0.20 Lakh	1.00 Lakh

Additional Provision is of Rs. 80,000/-

Differences:

As per AS – 7, Completion Method is specified for accounting purpose. In other statement completed method is also specified for accounting of contract. Under completed method income can be recognized only if contract is completed by the contractor at the end of completion period.