

# **SREERAM COACHING POINT**

**Accounting Standard (AS) - 7**

**Construction Contracts**

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This standard is applicable only for contractors and not for contractee

A construction contract is a contract specifically negotiated for the construction of an asset or combination of assets closely interrelated or interdependent.

Example: Contract for construction of bridge, building, dam, pipeline road etc.

This standard is applicable for following also

Contracts for rendering of services which are directly related to the construction of assets. Example: Service of architect

Contract for destruction or restoration of an asset and the restoration of the environment following the demolition of asset

Example: If existing structure / building in a plot of land has to be demolished before a new building as per new design is constructed, the destruction of building is construction contract.

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## Types of Construction Contract:

- a. Fixed Price contract
- b. Cost plus contract
- c. Mix of above

### Fixed Price contract

Contractor agrees for fixed price of the contract or fixed rate per unit. In some cases, the contract price may be subject to escalation

### Cost-plus contract

Contractor is reimbursed the cost as defined plus fixed percentage of fee/profit

If there are more than one contract is involved, this AS 7 is applied separately for each of them. But in substance if these contracts are part of single project with an overall profit margin, all may be combined to calculate the profit/loss

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$$\text{Profit/Loss} = \text{Contract Revenue} - \text{Contract Cost}$$

Contract Revenue includes

- a. Revenue/Price agreed as per contract
- b. Revenue due to escalation clause
- c. Claims which are reimbursed to contractors
- d. Incentive payments to contractors
- e. Increase in revenue due to increase in units of output
- f. Decrease in revenue due to penalties
- g. Increase or decrease due to change or variation in scope of work to be performed

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## Contract cost

- a. Includes Specific Cost + costs attributable + Cost specifically chargeable
- b. Contract cost do not include
  - i. Cost relate to future activity on the contract. Example: Cost of materials that have been delivered to a contract site or set aside for use of a contract but not used and applied
  - ii. Payment made to sub-contractors in advance of work performed under the sub-contract

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Revenue to be recognised for current period = Contract Price x Percentage of completion – Revenue previously recognised

Percentage of completion =  $\left[ \frac{\text{cost to date}}{\text{cumulative cost incurred} + \text{estimated cost to complete}} \right] \times 100$

If there is an uncertainty regarding the collectibility of amount already included in contract, then it is recognised as expenses instead of adjusting in the contract revenue

Provision for loss: When it is probable that total contract cost will exceed total contract revenue, the expected losses should be recognised as an expense irrespective of –

- a. Whether or not work has commenced
- b. Stage of completion of contract
- c. The amount of profit on other contracts which are not treated as a single contract