**INSTITUTE OF CHARTERED ACCOUNTANTS OF NEW ZEALAND**

FINANCIAL REPORTING STANDARD NO. 14
1994

# ACCOUNTING FOR CONSTRUCTION CONTRACTS

***Issued by the Financial Reporting Standards Board of the Institute of Chartered Accountants of New Zealand***

***Approved July 1994 by the Accounting Standards Review Board under the Financial Reporting Act 1993***

**CONTENTS**



*This Standard replaces SSAP-14: Accounting for Profit on Construction Contracts (1982), although that Statement will continue to apply until the completion of accounting periods which end prior to 31 December 1994.*

*This Standard should be read in the context of the Explanatory Foreword to General Purpose Financial Reporting published by the Council, Institute of Chartered Accountants of New Zealand.*

*The Accounting Standards Review Board (the Board) has approved FRS-14: Accounting for Construction Contracts, for the purposes of the Financial*

*Reporting Act 1993, to apply to reporting entities, the Crown and all departments, Offices of Parliament and Crown entities (each of which is defined in the Act) other than as expressly exempted by the terms of the Standard.*

*The Board has also approved this Standard to apply to local authorities (as defined in the Act) from 1 July 1998.*

## 1 INTRODUCTION

*COMMENTARY*

1.1 This Standard deals with accounting for construction contracts as defined.

1.2 Accounting for construction contracts requires the allocation of revenues and costs associated with the contract to accounting periods during the life of the contract. This Standard requires profit to be recognised as contract activity progresses when:

- it is probable that future net economic benefits will flow to the entity; and
- the amounts of those benefits can be measured reliably.

1.3 Financial reporting standards are paragraphs in bold type-face in this Standard. Where appropriate, interpretive commentary paragraphs in plain type-face follow the financial reporting standards.

## 2 APPLICATION

*STANDARD*

**2.1 This Standard applies to the general purpose financial reports of all entities except where exempted by paragraph 2.2.**

**2.2 Entities which qualify for differential reporting in accordance with the *Framework for Differential Reporting* may recognise profit on all construction contracts using the completed contract method described in paragraph 4.1, and need not comply with any other paragraphs of this Standard.**

**2.3 The financial reporting standards set out in this Standard shall apply to all financial reports where such application is of material consequence. A statement, fact, or item is material if it is of such a nature or amount that its disclosure, or the method of treating it, given full consideration of the circumstances applying at the time the financial report is completed, is likely to influence the users of the financial report in making decisions or assessments.**

**2.4 This Standard applies to general purpose financial reports covering periods ending on or after 31 December 1994.**

## 3 STATEMENT OF PURPOSE

*COMMENTARY*

3.1 The purpose of this Standard is to require for construction contracts in progress:

(a) profits to be recognised progressively when the profit at the completion of the contract can be estimated reliably;

(b) losses to be recognised as soon as they are foreseeable; and

(c) specific disclosures.

3.2 In the promulgation of this Standard the Financial Reporting Standards Board acknowledges that this Standard departs from the *Statement of Concepts for General Purpose Financial Reporting,* in that it does not require the recognition of an asset and a liability in respect of contractual rights and obligations proportionately unperformed. It also requires recognition of all losses in full as soon as these are foreseeable but requires profits to be recognised progressively or, in certain cases, on completion of the contract. These departures are considered necessary at this time in view of established traditional reporting practices, but will be subject to review in the future.

## 4 DEFINITIONS

*STANDARD*

**The following terms are used in this Standard with these meanings:**

**4.1 "Completed contract method" is a method of accounting by which the profit on a construction contract is recognised only when the contract is completed or substantially completed, subject always to the requirements of paragraph 5.17 of this Standard to recognise any loss as soon as it is foreseen.**

**4.2 "Construction contract" means a contract negotiated specifically 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. The term includes contracts for the rendering of services which are directly related to the construction of the asset(s).**

*COMMENTARY*

4.3 Examples of construction contracts are contracts for:

construction of buildings, bridges and major items of plant and equipment;

- major projects to develop software;
- services of project managers and architects; or
- construction of a combination of assets as a single project, such as a refinery or other complex plant. Such assets may be combined into a single project because they are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use.

4.4 A construction contract may include a number of component projects, or a number of construction contracts may relate to a single project. The recognition criteria for revenue and expenses in this Standard may be applied to:

- a single construction contract;
- identified components within a construction contract; or
- a package of two or more construction contracts, possibly with different customers.

In such circumstances revenue and expenses are to be recognised in terms of the substance of the transaction.

4.5 A construction contract may provide for the construction of an additional asset at the option of the customer. Alternatively a contract may be amended to include the construction of an additional asset. The construction of the additional asset is to be treated as a separate construction contract if:

(a) the asset differs significantly in design, technology or function from the asset or assets covered by the original contract; or

(b) the price of the asset is negotiated without regard to the original contract price.

4.6 The characteristic feature of construction contracts considered in this Standard is that they are contracts where the date when the contract is secured and the date of contract completion may fall in different reporting periods. The specific duration of the contract performance is not important in identifying a construction contract.

4.7 Construction contracts differ in their terms and conditions. There are three common types:

(a) lump sum or fixed price contracts — the contractor agrees to a lump sum price, in some cases subject to variation and cost escalation clauses;

(b) schedule of rates contracts — the contractor agrees to a schedule of rates on a unit basis; or

(c) cost reimbursable contracts — the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

*STANDARD*

**4.8 "Construction contract revenue" means the net total of:**

**(a) the initially agreed contract price; and**

**(b) variations in contract work approved by the customer, other claims made by the contractor, and incentive payments.**

**The components in sub-paragraphs (a) and (b) are only to be included in "construction contract revenue" to the extent that:**

**(i) it is probable that they will result in revenue; and**

**(ii) they are capable of being reliably measured.**

*COMMENTARY*

4.9 Variations in contract work approved by the customer, other claims made by the contractor, and incentive payments will probably result in revenue and be capable of reliable measurement when there is evidence that:

(a) the amount of the variation, claim or incentive payment has been accepted by the customer or that the customer will be obliged legally to accept that amount; and

(b) the amount of other claims made by the contractor is expected to be recovered by the contractor.

4.10 A variation in contract work is an instruction by the customer for a change in the scope of the work to be performed under the contract. Examples of variations include changes in:

- the specifications of the asset;
- the design of the asset; or
- the duration of the contract.

4.11 A claim by a contractor is an amount for which the contractor seeks payment from the customer or another party as reimbursement for costs not included in the contract price. For example, a claim by a contractor may arise from a dispute with the customer over the scope or value of variations.

4.12 Incentive payments are additional amounts paid to the contractor if specified standards are met or exceeded. For example, the contract may allow for an additional payment to the contractor for early completion of the contract.

*STANDARD*

**4.13 "Construction contract costs" means the total of:**

**(a) costs that relate directly to the specific contract;**

**(b) costs that are attributable to the entity's contract activity in general and can be allocated to the specific contract; and**

**(c) other costs chargeable to the customer in terms of the contract.**

- **For the purposes of this Standard, "construction contract costs" shall only include costs attributable to securing a contract when:**
  - **(i) those costs are specifically identifiable; and**
  - **(ii) the contract has been secured or there is reasonable certainty that the contract will be secured.**

*COMMENTARY*

4.14 Costs incurred by a contractor before a contract is secured are usually to be recognised as an expense in the periods in which they are incurred.

4.15 Examples of costs that relate directly to a specific contract include:

- labour cost, including supervision;
- materials used;
- depreciation of plant and equipment used on the contract;
- costs of moving plant and equipment to and from a site;
- expected warranty costs; or
- claims from third parties (for example, subcontractors) or penalties against the contractor arising from delays in completion of the contract or from other causes.

4.16 Examples of costs that are attributable to the entity's contract activity in general and can be allocated to a specific contract, include:

- insurance;
- design and technical assistance;
- construction overhead; or
- finance costs.

The allocation of such costs is to be systematic and rational and is to be applied consistently to all costs with similar characteristics. Construction overhead includes costs such as the preparation and processing of construction personnel payroll.

4.17 Other costs chargeable to the customer in terms of the contract may include:

- some general administration costs; or
- development costs where their reimbursement is specified in terms of the contract.

4.18 Examples of costs of the entity that cannot be related to specific contracts (although they relate to general contract activity) include:

- general administration and selling costs;
- research and development costs; or
- depreciation of idle plant and equipment.

These costs do not usually relate to the specific contract and are to be excluded from construction contract costs as defined in paragraph 4.13.

4.19 The total time period, when construction contract costs are to be identified, commences with the date of securing the contract and ends when the contract is completed, except where costs attributable to securing a contract meet the conditions in paragraph 4.13(i) and (ii).

*STANDARD*

**4.20 "Loss on a construction contract" means the loss that will arise when the contract is completed and is the difference between construction contract revenue and construction contract costs when construction contract costs exceed construction contract revenue.**

**4.21 "Percentage of completion method" means recognition of a proportion of profit on a construction contract by reference to the stage of completion of the contract.**

**4.22 "Profit on a construction contract" means the profit that will arise when the contract is completed and is the difference between construction contract revenue and construction contract costs when construction contract revenue exceeds construction contract costs.**

## FINANCIAL REPORTING

### Recognition of Contract Profit

*STANDARD*

**5.1 Profit shall be recognised when the profit on a construction contract can be estimated reliably.**

*COMMENTARY*

5.2 During the course of a construction contract estimation of the profit on the construction contract is subject to risk. For this reason, profit is only to be recognised in the financial report when there is a reliable estimate of the construction contract revenue and of the construction contract costs when the contract is completed.

5.3 To estimate reliably the profit to date of a lump sum contract, the following conditions are usually necessary:

(a) total contract revenue to be received can be estimated reliably;

(b) it is probable that the entity will receive the contract revenue;

(c) the total cost to complete the contract can be estimated reliably;

(d) the stage of contract performance completed at reporting date can be estimated reliably; and

(e) the costs attributable to the contract can be identified clearly.

5.4 To estimate reliably the profit to date of a schedule of rates contract, or a cost reimbursable contract the following conditions are usually necessary:

(a) the costs attributable to the contract can be identified clearly;

(b) costs other than those that will be specifically reimbursable under the contract can be estimated reliably; and

(c) it is probable that the entity will receive the contract revenue.

*STANDARD*

**5.5 Where a reliable estimate of profit on a construction contract cannot be made during the progress of a construction contract, no profit shall be recognised before the completion of the contract.**

*COMMENTARY*

5.6 During the early stages of a contract, the profit on a construction contract (in terms of paragraph 4.22) may often be impossible to estimate reliably. Nevertheless it may be probable that the entity will recover the costs incurred.

5.7 Contract revenue is to be recognised only when it is probable that, at the time revenue would otherwise be recognised, the entity will receive the revenue. If contract revenue is recognised and, in a later period, there is an uncertainty about collectability, the estimated uncollectable amount of the contract revenue is to be recognised as an expense.

5.8 Costs incurred may not be recoverable when:

(a) contracts are not fully enforceable, that is, their validity is seriously in question;

(b) pending legislation or litigation may influence the completion of the contract; or

(c) contracts relate to properties that are likely to be condemned or expropriated.

5.9 When the circumstances that prevented reliable measurement no longer exist, revenue and expenses are to be recognised in accordance with paragraph 5.10.

*STANDARD*

**5.10 The proportion of profit on a construction contract recognised before completion of the contract shall be determined using the percentage of completion method.**

*COMMENTARY*

5.11 The proportion of profit to be recognised is to be determined by reference to the stage of completion of the contract in order to report profits in the accounting period in which the contract activity takes place.

5.12 To recognise the proportion of profit on a construction contract by reference to the stage of completion, the contractor must be able to estimate reliably the result of the contract. A reliable estimate of the result of the contract requires that:

(a) the contract establishes:

  (i) each party's enforceable rights regarding the asset to be constructed;

  (ii) the consideration to be exchanged; and

  (iii) the terms of settlement; and

(b) the contractor has an effective internal financial budgeting and reporting system to provide reliable estimates.

The estimates are to be reviewed and revised as appropriate as the contract progresses. Although estimates may be revised from time to time, each revision may nevertheless provide a sufficiently reliable estimate of the result of the contract to support recognition of the proportion of the profit on the construction contract in terms of paragraph 5.10.

5.13 The percentage of completion method provides the best measurement of the extent of contract activity and performance during a reporting period. The profit attributed to the proportion of work completed is calculated by deducting costs from revenue in relation to the stage of completion. Under this method, contract costs are usually recognised as an expense of the period when they are incurred; such contract costs are considered as incurred when they reflect work performed. Examples of contract costs include:

- materials installed, used or applied to carry out the work performed; or
- materials as part of work specifically made for the contract.

5.14 The stage of completion used to determine profit to be recognised in the financial report can be measured in a variety of ways including:

(a) calculating the proportion that costs to date bear to the estimated total costs of the contract;

(b) calculating the proportion completed of the total contract revenue; or

(c) calculating the proportion completed of the physical content of the contract work.

5.15 Progress payments and advances received from customers do not necessarily reflect the stage of completion and are not to be treated as a reliable measure of work performed.

5.16 If profit to be recognised is determined as in the example in paragraph 5.14(a), that is by calculating the proportion that costs to date bear to the estimated total costs of the contract, only those costs that reflect work performed are to be included and therefore adjustments may be required. Examples of items which may require adjustment are:

(a) the costs of materials that have been purchased for the contract but have not been installed or used during contract performance; and

(b) payments to subcontractors to the extent that they do not reflect the amount of work performed under the contract.

**Loss on a Construction Contract**

*STANDARD*

**5.17 A loss on a construction contract shall be recognised in the financial report as soon as the loss is foreseen; the loss recognised shall include both the loss for the stage of completion reached on the contract and the loss for future work on the contract.**

*COMMENTARY*

5.18  When current estimates of total costs and revenue of a contract indicate a loss, provision is to be made immediately for the entire loss on the contract irrespective of the work done.  In some circumstances, the foreseeable losses may exceed the costs of work performed to date.  Provision is nevertheless to be made for the entire loss on the contract.

5.19  When a contract is expected to absorb a considerable part of the capacity of the entity for a substantial period, the forecast loss is to include the corresponding proportion of the entity's indirect costs to be incurred during the period of the completion of the contract.  An entity's indirect costs are described in paragraph 4.13(b) and paragraph 4.16.

5.20  If provision for a loss is to be made, the amount of the provision is to be determined irrespective of:

(a) whether or not work has commenced on the contract;

(b) the stage of completion of the contract; and

(c) the amount of profits expected to arise on unrelated contracts.

**Construction Work in Progress**

*STANDARD*

**5.21  Uncompleted construction contracts at balance date are to be stated in the financial report as gross construction work in progress and shall be recorded at construction contract costs plus any attributable profit less any losses brought to account including foreseeable losses.**

**Claims and Variations Arising Under Contracts**

*STANDARD*

**5.22  Construction contract revenue due in respect of claims and variations shall be recognised only when there is reasonable evidence of their recoverability.**

*COMMENTARY*

5.23  The contractor is to recognise as revenue only those variations in contract work approved by the client and only those claims made by the contractor where the contractor has reasonable evidence that the amounts will be recovered.

*STANDARD*

**5.24  Claims against the contractor or penalties payable by the contractor for delays in completion, or for other reasons, shall be provided for in full as costs attributable to the contract.**

**Progress Payments, Advances and Retentions**

*STANDARD*

**5.25 Progress payments received and/or receivable together with advances received from customers in respect of contracts, shall be recognised in the financial report as a deduction from the amount of work in progress.**

**5.26 Progress payments due and amounts retained by the customer until satisfaction of specific conditions of the contract shall be recognised in the financial report as receivables.**

**Disclosure**

*STANDARD*

**5.27 The financial report shall include separate disclosure at balance date of:**

**(a) the gross amount of contract work in progress (as in paragraph 5.21); and**

**(b) the total of cash received and receivable as progress payments, advances, and retentions on account of work in progress.**

## APPENDIX

### Comparison of FRS-14 with International and Australian Accounting Standards

This comparison appendix, which was prepared as at 15 March 1994 and deals only with significant differences in the standards, is produced for information purposes only and does not form part of the standards in FRS-14. The International Accounting Standard referred to in this Appendix was promulgated by the International Accounting Standards Committee.

The International and Australian accounting standards comparable with FRS-14 are:

- IAS-11 (1993): *Construction Contracts*;
- AASB 1009 (1986): *Accounting for Construction Contracts*; and
- AAS-11 (1983): *Accounting for Construction Contracts*.

There are few significant differences among the requirements in the New Zealand, Australian and International standards. FRS-14, AAS-11, AASB 1009 and IAS-11 require the use of the percentage of completion method.

The disclosure requirements in FRS-14, AAS-11, AASB 1009 and IAS-11 are similar. AAS-11 specifically requires the disclosure of details of the revenue recognition policy for the determination of profit on construction contracts. IAS-11 also requires the following additional disclosures:

(a) the amount of contract revenue recognised in the period;

(b) the methods used to determined the contract revenue recognised in the period; and

(c) the methods used to determine the stage of completion of contracts in progress.

Both FRS-14 and IAS-11 allow certain borrowing costs to be allocated to a specific contract.

## HISTORY

*Previously issued accounting standards superseded by this Financial Reporting Standard:*

*SSAP-14: Accounting for Profit on Construction Contracts (issued March 1982 and effective for periods beginning on or after 1 April 1982).*


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