

CONSTRUCTION CONTRACTS

Objective	To prescribe accounting for revenue and costs associated with construction contracts															
Scope	Accounting for construction contracts in the financial statements of contractors (not contractee)															
Meaning of construction contract	<p>It is a contract specifically negotiated for</p> <ul style="list-style-type: none"> → construction of an asset Example: Bridge, Building, Dam, etc. → Combination of assets that are closely interrelated or interdependent in terms of design, technology, function or ultimate purpose or use. Example: Refineries, Other complex pieces of plant or equipment etc. <p>Construction contracts also include:</p> <ul style="list-style-type: none"> (a) contracts for rendering of services which are directly related to construction of the asset, for eg., those for the services of project managers & architects; (b) contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets. 															
Types of construction Contracts:	Fixed price contract	In this contract, the contractor agrees to fixed contract price or fixed rate per unit of output. It may be with or without escalation clause														
	Cost plus contract	<p>In this contract, the contractor is reimbursed for the cost incurred plus percentage of these costs or fixed fee.</p> <table border="1"> <tr> <td>Cost incurred (allowable/defined cost)</td> <td>XX</td> </tr> <tr> <td>+% of cost or fixed fee</td> <td>XX</td> </tr> <tr> <td></td> <td>XX</td> </tr> </table>	Cost incurred (allowable/defined cost)	XX	+% of cost or fixed fee	XX		XX								
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Contract revenue	<p>It means the revenue which is agreed upon between the contractor and contractee</p> <table border="1"> <tr> <td>Initial contract revenue</td> <td>XX</td> </tr> <tr> <td>+/- Variations (alteration in job like change in specifications)*</td> <td>XX</td> </tr> <tr> <td>+ Incentive payments (price for timely completion of job)**</td> <td>XX</td> </tr> <tr> <td>+ Price escalation (extra compensation for increased cost)</td> <td>XX</td> </tr> <tr> <td>+ Claims (losses in contract due to contractee like customer caused delays, error in specification or design etc.</td> <td>XX</td> </tr> <tr> <td>Any penalty (from delays caused by contractor)</td> <td>(XX)</td> </tr> <tr> <td>Contract Revenue</td> <td>XX</td> </tr> </table> <p>* included in contract revenue when it is probable that the customer will approve the variation and amount of revenue arising from the variation; **included in contract revenue when the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; <i>These should be included in contract revenue if it is probable that they will result in revenue & they are capable of being reliably measured.</i></p>		Initial contract revenue	XX	+/- Variations (alteration in job like change in specifications)*	XX	+ Incentive payments (price for timely completion of job)**	XX	+ Price escalation (extra compensation for increased cost)	XX	+ Claims (losses in contract due to contractee like customer caused delays, error in specification or design etc.	XX	Any penalty (from delays caused by contractor)	(XX)	Contract Revenue	XX
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Contract cost	It means the expenses incurred at site along with the apportioned contract cost																
	Direct cost	Relate directly to specific contract <i>Example:</i> Site labour cost, cost of material used, depreciation of plant and equipment, etc.															
	Allocated cost	Attributable to contract in general and can be allocated <i>Example:</i> Insurance of machinery, salary of supervisor who is supervising more than 1 contract, etc.															
	Specific cost	Specifically chargeable to customer under the terms of contract <i>Example:</i> General administration cost and development cost for which reimbursement is specified under contract															
	Note	Direct cost may be reduced by any incidental income that is not included in contract revenue <i>Example:</i> Income from sale of surplus material and disposal of plant & equipment at the end of contract.															
	Exclusions	<ul style="list-style-type: none"> • general administration & research & development costs for which reimbursement is not specified in the contract • selling costs • depreciation of idle plant and equipment that is not used on a particular contract 															
Recognition of contract revenue and expenses	When to recognize	When the outcome of construction contract can be estimated reliably															
	Conditions	<ul style="list-style-type: none"> ❖ Total contract revenue can be measured reliably ❖ It is probable that economic benefits associated with contract will flow to the enterprise ❖ Contract cost can be clearly identified and measured reliably. 															
	Basis of recognition	<p>By reference to the stage of completion of the contract activity at the reporting date.</p> <p>Methods to determine stage of completion of contract</p> <p>1. % completion = $\frac{\text{Costs till date}}{\text{Total Estimated Costs}} \times 100$</p> <p>2. Survey of work performed (Certification by surveyor)</p> <p>3. Completion of a physical proportion of the contract work. <i>(Example: Contract to place tiles)</i></p>															
Computation of Profit	<table style="width: 100%; border-collapse: collapse;"> <tr> <td style="text-align: right;">Contract Revenue x Stage of Completion (%)</td> <td style="text-align: right;">=</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td style="text-align: right;">Less: Contract Costs till date</td> <td style="text-align: right;">=</td> <td style="text-align: right;">(XXX)</td> </tr> <tr> <td style="text-align: right;">Total Profit till date</td> <td style="text-align: right;">=</td> <td style="text-align: right;">XXX</td> </tr> <tr> <td style="text-align: right;">Less: Profit recognized till last year</td> <td style="text-align: right;">=</td> <td style="text-align: right;">(XXX)</td> </tr> <tr> <td style="text-align: right;">Profit for the Current Year</td> <td style="text-align: right;">=</td> <td style="text-align: right;">XXX</td> </tr> </table>		Contract Revenue x Stage of Completion (%)	=	XXX	Less: Contract Costs till date	=	(XXX)	Total Profit till date	=	XXX	Less: Profit recognized till last year	=	(XXX)	Profit for the Current Year	=	XXX
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Profit for the Current Year	=	XXX															
Recognition of expected losses	Para 35	When it is probable that Total contract cost will exceed Total contract revenue, Expected loss should be recognized as expense immediately.															

	Para 36	<p>Amount of such loss is determined irrespective of</p> <ul style="list-style-type: none"> ❖ Whether or not work has commenced on the contract. ❖ Stage of completion of contract activity ❖ Amount of profits expected to realize on other contracts which are not treated as single construction contract
Outcome of construction contract cannot be estimated reliably		<ul style="list-style-type: none"> ❖ Revenue should be recognized only to the extent of contract costs incurred of which recovery is probable; and ❖ Contract costs should be recognised as expense in the period in which they are incurred.
Combining & Segmenting Construction Contracts (CONDITIONS)	Separate	<ul style="list-style-type: none"> ❖ separate proposals have been submitted ❖ separate negotiations have been carried out and contractor & customer can accept or reject part of it. ❖ costs and revenue of each asset can be separately identified
	Combining	<ul style="list-style-type: none"> ❖ they are negotiated as a single package; ❖ they are closely interrelated and ❖ they will be performed concurrently i.e. in sequence
Construction of an additional asset		<p>It should be treated as a separate construction contract when:</p> <ul style="list-style-type: none"> ➤ the asset differs significantly in design, technology or function from the asset covered by the original contract; or ➤ the price of the asset is negotiated without regard to the original contract price
Treatment of Costs Relating to Future Activity		<p>The contract costs that relate to future activity on the contract are however recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.</p>
Uncollectable Contract Revenue		<p>When an uncertainty arises about the collectability of an amount already included in contract revenue, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue</p>
Change in estimates		<p>The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract cost. Therefore, the effect of a change in estimates is accounted for as change in accounting estimate as per AS-5 (Prospective effect).</p>
Disclosure requirements		<ul style="list-style-type: none"> ❖ Amount of contract revenue recognized ❖ Method used to determine such revenue ❖ Method used to determine stage of completion of contract in progress. ❖ Following to be disclosed for contract in progress: <ul style="list-style-type: none"> • Aggregate cost incurred • Profit recognized till date • Advance received • Amount of retention • Progress Billings <p>An enterprise should also present:</p> <ol style="list-style-type: none"> a) the gross amount due from customers for contract work as an asset & b) the gross amount due to customers for contract work as a liability

ASSIGNMENT QUESTIONS

Question 1 (RTP May 2020) / (ICAI Study Material) Pg no. _____

A construction contractor has a fixed price contract for ₹ 9,000 lacs to build a bridge in 3 years time frame. A summary of some of the financial data is as under:

	Amount (In Lacs)		
	Year 1	Year 2	Year 3
Initial Amount for revenue agreed in contract	9,000	9,000	9,000
Variation in Revenue (+)	-	200	200
Contracts costs incurred upto the reporting date	2,093	6,168*	8,100**
Estimated profit for whole contract	950	1,000	1,000

*Includes ₹ 100 lacs for standard materials stored at the site to be used in year 3 to complete the work.

**Excludes ₹ 100 lacs for standard material brought forward from year 2.

The variation in cost and revenue in year 2 has been approved by customer.

Compute year wise amount of revenue, expenses, contract cost to complete and profit or loss to be recognized in the Statement of Profit and Loss as per AS-7 (revised)

Question 2 (RTP May 2018) / (Nov 2018) / (Nov 2020) / (Jan 2025) Pg no. _____

Uday Constructions undertake to construct a bridge for the Government of Uttar Pradesh. The construction commenced during the financial year ending 31.03.2020 and is likely to be completed by the next financial year. The contract is for a fixed price of ₹ 12 crores with an escalation clause. The costs to complete the whole contract are estimated at ₹ 9.50 crores of rupees.

You are given the following information for the year ended 31.03.2020:

Cost incurred upto 31.03.2020, ₹ 4 crores

Cost estimated to complete the contract ₹ 6 crores

Escalation in cost by 5% and accordingly the contract price is increased by 5%.

You are required to ascertain the state of completion and state the revenue and profit to be recognized for the year as per AS-7.

Question 3 (ICAI Study Material) Pg no. _____

RT Enterprises has entered into a fixed price contract for construction of a tower with its customer. Initial tender price agreed is ₹ 220 crore. At the start of the contract, it is estimated that total costs to be incurred will be ₹ 200 crore. At the end of year 1, this estimate stands revised to ₹ 202 crore. Assume that the construction is expected to be completed in 3 years. During year 2, the customer has requested for a variation in the contract. As a result of that, the total contract value will increase by ₹ 5 crore and the costs will increase by ₹ 3 crore. RT has decided to measure the stage of completion on the basis of the proportion of contract costs incurred to the total estimated contract costs. Contract costs incurred at the end of each year is:

Year 1: ₹ 52.52 crore

Year 2: ₹ 154.20 crore (including unused material of 2.5 crore)

Year 3: ₹ 205 crore.

You are required to calculate:

- (a) Stage of completion for each year.
- (b) Profit to be recognised for each year.

Question 4 ***(Inter July 2021) (5 Marks) / (RTP May 2024)*** Pg no. _____

The following data is provided for M/s. Raj Construction Co.

- (i) Contract Price - ₹ 85 lakhs
- (ii) Materials issued - ₹ 21 Lakhs out of which Materials costing ₹ 4 Lakhs is still lying unused at the end of the period.
- (iii) Labour Expense for workers engaged at site 16 Lakhs (out of which 1 Lakh is still unpaid)
- (iv) Specific Contract Costs - ₹ 5 Lakhs
- (v) SubContract Costs for work executed 7 Lakhs, Advances paid to subcontractors 4 Lakhs
- (vi) Further Cost estimated to be incurred to complete the contract - ₹ 35 Lakhs

You are required to compute the Percentage of Completion, the Contract Revenue and Cost to be recognized as per AS-7.

Solution

Computation of contract cost

	₹ Lakh	₹ Lakh
Material cost incurred on the contract (net of closing stock)	(21- 4)	17
Add: Labour cost incurred on contract (incl. outstanding amount)		16
Specified contract cost	given	5
Sub-contract cost (advances should not be considered)		7
Cost incurred (till date)		45
Add: further cost to be incurred		35
Total contract cost		80

Percentage of completion = Cost incurred till date/Estimated total cost

$$= ₹ 45,00,000/₹ 80,00,000 = 56.25\%$$

Contract revenue and costs to be recognized

Contract revenue (₹ 85,00,000 × 56.25%) = ₹ 47,81,250

Contract costs = ₹45,00,000

Question 5 ***(ICAI Study Material)*** Pg no. _____

AB contactors enters into a contract on 1st January 2021 with XY to construct a 5- storied building. Under the contract, AB is required to complete the construction in 3 years (i.e., by 31st December 2023). The following information is relevant:

Fixed price (agreed) ₹5 crore

Material cost escalation (to the extent of 20% of increase in material cost)

Labour cost escalation (up to 30% of increase in minimum wages)

In case AB is able to complete the construction in less than 2 years and 10 months, it will be entitled for an additional incentive of ₹50 lakh. However, in case the construction is delayed beyond 3 years and 2 months, XY will charge a penalty of ₹20 lakh. At the start of the contract, AB has a reason to believe that construction will be completed in 2 years and 8 months. Assume that the construction was actually completed in 2 years 9 months.

Labour cost was originally estimated to be ₹1.20 crore (based on initial minimum wages). However, the costs have increased by 25% during the construction period. Material costs have increased by 40% due to short-supply. The total increase in material cost due to the 40% escalation is ₹80 lakh.

You are required to suggest what should be the contract revenue in above case?

Assume that in year 2022, XY has requested AB to increase the scope of the contract. An additional floor is required to be constructed and there is an increase in contract fee by ₹1 crore. AB has incurred a cost of ₹20 lakh for getting the local authority approvals which it will be entitled to claim from XY in addition to the increase in the fixed fee.

Also measure the total contract revenue in this case.

Question 6 ***(RTP Nov 2021)*** _____ Pg no. _____

Mr. 'X' as a contractor has just entered into a contract with a local municipal body for building a flyover. As per the contract terms, 'X' will receive an additional ₹ 2 crore if the construction of the flyover were to be finished within a period of two years of the commencement of the contract. Mr. X wants to recognize this revenue since in the past he has been able to meet similar targets very easily. Is X correct in his proposal? Discuss.

Solution

According to AS 7 (Revised) 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract.

Incentive payments are included in contract revenue when:

- (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
- (ii) the amount of the incentive payment can be measured reliably.

In the given problem, the contract has not even begun and hence the contractor (Mr. X) should not recognize any revenue of this contract

Question 7 ***(ICAI Study Material)*** _____ Pg no. _____

X Ltd. commenced a construction contract on 01/04/19. The fixed contract price agreed was ₹ 2,00,000. The company incurred ₹ 81,000 in 2019-20 for 45% work and received ₹ 79,000 as progress payment from the customer. The cost incurred in 2020-21 was ₹ 89,000 to complete the rest of work. Prepare P&L Account extract and Customer's Account for 2 years.

Question 8 ***(ICAI Study Material)*** _____ Pg no. _____

Show Profit & Loss A/c (Extract) in books of a contractor in respect of the following data

Information for Year 1	₹ ('000)
Contract price (Fixed)	600
Cost incurred to date	390
Estimated cost to complete	260

Assume that the contract period is 2 years. The contract is 100% completed by Year 2. Actual costs incurred are same as total estimated costs to complete (Cost incurred to date plus estimated cost to complete).

Question 9 ***(ICAI Study Material)*** _____ Pg no. _____

On 1st December, 2019, Vishwakarma Construction Co. Ltd. undertook a contract to construct a building for ₹ 85 lakhs. On 31st March, 2020 the company found that it had already spent ₹ 64,99,000 on construction. Prudent estimate of additional cost for completion was ₹ 32,01,000. What amount should be recognised in the statement of profit and loss for the year ended 31st March, 2020 as per provisions of Accounting Standard 7 (Revised)?

Question 10 ***(ICAI Study Material)*** _____ Pg no. _____

Akar Ltd. Signed on 01/04/19, a construction contract for ₹ 1,50,00,000.

Following particulars are extracted in respect of contract, for the period ending 31/03/20.

- ❖ Materials used ₹ 71,00,000
- ❖ Labour charges paid ₹ 36,00,000
- ❖ Hire charges of plant ₹10,00,000
- ❖ Other contract cost incurred ₹ 15,00,000
- ❖ Labour charges of ₹ 2,00,000 are still outstanding on 31.3.20.

- ❖ It is estimated that by spending further ₹ 33,50,000 the work can be completed in all respect.

You are required to compute profit/loss to be taken to Profit & Loss Account and any provision for foreseeable loss to be recognised as per AS-7.

Question 11 ***(ICAI Study Material)*** Pg no. _____

A firm of contractors obtained a contract for construction of bridges across river Revathi. The following details are available in the records kept for the year ended 31st March, 2020.

	₹ (in Lakhs)
Total Contract Price	1,000
Work Certified for the cost incurred	500
Work yet not Certified for the cost incurred	105
Estimated further Cost to Completion	495
Progress Payment Received	400
To be Received	140

Firm seeks your advice & assistance in presentation of accounts keeping in view the requirements of AS 7.

Question 12 Pg no. _____

An amount of ₹9,90,000 was incurred on a contract work upto 31-3-2020. Certificates have been received to date to the value of ₹12,00,000 against which ₹10,80,000 has been received in cash. The cost of work done but not certified amounted to ₹22,500. It is estimated that by spending an additional amount of ₹60,000 (including provision for contingencies) the work can be completed in all respects in another two months. The agreed contract price of work is ₹ 12,50,000. Compute a conservative estimate of the profit to be taken to the Profit and Loss Account as per AS-7.

Question 13 ***(ICAI Study Material)*** Pg no. _____

PQ & Associates undertakes a construction contract the details of which are provided below:

Total Contract Value	₹40 lakh
Costs incurred to date	₹3 lakh
Estimated future costs of completion	₹30 lakh
Work completed	10%

The work has started some time ago and there is an uncertainty with respect to the outcome of the contract due to expected changes in regulations. PQ is certain that it would be able to recover the costs incurred to date.

Solution

In the given case, revenue and costs can only be recognised to the extent of the costs incurred and those which are expected to be recovered. Therefore, the profit & loss statement would appear as under:

Contract Revenue	₹3 lakh	Contract Costs	₹3 lakh
Contract Profit	Nil		

When the uncertainties that prevented the outcome of the contract being estimated reliably cease to exist, revenue and expenses associated with the construction contract should be recognised by the percentage completion method.

Question 14 ***(ICAI Study Material)*** Pg no. _____

X Ltd. commenced a construction contract on 01/04/19. The contract price agreed was reimbursable cost plus 10%. The company incurred ₹ 1,00,000 in 2019-20, of which ₹ 90,000 is

reimbursable. The further non-reimbursable costs to be incurred to complete the contract are estimated at ₹ 5,000. The other costs to complete the contract could not be estimated reliably. Show the P&L A/c extract.

Question 15 *(RTP May 2019)*

Pg no. _____

GTI Ltd. negotiates with Bharat Oil Corporation Ltd. (BOCL), for construction of "Retail Petrol & Diesel Outlet Stations". Based on proposals submitted to different Regional Offices of BOCL, the final approval for one outlet each in Region X, Region Y, Region Z is awarded to GTI Ltd. A single agreement is entered into between two. The agreement lays down values for each of the three outlets i.e. ₹102 lacs, ₹150 lacs, ₹130 lacs for Region X, Region Y, Region Z respectively. Agreement also lays down completion time for each Region.

Comment whether GTI Ltd. will treat it as single contract or three separate contracts with reference to AS-7?

Solution

As per AS 7 'Construction Contracts', when a contract covers number of assets, the construction of each asset should be treated as a separate construction contract when:

- a) separate proposals have been submitted for each asset;
- b) each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- c) the costs and revenues of each asset can be identified.

In the given case, each outlet is submitted as a separate proposal to different Zonal Offices, which can be separately negotiated, and costs and revenues thereof can be separately identified. Hence, each asset will be treated as a "separate contract" even if there is one single agreement for contracts.

Therefore, three separate contract accounts must be recorded and maintained in the books of GTI Ltd. For each contract, principles of revenue and cost recognition must be applied separately and net income will be determined for each asset as per AS 7.

PRACTICE QUESTIONS

Question 1 (RTP Sep 2024) Pg no. _____

Mehta Ltd. has undertaken bridge construction contract where in, bridge will be constructed in 3 years. The details of the contracts are as follows:

- (i) Initial contract revenue ₹ 900 crore (ii) Initial contract cost ₹ 800 crore

	Year I	Year II	Year III
	₹ in crore	₹ in crore	₹ in crore
Estimated contract cost	805		
Increase in contract revenue	-	20	
Estimated additional increase cost	-	15	
Contract cost incurred upto	161	584	820

At the end of year II, cost incurred includes ₹ 10 crore, for material stored at the sites to be used in year III to complete the project.

State the amount of revenue, expenses and profit to be recognized in the Statement of Profit and Loss in these three years.

Solution**Statement showing analysis of the contract details**

		(₹ in crore)		
		Year I	Year II	Year III
(a)	Initial revenue agreed	900	900	900
(b)	Increase in contract revenue	-	20	20
(c)	Total Contract Value	900	920	920
(d)	Contract cost incurred up to the date of reporting	161	574 (excluding 10)*	820
(e)	Total estimated contract	805	820(805+15)	820
(f)	Stage of Completion	20%	70%	100%
	[(d/e) x 100]	(161/805 x 100)	(574/820 x 100)	(820/820 x 100)

* **Note:** 10 crore, for material stored at the sites to be used in III year. i.e. in IInd year it is already included so it will be deducted in II year only.

Statement showing amount of revenue, expenses and profit to be recognized in the Statement of Profit and Loss in three years.

		(₹ in crore)		
	Upto reporting date	Recognised in the prior year	Recognized in the current year	
Year I				
Revenue (900 x 20/100)	180	-	180	
Expenses	161	=	161	
Profit	19	=	19	
Year II				
Revenue (920 x 70/100)	644	180	464	
Expenses (820 x 70/100)	574	161	413	
Profit	70	19	51	
Year III				
Revenue	920	644	276	
Expenses	820	574	246	
Profit	100	70	30	

Question 2 *(Inter May 2024) (7 Marks)* Pg no. _____

Constructions Limited is engaged in the business of constructing Flyovers and Railway over bridges. It obtained a contract from Railway Authorities to construct a railway over bridge for ₹ 400 crores. The construction of the railway over bridge is expected to be completed in 4 years.

At the outset of the contract, it was estimated that the total costs to be incurred will be ₹ 370 crores but by the end of year 1, this estimate stands revised to ₹ 375 crores.

During year 3, the Construction Limited has requested for a variation in the contract which is approved by Railway Authorities and accordingly the total contract value will increase by ₹ 10 crores and costs will increase by ₹ 7 crores.

The Constructions Limited decided to measure the stage of completion on the basis of the proportion of contract costs incurred to the total estimated contract costs. Contract costs incurred at the end of each year is:

- Year 1 ₹ 98.8 crores
- Year 2 ₹ 202.4 crores
- Year 3 ₹ 310 crores (including unused material of 3 crores)
- Year 4 ₹ 382 crores

You are required to:

- (1) Calculate stage of completion of contract for each year
- (2) Profit to be recognised for each year.

Solution

(a) Stage of completion = Costs incurred to date / Total estimated costs

- Year 1: 98.8 crore / 375 crore = 26.35%
- Year 2: 202.4 crore / 375 crore = 53.97%
- Year 3: (310 crore – 3 crore) / (375+7) crore = 80.37%
- Year 4: 382 crore / 382 crore = 100%

(b) Profit to be recognized each year has been calculated as follows:

	Upto reporting date	Recognised in the prior year	Recognized in the current year
Year 1			
Revenue (400 x 26.35%)	105.40	-	105.40
Expenses	98.8	=	98.8
Profit	6.60	=	6.60
Year 2			
Revenue (400 x 53.97%)	215.88	105.40	110.48
Expenses	202.40	98.8	103.6
Profit	13.48	6.60	6.88
Year 3			
Revenue (410 x 80.37%)	329.52	215.88	113.64
Expenses	307	202.40	104.60
Profit	22.52	13.48	9.04
Year 4			
Revenue (410 x 100%)	410	329.52	80.48
Expenses	382	307	75
Profit	28	22.52	5.48

Question 3 **(RTP May 2021)** _____ Pg no. _____

Sky Limited belongs to Heavy Engineering Contractors specializing in construction of Flyovers. The company just entered into a contract with a local municipal corporation for building a flyover. No activity has started on this contract. As per the terms of the contract, Sky Limited will receive an additional ₹ 50 lakhs if the construction of the flyover were to be finished within a period of two years from the commencement of the contract. The Accountant of the entity wants to recognize this revenue since in the past the company has been able to meet similar targets very easily. Give your opinion on this treatment.

Solution

According to AS 7 'Construction Contracts', incentive payments are additional amounts payable to the contractor if specified performance standards are met or exceeded. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. Incentive payments are included in contract revenue when: (i) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and (ii) the amount of the incentive payment can be measured reliably.

In the given problem, the contract has not even begun and hence the contractor (Sky Limited) should not recognize any revenue of this contract. Therefore, the accountant's contention for recognizing ₹ 50 lakhs as revenue is not correct.

Question 4 **(ICAI Study Material)** _____ Pg no. _____

A contractor has entered into a contract with a municipal body for construction of a flyover. As per the contract terms, the contractor will receive an additional ₹ 2 Crore as incentive if the construction of the flyover were to be finished within a period of two years from the start of the contract. The contractor wants to recognize this revenue since in the past he has been able to meet similar targets very easily. Explain whether the contractor's view-point is correct?

Solution

The contractor's view is not entirely correct in considering the variation as a part of contract revenue. There is an argument that he has been able to complete similar contracts within stipulated time. However, each contract needs to be assessed in isolation with respect to the specific challenges associated with the timing and uncertainty in completion.

Accordingly, the contractor needs to validate the assumptions with respect to the specific contract. Only after that assessment is done, the incentive of ₹ 2 crore may be included within the contract revenue.

Question 5 **(RTP Nov 2019)/(RTP Nov 2022)** _____ Pg no. _____

On 1st December, 2019, "Sampath" Construction Company Limited undertook a contract to construct a building for ₹ 108 lakhs. On 31st March, 2020 the company found that it had already spent ₹ 83.99 lakhs on the construction. A prudent estimate of additional cost for completion was ₹ 36.01 lakhs. What is the provision for foreseeable loss, which must be made in the Final Accounts for year ended 31st March, 2020 based on AS 7?

Solution

Calculation of foreseeable loss for the year ended 31st March, 2020

	₹ in Lakhs
Cost incurred till 31st March, 2020	83.99
Prudent estimate of additional cost for completion	36.01
Total cost of construction	120.00

Less: Contract price	(108.00)
Foreseeable loss	12.00

According to para 35 of AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue; the expected loss should be recognized as an expense immediately. Therefore, amount of ₹ 12 lakhs is required to be provided for in the books of Sampath Construction Company for the year ended 31st March, 2020.

Question 6 *(RTP May 2022)* Pg no. _____

B Ltd. undertook a construction contract for ₹ 50 crores in April, 2019. The cost of construction was initially estimated at ₹ 35 crores. The contract is to be completed in 3 years. While executing the contract, the company estimated the cost of completion of the contract at ₹ 53 crores. Can the company provide for the expected loss in the book of account for the year ended 31st March, 2020?

Solution

As per Para 35 of AS 7 "Construction Contracts", when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Therefore, The foreseeable loss of ₹ 3 crores (₹ 53 crores less ₹ 50 crores) should be recognised as an expense immediately in the year ended 31st March, 2020. The amount of loss is determined irrespective of

- Whether or not work has commenced on the contract;
- Stage of completion of contract activity; or
- The amount of profits expected to arise on other contracts which are not treated as single construction contract.

Question 7 Pg no. _____

Five Star Construction Limited commenced a construction contract on 1st April, 2019. The Fixed Contract price agreed was ₹ 50,00,000. The company incurred ₹ 21,00,000 in 2019-20 for 40% work and received ₹ 19,00,000 as progress payment from the customer. The company estimated that a further ₹ 31,50,000 would incurred to complete it. What amount should be charged to revenue for the year 2019-20 as per AS 7?

Show the extract of Profit & Loss A/c for the year 2019- 20 in the books of the company.

Solution

	₹
Total expected loss to be provided for Contract Price -Total Cost = 50,00,000 - (21,00,000 + 31,50,000)	2,50,000
Calculation for 2019-20 on 40% work	
Contract Revenue	20,00,000
Contract Cost	21,00,000
Loss on contract	1,00,000
Expected loss recognized as per AS 7	2,50,000
Further provision required in respect of Expected Loss (₹2,50,000 - ₹1,00,000)	1,50,000

Profit & Loss A/c (Extract) for the year ended 31st March 2020

	₹		₹
To Construction costs (for 40% work)	21,00,000	By Contract Revenue	20,00,000
To Provision for loss	1,50,000	By Net Loss	2,50,000
	22,50,000		22,50,000

Question 8 _____ Pg no. _____

Shyan Limited commenced a construction contract on 01-04-2018. The company expended ₹500 crores in 2018-19 for 40% work. The total estimated cost of the project is ₹ 1,250 crores. Compute (i) Revenue, (ii) Expense, (iii) Provision for loss & (iv) Profit or loss to be recognized in the statement of Profit and Loss A/c as per AS-7 for the year ending 31-03-2019 if:

- (1) It is fixed price contract of ₹ 1,200 crores.
 (2) It is cost plus contract of 20%.

Solution

1. If it is a fixed price contract of ₹ 1,200 crores

Percentage of completion till date to total estimated cost of construction = 40%

i	Revenue (₹1,200 crores x 40%)	480
ii	Expenses	500
iii	Provision for loss (Refer Working note)	30
iv	Loss	50

2. If it is a cost-plus contract of 20%

i	Revenue (₹500 crores x 120%)	600
ii	Expenses	500
iii	Provision for loss (Refer Working note)	Nil
iv	Profit	100

Working Note: Calculation of provision for loss in case of fixed price contract

Amount of foreseeable loss	Amount (in crores)
Total cost of construction	1,250
Less: Total contract price	(1,200)
Amount of foreseeable loss	50
Loss for current year [500 - 480 (₹1,200 crores x 40%)]	(20)
Expected loss to be recognized immediately	30

According to AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

Question 9 *(Inter May 2018) (5 Marks) / (Inter May 2023) (5 Marks) (Sim.)* _____ Pg no. _____

Sarita Construction Co. obtained a contract for construction of a dam. The following details are available in records of company for the year ended 31st March, 2020:

	₹ In Lakhs
Total Contract Price	12,000
Work Certified	6,250
Work not certified	1,250
Estimated further cost to completion	8,750
Progress payment received	5,500
Progress payment to be received	1,500

Applying the provisions of Accounting Standard 7 "Accounting for Construction Contracts" you are required to compute:

- (i) Profit/Loss for the year ended 31st March, 2020.
 (ii) Contract work in progress as at end of financial year 2019-20.
 (iii) Revenue to be recognized out of the total contract value.
 (iv) Amount due from/to customers as at the year end.

Solution**(i) Profit/Loss for the year ended 31st March, 2020.**

Amount of foreseeable loss	
Total cost of construction (6,250 + 1,250 + 8,750)	16,250
Less: Total contract price	(12,000)
Total foreseeable loss to be recognised as expense	4,250

According to AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. Loss for the year ended, 31st March, 2020 amounting ₹ 4,250 will be recognized.

(ii) Contract work in progress as at end of financial year 2019-20.

Contract work-in-progress i.e. cost incurred to date are ₹ 7,500 lakhs	
Work certified	6,250
Work not certified	1,250
	7,500

(iii) Proportion of total contract value recognised as revenue

Cost incurred till 31.3.20 is 46.15% (7,500/16,250 x 100) of total costs of construction.

Proportion of total contract value recognised as revenue:

46.15% of ₹ 12,000 lakhs = ₹ 5,538 lakhs

(iv) Amount due from/to customers at year end

(Contract costs + Recognised profits - Recognised Losses) - (Progress payments received + Progress payments to be received)

= (7,500 + Nil - 4,250) - (5,500 + 1,500) ₹ in lakhs = [3,250 - 7,000] ₹ in lakhs

Amount due to customers = ₹ 3,750 lakhs

Question 10 (Inter Nov 2020) (5 Marks)

Pg no. _____

Rajendra undertook a contract ₹ 20,00,000 on an arrangement that 80% of the value of work done, as certified by the architect of the contractee should be paid immediately and that the remaining 20% be retained until the Contract was completed.

In Year 1, the amounts expended were ₹ 8,60,000, the work was certified for ₹ 8,00,000 and 80% of this was paid as agreed. It was estimated that future expenditure to complete the Contract would be ₹ 10,00,000.

In Year 2, the amounts expended were ₹ 4,75,000. Three-fourth of the work under contract was certified as done by December 31st and 80% of this was received accordingly. It was estimated that future expenditure to complete the Contract would be ₹ 4,00,000.

In Year 3, the amounts expended were ₹ 3,10,000 and on June 30th, the whole Contract was completed.

Show how Contract revenue would be recognized in the P & L A/c of Mr. Rajendra each year.

Solution

Year 1	₹
Actual expenditure	8,60,000
Future estimated expenditure	10,00,000
Total Expenditure	18,60,000

% of work completed = $\frac{8,60,000 \times 100}{18,60,000} = 46.24\%$ (rounded off)

Revenue to be recognized = 20,00,000 x 46.24% = ₹ 9,24,800

Year 2	₹
Expenditure incurred in Year 1	8,60,000
Actual expenditure in Year 2	4,75,000
Future estimated expenditure	4,00,000
	17,35,000

% of work completed = $\frac{4,75,000 + 8,60,000}{17,35,000} = 76.95\%$ (rounded off)

Revenue to be recognized (cumulative) = $20,00,000 \times 76.95\% = 15,39,000$
 Less: Revenue recognized in Year 1 = $(9,24,800)$
 Revenue to be recognized in Year 2 = $6,14,200$

Year 3

Whole contract got completed therefore total contract value less revenue recognized up to year 2 will be amount of revenue to be recognized in year 3 i.e. $20,00,000 - 15,39,000 (9,24,800 + 6,14,200) = ₹ 4,61,000$.

Note: Calendar year has been considered as accounting year.

Question 11 (Inter May 2022) (5 Marks)

Pg no. _____

Grace Ltd., a firm of contractors provided the following information in respect of a contract for the year ended on 31st March, 2022:

Particulars	(₹ in '000)
Fixed Price Contract with an escalation clause	35,000
Work Certified	17,500
Work not Certified (includes ₹ 26,25,000 for materials issued, out of which material lying unused at the end of the period is ₹ 1,40,000)	3,815
Estimated further cost to completion	17,325
Progress Payment Received	14,000
Payment to be Received	4,900
Escalation in cost is by 8% and accordingly the contract price is increased by 8%	

From the above information, you are required to:

- Compute the contract revenue to be recognized.
- Calculate Profit /Loss for the year ended 31st March, 2022 and additional provision for loss to be made, if any, for the year ended 31st March, 2022.

Solution

Calculation of total estimated cost of construction

	(₹ in '000)	(₹ in '000)
Cost of Contract incurred till date		
Work certified	17,500	
Work not certified (3,815 thousand - 140 thousand)	3,675	21,175
Add: Estimated future cost		17,325
Total estimated cost of construction		38,500
Contract Price (35,000 thousand x 1.08)		37,800

Stage of completion

Percentage of completion till date to total estimated cost of construction
 = $[\text{Cost of work completed till date} / \text{total estimated cost of the contract}] \times 100$
 = $[\text{₹ 21,175 thousand} / \text{₹ 38,500 thousand}] \times 100 = 55\%$

Revenue to be recognized for the year ended 31st March, 2022

Proportion of total contract value recognized as revenue = Contract price x percentage of completion = $₹ 37,800 \text{ thousand} \times 55\% = ₹ 20,790 \text{ thousand}$

Loss to be recognized for the year ended 31st March, 2022

Loss for the year ended 31st March, 2022 = Cost incurred till date - Revenue to be recognized for the year ended 31st March, 2022
 = $₹ 21,175 \text{ thousand} - ₹ 20,790 \text{ thousand} = ₹ 385 \text{ thousand}$

Provision for loss to be made at the end of 31st March, 2022

	(₹ in '000)	(₹ in '000)
Total estimated loss on the contract		
Total estimated cost of the contract	38,500	
Less: Total revised contract price	(37,800)	700
Less: Loss recognized for the year ended 31 st March, 2022		(385)
Provision for loss to be made at the end of 31 st March, 2022		315

Question 12 **(ICAI Study Material)** Pg no. _____

XYZ Construction Ltd., a construction company undertakes the construction of an industrial complex. It has separate proposals raised for each unit to be constructed in the industrial complex. Since each unit is subject to separate negotiation, it is able to identify the costs and revenues attributable to each unit. Should XYZ Ltd. treat construction of each unit as a separate construction contract according to AS 7?

Solution

As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- separate proposals have been submitted for each asset;
- each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- the costs and revenues of each asset can be identified.

Therefore, XYZ Ltd. is required to treat construction of each unit as a separate construction contract.

Question 13 **(Inter May 19) (5 Marks)/(RTP May 21)/(May 23)/(Nov 23)/(ICAI SM)(ii)** Pg no. _____

- AP Ltd., a construction contractor, undertakes the construction of commercial complex for Kay Ltd. AP Ltd. submitted separate proposals for each of 3 units of commercial complex. A single agreement is entered into between the two parties. The agreement lays down the value of each of the 3 units, i.e. ₹ 50 Lakh ₹ 60 Lakh and ₹ 75 Lakh respectively. Agreement also lays down the completion time for each unit. Comment, with reference to AS- 7, whether AP Ltd., should treat it as a single contract or three separate contracts.
- On 1st December, 2019, GR Construction Co. Ltd. undertook a contract to construct a building for ₹ 45 lakhs. On 31st March, 2020, the company found that it had already spent ₹ 32.50 lakhs on the construction. Additional cost of completion is estimated at ₹ 15.10 lakhs. What amount should be charged to revenue in the final accounts for the year ended 31st March, 2020 as per provisions of AS-7?

Solution

(i) As per AS 7 'Construction Contracts', when a contract covers a number of assets, the construction of each asset should be treated as a separate construction contract when:

- separate proposals have been submitted for each asset;
- each asset has been subject to separate negotiation and the contractor and customer have been able to accept or reject that part of the contract relating to each asset; and
- the costs and revenues of each asset can be identified.

AP Ltd. has submitted separate proposals for each of the 3 units of commercial complex. Also the revenue and completion time has been laid down for each unit separately which implies separate negotiation for them.

Therefore, Mr. AP Ltd. is required to treat construction of each unit as a separate construction contract as the above-mentioned conditions of AS 7 are fulfilled in the given case.

(ii)

	₹ in Lakhs
Cost of construction incurred till date	32.50
<i>Add.</i> Estimated future cost	15.10
Total estimated cost of construction	47.60

Percentage of completion till date = $(32.50/47.60) \times 100 = 68.28\%$

Proportion of total contract value recognised as revenue = Contract price x percentage of completion = ₹ 45 Lakhs x 68.28% = ₹ 30.73 Lakhs

Amount of foreseeable loss	₹ in Lakhs
Total cost of construction	47.60
<i>Less:</i> Total contract price	(45.00)
Total foreseeable loss to be recognized as expense	2.60

According to AS 7, when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognized as an expense immediately.

Question 14 *(ICAI Study Material)* Pg no. _____

It is argued that profit on construction contracts should not be recognised until the contract is completed. Please explain whether you believe that this suggestion would improve the quality of financial reporting for long-term construction contracts.

Solution

Usually, construction contracts are long term nature i.e., the contracts are entered in one accounting period, however, the work performed will flow into more than one accounting year. If the profit on construction contracts is not recognised over the construction period, then the costs incurred during the earlier years of the contract would be recognised without any corresponding revenue. This will result in losses for initial years followed high profits in future years.

The current treatment under AS 7 results in matching of revenue and associated costs as they are recognised during the same period. Also, the current accounting incorporates the prudence concept as any foreseeable losses are accounted for immediately.

Therefore, AS 7 results in a fair representation of the underlying financial substance of the transaction.