



CA INTERMEDIATE

MARATHON

Advanced Accounting

**AS 7:
Construction Contracts**

-By CA Nitin Goel



AS 7 Construction Contracts

(Accounting in financial statements of Contractor)

Meaning: Contract specifically negotiated for construction of asset or combination of interrelated assets. Include service contracts for asset construction e.g. architect & destruction or restoration contract.

Types:

- Fixed Price contract: Fixed price or rate (may be with or without escalation clause)
- Cost Plus contract: Defined costs + % of costs / Fixed fee.

Contract Revenue	Contract Costs																										
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Combining & Segmenting Construction Contract

- | | |
|---|---|
| <p style="text-align: center;"><u>Separate/Segmenting</u></p> <ul style="list-style-type: none"> * Separate Proposals * separate Negotiations * Identifiable costs & revenue | <p style="text-align: center;"><u>Combine</u></p> <ul style="list-style-type: none"> * Negotiation as single package * closely Interrelated * Performed concurrently (ie. in sequence) |
|---|---|

Recognition of Contract Revenue & Costs

Outcome of contract can be estimated reliably

Yes

Conditions:

- * Probable future benefits
- * Revenue & costs can be measured reliably

Stage of completion:

- 1) % of completion = $\frac{\text{Costs till date}}{\text{Total estimated costs}} \times 100$
- 2) Survey of work performed
- 3) Completion of Physical Proportion (e.g. Tiles)

Computation of Profit

Contract Revenue x % of completion	xx
Costs till date	(xx)
Profits till date	xx
Profits recognised till last year	(xx)
Current Year Profit	xx

NOTE: If costs till date not directly given, then it will be (work certified + work to be certified)
(By ICAI)

No

Recognise Revenue to the extent of costs of which recovery probable and

Recognise contract costs as expense in period in which incurred

Recognition of Expected losses

Para 35

When Total Contract Cost

>

Total Contract Revenue

Recognise expected loss immediately

Provision for Loss

⇒ Total Expected loss - loss already recognised

Such loss is determined irrespective:

- * Whether work commenced or not
- * Stage of completion
- * Profits expected on other contracts

Disclosure Requirements

- * Contract Revenue Recognised
- * Method to determine Revenue
- * Method to determine Stage of completion
- * Costs, Profits, Retention
- * Progress Billings (ie. Invoice Raised)
(Amount Received + To be Received)
- * Amount due from/(to) customers
(Contract costs + Profit/(Loss) - Progress Billings)

CONSTRUCTION CONTRACTS

Objective	To prescribe <u>accounting for revenue and costs associated with construction contracts</u>															
Scope	Accounting for <u>construction contracts in the financial statements of contractors</u> (not contractee)															
Meaning of construction contract	<p>It is a <u>contract specifically negotiated for</u></p> <ul style="list-style-type: none"> → <u>construction of an asset</u> Example: <u>Bridge, Building, Dam, etc.</u> → <u>Combination of assets that are closely interrelated or interdependent in terms of design, technology, function or ultimate purpose or use.</u> Example: <u>Refineries, Other complex pieces of plant or equipment etc.</u> <p>Construction contracts also <u>include:</u></p> <ul style="list-style-type: none"> (a) <u>contracts for rendering of services which are directly related to construction of the asset, for eg., those for the services of project managers & architects;</u> (b) <u>contracts for destruction or restoration of assets, and the restoration of the environment following the demolition of assets.</u> 															
Types of construction Contracts:	Fixed price contract	In this contract, the <u>contractor agrees to fixed contract price or fixed rate per unit of output. It may be with or without escalation clause</u>														
	Cost plus contract	<p>In this contract, the <u>contractor is reimbursed for the cost incurred plus percentage of these costs or fixed fee.</u></p> <table border="1" data-bbox="646 1176 1444 1294"> <tr> <td><u>Cost incurred (allowable/defined cost)</u></td> <td>XX</td> </tr> <tr> <td><u>+% of cost or fixed fee</u></td> <td>XX</td> </tr> <tr> <td></td> <td>XX</td> </tr> </table>	<u>Cost incurred (allowable/defined cost)</u>	XX	<u>+% of cost or fixed fee</u>	XX		XX								
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<u>Contract Revenue</u>	XX															

Contract cost		It means the <u>expenses incurred at site</u> along with the <u>apportioned contract cost</u>
	Direct cost	Relate <u>directly to specific contract</u> Example: Site <u>labour cost</u> , cost of <u>material used</u> , depreciation of <u>plant and equipment</u> , etc.
	Allocated cost	Attributable to <u>contract in general</u> and can be <u>allocated</u> Example: Insurance of <u>machinery</u> , salary of <u>supervisor</u> who is supervising more than 1 contract, etc.
	Specific cost	Specifically <u>chargeable to customer</u> under the <u>terms of contract</u> Example: General <u>administration cost</u> and <u>development cost</u> for which <u>reimbursement is specified</u> under contract
	Note	Direct cost may be reduced by any <u>incidental income</u> that is not included in <u>contract revenue</u> Example: Income from <u>sale of surplus material</u> and disposal of <u>plant & equipment</u> at the end of contract.
Exclusions	<ul style="list-style-type: none"> • general <u>administration & research & development costs</u> for which <u>reimbursement is not specified</u> in the contract • <u>selling costs</u> • <u>depreciation of idle plant and equipment</u> that is <u>not used</u> on a particular contract 	
Recognition of contract revenue and expenses	When to recognize	When the <u>outcome of construction contract</u> can be <u>estimated reliably</u>
	Conditions	<ul style="list-style-type: none"> ❖ <u>Total contract revenue</u> can be <u>measured reliably</u> ❖ It is <u>probable</u> that <u>economic benefits</u> associated with contract <u>will flow</u> to the enterprise ❖ <u>Contract cost</u> can be <u>clearly identified</u> and <u>measured reliably</u>.
	Basis of recognition	By reference to the <u>stage of completion</u> of the contract activity at the reporting date. Methods to determine stage of completion of contract <ol style="list-style-type: none"> 1. % completion = $\frac{\text{Costs till date}}{\text{Total Estimated Costs}} \times 100$ 2. Survey of <u>work performed</u> (Certification by surveyor) 3. Completion of a <u>physical proportion</u> of the contract work. (Example: <u>Contract to place tiles</u>)
Computation of Profit	$ \begin{array}{r} \text{Contract Revenue} \times \text{Stage of Completion (\%)} = \text{XXX} \\ \text{Less: Contract Costs till date} = (\text{XXX}) \\ \text{Total Profit till date} = \text{XXX} \\ \text{Less: Profit recognized till last year} = (\text{XXX}) \\ \text{Profit for the Current Year} = \text{XXX} \end{array} $ <p style="text-align: right;">} Till Year 2</p>	
Recognition of expected losses	Para 35 When it is <u>probable</u> that <u>Total contract cost</u> will <u>exceed</u> <u>Total contract revenue</u> , <u>Expected loss</u> should be <u>recognized as expense</u> 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
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

Costs inc. till date = 161

~~Total est cost = 825~~ AS 7

Total Estimated Profit = 95 $900 - 805 = 85$

Question 1: RTP Sep 2024

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	820
(e)	Total estimated contract	805	820 (805+15)*	820
(f)	Stage of Completion [(d/e) x 100]	20%	70%	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.

	Upto reporting date A	Recognised in the prior year B	Recognized in the current year A-B
(₹ in crore)			
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)

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

$310 - 3 = 307$

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: $98.8 \text{ crore} / 375 \text{ crore} = 26.35\%$
- Year 2: $202.4 \text{ crore} / 375 \text{ crore} = 53.97\%$
- Year 3: $(310 \text{ crore} - 3 \text{ crore}) / (375 + 7) \text{ crore} = 80.37\%$
- Year 4: $382 \text{ crore} / 382 \text{ crore} = 100\%$

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

	<u>Upto reporting date</u>	<u>Recognised in the prior year</u>	<u>Recognized in the current year</u>
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: ICAI Study Material

AB contractors 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.

Solution

Total Revenue after considering the escalation costs, claims and incentives:

Particulars	₹
Fixed Price	5.00 crore
Incentive for early completion	0.50 crore
Material costs recovery (to the extent of 20%)	0.40 crore
Labour costs recovery [1.20 crore x 25%] (Actual increase is less than 30%)	0.30 crore
Total Contract Revenue	6.20 crore
Add: Variation to the contract	1.00 crore
Add: Claims recoverable from XY	0.20 crore
Total Contract Revenue	7.40 crore

$$45\% \rightarrow 80L$$

$$25\% \rightarrow 80L \times 25\%$$

$$40\% = 40L$$

Question 5: Inter July 2021 (5 Marks) / RTP May 2024

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

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

$$\frac{45L}{80L} \times 100$$

Contract revenue and costs to be recognized

$$\text{Contract revenue (₹ 85,00,000} \times 56.25\%) = ₹ 47,81,250$$

$$\text{Contract costs} = ₹ 45,00,000$$

$$\text{Profit} = 281250$$

Question 6:

M/s Highway Constructions undertook the construction of a highway on 01.04.2019. The contract was to be completed in 2 years. The contract price was estimated at ₹ 150 crores. Up to 31.03.2020 the company incurred ₹ 120 crores on the construction. The engineers involved in the project estimated that a further ₹ 45 crores would be incurred for completing the work. What amount should be charged to revenue for the year 2019-20 as per AS 7? Show the extract of the Profit & Loss A/c in the books of M/s. Highway Constructions.

Solution

Statement showing the amount to be charged to Revenue as per AS 7

	₹ in crores
Cost of construction incurred upto 31.03.2020	120
Add: Estimated future cost	45
Total estimated cost of construction	165
Degree of completion $(120/165 \times 100)$	72.73%
Revenue recognized (72.73% of 150)	109 (approx.)
Total foreseeable loss (165 - 150)	15
Less: Loss for the current year (120 - 109)	11
Loss to be provided for	4

Profit & Loss A/c (Extract)

	₹ in crores		₹ in crores
To Construction costs	120	By Contract Price	109
To Provision for loss	4	By Net Loss	15
	124		124

Question 7: Inter May 2022 (5 Marks)

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

= [Cost of work completed till date / total estimated cost of the contract] x 100

= [₹ 21,175 thousand / ₹ 38,500 thousand] x 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 thousand x 55% = ₹ 20,790 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 thousand - ₹ 20,790 thousand = ₹ 385 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 8: Inter May 2018 (5 Marks)/ Inter May 2023 (5 Marks) (Sim.)

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 (Retentions)	1,500

✓
7,500
→ 16,250
7,000 Progress Billings

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. *Costs till date*
- (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

Total loss = 16,250 - 12,000 = 4,250
- loss already recognised 7,500 - 5,538 = (1,962)
Prov. for loss 2,288

Question 9: ICAI Study Material

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 10: RTP May 2025

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.

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, 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.

Costs plus contract

1) Costs + % of Profit : E-g: Costs + 10% Profit

	A	B
Costs	50L	60L
+ Profit @ 10%	<u>5L</u>	<u>6L</u>
	<u>55L</u>	<u>66L</u>

2) Costs + Fixed fees E-g: Costs + 5 Lakhs

	A	B
Costs	50L	60L
+ Profit (Fixed)	<u>5L</u>	<u>5L</u>
	<u>55L</u>	<u>65L</u>

3) Costs + 10% Profit
 (Costs not to exceed a particular Amount)

E.g: Costs + 10% Profit on costs
 & Costs not to exceed 58 Lakhs

	A	B *	
Actual Cost	50L	60L ✓	
Costs to be considered	50L	58L	
+ Profit 10%	5L	5.80L	
	<u>55L</u>	<u>63.80L</u>	

* Red Profit to Contractor

5.80L - 2L = 3.80L