

ED NASCO 16
CONSTRUCTION CONTRACTS

EXPLOSURE DRAFT
**NATIONAL ACCOUNTING STANDARD FOR COMMERSIAL
ORGANIZATIONS**
CONSTRUCTION CONTRACTS

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GENERAL PROVISIONS

Purpose of Standard

1. This Standard has been prepared in accordance with the Accounting Law of the Azerbaijan Republic and is based on International Accounting Standard 11 “Construction Contracts”.

Objective

2. The objective of this Standard is to describe the accounting treatment of revenue and costs associated with construction contracts. The primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed because of the nature of the activities undertaken in construction contracts. Construction contracts invariably encompass more than one accounting periods

Scope

3. This NASCO is to be applied in the financial statements of contractors.

DEFINITIONS

4. A *construction contract* is a contract 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.

A *fixed price contract* is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases may contain clauses that allow cost increases.

A *cost plus contract* is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

5. A construction contract may be negotiated for a single asset. A construction contract may also deal with the construction of a number of assets which are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use
6. Construction contracts include:
 - (a) contracts for the rendering of services which are directly related to the construction of the asset, for example, those for the services of project managers and architects; and

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- (b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.
7. Construction contracts are prepared in a number of ways which are classified as fixed price contracts and cost plus contracts. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract. In such circumstances, a contractor needs to consider all the conditions of paragraphs 22 and 23 of this Standard in order to determine when to recognise contract revenue and expenses.

COMBINING AND SEGMENTING CONSTRUCTION CONTRACTS

8. When a contract covers a number of assets, the construction of each asset is to 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.
9. A group of contracts, whether with a single customer or with several customers, will be treated as a single construction contract when:
- (a) the group of contracts is negotiated as a single package;
 - (b) the contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin; and
 - (c) the contracts are performed at the same time or in a continuous sequence.
10. A contract may provide for the construction of an additional asset at the option of the customer or may be amended to include the construction of an additional asset. The construction of the additional asset will be treated as a separate construction contract when:
- (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.

CONTRACT REVENUE

11. Contract revenue is comprised of:
- (a) the initial amount of revenue agreed in the contract; and
 - (b) variations in contract work, claims and incentive payments:
 - (i) to the extent that it is probable that they will result in revenue; and
 - (ii) they are capable of being reliably measured.

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12. Normally, contract revenue is the fair value of sums received or receivable. However the measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events and estimates often need to be revised as events occur and uncertainties are resolved. Therefore, the amount of contract revenue may increase or decrease from one period to the next.
13. A variation is an instruction by the customer for a change in the scope of the work to be performed under the contract. A variation may lead to an increase or a decrease in contract revenue. A variation is included in contract revenue when:
- (a) it is probable that the customer will approve the variation and the amount of revenue arising from the variation; and
 - (b) the amount of revenue can be reliably measured.
14. A claim is an amount that the contractor seeks to collect from the customer or another party as reimbursement for costs not included in the contract price. A claim may arise from, for example, customer caused delays, errors in specifications or design, and disputed variations in contract work. Claims are included in contract revenue only when:
- (a) negotiations have reached an advanced stage such that it is probable that the customer will accept the claim; and
 - (b) the amount that it is probable will be accepted by the customer can be measured reliably.
15. Incentive payments are additional amounts paid to the contractor if specified performance standards are met or exceeded. Incentive payments are included in contract revenue when:
- (a) the contract is sufficiently advanced that it is probable that the specified performance standards will be met or exceeded; and
 - (b) the amount of the incentive payment can be measured reliably.

CONTRACT COSTS

16. Contract costs are comprised of:
- (a) costs that relate directly to the specific contract;
 - (b) costs that are attributable to contract activity in general and can be allocated to the contract; and
 - (c) other costs that are specifically chargeable to the customer under the terms of the contract.
17. Costs that relate directly to a specific contract include:
- (a) site labour costs, including site supervision;
 - (b) costs of materials used in construction;
 - (c) depreciation of plant and equipment used on the contract;

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- (d) costs of moving plant, equipment and materials to and from the contract site;
- (e) costs of hiring plant and equipment;
- (f) costs of design and technical assistance that are directly related to the contract;
- (g) the estimated costs of rectification and guarantee work, including expected warranty costs; and
- (h) claims from third parties.

These costs are to be reduced by any incidental income that is not included in contract revenue such as income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

- 18 Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:

- (a) insurance;
- (b) costs of design and technical assistance that are not directly related to a specific contract; and
- (c) construction overheads.

Such costs are allocated using methods that are systematic and rational and are applied consistently to all costs having similar characteristics. The allocation is based on the normal level of construction activity. Construction overheads include costs such as the preparation and processing of construction personnel payroll. Costs that may be attributable to contract activity in general and can be allocated to specific contracts also include borrowing costs when the borrowings can be specifically attributed to the contract and the contractor has chosen to capitalize borrowing costs in terms of NASCO 13 – Borrowing Costs.

19. Costs that cannot be attributed to contract activity or cannot be allocated to a contract are excluded from the costs of a construction contract. Such costs include:

- (a) general administration costs for which reimbursement is not specified in the contract;
- (b) selling costs;
- (c) research and development costs for which reimbursement is not specified in the contract; and
- (d) depreciation of idle plant and equipment that is not used on a particular contract.

20. Contract costs include the costs attributable to a contract for the period from the date of securing the contract to the final completion of the contract. However, costs that relate directly to a contract and are incurred in securing the contract are also included as part of the contract costs if they can be separately identified and measured reliably and it is probable that the contract will be obtained. When costs incurred in securing a contract are recognised as an expense in the period in which they are incurred, they cannot be

included in contract costs when the contract is obtained in a subsequent period.

RECOGNITION OF CONTRACT REVENUE AND COSTS

21. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract are to be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 35 of this Standard.
22. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:
 - (a) total contract revenue can be measured reliably;
 - (b) it is probable that the economic benefits associated with the contract will flow to the entity;
 - (c) both the contract costs to complete the contract and the stage of contract completion at the balance sheet date can be measured reliably; and
 - (d) the contract costs attributable to the contract can be clearly identified and measured reliably so that actual contract costs incurred can be compared with prior estimates.
23. In the case of a cost plus contract, the outcome of a construction contract can be estimated reliably when all the following conditions are satisfied:
 - (a) it is probable that the economic benefits associated with the contract will flow to the entity; and
 - (b) the contract costs attributable to the contract can be clearly identified and measured reliably.
24. The recognition of revenue and expenses by reference to the stage of completion of a contract matches contract revenue with the contract costs incurred in reaching the stage of completion. This results in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed.
25. Under the percentage of completion method, contract revenue is recognised as revenue in the income statement in the accounting periods in which the work is performed. Contract costs are usually recognised as an expense in the income statement in the accounting periods in which the work to which they relate is performed. Any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 35 of this Standard..
26. Contract costs that relate to future activity on the contract are recognised as an asset provided it is probable that they will be recovered. Such costs

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represent an amount due from the customer and are classified as contract work in progress.

27 When an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognised in the income statement, 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.

28 An entity is generally able to make reliable estimates after it has agreed to a contract which establishes:

- (a) each party's enforceable rights regarding the asset to be constructed;
- (b) the consideration to be exchanged; and
- (c) the manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity reviews and, when necessary, revises the estimates of contract revenue and contract costs as the contract progresses. The need for such revisions does not necessarily indicate that the outcome of the contract cannot be estimated reliably.

29 The stage of completion of a contract may be determined in a variety of ways. The entity uses the method that measures reliably the work performed. Depending on the nature of the contract, the methods may include:

- (a) the proportion that contract costs incurred for work performed to date bear to the estimated total contract costs;
- (b) surveys of work performed; or
- (c) completion of a physical proportion of the contract work.

Progress payments and advances received from customers often do not reflect the work performed and cannot be a basis for determining the stage of completion.

30 When the stage of completion is determined by reference to the contract costs incurred to date, only those contract costs that reflect work performed are included in costs incurred to date. Examples of contract costs which are excluded are:

- (a) contract costs that relate to future activity on the contract, and
- (b) payments made to subcontractors in advance of work performed under the subcontract.

31 When the outcome of a construction contract cannot be estimated reliably:

- (a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and
- (b) contract costs shall be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 35 of this Standard.

- 32 During the early stages of a contract it is often the case that the outcome of the contract cannot be estimated reliably. Nevertheless, it may be probable that the entity will recover the contract costs incurred. Therefore, contract revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no profit is recognised. However, if it is probable that total contract costs will exceed total contract revenues, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36 of this Standard.
- 33 Contract costs that are not probable of being recovered are recognised as an expense immediately. Examples of circumstances in which the recoverability of contract costs incurred may not be probable and in which contract costs may need to be recognised as an expense immediately include contracts:
- (a) that are not fully enforceable,
 - (b) where completion is subject to the outcome of pending litigation or legislation;
 - (c) relating to properties that are likely to be condemned or expropriated;
 - (d) where the customer is unable to meet its obligations; or
 - (e) where the contractor is unable to complete the contract or otherwise meet its obligations under the contract.
- 34 When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract shall be recognised in accordance with paragraph 21 and not paragraph 31 of this Standard.

Recognition of Expected Losses

- 35 When it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.
- 36 The amount of such a loss is determined irrespective of:
- (a) whether work has commenced on the contract;
 - (b) the stage of completion of contract activity; or
 - (c) the amount of profits expected to arise on other contracts

Changes in Estimates

37. The percentage of completion method is applied on a cumulative basis in each accounting period to the current estimates of contract revenue and contract costs. Therefore, the effect of a change in the estimate of contract revenue or contract costs, or the effect of a change in the estimate of the outcome of a contract, is accounted for as a change in accounting estimate in accordance with NASCO 11 – Accounting Policies, Changes in Accounting Estimates and Errors.

DISCLOSURE

- 38 An enterprise will disclose:
- (a) the amount of contract revenue recognised as revenue in the period;
 - (b) the methods used to determine the contract revenue recognised in the period; and
 - (c) the methods used to determine the stage of completion of contracts in progress.
- 39 An enterprise will disclose each of the following for contracts in progress at the balance sheet date:
- (a) the aggregate amount of costs incurred and recognised profits (less recognised losses) to date;
 - (b) the amount of advances received; and
 - (c) the amount of retentions.
- 40 Retentions are amounts of progress billings that are not paid until the satisfaction of conditions specified in the contract for the payment of such amounts or until defects have been rectified. Progress billings are amounts billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.
- 41 An enterprise will include in the balance sheet:
- (a) the gross amount due from customers for contract work as an asset; and
 - (b) the gross amount due to customers for contract work as a liability.
- 42 The gross amount due from customers for contract work is the net amount of:
- (a) costs incurred plus recognised profits; less
 - (b) the sum of recognised losses and progress billings for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.
- 43 The gross amount due to customers for contract work is the net amount of:
- (a) costs incurred plus recognised profits; less
 - (b) the sum of recognised losses and progress billings for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).
- 44 An enterprise will disclose any contingent liabilities and contingent assets in accordance with NASCO 10 - Provisions, Contingent Liabilities and Contingent Assets.

EFFECTIVE DATE

45. The effective date of this standard is determined by appropriate order of Ministry of Finance of the Republic of Azerbaijan.