



HM TREASURY

Financial Reporting Advisory Board Paper

IAS 11: Construction Contracts

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| Issue: | Applying IAS 11 <i>Construction Contracts</i> in the context of resource accounts covered by the Government Financial Reporting Manual |
| Impact on guidance: | The proposed text in Annex A relates to the IFRS-based FReM. |
| IAS/IFRS adaptation? | No |
| IPSAS compliant? | Yes |
| Interpretation for the public sector context? | No |
| Impact on budgetary regime? | No |
| Alignment with National Accounts | No |
| Impact on Estimates? | No |
| Recommendation: | That the Board agree that IAS 11 applies in full to entities covered by the IFRS-based FReM |
| Timing: | Not yet known: depends on future decision on date for moving to EU-adopted IFRS. |

DETAIL

Background

1. IAS 11 *Construction Contracts* was issued so as to be effective for all periods beginning on or after 1 January 1995. It was subject to minor revision in May 1999 to incorporate changes stemming from the revision of IAS 10 *Events After the Balance Sheets Date*.

Objective of IAS 11

2. The objective of the standard is to prescribe the accounting treatment of revenue and costs associated with constructions contracts as such contracts tend to have start and finish dates that fall in different accounting periods.

Main features of IAS 11

3. The main features of IAS 11 are:

- a. Contract revenues comprise the initial amount of revenue agreed in the contract, variations in contract work and claims and incentives to the extent that it is probable that they will result in revenue and are capable of being reliably measured.
- b. Contract costs comprise those costs that relate directly to the specific contract, costs that are attributable to the contract activity and can be allocated to the contract and such other costs as are specifically chargeable to the customer under the terms of the contract.
- c. When the outcome of the construction contract can be estimated reliably contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expense 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.
- d. When the outcome of a construction contract cannot be estimated reliably revenue shall be recognised only to the extent of the contract costs incurred that it is probable will be recoverable. Contract costs shall be recognised as an expense in the period in which they are incurred.

Comparison with requirements of UK GAAP

4. IAS 11 does not cover the accounting treatment of long-term service contracts whereas SSAP 9 *Stocks and Long-term Contracts* does cover such contracts. IAS 18 *Revenue* deals with the accounting treatment of long-term service contracts. IAS 18 will be the subject of a separate FRAB paper.

Impact of IAS 11 on public sector accounts

5. The accounting treatment of construction contracts under IAS 11 is virtually the same as that under SSAP 9 (augmented by Application Note G of FRS 5 *Substance of Transactions*). As such the application of IAS 11 will not result in any change in the method of accounting for such contracts in the public sector.

6. There is a minor consequently change in the application of the modified historical cost accounting convention to construction costs. Under SSAP 9 work in progress balances are recognised as stocks. The existing FReM 2.1.5 *Accounting Conventions* requires that stocks are held at current values. Under IAS 11 no work in progress is recognised, IAS 11 instead recognises the gross amount owed to or from the customer in the appropriate asset or liability category. Within the existing FReM there is no requirement to hold such balances at current value.

Impact on disclosures in resource and other accounts

7. The balance sheet presentation requirements of IAS 11 differ to those of SSAP 9. IAS 11 requires those items which have yet to pass through the operating statement to be shown in the balance sheet as:

- Advances, amounts received in excess of that billed.
- Due from customers, the aggregate of all contracts where amounts are owed by customers (excluding advances).
- Due to customers, the aggregate of all contracts where amounts are owed to customers (excluding advances).

Whereas SSAP 9 requires that the following items are shown in the balance sheet:

- Debtors, amounts included in turnover but not billed.
- Creditors, payments on account in excess of turnover less WIP.
- WIP, the amount by which costs incurred exceeds those taken to cost of sales and not off set against creditors.
- Provisions for foreseeable losses.

IAS/IFRS compliance

8. The proposal in this paper is that IAS 11 is applied in full to the public sector.

IPSAS compliance

9. IAS 11 is compliant with IPSAS 11, *Construction Contracts*.

Proposed text for the IFRS-based Government Financial Reporting Manual

10. See Annex A for the proposed amendments to the IFRS-based FReM.

Impact on the budgetary regime

11. The adoption of IAS 11 will not impact on the budgetary treatment of construction contracts.

Alignment with National Accounts

12. In the UK the National Accounts are prepared following the European System of Accounts (ESA 95) format. For construction costs work in progress AN.12 *Inventories* details the stock (balance sheet) treatment, while P1 *Output* and P.52 *Changes in Inventories* details the flow (OCS) treatment.

13. The balance sheet treatment of construction costs in IAS 11 differ to those in the National Accounts. In the National Accounts unfinished output on such contracts is recorded in inventories of the producer. As detailed above IAS 11 requires that the balance sheet recognises a debtor or

creditor (i.e. there is no WIP recognised as stock) in respect of the amount owed by the customer or owed to the customer taking account of the stage of completeness and payments received (excluding those received in advance which are separately recognised as a liability).

Impact on Estimates

The adoption of IAS 11 will have no impact on the current Estimate treatment of construction costs.

Summary and recommendation

14. IAS 11 does not change the accounting treatment of construction contracts in the public sector. The Board is invited to approve the proposed text for the IFRS-based FReM at Annex A.

Financial Reporting Policy Team
21 September 2006

PROPOSED TEXT FOR THE IFRS-BASED GOVERNMENT FINANCIAL REPORTING MANUAL

IAS 11 Construction Contracts

Applicability

IAS 11 applies in full.

Objectives of IAS 11

The objectives of IAS 11 are to specify that

- a) income and expenses relating to construction contracts are reported in the operating cost statement reflecting the stage of completion of the contract.

Expected losses on long-term contract should be immediately recognised as an expense.