# AS 7 Construction Contract

AS 7 Construction Contract describes and lays out the accounting treatment in respect of the revenue and costs in relation to a construction contract. AS 7 Construction Contract is to be used in for the accounting of construction contracts in the financial statements of the contractors.

**1. Types of Contracts**

A Construction Contract is any contract which is entered into specifically for construction of an asset or a combination of assets that are closely inter-linked or inter-dependent w.r.t. their technology/design/function or the nature of their ultimate purpose or use.

***A. Fixed Price Contract:-***

A contract in which the contractor agrees to a fixed contract price. In some cases, there may be an element of cost escalation clause in the contract which is mutually agreed to between the parties.

For example, the parties agree to include a clause in the contract for adjusting the Contract price on the basis of an increase in the cost of raw materials.

***B. Cost-plus Contract***

A contract in which the contractor is reimbursed for costs incurred or agreed costs, plus a percentage of these costs of a fixed fee.

**2. Combining and Segmenting of Construction Contracts:-**

**I. Combining of Construction contracts** – A group of contracts, either with one or more customers, shall be considered as a single construction contract when all the contracts are negotiated as a single package, are inter-linked and form part of a single project and are performed in a continuous sequence. For example, a contract for construction of three similar buildings (similar in all aspects) on a single plot negotiated all at once.

**II. Segmenting of Construction contracts –** Where a contract includes more than one asset, the construction of each asset should be treated as a separate construction contract when separate proposals have been given for each asset, each asset has been separately negotiated and the costs and revenues of each asset can be identified separately.

For example, a contract for construction of three different buildings on the same plot with different specifications and each building is separately negotiated with the contractor.

**3. Revenue from a Contract:-**

The revenue from a contract includes the following to the extent it is probable of generating revenue and is measurable:

i. The initial amount of revenue agreed in the contract;

ii. Claims and incentives on account of variations in contract work;

**4. Costs of a Contract:-**

The cost of a contract includes the following:

i. Directly related costs that to the specific contract

ii. Costs which are generally attributable and allocated to the contract activities

iii. Other costs which are specifically chargeable to the customer under the terms of the contract

**5. Recognition of Revenue and Cost from a Contract:-**

Where the result or outcome of any contract for construction can be projected, the related contract revenue and contract costs shall be recognized by taking into account the stage of completion of such contract. Expected losses shall be recognized immediately as expenses.

I. In case of a fixed price contract, the outcome can be estimated in a reliable manner when all the following conditions are satisfied:

i. The entire revenue from a contract can be reliably measured

ii. It is apparent that the economic benefits of such contract will flow to the organization

iii. Both contract costs and stage of completion can be measured

iv. Contract costs can be clearly identified for a comparison between actual costs and prior estimates

II. In case of a cost-plus contract, the outcome can be estimated in a reliable manner when all the following conditions are satisfied:

i. It is probable that economic benefits of the contract will flow to the organization

ii. Contract costs attributable to the contract can be identified and measured clearly

III. Percentage of completion method – This method defines the recognition of revenue and cost taking into account the stage of completion of a contract. Under this method, revenue and cost are recognized in the statement of profit and loss in the accounting periods in which the work is performed.

IV. Contract work-in-progress – A contractor may incur costs that relate to future activity in a contract. Such costs are recognized as an asset if it is probable that they will be recovered.

**6. Determination of the stage of completion**

The stage of completion of a contract may be determined in different ways. Depending on the nature of the contract, the methods may include:

I. The proportion of contract cost incurred w.r.t. the total estimated cost of contract; (for example: if the total cost of the contract is Rs. 30 lakhs and the cost incurred till date is Rs. 15 lakhs, the stage of completion is regarded as 50% complete i.e. 15 lakhs / 30 lakhs)

II. Surveys of work performed; (for example: in a contract for construction of a bridge, the site inspector can do a survey and with regards to the technicalities of the project, inform how much work has been completed)

III. Completion of a physical proportion of contract work (for example: in a contract for construction of a five storey building, if three stories are complete, the stage of completion for the same is regarded as 60% i.e. 3 stories/5 stories)

When the outcome of a construction contract cannot be estimated, the revenue and cost should be recognized only to the extent of contract costs incurred whose recovery is probable.