

**Statement of
Financial Accounting Standards
No. 11**

20 July 1987

Translated by

Chi-Chun Liu, Professor

(National Taiwan University)

Financial Accounting Standards Committee

Statement of Financial Accounting Standards No. 11

Construction Contracts

I Introduction

- (1) This Statement establishes the accounting standards for long-term construction contracts. This Statement also applies to long-term service contracts directly related to long-term construction.
- (2) Long-term construction contracts in this Statement are construction events, extending over a period of more than one year, such as construction contracts of buildings, bridges, dams, ships and dredging of waterways.

II Explanation

- (3) If the construction period for a long-term contract is more than one year then accounting for the contract revenue and its associated cost allocation poses special problems.
- (4) Two types of pricing for long-term construction contracts are commonly used:
 - (a) *Fixed-price contract*: the contract price is either fixed or adjustable by specific predetermined factors such as a price index.
 - (b) *Cost-plus contract*: the contract price includes actual costs and a predetermined percentage or fixed profits.

- (5) Two different methods of accounting treatments for long-term construction contracts are recognized:
- (a) *Completed-contract method*: construction profit is recognized only when the contract is completed or substantially completed except for some miscellaneous jobs.
 - (b) *Percentage-of-completion method*: construction profit is recognized in each period based upon the percentage of completion.
- (6) The following methods are commonly used to measure the percentage of completion:
- (a) *Construction-cost-percentage method*: the degree of completion is measured by the ratio of costs already incurred to the estimate of the total costs to complete the project.
 - (b) *Construction-time-percentage method*: the degree of completion is measured by the ratio of hours worked (or labor dollars) to date to the total estimated hours (or total labor dollars) to complete the project.
 - (c) *Units-of-work-performed method*: this method uses the ratio of the output achieved to date to the total expected output of the contract. For example, the completed mileage is used to measure the percentage of completion of a road construction project.
- (7) The advantage of the completed-contract method is that construction profit (or loss) is objective and definite, and according to the principal of conservatism profit is not recognized until completion of the contract. Its disadvantage is that it will not reflect the performance for the period under construction since recognized profits and the measure towards completion are not matched.
- (8) The advantage of the percentage-of-completion method is that the amount of profit to be recognized in each period during construction is matched with the progress toward completion. Its disadvantages

are that profits for each period and the measure of progress toward completion are subjective estimates.

III Accounting standards

Choice of accounting method

- (9) The percentage-of-completion method is required when estimates of construction profits are reasonably dependable.

Under a fixed-price contract, reasonably dependable estimates of construction profit occur when the following conditions are met:

- (a) dependable estimates can be made as to total accounts receivable;
- (b) estimates for contract costs to be invested to complete the contract and the degree of its completion at the end of the period are reasonably dependable; and
- (c) costs belonging to the contract can be reasonably identified.

Under the cost-plus contract, reasonably dependable estimates of construction profit occur when the following conditions are met:

- (a) costs associated with the contract can be reasonably identified; and
- (b) contract costs other than those clearly allowable costs for reimbursement can be estimated reasonably.

Contract costs

- (10) The following costs incurred for long-term construction contracts should be included in construction costs:

- (a) costs directly associated with the contract such as direct materials, direct labor, and costs of contracts incidental to the main contract; and
 - (b) costs both indirectly associated with and allocable to the contract (eg, indirect labor, insurance, and indirect construction expenses).
- (11) Corporate selling and administrative expenses are not allocated to construction contracts. However, if the completed-contract method is adopted, and the costs can be identified definitely with a specific contract, selling and administrative expenses may be accounted for as contract costs.
- (12) Costs incurred before contract signing should be expensed in that period. However, if such costs are associated with a specific contract, and the contract is to be definitely signed, then they may be deferred and treated as construction costs of that contract.
- (13) Construction costs should be charged to the *Construction-in-progress* account or other appropriate asset account as incurred.

Recognition of construction income

- (14) Under the completed-contract method, construction profit is recognized only when the contract is completed or substantially completed except for some miscellaneous jobs.
- (15) Under the percentage-of-completion method, contract profit for the current period is the difference between the cumulative profit based on the percentage of completion at the end of the current period and the cumulative profit recognized in prior periods. However, if the cumulative profit recognized in prior periods is greater than the cumulative profit calculated based on the percentage of completion at the end of the current period, the excess should be recorded as a loss in the current period.
- (16) If a contract is estimated to bear a loss prior to completion, the full

amount of the loss should be recognized immediately whether the completed-contract or percentage-of-completion method is adopted. However, if the loss is estimated to be smaller in future years, the difference should be reversed and recognized as a gain in that year.

- (17) Damages or fines arising from delays or other causes should be accrued in full in that year.
- (18) When there are changes in construction contract prices or estimates of total construction costs, such changes should be treated as changes in accounting estimates.

Disclosure in financial statements

- (19) The following items should be reported on the balance sheet:
- (a) the balance of *Construction-in-progress*;
 - (b) the balance of *Billings on construction-in-progress*; and
 - (c) the balance of *Accounts receivable*.

When the balance of the *Construction-in-progress* account exceeds the balance of *Billings on construction-in-progress*, then the *Billings on construction-in-progress* account should be subtracted from the *Construction-in-progress* account and the balance should be reported as a current asset. When the balance in the *Billings on construction-in-progress* account exceeds the balance in the *Construction-in-progress* account, then the *Construction-in-progress* account, when subtracted from the *Billings on construction-in-progress* account, should be reported as a current liability.

- (20) When a company has undertaken a number of projects, and the balance in the *Construction-in-progress* account exceeds the balance in the *Billings on construction-in-progress* account on some contracts and the balance in the *Billings on construction-in-progress* exceeds the balance in the *Construction-in-progress* account on others, then the contracts should be segregated except when separate contracts are

parts of the same project.

- (21) The accounting method for long-term construction contracts should be disclosed in the footnotes to the financial statements. If the completed-contract method and the percentage-of-completion methods are adopted in different contracts, then the balance in the *Construction-in-progress* account under each method should be disclosed separately. For important contracts, the contract price, estimate of total costs, percentage of completion, expected year of the completion, and the accumulated profit and loss recognized should also be disclosed.

IV Notes

- (22) This Statement was issued on July 20, 1987 and should be effective for financial statements with fiscal years ending on or after December 31, 1987.

The provisions of this Statement need not be applied to immaterial items.