Construction contracts expenses and revenues reporting

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Abstract. According to the Conceptual Framework of the International Accounting Standards, expenses are recognized when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen that can be measured reliably. Under the matching principle between revenue and expenses, the latter are recognized based on the direct relation between the actually paid expenses and the earned revenue during the reporting period. In this context, expenses forming the value of finished goods are recognized when the revenue received from the sale of such goods is earned. In cases when the economic benefits are expected to be acquired during several reporting periods, expenses should be deferred and recognized during different reporting periods within which the acquisition of economic benefits is converted to cash. To defer them, a certain allocation base which is an item of the accounting policy followed by the entity should be applied. The key issue in the accounting of expenses and revenues under construction contracts is related to the allocation of the contract revenues and expenses between the reporting periods during which such works have been executed. Accounting standards outline the criteria for when to recognize expenses and revenue so that to identify the correct time when they should be recognized in the financial statements of the entity carrying out the works. The main concept underlying the accounting standards is that contract revenues and expenses associated with a construction contract are to be recognized as revenues and expenses by reference to the stage of completion of the contract activity at the end of the reporting period. Construction contracts applied in practice are classified as fixed-price contracts and cost-plus contracts. 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 is subject to cost escalation clauses. 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.

1. Introduction
Organizing financial reporting in each civil engineering company is of major significance for its optimal management and governance. Financial reporting is usually understood as a purposeful arrangement and improvement of reporting process methods and techniques, as well as collecting, processing, summarizing, and analyzing information about the facts, processes, and relationships in the business of an entity that is necessary for its management.

2. Features of construction industry and its impact on the reporting of revenues and expenses of construction entities
A major characteristic of a constructed product is its immobility. On the other side, the production process is mobile. Workers and machinery move from one place to another within the construction site depending on the performance of individual types of work.
Constructed production may be characterized as individual and small-scale. Each new project is executed in different conditions compared to the previous one. The organization of production, and hence the scale and structure of production costs are influenced by many factors that must be considered when constructing a project – soil category, seasons, sources of raw materials supply, etc.

There are also many other features characteristic to a constructed products: relatively long production cycle; the significant size of each physical unit of output; a large number of types of works and abrupt change of the structure of works on the same site; numerous relations of the construction entity with natural and legal entities (contracting authorities, suppliers, designers, subcontractors, etc.); production processes are running mainly outdoor, etc.

In entities engaged in construction activity, movable fixed assets prevail – various types of construction machinery and transportation vehicles. Their relocation from one construction site to another is related to the costs of their transportation, installation, and dismantling.

A significant part of the materials (such as concrete, sand, gravel, bricks, etc.) is very often supplied directly to the construction site. This requires accurate recording of all delivery costs and precise reporting of their use. Also, specific assets such as timber for formwork, wooden and metal formwork panels, and metal scaffolding are used on the sites. What is common for them is that they are used repeatedly on one and sometimes on several sites, which requires to adopt a certain allocation base to distribute their value when referring them as an expense. Another part of the materials (e.g. fittings, joinery, solutions, etc.) can be further processed and produced by the ancillary activities of the entity. The costs of this activity are complex and since they are subject to allocation to respective construction sites they also need the adoption of a special allocation base.

Prior to commencing the main construction project, various temporary buildings and facilities (such as warehouses, sheds, water pipes, power networks) are to be constructed, i.e. to incur costs for temporary construction. These costs and constructed temporary buildings and facilities are specific objects of reporting in the construction entities. [1]

These and other features have a significant impact on the organization of reporting production costs and calculating the cost of production. In this regard, an important role plays the selection of cost objects and account reporting objects. The cost object is understood as production having a certain consumer value and various degrees of completion, the prime cost of which is determined to measure the expenses incurred for its production. Depending on the characteristics of the technological process and the form of business relationship with contracting authorities, respectively with the main contractor, cost objects in construction entities are: all items of the works performed on a project (sub-project), a certain portion of it (stage, structural element) or individual types of work. Or, to put it otherwise, a separate project is any individual construction with a different location. A stage is part of the project having a stand-alone significance and may be put into operation before completing the entire project. A subproject is an integral part of the project having a separate functional purpose. Basic types of construction and building work – a quantity of a certain type of work that after completion creates conditions for another type of construction works.

3. Features of expense reporting
The organization of cost reporting in a construction entity is closely related to the methodology of calculating the value of constructed production. When the reporting objects coincide with the cost objects or part thereof, the most accurate determination of their prime cost is provided. In this case, the conditionality in the allocation of costs drops out. In addition, verifying performance results when handing over the works according to their place of execution, as well as identifying the specific factors influencing the dynamics and the level of costs becomes easier.

Accordingly, the object of reporting of construction expenses is part of the production process (stages, structural elements, and types of works), within which costs are grouped as per the requirements of calculation. When the reporting objects coincide with the cost objects or part thereof, the most accurate determination of their prime cost is provided. In this case, the conditionality in the allocation of costs drops out. In addition, verifying performance results when handing over the works according to
their place of execution, as well as identifying the specific factors influencing the dynamics and the level of costs become easier. [2]

In civil engineering, although production has a pronounced individual nature, matching reporting objects to cost objects can be only relative. Moreover, if several production units are involved in a certain project, the reporting is also made by contractors, i.e. in this case cost objects are more consolidated than the reporting objects. However, after summarizing the cost estimates per individual units, reporting objects match the cost objects.

The entity’s operating expenses are reported with Account 611 – Operating Expenses. For construction entities, it may be titled Civil Engineering Expenses or General Construction Works Expenses. Detailed accounts by individual projects (contracts) and by calculation items are added to it. Individual project expenses have been grouped by the following main items of calculation – raw materials, salaries and wages, social security contributions, hired services, construction machinery operating costs, etc. The Item of Raw Materials includes also: costs of reusable materials (metal scaffolding). These materials are used repeatedly in construction production. This implies that their value is included in the costs of producing parts, usually depending on their actual use. Therefore, the construction entity should determine wear rates per single-use.

The Item of Salaries and Wages reports the basic salary determined by quotas and rates as per the implemented payment system – to employees engaged to perform the construction works. These include agreed additional labor remuneration, out-employment remunerations, remuneration of persons engaged under management, and control agreements. For civil engineering, an object of reporting through this account are the costs for basic salaries under the applied payment systems: piece-rate pay, piece-rate bonus pay, standard wage rates, etc.

The Item of Social Security Contribution includes state social security contributions, health insurance contributions, supplementary mandatory social security contributions that are paid by the employer. In addition, the following are reported through the account: social security contributions on special grounds (benefits, seniority bonuses, allowances and staff benefits). Contributions to the Unemployment Fund are also reported there.

Hired Services Expenses – this item reports expenses for third parties’ services, excluding services for acquiring fixed assets and current tangible assets. These are expenses related to the entity's business such as repair of own and leased fixed assets, rents, transportation services, insurances, postal services, advertising and ads, business expenses. Expenses for courier services, subscription fees, notarial and other similar fees, security, commissions, training and qualification, and other expenses can also be included in the Item of Hired Services.

The Item of Construction Machinery Operating Costs includes all costs associated with the maintenance and operation of construction materials: loading and unloading, transportation to sites, installation and dismantling of facilities, temporary storage buildings, costs for electricity, fuels, lubricants, water, air, auxiliary materials, salaries of service personnel, depreciation and rental of machinery, maintenance and repair costs.

The Item of Other Expenses should be reflected in the following types of expenses: mission expenses in the country and abroad; exhibitions and fairs expenses; VAT paid on supplies not entitled to tax credit; scholarships for students; penalties and other financial payments subject to business contracts of the entity; fines and sanctions for violated regulatory acts; lack of assets reported at the expense of the entity; expenses for the conservation of assets upon their temporary decommissioning; and others. [3]

The main concept underlying the Accounting Standard 11 [4] and the International Accounting Standard 11 (Construction Contracts) [5] is that where the outcome of the construction contract can be estimated reliably, contract revenues and expenses associated with a construction contract are to be recognized as revenues and expenses by reference to the stage of completion of the contracting activity at the end of the reporting period. Construction contracts applied in practice are classified as fixed-price contracts and cost-plus contracts.

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 is subject to cost escalation clauses.
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.

In the case of a fixed-price contract, the outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:

1. Total contract revenue can be measured reliably;
2. It is probable that the economic benefits associated with the contract will flow to the entity;
3. Both the contract costs to complete the contract and the stage of contract completion at the end of the reporting period can be measured reliably;
4. 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.

In the case of a cost-plus contract, the outcome of a construction contract can be estimated reliably when all of the following conditions are satisfied:

1. It is probable that the economic benefits associated with the contract will flow to the entity;
2. The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

The stage of completion may be measured in many ways. The entity may use methods ensuring a reliable measurement of the extent of work that has been completed, such as:

1. The ratio of contract costs incurred to date to the total estimated contract costs;
2. Conducting a survey of work performed;
3. Physical units of work completed under the contract.

Under the meaning of the accounting standards, if the outcome of a construction contract cannot be estimated reliably, contract revenue should be recognized only to the extent that contract costs incurred are expected to be recoverable and contract costs should be expensed as incurred for the period they have been made.

4. Features of revenue reporting

Revenue of completed and handed over for use construction projects completed in full and to a certain degree of completion, as per the contract.

It should be noted that in practice there has been adopted a conditional division of revenues from:

- Finished construction product – where the projected has been constructed by the construction entity with own or borrowed funds, including advance payments from prospective buyers under preliminary contracts for subsequent sale as a finished construction product in a certain stage of completion.
- Construction services – when sites, improvements, repairs, restoration works are performed at the request of an investor or a contracting authority and are financed by him.

Account 701 Cash Inflows from Primary Activity, detailed account 1 – Revenues from Construction Activity is used for finished construction product revenues, as in addition to it, detailed accounts for individual construction sites have been kept.

Account 703 Service Sale Revenues is used for the revenues of other construction services and sales. Where a construction entity has revenues from other types of services, four-digit accounts for services such as design, ancillary activity, transport, etc. are kept to the account.

For account reporting, allocating and reporting revenues as such derived from finished construction products and from construction services is conditional. It is possible for the construction entity to report all revenues by account 701, and when there is more than one primary activity – to use four-digit accounts, one of them being for finished and delivered projects and completed construction and installation works.

Writing-off the book value of finished projects and completed construction and installation works is carried out in compliance with the revenues and expenses matching principle.

A construction entity may realize construction activity revenues in the following cases:
• Constructing on-site temporary buildings and facilities for the needs of the investor. They are reported and paid as per the adopted manner of reporting and payment of general construction works;
• Constructing on-site temporary buildings and facilities for own needs with funds provided by a contract for temporary construction. Funds obtained thereof are reported as fixed assets financing or running costs, and financing revenue is formed up to the amount of the fixed assets depreciation and the running costs incurred;
• The revenues from the respective projects are increased by the penalties received by the investor under the contract;
• The project price, respectively the value of the completed construction and installation works is reduced with the final deductions made;
• Other revenues have been formed as per the provisions of the contract or under an additional agreement, for early commissioning of the project, high quality, etc.

5. Disclosure in financial reports
The appendix to the annual financial statements should disclose information on:
   a) The amount of contract revenue during the reporting period;
   b) The methods used to determine contract revenues recognized during the reporting period;
   c) The methods used to determine the stage of completion of contracts in progress;
   d) Contracts being in progress at the end of the reporting period, where the entity should disclose:
      a) the sum of expenses incurred and revenues recognized at the end of the year; b) the sum of advance payments received; c) the sum of deductions made under the contracts; d) the amount of the receivables from customers for the work completed under the contract; e) the provision accrued.

6. Conclusion
In the conditions of increasing competition between economic subjects, the prime cost of constructed production becomes a key factor for construction organizations to achieve market success. To be properly accounted and included in the cost of a particular construction project or service, the costs incurred should be properly classified. When at the time expenses are incurred, they cannot be attributed immediately (directly) to the prime cost of a specific construction project or service, the latter should be allocated among individual items of calculation on a certain basis, which is an element of the accounting policy of the entity.

Through the application of the Calculation Method each specific construction project receives a value assessment. To achieve such an assessment, the expenses incurred in the entity are to be covered and classified, as well as certain calculations for their allocation between individual construction projects are to be made. Thus, these calculations are facilitated, and the more accurate and detailed the expenses reported in the accounts are, the more accurate the assessments become.

References
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