28

INVENTORIES

CONSTRUCTION AND SERVICE CONTRACTS

FINANCIAL REPORTING EXPOSURE DRAFT

ACCOUNTING STANDARDS BOARD

For the convenience of respondents in compiling their responses, the text of the questions in the Preface on which particular comments are invited (pages 7 and 8) can be downloaded (in Word format) from the 'Inventories & Construction and Service Contracts' pages in the Current Projects section of the ASB Website (www.asb.org.uk).

For ease of handling, we prefer comments to be sent (in Word format) by email to:

fred28@asb.org.uk

Comments may also be sent in hard copy form to:

The Technical Director
ACCOUNTING STANDARDS BOARD
Holborn Hall
100 Gray's Inn Road
London
WC1X 8AL

Comments should be despatched so as to be received no later than 16 September 2002. All replies will be regarded as on the public record and may be copied to the IASB and other standard-setters, unless confidentiality is requested by the commentator.

28

FINANCIAL REPORTING

EXPOSURE DRAFT

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STANDARDS
BOARD

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CONTENTS

PREFACE

1 This Financial Reporting Exposure Draft (FRED) is issued as part of the Accounting Standards Board's programme to bring about convergence between UK accounting standards and International Financial Reporting Standards ('IFRSs'*). It sets out for comment two proposed UK accounting standards, based on proposed and existing IFRSs. They address respectively accounting for inventories and accounting for construction contracts and other contracts for services. The ASB proposes to issue UK standards based on these draft standards, which will replace SSAP 9 'Stocks and long-term contracts'.

2 The International Accounting Standards Board (IASB) has recently published for comment a proposed revision of IAS 2 'Inventories'. The main changes to the present IAS 2 proposed by the IASB are summarised on page 23. The draft standard on inventories included in this exposure draft is based on the proposed revised text. The differences that the ASB proposes for the UK are summarised in paragraph 9 of this preface and are highlighted in the text. The ASB proposes to issue final standards based on this FRED at the same time as the IASB issues its final revised standard IAS 2, probably in the first quarter of 2003.

3 SSAP 9 deals with accounting for long-term contracts as well as accounting for inventories. It is therefore appropriate to incorporate a standard consistent with IAS 11 'Construction Contracts' into UK standards, at the same time as a new standard corresponding to IAS 2. The draft standard on

* *The IASB intends to designate its future standards as International Financial Reporting Standards, or IFRSs. Standards issued prior to 2002 are identified as International Accounting Standards, or IASs. In this Preface, the term IFRS is used to refer to both IFRSs and IASs.*

construction and service contracts is based on the text of IAS 11. The IASB is not proposing any revision of the text of IAS 11 at this time and has no plans to do so in the near future.

4 Although the main application of the requirements of SSAP 9 relating to long-term contracts has been in relation to construction contracts, they have also been applied to other long-term contracts, especially contracts for services. Accounting for such contracts is addressed in IAS 18 'Revenue'. As the ASB and other standard-setters are currently working on the subject of revenue recognition, the ASB does not propose UK adoption of the full text of IAS 18 at this time. However, in order to ensure that accounting for long-term service contracts continues to be addressed in UK standards, text based on the relevant part of IAS 18 has been incorporated into the draft standard on construction and service contracts.

5 IAS 18 contains principles of accounting for service contracts, which are consistent with those of IAS 11. It also states that the more detailed requirements of IAS 11 are generally applicable to such contracts.

Main changes proposed to existing UK requirements

6 There are no major differences between the accounting required by the proposals in the draft standards and the existing requirements of SSAP 9. However, paragraph 29 of SSAP 9 requires "prudently calculated attributable profit" to be recognised in the profit and loss account when the outcome of a contract can be assessed with "reasonable certainty"; paragraph 9, and paragraphs 24 and 26 of appendix 1 to the standard, contain similar references to prudence and reasonable certainty. The

draft standard on construction and service contracts requires the recognition of contract revenue and contract costs when the outcome of a contract can be "estimated reliably". In emphasising reliability rather than prudence, the approach of the draft standard is more in keeping with the ASB's Statement of Principles and FRS 18 'Accounting Policies'.

7 The draft standard requires that amounts received from the customer before the related work is performed are recognised as a separate liability ('advances'). However, there are no requirements relating to the further analysis of the remaining balance sheet amount (paragraph 42 requires it to be presented as a single asset or liability, the 'gross amount due to/from customers for contract work'). Paragraph 30 of SSAP 9 requires the separate disclosure of 'amounts recoverable on contracts' (a debtor), 'payments on account' (a creditor), 'long-term contract balances' (stock) and foreseeable losses (a provision or creditor).

8 Paragraph 7 of the draft standard allows the requirements of the standard to be applied to the separately identifiable components of a single contract or to a group of contracts together, if that would reflect the substance of a contract or a group of contracts. SSAP 9 itself does not include an equivalent requirement. Paragraph 22 of appendix 1 to SSAP 9 indicates that, in some businesses, it will be most appropriate to treat parts of a long-term contract separately, but does not mention the combination of more than one contract. A similar treatment to that of the draft standard should be achieved by applying SSAP 9 in the context of FRS 5 'Reporting the Substance of Transactions'.

Differences between proposed UK requirements and proposed IFRSs

9 The texts of the draft FRSs are the same as the proposed IAS 2 and IAS 11 with the following exceptions:

(a) For the reasons explained in paragraph 4 above, additional text has been added to the draft standard on construction and service contracts to deal with contracts for services. This additional material, which is paragraphs 45A to 45J in the draft standard, is the same as paragraphs 4 and 20 to 28 of IAS 18 'Revenue'.

(b) The draft FRSs include a paragraph on scope, applying the standards to all financial statements that are intended to give a true and fair view of a reporting entity's financial position and profit or loss (or income and expenditure), except that reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt.

(c) References to IFRSs have been removed or replaced with references to relevant UK accounting standards.

Development of the exposure draft

10 The IASB's recent work on these standards has been limited to considering the proposed changes to IAS 2. The ASB has expressed its support, in particular for the abolition of the LIFO method of accounting. LIFO is not permitted by SSAP 9, and its elimination from international standards enhances convergence between UK and international standards.

Amendments to other UK standards

11 The replacement of SSAP 9 by the draft standards set out in the exposure draft would not require any changes to other UK standards or UITF Abstracts.

Implementation

12 The ASB proposes to issue a standard based on the proposals in the FRED, and withdraw SSAP 9, at the same time as the IASB issues the revised IAS 2, which it plans to do in the first quarter of 2003. The ASB expects to incorporate into the new UK standard any changes the IASB makes to the revised IAS 2, unless those changes are a significant departure from the requirements proposed in the exposure draft.

13 The ASB is not aware of any reason for an extended implementation period or for special transitional arrangements.

UK law, EU law and international standards

14 EU Ministers have proposed that from 1 January 2005, all listed companies in the EU should prepare their consolidated financial statements in accordance with adopted international accounting standards. A draft Regulation to this effect is at a late stage of negotiation and EU Ministers are expected to approve it shortly. The intention is that IFRSs will form the basis of those adopted international accounting standards.

15 After wide discussion with interested parties, the ASB has indicated its intention to pursue a programme of work to align UK accounting standards with IFRSs wherever practicable. The effect of this is that the substance of IFRSs will apply in the UK not only to the group financial statements of listed companies but also to individual financial statements and unlisted companies. However, the ASB will consider the option of retaining a UK standard, or modifying an IFRS in its wider application, for example if it appears likely that the cost of extending an unmodified IFRS more widely would exceed the benefit.

16 The Government has said that it may wish to extend the Regulation to individual financial statements and unlisted companies from 2005 or later. Ministers intend to consult on this once the Regulation is agreed.

17 The legal requirements for UK and Irish companies relevant to accounting for inventories and construction contracts are summarised in appendices to the draft standards. There appears to be no conflict between these requirements and those proposed in the exposure draft.

Questions for respondents

18 The ASB is requesting comments on any aspect of the FRED by 16 September 2002—the same date as the IASB has set for comments on its proposed revisions to IAS 2.

19 The ASB would welcome comments in particular on the following:

ASB(i) Do you agree with the proposal to issue new UK standards on inventories and construction contracts to replace SSAP 9, once the revised IAS 2 is approved by the IASB?

ASB(ii) Do you agree with the proposal to incorporate part of IAS 18 in the standard on construction contracts, so that it may also apply to other contracts for services?

ASB(iii) Do you believe that the ASB should consider any transitional arrangements?

ASB(iv) Are there any aspects of the draft standard on inventories that the ASB should request the IASB to review when finalising the revised IAS 2?

ASB(v) Are there any aspects of the standard on construction contracts that the ASB should request the IASB to review in due course?

20 The IASB has asked commentators to respond to the following questions on the proposed changes to IAS 2:

IASB(i) Do you agree with eliminating the allowed alternative of using the last-in first-out (LIFO) method for determining the cost of inventories under paragraphs 23 and 24 of IAS 2?

IASB(ii) IAS 2 requires reversals of write-downs of inventories when the circumstances that previously caused inventories to be written down below cost no longer exist (paragraph 30). IAS 2 also requires the amount of any reversal of any write-down of inventories to be recognised in profit or loss (paragraph 31).

Do you agree with retaining those requirements?

The draft standards presented here are based on the IASB's texts. The revised IAS 2 proposed by the IASB will be available from its website, www.iasb.org.uk. It is presented here 'clean', ie without highlighting the IASB's proposed changes to the existing standard.

However, the ASB is proposing a small number of changes to the IASB's texts of both IAS 2 and IAS 11. These are highlighted by strikethrough of text to be deleted, by underlining of words to be added and by sidelining against altered text.

[Draft] Financial Reporting Standard ¥ Inventories is set out in paragraphs 1-41.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold italic type, should be read in the context of the Objective, the definitions set out in paragraphs 4 and 5, and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the [draft] FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comment received before being issued in final form.

[DRAFT] FINANCIAL REPORTING STANDARD: INVENTORIES

Objective

The objective of this Standard is to prescribe the accounting treatment for inventories. A primary issue in accounting for inventories is the amount of cost to be recognised as an asset and carried forward until the related revenues are recognised. This Standard provides guidance on the determination of cost and its subsequent recognition as an expense, including any write-down to net realisable value. It also provides guidance on the cost formulas that are used to assign costs to inventories.

Scope

1. This Standard shall be applied in accounting for inventories. It does not apply to:

(a) work in progress arising under construction contracts, including directly related service contracts (see <u>[draft] Financial Reporting Standard ¥, Construction and Service Contracts</u>~~IAS 11, Construction Contracts~~);

(b) financial instruments;

(c) inventories of agricultural and forest products, and mineral ores to the extent that they are measured at net realisable value in accordance with well established practices in certain industries; and

(d) biological assets related to agricultural activity~~ (see IAS 41, Agriculture)~~.

<u>1A. This Standard applies to all financial statements that are intended to give a true and fair view of a reporting entity s financial position and profit or loss (or income and expenditure), except that reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt. [ASB]</u>

2. [Deleted][1]

3. The inventories referred to in paragraph 1(c) are measured at net realisable value at certain stages of production. This occurs, for example, when agricultural crops have been harvested or mineral ores have been extracted and sale is assured under a forward contract or a government guarantee, or when an active market exists and there is a negligible risk of failure to sell. These inventories are excluded from the scope of this Standard.

Definitions

4. The following terms are used in this Standard with the meanings specified:

<u>Inventories</u> are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.

<u>Net realisable value</u> is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

5. Inventories encompass goods purchased and held for resale including, for example, merchandise purchased by a retailer and held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the entity and include materials and supplies awaiting use in the production process. In the case of a service provider, inventories include the costs of the service, as described in paragraph 16, for which the entity has not yet recognised the related revenue (see <u>[draft] Financial Reporting Standard ¥, Construction and Service Contracts</u>~~IAS 18, Revenue~~).

[1] <u>Note: paragraphs that are identified as deleted in this manner identify paragraphs included in the existing version of IAS 2 that the IASB has proposed should be deleted as a consequence of its improvements project.</u>

Measurement of Inventories

6. ***Inventories shall be measured at the lower of cost and net realisable value.***

Cost of Inventories

7. ***The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition.***

Costs of Purchase

8. The costs of purchase of inventories comprise the purchase price, import duties and other taxes (other than those subsequently recoverable by the entity from the taxing authorities), and transport, handling and other costs directly attributable to the acquisition of finished goods, materials and services. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase.

9. [Deleted]

Costs of Conversion

10. The costs of conversion of inventories include costs directly related to the units of production, such as direct labour. They also include a systematic allocation of fixed and variable production overheads that are incurred in converting materials into finished goods. Fixed production overheads are those indirect costs of production that remain relatively constant regardless of the volume of production, such as depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration. Variable production overheads are those indirect costs of production that vary directly, or nearly directly, with the volume of production, such as indirect materials and indirect labour.

11. The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over a number of periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased as a consequence of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred. In periods of abnormally high production, the amount of fixed overhead allocated to each unit of production is decreased so that inventories are not measured above cost. Variable production overheads are allocated to each unit of production on the basis of the actual use of the production facilities.

12. A production process may result in more than one product being produced simultaneously. This is the case, for example, when joint products are produced or when there is a main product and a by-product. When the costs of conversion of each product are not separately identifiable, they are allocated between the products on a rational and consistent basis. The allocation may be based, for example, on the relative sales value of each product either at the stage in the production process when the products become separately identifiable, or at the completion of production. Most by-products, by their nature, are immaterial. When this is the case, they are often measured at net realisable value and this value is deducted from the cost of the main product. As a result, the carrying amount of the main product is not materially different from its cost.

Other Costs

13. Other costs are included in the cost of inventories only to the extent that they are incurred in bringing the inventories to their present location and condition. For example, it may be appropriate to include non-production overheads or the costs of designing products for specific customers in the cost of inventories.

14. Examples of costs excluded from the cost of inventories and recognised as expenses in the period in which they are incurred are:

    (a) abnormal amounts of wasted materials, labour, or other production costs;

    (b) storage costs, unless those costs are necessary in the production process prior to a further production stage;

    (c) administrative overheads that do not contribute to bringing inventories to their present location and condition; and

    (d) selling costs.

15. In limited circumstances, borrowing costs are included in the cost of inventories. These circumstances are identified in the allowed alternative treatment in [draft] Financial Reporting Standard ¥ Borrowing Costs ~~IAS 23, Borrowing Costs.~~[2]

Cost of Inventories of a Service Provider

16. When revenues related to services provided have not been recognised, a service provider has inventories. The cost of inventories of a service provider consists primarily of the labour and other costs of personnel directly engaged in providing the service, including supervisory personnel, and attributable overheads. Labour and other costs relating to sales and general administrative personnel are not included but are recognised as expenses in the period in which they are incurred. The cost of inventories of a service provider does not include profit margins or non-production costs that are often factored into prices charged by service providers.

[2] Contained in FRED 29 Property, Plant and Equipment & Borrowing Costs .

Cost of Agricultural Produce Harvested from Biological Assets

16A[3]. ~~Under IAS 41, Agriculture, inventories comprising agricultural produce that an entity has harvested from its biological assets are measured on initial recognition at their fair value less estimated point-of-sale costs at the point of harvest. This is the cost of the inventories at that date for application of this Standard.~~

Techniques for the Measurement of Cost

17. Techniques for the measurement of the cost of inventories, such as the standard cost method or the retail method, may be used for convenience if the results approximate cost. Standard costs take into account normal levels of materials and supplies, labour, efficiency and capacity utilisation. They are regularly reviewed and, if necessary, revised in the light of current conditions.

18. The retail method is often used in the retail industry for measuring inventories of large numbers of rapidly changing items with similar margins, and for which it is impracticable to use other costing methods. The cost of the inventory is determined by reducing the sales value of the inventory by the appropriate percentage gross margin. The percentage used takes into consideration inventory that has been marked down to below its original selling price. An average percentage for each retail department is often used.

Cost Formulas

19. The cost of inventories of items that are not ordinarily interchangeable and goods or services produced and segregated for specific projects shall be assigned by using specific identification of their individual costs.

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[3] This paragraph, and the related cross-reference in paragraph 1(d) above, is deleted as there is no UK standard corresponding to IAS 41.

20. Specific identification of cost means that specific costs are attributed to identified items of inventory. This is the appropriate treatment for items that are segregated for a specific project, regardless of whether they have been bought or produced. However, specific identification of costs is inappropriate when there are large numbers of items of inventory that are ordinarily interchangeable. In such circumstances, the method of selecting those items that remain in inventories could be used to obtain predetermined effects on the net profit or loss.

21. The cost of inventories, other than those dealt with in paragraph 19, shall be assigned by using the first-in, first-out (FIFO) or weighted average cost formulas. An entity shall use the same cost formula for all inventories having a similar nature and use to the entity. For inventories with a different nature or use, different cost formulas may be justified.

21A. For example, inventories used in one business segment may have a use to the entity different from the same type of inventories used in another business segment. However, a difference in geographical location of inventories (or in the respective tax rules), by itself, is not sufficient to justify the use of different cost formulas.

22. The FIFO formula assumes that the items of inventory that were purchased or produced first are sold first, and consequently the items remaining in inventory at the end of the period are those most recently purchased or produced. Under the weighted average cost formula, the cost of each item is determined from the weighted average of the cost of similar items at the beginning of a period and the cost of similar items purchased or produced during the period. The average may be calculated on a periodic basis, or as each additional shipment is received, depending upon the circumstances of the entity.

23. [Deleted]

24. [Deleted]

Net Realisable Value

25. The cost of inventories may not be recoverable if those inventories are damaged, if they have become wholly or partially obsolete, or if their selling prices have declined. The cost of inventories may also not be recoverable if the estimated costs of completion or the estimated costs to be incurred to make the sale have increased. The practice of writing inventories down below cost to net realisable value is consistent with the view that assets should not be carried in excess of amounts expected to be realised from their sale or use.

26. Inventories are usually written down to net realisable value on an item by item basis. In some circumstances, however, it may be appropriate to group similar or related items. This may be the case with items of inventory relating to the same product line that have similar purposes or end uses, are produced and marketed in the same geographical area, and cannot be practicably evaluated separately from other items in that product line. It is not appropriate to write inventories down based on a classification of inventory, for example, finished goods, or all the inventories in a particular industry or geographical segment. Service providers generally accumulate costs in respect of each service for which a separate selling price is charged. Therefore, each such service is treated as a separate item.

27. Estimates of net realisable value are based on the most reliable evidence available at the time the estimates are made as to the amount the inventories are expected to realise. These estimates take into consideration fluctuations of price or cost directly relating to events occurring after the end of the period to the extent that such events confirm conditions existing at the end of the period.

28. Estimates of net realisable value also take into consideration the purpose for which the inventory is held. For example, the net realisable value of the quantity of inventory held to satisfy firm sales or service contracts is based on the contract price. If the sales contracts are for less than the inventory quantities held, the net realisable value of the excess is based on general selling prices. Provisions or contingent liabilities may arise

from firm sales contracts in excess of inventory quantities held or from firm purchase contracts. Such provisions or contingent liabilities are dealt with under FRS 12 Provisions, Contingent Liabilities and Contingent Assets ~~IAS 37, Provisions, Contingent Liabilities and Contingent Assets~~.

29. Materials and other supplies held for use in the production of inventories are not written down below cost if the finished products in which they will be incorporated are expected to be sold at or above cost. However, when a decline in the price of materials indicates that the cost of the finished products exceeds net realisable value, the materials are written down to net realisable value. In such circumstances, the replacement cost of the materials may be the best available measure of their net realisable value.

30. A new assessment is made of net realisable value in each subsequent period. When the circumstances that previously caused inventories to be written down below cost no longer exist, the amount of the write-down is reversed so that the new carrying amount is the lower of the cost and the revised net realisable value. This occurs, for example, when an item of inventory, which is carried at net realisable value because its selling price has declined, is still on hand in a subsequent period and its selling price has increased.

Recognition as an Expense

31. When inventories are sold, the carrying amount of those inventories shall be recognised as an expense in the period in which the related revenue is recognised. The amount of any write-down of inventories to net realisable value and all losses of inventories shall be recognised as an expense in the period the write-down or loss occurs. The amount of any reversal of any write-down of inventories, arising from an increase in net realisable value, shall be recognised as a reduction in the amount of inventories recognised as an expense in the period in which the reversal occurs.

32. [Deleted]

33. Some inventories may be allocated to other asset accounts, for example, inventory used as a component of self-constructed property, plant or equipment. Inventories allocated to another asset in this way are recognised as an expense during the useful life of that asset.

Disclosure

34. The financial statements shall disclose:

(a) the accounting policies adopted in measuring inventories, including the cost formula used;

(b) the total carrying amount of inventories and the carrying amount in classifications appropriate to the entity;

(c) the amount of any write-down of inventories recognised in accordance with paragraph 31;

(d) the amount of any reversal of any write-down that is recognised as income in the period in accordance with paragraph 31;

(e) the circumstances or events that led to the reversal of a write-down of inventories in accordance with paragraph 31; and

(f) the carrying amount of inventories pledged as security for liabilities.

35. Information about the carrying amounts held in different classifications of inventories and the extent of the changes in these assets is useful to financial statement users. Common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. The inventories of a service provider may simply be described as work in progress.

36. [Deleted]

37. [Deleted]

38. [Deleted]

39. [Deleted]

40. [Deleted]

Effective Date

41. The accounting practices set out in this Standard should be regarded as standard in respect of accounting periods ending on or after [date to be inserted after exposure]. Earlier adoption is encouraged. ~~***This Standard becomes operative for annual financial statements covering periods beginning on or after 1 January 2003. Earlier adoption is encouraged. If earlier adoption affects the financial statements, an entity shall disclose that fact.***~~

APPENDIX: NOTE ON LEGAL REQUIREMENTS

Great Britain and Northern Ireland

The relevant statutory requirements are set out in the Companies Act 1985 and the Companies (Northern Ireland) Order 1986. All paragraph references unless otherwise indicated are to Schedule 4 to the Companies Act 1985 and Schedule 4 to the Companies (Northern Ireland) Order 1986.

Schedule 4 does not apply to banking and insurance companies. Banking companies are dealt with in Schedule 9 and insurance companies are dealt with in Schedule 9A.

Paragraph 22 requires that, under the historical cost accounting rules, the amount to be included in respect of any current asset shall be its purchase price or production cost. Paragraph 23(1) provides for the inclusion of the asset at net realisable value if lower than purchase price or production cost.

Paragraph 26 requires expenses incidental to the acquisition of an asset to be included in the purchase price. It also requires the inclusion of directly attributable production overheads in the production cost of an asset and permits the inclusion of overheads which are only indirectly attributable to the production of an asset and interest on borrowed capital. In cases where interest is included the fact must be stated and the amount of interest included must be disclosed in a note to the financial statements. Paragraph 26 also prohibits the inclusion of distribution costs.

Paragraph 27 allows the following methods for valuation of stocks (but requires that the method chosen must be one which appears to the directors to be appropriate in the circumstances of the company):

(a) the method known as first in, first out (FIFO);

(b) the method known as last in, first out (LIFO);

(c) a weighted average price; and

(d) any other method similar to any of the methods mentioned above.

However, the use of the LIFO method is not permitted by this Standard.

Paragraph 27(3) requires a company to state in a note to the accounts the difference between the replacement cost of stocks and their carrying amount where this difference is material.

It is further provided in paragraph 27(5) that, if the most recent actual purchase price or production cost before the balance sheet date appears to the directors of the company to constitute a more appropriate standard of comparison, then that amount may be used as a surrogate for replacement cost.

Paragraph 31(5) provides that, where a company adopts the alternative accounting rules, stocks may be included at their current cost.

Republic of Ireland

The statutory requirements in the Republic of Ireland that correspond to those cited above for Great Britain are shown in the following table:

Great Britain	*Republic of Ireland*
Schedule 4 to the Companies Act 1985:	The Schedule to the Companies (Amendment) Act 1986:
paragraph 22	paragraph 10
paragraph 23(1)	paragraph 11(1)
paragraph 26	paragraph 14
paragraph 27	paragraph 15
paragraph 31(5)	paragraph 19(5)

SUMMARY OF MAIN CHANGES PROPOSED BY THE IASB

The main changes that the IASB are proposing to IAS 2 are:

- to delete producers , which is the first word in paragraph 1(c). This change extends the scope exception to non-producers such as those brokers and dealers whose inventories are measured at net realisable value in accordance with well-established practices.

- to delete paragraph 9[4] as a result of the proposed elimination of the allowed alternative treatment in paragraph 21 of IAS 21, The Effects of Changes in Foreign Exchange Rates.

- to eliminate the allowed alternative of using the last-in, first-out (LIFO) method (paragraphs 23 and 24).

- to change paragraph 34(c)[5] to require disclosure of the amount of any write-down of inventories.

- to delete paragraphs 37-39, which are unnecessary because the required disclosures are also required by IAS 1, Presentation of Financial Statements.

Also, SIC-1 Consistency — Different Cost Formulas for Inventories is withdrawn as it is covered in SIC-18 Consistency — Alternative Methods , which is incorporated into IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors .

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[4] In the existing standard, this paragraph permits foreign exchange differences to be included within the cost of purchase of inventories (in the rare circumstances permitted in the allowed alternative treatment in the existing IAS 21).

[5] In the existing standard, this paragraph requires the carrying amount of inventories carried at net realisable value to be disclosed.

[Draft] Financial Reporting Standard ¥ Construction and Service Contracts is set out in paragraphs 1-46.

The Statement of Standard Accounting Practice, which comprises the paragraphs set in bold italic type, should be read in the context of the Objective, the definitions set out in paragraphs 3-6, and also of the Foreword to Accounting Standards and the Statement of Principles for Financial Reporting currently in issue.

The explanatory paragraphs contained in the [draft] FRS shall be regarded as part of the Statement of Standard Accounting Practice insofar as they assist in interpreting that statement.

This draft is issued by the Accounting Standards Board for comment. It should be noted that the draft may be modified in the light of comment received before being issued in final form.

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[3] Paragraphs 45A to 45J are the same as paragraphs 4 and 20 to 28 of IAS 18 Revenue

[DRAFT] FINANCIAL REPORTING STANDARD: CONSTRUCTION AND SERVICE CONTRACTS

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction and service contracts. Because of the nature of the activity undertaken in ~~construction~~ such contracts, the date at which the contract activity is entered into and the date when the activity is completed ~~usually~~ often fall into different accounting periods. Therefore, the primary issue in accounting for ~~construction~~ these contracts is the allocation of contract revenue and contract costs to the accounting periods in which ~~construction~~ work is performed. This Standard uses the recognition criteria established in the Framework[1] for the Preparation and Presentation of Financial Statements to determine when contract revenue and contract costs should be recognised as revenue and expenses in the income statement. It also provides practical guidance on the application of these criteria.

Scope

1. This Standard should be applied in accounting for:-

(a) construction contracts in the financial statements of contractors; and

(b) revenue arising from the rendering of services.

1A. This Standard applies to all financial statements that are intended to give a true and fair view of a reporting entity s financial position and profit or loss (or income and expenditure), except that reporting entities applying the Financial Reporting Standard for Smaller Entities currently applicable are exempt. [ASB]

[1] Under paragraph 83 of the IASB Framework, an item that meets the definition of an element [of financial statements] should be recognised if: (a) it is probable that any future benefits associated with the item will flow to or from the enterprise; and (b) the item has a cost or value that can be measured with reliability. Chapter 5 of the ASB s Statement of Principles for Financial Reporting contains similar recognition criteria, whereby a new asset or liability (or an addition to an existing asset or liability) will be recognised if (a) sufficient evidence exists that the new asset or liability has been created or that there has been an addition to an existing asset or liability; and (b) the new asset or liability or the addition to the existing asset or liability can be measured at a monetary amount with sufficient reliability.

~~2. This Standard supersedes IAS 11, Accounting for Construction Contracts, approved in 1978.~~

Definitions

3. The following terms are used in this Standard with the meanings specified:

A <u>construction contract</u> is a contract specifically negotiated 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 <u>fixed price contract</u> 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 <u>cost plus contract</u> 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.

4. A construction contract may be negotiated for the construction of a single asset such as a bridge, building, dam, pipeline, road, ship or tunnel. 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; examples of such contracts include those for the construction of refineries and other complex pieces of plant or equipment.

5. For the purposes of this Standard, 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

   (b) contracts for the destruction or restoration of assets, and the restoration of the environment following the demolition of assets.

6. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, 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, for example in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 23 and 24 in order to determine when to recognise contract revenue and expenses.

Combining and Segmenting Construction Contracts

7. The requirements of this Standard are usually applied separately to each construction contract. However, in certain circumstances, it is necessary to apply the Standard to the separately identifiable components of a single contract or to a group of contracts together in order to reflect the substance of a contract or a group of contracts.

8. When a contract covers a number of assets, the construction of each asset should 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, should 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 concurrently 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 should 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 should comprise:

(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.

12. Contract revenue is measured at the fair value of the consideration received or receivable. The measurement of contract revenue is affected by a variety of uncertainties that depend on the outcome of future events. The 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. For example:

(a) a contractor and a customer may agree variations or claims that increase or decrease contract revenue in a period subsequent to that in which the contract was initially agreed;

(b) the amount of revenue agreed in a fixed price contract may increase as a result of cost escalation clauses;

(c) the amount of contract revenue may decrease as a result of penalties arising from delays caused by the contractor in the completion of the contract; or

(d) when a fixed price contract involves a fixed price per unit of output, contract revenue increases as the number of units is increased.

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. Examples of variations are changes in the specifications or design of the asset and changes in the duration of the contract. 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. The measurement of the amounts of revenue arising from claims is subject to a high level of uncertainty and often depends on the outcome of negotiations. Therefore, claims are only included in contract revenue 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. For example, a contract may allow for an incentive payment to the contractor for early completion of the contract. 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 should comprise:

(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) such other costs as 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;

(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 is 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 may be reduced by any incidental income that is not included in contract revenue, for example 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 is 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 contractor adopts the allowed alternative treatment in ~~IAS 23, Borrowing Costs~~[draft] Financial Reporting Standard ¥ Borrowing Costs .[2]

19. Costs that are specifically chargeable to the customer under the terms of the contract may include some general administration costs and development costs for which reimbursement is specified in the terms of the contract.

20. 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

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[2] Contained in FRED 29 Property, Plant and Equipment & Borrowing Costs .

(d) depreciation of idle plant and equipment that is not used on a particular contract.

21. 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 which 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 are not included in contract costs when the contract is obtained in a subsequent period.

Recognition of Contract Revenue and Expenses

22. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should 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 should be recognised as an expense immediately in accordance with paragraph 36.

23. 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 enterprise;

(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.

24. 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 enterprise; and

(b) the contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.

25. The recognition of revenue and expenses by reference to the stage of completion of a contract is often referred to as the percentage of completion method. Under this method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the reporting of revenue, expenses and profit which can be attributed to the proportion of work completed. This method provides useful information on the extent of contract activity and performance during a period.

26. 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. However, 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.

27. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised as an asset provided it is probable that they will be recovered. Such costs represent an amount due from the customer and are often classified as contract work in progress.

28. The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits associated with the contract will flow to the enterprise. However, 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.

29. An enterprise 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 enterprise to have an effective internal financial budgeting and reporting system. The enterprise 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.

30. The stage of completion of a contract may be determined in a variety of ways. The enterprise 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.

31. 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, such as costs of materials that have been delivered to a contract site or set aside for use in a contract but not yet installed, used or applied during contract performance, unless the materials have been made specially for the contract; and

    (b) payments made to subcontractors in advance of work performed under the subcontract.

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

(a) revenue should be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and

(b) contract costs should be recognised as an expense in the period in which they are incurred.

An expected loss on the construction contract should be recognised as an expense immediately in accordance with paragraph 36.

33. 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 enterprise 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, even though the outcome of the contract cannot be estimated reliably, it may be probable that total contract costs will exceed total contract revenues. In such cases, 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.

34. 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) which are not fully enforceable, that is, their validity is seriously in question;

    (b) the completion of which 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.

35. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract should be recognised in accordance with paragraph 22 rather than in accordance with paragraph 32.

Recognition of Expected Losses

36. When it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately.

37. The amount of such a loss is determined irrespective of:

    (a) whether or not 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 which are not treated as a single construction contract in accordance with paragraph 9.

Changes in Estimates

38. 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~~<u>estimation technique</u> (see ~~IAS 8, Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies~~<u>FRS 18 Accounting Policies</u>). The changed estimates are used in the determination of the amount of revenue and expenses recognised in the income statement in the period in which the change is made and in subsequent periods.

Disclosure

39. An enterprise should 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.

40. An enterprise should 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.

41. Retentions are amounts of progress billings which 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.

42. An enterprise should present:

(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.

43. 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.

44. 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).

45. An enterprise discloses any contingent liabilities and contingent assets in accordance with ~~IAS 37, Provisions, Contingent Liabilities and Contingent Assets~~FRS 12 Provisions, Contingent Liabilities and Contingent Assets . Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses.

Rendering of Services [3]

45A. The rendering of services typically involves the performance by the enterprise of a contractually agreed task over an agreed period of time. The services may be rendered within a single period or over more than one period. Some contracts for the rendering of services are directly related to construction contracts, for example, those for the services of project managers and architects. Revenue arising from these contracts is ~~not dealt with in this Standard but is~~ dealt with in accordance with the requirements for construction contracts as specified in ~~IAS 11, Construction Contracts~~ paragraphs 1 to 45 above.

45B. When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognised by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:

(a) the amount of revenue can be measured reliably;

(b) it is probable that the economic benefits associated with the transaction will flow to the enterprise;

(c) the stage of completion of the transaction at the balance sheet date can be measured reliably; and

(d) the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.

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[3] Paragraphs 45A to 45J are the same as paragraphs 4 and 20 to 28 of IAS 18 Revenue

45C. The recognition of revenue by reference to the stage of completion of a transaction is often referred to as the percentage of completion method. Under this method, revenue is recognised in the accounting periods in which the services are rendered. The recognition of revenue on this basis provides useful information on the extent of service activity and performance during a period. Paragraph 22 above~~IAS 11, Construction Contracts,~~ also requires the recognition of revenue on this basis. The requirements of paragraphs 1 to 45 above, including the disclosure requirements of paragraph 39,~~that Standard~~ are generally applicable to the recognition of revenue and the associated expenses for a transaction involving the rendering of services.

45D. Revenue is recognised only when it is probable that the economic benefits associated with the transaction will flow to the enterprise. However, when an uncertainty arises about the collectability of an amount already included in revenue, 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 revenue originally recognised.

45E. An enterprise is generally able to make reliable estimates after it has agreed to the following with the other parties to the transaction:

(a) each party s enforceable rights regarding the service to be provided and received by the parties;

(b) the consideration to be exchanged; and

(c) the manner and terms of settlement.

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

45F. The stage of completion of a transaction may be determined by a variety of methods. An enterprise uses the method that measures reliably the services performed. Depending on the nature of the transaction, the methods may include:

(a) surveys of work performed;

(b) services performed to date as a percentage of total services to be performed; or

(c) the proportion that costs incurred to date bear to the estimated total costs of the transaction. Only costs that reflect services performed to date are included in costs incurred to date. Only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Progress payments and advances received from customers often do not reflect the services performed.

45G. For practical purposes, when services are performed by an indeterminate number of acts over a specified period of time, revenue is recognised on a straight line basis over the specified period unless there is evidence that some other method better represents the stage of completion. When a specific act is much more significant than any other acts, the recognition of revenue is postponed until the significant act is executed.

45H. When the outcome of the transaction involving the rendering of services cannot be estimated reliably, revenue should be recognised only to the extent of the expenses recognised that are recoverable.

45I. During the early stages of a transaction, it is often the case that the outcome of the transaction cannot be estimated reliably. Nevertheless, it may be probable that the enterprise will recover the transaction costs incurred. Therefore, revenue is recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the transaction cannot be estimated reliably, no profit is recognised.

45J. When the outcome of a transaction cannot be estimated reliably and it is not probable that the costs incurred will be recovered, revenue is not recognised and the costs incurred are recognised as an expense. When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue is recognised in accordance with paragraph ~~20~~45B rather than in accordance with paragraph ~~26~~45H.

Effective Date

46. The accounting practices set out in this Standard should be regarded as standard in respect of accounting periods ending on or after [date to be inserted after exposure]. Earlier adoption is encouraged. ~~***This International Accounting Standard becomes operative for financial statements covering periods beginning on or after 1 January 1995.***~~

APPENDIX I: EXAMPLE

The appendix is illustrative only and does not form part of the Standard. The purpose of the appendix is to illustrate the application of the Standard to assist in clarifying their meaning.

Disclosure of Accounting Policies

The following are examples of accounting policy disclosures:

Revenue from fixed price construction contracts is recognised on the percentage of completion method, measured by reference to the percentage of labour hours incurred to date to estimated total labour hours for each contract.

Revenue from cost plus contracts is recognised by reference to the recoverable costs incurred during the period plus the fee earned, measured by the proportion that costs incurred to date bear to the estimated total costs of the contract.

The Determination of Contract Revenue and Expenses

The following example illustrates one method of determining the stage of completion of a contract and the timing of the recognition of contract revenue and expenses (see paragraphs 22 to 35 of the Standard).

A construction contractor has a fixed price contract for 9,000 to build a bridge. The initial amount of revenue agreed in the contract is 9,000. The contractor s initial estimate of contract costs is 8,000. It will take 3 years to build the bridge.

By the end of year 1, the contractor s estimate of contract costs has increased to 8,050.

In year 2, the customer approves a variation resulting in an increase in contract revenue of 200 and estimated additional contract costs of 150. At the end of year 2, costs incurred include 100 for standard materials stored at the site to be used in year 3 to complete the project.

The contractor determines the stage of completion of the contract by calculating the proportion that contract costs incurred for work performed to date bear to the latest estimated total contract costs. A summary of the financial data during the construction period is as follows:

	Year 1	Year 2	Year 3
Initial amount of revenue agreed in contract	9,000	9,000	9,000
Variation		200	200
Total contract revenue	9,000	9,200	9,200
Contract costs incurred to date	2,093	6,168	8,200
Contract costs to complete	5,957	2,032	
Total estimated contract costs	8,050	8,200	8,200
Estimated profit	950	1,000	1,000
Stage of completion	26%	74%	100%

The stage of completion for year 2 (74%) is determined by excluding from contract costs incurred for work performed to date the 100 of standard materials stored at the site for use in year 3.

The amounts of revenue, expenses and profit recognised in the income statement in the three years are as follows:

	To Date	Recognised in prior years	Recognised in current year
Year 1			
Revenue (9,000 x .26)	2,340		2,340
Expenses (8,050 x .26)	2,093		2,093
Profit	247		247
Year 2			
Revenue (9,200 x .74)	6,808	2,340	4,468
Expenses (8,200 x .74)	6,068	2,093	3,975
Profit	740	247	493
Year 3			
Revenue (9,200 x 1.00)	9,200	6,808	2,392
Expenses	8,200	6,068	2,132
Profit	1,000	740	260

Contract Disclosures

A contractor has reached the end of its first year of operations. All its contract costs incurred have been paid for in cash and all its progress billings and advances have been received in cash. Contract costs incurred for contracts B, C and E include the cost of materials that have been purchased for the contract but which have not been used in contract performance to date. For contracts B, C and E, the customers have made advances to the contractor for work not yet performed.

The status of its five contracts in progress at the end of year 1 is as follows:

	Contract					
	A	B	C	D	E	Total
Contract Revenue recognised in accordance with paragraph 22	145	520	380	200	55	1,300
Contract Expenses recognised in accordance with paragraph 22	110	450	350	250	55	1,215
Expected Losses recognised in accordance with paragraph 36	-	-	-	40	30	70
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
Contract Costs incurred in the period	110	510	450	250	100	1,420
Contract Costs incurred recognised as contract expenses in the period in accordance with paragraph 22	110	450	350	250	55	1,215
Contract Costs that relate to future activity recognised as an asset in accordance with paragraph 27	-	60	100	-	45	205
Contract Revenue (see above)	145	520	380	200	55	1,300
Progress Billings (paragraph 41)	100	520	380	180	55	1,235
Unbilled Contract Revenue	45	-	-	20	-	65
Advances (paragraph 41)	-	80	20	-	25	125

The amounts to be disclosed in accordance with the Standard are as follows:

Contract revenue recognised as revenue in the period (paragraph 39(a))	1,300
Contract costs incurred and recognised profits (less recognised losses) to date (paragraph 40(a))	1,435
Advances received (paragraph 40(b))	125
Gross amount due from customers for contract work - presented as an asset in accordance with paragraph 42(a)	220
Gross amount due to customers for contract work — presented as a liability in accordance with paragraph 42(b)	(20)

The amounts to be disclosed in accordance with paragraphs 40(a), 42(a) and 42(b) are calculated as follows:

	A	B	C	D	E	Total
Contract Costs incurred	110	510	450	250	100	1,420
Recognised profits less recognised losses	35	70	30	(90)	(30)	15
	145	580	480	160	70	1,435
Progress billings	100	520	380	180	55	1,235
Due from customers	45	60	100	-	15	220
Due to customers	-	-	-	(20)	-	(20)

The amount disclosed in accordance with paragraph 40(a) is the same as the amount for the current period because the disclosures relate to the first year of operation.

APPENDIX II: NOTE ON LEGAL REQUIREMENTS

Great Britain and Northern Ireland

The relevant statutory requirements are set out in the Companies Act 1985 and the Companies (Northern Ireland) Order 1986. All paragraph references unless otherwise indicated are to Schedule 4 to the Companies Act 1985 and Schedule 4 to the Companies (Northern Ireland) Order 1986.

Schedule 4 does not apply to banking and insurance companies. Banking companies are dealt with in Schedule 9 and insurance companies are dealt with in Schedule 9A.

Paragraph 22 requires that, under the historical cost accounting rules, the amount to be included in respect of any current asset shall be its purchase price or production cost. Paragraph 23(1) provides for the inclusion of the asset at net realisable value if lower than purchase price or production cost. In the [draft] FRS, the profit recognised on a contract results from the recognition of an appropriate portion of contract revenue. The effect is that profit is included in debtors (Amounts due from customers for contract work) rather than inventories (or stocks, in the terminology used in the Act).

Paragraph 26 requires expenses incidental to the acquisition of an asset to be included in the purchase price. It also requires the inclusion of directly attributable production overheads in the production cost of an asset and permits the inclusion of overheads which are only indirectly attributable to the production of an asset and interest on borrowed capital. In cases where interest is included the fact must be stated and the amount of interest included must be disclosed in a note to the financial statements. Paragraph 26 also prohibits the inclusion of distribution costs.

Paragraph 89 [paragraph 88 of Schedule 4 to the Companies (Northern Ireland) Order 1986] provides that provisions are amounts retained as reasonably necessary for the purpose of providing for any liability or loss which is either likely to be incurred, or certain to be incurred but uncertain as to amount or as to the date on which it will arise.

Republic of Ireland

The statutory requirements in the Republic of Ireland that correspond to those cited above for Great Britain are shown in the following table:

Great Britain	*Republic of Ireland*
Schedule 4 to the Companies Act 1985:	The Schedule to the Companies (Amendment) Act 1986
paragraph 22	paragraph 10
paragraph 23(1)	paragraph 11(1)
paragraph 26	paragraph 14
paragraph 88	paragraph 70

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