RECOGNITION OF CONTRACT REVENUES AND EXPENSES

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Abstract:
When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract should be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the balance sheet date. The contract costs are recognized as an asset provided it is probable that they will be recovered. 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. There are two methods of calculating the profits on uncompleted used by contractors: Percentage of Completion Method and Completion Contract Method.

Introduction

Among other things, IAS 11 "Building Contracts" sets the acknowledgement criteria for determining the period in which the receipts and expenditures must be acknowledged in the profit and loss account. From the juridical point of view (the primordially of the prudence principle), one must wait for the contract to end to account the result. From the economic point of view (the primordially of the principle that connects the expenses to income), the result must be distributed on the periods during which the operations of the contract take place, depending on the advancing degree of the works.

Buildings, as a branch of the material production, occupy an important place in the economy of a country. Therefore, the accounting must provide relevant and credible information regarding this field of activity. A limit of intelligible, credible, relevant accounting information is the balance between benefit and cost. The benefits obtained due to information must exceed the costs for providing it. The estimation of both benefits and costs represent a process of professional thinking because the costs are not necessary supported by those users that directly use the benefits; on the other hand, other users than those for whom the information was destined, can benefit from profits. The presence of the buildings in the balance sheet and the profit account has the following criteria: the probability of the economic benefits and the credibility of estimation. The probability concept is based on the uncertainty of the environment in which the economic entity unfolds its activity. The probability refers to the degree of uncertainty with which the future benefits associated to an element will form a flow to or from the company.

The credibility of the estimation refers to the fact that the respective element has a certain value or cost that can be estimated realistically. There are situations in which the cost or the value must be estimated. IASB, the accounting conceptual framework, asserts the fact that the reasonable estimations have an important role in drawing up the financial status and does not influence their credibility.

The objective of IAS 11 "Buildings" is the recognition of the income and costs corresponding to the building contracts. The income is written in the trading account when there is an increase of the future economic benefits, during the financial period, associated with an increase of assets or liabilities decrease.

Both in theory and practice the income is recognized when it is obtained and not necessary taken, only on condition that they are credibly estimated.

The expenses are written in the trading account when there is a diminishing of the future economic benefits associated with a diminishing of assets or an increase of liabilities.

For a continental accounting (with juridical determination), the fundamental criterion for the recognition of the transactions or of the events that generate expenses and income is the proprietary right. Any expense is recognized only because the proprietary right has been transferred. In a similar way, the income is recognized when the proprietary right has been transferred on the respective tangible good that was sold or on the respective service that was offered.

According to IAS 11, the income and the costs corresponding to the building contracts are accounted, in most of the cases, with the help of **the advancing percentage method** which is put into practice when the result obtained at the end of the contract can be estimated correctly. When the result obtained at the end cannot be estimated correctly, the entity resorts to an advance with zero margins. In these circumstances, when the result obtained at the end cannot be estimated correctly, as long as the contract is not finished, no profit is acknowledged and accounted. If there is the possibility that the result obtained at the end is a loss, then the entire loss must be immediately accounted together with the expenses.

1.Accounting treatment of the income and costs in the case of the building contracts

This Standard deals with the recognition of construction contract revenue and costs; it applies in accounting for construction contracts in the financial statements of contractors. Contracts include those construction contracts of which the dates of contracting and of completion typically fall in different accounting periods.

A building contract is negotiated. This contract refers to building an asset or combination assets that are interlinked from the point of conception, technology or purpose and use.

The income of the contract contains:

- initial income stated in the contract;
- the claims, the modifications occurred in the volume of the works and the performance bonuses if they can generate income that can estimated credible.

A modification is an instruction given by a client who can change the size of the works to be executed; this change is included in the income stated in the contract when the beneficiary of the building may approve the volume of the income resulting from this.

The estimation of the income coming from claims is characterized by a high degree of uncertainty, because it depends on the result of the negotiations. The claims are considered income only when they may be accepted by the beneficiary and their size can be measured credibly.

The performance bonuses occur when the standards stated in the contract are achieved or even exceeded.

According to IAS 11, the Contractual costs must contain:

- the direct costs corresponding to the specific contract;
- the costs that can be allotted to the contract rationally;
- other costs stated in the contract and charged with the beneficiary.
- The direct costs corresponding to the specific contract contain the following:
- the salary costs of the staff working on the site, including the costs for surveying the site;
- the costs of the materials used for the respective building;
- the costs for the amortization of the technical installation and with the equipment used in order to build the asset or assets stipulated in the building contract;
- the costs corresponding to the transport of the technical installation, of the equipments and of the materials necessary in order to perform the contract at and from the site;
- the costs for hiring the necessary equipment to perform the contract, if the respective company does not have such equipment and hires it from third parties to achieve this goal;
- the costs for projecting and for the technical assistance needed for the respective contract;

- the costs estimated for the work adjustment and guarantee, including the insurance costs.

The costs that are assigned to the activity of the contract, in general, and that can be allotted to the specific contracts according to IAS 11, contain the following:

- the insurance costs;
- the costs for projecting and technical assistance which are not directly connected to the specific contract;
- the indirect construction costs.

These costs must be allotted using systematic and rational methods that are applied to all costs having similar characteristics. The allotment must rely on the normal level of the building activity.

The costs which are paid by the beneficiary according to the terms stipulated in the contract can include some general costs of administration and development, for which the reimbursement is mentioned in the contract.

The costs that are not assigned to the activity of the contract or that can not be allotted to it will be excluded from the cost of the building contract. In accordance with IAS 11, such costs contain:

- the general and administration costs for which the reimbursement is not stated in the contract;
- the selling costs;
- the research and development costs for which the reimbursement is not stated in the contract;
- the depreciation of that machinery, plant and equipment that are not used in performing the respective contract.

2. The choice of methods of recognizing and accounting the building contracts

The accounting method in the case of building contracts is chosen taking into account the moment when the result of the work is set.

In accordance with IAS 1, **the advancing percentage method** must be used whenever the result of the contract can be estimated correctly.

There are two types of contracts: fixed-price contracts and State-managed contracts.

The result of a fixed-price contract can be estimated correctly only if the following conditions are obeyed:

- there is a high probability that the entrepreneur obtain the economic results that refer to the contract;
- when the balance sheet is made, both the costs necessary to perform the contract and the advancing degree of the works can be calculated precisely;
- the costs that can be allotted to the contract are easy to identify and measure.

The result of the State-managed contract can be estimated credibly if:

- all the expenses connected with the contract can be identified and measured with accuracy;
- there is a high probability that the entrepreneur obtains the economic advantages referring to the contract;

When the above mentioned conditions are not verified, the result of the contract can not be estimated credibly and, in this case, the proper method to be used is the **method of finishing the work**.

Solved application:
The following information about the SC OMEGA SA company is known for the financial period ended on 31.12. N:

-costs paid till 31.12. N 3.000 m.u
-future costs estimated by the company to perform the contract 2.000 m.u
- the value of the job fulfilled and acknowledged till 31.12. N 3.600 m.u
- the estimated value of the income 6.400 m.u
-income acknowledged in the previous years 1.200 m.u
-costs acknowledged in the previous years 950 m.u,

Calculate the following:

-the ending stage of the contract at the end of the financial period N;
- the values that must be recorded in the profit and loss account of the period as contractual income or contractual expenses in the year N.

Solution:

Table 1:The ending stage of the contract

The income-based method	The cost-based method
Ending stage = (the value of the job fulfilled and acknowledged/total estimated income)	Ending stage = (total expenses/total estimated costs
3600/6400= 56,25**%**	3.000/ (3.000+2.000)= 60%

Total obtained income = total estimated income x % for the ending stage

Total expenses to be acknowledged = total estimated expenses x % for the ending stage

The expense of the period = total expenses to be acknowledged – expenses acknowledged in the profit and loss account of the previous periods;

The income of the period
= total expenses to be acknowledged – the income acknowledged in the previous periods

Table 2 The advancing percentage method

	The income-based method	**The cost-based method**
Total obtained income	6.400 x 56.25% = 3600	6.400 x 60% = 3.840
Total expenses to be acknowledged	5.000 x 56.25% = 2813	5.000 x 60% = 3.000
The expenses of the N financial period	2813- 950=1863	3.000–950= 2050
Income connected with the N financial period	3600-1200= 2400	3840–1.200= 2.640
The profit of the period	**2400 – 1863= 537**	**2640 –2050=590**

Accounting policies include: methods used for revenue recognition and methods used for stage of completion.

The income statement includes amount of contract revenue recognized.

Conclusions

The use of the percentage of completion method requires that the total cost and total profit of a project be estimated at each balance sheet date. A pro rata proportion of the total estimated profit is then recognized in each accounting period during the performance of the contract

The advancing percentage method influences the financial status in the following manner:

From the point of view of the profit and loss account**:**

- the costs corresponding to the contract are accounted the very moment they are paid;

- the income is acknowledged depending on the share of the costs paid in the respective financial period in the total costs estimated for the respective contract;
- the reported earnings represent estimations of the future money flows obtained from exploitation.

From the point of view of the balance sheet:

- the invoices that have been issued but not cashed as debts;
- the cumulative expenses corresponding to the contract plus the reported income minus the invoices are registered as floating assets if their value is positive. If the value is negative, the above mentioned sum is registered as current debts.

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