Construction Contracts

G 3. Construction Contracts

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IAS 11 (International Accounting Standards) *Construction Contracts*

- provides requirements on the allocation of contract revenue and contract costs to accounting periods in which construction work is performed.
- **Objective of IAS 11** is to prescribe the accounting treatment of revenue and costs associated with construction contracts.

History of IAS 11 — Construction Contracts

December 1977	**Exposure Draft E11 *Accounting for Construction Contracts***
March 1979	**IAS 11 *Accounting for Construction Contracts***
1 January 1980	**Effective date of IAS 11**
May 1992	**Exposure Draft E42 *Construction Contracts***
December 1993	**IAS 11 (1993) *Construction Contracts* (revised as part of the 'Comparability of Financial Statements' project)**
1 January 1995	**Effective date of IAS 11 (1993)**
1 January 2017	**IAS 11 will be superseded by IFRS 15 *Revenue from Contracts with Customers***

TYPES OF CONSTRUCTION CONTRACTS

Two broad categories:

- Price Given in Advance Contracts (Priced-based Contracts)
- Cost Reimbursement Contracts (Cost-based Contracts)

Factors Influencing the Choice of the Type of Contract

- The appropriateness for providing an adequate incentive for efficient performance by the contractor
- The ability to introduce changes
- The allocation of risks
- The start and completion date of the project

TYPES OF CONSTRUCTION CONTRACTS

1. **Lump Sum Contact**
2. **Contract based on a Bill of Quantities**

- Sometimes called **Unit Price Contract**

3. **Schedule of Rates Contract**
4. **Cost plus Percentage of Cost**
5. **Cost plus Fixed Fee**
6. **Target Cost with Variable Fees Contract**
7. **Guaranteed Maximum Price Contract (GMP)**

1. Lump Sum Contact

Main Aspects

1. Payment may be staged at intervals of time.
2. The contractor is responsible for preparing his B.O.Q.
3. The responsibility is on the contractor to include in his price everything necessary for carrying out the work.

1. Lump Sum Contact

Advantages

1. The final price is known
2. The contractor has more incentive to reduce his cost to increase the profit.
3. The contractor hopes to complete the job as quickly as possible.

Disadvantages

1. Changes can be very expensive and source of trouble.
2. The contractor carries much of the risks.
3. Competent contractors may decide not to bid to avoid a high-risk lump sum contract.

2. Contract based on a Bill of Quantities
Sometimes called **Unit Price Contract**

Main Aspects

1. Items of work of the contract are specified with estimated quantities
2. Estimated quantities are surveyed by Architect/Engineer.
3. Contractors enter unit prices against the estimated quantities of work.
4. The contract is based on estimated quantities of work items.
5. Payment is made on the basis of units of work actually done.

2. Contract based on a Bill of Quantities
Sometimes called **Unit Price Contract**

Advantages

1. Saving the heavy cost of preparing many bills of quantities by the contractors.

2. Fair basis for competition.

- Changes in contract documents can be made easily by the owner.
- Lower risk for contractor.

Disadvantages

1. The exact final price of the project is not known to the owner until the completion of the project.

3. Schedule of Rates Contract

Main Aspects

1. A Schedule of the work items without quantities.

2. The descriptions of items and the units of measurement are similar to those used in a normal B.O.Q., but no quantities are given.

3. It is common for separate rates to be quoted for labor, plant, and materials.

4. Used for repair and maintenance works or under conditions of urgency.

3. Schedule of Rates Contract

Advantages

1. Work can be commenced earlier than if a full B.O.Q has been prepared.

Disadvantage

1. No indication of the final price of the works.
2. Very difficult to determine which contractor submitted the most advantageous offer.
3. May cause financial problems to the public owners.

4. Cost plus Percentage of Cost

Main Aspects

1. The contractor is reimbursed for all his costs with a fixed % age of costs to cover his services.

2. Project/site overheads may be covered by the % age or computed as one of the costs.

4. Cost plus Percentage of Cost

Advantages

1. Construction can start before design is completed.

2. If the contractor is efficient in the utilization of resources then the cost to the client should represent a fair price for the work undertaken.

Disadvantages

1. The total cost is completely unknown before start.

2. No incentive for the contractor to be efficient.

3. Minimum efficiency maximizes the profit.

4. Owner must exercise tight cost control.

5. Cost plus Fixed Fee

Main Aspects

1. The owner pays all costs of construction with a fixed sum of money.

2. The work must be fairly well defined by the owner.

Advantages

1. There is no incentive for the contractor to inflate costs.

2. There is incentive for the contractor to complete the work as quickly as possible.

Disadvantages

1. Major variations create problems.
2. The speed of commencing the work is undermined since before a fee can be agreed a fairly detailed description of work must be made.

6. Target Cost with Variable Fees Contract

Main Aspects

1. The contractor and owner agree to a target estimate of construction.

2. Bonus or penalty arrangements are tied to this target figure.

3. The work must have a fairly definite nature.

4. Cost target -> sharing of savings

5. Time target -> fixed sum of money for each day.

6. Target Cost with Variable Fees Contract

Advantages

1. There is an incentive to carry out the work as quickly as possible.

2. The client also stands to benefit through the contactor's efficiency.

Disadvantages

1. Difficulties may arise in agreeing on a revised target cost if there are major variations or cost inflation.

2. A tight cost control must be exercised, which may be difficult and/or costly.

7. Guaranteed Maximum Price Contract (GMP)

1. The contractor guarantees that he will construct the project in full accordance with the drawings and specifications and that the price to the owner will not exceed some total upset price.

2. If the price of the work exceeds the assured maximum, the contractor pays for the excess.

3. Contracts are often competitively bid in a manner similar to that for lump-sum contracts, but managed as cost plus.

4. The successful bidder is determined on the combined basis of his quoted maximum price and fixed fee.

Recognition methods

- **Stage of Completion *(Percentage of Completion)***
- **Value Based Methods**

$$\text{Stage of Completion \%} = \frac{\text{Value of Work Certified as complete}}{\text{Total Expected Production or Usage}} \times 100$$

- **Cost Based Method**

$$\text{Stage of Completion \%} = \frac{\text{Costs incurred to Date}}{\text{Total Contract Costs}} \times 100$$

Thanks for your attention!