

APPROVED

by Resolution No. 5 of 25 August 2004 of the
Standards Board of the Public Establishment the
Institute of Accounting of the Republic of Lithuania

25 BUSINESS ACCOUNTING STANDARD "CONSTRUCTION AND OTHER LONG-TERM CONTRACTS"

(*"Valstybės žinios"* (Official Gazette), 2004, No. 155-5686)

I. GENERAL PROVISIONS

1. The objective of this Standard is to set out how income and expenses related to construction contracts shall be recognised, accounted for and presented in financial statements. Usually the dates determined by long-term contracts for the beginning and end of the contract activities fall into different reporting periods, therefore this Standard discusses when contract income and costs shall be recognised as income and expenses in the income statement.

2. This Standard shall be applicable for accounting treatment of construction and other work performed under long-term contracts (hereinafter, construction contracts) in financial statements of a contractor or constructor (hereinafter, the contractor).

II. KEY DEFINITIONS

Outcome of a construction contract – an expected total contract amount less contract costs.

Total contract amount – the amount of received and (or) receivable contract inflows.

Fixed price contract – a construction contract with an agreed fixed contract price or a part of a constructed object, which is to be received by the contractor after completing contract activities and handing over the constructed object.

Cost plus contract – a construction contract under which the contractor is reimbursed for expected or otherwise defined costs based on the assumptions and terms defined in the contract, plus a fee fixed (agreed) in advance.

Claim – an amount that the contractor seeks to receive from the customer or another third party, as a reimbursement for costs not included in the total contract amount.

Contractor – a party to a construction contract that assumes an obligation to perform certain construction work at its own risk according to another party's (the customer's) specifications and to hand over this work to the customer.

Incentive payments – the amounts paid by the customer to the contractor for completing the construction work exceeding quality expectations and (or) faster than it is agreed in the contract.

Construction contract – a contract between a contractor and a customer, whereas the contractor assumes an obligation to construct a building or construction according to the customer's specifications or perform other work during a period set in the contract, and the customer assumes an obligation to provide the contractor with necessary operating conditions, to accept the work, and to pay the agreed contract price.

Amount of retention – an amount of interim payment that is not paid until the contract conditions are satisfied or defects eliminated.

Stage of contract completion – a percentage of completion of construction or other work under construction and other long-term contracts that are in progress at the balance sheet date.

Progress payment – amounts payable by or receivable from the contractor at specified dates and/or for completed work during the period of executing the construction contract.

Customer – a party to a construction contract that orders to perform certain construction work and assumes an obligation to accept the work and to pay for it.

III. ACCOUNTING OBJECTS OF CONSTRUCTION CONTRACTS

3. Usually each construction contract is recognised as a separate object for accounting income and expenses. However, in certain circumstances, several contracts shall be treated as a single accounting object regardless of whether they are entered into with a single or with several customers. On the other hand, one construction contract may be treated as several separate accounting objects.

4. Several contracts may be treated as a single accounting object if:

4.1. the group of contracts is negotiated as a single package;

4.2. the contracts are made for interrelated and dependent parts of the same project with an overall profit margin;

4.3. the contracts are performed concurrently or in a continuous sequence, without breaks, as a single complex of work.

5. In certain circumstances it is possible that a single construction contract involving the construction of several objects is treated as several accounting objects if:

5.1. separate proposals have been submitted for each construction object;

5.2. each construction object has been subject to separate negotiation and their parties (the contractor or customer) have been able to choose whether to include one or another object into the general contract;

5.3. the income and expenses of each construction object can be measured reliably and recognised separately.

6. A construction contract may specify that the customer has a right to require constructing an additional object or it may be amended to include the requirement to build an additional object. The construction of such object shall be treated as a separate accounting object if:

6.1. the additional object differs significantly in design, technology, and function from the construction object (objects) covered by the original contract; or

6.2. the price of the additional object is negotiated regardless of the original contract price.

IV. TOTAL CONTRACT AMOUNT

7. Total contract amount shall comprise:

7.1. the initial amount agreed with the customer in the contract;

7.2. income related to variations in contract work, claims, and incentive payments, which are expected to be recognised as income and which can be reliably measured.

8. Total contract amount is measured at the fair value of consideration received or receivable. The amount of contract may increase or decrease from one period to the next due to future events.

9. For example, total contract amount may change due to:

9.1. agreements between the contractor and customer concerning changes or claims that increase or decrease the income;

9.2. incentive payments paid by the customer if the contractor completes the construction work with a higher quality and (or) faster than it is agreed in the contract;

9.3. variations from the contract terms.

10. Variations from the contract terms arise if the customer gives instructions to the contractor concerning the scope of the object, change in quality of work, extension or shortening of contract term, reclassification of an object, change of current objects to another, used materials and construction

technologies, etc. There may be other different variations from the contract being executed by the contractor.

11. Variation from the contract terms may lead to an increase or decrease in the income of the contractor. The amount of income is determined by the agreement between the customer and contractor.

12. Examples of variations due to which the total contract amount may change:

12.1. penalties set by the customer due to execution of a contract;

12.2. in fixed price contracts, where it is agreed to settle by a part of the constructed object, the income of a contractor may increase or decrease due to changes in the value of the constructed object;

12.3. claims that can be submitted due to mistakes in design documentation, delay of the contractor to fulfil contract obligations, various adjustments, and in other cases.

13. Income arising from claims is recognised when, and only when, the negotiation has reached a stage when it is likely that the claim will be recognised and it will be possible to measure its amount reliably.

V. CONSTRUCTION CONTRACT COSTS

14. Construction contract costs, which will be recognised as expenses over the period of contract execution, shall comprise:

14.1. costs directly related to the specific contract of ordinary activities;

14.2. costs attributable to contract activities in general that can be reasonably allocated to contracts being executed.

15. Costs that cannot be allocated to contract activities or to the specific contract are not included into construction contract costs. Examples of such costs are as follows:

15.1. selling costs;

15.2. costs of loans intended for contract execution;

15.3. general and administrative costs;

15.4. research and development costs that will not be reimbursed according to the contract;

15.5. depreciation costs of idle plant and equipment that is not used in contract execution.

16. Contract costs include costs incurred during the period from the date of securing the contract to the final completion of the contract.

17. Costs that are related to the contract or are incurred in securing the contract may be included in the contract costs if it is probable that the contract will be secured.

18. If the contract is obtained in subsequent periods, costs that are related to the contract or are incurred in securing the contract shall be recognised as expenses immediately when they are incurred and excluded from contract costs.

VI. ACCOUNTING FOR AND PRESENTATION IN FINANCIAL STATEMENTS OF CONSTRUCTION CONTRACT INCOME AND EXPENSES

19. Before estimating the amount of income, the nature of a construction contract shall be determined (whether it is a fixed price or a cost plus contract). If the outcome of a construction contract can be estimated reliably, income and expenses of each construction contract shall be recognised in accounting by reference to the stage of completion of contract activities determined at the balance sheet date of each reporting period.

20. In the case of a fixed price contract, the outcome of a construction contract can be estimated reliably if all the following conditions are met:

20.1. it is probable that the economic benefits associated with the contract will flow to the entity;

20.2. total contract amount can be estimated reliably;

20.3. both the contract costs until the end of the contract and the stage of contract completion at the balance sheet date can be measured reliably;

20.4. the costs attributable to the contract can be clearly identified or estimated reliably so that actual contract costs incurred can be compared with prior estimates.

21. In the case of a costs plus contract, the outcome of a construction contract can be estimated reliably if all the following conditions are met:

21.1. it is probable that the economic benefits associated with the contract will flow to the entity;

21.2. the contract costs attributable to the contract, taking into consideration whether or not they are intended to be reimbursed, can be clearly identified and estimated reliably.

22. All expected construction contract losses shall be recognised as expenses of the reporting period.

23. The amount of construction contract loss is determined regardless of:

23.1. whether the work has commenced or not on the contract;

23.2. the stage of contract completion;

23.3. the expected amount of profit from other contracts that are not treated as a single construction contract.

24. Income and expenses of each contract are recognised by reference to the stage of contract completion. Under this method, contract income is matched with the costs incurred until the current stage of contract completion. This method provides useful information on the scope of the contract activities, stage of completion, and performance during the reporting period.

25. Under the percentage of completion method, contract income is recognised as income in the income statements of reporting periods in which the work was performed. Contract costs are usually recognised as expenses in the income statements of reporting periods in which the work to which they relate is performed. However, if any expected contract costs exceed the total contract amount, the excess is recognised as expenses immediately.

26. Costs related to future activities under the contracts shall not be treated as the expenses of the current reporting period. Such contract costs are recognised as assets provided that it is probable that they will be recovered. They are usually recognised as contracts in progress. The examples of such costs are:

26.1. value of raw materials, components and parts obtained for the construction work but not yet used by the reporting date of the reporting period;

26.2. prepayments to subcontractors for work that has not yet been performed in a way agreed in the contract.

27. When during the execution of construction work an uncertainty arises regarding the recovery of amounts already included in the contract income and recognised in the income statement, unrecoverable or doubtful amounts are recognised as operating expenses rather than adjustments of the amount of contract income.

28. An entity is generally able to make reliable estimates when the contract specifies:

28.1. each party's enforceable rights regarding the construction contract of a specific object to be constructed;

28.2. the obligations of each party;

28.3. the manner and terms of settlement.

29. The stage of completion of a contract, depending on the nature of the contract, may be determined in various ways:

29.1. by calculating a percentage ratio of costs incurred for work performed to the specific date to estimated total contract costs in order to determine the scope of work performed. The examples of contract costs excluded from contract costs incurred to date are costs related to the future contract activities, i.e., costs of materials that are intended to be used in the contract, delivered to the contract site or set aside but not yet prepared, unused or applied during contract performance; and prepayments to subcontractors for work to be performed under the subcontract;

29.2. by calculating the scope of work performed in proportion to human hours worked or machine running hours in the object;

29.3. by determining the actual scope of work performed according to the project.

30. Progress payments and prepayments received from the customer often do not reflect the work performed.

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

31.1. income shall be recognised only to the extent of contract costs that it is probable will be recoverable, and expected construction contract losses shall be recognised as expenses immediately;

31.2. contract costs shall be recognised as expenses in the period when they are incurred.

32. During the early stage of contract execution it is often the case that the outcome of the contract cannot be estimated reliably, however, it may be probable that the entity will recover the contract costs incurred, hence, contract income is recognised only to the extent of costs incurred that are expected to be recovered.

33. If the outcome of the contract cannot be estimated reliably, contract costs may exceed the total contract amount. In such cases, any expected excess amount of total contract costs over total contract income is recognised as expenses immediately.

34. Contract costs that are not probable of being recovered are recognised as expenses immediately. Examples of such cases and contracts are:

34.1. contracts the validity of which is in question;

34.2. contracts the completion of which is subject to the outcome of pending litigation or legislation;

34.3. contracts related to properties that are likely to be condemned or expropriated by the state;

34.4. cases when the customer is unable to meet its obligations;

34.5. cases when the contractor is unable to complete the contract conditions or otherwise meet its obligations under the contract.

VII. CHANGES IN ACCOUNTING ESTIMATES

35. Applying the percentage of completion method, the effect of changes in estimates of total contract amount, income, expenses or outcome of a construction contract is recognised according to the requirements of 7 Business Accounting Standard “Changes in Accounting Policies, Accounting Estimates, and Correction of Errors”. New estimates are used to determine the amount of income and expenses recognised in the income statement of the reporting period in which the change is made and in the income statements of subsequent periods.

VIII. DISCLOSING INFORMATION IN FINANCIAL STATEMENTS

36. In its financial statements an entity shall disclose:

36.1. the amount of contract income recognised as income in the income statement in the reporting period;

36.2. the methods used (by reference to the percentage of completion or to the costs that will probably be recovered) to recognise the contract income of the reporting period;

36.3. the methods used to determine the stage of completion of work under construction contracts.

37. In its financial statements an entity shall present the following data about construction contracts in progress:

37.1. the aggregate amount of incurred contract costs and recognised profit (less recognised loss) accumulated until the balance sheet date;

37.2. the amount of received prepayments;

37.3. the amount of retentions.

38. In its financial statements an entity shall present:

38.1. the total amount due from customers for agreed contract work as an asset;

38.2. the total amount due to customers for agreed contract work as a liability.

39. An entity discloses all contingent liabilities and contingent assets in accordance with 19 Business Accounting Standard "Provisions, Contingent Liabilities and Contingent Assets, and Events after the Balance Sheet Date". Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties or possible losses.

IX. FINAL PROVISIONS

40. Upon the first-time application of this Standard, an entity shall apply its provisions from the effective date of the Standard and adjust the comparative information of prior reporting periods according to the requirements of 7 Business Accounting Standard "Changes in Accounting Policies, Accounting Estimates, and Correction of Errors".

41. This Standard shall be effective for financial statements covering periods beginning on or after 1 January 2005. The Standard may be applied in preparing financial statements for 2004.