

**IPSAS 11 – CONSTRUCTION CONTRACTS
as adopted by the Maltese Government**

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International Public Sector Accounting Standard 11, *Construction Contracts*, as adopted by the *Maltese Government*, is set out in the objective and paragraphs 1–58A. All the paragraphs have equal authority. IPSAS 11¹ should be read in the context of its objective. IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*, provides a basis for selecting and applying accounting policies in the absence of explicit guidance.

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¹ References to IPSAS 11 or any other IPSAS shall be taken as meaning ‘as adopted by the Maltese Government’

Objective

The objective of this Standard is to prescribe the accounting treatment of costs and revenue associated with construction contracts. The Standard:

- Identifies the arrangements that are to be classified as construction contracts;
- Provides guidance on the types of construction contracts that can arise in Central Government; and
- Specifies the basis for recognition and disclosure of contract expenses and, if relevant, contract revenues.

Because of the nature of the activity undertaken in construction contracts, the date at which the contract activity is entered into and the date when the activity is completed usually fall into different reporting periods.

In many jurisdictions, construction contracts entered into by Central Government entities will not specify an amount of contract revenue. Rather, funding to support the construction activity will be provided by an appropriation or similar allocation of general government revenue, or by aid or grant funds. In these cases, the primary issue in accounting for construction contracts is the (a) allocation of construction costs to the reporting period in which the construction work is performed, and (b) the recognition of related expenses.

In some jurisdictions, construction contracts entered into by Central Government entities may be established on a commercial basis or a non-commercial full or partial cost recovery basis. In these cases, the primary issue in accounting for construction contracts is the allocation of both contract revenue and contract costs to the reporting periods in which construction work is performed.

Scope

1. **A contractor that prepares and presents financial statements under the accrual basis of accounting shall apply this Standard in accounting for construction contracts.**
2. [Deleted]
3. [Deleted]

Definitions

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

Central Government entities means Government Ministries and Departments.

Construction contract is a contract, or a similar binding arrangement, 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.

Contractor is an entity that performs construction work pursuant to a construction contract.

Cost plus or cost-based contract is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs and, in the case of a commercially based contract, an additional percentage of these costs or a fixed fee, if any.

Fixed price contract is a construction contract in which the contractor agrees to a fixed contract price, or a fixed rate per unit of output, which in some cases is subject to cost escalation clauses.

Terms defined in other IPSASs are used in this Standard with the same meaning as in those Standards, and are published separately.

Construction Contracts

5. A construction contract (the terms construction contract and contract are used interchangeably in the remainder of this Standard) 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 that 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 reticulated water supply systems, refineries, and other complex infrastructure assets.
6. For the purposes of this Standard, construction contracts include:
 - (a) Contracts for the rendering of services that 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.
7. For the purposes of this Standard, construction contracts also include all arrangements that are binding on the parties to the arrangement, but which may not take the form of a documented contract. For example, two government departments may enter into a formal arrangement for the construction of an asset, but the arrangement may not constitute a legal contract because, in that jurisdiction, individual departments may not be separate legal entities with the power to contract. However, provided that the arrangement confers similar rights and obligations on the parties to it as if it were in the form of a contract, it is a construction contract for the purposes of this Standard. Such binding arrangements could include (but are not limited to) a ministerial direction, a cabinet decision, a legislative direction (such as an Act of Parliament), or a memorandum of understanding.
8. Construction contracts are formulated in a number of ways that, for the purposes of this Standard, are classified as fixed price contracts and cost plus or cost-based contracts. Some commercial construction contracts may contain characteristics of both a fixed price contract and a cost plus or cost-based contract, for example in the case of a cost plus or cost-based contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 31 and 32 in order to determine when to recognize contract revenue and expenses.
9. Cost plus and cost-based contracts encompass both commercial and non-commercial contracts. A commercial contract will specify that revenue to cover the agreed constructor's construction costs and generate a profit margin will be provided by the other parties to the contract. However, a Central Government entity may also enter into a non-commercial contract to construct an asset for another entity in return for full or partial reimbursement of costs from that entity or other parties. In some cases, the cost recovery may encompass payments by the recipient entity and specific purpose construction grants or funding from other parties.
10. In many jurisdictions, where one Central Government entity constructs assets for another Central Government entity, the cost of construction activity is not recovered directly from the recipient. Rather, the construction activity is funded indirectly (a) by way of a general appropriation or other allocation of general government funds to the contractor, or (b) from general purpose grants from third party funding agencies or other governments. These are classified as fixed price contracts for the purpose of this Standard.

Contractor

11. A contractor is an entity that enters into a contract to build structures, construct facilities, produce goods, or render services to the specifications of another entity. The term “contractor” includes a general or prime contractor, a subcontractor to a general contractor, or a construction manager.

Combining and Segmenting Construction Contracts

12. 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.
13. **When a contract covers a number of assets, the construction of each asset shall 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.**
14. **A group of contracts, whether with a single customer or with several customers, shall 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 margin, if any; and**
 - (c) **The contracts are performed concurrently or in a continuous sequence.**
15. **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 shall 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

16. **Contract revenue shall comprise:**
- (a) **The initial amount of revenue agreed in the contract; and**
 - (b) **Variations in contract work, claims, and incentive payments to the extent that:**
 - (i) **It is probable that they will result in revenue; and**
 - (ii) **They are capable of being reliably measured.**
17. Contract revenue is measured at the fair value of the consideration received or receivable. Both the initial and ongoing measurement of contract revenue are 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. Where a contract is a cost plus or cost-based contract, the initial amount of revenue may not be stated in the contract. Instead, it may need to be estimated on a basis consistent with the terms and provisions of the contract, such as by reference to expected costs over the life of the contract.
18. In addition, 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 to 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, cost plus, or cost-based contract may increase as a result of cost escalation or other 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 or decreases as the number of units is increased or decreased.
19. 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.
20. 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.
21. 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.
22. Contractors should review all amounts relating to the construction contract that are paid directly to subcontractors by third party funding agencies, to determine whether they meet the definition of, and recognition criteria for, revenue of the contractor under the terms of the contract. Amounts meeting the definition and recognition criteria for revenue should be accounted for by the contractor in the same way as other contract revenue. Such amounts should also be recognized as contract costs (see paragraph 25). Funding agencies may include national and international aid agencies and multilateral and bilateral development banks.

Contract Costs

23. **Contract costs shall 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 on a systematic and rational basis; and**
 - (c) **Such other costs as are specifically chargeable to the customer under the terms of the contract.**

24. 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 are 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 revenue that is not included in contract revenue, for example, revenue from the sale of surplus materials at the end of the contract.

25. Contractors should review all amounts relating to the construction contract paid directly by subcontractors and which are reimbursed by third party funding agencies, to determine whether they qualify as contract costs. Amounts meeting the definition of, and recognition criteria for, contract expenses should be accounted for by the contractor in the same way as other contract expenses. Amounts reimbursed by third party funding agencies that meet the definition of, and recognition criteria for, revenue should be accounted for by the contractor in the same way as other contract revenue (see paragraph 22).

26. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:
- (a) Insurance;
 - (b) Costs of design that are not directly related to a specific contract; and
 - (c) Construction overheads.

Such costs are allocated using methods that (a) are systematic and rational, and (b) 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 IPSAS 5, *Borrowing Costs*.

27. 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.

28. 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
 - (d) Depreciation of idle plant and equipment that is not used on a particular contract.
29. 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 that 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 recognized 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

30. **When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognized as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected deficit on a construction contract to which paragraph 44 applies shall be recognized as an expense immediately in accordance with paragraph 44.**
31. **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, if any, can be measured reliably;**
 - (b) **It is probable that the economic benefits or service potential associated with the contract will flow to the entity;**
 - (c) **Both the contract costs to complete the contract and the stage of contract completion at the reporting 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.**
32. **In the case of a cost plus or cost-based 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 or service potential associated with the contract will flow to the entity; and**
 - (b) **The contract costs attributable to the contract, whether or not specifically reimbursable, can be clearly identified and measured reliably.**
33. 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 surplus/deficit that 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.

34. Under the percentage of completion method, contract revenue is recognized as revenue in the statement of financial performance in the reporting periods in which the work is performed. Contract costs are usually recognized as an expense in the statement of financial performance in the reporting periods in which the work to which they relate is performed. However, where it is intended at inception of the contract that contract costs are to be fully recovered from the parties to the construction contract, any expected excess of total contract costs over total contract revenue for the contract is recognized as an expense immediately in accordance with paragraph 44.
35. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognized 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.
36. The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits or service potential associated with the contract will flow to the entity. However, when an uncertainty arises about the collectability of an amount already included in contract revenue, and already recognized in the statement of financial performance, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognized as an expense rather than as an adjustment of the amount of contract revenue.
37. An entity is generally able to make reliable estimates after it has agreed to a contract that establishes:
- (a) Each party's enforceable rights regarding the asset to be constructed;
 - (b) The consideration, if any, to be exchanged; and
 - (c) The manner and terms of settlement.

It is also usually necessary for the entity to have an effective internal financial budgeting and reporting system. The entity 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.

38. The stage of completion of a contract may be determined in a variety of ways. The entity 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.

39. 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 that 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 especially for the contract; and
 - (b) Payments made to subcontractors in advance of work to be performed under the subcontract.
40. **When the outcome of a construction contract cannot be estimated reliably:**
- (a) **Revenue shall be recognized only to the extent of contract costs incurred that it is**

probable will be recoverable; and

- (b) Contract costs shall be recognized as an expense in the period in which they are incurred.**

An expected deficit on a construction contract to which paragraph 44 applies shall be recognized as an expense immediately in accordance with paragraph 44.

41. 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 entity will recover the contract costs incurred. Therefore, contract revenue is recognized only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no surplus or deficit is recognized. 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 revenues for the contract is recognised as an expense immediately in accordance with paragraph 44.
42. Where contract costs that are to be reimbursed by parties to the contract are not probable of being recovered, they are recognized 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 recognized as an expense immediately, include contracts:
- (a) That 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.
43. **When the uncertainties that prevented the outcome of the contract being estimated reliably no longer exist, revenue and expenses associated with the construction contract shall be recognized in accordance with paragraph 30 rather than in accordance with paragraph 40.**

Recognition of Expected Deficits

44. **In respect of construction contracts in which it is intended at inception of the contract that contract costs are to be fully recovered from the parties to the construction contract, when it is probable that total contract costs will exceed total contract revenue, the expected deficit shall be recognized as an expense immediately.**
45. Central Government entities may enter into construction contracts that specify that the revenue intended to cover the construction costs will be provided by the other parties to the contract. This may occur where, for example:
- (a) Government departments and agencies that are largely dependent on appropriations or similar allocations of government revenue to fund their operations are also empowered to contract with other Central Government entities, or public sector entities, or private sector entities for the construction of assets on a commercial or full cost recovery basis; or
 - (b) Government departments and agencies transact with each other on an arm's length or commercial basis as may occur under a "purchaser-provider" or similar model of government.

In these cases, an expected deficit on a construction contract is recognized immediately in accordance with paragraph 44.

46. As noted in paragraph 9, in some cases a Central Government entity may enter into a construction contract for less than full cost recovery from the other parties to the contract. In these cases, funding in excess of that specified in the construction contract will be provided from an appropriation or other allocation of government funds to the contractor, or from general purpose grants from third party funding agencies or other governments. The requirements of paragraph 44 do not apply to these construction contracts.
47. In determining the amount of any deficit under paragraph 44, total contract revenue and total contract costs may include payments made directly to subcontractors by third party funding agencies in accordance with paragraphs 22 and 25.
48. The amount of such a deficit 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 surpluses expected to arise on other commercial construction contracts that are not treated as a single construction contract in accordance with paragraph 14.

Changes in Estimates

49. The percentage of completion method is applied on a cumulative basis in each reporting 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 (see IPSAS 3, *Accounting Policies, Changes in Accounting Estimates and Errors*.) The changed estimates are used in the determination of the amount of revenue and expenses recognized in the statement of financial performance in the period in which the change is made and in subsequent periods.

Disclosure

50. **An entity shall disclose:**
- (a) **The amount of contract revenue recognized as revenue in the period;**
 - (b) **The methods used to determine the contract revenue recognized in the period; and**
 - (c) **The methods used to determine the stage of completion of contracts in progress.**
51. **An entity shall disclose each of the following for contracts in progress at the reporting date:**
- (a) **The aggregate amount of costs incurred and recognized surpluses (less recognized deficits) to date;**
 - (b) **The amount of advances received; and**
 - (c) **The amount of retentions.**
52. Retentions are amounts of progress billings that 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 of contract revenue billed for work performed on a contract, whether or not they have been paid by the customer. Advances are amounts of contract revenue received by the contractor before the related work is performed.

53. **An entity shall 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.**
54. The gross amount due from customers for contract work is the net amount of:
- (a) Costs incurred plus recognized surpluses; less
 - (b) The sum of recognized deficits and progress billings for all contracts in progress for which costs incurred plus recognized surpluses to be recovered by way of contract revenue (less recognized deficits) exceed progress billings.
55. The gross amount due to customers for contract work is the net amount of:
- (a) Costs incurred plus recognized surpluses; less
 - (b) The sum of recognized deficits and progress billings for all contracts in progress for which progress billings exceed costs incurred plus recognized surpluses to be recovered by way of contract revenue (less recognized deficits).
56. Guidance on the disclosure of contingent liabilities and contingent assets can be found in IPSAS 19, *Provisions, Contingent Liabilities and Contingent Assets*. Contingent liabilities and contingent assets may arise from such items as warranty costs, claims, penalties, or possible losses.

Effective Date

57. [Not used]
58. [Not used]
- 58A. Central Government entities shall apply this Standard for annual financial statements covering periods beginning or after DD/MM/YY. Earlier application is not permitted.

Appendix 1

Comparison with IPSAS 11

IPSAS 11 Construction Contracts as adopted by the Maltese Government is drawn from IPSAS 11 Construction Contracts.

The following are the main differences between IPSAS 11 as adopted by the Maltese Government and IPSAS 11:

Section	IPSAS 11 (as adopted)	IPSAS 11
Objective, 9, 10, 45, 46	Reference is made to Central Government Entities.	Reference is made to Public Sector Entities.