

FRS 11: CONSTRUCTION CONTRACTS

HIGHLIGHTS OF TECHNICAL CLINIC

A technical clinic on FRS 11 *Construction Contracts* was held for a group of practitioners, facilitated by an experienced practitioner, on 22 August 2012. The vibrant discussion yielded some “golden nuggets”, which ICPAS would like to share with other practitioners.

Q **It appears that many practitioners tripped up over this topic. Why is the audit of construction contracts so challenging? What’s so unique about companies operating in the construction industry?**

A The uniqueness predominantly lies in having to determine percentage-of-completion (POC) on a contract-by-contract basis. That said, construction companies differ in size and complexity. The audit may not be so bad for companies with only one or two projects, but for companies with multiple big projects, it can be quite a nightmare if documents and accounting records are not properly maintained. The audit of such companies can be difficult and tedious because for one, auditors have to analyse the revenue, costs, attributable profits, progress billings, and WIP on a contract-by-contract basis. The management is supposed

to prepare such detailed analyses and as auditors, you should audit this information, so you can imagine the consequences if the management does not have such analyses. Secondly, determining POC requires judgement, and ascertaining provision for foreseeable losses can be highly subjective. Management and auditors are often embroiled in protracted debates on the quantum

of losses that requires provision should they decide that losses are foreseen.

Q **Why is there a need to analyse the contracts on an individual basis? Can we not just select one or two samples of contract and walk them through?**

A This, unfortunately, is not

adequate work performed. For instance, if a company has five contracts and you select the top two for your testing, the remaining three contracts not selected could be material on a cumulative basis. There is also the danger that profit from any of these three contracts will offset the losses from the remaining contracts which breaches FRS 11, para 37(c). To elaborate, foreseeable losses may need to be made for loss-making contracts but should the analysis not be done on individual contracts but in totality, there is the possibility that profit arising from the profitable contracts is inadvertently used to offset the loss provision made.

Q Why do companies need to determine stage of completion for each individual contract? Would it not be sufficient to verify invoices acknowledged by

the customers or supported by third-party certifications to substantiate the revenue recognised? After all, these documents are acknowledged by third parties and therefore, should be reliable.

A No, this is not adequate work done. We are talking about project accounting here. What this means is that the POC point

determines the revenue, costs, profits and WIP that need to be recognised in the accounts, and each of these elements have to be tied back to the POC point and cannot be determined in isolation. For instance, assuming a simple example where the contract value is \$6 million and the project is 70% completed but the amount of invoices acknowledged by customer and supported by third-party certifications is \$3 million. You should not recognise only \$3 million as your revenue. Given that the POC determined is 70%, the amount of revenue that you should recognise is \$4.2 million. If you had not determined the POC, you would erroneously recognise only \$3 million as your revenue instead of \$4.2 million. The amount of costs that needs to be recognised and the resulting attributable profit and WIP have also to be computed based on the POC of 70% and accounted for in the financial statements. These elements are correlated.

Q Recognising POC is easier said than done. Not all companies use the “proportion of contract costs” method to determine POC. Also, for those that use the “survey of work performed” method or “completion of physical activity” method, companies may not engage external surveyors. Would this be tantamount to scope limitation?

A If the projects are big, it would be advisable for companies to engage third-party surveyors to determine the POC for all material projects as at year-end. The POC for the survey method or physical activity method must be determined by experts (these could be engineers, architects or surveyors) who are knowledgeable about the subject matter and

have the competence to make that determination. Some companies may not want to incur the costs to hire the experts but that said, auditors should exercise professional judgement in deciding whether to insist that experts be used, having taken into account the significance of each project and the potential impact on the financial statements should incorrect determination of POC be made.

Q What about using inhouse engineers? Most companies have project managers and/or inhouse engineers who determine the POC for the management. Can we then rely on the representation of the inhouse experts?

A This is a viable alternative to external experts. However, reliance can only be placed by auditors after having satisfied themselves that the inhouse personnel has the competence and capability to make the POC determination and more importantly, he is objective in his work. The expert's objectivity can be quite tricky to corroborate, especially if he is an employee of the company. You could, for instance, check that he is registered with a particular association or institute which requires that he comply with the relevant code of ethics and professional conduct. After you are satisfied with the expert's professional characteristics, you should then obtain an understanding of the expert's work and ascertain whether his work can be used as your audit evidence. All these are requirements of SSA 500(R) and must be complied with (refer to *Notes on page 48). After doing all these, remember to do one more thing – document it! All work done is not counted if there is no documentation to show for it.

Q Would there be less subjectivity if the “proportion of contract costs” method is adopted?

A This may not necessarily be so. If this method is adopted, you have to obtain an understanding of the management’s bidding process of each contract and their process of revising the estimated total contract costs as the contract progresses. The numerator, that is, the total contract costs incurred may be easier for the management to determine because they are based on actual amounts incurred and should be supported by relevant documents. However, the denominator, that is, the estimated total contract costs, requires exercise of judgement by the management because it requires consideration of factors like overruns, delays, over-/under-budgeting, changes in market conditions etc, especially for the bigger projects.

Q If the management does have processes in place to review and revise its estimated total contract costs, can auditors just document them as such and pass further work?

A This would not be adequate. Auditors have to corroborate management’s processes and representations. This can be done by verifying the major components in the estimated total contract costs which may include, but are not limited to, verifying quotations from suppliers to support materials costs, ascertaining the reasonableness of the basis and estimated amount of labour costs by reviewing payroll records and files, and reviewing the appropriateness of overheads allocation.

Q It was mentioned that determination of foreseeable losses is highly subjective due to the need to consider various factors. How can this determination be audited?

A To identify foreseeable losses, management has to first ascertain the estimated total contract costs. Foreseeable loss is the product of estimated total contract costs in excess of total contract revenue. We have discussed this in our previous question as to how these estimates can be corroborated, so we won’t repeat it here.

It would be useful to emphasise the additional factors that need to be considered when determining the appropriateness of the estimated total contract costs and the resulting foreseeable loss. Auditors are required to analyse and discuss these matters, among others, with the management – delays, cost overruns, penalty clauses, liquidated damages clauses etc. It is crucial that auditors read the contracts to sift out any clauses that affect elements of revenue, total costs and loss provisions.

Q For projects fully completed in a particular financial year, does it mean that auditors do not need to worry about performing all the aforementioned audit procedures?

A Only certain procedures may not be required anymore; for example, there may no longer be the need to corroborate estimated total contract costs as all costs should have been incurred and any loss realised. However, other procedures to confirm completion of projects are required, for instance, sighting Certificate of

Release acknowledged by customer, TOP, Certificate of Completion by architects and/or quantity surveyor or customer-acknowledged project handover documents. In addition, do perform post-balance sheet events review work to make sure that total contract costs have been captured and any loss has been accrued for in the financial year under audit.

Q If the management’s records are incomplete or not in proper order such that the auditors’ ability to perform the required audit procedures is hampered, what can be done?

A There is no single correct answer to this question. Auditors have to consider the extent of scope limitation and whether alternative audit procedures could be performed. If in doubt, it pays to consult with other practitioners. Suffice to say, if the scope limitation has significant impact on the financial statements in the auditors’ professional judgement, they should seriously consider issuing a modified opinion. It would also be wise for the auditors to obtain concurrence from another experienced practitioner just to make sure that the type of audit opinion issued is appropriate. Complete and robust documentation to justify the type of opinion issued should be prepared and filed. Any modified opinion should not be taken lightly. Thereafter, the auditor should also find out whether the company will make improvements to their accounting and financial reporting function to address incomplete and improper record-keeping and if not, the auditor should consider whether it is worth keeping the client. **CPA**

*Notes on SSA 500(R)

The requirements under SSA, para 8, include:

¹ Evaluating the competence, capabilities and objectivity of that expert (refer also SSA 500(R), para A37-A43);

² Obtaining an understanding of the work of that expert (refer also SSA 500(R), para A44-A47); and

³ Evaluating the appropriateness of that expert’s work as audit evidence for the relevant assertion (refer SSA 500(R), para A48)