Audit of Long-Term Construction Contracts
Practical Guidance No. 11

Topic: Audit of Long-Term Construction Contracts

Introduction

1. Companies in the business of construction of assets, rendering of services directly related to the construction of assets (e.g. those of project managers and architects) or are involved in contracts for the destruction or restoration of assets should apply Singapore Financial Reporting Standards ("FRS") 11 “Construction Contracts” in accounting for the construction contracts.

2. Due to 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 accounting periods. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the accounting periods in which construction work is performed. FRS 11.22 states that “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”.

3. FRS 11.30 provides that 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 cost incurred for work performed to date bear to the estimated total contract cost;
   (b) surveys of work performed; or
   (c) completion of a physical proportion of the contract work.

Objective of the publication

4. This practical guidance sets out some of the observations based on the reviewers’ inspection of audits of companies in the construction industry using the substantive audit approach. It aims to provide guidance to the auditors on the audit procedures to be performed when auditing a company that engages in fixed-price construction contract and uses the percentage of completion method to recognise revenue.

Key observations and Guidance

5. From the engagement files reviewed, the noted audit deficiencies are as follows:
   • Failure to analyse revenue, costs, attributable profits and progress billings on a contract-by-contact basis;
   • Inadequate work performed in ascertaining the stage of completion;
   • Inadequate work performed in ascertaining total revenue;
   • Inadequate work performed in ascertaining total estimated contract costs;
• Failure to assess foreseeable loss for uncompleted contracts on a contract-by-contract basis;
• Failure to perform work to verify the accuracy and the completeness of the total revenue recognised for completed contracts during the year; and
• Limitation of scope placed by management due to incomplete or improper records of the contracts kept.

**Failure to analyse revenue, costs, attributable profits and progress billings on a contract-by-contract basis**

6. The reviewers noted that the work performed on the significant account balances in the financial statements were limited to the following:

- **For contract revenue and work-in-progress - progress billings accounts**
  Verifying a sample of the recorded contract revenue or progress billings to the company’s invoices acknowledged by the customers or supported by third party’s certifications as part of the sales transaction test performed.

- **For contract costs and work-in-progress - construction costs incurred accounts**
  Verifying the contract costs or construction cost incurred during the year to the suppliers’ invoices as part of the purchases transaction test performed.

These stand-alone tests at the transaction level would not be adequate to ascertain if project accounting have been properly applied at the individual contract level.

7. The auditor should obtain an understanding of how the stage of completion for each contract is determined by management and perform an analysis on a contract-by-contract basis to review the correlation of the stage of completion, contract revenue, contract costs, and attributable profits recognised in the income statement as well as the work-in-progress recognised in the statement of financial position to ensure that they are correctly and appropriately recognised based on the stage of completion determined for each contract.

**Inadequate work performed in ascertaining the stage of completion**

8. For contracts where the stage of completion was determined using surveys of work performed or completion of a physical proportion of the contract work, the reviewers have noted in some instances that the work performed was limited to sighting of progress billings raised by the company which may be supported by in-house certification of the stage of completion. This is not considered adequate work since these documents were internally generated by the company. To properly address the occurrence of contract revenue recognised, auditor needs to perform work to verify to the latest architects’ certificates or latest cumulative billings certified by independent quantity surveyors, where applicable, for the contracts selected for testing.
9. Where reliance is placed on company’s in-house engineers’ certificates, auditor needs to ensure that the requirements under SSA 500(R) “Audit Evidence” paragraph 8 have been addressed. These requirements include:
   (a) Evaluate the competence, capabilities and objectivity of that expert; (Paragraph A37-A43)
   (b) Obtain an understanding of the work of that expert; and (Paragraph A44-A47)
   (c) Evaluate the appropriateness of that expert’s work as audit evidence for the relevant assertion. (paragraph A48)

10. In addition, where such certification provides the value of work done up to an earlier or later date than the balance sheet date, auditor may need to perform further work to ascertain whether there were any significant work or services performed between the date of the latest certification and the balance sheet date to ensure completeness and proper cut-off of the contract revenue.

   **Inadequate work performed in ascertaining total revenue**

11. The total contract sum or revenue impacts project accounting in two ways, either (a) the computation of percentage of completion (POC) where it is based on total cumulative revenue certified by quantity surveyors/architects divided by the total contract revenue; or (b) the amount of contract revenue to recognize based on work performed to-date relative to the estimated total contract costs. To address the completeness and accuracy of the total contract revenue, auditor needs to verify the amount to the original contract for the initial contract sum and any subsequent variation orders entered for the contracts selected for testing. This is performed to ensure that the total contract revenue as at year end has correctly included all subsequent variations in contract work (if any) whether due to both the additions to or reduction in scope of work to be performed or services to be rendered.

12. If there were any subsequent variation orders for the contract noted during the review of the contracts, auditor needs to understand the nature of these variation orders and assess their impact on the total estimated cost of the contract when reviewing the total estimated cost which is covered in the following paragraphs.

   **Inadequate work performed in ascertaining total estimated contract costs**

13. For contracts where the stage of completion was determined based on the proportion of contract cost incurred for work performed to date bear to the estimated total contract cost, the accuracy and completeness of the estimated total contract cost for each contract would directly impact the POC calculated.

14. The reviewers noted that in most of the audit engagement files reviewed, the work performed by the auditor on the estimated total contract cost was only limited to obtaining a representation from management (either verbal or written) stating that the estimates provided
were accurate. This was not considered adequate work as there was no work performed to corroborate management’s representation obtained.

15. Auditor should discuss with management to understand the estimation and bidding process of each contract to ascertain whether there are procedures in place to ensure the accuracy and completeness of the estimated total contract cost. This understanding obtained from management could be corroborated with audit work performed to verify the major components in the estimated total contract cost. This includes verifying quotation from suppliers in respect of the materials needed, reviewing the estimation basis of overheads such as depreciation and labour costs, etc to address the accuracy and completeness of the estimated total contract cost.

16. In addition, auditor should also obtain an understanding of management’s process of revising the estimated total contract cost as the contract progresses. This understanding obtained from management could also be corroborated with audit work performed by reviewing actual cost incurred vis-à-vis estimated contract cost at a particular stage of completion, reviewing of the cost overrun report (if available) etc to ascertain whether any change in circumstances (such as variation orders, contracts delay, etc.) which might result in cost overrun or over-budgeting and these have been subsequently adjusted and taken into account in the revised estimated total contract cost.

17. Any inadequate work performed to ascertain the accuracy and completeness of total estimated cost would also impact on the accuracy and completeness of contract cost accrued for contracts which use the surveys of work performed or completion of a physical proportion of the contract work to determine the POC.

18. For contracts that were completed subsequent to the balance sheet date before the audit sign-off date, auditor should analyse whether there were any significant differences between the total actual contract costs incurred and the total contract cost estimated as at the balance sheet date. Any unexplained material difference could be an indicator that the management’s cost estimation, monitoring and revision process may not be sufficiently robust to provide an accurate and complete estimated total contract cost for all other contracts. This in turn may affect the scope of the audit.

**Failure to assess foreseeable loss for uncompleted contracts on a contract-by-contract basis**

19. FRS 11 paragraph 36 states that when it is probable that total contract costs will exceed total contract revenue, the expected loss should be recognised as an expense immediately. As such, auditor needs to perform a review of foreseeable losses for each uncompleted contract to ensure compliance with FRS 11.

20. The reviewers noted that in most of the audit engagement files reviewed, the work performed to assess foreseeable losses was only limited to obtaining management’s representation (either verbal or written) stating that all contracts are profitable and there were no contracts at risk of
having foreseeable losses. This was not considered adequate work as there was no work performed to corroborate management’s representation obtained.

21. Auditor need to ensure that the provision for foreseeable loss made by management is at the contract level and that any profit arising from other contracts cannot be used to offset this provision made in accordance with FRS 11 paragraph 37(c).

22. To identify any foreseeable loss, auditor needs to perform audit procedures which ordinarily should include the following:
   • Analysis of the total contract revenue vis-à-vis estimated total contract costs on a contract-by-contract basis. Contracts with estimated total costs exceeding the total contract revenue would be an indication of foreseeable losses;
   • Analysis of the cumulative progress billings vis-à-vis cumulative total actual costs incurred. Contracts with unexplained cumulative total actual costs exceeding cumulative progress billings could be an indication that foreseeable losses might be present;
   • Analysis of the actual progress of the contract vis-à-vis the contractually agreed timeline set out in the contracts to identify any major delays and/or cost overruns which might result in profitable contracts becoming loss-making;
   • Discussion with management to ascertain whether there are any major delays, cost overruns, terminated contracts etc. which may result in profitable contracts becoming loss-making; and
   • Review of contracts for any penalty clauses, liquidated damages clauses, etc and assess the need to provide for liquidated damages based on the progress of the contracts.

Failure to perform work to verify the total revenue recognised for completed contracts during the year

23. To ascertain if a contract is fully completed and that all the corresponding contract revenue, contract cost and attributable profit pertaining to the contract are recognised in the income statement, auditor should not merely rely on management’s representation without obtaining corroborative evidence such as verification to the following third parties’ audit evidence:
   • Certificate of Release acknowledged by the customer which would usually state the commencement of the defect liability period; or
   • Temporary Occupation Permits; or
   • Certificate of final completion by architects and/or quantity surveyors; or
   • Project hand-over documents acknowledged by the customers, etc.

Limitation of scope placed by management due to incomplete or improper records of the contracts kept

24. The reviewers noted that in some of the audit engagement files reviewed, auditor highlighted that management was unable to provide the detailed breakdown of contract sum, estimated total cost, cumulative revenue recognised till date and cumulative cost recognised till date on a
contract-by-contract basis. However, there was no work performed by the auditor to assess if such situations constituted a limitation of scope placed by management which may impact the audit opinion.

25. In situations where a limitation of scope is placed by management due to incomplete or improper records of the contracts kept, auditor needs to consider the impact such limitation of scope has on the audit and assess the appropriateness of issuing an unqualified audit opinion in accordance with SSA 700 “Forming an Opinion and Reporting on Financial Statements” vis-à-vis a modified audit opinion in accordance with SSA 705 “Modifications to the Opinion in the Independent Auditor’s Report”. Below are some examples of possible limitation of scope placed by management:

(a) Management did not keep proper records of the total contract revenue (e.g. contracts/agreements signed and subsequent variation orders entered with the customers) on a contract-by-contract basis; and

(b) Management did not keep proper records of actual costs incurred (including direct purchases, direct labour, direct overheads and allocation of indirect labour and/or overhead for each contract) on a contract-by-contract basis such that contract cost for each contract can be clearly identified and measured reliably.

Conclusion

26. As the recognition of the contract revenue, contract costs and work-in-progress by the stage of completion is based on contract-by-contract basis, auditor should note that the stand-alone tests performed of merely selecting sales and purchases transactions from the general ledger and verifying to sales invoices with customers’ acknowledgement/third party’s certification and suppliers’ invoices respectively are not adequate work performed.

27. It is essential for auditor to ensure that the analysis of the correlation of contract revenue, contract cost and attributable profit recognised in the income statement and the work-in-progress recognised in the statement of financial position of each individual contracts with the following information on a contract-by-contract is obtained from management and filed as part of the audit work performed:

(a) Total contract sum including any variation orders;
(b) Total estimated cost;
(c) Total cumulative cost incurred as at balance sheet date; and
(d) Total progress billings raised.

28. Auditor also needs to ensure that appropriate audit procedures, including the verification of relevant documents, are carried out to address the relevant financial statements assertions in respect of the contract revenue and the contract cost recognised in the income statements and the work-in-progress recognised in the statement of financial position. Due to the differing nature of the construction contracts, auditor needs to ensure that the design and performance of the audit procedures are on an individual contract basis.
An illustrative example of an audit documentation prepared in respect of the analysis of each individual contract provided in Appendix A.

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Appendix A

This illustrative example is only serves as a guide for proper documentation of work performed. It should not be considered to be the only acceptable form of audit documentation to support the audit procedures performed in respect of construction contracts and/or service contracts. Auditors are responsible for ensuring that the audit documentation prepared is truly reflective of the audit procedures performed.

<table>
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<th>Contract no.</th>
<th>Total contractual revenue</th>
<th>Estimated total cost</th>
<th>Estimated attributable profit margin</th>
<th>Cost incurred to date</th>
<th>Cumulative revenue recognised to date</th>
<th>Revenue recognised in current year</th>
<th>Progress billings to customers</th>
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Disclosure:
- Cost Incurred till date: 5,500,000
- Add: Attributable Profit: 805,808
- Less: Progress Billings: (3,900,000)
- Net Amount Due to Customers: (94,192)

Amount Due from Customers: 25,077
Amount Due to Customers: (119,270)
Net Amount Due to Customers: (94,192)

Key to work done:
[1] Please refer to AWP 7000-30 for work performed on the review of initial contracts and variation orders (if any)
[2] Please refer to AWP 7000-20 for work performed to review the estimated total cost
[3] Please refer to AWP 7000-30 for work performed to verify cost incurred in current year
[4] Agreed to prior year audited figures
[5] Please refer to AWP 7000-40 for work performed to review the cumulative progress billings to date