MFRS Hot Topics

Construction contracts with costs or revenues in more than one currency

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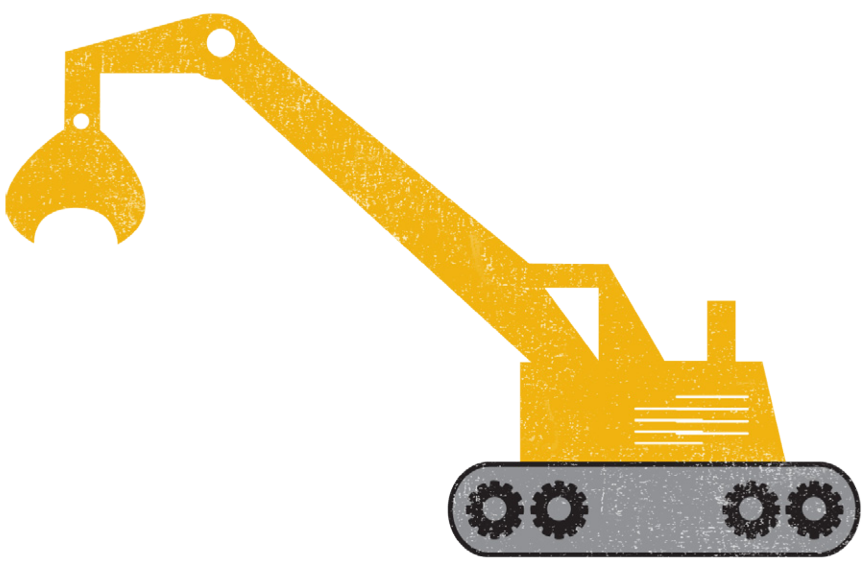
Welcome to MFRS Hot Topics - a publication from SJ Grant Thornton. This publication will provide guidance on the accounting treatment of construction contracts involving foreign currency.



If a construction contract has cost or revenues denominted in more than one currency, what exchange rate(s) should be used in estimating total contract costs and/or revenues?

Guidance

For the purposes of estimating total contract costs and revenues, future costs and revenues denominated in foreign currencies should be translated into the contractor's functional currency using the applicable spot rate(s). It is also acceptable to use the applicable forward market rate(s). Costs and revenues previously incurred or recognised should be translated at the actual exchange rates at the dates the transactions occurred (Paragraph 21 of MFRS 121 The Effects of Changes in Foreign Exchange Rates). If estimated total costs exceed contract revenue, the expected loss should be recognised in accordance with Paragraph 36 of MFRS 111 Construction Contracts.

If the entity's policy is to estimate the stage of completion by reference to the proportion of costs incurred to total contract costs (see MFRS 111.30(a)), foreign currency costs are translated using actual rates for costs incurred and spot rates for estimated future costs.

Although future exchange rate fluctuations may affect the final outcome of a contract, the estimated outcome should *not* be considered unreliable solely on the basis of uncertainty over future exchange rates.

Although some contractors use foreign currency derivatives to hedge their exposure to exchange rate risk, it is *not* appropriate to record contract costs/revenues at a hedged rate, or to use the hedged rate to estimate future costs/revenues.

Discussion

MFRS 111 specifies the accounting for construction contracts in the financial statements of contractors. For 'in progress' fixed price contracts, contract revenues and costs are recognised according to the stage of completion when the outcome of the contract can be estimated reliably and the other criteria are met (MFRS 111.22). Determination of the appropriate amount of contract revenue, costs and profit to recognise requires reliable estimation of:

- total contract revenue and costs (and therefore future revenue and costs); and
- the stage of completion of the contract.

Foreign currency costs and revenues are a source of uncertainty as to the final outcome of a contract. Future foreign currency costs and revenues need to be converted into the contractor's functional currency to estimate the contract outcome. Also, the stage of completion might be determined by reference to the proportion of costs incurred to date to total contract costs. If so, a single currency amount is required for costs to date and estimated future costs. (Other approaches to estimating the stage of completion include surveys of work performed, physical completion and labour hours incurred (MFRS 111.30 and the Appendix to MFRS 111)).

In our view, the translation of future revenues and cost into functional currency should be at the applicable spot (ie closing) exchange rate(s). Spot rates represent the market's view of the relative value of the currencies. Expectations about relevant future developments are taken into account by the market. The spot rate is therefore also the most reliable prediction of future rates. It is not appropriate to use management estimates of future exchange rates. We consider that it is acceptable to use appropriate forward market rates. However forward market rates to the estimated dates of the expected cash flows might be difficult to find.

Because the spot rate is a market rate, it is also sufficiently reliable for the purpose of recognition of revenues and (if applicable) profits. In other words, if the foreign currency estimates of cost and revenue are considered reliable, the estimated outcome of a contract should not be considered unreliable because of exchange rate uncertainty.

The discussion above relates mainly to estimating future contract revenues, costs and stage of completion. These estimates are used to determine the contract revenues and costs to be recognised. To the extent that recognised revenue and costs are denominated in a foreign currency, they are converted into the contractor's functional currency in accordance with MFRS 121. In particular:

- foreign currency revenues and costs should be converted at the spot rate at the date of each transaction. However, an average exchange rate over a longer period (such as a week or a month) can be used as a practical approximation if rates do not fluctuate significantly over that period (MFRS 121.21 and 22); and

- foreign currency receivables and payables arising from the contract are monetary items and should be retranslated using the applicable spot rate at each reporting date (MFRS 121.23(a)). For this purpose, we consider that gross amounts due and from customers for contract work (see MFRS 111.42-44) are monetary items.

Some contractors use derivatives to hedge exchange rate risk. Derivatives should be accounted for in accordance with MFRS 139 Financial Instruments: Recognition and Measurement. It is not appropriate to record contract costs/revenues at a hedged rate, or to use the hedged rate to estimate future costs/revenues. This is because the construction contract and any derivatives are separate contracts. They should therefore be accounted for separately in accordance with applicable MFRS. It may be possible to use hedge accounting in respect of the exchange risk in a construction contract, if the strict criteria in MFRS 139.88 are met.

Example

Entity A, a euro functional currency entity, enters into a contract to construct a building 1 Jan X1. The contract value is euro 1,200,000. The contract costs will be incurred partly in euros and partly in US$. The US$ costs will be incurred with subcontractors whose functional currency is US$.

On 31 Dec X1, entity A's actual costs incurred and expected costs to complete are:

	Costs incurred	Estimate to completion	Total
Euro costs	250,000	175,000	425,000
US$ costs	300,000	190,000	490,000

Estimated total contract revenue is unchanged at Euro 1,200,000. These estimates are considered reliable, and the criteria in MFRS 111.22 and 23 are all met.

Applicable exchange rates are:
Spot rate on 1 Jan X1: US$1 = euro 1.2
Spot rate on 31 Dec X1: US$1 = euro 1.4
Average rate for 20X1: US$1 = euro 1.3*

Analysis

The expected outcome of the contract and the stage of completion should be determined using spot Euro/US$ exchange rates for future costs. The calculation is as follows:

	Costs incurred	Estimate to complete	Total	Stage of completion
Euro costs (euros)	250,000	175,000	425,000	
US$ costs (US$)	300,000	190,000	490,000	
Exchange rate for US$ costs	1.3 (average*)	1.4 (spot)		
US$ costs (euros)	390,000	266,000	656,000	
Total costs (euros)	**640,000**	**441,000**	**1,081,000**	**59.2%**
Total revenue			1,200,000	
Estimated profit			119,000	

* in this case, the average rate is considered a sufficiently accurate approximation to the actual rates when the costs were incurred.

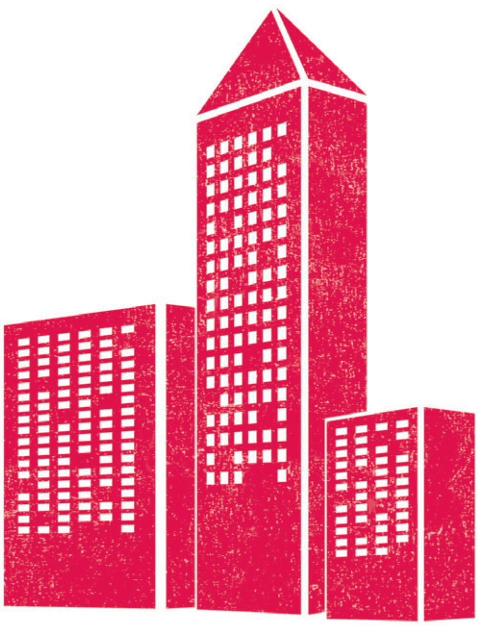
On the basis of these estimates, the amount of revenue to be recorded is (59.2% x 1,200,000) = euro 710,453. Costs incurred to date are euro 640,000. This gives a contact profit to date of euro 70,453.

If none of the US$ costs have been paid at 31 Dec X1, the statement of financial position at that date will include a contract-related creditor (or accrual) of US$300,000. This needs to be re-translated at the spot rate of 1.4 (euro 420,000). This gives rise to an exchange difference (loss) of euro 30,000 when compared to the US$ costs recognised in the income statement (euro 390,000).

The respective entries are as follows:

31 Dec X1 (euros)	**Debit**	**Credit**
Contact revenue		710,453
Contract costs	640,00	
Gross amount due from customers for contract work	710,453	
Creditors (accruals) (250,000 + 420,000)		670,000
Exchange loss (income statement)	30,000	

Note: this assumes that no progress billings have been made or costs settled at the reporting date.



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