

ACCOUNTING STANDARD

AASB 111
July 2004

Construction Contracts



Australian Government

**Australian Accounting
Standards Board**

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Australian Accounting Standard AASB 111 *Construction Contracts* is set out in paragraphs Aus1.1 – 45. All the paragraphs have equal authority. Terms defined in this Standard are in *italics* the first time they appear in the Standard. AASB 111 is to be read in the context of other Australian Accounting Standards, including AASB 1048 *Interpretation and Application of Standards*, which identifies the Australian Accounting Interpretations. In the absence of explicit guidance, AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors* provides a basis for selecting and applying accounting policies.

PREFACE

Reasons for Issuing AASB 111

The Australian Accounting Standards Board (AASB) is implementing the Financial Reporting Council's policy of adopting the Standards of the International Accounting Standards Board (IASB) for application to reporting periods beginning on or after 1 January 2005. The AASB has decided it will continue to issue sector-neutral Standards, that is, Standards applicable to both for-profit and not-for-profit entities, including public sector entities. Except for Standards that are specific to the not-for-profit or public sectors or that are of a purely domestic nature, the AASB is using the IASB Standards as the "foundation" Standards to which it adds material detailing the scope and applicability of a Standard in the Australian environment. Additions are made, where necessary, to broaden the content to cover sectors not addressed by an IASB Standard and domestic, regulatory or other issues.

The IASB defines International Financial Reporting Standards (IFRSs) as comprising:

- (a) International Financial Reporting Standards;
- (b) International Accounting Standards; and
- (c) Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or the former Standing Interpretations Committee (SIC).

The Australian equivalents to IFRSs are:

- (a) Accounting Standards issued by the AASB that are equivalent to Standards issued by the IASB, being AASBs 1 – 99 corresponding to the IFRS series and AASBs 101 – 199 corresponding to the IAS series; and
- (b) Interpretations issued by the AASB corresponding to the Interpretations adopted by the IASB, as listed in AASB 1048 *Interpretation and Application of Standards*.

Main Features of this Standard

Application Date

This Standard is applicable to annual reporting periods beginning on or after 1 January 2005. To promote comparability among the financial reports of Australian entities, early adoption of this Standard is not permitted.

First-time Application and Comparatives

Application of this Standard will begin in the first annual reporting period beginning on or after 1 January 2005 in the context of adopting all Australian equivalents to IFRSs. The requirements of AASB 1 *First-time Adoption of Australian Equivalents to International Financial Reporting Standards*, the Australian equivalent of IFRS 1 *First-time Adoption of International Financial Reporting Standards*, must be observed. AASB 1 requires prior period information, presented as comparative information, to be restated as if the requirements of this Standard had always applied. This differs from previous Australian requirements where changes in accounting policies did not require the restatement of the income statement and balance sheet of the preceding period.

Main Requirements

This Standard contains requirements relating to the recognition and measurement of construction contracts by the entity that performs the construction work. In particular, the Standard requires:

- (a) the substance of a contract or group of contracts to be considered when determining the composition of a construction contract;
- (b) where the outcome of a construction contract can be estimated reliably, contract revenue and contract costs to be recognised by applying the stage of completion method;
- (c) where the outcome of a construction contract cannot be estimated reliably, costs incurred to be recognised as expenses immediately and revenue to be recognised only to the extent that it is probable that the costs incurred will be recoverable;
- (d) the excess of total costs over total revenue to be recognised as an expense immediately where it is probable that total contract costs will exceed total contract revenue; and
- (e) specific information to be disclosed about construction contracts.

COMPARISON WITH INTERNATIONAL PRONOUNCEMENTS

AASB 111 and IAS 11

AASB 111 is equivalent to IAS 11 *Construction Contracts* issued by the IASB. Paragraphs that have been added to this Standard (and do not appear in the text of the equivalent IASB Standard) are identified with the prefix “Aus”, followed by the number of the relevant IASB paragraph and decimal numbering.

Compliance with IAS 11

Entities that comply with AASB 111 will simultaneously be in compliance with IAS 11.

AASB 111 and IPSAS 11

International Public Sector Accounting Standards (IPSASs) are issued by the Public Sector Committee of the International Federation of Accountants. IPSAS 11 *Construction Contracts* (June 2001) is drawn primarily from IAS 11. The main differences between IPSAS 11 and AASB 111 are:

- (a) IPSAS 11 explicitly includes binding arrangements that are not legal contracts (e.g. a ministerial direction, a legislative direction, or a memorandum of understanding) within the scope of a “construction contract” and also defines “contractor”;
- (b) IPSAS 11 provides detailed guidance on cost based and non-commercial contracts; and
- (c) IPSAS 11 states that the requirement to recognise an expense for the expected deficit on a contract immediately after it becomes probable that the total contract costs will exceed total contract revenues only applies to commercial or full cost recovery contracts.

Some of these differences are, however, addressed in the Australian Guidance that accompanies this Standard.

ACCOUNTING STANDARD AASB 111

The Australian Accounting Standards Board makes Accounting Standard AASB 111 *Construction Contracts* under section 334 of the *Corporations Act 2001*.

Dated 15 July 2004

D.G. Boymal
Chair – AASB

ACCOUNTING STANDARD AASB 111

CONSTRUCTION CONTRACTS

Objective

The objective of this Standard is to prescribe the accounting treatment of revenue and costs associated with construction contracts. 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. Therefore, the primary issue in accounting for construction contracts is the allocation of contract revenue and contract costs to the reporting periods in which construction work is performed. This Standard uses the recognition criteria established in the *Framework for the Preparation and Presentation of Financial Statements* to determine when contract revenue and contract costs should be recognised as revenue and expenses in the income statement. It also provides practical guidance on the application of these criteria.

Application

Aus1.1 This Standard applies to:

- (a) **each entity that is required to prepare financial reports in accordance with Part 2M.3 of the Corporations Act and that is a reporting entity;**
- (b) **general purpose financial reports of each other reporting entity; and**
- (c) **financial reports that are, or are held out to be, general purpose financial reports.**

Aus1.2 This Standard applies to annual reporting periods beginning on or after 1 January 2005.

- Aus1.3 This Standard shall not be applied to annual reporting periods beginning before 1 January 2005.
- Aus1.4 The requirements specified in this Standard apply to the financial report where information resulting from their application is material in accordance with AASB 1031 *Materiality*.
- Aus1.5 When applicable, this Standard supersedes:
- (a) AASB 1009 *Construction Contracts* as notified in the *Commonwealth of Australia Gazette* No S 532, 16 December 1997; and
 - (b) AAS 11 *Construction Contracts* as issued in December 1997.
- Aus1.6 Both AASB 1009 and AAS 11 remain applicable until superseded by this Standard.
- Aus1.7 Notice of this Standard was published in the *Commonwealth of Australia Gazette* No S 294, 22 July 2004.

Scope

1. This Standard shall be applied in accounting for *construction contracts* in the financial report of contractors.
2. [Deleted by the AASB]

Definitions

3. The following terms are used in this Standard with the meanings specified.

A *construction contract* is a contract 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.

A *cost plus contract* is a construction contract in which the contractor is reimbursed for allowable or otherwise defined costs, plus a percentage of these costs or a fixed fee.

A *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.

4. A construction contract 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 which 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 refineries and other complex pieces of plant or equipment.
5. For the purposes of this Standard, construction contracts include:
 - (a) contracts for the rendering of services which 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.
6. Construction contracts are formulated in a number of ways which, for the purposes of this Standard, are classified as *fixed price contracts* and *cost plus contracts*. Some construction contracts may contain characteristics of both a fixed price contract and a cost plus contract, for example in the case of a cost plus contract with an agreed maximum price. In such circumstances, a contractor needs to consider all the conditions in paragraphs 23 and 24 in order to determine when to recognise contract revenue and expenses.

Combining and Segmenting Construction Contracts

7. 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.
8. **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.
- 9. 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 profit margin; and
 - (c) the contracts are performed concurrently or in a continuous sequence.
- 10. 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

- 11. Contract revenue shall comprise:
 - (a) the initial amount of revenue agreed in the contract; and
 - (b) variations in contract work, claims and incentive payments:
 - (i) to the extent that it is probable that they will result in revenue; and
 - (ii) they are capable of being reliably measured.

12. Contract revenue is measured at the fair value of the consideration received or receivable. The measurement of contract revenue is 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. Therefore, 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 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 contract may increase as a result of cost escalation 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 as the number of units is increased.
13. 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.
14. 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 included in contract revenue only 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.
15. 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.

Contract Costs

16. **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; and**
 - (c) **such other costs as are specifically chargeable to the customer under the terms of the contract.**
17. 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 is 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 income that is not included in contract revenue, for example, income from the sale of surplus materials and the disposal of plant and equipment at the end of the contract.

18. Costs that may be attributable to contract activity in general and can be allocated to specific contracts include:
 - (a) insurance;
 - (b) costs of design and technical assistance that are not directly related to a specific contract; and
 - (c) construction overheads.

Such costs are allocated using methods that are systematic and rational and 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 AASB 123 *Borrowing Costs*.

19. 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.
20. 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.
21. 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 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 recognised 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

- 22. When the outcome of a construction contract can be estimated reliably, contract revenue and contract costs associated with the construction contract shall be recognised as revenue and expenses respectively by reference to the stage of completion of the contract activity at the reporting date. An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.**
- 23. 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 can be measured reliably;**
 - (b) it is probable that the economic benefits 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.**
- 24. In the case of a cost plus 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 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.**

25. 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 profit which 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.
26. Under the percentage of completion method, contract revenue is recognised as revenue in the income statement in the reporting periods in which the work is performed. Contract costs are usually recognised as an expense in the income statement in the reporting periods in which the work to which they relate is performed. However, any expected excess of total contract costs over total contract revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.
27. A contractor may have incurred contract costs that relate to future activity on the contract. Such contract costs are recognised 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.
28. The outcome of a construction contract can only be estimated reliably when it is probable that the economic benefits 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 recognised in the income statement, the uncollectable amount or the amount in respect of which recovery has ceased to be probable is recognised as an expense rather than as an adjustment of the amount of contract revenue.
29. An entity is generally able to make reliable estimates after it has agreed to a contract which establishes:
- (a) each party's enforceable rights regarding the asset to be constructed;
 - (b) the consideration 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.

30. 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.

31. 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 which 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 specially for the contract; and
 - (b) payments made to subcontractors in advance of work performed under the subcontract.

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

- (a) revenue shall be recognised only to the extent of contract costs incurred that it is probable will be recoverable; and**
- (b) contract costs shall be recognised as an expense in the period in which they are incurred.**

An expected loss on the construction contract shall be recognised as an expense immediately in accordance with paragraph 36.

33. 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 recognised only to the extent of costs incurred that are expected to be recoverable. As the outcome of the contract cannot be estimated reliably, no profit is recognised. 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 revenue for the contract is recognised as an expense immediately in accordance with paragraph 36.

34. Contract costs that are not probable of being recovered are recognised 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 recognised 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.
35. **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 recognised in accordance with paragraph 22 rather than in accordance with paragraph 32.**

Recognition of Expected Losses

36. **When it is probable that total contract costs will exceed total contract revenue, the expected loss shall be recognised as an expense immediately.**
37. The amount of such a loss is determined irrespective of:
- (a) whether work has commenced on the contract;
 - (b) the stage of completion of contract activity; or

- (c) the amount of profits expected to arise on other contracts which are not treated as a single construction contract in accordance with paragraph 9.

Changes in Estimates

38. 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 AASB 108 *Accounting Policies, Changes in Accounting Estimates and Errors*). The changed estimates are used in the determination of the amount of revenue and expenses recognised in the income statement in the period in which the change is made and in subsequent periods.

Disclosure

39. An entity shall disclose:
- (a) **the amount of contract revenue recognised as revenue in the period;**
 - (b) **the methods used to determine the contract revenue recognised in the period; and**
 - (c) **the methods used to determine the stage of completion of contracts in progress.**
40. An entity shall disclose each of the following for contracts in progress at the reporting date:
- (a) **the aggregate amount of costs incurred and recognised profits (less recognised losses) to date;**
 - (b) **the amount of advances received; and**
 - (c) **the amount of retentions.**
41. 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 billed for work performed on a contract whether or not they have been paid by the customer. Advances are amounts received by the contractor before the related work is performed.

42. **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.**
43. The gross amount due from customers for contract work is the net amount of:
- (a) costs incurred plus recognised profits; less
 - (b) the sum of recognised losses and progress billings;
- for all contracts in progress for which costs incurred plus recognised profits (less recognised losses) exceeds progress billings.
44. The gross amount due to customers for contract work is the net amount of:
- (a) costs incurred plus recognised profits; less
 - (b) the sum of recognised losses and progress billings;
- for all contracts in progress for which progress billings exceed costs incurred plus recognised profits (less recognised losses).
45. An entity discloses any contingent liabilities and contingent assets in accordance with AASB 137 *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 of IAS 11

46. [Deleted by the AASB]

AUSTRALIAN GUIDANCE

Australian Guidance accompanies, but is not part of, AASB 111.

Non-commercial Contracts

- G1. For not-for-profit entities that are construction contractors, the requirements of AASB 111 *Construction Contracts* should also be applied to non-commercial construction contracts and similar arrangements that are binding on the parties to the arrangement but which do not take the form of a documented contract.

- G2. A non-commercial contract or similar arrangement may be either a “fixed price contract” or a “cost plus contract” (which in a non-commercial context may also be referred to as a “cost based contract”). Contracts and arrangements classified as fixed price contracts may involve the funding of construction activity through indirect means such as through a general appropriation or other allocation of government funds or by general purpose grants. In contrast, contracts and arrangements classified as cost plus (or cost based) contracts may involve full or partial reimbursement of the costs incurred for the construction of the asset from the recipient of the constructed asset and/or from other parties.