

CONTRACT COSTING

<p><u>INTRODUCTION</u></p>	<p>Contract or terminal costing is “A form of specific order costing; attribution of costs to individual contracts”.</p> <p>This method is used in case of big jobs described as ‘contracts’. The contract work usually involves heavy expenditure, spread over a long period. Each contract is treated as a separate unit for the purpose of cost ascertainment.</p> <p>Shipbuilding, construction of premises, roads and bridges are few examples suitable for contract costing.</p> <p>Parties involved in a contract:</p> <ul style="list-style-type: none"> • Contractor: One who undertakes and executes work under a contract. • Contractee: One for whom work is undertaken. 																																												
<p><u>PREPARING A CONTRACT ACCOUNT</u></p>	<p>Contract account is a nominal account and its main purpose is to estimate the profit earned each year in case of contracts whose tenure or period of completion exceeds one year.</p> <p style="text-align: center;">CONTRACT A/C</p> <table border="1" style="width: 100%; border-collapse: collapse; margin-top: 10px;"> <thead> <tr> <th style="width: 50%;">Particulars</th> <th style="width: 5%;">₹</th> <th style="width: 40%;">Particulars</th> <th style="width: 5%;">₹</th> </tr> </thead> <tbody> <tr> <td>To Materials</td> <td></td> <td>By materials returned</td> <td>**</td> </tr> <tr> <td style="padding-left: 20px;">a. Purchased directly</td> <td>**</td> <td rowspan="3" style="padding-left: 20px;">By Material sold (cost price)</td> <td rowspan="3" style="vertical-align: middle;">**</td> </tr> <tr> <td style="padding-left: 20px;">b. Issue from site</td> <td>**</td> </tr> <tr> <td style="padding-left: 20px;">c. Supplied by contractee</td> <td>**</td> </tr> <tr> <td>To Wages and salaries</td> <td>**</td> <td>By WIP</td> <td></td> </tr> <tr> <td>To Other direct Expenses</td> <td>**</td> <td style="padding-left: 20px;">Work certified</td> <td>**</td> </tr> <tr> <td>To Sub-contractor fees</td> <td>**</td> <td style="padding-left: 20px;">Work Uncertified</td> <td>**</td> </tr> <tr> <td>To Plant & Machinery (purchase price/Book value)</td> <td>**</td> <td>By Materials at site</td> <td>**</td> </tr> <tr> <td>To Indirect expenditure (apportioned share of overheads)</td> <td>**</td> <td>By Plant and machinery(WDV)</td> <td>**</td> </tr> <tr> <td>To Notional profit (Surplus)</td> <td>**</td> <td></td> <td></td> </tr> <tr> <td>Total</td> <td>**</td> <td>Total</td> <td>**</td> </tr> </tbody> </table>	Particulars	₹	Particulars	₹	To Materials		By materials returned	**	a. Purchased directly	**	By Material sold (cost price)	**	b. Issue from site	**	c. Supplied by contractee	**	To Wages and salaries	**	By WIP		To Other direct Expenses	**	Work certified	**	To Sub-contractor fees	**	Work Uncertified	**	To Plant & Machinery (purchase price/Book value)	**	By Materials at site	**	To Indirect expenditure (apportioned share of overheads)	**	By Plant and machinery(WDV)	**	To Notional profit (Surplus)	**			Total	**	Total	**
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Material Cost:

All materials supplied from the stores or purchased directly for the contract are debited to the concerned contract account. In case the return of surplus material appears uneconomical on account of high cost of transportation, the same is sold and the concerned contract account is credited with the sale price. Any loss or profit arising therefrom is transferred to the Profit and Loss Account. Any theft, or destruction of material by fire represent a loss and as such, the same is transferred to the Profit and Loss Account. If the contractee has supplied some materials without affecting the contract price, no accounting entries will be made in the contract account, only a note may be given about it.

Labour Cost:

Labour actually employed on the site of the contract is regarded as direct (irrespective of the nature of the task performed) and the wages paid to them are charged to the concerned contract directly.

Direct Expenses:

Direct expenses (if any) are directly charged to the concerned contract.

Indirect Expenses:

Indirect expenses (such as expenses of engineers, surveyors, supervisors etc.) may be distributed over several contracts as a percentage of cost of materials, or wages paid or of the prime cost.

Plant and Machinery : The value of the plant in a contract may be either debited to contract account and the written down value thereof at the end of the year entered on the credit side for closing the contract account, or only a charge (depreciation) for use of the plant may be debited to the contract account.

Sub-Contract: Sub-contract costs are also debited to the Contract Account.

Cost of work certified : All building contractors received payments periodically known as “running payment” on the basis of the architect’s or surveyor’s certificates. But payments are not equal to the value of the work certified, a small percentage of the amount due is retained as security for any defective work which may be discovered later within the guarantee period.

The amount retained is called retention money. The full value of the work certified should be credited to the Contract Account and debited to the account of the contract.

Mathematically :

Cost of work certified = Cost of work to date – (Cost of work uncertified + Material in hand+ Plant at site)

Work uncertified : It represents the cost of the work which has been carried out by the contractor but has not been certified by the contractee's architect. It is always shown at cost price.

Micellaneous Accounts:

W.I.P A/C

Particulars	Amt.	Particulars	Amt.
To contract A/C		By contract A/C	**
- Work certified	**	- Reserve or	
- Work uncertified	**	provision against	
- Escalation claim	**	profits	
	**		**

Contractee A/C

Particulars	Amt.	Particulars	Amt.
To Balance c/d(*)	**	By Balance b/d	**
		By Cash/Bank (amount	**
	**	recd.)	**
			**

(*) Transfer the entire amount to contract A/c on completion of contract.

Extract of Balance Sheet

Liabilities	(₹)	Asset	(₹)
Profit & loss a/c		Work-in-progress:	
Sundry creditors		Value or work certified	
Wages accrued		Cost of work uncertified	
Direct expenses accrued		Less :- Reserve for unrealized profit	
Any other expenses		Less :- Amount received from contractee	
Capital			

ESTIMATION OF PROFIT

- 1) When % of completion is **less than or equal to 25%** then full Notional profit is transferred to reserve.
- 2) When % of completion is **above 25% but less than 50%** following amount should be credited to profit & loss a/c

$$= \frac{1}{3} * \text{Notional Profit} * \{ \text{Cash received} / \text{Work certified} \}$$
- 3) When % of completion is **more than or equal to 50%** then the amount transferred to profit is

	<p>$= \frac{2}{3} * \text{Notional Profit} * \left\{ \frac{\text{Cash received}}{\text{Work certified}} \right\}$ [Balance is transferred to reserve a/c]</p> <p>4) Completion of contract is upto 90 per cent or more than 90 per cent i.e. it is nearing completion: In this case the profit to be taken to Profit and Loss Account is determined by: $= \frac{\text{Estimated Profit} * \text{Work certified}}{\text{Contract price}} * \frac{\text{Cash received}}{\text{Work certified}}$</p> <div style="border: 1px solid black; padding: 5px; margin: 10px 0;"> <p>Estimated profit = Contract Price – Cost incurred – Cost yet to be incurred</p> </div> <p>Where: Degree (%) of completion = $\left\{ \frac{\text{Work certified}}{\text{Contract price}} \right\} * 100$</p> <p>5) If contract is complete in full , then the entire amount is transferred to P&L A/C.</p> <p>6) If there are losses being incurred in contract, then the entire amount is transferred to P&L A/C.</p>
<p><u>ESCALATION CLAUSE</u></p>	<p>Escalation, in general, refers to ‘increase or rise’. This clause is concerned with the rise in prices of materials and labour which are to be applied for completing the contract.</p> <p>Thus, we can conclude that if there is a gap between signing of agreement and execution of contract and during such period if prices increase, contractee has to compensate contractor for such increase. This is known as escalation claim.</p>
<p><u>CERTAIN INCLUSIONS AND EXCLUSIONS</u></p>	<p>Expenses not related to contract: →Depreciation on fixed assets not used directly for contract. →Depreciation on Plant & Machinery for the period not used for the contract. →General office expenses not incurred particularly for the contract. →Loss on sale of raw material / machinery etc. →Any fines and penalties paid is to be excluded from contract A/c.</p> <p>Incomes not related to contract: →Dividend received, interest received ,rent received ,brokerage Received ,commission received. →Profit on sale of raw material / machinery etc.</p>
<p><u>ADDITIONAL POINTS FOR PRACTICAL QUESTIONS</u></p>	<ul style="list-style-type: none"> • Opening WIP is always taken at net of reserves i.e. work certified + work uncertified – Reserves, irrespective of whether contract is complete or not. • For calculating work certified as a percentage of contract price for the purpose of calculating the notional profits, take cumulative work certified.

	<ul style="list-style-type: none"> • For applying cash basis on notional profits only current year cash received as a percentage of current year work certified is to be considered. • Escalation claim is given on gross quantity if wastages are normal and on net quantity if wastages are abnormal. • In case, there is an estimated loss on a contract, provision must be created for any future loss that will take place.
<p><u>IMPORTANT QUESTIONS FOR THEORY</u></p>	<p>Question 1 Write notes on Escalation Clause</p> <p>Answer Escalation Clause: This clause is usually provided in the contracts as a safeguard against any likely changes in the price or utilization of material and labour. If during the period of execution of a contract, the prices of materials or labour rise beyond a certain limit, the contract price will be increased by an agreed amount. Inclusion of such a term in a contract deed is known as an 'escalation clause' An escalation clause usually relates to change in price of inputs, it may also be extended to increased consumption or utilization of quantities of materials, labour etc. In such a situation the contractor has to satisfy the contractee that the increased utilization is not due to his inefficiency.</p> <p>Question 2 Discuss briefly the principles to be followed while taking credit for profit on incomplete contracts</p> <p>Answer <i>Principles to be followed while taking credit for profit on incomplete contracts:</i> The portion of profit to be credited to, profit and loss account should depend on the stage of completion of the contract. This stage of completion of the contract should refer to the certified work only. For this purpose, uncertified work should not be considered as far as possible. For determining the credit for profit, all the incomplete contracts should be classified into the following four categories:</p> <ul style="list-style-type: none"> (i) Contract less than 25% complete (ii) Contracts between 25% and 50% complete (iii) Contracts between 50% and 90% complete (iv) Contracts nearing completion, say between 90% and 100% complete. <p>Question 3 Explain the following:</p> <ul style="list-style-type: none"> (i) Notional profit in Contract costing (ii) Retention money in Contract costing <p>Answer (i) Notional profit in Contract costing: It represents the difference between the value of work certified and cost</p>

	<p>of work certified.</p> <p>(ii) Retention Money in Contract Costing: A contractor does not receive the full payment of the work certified by the surveyor. Contractee retains some amount to be paid after some time, when it is ensured that there is no default in the work done by the contractor. If any deficiency or defect is noticed, it is to be rectified by the contractor before the release of the retention money. Thus, the retention money provides a safeguard against the default risk in the contracts.</p> <p>Question 4 What is cost plus contract? State its advantages.</p> <p>Answer Cost plus contract: Under cost plus contract, the contract price is ascertained by adding a percentage of profit to the total cost of the work. Such types of contracts are entered into when it is not possible to estimate the contract cost with reasonable accuracy due to unstable condition of material, labour services etc. Following are the advantages of cost plus contract:</p> <p>(i) The contractor is assured of a fixed percentage of profit. There is no risk of incurring any loss on the contract. (ii) It is useful specially when the work to be done is not definitely fixed at the time of making the estimate. (iii) Contractee can ensure himself about the 'cost of contract' as he is empowered to examine the books and documents of the contractor to ascertain the veracity of the cost of contract.</p>																								
<p><u>REVISION ILLUSTRATION</u></p>	<p>Compute a conservative estimate of profit on a contract (which has been 90% complete) from the following particulars :</p> <table style="width: 100%; border-collapse: collapse;"> <thead> <tr> <th style="width: 80%;"></th> <th style="text-align: right; width: 20%;">(₹)</th> </tr> </thead> <tbody> <tr> <td>Total expenditure to date</td> <td style="text-align: right;">22,50,000</td> </tr> <tr> <td>Estimated further expenditure to complete the contract (including contingencies)</td> <td style="text-align: right;">2,50,000</td> </tr> <tr> <td>Contract price</td> <td style="text-align: right;">32,50,000</td> </tr> <tr> <td>Work certified</td> <td style="text-align: right;">27,50,000</td> </tr> <tr> <td>Work uncertified</td> <td style="text-align: right;">1,75,000</td> </tr> <tr> <td>Cash received</td> <td style="text-align: right;">21,25,000</td> </tr> </tbody> </table> <p>Solution: Calculation of conservative Estimate of Profit (₹)</p> <table style="width: 100%; border-collapse: collapse;"> <tbody> <tr> <td>Total expenditure to date</td> <td style="text-align: right;">22,50,000</td> </tr> <tr> <td>Estimated further expenditure to complete the contract (including contingencies)</td> <td style="text-align: right;">2,50,000</td> </tr> <tr> <td></td> <td style="text-align: right;">25,00,000</td> </tr> <tr> <td>Estimated profit on contract</td> <td style="text-align: right;">7,50,000</td> </tr> <tr> <td>Contract price</td> <td style="text-align: right;">32,50,000</td> </tr> </tbody> </table> <p>Profit to be transferred to Profit and Loss A/c: Estimated profit = $\frac{₹7,50,000}{₹32,50,000} * ₹21,25,000 = ₹4,90,385$</p>		(₹)	Total expenditure to date	22,50,000	Estimated further expenditure to complete the contract (including contingencies)	2,50,000	Contract price	32,50,000	Work certified	27,50,000	Work uncertified	1,75,000	Cash received	21,25,000	Total expenditure to date	22,50,000	Estimated further expenditure to complete the contract (including contingencies)	2,50,000		25,00,000	Estimated profit on contract	7,50,000	Contract price	32,50,000
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