



# Contract Costing



# Meaning of Contract

- Generally the term 'Contract' used for big jobs undertaken on behalf of the customers.
  - It involves considerable length of time and are generally undertaken outside the precincts of the factory.
  - It involves construction of buildings, roads, bridges, ship, etc.
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- Normally there are two parties involved in the contract, namely **Contractor** and **Contractee**.
  - The person who undertakes the contract is known as Contractor.
  - The person for whom the work is undertaken is known as Contractee.



# Contract costing

- ▶ Contract costing is a method of costing in which an account is opened for each contract in the books of the contractor to ascertain profit/loss.
- ▶ Here each contract is a cost unit.
- ▶ Contract costing method can be applied in the following industries:

Building construction, road construction, Bridge construction, ship building, etc.



# Features of Contract Costing

- ▶ A contract normally takes more than one year to complete.
- ▶ Work is carried out at the site of contracts and not in factory premises.
- ▶ A separate contract account is opened for each contract to ascertain profit or loss.
- ▶ Materials are either specially purchased for the contract or they are supplied from the stores.
- ▶ Specialist sub-contractors may be employed for electrical fittings, welding, glass work, etc.

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- ▶ Plant and equipment may be purchased for the contract or it may be hired.
  - ▶ Based upon the architect certificate of work completion, payment is made to the contractee.



# Special points in contract costing

- **Material:**

Materials include the following:

[1] Material specifically purchased for the contract

[2] Material issued from stores.

- **Wages:**

All wages of workers engaged on a particular contract are charged direct to contract irrespective of the type of work they perform.



- **Plant and Machinery:**

Normally the full value of machine is charged to contract and at the end of the year the depreciation is deducted and written down value is credited to contract account.

- Plant used can be **[1] Special plant, [2] General plant**



# Special plant

- ▶ The plant specially bought for the contract which would not generally used for the other contract is known as special plant.
- ▶ Contract Account is debited with the value of plant.
- ▶ In case of sale of plant, contract account is credited with only the sales proceeds of the plant.
- ▶ **No entry for profit or loss on sale of special plant is made in contract account.**

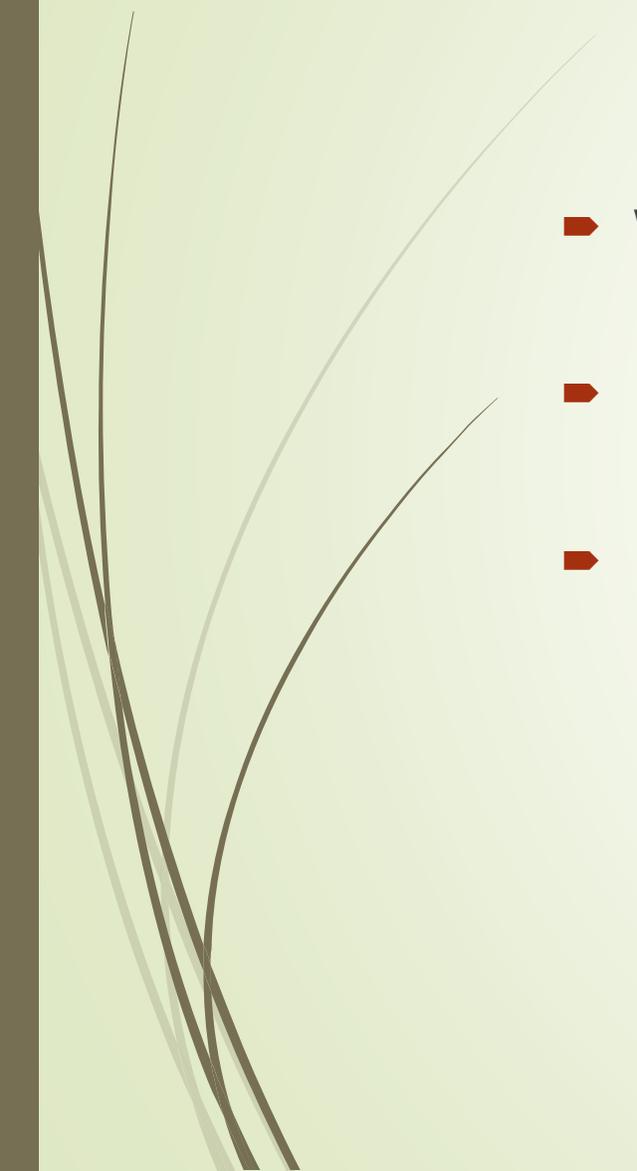


# General Plant

- ▶ The plant which can be used for a number of contracts and not specially purchased for a specific contract is known as general plant.
- ▶ Contract Account is debited with the value of plant.
- ▶ Profit / loss on sale of general plant is also recorded in the contract account along with the sales proceeds



# Sub- Contract cost:

- ▶ Work of specialized character is offered to sub – contractor.
  - ▶ For e.g. steel work, glass work, etc.
  - ▶ The cost of such sub contract is debited to contract account.
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# Work-in-progress

➤ Work in progress includes:

[1] Work certified

[2] Work uncertified

[3] Material at site

[4] Plant at site

➤ Work in progress is recorded on the credit side of contract account.



# Work certified

- ▶ This is that part of work-in-progress which has been approved by the contractee's architect or engineer for payment.
- ▶ Work certified is valued at **Contract price** and includes an element of profit.



# Work uncertified

- ▶ This is that part of work-in-progress which is not approved by the architect's engineer.
  - ▶ Work uncertified is valued at **Cost** and not include an element of profit.
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# Payment of contract price:

- Usually full payment is made on the completion of contract if the contract is of one year only.
- If the contract is for more than one year, then the contractee pays a fixed percentage say 80% or 90% of work certified towards contract price. This is known as **Cash Ratio**.
- The remaining amount not paid is kept as a guarantee for timely completion of contract which is known as **Retention Money**.



# Profit / loss on contract

- **[A] When the contract is complete:**

The contract account is credited with contract price and the entire profit / loss is transferred to profit & loss A/c.



- ▶ **[B] Profit/loss on incomplete contracts:**

- ▶ A reasonable amount of profit on incomplete contracts is taken into consideration and the remaining profit is kept reserved as contingencies.
- ▶ In case of loss the entire amount of loss is transferred to Profit and loss Account.

- ▶ **Estimated profit:**

It represent excess of the contract price over the estimated total cost of the contract.

Estimated profit is calculated by preparing proforma contract account.

# Rules for ascertaining profit to be transferred to Profit & loss A/c in case of incomplete contract.

<b>(A) When work certified is less than <math>\frac{1}{4}</math> of the contract price</b>	<b>No profit is transferred to Profit and loss A/c. Entire profit is treated as reserve profit.</b>
(B) When work certified is more than $\frac{1}{4}$ but less than $\frac{1}{2}$ of the contract price	Profit transferred to Profit and loss A/c is computed by following formula. $\text{Profit} \times \frac{1}{3} \times \frac{\text{Cash received}}{\text{Work certified}}$
(C) When work certified is more than $\frac{1}{2}$ but less than $\frac{9}{10}$ of the contract price	Profit transferred to Profit and loss A/c is computed by following formula. $\text{Profit} \times \frac{2}{3} \times \frac{\text{Cash received}}{\text{Work certified}}$
(D) When contract is near completion	Profit transferred to Profit and loss A/c is computed by following formula. $\text{Estimated profit} \times \frac{\text{Work certified}}{\text{Contract price}}$



# Types of contract:

- 1. Fixed price contract
  - 2. Cost-plus contract
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# Escalation Clause

- Escalation Clause is inserted to provide protection to both the parties against losses which are likely to arise due to increase in prices.
  - The value of contract is changed in proportion to the rise in price of material and labour.
  - It is generally inserted in the building and engineering contracts.
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# De Escalation Clause

- ▶ De Escalation Clause provides for decrease in contract price if there is a decrease in certain costs.
- ▶ In other words, de-escalation clause is a contractual provision that allows prices to be lowered after the contract is signed.
- ▶ It is opposite of escalation clause.

# Journal enteries:

Transactions	Account to be debited	Account to be credited
Material supplied from stores	Contract A/c	Materials A/c
Materials directly purchased	Contract A/c	Bank or suppliers A/c
Material transferred from one contract to another	Contract (Receiving) A/c	Contract (giving) A/c
Materials returned to store	Materials A/c	Contract A/c
Materials stolen or destroyed by fire	Bank A/c (or Ins. Co.) A/c Profit & loss A/c	Contract A/c
Sales of material	Bank A/c	Contract A/c
Profit on sale of material	Contract A/c	Profit & loss A/c

Transactions	Account to be debited	Account to be credited
Loss on sale of material	Profit & loss account	Contract A/c
Wages paid	Contract A/c	Bank A/c
Special / General plant purchased	Contract A/c	Plant A/c
Sale of special / general plant	Bank A/c	Contract A/c
Profit on sale of general plant	Contract A/c	Profit & loss A/c
Loss on sale of general plant	Profit & loss A/c	Contract A/c
Profit / loss on sale of special plant	No entry	

# Journal enteries:

Transactions	Account to be debited	Account to be credited
Other expenses	Contract A/c	Expense A/c
Work certified	Work-in-progress A/c	Contract A/c
Work uncertified	Work-in-progress A/c	Contract A/c
Profit transferred to P & L A/c	Contract A/c	Profit & loss A/c
Reserve profit	Contract A/c	Work-in-progress A/c
Amount received from contractee	Cash / Bank A/c	Contractee's A/c