B. COM.(HONS. & GEN.) SEM. - II

CONTRACT COSTING

Dr. Dilip Kumar Karak

(M) 9433307384

dilipkumar.karak@yahoo.in

CONTRACT COSTING

Contract:

Contract refers to a large job / assignment / work order, where the execution of work is spread over two or more financial years. Generally, a Contract commences in one financial year, but ends in a different year.

Contract Costing:

Contract costing known as terminal costing. It is a variant of job costing. Contract means a big job in which work is done at site and not in factory premises. The cost of each contract is ascertained. Thus in this method of costing, each contract is a cost unit and an account is opened for each contract in the books of contractor to ascertain profit/loss thereon. Contract or Terminal Costing involves ascertainment of costs of contract. It is an extension of principles of job costing for long-term projects like Civil Construction, Ship Building, Interior Decoration, etc.

Features of Contract Costing

The following are the major features of Contract Costing:

1. **Party Involved:** The parties to a contract are -
   a. Contractor - One who undertakes and executes work under a contract, and
   b. Contractee - One for whom the work is undertaken.
2. **Site Work:** Major part of the work in each contract is generally carried out at the site of the contract.
3. **Direct Expenses:** Most of the expenses incurred by the Contractor are directly relatable to the site.
4. **Indirect Expenses:** Indirect Expenses, e.g. Administrative Office Expenses and common expenses are apportioned to various contracts on appropriate basis. For example, depreciation of common equipment used on various contracts is apportioned on the basis of the number of days the equipment has been used on various contracts.
5. **Separate Accounts:** A separate account is maintained for each contract, to ascertain Profit or Loss.
6. **Cost Centre and Cost Unit:** The Cost Centre (place) and Cost Unit (output) in Contract Costing is the Contract itself, e.g. Building Construction.
7. **Recognition of Profit**: A contract usually takes long time periods for completion. In certain years, no contract might be completed, while in others, many contracts may be completed. Recognition of Profits after full completion of contract might lead to wide

fluctuations in profit every year. To avoid these fluctuations, profits are generally recognized every year on the basis of percentage of completion and the amount of Notional Profit

Purpose of Contract Costing

This is used to ascertain the cost and profit/loss of each contract for a given period. This is useful for accounting for projects that are completed over an extended period of time, such as the construction of bridges, roads or other civil engineering work. Thecontractor is the person/business entity who undertakes the contract and the contractee is the person/business entity for whom the contract is undertaken (or the party who gives the contract). The contractee agrees to pay the contractor a contract price to complete work within a given time frame. The contractor may receive payment against the value of work that is completed at specific intervals. This work is referred to as certified work as it is certified by an engineer/architect who attests to the extent of the work completed. Full payment for work done is not usually made as the contractee seeks to safeguard his/her interest. The money held by the contractee until work is completed in satisfaction with the contractee's terms is referred to as retention money.

Accounting for Contracts

Contract Costing is supported by the maintenance of the following three accounts:

1. Contract Account
2. Contractee's Account
3. Contract Profit and Loss Account

Work-in-progress (W-I-P)

When the contract is not completed till the end of the accounting year, the architect is required to value the work-in-progress. Such work-in-progress is classified into -

1. Value of work certified and
2. Cost of uncertified work

1. Value of Work Certified

As per the prevailing business practices in contract activity, the Contractor raises periodical bills on the Contractee. Such bills are raised on the basis of Architect's or Surveyor's Certificates stating the extent and value of work completed. Hence, that portion of the work which has been completed by the Contractor and certified by the Architect / Surveyor is called as Work Certified. Value of Work Certified constitutes Income on the Contract, and is credited to the Contract A/c and debited to Work-in-Progress A/c (if the contract is in progress) or to Contractee's A/c (if the contract is completed). Work certified is valued at contract price (i.e , selling price), and includes an element of profit.

2. Cost of Uncertified Work

It represents the cost of work, which has been carried out by the Contractor but is not certified by the Architect /Surveyor. It constitutes the work completed from the date of the earlier certification till the end of the accounting year. The Cost of Work Uncertified is also credited to Contract A/c under the head "Work in Progress". This is that part of the work-in-progress which is not approved by the architect or engineer. This is valued at cost and thus does not include an element of profit. Both work certified and uncertified appear on the credit side of the contract account and also on the assets side of the balance sheet.
Cost of Work Uncertified = Total Cost to date – Cost of Work Certified – Material in Hand – Plant at Site (at WDV)

Retention Money and Cash Ratio
It is usual practice not to pay the full amount of work certified. The contractee may pay a fixed percentage, say 80% or 90% of the work certified, depending upon the terms of the contract. This is known as Cash Ratio. The balance amount not paid is known as RetentionMoney.
For example, if cash ratio is 75%, the retention money will be remaining 25%. This retention money is a type of security for any defective work which may be found in the contract later on. This also works as a deterrent for the contractor to leave the contract incomplete, if he finds the contract unprofitable. The retention money may also be adjusted against penalties that become due if the contract is not completed within the stipulated time as per the terms of the agreement.

Profit Recognition and Accounting

Contracts which are started and finished during the same financial year create no accounting problems. But in case of those contracts which take more than one year to complete, a problem arises whether profit on such contracts should be worked out only on the completion of the contract or at the end of each financial year on the partly completed work. If profit is computed only on the completion of the contract, profit will be high in the year of completion of the contract, whereas in other years of working on contract, profit will be nil. This would result not only in distorted profit pattern but also higher tax liability because income tax at higher rates may have to be paid. Therefore, when contracts extend beyond a year, it becomes necessary to take into account the profit earned (or loss incurred) on the work performed during each year. This helps in avoiding distortion of the year-to-year profit trend of the business. There are two aspects of profit computation:

(a) Computation of notional profit or estimated profit.
(b) Computation of the portion of such profit to be transferred to Profit and Loss Account.

Actual Profit on a Contract can be ascertained only after it is entirely completed. However for recognition of profits during the course of contract, the concept of Notional Profit is used. Notional Profit is the excess of Income till date over Expenditure till date on a contract.
Notional Profit can be ascertained as under -

Notional Profit = Income till date – Expenditure till date

Profit on Incomplete Contracts is recognised based on the Notional Profit and Percentage of Completion. The rules of recognition are -

Description	% of Completion	Profit to be Transferred to P & L A/c
Initial Stage	≥ 25%	Nil
Work Performed but not Substantial	26% to 50%	$\frac{1}{3}$ x $\frac{Cash\ Received}{Work\ Certified}$ x Notional Profit
Substantially Completed	51% to 90%	$\frac{2}{3}$ x $\frac{Cash\ Received}{Work\ Certified}$ x Notional Profit
Almost complete	91% - 99%	Profit is recognised on the basis of Estimated Total Profit
Fully complete	100%	$\frac{Cash\ Received}{Work\ Certified}$ x Notional Profit

Notes: Percentage of Completion = $\frac{Work\ Certified}{Contract\ Price}$