CONTRACT COSTING

Presented by

Asst.Prof Gaikwad J S

Commerce Department

Meaning

- Contract costing is a variant of job costing. Like job costing, contract costing is also a form of specific order costing. So, both job costing and contract costing are based on the same costing principles. In fact, a big order is termed as a contract and a small order as a job. Contract costing is also known as terminal costing as the preparation of Contract Account is terminated or closed after the completion of contract. Example of undertakings which adopt contract costing are builders, civil engineering contractors, road making or repairing concerns, dams and bridge constructional concerns. The person who undertakes the work to complete is known as 'Contractor' and the person who gets the work done through contractor is known as 'Contractee'.

Definition

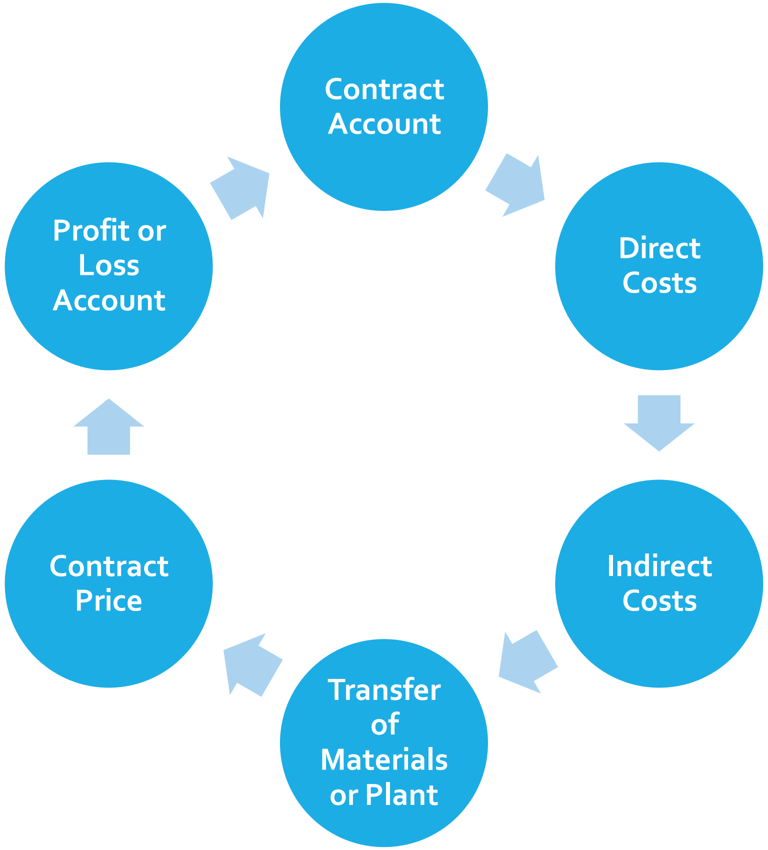
- “that form of specific order costing which applies where work is undertaken to customer’s special requirements and each order is of long duration.”

- “Contract or terminal costing is the term applied to the system adopted by those businesses which carry out substancial building or constructional contracts.”

Features

- Each contract is given a distinguishing number in respect of which cost is ascertained.
- It is the contract between the contractor and contractee.
- Many contracts require more than one accounting year.
- Most- of the items of cost are directly chargeable to individual contract.
- The work is generally carried out at a site and not in the factories.
- More often, one contract differs from others.
- Part payments are made depending on the certificate issued by the architect, showing value of work completed and retention money.
- An “escalation clause”, under which the contractor is compensated for increase in costs on account of inflation, may be included in the contract.
- In case of non-fulfillment of contract within the stipulated time, the contractor is required to pay penalty.

Procedure


Contract Account
Direct Costs
Indirect Costs
Transfer of Materials or Plant
Contract Price
Profit or Loss Account

Contract Costing Procedure

- **Contract Account:**

Each contract is allotted a separate number and a separate account is opened for each contract.

- **Direct Costs:**

of the costs of a contract can be allocated direct to the contract. All such direct costs are debited to the Contract Account.

- **Indirect Costs:**

Contract cost is also debited with overheads which tend to be small in relation to direct costs. Such costs are often absorbed on same arbitrary basis as a percentage on prime cost, or material or wages, etc. Overheads are normally restricted to head office and storage costs.

- **Transfer of Materials or Plant:**
- When materials, plant or other items are transferred from the contract, the Contract Account is credited by that amount.
- **Contract Price:**

The Contract Account is also credited with the contract price. However, when a contract is not complete at the end of financial year, the Contract Account is credited with the value (cost) of work-in-progress as on that date. Work- in-progress includes value of work certified and the cost of work uncertified.

- **Profit or Loss Account:**

The balance of Contract Account represents profit or loss which is transferred to Profit and Loss Account. However, when contract is not completed within the financial year, only the part of the profit arrived is taken into account and the remaining profit is kept as reserve to meet any contingent loss on the complete portion of the contract.

Rules

- **First Rule:**
- When work certified is less than 1/4 of the contract price, no profit is transferred to Profit and Loss Account. This is based on the principle that no profit should be taken into account unless the contract has reasonably advanced.
- **Second Rule:**
- When work certified is 1/4 or more but less than 1/2 of the contract price, then generally 1/3 of the profit is transferred to Profit and Loss Account. The balance amount is treated as reserve.
- **Third Rule:**
- When work certified is 1/2 (i.e. 50%) or more but less than 9/10 (i.e. 90%) of the contract price, then the profit to be transferred to Profit and Loss Account

- **Fourth Rule:**
- When contract is near completion then the estimated profit should be calculated on the whole contract.
- **Fifth Rule – Loss on Uncompleted Contracts:**
- In the event of a loss on uncompleted contracts, this should be transferred in full to the Profit and Loss Account. Whatever be the stage of completion of the contract.

Cost Plus Method of Contract:

- Cost plus method of contract is that where contract price is not settled between contractor and contractee, but it is agreed that contractor will be paid a fixed percentage of profit on the total cost incurred by contractor on and above the total cost of the work done. Such type of contract is entered into in war time or time of economic fluctuation or where contract is to be executed in urgency and it is difficult to quote the price of the contract.

Work-in-Progress Account

- If the contract is not completed by the end of financial year, then the uncompleted work is recorded in Work-in-progress Account. Work-in-progress Account is prepared by debiting to this account, the account of work certified and work uncertified and crediting it with the profit in reserve i.e. the portion of the profit not transferred to the Profit and Loss Account. The difference between the debit and credit side is Work-in-progress, while showing it in Balance Sheet, all cash received on account of such uncompleted contracts is to be shown as a deduction.

Advantages

- The contractor controls the costs involved in the contract for labor, material, other fixed expenses, etc.
- A contract account is prepared for each customer, identifying the cost incurred to date & work completion.
- Control is also maintained over the defects arising out of quality deficiency.
- Expert advice is helpless in completing a contract & he also helps to identify defects before completing the whole contract.
- Retention money becomes a reason for inspiration to provide quality work.
- A team spirit is built.

Disadvantages

- The biggest disadvantage is that it is time-consuming.
- Each customer may not agree with the escalation clause.
- Lack of accounting may lead to improper calculation of profits.
- Lack of control may make the contract lose-making for the contractor.
- A continuous eye on market conditions is required.
- Larger time gives rise to complications in the completion of work.

Objectives

- 1. Comparison of actual cost with estimated cost.
- 2. Detailed analysis of cost to provide a basis for cost-plus pricing.
- 3. Calculation of profit which may reasonably be taken each year on a long-term contract.
- 4. Guidance to management on the utilisation of resources.

Thanks