

Contract Costing

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Contract Costing : Meaning

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Meaning	<p>(a) Contract costing is also referred to as 'terminal costing' as the preparation of contract account is terminated or closed after the completion of the contract.</p> <p>(b) Contract costing is a form of specific order costing which applies where work is undertaken to customer's special requirements and each order is of a long duration.</p>
Period of Contract	<p>(a) Contract costing is a specialized system of Job costing applies to long-term contracts as distinct from short-term jobs.</p> <p>(b) It is applied to contracts where substantial time is taken to complete the contract and it falls into different accounting periods. However, a duration of exceeding one year is not an essential feature of a long-term contract.</p> <p>(c) Some contracts with a shorter duration than one year should be accounted for as long-term contracts if they are sufficiently material to the activity of the period.</p>
Difficulty in Control	<p>(a) Generally, contracts are big in size and contract work is to be carried out at sites.</p> <p>(b) Due to this some problems will arise concerning usage of material, labour utilization, supervision of labour, damage to plant and work, pilferage of materials and tools etc.</p> <p>(c) This site based work make it difficult to control costs of the contract.</p>
Application	Contract costing is mainly applied in building constructions, civil engineering projects, ship building, road and railway line contracts, construction of bridges etc.

Features of Contract Costing

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- (a) Contracts are undertaken to special requirements of the customers. Therefore, it is very rarely two contracts resemble one another.
- (b) Each contract is a distinct cost unit for purposes of accumulation of costs.
- (c) In the contract cost structure, majority of the expenditure is of direct nature in the form of materials, wages, use of plant and stores, direct expenses etc., and only a small portion will be charged as apportioned overheads. Therefore, there is no question of over or under recovery of overheads.
- (d) Duration of contracts are relatively for a long period, generally more than a year.
- (e) The work is to be carried out at site, it is very difficult to exercise cost control.
- (f) Separate accounts are prepared for each contract to determine its profitability.
- (g) Contract work is to be carried out at the sites of customer, not in the factory premises.
- (h) Contract work mainly consists of construction activities.
- (i) The payment is received from the contractee depending on the stage of completion of work basing on the surveyor's completion certificate.
- (j) There may be imposition of penalties for delay in completion of contract and bonus for early completion of contracts.
- (k) The main contract may be broken into parts and some parts may be outsourced through sub-contracting.
- (l) Plant and equipment may be purchased for the contract or may be hired for the duration of the contract.
- (m) Contracts involve difficulty in valuation of work-in-progress at the end of each accounting period.
- (n) Since the contract takes more than one year to complete, it is the general practice to transfer a percentage of notional profit to the profit and loss account at the end of each accounting year till the contract is completed.

Job Costing and Contract Costing : Distinction

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Basis	Job Costing	Contract Costing
Place of Work	Job work is carried in the factory premises.	Contract work is carried at site other than contractor's own premises.
Cost Unit	An order, a unit, lot or batch of product may be taken as a cost unit.	Each contract is a cost unit.
Price Fixing	The prices of the jobs are fixed basing on the nature of costs and policy of the firm.	The pricing is generally through bidding and external forces have major influence in fixing the offer price.
Duration of Work	The duration of the job work is smaller.	Generally the contract works will take more time to complete.
Value of Work	The value of the job work would be lesser.	The contract works are bigger in nature and the value of contract would also be higher.
Size	A job is small in size.	A contract is big in size.
Nature of Expenses	Expenses takes the form of direct and indirect.	Most expenses are direct in nature.
Accounting of Cost	Collection, analysis, allocation and apportionment of expenses is much complicated.	Collection, analysis, allocation and apportionment of expenses is much simpler.
Influence on Pricing	Pricing is influenced by individual conditions and general policy of organization.	Pricing is influenced by specific clauses of the contract.
Initial Investment	It involves heavy investment in assets initially.	This is not so under contract costing.
Receipt of Payment	The selling price of the job is paid after completing the job.	Contract price is paid in various instalments depending upon the progress of the work.
Accounting of Profit	Profit on job is entirely taken to profit and loss account.	In case of incomplete contracts, only proportionate profit is taken to profit and loss A/c.

Recording of Contract Costs

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Numbering of Contracts If the number of contracts are more, a distinguishing number or name is given to each contract for accounting and administration convenience. A separate contract account is maintained for each contract. All costs relating to contracts are charged to the respective contract accounts. Accounting of each item of cost in contract accounts is discussed below.

Material Cost

- All the materials purchased for the contract or any materials issued from stores through 'material requisitions notes' is debited to Contract Account.
- If any material is returned to stores accompanied by 'material return note', it is credited to the Contract Account.
- If any material is transferred to another contract site accompanied by 'material transfer note', it is credited to the Transferor Contract Account and debited to the Transferee Contract Account.
- If any material lying at site unused at the end of accounting period, is credited to the Contract Account and is carried forward for charging against the next accounting period.
- If materials are not required immediately, the materials may be stored and its cost is debited to Stock Account.
- Materials stolen or destroyed by fire or other reason, will be transferred to Profit and Loss Account.
- Normal wastage incurred in stores and materials should be charged to contracts by inflating the rates at which materials are priced out.

- (h) Stores used in manufacture of tools should be charged to Works Expenses Account.
- (i) In case the contractee supplies any materials, as per the terms of the contract, to be adjusted against contract price, it should be debited the Contract Account and credited the Contractee Account.
- (j) In case the contractee supplies any materials, as per the terms of the contract, over and above the contract price, the value of such materials should not be brought into the books, but a note will have to be kept to account for the quantity received and issued.

Labour Cost

- (a) All the labour employed or worked at site is treated as direct labour irrespective of the nature of work and all costs relating to them is charged to the Contract Account.
- (b) The salaries and incentives of the administrative and supervisory staff of a specific contract is also charged to that specific contract.
- (c) In case several contracts are being executed at various places, payroll is sectionized for each contract to determine the wages payable to workers on different contracts.
- (d) Difficulty may arise when the workers move frequently from one contract place to another. Therefore, proper time record should be maintained to avoid inaccuracies in preparation of wage sheets of each contract.
- (e) The wages accrued and outstanding at the end of the accounting year should appear on debit side of Contract Account.
- (f) There are chances of inclusion of dummy workers in the payroll since the work is carried at the site. Therefore, the head office should conduct frequent and surprise inspections to avoid such malpractices.
- (g) Wages paid for the period of stoppage of work due to abnormal reasons like breakdown of machinery, strike, lockout etc. should be debited to Profit and Loss Account.

Direct Expenses

- (a) All site expenses other than materials and direct wages are charged to contract as and when they are incurred.
- (b) These site expenses are considered as direct expenses relating to that particular contract.

Indirect Expenses

- (a) There are certain expenses like fees paid to engineers, surveyors, supervisors etc. incurred not for a particular contract and can be identified for that contract, then it is a direct expense.
- (b) If it is incurred for several contracts, then it is treated as indirect expense and it should be distributed on some appropriate basis.
- (c) The general overheads and head office expenses are apportioned to different contracts on equitable basis, and the portion of overheads are charged to the Contract Account.

Plant

- (a) When the plant is taken on hire for a particular contract, the hire charges are charged to that Contract Account.
- (b) If the plant is specifically purchased for the contract or plant was sent to site, the value of the plant is debited to Contract Account.
- (c) The written down value of plant returned or remaining at site is credited to Contract Account. This requires the plant to be revalued at the end of every financial year.
- (d) The balance between amounts debited and credited to contract represents the value of plant used at site.
- (e) Sometimes the value of depreciation provided on the plant is debited to Contract Account instead of showing the value of plant issued to site and remaining at site.
- (f) In case some machinery lost due to theft, accident, fire etc., the depreciated value till the time of loss should be debited to Profit and Loss Account and credited to Machinery Account.

Sub-contract Charges	<p>(a) Sometimes part of the contract work is given on sub-contract basis and payments made on sub-contract work is debited to Contract Account.</p> <p>(b) When a sub-contractor is engaged for special work connected with the main contract, the work performed by the sub-contractor forms a direct charge to main contract.</p> <p>(c) The sub-contractors are accountable to the main contractor as regards specifications of the work.</p>
Cost of Extra Work	<p>(a) In many cases, the contractor will also undertake to complete extra work which is not covered by the terms of the contract. In such cases, he will charge for the additional work.</p> <p>(b) If the additional work is substantial, another Contract Account will be opened for it.</p> <p>(c) If the additional work is minor, the expenses incurred for it shall be debited to the Contract Account as 'cost of extra work' and the extra amount which the contractee agreed to pay should be added to the contract price.</p>
Cost of Maintenance of asset	If the contract contains a clause that after completion of the project if such an asset has to be maintained for some time by the contractor, any expenses incurred on such maintenance is to be debited to Contract Account.
Penalties	The contractee may impose penalties on the contractor for delay in completion of the project or for defects in construction of the project. If such penalties are anticipated and normal in nature, such an amount has to be debited to the Contract Account and credited to the Contractee Account. If it is of abnormal nature, such an amount has to be charged against Profit and Loss Account.

Work-In-progress, Work Certified and Work Uncertified

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Work-In-Progress	<p>(a) Work-in-progress means the contract in various stages of completion at the end of the financial year.</p> <p>(b) The value of work-in-progress is shown on the Assets Side of the Balance Sheet.</p> <p>(c) The amount of work-in-progress includes the value of work certified, work uncertified and the amount taken as credit appearing in the Contract Account.</p>
Work Certified	<p>(a) Surveyor Certificate - In all civil construction contracts, generally the contractor receive payments from contractee periodically called as 'running payment'. In contract works, a surveyor or an architect or civil engineer is appointed to periodically visit the site for inspection of the work completed. He will issue a certificate mentioning the stage of completion of work and the value of the work completed to the date of issue of certificate. The payments will be released to the contractor by the contractee based on the said certificate. The value of work certified denoted in terms of money value contract appears on credit side of the Contract Account.</p> <p>(b) Retention Money - Normally the payments will be released only to the certain percentage, say 80% of the work certified. The balance amount of work certified is retained by the contractee till the completion of the entire contract satisfactorily. The amount so retained is called 'retention money'. The contractee so retains to safeguard himself from the risks that may arise from the contractor. Usually the percentage of retention money is upto 20% of the amount of work certified.</p> <p>Cost of Work Certified = Cost of work to date - (Cost of work uncertified + Materials in hand + Plant at site)</p> <p>Cash Received = Value of work certified - Retention money</p>
Work Uncertified	<p>(a) The cost of work uncertified represents the cost of work which has already been completed, but for that the contractor has not received completion certificate from the contractee's surveyor or architect.</p> <p>(b) The reasons for the same may be : (i) work not sufficient enough to be certified, (ii) work has not reached the stipulated stage to qualify for certification.</p>