

Contract Costing

Contract

A *contract* is an agreement between the contractor and contractee for execution of a work assigned by the contractee upon the contractor as per terms and conditions specified in the tender or agreement and it is enforceable by law. Normally long-term constructional or civil engineering works are considered as contracts in this case.

Contract Cost

The amount of costs or expenses incurred for completion of a contract is known as *Contract Cost*. According to the *Terminology of CIMA, London*, contract cost is the "aggregated costs relative to a single contract designated a cost unit. This usually applies to major long term contracts as distinct from short-term job costs".

Contract Costing

The method of costing used by the contractors is generally known as *Contract Costing*. As the contractors are engaged in execution of long-term constructional works as per agreement with the contractees, the method applicable for the ascertainment of cost of each contract is different from other costing methods. Here, contract costing is used on the principles of terminal costing or specific order costing.

Areas of Application

The technique of contract costing is applicable to the persons engaged individually or through any contractor concern of sole-proprietorship, partnership, joint family or company form, for the following long-term constructional activities of civil engineering

- (i) Building, Factory Premises or House Construction;
- (ii) Bridge Construction;
- (iii) Road or High-Way Construction;
- (iv) Dam Construction;
- (v) Drain or Wall Construction;
- (vi) Ship Building;
- (vii) Machines, Tools, Apparatus Production, etc.

Contract Costing vs. Job Costing

A. Similarities

The following are the main similarities between the contract costing and job costing

- (i) Both contract costing and job costing are made on the principles of terminal costing. In both the cases each order (i.e., job or contract) can be easily identified from the starting to the end in relation to others. As a result the costs of each order can be separately charged.
- (ii) The orders in both cases (i.e., contract or job) are based on the specific requirements of customers/clients and as a result each order in both cases is "tailor made" having unique features and there is no exact repetition in subsequent orders.

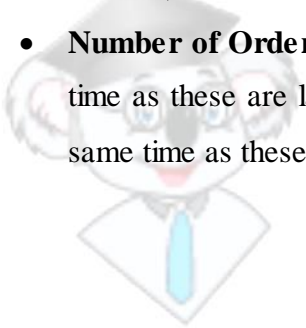
B. Dissimilarities / Differences

The main point of difference between the job costing and contract costing is the size of the orders. Actually, the size of order and activities of a job operated in Job Costing are relatively small, whereas the size of order and activities of a contract performed in contract costing are too large. As a result the cost accountants are of opinion that "a job is a small contract and a contract is a big

job."

The following are the main differences between the Contract Costing and Job Costing

- **Place of Work:** A contract is executed at client's site or place away from the factory or premises of contractors, but a job is manufactured inside the factory away from client's site.
- **Nature of Work** The work of a contract is normally immovable while the work of a job is purely movable.
- **Relation with Other Orders:** Different contracts are performed at separate places having no direct relation with others. But a number of separate jobs can be executed in the same factory at a time.
- **Tenure of Order:** An order of a contract can be executed by passing a long period of time (i.e., normally certain months or few years), whereas an order of a job can be performed within a very short period of time (i.e., normally few hours, days, weeks or months.).
- **Number of Orders:** A few number of contracts can be undertaken by a concern at a time as these are large in size but a large number of jobs can be easily performed at a same time as these are small units.



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The General Proforma of Contract A/c and Contractee A/c may be shown as follows :

Contract No. A/c or Contract A/c (Contract No.)

Dr.		for the year / period ended on		Cr.	
Particulars	Amount	Particulars	Amount	Particulars	Amount
	Rs.				Rs.
To Materials at site b/d *	***	By Outstanding Expenses b/d *			***
To Plant & Equipment at site b/d *	***	By Materials returned to store/supplier/transferred			***
To Prepaid Expenses b/d *	***	By Plant & Equipments returned to store/supplier/transferred			***
To Materials issued/sent	***	By Bank Account (Sale proceeds or compensation on plant or material)			***
To Wages/Salaries paid	***	By Profit & Loss A/c (Abnormal loss of materials, plant etc, adjusted)			***
To Direct Expenses	***	By Materials at site c/d			***
To Plant & Equipments issued (on long-term basis)	***	By Plant & Equip. at site (WDV) c/d			***
To Depreciation on Plant & Equipment (on long-term basis)	***	By Pre-paid Expenses c/d			***
To Hire Charges of other Plant & Equipments	***	By Cost of Contract c/d			***
To Other Expenses/Overhead	***				***
To Profit & Loss A/c (Profit on plant or materials sold)	***				***
To Outstanding Expenses c/d	***				***
	***				***
To Work-in-Progress b/d *	***	By Work-in-Progress c/d :			***
To Cost of Contract b/d	***	Work Certified	***		***
		Work Uncertified	***		***
To Notional/Accounting Profit c/d	***				***
	***				***
To Profit & Loss A/c (Profit considered & transferred)	***	By Notional/Accounting Profit b/d			***
To Work-in-Progress c/d (Reserve for Contingencies)	***				***
	***				***
To Materials at site b/d	***	By Outstanding Expenses b/d			***
To Plant & Equipmt. at site b/d	***				***
To Prepaid Expenses b/d	***				***
To Work-in-Progress b/d :					***
Value of Work certified	***				***
Add : Work Uncertified	***				***
	***				***
Less : Profit in Suspense	***				***

D. Profit on Incomplete Contracts :

- (1) Contract at Preliminary / Initial Stage (Normally below 25% complete) :
The Portion of Notional Profit taken to Profit & Loss A/c = Nil.
- (2) Contract of Sufficiently Advanced Stage (Normally 25% – 75% or 90% complete) :

(a) Where value of Work Certified is below 50% : Portion of Notional Profit taken to

$$\text{Profit \& Loss A/c} = \frac{1}{3} \times \text{Notional Profit} \times \frac{\text{Cash Received}}{\text{Work Certified}}$$

(b) Where value of work certified is 50% or more : Portion of Notional Profit taken to

$$\text{Profit \& Loss A/c} = \frac{2}{3} \times \text{Notional Profit} \times \frac{\text{Cash Received}}{\text{Work Certified}}$$

- (3) Contracts at Nearly Completion Stage (More than 75% or 90% complete) : Portion of Notional Profit taken to Profit & Loss A/c

$$= \text{Estimated Profit} \times \frac{\text{Cash Received}}{\text{Work Certified}} \times \frac{\text{Work Certified}}{\text{Contract Price}}$$

N. B. : *Estimated Profit = Contract Price – Estimated Total Cost = Contract Price – (Total Cost upto date + Estimated Further Cost + Provision for Contingency).*

Illustration (Medium Size) M1 : The following particulars are in respect of Contract No. 20 which commenced on 1st January 2001 :

	Rs.		Rs.
Materials	58,000	Direct Expenses	12,000
Direct Wages	75,000	Establishment Charges	8,000
Cost of Special Plant	30,000		

The contract was completed by 31st December, 2001. The Contract price was Rs. 1,75,000. The value of materials returned to store was Rs. 5,000. The special plant was returned to store subject to depreciation at 20% p.a. Contract price was received in full on 31st December, 2001.

Prepare Contract Account and Contractee Account. [Bangalore Univ., B.Com.]

Solution : In the books of (Contractor)

Contract A/c (Contract No. 20)

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Materials Issued	58,000	By Materials returned to Store	5,000
To Direct Wages	75,000	By Special Plant returned to Store	24,000
To Cost of Special Plant	30,000	By Contractee's A/c	1,75,000
To Direct Expenses	12,000	(Contract price realised)	
To Establishment Charges	8,000		
To Profit & Loss A/c	21,000		
(Profit on contract transferred)	2,04,000		2,04,000

Working Notes : (i) As the contract is completed in the current year, the profit on contract is fully transferred from the Contract A/c to the Profit & Loss A/c.

(ii) Closing value of Special Plant = Opening Balance – Depreciation for one year = Rs. 30,000 – 20% of Rs. 30,000 = Rs. 30,000 – Rs. 6,000 = Rs. 24,000.

Dr.		Cr.	
Particulars	Amount	Particulars	Amount
	Rs.		Rs.
To Contract A/c (Contract price)	1,75,000	By Bank A/c (Contract Price realised)	1,75,000

