Contract Costing

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CONTRACT COSTING

Contract Costing is a variation of job costing.

It is also known as terminal costing as the preparation of contract account is terminated or closed after the completion of contract.

In this method of costing each contract is treated as a cost unit and an account is opened for each contract in the books of the contractor to ascertain profit or loss thereon.

Distinction between Contract Costing and Job Costing:-

1.A contract is generally big order while a job is small in size Thus, It is said “a job is small contract and a contract interior designing a big job”.

2. A job is usually carried out in the factory premises or workshop of the proprietor. But a contract is executed mostly at contractee site.

3. A contract takes long period for completion. A job usually takes less time for completion.

4. In case of contract costing most of the expenses are direct in nature. Where as in job costing expenses may be direct and indirect.

5. Compared to contract costing there will be heavy investment on assets initially in case of job costing.

6. The contract price is paid in installment depending upon the progress of the work. While the selling price of a job is paid in full after the completion of the job.

7. In case of incomplete contracts profit is transferred to profit/Loss account depending on the stage of completion of the contract. But in job costing entire profit earned is taken to profit and loss account.

Features of Contract Costing:-

1. The work is executed at the premise or site of contractee.
2. Most of the contracts involve longer duration for completion.
3. Each contract undertaken is treated as a cost unit.
4. A separate contract account is prepared for each contract to ascertain profit or loss.
5. Most of the expenses (Materials, Labour & Expenses) Chargeable to contracts are direct in nature.
6. Specialist's sub-contractors may be employed by the contractor, For ex: Electrical fittings, flooring work, painting etc., In case of construction work Interior designing.
7. Plant and Equipment may be purchased for the contract or may be hired for the duration of the contract
8. Payment by the contract ee are made at various stages of completion of the contract based on architects' certificate for the completed stage.
9. An amount known as retention money is withheld by the contract ee as per agreed terms.
10. Penalties may be incurred by the contractor for failing to complete the work within the agreed period.

Special points in contract costing

1. **Sub Contract costs: -** Work of specialized nature is offered to a subcontractors for ex:- steelwork, glave work, painting, installation of lift, interior designing, woodwork, floor laying etc., are usually carried out by the sub-contractors who are accountable to the main contractor. The cost of sub-contract is charged to contract accounts.

2. **Work Certified: -** This is that part of work in progress which has been approved by contractee's architect or surveyor or engineer for payment. Work certified appears on the credit side of the contract account. It is shown on the asset side of the balance sheet under the heading "workin-progress."

3. **Work uncertified: -** This is that part of work in progress which is not approved by the architect or engineers. This is valued at cost. This includes the cost materials, labour and other expenses incurred since certification by the architect. As such it does not include profit element. The value of work uncertified appears on the credit side of contract of a/c. It is shown on the assets side of the balance sheet under the heading "work-in-progress".

4. **Work-in-Progress: -** The work-in-progress represent the value of work which is in progress on a contract and requires further costs for completion. In other words when the contract is not completed at the end of the accounting year is called work-in-progress. This includes the value of work certified and work uncertified work-in-progress appears on the assets side of the balance sheet

5.**Retention Money: -** entire amount certified by the architect. A certain percentage is retained by the contractee as per the terms of the contract deed. The amount so with held by the contractee is known as retention money. The purpose of retention money is to make sure that the contractor has performed all work relating to contract in satisfactory manner. Retention money is a security for any defective work which may be found in the contract later. Retention money is paid later to the contractor as per the terms of the contract agreement.

6. Escalation Clause: - Sometime contractor and contractee agree to a fixed contract price with escalating clauses. The escalation clause provides for increase in the contract price due to increase in the price of materials, wages and expenses or due to change in the utilization of factors of productions. The object of this clause is to safeguard the interest of the contractor against un-favourable change in prices.

7**. De-escalation Clause:** - To protect the interest of contractee against fall in the prices of materials, labour and overheads a de-escalation clause is inserted in the contract agreement. This clause provides for downward revision of the contract price in the event of cost of contract going down below as agreed level.

8. Cost-plus Contract: - It is a contract in which the contract price is ascertained by adding a specified amount percentage or profit to the cost of the contract. This type of contract is agreed upon when it is not possible to compute the cost of the contract in advance. With reasonable degree of accuracy, the contractee undertakes to reimburse the contractor the total cost of the contract plus a stipulated amount of profit or stipulated percentage of profit. The account of the contractor is usually subject to audit by the contractee. This type of contract is entered into for executing special works like contraction of dam, powerhouse, defence products, newly designed ships etc., Govt. prefers to give Contractor Pays advance to the contractor based on work certified by the architect however the contractee will not pay the contract on cost plus.

Types of Contract

1.Fixed Price Contracts: - Under these contracts both parties agree to a fixed contract price.

2. **Fixed Price Contracts Subject to escalation clauses: -** Some time both parties to the contract agree to a fixed contract price with escalation clause. The escalation clause provides for change in the contract price due to change in the price of raw materials and labour or due to change in the utilization of factors of production. The object of this clause is to safeguard the interest of the contractor against unfavorable changes in the price. The escalation clause is of particular importance where prices of materials and labour are anticipated to increase and where quantity of material and labour time cannot be accurately estimated. A de-escalation clause may also be inserted in a contract agreement. This clause looks after the interest of the contractee by providing for the downward revision of contract price in the event of cost of the contract going down below on agreed level.

3. Cost-Plus Contract: - It is contract in which the value of the contract is ascertained by adding a stipulated amount of profit as a certain percentage of profit over the total cost of the work. It is adopted in those contracts where the probable cost of the contract cannot be computed in advance with the reasonable degree of accuracy due to unstable conditions of materials and labour or when the work is spread over a long period of time or when the prices of materials and rates of labour are liable to fluctuate, such contract are undertaken for production of special products Ex:-Newly designed ship, construction of dam, powerhouse, etc., Government prefers to give contracts on cost plus terms.

Advantages:-

1. To the constructor:-

a) There is no risk of loss on such contracts.
b) It protects him from the risk of fluctuations in market prices of material, labour etc.,
c) It simplifies the work of preparing tenders and quotations.

2**. To the contractee:-**

a) It ensures that the --- is based on actual cost.
b) The constractee is entitled to audit the accounts of the contractor.

Disadvantage:-

1. **To the contractor:**

a) The contractor cannot take advantage of favourable market prices

b) The contractor has to suffer for his own efficiency. This is because profit is usually based as a percentage of cost and efficient working of contractor resulting in lower cost leading to lower profits.

2**. To the Contractee**:-

a) Contractee has to pay more for the inefficiency of the contractor as the contractor will have no incentive to reduce costs.

b) The contract price is unknown to the contractee until after the completion of work. Thus the price the contractor has to pay in unknown until the completion of the contract.

THANK YOU