COST AND WORKS ACCOUNTING
(Overheads and Methods of Costing-II)
T.Y.B.COM

Topic- VI: Contract Costing
(Contract Costing: Meaning, Definitions, Important Terms)
CONTRACT COSTING:

Meaning:

Contract is a special type of Job Costing where the unit of cost is a single contract. This method is also termed as ‘Terminal Costing’ as when the work is terminated the cost-sheet has to be completed. It is a variant of Job Costing. In this method it is desired to find out the cost of carrying out a complete contract for a customer involving numerous jobs and batches of jobs. The costs are ascertained and analysed with respect to the contract accepted for execution. This method of costing is adopted by those concerns undertaking definite contracts e.g. long-term projects like construction of roads, bridges, houses, large estates, irrigation schemes etc.

Contract Costing also adopted by the concerns where the unit of output is heterogeneous. e.g. ship building companies, turbines and boilers manufacturing companies etc.
Definitions: (Job Costing)

1. Institute of Cost and Management Accountants, London:

“Contract Costing is that form of specific order costing which applies where work is undertaken to customers’ special requirements and each order is of long duration”.

2. According to Certified Institute of Management Accountants:

“Job Costing is the aggregated costa relative to a single contract designated a cost unit”.

In short, Contract Costing is that form of specific order costing under which each contract is treated as a separate cost unit and costs are accumulated and ascertained separately for that contract.
Important Terms in Contract Costing:

1. Material costs:

The material requested for the contract are ‘Debited’ to Contract Account which includes:

a) Materials specially purchased for the contract.
b) Materials issued from stores against requisition.
c) Materials urgently required transferred from another contract.

On completion of the contract the following types of materials should be ‘Credited’ to Contract Account:

a) Materials returned to stores.
b) Materials in hand on site at the end of the accounting period.
c) Materials transferred to another contract.
d) Sale of materials.
Following are certain items of losses should be ‘Debited’ Profit and Loss Account and should be ‘Credited’ to Contract Account:

a) Loss on sale of materials.
b) Materials which are stolen away or destroyed by fire.
c) Materials lost in accidents.
d) Cost of defective materials.

2. Labour Cost:

All labour actually engaged at contract site is regarded as direct labour, irrespective of the nature of the tasks performed by the workers concerned and charged to the contract. The extra labour cost that should be debited to a Contract Account thus includes the total remuneration paid and payable to all workers engaged on contract at the end of the accounting period.

3. Other Direct Expenses:

All other expenses incurred directly for the contract should be debited to Contract Account. e.g. Architect’s or surveyors fee, Sub-contract cost, hire charges of Plant and Machinery etc.
4. Overhead Costs:

There are some common indirect expenses incurred for various contracts, which cannot be charged directly to the individual contract. These expenses are divided into works expenses, office expenses and are distributed on various contracts on some appropriate basis. These expenses are debited to Contract Account. i.e. head office expenses, expenses of central stores, establishment charges etc.

5. Plant and Machinery Costs:

In every contract work some special plant, heavy machines and special tools are usually employed. The Plant and Machinery cost represents the cost for the use of Plant and Machinery and tools for the contract.

a) If Plant and Machinery and tools are used for the contract only for a short period, Contract Account may be ‘debited’ with the amount of depreciation on it.

b) If Plant and Machinery and tools are used for the contract for a long period, the full amount of it may be ‘debited’ to Contract Account and at the end of the accounting period or completion of the contract, the residual or written down value of it may be ‘credited’ to the Contract Account.
6. Sub-Contract Cost:

If the contractor has entrusted some special work to some expertise sub-contractor, the costs incurred for each sub-contract is treated as a direct charge to the contract and hence should be debited to Contract Account e.g. a building contractor may entrust the following types of specialised jobs as a sub-contractor to the sub-contractors e.g. task of digging foundations, electrical installation, specialised flooring, installation of lifts, painting work, plumbing work etc.

7. Cost of additional Work:

If a contractor is asked to do some extra work or alteration in the work which is not included in the original contract, the cost of such additional work may be charged separately to the contract as follows:

a) If the additional work is substantial and the amount involved is large, it is better to treat the same as a subsidiary contract and a separate contract account should be operated for the same.

b) If the additional work is not substantial, its cost should be debited to Contract Account and should be added in to the contract price.
8. Architect’s Certificate:

In case of large contract which takes a long period, it is a normal practice for the contractor to get interim advanced payments against the actual portion of contract completed by him. The contractee appoints the architect or surveyor or engineer who works as a technical assessor. Architect visits the site periodically, inspects the work done at site, makes the necessary record in the measurement register and issues a certificate showing the stage of completion of work and the value of work done completely as on the date of issue of certificate. Thus, as per the contract agreement, the periodical payment is made to the contractor on the basis of such an architects certificate.

9. Retention Money:

It is a common practice to include the clause of retention money in the contract agreement. Under this clause the contractee will not make payment of work certified by the architect, but a certain portion thereof shall be retained by him which is called ‘Retention Money’. The object of this retention money is to place the contractee in a favourable position in case of faulty work or penalty payable by the contractor. This amount will be paid to the contractor after the satisfactory completion of the work depending upon the terms of contract.
Retention Money is paid when it is ensured that there is no fault in the work carried out by the contractor. It is calculated as follows:

Retention Money = Value of Work Certified (-) Cash Received

10. Cash Received:

Cash Received is that portion of the value of work certified which is paid by the contractee. It is usually expressed as percentage of work certified. Cash received is calculated as follow:

\[
\text{Cash Received} = \text{Value of Work Certified} - \text{Retention Money}
\]

OR

\[
\text{Cash Received} = \text{Value of Work Certified} \times \text{Cash Received as \% of Work Certified}
\]

OR

\[
\text{Cash Received} = \text{Contract Price} \times \% \text{ of Work Certified} \times \% \text{ of Cash Received}
\]
11. Notional Profit:

Notional Profit is the difference between the value of work-in-progress certified and the cost of work-in-progress certified.

Notional Profit is computed as follows:

\[
\text{Notional Profit} = \text{Value of Work Certified} - \text{Cost of Work Certified}
\]

OR

\[
\text{Notional Profit} = \text{Value of Work Certified} - \text{Total Cost incurred till date} - \text{Cost of Work Certified}
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Thank You