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CONTRACT COSTING

Q.NO.1:- What do you mean by contract costing? What are its features?

Ans:-

Meaning:

- It is a method used in construction industry to find out the cost and profit of a particular construction assignment.
- Contract Costing is used by concerns like construction firms, civil engineering contractors, and engineering firms.

Features

I. **Parties involved:-** There are two parties namely, contractor and contractee.
II. **Site work:-** Major part of the work in each contract is generally carried out at the site of the contract.
III. **Direct expenses:-** Most of the expenses incurred by the contractor are directly relatable to site.
IV. **Indirect expenses:-** Indirect expenses like administrative exp and common expenses of various sites are apportioned on appropriate basis.
V. **Separate accounts:-** A separate account is maintained for each contract, to ascertain profit or loss.
VI. **Cost centre and cost unit:-** is contract itself.
VII. **Recognition of Profit:-** Generally profit from a contract is recognized on the basis of percentage of completion of contract.

Q.NO.2:-Distinguish between job costing and contract costing.

Ans:

Points of Difference	Job Costing	Contract costing
Meaning	Job refers to any specific assignment , contract or work order wherein work is executed as per customer's requirement.	Contract costing refers to a large job /assign-ment/work order. The execution of work is spread over two or more financial year.
Application	Job costing is applied in printing Press, Furniture works, interior decorators and other similar works.	Contract costing is applied in activities like civil construction , ship building etc.

Q.NO.3:- What do you mean by Cost Plus contract? What are its advantages and disadvantages?

Ans:-

Meaning

A Cost Plus contract is one where the contract price is ascertained by adding a percentage of profit to the total cost of the work. Such type of contracts is entered into when contract costs cannot be estimated with reasonable accuracy due to unstable conditions e.g. material prices, labour etc.

Advantages	Disadvantages
1.No Risk for Contractor: The contractor is assured of a fixed percentage of profit. There is not risk of incurring any loss on the contract **2.Undefined work:** It is useful particularly when the work to be done is not definitely fixed at the time of making the estimate. **3.Examination by Contractee:** Contractee can ensure himself about the cost of the contract, as he is empowered to examine the books and documents of the contractor , to ascertain the accuracy of the costs.	**1.No incentive :**There is no incentive to the contractor to avoid wastages and achieve economy in production. **2. Uncertainty:** The contractee may not know the actual cost of contract till its completion, unlike a Fixed price contract, where his outflow/cost is pre determined.

Q.NO.4:- What do you mean by Fixed Price contract? What are its advantages and disadvantages?

Ans:-

Meaning

A Fixed Price contract is one where the contract price is fixed in advance at the time of entering into the agreement.

Such type of contracts is entered into when contract costs can be estimated with reasonable accuracy ..

Advantages	Disadvantages

1.Certainty :The contractee's outflow on the contract is known and determined in advance. **2.Useful: It is useful specially when the costs of work to be done can be determined with certainty.**	**1.Quality deterioration: Contractors may resort to the use of materials of lesser quality /Price to increase his profit margin.** **2.Risk of loss : Contractor may incur losses if he had not estimated the contract costs properly or if price levels increase due to abnormal reasons, after entering into the agreement.** **3.Uncertainty about Cost : Contractee cannot have any idea about the real costs since he cannot examine the books of the contractor.**

Q.NO.5:-What do you mean by Cost escalation clause?

Ans:-

1.In a Fixed Price Contract , the contract price is fixed and pre-determined. If there is an increase in prices of material , rates of labour etc. during the period of execution of contract , the contract cost may rise, the contractor's profit may be reduced.

2.This increase in prices may induce the contractor to use materials of lower quality and price in order to maintain his profit margin on the contract.

3.To overcome this situation, the agreement generally contains a stipulation that the contract price will be increased by an agreed amount or percentage, if the prices material wages etc. rise beyond a particular limit. Such a condition is called escalation clause.

4.Journal entry in the books of contractor :- Contractee's account Dr. and Contract account Cr.

Q.NO.6:-Distinguish between work certified and work uncertified.

Ans:-

Work Certified	Work uncertified
It represents work done during the period , and also certified by the Architect's /surveryor.	It represents work done during the period but not yet certified by the Architects own estimate.
The amount of work certified is based on Architects certificate.	Cost of work uncertified is based on the contractor's own estimate.
It includes profit element, since it is based on contract price.	It is a conservative cost estimate and does not include any profit element.
It is considered for calculating percentage of completion.	It is not considered in calculating of percentage of completion.
It provides the basis for claiming periodical progress payments from the contractee.	It arises due to time gap between the date of previous certificate to the close of the financial year.

Q.NO.7:- What do you mean by Progress payments and Retention money?

Ans:-

I. Progress Payments / Cash received:

- **Payments received by the contractor when the contract is ' in progress/s' are called progress payments/Running payment.**
- **Such payments are released by the contractee on the basis of Architect's certificates and as per the terms of the contract.**
- **Generally , the entire amount of work certified is not fully paid. A percentage of the amount due (called Retention money) is retained and only the balance is paid to the contractor.**

II. Retention money:

- **The amount withheld by the contractee while making progress payments is called Retention money.**
- **Retention money = value of work certified less progress payment.**
- **Retention money is withheld to ensure completion of entire contract and compliance with the terms of the contract**

Q.NO.8:-What are the principles for recording Material cost incurred on contract?

Ans:-

I. Supply from Stores:-Cost of all materials supplied from stores is debited to the contract Account, based on the Material Requisition slip.

II. Direct Purchases:- Cost of materials purchased and directly received at site is debited to contract account.

III. Tool making materials :- If any stores items are used for manufacturing tools, the cost of such stores

items are charged to works expenses account.

IV. **Supply by contractee:-** If the contractee has supplied materials without affecting the contract price, no accounting entries will be made in the contract account , only a note may be given about it.

V. **Transfer of materials:** When excess materials is transferred form one contract to another , their costs would be adjusted on the basis of material Transfer Note. The receiving contract account will be debited while the transferring contract account will be credited.

VI. **Return of material to store:-** These are credited to contract account.

VII. **Sale of surplus material:-** contract account is credited with sale price. Any loss or profit is transferred to Profit and loss account.

VIII. **Abnormal loss of materials:-** Any theft or destruction of material by fire or other abnormal causes represents a loss. Such amount is transferred to the Profit and loss account, by crediting the contract account.

Q.NO.9:-Write a short note on recording of labour costs incurred on contracts.

Ans:-

i. Wages paid to the workers engaged on a particular contract should be charged to that contract irrespective of the work performed by them.

ii. If there are common workers on more than one contract and/or if the workers are transferred from one contract to the other contract, time sheets must be maintained and wages may be distributed on the basis of time spent on each contract.

iii. Some of the workers may be working in the central Office or central stores, their wages can be apportioned to a particular contract on suitable basis like time spent etc.

Q.NO.10:- How are costs other than materials and labour ascertained and recorded.

Ans:-

1) **Direct Expenses:-** All expenses incurred for a particular contract should be charged to that contract.

2) **Indirect Expenses:-** In case of any indirect expenses incurred for the organization as a whole, they should be charged to the contract on some suitable basis.

3) **Depreciation:-**

Depreciation on contracts may be treated in any of the following ways-

a. **Method 1:-** The value of plant in a contract may be either debited to contract account and the written down value thereof at the end of the year posted on the credit side.

b. **Method 2:-** Only depreciation for use of the plant may be debited to the contract account.

Sometimes plants may be taken on hire for a particular contract. In such cases the amount of rent paid should be debited to the contract account.

4) **Subcontract cost:**

- Sometimes due to certain situations, a sub contractor is appointed to carry out certain special work for the main contract.
- This special work done by the sub contractor becomes a direct charge to the main contract and accordingly debited to the contract account.
- The payments made to the sub contractor are charged to the main contract as direct expenses and no detailed break up of the same is required.
- Material supplied to the sub contractor without any charge, is debited to the contract account as direct material and machinery, tools etc supplied to him on rent should be depreciated on appropriate basis and debited to the contract account.
- Rent received for the use of such tools and machines should be credited to the contract account or deducted from the final bill of the sub contractor.

5) **Additional Work:**

- Sometimes additional work may be necessary in addition to the work originally contracted for.
- This forms a separate charge and if the amount involved is large, a subsidiary contract is generally entered into with the contract.

Q.NO.11:- What do you mean by Notional Profit?

Ans:-

Actual Profit on a contract can be ascertained only after it is entirely completed. However for recognition of

profits during the course of contract, the concept of Notional profit is used.

Notional profit is the excess of income till date over expenditure till date on a contract. Notional profit can be ascertained as :

Notional profit =	**Income till date (i.e. value of work certified + cost of work uncertified**	**Less**	**Expenditure till date (Total costs on contract, after adjusting materials at site, WDV OF Plant at site, prepaid expenses etc.)**

Q.NO.12:- List the rules for recognition of profit on incomplete contracts.

Ans:-

Treatment of Profit on incomplete contract:

Value of Certified work only should be taken into consideration while determining the Profit. Value of work not Certified should not be taken into consideration.

% of completion (cumulative)	Quantum of profit to be booked
< 25%	nil
>= 25% but <50%	1/3 of NP x CR/WC
>= 50% but < 90%	2/3 of NP x CR/WC
>=90%	EP x WC/CP or EPxWC/CPxCR/WC or EPxCR/CP (Preferable)
NP= Notional Profit, CR= Cash Received/Progress Payment received, CP= Contract Price, WC=Value of Work Certified	

Important Points

1. Notional Profit = Value of work Certified – [cost of work to date – cost of work completed but not Certified]

2. Estimated total Profit = Contract Price - (total costs to date + additional expenditure necessary to complete the contract .

3. Additional Expenditure not given in the Question: In case, additional expenditure to complete the contract not mentioned, the amount of Profit to be transferred to the Profit and Loss Account is determined using the following formula. Notional Profit x Work Certified/Contract Price

4. Loss: If there is a loss, the total amount of loss should be transferred to the Profit and Loss Account by crediting the contract account.

5. Logic behind proportion of Profit: It will be observed that in case of incomplete contract, amount of Profit credited to the Profit and Loss Account is reduced proportionate to the work Certified and cash received. The reason is that this being unrealized Profits should not be used for distribution of dividend. Similarly, the principle of conservatism should also be applied in computing and crediting the Profits.

Q.NO.13:-How is WIP displayed in the Balance sheet till a contract is completed?

Ans:-

CURRENT ASSETS:

Contract work in progress

Value of work certified
Add: Cost of work uncertified
Add: WDV of plant at site
Add: Cost of materials at site
Less: Reserve profit
Less: Balance in contracee's personal account
Net value of contract WIP