Preparation of Contract accounts, escalation clause, Calculation of work in progress

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Generally a contract is a big job requiring considerable length of time to complete and the work may be undertaken outside the factory. The person who agrees to perform the work is called a Contractor. The person who gives the contract or for whom the work is done is called the Contractee.

The sum of money agreed upon to be paid by the Contractee is known as Contract Price. The agreement between the Contractor and the Contractee to complete a job is called a Contract. A contract account is prepared to find out the cost of the contract and to know the profit or loss made on the contract. On the basis of the contract, other similar contracts can be undertaken.

According to the Accounting Standard – 7 (AS – 7) issued by the Institute of Chartered Accountants of India, a construction contract" is a contract for the construction of an asset or of a combination of assets which together constitute a single project. Examples of activity covered by such contracts include the construction of bridges, dams, ships, buildings and complex pieces of equipment."

A Contractor has to maintain a separate account known as Contract Account for each job and this facilitates to know the profit earned or loss incurred. It is akin to factory job costing, but varies only in size; and the contract continues for a longer time.

A contractor undertakes a small number of big contracts at a time. For example, builders, civil engineering firms, constructional and mechanical engineering firms etc., adopt this method of costing.

Accounting Procedure:

A contract ledger is kept in which a separate account is opened for each contract undertaken. It is usual to give each contract a distinguishing number. A contract account is debited with all direct and indirect expenditure incurred in relation to the contract. It is credited with the amount of contract price on completion of the contract. The balance represents profit or loss made on the contract and is transferred to Profit and Loss Account.

The treatment of important expenses dealt with is as follows:

(a) Material:

Materials needed for a contract may be obtained either from direct purchase or from the store. When the materials are purchased from outside for the use of a contract, the total cost is directly debited to the related contract.

If the materials are received through Material Requisitions from store, the cost of the material will be debited to the related contract. Each Material Requisition contains the contract number.

Alternatively, material cost of a job can be known from the Material Abstract, prepared on the basis of Material Requisition and debited to the contract directly, in summary, either weekly or monthly.

There may be two types of wastages – normal and abnormal. In the case of normal wastages, the issue rate of materials is inflated in order to recover the normal wastages and the total cost of materials at the inflated rate is debited to the contract.

The abnormal wastage is to be transferred to profit and loss account. Any type of theft or destruction of materials is lost which is transferred to profit and loss account.

Surplus materials lying at the site are credited to the contract account with the cost, whether the surplus is returned to the store or transferred to another job. Sometimes, the customer himself supplies certain materials for the contract; and the same should be entered into a separate book of accounts and not debited to the contract. At the time of closing accounts, materials, if any, in hand are credited to the contract account.

(b) Labor:

The contracts are carried out at the site of the construction i.e., away from the contractor's premises. Therefore, there arises a problem of control. The labor employed on contracts is treated as direct labor, and the labor cost is debited to the contract. When there are a number of contracts, a pay-roll is prepared for each contract.

The total amount of each contract is to be debited to the respective contracts. The salaries of supervisory staff, supervising two or more contracts, are apportioned on equitable basis. Wages accrued will also be debited to the contract account.

(c) Overhead:

Generally apportioning overhead expenses do not arise, because most of the expenses such as lighting, power, maintenance of plant, architect fees, hire charges of special plant etc., are entirely charged to the contracts. However, costs common to more than one contract such as Head Office expenses should be apportioned and charged to each contract with respective share on some suitable basis; for example, labor-hour rate.

(d) Plant:

The cost of the plant used for the contract is charged. Special types of plants are brought to the site for use, such as cement concrete mixer, crane, tractor, floor polishing machine etc. A clear record may be kept and properly accounted. There are two methods of charging the contract for using the machines.

- Contract is debited with the full value of the plant. When a new plant or old plant is issued to a contract, the cost of the plant or book value of the old plant is debited to the contract. The plant is revalued at the end of the year and credited to the contract with revalued (depreciated) value.

This method is good when the plant is put under regular use for the contract for a longer period, in certain cases; the plant gets completely worn out before completion of the work. The depreciated value of the plant is carried forward as the opening balance at the commencement of the next accounting year.

- Alternatively, the depreciation calculated on the basis of hourly or daily rate, is debited to the contract. In such case, the value of the plant is not debited to contract. For this, an 'Upkeep Account' is to be maintained. The cost of running expenses of the plant, repairs, maintenance, oil etc., is debited, a higher rate is fixed with the help of this account and the contract is charged accordingly.

When a portion of the plant is returned to the store, the contract is credited with the depreciated value of that part. If the plant is sold, the full value is debited to the contract and credit must also be given to the contract. When the plant is lost or destroyed, it will be transferred to profit and loss account.

(e) Sub – contracts:

Sometimes, the contractor gives a portion of work to sub-contractor. For instance, the work of painting, special flooring etc., may be given to another contractor. The cost of the sub-contract is directly charged to the main contract.

(f) Extra Work:

It is possible that the contractor may be given additional work or the original contract may be altered by the contractee. In such cases, the work is additional and will be subjected to a separate charge. If the amount is small, the contract is debited or if the amount is large, a separate account is to be opened. In both the cases, the cost of extra work is added to the cost of the original contract.

Profits on Incomplete Contracts:

Big contracts take several years for completion. The exact amount of profit can be ascertained only after the completion of the contract. Incomplete contracts are known as work-in-progress and are valued at cost. Generally profits should not be anticipated. As such, no profit should be transferred to profit and loss account in respect of incomplete contracts. If it is so, there may be wide fluctuations in the profit and loss account and may invite serious repercussions.

For example, profit and loss account in respect of incomplete contracts will show a loss notwithstanding the fact that the year was a good year of profits. Secondly, trading result will differ from year to year and will be un-comparable. Thirdly, high rate of income tax will have to be paid, if the profit is ascertained after the completion of the contract.

Therefore, on account of these drawbacks, it is desirable that the entire profits are not shown in one year, because the profits are not earned in a year. Hence, the profits on incomplete contracts are anticipated carefully.

Treatment of Profits:

1. If the contract is recently started and the work completed is one-fourth or less than one – fourth of the total work, no profit should be transferred to profit and loss account.

2. If the contract has reasonably advanced and if the architect of the contractee certifies that the work completed is more than one-fourth, but less than half of the work, one-third of the notional profits is normally credited to the profit and loss account. This is further reduced by the ratio cash received to work certified i.e.,

$$\text{Notional profit} \times \frac{1}{3} \times \frac{\text{Cash received}}{\text{Work certified}} = \text{Profit to be credited.}$$

3.If more than half or the contract is nearing completion, then two-thirds of the notional profit may be credited on the basis of cash received to profit and loss account, i.e.,

$$\text{Notional profit} \times \frac{2}{3} \times \frac{\text{Cash received}}{\text{Work certified}} = \text{Profit to be credited.}$$

In the second case 2/3 of the profit and in the third case 1/3 of the profit are left over to meet future contingencies such as penalties, increase in costs or losses if any.

Work-in-Progress:

Incomplete contracts are referred to as work-in-progress includes the value of work certified and the cost of work uncertified. When less than 1/3 of the work is complete, the net expenditure incurred up to date is taken to be the value of work-in-progress. Net expenditure means gross expenditure MINUS value of material, plant in hand at the end of the year.

When contract is well progressed of nearing completion, the work-in-progress is valued either way for Balance Sheet purpose:

First Method

Value of work certified	–
Add: Uncertified Work	–
Total	–
Less: Profit carried forward, and Cash Received	–
WIP for B/S Purpose	–

Second Method

Net Expenditure incurred	–
Add: Profit taken credit for	–
Total	–
Less: Cash Received	–
WIP for B/S purpose	–

Proof (illustration No. 25. 1)

First Method

		Rs.
Value of Work Certified		Rs. 6,00,000
Add: Uncertified work		–
Total		6,00,000
Less: Profit Carry		
Forward	12,507	
Cash Received	4,80,000	4,92,507
WIP for B/s Purpose		1,07,493

Second Method

	Rs.
Net Expenditure incurred: (Rs. 6,25,200 – Rs. 52,000)	5,73,200
Add: Profit taken credit for	14,293
Total	5,87,493
Less: Cash Received	4,80,000
WIP for B/S purpose:	1,07,493