

## Contract Profit and Loss Account

### (a) Completed Contracts:

When a contract is completed, the overall profit or loss on the contract is transferred to the profit & Loss Account fully.

### (b) Incomplete Contracts:

When there is loss on an incomplete contract, it is fully transferred to the profit and loss account. When the contract account of an incomplete contract shows profit, it should not be treated as profit earned but only as 'Notional profit. Uncertainty exists relating to material prices and wage rates. Natural calamities like rains and floods can cause loss on contracts. So, a conservative policy of making provision for contingencies and taking to the credit of P & L A/c the balance of notional profit is usually practiced.

The following are the rules or principles to be followed in relation to profit on incomplete contracts:

(a) When work-certified is less than 25% of contract price- No profit should be transferred to P & L A/c. The entire notional profit is kept in reserve for contingencies.

(b) When work certified is 25% or more but less than 50% of the contract-  $\frac{1}{3}$ rd of the notional profit, subject to the ratio of cash received to work certified, and is transferred to P & L A/c.

$$\text{Profit credited to P \& L A/c} = \text{Notional profit} \times \frac{1}{3} \times \frac{\text{Cash received}}{\text{Work certified}}$$

(c) When work certified is 50% or more of the contract price-  $\frac{2}{3}$ rd of the notional profit is transferred to P & L A/c, after reducing it further in the ratio of cash received to work certified.

$$\text{Profit credited to P \& L A/c} = \text{Notional profit} \times \frac{2}{3} \times \frac{\text{Cash received}}{\text{Work certified}}$$

## When a Contract is Nearing Completion:

Contracts on the verge of completion or nearing completion are dealt with in a different manner. The additional expenditure required to complete the contract is estimated. On this basis, the total estimated profit on the contract is ascertained. Then any one of the following formulae can be used to credit profit to P & L A/c.

$$\begin{aligned} \text{(c) Estimated profit} &\times \frac{\text{Cost of work to date}}{\text{Estimated total cost}} \\ \text{(d) Estimated profit} &\times \frac{\text{Cost of work to date}}{\text{Estimated total cost}} \times \frac{\text{Cash received}}{\text{Work Certified}} \end{aligned}$$

Formulae (a) & (b) are more popular because they are based on work certified. Formula (b) is more conservative and preferable.

## Escalation Clause:

When a contract is negotiated, 'escalation clause' may be included if the contract is likely to take some length of time. In periods of inflation and also when the economy is unstable, the contractor may feel that protection is needed against rise in material prices and wages rates.

The clause may provide for compensation to the contractor if the escalation in costs is more than an agreed limit. In such cases the contract price is increased to the agreed extent after calculating the exact amount of compensation. It can be credited to the contract account in case of incomplete contracts along with the work certified and uncertified.

## Cost plus Contracts:

Estimating the costs exactly may prove difficult in some cases. Violent fluctuations in material prices and unexpected changes in wage rates may make quoting for a contract a hazardous task. The contractor may desire to make a specific rate of profit. In such circumstances, cost plus contracts are generally accepted.

## **Advantages**

- (1) The contractor is sure of making desired profit, irrespective of cost fluctuations.
- (2) It insures the contractor from price fluctuations.
- (3) The contractee knows definitely the profit to be earned by the contractor.
- (4) Contractee pays on the basis of cost rather than arbitrary price quoted.

## **Disadvantages:**

- (1) There is premium or incentive for inefficiency because the contractor has no incentive to control or reduce costs.
- (2) The contractor has the scope to inflate his costs and consequently his profits also.
- (3) The burden of justifying each cost falls on the shoulders of the contractor.
- (4) In contractee's anxiety to minimize the costs, quality may be sacrificed. Generally, cost plus contracts are more popular with government organizations