Treatment of Plant and Equipment used for the Contract

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.

(a) If the plant and machinery is used for the contract for a long period of time, then the particular contract should be debited with the original cost of the plant and the same be credited with the depreciated value at the end of the accounting period.

(b) When a plant and machinery is used for different contracts, the cost of operation (depreciation) of such plant should be determined and be charged to individual contracts based on certain predetermined hourly rate during the period of use.

Advance Payment

When the contract extends beyond one accounting year, the architect will certify the value of the work performed. This certificate is issued to contracts as a guide to support the work performed. The advance payment is made on the basis of the approved work.

Retention Money

When the contract provides for the interim payment, a percentage (a certain percentage) of the contract price or the value approved for a specified period of time will be withheld as holding funds.

This money will only be paid upon satisfactory completion of the contract and all defects in work are set correctly. It will range from 10 to 20 per cent depending on the reputation of the contractor reliability.

Profits on Incomplete Contracts:

When the contractor has a number of contracts at different stages of completion at the end of an accounting period, the usual practice is to proceed with the work in progress at cost and the profit is not calculated before the contracts are completed.

However, in order to settle the profits over the contract period, the practice is to calculate some hypothetical profits every year on incomplete contracts and transfer to a profit and loss account proportionately depending on the ratio of the work done to the total contract price.

Theoretical profit is equal to the total value of the work performed minus the net actual cost incurred in completing this work. Depending on the degree of achievement and the cash advance received from the contractor, the theoretical profit is transferred relative to the profit and loss account and the balance is kept as a reserve for future contingencies.

$$\text{Profit transferred to P\&L a/c} =$$

$$\text{National Profit} \times \frac{\textit{Work certified}}{\textit{Total contract Price}} \times \frac{\textit{Cash recieved}}{\textit{Work certified}}$$

Guidelines for Transferring Profits to P & L A/c:

(1) If the contract is 1/4 but less than 1/2 complete, then one third of the disclosed profit (i.e. theoretical profit) should be converted as reduced to the percentage of cash received for approved work to P&L a / c, the balance is handled As a custom.

(2) In the event that the contract is completed for half or more, the two-thirds of the theoretical profit must be transferred as it was reduced in proportion to the cash received into profit and loss, and the remaining profit is treated as an allowance.

(3) In the event of a loss, the loss must be completely transferred to profit and loss.

Cost plus Contract:

The term cost plus refers to a contract between the contractor and the contractor whereby the contract price is determined on the basis of the actual cost of the product or services in addition to an agreed profit margin.

When the actual cost cannot be estimated in advance, an agreement can be concluded whereby the contractor undertakes to pay the actual cost of the work in addition to a reasonable percentage to cover the overheads and profits of the contractor. Profit margin may be a certain percentage of costs incurred or related to cost.

In this case, the acceptable costs are agreed upon and included in the text of the agreement. There is also a requirement to review the cost before accepting claims.

Escalation Clause:

The escalation clause refers to a clause in any contractual agreement whereby the contract price is adjusted up or down according to the increase or decrease in costs incurred by the contractor in excess of a certain percentage of the original estimates submitted at the time of bidding or quotation.

This clause generally provides that the contractor shall compensate the contractor for the prices of materials or wages exceeding a certain percentage. It may also provide for a discount on the contract price, if material prices or wages rates fall below the agreed level. Sometimes, the item may also provide for certain additional costs arising from the overuse of the materials or the working time after a certain limit.

Illustration:

A limited obtained a contract for the building of an office for Rs.3, 00,000. Building operations started on 1st April 2001, and at the end of the financial year 31st March 2002, they received from the party a sum of Rs.1 20,000 being 80% of the amount on the surveyor's certificate.

The following additional information is given from the books of A ltd.:

	Rs.
Stores issued to contract	60,000
Stores on hand (31-3-2002)	2,500
Wages paid	80,000
Plant purchased for the contract	60,000
Direct expenses	11,000
Overheads allocated to this contract	5,500
Works completed but uncertified	5,000

Plant to be depreciated at 10 per cent

You are required to prepare an account showing the profit on contract as on 31-3-2002.

Discuss whether A ltd., would be justified in taking the full amount of this profit to the credit of their Profit and Loss Account.

Solution:

Particulars	Amount (Rs.)	Particulars	Amount (Rs.)
To Materials	60,000	By Work in progress:	
To Wages	80,000	Work certified	1,50,000
To Direct expenses	11,000	Work uncertified	5,000
To General overheads	5,500	By Materials on hand	2,500
To Plant	60,000	By Plant less depreciation	54,000
		By Profit and Loss a/c	5,000
	2,16,500		2,16,500

Notes:

Work certified = 1, 20,000 x 100/80 = 1, 50,000

Normally when there is profit, the proportion of the profit to be taken to the credit of P & L a/c is

= Notional Profit x 2/3 x 80%.

As it is a case of loss in the present problem, the full amount of loss should be taken to the debit of Profit and Loss account.