

Objectives

At the end of this chapter, students should be able to:

- Explain contract accounts terminologies;
- Prepare contract account.

6.1 Introduction

When a firm or an individual undertakes a contract, the firm or person is known as a Contractor and the other party for whom the work is being done is known as the Contractee or Proprietor. It is usual to embody in the agreement (contract) particulars of the class of materials to be used, the condition governing payment, the price of the contract and the completion date. When the contract is signed, the contractor is liable to certain specific penalties if he fails to carry out the terms of the contract. Contract accounts are associated with building construction firms, ship building and repairs of docks, harbors etc. In large contracts, the contractor is not paid the contract price at once at the completion of the work, instead, he is usually paid instalments at intervals.

6.2 Meaning of Terminologies Used in Contract Accounts

Contract accounts can be defined as a system adopted to match contract expenses against prices and periodically monitoring or reviewing the work done so far, in order to ascertain the profit or loss (if possible). It is purposely designed for taking care of progress on contract.

Terminologies

- Retention Money:** This is the amount that is usually withheld until final certification that the contract has been satisfactorily completed. The retention fee is usually stated as a percentage of contract price certified by the architect or engineer (e.g. 10%). This money is held back against claims for faulty work.
- Notional Profit:** This is usually calculated by deducting the original cost of work certified from the value of work certified. At times, the cost of work certified might not be the same with the cost date as cost may be incurred on work which for one reason or the other the architect is yet to be certified. In this case, the profit would be calculated as two-third of notional profit time (x) cash received value of work certified.
- Work certified:** This is the amount of work accredited by the architect or engineers as the sales price of work done so far by the contractor. This is done at intervals as work progresses

until it is completed. It is basically an architect engaged by the contractor who supervises the work and issues a valuation certificate upon which payment would be made to the contractor.

iv. **Work-in-progress:** At the date of balancing the books of a contractor, it is possible that a contract is uncompleted. In this case, the balance on the contract account is carried down as work-in-progress. This is the amount to which the contractor remains entitled. It is usually calculated by adding total expenditure on uncompleted contracts to the portion of profit taken in the amounts.

V. Percentage of work completed: This is the total amount payable to the contractor up to the stage of work done relatively compared to the total contract price.

6.3 Preparation of Contract Accounts

In the ledger, two accounts are usually opened for every contract. These are:

- (i) A contract account and
- (ii) A proprietor's account.

The contract account is a nominal account. It is debited with the following:

(A) Direct expenses: There are all expenditure directly incurred on the contract. Examples are:

- (i) Materials specially bought for the contract (transferred from the purchases day book).
- (ii) Plant specially bought for the contract (transferred from the purchases day book).
- (iii) Hire of machinery (transferred from the general journal).
- (iv) Wages paid for direct labour on the contract (transferred from wages analysis book or cash book).
- (v) Wages accrued (owings) (transferred from the general journal).
- (vi) Cash expended directly on the contract (transferred from the cash book).

(B) Indirect expenses: These include all expenditure relating indirectly to the contract. Indirect expenses are usually allocated to a contract account on an apportionment basis e.g. as a percentage or ratio of direct wages charged. Examples are office salaries, rent and rates, postages, stationery etc.

On completion of a contract, each contract account is credited with the agreed price of the contract. The balance of the account is the profit or loss on the contract and it is usually transferred to the general profit and loss account. It is now seen that a contract account is prepared to determine profit or loss on each contract.

Example 6.1

		N
July 1	Signed contract 77 with Mr Adesanya	13, 000
July 5	Signed contract 78 with Mr Ugohchukwu	8, 400
July 6	Signed contract 79 with Mr Sule Adamolekun	6,000
July 7	Materials supplied contract 77	4, 000
	Materials supplied contract 78	4, 000
	Materials supplied contract 79	2, 000
	Wages Contract 77	400
	Wages Contract 78	340
	Wages Contract 79	570
July 10	Plant Contract 77	2, 500
July 12	Motor cycle Contract 77	1,600
July 15	Wages Contract 77	200
	Wages Contract 78	130
	Wages Contract 79	316
July 21	Cash Contract 79	264
July 28	Office Salary Contract 77	800.00
	Office Salary Contract 78	500.00
	Office Salary Contract 79	300.00
	Telephone - Contract 77	40.00
	Telephone Contract 78	30.00
	Telephone Contract 79	20.00

July 30 Contract 77, 78 and 79 completed and agreed price paid by cheque. For the above example, the contractor will show each contract account as follows:

Solution

Dr			Contract 77		Cr	
2010		N	K	2010	N	K
July 7	Materials		4,000	July 30	Proprietor 97	13,000
July 7	Wages		400			
July 10	Plant		2,500			
July 15	Wages		200			
July 28	Salary		800			
July 28	Telephone		40			
July 30	Profit Transferred to					
	Profit and Loss Account		50			
	Balance c/d		5000			
			<u>13,000</u>			<u>13,000</u>

Dr			Contract 78		Cr	
2010		N	K	2010	N	K
July 7	Material		4.00	July 30	Proprietor No 78	13,000
July 7	Wages		400.00			
July 12	Plant		2,500.00			
July 15	Wages		200.00			
July 28	Salary		500			
July 28	Telephone		30			
July 30	Profit Transferred to					
	Profit and Loss Account		1,800			
			<u>8,400</u>			<u>8,400</u>

Dr			Contract 79		Cr	
2010			2010		N	K
July 7	Materials	4,000	July 30	Proprietor No 79	6,800	
July 7	Wages	570				
July 15	Wages	316				
July 21	Cash	264				
July 28	Salary	300				
July 28	Telephone	20				
July 28	Profit Transferred to					
	Profit and Loss Account	2, 430				
		<u>6,800</u>				<u>6,800</u>

The Proprietor's Account

A proprietor's account is the personal account of the contractee in the ledger of a contractor. For each contract account, there is a corresponding proprietor's account. In the example given above, the proprietors are Mr. Adesanya for contract 77, Mr. Ugochukwu for contracts 78, and Alhaji Adamolakun for contract 77. On completion of a contract, the proprietor's account is debited with the agreed price of the contract. You have been told earlier that the agreed price of the contract is credited to the contract account concerned. The proprietor's account is usually credited with the payment made by the proprietor (contractee) to the contractor. In the example given earlier, accounts of the various proprietors will appear in the ledger as shown below:

Solution:

Proprietor s Account - Contract 77						
2010		N	K	2010	N	K
July 30	Contract 77		<u>13,000</u>	July 30	Bank	<u>13,000</u>

Proprietor s Account - Contract 78						
2010		N	K	2010	N	K
July 30	Contract 78		<u>8,400</u>	July 30	Bank	<u>8,400</u>

Proprietor's Account - Contract 79

2010	N	K	2010	N	K
July 30 Contract 79		<u>6,800</u>	July 30 Bank		<u>6,800</u>

Example 6.2

Ayomide Olowo Construction Co. Ltd secured contract No 97 to build an ultra-modern Library Complex at a price of N600m, at Ajirosun Polytechnic. Work commenced in January 2009 and the contract was due for completion in 18 months from the date of commencement.

By December 31st 2009, the contract had advanced reasonably well and the expenditure incurred up to that date was as follows:

	₦
Direct expenses	2,800,000
Overhead expenses	560,000
Cost of work certified	1,400,000
Work completed but not yet certified	240,000
Money for work certified has been received subject to 10% retention	
Plant valued at site	2,000,000
Material valued at site	40,000
Calculate the following:	

- (i) Estimated total profit (Notional profit).
- (ii) The amount of profit to be taken to profit & loss account for work done.
- (iii) Work-in-progress.

Solution

- (i) Estimated total profit is calculated.

Work certified	1,400,000.00	
Work not yet certified	240,000.00	1,640,000.00
Total Expenditure on Contract		
(i) Direct Expenses		2,800,000.00
(ii) Overhead expenses	560,000.00	3,360,000.00
Less: Plant on site	2,000,000.00	
Material at site	400,000.00	2,040,000.00
		(1,320,000.00)
Total Profit		320,000.00

Portion of profit taken will be calculated thus

$$\frac{2}{3} \times \text{total profit} \times \frac{\text{cash received}}{\text{work certified}}$$

$$\begin{array}{r}
 \frac{2}{3} \times 320,000 \times \frac{1,260,000}{1,400,000} \\
 \hline
 192,000
 \end{array}$$

(iii) Work-in-progress is calculated as follows:

	N
Total expenditure on contract	3,360,000.00
Less: Plant on site	2,000,000.00
Material on site	40,000.00
Add: Profit taken to P & L Acct	1,320,000.00
Work-in-progress	192,000.00
	<u>1,512,000.00</u>

Activity

1. Mention ten registered big contract companies in your locality or state or country.
2. Visit one contracting company in your area and state the reasons why you think that Trading, Profit and Loss Account is not suitable for execution of contracts awards.

6.4 Summary

In this chapter, students have learnt that:

- A contract account is adopted to match contract expenses against prices and is periodically monitored to ascertain profit or loss.
- When a contract is uncompleted at the end of a firm's financial year, cost of work done is calculated and the balance appears in the balance sheet as an asset known as work-in-progress.
- Retention money which is a percentage of certified work is not paid until after the whole contract has been satisfactorily completed.
- When a contract is in progress, money is paid only for work certified by an architect or engineer.
- Proportion of profit is taken to profit and loss account only in the case of uncompleted term of contract which has sufficiently advanced.

6.5 Revision Questions

1. _____ is a firm or individual who undertakes a contract.
 - (A) A contractee
 - (B) A contractor
 - (C) A proprietor
 - (D) A conductor
2. Which of the statement is true?
 - (A) A contractor has the right to collect his money at once before the commencement of work.
 - (B) The contract is often carried out in the contractor's office.
 - (C) The contractor is liable to a penalty if he fails to carry out the terms of a contract.

(D) No expert is required to supervise the contractors work.

3. In a contract account, total expenditure on uncompleted contracts plus the portion taken in the accounts equals to: _____

(A) retention fee

(B) work-in-progress

(C) balance sheet

(D) performance certified

4. The retention fee is usually stated as a _____ of the contract price.

(A) ratio

(B) percentage

(C) weighted average

(D) turnover

5. An example of a contract account is _____.

(A) purchase of stationeries

(B) installation of computer

(C) construction of roads and airports

(D) repair of machinery

6. Explain the term .retention of money..

B. State two reasons why it is part of a contract agreement.

7. Explain the following terms:

(a) Notional profit

(b) Work-in-progress

(c) Work certified

(d) Percentage of work completed.

8. Enumerate four reasons why it is necessary to keep a contract account.

9. On 1st April, 2009, Justus Temidayo Construction and Company Limited commenced work on the building of a new Abuja Town Hall, the contract price being paid N8,000,000. The company's financial year ended on 30th September, 2009 on which date the following expenditure has been incurred in connection with the contract.

	N
Material	1,200,000
Wages	840, 000
Plant	200, 000
Overhead expenses	60,000

Work to the value of N2,400,000 has been certified on 30th September of which 75 percent had been received in cash. Work completed but not certified was estimated at N21,000 and materials valued at N100,000 were on hand at the site.

After allowing for depreciation of 10% per annum on plant, Prepare the contracts in progress account for the period ended 30th September, 2009. 10. SUNAK Nigeria Limited is a medium-sized construction company based in Ibadan. At present, the company has two contracts in progress.

Details extracted at 31st December 2010 were:

Contract name (project):	Plumbing	Furniture
	1 Jan. (N)	1 Jan. (N)
Contract price:	550,000	700, 000
Expenditure:		
Material:	25,360	38,500
Wages:	96,886	74,436
Site of expenses:	13,000	17,240
Plant purchases:	300,000	130,000
Material on site (31st Dec 2010):	4,200	12,800
Accrued wages:	8,434	4,484
Value of work certified:	220,000	170,000
Cash received on work certified:	187,000	127,500
Work completed but not certified:	7,000	4,400

Head office charges of N45,000 are charged in the proportion to their prime costs. The plant was installed at the commencement of the contracts and depreciation is calculated at 20% per annum. Both contracts have been estimated to give an overall profit on completion. You are required to prepare contract accounts for the company.