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IV-SEMESTER
COST ACCOUNTING

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Contract Costing: Definition and Features

Definition of Contract Costing:

Contract costing is a specialized system of Job costing applies to long-term contracts as distinct from short-term jobs. Contract costing is mainly applied in civil construction and engineering projects, ship building, road and railway line contracts, construction of bridges etc.

Contract costing is a form of Specific order costing. It is applied to contracts where substantial time is taken to complete the contract and it falls into different accounting periods. However, a duration of exceeding one year is not an essential feature of a long-term contract. Some contracts with a shorter duration than one year should be accounted for as long-term contracts if they are sufficiently material to the activity of the period.

CIMA defines Contract cost and Contract costing as follows:

“Contract cost is the aggregated costs relative to a single contract designated a cost unit”.

“Contract costing is that form of specific order costing which applies where work is undertaken to customers’ special requirements and each order is of long-term duration”.

Features of Contract Costing:

The contracts for which Contract Costing is applied will have the following features:

- (a) Contracts are undertaken to special requirements of the customers.
- (b) Duration of contracts are relatively for a long period.
- (c) Contract work is done on the sites unlike manufacturing under a roof.
- (d) Contract work mainly consists of construction activities.

Accounting Procedure for Contract Costing:

If the numbers of contracts are more, a distinguishing number or name is given to each contract for accounting and administration convenience. A separate Contract Account is maintained for each contract.

All costs relating to contracts are charged to the respective Contract Accounts. In the contract cost structure, majority of the expenditure is of direct nature in the form of materials, wages, use of plant and stores, direct expenses etc., and only a small portion will be charged as apportioned overheads.

Accounting Treatment of Costs:

Accounting of each item of cost in contract accounts is discussed below:

1. Materials:

- (a) All the materials purchased for the contract or any material sent to site is charged to contract.
- (b) If any material is returned to stores or lying at site unused or materials transfers to another contract site is credited to the Contract Account.
- (c) If materials are not required immediately, the materials may be stored and its cost is debited to Stock Account.

2. Labour:

All the labour employed or worked at site is treated as direct labour and all costs relating to them is charged to the Contract Account. The salaries and incentives of the administrative and supervisory staff of a specific contract is also charged to that specific contract.

3. Plant:

- (a) When the plant is taken on hire, the hire charges are charged to Contract Account.
- (b) If the plant is specifically purchased for the contract or plant was sent to site, the value of the plant is debited to Contract Account. The value of plant returned or remaining at site is credited to Contract Account. The balance between amounts debited and credited to contract represents the value of plant used at site.
- (c) Sometimes the value of depreciation provided on the plant is debited to Contract Account instead of showing the value of plant issued to site and remaining at site.

4. Sub-Contract Charges:

Sometimes part of the contract work is given on subcontract basis and payments made on subcontract work is debited to Contract Account.

5. Overheads:

The general overheads and head office expenses are apportioned to different contracts on equitable basis, and the portion of overheads are charged to the Contract Account.

6. Difficulties in Cost Control:

Generally, contracts are big in size and the contract work is to be carried out at sites. Due to this some problems will arise concerning usage of material, labour utilization, supervision of labour, damage to plant and work, pilferage of materials and tools etc. This site based work makes it difficult to control the costs of the contract.

7. Surveyor's Certificate and Retention Money:

In contract works, a surveyor or an architect or civil engineer is appointed to periodically visit the site for inspection of the work completed. He will issue a certificate mentioning the stage of completion of work and the value of the work completed to the date of issue of certificate. The payments will be released to the contractor by the contractee based on the said certificate.

Normally the payments will be released only to the certain percentage, say 80% of the work certified. The balance amount of work certified is retained by the contractee till the completion of the entire contract satisfactorily.

The amount so retained is called 'retention money'. The contractee so retains to safeguard himself from the risks that may arise from the contractor. Usually the percentage of retention money is up to 20% of the amount of work certified.

8. Work-in-Progress:

The amount of work-in-progress includes the value of work certified and uncertified appearing in the Contract Account. Materials at site, Plant at site are shown separately in the Assets side of the Balance sheet.

9. Costing of Running Contracts:

The long-term nature of contracts has necessitated to determine profit to be attributed to each accounting period. In the long-term contracts it is considered that their outcome can be assessed with reasonable certainty before their conclusion, the attributable profit should be calculated on a prudent basis and included in the accounts for the period under review.

The profit taken up should be based on Standard Cost Accounting principles. In case of Completed Contracts, all the profit that arise from the contract can be transferred to Profit and Loss Account.

But in case of Incomplete Contracts, only a portion of the profit is taken to the Profit and Loss Account depending on the extent of work completed on the contract because some

provision is to be made for meeting contingencies and unforeseen loss. There are no hard and fast rules in calculation of profit to be taken to profit and loss account.