

COST ACCOUNTING (PART-13)

UNIT- V

CONTRACT COSTING (PART-IV)

1. INTRODUCTION

Hello students, welcome to the lecture series of cost accounting. Today in this lecture, we shall take up unit-v and we will learn about contract costing. We shall learn in detail about contract costing; started from its meaning. In our previous lecture, we have already learned a few aspects in relation to job costing, batch costing and contract costing. So this lecture is exclusively for contract costing where we will learn in detail the fundamental concepts which are related to the contract costing and how an important aspect are being computed under contract costing.

We will understand the objective of this lecture; here we are going to deal with meaning of contract costing then fundamental concepts, which we are going to learn in detail with their computational aspect. The first one is work certified. We will learn its meaning, accounting treatment as well as the method of computation of value of the work certified then we will learn about retention money. What do you mean by retention money? What's the purpose of retention money? When it is to be paid? And how we are going to account for such retention money and when we prepare the contract account? The next aspect is cash received.

We will learn, how we will account for cash received and how we are going to compute it and show it in the contract costing. Then work un certified, similarly as we have computed work certified. We will compute work uncertified by the formula being drafted under contract costing. We will learn its accounting treatment as well then we will learn the meaning of notional profit. Why it is being computed that means its accounting treatment as well as the computational aspect of the notional profit. So these are the basic fundamentals concept in relation to the contract costing. Which we are going to learn in detail.

2. CONTRACT COSTING

Now students, first of all we will have insight of contract costing. So that we can understand all the fundamentals assumptions in relation to the contract costing.

So contract costing has been defined as that form of specific order costing under which each contract is stated as cost unit and costs are accumulated and ascertained separately for each contract. So let us understand this definition first of all. We will analyse this definition. First of all it is form of specific order costing. So wherever there is a specific order for manufacturing or constructing certain thing. We are going to follow the contract costing. And here each contract is treated as the cost unit.

If each unit is treated as the cost unit then What we are going to do is that we need to ascertain the cost for each cost unit that means materials, labours and direct expenses associated with that cost units are to be ascertained. So that the cost of that unit can be ascertained. So here we are very sure that each contract will have its separate cost. Now another part of the definition says that cost are accumulated and ascertained separately. That means costs are going to be ascertained.

There should be a specific procedure where material cost are to be ascertained then we are going to follow certain other method to accumulate labour cost and similarly we will account for the overheads and all direct and indirect expenses in relation to that specific order costing which we are saying as contract costing. So each contract that is if the contractor is having four contracts from different contract, each contract cost would be recorded separately.

Now where will contract costing apply, so as we know that it's the long term project and its duration is more than job and batch costing. So it will apply in construction industries, where it is comprising of construction of dams, bridge, canal where there is a long term project in the hands of contractor we are going to use the contract costing. And industries taking up engineering project work, so under these short of industries the contract costing would be applied. Where each contract would be treated as a cost unit and all the associated cost would be accumulated for the contract.

Having understood the meaning and utility of contract costing. now we will throw the light on certain important assumptions. Which are necessary to be computed and understood for contract costing? Among it the first one is work certified.

So first of all let us understand. What do you mean by work certified? Work certified is that portion of the work completed which has been certified or approved by the contractee or architect or surveyor. It is valued in terms of contract price. So here the work certified would be valued that means the amount of work which is being completed and is being approved and the approving authority would be the architect of **contractee**.

Contractee is the person for whom, we are going to prepare a certain building or we are going to construct the project being given. So where the contractee's person. It can be the technical person, which is being named as architect or surveyor. He will give a certificate for the work being completed. And it is known as work certified. Now let us learn the accounting treatment of work certified.

The value of the work certified is debited to contractees account or work in progress account and it's credited to contract account. So when we prepare the contract account; the value of work certified would be reflected on the credit side of contract account. And it is being shown as by contractees a/c or by work in progress account then the value of the work certified is being credited in the contract account. Now how to ascertain this value of work certified. We will be computed the following manner. Work certified would be valued as value of work certified is equal to:

Contract price x work certified is the percentage of contract price. Because by the learning the definition of work certified. We have discussed that it is being valued in terms of contract price. So what we are going to do is that we will apply the work certified percentage that means the contract price, if it is 1 lakh and the work certified as the percentage of contract prices 40 percent. So our value work certified is come as 40,000/- or it can be computed on the basis of cash received. Where we will use the formula; cash received divided by the cash received as the percentage of work certified. Its difference between the both the formula is that here the percentage is taken of the contract price and that two of the work certified. While the denominator is the second formula is the percentage of cash received in relation to the work certified rather than the contract price. Both the methods are correct and it can be applicable depending upon the agreement. Which is being entered by the contractor and the contractee.

3. RETENTION MONEY

Now the next important aspect is retention money. What do you mean by retention money? And what's the purpose of retention money? first of all let us understand the meaning of retention money in terms of contract costing. Retention money is that portion of value of work certified. Which is restrained by the contractee as security for a defective work, which may be discovered later with in the guaranteed period. So let us understand this definition first. When we say that there is a retention money, such retention money is being retained by contractee.

Because we have taken up a work of a contractee. So he supposes to give us certain money. That means the contract price, he is requires to pay to the contractor. But what happens that he retains certain portion of the contract price which is to be paid by him to the contractor. And why he resrains money because his restrains money in the form of security. If the contract is being completed but there is a defective work, so he can reduce that money from the contract price and can be made good his loss.

So it is also important that guaranteed money is being retained with in the guaranteed period and let's learn its purpose. Its purpose is to provide us safe guard against the risk of loss due to faulty work man ship. If any deficiency or defect is noticed in the work. It is to be rectified by the contractor before the release of retention money. So what happens that if the contractor wants to release his retention money. He has to make good the defective or the consideration which he is going to receive in the form of contract price would be reduced. So the underline principle of retaining money in the form of retention money is that the risk of loss can be minimized in the hands of the contractee.

Because once the work is being completed and it's not up to the mark, such security portion would always the beneficial in the hands of contractee. When his retention money paid. This is a question, now the retention money is paid. When it is ensured that there is no fault in the work carried out by the contractor. If the work is being completed. As it has been desired, such money can be paid back to the contractor. How it is being computed. It's one of the very important aspects.

Which we need to understand so that by solving the question. We can compute the retention money properly. So it is being computed as retention money is equal to value of work certified minus cash received.

And value of work certified can be ascertained on the basis of the contract price or on the basis of the cash received which ever has been the mode of agreement between the parties concerned. So once we are with the value of the work certified and the cash received. We can always ascertain the retention money or if either of three elements; one is missing, we can always ascertain the remaining element.

4. CASH RECEIVED

Now next important fundamental assumption of the contract costing is cash received. Cash received is that portion of the value work certified which is paid by contractee. It is usually express as percentage of work certified. So here what happens that at the time of receiving of cash by the contractor. The contractee is going to pay the cash in the proportion of value work certified. For an example; the work certified is certain amount, so 80 percent of the work certified can be the cash received value. Now let us understand how we are going to compute it.

So calculation of cash received would be value of work certified minus retention money. So we will with the cash received figure. Its just the manipulation of the previous data or previous value, which we have used. Where we have ascertained the retention money. We have just manipulated that very equation and have ascertain their formula. Where value of work certified is being subtracted from retention money or another aspect is value work certified multiplied by cash received as the percentage of work certified.

Another formula is contract price into percentage of work certified into the percentage of cash received. Either of the formula can be used depending upon the information, which is being furnished to us. So let us take up a example to apply this principle. Calculate the amount of payment received from the contractee in the each of the following cases. The first one is work certified is rupees 3 lakh, payment received from contract is 80 percent.

And second situation is contract price is being given, it is 5 lakh work certified 60 percent and payment received from contract is eighty percent. Now let us analyse how we are going to solve it. So under first option that is where work certified is 3 lakh and payment received is 80 percent. How we are going to ascertain the cash received or payment received from contractee. here we will use the formula: work certified multiplied by the percentage of cash received.

Because here the percentage of cash received is percentage in relation to the work certified. So we will ascertain the cash received as 3 lakh into 80 percent. And it will give us the figure of payment received from contractee to be two lakh fourty thousand. The second one is payment received from contractee.

It is being computed on the bases of contract price because we are with the three information, the contract price of 5 lakh then work certified then work certified 60 percent of the contract price and payment's received would be 80 percent. So let's see how we are going to computed, its 5 lakh into 60 percent into 80 percent. So again we are with the value of two lac fourty thousand. If we go to previous slides, we can ascertain. We have taken up the third formula; contract price multiplied by percent of work certified into percent of cash received. Using this formula, we have computed the part-2 of question being given to us.

5. WORK UNCERTIFIED

Now moving ahead, let us understand one very important concept that is work uncertified. Because out of the total contract. If some portion is work certified and another portion would be work uncertified, so let us understand its meaning. How we are going to treated in accounting terminology. And how we are going to computed. Work in satisfied is that portion of work completed, which has not being certified or approved by the contratee, architect or surveyor.

It is value at cost. Various at one at work certified is being valued on the basis of contract price. Work uncertified is being valued on the basis of cost. Because it's that portion or left out portion which is not being satisfied by the contratee architect. So out of the completed work that portion Which has remained unapproved is known as work uncertified which is known work un certified. Which is to be valued at cost. Now let us understand its accounting treatment. The cost of work uncertified is debited to work in progress account and it's credited to contract account. Its cost is transferred to the debit of contract account at the beginning of the next accounting period.

So here also, it will be reflected on the credit side of contract account with the value of work certified. Show on the credit side, both the things are reflected under work in progress value of work certified as well as value of work un certified. And in the beginning of the next accounting period. It will be reflected on the debit side, as we generally transfer or carry forward the balance.

Now let us understand how we are going to compute it. Computation of work uncertified is being done as total cost incurred till date that means whatever material, labour or other expenses which are being recorded on the debit side of contract account would be added up. And out of it, we will subtract the cost of work certified. So the difference between total cost incurred till date and the cost of work certified would be our cost of work uncertified.

Because its calculation is to be done on cost basis. Another way to compute the value of work uncertified is total cost incurred till date multiplied by percentage of work uncertified divided by percentage of total work done till date either of the formulas can be used to compute the value of work uncertified. So let us take up an example: calculate the cost of work uncertified in each of the following alternative cases. The first one is total cost incurred to date is rupees 1.20 lac and the cost of work certified is rupees 1 lac. Now we are going to compute the cost of work uncertified.

When we say that we are with the total cost incurred to date it means that total of cost which is being reflected on the debit side of contract account. And if there is any adjusting entry on the credit side the same is to be subtracted. So as to ascertain the total cost incurred and out of such cost incurred till date. We are going to subtract this cost of work certified.

So it's very simple here we are going to subtract 1.20 lac and 1 lac, so our cost of work uncertified in this case would be 20,000/-. Now the second aspect is total cost incurred to date is given as rupees 1,20,000/- to complete 60 percent of the contract work. However the architect gives certificate only for 50 percent of the contract price. That means the percent of work completed is 50 percent. So let see how we will solve it. So the solution no. 1 is clear to us, its total cost incurred to date minus cost of work certified that is 1,20,000/- minus 1,00,000/- that is 20,000/-. While we compute the cost of work certified under second option.

We are going to use the formula as: percentage of work uncertified divide by percentage of total work done till date. So we are with the value of work being done and the total cost. So the difference would be computed. And it is to be multiplied by total cost incurred till date. So we are going to solve it as 60 percent minus 50 percent is our percent of work uncertified divided by 60 percent that is the percentage of total work done till date. So 10 percent divided by 60 percent is to be multiplied by 1.20 lac. So this way we are going to compute our value of cost of work uncertified. The cost of work uncertified would be computed by simplifying it to be rupees twenty thousand.

6. NOTIONAL PROFIT

Now the next aspect is notional profit. Let us understand its meaning first. Notional profit is difference between value of work in progress certified and the cost of work in progress certified. So notional profit is computed as value of work certified minus cost of work certified or we will compute in another manner that is a statement form. Where we will write first of all value of work certified at end.

Where we will compute the value of work certified in the final column then we will write as total cost till date in a column and subtract out of it cost of work uncertified and the final figure would be reflected in the final column. So here we are going to take up the difference of the value of work uncertified and the final value of the difference between total cost till date and cost of work uncertified.

So what we are going to get is the figure of the notional profit. Here we are with the example where we are going to compute the value of notional profit. The value of work certified is 2.50 lac in cost of work certified is 1 lac. So its simply the difference of the two that how we will compute the notional profit and it is notional profit is equal to 2.50 lac minus 1 lac. So our notional profit will be 1.50 lac.

7. SUMMARY

Now we are summing up our lecture of today. In today's lecture, we have learned the meaning of contract costing and purpose of using the contract costing. We have learned the various fundamental principle concepts. Which are to be applied so that we can draft our contract costing accounts and can analyse each and every important concept that is work certified, work uncertified, value of the notional profit which is being computed. So in this way we have learned entire mechanism to be used to solving the question based on contract costing.

Thank you!