

Contract Account

Introduction:

Contracts are undertaken to meet specific customer requirements, usually involving large-scale construction projects such as buildings, ships, bridges, roads, etc. Each contract is given a unique number, and a separate account is maintained for each contract. The contract account records all expenses and revenues related to a specific contract.

Features of Contract Accounting

- 1. Direct Costs:** Direct costs form the bulk of expenses in a contract account. These include costs directly attributable to the contract, such as materials, labor, and plant usage. In some cases, indirect expenses, when they can be attributed directly to a specific contract, are also treated as direct costs.
- 2. Indirect Costs:** These costs are relatively low in contract accounting. They include expenses related to the head office and are allocated to various contracts. Examples include administrative expenses and office overheads.
- 3. Cost Control:** Controlling costs is a significant challenge, especially in large-scale contracts. It involves managing material costs, labor costs, and minimizing losses and damages. Effective cost control ensures that the project stays within budget and is profitable.
- 4. Surplus Material:** After the completion of a project, any remaining materials such as cement, iron, steel, marbles, etc., are considered surplus. These materials can be reused in other projects or sold to recover costs.

Important Terms in Contract Accounting

- 1. Material:** Materials required for a contract can be obtained through direct purchase or from existing stores. When materials are purchased specifically for a contract, the cost is directly debited to the contract account.
- 2. Labour:** Labor employed on contracts is treated as direct labor. The cost of labor is debited to the contract account, reflecting the wages and salaries paid to workers directly involved in the contract.
- 3. Extra Work:** Sometimes, contractors may be given additional work beyond the original scope, or the contract may be altered by the contractee (the party who commissions the work). This extra work is also accounted for in the contract account.
- 4. Plant:** The cost of plants used in the contract, such as cement mixers and other machinery, is charged to the contract account. These plants are brought to the site specifically for use in the contract.

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Advantages of Contract Accounting

- 1. Timely Completion:** Contract accounting ensures that work can be completed without delays as all costs and revenues are tracked efficiently.
- 2. Cost Plus Contracts:** For high-value contracts, the cost-plus method is often adopted. This method allows the contractor to be reimbursed for all costs incurred plus a profit margin, reducing financial risk and ensuring profitability.

Disadvantages of Contract Accounting

- 1. Impact on Contractee:** In cost-plus contracts, the contractee bears the financial risk and might be affected by the rising costs since they are required to pay all the costs incurred plus a margin.
- 2. Fixed Contract Advantage for Contractor:** In fixed-price contracts, the contractor benefits if the market conditions are favorable. They can maximize their profit by keeping costs lower than the contract price. However, they also bear the risk if costs exceed the contract price.

Conclusion

Contract accounting is crucial for managing large-scale construction projects. It involves tracking direct and indirect costs, controlling expenses, and managing surplus materials. Understanding the important terms and advantages and disadvantages of contract accounting helps in effectively managing and executing contracts to ensure timely completion and profitability.

Solved Example: Recording Costs and Recognizing Revenue

Scenario: ABC Construction Company has undertaken a contract to build a bridge. The contract value is Rs 10,00,000. The contract started on 1st January 2023. During the year, the following costs were incurred:

- Materials purchased: Rs 2,50,000
- Direct labor: Rs 1,80,000
- Plant hire charges: Rs 70,000
- Indirect costs: Rs 30,000

At the end of the year, 40% of the contract was completed, and the work certified was Rs 6,00,000. Prepare the contract account for the year ending 31st December 2023 and calculate the profit to be recognized.



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Solution

We need to prepare a Contract Account for ABC Construction Company for the year ending 31st December 2023 and calculate the profit to be recognized.

Step 1: Prepare the Contract Account

Contract Account for ABC Construction Company

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To Materials Purchased	2,50,000	By Work Certified	6,00,000
To Direct Labor	1,80,000		
To Plant Hire Charges	70,000		
To Indirect Costs	30,000		
To Notional Profit c/d	70,000		
Total	6,00,000	Total	6,00,000

Step 2: Calculate the Notional Profit

Notional Profit = Work Certified - (Materials Purchased + Direct Labor + Plant Hire Charges + Indirect Costs)

Notional Profit = 6,00,000 - (2,50,000 + 1,80,000 + 70,000 + 30,000) Notional Profit = 6,00,000 - 5,30,000 Notional Profit = 70,000

Step 3: Calculate the Recognized Profit

Since the work certified is 40% of the total contract value, we need to recognize the profit proportionally.

The formula to calculate the recognized profit is:

Recognized Profit = (Notional Profit × Work Certified) / Contract Price
Recognized Profit = (70,000 × 6,00,000) / 10,00,000 Recognized Profit = 42,000

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Conclusion:

- Notional Profit: Rs. 70,000
- Recognized Profit: Rs. 42,000

Assignment

Ques 1: XYZ Construction has undertaken a contract to build a hospital. The contract value is Rs 15,00,000. The contract started on 1st April 2023. During the year, the following costs were incurred:

- Materials purchased: Rs 2,00,000
- Direct labor: Rs 1,20,000
- Plant hire charges: Rs 1,00,000
- Indirect costs: Rs 50,000

At the end of the year, 35% of the contract was completed, and the work certified was Rs 5,25,000.

Calculate the notional profit and the recognized profit for the year.

Ques 2: PQR Builders is working on a contract to construct a school. The contract value is Rs 12,00,000. The contract started on 1st February 2023. During the year, the following costs were incurred:

- Materials purchased: Rs 2,20,000
- Direct labor: Rs 1,90,000
- Plant hire charges: Rs 60,000
- Indirect costs: Rs 40,000

At the end of the year, 45% of the contract was completed, and the work certified was Rs 5,40,000.

Calculate the notional profit and the recognized profit for the year.

Ques 3: DEF Construction Company has undertaken a contract to build a residential complex. The contract value is Rs 20,00,000. The contract started on 1st June 2023. During the year, the following costs were incurred:

- Materials purchased: Rs 4,00,000
- Direct labor: Rs 2,50,000
- Plant hire charges: Rs 1,50,000
- Indirect costs: Rs 70,000



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At the end of the year, 30% of the contract was completed, and the work certified was Rs 9,50,000.

Calculate the notional profit and the recognized profit for the year.

Ques 4: GHI Constructions took on a contract to build a commercial complex. The contract value is Rs 18,00,000. The contract started on 1st May 2023. During the year, the following costs were incurred:

- Materials purchased: Rs 3,50,000
- Direct labor: Rs 2,70,000
- Plant hire charges: Rs 80,000
- Indirect costs: Rs 60,000

At the end of the year, 50% of the contract was completed, and the work certified was Rs 9,00,000.

Calculate the notional profit and the recognized profit for the year.

Ques 5: JKL Builders has undertaken a contract to build a shopping mall. The contract value is Rs 25,00,000. The contract started on 1st March 2023. During the year, the following costs were incurred:

- Materials purchased: Rs 5,00,000
- Direct labor: Rs 3,00,000
- Plant hire charges: Rs 2,00,000
- Indirect costs: Rs 1,00,000

At the end of the year, 40% of the contract was completed, and the work certified was Rs 12,00,000.

Calculate the notional profit and the recognized profit for the year.

Solved Example: Treatment of Extra Work and Surplus Material

Scenario: XYZ Builders is working on a contract to construct a shopping mall. The original contract value is Rs 20,00,000. During the construction, the contractee requested additional work worth Rs 2,00,000, which was agreed upon. The following costs were incurred during the year:

- Materials purchased: Rs 6,00,000
- Direct labor: Rs 3,50,000
- Plant hire charges: Rs 1,50,000
- Indirect costs: Rs 50,000

Materials worth Rs 80,000 were returned to the store as surplus at the end of the year. The work certified was Rs 8,00,000. Prepare the contract account and calculate the profit for the year ending 31st December 2023.

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Solution:

To solve the problem, we need to prepare the contract account and calculate the profit for the year ending 31st December 2023.

Step 1: Prepare the Contract Account

First, calculate the total contract value, including the additional work:

- **Original Contract Value:** Rs 20,00,000
- **Additional Work:** Rs 2,00,000
- **Total Contract Value:** Rs 22,00,000

Next, prepare the Contract Account including all costs and work certified:

Contract Account for XYZ Builders

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To Materials Purchased	5,50,000	By Work Certified	11,00,000
To Direct Labor	1,70,000	By Surplus Materials	1,00,000
To Plant Hire Charges	1,80,000		
To Indirect Costs	1,00,000		
To Notional Profit c/d	2,00,000		
Total	12,00,000	Total	12,00,000

Step 2: Calculate the Notional Profit

Notional Profit = Work Certified - (Materials Purchased - Surplus Materials + Direct Labor + Plant Hire Charges + Indirect Costs)

$$\text{Notional Profit} = 11,00,000 - (5,50,000 - 1,00,000 + 1,70,000 + 1,80,000 + 1,00,000)$$

$$\text{Notional Profit} = 11,00,000 - (4,50,000 + 1,70,000 + 1,80,000 + 1,00,000)$$

$$\text{Notional Profit} = 11,00,000 - 9,00,000$$

$$\text{Notional Profit} = 2,00,000$$

Step 3: Calculate the Recognized Profit

Since the work certified is 50% of the total contract value, we need to recognize the profit proportionally. The formula to calculate the recognized profit is:

$$\text{Recognized Profit} = (\text{Notional Profit} \times \text{Work Certified}) / \text{Contract Price}$$

$$\text{Recognized Profit} = (2,00,000 \times 11,00,000) / 22,00,000$$

$$\text{Recognized Profit} = 22,00,00,000 / 22,00,000$$

$$\text{Recognized Profit} = 1,00,000$$

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Step 4: Adjust the Contract Account

Contract Account for XYZ Builders (Adjusted)

Particulars	Amount (Rs)	Particulars	Amount (Rs)
To Materials Purchased	5,50,000	By Work Certified	11,00,000
To Direct Labor	1,70,000	By Surplus Materials	1,00,000
To Plant Hire Charges	1,80,000		
To Indirect Costs	1,00,000		
To Notional Profit c/d	2,00,000		
		By Notional Profit b/d	2,00,000
To P&L A/c (Recognized Profit)	1,00,000		
To Reserve (Notional Profit - Recognized Profit)	1,00,000		
Total	12,00,000	Total	12,00,000

Final Summary

- Notional Profit: Rs 2,00,000
- Recognized Profit: Rs 1,00,000
- Reserve: Rs 1,00,000

Conclusion:

- **Notional Profit: Rs. 2,00,000**
- **Recognized Profit: Rs. 1,00,000**



Assignment



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Ques 1: Scenario: ABC Construction is working on a contract to build a new office complex. The original contract value is Rs 25,00,000. During the construction, the contractee requested additional work worth Rs 3,00,000, which was agreed upon. The following costs were incurred during the year:

- Materials purchased: Rs 7,50,000
- Direct labor: Rs 4,00,000
- Plant hire charges: Rs 2,00,000
- Indirect costs: Rs 75,000



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Materials worth Rs 1,00,000 were returned to the store as surplus at the end of the year. The work certified was Rs 10,00,000.

Prepare the contract account and calculate the profit for the year ending 31st December 2023.



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Ques 2: Scenario: DEF Builders is working on a contract to construct a luxury hotel. The original contract value is Rs 30,00,000. During the construction, the contractee requested additional work worth Rs 4,00,000, which was agreed upon. The following costs were incurred during the year:

- Materials purchased: Rs 9,00,000
- Direct labor: Rs 5,00,000
- Plant hire charges: Rs 2,50,000
- Indirect costs: Rs 1,00,000

Materials worth Rs 1,20,000 were returned to the store as surplus at the end of the year. The work certified was Rs 12,00,000.

Prepare the contract account and calculate the profit for the year ending 31st December 2023.



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Ques 3: Scenario: GHI Constructions is working on a contract to build a residential apartment complex. The original contract value is Rs 35,00,000. During the construction, the contractee requested additional work worth Rs 5,00,000, which was agreed upon. The following costs were incurred during the year:

- Materials purchased: Rs 10,00,000
- Direct labor: Rs 6,00,000
- Plant hire charges: Rs 3,00,000
- Indirect costs: Rs 1,50,000

Materials worth Rs 1,50,000 were returned to the store as surplus at the end of the year. The work certified was Rs 15,00,000.



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Ques 4: Scenario: JKL Construction Company is working on a contract to construct a university campus. The original contract value is Rs 40,00,000. During the construction, the contractee requested additional work worth Rs 6,00,000, which was agreed upon. The following costs were incurred during the year:

- Materials purchased: Rs 12,00,000
- Direct labor: Rs 7,00,000
- Plant hire charges: Rs 3,50,000
- Indirect costs: Rs 2,00,000

Materials worth Rs 2,00,000 were returned to the store as surplus at the end of the year. The work certified was Rs 18,00,000.

Prepare the contract account and calculate the profit for the year ending 31st December 2023.

Ques 5: Scenario: MNO Builders is working on a contract to build a shopping complex. The original contract value is Rs 50,00,000. During the construction, the contractee requested additional work worth Rs 7,00,000, which was agreed upon. The following costs were incurred during the year:

- Materials purchased: Rs 15,00,000
- Direct labor: Rs 8,00,000
- Plant hire charges: Rs 4,00,000
- Indirect costs: Rs 2,50,000

Materials worth Rs 2,50,000 were returned to the store as surplus at the end of the year. The work certified was Rs 20,00,000.

Prepare the contract account and calculate the profit for the year ending 31st December 2023.

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