**UNIT 2- COSTING METHODS**

**Job Order Costing:**

Job order costing or *job costing* is a system for assigning and accumulating [manufacturing costs](https://www.accountingcoach.com/blog/what-are-manufacturing-costs) of an individual unit of output. The job order costing system is used when the various items produced are sufficiently different from each other and each has a significant cost

Since there is a significant variation in the items manufactured, the job order costing system requires a separate job cost record for each item (or each job or special order). The job cost record will report each item's direct materials and [direct labor](https://www.accountingcoach.com/blog/what-is-direct-labor) that were actually used and an assigned amount of [manufacturing overhead](https://www.accountingcoach.com/blog/what-is-manufacturing-overhead-and-what-is-included).

The job cost records also serve as the [subsidiary ledger](https://www.accountingcoach.com/blog/subsidiary-ledgers-control-account) or documentation for the manufacturer's cost of the work-in-process inventory, the finished goods inventory, and the [cost of goods sold](https://www.accountingcoach.com/blog/cost-of-goods-sold-2).

**Examples of Job Order Costing**

A few examples of the use of job order costing are:

* A company that designs and produces custom-made machines and/or machine tooling
* A company that constructs custom-designed buildings
* A company that modifies trucks to meet customers' special needs

#### Job Cost Accounting Procedure:

Cost of direct materials in respect of a job is obtained from copies of Material Requisitions costed by the Stores Accounting Section. Cost of direct wages is obtained from various Time Tickets costed by the Payroll Department. Direct Expenses, if any, are also taken up.

Manufacturing overheads are then applied at predetermined departmental absorption rates and recorded in the cost-sheet. Various overheads may be recorded in the separate columns meant for these in the cost sheet which are totaled to obtain the total cost of direct material, direct labour, direct expenses and apportioned manufacturing overheads. These are the four elements of cost which together give the production cost or manufacturing cost of the job.

**Following is a specimen of a job cost sheet meant for publishing of a book:**

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#### Advantages of Job Order Costing:

(i) Profitability of each job can be individually determined.

(ii) It provides a basis for estimating the cost of similar jobs which are to be taken in future.

(iii) It provides the detailed analysis of the cost of material, labour and overheads for each job as and when required.

(iv) Plant efficiency can be controlled by confining attention to costs relating to individual jobs.

(v) Spoilage and defective work can be identified with a specific job and responsibility for the same may be fixed on individuals.

(vi) By adopting pre-determined overhead rates in job costing, we can get all advantages of budgetary control.

(vii) Job costing is essential for cost-plus contract where contract price is determined directly on the basis of cost.

#### Limitations of Job Order Costing:

(1) It is expensive to operate as it requires considerable detailed clerical work.

(2) With the increase in the clerical work the chances of errors are increased.

(3) Job order costing cannot be efficiently operated without highly developed production control system. The job costing requires intricate factory organization system.

(4) The costs as ascertained are historical as they compiled after incidence and therefore does not provide control of cost unless it is used with standard costing system.

**Contract Costing:**

Contract costing is a variant of job costing. Like job costing, contract costing is also a form of specific order costing. So, both job costing and contract costing are based on the same costing principles. In fact, a big order is termed as a contract and a small order as a job. Contract costing is also known as terminal costing as the preparation of Contract Account is terminated or closed after the completion of contract.

Example of undertakings which adopt contract costing are builders, civil engineering contractors, road making or repairing concerns, dams and bridge constructional concerns. The person who undertakes the work to complete is known as ‘Contractor’ and the person who gets the work done through contractor is known as ‘Contractee’.

Definition:-

The Institute of Cost and Management Accountants (I.C.M.A.) London, defines contract costing as, “that form of specific order costing which applies where work is undertaken to customer’s special requirements and each order is of long duration.”

“Contract or terminal costing is the term applied to the system adopted by those businesses which carry out substancial building or constructional contracts.” —Walter W. Bigg

From the above definition, it is clear that contract costing is a form or type of specific order costing under which there is an attribution of costs to individual contracts.

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**2. Features of Contract Costing:**

**Contract costing has certain distinctive features. The important features of contract costing are**:

(1) Contracts are generally of large size and, therefore, a contractor usually carries out a small number of contracts in the course of one year.

(2) A contract generally takes more than one year to complete.

(3) Work on contract is carried out at the site of contracts and not in factory premises.

(4) Each contract undertaken is treated as a cost unit.

(5) Separate Contract Account is prepared for each contract in the books of contractor to ascertain profit or loss on each contract.

(6) Most of the materials are specially purchased for each contract. These will, therefore, be charged direct from the supplier’s invites. Any materials drawn from the store are charged to contract on the basis of material requisition notes.

(7) Generally, all labourers are treated as direct labourers.

(8) Most expenses, such as, electricity, telephone, insurance, etc. are also direct in nature.

(9) Plant and equipment may be purchased for the contract or may be hired for the duration of the contract.

(10) Payments by the contractee are made at various stages of completion of the contract based on architect’s certificate for the completed stage. An amount known as retention money is withheld by the contractee as per agreed terms.

(11) Penalties may be incurred (paid) by the contractor for failing to complete the work within the agreed period.

(12) Contract costing is less detailed and simpler than job costing.

(13) Each contract or work involved in contract costing is executed or done as per the specifications given by the contractee. So one contract may be dissimilar to another contract.

(14) Contract costing is concerned with the costing of construction work or repair work and not with the costing of any goods.

(15) As the contract is undertaken at the contractee’s promises most of the items of cost chargeable to a contract are direct costs. Indirect costs are very few.

(16) As the contract or work is done at the contract site far away from the premises of the contractor, the problem of cost control is greater in the case of contract costing. There can be loss of materials and equipment, damage to plants and wastage of labour, posing problem of cost control.

(17) In the case of contract costing, work commences on receipt of order from the customer.

(18) In case of complete contract, there is the problem of determination of the amount of profit to be carried to current year’s Profit and Loss Account, and the amount of profit to be carried forward.

(19) There is no heavy investment on assets initially in the case of contract costing.

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**3. Contract Costing Procedure:**

**The basic procedure for costing of contracts are as follows:**

**1. Contract Account:**

Each contract is allotted a separate number and a separate account is opened for each contract.

**2. Direct Costs:**

Most of the costs of a contract can be allocated direct to the contract. All such direct costs are debited to the Contract Account.

**Direct costs for contract include:**

(i) Direct cost of materials,

(ii) Direct labour and supervision,

(iii) Direct Expenses,

(iv) Depreciation of Plant and Machinery,

(v) Sub-contract costs, etc.

**3. Indirect Costs:**

Contract cost is also debited with overheads which tend to be small in relation to direct costs. Such costs are often absorbed on same arbitrary basis as a percentage on prime cost, or material or wages, etc. Overheads are normally restricted to head office and storage costs.

**4. Transfer of Materials or Plant:**

When materials, plant or other items are transferred from the contract, the Contract Account is credited by that amount.

**5. Contract Price:**

The Contract Account is also credited with the contract price. However, when a contract is not complete at the end of financial year, the Contract Account is credited with the value (cost) of work-in-progress as on that date. Work- in-progress includes value of work certified and the cost of work uncertified.

**6. Profit or Loss Account:**

The balance of Contract Account represents profit or loss which is transferred to Profit and Loss Account. However, when contract is not completed within the financial year, only the part of the profit arrived is taken into account and the remaining profit is kept as reserve to meet any contingent loss on the complete portion of the contract.

**Cost Plus Method of Contract:**

Cost plus method of contract is that where contract price is not settled between contractor and contractee, but it is agreed that contractor will be paid a fixed percentage of profit on the total cost incurred by contractor on and above the total cost of the work done. Such type of contract is entered into in war time or time of economic fluctuation or where contract is to be executed in urgency and it is difficult to quote the price of the contract.

**Application of Cost Plus Method of Contract:**

Although, this type of contract is commonly entered into in war time or in time of economic fluctuation.

**But, in the following situations, it proves to be useful:**

(i) Where the production work has to be completed urgently.

(ii) When it is difficult to estimate the cost of labour, material and other costs.

(iii) When plant and machinery have to be imported from foreign countries.

(iv) When the work to be done is of nature and estimation of cost is difficult for the contractor.

(v) If material, labour, machinery and expert is provided by the contractee and contractor is to do the work of contract only.

**Advantages of the Cost Plus Method of Contract:**

**(A) Advantages to the Contractor:**

(i) Free from losses.

(ii) Certainty of profits in case of increasing prices of labour and material.

(iii) In times of uncertainty execution of contract becomes possible.

(iv) Free from getting approval of tender price.

(v) In case of urgency of execution of a contract.

(vi) Availability of the services of experts, raw materials and labour.

**(B) Advantages to the Contractee:**

(i) Quick completion of work.

(ii) Quality work.

(iii) Easy to get the work done in emergency.

**Disadvantages of Cost Plus Contract Method:**

(i) Generally contract price is increased under this method.

(ii) Excessive increase in expenses, since contractor is not worried about increasing cost.

(iii) Uneconomic use of raw material and labour by contractor.

(iv) Limited income to the contractor.

(v) Monotonous in contractor.