Accounting for Contracts

By Howard M. Ingham

What is the best method of accounting for payments received on account of uncompleted contracts? This question arises in all branches of the building industry and in a great many manufacturing enterprises—in fact, wherever large contracts are undertaken on which part payments will be made. Often the work is paid for on schedule, that is, specified sums are due at certain stages of completion. In the majority of cases, however, these specified sums bear little relation to the cost of the work performed up to the time when the payment is due, even though an effort may have been made, in drawing up the contract, to keep cost of production and payment therefor in reasonable agreement.

If the work is paid for by percentages of its cost to date, no particular difficulty arises. Any trustworthy system of records furnishes the basis for equitable payments, and the only question is as to the advisability or propriety of including some of the prospective profits in the invoice. This question is frequently discussed, and needs no further mention here. But when work is paid for on schedule or in any way except by a percentage of its cost, the contractor or manufacturer must decide how to determine the entries in his sales account.

If the contract, when made, is credited to sales, the balance-sheet must always contain an item on the debit side "reserve to finish contracts." There is no more unsatisfactory job than estimating the proper size of this reserve, and the books would never be of any value, as a guide, unless this reserve could be carried continuously, which is, of course, utterly impracticable and not even to be considered.

The second suggestion might be to credit to sales the schedule sum or amount to be received at certain stages. If this sum should happen to be smaller than the cost of the work delivered (or completed, if a building) the difference between the sales and cost of sales accounts would show that the company was losing money, and vice versa. In either case, the true facts would be concealed by the chance size of the schedule payments. As these are arranged in advance and their size is frequently determined by bargaining, the books could never show the true state of the business, unless all contracts should happen to be completed at exactly the same time. As this would never happen with a going concern, the second suggestion must be dismissed as of no value.

A third suggestion might be to estimate the sales value of the work delivered or completed and credit this sum to the sales account. This, however, is almost as unsatisfactory as estimating the reserve to finish contracts, as well as a great waste of effort. Also, the profits shown by the books would be dependent upon the accuracy of the estimates and hence of dubious value as a guide.

Many standard works on accounting have been examined by the author in the effort to find a satisfactory answer to this question, with little result. It is hardly even mentioned in some of the best-known works. It recently had to be solved, however, in relation to a cost system in a large manufacturing plant, and the method described below was evolved. It is presented herewith for discussion, in the hope that, if any flaws exist, they may be exposed, and references may be made to any works wherein the subject is comprehensively treated.

In the system evolved by the author, the contracts, when made, are not recorded in the ledger. However, if it were thought desirable, they could be recorded in other accounts, without affecting in any way the entries about to be described. The costs of manufacture, labor, burden and material are debited in the account "work in process" in the usual way. Upon the completion of an order, the cost is credited to "work in process" and debited to "cost of sales," as is customary. When a partial delivery is made on an uncompleted contract, an invoice is rendered to the customer for the sum due as per schedule or for any equitable sum, if there is no schedule. This invoice is charged to the customer's account and credited to an account called, for want of a better name, "bills rendered." This process is repeated until the contract is finished, when the final cost can be made up from the cost books. The total cost is then credited to "work in process" and debited to "cost of sales," as stated above, and, in the *same accounting period,* the contract price is credited to sales and debited to "bills rendered." As all the accounts above mentioned, except "bills rendered," are standard accounts and used in the customary way, there is no need for discussing here the significance of their balances. Such a discussion appears in any work on accounting.

The only account requiring discussion is "bills rendered." Its balance will always be on the credit side of the ledger, and it must be classed among the liabilities of the business. It represents sums of money advanced on account of unfinished contracts, which are, to a certain extent, in the nature of loans. On a balance-sheet, the credit balance in "bills rendered" should be deducted from the asset represented by "work in process," thus:

Work in process	$500,000.00
Less: bills rendered on account of uncompleted contracts	100,000.00
	$400,000.00

Objection might be made that by debiting a customer for a part payment, thus making it appear as an asset among accounts receivable, the asset appeared twice, once as a part of work in process and again among accounts receivable. While this might appear to be the case, the latter asset is balanced by the liability in "bills rendered," and the net amount of assets appears correctly in the books and can be correctly stated on the balance-sheet, as shown above.

Another objection might be that, on long contracts, lasting a year or more, work delivered a year ago would still appear as "work in process" in the ledger, unless the whole contract had been completed. The answer to that is that so long as work delivered has to be combined with work not yet completed, it is still actually in process, and cannot properly be taken out of the "work in process" account.

The facts seem to be reflected by this system of entries more correctly than they would be by any other method. Accounts receivable are stated in their true amount, sums of money actually due; the difference between sales and cost of sales is the actual profit on completed work, and no other statement of profit is trustworthy. The balance in "work in process" is the cost of all work not altogether completed—and that is the significance of the name.

The purpose of these notes is to bring forth answers to three questions:

1. Are there any flaws in this method of accounting for contracts?
2. Is it in general use on contract work?
3. Where is it described in standard works on accounting?