

SSAP 9 : STOCKS AND LONG TERM CONTRACTS

(A) STOCKS

- “Stock” will generally include :
 - raw materials and consumables
 - work in progress
 - finished goods

VALUING STOCKS

- The use of selling prices in stock valuation is ruled out because this would create a profit for the business before the stock has been sold

The prudence concept dictates that profits should not be recognised until realised

- The rules used to value stock are governed by an accounting standard SSAP 9 " Stocks and Long Term Contracts " which states that :

"Stocks should be quoted at the lower of cost and net realisable value"

COST

That expenditure which has been incurred in the normal course of business in bringing the product to its present location and condition

This can be split into :

- (1) **cost of purchase** : purchase price
(including import duties ,
transport , handling costs etc.)

: trade discounts and subsidies

- (2) **cost of conversion** : direct costs and labour

NET REALISABLE VALUE

SSAP 9 defines the NRV as :

"The actual or estimated selling price (net of trade but before settlement discounts) less :

- all further costs to completion
- all costs to be incurred in marketing , selling + distributing

ESTIMATES OF COST

In certain circumstances , it is not possible to accurately determine the original cost of each item purchased . For example , the business might be purchasing from different suppliers and under fluctuating price levels

In such cases , methods are used which approximate the cost of the stock held . These methods are :

- FIFO
- LIFO
- Weighted Average

N.B.

SSAP 9 does not permit LIFO as this would result in stock being valued at outdated prices which may bear little resemblance to current price levels

ACCOUNTING FOR LONG TERM CONTRACTS

Long term contracts will generally extend over a number of years . The prudence concept dictates that profits should not be recognised until realised i.e until the end of the contract's life

If this was adhered to , the profit and loss account would not give a true and fair view of the organisation's financial activities during the period . Also , recording all of the profit in one accounting period upon completion of the contract would give a misleading impression of performance in that period

Therefore the accruals concept is followed in that costs and revenues are matched together within the period to which they relate .

i.e. an element of profit is recognised each year relating to the profit earned in that period , which is known as the attributable profit

Hence SSAP 9 promotes consistency between companies by setting out guidelines for apportioning profits and turnover between accounting periods . However , there is still an element of choice in the calculation of estimated turnover and attributable profit and there will always be some element of inconsistency between companies due to the subjective nature of the figures involved

DEFINITIONS

Long Term Contract

Contracts entered into for the design , manufacture or construction of a single asset where the time taken to complete the contract is such that the contract activity falls into different accounting periods

Attributable Profit

That part of the total profit currently estimated to arise over the duration of the contract , that fairly reflects the profit attributable to that part of the work performed at the accounting date

Foreseeable Losses

Foreseeable losses are those which are currently estimated to arise over the duration of the contract

Payments on Account

Payments on account are all amounts received and receivable at the accounting date in respect of contracts in progress

ACCOUNTING TREATMENT

- (1) Where the outcome of a contract can be foreseen with reasonable certainty, SSAP 9 states that attributable profit should be calculated on a prudent basis and included in the accounts. The amount of profit taken up should reflect the proportion of work carried out at the accounting date
- (2) Where the outcome of a contract cannot be assessed with reasonable certainty, no profit should be reflected in the profit and loss account
- (3) If an ultimate loss is expected on the contract, all the loss should be recognised as soon as it is foreseen

PROFIT AND LOSS ACCOUNT

(A) Calculation of Attributable Profit

This represents that proportion of the overall profit expected on the contract which has been estimated to have been earned to date

We need to arrive at an estimate of the percentage completion of the contract in order to be able to calculate the attributable profit. One of 2 fractions is commonly used:

$$(a) \quad \frac{\text{Costs to Date}}{\text{Total Contract Costs}}$$

$$(b) \quad \frac{\text{Work Certified to Date}}{\text{Total Contract Price}}$$

(B) Turnover and Cost of Sales

The turnover in the profit and loss account will be represented by the value of the work certified in the year under consideration

The cost of sales will have be the balancing figure between the turnover and the attributable profit

BALANCE SHEET

(A) Debtors / Creditors

The value of work certified has been credited to the profit and loss account as part of turnover . The debit side of the journal will represent how much our customer owes us for the work done to date

However , the payments on account will already be included within cash or debtors . Hence , we need a further debtor to represent the value of work done which has not yet been invoiced to the customer

This is termed “Debtors : Amounts Recoverable on Contracts”

If we have invoiced our customer more than the value of work certified to date , a creditor will arise which is termed “Creditors : Excess Payments on Account”

(B) Stock

The other balance which will be necessary in the balance sheet in relation to the long term contract will be a stock balance . This will be the difference between the total costs incurred to date and those costs which have already been transferred (debited) to cost of sales in the profit and loss account .

The remainder of the total costs will need to be debited as an asset in the balance sheet and termed “Stock : Long Term Contract Balances”

EXAMPLE 1

Project A commenced during 2003 , the following balances relate to the first year of the contract :

	2003 £'000
Total contract price	1000
Costs incurred to date	320
Estimated costs to completion	480
Payments on account	360
Value of work certified	390

Show how the contract would be recorded in the financial statements for the year .
The company calculates attributable profit by reference to the proportion of the cost incurred to date to the total estimated contract costs

EXAMPLE 2

Project B commenced during 2002 , the following balances relate to the first 2 year's of the contract :

	2003 £'000	2002 £'000
Total contract price	820	820
Costs incurred to date	500	264
Estimated costs to completion	120	350
Payments on account	510	240
Value of work certified	640	348

Show how the contract would be recorded in the financial statements for each year .
The company calculates attributable profit by reference to the proportion of value of work certified to the total contract price

(1)

Profit and Loss Account (Extract)

2003
£'000

Turnover

390

Cost of Sales

(310)

Gross Profit

80

Balance Sheet (Extract)

2003
£'000

Debtors: Amounts receivable on contracts

30

Stocks: Long Term Contract Balances

10

(w1) Contract Price

4'000
1000

less: costs to date
costs to complete

(320)
(480)

Estimated Profit

200

$$(w2) \% \text{ completion} = \frac{320}{320 + 480} = 40\%$$

$$\therefore \text{Attributable Profit} = 40\% \times 200$$
$$= \underline{\underline{80}}$$

W3

Value of work certified

1000
390

less: POA

(360)

Debitors: ~~Amn~~

30

W4 Costs to Date

320

less: transferred to COS

(30)

STOCKS

10

PROFIT AND LOSS ACCOUNT (EXTRACT)

(2)

	2003 £'000	2002 £'000
Turnover	292	348
Cost of Sales	(223)	(261)
Gross Profit	<u>69</u>	<u>87</u>

BALANCE SHEET (EXTRACT)

	2003 £'000	2002 £'000
Debtors: Amounts receivable on contracts	<u>130</u>	<u>108</u>
Stock: Long Term Contract Balances	<u>16</u>	<u>3</u>

(iv) P+C A/C (2002)

Total contract price £ 870

Costs to date (264)
Costs to complete (350)

Total Estimated Profit 206

$$\% \text{ completion} = \frac{348}{870} \times 100\% = 42.4\%$$

$$\text{Attributable profit} = \frac{206 \times 100}{100} = \underline{\underline{87}}$$

Turnover 348

COS (261)

Gross Profit 87

W2 P+L A/C (2003)

Total contract price	£1000 870
Costs to date	(500)
Costs to complete	(120)
Total estimated profit	<u>200</u>

$$\% \text{ completion} = \frac{640}{870} \times 100\% = 73\%$$

$$\begin{aligned} \text{Total attributable profit to date} &= 73\% \times 200 \\ &= \text{£1000} \\ &\quad 156 \end{aligned}$$

$$\text{I.e.: earned in 2002} \quad (87)$$

$$\text{Earned in 2003} \quad \underline{\underline{69}}$$

$$\begin{aligned} \text{Turnover (640 - 348)} &\quad \text{£1000} \\ &\quad 292 \end{aligned}$$

$$\text{COS} \quad (223)$$

$$\text{Gross Profit} \quad \underline{\underline{69}}$$

W3

Debtors

2003
£1000

2002
£1000

Value of work certified

640

348

less: POA

(510)

(260)

Debtors

130

108

W4

Stocks

2003
£1000

2002
£1000

Costs to date

500

264

less: transferred to p+l a/c

(484)

(260)

stocks

16

3