

Quadrant II - Notes

Course Code: DSE 7 COD126

Module Name: Calculation of Work Uncertified and Escalation Clause

Notes on Work Certified, Uncertified and Escalation Clause

I. Meaning and Introduction to Work-in-progress:

Work in progress includes Work Certified and Uncertified. When the contract is not completed till the end of the accounting or financial year, the architect values the work-in-progress. Work-in-progress is classified into two i.e 'Work certified and work uncertified'.

A. Meaning and Introduction of Work Certified.

When contractor takes the contract to complete any construction work or project, it may be completed in six, seven years and above. The contractor has to pay different expenses for material, labour and other overheads. So, it is very important for the contractee to pay contractor some money of contract. This money is given on the basis of work done. So, any part of construction which is completed by contractor will be termed as '**Work certified**' if it is certified by an authority. Authority may be independent engineer or architect who can estimate the work. He will issue the certificate of work done after certifying the work of construction. On this work certified, contractor has the right to get money of contract. Work Certified is a part of the work-in-progress which has been approved by the Contractee's Engineer or Architect for payment. Work certified is valued at contract price (i.e, selling price), and includes an element of profit.

B. Meaning and Introduction of Work Uncertified:

Work Uncertified is that part of the work-in-progress which is not approved by the engineer, architect or surveyor. So, contractee will deduct some amount on the basis of work uncertified and retain the same. This amount retained is called as '**Retention money**'. Work uncertified is valued at cost price and does not include an element of profit. Both work certified and uncertified are shown on the credit side of the contract account and also on the assets side of the Balance sheet.

C. Accounting Treatment of Work Certified and Work Uncertified:

a. Work certified and work uncertified will be shown on the credit side of contract account. This is because the contract account is just like income and expenditure account. We show all expenses incurred on the contract on the debit side and all income on the credit side. Work certified and works uncertified are just like outstanding income.

b. Work certified and work uncertified will be shown on the asset side of balance sheet. This is because both are outstanding income of contractor. But we deduct cash received and reserves from it because cash received will become income of current, so it will not be included in the Balance sheet.

D. Distinction between Work Certified and Work Uncertified

| Sr. No | Work Certified | Work Uncertified |
|---------------|---|--|
| 1. | It represents work done during the period, and also certified by the Architect, Surveyor or Engineer. | It represents work done during the period but not yet certified by the Architect / Surveyor or Engineer. |
| 2. | The amount of Work Certified is based on Architect's Certificates. | Cost of Work Certified is based on the Contractor's own estimate. |
| 3. | It includes profit element, since it is based on Contract Price. | It is a conventional cost estimate and does not include any profit element. |
| 4. | It is considered for calculating percentage of completion. | It is not considered in calculation of percentage of completion. |
| 5. | It provides the basis for claiming periodical Progress Payments) from the Contractee. | It arises due to time gap between the date of previous certificate to the close of the financial year. |

Note: Value of Work Certified and Cost of Work Uncertified constitutes Income on a Contract, and is credited to the Contract Account in the books of the Contractor.

II. Meaning and Introduction of Escalation clause

- 1. Escalation clause:** Most of the Contracts generally take long time to complete and in this period there may be changes in prices of material, labour and other overheads. Escalation clause is often provided in contracts to cover any likely changes in the price or consumption of materials and labour. Thus, a contractor is entitled to suitably increase the contract price if the cost rises beyond a given percentage.

II. Features of Escalation clause:

- a. In case of Fixed Price Contracts, the Contract Price is fixed and pre-determined. If there is an increase in prices of materials, rates of labour, and other overhead expenses during the period of performance of a contract, the Total Contract Costs may increase and the Contractor's profit may be reduced.
- b. This increase in prices may induce the Contractor to use materials of lower quality and price in order to maintain his profit margin on the contract.
- c. To overcome such a situation, the agreement generally contains a condition that the Contract Price will be increased by an agreed amount or percentage, if the prices of Materials, Wages, and other overheads rise beyond a particular limit. This condition is called 'Escalation Clause'.
- d. Main objective is to safeguard the interest of the contractor against adverse changes in cost due to price of material, labour and other expenses.
- e. The escalation clause is of particular importance where prices of material and labour are expected to increase or where quantity of material and/or labour time cannot be correctly assessed.

Accounting Treatment for Escalation Clause:

The amount of reimbursement due should be determined by reference to the Escalation Clause. The amount due from the Contractee should be recorded by the following Journal Entry in the Contractor's Books, at the end of every each year by passing the following entry:

Contractees A/cDr.

To Contract A/c.

Note: Alternatively, the amount due under Escalation Clause can be added to the value of Work-in-Progress at the end of every year.

III. Meaning of De-escalation clause:

An escalation clause safeguards the interest of the contractor by upward revision of the contract price; however, a de-escalation clause may be inserted to look after the interest of the contractee by providing to downward revision of the contract price in the event of cost going down beyond an agreed level.