

UNIT-IV

Depreciation and Cost Accounting

Depreciation is decrease in the value of an asset as a result of wear and tear.

Methods of Depreciation

Straight Line Method

A method of depreciation in which a fixed amount is written off year on year, during the useful life of the asset, to reduce the value of the asset to zero or its scrap value at the end of its useful life is a straight line method. In this method, the cost of the asset is uniformly spread over the lifetime of the asset. This method is also known as fixed instalment method. Under this method, a particular asset is expected to generate equal utility (economic benefits) during its useful life.

Written Down Value Method

The depreciation method in which a fixed percentage of the reducing balance is written off every year as depreciation, to reduce the fixed asset to its residual value at the end of its working life. This method is also known as reducing balance or diminishing balance method where the annual charge of depreciation keeps on decreasing every year. So the depreciation charged in the initial years is higher as compared to the subsequent years. Although, according to this method the value of the asset is not fully extinguished.

Key Differences Between SLM and WDV

The difference between SLM and WDV are explained in the given below points in detail

SLM is a method of depreciation in which the cost of the asset is spread uniformly over the life years by writing off a fixed amount every year. WDV is a method of depreciation in which a fixed rate of depreciation is charged on the book value of the asset, over its useful life.

In straight-line method, depreciation is calculated on the original cost. On the other hand, in the written down value method, the calculation of depreciation is on the basis of written down value of the asset.

The annual depreciation charge in SLM remains fixed during the life of the asset. In contrast, the amount of depreciation in WDV method diminishes every year.

In straight line method, the book value of the asset is completely written off i.e. the asset value is reduced to zero or its salvage value. Conversely, the asset's book value is not completely written off in written down value method.

If a firm is using SLM method, then the amount of depreciation is initially lower while if the method of depreciation is WDV then in the beginning the amount of depreciation is higher.

The SLM method is best for the fixed assets with negligible repairs and maintenance like leases. On the contrary, WDV method is appropriate for the fixed assets whose repairs increase, as they get older like machinery, vehicles, etc.

The impact of repairs and depreciation on the P&L account can be easily understood by an example – We all know it is natural that as the asset gets older, the amount of repairs and maintenance, increase year on year. Now look at the given situation:

SLM

Cost

It means the total of all expenditures incurred on the production of an article.

Costing

It is the techniques and process of ascertaining costs. It enables the management to know the total cost and each elements of cost of a product. It has been defined by Wheldon as, “the classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services, and the presentation of suitably arranged data for purposes of control and guidance of management”.

Cost Accounting

Cost accounting is the process of classifying, recording, allocating and reporting the various costs incurred in the operation of an enterprise.

Difference between Costing and Cost Accounting

The words costing and cost accounting are used interchangeably. However, they do not mean the same thing. Costing denotes the techniques and process of ascertaining cost. It can be carried out arithmetically. However, cost accounting is a formal system established for recording costs in the books of accounts.

Cost Accountancy: Cost Accountancy is a comprehensive term. Cost accountancy is the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost control and ascertainment of profitability. It includes the presentation of information for decision-making.

Definition

Costing is referred to as, “Classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services”

ICMA, London defines Costing as, ” The technique and process of ascertaining cost”

Scope of Cost Accountancy

The scope of cost accountancy is very wide and includes the following:

1. Cost Ascertainment

It deals with the collection and analysis of expenses, the measurement of production of the different products at the different stages of manufacture and the linking up of production with the expenses. In fact, the varying procedures for the collection of expenses give rise to the different systems of costing as Historical or Actual costs, estimated costs, standard costs etc. Again the varying procedures for the measurement of production have resulted in different methods of costing such as specific order costing, operation costing etc. For linking up of production with the expenses the different techniques of costing such as marginal costing, the total cost technique, direct cost technique have been evolved. All the three i.e., systems, methods and techniques can be used in one concern simultaneously.

2. Cost Accounting

It is the process of accounting for cost, which begins with recording of expenditure and ends with the preparation of statistical data. Costs of products or services are ascertained and controlled by means of formal mechanism. Cost can be ascertained wither by following the historical or predetermined system of costing. Cost either can be predetermined by standard costing or estimated costing. If the cost and financial accounts are kept separately then their reconciliation is also to be done in order to verify the accuracy of both the sets of accounts.

3. Cost Control

Cost Control is the guidance and regulation by executive action of the costs of operating an undertaking. It aims at guiding the actual towards the line of targets, regulates the actual if they deviate or vary from the targets, this guidance and regulation is done by an executive action. The cost can be controlled by standard costing, budgetary control, proper presentation and reporting of cost data and cost audit objectives of Costing Accounting

Objectives of Cost Accounting

The objectives are listed below:

1. To find out the total cost and cost per unit of various products produced.

2. To disclose the proportion of different elements such as materials, labors and overheads in the total cost
3. To provide necessary data for fixing the selling price.
4. To ascertain the profitability of each product and advise the management to how to maximize these profit.
5. To supply estimates of costs based on historical data, for the preparation of tender etc.
6. To provide important cost data to the management for decision-making, planning and controlling.
7. To adopt suitable system of inventory control to avoid excessive locking up of working capital in stocks
8. To identify the sources of wastages and losses in the business
9. To help in the preparation of budgets and implementation of budgetary control
10. To compare actual cost with standard cost and analyse the causes of variances.
11. To advise the management on future expansion policies and proposed capital projects
12. To exercise effective control on the idle time of men and machines
13. To supply useful data to the management to take decisions such as introduction of new product etc.,

Advantages of Cost Accounting

I. To the Management

i. Action against unprofitable activities

It tells the unproductive, unprofitable and inefficient activities to the management which will act as a base to take correct and proper steps in time.

ii. It helps in decision-making

Cost accounting helps in decision-making. It provides vital information necessary for decision-making. For example, it helps in deciding whether to make or buy a product, whether to accept or reject an export order.

iii. It helps in fixing prices

Cost accounting helps in fixing prices. It provides detailed cost data of each product, which enables in fixation of selling prices.

iv. Reward to efficiency

By using standard costing and budgetary control, they can introduce new principles and thereby they can improve the efficiency, which in turn will result in reward of profit to the management.

v. It helps cost control

By comparison, of various products produced, it is possible to reduce the cost and to control the cost to the maximum possible extent.

vi. Inventory control

The control on stock of materials, stores can be effectively carried out only by proper costing system. This system helps in avoiding both the purchase of excess stock and lack of stock of goods to carry out the production.

vii. To prevent fraud

By preventing fraud, cost accounting supplies realizable cost data to the management. Scope of manipulation and fraud is minimized as the cost accounting envisages sound systems of inventory control and standard costing.

II. To the Employees

i. Incentives

Cost accounting introduces bonus plans and incentive wages system to suit the needs of the organizations. These plans and system provides more remuneration to an efficient labour and less to an inefficient labor.

ii. Promotion

As the efficiency is clearly found out by the management, most efficient person will get promotion. By this, not only the worker is benefited but also the management because an efficient person alone can change an unprofitable concern to a profitable concern.

III. To the Creditors

i. Bankers, creditors, investors can have a better understanding of the firm regarding the progress and growth.

ii. The exact cause of an increase or decrease in profit or loss can be found with the aid of cost accounting, which in turn will provide more benefit to the creditors.

IV. To the Government

i. Plans and Developments

Cost accounts are of great use in the preparation of national plans and economic development.

ii. Formulation of plans

Cost accounting is not post mortem examination. It is a system of foresight based on past, it helps in the formulation of definite plans in quantitative terms.

iii. Cost Audit

It is important. Industries have to keep books of accounts to show the use of materials, labour and other costs.

V. To the Public

- i. Consumers will get good quality product at cheaper rate.
- ii. This system helps the customers to pay fair price.
- iii. By development of industries, it creates employment opportunities.
- iv. A steady progress is there for the constant economic growth.

Disadvantages

1. It is unnecessary

Cost accounting is of recent origin. Many industries have prospered in the past without the aid of cost accounting. Even today, some companies doing well without cost accounting. Hence, it is unnecessary.

2. It is expensive

It is said that installation of costing system is expensive, especially in the introduction stage. The benefits derived are less as compared to the expenses incurred.

3. It is a failure

It is argued that costing system has failed to produce desired results in many cases. The main reasons behind this is only due to lack of facilities which are required for carrying out the costing system in an effective way.

4. Routine forms and Statements

Cost accounting involves reporting cost data to the management. A large number of forms and statements are to be sent as matter of routine. As a result, there is a lot of unwanted paper work, which creates only additional burden to the workers.

5. Restricted Applicability

Modern methods of costing have only restricted applicability. Costing can be applied effectively only in trading concerns or small organizations. It is not applicable in all types of industries.

6. It is not reliable

Costing is also based on estimates. It may give a correct answer. However, this system is also not a fully reliable system.

Difference between Cost Accounting and Financial Accounting

BASIS FOR COMPARISON	COST ACCOUNTING	FINANCIAL ACCOUNTING
Meaning	Cost Accounting is an accounting system, through which an organization keeps the track of various costs incurred in the business in production activities.	Financial Accounting is an accounting system that captures the records of financial information about the business to show the correct financial position of the company at a particular date.
Information type	Records the information related to material, labor and overhead, which are used in the production process.	Records the information which are in monetary terms.
Which type of cost is used for recording?	Both historical and pre-determined cost	Only historical cost.
Users	Information provided by the cost accounting is used only by the internal management of the organization like employees, directors, managers, supervisors etc.	Users of information provided by the financial accounting are internal and external parties like creditors, shareholders, customers etc.
Valuation of Stock	At cost	Cost or Net Realizable Value, whichever is less.
Mandatory	No, except for manufacturing firms it is mandatory.	Yes for all firms.
Time of Reporting	Details provided by cost accounting are frequently	Financial statements are reported at the end of the accounting period,

BASIS FOR COMPARISON	COST ACCOUNTING	FINANCIAL ACCOUNTING
	prepared and reported to the management.	which is normally 1 year.
Profit Analysis	Generally, the profit is analyzed for a particular product, job, batch or process.	Income, expenditure and profit are analyzed together for a particular period of the whole entity.
Purpose	Reducing and controlling costs.	Keeping complete record of the financial transactions.
Forecasting	Forecasting is possible through budgeting techniques.	Forecasting is not at all possible.

What Is a Cost Sheet?

A cost sheet is a statement that shows the various components of total cost for a product and shows previous data for comparison. You can deduce the ideal selling price of a product based on the cost sheet. A cost sheet document can be prepared either by using historical cost or by referring to estimated costs. A historical cost sheet is prepared based on the actual cost incurred for a product. An estimated cost sheet, on the other hand, is prepared based on estimated cost just before the production begins.

Importance of cost sheet

Cost sheets help with a number of essential business processes:

1. **Determining cost:** The main objective of the cost sheet is to obtain an accurate product cost. It gives you both the total cost and cost per unit of a product.
2. **Fixing selling price:** In order to fix the selling price of a product, you need to create a cost sheet so you can see the details of its production cost.
3. **Cost comparison:** It helps the management compare the current cost of a product with a previous per unit cost for the same product. Comparing the costs helps management take corrective measures if costs have increased.

4. Cost control: The cost sheet is an important document for a manufacturing unit, as it helps in controlling production costs. Using an estimated cost sheet aids in monitoring labour, material and overhead costs at each step of production.

5. Decision-making: Some of the most important decisions management makes are based on the cost sheet. Whenever a business needs to produce or buy a component, or quote prices for its goods on a tender, managers refer to the cost sheet.

Types of cost

Costs are broadly classified into four types: fixed cost, variable cost, direct cost, and indirect cost.

1. Fixed cost: These are costs that do not change based on the number of items produced. For example, the depreciating value of a building or the price of a piece of equipment.

2. Variable cost: These costs are tied to a company's level of production. For example, a bakery spends \$10 on labor and \$5 on raw materials to produce each cake. The variable cost changes based on the number of cakes the company bakes.

3. Operating costs: These are those expenses incurred by an organisation to maintain the product on a day to day basis. Traveling cost, telephone expenses, office supplies are some of things that come under operating costs.

4. Direct costs: These costs can be directly associated with production. For example, if a furniture manufacturing company takes five days to produce a couch, then the direct cost of the finished product includes the raw material cost and labor charges for five days.

Components of total cost

Components of total cost are constituted mainly of prime cost, factory cost, office cost and cost of sales. Let us take a detailed look at each of these elements:

1. Prime cost: This comprises direct material, direct wages, and direct expenses. It is also called basic cost, first cost, or flat cost. It can be defined as an aggregate of the price of the material consumed, the wages involved in production, and the direct expenses.

Prime cost = Direct material + Direct wages + Direct expenses

Direct material cost usually refers to the cost of raw materials used or consumed during a given period. To calculate the amount of raw material actually consumed during a given period, you add the opening stock and the amounts of material purchased, and deduct the closing stock. Here is the formula for material consumed:

Material consumed = Material purchased + Opening stock of material – Closing stock of material

2. Factory cost: This is made up of prime cost plus factory overhead, which includes indirect wages, indirect material and indirect expenses. Factory cost is also known as works cost, production cost, or manufacturing cost.

Factory cost = Prime cost + Factory overhead

3. Office cost: This is also called administration cost or total cost of production. Office cost is equal to factory cost plus office and administration overhead.

4. Total cost or cost of sales: This is the sum of the total cost of production and the total of selling and distribution overhead.

Total cost = Cost of goods sold + Selling and distribution overhead

In the production process, some units of a product are scheduled to be finished at the end of a period. Such incomplete units are called work-in-progress. In such situations, while calculating the factory cost of a product unit, it is necessary to make adjustment for opening and closing stock to arrive at net factory cost of the product. Generally, the cost of these unfinished units includes direct material, direct expenses, and factory overheads.

Besides this, the adjustments for inventories need to be made in the following manner

1. Direct material consumed = Opening stock of direct material + Purchases of direct material – Closing stock of direct

2. Works cost = Gross works cost + Opening work in progress – Closing work in progress

3. Cost of production of goods sold = Cost of production + Opening stock of finished goods – closing stock of finished goods

Sample cost sheet

The various components of cost explained in the previous section can be represented in the form of a statement. A cost sheet statement consists of prime cost, factory cost, cost involved in the production of goods sold, and total cost. Let us look at an example, in which you have to prepare a cost sheet for a furniture company for the financial year ending March 31, 2019. Now take a look at the following information which is available to you to prepare a cost sheet statement.

Direct material consumed – \$12,000

Opening stock of raw materials – \$130,000

Closing stock of raw materials – \$8,000

Direct wages – \$50,000

Direct expenses – \$10,000

Factory overhead is 100% of direct wages

Office and administration overhead is 20% of works

Selling and distribution overhead – \$25,000

Cost of opening stock for finished goods – \$10,000

Cost of closing stock for finished goods – \$15,000

Profit on cost is 20%

COST SHEET

DETAILS	CALCULATIONS	AMOUNT (\$)
Direct Material: Material consumed	12,000	
Opening stock of raw material	130,000	
Add: Purchases	142,000	
Less: Closing stock of raw materials	8,000	134,000
Direct wages		50,000
Direct expenses		10,000
Prime cost		194,000
Factory overhead: 100% of direct wages	$100 \times (50,000 / 100)$	50,000
Works cost		244,000
Office and administrative overhead: 20% of works cost	$244,000 \times (20 / 100)$	48,800
Total cost of production		292,800
Add: Opening stock of finished goods		10,000
Cost of goods available for sale		302,800
Less: Closing stock of finished goods		15,000
Cost of goods sold		287,800
Selling and distribution overhead		25,000
Cost of sales		312,800