Current Cost Accounting Techniques Used in Manufacturing Companies of India

by

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Abstract

This is a research paper that aims at exploring the use of current cost accounting techniques in the manufacturing companies of India. For this purpose, the researcher used secondary qualitative research methodology and based on this he made the review of existing literature. Current cost accounting is an important tool that helps the firms in making the effective decisions related to their investment. It is an internal accounting and mainly used by the managers of a company in order to determine the real value of assets and other items in incomes statement and balance sheet of a company. It has been found that this method is advantageous in providing an accurate value of assets, maintaining balance in the value of capital. On the other hand, this method has complications as well because it is based on the assumptions of replacing the asset, which may not be the intent of an organization while the evaluation. Furthermore, this method is a new concern in the research and needs more investigation about its usage and suitability.

Keywords: Current Cost Accounting (CCA), features and techniques of CCA, advantages, and disadvantages of CCA and Use of CCA in India.

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Introduction

Background

Accounting is a function of business that involves in collecting, organizing, recording and analyzing the data. This data represents the transactions of the business of the company that it makes. The main thing for accounting is to present data about the financial transactions and nothing else. Because all the stakeholders are majorly concerned with the financial information of a company (Jaffe, & Irizarry, 2014). Stakeholders especially, the shareholders, stockholders, creditors, and suppliers are mainly interested in financial transactions and financial performance of a company in order to make the investment decisions. In order to further specify, accounting authorities and professionals have subdivided the accounting into two broad categories, which include financial accounting and managerial accounting. According to Zeff (2016), financial accounting aims at presenting the external orientation of financial records as it presents the information towards the external stakeholders. This accounting chiefly deals with the recording of transactions and cash-flow of a company.

In contrast, the managerial accounting presents the information in front of internal stakeholders of a company, which merely include cost accounting, financial managers and owners of the firms. This implies that the managerial accounting is for the manager use only (Brown, 2014; Jaffe, & Irizarry, 2014). Besides this, the cost accounting is the oldest and central part of managerial accounting, which contains a collection of, methods, procedures, and principals to define the revenue, cost, and information related to the results. Alongside, it also contains the means that help in delivering such information to the internal stakeholders of a company (Brown, 2014). Like managerial accounting, cost accounting possesses internal orientation, which means that it works for and assists the managers of a company. The cost accounting has been facing a stage of transition, amendments, corrections, and replacement with new methods and techniques (Brown, 2014). Therefore, this research paper has aimed at offering a productive and quality research on current cost accounting technique, which is a major part of cost accounting.

A number of studies have been conducted in order to shed light on various aspects of current cost accounting. The researchers have tended to discuss features, advantages and disadvantages and prevalence of current cost accounting in the context of its use in the manufacturing industries (Brown, 2014,). According to Zeff (2016), the basic motive of this sort of accounting is to present the items as per their current value regardless of any other concern or calculation.

Historically, cost accounting has a big history as it dates back to the first decade of 18th century. The passage of time has brought a significant alteration in its methods and concepts. In the starting, companies did not possess any technological instruments as compared to the present. Bookkeeping was made using the “pencil-paper” method (Mora, 2017). It was the easiest method to record the record regarding significant figures and amounts of costs incurred in a company or any entity. Company based on these methods did not make any allocation of cost as in the past, it was a mass production era (Mora, 2017). Costing was simple as it contained direct labor costs, direct material costs, whereas, non-manufacturing and manufacturing overheads were not included in it at a large scale (Mora, 2017). It is the technology that has brought a significant change in the costing and recording patterns of accounting. Technology has created openness for product diversity, and new product lines due to which the mass-production has declined significantly. Markets have become worldwide and the companies aim at offering low-cost and high-quality services and goods.

In order to make an effective decision-making, the companies have been using various methods so that they can obtain their goals and objectives. For this purpose, the manufacturing companies use two methods such as Historical Cost Accounting (HCA) and Current Cost Accounting (CCA) (Winans, Kendall, & Deng, 2017). HCA considers all the historical and previously recorded costs when making decisions, whereas the CCA considers to record and present the accounting items in a value that they have if sold or presented in the market. According to Arnold, Javorcik, Lipscomb, and Mattoo, (2016), in India, the manufacturing companies are mostly using this sort of cost accounting in order to know what they really possess and can really obtain against what they have in the form of assets or any other item. It is a highly pertinent method and allows making the rational decision on the basis of the original value of items rather than their value in books and records of a company.

Research Rationale

The main reason behind the selection of this topic is to identify and explore the prevalence of current costing accounting in the manufacturing companies of India, which is a new initiative in the field of research. Although there is much literature available on the various components of accounting in the context of manufacturing, still there is a dire need to conduct an integrated research in the context of current cost accounting techniques used by the Indian manufacturing companies. This research can add value to the studies that various authors and researchers of have conducted in order to identify features, advantages, and disadvantages of current cost accounting.

Problem Statement

The research problem is to identify how the manufacturing companies are using the current cost accounting in order to ensure an effective decision making. Since most of the companies are using the methods and techniques of current cost accounting but no one has observed and made any evaluation of those companies. Besides this, it is also a problem to offer suggestions to the companies so that they can make an effective use of the current cost accounting. It has been evidenced that current cost accounting allows the firms to make decisions based on their current item value approach. Therefore, it is of the main interest to find out how this sort of accounting pattern helps the manufacturing firms of India to adjust the historical and current cost of their items.

Research Significance

This research is highly significant as it aims at bringing something new in the literature of current cost accounting. This research can be advantageous for the manufacturing firms in making effective decisions related to their investment and costs of various heads of accounts. In addition to this, the researcher has conducted the research in context Indian manufacturing markets, which clearly defines the scope and limit of the study. Outcomes of this research can be more applicable to Indian manufacturing companies, as they can use this study to benefit from all the features of current cost accounting.

Research Aim and Objectives

Research Aim

The researcher has aimed at exploring the use of current cost accounting techniques in the manufacturing companies of India. On the basis of this aim some more objectives have been set, which are outlined below:

Research Objectives

- To understand the concept of current cost accounting
- To identify the prevalence and practice of current cost accounting in Indian manufacturing companies
- To understand the features and techniques of current cost accounting
- To explore the advantages and inconveniences of current cost accounting

Research Questions

What is current cost accounting?

How do the manufacturing companies in India practice the current cost accounting?

What are the features and techniques of current cost accounting?

What are the advantages and inconveniences of current cost accounting?

Literature Review

Current Cost Accounting (CCA)

Sandilands Committee of the United Kingdome (UK) has proposed that current value of all the items need to be assumed as the basis when it comes to preparing the financial statements of a company. This method is also called ‘Replacement Cost Accounting’ or ‘Specific Price

Level Approach'. According to Chambers (2015), in this method, the accountants develop the profit and loss account and balance sheet on the basis of the current cost or value of items. A cost at which a company can replace its asset by any desired asset is called the current cost. Chambers (2015) further states that a cost that a company pays to replace the present asset by new or any other assets is known as a replacement cost.

Consequently, a company can substitute the cost of replacement by the economic value or net realizable value depending on the higher value of any one of them (Chambers, 2015). Net realizable value abbreviated as NRV refers to a price at which a firm can sell its asset less cost of its disposal. On the other hand economic value is an addition of discounted future cash flows that a company anticipates from its assets during their lives. According to Prodhan and Al Najjar (2014), when a company finds itself unable to ascertain an item's current cost then uses a specific index that helps it in ascertaining the current cost of an asset. This cost is used adjust the historical cost against inflation along with the adjustment like depreciation.

Features of Current Cost Accounting (CCA)

Fixed Assets and Revaluation Reserve and Depreciation and Backlog Depreciation Adjustment

According to Gleason, Bruce Johnson and Li (2013), current cost accounting has various features and fixed assets revaluation reserve is one of those features. As per this feature, a company shows its fixed assets at their current value in the balance sheet. The company can ignore the depreciated original costs and a difference between depreciated original cost and the current value is moved to "Revaluation Reserve Account" and the reserve is presented on the liabilities side of balance sheet. Gleason et al. (2013) believe that depreciation adjustment and backlog depreciation is also one of the features of accounting and suggests that in this method a company needs to calculate the depreciation of the present replacement value of fixed assets. The formula is presented below:

Depreciation Adjustment = Depreciation. as per CCA – Depreciation as per HCA

Cost of Sales Adjustment (COSA), Monetary Working Capital Adjustment (MWCA) and Gearing Adjustment

According to Heidhues and őszegi (2014), matching principle requires the firms to match the current costs with current revenues. Operating and purchasing expenses present the current value, whereas the sales present current value. However, for stock, it is probable to whether present the current value or not. Therefore, it is necessary to make an adjustment for the cost of sales. The authors like Heidhues and őszegi (2014) have called this adjustment as Cost of Sales Adjustment (COSA). COSA adds some value to the stock because of the increase in inflation or prices in future.

According to Jianu, Jianu, and Turlea (2017), Monetary Working Capital Adjustment (MWCA) increases in response to increase in the prices instead of no any change in the volume of business. Since the adjustment indicates the determining of extra monetary working capital needed in response to increases in prices. The study further indicates that monetary working capital can be a difference between monetary current liabilities and the monetary current assets. Monetary current assets are the assets that can be easily and rapidly converted into cash and they consist of accounts receivable, trade debtors, advances, and bills receivable. On the other hand, monetary current liabilities consist of accounts payable, trade creditors, outstanding expenses and bills payable.

Monetary Working Capital = Monetary Current Assets – Monetary Current Liabilities

According to a study by Buckland and Davis (2016), gearing adjustment is a ratio of two funds i.e. funds borrowed from creditors and the funds of shareholders. The shareholders are likely to obtain and sacrifice the prices of shares in case of inflation and deflation (Buckland & Davis, 2016). Therefore, a company also needs to ensure the sharing of profits and losses with its long term lenders as per their proportion of investment. In fact, both the shareholders and lenders should share their charges with respect to the deflation or inflation. Following is a formula that can help in calculating the gearing adjustment.

$$\text{Gearing Adjustment} = \frac{L}{O} \times A$$

Where,

L refers to net borrowings

O indicates the net operating assets

A presents the total of current cost adjustments

An alternate formula for gearing adjustment calculation is given below:

$$\text{Gearing Adjustment} = \frac{L}{L+S} \times A$$

Where,

L reveals the net borrowings

S indicates shareholders’ funds

A reveals a total of current cost adjustments such as depreciation adjustment MWCA and COSA.

Use of Current Cost Accounting

A study shared by Das, Mishra, and Rajib (2016) shows that technological achievement like barcoding has made it possible to record use of time, and resources automatically by using the complex computer systems. Additionally, the companies are using these systems in order to ensure effective decision making about the expenses of a business. The main reason behind the use of technology is to be cost effective and cost leader in the global and national markets. Competitors in global or local markets are offering products at high-quality and lower prices, in order to secure the competitive advantage. The more focus of manufacturing companies is on their costing systems as they have to face the market challenges and survive as well. Managers in manufacturing companies of India invest in the computer systems for the purpose of making decisions related to costing of items.

According to a study by Tschopp, and Huefner (2015), new costing systems assist the Indian manufacturing companies in finding a proper base for allocation of overhead costs. Since the new systems enable the accountants to know about the cause and effect of the costs that incur in various heads of accounts of a company and they can further bring improvement. As they become able to understand about what portion or part of a business is providing more benefit or value to the business. The new costing systems mostly used in India consist of target costing activity-based costing, department costing, and variable costing. All these costing methods are based on current cost accounting as they allow the accountants to find the current value of what they spend on various functions and operations of an organization.

A study shared by Mattessich (2016) reveals that Indian manufacturing companies use the techniques and methods of current cost accounting for the purpose of offering reliable and correct financial information, which is grounded on prevailing replacement cost. This statement reveals that the main objective keeping in view the Indian manufacturing firms use the current cost accounting is that they want to know what amount they are actually required to pay for replacing an asset (Mattessich, 2016). It is a very important technique because it enables the managers to decide about the investment of assets. In the same, the study presents that the current cost accounting is also used for the purpose of calculating the profit without bringing any alteration in the historical profit. Since the historical profit is kept constant and the current profit is taken in order to identify the level of profit a company can achieve.

According to a research conducted by Lohri, Camenzind, and Zurbrügg (2014), the manufacturing companies use the current cost or current value accounting in order to prevent the business in a situation when any normal inflation occurs. This implies that this sort of accounting responds to changes in prices and allows the businesses to allocate extra working capital and other resources in order to adjust the impact of impact on the overall business. Simultaneously, the manufacturing companies in India use this type of accounting for keeping the capital level in a balanced position as they make a proper valuation of assets on the basis of replacement value (Lohri et al. 2014). In addition to this, the Indian manufacturing companies use this accounting for the purpose of offering original and current value-based information to the investors, management, creditors, suppliers, governments and other stakeholders. Likewise, the companies use CCA techniques to show the real and realizable value of all the assets and other items prevailing in the financial statements of a company.

Advantages and Disadvantages of CCA

Discussing the advantages of Current Cost Accounting (CCA) Lohri et al. (2014) in their study mentioned that its major advantages include the maintenance of physical capital, statement of inventories and fixed assets on their value to the company, and elimination of holding gains from the profit. This method provides more accurate and relevant information. Some more benefits contain its practicality, as the company can measure its loss and profit, and use of matching concept. The matching concept enables to calculate the cost of sales and depreciation and also adjusts both of them. The study further indicated that decisions based on this type of accounting become more productive, beneficial and meaningful.

In contrast, a study by Drury (2013) shows that the CCA has a problematic side as well. This technique of accounting lacks to be concerned with the maintenance of financial capital in normal purchasing power and it also neglects losses or gains on the monetary items. It means that this method is beneficial for non-monetary assets but not for the monetary assets (Drury, 2013). In the same way, this technique ignores to make depreciation of inventories and fixed assets when making the gearing adjustment. Subsequently, this method is not acceptable at accounting and tax authorities. Alongside, this technique does not offer any proper adjustment for the backlog depreciation (Drury, 2013). Furthermore, the method has practical implications as well, which create hindrances in its use by the manufacturing firms India. This technique assumes the replacement of an asset, which may not be the intention of a company. Asset being replaced may not have any substitute, which can replace it. Another implication can be the inability of a firm to obtain the real market value of items to be evaluated. Since the market price cannot be predicted because of its fluctuating situation.

Methodology

The research method is a doctrine for how to accomplish the research process. In simple words, it is an outline for a researcher that can assist him in every step of the research. It also allows the researchers selecting the method for research inquiry, research investigation. Various methods for conducting a research exist, which include mixed research methods, qualitative research methods, and the quantitative research methods. All of them have their own features and guidelines for research inquiry. The research inquiry is a term used to define the collection of data. In this research, the researcher has chosen the qualitative research methodology. According to Silverman, (2016), the qualitative research methodology enables researchers to obtain the theoretical and conceptual information. Meanwhile, this methodology has assisted the researcher in obtaining the theoretical and conceptual information about the use of current cost accounting in Indian manufacturing firms.

Moreover, the level of data collected in the research is secondary, which means that already existing knowledge and literature has been collected. Previously held information has assisted the research in developing findings as this information contains various aspects of the topic selected for this research. According to some more authors like Marshall, and Rossman (2014), secondary data in the form of literature provides opinions, perceptions, and reviews of scholars, which can be useful for accomplishing the research. The researcher has developed a transition in collecting the data. It means that in the initial steps, literature about general understanding and concepts of accounting were collected. Later on, the researcher collected the information about current cost accounting and its prevalence in Indian manufacturing firms from books, articles, and magazines.

While the data collection and usage in the study, researcher considered about ethical considerations and therefore, he cited all the text that was derived from those sources.

Discussion

It has been found that current cost accounting helps the companies to make the effective decisions regarding their investment. It is a branch or part of cost accounting and believes in the real and current value of all the items regardless of their value in the record books of a company (Chambers, 2015; Prodhan, & Al Najjar, 2014). Studies also present that it unlike the historical cost accounting aims at adjusting the current value of items by relating these values to inflation and other economic aspects.

The major features that have attracted Indian manufacturing companies to use this sort of accounting include consideration of fixed assets revaluation reserve, backlog depreciation adjustment, cost of sales adjustment, gearing adjustment and cost of working capital adjustment (Gleason, Johnson & Li, 2013; Heidhues, & őszegi, 2014; Buckland & Davis, 2016). All these adjustments help the Indian manufacturing companies determine the costs to be needed in a response to change in prices.

On the other hand, studies have also revealed various advantages and disadvantages of current cost accounting techniques for the Indian manufacturing companies (Lohri et al., 2014). The manufacturing companies were able to obtain reliable and correct information about the value of their items. It also enables the firms to save their businesses from inflationary event mismanagement. This accounting also responds to the changes in the inflation and prices of items such as buildings, machines, inventories etc. The techniques of CCA allow the companies track the current value of their items in the market. Information based on the actual values of items can be useful for manufacturing companies in attracting all the stakeholders such as shareholders, creditors, and other interested parties.

On the other hand, a study by Drury (2013) has presented some weaknesses and complications of this accounting method. One of those weaknesses is non-existence of the other assets based on which the company aims to evaluate its own asset. Apart from that, this method has an assumption that company wants to replace its assets, which may not be true. It means that, if a company does not want to replace its assets, then no calculation can be possible.

Conclusion

When it comes to concluding, it can be stated that current cost accounting is a concept of treating the items of accounting as per their current value, which the accountants can determine by using its various techniques and features. This accounting method is widely used in the Indian manufacturing companies for the purpose of making investment decisions. Fixed asset revaluation enables firms to obtain the original cost of assets rather than their value written in the books of the company. This value can assist the company in replacing those fixed assets with any new and useful fixed assets in order to increase the productivity of a firm. Additionally, the consideration of adjustment of the cost inventory as per the inflation in the market allows firms to determine the cash that can come in future. However, Indian manufacturing firms can understand the amount of cost to be incurred on the assets and inventories because of inflation. Techniques of this accounting approach are rich in both advantages and disadvantages. Since the method is based on assumptions and not accepted by the tax and other authorities. But this method presents the actual cost of all the items in front of investors, shareholders, governments, managers, other stakeholders.

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