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UNITED STATES DEPARTMENT OF AGRICULTURE

BULLETIN No. 660

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Washington, D. C. September 12, 1918

HIGHWAY COST KEEPING.

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PART I.

COST KEEPING IN GENERAL.

THE FUNDAMENTALS OF COST KEEPING.

Definition.—Cost keeping is a system for recording the cost of each unit of product or division of work in order to facilitate comparison of such costs with cost of other similar units or divisions under like conditions. Cost keeping analyzes each unit of product or work to determine the reasonableness or unreasonableness of the cost, and also to secure an intelligent basis for predicting the cost of producing similar units in future.

Lack of cost records.—The Office of Public Roads and Rural Engineering, in an extensive investigation of highway management, both by the State highway departments and by a large number of individual counties and townships, brought out, among other conditions, the very general absence of cost keeping. Few examples of practical and efficient cost keeping were found in operation, and

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these were confined largely to the State highway departments. Only in rare instances were cost-keeping systems found in counties or townships. This condition is due largely to the notable scarcity of information available on the subject of highway cost keeping, as practically all textbooks on cost keeping have been prepared from the viewpoint of factory management and are not readily adaptable to highway work. Furthermore, the usefulness of highway cost data has not yet been generally appreciated by public officials.

Purpose of the bulletin.—The purpose of this publication is to present, first, in an elementary way the principles which govern cost keeping; second, a practicable application of those principles to highway work.

Development of cost systems.—Cost keeping was developed in the manufacturing industries. To Charles Babbage has been conceded the honor of having first called the attention of the manufacturing world to its desirability, in 1832, in his publication entitled "The Economy of Manufacture." Half a century elapsed, however, before factory managers, forced by relentless competition to eliminate waste and incompetency from their factories, began to introduce systems of cost keeping.

Since 1900 the use of cost keeping in manufacturing industries has developed steadily. During this period of development principles regarded as basic have been established. While cost keeping for highway work is of comparatively recent origin, it is based upon factory cost keeping, and the same principles govern.

COST ELEMENTS.

The term "cost," as generally interpreted and as used in this bulletin, is the summation of expenditures expressed in terms of money involved to acquire or produce a utility or to perform a service.

The cost of every unit of product, whether it be a square yard of road surface maintained, or a cubic yard of concrete which is a part of a bridge or culvert, is composed of four basic elements of expense, namely:

(1) The cost of labor.
(2) The cost of materials.
(3) The cost of service of plant and equipment.
(4) The cost of general expense or overhead.

LABOR.

The costs of labor are divided into two classes; first, direct labor cost; and, second, indirect labor cost. All labor chargeable against the product which can be designated as directly expended on it is called direct labor. All labor chargeable against production and not directly expended on the product is called indirect labor.

For example, the cost of men using picks and shovels on excavation who are directly expending their efforts on that piece of work is a direct labor charge. A superintendent in charge of a road job is not directly expending labor on excavation, but is engaged in directing the prosecution of all kinds of work and his expense is an indirect labor charge, chargeable pro rata against the production of all the work units he may be supervising. Other examples of indirect labor are the services of watchmen, timekeepers, and water boys.

MATERIALS.

Materials also are divided into two similar classes—direct and indirect. All materials entering the product as an integral part of its composition are called direct materials. All materials chargeable against the production but which do not enter directly into the product as an integral part of it are called indirect or expense materials or sometimes supplies. The cement, stone, and sand that are mixed together to form the concrete of which a concrete road is constructed are all direct materials, but the oil used for lubricating and the gasoline for operating the mixer in which these materials are prepared for use are indirect materials or supplies. It is easy to charge direct material cost, but often it is very difficult to charge to each product its correct share of indirect material cost.

Small, or hand, tools not used as a part of some plant unit and which have such a short period of usefulness that they are seldom used on more than one job, usually are considered supplies and therefore are part of the indirect materials charged to the work.

PLANT AND EQUIPMENT.

"Plant" includes such physical property used on the work as land, structures, machinery, live stock, and tools of a more permanent character than those referred to as supplies. "Equipment" is a less inclusive term and is interpreted generally to mean the smaller and especially the movable plant units. The cost of the service of "plant" can be charged most readily in the form of a daily rental against the work upon which it is used. This rental should be charged whether the equipment be owned by the operating organization or leased from other owners. It consists of "operating charges," which are—

(*a*) The expense of operation,
(*b*) The average cost of repairs,
(*c*) Charges for the time spent in idleness,

and "fixed charges," which are—

(*d*) Charges for depreciation,
(*e*) Interest,
(*f*) Taxes,
(*g*) Insurance.

The expense of operation.—This includes the wages of operators and helpers and the cost of supplies during the periods of operation. Usually these are charged directly against the work done and not included in the plant rental. It is only necessary that they be charged in one place or the other, and it is important to specify what is included in rental when leasing equipment.

The average cost of repairs.—There is a difference of opinion among cost accountants as to how repairs and renewals to plant should be charged. One view is that renewals may be of such a nature that the useful life of the machine has been increased and therefore the expense of such renewals should be looked upon as an offset to depreciation. Another view is that there is no difference between repairs and renewals, except in degree, and that they all should be considered in the same light; i. e., independent of depreciation charges. It appears that the latter consideration permits simpler accounting and does not rely so much upon individual judgment as to whether the expenditure is for repairs or for renewals.

After a machine has been rebuilt or repaired extensively with the intention of increasing its serviceable life, it should be considered as a piece of new equipment valued at its depreciated value, plus the cost of renewals. This necessitates the computing of a new rate of depreciation on the basis of the new value and assumed new useful life.

The approximate average cost of repairs, including extraordinary repairs, often can be arrived at by casting up old accounts and finding what a similar piece of machinery used on similar work has cost for repairs over a term of years.

Charges for time spent in idleness.—To arrive at a fair and equitable daily charge for rental some allowance must be made for time spent in idleness, because on these days the fixed charges still are continuing and certain supplies are necessary even though the machine be not in operation. The usual way of arriving at the charge for lost time through idleness is to bring together all of the charges for a year and divide them by the number of days the machine actually was in use. By dividing the sum total of expense by the number of days the machine was available for use even though no work existed on which it could be used, the result would be a daily rental with no allowance for lost time. The difference between these two rentals will show what a considerable factor in the fixed charges this item of lost time may become. In all contracts or agreements on rental of equipment care should be taken to specify whether the rental is "per day" or "per day of service."

Charges for depreciation.—Equipment is consumed in production just as truly as material. This loss is called natural depreciation. Depreciation may be either natural or functional. "All equipment

progresses steadily toward the scrap pile, starting the date it is purchased, and while its progress may be delayed it can not be prevented by repairs." [1] It is as much an expense on a steam roller as the cost of fuel burned in the fire box. In the case of fuel the expense is immediate; in the case of depreciation the expense is extended over a period of time. Functional depreciation is loss due to the obsolescence or inadequacy of equipment.

There is no doubt in the minds of cost accountants that depreciation of plant and equipment should be included as a charge against operation, but there is considerable difference of opinion as to how depreciation should be computed.

Three factors determine in all cases what the depreciation should be: First, the original cost; second, the length of useful life; and third, the scrap value of the machine when it no longer can be used for the purpose for which it was purchased, or the salvage value, if it is to be considered as a "second-hand" piece of equipment. Knowing these factors, the problem resolves itself into how to divide the difference between the original cost and the scrap or salvage value (called total depreciation or wearing value) over the length of the useful life of the machine. A number of formulas have been devised for computing decrease in value or depreciation. Fish, in his textbook on "Engineering Economics," explains five such formulas. Three of the more commonly used are the straight line, the declining balance, and the sinking fund.

The first is recommended as the simplest and perhaps best method for road work. By this method the total depreciation is divided by the number of years of useful life and the quotient charged off as a yearly depreciation. This is called the straight-line method, and its greatest advantage is its extreme simplicity.

The second method, a modification of the straight-line method, is called the declining balance method. It is based on the theory that during the earlier years of the life of any machine the repairs are smallest, and therefore to arrive at a constant charge for repairs and depreciation, the depreciation must be heaviest in the earlier years of the life of the machine and lightest in the last. The plan, therefore, is to charge off a fixed percentage annually from the net value of the machine. This gives a diminishing annual charge for depreciation. In the comparative table (p. 6) this annual rate is about 30 per cent. This is determined by the formula $r = 1 - \sqrt[n]{\frac{v_2}{v_1}}$ in which r is the percentage of diminishing value, n the life of the equipment in years, v_1 the original value, and v_2 the scrap value.

[1] Modern Accounting, by H. R. Hatfield.

The third method is called the sinking-fund method. It is based on the assumption that the depreciation on a structure at any time is equal to the accumulations of a sinking fund established for renewal at the end of its useful life. The depreciated value plus this sinking fund (actual or imaginary) at any period equals the original cost.

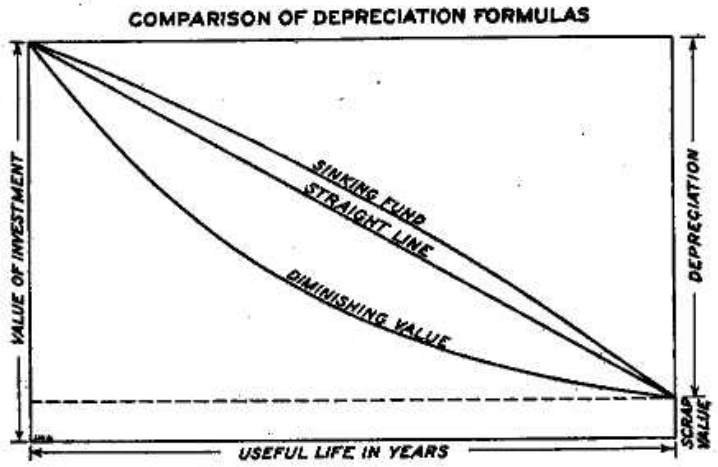

FIG. 1.

It should be observed that none of these formulas takes into consideration interest on investment, output, cost of operation, or maintenance charges. Figure 1 gives a graphic comparison of the above formulas.

The following table is a comparison of the annual depreciation on a $600 machine that has an assumed useful life of five years. It also is assumed that at the end of this period it will have a scrap value of $100. The annual depreciation is computed by the three formulas described:

Comparison of three methods of computing depreciation.

Years.	Straight-line method.	Diminishing-value method.	Sinking-fund method, 6 per cent interest.
First	$100	$180.72	$88.70
Second	100	126.28	94.02
Third	100	88.25	99.66
Fourth	100	61.67	105.64
Fifth	100	43.08	119.98
Total	500	500.00	500.00

The theory of natural depreciation, epitomized, is that all equipment, even if kept in the best of repair, in time will reach a state where repairs no longer are sufficient to keep it in economical working condition and the entire machine must be renewed. The fund created by the depreciation charges is intended to supply the money to purchase a new machine to take the place of the one expended, or to retire the original investment in case the machine no longer is needed.

Any of the depreciation formulas is satisfactory in determining rental charges, provided the assumed life of the machine be approximately correct. As the assumption of the useful life of the machine may be the source of considerable error, there seems to be little argument for the finer calculations as to methods of distributing the depreciation.

It will be found convenient in computing depreciation to group elements of the plant having approximately the same serviceable life. This will have the advantages of requiring fewer accounts and tending to equalize high and low assumed machine life.

Repairs and renewals are charges due to breakage or the wearing out of expendable parts of equipment. It is obviously incorrect to charge to repairs or renewals any improvements or betterments added to any piece of equipment. When such improvements have been made the cost should be added to the present value of the machine and a new depreciation computed upon this new value. An example of such a case would be the addition of a conveyor to an old stone crusher for the purpose of doing away with shovelers. The The improvement is not a repair of any broken parts or a renewal of any part worn out by the continual use of the machine; it is a new feature which adds to the value of the crusher. A rebuilt second-hand machine may be considered in the same light.

Interest, taxes, and insurance.—Interest should be charged on the investment at the rate paid or the prevailing rate, where there is no indebtedness.

Taxes, as paid, should be charged in the rental rate.

Insurance should be charged either as paid or at the prevailing rates if the organization carries its own risk.

Fixed charges are discussed further on page 9. A table of plant rental is included in the Appendix.

GENERAL EXPENSES.

The fourth element of cost is general expense. It often is called "overhead" or "burden," terms derived from factory cost keeping, the use of which in highway-cost keeping is not recommended.

General expense includes all charges that can not be connected directly with the cost of labor, material, and plant. For convenience in accounting and for the purpose of securing a desirable division of road cost, general expense will be considered as divided into two