SILESIAN
UNIVERSITY
SCHOOL OF BUSINESS
ADMINISTRATION IN KARVINA

COST CONCEPTS, TERMS, AND CLASSIFICATIONS

Ing. Markéta Skupieňová, Ph.D.
MANAGERIAL ACCOUNTING/NANMU

COST CLASSIFICATIONS

- Costs can be classified into various categories, according to:

1. Their management function
   a) Manufacturing costs
   b) Nonmanufacturing costs

2. Their ease of traceability
   a) Direct costs
   b) Indirect costs

3. Their timing of charges against sales revenue
   a) Product costs
   b) Period costs

COST CLASSIFICATIONS

4. Their behavior in accordance with changes in activity
   a) Variable costs
   b) Fixed costs
   c) Semi-variable costs

5. Their relevance to control and decision making
   a) Controllable and non-controllable costs
   b) Standard costs
   c) Incremental costs
   d) Sunk costs
   e) Opportunity costs
   f) Relevant costs

COSTS BY MANAGEMENT FUNCTION

In a manufacturing firm, costs are divided into two major categories, by the functional activities they are associated with

(1) manufacturing costs and (2) nonmanufacturing costs, also called **operating expenses.**

MANUFACTURING COSTS

- Manufacturing costs are those costs associated with the manufacturing activities of the company.

- Manufacturing costs are subdivided into three categories:

    1. Direct materials
    2. Direct labour
    3. Factory overhead

DIRECT MATERIALS

- Are all materials that become an integral part of the finished product.
- Examples are the steel used to make an automobile and the wood to make furniture.
- For example, glues, nails, and other minor items are called *indirect materials* (or supplies) and are classified as part of **factory overhead.**

DIRECT LABOUR

- Is the labour that is involved directly in making the product.
- Examples of direct labour costs are the wages of assembly workers on an assembly line and the wages of machine tool operators in a machine shop.
- Indirect labour, such as wages of supervizory personnel and janitors, is classified as part of factory overhead.

FACTORY OVERHEAD

- Can be defined as including all costs of manufacturing expect direct materials and direct labour.
- Some of the many examples include depreciation, rent, taxes, insurance, fringe benefits, payroll taxes, and cost of idle time.
- Factory overhead is also called *manufacturing overhead, indirect manufacturing expenses and factory burden.*

PRIME COSTS

- Direct materials and direct labour when combined are called **prime costs**

CONVERSION COSTS

- Direct labour and factory overhead are combined into *conversion costs* (or processing costs).

NONMANUFACTURING COSTS

- Nonmanufacturing costs (or operating expenses) are subdivided into:

    1. Selling expenses
    2. General and administrative expenses

SELLING EXPENSES

- Are all the expenses associated with obtaining sales and the delivery of the product.

- Examples are *advertising* and *sales commissions.*

GENERAL AND ADMINISTRATIVE EXPENSES

- Include all the expenses that are incurred in connection with performing general and administrative activities.

- Examples are *executives salaries* and *legal expenses.*

DIRECT COSTS AND INDIRECT COSTS

- Costs may be viewed as either *direct* or *indirect* in terms of the extent to which they are traceable to a particular object of costing, sduch as products, jobs, departments, of sales territories.

DIRECT COSTS

- Are those costs that can be traced directly to the costing object.
- Examples are direct materials, direct labour, and advertising outlays made directly to a particular sales territory.

INDIRECT COSTS

- Are costs that are difficult to trace directly to a specific costing object.
- Factory overhead items are all indirect costs.
- Costs shared by different departments, products, or jobs, called *common costs* or *joint costs*, are also indirect costs.
- National advertising that benefits more than one product and sales territory is an example of an indirect cost.

PRODUCT COSTS AND PERIOD COSTS

- By their timing of charges against revenue or by whether they are inventoriable, costs are classified into:

  1. Product costs
  2. Period costs

PRODUCT COSTS

- Are inventoriable costs, identified as part of inventory on hand.
- They are therefore assets until they are sold.
- Once they are sold, they become expenses, i.e., cost of goods sold.
- All manufacturing costs are product costs.

PERIOD COSTS

- Are not inventoriable and hence are charged against sales revenue in the period in which the revenue is earned.

- Selling and general and administrative expenses are period costs.

VARIABLE COSTS, FIXED COSTS, AND SEMIVARIABLE COSTS

- From a planning and control standpoint, perhaps the most important way to classify costs is by how they behave in accordance with changes in volume of some measure of acitivity.

- By behavior, costs can be classified into three basic categories:

  1. Variable costs
  2. Fixed costs
  3. Semivariable (or mixed) costs

VARIABLE COSTS

- Are costs that vary in *total* in direct proportion to changes in aktivity.
- Examples are direct materials and gasoline expense based on mileage driven.

FIXED COSTS

- Are costs that remain constant in *total* regardless of changes in aktivity.
- Examples are rent, insurance, and taxes.

SEMIVARIABLE (OR MIXED) COSTS

- Are cost that vary with changes in volume but, unlike variable costs, do not vary in direct proportion.
- In other words, these costs contain both a variable component and a fixed component.
- Examples are the rental of a delivery truck, for which a fixed rental fee plus a variable charge based on mileage in made; and power costs, for which the expense consists of a fixed amount plus a variable chargé based on consumption.

VARIABLE COSTS, FIXED COSTS, AND SEMIVARIABLE COSTS

- The breakdown of costs into variable and fixed components is very important in many areas of management accounting, such as:

    - flexible budgeting,
    - break-even analysis,
    - and short-term decision making.

COSTS FOR PLANNING, CONTROL, AND DECISION MAKING

- A cost is said to be **controllable** when the amount of the cost is assigned to the head of a department and the level of the cost is significantly under the manager s influence.

- **Noncontrollable costs** are those costs that are not subject to influence at a given level of managerial supervision.

- We can classified:

  1. Standard costs
  2. Incremental (of differential) costs
  3. Sunk costs
  4. Opportunity costs
  5. Relevant costs

STANDARD COSTS

- The standard cost is a production or operating cost that is carefully predetermined.

- It is a target cost that should be achieved.

- The standard cost is compared with the actual cost in order to measure the performance of a given costing department.

INCREMENTAL (OF DIFFERENTIAL) COSTS

- The incremental cost is difference in costs between two or more alternatives.

SUNK COSTS

- Sunk costs are the costs of resources that have already been incurred whose total will not be affected by any decision made now or in the future.

- They represent past or historical costs.

SUNK COST

- a sunk cost is a cost that has already been incurred and that cannot be changed by any decision made now or in the future
- because sunk costs cannot be changed by any decision, they are not differential costs
- and because only differential costs are relevant in a decision, sunk costs should always be ignored
- To illustrate a sunk cost, assume that a company paid € 500 several years ago for a special-purpose machine. The machine was used to make a product that in now obsolete and is no longer being sold. Even though in hindsight purchasing the machine may have been unwise, the € 500 cost has already been incurred and cannot be undone. And it would be folly to continue making the obsolete product in a misguided attempt to recover the original cost of the machine. In short, the € 500 originally paid for the machine is a sunk cost that should be ignored in current decisions.

OPPORTUNITY COSTS

- An opportunity cost is the net revenue forgone by rejecting an alternatives.

OPPORTUNITY COST

- opportunity cost is the potential benefit that is given up when on alternative is selected over another
- opportunity costs are not usually found in accounting records, but they are costs that must be explicitly considered in every decision a manager makes
- virtually every alternative involves an opportunity cost
- For example, assume that you have a part-time job while attending college that pays €200 per week. If you spend one week at the beach during spring break without pay, then the €200 in lost wages would be an opportunity cost of taking the week off to be at the beach.

RELEVANT COSTS

- Relevant costs are expected future costs that will differ between alternatives.

PRIME COST AND CONVERSION COST

- **prime cost -** is the sum of direct materials cost and direct labor cost
- **conversion cost -** is the cum of direct labor cost and manufacturing overhead cost
- the term conversion cost is used to describe direct labor and manufacturing overhead because these costs are incurred to convert materials into the finished product

SUMMARY

Product cost = Direct materials + Direct labour + Manufacturing overhead

Period cost = Selling expenses + Administrative expenses

Conversion cost = Direct labour + Manufacturing overhead

Prime cost = Direct materials + Direct labour

Thank you for your attention.