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# COST CONCEPTS, TERMS, AND CLASSIFICATIONS

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## 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 supervisory personnel and janitors, is classified as part of factory overhead.

## FACTORY OVERHEAD

- Can be defined as including all costs of manufacturing except 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, such as products, jobs, departments, or 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 activity.
- 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 activity.
- Examples are direct materials and gasoline expense based on mileage driven.

## FIXED COSTS

- Are costs that remain constant in *total* regardless of changes in activity.
- 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 charg  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 classify:
  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 is 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 one 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.