

B.Com(H), Sem IV, Paper BCH 4.1
COST ACCOUNTING MODULE 4

Cost Concepts and Classifications

Cost

- *In general*, Cost means amount of resources foregone or sacrificed to achieve a specified purpose
- It can be defined as ***“the amount of expenditure (actual or notional), incurred or potentially to be incurred, to achieve a specific purpose or attributable to a specified thing or activity”***
- **ICWAI**, India defines cost as *“measurement in monetary terms, of the amount of resources used for the purpose of production of goods or rendering services”*

Cost: Expense, Loss and Asset

- The term COST is not the same thing as ***Expense, Loss and Asset***. The three terms have different meanings and can be said to be the subsets of Cost

Expense

- Expense: *Financial Accounting Concept*
- Expense is that ***portion of the cost*** which has been consumed during the current accounting period and which has contributed to the revenue generation
- In other words, ***when the economic benefit of an outflow of resources is received and matched against a revenue, it becomes an expense of that year***
- Also called as ***EXPIRED COST***
- ***Example:*** depreciation on machine

Loss

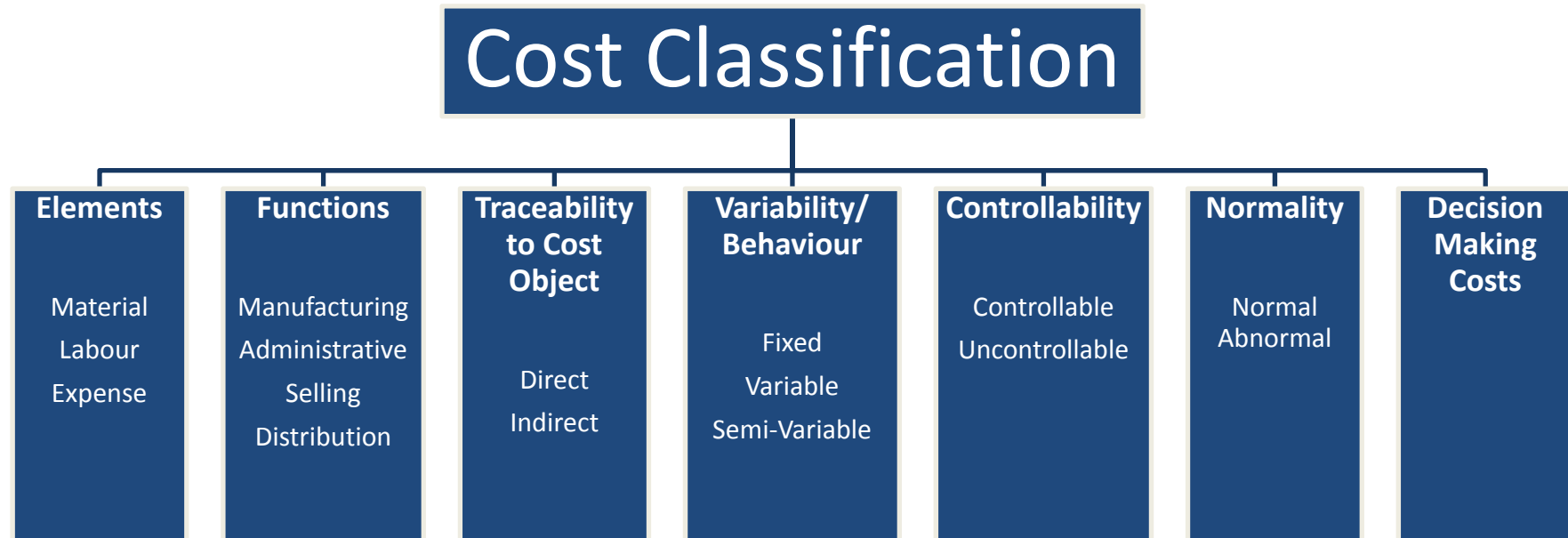
- Loss is that ***portion of the cost*** which has been incurred but which did not contribute to the revenue generation
- In other words, loss is incurred ***when the resources have been foregone but the economic benefit of the outflow of resources has neither been received nor will it be received in future***
- ***Example:*** loss of an uninsured asset like stock of material or a machinery due to fire

Asset

- It is that ***portion of the cost*** which has not been consumed during the current accounting period and is expected to generate benefit in the future period
- In other words, ***when the economic benefit of an outflow of resources is expected to be received in a future period, it is termed as an asset***
- Also called as ***UNEXPIRED COST***
- Shown on the asset side of Balance Sheet
- ***Example:*** closing stock of material, work-in-progress and finished stock, depreciated value of a machine etc.

Classification of Cost

- ✓ Grouping of Costs according to their ***common characteristics***



Cost Classification: By *Elements* of Cost

- Every cost is made up of three elements: *Material*, *Labour* and *Expense*

Material Cost

- Refers to cost incurred on the commodities/ substance, which may become or may not become the integral part of the product
- **Examples:**
 - Timber for furniture
 - Paper in books
 - Consumable stores
 - Stationary used in accounts office or sales department etc.

Labour Cost

- Refers to cost of human effort involved in the process of production, administration and sales
- **Examples:**
 - Wages of Carpenter
 - Supervisor salaries
 - Manager's Remuneration
 - Salesman Commission etc.

Expense*

- Refers to every such cost which is neither material cost nor labour cost
- **Examples:**
 - Royalty payable
 - Hiring charges on equipment
 - Rent , rates and taxes
 - Depreciation on equipment
 - Cost of power and electricity etc.

- *Note: it refers to expense as a component of total cost and not the expense as a financial accounting concept discussed earlier

Cost Classification: By Functions

❑ Cost can also be classified by the function it relates to as:

✓ ***Manufacturing Cost***

- It is the cost of sequence of operations which begins with supplying materials, labour and services and ends with the primary packing of the product
- Taking an *example* of a furniture manufacturer, manufacturing cost will include cost of wood, wages of carpenter, cost of consumable stores, printing, postage and stationery used in the workshop (production department), salaries of supervisor and foreman, repairs, insurance and depreciation of assets used in production department, excise duty on production etc.

✓ ***Administrative Cost***

- It represents the cost of formulating the policy, directing the organisation and controlling the operations of the undertaking, not related to production, sales and research & development.

Cost Classification: By *Functions*

(contd..)

✓ ***Selling Cost***

- It is the cost incurred for the purpose of promoting sales (stimulating the demand) and retaining customers
- It includes cost incurred on *advertisements, cost of free samples distributed, exhibitions conducted, printing of sales catalogues, after sale services etc.*

✓ ***Distribution Cost***

- It represents the cost incurred on making the packed product available to the customer. It consists of the *packing cost (meant for facilitating storage and transportation of product), carriage outward, warehousing costs, showroom rent etc.*

Cost Classification: By Functions ***(contd..)***

✓ Research Cost

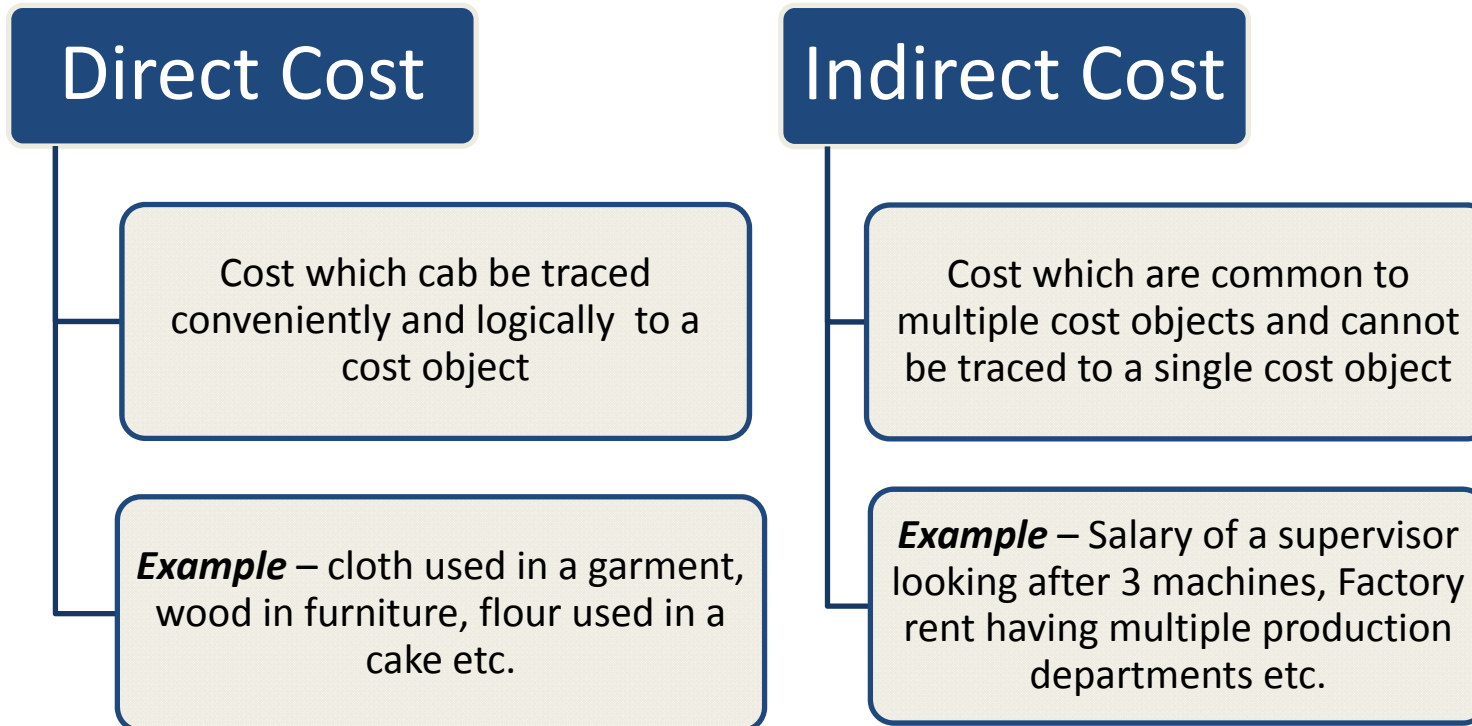
- It consists of the cost of searching for new or improved products, new application of materials, or new or improved methods of production etc.

✓ Development Cost

- It refers to the cost of process which begins with the implementation of the decision to produce a new or improved product or to employ a new or improved methods of production and ends with commencement of formal production of that product or by the method

Cost Classification: By *Traceability to Cost Object*

- ❑ Costs may be categorised as **Direct Cost** or **Indirect Cost** with respect to its *traceability to the cost object* (a unit, a machine or a department, or anything for which a separate measurement of cost is desired)



Cost Classification: By Variability/Behaviour

□ Costs are also classified as:

- Fixed Costs
- Variable costs
- Semi-Variable/Semi-fixed costs

on the basis of their variability, i.e. behaviour with the change in the level of activity (like change in the volume of production)

Fixed Costs (cost classification by variability)

- ✓ These are the costs which do not vary with the change in the level of activity, i.e. they remain constant at different levels of activity but upto a given range of output
- ✓ If the range of output is crossed, these costs jump up to a new level and remains constant at that level for next range of output
- ✓ ***Example:*** rent of a building, insurance premium on plant and machinery, manager's salary etc.

Types of Fixed Costs

- Fixed costs can also be of ***two types***:
 - ✓ ***Committed fixed costs***
 - Costs like ***rent of a building, insurance premium on plant and machinery, manager's salary etc.*** which cannot be avoided and affected in short run if an organisation has to function.
 - ✓ ***Discretionary Fixed Costs***
 - Costs such as ***Research and development expenditure, advertising budget, training budget etc.***, which are set at a fixed amount and periodically revised by the management in the budgeting process. These are the costs resulting from management discretion and policy

Variable Costs (cost classification by variability)

- These are the costs which changes proportionally with the change in the volume of output.
- ***Example:*** *cost of raw material used for product, wages of labour converting material into product etc.*
- It is the total variable cost which changes with the change in level of output, but the *variable cost per unit remains constant*

Semi-Variable Costs/ Semi-Fixed Costs

(cost classification by variability)

- Certain costs are mixed in nature, i.e. they neither remain constant nor changes proportionally with the change in level of output
- Such costs comprises one component as fixed and another variable.
- *For example*, if the telephone rental is paid as Rs. 200 fixed monthly and 30 paise per minute of call, then Rs. 200 is a minimum unavoidable fixed amount which is payable irrespective of the usage and 30 p per minute is the variable amount which will change proportionally with usage
- Other examples of semi-variable or semi-fixed costs could be *Depreciation* (loss of value due to lapse of time is bound to take place irrespective of use of asset and level of usage will also affect loss of value), *repairs and maintenance* , *electricity bill etc.*

Cost Classification: By

Controllability

- Costs can also be categorised as **controllable costs** or **uncontrollable costs** with reference to a **specified level of authority**.
- If a cost can be significantly influenced by the action of a member of a specified level of authority, it is said to be a **controllable cost** at that level, while if a cost cannot be influenced by the action at that level of authority, it is said to be **uncontrollable cost**
- *For example, cost due to efficiency in the usage of material, labour etc. are controllable by a factory supervisor (shop level management) while factory rent or managerial salaries are not controllable at his level.*

Cost Classification: By Normality

➤ On the basis of Normality, cost can be classified as:

✓ ***Normal Cost***

- It is the cost which is ***normally incurred*** at a given level of output in the conditions in which that level of output is normally attained
- It is treated as part of cost of production
- ***Example:*** cost of material and labour required as per standard

✓ ***Abnormal Cost***

- It is the cost which is ***not normally incurred*** at a given level of output in the conditions in which that level of output is normally attained
- It is not treated as part of cost of production
- It is ***charged to Costing P&L account***
- ***Example:*** wages paid for strike period, cost of material destroyed due to fire etc.

Decision-Making Costs

- There are certain special costs used for ***Managerial Decision-Making***
- These are the ***Special Purpose costs*** which are ascertained to ***suit specific decision*** and are useful for special purpose only
- They may not conform to established accounting practices
- They are ***futuristic*** in character
- Different decision making costs are calculated to suit different decision areas
- ***Example:*** *Shut down costs, Sunk costs, Opportunity costs, Imputed costs, Relevant and Irrelevant costs, Out-of-pocket cost, Differential cost etc.*

Relevant and Irrelevant Cost

(Decision making cost)

❖ *Relevant Costs*

- ✓ All those costs which influence a choice of alternatives in a particular situation (decision to be taken) and are also affected by that decision are said to be relevant costs of that decision

❖ *Irrelevant Costs*

- ✓ All those costs which remain the same and are not affected by the decision whatever alternative is chosen are said to be irrelevant costs for that decision

Example of Relevant and Irrelevant Cost

- *An organisation has to take a decision regarding production of a new product, to be produced in same factory premises where production is already taking place and there is sufficient capacity (space) for additional production. Company is paying annual rent of Rs. 1,00,000 for the factory. For this decision, raw material cost of new product is a relevant cost as it will be incurred if decision to produce will be taken and will not be incurred if product is not produced. However the rent paid for the factory is an irrelevant cost of this decision as rent will be paid irrespective of production or non production of new product.*

Note: any cost is relevant or irrelevant in context of decision in hand. One item of cost relevant in one situation may be irrelevant for decision making in another situation

Other Decision-making Costs

❖ Sunk Costs

- Sunk costs are the historical costs that arise due to decisions made in the past and cannot be changed by any decision made in future
- **Example:** *investments in Plant & Machinery is a prime example of sunk cost; in decisions relating to replacement of old machine, the written down value of old machine adjusted for its recoverable value is a sunk cost as it has been incurred in past and cannot be changed by future decision*
- Since sunk costs cannot be altered in future, they are always irrelevant costs in future decision making

❖ Shut-down Costs

- These are the unavoidable fixed costs which continue to be incurred even when a plant is temporarily shut down
- **Example:** *rent, insurance and depreciation of building, salaries of permanent staff etc.*
- Managers must take into account shut-down costs while considering shut-down or continue decisions

Other Decision-making Costs (contd...)

❖ *Imputed/Hypothetical/Notional Costs*

- These are the costs for which neither any transaction has taken place nor any cash outlay is there but it *represents a sacrifice or resource use capable of being measured in monetary terms*
- **Example:** *a producer is doing production in his own premises for which no rent is paid but which has a market value of Rs. 15,000 per month, he can record Rs. 15,000 per month as notional factory rent while determining the cost of production of output*
- Similarly, interest which one would have earned on his capital, if it was invested outside is a notional or imputed rent cost
- Notional costs **do not appear in Financial accounts**
- It is same as concept of **opportunity cost** in Economics

Other Decision-making Costs (contd...)

❖ *Differential Costs*

- The ***difference*** in total cost resulting from a **proposed change** (like ***change in activity level, technology, process or method of production etc.***) is called Differential costs
- It is the increase or decrease in total cost due to an alternative course of action
- If choice of alternative results in increased cost, such increased costs are termed as ***Incremental Cost***. While assessing the profitability of a proposed change, the incremental costs are matched with incremental revenues.
- Choice of alternative resulting in decreased cost, such decrease in cost is called as ***Decremental Cost***

Other Decision-making Costs (contd...)

❖ *Out of Pocket Cost / Explicit Costs*

- These are those costs that require ***cash outlay*** due to a particular managerial decision
- It represents both present and future outflow of cash due to a decision
- ***Example:*** *In decision regarding replacement of own truck by a private career, present expenditure on fuel, salary to drivers, road tax etc. will be considered as out-of-pocket costs, while depreciation does not require any cash outlay and thus not considered*