Cost Classification

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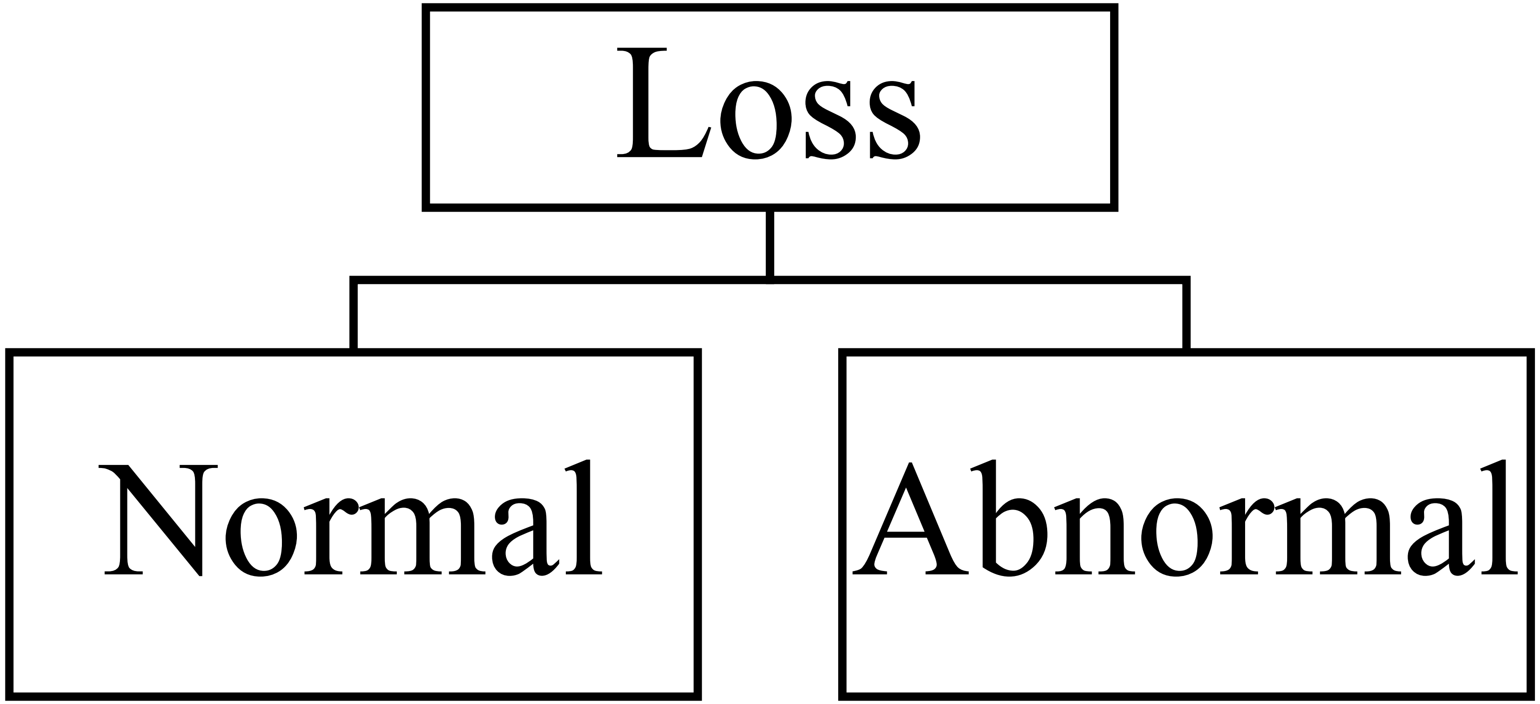
Cost Vs. Expenses

- **Cost:**
- Generally cost may be explained as the amount of expenditure, actual or notional, relating to a specific thing or activity such as product, job, service, process etc.
- Cost and expenses are different but relative terms.
- Where 'costs' includes the cost of material and labour in addition to expenses, the term expenses is widely applied in financial accounts for various types of historical cost. In cost accounting, it is used for costs other than cost of raw material and wages.
- **Expenses:**
- Generally expenses are called expired costs means those costs which have been used up totally in generating revenue.
- They are not capitalised but only shown as expenses in income statement.
- There are so many examples of expenses such as costs of goods sold expenses, selling expenses and administrative expenses.

Loss:

- Loss is lost cost. It is applied to define two accounting events.
- In financial accounting, it is used to describe a circumstance where expenses exceed revenues for an accounting period, that is, the reverse of net income (earnings) for the accounting period.



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Loss:

- This unfavourable event does not arise from a normal business activity but from non-operating transactions or events. This meaning of loss is used to recognize the reverse of gain.
- That is, if no gain is achieved from the cost incurred or it becomes definite that no benefits accrue, the cost becomes a lost cost, i.e., loss on sale of fixed asset, loss of stock due to fire etc.

COST CENTRE AND PROFIT CENTRE

	Marketing / SALES8	HR	Finance	Total
RM	10	10	10	30
Wages	10	8	5	23
Total Cost	20	18	15	53
SP	30	15	20	65
	10	-3	5	

Cost Classification

- There are so many objectives of cost accounting such as planning, decision- making, stock valuation, profit measurement, control etc. For achieving these objectives, cost should be computed, classified and grouped.
- Cost classification may be known as the process of grouping costs according to their general characteristics.

The various cost classifications are as follows:

1 Natural Classification of Cost

(A)	Direct Material Cost	(B)	Indirect Material Cost
(C)	Direct Labour Cost	(D)	Indirect Labour Cost
(E)	Direct Expenses Cost	(F)	Indirect Expenses Cost

2. According to Variation in Production Activity and Quantity

(A)	Fixed Cost	(B)	Variable Cost
(C)	Semi-variable/Fixed Cost (Mixed Cost)		

3. Degree of changeability to the product

(A)	Direct Cost	(B)	Indirect Cost

4. Degree of Relation with the Product

(A)	Product Cost	(B)	Period Cost

Cost Classification

5. Functional Classification of Cost

(A)	Manufacturing Cost	(B)	Selling and Distribution Cost
(c)	Administrative Cost		

6. Association with the Accounting Period

(A)	Capital Cost	(B)	Revenue Cost

7. Costs for Decision-Making and Planning

(A)	Opportunity Cost	(B)	Sunk Cost
(C)	Relevant Cost	(D)	Differential Cost
(E)	Imputed Cost/Notional Cost	(F)	Out-of-pocket Cost
(G)	Fixed, Variable and Mixed Cost	(H)	Shut Down Cost

8. Costs for Control

(A)	Controllable and Uncontrollable Cost	(B)	Standard Cost
(C)	Fixed, Variable and Mixed Cost		

9. Other Costs

(A)	Joint Cost	(B)	Common Cost

On basis of : Normal / Elements/ Relation with product

- A) Direct Material cost: Material means those items which are applied for manufacturing of a product and direct material is directly related to production.
- For example, raw cotton in textiles, crude oil to make diesel etc.
- There are so many names of direct materials such as process material, prime cost material, stores material and construction materials.

On basis of : Normal / Elements/ Relation with product

- Main points for direct material can be summarized as follows:
  - (1) Direct **material specially acquired for a particular Job**, order, process or product.
  - (2) It **is integrated part** of manufacturing unit.
  - (3) Value of **direct material is comparatively higher** than that of other materials.
  - (4) **Material passing** from one process to another process.
  - (5) **Primary packing materials** e.g. wrapping, cardboard boxes, the glass bottle in production of syrup etc
  - (6) It Increases in the same ratio as the increase in production

On basis of : Normal / Elements/ Relation with product

- **B)** Indirect Material Cost: In the words of **C.I.MA., London**, “indirect material cost is the material cost which cannot be allocated but which can be apportioned to or absorbed by cost centres or cost units”.
- Thus it may be said that indirect cost is the cost which cannot be directly identified to the unit of output or to the segment of a business activity e.g. oil, grease, consumable stores etc.

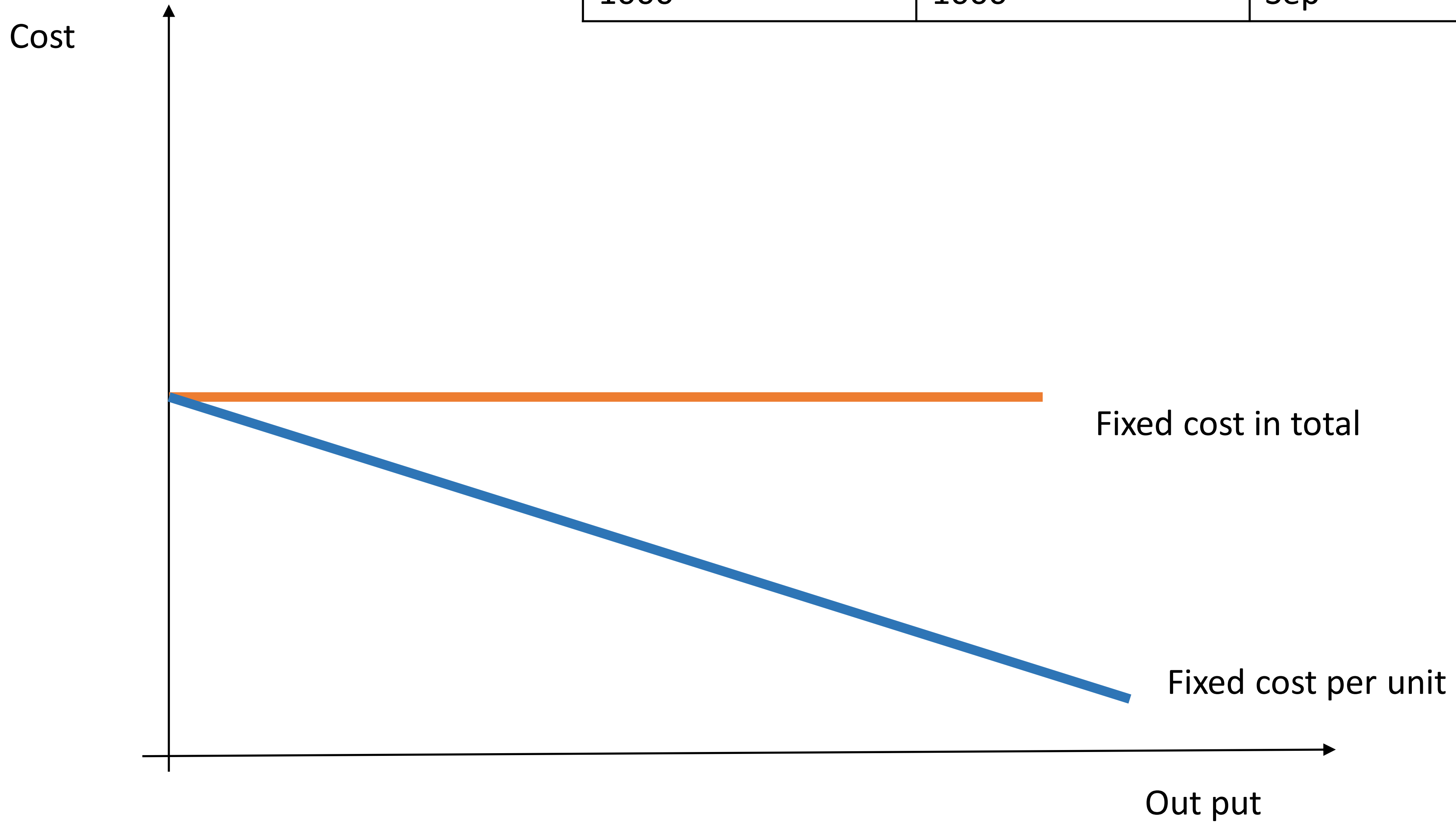
According to Variation in Production Activity and Quantity:

- Costs can be divided into (i) fixed, (ii) variable, and (iii) mixed costs, in terms of their changes in <u>cost behaviour in relation to variation in output</u>, or <u>activity or volume</u>.
- Activity can be expressed in any form such as units of output, hours worked, sales, etc.

According to Variation in Production Activity and Quantity:

- **Fixed Cost:** Fixed cost is a cost which does not vary in total for a given time period in spite of wide fluctuation in production or volume of activity.
- These costs are also termed as standby costs, capacity costs or period costs.
- **Few examples** explaining the nature of fixed costs are rent, property taxes, supervising salaries, depreciation on office facilities, advertising, Insurance, etc.
- Fixed costs are incurred with the passage of time and not with the production of the product or the job.
- Hence, fixed costs are defined in terms of time, such as per day, per month or per year and not in terms of unit (production).
- It is totally illogical to say that remuneration of supervisor in the form of salary and perquisites are so much per unit but, it can be said that supervisor's salary and perquisites are so much per month.

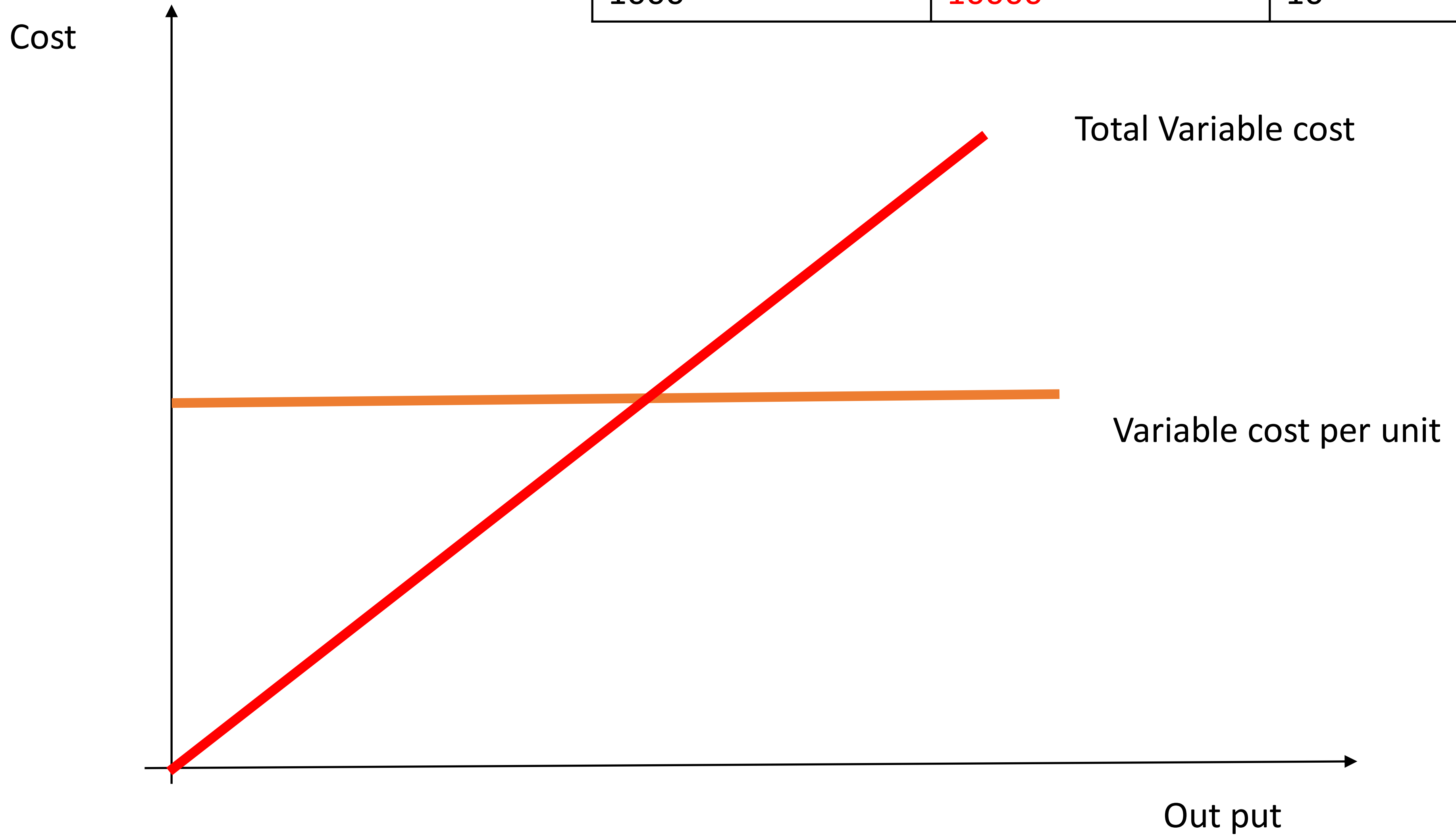
Out put	Rent Rs. 1000 total		Per unit
0	1000	June	1000/0=
100	1000	July	1000/100=10
200	1000	Aug	1000/200=5
1000	1000	Sep	1000/1000=1



According to Variation in Production Activity and Quantity:

- Variable Cost: Variable Cost is those costs that change directly and accordingly with the production.
- There is a fixed ratio between the variation in the cost and variation in the level of output.
- Direct materials cost and direct labour cost are the costs which are generally variable costs.
- For example, if direct material cost is Rs. 50 per unit, then for producing each extra unit, a direct material cost of Rs. 50 per unit will be incurred.
- That is, the total direct material cost increases in direct proportion to increase in units manufactured.
- However, it should be highlighted that it is only the total variable costs that vary as more units are produced; the per unit variable cost remains fixed.

Out put	Cost per Total cost	Per unit	
0	0	10	
100	1000	10	
200	2000	10	
1000	10000	10	



According to Variation in Production Activity and Quantity:

- Semi-variable/Fixed Cost (Mixed Cost): Mixed costs are costs made up of fixed and variable items.
- They are a combination of semi-variable costs and semi-fixed costs.
- Because of the variable element, they vary with volume; because of the fixed element, they do not fluctuate in direct proportion to output.
- Semi-fixed costs are those costs which remain fixed up to a certain level of production after which they become variable.

According to Variation in Production Activity and Quantity:

- **Step costs:** A step cost is fixed for a given amount of production and then rises in a constant amount at a higher production level.
- For example, in a manufacturing concern, one supervisor is needed at a salary of Rs 20,000 p.m. for every 50 workers.
- So long as 50 workers or less than that are working, the supervision costs will be Rs. 20,000 p.m.
- But, as soon as the 51st worker is employed, the cost of supervision rises by Rs. 20,000 p.m. and will be Rs. 40,000.
- Up to 100 workers the cost of supervision remains fixed at Rs. 40,000.
- But, if more than 100 workers are employed the cost of supervision will go up further. The following figure can be used to explain this concept :

According to Variation in Production Activity and Quantity:

- **Step costs:**

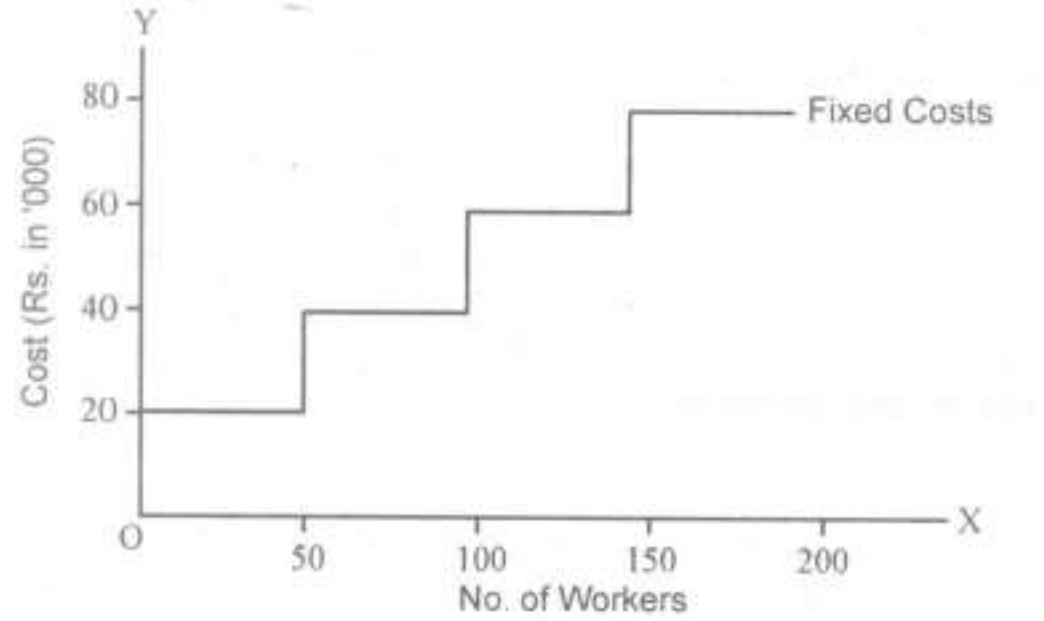


Figure : Step Cost

According to Functional Classification of Costs:

- **Functional classification** of costs defines how the cost was applied (manufacturing, administration or selling).
- A functional classification expresses that the business performs various functions for which costs are incurred.
- In measuring net income, expenses are usually classified by function and grouped under the headings of manufacture, selling and administrative costs.
- Manufacturing costs are all production cost incurred to manufacture the products and to bring them to a saleable condition, including direct materials, direct labour and indirect manufacturing (or factory overhead) costs.
- Office & administrative charges may be assumed as expenses when incurred or charged to prepaid expense accounts such as prepaid insurance.
- Selling
- Functional classification is also important because it gives an opportunity to the management to calculate the efficiency of departments performing various functions in the firm.

Other concepts

- **Opportunity Cost:** opportunity cost is the cost of opportunity lost. Opportunity cost is the cost of choosing one item of action in terms of the opportunities which are given up to carry out that course of action.
- **Sunk Cost:** Sunk cost is past or historical cost which has already been incurred. It may be known as unavoidable cost, it refers to all past costs since these amounts cannot be changed once the cost is incurred.
- **Relevant Cost:** Relevant costs are related to future, which differ between alternatives. Relevant costs may also be termed as the costs which are influenced and changed by a decision. On the other hand, irrelevant costs are not influenced by the decision, whatever alternative is selected.
- **Imputed Cost / Notional Costs:** Imputed costs are those costs which do not involve actual cash outlay. These costs are not actually incurred in some transaction but which are relevant to the decision as they pertain to a particular situation.
- **Shut Down Cost:** Shut down costs are those costs which have to be arise under all conditions in the case of stopping manufacture of a product or closing down a department or a division. Shut down costs are always fixed costs.

References

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