

COST CLASSIFICATION

THE NATURE, SOURCE AND PURPOSE OF MANAGEMENT INFORMATION

- Explain and illustrate production and non-production costs.
- Describe the different elements of non-production costs – administrative, selling, distribution and finance.
- Describe the different elements of production cost – material, labour and overheads.
- Explain the importance of the distinction between production and non-production costs when valuing output and inventories.
- Explain and illustrate with examples classifications used in the analysis of the product/service costs including by function, direct and indirect, fixed and variable, stepped fixed and semi-variable costs.

THE NATURE, SOURCE AND PURPOSE OF MANAGEMENT INFORMATION

- Explain and illustrate the use of codes in categorizing transaction.
- Explain and illustrate the concept of cost objects, cost units and cost centres.
- Distinguish between cost, profit, investment and revenue centres.
- Describe the differing needs for information of cost, profit, investment and revenue centre managers.

PRODUCTION AND NON PRODUCTION COST

Production Costs

- All costs related to the production process, which means costs incurred to produce goods or to produce services.
- It must be noted that production costs are not only related to manufacturing but they also exist in service businesses, as service business also produce, the produce services.
- Examples could be raw materials, salaries and wages of production staff, fuel or energy consumed in the production process, depreciation and insurance of production equipment.

Non Production Costs

- Costs which are not associated with the production process.
- Examples could be office salaries, sales, marketing, distribution, office utilities, transportation, depreciation and insurance of office equipment.

FIXED AND VARIABLE COST

- **Variable Cost** is a cost that changes with the level of activity

Examples could be raw materials, fuel, electricity and wages

- **Fixed Cost** is a cost that remain same for a certain level of activity

Examples could be office salaries, rent, insurance, depreciation etc.

DIRECT COSTS AND INDIRECT COSTS

- **Direct cost** is a cost that can be traced in full to the product, service or department that is being costed.
- An **indirect cost** (or **overhead**) is a cost that is incurred in the course of making a product, providing a service or running a department, but which cannot be traced directly and in full to the product, service or department

TOTAL COST

Total Cost = Production + Non Production Cost

Total Cost = Fixed + Variable Cost

Total Cost = Direct + Indirect Cost

TOTAL PRODUCT/SERVICE COSTS

- The total cost of making a product or providing a service consists of the following.
- (a) Cost of **materials**
- (b) Cost of the **wages** and **salaries** (labour costs)
- (c) Cost of **other expenses**
 - (i) Rent and rates
 - (ii) Electricity and gas bills
 - (iii) Depreciation

MATERIALS, LABOUR AND EXPENSES

- (a) **Direct material costs** are the costs of materials that are known to have been used in making and selling a product (or even providing a service).
- (b) **Direct labour costs** are the specific costs of the workforce used to make a product or provide a service. Direct labour costs are established by measuring the time taken for a job, or the time taken in 'direct production work'.
- (c) **Other direct expenses** are those expenses that have been incurred in full as a direct consequence of making a product, or providing a service, or running a department.

ANALYSIS OF TOTAL COST

Materials	=	Direct materials	+	Indirect materials
+		+		+
Labour	=	Direct labour	+	Indirect labour
+		+		+
<u>Expenses</u>	=	<u>Direct expenses</u>	+	<u>Indirect expenses</u>
Total cost	=	Direct cost	+	Overheads

DIRECT MATERIAL

- Direct material costs are charged to the product as part of the **prime cost**. Examples of direct material are as follows.
- (a) **Component parts**, specially purchased for a particular job, order or process
- (b) **Part-finished work** which is transferred from department 1 to department 2 becomes finished work of department 1 and a direct material cost in department 2
- (c) **Primary packing materials** like cartons and boxes

DIRECT LABOUR

- **Direct wages** are all wages paid for labour (either as basic hours or as overtime) expended on work on the product itself.
- **Direct wages** costs are charged to the product as part of the **prime cost**.
- Examples of groups of labour receiving payment as direct wages are as follows.
- Workers engaged in **altering** the condition or composition of the product
- Inspectors, analysts and testers **specifically required** for such production
- Foremen, shop clerks and anyone else whose wages are **specifically identified**

DIRECT EXPENSES

- **Direct expenses** are any expenses which are incurred on a specific product other than direct material cost and direct wages.
- **Direct expenses** are charged to the product as part of the **prime cost**. Examples of direct expenses are as follows.
- The **hire of tools** or equipment for a particular job
- **Maintenance costs** of tools, fixtures and so on
- Direct expenses are also referred to as **chargeable expenses**

PRODUCTION OVERHEAD

Production includes all indirect material costs, indirect wages and indirect expenses incurred in the factory from receipt of the order until its completion. Production overhead includes the following.

- (a) **Indirect materials** which cannot be traced in the finished product. Consumable stores, eg material used in negligible amounts
- (b) **Indirect wages**, meaning all wages not charged directly to a product. Wages of non-productive personnel in the production department, eg foremen
- (c) **Indirect expenses** (other than material and labour) not charged directly to production. Rent, rates and insurance of a factory, Depreciation, fuel, power, maintenance of plant, machinery and buildings

ADMINISTRATION OVERHEAD

- **Administration overhead** is all indirect material costs, wages and expenses incurred in the direction, control and administration of an undertaking.
- Examples of administration overhead are as follows.
- **Depreciation** of office buildings and equipment
- **Office salaries**, including salaries of directors, secretaries and accountants
- Rent, rates, insurance, lighting, cleaning, telephone charges and so on

SELLING OVERHEAD

- **Selling overhead** is all indirect materials costs, wages and expenses incurred in promoting sales and retaining customers.

Examples of selling overhead are as follows.

- **Printing** and **stationery**, such as catalogues and price lists
- **Salaries** and **commission** of salespeople, representatives and sales department staff
- **Advertising** and **sales promotion**, market research
- Rent, rates and insurance of sales offices and showrooms, bad debts and so on

DISTRIBUTION OVERHEAD

- **Distribution overhead** is all indirect material costs, wages and expenses incurred in making the packed product ready for dispatch and delivering it to the customer.

Examples of distribution overhead are as follows.

- Cost of packing cases
- Wages of packers, drivers and dispatch clerks
- Insurance charges, rent, rates, depreciation of warehouses and so on

FUNCTIONAL COSTS

- **Classification by function** involves classifying costs as production /manufacturing costs, administration costs or marketing/selling and distribution costs.

In a 'traditional' costing system for a manufacturing organisation, costs are classified as follows.

- (a) **Production or manufacturing costs.** These are costs associated with the factory.
- (b) **Administration costs.** These are costs associated with general office departments.
- (c) **Marketing, or selling and distribution costs.** These are costs associated with sales, marketing,

FULL COST OF SALES

Production costs

▪ Direct materials	A
▪ Direct wages	B
▪ Direct expenses	<u>C</u>
▪ Prime cost	A+B+C
▪ Production overheads	<u>D</u>
▪ Full factory cost	A+B+C+D
▪ Administration costs	E
▪ Selling and distribution costs	<u>F</u>
▪ Full cost of sales	A+B+C+D+E+F

FUNCTIONAL COSTS

- Production costs
- Administration costs
- Selling costs
- Distribution costs
- Research costs
- Financing costs

FIXED COSTS AND VARIABLE COSTS

- A different way of analysing and classifying costs is into **fixed costs** and **variable costs**. Many items of expenditure are part-fixed and part-variable and hence are termed **semi-fixed** or **semi- variable costs**
- A **fixed cost** is a cost which is incurred for a particular period of time and which, within certain activity levels, is unaffected by changes in the level of activity.
- A **variable cost** is a cost which tends to vary with the level of

EXAMPLES OF FIXED AND VARIABLE COSTS

- (a) Direct material costs are **variable costs** because they rise as more units of a product are manufactured.
- (b) Sales commission is often a fixed percentage of sales turnover, and so is a **variable cost** that varies with the level of sales.
- (c) Telephone call charges are likely to increase if the volume of business expands, but there is also a fixed element of line rental, and so they are a **semi-fixed** or **semi-variable overhead cost**.
- (d) The rental cost of business premises is a constant amount, at least within a stated time period, and so it is a **fixed cost**.

PRODUCTION AND NON-PRODUCTION COSTS

- The distinction between production and non-production costs is the basis of valuing inventory

COST CODES

COST UNITS, COST OBJECTS AND RESPONSIBILITY CENTRES

- **Cost centres** are collecting places for costs before they are further analysed. Costs are further analysed into cost units once they have been traced to cost centres.
- A **cost unit** is a unit of product or service to which costs can be related. The cost unit is the basic control unit for costing purposes
- A **cost object** is any activity for which a separate measurement of costs is desired.
- **Profit centres** are similar to cost centres but are accountable for both **costs** and **revenues**.

COST UNITS, COST OBJECTS AND RESPONSIBILITY CENTRES

- **Revenue centres** are similar to cost centres and profit centres but are accountable for **revenues only**. Revenue centre managers should normally have control over how revenues are raised.
- An **investment centre** is a profit centre with additional responsibilities for capital investment and possibly for financing, and whose performance is measured by its return on investment.
- A **responsibility centre** is a department or organisational function whose performance is the direct responsibility of a specific manager.