

Cost Classification

AAT Level II

AFC - Advanced Financial Accounting & Costing

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AAT 02

Advanced Financial Accounting and Costing

Cost Classification



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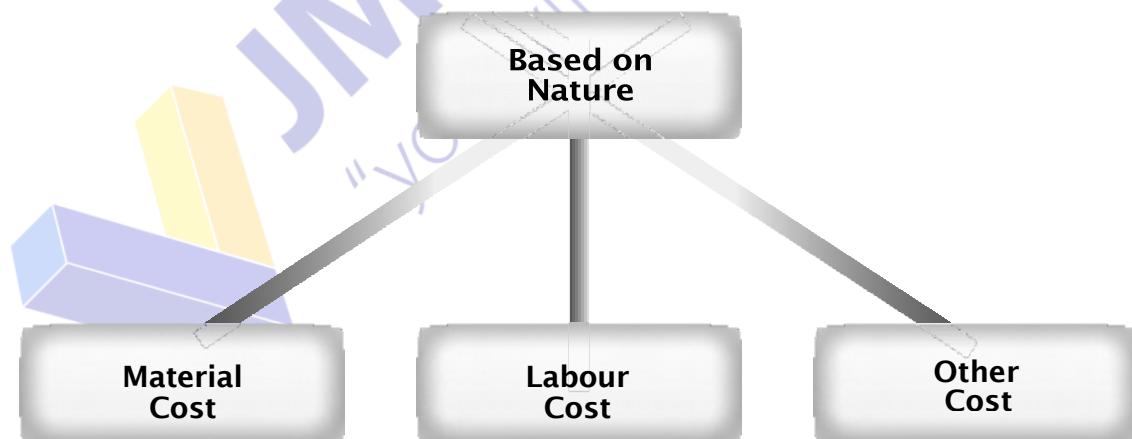
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2.1 Cost Categories

An organization can classify costs based on various classification bases depending on common characteristics and classification objectives.

Base	Classification
Based on Nature	<ul style="list-style-type: none"> • Material cost • Labour cost • Other costs
Based on Identifiability (traceability)	<ul style="list-style-type: none"> • Direct cost • Indirect cost
Based on Behaviour	<ul style="list-style-type: none"> • Variable cost • Fixed cost • Semi-variable cost (mixed)
For profit measurement and stock valuation	<ul style="list-style-type: none"> • Product cost • Periodic cost
Based on Function	<ul style="list-style-type: none"> • Manufacturing cost • Non-manufacturing cost
Based on controllability (for decision making)	<ul style="list-style-type: none"> • Controllable cost • Non-controllable cost
Based on relevance (for decision making)	<ul style="list-style-type: none"> • Relevant cost • Non-relevant (irrelevant) cost

2.1.1 Classification based on Nature



Materials: Material cost includes cost of tangible items that are used in production of goods and services. The costs of purchasing and holding is included in material cost.

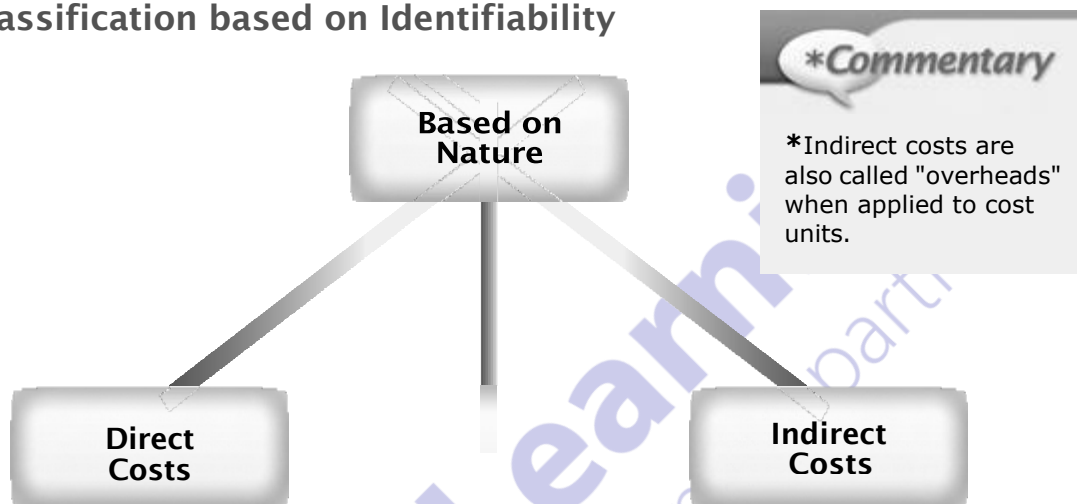
Ex – Raw Materials, Components, Consumables, Maintenance materials, packing materials

Labour: Labour cost will include the salaries and wages, overtime payments, bonus and incentives and all other benefits paid to labourers in an organization.

Other Cost: This includes all other costs and expenses that are incurred in a business that cannot be classified as material cost or labour cost.

Ex – Rent, Fuel, Depreciation etc...

2.1.2 Classification based on Identifiability



- **Direct materials** are those that vary directly with output (e.g. raw materials and components which will be found in the manufactured product).

- **Direct labour** will include the wages of labourers paid by the hour in the manufacture of output

- **Other Direct Expenses** may include payments such as royalties that are paid per output unit.

- **Indirect materials** will include "consumables" such as machine lubricants and cleaning fluids used in the production process to keep the machines operating.

- **Direct Indirect labour** would include the wages of supervisors and other factor related labourers those who are not directly engaged in production.

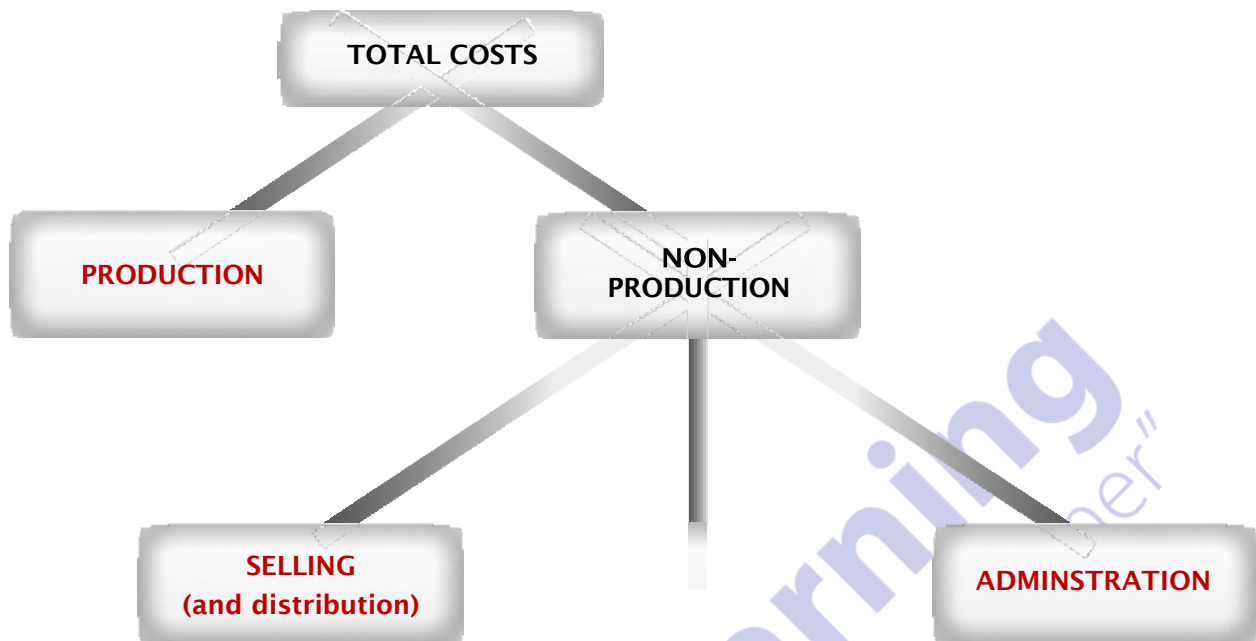
- **Other Indirect Expenses** may include payments such as rent, rates and depreciation.



Key Point

Units are valued to include both direct and indirect **production** costs only.

2.1.3 Classification based on Functions



This "**traditional**" classification is becoming less significant in modern costing (as entire business functions are more integrated).

Several of the non-production costs warrant further definition:

- **Selling:** costs incurred specifically in **making sales of** goods or services will include salaries and commissions of sales representatives, depreciation of the sales director's car, printing costs of product brochures, marketing campaigns, etc.
- **Distribution:** costs incurred in the **dispatch of goods to customers** include packaging, postage/couriering, depreciation of delivery vans, wages of drivers, etc.
- **Administrative:** these are **general costs** relating to the business as a whole rather than to individual functions. Examples include salaries of senior executives, accounting services (e.g. payroll), general office cleaning and maintenance, depreciation of computers used in accounting systems, etc.

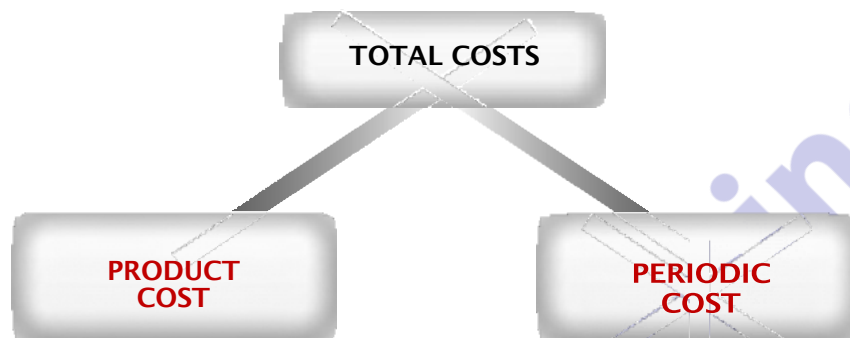
Key Point

Non-production costs are never included in the inventory value because they are not costs of making the product (but arise in converting finished goods into revenue).

2.1.4 Classification for profit measurement and stock valuation

For inventory valuation and profit measures it is necessary to distinguish between:

- **ASSET** (unexpired cost) → Statement of financial position;
- **EXPENSE** (expired cost) → Profit or loss (Statement of comprehensive income).



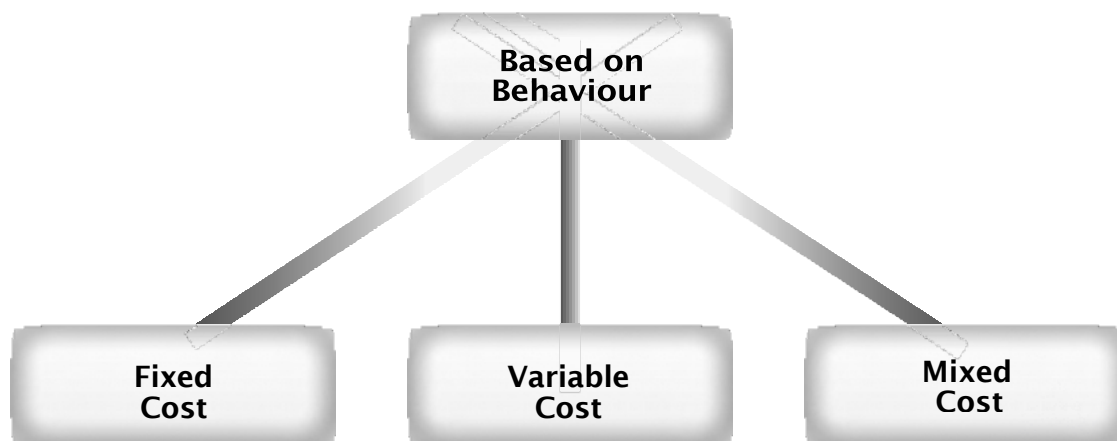
- **Identified** with goods purchased or manufactured for resale. *For example, direct material and direct labour costs*
- Also known as production cost
- All the costs involved in the manufacture of goods
- **Expensed** in the period in which they are incurred; therefore, not assigned to products for inventory valuation purposes

2.1.5 Classification based on behaviour

Costs also can be classified according to how they behave (are affected) as the level of output (activity level) changes.

Examples for level of output(activity):

- Number of units produced
- Value of items sold
- Number of items sold
- Number of invoices issued
- Number of units of electricity consumed



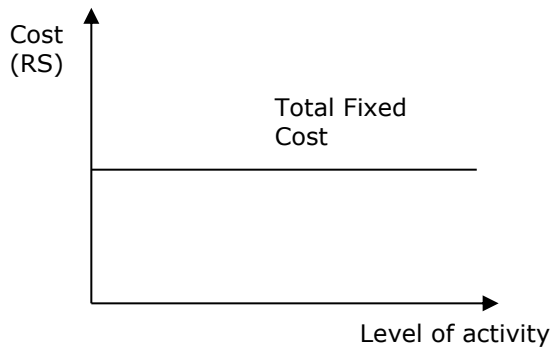
- Cost which is incurred for a particular **period of time** and which, **within certain activity levels**, is **unaffected by changes in the level of**
- Cost which **tends to vary with** the level of production activity

Examples of fixed cost and variable cost

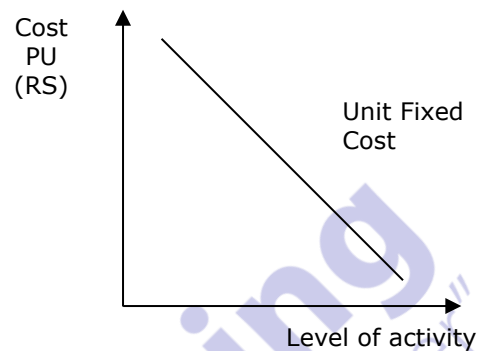
Example	Type	Reason
Direct material costs	Variable costs	Because they rise as more units are manufactured
Sales commission	Variable cost	Since varies with the level of sales.
Telephone call charges	Semi-fixed or semi-variable overhead cost	Increase if the volume of business expands but there is also a fixed element of line rental,
Rental cost of business premises	Fixed cost	Constant amount, at least within a stated time period

2.1.5.1 Fixed Costs

A fixed cost is a cost which tends to be unaffected by increases or decreases in the volume of output. Fixed costs are a period charge.



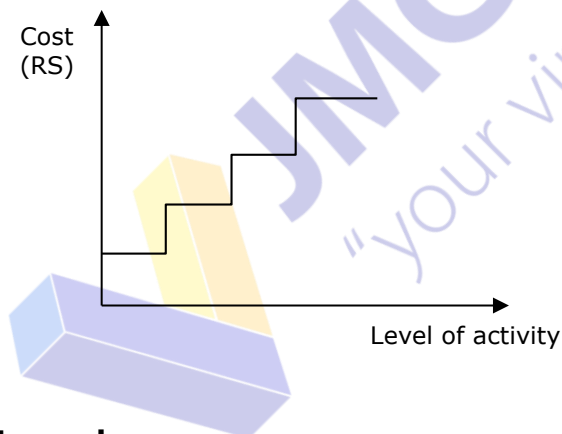
Total Fixed Cost Graph



Unit Fixed Cost Graph

2.1.5.2 Step Fixed Costs

Are fixed for a certain range of output, and then increase in a "step".

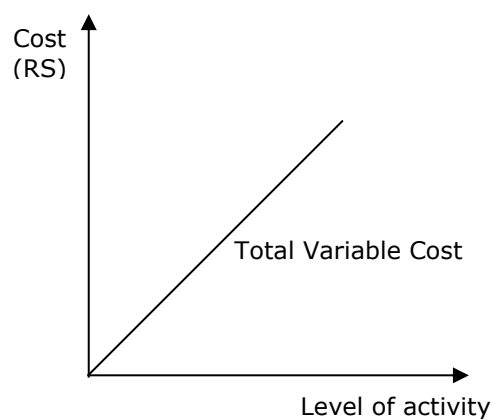


Examples

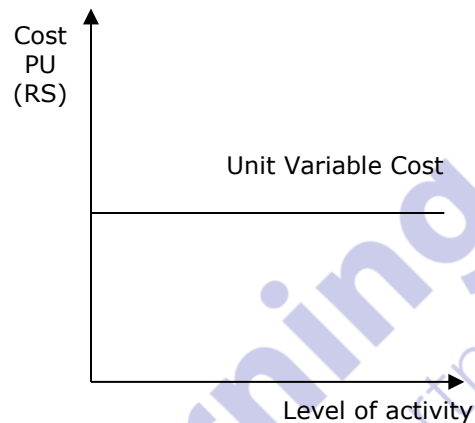
- Rent is a step fixed cost in situations where accommodation requirements increase as output levels get higher.
- Basic pay of employees is nowadays usually fixed, but as output rises, more employees are required.
- Royalties

2.1.5.3 Variable Costs

A variable cost is a cost which tends to vary directly (usually in same proportion) with the volume of output. The variable cost per unit is the same amount for each unit produced.



Total Variable Cost Graph



Unit Variable Cost Graph

2.1.5.4 Semi - Variable Costs (Mixed Costs)


A cost which contains both fixed and variable components and so is partly affected by changes in the level of activity

Example	Fixed Portion	Variable Portion
Electricity and gas bills	Standing charge	Charge per unit of electricity used
Salesperson's salary	Basic salary	Commission on sales made
Costs of running a car	Road tax, insurance	Petrol, oil, repairs

High-Low Analysis

- This is a technique for identifying the fixed and variable elements of a semi-variable cost so that more accurate predictions of costs can be made.
- It requires a range of data, collected over a period of time, which corresponds costs with different activity levels.

- Cost as a linear function of output will be of the form: $y = a + bx$ where:
 - "b" is the slope or gradient (i.e. variable cost per unit);
 - "a" is the intercept on the y axis (i.e. total fixed cost).
- The gradient is the amount by which y increases when x increases by 1:
- If the line slopes from top left to bottom right (y decreasing as x increases), the gradient is a negative number.
- The results can then be used for forecasting purposes

 **Key Point**

The costs for the highest and lowest **levels of activity** (output) are selected and a straight-line relationship between the two is assumed.

Example 1 - High-Low Analysis

Total costs have been recorded for a process for each of the last six months as follows:

Month	Output (units)	Total cost Rs.
1	4,500	33,750
2	3,500	30,500
3	5,100	34,130
4	6,200	38,600
5	5,700	38,000
6	4,100	31,900

Required:

- (a) Calculate variable cost per unit and total fixed cost using high-low analysis.
- (b) Predict total cost at the budgeted activity level for month 7 of 6,000 units.

2.1.6 Classification based on Controllability (For decision making)

A controllable cost is a cost which can be influenced by management decisions and actions and an uncontrollable cost is a cost which cannot be affected by management within a given time span.

Most variable costs within a department are thought to be controllable in the short term.

A cost which is not controllable by a junior manager might be controllable by a senior manager. A cost which is not controllable by a manager in one department may be controllable by a manager in another department. Some costs are non-controllable, such as increases in expenditure due to inflation

2.1.7 Classification based on Relevance (For decision making)

Relevant costs are future cash flows arising as a direct consequence of a decision. They have three significant characteristics.

- Relevant costs are **future costs**
- Relevant costs are **cash flows**
- Relevant costs are **incremental costs**

Examples for Relevant Costs:

- Avoidable costs
- Specific Fixed Costs
- Opportunity Costs

Non-relevant costs are costs which would not be incurred if the activity to which they relate did not exist;

Types of Non- relevant Costs

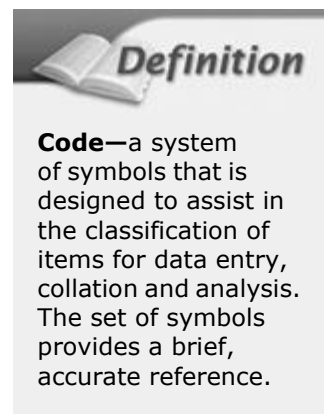
- Sunk cost
- Committed cost
- Non-cashflow cost
- Notional cost
- General fixed overhead

2.2 Coding of costs

2.2.1 Features of a good coding system

Good codes are:

- **Uniform** (i.e. presented in the same way). For example, writing a telephone number as 0208xxxxxxx or 020 8xxxxxxx, etc). Consistent



Definition

Code—a system of symbols that is designed to assist in the classification of items for data entry, collation and analysis. The set of symbols provides a brief, accurate reference.

presentation helps avoid confusion and standardises fields for data input.

- **Exhaustive** (i.e. take into account every possible item to be coded in the system).
- **Capable of simple expansion** (i.e. it should be possible to add blocks, facets or fields as an alternative to a complete overhaul). For example, when London telephone numbers "ran out" the pre-fix "01" was replaced with "020" followed by "7" for inside London and "8" for greater London. This was at huge expense to businesses.
- **Unique** (i.e. each code identifies only one item or characteristic).

