

COST CLASSIFICATION

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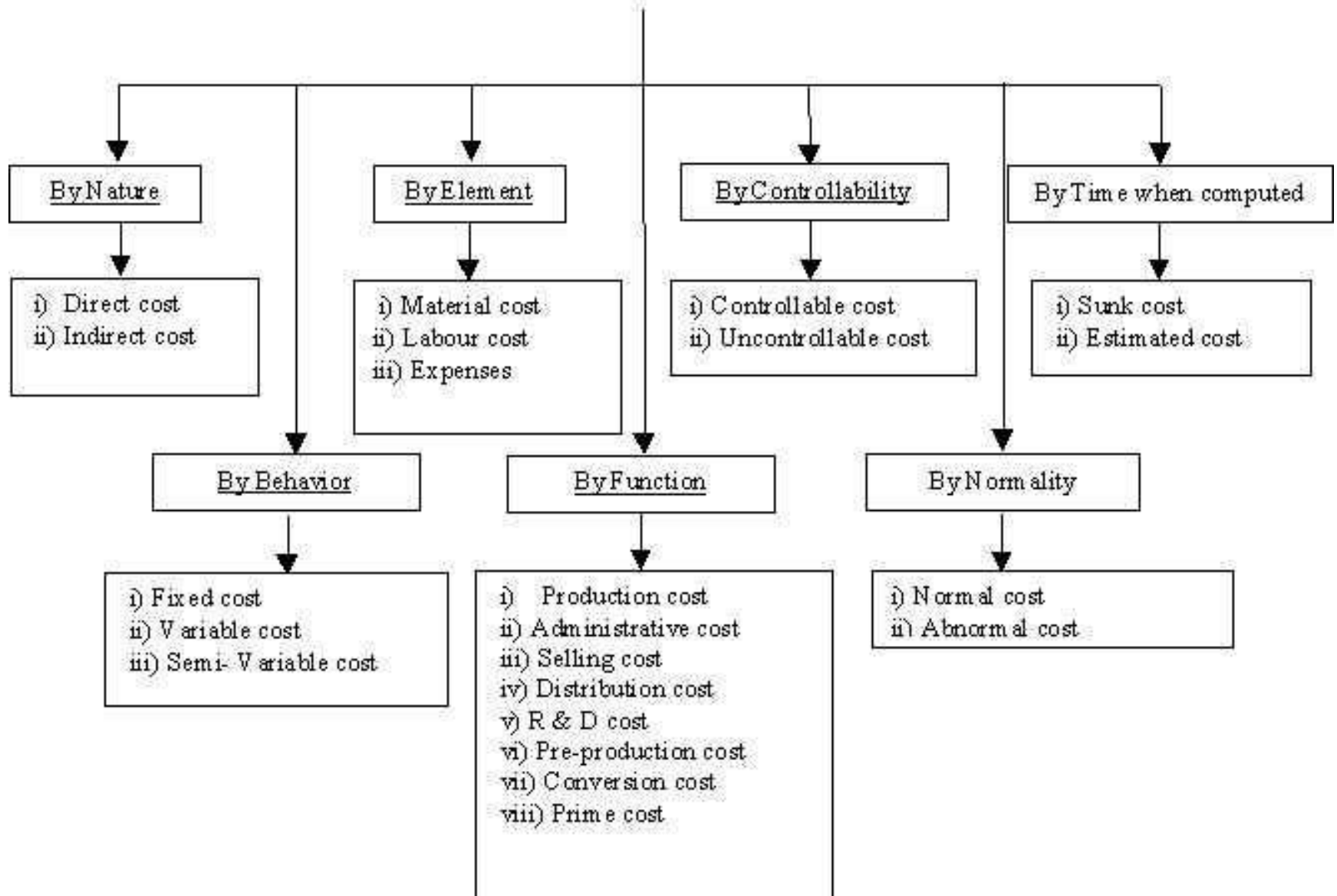
Cost classification is the process of grouping costs according to their common characteristics.

A suitable classification of costs is of vital importance in order to identify the cost with cost centers or cost units.

Cost may be classified according to their nature, i.e., Material, labor and expenses and a number of other characteristics.

The same cost figures are classified according to different ways of costing depending upon the purpose to be achieved and requirements of particular concern.

CLASSIFICATION OF COSTS



1. CLASSIFICATION ON THE BASIS OF ELEMENTS.

(A). MATERIAL:

Material is the most important element to produce a product. All most 50% of the cost is covered by raw material used to produce a product. Material is also called as tangible items used in production

e.g. Wood used for furniture, cotton for clothes etc.

MATERIAL CAN BE DIVIDED INTO TWO PARTS:

DIRECT MATERIAL:

Raw material that is consumed in the manufacturing process, physically incorporated in the finished product, and can be traced out to product conveniently and economically is called direct materials.

e.g. : Steel in Machines , Leather in Shoes , Cloth in garments etc.

INDIRECT MATERIAL:

It is that material which is required for production but do not become an integral part of production.

e.g. : lubricating oil, Gum, stationery etc.

(B). LABOUR

After raw material Labour is an important part of cost of a product. Labour plays an important role in conversion of raw material into finished product. The reward for the human efforts in the form of salaries and wages is calculated in the cost of a product.

LABOUR CAN BE DIVIDED INTO TWO PARTS.

DIRECT LABOUR:

Labour, which takes an active and direct part in the production, is called as direct labour.

E.G. : Wages of operator, labour , carpenter etc.

INDIRECT LABOUR:

The cost of human being who do not takes direct part in production but they help indirectly in production process called as indirect labour.

e.g. : wages of storekeeper, director's fee, salaries of salesman, clerk, peon etc.

(C) EXPENSES:

There are other so many expenses other than material and labour are there like factory rent, office rent etc.

EXPENSE CAN BE DIVIDED INTO TWO PARTS.

DIRECT EXPENSES:

These are the expenses, which are directly related to cost of the product such as hire of special machinery .

INDIRECT EXPENSES:

These expenses are not of direct in nature but without these expenses production cannot be completed.

e.g. : rent, insurance, advertising, lighting and power etc.

2. CLASSIFICATION OF COSTS ON THE BASIS OF THE PRODUCT

(A). DIRECT COST

The expenses incurred on materials and labour, which are easily and economically traceable to a product, service, or job are direct costs.

e.g. Direct material, direct labour and some expenses are included in direct expenses.

(B). INDIRECT COST

Indirect cost are those expenses, which are incurred on those items, which are not directly chargeable to cost of a product.

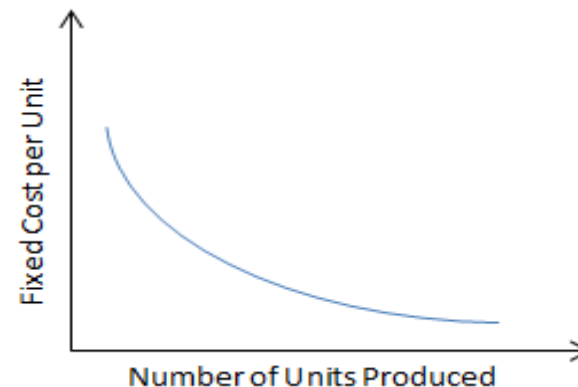
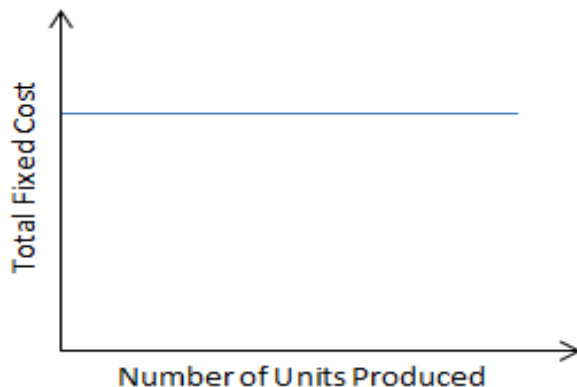
e.g. factory rent, lighting

3. CLASSIFICATION OF COST ON THE BASIS OF CHANGE IN THE LEVEL OF PRODUCTION

(A) FIXED COST

Fixed cost is the cost, which will remain same whether there is increase or decrease in size of production. Ex. Rent, insurance, salary etc. Will remain fixed at all levels of production. But it does not mean fixed cost remains fixed forever. It also changes after the specific level of production.

e.g. rent , managerial salaries, building of insurance etc.



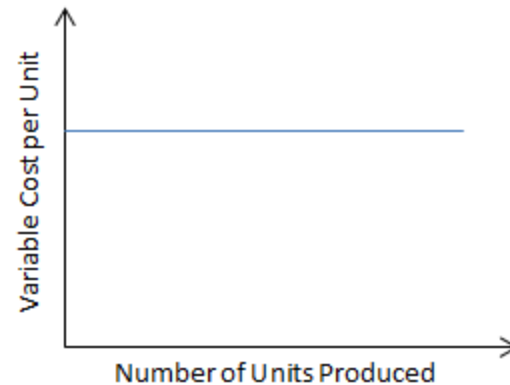
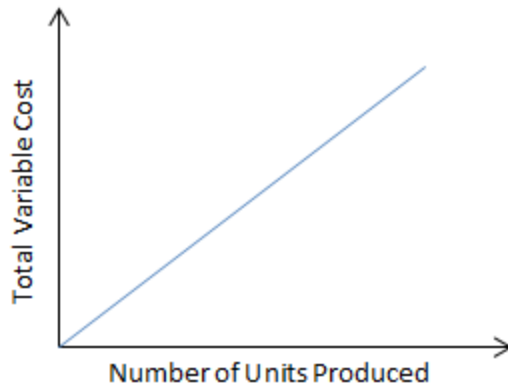
Example

No of units produced	Total Fixed cost (RS)	fixed cost per unit(RS)
1	20,000	20,000
2	20,000	10,000
20	20,000	1,000
200	20,000	100
2000	20,000	10

(B) VARIABLE COST

Variable cost is the cost, which varies with the level of production. Variable cost will increase with the increase in production level.

e.g. direct material, direct wages



Total units produced	Total VC (RS)	VC per Unit (RS)
1	10	10
2	20	10
20	200	10
200	2,000	10
2000	20,000	10

(C) SEMI-VARIABLE COST

This cost is partly fixed and partly variable in relation to the output.

e.g. telephone bill, electricity bill etc.

4. CLASSIFICATION OF COSTS ON THE BASIS OF FUNCTIONS

PRODUCTION COST

The production cost is the cost, which occurred on the conversion of raw material into finished product.

ADMINISTRATION COST

The cost of formulating the policies, directing organization, and controlling the operations of an undertaking, which is not related to direct cost.

SELLING COST

The cost incurred in promoting sales and retaining customers is called as selling cost. It also called as marketing cost of the company.

DISTRIBUTION COST

In the present era after production distribution is also very important task and the expenses incurred for distribution is called as distribution cost.

R&D COST

"Research cost" and "Development cost" are two different types of costs.

Research cost - is the cost of researching for new products, methods and applications.

Development cost - is the cost of the process which begins with the implementation of the decision to produce the new product or apply the new method and ends with the commencement of formal production of that product or by that method.

PRE-PRODUCTION COST

It is that part of the development cost which is incurred for the purpose of a trial run, before the commencement of formal production.

CONVERSION COST

It is the cost incurred for converting the raw material into finished product. It comprises of direct labour cost, direct expenses and factory overheads.

PRIME COST

Prime cost is the aggregate of direct material cost, direct labour cost and direct expenses. The term 'direct' indicates that the elements of cost are traceable to a particular unit of output.

5. CLASSIFICATION OF COSTS ON THE BASIS OF CONTROLLABILITY

CONTROLLABLE COST

These costs are those which can be influenced by the action of a specified member of a company. Controllable costs incurred in a particular responsibility center can be influenced by the actions of the executive head of that responsibility center.

For example, the supervisor of a production department can control the utilization of power or raw materials in his department. These are, therefore, controllable costs as far as he is concerned.

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UNCONTROLLABLE COST

- **These are the costs, which cannot be influenced by the action of a specified member of an undertaking. The difference in both the costs are not very clear, and sometimes it is left to individual judgment.**
- **For example, the supervisor of a production department can control the wastage of power in his department, but he cannot control the power, which is being wasted in other department.**
- **Similarly, he cannot control the increase in the cost of materials consumed in his department if the purchase department, which is the supplying department, buys the materials at higher prices.**
- **Such costs are controllable at a particular level of management while they are uncontrollable at some other level of management**

6. CLASSIFICATION OF COSTS ON THE BASIS OF TIME

SUNK COST

- **these are historical or past cost which have been incurred as a result of a decision-made in the past. Such costs cannot be reversed or revised by subsequent decisions.**
- **Investments in plant and machinery, building, etc. are some prominent examples of such costs.**

ESTIMATED COST

These are predetermined cost i.e. computed in advance of production, taking into consideration the previous periods costs and the factors affecting such cost.

7. CLASSIFICATION OF COSTS ON THE BASIS OF DECISION-MAKING

SHUT DOWN COST

- These are the fixed costs which have to be incurred even during the period when a factory is shut down on account of some temporary difficulties, viz., shortage of raw materials, non-availability of requisite labour force, etc.
- During this period, though no work is done, the fixed costs, such as rent, insurance, depreciation, maintenance, etc. for the entire plant have still to be incurred.
- Such costs of the idle plant are known as shut down costs

Differential, Incremental or Decremental Costs:

- The difference in total cost between two alternatives is termed as differential cost.
- In case the choice of an alternative results increase in the total cost, such increased costs are known as incremental costs.
- If the choice results decrease in total costs, the resulting decrease is known as decremental costs.

Opportunity costs

- An Opportunity cost refers to the advantage, in measurable terms, which has been foregone on account of not using the facilities in the manner originally planned.
- For example: If an own building is utilized for housing a new project, the likely revenue, which the building could fetch, if rented out, is the opportunity cost.
- It should be taken into account while evaluating the profitability of the project.

Traceable, Untraceable and Joint Costs

TRACEABLE COST

- These are costs, which can be easily identified or traced to specific products, services or units of the company such as raw material and labour, etc.

UNTRACEABLE COST

These are costs, which cannot be identified with a department, process or product. Such costs are also termed as common costs, as they are incurred collectively for a number of products or cost centers.

EX: Overheads incurred for the factory as a whole. As such they are apportioned among various products or cost centers using suitable criterion.

JOINT COST

- Whenever two or more products reproduced out of one and the same raw material or process, the cost of material purchased and the processing are called joint costs.
- Example:
- An oil refinery where a range of products such as petrol, Kerosene, diesel, etc. is derived in the process of refining crude oil.
- All these products have joint costs comprising the cost of crude and the cost incurred in the course of refining. These joint costs are then apportioned to various products on some basis.

- The above classification concepts of costs help the management in the decision making process. For example, segregation of cost into fixed and variable elements will help the management in analyzing the total cost.
- Similarly, segregation of cost into controllable and uncontrollable categories will help the management in fixing responsibilities of different executives for unfavorable cost variances.