

CLASSIFICATION OF COST

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Classification of Costs on The Basis of Their Common Characteristics are:

- By Nature or Elements**
- By Functions**
- By Identifiably**
- By Variability**
- By Controllability**
- By Normality**
- Other Costs**

1. BY NATURE OR ELEMENT

- ▶ **MATERIAL: COST** Cost of materials used for the manufacture of a product, a particular work order, or provision of a service.
Example: Cloth for making a dress, stores used for maintaining machines and buildings such as lubricants, cotton waste, bricks etc.
- ▶ **LABOUR COST:** Labour cost is defined as the total Expenditure borne by employers in order to employ workers. Labour costs include the direct costs linked to remuneration for work carried out such as direct remuneration, bonuses and ex gratia payments not paid at each pay period, payments for days not worked, severance pay, benefits in kind. They also include indirect costs linked to employees, independently of the remuneration paid by the employer, such as direct social benefits, vocational training
- ▶ **EXPENSES:** Expense is defined as money expended or cost incurred in a firm's efforts to generate revenue, representing cost of doing business. They may be in the form of actual cash payments (such as wages and salaries), a computed 'expired' portion (depreciation) of an asset, or an amount taken out of the firm's earnings (such as bad debts).
Whereas all expenses are costs, not all costs (such as those incurred in acquisition of income generating assets) are expenses.

By Functions

PRODUCTION COST: The cost of the sequence of operations which begins with supplying materials, labour and services and ends with primary packing of the product. Thus it includes the cost of direct materials, direct labour, direct expenses and factory overheads.

- **SELLING COST:** The cost seeking to create and stimulate demand (sometimes termed 'marketing') and of securing orders.
- **DISTRIBUTION COST:** The cost of the sequence of operations which begins with making the packed product available for dispatch and ends with making the reconditioned returned empty package, if any available for re-use.
It also includes expenditure incurred in transporting articles to central or local storage as well as in moving articles to and from prospective customers as in case of goods on sale or return basis. In gas, electricity and water industry distribution means pipes, mains and services which may be regarded as the equivalent of packing and transportation.
- **ADMINISTRATIVE COST:** The Cost of formulating the policy, directing the organization and controlling the operations of an undertaking which is not related directly to a production, selling and distribution, research or development activity or function.
- **RESEARCH COST:** The cost of researching for new or improved products, new applications of materials, or improved methods.
- **DEVELOPMENT COST:** The cost of the process which begins with the implementation of a decision to produce a new or improved product or to employ a new or improved method and ends with commencement of formal production of that product or by that method.
- **PRE-PRODUCTION COST:** The part of development cost incurred in making a trial production run preliminary to formal product.
- This term is sometimes used to cover all activities prior to production including Research & Development, but in such cases the usage should be made clear in the context
- **CONVERSION COST:** The sum of direct wages, direct expenses and overhead cost of converting raw materials to the finished stage or converting a material from one stage of production to the next.
In some cases this also includes any excess material cost or loss of material incurred at the particular stage of production.
- **PRODUCT COST:** These are inventoriable cost. These are the costs which are assigned to the product. Under marginal costing variable manufacturing cost and under absorption costing, total manufacturing cost constitutes product cost.



By Identifiably

- **DIRECT COST:** The expenses on material and labour economically and easily traceable to a product, service or job are considered as direct costs. In the process of manufacture or production of articles, materials are purchased, labourers are employed and the wages are paid to them, certain other expenses are also incurred directly. Since all these take an active and direct part in the manufacture of a particular commodity, hence are called direct costs.

Example: Cost of meat in a burger

- **INDIRECT COST:** The expenses incurred on those items which are not directly chargeable to production are known as indirect costs. **Example:** In production, salaries of timekeepers, storekeepers, foremen are paid, certain expenses for running the administration are incurred. All of these cannot be conveniently allocated to production and hence are called indirect costs

By Variability

- **FIXED COST:** The cost which does not vary but remains constant within a given period of time and range of activity in spite of the fluctuations in production, is known as fixed cost. Example: rent, insurance of factory buildings etc. remain the same for different levels of production.
- **VARIABLE COST:** These costs tend to vary with the volume of output. Any increase in the volume of production results in an increase in the variable cost and vice versa.

Example: cost of material, cost of labour etc.

- **Semi-variable Cost:** The cost which does not vary proportionately but simultaneously cannot remain stationary at all times is known as semi variable cost. It can also be called as semi-fixed cost.
- **Example:** Depreciation, repairs etc.
- **STEP COSTS:** Fixed cost can be further classified into committed fixed costs and discretionary fixed costs.
 - Committed fixed costs are unavoidable in the short term if the organization has to function. Examples are depreciation, rent, pay etc,
 - Discretionary fixed costs are those which are set at a fixed amount for specific time periods by management . Examples are research and development costs, advertisement and market research expenses
- Certain costs remain fixed over a range of activity and then jump to a new level as activity changes. Such costs are treated as “Step Costs”.
- **Example:** A foreman is in a position to supervise a given number of employees. Beyond this number it will be necessary to hire a second then a third and so on.



By Controllability

➤ **CONTROLLABLE COSTS:** These are the costs which can be influenced by the action of a specified member of an undertaking. A business organization is usually divided into a number of responsibility centres and each centre is headed by an executive. The executive can thus control the costs incurred in that particular responsibility centre.

➤ **UNCONTROLLABLE COSTS:** Costs which cannot be influenced by the action of a specified member of an undertaking.

Example: Expenditure incurred by the tool room is controllable by the foreman in charge of that section but the share of the tool room expenditure which is apportioned to a machine shop is not to be controlled by the machine shop foreman.



By Normality

- **NORMAL COSTS:** It is the cost which is normally incurred at a given level of output under the conditions in which that level of output is normally attained.
- **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. This is charged to Costing P&L A/c



Other Cost

- **Product Costs and Period Costs**
- **Decision making Costs and Accounting Costs**
- **Relevant and Irrelevant Costs**
- **Shutdown and Sunk Costs**
- **Avoidable / Escapable and Unavoidable / Inescapable**
- **Imputed or Hypothetical Costs**
- **Differential, Incremental or Decremental Cost**
- **Out of Pocket Costs**
- **Opportunity Cost**
- **Traceable, Untraceable Costs**
- **Joint Costs and Common Costs**

- **PRODUCT COSTS:** Costs which become part of the cost of the product rather than an expense of the period in which they are incurred are called as “Product Costs”. In financial statements such costs are treated as assets until the goods they are assigned to are sold. They become an expense at that time. These costs may be fixed as well as variable.

Example: Cost of raw materials and direct wages, depreciation on plant & equipment etc.

- **PERIOD COSTS:** Costs which are not associated with production are called “Period Costs”. They are treated as an expense of the period in which they are incurred. They may also be fixed as well as variable. Such costs include General Administration costs, Salesman salaries and commission, depreciation on office facilities etc. They are charged against the revenue of the relevant period.
- **DECISION MAKING COSTS:** These are special purpose costs that are applicable only in the situation in which they are compiled. They have no universal application. They need not tie into routine financial accounts. They do not and should not conform to the accounting rules.
- **ACCOUNTING COSTS:** These costs are compiled primarily from financial statements. They have to be altered before they can be used for decision making. Moreover they are historical costs and show what has happened under an existing set of circumstances, while decision making costs are future costs.

Example: Accounting costs may show the cost of the product when the operations are manual, while decision making costs might be calculated to show the costs when the operations are mechanised.

- **RELEVANT & IRRELEVANT COST:** Relevant costs are those costs which would be changed by the managerial decision, while irrelevant costs are those which would not be affected by the decision.

Example: If a manufacturer is considering closing down of an unprofitable retail sales shop, wages payable to the workers of the shop are relevant in this connection since they will disappear on closing down of the shop. But prepaid rent for the shop or unrecovered costs of any equipment which will have to be scrapped, will be irrelevant costs which must be ignored.

- **SHUTDOWN COSTS:** A manufacturer or an organization rendering service may have to suspend its operations for a period on account of some temporary difficulties such as shortage of raw materials, non availability of labour etc. During this period though no work is done yet certain fixed costs such as rent and insurance of buildings, depreciation etc. for the entire plant will have to be incurred. Such costs of the idle plant are known as shut down costs.
- **SUNK COSTS:** These are costs which have been created by a decision that was made in the past that cannot be changed by any decision that will be made in the future. Investment in plant & machinery are prime examples of such costs. Since sunk costs cannot be altered by later decisions, they are irrelevant for decision making.

➤ **IMPUTED OR HYPOTHETICAL COSTS:** These are costs which do not involve any cash outlay. They are not included in cost accounts but are important for taking into consideration while making management decisions.

Examples: Interest on internally generated funds, salaries of the proprietor or partner of a partnership firm, rented value of company's own property etc. When two projects require unequal outlays of cash, the management must take into consideration interest on capital for judging the relative profitability of the projects though the company may use internally generated funds for the purpose.

➤ **DIFFERENTIAL COSTS:** The difference in total costs between two alternatives is termed as 'differential costs'. In case the choice of an alternative results in increase in total costs, such increase in costs is known as 'incremental costs.' In case the choice results in decrease in total costs, such decrease in total costs is termed as 'decremental costs'. While assessing the profitability of a proposed change the incremental costs are matched with incremental revenue and vice versa. The proposed change is taken only when it is profitable.

➤ **OUT-OF-POCKET COST:** This means the present or future cash expenditure regarding a certain decision which varies depending upon the nature of decision made.

Example: A company has its own trucks for transporting raw materials and finished products from one place to another. It seeks to replace these trucks by employment of public carrier of goods. In making this decision of course, the depreciation of the trucks is not to be considered, but the management must take into account the present expenditure on fuel, salary to drivers and maintenance. Such costs are termed as out-of-pocket expenses.

➤ **OPPORTUNITY COST:** This cost refers to the advantage, in measurable terms, which has been foregone on account of not using the facilities in the manner originally planned.

Example: If an owned building is proposed to be utilized for housing a new project plant, the likely revenue which the building could fetch if rented out is the opportunity cost which should be taken into account while evaluating the profitability of the

➤ **TRACEABLE OR UNTRACEABLE COSTS:** Costs which can be easily identified with a department, process or product are termed as traceable costs. Example: the cost of direct material, direct labour etc. Costs which cannot be so identified are termed as untraceable or common costs.

➤ In other words common costs are costs incurred collectively for a number of cost centres and are to be suitably apportioned for determining the cost of individual cost centres. Example: overheads incurred for a factory as a whole etc.

➤ **JOINT COSTS:** These are a sort of common costs. When two or more products are produced out of one and the same material or process, the costs of such material or process are called joint costs.

Example: When cotton seeds and cotton fibre are produced from the same raw materials, the cost incurred till split off or separation point will be joint costs.

➤ **COMMON COSTS:** Common costs are those which are incurred for more than one product, job, territory or any other specific costing unit. They are not capable of being identified with individual product, and are therefore apportioned on a suitable basis.

Example: Rent, lighting and supervision costs are common costs to all departments located in the factory.



THANKS