

Topic 2. Cost classifications, concepts and uses

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1. Using different costs for different purpose

Expenses are the economic benefits decreasing or liabilities increasing cause decreasing own capital with the exception of the capital decreasing as a result of impressments distribution by owners.

Managerial accountants use several modifiers to identify specific meanings of cost because they are concerned about how one definition of cost is suitable for a given purpose while another is meaningless. Examples include product cost, period cost. direct cost, indirect cost, variable cost, fixed cost, controllable cost, uncontrollable cost, relevant cost, and irrelevant cost. Before we can choose meaningfully from the different types of cost, we have to identify the purpose for which we want the information.

The important point is that different costs will be applicable for different purposes. The same principle applies lo business decisions because managers must evaluate the purpose for which they want cost information before they can choose the correct type of cost.

2. Comparing business organizations

Types of business organizations

Cost information must be developed in all three types of business organizations - service, merchandising, and manufacturing. The kinds of costs incurred and the way the costs are classified will depend somewhat on the type of organization involved. Consequently, we need to consider the basic nature of each of the three types of organizations before continuing our discussion of cost information.

Service organizations

Service organizations provide services rather than products for their customers or clients. Examples of these services include accounting, health care, consulting legal, hair styling, travel, entertainment, postal, freight hauling, and recreation. Two fundamental accounting considerations for service organizations are: (1) the relatively high cost of labor and (2) the absence of inventories that are sold. Success in a service business is highly dependent on the quality of the services performed, so the expertise and talents of the people involved are important.

Merchandising organizations

Merchandising firms such as department stores, computer stores, clothing stores, sporting goods stores, supermarkets, and drugstores purchase the merchandise they sell to customers. These businesses are called retailing operations since they sell directly to the public. Other merchandisers operate as wholesalers because they only sell to retail outlets. Inventory usually represents the largest cost item for a merchandising operation and is often 60 to 70% of sales dollars. In contrast, the amount of labor involved is significantly less than that needed by a service firm.

Manufacturing organizations

Manufacturing firms produce the products purchased by retailers and wholesalers. Some manufacturers also sell directly to the public. Manufacturers purchase raw materials and convert them into the finished products that are sold. Value is added as a result of the production operation. Examples of products produced by manufacturing organizations include automobiles, computers, jewelry, clothing, building materials, chemicals, furniture, appliances, and electronic equipment.

3. Comparing product cost and period costs

The terms "product cost" and "period cost" (also called inventoriable cost and noninventoriable cost) are important in the development of an income statement. A proper determining of revenues and expenses must be based on a well-defined distinction between the product and period costs. The period in which the benefit of any cost is received is the period in which the cost should be deducted as an expense.

Period costs are the selling and administrative expenses charged to the period in which they are incurred. Examples are the sales manager's salary and depreciation on the company manager's automobile.

Period costs are identified with a specific time interval since they are not required to have a salable product.

Product costs are the costs assigned to the output of products. The direct materials, direct labor, and manufacturing overhead incurred to produce are treated as product costs.

Product costs for a merchandising firm consist only of its purchase costs because the inventory purchased is ready for resale.

In a manufacturing firm, all manufacturing cost elements that are needed to produce a salable product are treated as product costs.

4. Comparing direct costs and indirect costs

Direct costs and direct costs must be related to some cost objective to be useful to management. A cost objective is defined as any activity for which separate cost measurement is performed. For inventory valuation in a manufacturing firm, the cost objective is the product or products being produced.

They are important to us now because they provide the basis for classifying and accounting for manufacturing costs. Direct costs are treated one way, indirect costs another. A direct cost can be traced to a specific cost objective because it is incurred solely, for the benefit of the single cost objective. In contrast, an indirect cost is incurred for multiple cost objectives, so it is a common cost.

Since an indirect cost cannot be traced to individual cost objectives, it can be assigned to them only on some allocation basis. This means that the indirect costs are apportioned among the various cost objectives that jointly benefit from the costs. For example, the rent on a building occupied by several departments is often allocated to the departments on the basis of relative square footage used. For product costing in a manufacturing firm, those costs that are easily identified as being part of the product are classified as direct costs. All other manufacturing costs are indirect or common for the products produced. We should also point out that cost items classified as being either direct or indirect are the same ones separated as product or period costs, but simply considered in a different way.

Direct costs are the costs traceable to a specific cost objective.

Indirect costs are incurred for more than one cost objective so they are common costs.

5. Manufacturing cost elements.

Manufacturing cost elements.

Manufacturing firms need five manufacturing cost elements to produce finished products during the production operation.

Material costs - the raw materials directly traceable as an integral part of a finished product are called direct materials. The aluminum used for an automobile, the crude oil used for gasoline, the steel used for a golf club are some examples of direct materials.

Labor costs - compensation paid to employees whose time and effort can be traced to the products is classified as direct labor. As long as the employees perform tasks that can be identified specifically with the conversion of raw materials to finished goods, the labor is a direct cost. Examples are the wages paid to welders on an automobile assembly line. Other labor is required to support the production process but will not be traceable to finished products. Wages or salaries paid to janitors, maintenance people, production supervisors,, cafeteria workers, medical staff, and materials handlers are classified as indirect labor and included in manufacturing overhead. The combination of direct materials and direct labor is referred to as prime costs because these costs are such an integral part of the total product costs.

Allocation to the social funds include allocation to the pension fund, fund of the social insurance, fund of the social insurance on the case of unemployment, fund of the social insurance of accidents and occupational diseases

Amortization include the sum of amortization accrual of fixed assets, intangible assets and other non-negotiable material assets.

Other operating costs include expenses of operating activity that are not reflected in other elements particularly travel expenses, communication service, cash service.

6. Three types of inventories for a manufacturing firm

There are three types of inventory for a manufacturing firm:

Raw materials — The costs of the basic materials and parts that have been purchased and are available for future conversion into salable products of a different form are classified as raw materials. Examples include the plastic, steel, and electronic components used to manufacture microcomputers.

Work in process — Inventory that is partially finished but requires further processing before it can be sold is called work in process inventory. All the microcomputers placed into production on an assembly line but unfinished at the end of an accounting period are treated as work in process inventory.

Finished goods — The total cost assigned during the production operation to all products fully manufactured and ready for sale is classified as finished goods inventory. The microcomputers that have been completed and are ready for delivery to retail stores are identified as finished goods inventory.

7. Importance of JIT inventory systems

Many firms with repetitive manufacturing operations have adopted just in time (JIT) inventory systems to minimize the costs of holding inventory and, at the same time, improve the quality of their products. The ultimate goal with a JIT inventory system is to operate with zero (minimum or without) inventories. Attempting to produce with the lowest amount of inventory possible can result in significant savings for a business.

When a JIT inventory system is used, finished goods inventory is produced for specific orders and shipped to customers immediately upon completion. Work in process inventory is only started when its completion is required to replace a product that has been finished. In turn, raw materials are received from suppliers just as they are needed for production. The result is a constant-flow manufacturing process in which the rate of production is dictated by the needs of the final phase and work is only performed at each stage of the operation when the next stage needs it. Inventories minimizing is reducing the investment of funds required, storage space needed, time involved with handling the goods, and obsolescence costs.

8. Use of other cost classifications

Managers also require other cost information to plan and control operations as well as to make decisions. Among the additional important cost classifications used in the management process are variable and fixed, controllable and uncontrollable, and relevant and irrelevant.

Variable and fixed costs

Managers often must evaluate the effect of changes in sales or production volume on the profits of the firm. To do so, the managers must be able to use of other predict what will happen to costs when the level of business activity changes.

Variable Cost

A variable cost fluctuates in total amount proportionately with some measure of business activity such as units produced or direct labor hours worked. Direct materials cost, direct labor cost, and certain manufacturing overhead items such as equipment repairs are typically variable costs. For example, if 0,2 m³ of plank are used to produce a chair, the total cost of the of planks increases and decreases proportionately with the number of chairs produced.

Fixed Cost

A fixed cost remains constant in total amount over a wide range of business activity for a given period. A fixed cost is the same regardless of the items amount produced. Many of the overhead items are fixed costs. Examples are depreciation, rent, property taxes, and supervisory salaries. As manufacturing operations become more and more automated, including using robots instead of labor, their cost structures are increasingly fixed because of high depreciation charges.

Controllable and uncontrollable costs

Controllable costs can be regulated or influenced at a given level of management during a specific time period. The manager of the machine-shop would be responsible for the direct materials and direct labor used in her department because both items are controllable.

Uncontrollable costs cannot be regulated or influenced at a given level of management during a specific time period. The depreciation of machine-shop building is uncontrollable by the manager of the machine-shop.

For example, consider the workshop with tables and chairs production. The workshop superintendent can influence the joiner' (labor by controlling such factors as efficiency, idle time, overtime, the number of employees, and work scheduling. Consequently, the related labor cost is controllable by the workshop superintendent. However, the rent paid on the building occupied by the entire firm is uncontrollable by the workshop superintendent. As such, the workshop superintendent should not be held responsible for the amount of rent expense charged to his department.

Relevant and irrelevant cost

Relevance is one of the most important qualities of good managerial accounting information. If we extend this concept to the subject of cost, we will find relevance to be very useful for managerial decision making. A relevant cost is a future expected cost that will differ depending on the alternative selected in a specific situation. Because of the difference, it will have a bearing on the decision, whereas an irrelevant cost will not since it will be the same for all alternatives.

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Relevant costs are future expected costs that will differ in a decision depending on the alternative selected. For example, if two new combine harvesters are being evaluated and the operating/running costs for each machine is significantly different, that cost is relevant.

Irrelevant costs are the same regardless of the alternative chosen in a given decision. If the two new combine harvesters above require the same operating/running costs, the cost of thread is irrelevant.

9. Significance of the cost classification

The many different types of costs must be understood by managers so they can select the correct ones for different situations. The theme "different costs for different purposes" is a fundamental part of managerial accounting. This theme means that the purpose for which we want the cost information must be identified carefully before we select from the many types of costs. Examples of cost classifications are product cost, period cost, direct cost, indirect cost, variable cost, fixed cost, controllable cost, uncontrollable cost, relevant cost, and irrelevant cost. Most of the different types of costs are applicable in all forms of business-manufacturing, merchandising, and service.



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