Lesson 2:

Introduction to Cost Accounting & Elements of Cost

2.1 Introduction

This lesson introduces the element of cost in management accounting. Costs are classified as either direct or indirect with respect to the cost object. Direct cost is a cost that can be traced to the cost objects. On the other hand, indirect cost is a cost that relates to the cost object but cannot be traced to the cost object.

2.2 Learning Outcomes

Upon completion this lesson, you should be able to:

- describe the cost and classification of cost in order to provide various types of cost information; and
- apply cost collection methods to determine at product cost

2.3 Required Readings

Drury, Chapter 2

2.4 Points to Ponder/Takeaways

Direct Costs	Costs that are easily traced to the cost object. Total direct cost is known as prime cost
Indirect Costs .	Costs that are not easily or conveniently traced to the cost object.
Fixed Cost	Costs which remain constant in total, regardless of changes in the level of activity. Unit fixed costs vary inversely with changes in activity level.
Variable Cost	Costs which vary, in total, in direct proportion to changes in the level of activity.

2.5 Learning Material

1.Cost Objects

• A cost object is any activity for which a separate measurement of cost is required (e.g.cost of making a product or providing a service).

• A cost collection system normally accounts for costs in two broad stages:

Accumulates costs by classifying them into certain categories (e.g. labour, materials and overheads).

Assigns costs to cost objects.

2.Direct and indirect costs

• Direct costs can be specifically and exclusively identified with a given cost object.

• Indirect costs cannot be specifically and exclusively identified with a given cost object.

• Indirect costs (i.e. overheads)are assigned to cost objects on the basis of cost allocations.

• Cost allocations = process of assigning costs to cost objects

that involve the use of surrogate, rather than direct measures.

• The distinction between direct and indirect costs depends on what is identified as the cost object.

2.1. Categories of Manufacturing Costs

• Traditional cost systems accumulate product costs as follows:

Direct materials	xxx
Direct labour	xxx
Prime cost	xxx
Manufacturing overhead	xxx
Total manufacturing cost	xxx
Non-manufacturing overheads xxx	
Total cost	**xxx**

3. Period and product costs

• Product costs are those that are attached to the products and included in the stock (inventory valuation).

• Period costs are not attached to the product and included in the inventory valuation.

Example

Product costs = £100,000

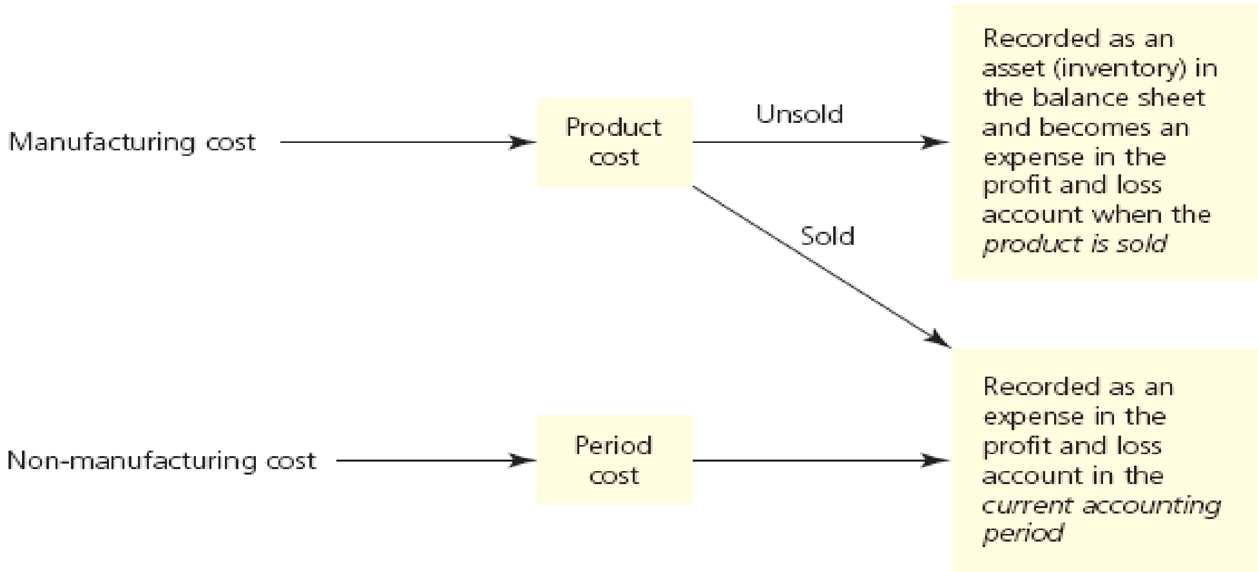
Period costs = £80,000

50% of the output for the period is sold and there are no opening inventories.

Production cost (product costs)	100,000	
Less closing stock (50%)		50,000

Cost of goods sold (50%)		50,000
Period costs (100%)		80,000
Total costs recorded as an		
expense for the period	130,000	

4. Treatment of product and period costs



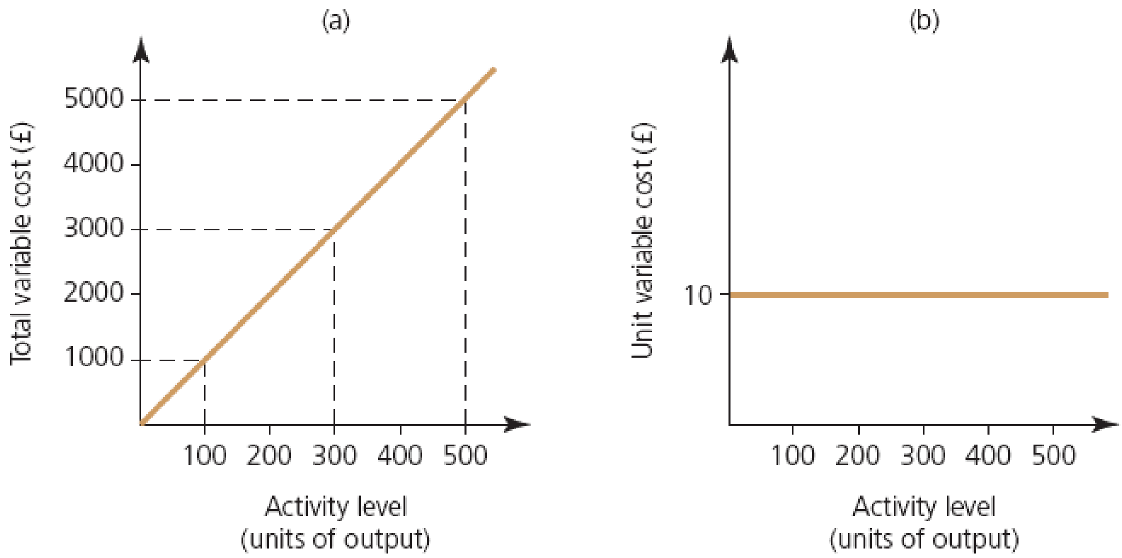
5. Classification by cost behaviour

Important to predict costs and revenues at different activity levels for many decisions.

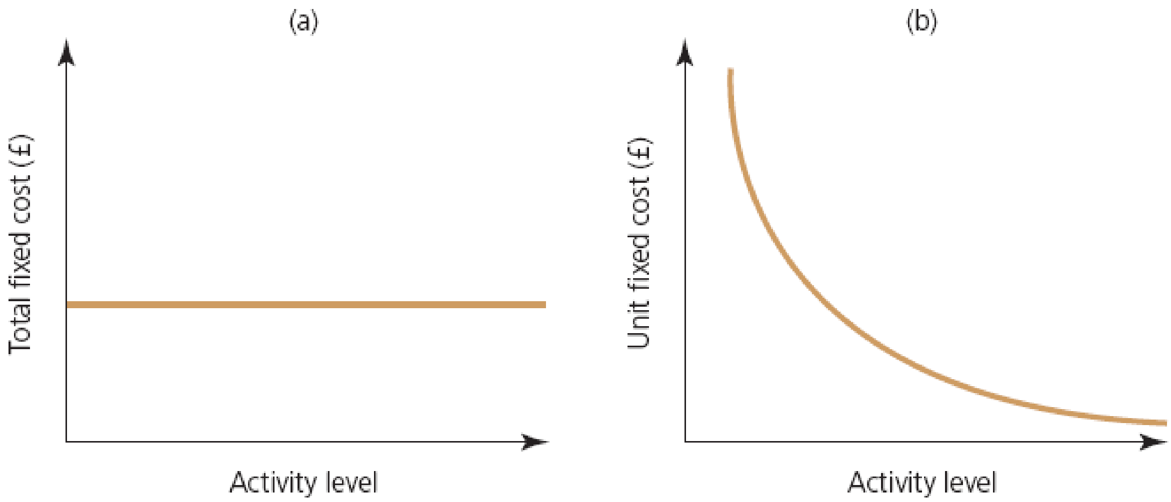
- Variable costs vary in direct proportion with activity.
- Fixed costs remain constant over wide ranges of activity.
- Semi-fixed costs are fixed within specified activity levels, but they eventually increase or decrease by some constant amount at critical activity levels.
- Semi-variable costs include both a fixed and a variable component (e.g. telephone charges).

Note that the classification of costs depends on the time period involved. In the short term some costs are fixed, but in the long term all costs are variable.

5.1Variable costs: (a) total: (b) unit

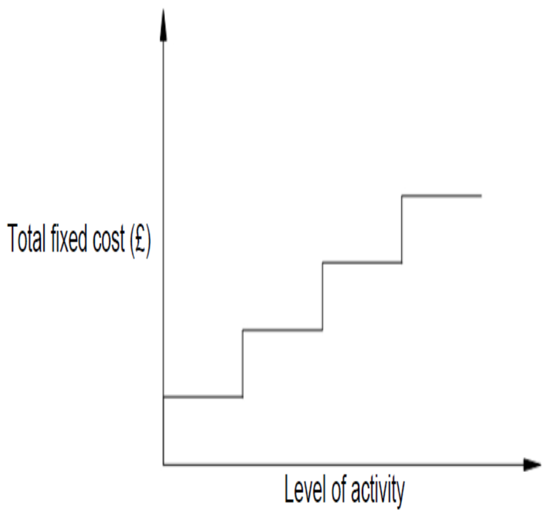


5.2Fixed costs: (a) total; (b) unit



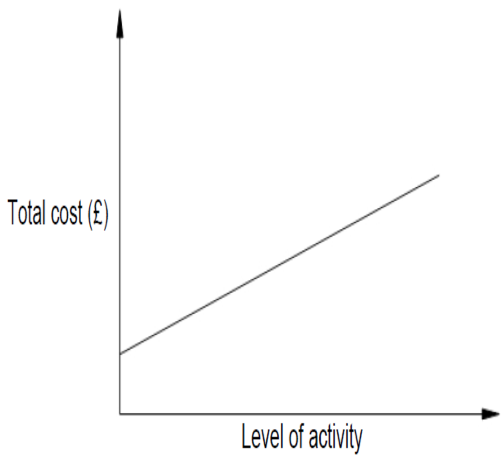
5.3 Step fixed costs

Semi-fixed costs



5.4 Semi-variable cost

Semi-variable costs



5.4 Avoidable and unavoidable costs

• Avoidable costs are those costs that can be saved by not adopting a given alternative, whereas unavoidable costs cannot be saved.

• Avoidable/unavoidable costs are alternative terms sometimes used to describe relevant/irrelevant costs.

5.5 Relevant and irrelevant costs and revenues

• Relevant costs and revenues are those future costs and revenues that will be changed by a decision, whereas irrelevant costs and revenues will not be changed by a decision.

Example

Materials previously purchased for £100 have no alternative use other than being converted for sale at a cost of £200. The sale proceeds after conversion would be £250.

	Do not Convert £	Convert £	
Materials	100	100	Irrelevant
Conversion costs	-	200	Relevant
Revenue	-	(250)	Relevant
Net cost	100	50	

Note that in the short term not all costs may be relevant for decision-making.

5.5.1 Sunk costs

• Sunk costs are the costs of resources already acquired and are unaffected by the choice between the various alternatives (e.g.depreciation).

• Sunk costs are irrelevant for decision-making.

5.5.2 Opportunity costs

• A cost that measures the opportunity that is lost or sacrificed when the choice of one course of action requires that an alternative course of action be given up.

5.5.3 Marginal and incremental costs/revenues

• Incremental costs and revenues are the additional costs/revenues from the production or sale of a group of additional units.

• Marginal cost/revenue represents the additional cost/revenue of one additional unit of output