

Topic: Elements of Cost and Types of Cost

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Elements of Cost and Types of Cost

There are three elements of Cost. These elements are 1.Material.2 Labour 3.Other Expenses

1. Materials: The substance from which the product is made is known as material. It can be direct as well as indirect.

Direct material: It refers to those materials which become a major part of the finished product and can be easily traceable to the units. Direct materials include:

- (i) All materials specifically purchased for a particular job/process.
- (ii) (ii) All material acquired and latter requisitioned from stores.
- (iii) (iii) Components purchased or produced.
- (iv) (iv) Primary packing materials.
- (v) (v) Material passing from one process to another.

Indirect material: All material which is used for purposes ancillary to production and which can be conveniently assigned to specific physical units is termed as indirect materials. Examples, oil, grease, consumable stores, printing and stationary material etc.

2. Labour: Labour cost can be classified into direct labour and indirect labour.

Direct labour: It is defined as the wages paid to workers who are engaged in the production process whose time can be conveniently and economically traceable to units of products. For example, wages paid to compositors in a printing press, to workers in the foundry in cast iron works etc.

Indirect labour: Labour employed for the purpose of carrying tasks incidental to goods or services provided, is indirect labour. It cannot be practically traced to specific units of output. Examples, wages of store-keepers, foreman, time-keepers, supervisors, inspectors etc.

3. Expenses: Expenses may be direct or indirect.

Direct expenses: These expenses are incurred on a specific cost unit and identifiable with the cost unit. Examples are cost of special layout, design or drawings, hiring of a particular tool or equipment for a job; fees paid to consultants in connection with a job etc.

Indirect expenses: These are expenses which cannot be directly, conveniently and wholly allocated to cost centre or cost units. Examples are rent, rates and taxes, insurance, power, lighting and heating, depreciation etc.

It is to be noted that the term overheads has a wider meaning than the term indirect expenses. Overheads include the cost of indirect material, indirect labour and indirect expenses. Overheads may be classified as (a) production or manufacturing overheads, (b) administration overheads, (c) selling overheads, and (d) distribution overheads.

Types of Cost

The different bases of cost classification are:

- A. By time (Historical, Pre-determined).
- B. Association with the product (Product, Period).
- C. By Changes in activity or volume (Fixed, Variable, Semi-variable).
- D. By function (Manufacturing, Administrative, Selling, Research and development, Pre-production).
- E. Relationship with accounting period (Capital, Revenue).
- F. Controllability (Controllable, Non-controllable).
- G. Cost for analytical and decision-making purposes (Opportunity, Sunk, Differential, Joint, Common, Imputed, Out-of-pocket, Marginal, Uniform, Replacement).
- H. Others (Conversion, Traceable, Normal, Avoidable, Unavoidable, Total).

A. By time (Historical, Pre-determine)

(a) Historical Costs: These costs are ascertained after they are incurred. Such costs are available only when the production of a particular thing has already been done. They are objective in nature and can be verified with reference to actual operations.

(b) Pre-determined Costs: These costs are calculated before they are incurred on the basis of a specification of all factors affecting cost. Such costs may be:

(i) Estimated costs: Costs are estimated before goods are produced; these are naturally less accurate than standards. 8 EP-CMA

(ii) Standard costs: This is a particular concept and technique. This method involves: (a) setting up predetermined standards for each element of cost and each product; (b) comparison of actual with standard to find variation;

(C) pin-pointing the causes of such variances and taking remedial action.

Obviously, standard costs, though pre-determined, are arrived with much greater care than estimated costs.

B. Association with the product (Product, Period)

Cost can be classified as product costs and period costs

. **Product Costs:** Product costs are those which are traceable to the product and included in inventory values. In a manufacturing concern it comprises the cost of direct materials, direct labour and manufacturing overheads. Product cost is a full factory cost. Product costs are used for valuing inventories which are shown in the balance sheet as asset till they are sold. The product cost of goods sold is transferred to the cost of goods sold account.

Period Costs: Period costs are incurred on the basis of time such as rent, salaries, etc., include many selling and administrative costs essential to keep the business running. Though they are necessary to generate revenue, they are not associated with production, therefore, they cannot be assigned to a product. They are charged to the period in which they are incurred and are treated as expenses. Selling and administrative costs are treated as period costs for the following reasons:

(i) Most of these expenses are fixed in nature.

(ii) It is difficult to apportion these costs to products equitably.

(iii) It is difficult to determine the relationship between such cost and the product.

(iv) The benefits accruing from these expenses cannot be easily established. The net income of a concern is influenced by both product and period costs. Product costs are included in the cost of the product and do not affect income till the product is sold. Period costs are charged to the period in which they are incurred.

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