

Topic: Types of Cost

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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).

***In previous PDF I have discussed type A and type B cost
In this PDF I am going to discuss Type C and D cost.***

C. By Changes in Activity or Volume (Fixed, Variable, and Semi-variable): Costs can be classified as fixed, variable and semi-variable cost.

Fixed Costs: The Chartered Institute of Management Accountants, London, defines fixed cost as “the cost which is incurred for a period, and which, within certain output and turnover limits, tends to be unaffected by fluctuations in the levels of activity (output or turnover)”. These costs are incurred so that physical and human facilities necessary for business operations, can be provided. These costs arise due to contractual obligations and management decisions. They arise with the passage of time and not with production and are expressed in terms of time. Examples are rent, property taxes, insurance, supervisors’ salaries etc. It is wrong to say that fixed costs never change. These costs may vary depending on the circumstances. The term fixed refer to non-variability related to the relevant range. Fixed cost can be classified into the following categories for the purpose of analysis:

(a) Committed Costs: These costs are incurred to maintain certain facilities and cannot be quickly eliminated. The management has little or no discretion in this cost, e.g., rent, insurance etc.

(b) Policy and Managed Costs: Policy costs are incurred for implementing particular management policies such as executive development, housing, etc. Such costs are often discretionary. Managed costs are incurred to ensure the operating existence of the company e.g., staff services.

(c) Discretionary Costs: These are not related to the operations and can be controlled by the management. These costs result from special policy decisions, new researches etc., and can be eliminated or reduced to a desirable level at the discretion of the management. **(d) Step Costs:** Such costs are constant for a given level of output and then increase by a fixed amount at a higher level of output.

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Variable Cost: Variable costs are those costs that vary directly and proportionately with the output e.g. direct materials, direct labour. It should be kept in mind that the variable cost per unit is constant but the total cost changes corresponding to the levels of output. It is always expressed in terms of units, not in terms of time.

Management decisions can influence the cost behaviour patterns. The concept of variability is relative. If the conditions upon which variability was determined changes, the variability will have to be determined again.

Semi-fixed (Semi-Variable) costs: Such costs contain fixed and variable elements. Because of the variable element, they fluctuate with volume and because of the fixed element; they do not

change in direct proportion to output. Semi-variable costs change in the same direction as that of the output but not in the same proportion. Depreciation is an example; for two shifts working the total depreciation may be only 50% more than that for single shift working. They may change with comparatively small changes in output but not in the same proportion.

D. By function (Manufacturing, Administrative, Selling, Research and development, Pre-production): A company performs a number of functions. Functional costs may be classified as follows:

(a) Manufacturing/production Costs: It is the cost of operating the manufacturing division of an undertaking. It includes the cost of direct materials, direct labour, direct expenses, packing (primary) cost and all overhead expenses relating to production.

(b) Administration Costs: They are indirect and covers all expenditure incurred in formulating the policy, directing the organisation and controlling the operation of a concern, which is not related to research, development, production, distribution or selling functions.

(c) Selling and Distribution Cost: Selling cost is the cost of seeking to create and stimulate demand e.g. advertisements, market research etc. Distribution cost is the expenditure incurred which begins with making the package produced available for dispatch and ends with making the reconditioned packages available for re-use e.g. warehousing, cartage etc. It includes expenditure incurred in transporting articles to central or local storage. Expenditure incurred in moving articles to and from prospective customers as in the case of goods on sale or return basis is also distribution cost.

(d) Research and Development Costs: They include the cost of discovering new ideas, process, and products by experiment and implementing such results on a commercial basis.

(e) Pre-production Cost: When a new factory is started or when a new product is introduced, certain expenses are incurred. There are trial runs. Such costs are termed as pre-production costs and treated as deferred revenue expenditure. They are charged to the cost of future production.

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