Topic: Types of Cost (G and H)

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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 types A, B, C, D, and F cost. In this PDF I have discussed remaining parts G and H.

G. Cost for analytical and decision-making purposes (Opportunity, Sunk, Differential, Joint, Common, Imputed, Out-of-pocket, Marginal, And Uniform, Replacement).

(a) Opportunity Costs: Opportunity cost is the cost of selecting one course of action and the closing of other opportunities to carry out that course of action. It is the amount that can be received if the asset is utilised in its next best alternative

Example1. Capital is invested in plant and machinery. It cannot be now invested in shares or debentures. The loss of interest and dividend that would be earned is the opportunity cost.

Example2. The owner of a business foregoes the opportunity to employ himself elsewhere. Opportunity costs are not recorded in the books. It is important in decision making and comparing alternatives.

(b) Sunk Costs: A sunk cost is one that has already been incurred and cannot be avoided by decisions taken in the future. As it refers to past costs, it is called unavoidable cost.

CIMA defines it as the past cost not taken into account in decision making. It has also been defined as the difference between the purchase price of an asset and its salvage value.

(c) Differential Cost: Differential cost has been defined as “the difference in total cost between alternatives, calculated to assist decision making”. Differential cost is the increase or decrease in total costs resulting out of: (a) Producing and distributing a few more or few less of products; (b) A change in the method of production/distribution; (c) An addition or deletion of a product or a territory; and (d) The selection of an additional sales channel. The differential cost between any two levels of production is the difference between the marginal costs at these two levels and the increase or decrease in fixed costs, if any. These costs are usually ‘specific purpose costs’ as they are determined for a particular purpose and under specific circumstances. Incremental cost measures the addition in unit cost for an addition in output. This cost need not be the same at all levels of production. It is usually expressed as a cost per unit whereas the differential cost is measured in total. The former applies to increase in production and is restricted to the cost only, whereas the differential cost has a comprehensive meaning and application in the sense that it denotes both increase and decrease. Differential costs are useful in planning and decision making and helps to choose the best alternative. It helps management to know the additional profit that would be earned if idle capacity is used or when additional investments are made.

(d) Joint Costs: The processing of a single raw material results in two or more different products simultaneously. The joint products are not identifiable as different types of product until a certain stage of production known as the split-off point is reached. Joint costs are the costs incurred upto the point of separation. One product may be of major importance and others of minor importance which are called by-products The National Association of Accountants defines it as follows:

"Joint costs relate to two or more products produced from a common production process or element-material, labour or overhead or any combination thereof or so locked together that one cannot be produced without producing the other". Joint costs can be apportioned to different products only by adopting a suitable basis of apportionment.

(e) Common Costs: Common costs are those costs which are incurred for more than one product, job, territory or any other specific costing object. They are not easily related with individual products and hence are generally apportioned. The National Association of Accountants defines the term as "the cost of services employed in the creation of two or more outputs which is not allocable to those outputs on a clearly justified basis". It should be kept in mind that management decisions influence the incurrence of common costs e.g. rent of the factory is a common cost to all departments located in factory.

(f) Imputed Costs: Some costs are not incurred and are useful while taking decision pertaining to a particular situation. These costs are known as imputed or notional costs and they do not enter into traditional accounting systems. Examples: Interest on internally generated funds, salaries of owners of proprietorship or partnership, notional rent etc.

(g) Uniform Costs: They are not distinct costs as such. Uniform costing signifies common costing principles and procedures adopted by a number of firms. They are useful in inter-firm comparison.

(h) Marginal Costs: It is the aggregate of variable costs, i.e., prime cost plus variable overheads. Thus, costs are classified as fixed and variable.

(i) Replacement Costs: This is the cost of replacing an asset at current market values e.g. when the cost of replacing an asset is considered, it means the cost of purchasing the asset at the current market price is important and not the cost at which it was purchased.

(j) Out of Pocket Cost: It involves payment to outsiders i.e. gives rise to Cash Expenditure as opposed to such costs as depreciation which don't involve any cash expenditure. Such costs are relevant for price fixation during recession or when make or buy decision is to be made.

H. Other Costs

(i) Conversion Cost: It is the cost of a finished product or work-in-progress comprising direct labour and manufacturing overhead. It is production cost less the cost of raw material but including the gains and losses in weight or volume of direct material arising due to production.

(ii) Normal Cost: This is the cost which is normally incurred at a given level of output in the conditions in which that level of output is achieved.

(iii) Traceable Cost: It is the cost which can be easily associated with a product, process or department.