

COST CLASSIFICATION FOR STOCK VALUATION, PROFIT MEASUREMENT, DECISION MAKING AND CONTROL

- Different cost objectives lead to different approaches to costs classifications and cost accumulation

Cost Classification for Stock Valuation and Profit Measurement :

For the purpose of stock valuation and profit measurement, the cost accountant must calculate the cost of one unit.

- The total cost is made up of the following 3 elements of cost viz: (a) Materials (b) Labour. (c) other expenses (such as rent, interest charges. etc.)

- On the basis of Elements of Cost :

(a) **Direct Cost :**

• It is a cost which is directly chargeable to the product manufactured. It is easily identifiable.

(i) **Direct Materials Cost** : Costs of materials that are known to have been used in making and selling a product or providing a service.

(ii) **Direct Labour Costs** : Specific costs of the workforce used to make a product or provide a service. It is established by measuring the time taken for job.

(iii) **Other Direct Expenses** : Expenses that have been incurred as a direct consequence of making a product or providing a service.

b) **Indirect Costs :**

It is the cost which cannot be identified and charged directly to the product, service or department.

Total cost of a unit can be analysed as follows:

Material cost	=	Direct Material cost	+	Indirect Material cost
+		+		+
Labour cost	=	Direct Labour cost	+	Indirect Labour cost
+		+		+
Expenses	=	Direct Expenses	+	Indirect Expenses
TOTAL COST	=	DIRECT COST or PRIME COST	+	OVERHEAD COST

Cost Classification for Decision making :

Decision making is concerned with future events and hence management requires information on expected future costs and revenues.

Cost accounting systems accumulate past costs and revenues and this historical information provides a starting point for forecasting future events.

On the basis of Cost Behaviour :

(a) Fixed Cost :

It is that portion of total cost which remains constant irrespective of output.

(b) Variable Cost:

It is the cost that varies with output on the level of activity.

Example : Sales commission is a fixed percentage of sales turnover, so it is a variable cost.

(c) Semi-variable Cost

It is the combination of fixed and variable cost.

(factory supervision, maintenance, power)

On the basis of Management Function :

(a) Manufacturing Cost:

It is the cost of resources consumed in the process of making a product.

It includes direct materials cost, direct labour cost and direct expenses.

(b) Administrative Cost:

It is the cost which is incurred for formulating policies, directing the organization and controlling the operations. (Salaries of administrative & accounts staff, General office expenses, Audit fees, Legal fees)

(c) Selling and Distribution Cost :

- Selling cost is the cost of stimulating demand, (Advertisement cost, marketing research cost, after sale service cost)
- Distribution cost is incurred for product distribution (Warehousing cost of saleable products, Cartage expenses, transportation cost , Salesman commission)

Management Related Cost :

(a) Opportunity Cost :

Opportunity cost of a good or service is measured in terms of revenue which could have been earned by employing that good or service in some other alternative uses.

It represents income foregone by rejecting alternatives.

(b) Sunk Cost:

These are the historical costs which have already been incurred or sunk in the past. These are the cost that have been invested in a project but will not be recovered if the project is terminated.

Example : Amortisation of past expenses, Depreciation is a sunk cost.

(c) Relevant Cost :

A cost is said to be relevant if it helps in taking the right decision in furtherance of the company's objectives. Relevant cost are cost which are relevant for a specific purpose or situation.

(d) Differential Cost :

It is also known as incremental cost. It is the difference in cost that will arise from the selection of one alternative to the other

Example : Refers to any kind of change i.e. adding new machinery. adding/dropping a new product/existing product.

(e) Imputed Cost:

Imputed costs are the notional costs which do not involve any cash outlay/ payt. (interest on owners capital, rent on own property)

Cost Classification for Control :

(a) Controllable Cost:



It is the cost which can be influenced by the action of a specific member of an organisation. (Excessive scrap arising from inadequate supervision)

(b) Non-Controllable Cost:

It is the cost which cannot be influenced by the action of a specific member of an organization.

(c) Standard Cost :

A standard cost is a planned cost for a unit of product or service rendered. Its main purpose is to provide basis for control through accounting for stock valuation and for fixing selling prices.

CODING SYSTEM

One of the important function of store-keeping is the classification and codification of materials.

Classification relates to grouping of materials and codification covers the process of assigning codes or symbols to various groups and kinds of materials.

Codification facilitates the identification of materials and is convenient in case of bill of materials and other materials documents. Codification is advantageous not only to the purchase department and production department, but also to the cost accounting department

A good system of classification and codification is characterised by its simplicity, brevity, aid to memory, elasticity and certainty.

Basic Principles of Coding:

While assigning codes, the following important principles should be kept in mind :

(a) **Exclusive/ Unique Numbering**

Each code number should relate to only one type of material and there should be no duplication.

(b) **Certain :**

The code must identify the materials without any ambiguity; simplicity is essential for coding.

(c) **Brief** :

Codes should be brief and meaningful

(d) **Elastic** :

The code should be such that new materials can be added easily and logically

(e) **Same length** :

Codification system should be of same length. This makes errors easier to spot and it assist computerised data processing.

(e) **Mnemonic**:

As far as possible, codes should be easier to remember (HCB for Hard Copper Bar, MCB for Mild Copper Bar)

Procedure for Classification and Codification:

(a) Firstly, materials are grouped under various categories (Eg. Steel, metals, petrol, diesel, spares etc)

(b) It may be further classified into sub-groups (ferrous metals and non-ferrous)

(c) Then, the codes or symbols are allotted. These may be further categorised as indigenous and imported.

Methods of Codification :

• There are three methods of codification viz. (a) Alphabetical, (b) Numerical (c) Alpha Numerical.

(a) **Alphabetical** : • In this method, alphabets are used for codification of each category of materials, (screws of brass and steel could be given the symbols such as B.S. (Brass Screws) and S.S. (Steel Screws) respectively.)

If the alphabets indicate the first sound as indicated above, the system is also known as 'Mnemonic' system.

(b) **Numerical** :

In this method, each item is allotted a number. This facilitates mechanisation and computerised accounting.

The numbering may be straight or in groups of materials. In large organisations, straight numbering is not enough. Generally, numerals by grouping is followed.

First Two DigitsMain group like steel items or building materials etc.

Third DigitSub-grouping like ferrous and non-ferrous metals or mild steel, stainless etc.

Fourth and Fifth Digits Category of material

Sixth and Seventh Digits.. Size or thickness etc.

(c) **Alpha Numerical**:

This is a combination of numerical and alphabetical methods.

In the above example, SS 10 may indicate steel screws 2/8".

Advantages of Classification and Codification :

(a) It facilitates the identification of various stores resulting in prompt issue of stores.

(b) Saves time

(c) It helps in material control.

(d) It reduces clerical work and effects economy in space.

(e) It helps in maintaining mechanised accounts (easy for computerisation)

(f) Reduces ambiguity

ELEMENTS OF COST

Elements means nature of items.

A cost is composed of three elements viz., material, labour and expenses.

Each of these three elements can be direct and indirect.

Different Elements of Cost :

(I) Material Cost :

The substances from which the product is made is known as Material



It may be in raw or manufactured stage.

Direct Material	Indirect Material
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(a) Direct Material

All material which becomes an integral part of the finished product and which can be conveniently assigned to specific physical units is termed as 'Direct Material'

Direct material is also described as 'Process material', 'Prime cost material', 'Product material', 'Stores material'. 'Construction material' etc.

(b) Indirect Material :

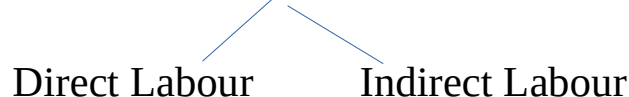
All material which is used for purposes which are ancillary to the business and which cannot be conveniently assigned to specific physical unit is termed as Indirect Materials.

Indirect material may be used in the factory, in the office or in the selling and distribution departments.

Consumable stores, oil and waste, printing and stationery material etc. are few examples of indirect material.

(II) Labour :

For conversion of material into finished goods, human effort is needed, such human effort is called as Labour.



(a) Direct Labour :

Labour which takes an active and direct part in the production of a particular commodity is called as 'Direct labour'.

Direct labour costs are therefore, specifically and conveniently traceable to specific products.

Direct labour is also described as 'Process labour', 'Productive labour', 'Operating labour' etc.

(b) Indirect Labour :

Labour employed for the purpose of carrying out tasks incidental to goods purchased or services provided is termed as 'Indirect labour'. Such labour

does not alter the construction, composition or condition of the product. They cannot be practically traced to specific unit of output.

Examples : Wages of store-keepers, foremen, time-keepers, director's fees, salaries of salesman etc. are all examples of indirect labour costs. Indirect labour may relate to the factory, the office or the selling and distribution departments.

(III) Overheads:

The term overheads includes indirect material, indirect labour and indirect expenses. Thus, all **indirect cost are overheads**.

A manufacturing organisation can broadly be classified into three divisions

(a) Factory or works, where production is done.

(b) Office and administration, where routine as well as policy matters are decided.

(c) Selling and distribution, where product are sold and finally dispatched to the customers.

Overheads may be incurred in the factory or office or selling and distribution departments.

Thus, overheads may be of three types, viz;

(a) **Factory Overheads** : These include

(i) Indirect material used in the factory such as lubricants, oil, consumable stores etc

(ii) Indirect labour such as gate-keeper's salary, time-keeper's salary, works manager's salary etc.

(iii) Indirect expenses such as factory rent , factory insurance, factory lighting etc.

(b) **Office and Administrative Overheads** : These include:

i) Indirect material used in the office such as printing and stationery, material, brooms and dusters etc.

ii) Indirect labour such as salaries payable to office manager, office accountant. clerks etc.

(iii) Indirect expenses such as rent, insurance, lighting of the office etc.

(c) **Selling and Distribution Overheads**: These include:

(i) Indirect material used such as packaging material, printing and

stationery material etc.

ii) Indirect labour such as salaries of salesmen and sales manager, etc.

(iii) Indirect expenses such as rent, insurance of the godown, advertising

(IV) Expenses :

Expenses may be classified into direct or indirect expenses.

(a) Direct Expenses:

These are the expenses which can be directly, conveniently and wholly allocated to specific cost centre or cost unit.

Example of Direct Expenses: Hire of some special machinery required for particular contract, cost of defective work incurred in connection with a particular job or contract etc.

Direct expenses are sometimes also called as 'Chargeable expenses.

(b) Indirect Expenses :

These are expenses which cannot be directly, conveniently and wholly allocated to cost centres or cost units. Examples of Indirect Expenses :

Rent, Lighting, Insurance Charges etc.

Example 1.

Elements – Material, Labour, Expenses

Function – whether its related to Production, Office & Administration, Selling & Distribution

Traceability- Direct cost or Indirect cost

Behaviour- Fixed, Variable, Semi-variable

ITEM	ELEMENT	FUNCTION	TRACEABILITY	BEHAVIOUR
Factory Rent				
Repairs to Machinery				
Freight Inward				
Directors fees				
Direct wages				
Free Samples				
Office stationery				