

Chapter 2: An introduction to cost terms, concepts and classifications

1. Definition of cost

The amount of resources, usually measured in monetary terms, sacrificed to achieve a particular objective. These resources may include materials, labor, and overheads involved in producing goods or services.

2. Cost Classification

Understanding how costs are classified is essential for effective decision-making, planning, and control in management accounting. Below are key classifications:

2.1 Product & Period

- **Product (Manufacturing) Costs:** These costs are directly associated with the production of goods. They include:

Direct materials: Raw materials that can be easily traced to the finished product.

Direct labor: The cost of wages for employees directly involved in manufacturing.

Manufacturing overhead: Indirect costs related to production, such as utilities, depreciation of equipment, and factory maintenance.

Example: In a furniture factory, the wood used to make a table is a direct material, while the wages of workers assembling the tables are direct labor. The electricity used in the factory is part of manufacturing overhead.

- **Period (Non-Manufacturing) Costs:** These are costs incurred outside the manufacturing process and are expensed in the period they are incurred. They include:

Marketing and selling costs: Expenses related to securing orders and delivering products.

Administrative costs: Executive, organizational, and clerical expenses.

Example: The salary of the sales team and office rent are period costs.

2.2 Direct & Indirect Costs:

- **Direct Costs:** Costs that can be easily and conveniently traced to a specific product or cost object.

Examples: Direct materials (e.g., steel used in car manufacturing) and direct labor.

- **Indirect Costs:** Costs that cannot be easily traced to a specific product. These are often included in manufacturing overhead.

Examples: Factory supervisor's salary and maintenance expenses.

3. Variable & Fixed:

- **Variable Costs:** Costs that change in direct proportion to changes in activity levels.

Example: The cost of raw materials increases as more units are produced.

- **Fixed Costs:** Costs that remain constant regardless of changes in activity levels.

Example: Rent for a factory building remains the same whether 100 or 1,000 units are produced.

4. Opportunity cost & sunk cost

- **Opportunity Cost:** The potential benefit that is foregone when one alternative is selected over another.

Example: If a company uses a building for its operations rather than renting it out, the rental income it could have earned is the opportunity cost.

- **Sunk Cost:** Costs that have already been incurred and cannot be changed by any decision made now or in the future. These costs should not influence current decision-making.

Example: Money spent on research and development for a product that has been discontinued is a sunk cost.

5. Relevant & irrelevant costs

- **Relevant Costs:** Future costs that differ between decision alternatives. For a cost to be relevant, it must:

Relate to the objective being pursued.

Be a future cost.

Vary depending on the decision.

Examples: Opportunity costs and differential future outlay costs.

- **Irrelevant Costs:** Costs that do not affect the decision because they remain the same regardless of the alternative chosen.

Examples: Sunk costs, committed costs, and non-differential future outlay costs.

Activity 1:

Complete the following table of cost classifications for a shop selling bicycles:

Cost	Product or Period	Direct or indirect with respect to each bicycle sold	Fixed or variable with respect to the number of bicycles sold
Salespersons' weekly wage			
Salespersons' commission as percentage of bicycle selling price			
Pre-sale service and check of each bicycle sold			
Office clerk's weekly wage			
Shop manager's monthly salary			
Free helmet given with each bicycle sold			
Shop cleaner's weekly wage			
Weekly advertising in local newspaper			
Fire insurance premium for shop			
Theft insurance premium based on estimate in advance of the total value of bicycles to be purchased and sold			
Cost of purchasing bicycles from supplier			
Cost of transporting bicycles to customers			