MANAGEMENT AND COST ACCOUNTING
7TH EDITION

Part One:
Introduction to Management and Cost Accounting

Chapter Two:
An introduction to cost terms and concepts

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2.1a

Cost Objects

• A cost object is any activity for which a separate measurement of cost is required (e.g.cost of making a product or providing a service).

• A cost collection system normally accounts for costs in two broad stages:

1. Accumulates costs by classifying them into certain categories (e.g.labour,materials and overheads).

2. Assigns costs to cost objects.

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2.1b

Direct and indirect costs

• Direct costs can be specifically and exclusively identified with a given cost object.

• Indirect costs cannot be specifically and exclusively identified with a given cost object.

• Indirect costs (i.e.overheads)are assigned to cost objects on the basis of cost allocations.

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2.1c

• Cost allocations = process of assigning costs to cost objects that involve the use of surrogate, rather than direct measures.

• The distinction between direct and indirect costs depends on what is identified as the cost object.

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2.2a

Categories of Manufacturing Costs

• Traditional cost systems accumulate product costs as follows:

Direct materials		xxx
Direct labour		<u>xxx</u>
Prime cost		xxx
Manufacturing overhead		<u>xxx</u>
Total manufacturing cost		xxx
Non-manufacturing overheads		<u>xxx</u>
Total cost	<u>xxx</u>	

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2.2b

Period and product costs

• Product costs are those that are attached to the products and included in the stock (inventory valuation).

• Period costs are *not* attached to the product and included in the inventory valuation.

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2.2c

Example

Product costs = £100,000
Period costs = £80,000
50% of the output for the period is sold and there are no opening inventories.

Production cost (product costs)	100,000
Less closing stock (50%)	50,000
Cost of goods sold (50%)	50,000
Period costs (100%)	80,000
Total costs recorded as an expense for the period	130,000

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2.3

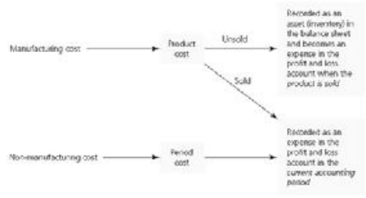

FIGURE 2.1
Treatment of period and product costs

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2.4

Classification by cost behaviour

- Important to predict costs and revenues at different activity levels for many decisions.
- Variable costs vary in direct proportion with activity.
- Fixed costs remain constant over wide ranges of activity.
- Semi-fixed costs are fixed within specified activity levels, but they eventually increase or decrease by some constant amount at critical activity levels.
- Semi-variable costs include both a fixed and a variable component (e.g.telephone charges).

Note that the classification of costs depends on the time period involved.In the short term some costs are fixed,but in the long term all costs are variable.

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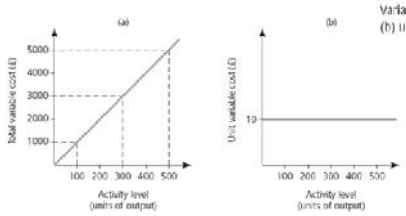
2.5a

FIGURE 2.2
Variable costs: (a) total; (b) unit



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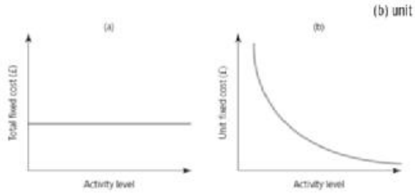
2.5b

FIGURE 2.3
Fixed costs: (a) total; (b) unit



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2.6a

FIGURE 2.4
Step fixed costs

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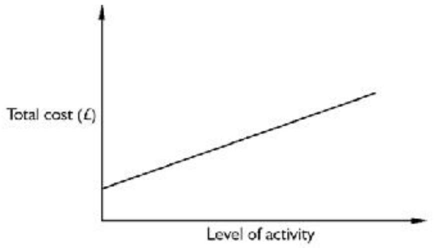
2.6b

Semi-variable costs



2.7a

Avoidable and unavoidable costs

• Avoidable costs are those costs that can be saved by not adopting a given alternative,whereas unavoidable costs cannot be saved.

• Avoidable/unavoidable costs are alternative terms sometimes used to describe relevant/irrelevant costs.

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2.7b

Relevant and irrelevant costs and revenues

• Relevant costs and revenues are those future costs and revenues that will be changed by a decision,whereas irrelevant costs and revenues will not be changed by a decision.

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2.7c

Example

Materials previously purchased for £100 have no alternative use other than being converted for sale at a cost of £200. The sale proceeds after conversion would be £250.

	Do not Convert £	Convert £	
Materials	100	100	Irrelevant
Conversion costs	–	200	Relevant
Revenue	–	(250)	Relevant
Net cost	100	50	

Note that in the short term not all costs may be relevant for decision-making.

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2.8a

Sunk costs

• Sunk costs are the costs of resources already acquired and are unaffected by the choice between the various alternatives (e.g.depreciation).

• Sunk costs are irrelevant for decision-making.

Opportunity costs

• A cost that measures the opportunity that is lost or sacrificed when the choice of one course of action requires that an alternative course of action be given up.

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2.8b

Example

To produce product X requires that an order that yields £1 000 contribution to profits is rejected.The lost contribution of £1 000 represents the opportunity cost of producing product X.

Marginal and incremental costs/revenues

• Incremental costs and revenues are the additional costs/revenues from the production or sale of a *group* of additional units.

• Marginal cost/revenue represents the additional cost/revenue of *one* additional unit of output.

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2.9a

Job and process costing systems

• There are two types of costing systems that companies can adopt job and process costing systems.

• Job costing applies where each unit or batch of output of product or service is unique so that the cost of each unit must be calculated separately.

• Process costing relates to those situations where masses of identical units are produced so that it is unnecessary to assign costs to individual units of output.

• Cost per unit is assumed to be the average cost per unit of output.

• In practice these two systems represent extreme ends of a continuum.

2.9b

Maintaining a cost database

A cost and management accounting system should generate information for meeting the following requirements:

1. Inventory valuation for internal and external profit measurement
2. Provide relevant information to help managers make better decisions
3. Provide information for planning,control and performance measurement

A database should be maintained, with costs appropriately coded and classified so that relevant information can be extracted to meet each of the above requirements.