**COST BEHAVIOUR AND COST CLASSIFICATION**

The management accounting function, among other roles, will be required to perform the task of assessing and understanding costs.

Understanding the cost of a product or service, that it, how much it costs to make a product or to deliver a service will help management make some key decisions e.g.

• How to price a product correctly so as to cover all of the costs and make a profit in the long term

• How to price a product in the short term if, for example there is surplus capacity in a factory

• Whether to seek alternative suppliers who could, for example, supply material at a lower cost for the same level of quality as the current supplier

**COST BEHAVIOUR**

The most important way of classifying cost behaviour is to separate costs into variable and fixed costs.

Variable cost

This is a cost that increases or decreases in proportion to the level of activity. When one extra unit of a product is produced then this cost will increase proportionally.

Examples of variable costs are direct costs [vary with production quantities] and sales commissions [vary with sales quantities].

Fixed cost

This is a cost that remains constant in total terms when the level of activity in a business change. These costs vary with time.

Examples of fixed costs would be rent, salaries, rates or insurance.

Semi-variable costs

Costs can also be semi-fixed or semi-variable. This means that the costs have a fixed element and a variable element.

Examples of semi-variable cost would typically be telephone or electricity expenses.

Semi-fixed costs

These are fixed costs that increase at regular intervals within the relevant range

Examples of semi-fixed costs are supervision labour costs.

**COST CLASSIFICATION**

Direct costs

This is the term given to costs that can be directly related to a single unit or product that is manufactured. Examples would be the direct cost of material or the direct cost of labour. Most direct costs are also variable costs e.g. the steel used to make one car on a production line.

Indirect costs (or overheads)

This is the term given to costs that cannot be directly related to a single unit or product that is manufactured. Indirect costs can be fixed or variable in nature e.g.

Lubricant used to oil the machines when manufacturing cars is an indirect cost which is likely to be a variable cost. As the number of cars manufactured increases the machines will run for longer hours and hence more of the lubricant will be used

Rent payable on a factory building in which cars are manufactured is an indirect cost that is likely to be a fixed cost. The rent will be the same irrespective of how many cars are produced

**COSTING SYSTEMS**

**FULL ABSORPTION AND MARGINAL** **COSTING**

• Full Absorption Costing

means that all production costs, both fixed and variable, will be charged to obtain a full absorption cost for the product. A profit margin is then added to this.

• Marginal Costing

means that the variable costs only are considered as a means to determine the cost of a product. A contribution margin is then added to this. The selling price less the variable costs is referred to as 'THE CONTRIBUTION’. The term means that every time a unit is sold it is contributing to covering the fixed overheads.

**ABSORPTION COSTING**

**Total Direct Costs**

* Direct Materials
* Direct Labour

**PLUS**

**Total Production Overhead**

* Variable production overhead
* Fixed production overhead

**EQUALS: Production costs**

**PLUS**

**Period Costs**

* Selling Overhead
* Distribution Overhead
* Admin Expenses

**EQUALS: Total costs**

**PLUS**

**Profit margin**

**EQUALS: Selling price.**

**MARGINAL COSTING**

**Selling price**

**Less:**

**Total variable costs**

* Direct Materials
* Direct Labour
* Variable Production Overhead
* Variable Selling & Distribution Overhead

**EQUALS: Contribution Margin**

[Proposed Selling Price Minus the Total Variable Cost]

**Less: Total Fixed Costs**

**EQUALS: Profit (or Loss)**

**Example**

**SAP** Ltd manufactures one standard product and in common with other

companies in the industry is suffering from the current depression in the

market. Currently it is operating at a normal level of activity of 70%, which

represents an output of 6300 units, but the sales director believes that a realistic

forecast for the next budget period would be a level activity of 50%.

|  |  |  |  |
| --- | --- | --- | --- |
| Level of activity (%) | 60=5400 | 70=6300 | 80=7200 |
| Direct materials (£). | 37,800 | 44,100 | 50,400 |
| Direct wages (£). | 16,200 | 18,900 | 21,600 |
| Production overhead (£) | 37,600 | 41,200 | 44,800 |
| Administration overhead (£) | 31,500 | 31,500 | 31,500 |
| Selling overhead (£) | 42,300 | 44,100 | 45,900 |

Profit is 25% of total costs

|  |
| --- |
|  |

Required:

a) Calculate cost per unit for the following at the 50% activity level:

* Direct cost per unit = £ [7 + 3] = £10/unit
* Variable production cost unit = £10 + £4 = £14
* Production cost per unit
* Variable cost per unit
* Total cost per unit
* Selling price per unit

b) Budgeted absorption costing profit statement based on a 50% activity

level.

c) Budgeted marginal costing profit statement based on a 50%

activity level.

**Note:**

**Semi-variable costs can be analysed into variable costs and fixed cost using the high-low method:**

**Variable production overhead per unit**

= £ [44,800 - 37,600] / [7200 – 5400]

= £7200 / 1800

**= £4/unit**

**Total production fixed overhead**

= £44,800 - £4 per unit x 7200 units = £44,800 - £28,800 = **£16,000**

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