

Chapter

2



Cost Terms, Concepts, and Classifications

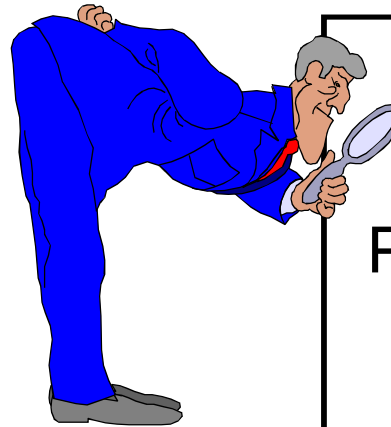
Manufacturing Cost Concepts

*Our focus changes from financial
statement costs to product costs*



Financial Accounting

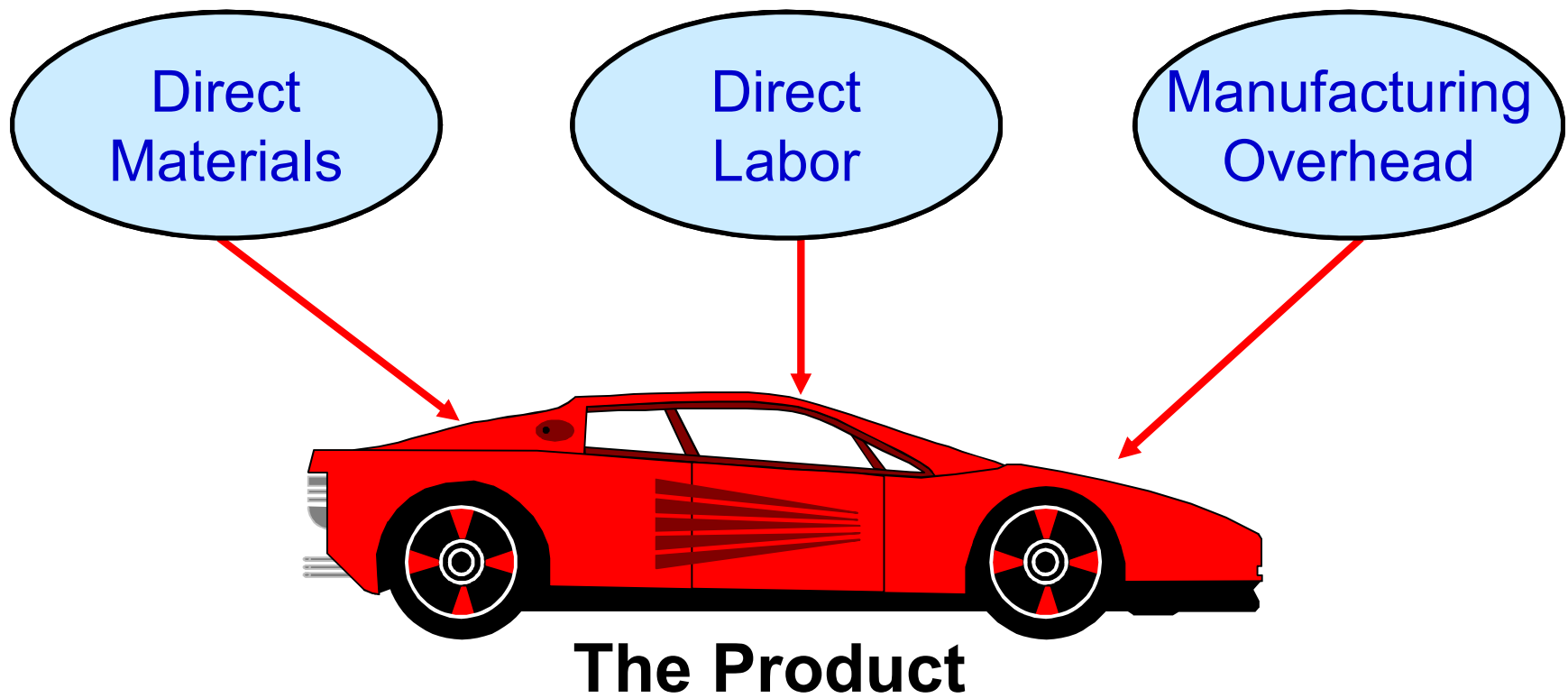
Cost is a measure of resources used or given up to achieve a stated purpose.



Managerial Accounting

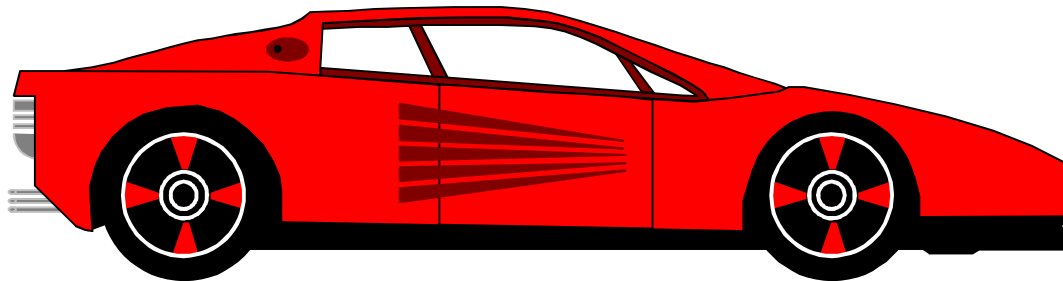
Product costs are the costs a company assigns to units produced.

Manufacturing Costs



Direct Materials

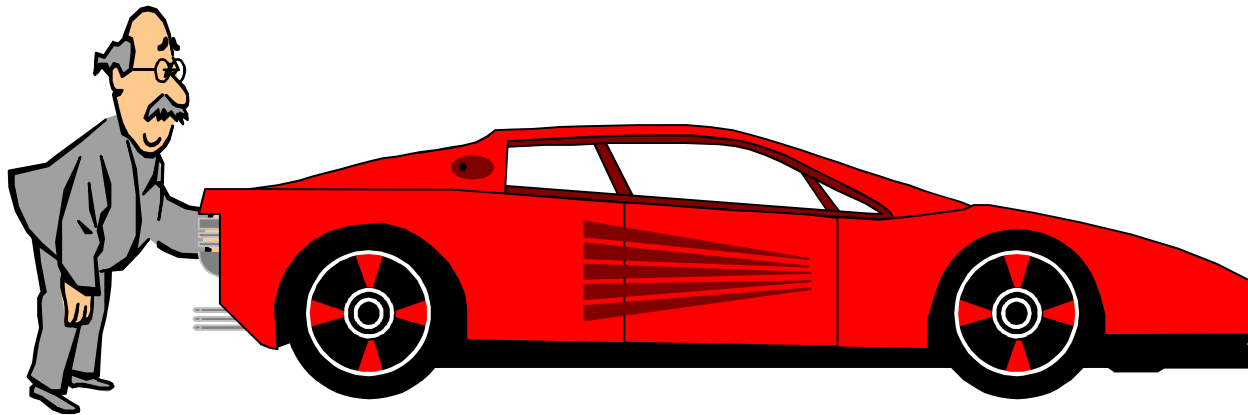
Those materials that become an integral part of the product and that can be conveniently traced directly to it.



Example: A radio installed in an automobile

Direct Labor

Those labor costs that can be easily traced to individual units of product.



Example: Wages paid to automobile assembly workers

Manufacturing Overhead

Manufacturing costs that **cannot** be traced directly to specific units produced.

Examples: Indirect labor and indirect materials

Wages paid to employees who are not directly involved in production work.

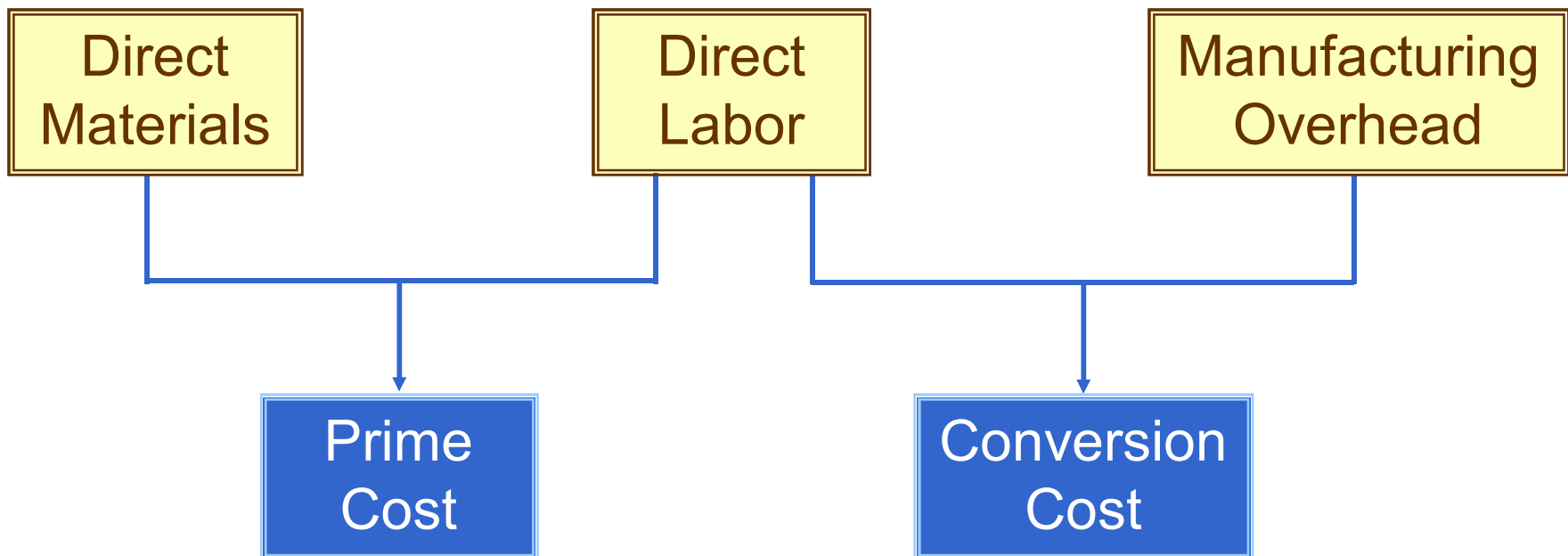
Examples: maintenance workers, janitors and security guards.

Materials used to support the production process.

Examples: lubricants and cleaning supplies used in the automobile assembly plant.

Classifications of Costs

Manufacturing costs are often combined as follows:



Nonmanufacturing Costs

Marketing and selling costs . . .

- ❖ Costs necessary to get the order and deliver the product.

Administrative costs . . .

- ❖ All executive, organizational, and clerical costs.



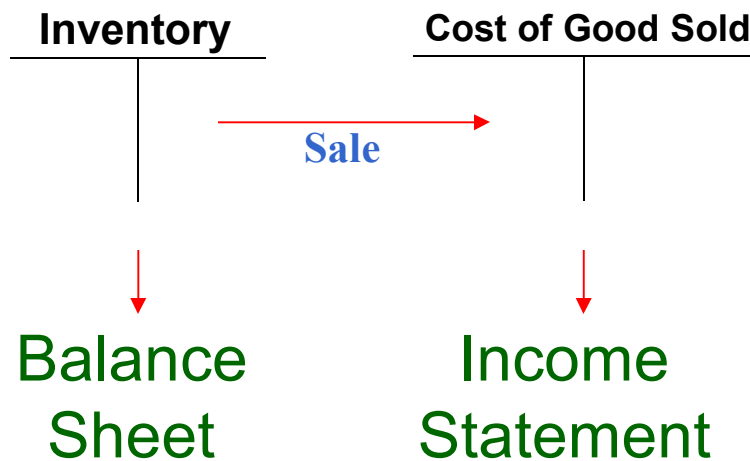
Quick Check ✓

Which of the following costs would be considered manufacturing overhead at Boeing?
(More than one answer may be correct.)

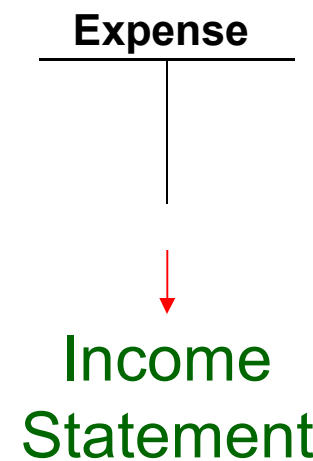
- A. Depreciation on factory forklift trucks.
- B. Sales commissions.
- C. The cost of a flight recorder in a Boeing 767.
- D. The wages of a production shift supervisor.

Product Costs Versus Period Costs

Product costs include direct materials, direct labor, and manufacturing overhead.



Period costs are not included in product costs. They are expensed on the income statement.



Quick Check ✓

Which of the following costs would be considered a period rather than a product cost in a manufacturing company?

- A. Manufacturing equipment depreciation.
- B. Property taxes on corporate headquarters.
- C. Direct materials costs.
- D. Electrical costs to light the production facility.

Cost Classifications for Predicting Cost Behavior

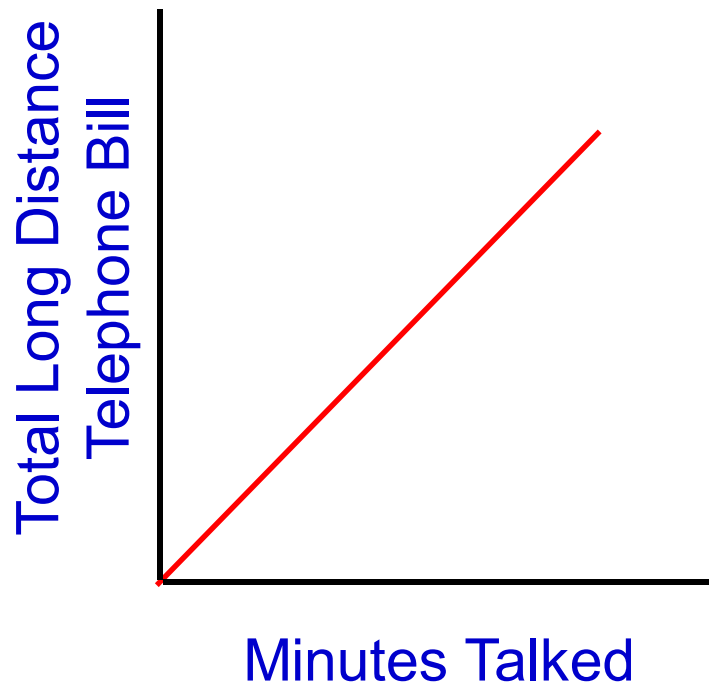


How a cost will react to changes in the level of business activity.

- ❖ Total **variable costs** change when activity changes.
- ❖ Total **fixed costs** remain unchanged when activity changes.

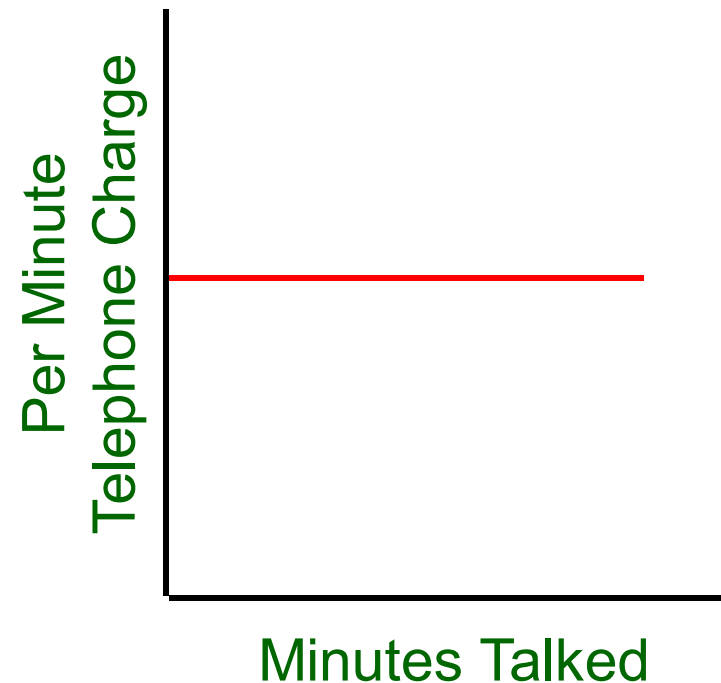
Total Variable Cost

Your **total long distance** telephone bill is based on how many minutes you talk.



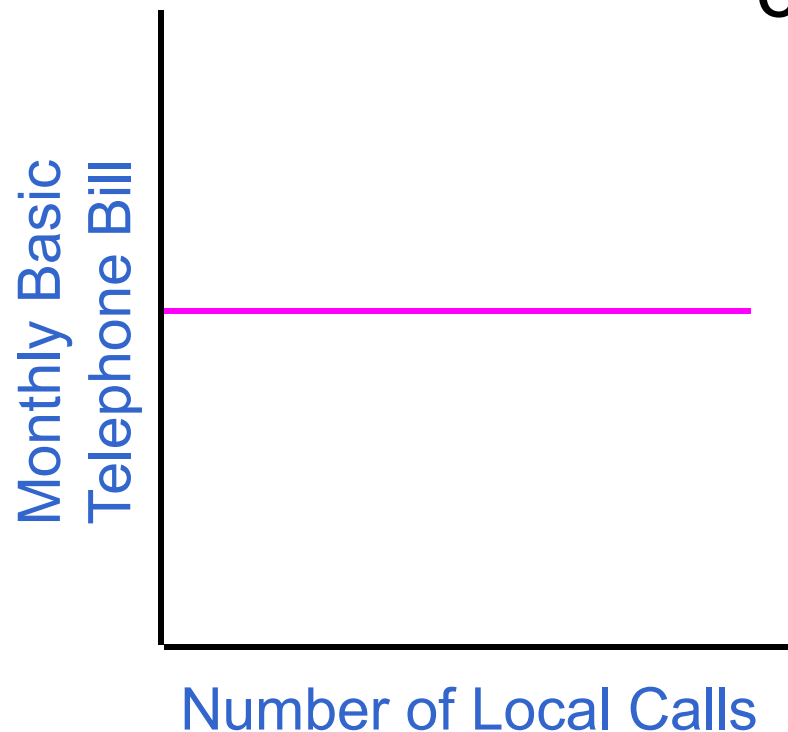
Variable Cost Per Unit

The **cost per long distance minute** talked is constant. For example, 10 cents per minute.



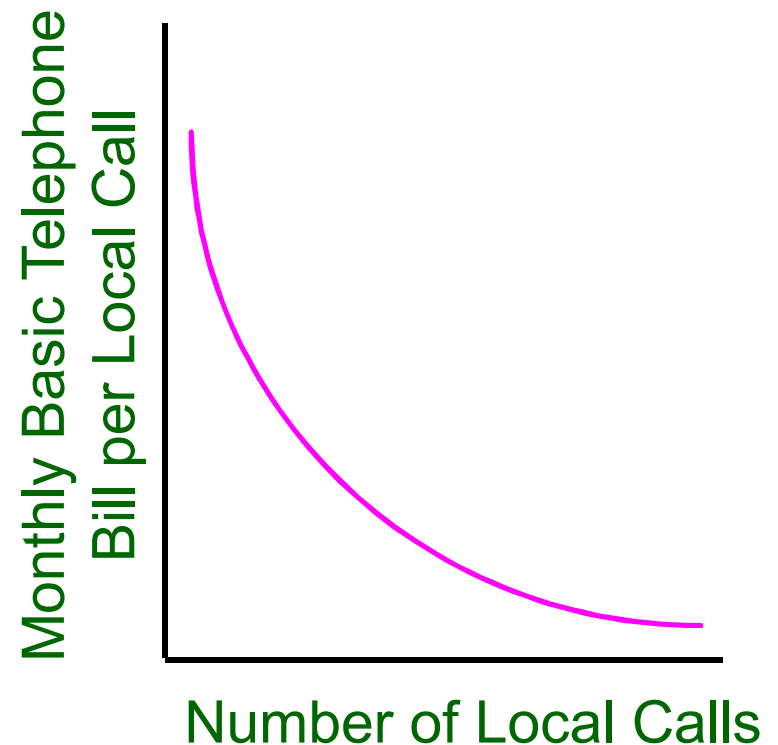
Total Fixed Cost

Your monthly **basic telephone bill** probably does not change when you make more local calls.



Fixed Cost Per Unit

The average cost **per local call** decreases as more local calls are made.



Cost Classifications for Predicting Cost Behavior

Behavior of Cost (within the relevant range)		
Cost	In Total	Per Unit
Variable	Total variable cost changes as activity level changes.	Variable cost per unit remains the same over wide ranges of activity.
Fixed	Total fixed cost remains the same even when the activity level changes.	Fixed cost per unit goes down as activity level goes up.

Quick Check ✓

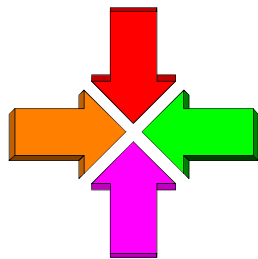
Which of the following costs would be variable with respect to the number of people who buy a ticket for a show at a movie theater? (There may be more than one correct answer.)

- A. The cost of renting the film.
- B. Royalties on ticket sales.
- C. Wage and salary costs of theater employees.
- D. The cost of cleaning up after the show.

Direct Costs and Indirect Costs

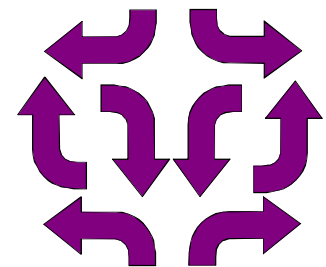
Direct costs

- Costs that can be easily and conveniently traced to a unit of product or other cost objective.
- Examples: direct material and direct labor



Indirect costs

- Costs cannot be easily and conveniently traced to a unit of product or other cost object.
- Example: manufacturing overhead



Differential Costs and Revenues

Costs and revenues that differ among alternatives.

Example: You have a job paying \$1,500 per month in your hometown. You have a job offer in a neighboring city that pays \$2,000 per month. The commuting cost to the city is \$300 per month.

Differential revenue is:
 $\$2,000 - \$1,500 = \$500$

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$$\text{\$2,000} - \text{\$1,500} = \text{\$500}$$

Differential cost is:

\\$300

Quick Check ✓

Suppose you are trying to decide whether to drive or take the train to Portland to attend a concert. You have ample cash to do either, but you don't want to waste money needlessly. Is the annual cost of licensing your car relevant in this decision?

- A. Yes, the licensing cost is relevant.
- B. No, the licensing cost is not relevant.

Quick Check ✓

Suppose you are trying to decide whether to drive or take the train to Portland to attend a concert. You have ample cash to do either, but you don't want to waste money needlessly. Is the depreciation on your car relevant in this decision?

- A. Yes, the depreciation is relevant.
- B. No, the depreciation is not relevant.

Opportunity Costs

The potential benefit that is given up when one alternative is selected over another.

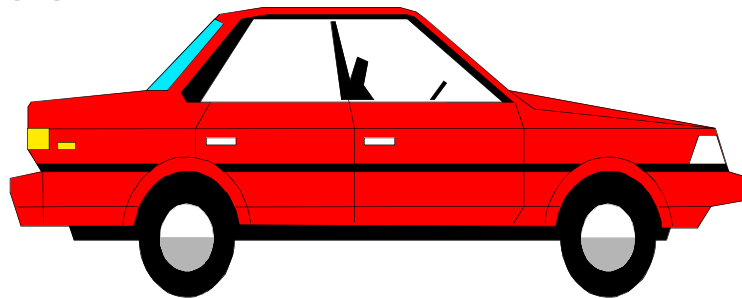
Example: If you were not attending college, you could be earning \$15,000 per year. Your opportunity cost of attending college for one year is \$15,000.



Sunk Costs

Sunk costs cannot be changed by any decision. They are not differential costs and should be ignored when making decisions.

Example: You bought an automobile that cost \$10,000 two years ago. The \$10,000 cost is sunk because whether you drive it, park it, trade it, or sell it, you cannot change the \$10,000 cost.



Quick Check ✓

Suppose that your car could be sold now for \$5,000. Is this a sunk cost?

- A. Yes, it is a sunk cost.
- B. No, it is not a sunk cost.

Further Classification of Labor Costs

