

Cost Classification and Elements of Cost

Cost classification

The cost classification refers to a complete and transparent idea of separating expenditures in a different sector such as manufacturing cost, product cost, sunken cost, variable cost, direct cost, indirect cost, etc. Cost rankings are a vital part of the company. It is almost impossible to run a company without properly understanding it. Cost classification is a widespread motive. We can divide the cost classification into several categories. The main categories include-

1. Classification of cost by component:

According to the cost of the item it can be divided into two main categories. Also known as cost classifications by nature.

A. Direct Costs:

Direct Costs are the costs which can be conveniently identified with and allocated to a particular unit of final product. Such costs are treated as the cost of the unit produced. The examples of direct costs are raw materials, labor and other direct expenses which are exclusively incurred for a particular unit of cost, i.e., job, product or process.

Hence, direct costs can be further classified as:

(a) Direct Material

All materials which become an integral part of the finished product and which can be conveniently assigned to specific physical units is called direct material. Direct materials include all materials specifically purchased or requisitioned for specific cost unit, all primary packing materials.

(b) Direct Labour

This cost consists of wages paid to workers directly engaged in manufacturing or handling a product, job or process. It includes the payment of wages to the workers engaged on the actual production of the product or an operation or a process; and to the workers engaged in helping such production operation or process by way of supervision, maintenance, etc.

(c) Direct Expenses

All expenses other than the direct material or direct labor that are specifically incurred for a particular job, product or process are called direct expenses. Direct expenses are also known as chargeable expenses as they are charged directly to the particular unit of cost concerned.

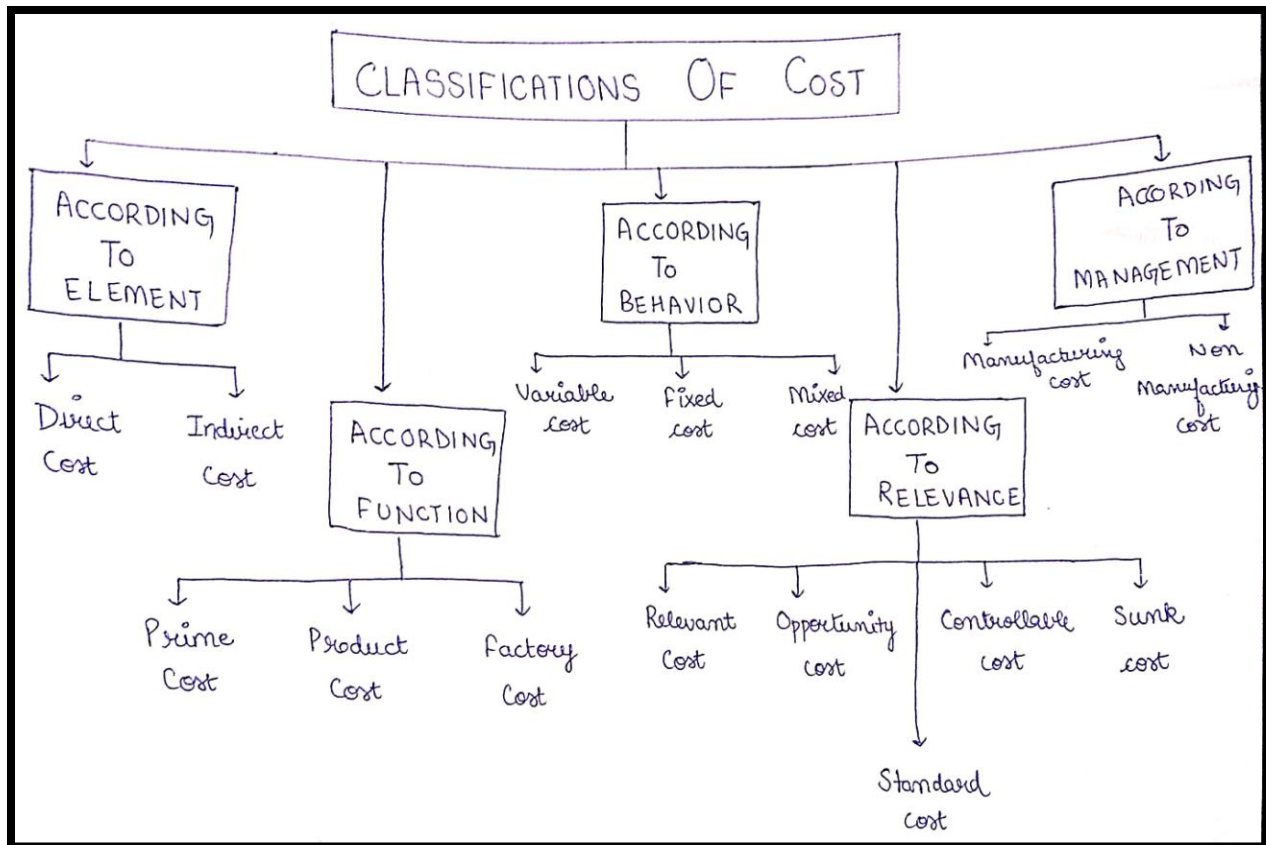
Examples of direct expenses are: cost of special tools, patterns, etc., made for a specific job, product or process, hire charges of a special equipment, excise duty, cost of trial castings, royalties, freight and insurance on special materials, etc.

B. Indirect Costs:

Indirect Costs are those costs which cannot be assigned to any particular cost unit, i.e., job, product or process. Indirect costs are, usually, incurred for the business as a whole and are, therefore, apportioned among the various cost units (product, job or process) on some reasonable basis.

Like direct costs indirect costs include:

- a) Indirect Material such as fuel, lubricating oil, small tools, and material consumed for repairs and maintenance work, miscellaneous stores used in the factory, etc.
- b) Indirect labor which includes wages of general supervisors, inspectors, workshop cleaners, store-keepers, time-keepers, etc.
- c) Indirect expenses such as rent, lighting, insurance, canteen, hospital, welfare expenses, etc.



2. Cost classification according to function:

Functionally, costs can be classified under the following heads:

(a) Prime Cost:

It consists of the costs of direct materials that go into the product, the costs of direct labour and direct expenses. It is also known as direct cost or first cost.

(b) Factory Cost:

It consists of prime cost plus factory overhead or works expenses or factory on cost. Factory cost is also known as works cost, production cost or manufacturing cost.

(c) Cost of Production:

Also called office cost, administration cost or gross cost of production, it consists of factory cost plus office and administrative expenses.

3. Cost classifications depending on behavior:

On the basis of behavior or variability, costs may be classified as:

(a) Variable Costs:

Costs that vary almost in direct proportion to the volume of production are called variable costs. The examples of such costs are direct material, direct labor and direct chargeable expenses, such as electric power, fuel, etc.

(b) Fixed Costs:

Costs which do not vary with the level of production are known as fixed costs. These costs are called fixed costs because these remain constant irrespective of the level of output. It must, however, be noted that fixed costs do not remain constant for all times. In fact, in the long run all costs have a tendency to vary. Fixed costs remain fixed up to a certain level of production.

(c) Mixed cost:

Mixed cost can change overall but not with the proportion of production. More changeable cost is count under a mixed cost. The example of a mixed cost is electricity expenses.

4. Cost classification according to relevance:

Relevance base cost is mainly divided into five categories which are given below;

- **Relevant cost:** Which cost can be by making a new decision is called relevant cost. Occasionally there may have many relevant costs. This cost is not fixed from before.
- **Opportunity cost:** Opportunity cost is the system of getting some extra advantages from the existing things of a factory like land, money and time etc. Someone can rent his office for another purpose of advantages. Moreover, they can rent their other things also. It is actually an extra benefit for a company.
- **Standard cost:** Standard cost is fixed from the previous experience. It was fixed according to the specific budget, the volume of an industry. The actual cost is also included with this cost.
- **Controllable cost:** Which cost can be controlled by management is called controllable cost. The manager can control some cost.
- **Sunk cost:** It is known as a historical cost. Sunk cost effect is most important for a company. It is such a cost which is already lost and can't be undone anymore. If a company is paid their monthly rent than we can say this rent cost is sunk cost.

5. Classification of cost according to management:

These costs are mainly divided into two categories; Manufacturing cost and Non-manufacturing cost given are given below;

- **Manufacturing cost:** Manufacturing cost refers to the total cost of a product from the raw materials to finish the product. It is mainly the combination of direct material cost, labor cost, and manufacturing overheads.
- **Non-manufacturing cost:** In order, the rules of GAAP Non-manufacturing cost are not actual product cost. It is a part of the company's income statement.

Elements of Cost

Simple ascertainment of the total cost cannot meet the different requirements of decision making. For effective control and management decision-making, data must be provided on the basis of classified and analyzed costs. In order to achieve this goal, the cost is analyzed according to the cost elements, that is, according to the nature of the spending.

The elements of cost are:

1. Materials

Material costs are the tangible goods used to produce the product. These costs can be direct or indirect. Direct materials are the quantifiable and traceable costs of the materials used in production. Indirect materials cannot be traced to the products or are not cost-effective to do so. For example, the company that produces wooden handicrafts may be considered a direct material, as the company can easily determine the amount of wood that goes into each craft. However, glue and other stabilizers may not be cost-effective to track this way. In this case, these terms are indirect materials.

2. Labor

Wages and salaries paid to labor working in manufacturing are known as labor costs. These costs can be divided into direct and indirect labor. Direct labor costs include wages paid to labor who actually deal with the product. For this reason, direct action is also referred to as touch action. Indirect labor costs are any wages and other salaries related to production, but they cannot be returned to product units. For example, the wages of material handlers and line workers are usually direct labor costs. However, factory maintenance workers, factory supervisors and quality control engineers will be considered indirect labor.

3. Overhead

Overhead costs are related to production, but are not classified as direct labor or direct materials. This includes all labor costs and indirect materials, as well as any other untraceable costs. Common overhead costs include factory equipment depreciation, manufacturing rents, supply costs, insurance costs, and licensing fees. For some small companies, overhead costs make up the majority of production costs. In these cases, small business owners should be careful when realizing that just because overheads cannot be easily tracked for products does not mean that effective cost management is less important.

4. Period costs

Period costs are costs that are not related to manufacturing and are not a cost component of management accounting. Unlike product costs, which are kept in stock, generally accepted accounting principles require that costs for the period be charged as soon as they are incurred. Common costs for a small business period include advertising costs, sales commissions, owner salaries, senior management, administrative costs, and non-factory equipment consumption. Although the costs for the period are not considered cost elements in management accounting, these costs reduce net income in the same way. As such, management may want to track these costs on an ongoing basis and intervene if these costs are higher than expected.