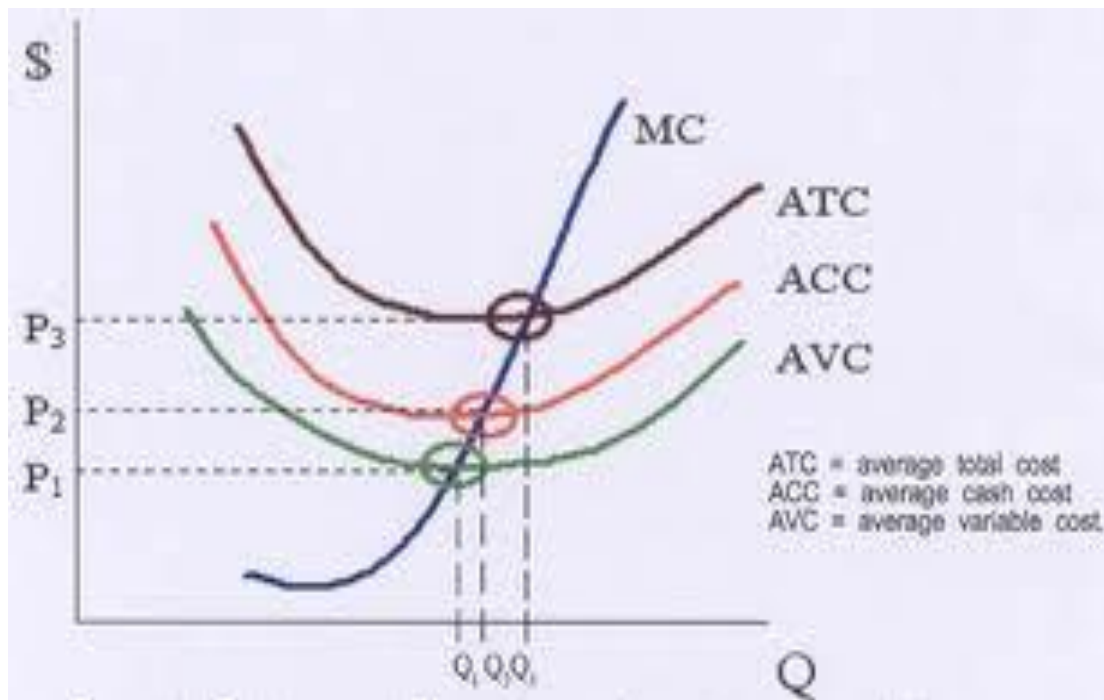


COST CONCEPTS



P V Ram
B.Sc., ACA, ACMA
Hyderabad
98481 85073
ram_pv@rocketmail.com

COST CONCEPTS

The word **COST** has different meanings in different situations and scenarios. For the purpose of control and decision making costs are classified into Relevant Costs and Irrelevant costs.

Question

Explain briefly the concept of relevant costs.

Answer

Relevant costs are those expected future costs that are essential but differ for alternative courses of action. These are specific for a particular decision. Relevant cost is a future cost that would arise as a direct consequence of the decision under review. It is not essential that all variable costs are relevant and all fixed costs are irrelevant. Fixed or variable costs that differ for various alternatives are relevant costs.

E.g. Direct labour under alternative I – Rs.10/ hour

Direct labour under alternative II – Rs.20/hour

Then, direct labour is relevant cost.

Irrelevant costs are those costs which do not have any bearing and impact on decision or issue being considered.

Sunk costs are those costs that have already been incurred in the past and are historical in nature.

Question

Explain with one example each that sunk cost is irrelevant in making decisions, but irrelevant costs are not sunk costs.

Answer

Sunk cost is a historical cost incurred in the past and has been irreversibly committed or prior to the decision point and which therefore cannot be considered. In other words it is a cost of a resource already acquired. Future decisions in respect of this resource will not be affected by it. For example, book value of machinery. Hence sunk costs are irrelevant in decision making.

Irrelevant costs are not necessarily sunk costs. For example, when a comparison of two alternative production methods using the same material quantity is made, then direct material cost is not affected by the decision as

we take into account the quantities of materials only for the decision under consideration. Thus the material cost is irrelevant but the material cost is not sunk cost as it will be incurred for production, under both the production methods.

Hence the notation sunk costs are irrelevant costs but not vice versa.

Question

Explain the concept of relevancy of cost by citing three examples each of relevant costs and non-relevant costs.

Answer

Relevant costs are those costs which are pertinent to a decision. In other words, these are the costs which are influenced by a decision. Those costs which are not affected by the decision are not relevant costs.

Examples of relevant costs:

- (1) All variable costs are relevant costs.
- (2) Fixed Costs which vary with the decision are relevant costs.
- (3) Incremental costs are relevant costs.

Examples of non-relevant costs:

- (1) All fixed costs are generally non-relevant.
- (2) Variable costs which do not vary with the decision are not relevant costs.
- (3) Book value of the asset is not relevant.

Question

Explain briefly the concept of opportunity costs.

Answer

Opportunity cost is the value of sacrifice made or benefit of opportunity foregone by selecting one alternative in preference of other alternative. Opportunity cost is a relevant cost where alternatives are available. However, Opportunity cost does not find any place in formal accounts and is computed only for comparison purposes. It is the maximum contribution that is foregone by using limited resources for a particular purpose. It represents the measurable value of opportunity bypassed by rejecting an alternative use of resources. For example, opportunity cost of funds invested in business is the interest that could have been earned by investing the funds in bank deposit.

Question

Comment on the use of opportunity cost for the purpose of decision-making.

Answer

Opportunity costs apply to the use of scarce resources only. When resources are not scarce, there is no sacrifice from the use of these resources. Hence, there will not be any opportunity cost. Where a course of action requires the use of scarce resources, it is necessary to incorporate the lost of profit which will be foregone from using scarce resources for alternative course of action apart from the cost of resources themselves. If resources have no alternative use only the additional cash flow resulting from the course of action should be included in decision making as relevant cost.

Question

Distinguish between "Marginal cost" and 'Differential Cost'.

Answer

Marginal cost represents the increase or decrease in total cost which occurs with a small change in output say, a unit of output. In Cost Accounting **variable costs** represent marginal costs and the words are used interchangeably. In other words, it can be defined as the cost of one unit of product or service which would be avoided if that unit was not produced or provided.

Differential costs are those costs (both fixed and variable) that change due to change in the level of activity or pattern or method of production. When change results in increase in cost, it is called **Incremental cost**. Whereas if costs are reduced due to decrease of output, the difference is called **Decremental cost**.

The main point which distinguishes marginal cost and differential cost is that, In the case of differential cost variable as well as fixed cost. i.e. both costs change due to change in the level of activity, whereas under marginal costing only variable cost changes due to change in the level of activity. Further, in case of marginal costs, it is the difference in cost due to change in unit level of activity whereas in case of differential cost, it is the change in different levels (i.e. more than unit level of activity also) of activities including unit level of activity. Hence all marginal costs are differential costs but not vice versa.

Fixed costs are those costs that remain same irrespective of the change of level of activity. E.g. Rent, Insurance on building etc.

Question

Fixed Costs are variable and variable costs are fixed. Comment.

Answer

Fixed costs are fixed irrespective of the level of activity. However, absorption of fixed cost per unit varies with changes in the level of activity. Hence, fixed cost per unit is variable.

Variable costs are variable with respect to the level of activity. However, per unit variable cost is fixed irrespective of the level of activity. Hence, variable costs are fixed.

Semi variable costs are those costs that are partly fixed and partly variable. These costs show mixed relationship when plotted against volume. Semi variable costs remain fixed within a given range of level of activity. Once this level is breached, they change without any relationship with volume.

Question

Pick out from each of the following items, costs that can be classified under 'committed fixed costs' or 'discretionary fixed costs'.

- a. Annual increase of salary and wages of administrative staff by 5% as per agreement
- b. New advertisement for existing products is recommended by the Marketing Department for achieving sales quantities that were budgeted for at the beginning of the year.
- c. Rents paid for the factory premises for the past 6 months and the rents payable for the next six months. Production is going on in the factory.
- d. Research costs on a product that has reached 'maturity' phase in its life cycle and the research costs which may be needed on introducing a cheaper substitute into the market for facing competition.
- e. Legal consultancy fees payable for patent rights on a new product
Patenting rights have been applied for.

Answer

Committed Fixed Costs	Discretionary Fixed Costs
a. Salary and wage increase	b. New Advertisement Cost
c. Rents payable for the next 6 months	d. Research cost for substitutes

e. Legal fees for filing for patent rights.	
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Question

What is meant by incremental revenue?

Answer

Incremental revenue is the additional revenue that arises from the production or sale of a group of additional units. It is the extra income derived from pursuing a particular course of action. Incremental revenue and Incremental income have same meaning and are used interchangeably. E.g. sale of a product after further processing rather than at split off point.

Incremental revenues are compared with Incremental costs and are relevant for decision making.

Similarly **Incremental costs** are those costs that arise due to increase in the level of production.

Question

What are the applications of incremental cost techniques in making managerial decisions?

Answer

Incremental cost technique is a technique used in the preparation of information in which only cost and income differences between alternative courses of action are taken into consideration to compare the incremental costs with incremental revenues. So long as the incremental revenue is greater than incremental costs, the decision should be in favour of the proposal.

Application of Incremental / Differential Cost Techniques in Managerial Decisions

This technique can be used in several areas in the day to day commercial operations of an organisation. Some of them are:

- a. Whether to process a product further or not.
- b. Dropping or adding a product line.
- c. Making the best use of the investment made.
- d. Acceptance of an additional order from a special customer at lower than existing price.
- e. Opening of new sales territory and branch.
- f. Make or Buy decisions.

- g. Submitting tenders.
- h. Lease or buy decisions.
- i. Equipment replacement decision etc.

Avoidable costs are those costs of an activity or sector of a business that can be avoided if that sector or business does not exist.

Out of pocket cost is not a regular costing term but often used in examination questions. It represents the actual cash outflow from an action. If it is stated that a material is bought for Rs. 10,000 of which Rs. 8,000 is out of pocket expenses, then it implies Rs. 8,000 is cash outflow. This is in contrast to depreciation where there will not be any cash outflow.

Committed costs are those costs arising from prior decisions which cannot in the short run be changed.

Engineered costs results from a defined mathematical relationship with the cost object and resources consumed to produce an output. For example, to produce one unit of a leather shoe requires known amount of leather and time to be spent in stitching is also known. The leather, labour and machine hours are therefore engineered costs.

Inventoriable costs are considered as part of merchandise and considered as asset when these are incurred and these costs become cost of goods sold when the final output is sold. In other words inventoriable costs are cost of purchase plus cost expended to make final product in saleable condition. For a manufacturer, cost of raw material issued to production plus labour cost plus manufacturing overheads are inventoriable cost.

Period costs are all costs other than cost of goods sold and treated as expense in income statement. CIMA defines it as 'Cost relating to a time period rather than to the output of products or services'. A period cost is charged to expense in the period incurred. This type of cost is not included within the cost of goods sold on the income statement. This type of expenses is generally included within the selling and administrative expenses. Example of period costs are: depreciation expenses, commission, advertisement expenses, sales expenses etc.

Cost indifference point is that point at which the total cost (i.e. fixed and variable) between alternative courses of action remains constant.



P V Ram
B.Sc., ACA, ACMA
Hyderabad
98481 85073
ram_pv@rocketmail.com