CLASSIFICATION OF COSTS

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Classification of costs means the grouping of costs according to their common characteristics. The important ways of classification of costs are:

(1) By nature or element
(2) By functions
(3) As direct and indirect
(4) By variability
(5) By controllability
(6) By normality

(1) By Nature of Element - Under this classification the costs are divided into three categories *i.e.,* materials cost, labour cost and expenses. This type of classification is useful to determine the total cost.

(2) By Functions - Under this classification, costs are divided according to the function for which they have been incurred. Some of the examples are:

Production cost - The cost of sequence of operations which begins with supplying materials, labour and services and ends with primary packing of the product.

Selling cost - The cost seeking to create and stimulate demand (sometimes termed 'marketing') and of securing orders.

Distribution cost - The cost of the sequence of operations which begins with making the packed product available for dispatch and ends with making the reconditioned returned empty package, if any available for re-use.

Note - It also includes expenditure incurred in transporting articles to central or local storage. Distribution costs include expenditure incurred in moving articles to and from prospective customers as in case of goods on sale or return basis. In the gas, electricity and water industry distribution means pipes, mains and services which may be regarded as the equivalent of packing and transportation.

Administrative cost - The cost of formulating the policy, directing the organization and controlling the operations of an undertaking which is not related directly to a production, selling and distribution, research or development activity or function.

Research cost - The cost of researching for new or improved products, new applications of materials, or improved methods.

Development cost - The cost of the process which begins with the implementation of the decision to produce a new or improved product or to employ a new or improved method and ends with commencement of formal production of that product or by that method.

Pre-production cost - The part of development cost incurred in making a trial production run preliminary to formal product.

Note - This term is sometimes used to cover all activities prior to production including research and development, but in such cases the usage should be made clear in the context.

Conversion cost - The sum of direct wages, direct expenses and overhead cost of converting raw materials to the finished stage or converting a material from one stage of production to the next.

Note - In some circumstances this phrase is used to include any excess material cost or loss of material incurred at the particular stage of production.

Product costs – These are the costs which are associated with the purchase and sale of goods (in the case of merchandise inventory). In the production scenario, such costs are associated with the acquisition and conversion of materials and all other manufacturing inputs into finished product for sale. Hence, under marginal costing, variable manufacturing costs and under absorption costing, total manufacturing costs (variable and fixed) constitute inventoriable or product costs. Under the Indian GAAP, product costs will be those costs which are allowed to be a part of the value of inventory as per Accounting Standard 2, issued by the Council of the **Institute of Chartered Accountants of India**.

Purposes for computing product costs:

The three different purposes for computing product costs are as follows:

(i) *Preparation of financial statements:* Here focus is on inventoriable costs for complying with Accounting Standard –2, issued by the Council of ICAI.

(ii) *Product pricing:* It is an important purpose for which product costs are used. For this purpose, the cost of the other areas of the value chain should be included to make the product available to the customer.

(iii) *Contracting with government agencies:* Normally such contracts are on a cost plus basis. For this purpose government agencies may not allow the contractors to recover research and development and marketing costs under cost plus contracts.

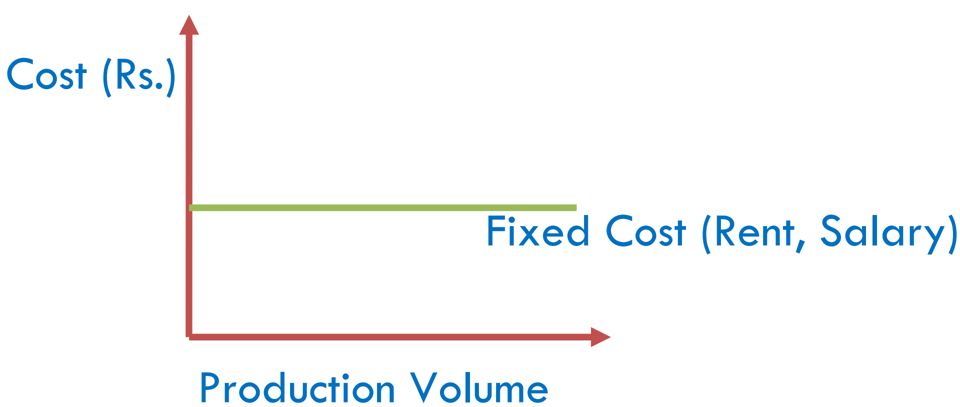
(3) As Direct and Indirect Costs –

Direct costs – Costs that are related to the cost object and can be traced in an economically feasible way.

Indirect costs – Costs that are related to the cost object but cannot be traced to it in an economically feasible way.

(4) By Variability - According to this classification costs are classified into three groups *viz.*, fixed costs, variable costs and semi-variable costs.

(a) *Fixed costs* - These are the costs which are incurred for a period, and which, within certain output and turnover limits, tend to be unaffected by fluctuations in the levels of activity (output or turnover). They do not tend to increase or decrease with the changes in output. For example, rent, insurance of factory building etc., remain the same for different levels of production. A fixed cost can be depicted graphically as follows,



Note: Fixed Costs vary with time.

Fixed costs can further be classified as follows:

(i) *Committed Fixed Costs:* These are those fixed costs which are to be paid even when the production volume is zero.

Examples:

a) Rent of the factory,

b) Depreciation of Machinery,

c) Interest on loan taken for machinery,

d) Top management salary, etc.

(ii) Discretionary Fixed Costs: These are those fixed costs which are not related with the production volume; rather it is at the choice of top management regarding its expenditure.

Examples:

a) Advertisements,

b) Labour Motivation Training expenses,

c) Labour Welfare expenses,

d) Drawing and Design cost of a new product, etc.

(iii) Slab/Step Fixed Costs: These are those fixed costs which are expensed or thought to be implemented for expensing by considering a certain range or level for undertaking a particular volume or quantity of production. That is if any production is carried out then cost incurred will be between a fixed range.

Examples:

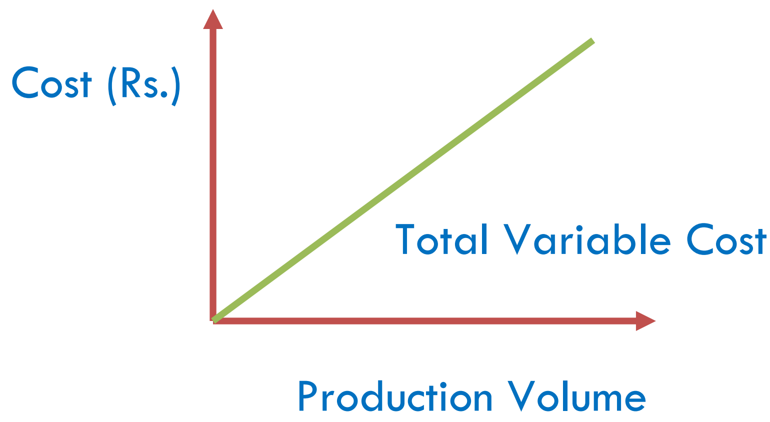
a) Machine maintenance and supervision,

b) Quality Control Cost and testing cost.

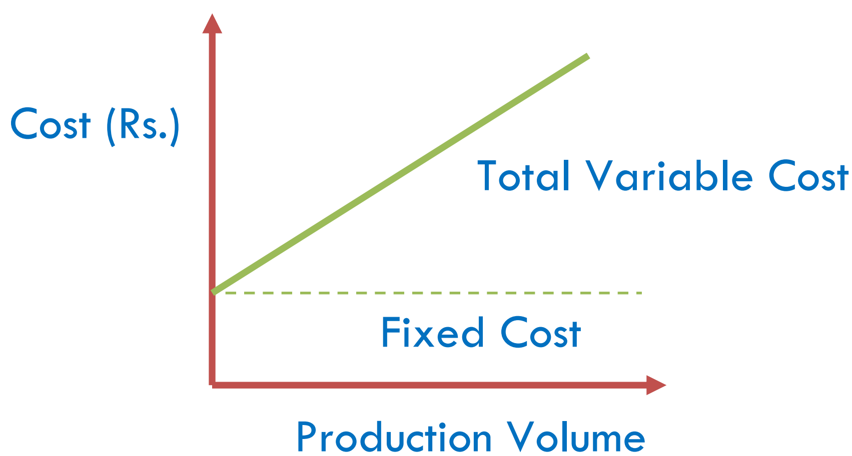
c) Parking Fees,

d) Metro Rail Ticket.

(b) *Variable costs* - These costs tend to vary with the volume of activity/production directly. Any increase in the activity results in an increase in the variable cost and vice-versa. For example, cost of direct labour, direct wages, etc. Variable costs are depicted graphically as follows,



(c) *Semi-variable costs* - These costs contain both fixed and variable components and are thus partly affected by fluctuations in the level of activity. Examples of semi variable costs are telephone bills, gas and electricity bills etc. Such costs are depicted graphically as follows:



(5) By Controllability - Costs here may be classified into controllable and uncontrollable costs.

(a) *Controllable costs* - These are the costs which can be influenced by the action of a specified member of an undertaking. A business organization is usually divided into a number of responsibility centres and an executive heads each such centre. Controllable costs incurred in a particular responsibility centre can be influenced by the action of the executive heading that responsibility centre. Direct costs comprising direct labour, direct material, direct expenses and some of the overheads are generally controllable by the shop level management.

(b) *Uncontrollable costs* - Costs which cannot be influenced by the action of a specified member of an undertaking are known as uncontrollable costs. For example, expenditure incurred by, say, the Tool Room is controllable by the foreman incharge of that section but the share of the tool-room expenditure which is apportioned to a machine shop is not to be controlled by the machine shop foreman.

The distinction between controllable and uncontrollable costs is not very sharp and is sometimes left to individual judgment. In fact no cost is uncontrollable; it is only in relation to a particular individual that we may specify a particular cost to be either controllable or uncontrollable.

(6) By Normality - According to this basis cost may be categorized as follows:

(a) *Normal cost* - It is the cost which is normally incurred at a given level of output under the conditions in which that level of output is normally attained.

(b) *Abnormal cost* - It is the cost which is not normally incurred at a given level of output in the conditions in which that level of output is normally attained. It is charged to Costing Profit and loss Account.