

# CHAPTER 2

An Introduction to  
Cost Terms and Purposes

# Basic Cost Terminology

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- Cost – sacrificed resource to achieve a specific objective
- Actual Cost – a cost that has occurred
- Budgeted Cost – a predicted cost
- Cost Object – anything of interest for which a cost is desired

# Basic Cost Terminology

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- Cost Accumulation – a collection of cost data in an organized manner
- Cost Assignment – a general term that includes gathering accumulated costs to a cost object. This includes:
  - Tracing accumulated costs with a direct relationship to the cost object and
  - Allocating accumulated costs with an indirect relationship to a cost object

# Direct and Indirect Costs

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- Direct Costs – can be conveniently and economically traced (tracked) to a cost object
- Indirect Costs – cannot be conveniently or economically traced (tracked) to a cost object. Instead of being traced, these costs are allocated to a cost object in a rational and systematic manner

# Cost Examples

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- Direct Costs
  - Parts
  - Assembly line wages
- Indirect Costs
  - Electricity
  - Rent
  - Property taxes

# Factors Affecting Direct/Indirect Cost Classification

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- Cost Materiality
- Availability of Information-gathering Technology
- Operational Design

# Cost Behavior

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- Variable Costs – changes in total in proportion to changes in the related level of activity or volume
- Fixed Costs – remain unchanged in total regardless of changes in the related level of activity or volume
- Costs are fixed or variable only with respect to a specific activity or a given time period

# Cost Behavior, continued

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- Variable costs – are constant on a per-unit basis. If a product takes 5 pounds of materials each, it stays the same per unit regardless of whether one, ten, or a thousand units are produced
- Fixed costs – change inversely with the level of production. As more units are produced, the same fixed cost is spread over more and more units, reducing the cost per unit



# Cost Behavior Summarized

	<b>Total Dollars</b>	<b>Cost per Unit</b>
<b>Variable Costs</b>	Change in proportion with output <b>More output = More cost</b>	Unchanged in relation to output
<b>Fixed Costs</b>	Unchanged in relation to output	Change inversely with output <b>More output = lower cost per unit</b>

# Other Cost Concepts

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- Cost Driver – a variable that causally affects costs over a given time span
- Relevant Range – the band of normal activity level (or volume) in which there is a specific relationship between the level of activity (or volume) and a given cost
  - For example, fixed costs are fixed only within the relevant range.

# A Cost Caveat

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- Unit costs should be used cautiously. Since unit costs change with a different level of output or volume, it may be more prudent to base decisions on a total dollar basis.

# Different Types of Firms

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- Manufacturing-sector companies – create and sell their own products
- Merchandising-sector companies – product resellers
- Service-sector companies

# Types of Inventories

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- Direct Materials – resources instock and available for use
- Work-in-Process (or progress) – products started but not yet completed. Often abbreviated as WIP
- Finished Goods – products completed and ready for sale

# Types of Product Costs

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- Direct Materials
- Direct Labor
- Indirect Manufacturing – factory costs that are not traceable to the product. Also known as Manufacturing Overhead costs or Factory Overhead costs

# Distinctions Between Costs

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- Inventoriable Costs – product manufacturing costs. These costs are capitalized as assets (inventory) until they are sold and transferred to Cost of Goods Sold
- Period Costs – have no future value and are expensed as incurred

# Cost Flows

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- The Cost of Goods Manufactured and the Cost of Goods Sold section of the income statement are accounting representations of the actual flow of costs through a production system.
  - Note the importance of inventory accounts in the following accounting reports, and in the cost flow chart



# Cost of Goods Manufactured

Cellular Products  
Schedule of Cost of Goods Manufactured  
For the Year Ended December 31, 2007 (in thousands)

Direct Materials:	
Beginning Inventory, January 1	\$ 11,000
Add: Purchases	73,000
Cost of Direct Materials Available for Use	84,000
Less: Ending Inventory, December 31	8,000
Direct Materials Used	76,000
Direct Labor	9,000
Manufacturing Overhead:	
Indirect Labor	7,000
Supplies	2,000
Heat, Light & Power	5,000
Depreciation - plant building	2,000
Depreciation - plant equipment	3,000
Miscellaneous	1,000
Total Manufacturing Overhead Costs	20,000
Manufacturing costs incurred during 2007	105,000
Add: Beginning WIP, January 1	6,000
Total Manufacturing Costs to account for	111,000
Less: Ending WIP, December 31	7,000
Cost of Goods Manufactured	\$ 104,000

Calculates the cost of Direct Materials Used

Accumulates the three product costs for the current period

Adjusts the current period manufacturing costs to account for units actually completed

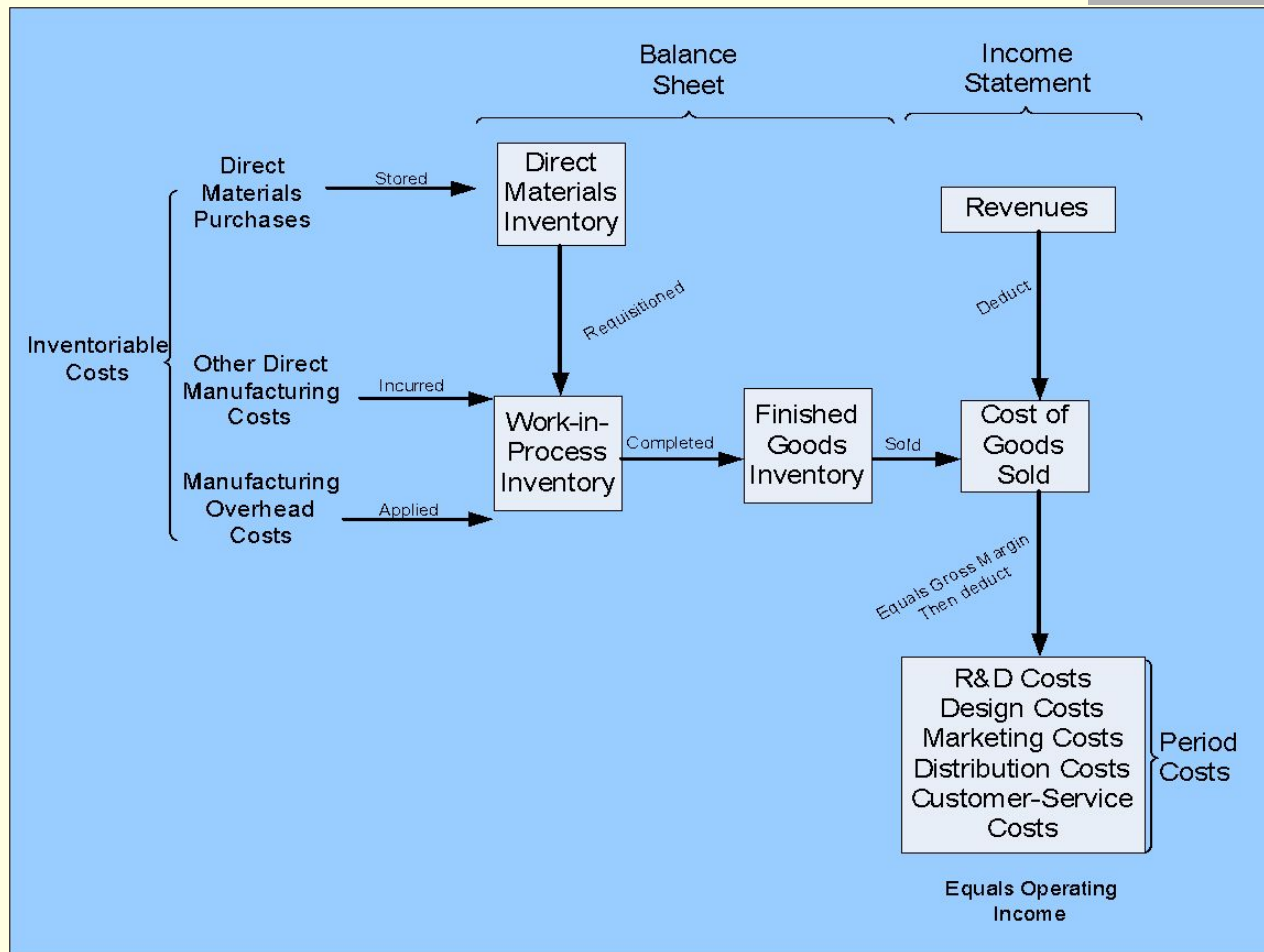
# Income Statement

Cellular Products		
Income Statement		
For the Year Ended December 31, 2007 (in thousands)		
Revenues		\$210,000
Cost of Goods Sold		
Beginning Finished Goods, January 1	22,000	
Cost of Goods Manufactured	104,000	
Cost of Goods Available for sale	126,000	
Ending Finished Goods, December 31	18,000	
Cost of Goods Sold		108,000
Gross Profit		102,000
Operating Costs:		
Marketing, distribution, and customer-service	70,000	
Total operating costs		70,000
Operating Income		\$32,000

Figure carries forward from the Schedule of Cost of Goods Manufactured

Period Costs are expensed as incurred

# Cost Flowchart



# Other Cost Considerations

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- Prime cost is a term referring to all direct manufacturing costs (labor and materials)
- Conversion cost is a term referring to direct labor and factory overhead costs, collectively
- Overtime labor costs are considered part of overhead

# Different Definitions of Cost for Different Applications

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- Pricing and product-mix decisions – may use a “super” cost approach (comprehensive)
- Contracting with government agencies – very specific definitions of cost for “cost plus profit” contracts
- Preparing external-use financial statements – GAAP-driven product costs only

# Three Common Features of Cost Accounting and Cost Management

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- Calculating the cost of products, services, and other cost objects
- Obtaining information for planning and control, and performance evaluation
- Analyzing the relevant information for making decisions