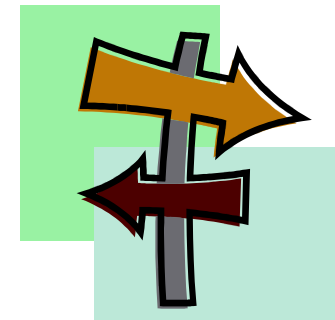


Topic 2

Production and Non-Production Costs

Session Objectives

- Explain and illustrate production and non-production costs
- Describe the different elements of production cost - materials, labour and overheads
- Describe the different elements of non-production cost



Session Objectives

- Explain the importance of the distinction between production and non-production costs when valuing output and inventories
- Distinguish between direct and indirect costs in manufacturing and non-manufacturing organizations



Session Objectives

- Identify examples of direct and indirect costs in manufacturing and non-manufacturing organizations
- Describe and illustrate, graphically, different types of cost behaviour
- Explain and provide examples of costs that fall into the categories of fixed, stepped fixed and variable costs



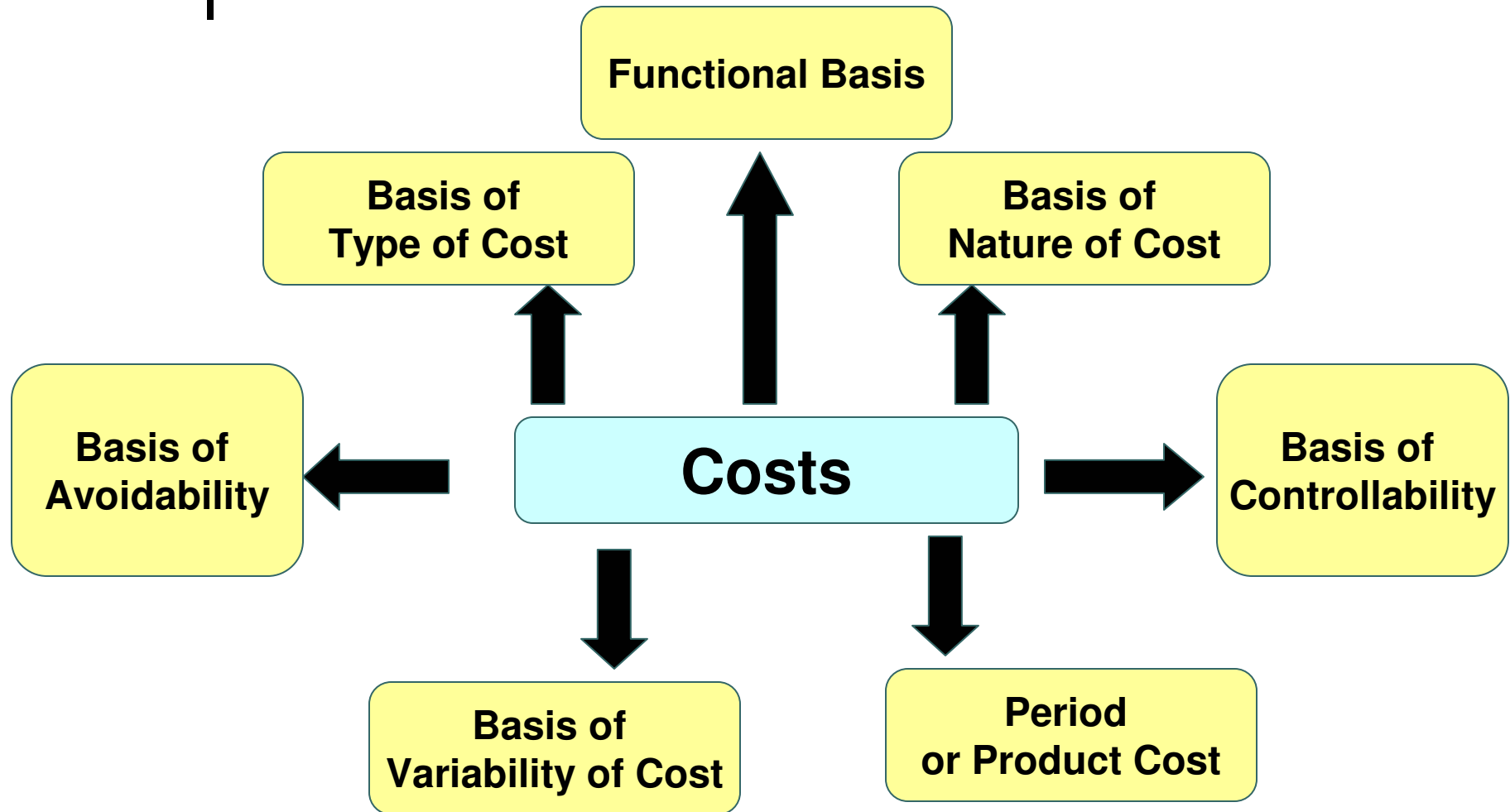
What is Classification of Cost

- A means of analysing costs into logical groups so that they may be summarised into meaningful information form management use or for use in the preparation of external financial reports

Why Should Costs be Analysed?

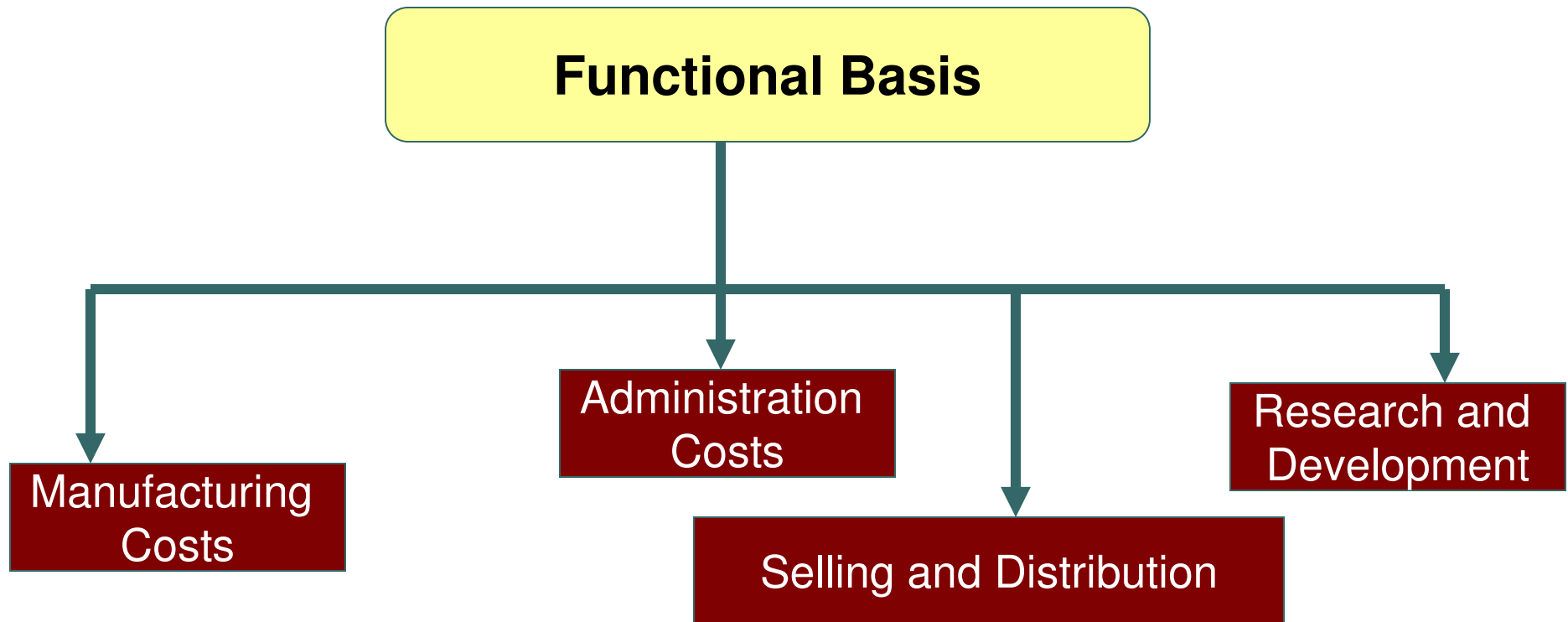
- Different issues require different cost summaries
- Enable management to exercise control by means of comparisons between planned costs and actual costs

Classification of Cost: Basis



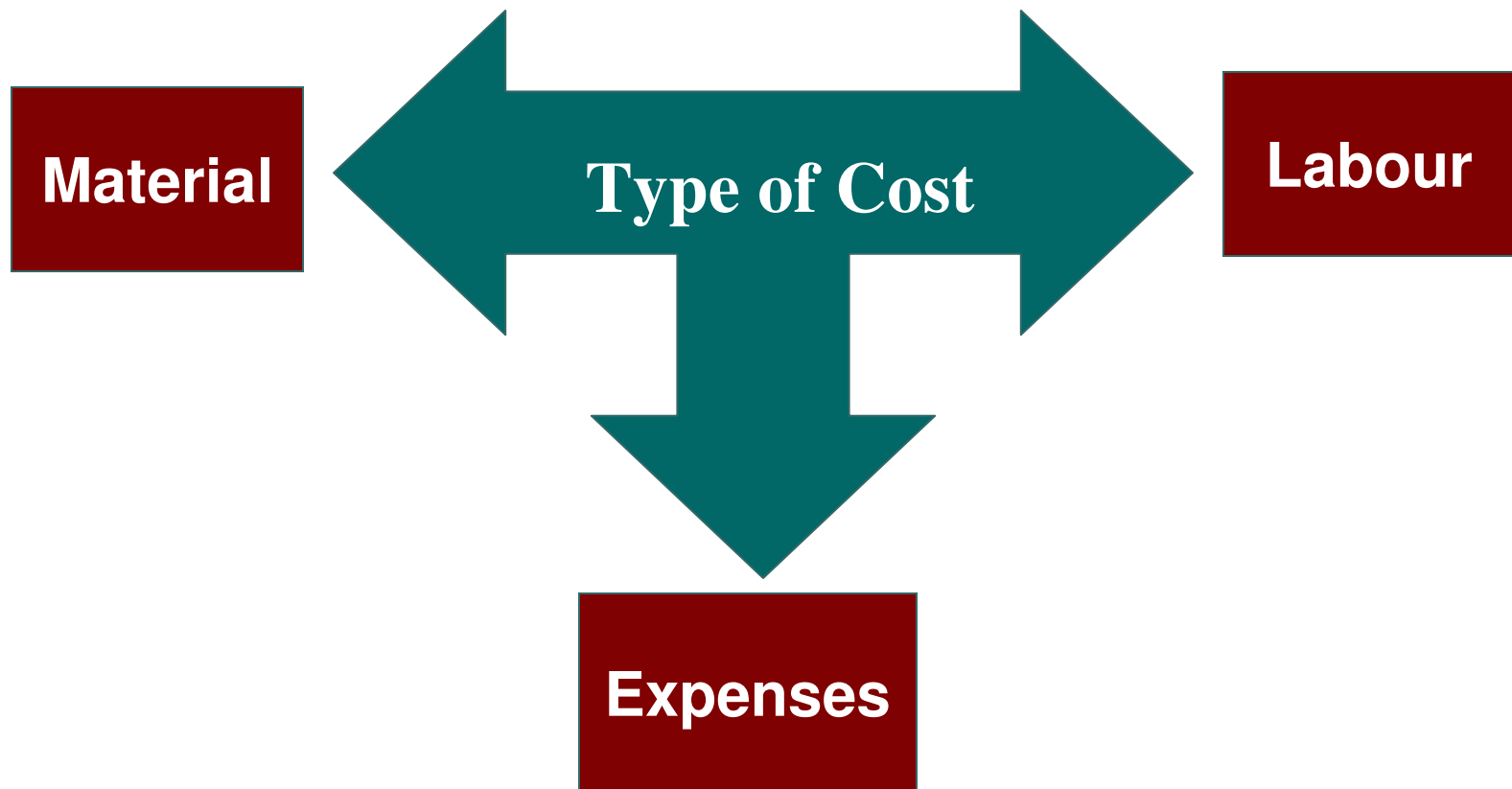
ACCA-F2-Management Accounting

Basis 1: Functional Classification of Costs

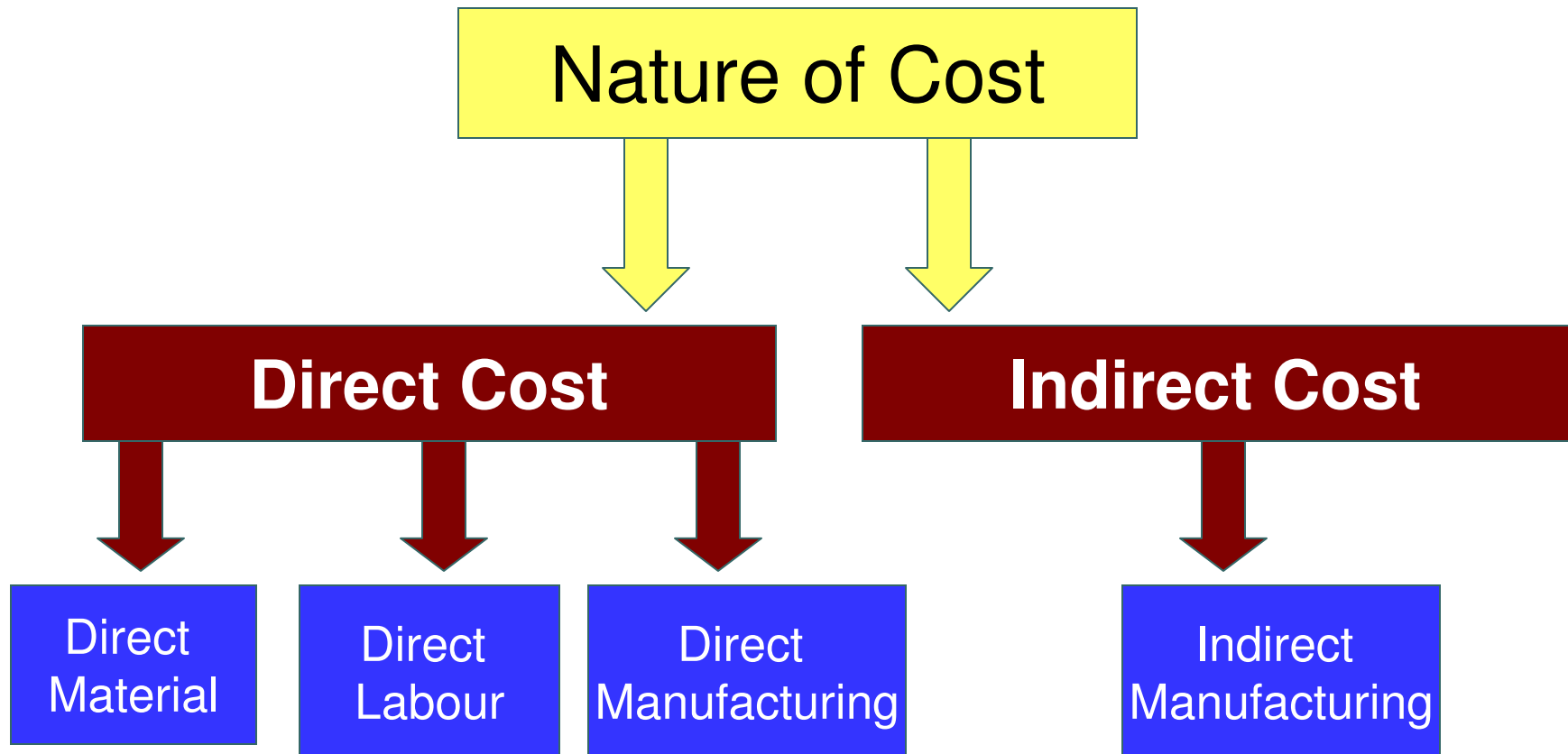


Functional Classification varies from organisation to organisation

Basis 2: Type of Cost



Basis 3: Nature of Cost



What are Direct Costs

- Those costs that can be consistently related to work performed on a cost objective.
- Direct costs are made up of direct material, direct labour and direct manufacturing or servicing costs.



What are Indirect Costs

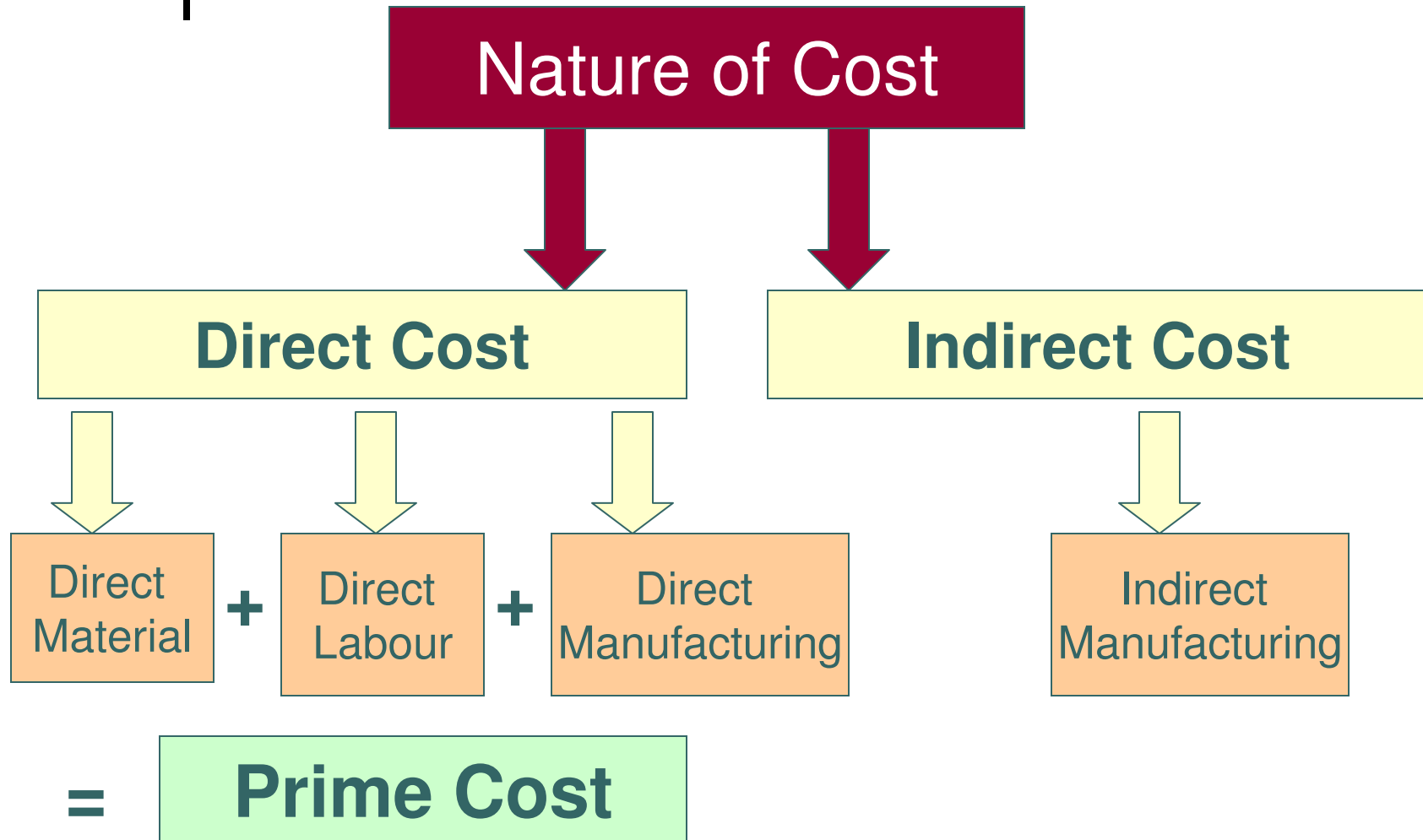
- Costs that cannot be traced exclusively with a given cost objective in an economically feasible way.
- These costs incurred for common or joint objectives



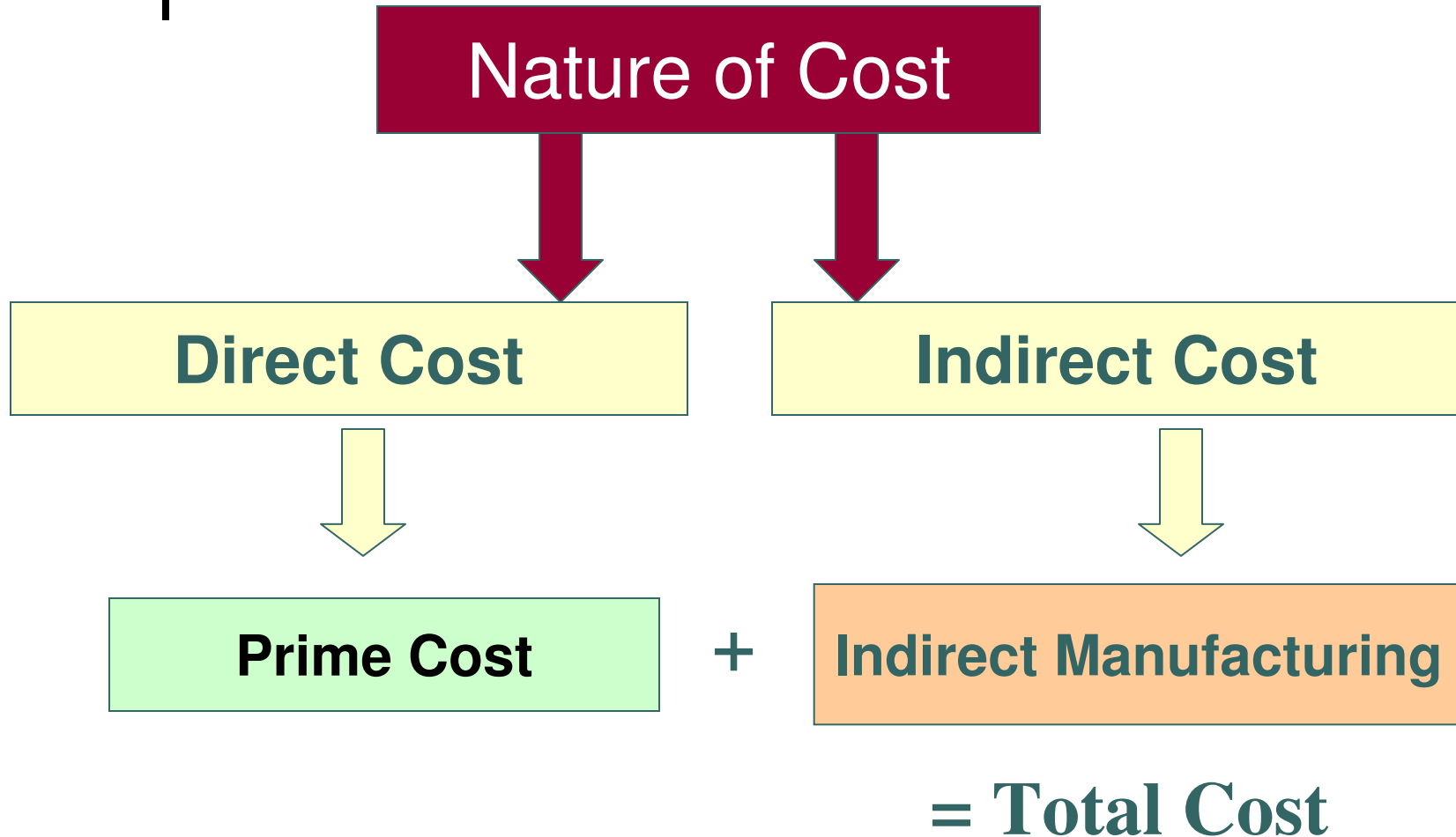
Classifying Costs as Direct and Indirect

- Managers prefer to classify costs as direct rather than indirect whenever it is “economically feasible” or “cost effective.”
- Other factors also influence whether a cost is considered direct or indirect.
- The key is the particular cost objective.

Direct and Indirect Costs

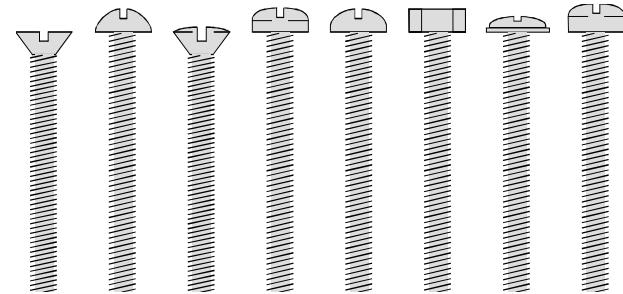


Direct and Indirect Costs

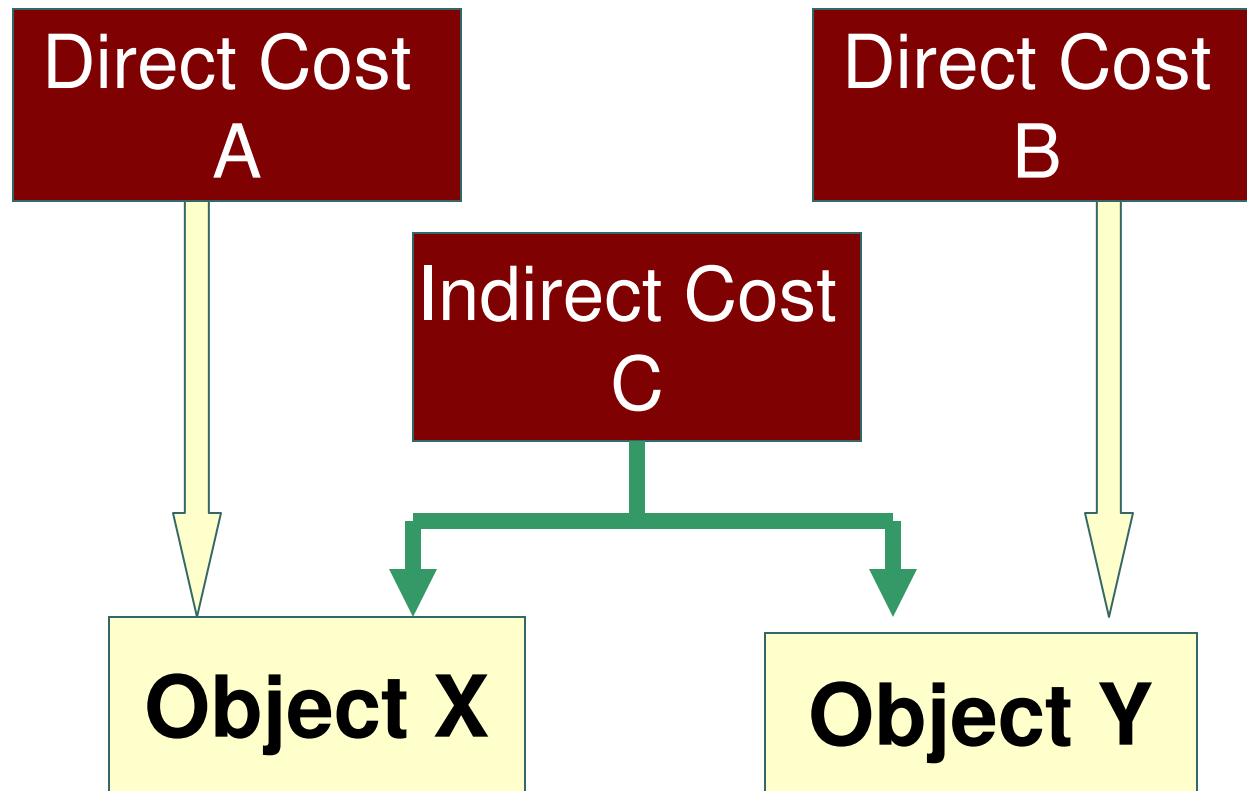


Indirect Manufacturing Costs...

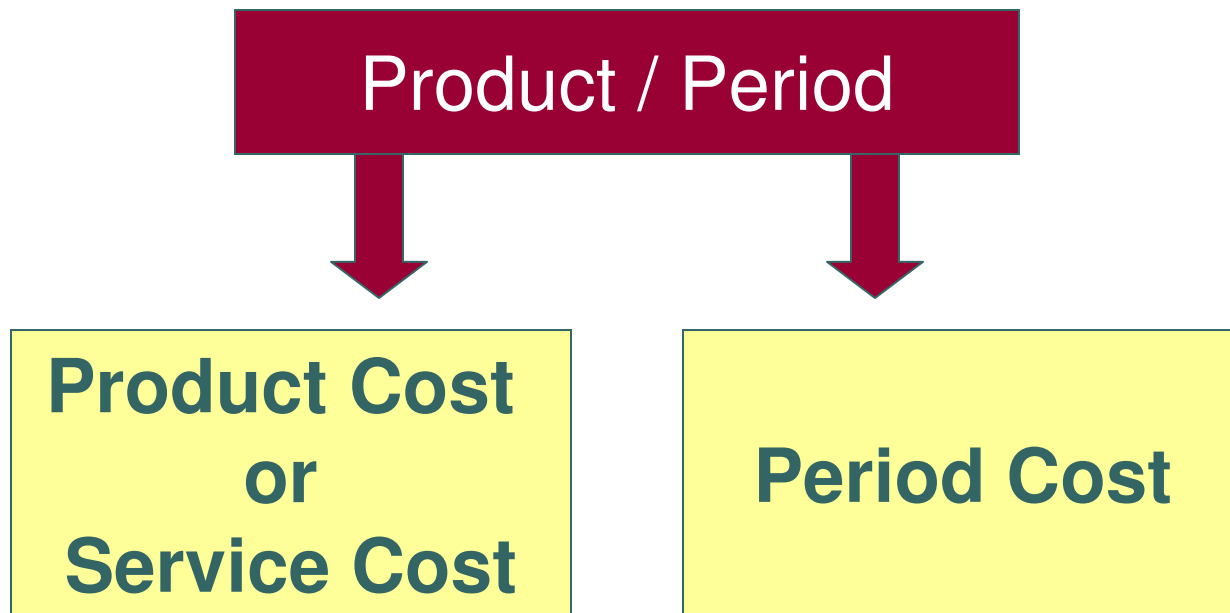
- Also called *factory overheads*
- Include all costs associated with the manufacturing process that cannot be traced to the manufactured goods in an economically feasible way.



Cost Assignment

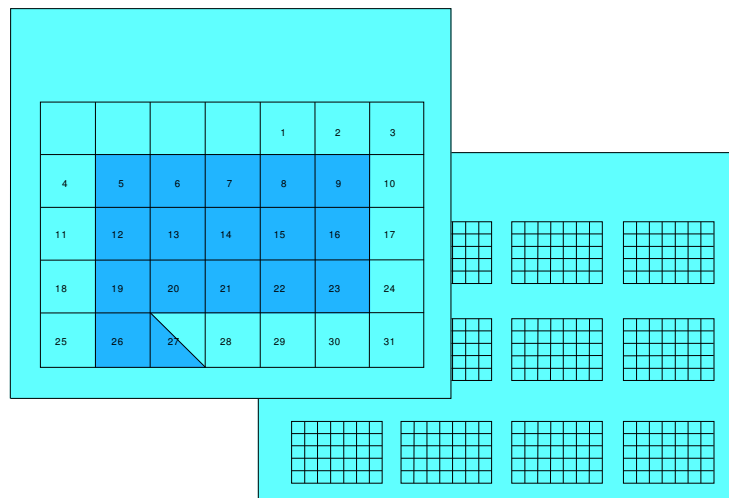


Basis 4: Product Costs and Period Costs



What are Period Costs...

- Costs related to the passage of time rather than product volumes, which may include depreciation, rent, property taxes or insurance.

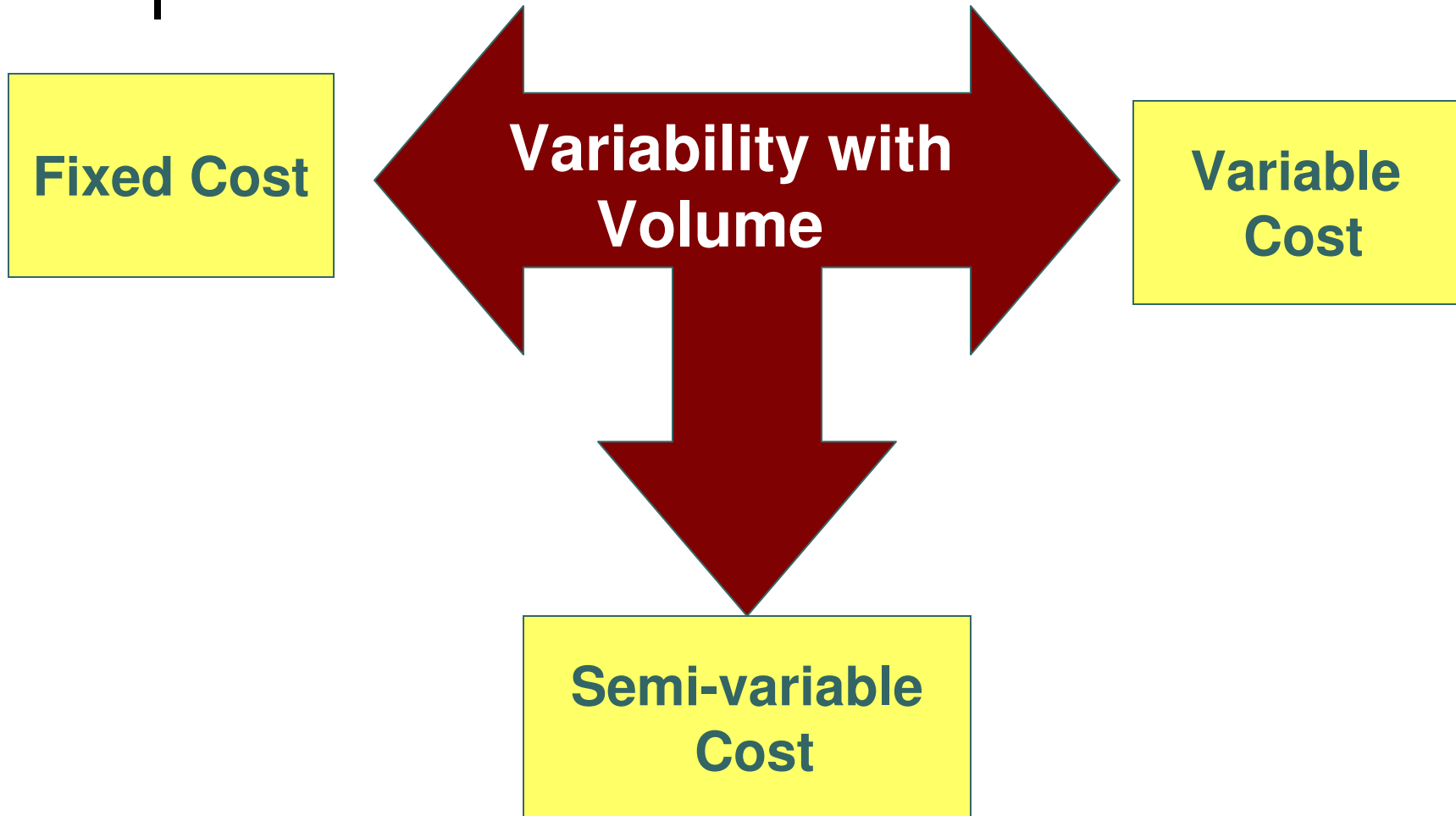


What are Product Costs...

- Total manufacturing cost of product excluding sales, marketing and company overhead.



Basis 5: Variability with Volume



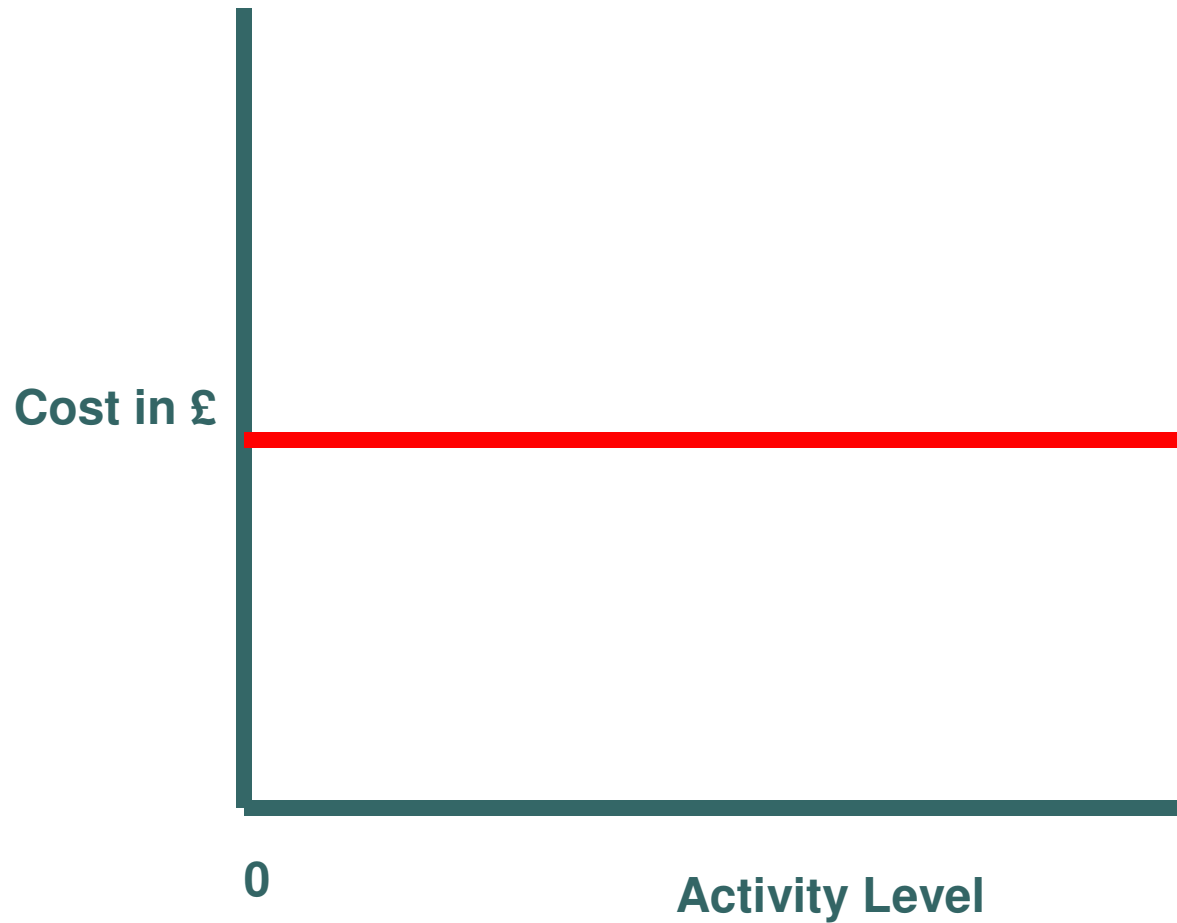
Fixed Cost

- Fixed costs are costs that are incurred by the firm whether it produces or not
- These costs remain constant in amount whether its production volume is large or small.
- **Examples:**
 - Rent, insurance, and salaries of supervisory personnel are common examples.

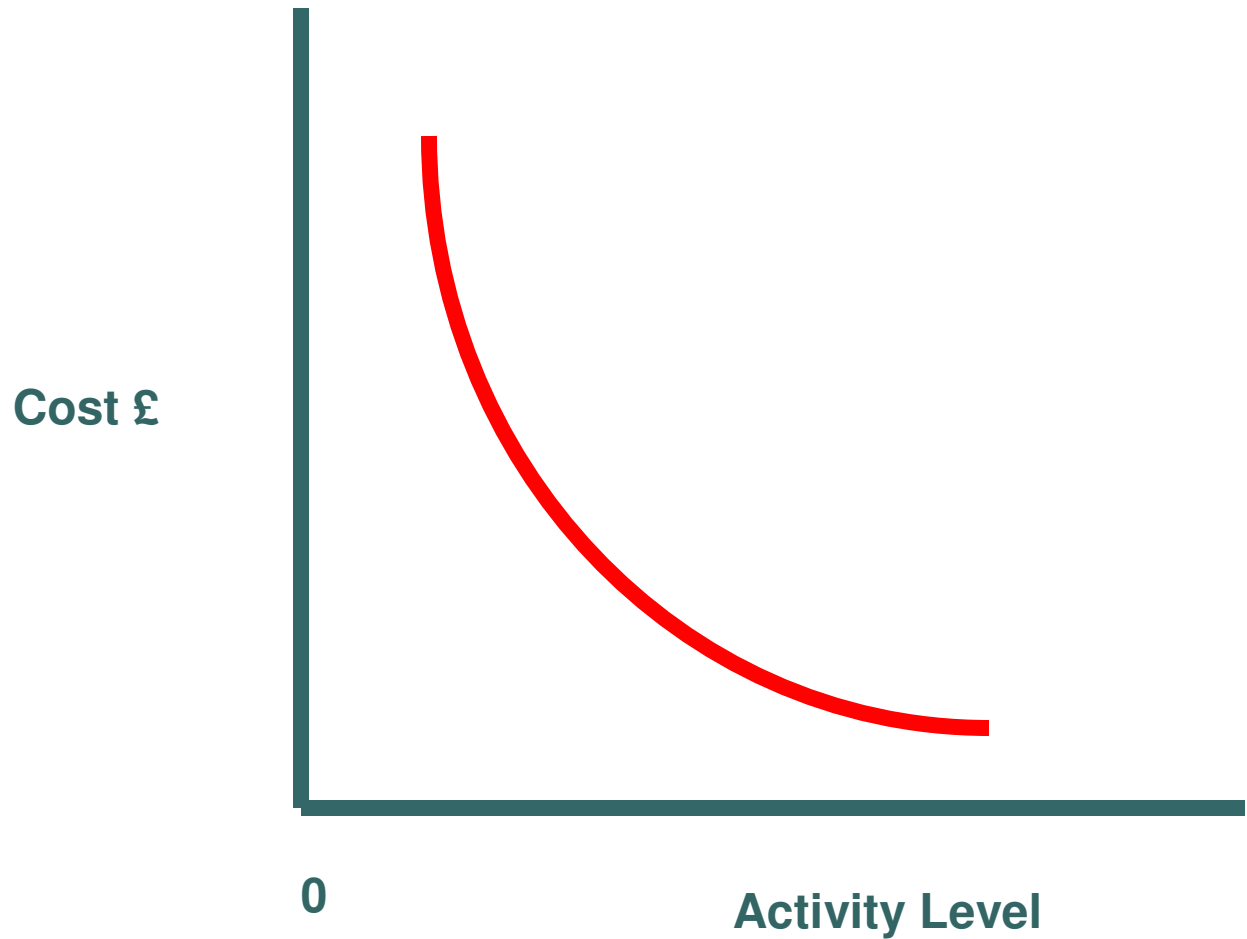
Fixed Cost

- In reality all fixed costs after a level change
 - **Example:**
 - After a specific level of production you may need an additional factory so additional rent
- If such costs are fixed in total, then the cost per unit falls with increase in activity level

Fixed Cost (Total)



Fixed Cost (per unit)



Variable Costs

- Costs associated with production that changes directly with the amount of production

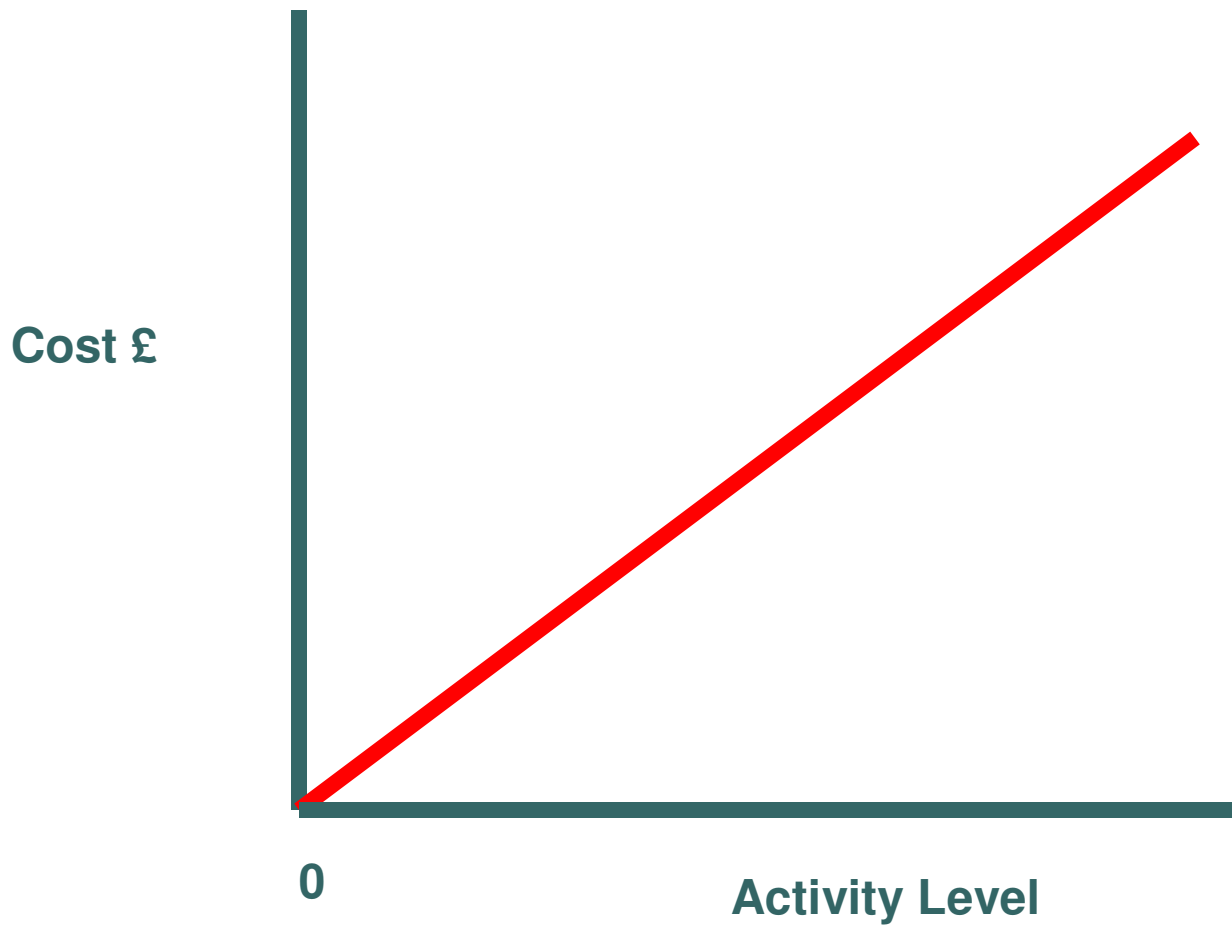
- **Examples**

Direct material or labour required to complete the build or manufacturing of a product.

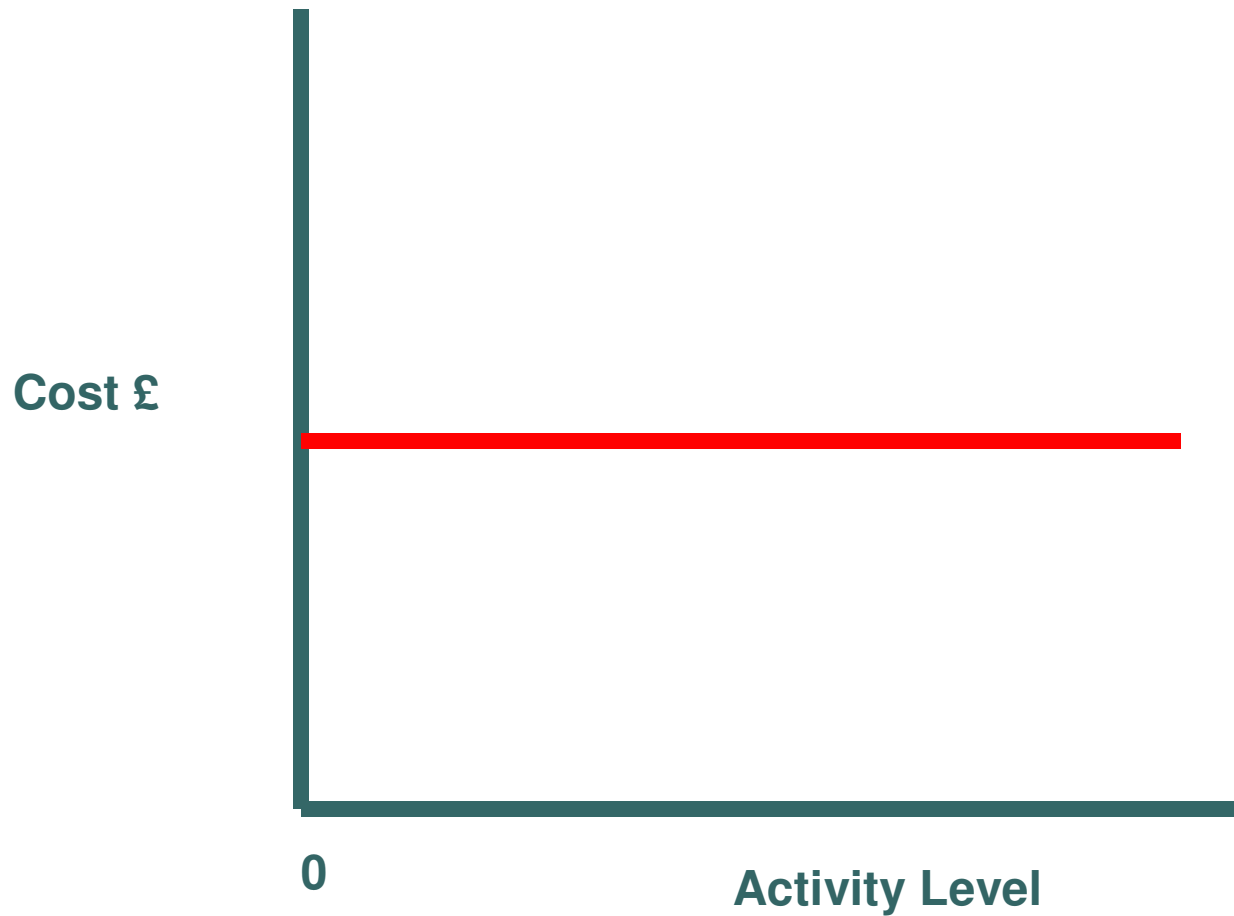
Variable Costs

- Some indirect costs may also be variable. Indirect costs that vary with activity level are called variable overheads
- Direct cost can also be fixed costs such as salaries of supervisory staff

Variable Cost (Total)



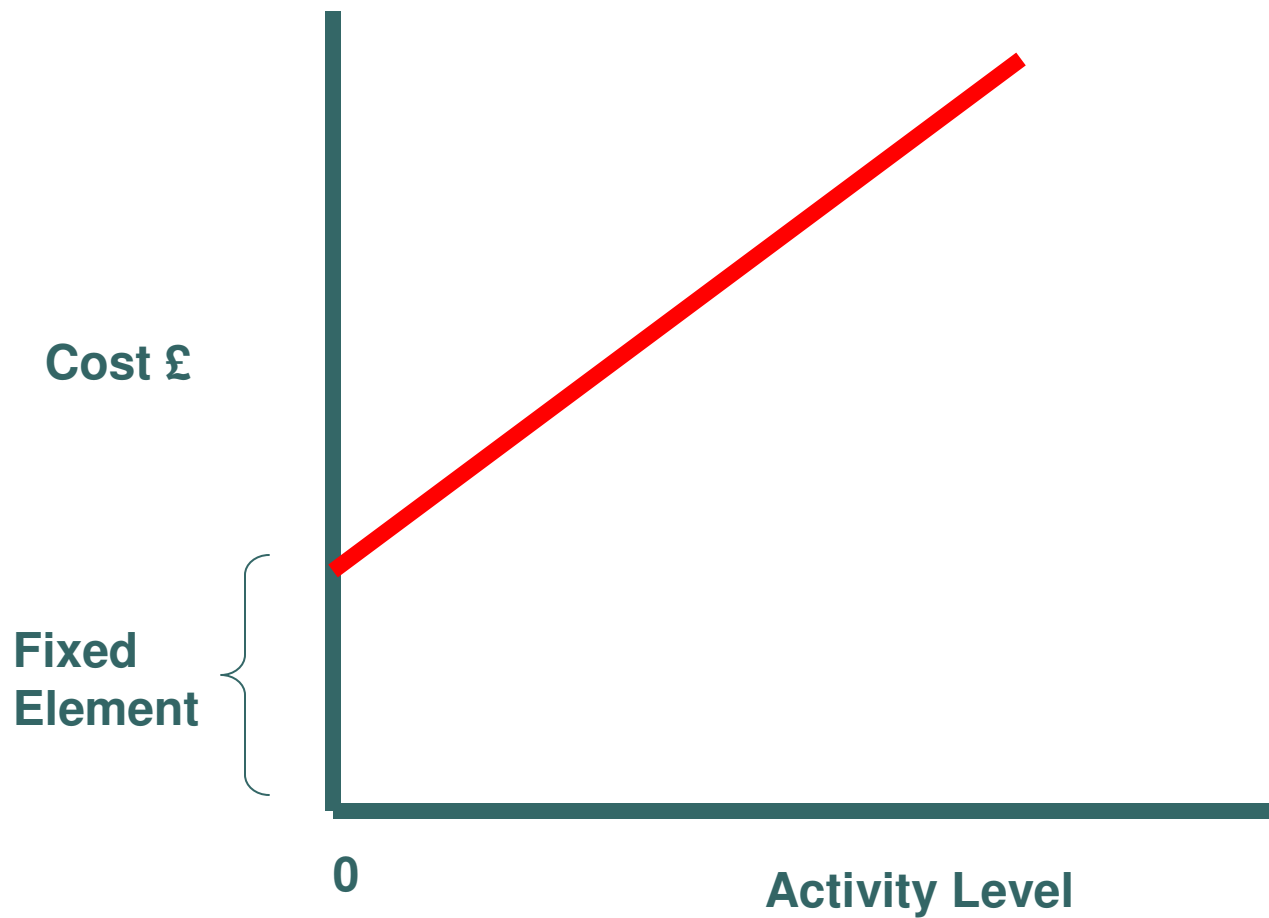
Variable Cost (Per Unit)



Semi-Variable costs

- have both fixed and variable components
- **Example:**
 - Utilities have a base charge plus additional charges depending on usage.
 - Sales managers may have a base salary plus additional compensation based on sales.

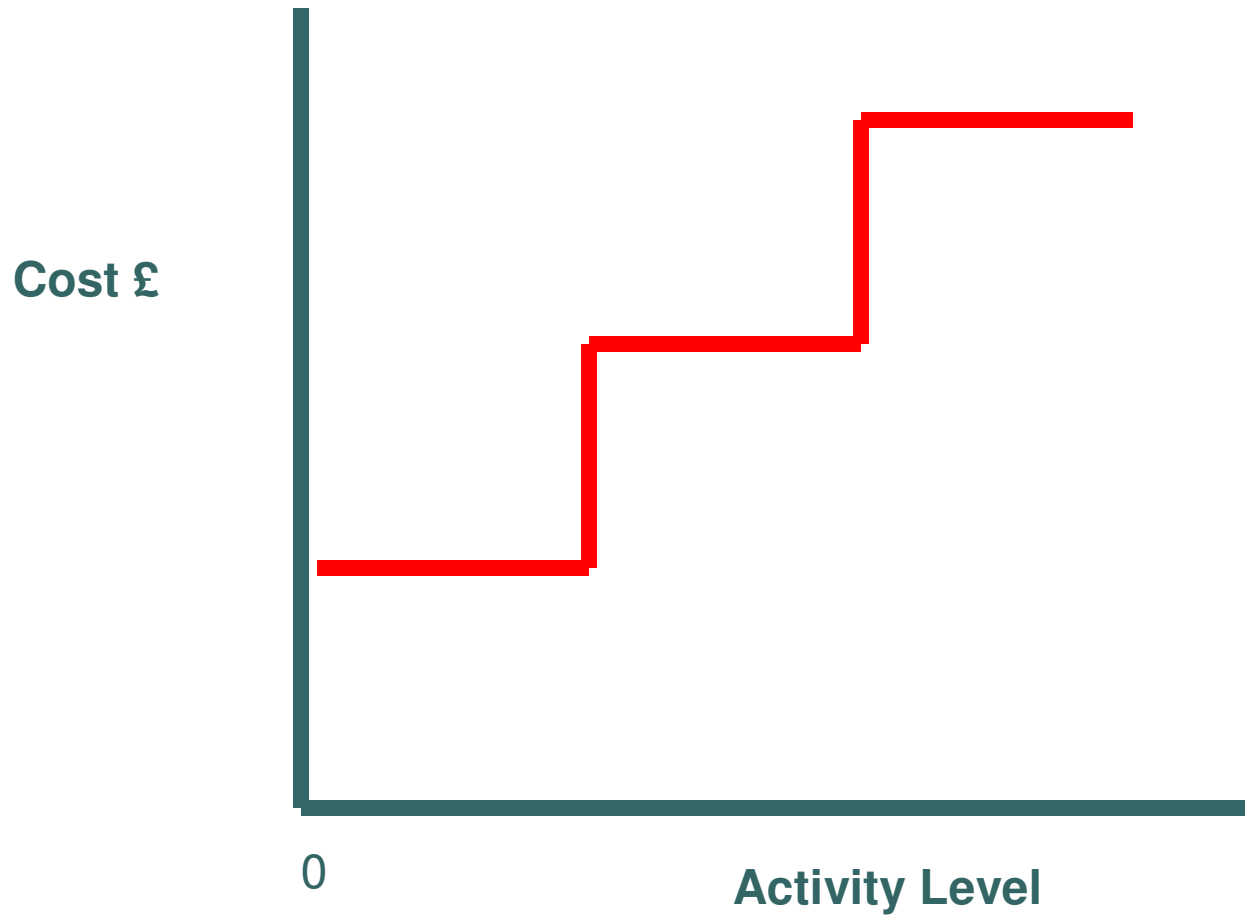
Semi-Variable Cost



Stepped up Cost

- Costs that are constant for a range of activity levels and then change
- Important for decision makers who need to know whether as a result of any decision they take some costs may rise or fall

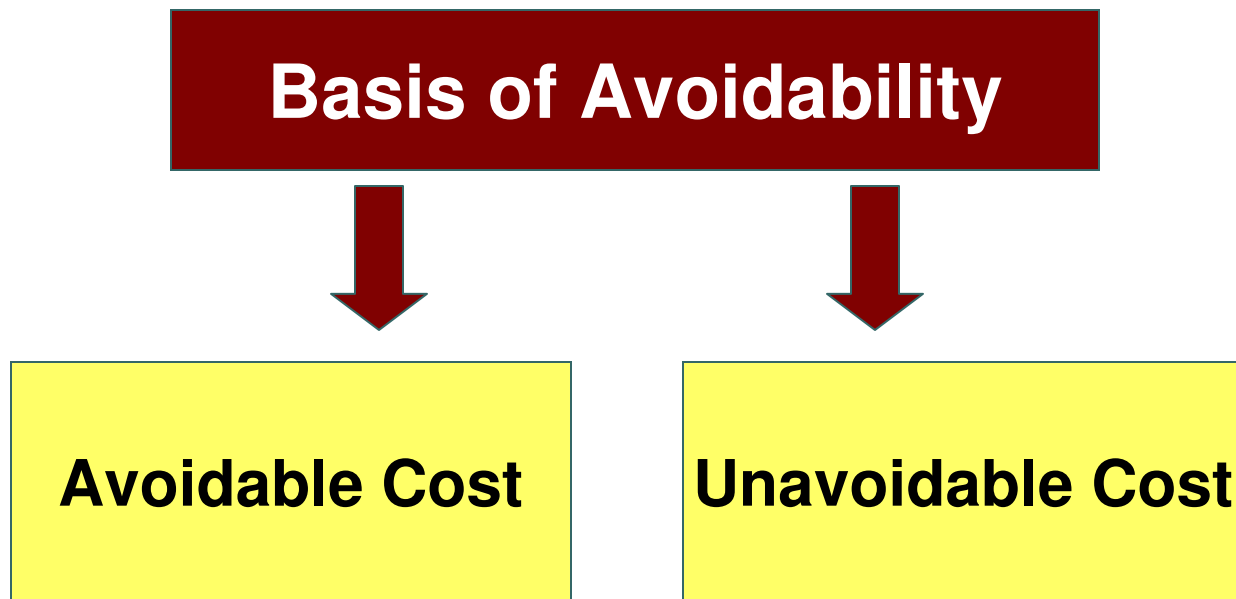
Step-up Cost



Need for Distinction between Fixed and Variable Costs

- For product costing
- To analyse profitability
- Take decision on changing the activity level
- Estimate future costs
- Assess performance

Basis 6: Avoidability



Avoidable and Unavoidable Costs

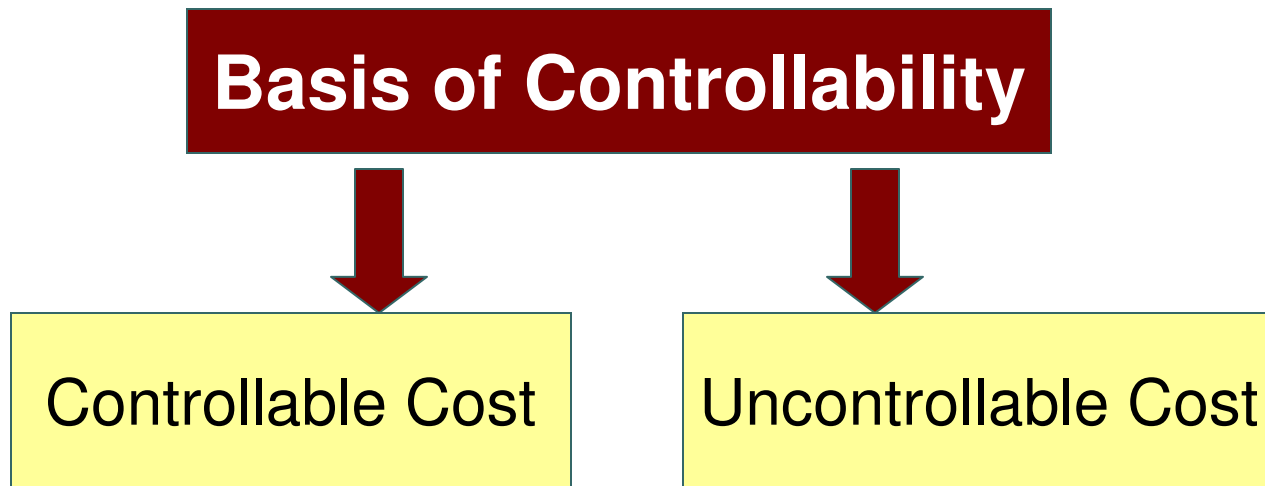
- **Avoidable Costs:** Can be eliminated by changing the operation or taking one course of action rather than another
- **Unavoidable Costs:** Costs that will **not** be changed regardless of any decision that is made.

Avoidable and Unavoidable Costs

- Depends on the decision being made and the time period being considered
- **Example:**

Organization wants to stop production of Product A. Avoidable costs are likely to be direct materials, direct labour and direct expenses. However, rent on the factory is an unavoidable cost.

Basis 7: Controllability



Controllable and Uncontrollable Costs

- Cost may be controllable by a particular manager in a given time period.
- Over a long enough time-span most costs are controllable by someone in the organisation
- **Example:**
Factory rental may be fixed for a number of years but after a few years top management may decide to move to another premises

Sample Exam Question

- Which of the following costs are NOT classified as production costs by a manufacturing organisation?
 - A. Product inspection costs
 - B. Product packaging costs
 - C. Commission payable to direct salesmen
 - D. Machinists wages

Answer

- C
- Sales commission is selling and distribution cost and not a production cost. All other listed costs can be classified as production costs.

Sample Exam Question

- What is the total production cost of a product composed of?
 - A. Direct material and direct labour costs
 - B. Direct material, direct labour, manufacturing overhead and selling costs
 - C. Direct material, direct labour, manufacturing overhead, selling and administrative costs
 - D. Direct material, direct labour and absorbed manufacturing overhead

Answer

D

Total production cost is constituted by direct material, direct labour and absorbed manufacturing overhead. Selling and administrative costs are not included in the production costs.