Programmed costs

The following definition of terms with corresponding examples will help us fully understand the meaning of costs. A cost may be broadly defined as being the sacrifice required to obtain a given object or objective. If costs are to be identified with some relevant unit, such as a department, product line or given amount of service, it is necessary to determine how costs can be expected to behave under different conditions. For example, which costs can be expected to remain constant when there are increases or decreases in the amount of work done?

Also, which costs increase as more work is performed? If costs are to be estimated and controlled properly, it is necessary to know whether or not the cost can be expected to change under given conditions and, if so, by what amount. In accounting, fixed costs refer to the costs that do not change in total amount with changes in volume of output or activity over an established or relevant range. Such items as salary of plant of a plant superintendent, depreciation, insurance, taxes, and rent usually remain the same regardless of whether the plant is above or below its normal operating capacity.

However, a fixed cost, like any cost, is subject to certain variations. Rent may increase or insurance rates go up, but these changes are caused by factors independent of the firm’s operating level. Fixed costs are sometimes classified as being either committed costs or programmed costs. Management, in making long-range decisions, may commit a company to a cost pattern that extends several years in the future. For example, when a building is acquired, future years have to absorb the depreciation cost and the related property tax, insurance, repairs, and maintenance.

These fixed costs are committed costs. Programmed costs, also referred to as managed costs or discretionary costs, are determined as a part of general management policy. A budget for product research and development, for example, may be established each year; or supervisory salaries are set each year by management decisions. These costs are established at a certain fixed amount, but the amount is determined by management. Variable costs are costs that vary in direct proportion, or in a one-to-one relationship, to changes in productive output or activity.

For example, direct material cost is usually a variable cost with each unit manufactured requiring a certain quantity of material. Thus, the materials cost changes in direct proportion to the number of units manufactured. Irrelevant cost is a cost that will not be changed by a decision. Because an irrelevant cost will not be affected, it may be disregarded in the decision-making process. The cost may be variable cost or a fixed cost . The important point is that the cost is not changed by the decision.

If the decision involves the production of more units of product, variable are increased and are not irrelevant costs. On the other hand, if no change in productive output or hours of activity is involved in the decision, the variable cost may not be affected, in which case they are disregarded withrespectto the decision. Costs can also be classified as being direct or indirect with respect to an activity, a department, or a product. The distinction depends upon whether or not the cost can be identified with the activity or other relevant unit without allocation.

A cost such as the plant superintendent’s salary can be readily identified with the plant and hence is a direct cost of the plant. However, it is an indirect cost of any department within the plant or of any line of product manufactured. The plant superintendent's salary cannot be identified with any unit within the plant except by allocation. A sunk cost is a cost that has already been incurred in the past whose total will not be affected by any decision made now or in the future.

Example, an individual may regret having made a purchase but, after the purchase have been made, cannot avoid the cost by taking subsequent action. Perhaps the property can be sold, in which case the cost of the property is matched against the proceeds from the sale in the determination of gain or loss. Or the person may decide to keep the property, in which case the cost is matched against revenue over the time that it is used in operations. In any event, the cost has been incurred and cannot be avoided.

It is sunk cost with respect to present and future decisions. Another important aspect of cost to be considered is the distinction between cost that can be controlled by a given person and those that cannot be controlled by that person. Cost are incurred upon the authorization of some member of the management group. If a manager is responsible for a given cost, that cost is said to be controllable with respect to that person. If the manager does not authorize that cost, the cost is uncontrollable with respect to that manager.

For example, top management can increase or decrease executive salaries and can initiate or abandon major projects. At intermediate or at lower management levels, such cost are beyond their authority and are uncontrollable. Costs that can be authorized at a certain managerial level are said to be controllable at that level. REFERENCES : Blocher, E... et al. (2005). Cost Management: A strategic emphasis. Boston : Mcgraw-Hill/ Irwin.

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