

Identify different  
types of cost that an  
organization would  
incur



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In management accounting there are several ways of classifying the different types of cost. These classifications depend according to the immediate need of management. I have classified different types of cost and have explained each of them below.

## **Cost classification**

Cost elements

Direct cost

Direct materials

Direct labor

Direct expenses/ overheads

Indirect cost

Indirect materials

Indirect labor

Indirect expenses/ overheads

## **Types of cost**

Fixed cost

Variable cost

Semi-variable

Marginal cost

## Cost element

A cost is incurred in purchase raw materials to producing finished goods, administrative, marketing and selling activities. These costs are normally classified by manufacturing companies as direct and indirect costs.

## Direct cost

Direct costs are all those cost that are directly linked with the production of goods and services. The direct costs can be further divided into 3 main categories.

## Direct materials costs

Direct Material is the initial material that goes into the final product and can be traced back to it from the finished product.

E g: - A company that manufactures note books will use papers, ink, stapler pins, machines and labors for producing books. Here the papers, ink and stapler pins are the direct material for this company. So any cost incurred in buying and handling of these raw materials can be taken under the direct raw material costs.

## Direct labor costs

Direct labor cost is the cost of employees or workers directly involved in the production of goods or a service.

E g: - Fixed salary of a worker involved in the production line; that is in some part of production like cutting papers, binding papers etc.

### Direct expenses / overheads costs

The cost of services which involved producing finished product or expenses included particular production.

E g: - Chargers for electricity usage for the machine used to make the note books in a book manufacturing company.

### Indirect costs

Indirect costs are those that are not directly involved in the production of the good or services. These costs are essential part of producing the final product. The indirect can be further divided in to 3 main categories.

#### Indirect material costs

Indirect Material is not the initial material that goes into the final product and can be traced back to it from the finished product. It is the materials or tools that can make the production of goods or a service efficient and easier.

E g: - In a government factory, the sewing machines, printing machines etc. can be the indirect materials as these machines are not a part of the final product (clothes).

#### Indirect labor cost

Indirect labor cost is the cost of employees or workers not directly involved in the production of goods or a service. In other words it is the work or task done by a worker that does not produce any products but this service is necessary for the success of the finishing point of the production.

E g: - The wages of inspectors, store keeper, watchmen, machine maintenance etc.

Indirect expenses/ overheads costs

Indirect expenses are the expenses are not directly linked with the production of a good. These costs are charged to the final product.

E g: - Selling and administrative expenses, telephone expenses etc.

Types of costs

Cost can also be classified based on how frequent they react to production.

Fixed cost

Fixed cost is the cost that never changes over a period of time. And also it does not increase with the output of the firm.

E g: - Rent, wages of permanent workers etc.

Variable cost

Variable cost is the cost which sustain of the input that vary with the production level. These cost change in the short run.

E g: - cost of raw materials, wages paid for the worker of the production line.

Semi variable cost

Semi variable cost is composed of a mixture of fixed and variable elements.

Therefore it also named as semi fixed cost. It is also referred to those cost

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that remain as a fixed cost until a particular level at which it becomes variable.

E g: - monthly rental for a phone may be charged with call charges. Here the rental is fixed as the call charges are variable.

Explain with examples why different costing methods are used by organizations in the modern context.

Costing methods are used by companies as means for pricing or stock valuation and to control business or to assist in managerial decision making. Costing methods are very important in accounting in order to make the right decision for the success of the organization. If the company failed to make the right decision at the right moment, it will be a reason for the drawback of the organization. Now let me show you some reasons why these methods are Applying in a business.

To decide buying or making a product more profitable for the organization.

To decide whether to accept or reject an order placed by a consumer.

Make decisions of extending business to international level by doing business with foreign countries.

To decide extra shifts or extra efforts in a production of a product or reducing production.

To plan how much profit is needed or measure the capacity of the profit of the business.

To decide whether to shut down the company if it is making continues loss or to try to improve the business if there any chance.

A company starting out might use the break even concept to calculate and see at what level the company can start earning profits and at which level the company will be suffering a loss.

To decide whether the current plant is working out or not and to decide if replacing the existing plant is going to be profitable for the company or not.

To decide to star production of a new product or to stop the production of an existing product.

## Examples

Costing for pricing and stock valuation

### Job costing

This method for costing is followed where the costing is done separately for each product. Therefore job costing is mostly used in a situation where the products manufactured or service provided are based on a particular specification of the customer or many goods are made for costing done separately. The productions of these goods are higher due to the fact that they are orders placed by customers.

E g: - Job costing used in construction industry because the constructions based on the orders placed by the customers. Here the costs are calculated separately for each building.

### Batch costing

Batch costing means all the fixed and variable cost which is incurred when producing a batch or a set of products. Here a number of products are taken as a single job in total. The unit cost of a batch of products can be calculated by dividing the batch cost by the number of units produced.

E g: - A shoe manufacturing company may produce 100000 products per month. These 100000 products may be labeled as a batch at that particular date and cost is calculated for the entire batch taking all products as a single job.

### Contract or terminal costing

Contract costing is also similar to job costing. It is usually connect with site based work, by the requirement s of the customers' undertaken and relatively long duration.

E g: - Company involved in the construction industry may use this method as individual customers place different contracts which last for several years or accounting periods.

### Process costing

Process costing is found where the product go through various stages as it goes to the finished product. Products which are made by combining different parts of the final product are also including the process costing method. The following is terms are also used under process costing.



## Operation costing

### Single or output costing

E g: - A finished computer passes through various processes. First of all are made separately and they are fixed together in the final progress. For this product the costing is calculated based on the process.

### Operation costing or service costing

Operation costing method is used by companies which does not have a specified finish product as the output like the service industry.

E g: - Service of a lecture

### Departmental costing

Here the costing of the products is based on the departments at which they are produced. Costs of products are calculated as how cost and at which department.

E g: - News papers are made at different departments.

### Multiple costing or composite costing

Multiple costing applied to calculate the cost for the products which have a very complex production. For these kinds of products one costing method may not be enough. Therefore they use several costing methods in calculating.

E g:- Products like vehicles, airplanes etc. the total cost is based upon a mixture of sub prices calculated in the job costing and service costing etc.

Control and managerial decision making

Activity based costing

It is the attribution of costs to cost units based on the benefits received from indirect activities.

E g: - Cost of quality controls is spread among the units produced and each contains a part of this expense.

Historical costing

Historical costing is ascertaining costs after it have been incurred so that costs can be compared over different period.

Direct costing

All direct costs are charged to the finish product and all indirect products are charged to profit and loss.

Absorption costing

Here both variable and fixed costs are taken as a total cost and charged on the product.

Marginal costing

In this costing method the variable costs are taken rather than the full cost of production and total fixed costs are deducted to get the profit or loss.

Collect production details from any organization that produced three products, analyze and present these data.

### **Propose the terms productivity, efficiency and effectiveness and evaluate its impact on any selected organization.**

Explain the terms productivity, efficiency and effectiveness and evaluate its impact on any selected organization.

The modern environment to managing a company specifies that productivity, efficiency and effectiveness are important for the success of the organization and also for the survival among the competitors in the business field. This is based on the fact that one company which is not concerned with these matters is actually on a worthless path and may easily lead the company to come to an end of business.

#### Productivity

Productivity is a measure of output from a production process, per unit of input. It is fairly similar to efficiency as productivity also measures the same as efficiency. However productivity is an outcome from the sum of effectiveness and efficiency or by the way of increasing the effectiveness and efficiency productivity also increase. There are two way to measure the productivity of a company as I shown below.

Productivity = Output

Input

Productivity = Value of output / time

In the above formulae the time can be many different factors such as energy, resources etc. And the value of output is the defined quality of output by the organization.

**Productivity = Output > Amount of achieved goals > Effectiveness.**

**Inputs > Amount utilized resources > Efficiency.**

However enhanced productivity always defines rather value of an organization as follows:

Can restrict the waste of resources.

Company always can sustain the increasing demand.

Company easily can faces to the competition of the market.

Employee development also increases.

Manufacturing quality increases.

Production cost can get low and purchase prizes can restricted.

Net profit increases.

There are five ways that can helps to enhance the productivity as I have shown below.

Enhancing the output, when the inputs keeping as stet.

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Output keeping as stet, when as the input decreasing.

Enhancing the output, when as the input decreasing.

Enhancing output rather than enhancing inputs.

Decreasing inputs rather than decreasing inputs.

### Efficiency

Efficiency is doing the thing right. In other words contribute the resources by minimum wasting to achieve the organizational goals and objectives or the way to utilize the resources to achieve the organizational goals and objectives. Efficiency is closely related to the productivity.

E g: - A company that produces shoes could be said efficient if it uses up all the resources in order to output as much products or services. If a company reaches criteria it could be labeled as an efficient company.

Efficiency = total output/ total input.

Now let me evaluate its impact on ABC Company and XYZ Company

E g: - Company ABC produce 50 tables in 10 days and company XYZ produce 120 tables in 20 days.

Based on the above calculations we can identify that the company XYZ is more efficient as it is able to produce 6 tables per day compared to company ABC which can only produce 5 products per day.

### Effectiveness

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Effectiveness is doing the things right. In other words achieving the appropriate objectives in the given period or deciding the right things.

Therefore effectiveness is the liability of the company to achieve the set targets and objectives. Effectiveness is measured by output in terms of the set target by the company.

E g: - A company is producing mobile phones. The company wants to earn a minimum of \$100000 profits in one month and has set a target of producing 5000 mobile phones in order to achieve the profit. And after a month the company is able to make 6000 mobile phones.

Effectiveness =  $6000/5000$

Effectiveness = 1.2

However Effectiveness and Efficiency always expresses the relativity between each other's to the Management as follows:

## **How it is done?**

### **In the wrong way, in the right way,**

Ineffectiveness & Inefficient Effectiveness but Ineffectiveness

[Die fast] [Die Slow]

Effectiveness but Inefficient Efficient & Effective = Management

[Survive] [Strive for success]

The best approach for a company would be a mix of both efficiency and effectiveness. This is because without effectiveness an efficient company will

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eventually meet the wrong conclusions and without efficiency an effective company cannot gain the maximum profits or may be in loss. By having the perfect mix of these a company can save time and stress to gain more profits.

Explain in detail the principles of Quality & Value and how it is implemented in organizations.

An introduction to quality management

Quality control can be traced back to a very long time ago in craftsmanship and at the time of building the pyramids. Here a master craft man looks after all the craft to see whether they satisfy the necessary quality needed. It was then used in all aspects of arts to make sure a good end product is made to satisfy the customers. This concept changed as US introduced assembly lines in production by dividing the product into interchangeable parts. Later the Japanese have adapted quality management in their business and defined quality management as a continuous improvement (which never ends).

What is quality?

Quality is the ongoing process of building and sustaining relationships by assessing, anticipating and fulfilling stated and implied needs. There are several ways of measuring quality and different people view quality in relation to different criteria.

It can be a measure of excellence where the product is free from all kinds of defects.

Quality can also be how much the company, product or service is able to satisfy the customers or how much they meet the customer expectations.

It maybe also a measure set by the company for a characteristic such as how much heavy, light, soft, tall, Thick or thin etc.

Reducing waste created in the production process or using the waste in creation of other goods.

The quality also is how uniform the end products are, with as minimum differences possible.

Quality management

Quality Management ensures the customer confidence and better efficiency within company. Therefore allow the company to better compete with the others in the business field. It involves several stages Quality control, quality assurance and quality improvement.

Quality control is a way of ensuring that finished products are reliable, suitable and money-wise best to meet a specification determined by the company. Quality control involves certain tests performed at the end to determine whether the product meets the set quality. Basically quality control is maintaining the quality within certain limits.

Quality assurance is ensuring that the products exceed the customer expectations. Quality assurance is more process oriented while the quality control is more concerned with the product. Basically quality assurance is



making sure that all the end products are free of defects. PDCA (Plan Do Check Act) is an effective method for monitoring quality assurance.

Quality improvement is an approach where ongoing process is analyzed and systematic efforts are put to improve it. It focuses on areas like:-

In industry: product failures or work-related injuries etc.

In administration: increasing efficiency or reducing re-works etc.

In medical practice: reducing medical errors and needless deaths etc.

Principles of quality for any organization

“ Create constancy of purpose towards improvement”. Replace short-term reaction with long-term planning.

“ Adopt the new philosophy”. The implication is that management should actually adopt his philosophy, rather than merely expect the workforce to do so.

“ Cease dependence on inspection”. If variety is reduced, there is no need to inspect manufactured items for defects, because there won't be any.

“ Move towards a single supplier for any one item”. Multiple suppliers mean variation between feedstock.

“ Improve constantly and forever”. Constantly strive to reduce variation.

“ Institute training on the job”. If people are inadequately trained, they will not all work the same way, and this will introduce variation.

“ Institute leadership”. Deming makes a distinction between leadership and mere supervision. The latter is quota-and target-based.

“ Drive out fear”. Deming sees management by fear as counter-productive in the long term, because it prevents workers from acting in the organization’s best interests.

What is value?

Value means extent to which a good or service is perceived by its customers to meet his or her needs or want, measured by customer’s willingness to pay for it. It commonly depends more on the customer’s perception of the worth of the product than on its intrinsic value.

Principle of value for any organization

Anticipation: the anticipated future benefits to be derived from the property.

Balance: the equilibrium reached in a free market when complementary used of neighboring property permit maximum value for individual properties and the neighborhood.

Change: the continuing effects of economic, social, and governmental forces on the property and its environment, resulting in continuous change in market value which must be anticipated.

Competition: the tendency of a highly profitable use to be duplicated by others until an excess supply of similar goods and services reduces profitability, and thus value.

Conformity: the creation of maximum market value through a reasonable degree of similarity of property use, appearance, and owner demographics.

Consistent use: the requirement to value all aspects of a property: land, improvements, and personal property on the basis of a single class of usage at any given point in time.

Identify and assess potential improvement tools and techniques that modern organization use.

Many improvements can be brought to organizations by using tools and techniques. Quality experts have introduced many different theories which can help an organization in identifying and assessing potential improvements.

Deming's 14 points summarized

Create constancy of purpose towards improvement - replace short term reaction with long term planning.

Adopt the new philosophy - similarly by management and workers.

Stop depending on inspection- if variation is reduced; there is no need of inspection because there are no any items for defects.

Choose quality suppliers over low cost suppliers - to minimize variation in raw materials and supply.

Improve constantly - to reduce variation in all aspects e. g.:- planning, production, and service.

Set up training on the job - to reduce radiation for managers and workers in how job is done.

Leadership not supervision - to motivate people and get the best output from them not just to meet the targets.

Drive out fear - encourage two way communications and make interest for employees to work in the organization.

Break down internal barriers - internal departments have to work together as internal customers.

Eliminate slogans - processes make mistakes not people. Management harassment of workers will create bad relations if no effort made to improve processes.

Eliminate management by objectives - management by objectives encourages low quality goods.

Remove barriers to satisfy workers - including annual appraisals.

Encourage self improvement and education for everyone.

Everyone is responsible for continual improvement in quality and productivity.

(" W. Edwards Deming - Total Quality Management & Deming's 14 points".

Mftrou. com management for the rest of us. - Cited on July 27, 2010.)

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## **The Deming cycle (PDCA cycle)**

The Deming cycle is a process which includes four stages. It is mainly used for solving problems in business. The Deming cycle also called as PDCA cycle. PDCA stands for:

Plan

Do

Study (check)

Act

Plan - identify an opportunity and plan a change.

Do - test the change and take steps in control.

Study - study the results.

Act - take action based on what you learned in the study step. If you are not satisfied with the change, start going through the cycle from the beginning with a different plan and if you are successful take action to improve the process.

## **Six Sigma**

Six sigma is a data- driving method for quality improvement. It finds and eliminates the defects in production process by focusing on outputs. It focuses on customer satisfaction and outcome results by reducing variation and waste. Therefore it applies anywhere variation and waste exist. There

are two sub methodologies of Six Sigma. That is six sigma DMAIC and six sigma DMADV.

Six sigma DMAIC is an improvement system for improving an existing process by analyzing the defects in the end products and eliminating them.

Define

Define the project goals and customer (internal and external) deliverables

Measure

Measure the process to determine current performance

Analyze

Analyze and determine the root cause(s) of the defects

Improve

Improve the process by eliminating defects

Control

Control future process performance

Six sigma DMADV is an improvement system used to develop new process or product at six sigma level quality.

Define

Define the project goals and customer (internal and external) deliverables

## Measure

Measure and determine customer needs and specifications

## Analyze

Analyze the process options to meet the customer needs

## Design

Design (detailed) the process to meet the customer needs

## Verify

Verify the design performance and ability to meet customer needs

## **Kaizen**

This is the Japanese word for continuous improvement to the manufacturing of organizations. Kaizen goals are established each year as part of the planning process that's how Kaizen costing involved to process. This strategy involves everyone in the organization working together to make improvements focusing on eliminating waste on all process starting with the workplace. It relies on human resources rather than capital investments.

### Kaizen principles

Human resource is the most valuable company assets.

Process must be evolved by gradual improvement rather.

Improvement must be based on evaluation of process perform.

Five elements (foundation) of Kaizen

Teamwork.

Personal discipline.

Improved morale.

Quality circles.

Suggestions for improvement.

## **Tools for mapping processes**

Flowcharts

Flowchart represents a process which consists of many different types of steps. Flowchart divides the huge process into small tasks in an order. Mostly flow charts can be used to analyze a process and to divide a process into different stages. With the intention of that, many can involve in particular stage. A flow chart is made up of different shapes drawn for different events and all the events are joined together by arrows from start to end.

Work flow diagram

Workflow diagrams are very similar to flow charts. Graphical picture of steps taken, time spent, and distance traveled and other aspects of the way a particular piece of work is done. Workflow diagram is suitable for showing the over view of a business process.

Value added flowchart



The value-added flow chart also known as value stream map. It is a method to improve cycle times and productivity by visually separating value-adding from non-value-adding activities.

## **Tools for ideas generation and seeing connections**

Cause and effect diagram (fish-bone diagram)

Cause and effect diagram was invented by Kaoru Ishikawa. Therefore is also called as the Ishikawa diagram. Cause and effect diagram is also called as fish bone diagram because a completed diagram can look like a skeleton of a fish. It is a diagram which makes out all the causes or inputs that result in an effect or output. This method combines the brain storming with a type of a concept map. Causes are arranged according to their importance. This helps to identify sub causes and check where a problem might be caused and helps to compare the importance of different causes. And also fish bone diagram can help in systematic analyzing of the problem.

Brainstorming

Brainstorming invented by Alex Osborn who is the founder of the Creative Education Foundation. This is a powerful tool that creates ideas, solves problems, motivates and develops teams. In brainstorming mostly members from a mixed group, joins together for a brain storming session. The brain storming session is held mostly in an open space where members can feel free to express their ideas. All the members keep adding their opinions on a particular topic and also on other ideas provided by members. At the end of a brain storming session the whole problem will be recognized and solved as necessary.

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## Relations diagram

Relationship diagrams show all the relationship between factors or areas of a process. It helps to identify the key areas which may be driving several other factors. As an alternative of a process shown in a chain, this diagram shows the areas of the process which have effects on other areas and links them all. Therefore you can find which the areas that have the most impact.

## **Tools for data collection and analysis**

### Histogram

It is used to graphically summarize and show an allocation of a process data set. It is built by dividing the data into different classes or bins in the x-axis and identifying their frequency in the y-axis. As u can see in the figure 6 a histogram looks like a bar graph. But its frequency is taken depending on class width which can vary unlike in a bar graph.

### Scatter gram

A scatter diagram is a tool for evaluating the relationship between two variables where one variable is plotted in the horizontal axis and other variable is plotted in the vertical axis. It can be used to identify whether or not a cause and effect relationship exists between the two variables. In a scatter diagram higher relations are shown with close points or points along a curve or line. And in case the relationship is low or no relationship is shown with points scattered throughout the diagram with no logical sequence.

### Control chart

Control charts also called as statistical process control are a type of chart that is used to control the quality or to manage the quality within a certain level. It identifies the quality of a process and displays them in the form of a line graph with set upper and lower limits. It can also have a center or middle line for average. These lines are created based on the historical data. The control chart identifies how the process changes over time and records them in the time order.

### Pareto analysis

Pareto analysis technique which helps you chooses the most effective change. The 80-20 theory was first introduced by an Italian economist, Vilfredo Pareto. His theory was adapted to business application by Joseph M. Juran. Pareto chart is a tool for visualizing the Pareto principal which states that a small set of problems affecting a common outcome tends to occur much more frequently than the remainder. A Pareto chart can be used to decide which problems to be solved first and which needs more attention.

## **Prepare forecasts and budgets for business.**

### **Explain in detail the purpose & the nature of the budgeting process for an organization like The Shovel Company.**

What is a budget?

A budget is a master financial plan. Once a firm has identified customer needs & changes through estimating, it needs to decide if it can be met profitably. A budget is a plan expressed in dollar amounts that acts as a road map to carry out an organization's objectives, strategies and assumptions.

The budget plans the future incomes and expenses. It is the process in which the company decides on how to spend to achieve their set objectives.

Having a budget is very important for a company in order to make the most effective decision. Each department in the organization will have a separate budget for their operations. When all these budgets join together we call it a master budget. Master budget give the overview of what the company wants to achieve and how to achieve for the next decided time period. The decisions which taken without a master budget do not contribute to the profit