

Cost classification and material management assignment



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In this assignment I will be discussing how costs incurred in any organization may be classified in a number of different ways for a number of different purposes. I will also be looking to find companies that use a variety of different costing techniques and methods. I will also be discussing the comparisons between marginal and absorption costing and how the concept of activity based costing can also be compared with these.

To complete the assignment I will be using a combination of lectures notes, text books and the internet to research the various ways of cost classification, and how different companies use these, to enable me to answer the assignment question. Cost classification: Cost classification is the breakdown of costs in to similar categories and sub-categories. Cost classification can be done with various methods and for different reasons, depending upon the reason for use. For example, a management may use controllable and uncontrollable cost classification, to identify which costs are controlled by management and which are not.

The main areas in which costs can be classified are decision making, planning, control and stock valuation. (Management Accounting Techniques, 1994, Pg1). Findings: Cost can classify in many different ways. So considering all classification of cost with brief description is discussed below under respective heads: Direct v Indirect Costs: The expenses incurred on material and labor which are economically and easily traceable for a product, service or job is considered as Direct costs. Direct costs are those which can be identified with the end product.

This includes raw materials used in manufacturing the product (direct material); machine operators who make the product (direct labour), royalties paid or special plant hire (direct expenses). These costs are generally allocated to products or cost units. They do not take into account costs such as admin expenses or electricity used. An example of a direct cost would be in the production of leather sofas or other related manufacturing industries. The direct cost is the actual leather which is used to make the sofa.

Indirect costs are those that cannot be identified with, or traced to the end product and include the following: scrap material (indirect material): the salaries of factory supervisors (indirect labour): rent, rate and depreciation (indirect expenses). Indirect costs are often called overheads. The expenses incurred on those items which are not directly chargeable to production are known as indirect costs. For example, salaries of timekeepers, storekeepers and foremen. Also certain expenses incurred for running the administration are the indirect costs.

All of these cannot be conveniently allocated to production and hence are called indirect costs. Again taking the leather sofa example to illustrate indirect costs, the salaries that are paid to the management do not affect the cost of producing the sofa itself even though they are associated with the production of the sofa. Cost behaviour: Cost behaviour is the way in which costs per unit of output are affected by fluctuations in the level of activity. The level of activity refers to the amount of work done, or the number of events that have occurred. Fixed v Variable costs:

The costs of expenses whose total does not change in proportion to the activity of a business, within the relevant time period or scale of production in spite of the fluctuations in production is known as fixed cost. Examples: For a business, fixed costs might be business rates, overheads (rent, insurance etc), salary of the managing director (per month or per annum), and straight line depreciation of a single machine (per month or per annum). Fixed costs are irrelevant for short-term decisions, as fixed costs do not change if more or less products or services are sold.

Fixed costs are sometimes referred to as “ period costs” in system of direct costing. Fixed costs can be further classified into:

- Committed fixed costs
- Discretionary fixed costs

a) Committed fixed costs consist largely of those fixed costs that arise from the possession of plant, equipment and a basic organization structure. For example, once a building is erected and a plant is installed, nothing much can be done to reduce the costs such as depreciation, property taxes, insurance and salaries of the key personnel etc. without impairing an organization’s competence to meet the long-term goals.

b) Discretionary fixed costs are those which are set at fixed amount for specific time periods by the management in budgeting process. These costs directly reflect the top management policies and have no particular relationship with volume of output. These costs can, therefore, be reduced or entirely eliminated as demanded by the circumstances. Examples of such costs are research and development costs, advertising and sales promotion costs, donations, management consulting fees etc.

These costs are also termed as managed or programmed costs. The costs which vary in direct proportion to changes in the level of activity with every

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increase or decrease in the volume of output or production is known as variable cost. This means that if the activity level doubles, then the variable cost will double. Examples of variable costs are direct material, direct labour and direct expenses, wages of laborers, cost of direct material, power, etc. Variable costs are relevant for short-term decisions as they vary with the level of production or services provided.

These costs are sometimes referred to as “ direct costs” in system of direct costing. In some circumstances, variable costs are classified into the following: •Discretionary cost •Engineered cost a) The term Discretionary variable cost is generally linked with the class of fixed cost. However, in the circumstances where management has predetermined that the organization would spend a certain percentage of its sales for the items like research, donations, sales promotion etc. b) Engineered variable costs are those variable costs which are directly related to the production or sales level.

These costs exist in those circumstances where specific relationship exists between input and output. For example, in an automobile industry there may be exact specifications as one radiator, two fan belts; one battery etc. would be required for one car. In a case where more than one car is to be produced, various inputs will have to be increased in the direct proportion of the output. Thus, an increase in discretionary variable costs is due to the authorization of management whereas an increase in engineered variable costs is due to the volume of output or sales.

Semi-Fixed v Semi- Variable costs: Semi-fixed costs which are fixed for a certain level of activity but eventually increase by a constant amount at

some particular point. For example, supervisors salaries-can cope with up to 1000 hours of activity per week, beyond which the costs will increase by 20% of the existing cost, for each increase in 1000 hours of activity. Semi-variable costs have both fixed and variable elements. For example, a telephone bill has a fixed line rental charge and variable costs associated with the calls made. Controllable v Non-controllable Costs:

A controllable cost is reasonably subject to regulation by the manager. If this condition does not hold, then the cost will be classified as non-controllable. However, such non-controllable costs may be controllable at a higher level of responsibility. For example, a responsibility centre manager may have no control over the number of superiors employed in his department, but this decision may be made by his superior. This means the supervision costs will be a non-controllable cost on the responsibility mangers performance report, but a controllable cost on his or her superior performance report.

Relevant and Irrelevant Costs: A Relevant cost is defined as a cost that is appropriate to aiding the making of specific management decisions. Relevant costs are those which change by managerial decision. Irrelevant costs are those which do not get affected by the decision. For example, if a manufacturer is planning to close down an unprofitable retail sales shop, this will affect the wages payable to the workers of a shop. This is relevant in this connection since they will disappear on closing down of a shop.

But prepaid rent of a shop or unrecovered costs of any equipment which will have to be scrapped are irrelevant costs which should be ignored. Irrelevant cost represents a cost, either positive or negative, that does not relate to a

situation requiring management's decision. Costs which are not relevant include; past costs, or money already spent, costs which are not of a cash nature, e. g. depreciation and absorbed overheads. Only cash overheads incurred are relevant to a decision. Shutdown and Sunk Costs A manufacturer or an organization may have to suspend its operations for a period on account of some temporary difficulties, e. . , shortage of raw material, non-availability of requisite labor etc. During this period, though no work is done yet certain fixed costs, such as rent and insurance of buildings, depreciation, maintenance etc. , for the entire plant will have to be incurred. Such costs of the idle plant are known as Shutdown costs. Sunk costs are historical or past costs. These are the costs which have been created by a decision that was made in the past and cannot be changed by any decision that will be made in the future. Investments in plant and machinery, buildings etc. re prime examples of such costs. Since sunk costs cannot be altered by decisions made at the later stage, they are irrelevant for decision-making. Incremental Cost: Incremental costs are those cost which increase or decrease because of an increase or decrease in one whole unit of output. As an example, the incremental cost of increasing the level of software packages from 10 units to 15 units is the additional cost for Microsoft of producing five extra units of software packages. Techniques used to classify COST:

There are many different ways in which costs can be classified and allocated. Each one of these costs gives rise to a number of debates as to their accuracy, techniques, purpose and objectives. The most common types are Absorption Costing, Marginal Costing, Cost Separation, Activity Based

Costing, Process Costing, and Product Costing. Absorption Costing: As mentioned earlier production overheads cannot be directly identified with a specific product so instead it is apportioned throughout the whole department(s) through the method of absorption costing.

The purpose of Absorption costing is to allocate a share of all the production costs which include variable manufacturing and fixed manufacturing costs that are incurred by a business to either its products or services. Another term that is commonly used to describe this process is apportioning costs. The primary basis for this method is to use direct costs such as materials or labour. This effectively gives a better picture of an organisations' cost structure although it is up to the manager to decide which technique to use.

Also prices can be set based on total cost, which may be useful when demand is uncertain as it is better to consider the final profit figure and not just the contribution. This method recognized the importance of fixed costs in production. Marginal Costing: Marginal costing is a costing technique where each unit of output is charged with variable production costs. Marginal costing also shows the effect on profit of changes in volume/type of output by differentiating between fixed and variable costs. Fixed production costs are not considered to be real costs of production, but just enabling the production to take place.

They are treated as costs of the period and charged to the period in which they are incurred. An advantage of marginal costing is that it helps decision making by providing a method of charging variable costs to cost units and the remaining fixed costs for that specific period are written off in full against

the total contribution. It also enables the management to work out easily the profit or loss at a certain level of output if the break-even point and the contribution per unit are already worked out. This is because for every unit sold above the break even point the profit will equal the contribution per unit.

If the units sold are less than the break-even point then the contribution will fall. Activity Based Costing: Activity Based Costing (ABC) is the method of costing which concerned with the allocation of costs to a company's products and services. Activity based costing is a tool for managers to help them plan and control business activities. The main purpose of this cost method is to identify all the directly attributable costs of a particular activity and then dispense those costs to each product to the extent that the product uses the activity. ABC has been said to be a more modern way of cost classification.

Cooper and Kaplan (1988) argue that traditional cost systems report distorted product cost whenever the cost of no-volume-related activities is significant. In particular low-volume products tend to be undercosted and high volume products overcosted. Recommendations were made to identify what causes overheads to be incurred, and to apportion overheads on the basis of these factors. This approach was called Activity Based Costing (ABC). ABC emphasizes the need to obtain a better understanding of the behaviour of overhead costs, and thus ascertains what causes overhead accosts and how they relate products.

ABC recognizes that in the long run most costs are not fixed, and it seeks to understand the forces that cause overhead costs to change overtime. Cost

Separation: Many costs within the manufacturing industry can be easily separated from fixed and variable costs. The method used to achieve this is known as Cost Separation. The calculation for this is very simple and it enables the management to work out how much an individual unit will cost so that pricing and other useful decisions such as planning and control.

Process Costing, and Product Costing:

Product costing is the process of accumulating, classifying and assigning direct materials, direct labor, and factory overhead costs to products or services. Process costing is a product costing system that accumulates costs according to processes or departments and assigns them to a large number of nearly identical products. Conclusion for Cost Classification: In conclusion to my findings, I think that all the cost classifications link with marginal and absorption costing. Not only that, but activity based costing can also be linked into the debate.

With the need to identify fixed and variable cost, and their importance to the production or service, as well being needed for managerial decisions these all interlink and are useful in identifying the needs of methods of use. The purpose of the various costing classification are dependent upon what type of project is being undertaken and what the intended outcome is. However, I feel that ABC fits in to the uses of various different methods and that this indeed is a very effective method in cost classification.

I feel that this method can be a more appropriate way of classification of costs as it recognizes that in the long run most costs are not fixed, and it seeks to understand the forces that cause overhead costs to change

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overtime, and what activities cause costs and create demand. Material Management: The objectives of materials management which are to reduce inventories while maintaining strategic stocks, improve product quality, minimize the total cost of operations and procurement, ensure service levels to customers and minimize variance materials flow.

Materials management was pointed out by Compton (1985) as management of materials; storage, selection and issue; handling and distribution and stores management. Johnson (1999) has defined the important role of materials management as continues replenishment programs, vendor managed inventories programs, joint managed inventories programs, and collaborative planning, forecasting and replenishment business models.

For that reason, most organization has re-developed and re-implemented planning system, which allow organizations to manage procurement activities effectively in order to meet customers' needs and requirements This article proposes a methodology to help purchasers determine what type of cost analysis techniques should be applied to a particular purchase by: 1) Developing a framework for classifying purchases. 2) Discussing which cost techniques best support each classification in the framework 3) Focusing on Strategic cost management techniques. Features of material management:

Some of the important features of materials management system have been classified by as follows: +Integrate front-office function (estimating and construction) and back office functions (Accounting and purchasing).

+Integrate cost control, project scheduling, and material quantities measurement functions. +Utilize world-wide-web technology to facilities

communications and data transfer. +Provide a common database of price, project information, productivity, etc. across the company +Provide tracking of stockpile and consumption of materials.

A plan for continuous materials management improvement - Materials

Management: If we want to be successful in material management, so, you must become a leader in your organization-and strong leadership requires a clear vision and a sound strategic plan. Your success hinges on the ability to map out and follow a strategic direction for material management such that:

- # Effectively organizes of the material management effort to coordinate strategic initiatives.
- # Improves communication between material management, end user and administration. Enhances the skills and the roles of personnel involved in material management effort.
- # Expands service level provided to supply users throughout the organisation.
- # Material management efforts within and among facilities.
- # Standardizes material management processes between departments and facilities.
- # Automates material management functions in an effective and efficient manner.
- # reduces overall costs to become the lowest cost /highest quality provider in the market place.

Summary of material management: Every organization invests a considerable amount of capital on materials.

In many cases, the cost on materials exceeds 50 percent of the total cost of goods produced. Such a large investment requires considerable planning and control so as to minimize wastage. Materials management encompasses all operations management functions from purchasing to the final delivery of the end items. The scope of materials management includes decision on purchasing raw materials, management and control of work in progress

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items, stores and warehouse management, and the shipping and distribution of finished products.

The materials flow is divided into three different overlapping functions - production control, inventory control and the materials handling function. The objective of the production control function is to regulate the flow of materials throughout the manufacturing cycle. The departments that are part of the production control are the purchasing, receiving, raw materials inventory and production departments. The inventory control function covers raw materials inventory, the production department and the finished goods department.

The materials management function handles the physical movement of materials into, through and out of the firm. The departments that are involved in material handling functions are the purchasing, receiving, raw material inventory, production, finished goods inventory, shipping, distribution and warehouse departments. Storage of materials is an important aspect of materials management. All types of materials such as raw materials, work-in-progress, finished goods, spare parts and other consumable goods are stored such that they are easily available whenever and wherever required.

Usage of technology has improved the efficiency of the material handling. The technologies that are commonly used in materials handling are robots, automated guided vehicles, and automated storage and retrieval systems. Techniques used in the management and control of material in an organization include the Kanban system, the ABC classification system and

JIT purchasing. Through proper management and control of materials, an organization can achieve significant cost saving, reduction in lead time, improvement in production efficiency and reduction in wastage.

Conclusion for Material management: There are increasing recognize that the material management play an important role in manufacturing organizations especially the perfect combination. The relationship between buyer and seller are very important for every organization. The key issues of organization to coordinate and make a relationship between each other are to reduce operating expenses and working capital requirements, increasing response time and ultimately provide a competitive advantage.

Organization normally will investigate the best and most suitable supply management of materials which will satisfy the needs and wants of customers. In a Nutshell we can say that the materials management system has become necessary on this competitive market force. Many authors suggested that the materials management should implement along with materials requirements planning, information technology, quantitative methods and Just-in-time.