Chapter 2

Essential cost accounting terminology

Chapter objectives

Having studied this chapter you should be able to:

- define key cost accounting terms;
- understand the meaning of the term 'overheads';
- appreciate how overheads may be determined;
- be able to classify business expenses using a cost accounting framework;
- demonstrate the importance of aggregating costs on a unit basis.

Introduction

Every discipline utilises a certain amount of terminology or jargon. The purpose of this chapter is to introduce some of the key cost accounting terminology and offer some definitions for the same, with which you will need to be familiar before studying the rest of the text.

You may already be familiar with the typical financial accounting classification used in a profit and loss account, whereby sales revenue (income) is compared with expenses (expenditure) for the same period to determine the profit for the period. Examples of such expenses could be wages and salaries, rent, rates, telephone, stationery, motor expenses, heat, light and purchase of goods for sale if appropriate.

By contrast, cost accounting would classify the same expenses in a different manner. Cost accounting attempts to show in which part of the business expenditure is incurred. For example rent and rates would for the purpose of financial accounting be included in the profit and loss account as an expense being a single total figure. Cost accounting would attempt to redistribute such a cost to the various parts of the business where the expenditure was incurred (e.g. the factory, sales department, head office etc.) and categorise the same using some of the costing terminology discussed in this chapter, thereby providing management with more useful information for planning and controlling the business as well as for the purpose of decision making.

Cost accounting terminology

Direct costs

A crucial method of cost classification is into direct and indirect costs. Direct costs are specific costs that can be identified with a product or service. The three principal categories of direct cost are as follows.

Direct labour cost

The wages paid to employees actually engaged in production or providing the service. For example, in car production, the employees welding the cars together on the production line would be a direct cost. The cost of workers engaged in supervising the activity would not be a direct cost. In banking, a bank clerk serving customers would be a direct labour cost, whereas the cost of a bank manager would not be a direct cost.

Direct materials cost

The cost of buying in the materials from which the finished product is made. This would include all bought in parts and assemblies, but would exclude (say) lubricants for the machinery engaged in the production process.

Direct expenses

Those expenses specifically incurred in the production of a unit of output or the provision of a service. For example, a royalty may have to be paid for each unit of production in a factory. This expense can clearly be traceable to a unit of manufacture.

Indirect costs

Direct costs are specific costs that can be identified with a product or service. It follows that indirect costs are all labour, material and expense costs which cannot be identified with a product or service. Indirect costs are collectively termed overhead. The three principal categories of indirect cost are as follows.

Indirect labour cost

The wages and salaries paid to workers not directly involved in production or service delivery. The cost of workers engaged in supervising such an activity would be an indirect labour cost. Other examples include quality controllers, stores personnel and cleaners.

Indirect materials cost

The costs of all other materials not directly used in production. Lubricants for the machinery engaged in the production process would be an indirect material cost.

Other examples include spare parts for plant and equipment, cleaning materials and stationery.

Indirect expenses

Those expenses not specifically incurred in the production of a unit of output or the delivery of a service. Examples of categories of indirect expenses are:

- **Establishment costs** All the expenses incurred in providing the production or service environment. For example, for manufacturing, this would include the expenses of providing the structure of the factory and the services within it. For healthcare, this would include the expenses of providing the structure of a hospital. Such expenses include rent, rates, insurance and electricity.
- **Selling and distribution costs** All the costs of selling the product or service and delivering it. This includes the salaries and wages of sales personnel and delivery staff, and the cost of transport. Expenses such as rent, rates, insurance and electricity would also be included in so far as they related to the sales and distribution premises.
- **Administration costs** All the costs of directors, managers, administrative staff and similar personnel in the organisation. Again, expenses such as rent, rates, insurance and electricity would also be included in so far as they related to administration.
- **Finance costs** All the costs of borrowed capital. This includes loan interest, any expenses incurred in raising the initial loan and commissions paid to third parties for the same.

Basic classification of costs

Having defined the types of direct and indirect costs, a basic classification of costs statement can be illustrated, as in Figure 2.

The figure includes two important sub-totals in the classification: **prime cost** (direct materials + direct labour) and **cost of production** (prime cost + factory indirect expenses). Some of the terminology used in the statement appears specifically to relate to manufacturing organisations. This is a consequence of cost accounting arising out of the costing and estimating practices in engineering. Statements of this type were originally derived to satisfy the needs of manufacturing organisations. Today service industries are more prominent in the economy and such a statement is also appropriate for this sector. However, some of the descriptions used above may not be as applicable to a service organisation. The descriptions may be modified as appropriate as cost accounting is not required to comply with statutory legal presentation requirements in the

Direct labour cost	
+	
Direct material cost	
Prime cost	
+	
Indirect labour cost	*Factory indirect expenses*
+	
Indirect material cost	
+	
Machinery costs	
+	
Establishment costs	
Cost of production	
+	
Sales and distribution costs	*Office costs*
+	
Administration costs	
+	
Financial costs	
Total cost	

Figure 2 The most commonly used classification of costs for cost accounting purposes

same way as financial accounting. For example, 'sales and distribution costs' may be more appropriately retitled 'external relations and transport costs'.

Further cost accounting terminology

Cost centre

It is necessary to divide a large business into smaller logical parts to facilitate the charging of costs to individual units of output. A cost centre, usually an intermediate stage where expenditure may be gathered for later distribution, is a logical place to assemble costs for a particular organisation. A cost centre could, for example, be a location, a person, an item of equipment or a group of equipment, an inspection department or even sales representatives. Cost centres have the added advantage of clearly identifying individuals, machinery etc., thereby facilitating the relating of costs to individual responsibility.

Cost unit

A cost unit is a unit of output for an organisation. This may be a tonne of coal from a coal mine, or a book loaned from a library. Once cost centres and cost units are established for an organisation, it is possible to charge costs from cost centres to cost units to determine the cost per unit of output.

Conversion cost

This is a term to refer to the costs of converting purchased materials into finished goods.

Added value

The value of a manufactured product, or service delivered, should be greater than the cost of the constituent bought in materials and services. Added value is an important notion that seeks to draw attention to the efficacy of the organisation, by focusing on the activities of the organisation rather than the costs of bought in materials and services, which an organisation can do little about.

An introduction to overhead

Overhead refers to all costs except direct labour, direct materials and direct expenses. Direct costs, by their nature and definition are easily associated with cost units. However, overheads (indirect costs, machinery costs, establishment costs, selling and distribution, administration and financial costs) may be considerable and by their very nature are not so readily identifiable to cost units. For example, it is difficult to determine the appropriate amount of loan interest to charge to a single cost unit, particularly if some cost units take longer than others to complete. See Figure 3.

Direct labour cost Direct material cost		
Indirect labour cost Indirect material cost Machinery costs Establishment costs	*Factory overhead*	*Total overhead*
Sales and distributions costs Administration costs Financial costs	*Office overhead*	

Figure 3 Categories of overhead form a basic classification of costs for cost accounting purposes

Cost allocation

Cost allocation may apply equally to direct costs and overhead. Where a cost may be clearly identified with a cost centre it may be allocated without division or splitting. For example, electricity could be separately metered to a cost centre where the cost centre is (say) the inspection department. In this instance the entire charge for the metered supply may be allocated to this cost centre without further computation. (The allocation for this would take place via the costing system.)

Cost apportionment

Some just and equitable method must be determined to share out very significant costs which cannot be easily allocated to cost centres or cost units. Cost apportionment is an attempt to share a cost between two or more cost centres on a just and equitable basis with regard to the benefit received. The emphasis here is upon fairness in sharing the common cost as it is acknowledged that precisely determining the benefit received would prove very difficult in many cases. For example, office rent could be apportioned on the basis of floor area used by a cost centre. The choice of basis for apportionment is paramount and can prove to be somewhat subjective in some cases.

Overhead recovery

After overhead has been allocated and apportioned to cost centres, it may be charged to cost units using a technique referred to as overhead recovery. Overhead may be recovered using absorption costing or activity based costing techniques (which are dealt with in Chapters 6 and 7 respectively).

Essentially the process involves the recovery of overhead using a predetermined recovery rate based upon the dominant activities involved in the manufacturing process or the service delivery. This could be the number of labour hours, the number of machine hours or the number of inspections carried out.

Determination of total cost

It is appropriate to illustrate the terminology used in this chapter (classification of costs, cost centres, cost units, cost allocation, cost apportionment and overhead recovery) as part of a single diagram (Figure 4), to demonstrate the build-up of total cost.

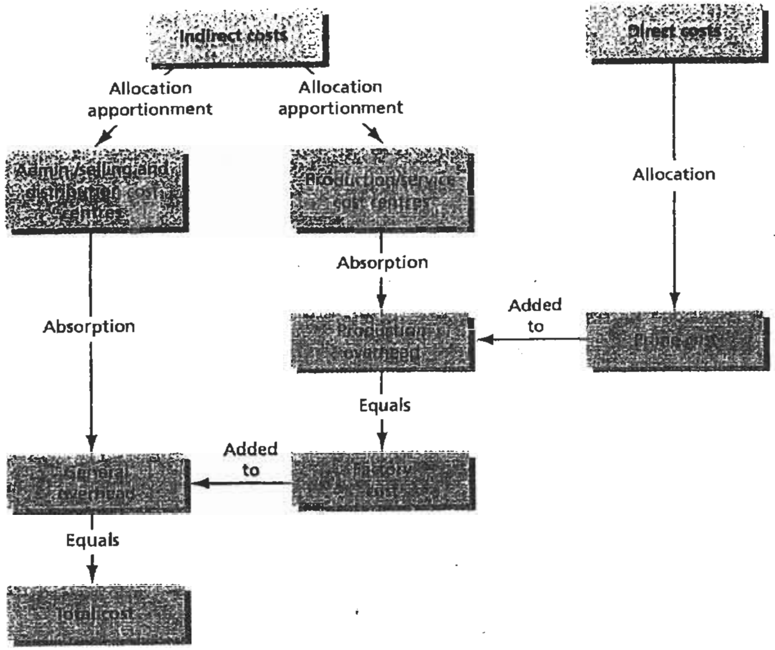

Figure 4 Determination of total cost

Summary

- Cost accounting terminology seeks to differentiate between two fundamental types of cost:
  - direct cost,
  - overhead.
- Cost centres and cost units are derived from the need to be able to charge direct costs and overheads to each unit of output or service delivery, in an attempt to identify the viability of the operation.
  - This may be referred to as value added.
- Overhead refers to all costs except direct costs. Overheads are charged to cost units via:
  - cost allocation,
  - cost apportionment,
  - overhead recovery (absorption or activity based).

Questions for review

1 What is a direct cost and what differentiates it from an indirect cost?

2 Define a cost centre and give *three* examples.

3 What is the difference between a cost centre and a cost unit?

4 Describe

a Cost allocation
b Cost apportionment

5 Give an example of a cost unit for a manufacturing organisation.

6 Give an example of a cost unit for a service organisation.

7 Give an example of a cost which is not readily identifiable to a cost unit.

8 What does overhead recovery seek to achieve?

9 What are the *two* principal methods of overhead recovery?

10 What is prime cost?

Self-assessment questions

(*Denotes that a suggested solution may be found at the end of this book.)

1* Classification and categories of cost
The data below relates to the accounts on Univat Ltd, a company engaged in the manufacture of a single product, missiles.

	£
Factory wages, 65% of which are paid to production line staff	40,000
Rent and rates 74% of which is for the factory area	12,000
Sales and admin. offices are of equal size	
Material purchases, 85% of which are for missiles	75,000
Material purchases for other factory materials are 10%	
Material purchases for office cleaning are 5%	
Factory machine depreciation	29,000
Office wages, 50% sales, 50% admin.	18,000
Telephone and postage, 15% factory, 85% sales	15,000
Salespeople's motor expenses	9,000
Delivery costs	15,000
Advertising costs	17,000
Total cost	230,000