Module 1: Notes 2 - Cost Terminology

Cost Terminology

In organizational terms, cost is a resource sacrificed to achieve a specific objective. It is usually measured as the monetary amount that must be paid to acquire goods or services. An **actual cost** is the cost actually incurred, while a **budgeted cost** is a predicted or forecasted cost.

You will be introduced to basic cost terms in this lesson. You will learn about cost objects, cost assignment, direct and indirect costs, and variable and fixed costs within an organizational setting.

Cost Assignment

A **cost object** is anything for which a measurement of cost is desired. In a manufacturing company, the cost object is the product. In a service company, the cost object is the service.

Cost data is accumulated or collected by means of an accounting system and then **assigned** to specific cost objects. Cost assignment is accomplished by tracing **direct costs** to a cost object and allocating **indirect costs** to a cost object.

Direct and Indirect Costs

Direct costs are costs that are directly related to a specific cost object. If you are producing a diamond ring, the diamond in the setting can be easily traced to the specific setting.

Indirect costs cannot be traced to a specific cost object in a cost-effective manner. Continuing with the diamond ring example, the tools used to cut the stone are not specific for one diamond ring but are used across multiple diamond rings or even multiple products.

The factors that affect direct and indirect cost classifications are:

- Materiality of cost

The smaller the cost, the less likely that it is economically feasible to trace.

- Information availability

Improvements in information-gathering technology make it possible to consider more and more costs as direct costs and help trace cost objects in an economically feasible way.

- Design of operations

Classifying a cost as direct becomes easier if exclusive space is allocated for a specific cost object, such as a specific product or customer.

Variable and Fixed Costs

There are two basic types of cost-behavior patterns - variable and fixed.

Total variable costs fluctuate in proportion to changes in levels of activity or volume. For example, the total cost incurred for gold for a jewelry store increases as the number of pieces of jewelry produced increases. A cost driver has a cause-and-effect relationship between the change in the level of activity and the change in the level of total costs. For example, the number of diamond rings produced is a cost driver for the total variable cost of diamond rings.

Total fixed costs remain unchanged for a given time period, despite changes in the related level of activity. Therefore, in the short run, fixed costs do not have a cost driver. For example, the supervision cost remains the same despite a change in the level of activity during a specific period.

Average Cost

Average cost, also known as unit cost, is calculated by dividing total cost by the related number of units produced.

Variable cost per unit does not change based on changes in the activity level within a relevant range. However, total variable costs for the company do change when the activity level changes. For example, the cost of gold per piece of jewelry ($200) is the same if 1,000 pieces of jewelry are produced or 1,200 pieces but the total variable cost would change ($200,000 versus $240,000).

Fixed costs per unit change based on changes on the activity level. However, total fixed costs for the company do not change when activity level changes. For example, if supervisor costs are $360,000, the fixed cost per unit will be higher when 1,000 pieces of jewelry are produced ($360 fixed cost per unit) than when 1,200 pieces of jewelry are produced ($300 fixed cost per unit).

Relevant Range

Relevant Range, refers to the range of normal activity or volume in which there is a specific relationship between the level of activity and the cost in question.

For example, fixed costs may include the wage and benefit cost for one supervisor. Supervisor cost is fixed within a relevant range. The relevant range is the level of activity that can be handled by one supervisor. If the company suddenly triples its activity and the company now requires two supervisors, this activity level would be outside the relevant range.