

Cost accounting

02

Direct and indirect costs

Cost accounting involves calculating the costs of different products or services, so that company managers can know what price to charge for particular products and service and which are the most profitable. **Direct costs** – those that can be directly related to the production of particular units of a product – are quite easy to calculate. Examples include manufacturing materials and manufacturing wages. But there are also **indirect costs** or **overheads** – costs and expenses that cannot be identified with particular manufacturing processes or units of production. Examples include rent or property taxes for the company's offices and factories, electricity for lighting and heating, the maintenance department, the factory canteen or restaurant, managers' salaries, and so on. Costs such as these are often grouped together on the profit and loss account or income statement as Selling, General and Administrative Expenses.

BrE: c
AmE: c

Fixed and variable costs

Companies also differentiate between fixed costs and variable costs. **Fixed costs** are those that do not change in the short term, even if the production level changes, such as rent and interest payments. **Variable costs** are those that change in proportion to the volume of production, such as components and raw materials, and overtime payments.

Manufacturing companies have to find a way of allocating fixed and variable costs to various products they make: that is, they divide up the costs and charge them to the different products. **Absorption costing** attempts to charge all direct costs and all production costs, and sometimes all indirect costs such as administrative expenses, to each of the company's products or services. **Activity-based costing** calculates all the costs connected with a particular activity (e.g. product design, manufacturing, distribution, customer service), even if they are carried out by different departments in the company. Most companies have departments or functions that do not generate any profit but only incur costs (e.g. accounting and legal departments). For accounting purposes, companies often make these departments into **cost centres**, and allocate or charge all the costs related to them separately.

BrE: c
AmE: c

Breakeven analysis

When deciding whether it would be profitable to produce a product, or offer a service, companies do a **breakeven analysis**. This compares expected sales of the new product with expected costs – both direct and indirect – at various production levels. The **breakeven point** is the sales volume – the number of units sold – at which the company covers its costs – pays all its expenses. To make a profit, it is necessary to sell more than this.

Although cost accounting allows companies to calculate production costs, pricing decisions also depend on:

- the level of demand
- the prices of competitors' products
- the company's financial situation
- the company's objectives – the goals or aims it wants to accomplish
- the company's marketing policies – whether it is interested in maximizing sales or maximizing profit.

- 17.1 Match the words in the box with the definitions below. Look at A, B and C opposite to help you.

breakeven point	cost centre	fixed costs
overheads	variable costs	profitable

- 1 expenses that are not clearly related to production or manufacturing
- 2 a unit of activity in an organization for which costs are calculated separately
- 3 costs that depend on the amount produced
- 4 adjective meaning providing income for a company
- 5 costs that do not change according to the production volume
- 6 the sales volume at which a company doesn't make a loss, but doesn't make a profit

- 17.2 Sort the following into direct, indirect, fixed and variable costs. Look at A and B opposite to help you.

Cost	Direct	Indirect	Fixed	Variable
Advertising expenses				
Bad debts		✓		✓
Components	✓			✓
Electricity to run machines				
Electricity for heating				
Equipment repairs				
Factory canteen				
Overtime pay				
Raw materials				
Property tax				
Rent				

- 17.3 Which of the following statements describes:

- 1 absorption costing?
- 2 activity-based costing?

a As well as direct manufacturing costs – materials and labour – we allocate part of our fixed and variable manufacturing overheads to the cost of every product.

b We identify all the different functions within the company, and assign costs to products and services according to how much these functions are involved in the process of providing the products and services.

Over to you

What do you think were the most important factors in the pricing of:

- this book?
- two other products you bought recently?