

3 Cost Components

Companies that manufacture a product face an expanded set of accounting issues. In addition to the usual accounting matters associated with selling and administrative activities, a manufacturer must deal with accounting concerns related to acquiring and processing raw materials into a finished product. Cost accounting for this manufacturing process entails consideration of three key cost components that are necessary to produce finished goods:

1. *Direct materials* include the costs of all materials that are an integral part of a finished product and that have a physical presence that is readily traced to that finished product. Examples for a computer maker include the plastic housing of a computer, the face of the monitor screen, the circuit boards within the machine, and so forth. Minor materials such as solder, tiny strands of wire, and the like, while important to the production process, are not cost effective to trace to individual finished units. The cost of such items is termed “indirect materials.” These indirect materials are included with other components of manufacturing overhead, which is discussed below.
2. *Direct labor* costs consist of gross wages paid to those who physically and directly work on the goods being produced. For example, wages paid to a welder in a bicycle factory who is actually fabricating the frames of bicycles would be included in direct labor. On the other hand, the wages paid to a welder who is building an assembly line that will be used to produce a new line of bicycles is not direct labor. In general, indirect labor pertains to wages of other factory employees (e.g., maintenance personnel, supervisors, guards, etc.) who do not work directly on a product. Indirect labor is rolled into manufacturing overhead.
3. *Manufacturing overhead* includes all costs of manufacturing other than direct materials and direct labor. Examples include indirect materials, indirect labor, and factory related depreciation, repair, insurance, maintenance, utilities, property taxes, and so forth. Factory overhead is also known as indirect manufacturing cost, burden, or other synonymous terms. Factory overhead is difficult to trace to specific finished units, but its cost is important and must be allocated to those units. Normally, this allocation is applied to ongoing production based on estimated allocation rates, with subsequent adjustment processes for over- or under-applied overhead. This is quite important to product costing, and will be covered in depth later.

Importantly, nonmanufacturing costs for selling and general/administrative purposes (SG&A) are not part of factory overhead. Selling costs relate to order procurement and fulfillment, and include advertising, commissions, warehousing, and shipping. Administrative costs arise from general management of the business, including items like executive salaries, accounting departments, public and human relations, and the like.

Accountants sometimes use a bit of jargon to describe certain “combinations” of direct materials, direct labor, and manufacturing overhead:

$$\begin{aligned}\text{Prime Costs} &= \text{Direct Labor} + \text{Direct Material} \\ \text{Conversion Costs} &= \text{Direct Labor} + \text{Manufacturing Overhead}\end{aligned}$$

Prime costs are the components that are direct in nature. Conversion costs are the components to change raw materials to finished goods.

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