

Cost Behaviors

Module 1

- A. **Cost Behavior: How costs change (react) to changes in the volume of activity)**
 - a. **Three types of Costs in Costs Behavior**
 - i. **Variable Costs**
 - ii. **Fixed Costs**
 - iii. **Mixed Costs**
 - b. **Variable Costs: IN TOTAL** (dollar amount) change in direct to proportion to changes in volume of activity
 - i. **As activity goes up 15%, total variable costs go up 15%**
 - ii. **Variable costs PER UNIT** are constant meaning they do not change when the volume of activity changes
 - iii. **Examples: direct (raw) materials and direct labor**
 - c. **Fixed Costs: IN TOTAL** are constant, meaning they do not change when the volume of activity changes
 - i. **Fixed costs PER UNIT** change inversely with the changes in the volume of activity
 - ii. **Examples: Rent, Depreciation, and advertising (USUALLY, not always)**
 - d. **Mixed Costs: Contain both a variable and a fixed element**
 - i. **Neither the total cost nor the unit cost is constant in MIXED costs**
 - ii. **Examples: Utilities and overhead – USUALLY, not always**
 - e. **Assumptions**
 - i. **The cost behaviors are assumed to exist over a relevant range**
 - 1. **Range of activity between which the assumptions made about cost behaviors are valid**
 - ii. **Cost behavior patterns are assumed to be linear within the relative range**
 - 1. **Graph all, would be straight line**

Module 2

- B. **High-Low Method: Used to separate a mixed cost into its Fixed and Variable components**
 - a. **Step 1: From a set of data—choose 2 data points—the high and the low activity level.**
 - b. **Step 2: Calculate the variable cost per unit**

- i. **Variable cost per unit = Change in cost for 2 data points / change in activity level for 2 data points**
- c. **Step 3: Calculate the total fixed cost**

Module 3

- C. **Traditional Income Statement Format** – Classifies expenses as function
 - a. **Sales Revenue – Costs of Goods Sold = Gross Profit**
- Other Expenses = Net Income
- D. **Contribution Income Statement:** Managers would rather classify expenses by cost behavior pattern
 - a. **Sales Revenue – Variable Costs = Contribution Margin**
- Fixed costs = Net Income
 - b. **Contribution Margin:** Represents the amount of revenue that is available to
 - 1. Pay fixed costs
 - 2. Contribute toward profit
 - ii. Revenues increase as a result of selling more, variable costs increase proportionately and so will contribution margin
- E. **Flexible Budget**
 - a. To prepare we need to know that **Total Variable costs change** in direct proportion to changes in activity
 - b. **Total Fixed costs** remain unchanged within the relevant range