

LECTURE 2

ELEMENT AND CLASSIFICATION OF COST

Lecturer: Emily M. Karanja

Content

Classification standard

Basis of classification of cost

Element of cost

Classification of cost

Costs are often regarded as a basis for management decisions particularly where there are options in the course of action to be taken. The process of maintaining the profitability of any business begins with the understanding of various types of costs alongside their ideal levels. High costs contribute to reduced profitability and vice versa.

The understanding of various types of costs enables business owners to retain the maximum amount of revenue using available resources. The term **cost** refers to the economic unit of a monetary resource directed at the acquisition and delivery of goods and services. In a hospitality business, this is the price paid in order to facilitate the consumption of the hospitality product.

Classification standard

According to CAS (2015), classification of cost refers to the logical array of different types of costs based on their characteristics and use. The classification of cost is primarily based on an accounting standard which ensures that uniformity of standards is achieved. This uniformity of standards promotes accuracy in the implementation of cost control measures as well as compliance with statutory requirements.

Food and Beverage Cost Control

Benefits of the classification standard include:

- Promotes uniformity in various cost applications
- Contributes to transparency in financial statements
- Acts as a basis for profit planning
- Enhances effectiveness in cost control
- Supports marginal costing
- Enables effective budgetary control and the use of flexible budgets
- Champions management decisions in purchasing, menu evaluation etc.

Classification of costs is based on:

- a. Characteristic of expense - the nature of cost may be based on material, labor or expense.
- b. Traceability – cost component is based on a unit that is either economically feasible or not.
- c. Function – function of use may include production, administrative, selling, distribution or research and development.
- d. Behaviour – the response to change of activity results to fixed, variable and semi-variable costs.
- e. Production process - the manufacturing cost could include process cost, operation cost, operating cost, joint cost, batch cost and contract cost.
- f. Time period – costs based on a specified time include standard cost, estimated cost, historical cost and pre-determined cost.
- g. Decision making – management decisions are made at different stages and for varying reasons. Classes of costs here may include sunk cost, marginal cost, differential cost, opportunity cost, replacement cost, relevant cost, imputed cost, normal/ abnormal cost and avoidable/ un-avoidable cost.

A healthy food service business is characterized by its ability to deliver good quality products through exemplary service and at a great value to both the business and consumer. The knowledge of various types of costs plays a major role in revenue management. Food service operators are able to manage these costs in order to maintain a healthy balance in their expenses, revenue and profit (Miller, Dopson, Hayes, 2005).

$$\text{Profit} = \text{Revenue} - \text{Expenses}$$

Food and Beverage Cost Control

Revenue

Revenue is an output of the sale of the food and beverage product, which includes all items produced and or sold by the establishment. Businesses should ensure that they earn revenue that is high enough to cater to their expenses, need for growth and leave a reservoir for any unprecedented needs. This enables the continuity of any business under normal circumstances.

Revenue management efforts geared towards increase of revenue may take any of the following approaches;

1. Increasing guest numbers – through promotions, increasing capacity, lengthening the time of operations etc.
2. Increasing purchases per guest – through suggestive selling, appropriate menu pricing, promotional discounts etc.

Revenue varies based on customer behavior. It is therefore the responsibility of any managers within these entities to ensure all efforts are geared towards attracting more guests to the operation and getting them to spend more. Although these revenue management practices may enhance profitability, it is also essential that they are complementary to effective cost control activities.

Profit

Great profits are a result of consistent planning, strategic decision making and sound management practices. Profits should be as a result of the implementation of proper plans as opposed to a random amount of income left over after expenses are catered to. This brings about the idea of an ideal expense and a desired profit as a result of profit planning.

Expenses

An expense may be summarized as the cost paid in the acquisition and processing of raw materials for sale. These are grouped into four categories in food businesses.

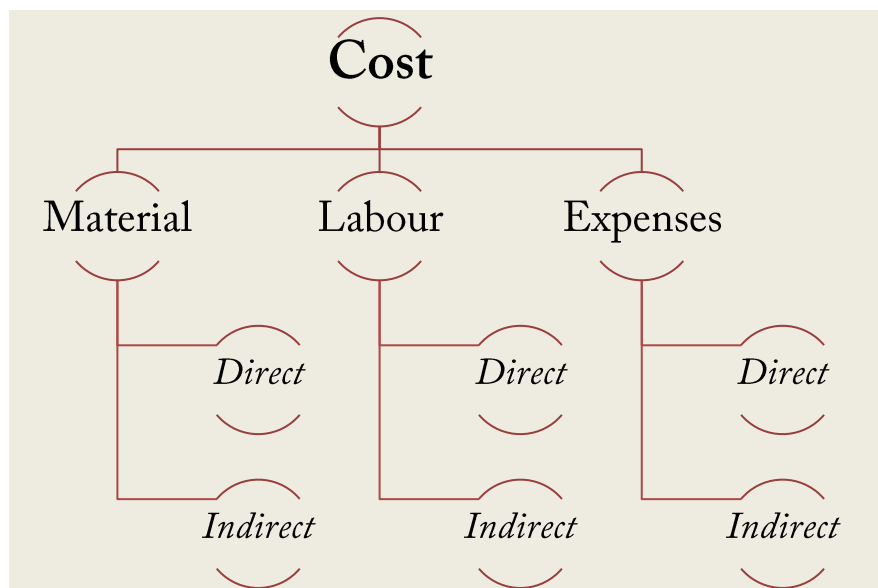
- a) **Food costs** - costs concerned with producing and presenting a guest's order from the menu. Include all food and non-food items used up in the delivery of a guest's selection.
- b) **Beverage costs** - costs incurred in the sale of alcoholic beverages such as wine, liquor, beer as well as all other items needed in preparing and presenting cocktails e.g. lemon, carbonated drinks, olives etc.

Food and Beverage Cost Control

- c) **Labor costs** - the cost of the manpower needed to successfully produce and sell the food and beverage product.
- d) **Expenses** - all other costs excluded in food, beverage and labor are included here. These include business fees, rent, tools, equipment, furnishings, utilities etc.

Element of cost

According to the Uttarakhand Open University, the element of cost is broadly categorized into three; material, labour and expenses as illustrated below.



1. Material

This is the matter from which the products are made. In a food and beverage operation, the material includes all ingredients required in the production and presentation of a drink or food item.

Direct material - is the value of acquisition of all items required in the preparation of a dish or meal e.g. seasonings and flavorings, meat, vegetables etc.

Indirect material – these are supplementary to the availability of the main business product. They include; cleaning supplies, fuel, electricity etc.

Food and Beverage Cost Control

2. Labour

Labour cost is the payment or reward offered to any member of staff present at a food and beverage operation. These employees enable the processing of raw materials into ready products that are then served to guests. Depending on the nature of the contract, labour cost may encompass; salaries, wages, bonuses, commission, incentives among other forms of rewards.

Direct labour – includes all monies paid out to employees who are directly involved in the production and sale of the food and beverage product. These include payouts to chefs, waitstaff, bartenders, supervisors etc.

Indirect labour – is the cost of compensation paid out to members of staff who indirectly support the production and sale of the food and beverage product. For example, the purchasing personnel, storekeeper, kitchen stewards, maintenance staff etc.

3. Expense

This incorporates all other expenses incurred in a food and beverage operation aside from labour and material costs.

Direct expense – are expenses incurred on specified costs such as royalties on production, outsourcing, hire of equipment etc. these are charged to the production of the product.

Indirect expense – these expenses are impossible to charge to wages, labour or direct expenses. They include; rent, tax, facility maintenance, insurance etc.

Classification of cost

Classification of cost is based on various criteria as observed in page 2 of this section. Various types of costs observed within a food and beverage operation may include:

- a) **Fixed cost:** fixed costs remain constant with any variations in sales or the volume of business. These include rent, tax, depreciation etc. Fixed costs may increase or decrease over time; however, these changes are not attributed to increase or decrease in business volume.
- b) **Variable cost:** in contrast to fixed costs, variable costs are directly affected by the level of business and thus change with increments or reductions in sales volume. Increased sales require an increase in these costs. They include; food, labour, beverage etc. An influx in

Food and Beverage Cost Control

guest numbers will require that more food is purchased and processed for consumption. Depending on the rate of the influx in numbers, more employees might also be needed in order to produce or serve the meals in time and vice versa.

- c) **Semi-variable cost:** has a partial element that is affected by a change in business volume and another that isn't. For instance, although additional employees may be acquired during increased business activity and let go of during periods of low activity, the still business retains a number of permanent employees regardless of business activity. In this case, labour cost becomes a variable cost due to the fixed and variable factors.
- d) **Controllable cost:** are costs that can be altered within a short period of time. This involves: variable costs as it is possible to control the cost food and labour. The cost of food and beverages may be affected by adjusting the portion size, buying from cheaper suppliers that offer similar quality, reducing or replacing certain ingredients of a dish, minimizing food waste etc. Additionally, it is possible to make short term decisions that control certain fixed costs such as marketing, facilities maintenance and administrative costs among others.
- e) **Non-controllable cost:** include fixed costs that operators have no ability to change in the short term such as rent, mortgage, taxes, licenses etc.
- f) **Budgeted cost:** the cost a food business expects to pay within a specified time frame. E.g. a projection of labour costs for a month may form a vital basis for decision making when evaluating the performance of the establishment on revenue for the said time period. Unachieved targets in revenue may prompt one to consider whether labour costs were justified or over-projected. The same is done for all other budgeted costs.
- g) **Actual cost:** the exact price paid in the acquisition of any materials needed for a food and beverage product.
- h) **Direct cost:** is attached to a specific area or department where the head is answerable to its performance. This cost is affected by the volume of business.
- i) **Indirect cost:** are not directly related to any particular area or department e.g. power charges.
- j) **Prime cost:** forms the largest percentage of all costs within a food and beverage operation. It is the total of all labour, food and beverage costs as illustrated below.

$$\text{Food Cost} + \text{Beverage Cost} + \text{Labour Cost} = \text{Prime Cost}$$

Food and Beverage Cost Control

- k) **Opportunity cost:** describes a foregone opportunity to make the most profits by an organization presented by multiple opportunities while relying on limited resources. Such an organization is forced to take an alternative decision passing on the best alternative.
- l) **Sunk cost:** is one that has already been incurred and is irreversible. Any asset or equipment purchased and used to a point that a replacement is required compounds this type of cost.
- m) **Standard cost:** directs what the ideal cost should be at a specified level of revenue. It is a realistic figure based on historical costs and is later used as a benchmark in future standardizations and evaluation of performance.
- n) **Joint cost:** is shared between two departments and mostly includes indirect costs. For example, in a food operation, the labour cost may be shared between the beverage and food service sections.
- o) **Outlay cost:** is the cost incurred when the operation conducts enhancement activities such as renovating the facility, enhancing the product or streamlining sales among others.
- p) **Historical costs:** these comprise of previously incurred costs that exist as part of business records.
- q) **Planned costs:** planned costs are hinged on historical costs and are used to predict the future.

Food and Beverage Cost Control

Quiz

1. Explain why it is important to have a universal standard in the classification of costs.
2. Outline various criteria that the classification of costs is based on.
3. Describe why food and beverage managers need to have knowledge of different types of costs.
4. State various strategies you may use to maximize on revenue within a food and beverage operation.
5. Differentiate between direct expense and indirect expense elements of costs.
6. Explain the following types of costs:
 - a. Prime cost
 - b. Sunk cost
 - c. Opportunity cost

REFERENCES

- CAS (2015). Cost accounting standard on classification of cost [Online] Available: <https://icmai.in/upload/CASB/ED/CAS-1-ED.pdf>
- Miller. J. E, Dopson. L. R & Hayes, D.K (2005). Food and Beverage Cost Control. 3rd Edition. John Wiley & Sons, Inc. 3-12
- Uttarakhand Open University 2019, HM 301. Food and Beverage Management [Online] Available: <http://www.uou.ac.in/old-papers/june-2019/HM-301.pdf>