

Types of cost and cost behaviour

[Psychology](#), [Behaviorism](#)



Introduction

When looking at the financial position of a company, it is first necessary to identify the costs associated with operations and to categorise them as fixed, semi variable and variable. These concepts will firstly be looked at, in general, before drawing on an example within the restaurant industry to illustrate their importance.

A fixed cost refers to the costs that the company will incur, regardless of the amount of goods or products they produce (Drury, 2005). Examples are rent on the premises or fixed line depreciation on equipment. Within the restaurant industry, rent would be a primary example of fixed costs as it is likely to be payable, regardless of how many customers actually enter the restaurant. Therefore, when looking at overall profit, this is the first cost which needs to be deducted, as this is an expense that will be payable. If used in the calculation of a fixed cost per customer, these costs will be reduced on a per customer basis depending on the number of customers who are serviced. For example, if the cost is £ 10, 000 per year and the restaurant had just 1, 000 customers over the last year, the effect of this would be £ 10 per customer; however, this would be reduced to 1 pound if there had been 10, 000 customers (Garrison et al 2009).

By contrast, there are semi variable costs which have both fixed and variable elements. This would mean that there is a fixed cost that will be charged, regardless of the number of customers (Garison et al 2009). There is also a variable element which will increase depending on the situation. An obvious example would be a telephone charge where there is a fixed line rental and

a variable element, which depends on the number of calls actually made. Another example is the salary of employees. Depending on the way in which financing is arranged, these could be perceived as a semi-variable cost, as there may be staff on a fixed salary or full-time staff within the restaurant. There may also be casual labour, which will be brought in when there are more customers to deal with.

At the other end of the scale are truly variable costs, which will change in direct relation to the level of service or production (Garrison et al 2009). Within the restaurant environment, this would typically include items such as food; however, it is questionable as to whether this is a truly variable cost as this would suggest that if there were no customers, then there would be no costs relating to food. In reality, it is likely that the restaurant would purchase certain stocks of food; therefore, there would be a cost associated with this food, regardless of the level of customers.

Identifying the types of costs that are relevant within a particular organisation such as rent, raw materials, staffing, and the depreciation of equipment is an important aspect of identifying the optimum level of production, as there may be a situation whereby having more customers does not necessarily increase the profits per customer. By categorising these costs, it is argued, therefore, that the company can make better management decisions and can identify the profitability of the various aspects of its operation by attributing appropriate levels of units produced or customers serviced (Drury, 2008).

Explain contribution margin and answer the question as asked in the following situation:

The contribution margin is defined as the amount by which the sales revenue is larger than the variable costs. Essentially, this then gives the amount each customer can contribute towards the fixed costs of the organisation. This can be calculated either as a unit (i. e. in this case the customer) or as a total contribution margin, which is the total sales less the total variable costs (Drury, 2008).

In this case, the restaurant operates with a monthly fixed cost of ? 18, 000. The costs are ? 100 per person for arranging the dinner and the meal is sold for ? 200. The total contribution margin per customer is therefore ? 200 - ? 100 = ? 100. This means that each customer will provide ? 100 towards the fixed costs. Bearing in mind that the restaurant has a fixed monthly cost of ? 18, 000, the number of customers that would be required in order to cover this fixed cost would be calculated as follows: $18,000 \div 100 = 180$ total number of customers are needed in order for the restaurant to break even.

The break even point is the point at which total income is equal to the total of the fixed and variable costs (Drury, 2005). In this case, the restaurant breaks even at 180 customers which means a total revenue of ? 36, 000 (180×200).

Finally, on the basis that the restaurant makes a profit of ? 11, 000 per month, the number of customers required can be calculated by adding the

profit to the fixed costs (£ 18, 000 + £ 11, 000). This is equal to a total of £ 29, 000. Bearing in mind that each customer contributes £ 100 towards the fixed costs, then £ 29, 000 would need to be divided by £ 100 to give the total number of customers required as 290. From this, the fixed costs of £ 18, 000 would be taken and the resulting profit of £ 11, 000 would remain.

It can be seen therefore that, by identifying the distinction between fixed and variable costs, this will enable an organisation to make decisions based on the number of customers required. It will also enable the management team to understand how it can increase its profits, or how the changes in customer patterns are likely to affect its bottom line (Drury, 2005).

More importantly, the distinction between fixed and variable costs helps especially when calculating for the break-even point. The break-even point needs to be established before a company can move towards making a profit. By using the analysis in this situation, it can be determined how many customers would be required in order to achieve a particular profit level. This gives the opportunity to work towards achieving the required level.

References

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