COLLEGE OF ACCOUNTING

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Video Transcription: Direct and Indirect Costs – Part 1

Hi my name is Jason and today we are looking at the importance of costing in a business environment. In order to meet the video objectives, let's look at the following example.
Tam owns a coffee shop and she wants to introduce milkshakes as a product offering in her current coffee shop in order to reach new customers.

What costs would Tam incur in making the milkshake? Did you think of milk, ice cream, flavouring?

Tam identified the following ingredients needed to make a milkshake: firstly, ice cream at R50 for a 10 litre tub, milk at R10 per litre and a chocolate bar at R3 per bar. So, how much does it cost to make one milkshake? Well, if Tam uses 100g of ice cream per every milkshake, how many milkshakes can she make with one tub? We know: 10 litres is equal to 10 000g, therefore 10 000g divided by 100g per milkshake gives us 100 milkshakes per tub. Given this, what is the ice cream cost per milkshake? Well, if one tub costs R50 and we can make 100 milkshakes, then 50 divided by 100 gives us 50 cents per milkshake. If Tam uses 100ml of milk per milkshake, how many milkshakes can she make with one litre?

Well, we know that one litre equals 1 000ml, therefore 1 000ml divided by the 100ml required per milkshake means that we can make 10 milkshakes per litre. So, what does the milk cost per milkshake? If milk costs us R10 per litre, and we can make 10 milkshakes per litre, it results in a cost of R1 of milk per milkshake.

Tam uses one chocolate bar in each milkshake. So what is the cost of chocolates in a milkshake? Well, if a bar costs us R3 and we use one chocolate bar in a milkshake, this results in a cost of R3 per milkshake. So do you think it would be correct to say that the cost per milkshake is R4.50? No.

What other costs would Tam have to pay in order to make the milkshake? Did you think about: there is a cost for the employee needed in order to add the ingredients to the mixer and work the process. There is also an electricity cost to run the mixer and store the perishable ingredients needed to make the milkshake. And then, lastly, what about the depreciation of the machine, which is used to make the milkshakes?

So let's review the costing terms in a little more detail. The product costs, in our case the costs to produce the product, can be broadly grouped into one of three categories.

Namely, materials, materials that can be specifically and exclusively identified with the production of a certain product; labour, this is the sum of all the wages paid to the employees; and lastly, manufacturing overheads; this includes all the costs to manufacture excluding the material and labour costs. In Tam's business, what would the following cost be regarded as? Firstly, the milkshake ingredients. These are materials, as they can be specifically identified in the milkshake. What about the cost of the employee? Well, this would be labour as this is the cost of a labourer, who is physically making the milkshake. Lastly, the electricity and depreciation costs are manufacturing overheads. This is because they are costs associated with the manufacture of a product that cannot be physically identified as a material or a labour cost.

In this video, we have identified that the cost of the materials are not the only costs associated with making the milkshake. In part two of the video, we will look at when product, labour and overhead costs are treated as either being direct or indirect in nature. We will then look at how to allocate our overheads. This will all be put together in calculating the final cost of a milkshake.

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