Chapter 6: Business costs and revenue

Business costs

All business activity involves some kind of cost. Managers need to think about the because:

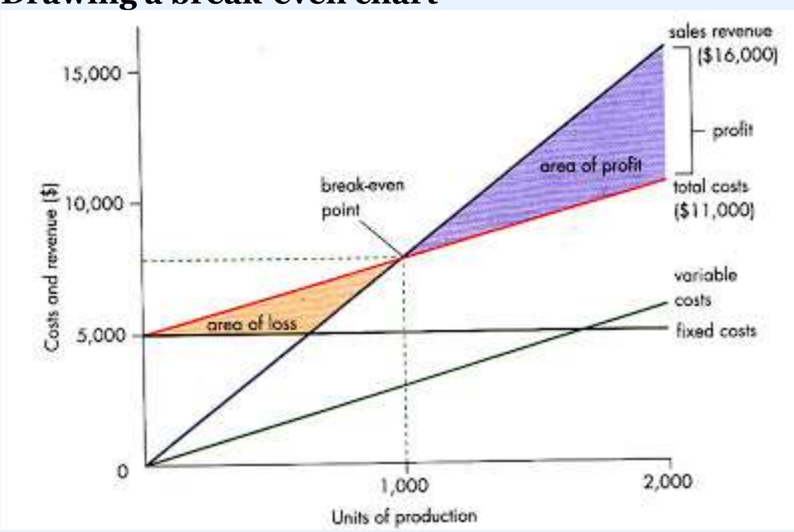
- Whether costs are lower than revenues or not. Whether a business will make a profit or not.
- To compare costs at different locations.
- To help set prices.

There are two main types of costs, **fixed** and **variable costs.** Here are some types of costs:

- **Fixed costs** = stay the same regardless of the amount of output. They are there regardless of whether a business has made a profit or not. Also known as **overheads**.
- **Variable costs =** varies with the amount of goods produced. They can be classified as **direct costs** (directly related to a product).
- **Total costs** = **fixed + variable costs**

Break-even charts, comparing costs with revenue

Drawing a break-even chart



Uses of break-even charts

There are other benefits from the break-even chart other than identifying the breakeven point and the maximum profit. However, they are not all reliable so there are some disadvantages as well:

Pros:

- The expected profit or loss can be calculated at any level of output.
- The impacts of business decisions can be seen by redrawing the graph.
- The breakeven chart show the **safety margin** which is the amount by which sales exceed the breakeven point.

Cons:

- The graph assumes that all goods produced are sold.
- Fixed costs will change if the scale of production is changed.
- Only focuses on the breakeven point. Completely ignores other aspects of production.

- Does not take into account discounts or increased wages, etc. and other things that vary with **time**.

Break-even point: the calcultion method.
It is possible to calculate the breakeven point withought having to draw the graph. We need two formulas to achieve this:

- Selling Price - Variable Costs = Contribution
- Break-even point = Total fixed costs/Contribution

Business costs: other definitions
There are other types of costs to be analysed that is split from fixed and variable costs:

- **Direct costs:** costs that are directly related to the production of a particular product.
- **Marginal costs:** how much costs will increase when a business decides to produce one more unit.
- **Indirect costs:** costs not directly related to the product. They are often termed **overheads**.
- **Average cost per unit**: total cost of production/total output

Economies and Diseconomies of scale:
Economies of scale are factors that lead to a reduction in average costs that are obtained by growth of a business. There are five economies of scale:

- **Purchasing economies:** Larger capital means you get discounts when buying bulk.
- **Marketing:** More money for advertising and own transportation, cutting costs.
- **Financial:** Easier to borrow money from banks with lower interest rates.
- **Managerial:** Larger businesses can now afford specialist managers in all departments, increasing efficiency.
- **Technical:** They can now buy specialised and latest equipment to cut overall production costs.

However, there are **diseconomies of scale** which increases average costs when a business grows:

- **Poor communication:** It is more difficult to communicate in larger firms since there are so many people a message has to pass through. The managers might loose contact to customers and make wrong decisions.
- **Low morale:** People work in large businesses with thousands of workers do not get much attention. They feel they are not needed this decreases morale and in turn efficiency.
- **Slower decision making:** More people have to agree with a decision and communication difficulties also make decision making slower as well.

Budgets and forecasts: looking ahead
Business also needs to think ahead about the problems and opportunities that may arise in the future. There are things to try to **forecast** such as:

- sales or consumer demands.
- exchange rates appreciation or depreciation.
- wage increases.

There are some forecasting methods:

- Past sales could be used to calculate the **trend**, which could then be extended into the future.

- Create a **line of best fit** for past sales and extend it for the future.
- **Panel consensus**: asking a panel of experts for their opinion on what is going to happen in the future.
- **Market research**.

Budgets

"Budgets are plans for the future containing numerical and financial targets". Better managers will create many budgets for costs, planned revenue and profit and combine them into one single plan called the **master budget**.

Here are the advantages of budgets:

- They set **objectives** for managers and workers to work towards, increasing their **motivation**.
- They can be used to see how well a business is doing by comparing the budget with the result in the process of **variance analysis**. The**variance** is the difference between the budget and the result.
- If workers get a say in choosing the objectives for a budget, the objectives would be more **realistic** since they are the ones that are going to do it and it also gives them better **motivation**.
- Helps control the business and its **allocation of resources/money**.

All in all, budgeting in useful for:

- reviewing **past** activities.
- controlling **current** business activity - following objectives.
- planning for the **future**.