Costs

Identify the set-up and running costs for a new clothing retailer

START-UP	RUNNING COSTS
Premises	Wages and salaries
Fixtures and fittings	Packaging materials
Equipment	Marketing and promotion
Utilities connection/installment	Stock
Legal and professional fees	Rent/mortgage payments
Recruitment costs of hiring staff	Utility bills
Building alterations	Tax
	Repairs, maintenance and day-to-day expenses
	Depreciation on capital equipment

Important terms

- Revenue is the money a business collects from sales. Unit Price x Quantity Sold.
- Costs are the amounts the business pays in order to set up and run the business.
- Profit is the amount of money left over after costs have been deducted from revenue (revenue-total costs).

Revenue

- Sales
- Selling assets
- Selling shares/investors
- Donations
- Fund-raising
- Sponsorship
- Dividends
- Interest on savings
- Government grants

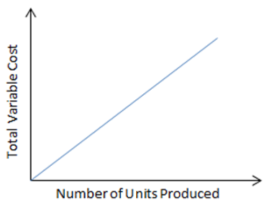
Types of costs – fixed costs

The costs of production that a business has to pay regardless of how much it produces or sells.

They can change, independently of output.

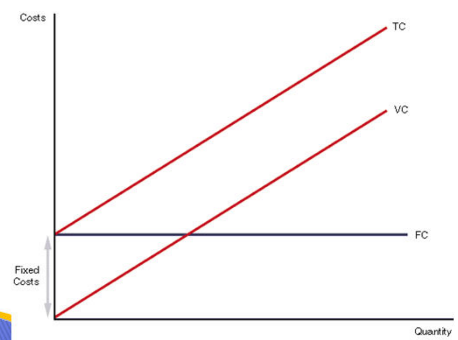
Types of costs – variable costs

The costs of production that change in proportion to output/sales levels.



Types of costs – total costs

The sum of total fixed costs and total variable costs (TC=TFC+TVC)



Semi-variable costs

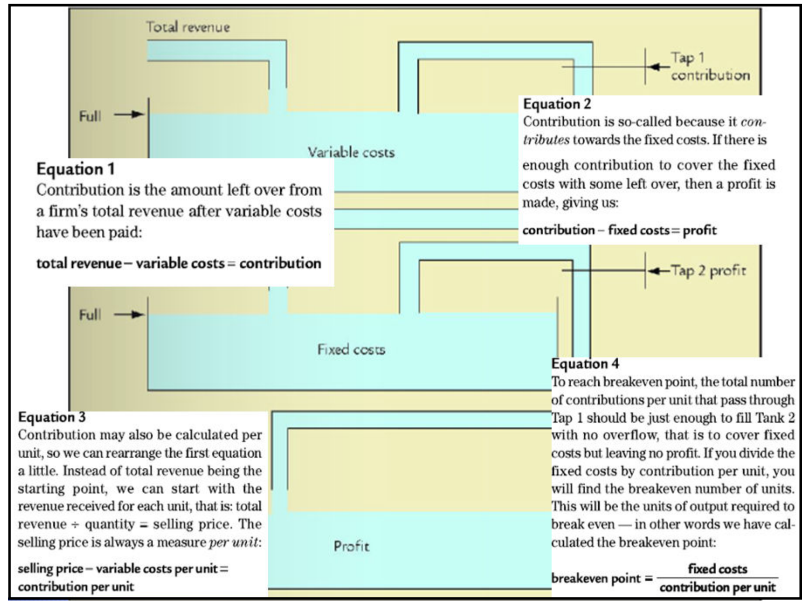
Contain elements of fixed and variable costs that usually change when production exceeds a certain level. For example…

- *Labour may be paid a fixed basic rate but earn commission on sales.*
- *Leasing of machinery may be fixed, but maintenance costs increase the more it is used.*

Direct and Indirect Costs

Direct	Indirect (overheads)
Specifically related and easily attributed to a specific project or product. Not necessarily related to output. e.g. wages to a tailor that makes a suit for a customer.	Costs that cannot be clearly traced or attributed to any specific project or product. Often also fixed costs as they do not directly relate to output e.g. the heating and lighting in the tailor's workshops.

Activity 5.2.1a, page 546



Contribution

Contribution per unit = Price – AVC (direct and variable)

If a firm sells chairs at $100 each and direct and variable costs are $45 per chair, contribution is $55 per chair.

This is NOT profit, because fixed and indirect costs (overheads) have not been deducted.

Profit = Total Contribution – TFC

Working out contribution for multi-product firms helps identify underperforming products (table 5.2a 550)

Topic 5
Operations Management

5.2 HL – Costs, Revenues and Contribution

Contribution analysis

Many firms are 'multi-product', with lots of products contributing to shared fixed and indirect costs.

In general, any product that makes a positive contribution is worth making/keeping, even if it is relatively low.

Table 5.2b (550)

Contribution analysis

Analysing product contribution is useful as…

1. Helps a firm set prices to ensure positive contribution (being wary of PED)
2. Helps the firm manage its portfolio and prioritise investment/time allocation
3. Helps allocate overheads
4. Helps make or buy decisions – may wish to buy products with negative contribution
5. Helps special order discounts decisions – will the discounted price still generate positive contribution?

Cost and Profit Centres

Cost Centre

A section of the business to which costs can be charged/allocated.

Manufacturing – products, departments, factories, processes.

For a hotel?

Cost and Profit Centres

Profit Centre

A section of the business to which both costs and revenues can be allocated and profit calculated.

e.g. a branch or chain of shops, departments in a department store

Apportioning Overheads

Unit 4.4 was about how we can allocate overheads and indirect costs to different profit centres fairly (or at least consistently)

Full costing allocates total indirect costs to each centre based on a single critrion

Absorption costing allocated both direct and indirect costs to each centre based on one or several criteria.

Apportioning Overheads – 5.2.5

Dept.	Art	Business	Chemistry	Design
Tuition fee/hr	35	40	38	32
Customers (hrs/month)	225	125	320	185
Revenues	7875	5000	12160	5920
Overheads (3000) based on sales	~~750~~ 765.2	484.57	1,178.48	573.74
Contribution	~~7125~~ 7111.8	4515	10,981	5346

OVERHEAD ALLOCATION
1 – find proportion of total sales for each PC
e.g Art…7875/30,955 = 25.44%

2 – allocate overheads as a % based on sales
e.g. Art…3000*25.44% = 763.2

CONTRIBUTION
Contribution = Sales-Costs
e.g. Art…7875-763.2 = 7111.8