

Business Costs

A business has many different costs, from paying for raw materials through to paying the rent or the heating bill. By careful classification of these costs a business can analyse its performance and make better-informed decisions.

The main ways in which a business needs to manage its costs are as follows:

- ▶ **Classification of costs** into fixed and variable, direct and indirect.
- ▶ **Variance analysis** to see if the business is keeping control of its costs.
- ▶ **Break even analysis** which tells a business what it needs to sell to cover its costs.

An opportunity cost is the financial benefit forgone of the next best alternative use of money. A business can measure the outcome of a decision by comparing it with the benefits (probably measured in profits or revenue) it could have had if it had taken the next best option. The opportunity cost of buying a new piece of machinery might be compared with the benefits of spending the money on a new advertising campaign.

Fixed and Variable Costs

- ▶ **Variable costs** change in proportion to the amount of output produced.
- ▶ **Fixed costs** remain the same, no matter how much the business produces.

The main kinds of costs are:

Variable costs	Fixed costs
Raw materials	Rent
Workers wages	Salaries of head office workers
Energy/fuel for machines	Heating and lighting
	Insurance
	Interest on loans

Semi-fixed costs are costs which only change when there is a **large change in output**. For example, costs associated with buying a new machine to cope with increased production.

Also telephones and electricity for instance have a fixed and variable element: a standard line rental and then a charge for each call/unit of electricity after that.

- ▶ **Direct costs** are costs which can be identified directly with the production of a good or service; e.g. raw materials.
- ▶ **Indirect costs** are costs which cannot be matched against each product because they need to be paid whether or not the production of good or services takes place; e.g. rent on the premises.

Classification of costs help allocate costs to right parts of the profit and loss account and also helps analysis of the break even point of the business.

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