

Unit 3.2: Costs and revenues

Answers

Activity 1

1. Classify these costs by ticking in the appropriate boxes in the above table. [6 marks]

Costs	Direct	Indirect	Fixed	Variable
Rent of factory		✓	✓	
Management salaries		✓	✓	
Electricity		✓	✓	
Piece rate labour wages of production staff	✓			✓
Depreciation of equipment		✓	✓	
Lease of company cars		✓	✓	
Wood and other materials used in production	✓			✓
Maintenance cost of special machine used to make one type of wooden chair				✓

2. Explain why these costs have been classified as you did in Question 1. [6 marks]

- Rent of factory – **Indirect** if firm produces a range of different products, **fixed** if the firm produces a single product.
- Management salaries – **Indirect** if firm produces a range of different products, **fixed** if the firm produces a single product.
- Electricity – **Indirect** if firm produces a range of different products, **fixed** if the firm produces a single product. Electricity costs may vary with product output in some industries, but electricity almost always has a fixed charge component and electricity is used to power back offices, etc.
- Piece rate labour wages of production staff – **Direct** if firm produces a range of different products, **variable** if the firm produces a single product.
- Depreciation of equipment – **Indirect** if firm produces a range of different products, **fixed** if the firm produces a single product.
- Lease of company cars – **Indirect** if firm produces a range of different products, **fixed** if the firm produces a single product.
- Wood and other materials used in production – **Direct** if firm produces a range of different products, **variable** if the firm produces a single product.
- Maintenance cost of special machine used to make one type of wooden chair – **Direct** if firm produces a range of different products, **variable** if the firm produces a single product.

3. Distinguish between direct/variable and indirect/fixed costs.

[4 marks]

Variable costs are associated with businesses that sell a single product. Direct costs are associated with one product in a range of products a business may be selling.

Likewise, fixed costs are tied to a single product business. Indirect costs are associated with multi-product firms.

4. Justify why it is important for a business to identify the direct/variable and indirect/fixed costs.

[9 marks]

One of the key principles to managing a business effectively is analysing expenses to determine an appropriate budget and forecast. In order to successfully understand a firm's cost commitments and develop a base line forecast, it is important to first identify its fixed and variable costs.

Fixed Costs are those expenses that do not change in relation to the activity of the business. These costs would be incurred regardless of the amount of sales or work performed. They are generally weekly, monthly, or annually general and administrative expenses. For example, the monthly office space lease payment will remain consistent with the terms set forth in a lease regardless of an increase or decrease in sales each month. Other examples would include employee salaries, office equipment leases, utilities, depreciation, etc. Although these costs will vary over time, they are not directly related to the performance over a specific period or tied to the sale of a good or service.