**Look! Overhead!**

Every business has **operating costs**. There are a few different terms that may be used to describe these costs, such as “overhead” or “OPEX” (operating expenses). No matter what they’re called, these are the ongoing, day-to-day expenses of running a business that are not directly related to production.

Operating costs are the opposite of **capital expenditures**. Capital expenditures are one-time purchases that a company makes—perhaps a building or a piece of equipment. Operating costs, on the other hand, relate to maintaining that building (e.g., janitorial services) or running that piece of equipment (e.g., electricity). For more on the difference between operating costs and capital expenditures, including a video, visit <http://www.diffen.com/difference/Capex_vs_Opex>.

The two main types of operating costs are fixed and variable. They are sometimes further subdivided into categories such as “selling expenses v. manufacturing expenses” or “administrative expenses v. manufacturing expenses.” For more on these distinctions, read Sam Ashe-Edmunds’ article “Selling Expenses v. Administrative Expenses” at <http://smallbusiness.chron.com/selling-expenses-vs-administrative-expenses-57899.html>.

**The fix is in**

Operating costs that do not increase or decrease with changes in production are called **fixed expenses**. In other words, these are the expenses that must be paid no matter what. Examples of fixed expenses include:

* Maintenance and repairs for the business facility:
* Janitorial services
* Trash removal
* Lawn care
* Utilities (electricity, gas, water, sewage, etc.)
* Insurance
* Property taxes
* Rent/Mortgage
* Wages/Salaries
* Employee benefits:
* Health insurance
* Retirement
* Vacation
* Office supplies
* Office equipment (computers, copiers, etc.)
* Certain business services, such as accounting, legal, etc.
* Interest on debt
* **Depreciation** (loss of value on certain company property, such as computers or vehicles)

For more on fixed operating costs, go to <http://www.wisegeek.com/what-are-the-different-types-of-fixed-operating-costs.htm>.

**It varies**

Operating costs that fluctuate with changes in production are called **variable expenses**. When a company produces more of a product, variable expenses go up. When a company produces less of a product, variable expenses go down. Most people don’t associate variable expenses with overhead; rather, they think of them mainly as direct costs relating to production. However, there are several variable operating expenses, such as:

* Advertising and promotion

*Example: A company ramps up its production of pool accessories for the summer. During this season, it spends more on advertising and promotion to keep sales moving.*

* Travel expenses

*Example: A company has slowed down its production of medical supplies due to lower demand. This also means that the company is spending less on travel expenses for its sales associates, as they are now visiting accounts just once a month, instead of twice.*

* **Sales commissions**

*Example: Demand for flat-screen televisions is up during the holiday season, so an electronics manufacturer is producing more of them. Its sales associates are selling more televisions to wholesalers and retailers, meaning their commissions have been higher lately.*

* Employee bonuses

*Example: A financial-services firm has had a stellar year selling its products (e.g., retirement-plan administration, investment advising, etc.) to more customers than ever. As a result, its employees will be receiving larger bonuses this year.*

* Certain permits and fees

*Example: As the economy recovers and more people build new homes, a construction business has more customers and is paying more in building permits and fees.*

* Costs of providing free shipping, delivery, or installation

*Example: An appliance manufacturer offers free delivery to wholesalers and retailers who spend a certain amount of money with each order. Demand for appliances is up, so the manufacturer has been producing more, customers have been ordering more, and—as a result—the costs of providing free delivery have risen as well.*

**Mix it up**

Some operating costs may be considered partially variable and partially fixed. These are known as **semi-variable costs** (sometimes called **semi-fixed costs** or **mixed costs**). Semi-variable costs are fixed until the company reaches a certain level of production; after that, they become variable. Here are a few examples:

To see how companies calculate their semi-variable costs, go to <http://www.variablecost.net/Semi-Variable-Costs.html>.

* A manufacturer has a fixed cost for its employees’ wages, but when it decides to produce a greater number of products this month, its employees work more hours and earn overtime. The employees’ base wages are still fixed, but the cost of paying this overtime is variable, depending on how many extra hours are worked.
* This same manufacturer also has a fixed cost for its electric bill, but with the increased production, it’s been using more electricity. The amount that is over and above the regular, fixed expense is variable.
* A company has a fixed cost for its salespeople’s salaries, but when the company produces more, and salespeople sell more, their sales commissions increase. The salaries are fixed, but the commissions are variable. Considered together, they are a mixed cost.

**Either/Or**

As you can probably guess, certain costs may be considered either fixed *or* variable, depending on how you look at them. For instance, one business may consider pest-control costs to be fixed, since it spends the same amount of money each year ridding its facility of spiders and ants. Another business, however, may consider the costs to be variable, since it only spends money for pest control as needed (perhaps only once every few years). The decision of whether to categorize an expense as fixed or variable is ultimately up to the individual business. However, for accounting purposes, the decision must remain consistent over time.

**Summary**

Operating costs are the ongoing, day-to-day expenses of running a business that are not directly related to production. The two main types of operating costs are fixed and variable. Fixed expenses (e.g., rent, insurance) do not increase or decrease with changes in production. Variable expenses (e.g., advertising, travel costs) fluctuate along with production levels. Semi-variable (also called semi-fixed or mixed) costs are fixed until the company reaches a certain level of production; after that, they become variable. Some costs may be considered either fixed *or* variable. The decision of how to categorize an expense is up to the individual business; however, for accounting purposes, the decision must remain consistent over time.