**PRACTICE TEST KEY**

**Objective A**

 1. Operating costs are the ongoing, day-to-day expenses of running a business that are not
directly related to production. (8 points)

 2. 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). (6 points)

 3. Fixed expenses are operating costs that do not increase or decrease with changes in production. In other words, these are the expenses that must be paid no matter what. (6 points)

 4. Answers will vary but should include at least four examples of fixed operating expenses,
such as: (16 points; 4 points each)

 • 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)

 5. Variable expenses are operating costs that fluctuate with changes in production. When a company produces more of a product, variable expenses go up. When a company produces less of a product, variable expenses go down. (6 points)

**PRACTICE TEST KEY** (cont’d)

 6. Answers will vary but should include at least four examples of variable operating expenses, such as: (16 points; 4 points each)

 • Advertising and promotion

 • Travel expenses

 • Sales commissions

 • Employee bonuses

 • Certain permits and fees

 • Costs of providing free shipping, delivery, or installation

 7. 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. For example, 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. (6 points)

**OBJECTIVE B**

 8. Operating costs have a great influence on a product’s final selling price. The total costof a product is the sum of the overhead and direct costs required to produce it. Let’s say the total cost of producing a pair of basketball shoes is $25 ($5 in operating costs and $20 in materials). To make a profit, then, the company must set a selling price that is higher than $25. Don’t forget that there will be price markupsbetween the manufacturer and the wholesaler,
between the wholesaler and retailer, and between the retailer and the customer. The final selling price of the shoes that cost $25 to make may be $100 or more. (6 points)

 9. In cost-based pricing, the business figures out a product’s total cost and then charges a pre-determined markup. For instance, if a piece of jewelry costs $50 total to make, the company charges $75 for it to create a $25 profit. The downside of cost-based pricing is that it is easy for competitors to undercut. Another company can come along with a similar piece of jewelry and charge just $65 or $70 for it. (6 points)

 10. In price-based costing, the business determines how much customers will pay for a certain product, and then figures out how to produce it for a cost that still leaves room for profit. Perhaps a jewelry business conducts market research and determines that it can reasonably expect customers to pay $65 for a piece of jewelry. The business then determines how it can make the jewelry for just $40, so it can still make $25 in profit for each piece. This means whittling down costs, either operating costs or direct costs. In most cases, a business will look to reduce operating costs first. (6 points)

**PRACTICE TEST KEY** (cont’d)

 11. One way for businesses to combat high operating costs is to create economies of scale.
Economies of scale happen when a business creates enough of a product to spread out and “dilute” its fixed costs. Let’s say that a manufacturer’s monthly operating costs are $20,000.
If it produces 10,000 products a month, each product carries $2 of operating costs into its
total cost. However, if the company can manufacture 15,000 products in that same time period, that number is only about $1.33. This economy of scale allows the company to reduce the impact of its operating costs without actually lowering them at all. (6 points)

 12. A company’s gross profitis the revenue it makes after subtracting the costs of the products it has sold. If a company made $1 million last quarter and spent $200,000 producing its goods, its gross profit is $800,000. Gross profit is a good indicator of how well a company keeps its costs under control. A similar company may also have made $1 million in revenue during the same quarter; however, it spent $300,000 producing its goods. This company’s gross profit is only $700,000. It is spending more money to make the same amount of revenue. Clearly, the first company is more efficient. (6 points)

 13. A company reaches its breakevenpoint when total expenses equal total sales. At this point, the business has covered its costs but has not yet made a profit. The formula for calculating breakeven point is: **Fixed costs / (Price per unit - Variable costs per unit) = Breakeven point.** For example, a company incurs a total of $20,000 in fixed costs, and each product carries $3 in variable costs. If the company sells each product for $10, it will break even after selling 2,858 products: $20,000 / ($10 - $3) = 2,858. When budgeting for operating and production costs, companies should consider the breakeven point to see if it’s feasible to sell the number of products that will ensure a profit. (6 points)

**Suggested** Criterion Level: 80 points