**Performance Indicator:** OP:024 Explain the nature of overhead/operating costs

**OBJECTIVES**

A – Explain overhead/operating costs.

B – Describe the impact of overhead/operating costs on the business.

3

**DISCUSSION GUIDE**

**OBJECTIVE A** (Slides 1–3)

(Slide 4)

• So What? Why learn about operating costs?

A. Even though you might not have spent any money today, you still incurred expenses.

1. You woke up at home—someone pays the rent or mortgage for you to live there.

2. Perhaps the heat or air-conditioning was running—someone pays for utilities, too.

3. How about the cereal you ate for breakfast or the pair of jeans you threw on before leaving for school?

4. Though you might not have purchased those items today, they still cost money.

B. The expenses that keep your life running on a day-to-day basis—housing, food, clothing, etc.—might be considered your personal “operating” costs.

C. Businesses have operating costs as well.

D. These expenses don’t directly relate to the business’s product(s), but they are still essential for success.

**DISCUSSION #1:** Ask students to name some of their personal “operating costs.”

(Slide 5)

• Every business has operating costs.

A. There are a few different terms that may be used to describe these costs, such as
“overhead” or “OPEX” (operating expenses).

B. 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.

**DISCUSSION GUIDE** (Obj. A, cont’d)

(Slide 6)

C. Operating costs are the opposite of **capital expenditures**.

1. Capital expenditures are one-time purchases that a company makes—perhaps a building or a piece of equipment.

2. Operating costs, on the other hand, relate to maintaining that building (e.g., janitorial services) or running that piece of equipment (e.g., electricity).

**ON THE WEB:** For more on the difference between operating costs and capital expenditures, including a video, visit <http://www.diffen.com/difference/Capex_vs_Opex>.

D. The two main types of operating costs are fixed and variable.

E. They are sometimes further subdivided into categories such as “selling expenses v.
manufacturing expenses” or “administrative expenses v. manufacturing expenses.”

**ON THE WEB:** For more on the distinctions among operating costs, read Sam Ashe-Edmunds’ article “Selling Expenses v. Administrative Expenses” at <http://smallbusiness.chron.com/selling-expenses-vs-administrative-expenses-57899.html>.

(Slide 7)

• Operating costs that do not increase or decrease with changes in production are called fixed expenses.

A. In other words, these are the expenses that must be paid no matter what.

B. Examples of fixed expenses include:

1. Maintenance and repairs for the business facility:

a. Janitorial services

b. Trash removal

c. Lawn care

2. Utilities (electricity, gas, water, sewage, etc.)

3. Insurance

4. Property taxes

**DISCUSSION GUIDE** (Obj. A, cont’d)

5. Rent/Mortgage

6. Wages/Salaries

7. Employee benefits:

a. Health insurance

b. Retirement

c. Vacation

8. Office supplies

9. Office equipment (computers, copiers, etc.)

10. Certain business services, such as accounting, legal, etc.

11. Interest on debt

12. **Depreciation** (loss of value on certain company property, such as computers or vehicles)

**DISCUSSION #2:** Ask students if they can give more examples of fixed operating expenses.

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

(Slide 8)

• Operating costs that fluctuate with changes in production are called variable expenses.

A. When a company produces more of a product, variable expenses go up.

B. When a company produces less of a product, variable expenses go down.

C. Most people don’t associate variable expenses with overhead; rather, they think of them mainly as direct costs relating to production.

**DISCUSSION GUIDE** (Obj. A, cont’d)

D. However, there are several variable operating expenses, such as:

1. Advertising and promotion

a. For example, a company ramps up its production of pool accessories for
the summer.

b. During this season, it spends more on advertising and promotion to keep
sales moving.

2. Travel expenses

a. For example, a company has slowed down its production of medical supplies due to lower demand.

b. 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.

3. **Sales commissions**

a. For example, demand for flat-screen televisions is up during the holiday season, so an electronics manufacturer is producing more of them.

b. Its sales associates are selling more televisions to wholesalers and retailers, meaning their commissions have been higher lately.

4. Employee bonuses

a. For 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.

b. As a result, its employees will be receiving larger bonuses this year.

5. Certain permits and fees—For 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.

6. Costs of providing free shipping, delivery, or installation

a. For example, an appliance manufacturer offers free delivery to wholesalers and
retailers who spend a certain amount of money with each order.

b. 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.

**DISCUSSION #3:** Ask students if they can think of any more examples of variable operating expenses.

**DISCUSSION GUIDE** (Obj. A, cont’d)

(Slide 9)

• Some operating costs may be considered partially variable and partially fixed.

A. These are known as **semi-variable costs** (sometimes called **semi-fixed costs** or **mixed costs**).

B. Semi-variable costs are fixed until the company reaches a certain level of production; after that, they become variable.

C. Example:

1. 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.

2. The employees’ base wages are still fixed, but the cost of paying this overtime is
variable, depending on how many extra hours are worked.

D. Example:

1. This same manufacturer also has a fixed cost for its electric bill, but with the increased production, it’s been using more electricity.

2. The amount that is over and above the regular, fixed expense is variable.

E. Example:

1. 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.

2. The salaries are fixed, but the commissions are variable. Considered together, they are
a mixed cost.

**DISCUSSION #4:** Ask students if they can give any more examples of semi-variable operating costs.

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

**DISCUSSION GUIDE** (Obj. A, cont’d)

(Slide 10)

• Certain costs may be considered either fixed *or* variable, depending on how you look at them.

A. 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.

B. 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).

C. The decision of whether to categorize an expense as fixed or variable is ultimately up to the individual business.

D. However, for accounting purposes, the decision must remain consistent over time.

**DISCUSSION #5:** Ask students if they can think of more examples of operating costs that might be considered either fixed *or* variable.

**OBJECTIVE B** (Slide 11)

(Slide 12)

• Business owners and managers must keep operating costs in mind every time they engage in important business activities, such as setting organizational goals, determining whether or not to launch new products, setting budgets, etc.

A. Though most businesses try to keep operating costs as low as possible so they can focus
on production, these expenses are still vital for success.

B. A realistic budget, for example, plans for operating costs (both fixed and variable)
appropriately.

• Operating costs have a great influence on a product’s final selling price.

A. The **total cost** of a product is the sum of the overhead and direct costs required to produce it.

B. Let’s say the total cost of producing a pair of basketball shoes is $25 ($5 in operating costs and $20 in materials).

C. To make a profit, then, the company must set a selling price that is higher than $25.

**DISCUSSION GUIDE** (Obj. B, cont’d)

D. Don’t forget that there will be **price markups** between the manufacturer and the
wholesaler, between the wholesaler and retailer, and between the retailer and the
customer.

E. The final selling price of the shoes that cost $25 to make may be $100 or more.

**ON THE WEB:** To learn more about markups and how they affect selling price, read Tamara Monosoff’s article “Demystifying Profit Margins and Markups” at <http://www.entrepreneur.com/article/170964>.

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• Many different factors go into setting a product’s final selling price, and there are several pricing methods businesses can follow.

A. One is **cost-based pricing**, in which the business figures out a product’s total cost and then charges a predetermined markup.

1. For instance, if a piece of jewelry costs $50 total to make, the company charges $75 for it to create a $25 profit.

2. The downside of cost-based pricing is that it is easy for competitors to undercut.

3. Another company can come along with a similar piece of jewelry and charge just $65 or $70 for it.

B. Another method for setting selling prices is “**price-based costing**,”in which the business
determines how much customers will pay for a certain product, then figures out how to produce it for a cost that still leaves room for profit.

1. Let’s say the same jewelry business conducts market research and determines that it can reasonably expect customers to pay $65 for the piece of jewelry in question.

2. The business then determines how it can make the jewelry for just $40, so it can still make $25 in profit for each piece.

3. This means whittling down costs, either operating costs or direct costs.

4. In most cases, a business will look to reduce operating costs first.

**DISCUSSION GUIDE** (Obj. B, cont’d)

5. Cutting operating costs *too* deeply can affect product quality, so businesses must be careful.

a. This risk can be especially evident in service businesses.

b. Consider a hair salon.

c. Its owners may cut down on operating costs by having only three stylists on duty at one time.

d. However, if walk-in customers are kept waiting too long, the overall product suffers, and the salon may lose business.

**DISCUSSION #6:** Ask students if they think cost-based pricing or price-based
costing is a better method. Why do they think this?

(Slide 14)

• One way for businesses to combat high operating costs is to create economies of scale.

A. Economies of scale happen when a business creates enough of a product to spread out and “dilute” its fixed costs.

B. Let’s say that a manufacturer’s monthly operating costs are $20,000.

C. If it produces 10,000 products a month, each product carries $2 of operating costs into its total cost.

D. However, if the company can manufacture 15,000 products in that same time period,
that number is only about $1.33.

E. This economy of scale allows the company to reduce the impact of its operating costs
without actually lowering them at all.

**ON THE WEB:** Read more about economies of scale at <http://www.economist.com/node/12446567>.

(Slide 15)

• As costs go up or down, profits fluctuate as well.

A. More costs equal less profit, and fewer costs equal greater profit.

**DISCUSSION GUIDE** (Obj. B, cont’d)

 (Slide 16)

B. A company’s **gross profit** is the revenue it makes after subtracting the costs of the products it has sold.

1. For example, if a company made $1 million last quarter and spent $200,000 producing its goods, its gross profit is $800,000.

2. Gross profit is a good indicator of how well a company keeps its costs under control.

3. You see, a similar company may also have made $1 million in revenue during the same quarter; however, it spent $300,000 producing its goods.

4. This company’s gross profit is only $700,000.

5. It is spending more money to make the same amount of revenue.

6. Clearly, the first company is more efficient.

**ON THE WEB:** Learn more about gross profit at <http://www.entrepreneur.com/article/226158>.

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• A company reaches its breakeven point when total expenses equal total sales.

A. At this point, the business has covered its costs but has not yet made a profit.

B. The formula for calculating breakeven point is: **Fixed costs / (Price per unit- Variable costs per unit) = Breakeven point**

C. Example:

1. A company incurs a total of $20,000 in fixed costs, and each product carries $3 in
variable costs.

2. If the company sells each product for $10, it will break even after selling 2,858
products: $20,000 / ($10 - $3) = 2,858.

D. 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.

**ON THE WEB:** You can find a breakeven calculator online at <http://www.calculatorpro.com/calculator/break-even-calculator/>.

**DISCUSSION GUIDE** (Obj. B, cont’d)

• Operating costs are just “a part of life” for every business and organization.

A. They relate to the everyday routine, but they are anything but ordinary.

B. Operating costs can mean the difference between profit and loss, failure and success.

C. Prosperous businesses are mindful of operating costs and work to keep them in line.

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• Make It Pay

A. Consider the operating costs at your place of employment or at your school.

B. What are they?

C. Which ones are fixed?

D. Which ones are variable?

E. Which might be considered semi-variable?

F. How do these costs affect the business’s (or school’s) prices and profits?

(Slide 19)

• The Gray Zone

A. Businesses like to keep operating costs as low as possible, so they can focus on
production and profit.

B. One way to keep operating costs down is to keep wages low.

C. Many businesses pay their workers the minimum wage required by law.

D. Often, workers consider this unfair and feel they should be paid more than the bare
minimum for the work they do.

E. Paying employees the minimum wage is certainly not illegal, but is it always ethical?

F. What do you think?