Costs

What are costs?

Costs are the amounts that a business incurs in order to make goods and provide services. Every business incurs costs, but they vary in terms of their type and amount.

For a new business, estimating what the likely costs are going to be is often very difficult. However, researching the likely costs of the business is very important.

In fact, successful entrepreneurs are usually obsessed with costs. In most cases they want to ensure that costs are kept as low as possible. They run a very "tight ship". Entrepreneurs will want to know:

- What it costs to produce the product or service?
- What the cost of marketing the product is?
- How high are the overheads of the business?
- What the potential costs of a business decision are?

Why the obsession with costs? Because costs:

- Are the thing that drains away the profits made by a business
- Are the difference between making a good and a poor **profit margin**
- Are the **main cause of cash flow problems** in a small business
- Change as the output or activity of a business changes – the entrepreneur needs to know how these are likely to change

A good starting point is to consider the difference between the two main types or categories of cost, namely:
Fixed costs – costs which do not vary with output
Variable costs – costs which change as output changes

Fixed costs

Fixed costs do not change as output varies. In other words, they are fixed even if output moves up or down from period to period.

Examples of fixed costs include:

- Rent & council tax
- Wages and salaries
- Marketing (advertising, market research)
- Insurance, banking & legal fees
- Software

- Consultant and adviser costs
- Design and development
- Heating, light and other energy costs
- Leased equipment charges

Note – just because a cost is classified as "fixed", that does not mean that the cost will stay the same.

For example, the rental of an office or shop will be paid to the landlord. The rent stays the same for a specific period (e.g. 5 years). However, the rent may change (up or down) when the rental agreement is renegotiated when due.

The important point about a cost like rent being "fixed" is that it **has to be paid,** whatever the level of sales achieved.

Fixed costs are particularly important when it comes to calculating the **break-even output** of a business. A business needs to generate enough **contribution** (a kind of profit) to cover its fixed costs in order for it to break-even.

The higher the level of fixed costs in a business, the higher must be the achieved output in order to break-even.

As a result, a good strategy for most start-ups is to focus on controlling and minimising fixed costs.

Variable costs

Costs which change when output changes are called **"variable costs"**

Variable costs tend to be those relating directly to the production or sale of a product. Good examples include:

- Raw materials & bought-in stocks and components
- Wages based on hours worked or amount produced
- Marketing costs based on sales (e.g. % discounts offered on a sales price)
- Agent and other commissions

Total variable costs can be calculated by a simple formula:

Variable cost per unit x output

Total costs

The total costs of a business can be calculated by simply adding together the variable costs at different levels of output to fixed costs.

Total costs (TC) = Fixed costs (FC) + variable costs (VC)

Let's look at an example: Graham's van repair business has the following costs and sales output for March:

Variable costs per job	£75
Garage rent & rates	£500
Wages	£1,500
Advertising	£100
Other fixed costs	£400
Expected number of jobs for month	100

What are the total costs for March?

Start with the variable costs, which equal £75 x 100 (i.e. VC per job times the number of jobs) = £7,500

Fixed costs total £2,500 (i.e. £500 + £1,500 + £100 + £400)

So total costs are £10,000 (i.e. VC + FC or £7,500 + £2,500)

Problems estimating costs

A business start-up is faced with the challenge of estimating what the costs of setting up and operating the business will be. It is not always easy.

Some costs are pretty straightforward to estimate – most of them are in the "fixed cost" category.

For example, a business that rents its location (e.g. a shop unit, a room in a shared office complex) will know what the cost will be. It is easy to get a quote from the landlord before signing the lease.

Some basic market research will soon tell the entrepreneur what it will cost to design, print and distribute some marketing leaflets. A call to the newspaper or Yellow Pages will quickly get a quote for the fixed costs of an advertising campaign.

Wages and salaries are also pretty easy to estimate. The entrepreneur knows what he or she is prepared to pay and the actual amount will be agreed in the employment contract. An entrepreneur can control hourly wages by restricting the amount of overtime available.

It is with variable costs that estimation becomes a bit harder. It is easy to get quotes for the price that has to be paid for raw materials and components. However, it might be that the business does not operate efficiently – for example suffering a high degree of waste. That would increase the average cost per unit produced.

Another problem comes when an entrepreneur enters a market in which he/she has little or no experience. For example, the business may discover that there are hidden marketing costs (e.g. commissions) which need to be taken into account. Sometimes the start-up business plan simply misses out a cost category due to inexperience or lack of care in putting the plan together.