Fixed Expenses. A business tries to earn a profit by selling products or providing services. Every sale has related expenses, so a business can only make a profit if the selling price for its product or service is greater than all of the expenses associated with that product or service. For example, if you owned a business called Matt's Hats and you paid a wholesaler $6 for every hat you sold, you would have to charge more than $6 for a hat to make a profit. Besides paying for the hats, you would have other expenses-rent, utilities, and the other expenses of operating your business. Today, you will examine how an entrepreneur can determine the actual cost of each product sold.

What Are Fixed Expenses? After you start your business, you will have to pay certain expenses regularly. Monthly expenses typically include rent, Internet access, salaries, and utilities (gas and electricity). An expense of this type is called a fixed expense-an expense that isn't affected by the number of items a business produces. The business will incur fixed expenses no matter how many products it sells. For example, if the rent for your space at Matt's Hats is $500 per month, it will remain $500 even if in September your business makes and sells twice as many items as it produced and sold in August.

Another way of looking at fixed expenses is that they are ongoing expenses a business must pay to be able to operate. The important thing to remember is that fixed expenses don't include expenses directly related to the products the business sells.

An easy way to remember eight of the most common fixed expenses is to remember the phrase: **I SAID U R + "Other FXs"**

Common Fixed Expenses

I SAID U R + "Other FXs"

Insurance

Salaries

Advertising

Interest

Depreciation

Utilities (gas, electric, phone)

Rent

Other Fixed e**X**penses

Depreciation. Depreciation is an accounting method of spreading the total cost of the equipment a business buys over the number of years it will be used. There are several depreciation methods a company can use. One of the most common ways of determining depreciation is the straight-line method of depreciation. The entrepreneur estimates how long the equipment will last and then figures what it could be sold for at the end of its business life (this is often referred to as the equipment's disposal value or salvage value). Next, to find the total depreciation, the entrepreneur subtracts the disposal value of the equipment from its actual cost. Then he or she divides that number by the estimated number of years during which the equipment will be used. The amount calculated per year is the depreciation expense.

Fixed Expenses Can Change. The word "fixed" doesn't mean the expense will never change. It means only that an expense doesn't change in response to sales. For example, if Matt's Hats needs air conditioning, its electric bills will likely be higher in the summer than they are in the winter. The electric bills will fluctuate based on the season. However, they will not change according to sales. The business might even have more sales in the winter, when the electric bills are lower.

Variable Expenses. As you now know, fixed expenses don't vary with the amount of product sold. Most businesses have another type of expense, referred to as a variable expense. This is an expense that changes based on the amount of product or service a business sells. The two types of variable expenses are:

- Cost of Goods Sold (COGS). For manufacturing and merchandising (retailing and wholesaling) businesses, the variable expense that is associated with each unit of sale is called the cost of goods sold. This includes the cost of materials and labor used to make the product or provide the service.
- Other Variable Expenses. These can include such expenses as commissions for salespeople, shipping and handling charges, or packaging.

Economies of Scale. As a business grows, it may be able to negotiate better prices from suppliers because it is purchasing larger quantities of goods. The cost reduction made possible by spreading costs over a larger volume is called an economy of scale.

Be Your Own Boss
Imagine you operate a retail business selling disposable cell phones. First, decide on a selling price for the phones and prepare a list of the estimated fixed and variable expenses. Second, you want the business to increase its profit, so you try to come up with several ways to lower the variable and fixed expenses.

Think Critically

1. How are expenses related to profits?
2. What is a fixed expense? Why don't fixed expenses change in response to sales?
3. What is a variable expense?
4. What is Cost of Goods Sold (COGS) and what does it include?
5. What is an economy of scale?
6. What is a unit of sale?
7. Explain why a unit of sale is not the same for every business.
8. How do you calculate the contribution margin?
9. What is a break-even point?
10. Describe a break-even analysis.
11. What are some actions an entrepreneur can take if his business is not selling enough to pay its expenses?
12. How can break-even analysis be used when planning a business?

Problem Solving

1. You own AAA AudioVideo Repair. You make service calls to customers' homes to repair their audio/video equipment such as television sets and home theater systems. Your fixed costs are $10,000 a year and your variable costs for each service call are $20. If you charge $75 for each service call, how many service calls will you have to make in order to break even? Show your work!

2. The Fancy Feet Shoe Company provides you with the following data for its new line of shoes:

   Selling price: $25 (per unit)   Variable costs: $20 (per unit)   Total fixed costs: $33,600

   (a) What is the gross profit per unit for the shoes? *(show your calculation)*

   (b) How many shoes does the company have to sell to cover all of its fixed costs? *(show your calculation)*