Chapter 28 Cost / Scale of production and break-even points

Key terms

1. Fixed costs: costs which do not vary with the number of items sold or produced in the short run. They have to be paid whether the business is making any sales or not. They are also known as overhead costs.
2. Variable costs: costs which vary directly with the number of items sold or produced.
3. Total costs: fixed and variable costs combined.
4. Average cost per unit(unit cost): the total cost of production divided by total output
5. Economies of scale: the factors that lead to a reduction in average costs as a business increases in size.
6. Diseconomies of scale: the factors that lead to an increase in average costs as a business grows beyond a certain size.
7. Break-even level of output(Break-even point): the quantity that must be produced/ sold for total revenue to equal total costs.
8. Break-even charts: graphs which show how costs and revenues of a business change with sales. They show the level of sales the business must make in order to break even.
9. Revenue: income during a period of time from the sale of goods and services.
10. Total revenue = quantity sold x price.
11. Break-even point: the level of sales at which total cost = total revenue.
12. Contribution: its selling price less its variable cost.

1.Identify and classify costs

1.1 **Cost** : expense from producing goods.

- **Fixed costs**: are costs which do not vary with the number of items sold or produced in the short run.
- **Variable cost**: are costs which vary directly with the number of items sold or produced.
- **Total cost**: Fixed cost + Variable cost
- **Average cost**: Total cost / Total output, cost per unit

2. Economics and diseconomies of scale

2.1 Economies of scale : are the factors that lead to a reduction in average cost per unit as a business increases in size.

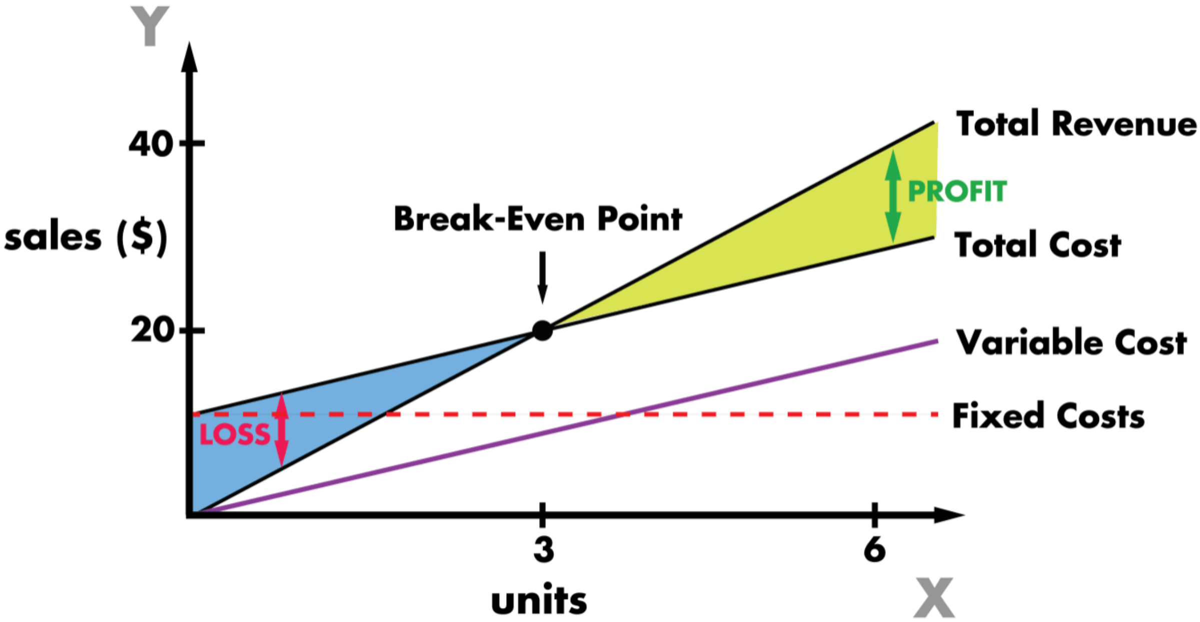
- **Purchasing economies**: When businesses buy large numbers of raw material, they are able to gain discounts from buying in bulk.
- **Financial economies**: Large firms means more reliable and therefore lower risk for delay repayment and hence receive lower cost of borrowing.
- **Marketing economies** : Advertising rates in papers and on television do not go up in the same proportion as the size of an advertisement ordered by the business.
- **Technical economies**: Big firm means high budget investment on high technology which brings to high standard quality of products and lower average cost.
- **Managerial economies**: Large firms can afford specialists and this increases their efficiency and helps to reduce their average cost.

2.2 **Diseconomies of scale**: are the factors that lead to an increase in the average cost as a business grows beyond a certain size.

- **Poor communication**: Large organisation makes slow or inaccurate communication. As a result, this leads to higher average cost.
- **Low morale**: Lots worker means rarely to contact with head manager/ feel unimportant/lower efficiency ; all in all, bring to higher average cost
- **Slow making decisions**: because lots people / longer step when deciding something therefore bring to higher average cost.

3. Break-even point find quantity that must be produced in order to cover total cost but not generate profit (total revenue = total cost)

Break-even charts : are graphs which show how costs and revenues of a business change of sales. They show the level of sales the business must make in order to break even.



Advantages	Limitation
1.Able to find the expected profit or loss to be made at any level of output. 2.Able to show the safety margin.	1.The graph does not show the possibility that inventories may build up if not all goods are sold. 2.Fixed costs only remain constant if the scale of production does not change. 3.Break even point does not include other factors eg. wastages. 4.The simple charts used in this section have assumed costs and revenues can be drawn with straight lines. In reality, variable cost lines slope more steeply upwards as output expands.