Chapter 31: Worksheet mark scheme (26 marks, HL 26 + 2)

1 Explain the types of cost stated below. Give examples of each for a frozen pizza company. **((2 + 1) × 5 = 15)**

- direct costs
  These are raw material and production costs that can be clearly allocated to a single item produced. They are usually mostly variable costs, e.g. cheese, bread, tomato, packing, wages of workers.
- indirect costs
  (Also know as overhead costs.) These cannot be allocated to a single unit produced. They may be associated with production, administration, selling, distribution, warehousing and finance costs. They are usually mostly fixed costs, e.g. management, warehousing and selling costs.
- fixed costs
  These are costs that do not change in relation to the number of items produced. They are usually mostly indirect costs, e.g. manager salaries, rent, mortgage payments.
- variable costs
  These are costs that increase or decrease according to the number of items produced. They are usually mostly direct costs, e.g. cheese, bread, tomato, packing, wages of workers.
- marginal costs
  These refer to the extra cost of making one more unit, e.g. the cost of making an extra pizza.

Award 2 marks for a statement and explanation and a further 1 mark for an example of each of the five types of costs.

2 What is the difference between revenue and cash flow? **(2)**

Revenue is the income received from the sale of a product. This only counts as cash flow when the product is actually paid for.

3 Define ‘contribution’. **(2)**

Contribution = revenue – direct costs. It is the money available to pay indirect costs (overheads).

4 Louis Desks Ltd makes tables for commercial customers at a price of $150 each for bulk purchase, $50 of which covers direct costs. Revenue from current orders will cover overheads but there is spare factory capacity and no more orders have been placed for the rest of the year. What quantitative argument could be used to justify accepting an order for 500 desks at a unit price of $80? **(3)**

Each desk would make a contribution towards overheads of $30 ($80 – $50).

As overheads are already covered by existing orders, this would represent a gain of $15,000 (500 × $30) which the business would not otherwise make.

5 Give **two** arguments for and **two** arguments against a business accepting orders at a sales price that does not cover full cost. **(4)**

For:

- It is better to earn some contribution towards fixed costs than no contribution at all, if capacity would otherwise lie unused.
- It may be the start of a relationship with a new customer who could generate profit in the future.

Against:

- Old customers may hear of the deal and be angry.
- The new customer may expect the same price for any future orders that they place.
- Another order may come in at full price and capacity would already be used.
- The buyer may resell in competition with the business.

5 **(HL)** What is the difference between a profit centre and a cost centre? **(2)**

A profit centre is a part of the business to which both revenues and costs can be allocated, whereas only costs can be charged to a cost centre.