One of the most important tools that a businessman has is the budget. The purpose of business is to increase profit and minimize costs. A good budget should reflect all profits and costs clearly and accurately so that decisions can be made about how to increase the profitability of the business. At no point in business is this tool more important than in the planning phase before the business has been started. If one is building a house, and the foundation is not strong, the house will never stand. Similarly if the budget is not sound from the beginning the business cannot be fixed but a strong budget, like a strong foundation will give one a strong base to fix later problems.

One of the most important steps in developing a good budget is categorizing one's costs. There are two major types of costs, capital costs and variable expenses. Capital costs refer to business expenses that are paid regardless of how much of the product is produced. Capital costs tend to be purchases of items a company will own for a long time, such as buildings or machines. Variable expenses are costs that change depending on how much of the product is made. They tend to be items that are consumed in the process of production, for example raw materials.

For example, imagine that one is starting a bread factory. Capital costs would include the factory to make the bread in, the mixer to mix the ingredients, and the oven. They would also include computers to keep track of orders, telephones, and other office equipment. Note that capital costs tend to be physical items and that later you can sell these items.

There is also another important feature of capital costs, in that they include costs of upgrading. If one buys delivery trucks, one may also want to paint the company name and logo on the trucks, or one may have to adapt the trucks to carry bread. These costs of customizing the trucks for use in a business are also capital costs and in some cases they can increase value. For example, if one adapts a truck to carry bread, other food companies will be more willing to buy the truck. The value of the truck has increased one's capital.

For the bread factory, variable expenses would include the flour, yeast, and eggs that go into the bread. The more bread that is made, the more of these materials that will be needed. Variable expenses will also include printed forms to take orders and other purchase of other items not directly related to the production of bread.

There is some debate over how to classify certain business expenses, for example, wages for employees. Some employees are required no matter how large production is. For example, staff to clean and guard your factory are needed before you even go into production. On the other hand, the number of workers needed to actually make your product will increase as you make more and more.

Nonetheless, some businessmen point out that the number of employees and the quantity of your product made are not directly related. For example, suppose that one loaf of bread requires 500 grams of flour. Every extra loaf of bread you make requires an extra 500 grams of bread. However the same is not true of employees. You cannot make a mathematic relationship between the number of employees and number of loaves of bread. It depends on how hard the workers work, how many hours they work, and the exact process of production. Most businesses therefore list wages as a separate category of costs and this is useful because it allows one to also keep track of bonuses and health or other benefits given to workers, separate from production.

1) Which of the following sentences best expresses the author’s point in paragraph 1? Incorrect choices change the meaning in important ways or leave out essential information.

A. A budget is a required part of a business plan to apply for bank loans
B. Businesses should only consider how to make more money.
C. Housing construction is a very profitable business
D. A good budget is important, especially one is planning to go into business

Paragraph 1 is marked with an arrow (→)

2) The word sound in the passage is closest in meaning to:

A. noise
B. strong
C. cost
D. foundation
3) All of the following are mentioned in paragraph 3 as examples of capital costs for a bread factory EXCEPT:

A. employee wages
B. the factory
C. computers
D. mixing machines

4) The word consumed in the passage is closest in meaning to:

A. eaten
B. burnt
C. used
D. bought

5) The word adapt in the passage is closest in meaning to:

A. evolve
B. change
C. purchase
D. sell

6) Based on information in paragraphs 3 and 4, what can be inferred about costs such as buildings and computers?

A. They are highly demanded by food companies
B. They should always be painted with the company name and logo
C. They should be adapted to increase efficiency of delivery.
D. If they are upgraded, they can increase in value.

7) In paragraph 4 under what conditions does the author state that the value of a delivery truck may increase?

A. It has been upgraded to serve a specific purpose
B. Many food companies are competing to buy it
C. It is equipped with computers
D. The truck was very expensive to buy

8) In paragraph 5, the phrase these materials refers to

A. delivery trucks
B. bread
C. flour, yeast, and eggs
D. printed forms

9) In paragraph 7 the author cites the opinion that employee wages are NOT a variable expenses because:

A. More employees are needed when more of a product is made
B. The number of hours an employee works is variable
C. Some employees are needed regardless of how much a product is made
D. The relationship between quantity of a product and number of employees needed is unclear.

10) Which of the sentences below best expresses the essential information in the highlighted sentence in the passage?

There is some debate over how to classify certain business expenses, for example, wages for employee?

Incorrect choices change the meaning in important ways or leave out essential information.

A. Employee wages cannot be classified as either capital costs or variable expenses.
B. It is not clear whether employee wages should be considered capital costs or variable expenses.
C. Employee wages are not important business wages and do not need to be planned for.
D. Businesses categorize some employee wages as capital costs and some as variable expenses.
1) Look at the four squares ■ that indicate where the following sentence could be added to the passage.

**The biggest mistake businesses make is failing to accurately plan costs from the beginning and so it is important to understand how to budget costs correctly.**

Where would the sentence best fit?
Choose a square ■ to add the sentence to the passage.

12) Fill out the table below

Select the appropriate phrases from the answer choices and match them to the type of cost to which they refer. TWO of the answer choices WILL NOT be used. *This question is worth 4 points.*

Write the letter of the correct phrases in the appropriate box below.

<table>
<thead>
<tr>
<th>Answer Choices</th>
<th>Type of Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Must be carefully planned for when deciding to start a business</td>
<td>Capital Costs</td>
</tr>
<tr>
<td>B. Include items such as raw materials and order forms.</td>
<td></td>
</tr>
<tr>
<td>C. Do not vary based on how much of the product is produced</td>
<td></td>
</tr>
<tr>
<td>D. Items not directly related to the process of production</td>
<td></td>
</tr>
<tr>
<td>E. Will be owned for a long time</td>
<td></td>
</tr>
<tr>
<td>F. Tend to be items that are consumed in the process of production</td>
<td>Variable Expenses</td>
</tr>
<tr>
<td>G. Include expenses that increase the value of materials</td>
<td></td>
</tr>
<tr>
<td>H. Dependent on how much of a product is produced</td>
<td></td>
</tr>
</tbody>
</table>