

Categorize costs as fixed, variable and semi-variable for a given scenario

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## Categorize Costs as Fixed, Variable and Semi-Variable for a Given Scenario

### Variable costs

They are costs that increase as production volumes or sales increases like the direct material costs. They are costs that change when responding to activity level changes e. g. costs of toys in a toyshop or food and beverage costs in a restaurant. Costs per unit remain constant in variable costs (Jordan, Gould, 1925 p. 12).

Below is a graphical example in relation to variable cost scenario.

As per the graph, the variable cost of a meal is constant at €2 and as sales volumes increase, variable costs also increase

### Fixed costs

These are costs that are insensitive to sales volumes; they use time as their function rather than sales volumes. They are costs like rent, insurance, rates and salaries. These costs will change in relation to sales volumes

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From the graph, fixed costs per week are constant at €2, 000

### Semi-variable cost

They are costs that include both variable and fixed components. After a certain point or level is exceeded, they become variable.

For mobile phone charge, the user pays a fixed charge until a certain level whereby after that level, the charge will be as per each phone call.

Calculate contribution per product/customer and explain the cost/profit/volume relationship for a given scenario

Contribution per product/customer will calculate how much contribution a certain product would earn for every unit of sales generated, which is

expressed as a percentage or decimal. If the C/S ratio is 0.4, for every £1 of sales revenue, 40 pence will be a contribution.

$C/S \text{ ratio} = \text{Contribution per unit} / \text{Sales price per unit}$  or

$C/S \text{ ratio} = \text{Total contribution} / \text{Total sales revenue}$

Cost-Volume-Profit analysis looks at changes in profits as variable costs, fixed costs, sales price and quantity change. It is also called “what if?” analysis and it particularly looks at sales less variable costs. It is also called contribution. With the contribution, management can easily understand the level of sales that they are likely to start making profits or cover all costs.

At break-even point, the company is neither making losses nor profits (Drury, 1992, p14). The assumption is that fixed costs, selling price and variable costs are constant.

Justify short-term management decisions based on profit/loss potentials and risk (break-even) calculations for a given business and services operation

For one to have a successful business there must be a clear understanding of the financial impact that basic financial decisions may pose (Dohr, Howell 1946, p15). One is ought to know his or her most profitable services or products, what will happen if sales volumes will suddenly drop, the impact of lowering sales prices or taking a loan, etc. To answer these questions,

Cost/Volume/Profit (CVP) analysis becomes the answer (Atkinson 1997, p51).

Cost/Volume/Profit analysis examines the relationships between variable costs and fixed costs, profits and sales volumes. The contribution margin analysis will help an entrepreneur in comparing the profitability of different products, services or even a line that he or she is offering. Breakeven analysis will help a businessperson to tell the sales volumes that he or she

will need to breakeven under different cost scenarios and prices (Upchurch, 2002, 72). Operative leverage, on the other hand, will examine the degree at which the business is using fixed costs, this will in turn magnify the returns when there is an upturn in sales and will also magnify losses as sales will be dropping.

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