

Fixed cost and variable cost

Business



Fixed Cost and Variable Cost

Fixed Cost and variable cost makes up the total cost of the business. Fixed Cost is costs that do not change during a specified period. They are expenses of the company that is not affected by the change in proportion to the activity of a business (Ross et. al, 1995) . For example the least payment on the production facility and the company president's salary are fixed cost. But of course, fixed cost are not fixed forever. They maybe only fixed, maybe let's say for a quarter or a year. Beyond that time, lease can be terminated and executives may retire. More to the point, any fixed cost can be modified or eliminated given enough time, so in the long run all cost are variable. Thou we should always remember that during the time that the cost is fixed, that cost is effectively a sunk cost because we are going to pay for it no matter what.

On the other hand, a variable cost is a cost that is directly proportional to the activity of the business. It depends on the amount of good or services produced during a period of time. Examples of this kind of cost are the labor, transportation and raw materials.

A manufacturer's perspective (Piana, 2003)

The main costs that a manufacturer faces can be summarized in the following table:

Cost	item
Cost	category
Justification	
Raw materials	to be processed

Variable (proportionally)

Production recipe: any un-proportional change would impact the features of the product

Semi-manufactured components to be assembled

Variable (proportionally)

Production recipe

Energy

Variable (less than proportionally)

Physical properties produce economies of scale

Personnel (direct labour)

Variable (proportionally)

Constant productivity of people directly involved in production

Particularly flexibility-oriented legal contracts with the labour force

Personnel (indirect labour)

Quasi-fixed

The size of necessary administrative personnel (and of other indirect labour) doesn't change so much if production incrementally changes. Discrete jump will happen when the overall scale of production drastically changes.

Plant rent

Fixed

The typical contract of rent makes no reference to effective production levels

Amortization of capital goods

Fixed

Fiscal and accountancy rules

Policy	costs	(advertising,	R&D,...)
Fixed	or	quasi-fixed	
Discretionary		costs	

The above-mentioned table is just a rough and conditional description. It is only meant for easy introduction to the problem - often implicitly assuming many specific hypotheses. (Piana, 2003)

References:

Piana, Valentino (2003) Cost. Economics Web Institute. Viewed on: June 9, 2006. Available at: <http://www.economicswebinstitute.org/glossary/costs.htm#cost>

Ross, S. A., Westerfield, R. W., & Jordan, B. D (1995) Fundamentals of Corporate Accounting (3rd ed.). The Irwin Series in Finance. Chicago; Bogota; Boston; Buenos Aires; Caracas; London; Madrid; Mexico City; Sydney; Toronto.