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Fixed costs are expenses that remain the same no matter how much a company produces, such as rent, property tax, insurance, and depreciation. Variable costs are any expenses that change based on how much a company produces and sells, such as labor, utility expenses, commissions, and raw materials. Fixed costs are normally independent of a company's specific business activities. Variable costs increase as production rises and decrease as production falls. Understanding the difference between these costs can help a company ensure its fiscal solvency. Companies incur two types of production costs: variable and fixed costs.Variable costs change based on the amount of output produced.Variable costs may include labor, commissions, and raw materials.Fixed costs remain the same regardless of production output.Fixed costs may include lease and rental payments, insurance, and interest payments. Variable costs are any costs that a company incurs that are associated with the number of goods or services it produces. A company's variable costs increase and decrease with its production volume. When production volume goes up, the variable costs increase. But if the volume goes down, the variable costs follow suit. If a company has a product line that is underperforming or outdated, it may choose to stop production of that line. The costs associated with this product are considered avoidable costs. Examples of variable costs generally include: Labor Commissions Packaging Utility expenses Raw materials for production Calculating variable costs can be done by multiplying the quantity of output by the variable cost per unit of output. Suppose ABC Company produces ceramic mugs for a cost of $2 per mug. If the company produces 500 units, its variable cost will be $1,000. However, if the company doesn't produce any units, it won't have any variable costs for producing the mugs. Similarly, if the company produces 1,000 units, the cost will rise to $2,000. One important point to note about variable costs is that they differ between industries, so it's not at all useful to compare the variable costs of a car manufacturer and an appliance manufacturer. That's because their product output isn't comparable. If you're going to compare the variable costs between two businesses, make sure you choose companies that operate in the same industry. Companies may also have semi-variable costs. These costs are a mixture of both variable and fixed costs. Fixed costs remain the same regardless of whether goods or services are produced or not. Thus, a company cannot avoid fixed costs. As such, a company's fixed costs don't vary with the volume of production and are indirect, meaning they generally don't apply to the production process—unlike variable costs. The most common examples of fixed costs include lease and rent payments, property tax, certain salaries, insurance, depreciation, and interest payments. To demonstrate, let's use the same example from above. In this case, suppose Company ABC has a fixed cost of $10,000 per month to rent the machine it uses to produce mugs. If the company does not produce any mugs for the month, it still needs to pay $10,000 to rent the machine. But even if it produces one million mugs, its fixed cost remains the same. The variable costs change from zero to $2 million in this example. A company's net profit is affected by changes in sales volumes. That's because as the number of sales increases, so too does the variable costs it incurs. The more fixed costs a company has, the more revenue a company needs to generate to be able to break even, which means it needs to work harder to produce and sell its products. That's because these costs occur regularly and rarely change over time. While variable costs tend to remain flat, the impact of fixed costs on a company's bottom line can change based on the number of products it produces. So, when production increases, the fixed costs drop. The price of a greater amount of goods can be spread over the same amount of a fixed cost. In this way, a company may achieve economies of scale by increasing production and lowering costs. For example, let's say that Company ABC has a lease of $10,000 a month on its production facility and produces 1,000 mugs per month. As such, it may spread the fixed cost of the lease at $10 per mug. If it produces 10,000 mugs a month, the fixed cost of the lease goes down to the tune of $1 per mug. The term marginal cost refers to any business expense that is associated with the production of an additional unit of output or by serving an additional customer. A marginal cost is the same as an incremental cost because it increases incrementally in order to produce one more product.Marginal costs can include variable costs because they are part of the production process and expense. Variable costs change based on the level of production, which means there is also a marginal cost in the total cost of production. The term sunk cost refers to money that has already been spent and can't be recovered. While sunk costs may be considered fixed costs, not all fixed costs are considered sunk. For instance, a fixed cost isn't sunk if a piece of machinery that a company purchases can be sold to someone else for the original purchase price. Semi-variable costs are also called semi-fixed or mixed costs. These types of expenses are composed of both fixed and variable components. They are fixed up to a certain production level, after which they become variable. Costs remain fixed even if no production occurs. It's easy to separate the two, as fixed costs occur regularly while variable ones change as a result of production output and the overall volume of activity that takes place. There are many ways that a business can reduce its variable costs. For instance, increasing output using the same amount of material can dramatically cut down costs, provided the quality of goods isn't impacted.Developing a new production process can help cut down on variable costs, which may include adopting new or improved technological processes or machinery. If this isn't possible, management may consider analyzing the process to spot opportunities for efficiencies and improvement, which can bring down certain variable costs like utilities and labor. Businesses incur all sorts of costs. Some of these remain static regardless of output, while others will fluctuate. Understanding the differences between fixed and variable costs will allow businesses to better manage their operations, margins, and overall strategy. The AccountingTools site is the complete source of information for the accountant. It contains continuing professional education (CPE) courses, business books, the Accounting Best Practices podcast, and articles on thousands of topics. Our emphasis is on clear explanations of the accounting standards and the practical management aspects of accounting, finance, and operations. The core areas of the site are noted below.CPE CoursesWe offer more than 320 courses, mostly developed in-house, for those needing continuing professional education training. AccountingTools is registered with the National Association of State Boards of Accountancy (NASBA) as a sponsor of continuing professional education.BooksWe offer more than 50 business books, with a primary emphasis on accounting and finance topics. These books are intended for both the student and the professional accountant. They can all be purchased as printed softcover books from Amazon. The book list is located in the right sidebar.ArticlesThe site contains nearly 4,000 articles on accounting, finance, and operations topics. The database of articles can be searched from the search feature in the right sidebar, as well as from the topics index and site archive, located in the drop-down menu.PodcastThe site contains links to every episode of the Accounting Best Practices podcast, which has been downloaded more than 5 million times. The podcast episodes can be searched from the podcast index, located in the drop-down menu. A fixed cost is a cost that does not increase or decrease in conjunction with any business activities. Thus, a business will incur fixed costs even when there is no business activity. Examples of fixed costs are rent, insurance, depreciation, salaries, and utilities. A common fixed cost situation for a business is a building that must be heated and air conditioned, even if no one is currently occupying it.What are Variable Costs?A variable cost is a cost that varies in relation to either production volume or the amount of services provided. If no production or services are provided, then there should be no variable costs. Examples of variable expenses are direct materials, sales commissions, and credit card fees. A common variable cost situation is a warehouse full of finished goods; these items are not charged to expense until they are sold to a customer.Related AccountingTools CoursesActivity-Based CostingCost Accounting FundamentalsComparing Fixed and Variable CostsThe difference between fixed and variable costs is that fixed costs do not change with activity volumes, while variable costs are closely linked to activity volumes. Thus, fixed costs are incurred over a period of time, while variable costs are incurred as units are sold.This difference is a key part of understanding the financial characteristics of a business. If the cost structure is comprised mostly of fixed costs (such as an oil refinery), managers need to generate a significant volume of sales in order to pay for the fixed costs being incurred. If they cannot generate sufficient sales, then the business will be forced to close. This means that managers are more likely to accept low-priced offers for their products in order to generate sufficient sales to cover their fixed costs. This can lead to a heightened level of competition within an industry, since they all likely have the same cost structure, and must all cover their fixed costs. Once fixed costs have been paid for, all additional sales typically have quite high margins. This means that a high fixed-cost business can make very large profits when sales spike, but can incur equally large losses when sales decline.If the cost structure is comprised mostly of variable costs (such as a services business), managers need to turn a profit on every sale, and so are less inclined to accept low-priced offers from customers. These businesses can easily cover their small amounts of fixed costs, and so can stay in business at relatively low sales levels. Variable costs tend to comprise a relatively high proportion of sales, so the profits generated on each individual sale once fixed costs have been covered tend to be lower than under a high fixed cost scenario.How to Reduce Fixed CostsIt can be difficult to reduce fixed costs. They are usually associated with a longer-term contract (such as a rent agreement), and so can only be adjusted at relatively long intervals. When these arrangements come up for renewal, be sure to put them out for bid, or look for alternative arrangements. For example, it may be possible to shrink the square footage occupied by a business by letting some people work from home, or by outsourcing selected activities. Or, a business could reduce its utility bill by shifting to solar panels mounted on the roof.How to Reduce Variable CostsThere are several ways to reduce your variable costs. Here are some suggestions:Obtain volume discounts. A good way to obtain volume discounts is to concentrate your purchases with fewer suppliers, so that the unit volumes purchased from each one increase. This provides you with extra leverage with which to negotiate volume discounts.Switch to performance-based compensation. Where possible, shift compensation arrangements away from a fixed amount and toward commissions, bonuses, and/or profit sharing. By doing so, your variable wage expenses only increase when the business performs well.Engage in target costing. Use a strict process of designing new products that have lower costs of materials and/or lower labor costs. If you cannot design a product that meets your target costs, then don’t produce it at all. 10 Min. Read June 21, 2024 Fixed vs variable cost refers to categorizing business expenses as either static or fluctuating during changes in production output and sales volume. Fixed costs remain the same irrespective of changes in production output, no matter what’s happening in the business. Variable expenses increase or decrease depending on your business activity and revenue. Understanding the difference between variable and fixed costs is essential for any business. Whether it’s calculating your monthly budget, setting prices for your products, or making important decisions regarding profitability and expense structure for the business, distinguishing between variable and fixed costs is crucial. In this guide, we’ll explain the difference between fixed and variable expenses, provide examples of each, go over accounting differences for the two, and more. Key Takeaways Fixed and variable costs are the two ways to categorize business expenses that almost all businesses need to pay. A fixed cost remains the same regardless of a business’s sales volume, production output, or total revenue. Variable costs change in relation to a company’s production output and/or sales volume. Analyzing and managing fixed and variable expenses is essential for budgeting, financial strategizing, pricing, job costing, and more. Accounting software can help you better track fixed and variable expenses. Table of Contents A fixed cost is any business expense that remains the same, regardless of how many units your business produces, how many sales it makes, or how much revenue it generates. A fixed cost is a constant expense—something you can predict every single time. A variable cost is any business expense that increases or decreases in relation to the company’s revenue, production output, or sales volume. These costs are tied to the production of your business’s product or service and will fluctuate depending on your company’s activity. In other words, when you’re producing more units, your variable costs increase. When you’re producing fewer units, your variable expenses decrease. If you’re not producing any units at all, your variable expenses fall to zero. Both fixed and variable expenses need to be accounted for to provide a complete picture of your business’s overall financial health and profitability. Understanding your fixed and variable costs will help you get more information during financial analysis, make more accurate and useful budgets for the future, and guide decision-making regarding product pricing, expense structures, or expansion plans. Fixed costs are also known as overhead costs since they remain static and unchanging no matter what your production output is. These are relatively easy to track using your normal accounting methods—they’re entered as expenses, and are subtracted from gross income to calculate net profit. Any small business owner will have certain fixed costs regardless of whether or not there is any business activity. Since they mostly stay the same throughout the financial year, fixed costs are easier to budget. They are also less controllable than variable expenses because they’re not related to operations or volume. Variable costs are a little more complicated to track using accounting. Since they’re tied to the production of units or the volume of sales, you’ll first need to calculate the variable cost per unit, which refers to the costs (usually for direct labor and materials) associated with producing a single unit of your product. Then, this per-unit cost is multiplied by the total amount of units you create over a given time to calculate your total variable expenses. Since they are changing continuously and the amount you spend on them differs from month to month, variable expenditures are harder to monitor and control. They can decrease or increase rapidly, cut your profit margins, or result in a steep loss or a whirlwind profit for the business. Fixed costs are expenses that are incurred regardless of changes in production or sales of the business. These costs are usually recurring expenses, such as employee salaries or monthly rent payments. Other fixed expenses include telephone and internet costs, insurance, and loan repayments. For example, say you rent a warehouse for your business for $40,000 per month, your rent costs will be $40,000 each month, regardless of how many products you sell. This makes rent a fixed cost since it doesn’t change with your sales volume. Just because a cost is fixed doesn’t mean that it won’t change—it simply means that the cost is not tied to changes in production output. So the rent of your warehouse may increase, but this change is separate from increases or decreases in your production output or revenue. Variable cost change is directly related to your production output. So, if you produce zero products in a period, your variable costs for that period would also be zero. Examples of common variable costs include: Direct labor Direct materials Commissions Transaction fees Production equipment Utility usage fees Variable expenses are calculated by first calculating the variable cost per unit—what it costs to produce a single unit in expenses such as labor and materials. You then multiply this by the total number of units produced to calculate your total variable costs for the production of that particular product. For your business budget to be useful, it needs to forecast both fixed and variable costs. Successful businesses will use their knowledge of their fixed and varying expenses to allocate their resources efficiently, ensuring there’s always enough money to cover fixed overhead expenses and to pay for the variable costs associated with unit production. Maximizing profitability comes down to effectively managing both fixed and variable costs. Your business should strive to keep its variable cost per unit as low as possible without compromising on quality—this ensures you’re getting as much profit as possible for each unit sold. While fixed costs can’t be lowered in the same way, you can effectively lower the impact of fixed expenses on your bottom line by increasing production and lowering variable costs—this is known as economies of scale. Managing variable costs tends to be fairly straightforward. For example, if you invest in more energy-efficient machinery, it will eventually pay for itself and save you money by lowering your utility bills. If you switch to a cheaper material for your units or find ways to complete the same tasks with fewer labor hours, you’ll also save. These are all valid ways to cut variable costs and increase your profit margins. Fixed overhead costs are more complicated to control. While you can theoretically rent a cheaper property for your work or downgrade your telephone service to get a cheaper plan, your business will always have fixed overhead costs of some kind. Instead, it’s recommended to find ways to reduce variable costs and increase production to offset the burden of fixed overhead costs on your budget. You should also be considering ways to manage fixed expenses whenever you look at expansion for your business—is a larger, more expensive warehouse worth it when you consider how much your production output will increase? Answering questions like this will help you keep fixed and variable costs under control, ensuring profitability for your company.   Fixed CostsVariable CostsMeaningFixed expenses are costs that remain constant for a period of time regardless of changes in production output.Variable expenses are costs that change directly and proportionally to the changes in business activity level, production output, or sales volume.Incurred whenFixed costs are always incurred, even if production output or sales volume is nil (zero).Variable costs are incurred when production output or sales volume increases.Also known asFixed costs are also known as overhead costs, period costs, or supplementary costs.Variable costs are also referred to as prime costs or direct costs, as they are directly affected by output levels.NatureFixed costs are time-related (i.e., they remain constant for a period of time).Variable costs are volume-related (i.e., they change with changes in output level).ExamplesDepreciation, interest paid on capital, rent, salary, property taxes, insurance premiums, etc.Commission on sales, credit card fees, utilities, direct materials, wages of direct labor staff, etc. It’s vital for small business owners to distinguish between fixed and variable costs. There are countless reasons for this, such as to help budget effectively, set prices, cost jobs and orders, and strategize for future growth. Other information that can only be gained by differentiating fixed and variable costs includes: Understanding the difference between fixed expenses and variable expenses is essential for identifying a profitable price level for your products or services. This is done by performing the break-even analysis (dollars at which total revenues equal total costs), which requires fixed expense information. The formula for calculating your break-even analysis is: Break-Even Point = Fixed Costs / (Revenue – Variable Costs) The equation not only provides valuable information about pricing but can also be modified to answer other important questions, such as the feasibility of a planned expansion. Break-even analysis can also provide information about projected profits for those considering buying a business. The equation can help them calculate the number of units and the dollar amount needed to make a profit, and then decide whether these numbers seem credible and realistic. An understanding of the fixed and variable expenses can be used to identify economies of scale. Economies of scale is the name of a financial concept that states that, as output increases, fixed costs will be spread over a larger number of output items, therefore decreasing their overall impact on the business’s bottom line and helping you save money. Both fixed costs and variable costs provide a clear picture of the overall cost structure of the business. Understanding the difference between fixed costs and variable expenses is important for making rational decisions about business expenses which have a direct impact on profitability. Understanding your fixed and variable costs is essential for running your business effectively and efficiently. With a thorough understanding of the difference between variable and fixed costs, and information on how to control each of them to ensure profitability, you’ll be able to scale and grow your business consistently over time. If you’re looking for an easier way to track and manage your business’s fixed and variable costs, you’ll find the monitoring tools offered by accounting software helpful. With detailed tracking capabilities and powerful reporting features, accounting software makes it easier than ever to run your business with confidence. Try FreshBooks free today! Reviewed by Jami Gong is a Chartered Professional Account and Financial System Consultant. She holds a Masters Degree in Professional Accounting from the University of New South Wales. Her areas of expertise include accounting system and enterprise resource planning implementations, as well as accounting business process improvement and workflow design. Jami has collaborated with clients large and small in the technology, financial, and post-secondary fields. RELATED ARTICLES Fixed costs are expenses that do not fluctuate with the level of production or sales within a certain range of activity. These costs remain constant regardless of how much a business produces or sells, making them a crucial component of financial planning and analysis. Common examples of fixed costs include rent, salaries of permanent staff, insurance premiums, and depreciation on equipment.For instance, a manufacturing company may pay a set amount for its factory lease each month, irrespective of whether it produces 1,000 or 10,000 units of its product. This characteristic of fixed costs allows businesses to predict their expenses with a degree of certainty, which is essential for budgeting and long-term financial forecasting. Understanding fixed costs is vital for businesses as they form the foundation upon which variable costs and overall pricing strategies are built.By knowing their fixed costs, companies can determine the minimum revenue required to cover these expenses before they can start making a profit. This understanding is particularly important in industries with high fixed costs, such as airlines or telecommunications, where significant investments in infrastructure are necessary. In such cases, the ability to manage and analyse fixed costs effectively can be the difference between profitability and financial distress.Fixed costs are expenses that remain constant regardless of the level of production or sales, such as rent and salaries.Variable costs are expenses that change in direct proportion to the level of production or sales, such as raw materials and labour.Understanding the differences between fixed and variable costs is crucial for effective financial management in business.Fixed costs play a key role in determining the break-even point and profitability of a business.Variable costs are important for businesses to control in order to maintain profitability and competitiveness. Explaining Variable CostsUnderstanding Variable Costs in PracticeFor instance, if a bakery produces more loaves of bread, it will incur higher costs for flour, sugar, and other ingredients. Conversely, if production decreases, these costs will also decline accordingly. Variable costs play a significant role in determining a company’s overall cost structure and profitability.Controllable Costs and Operational EfficiencyThey are often considered controllable costs because businesses can adjust them based on demand and operational efficiency. For example, during peak seasons, a clothing retailer may hire additional staff to manage increased sales, thereby increasing its variable labour costs. Conversely, during slower periods, the retailer might reduce hours or lay off temporary workers to keep variable costs in check.This flexibility allows businesses to respond dynamically to market conditions and consumer demand. Differences Between Fixed and Variable CostsThe primary distinction between fixed and variable costs lies in their behaviour relative to production levels. Fixed costs remain unchanged regardless of output levels within a relevant range, while variable costs fluctuate directly with production volume. This fundamental difference has significant implications for how businesses manage their finances and make strategic decisions.For example, a company with high fixed costs may experience greater financial risk during downturns in sales since these expenses must be paid regardless of revenue levels. Another key difference is the impact on pricing strategies and break-even analysis. Fixed costs contribute to the overall cost structure that must be covered before a business can achieve profitability.In contrast, variable costs are often considered when setting prices for individual products or services since they directly affect the marginal cost of production. Understanding these differences is crucial for managers when making decisions about scaling operations, pricing products, and evaluating profitability across different segments of their business. Importance of Fixed Costs in BusinessFixed costs play a pivotal role in establishing a business’s financial stability and operational framework. They provide a baseline for understanding the minimum revenue required to sustain operations. For instance, a company that has substantial fixed costs must ensure that its sales consistently exceed this threshold to avoid losses.This necessity can drive strategic decisions regarding pricing, marketing efforts, and production levels. In industries with high fixed costs, such as manufacturing or real estate, understanding these expenses is essential for long-term viability. Moreover, fixed costs can influence a company’s competitive positioning within its industry.Businesses with lower fixed costs may have more flexibility to adjust prices in response to market changes or competitive pressures. Conversely, companies with high fixed costs may need to maintain higher sales volumes to spread these expenses over a larger base, which can create challenges during economic downturns or periods of reduced demand. Therefore, managing fixed costs effectively is not only about maintaining profitability but also about ensuring resilience in an ever-changing market landscape. Importance of Variable Costs in BusinessVariable costs are equally important as they directly impact a company’s ability to respond to market demands and operational efficiency. The flexibility associated with variable costs allows businesses to scale operations up or down based on current conditions without incurring significant long-term commitments. This adaptability is particularly valuable in industries characterised by fluctuating demand patterns, such as retail or hospitality.For example, during holiday seasons or special events, businesses can increase their workforce or inventory levels to meet heightened consumer demand without being burdened by excessive fixed expenses. Furthermore, variable costs are critical for pricing strategies and profit margins. Understanding the relationship between variable costs and pricing enables businesses to set competitive prices while ensuring profitability on each unit sold.For instance, a software company may offer tiered pricing based on usage levels; as customers use more of the service, their variable costs increase due to additional server usage or customer support needs. By carefully analysing variable costs, companies can optimise their pricing models to maximise revenue while remaining attractive to consumers. Managing Fixed CostsEffective management of fixed costs is essential for maintaining financial health and operational efficiency within a business. One approach to managing these expenses is through careful budgeting and forecasting. By accurately predicting future fixed costs based on historical data and market trends, businesses can allocate resources more effectively and avoid unexpected financial strain.For example, a company might negotiate long-term leases for office space at favourable rates to lock in lower rental expenses over time. Another strategy involves regularly reviewing fixed cost commitments to identify potential areas for reduction or renegotiation. Businesses can assess whether certain fixed expenses are still necessary or if alternatives exist that could lower overall costs.For instance, companies may consider remote work arrangements that reduce the need for large office spaces or explore outsourcing options for non-core functions like IT support or payroll processing. By actively managing fixed costs, businesses can enhance their financial resilience and improve their ability to weather economic fluctuations. Managing Variable CostsManaging variable costs requires a different approach than managing fixed costs due to their inherent variability and direct correlation with production levels. One effective strategy is implementing just-in-time (JIT) inventory management systems that minimise excess inventory and reduce holding costs. By synchronising production schedules with customer demand, businesses can lower their variable material costs while ensuring they have sufficient stock on hand to meet orders promptly.Additionally, investing in technology and process improvements can lead to more efficient operations that reduce variable labour and material costs. For example, automating certain production processes can decrease reliance on manual labour while increasing output consistency and quality. Similarly, leveraging data analytics can help businesses identify trends in customer behaviour that inform more accurate demand forecasting, allowing them to adjust production levels accordingly and optimise variable cost management. Finding the Right Balance between Fixed and Variable CostsStriking the right balance between fixed and variable costs is crucial for achieving sustainable growth and profitability in any business environment. Companies must evaluate their unique circumstances—such as industry characteristics, market conditions, and competitive landscape—to determine the optimal cost structure that aligns with their strategic objectives. For instance, startups may prefer a lean model with lower fixed costs to maintain flexibility as they establish their market presence.Conversely, established firms with stable demand may benefit from investing in fixed assets that enhance operational efficiency and reduce long-term variable expenses. The key lies in understanding how both types of costs interact within the broader context of the business model and market dynamics. By continuously monitoring performance metrics related to both fixed and variable costs, companies can make informed decisions that support long-term success while remaining agile enough to adapt to changing conditions.In conclusion, navigating the complexities of fixed and variable costs requires a nuanced understanding of their implications for business operations and financial health. By effectively managing both types of expenses and finding an appropriate balance between them, companies can position themselves for sustained growth and resilience in an ever-evolving marketplace.When considering the costs associated with running an e-commerce business, it is important to understand the difference between fixed and variable costs. Fixed costs are expenses that remain constant regardless of the level of sales, such as rent and salaries, while variable costs fluctuate with sales volume, like packaging and shipping. To ensure your e-commerce business is successful, it is crucial to manage these costs effectively. For example, outsourcing product photo editing services can help reduce variable costs associated with in-house editing teams. This article provides a comprehensive guide for businesses looking to streamline their operations and cut costs.FAQsWhat are fixed costs?Fixed costs are expenses that do not change with the level of production or sales. These costs remain constant regardless of the business’s activity, such as rent, salaries, insurance, and depreciation.What are variable costs?Variable costs are expenses that change in direct proportion to the level of production or sales. These costs fluctuate as the business’s activity changes, such as raw materials, direct labour, and sales commissions.What is the difference between fixed and variable costs?The main difference between fixed and variable costs is that fixed costs remain constant regardless of the level of production or sales, while variable costs fluctuate with the level of activity. Fixed costs are incurred even if there is no production or sales, while variable costs only occur when there is production or sales.How do fixed and variable costs affect a business’s profitability?Understanding the distinction between fixed and variable costs is crucial for businesses to make informed decisions about pricing, production levels, and overall financial performance. By analysing the impact of fixed and variable costs, businesses can determine their break-even point, set pricing strategies, and make cost-effective decisions to improve profitability.Can fixed costs become variable costs?In some cases, fixed costs can become variable costs if the business makes changes to its operations. For example, if a business decides to outsource a function that was previously performed in-house, the cost may change from a fixed cost to a variable cost.How can businesses manage fixed and variable costs?Businesses can manage fixed and variable costs by conducting regular cost analysis, implementing cost-saving measures, negotiating with suppliers, and making strategic decisions about production levels and pricing. By understanding the nature of fixed and variable costs, businesses can make informed decisions to improve their financial performance. Fixed costs are expenses that remain the same no matter how much a company produces, such as rent, property tax, insurance, and depreciation. Variable costs are any expenses that change based on how much a company produces and sells, such as labor, utility expenses, commissions, and raw materials. Fixed costs are normally independent of a company's specific business activities. Variable costs increase as production rises and decrease as production falls. Understanding the difference between these costs can help a company ensure its fiscal solvency. Companies incur two types of production costs: variable and fixed costs.Variable costs change based on the amount of output produced.Variable costs may include labor, commissions, and raw materials.Fixed costs remain the same regardless of production output.Fixed costs may include lease and rental payments, insurance, and interest payments. Variable costs are any costs that a company incurs that are associated with the number of goods or services it produces. A company's variable costs increase and decrease with its production volume. When production volume goes up, the variable costs increase. But if the volume goes down, the variable costs follow suit. If a company has a product line that is underperforming or outdated, it may choose to stop production of that line. The costs associated with this product are considered avoidable costs. Examples of variable costs generally include: Labor Commissions Packaging Utility expenses Raw materials for production Calculating variable costs can be done by multiplying the quantity of output by the variable cost per unit of output. Suppose ABC Company produces ceramic mugs for a cost of $2 per mug. If the company produces 500 units, its variable cost will be $1,000. However, if the company doesn't produce any units, it won't have any variable costs for producing the mugs. Similarly, if the company produces 1,000 units, the cost will rise to $2,000. One important point to note about variable costs is that they differ between industries, so it's not at all useful to compare the variable costs of a car manufacturer and an appliance manufacturer. That's because their product output isn't comparable. If you're going to compare the variable costs between two businesses, make sure you choose companies that operate in the same industry. Companies may also have semi-variable costs. These costs are a mixture of both variable and fixed costs. Fixed costs remain the same regardless of whether goods or services are produced or not. Thus, a company cannot avoid fixed costs. As such, a company's fixed costs don't vary with the volume of production and are indirect, meaning they generally don't apply to the production process—unlike variable costs. The most common examples of fixed costs include lease and rent payments, property tax, certain salaries, insurance, depreciation, and interest payments. To demonstrate, let's use the same example from above. In this case, suppose Company ABC has a fixed cost of $10,000 per month to rent the machine it uses to produce mugs. If the company does not produce any mugs for the month, it still needs to pay $10,000 to rent the machine. But even if it produces one million mugs, its fixed cost remains the same. The variable costs change from zero to $2 million in this example. A company's net profit is affected by changes in sales volumes. That's because as the number of sales increases, so too does the variable costs it incurs. The more fixed costs a company has, the more revenue a company needs to generate to be able to break even, which means it needs to work harder to produce and sell its products. That's because these costs occur regularly and rarely change over time. While variable costs tend to remain flat, the impact of fixed costs on a company's bottom line can change based on the number of products it produces. So, when production increases, the fixed costs drop. The price of a greater amount of goods can be spread over the same amount of a fixed cost. In this way, a company may achieve economies of scale by increasing production and lowering costs. For example, let's say that Company ABC has a lease of $10,000 a month on its production facility and produces 1,000 mugs per month. As such, it may spread the fixed cost of the lease at $10 per mug. If it produces 10,000 mugs a month, the fixed cost of the lease goes down to the tune of $1 per mug. The term marginal cost refers to any business expense that is associated with the production of an additional unit of output or by serving an additional customer. A marginal cost is the same as an incremental cost because it increases incrementally in order to produce one more product.Marginal costs can include variable costs because they are part of the production process and expense. Variable costs change based on the level of production, which means there is also a marginal cost in the total cost of production. The term sunk cost refers to money that has already been spent and can't be recovered. While sunk costs may be considered fixed costs, not all fixed costs are considered sunk. For instance, a fixed cost isn't sunk if a piece of machinery that a company purchases can be sold to someone else for the original purchase price. Semi-variable costs are also called semi-fixed or mixed costs. These types of expenses are composed of both fixed and variable components. They are fixed up to a certain production level, after which they become variable. Costs remain fixed even if no production occurs. It's easy to separate the two, as fixed costs occur regularly while variable ones change as a result of production output and the overall volume of activity that takes place. There are many ways that a business can reduce its variable costs. For instance, increasing output using the same amount of material can dramatically cut down costs, provided the quality of goods isn't impacted.Developing a new production process can help cut down on variable costs, which may include adopting new or improved technological processes or machinery. If this isn't possible, management may consider analyzing the process to spot opportunities for efficiencies and improvement, which can bring down certain variable costs like utilities and labor. Businesses incur all sorts of costs. Some of these remain static regardless of output, while others will fluctuate. Understanding the differences between fixed and variable costs will allow businesses to better manage their operations, margins, and overall strategy. 13 Min. Read July 5, 2024 A variable cost is a type of corporate expense that changes depending on how much (or how little) your company produces or sells. Depending on how your sales or production rates are going, your variable costs can rise or fall—hence the name. So what do you need to know about budgeting for these fluctuating costs? How do variable costs impact your bottom line? What are some examples of variable costs, and how should you consider them in your business strategy? What’s the difference between variable and fixed costs? In this guide, we’ll break down everything you need to know about variable costs. Key Takeaways Variable costs are any expense that increases or decreases with your production output. Examples of variable costs include direct labor, direct materials, commissions, and utility costs. Variable costs differ from fixed costs, which don’t fluctuate depending on production output or revenue generated. Variable cost analysis can help you set prices, budget for future expansions, and gauge the financial success of your business. Accounting software can be useful for tracking and managing your variable costs. Table of Contents A variable cost is a recurring cost that changes in value according to the rise and fall of a company’s revenue and output level. Variable costs are the sum of all labor and materials needed to produce units for sale or run your business. What does this mean for businesses? Even though the amount it costs to produce a single unit of your product is fixed, the overall cost is variable, since the total amount will change depending on how many units you’re producing. This differs from fixed costs like rent or insurance, which will remain the same regardless of your company’s activity. Understanding your variable costs is essential for small and mid-sized businesses. The higher your variable costs, the lower your profit margin, meaning your business makes less money. Different industries tend to have more fixed or variable costs, depending on the nature of the service or product they provide. For instance, airlines have high fixed costs, such as paying for their aircraft. This means they have huge startup costs, but are much less vulnerable to competition once they’re up and running. Restaurants, on the other hand, tend to have much higher variable costs, since they depend so heavily on labor. This means that service industry businesses are more vulnerable to competition since startup costs are much lower than other types of businesses. Variable costs have three main components that need to be considered: Variable cost per unit refers to the total cost of producing a single unit of your business’ product. It encompasses all necessary resources, including labor, materials, marketing, and anything else needed to sell the product. Let’s say your business sells chairs for $80 each, but it costs you $25 in labor and $25 in materials to make them, for a total production cost of $50 per unit. Your variable cost per unit would be $50. Your total variable cost lets you calculate how much you’ve spent to create a certain number of product units. So if you’ve built 60 chairs to sell, you would multiply the variable cost per unit by the total number of units produced, like so: $50 (cost per unit for one chair) x 60 (total number of units produced) = $3,000 (total variable cost) Calculate your average variable cost to find out how much you spend to create a single unit of your product on average. Returning to the example of the chair company, the formula would look like this: $3,000 (total variable cost) / 60 (total output of units produced) = $50 (average variable cost per unit) In this example, the average variable cost formula simply works backward to arrive at our original cost per unit. Where average variable cost is most useful, however, is when you’re trying to calculate your average costs while accounting for multiple products with different variable costs per unit. If our chair company also produced a second type of chair that cost $40 to produce and sold for $65, you would use this formula to find your average variable cost for all types of chairs produced, not just for one or the other. The formula to calculate your total variable cost is: Total Variable Cost = Total Quantity of Output x Variable Cost Per Unit of Output For example, the chair company gets an order for 30 chairs for a total selling price of $2,400. To find variable cost per unit, we add the cost per unit in materials ($25) and direct labor costs ($25), and multiply it by our total quantity of output (how many chairs are produced for the order). 30 x ($25 + $25) = $1,500 The total variable cost for this order of 30 chairs would be $1,500, meaning the chair company’s gross profit for the order would be $900 ($2,400 – $1,500). Different industries have all kinds of different variable costs to consider. While labor and materials are the most common, you may have to account for other fluctuating expenses. Common variable costs include: Direct materials refer to any materials that are used in the production of a unit that makes it into the product itself. For example, wood is a direct material for the chair company, since the final chair is made of it. Wood is considered a variable cost because the price of it can change over time. An example of an indirect material would be sandpaper, which is necessary for creating the chairs, but doesn’t make it into the final product. Production supplies and equipment refers to any necessary supplies or equipment that fluctuate with your output level. For the chair company, an example would be oil for machines involved in the woodworking process. If the company makes more chairs, they’ll need more machine oil, making this a variable cost. Direct labor is sometimes a variable cost depending on how you staff your production area. Odds are, your production area needs a minimum amount of staff to operate regardless of how many units you produce—this is a fixed cost. But if you need more staff (or need staff to work more hours) to fulfill an order, paying wages for these labor increases would be considered a variable cost. If your company offers commissions (a percentage of a sale’s proceeds granted to staff or the company as an incentive), these will be variable costs. This is because your commission expenses depend entirely on how many sales you make. This differs from paying an employee’s salary, which is a fixed cost. If your company accepts credit card payments from customers, you’ll have to pay transaction fees on each sale. This is a variable cost since it depends on how many sales you make (and what methods your customers use to pay). The longer your production facility is actively operating, the more power and water it’s likely to use. Utilities are a variable cost because they usually increase and decrease alongside your production. If your company offers shipping to customers, you’ll need to consider packaging and shipping among your other variable costs. Since you’ll only need to pay for packaging and shipping if/when you make a sale for delivery, it’s considered a variable cost—even if the price of shipping remains the same over time. To better explain this concept and differentiate variable and fixed costs, we’ll use a few examples to help you understand how they may apply to your industry. We’ll once again use the example of the chair company. As we mentioned, it costs $25 in direct labor and $25 in direct materials to produce a single chair, for a total variable cost per unit of $50. They have fixed costs of $500 for the equipment they need to produce chairs. Here’s how we’d break down variable costs for the chair company: Chairs ProducedDirect Materials CostDirect Labor CostsTotal Variable CostsFixed CostsTotal
Costs0$0$0$0$500$5001$25$25$50$500$5505$125$125$250$500$75010$250$250$500$500$1,00025$625$625$1,250$500$1,75050$1,250$1,250$2,500$500$3,000 Note how the total variable cost rises with the number of chairs produced, while the fixed cost remains the same regardless of production output. Variable costs don’t just apply to manufacturing industries. They can also apply to service-based businesses. For example, a business consultant takes on a new 1-month contract. The contract will pay a total of $8,500. But to complete the contract, the consultant has to incur several variable costs, including: Paying for market research ($450) Travel out of state to work with the client ($600 for a plane ticket, $40 for cab fare) Renting temporary office space for one month ($800) Hiring a temporary assistant specifically for the contract ($25 per hour for 30 hours of work = $750) This is a simple equation for a single contract. We would simply add up the above expenses to get the total variable cost for completing the contract: $450 + $600 + $40 + $800 + $750 = $2,640 (total variable costs) The consultant would then subtract the total variable cost from the project pay to get their net profit (before paying any fixed expenses): $8,500 – $2,640 = $5,860 (profit after variable costs) This can get more complicated if the client takes on another 1-month contract with the same client the next year, and has to incur all the same expenses again. For the sake of the example, we’ll say the consultant has $500 in monthly fixed costs (in equipment leases and a fixed-rate phone plan), whether they have a contract that month or not. Here’s how we’d break it down: # of Contracts ResearchTravelTemporary Office Space RentalLabor Fixed CostsTotal Costs0$0$0$0$0$500$5001$450$640$800$750$500$3,1402$900$1,280$1,600$1,500$1,000$6,280 Notice how the total variable cost goes up according to the number of contracts, much like in the previous example. The data you gather from calculating your variable costs can be valuable for your business. It’s an essential tool when analyzing your expenses, setting prices, and generally gauging the profitability of your business. Here’s a breakdown of the importance of knowing your total variable cost: One of the most common uses for variable expense info is to set prices for your products or services. If the chair company knows it costs $50 per unit in variable costs to produce a single chair, it wouldn’t make sense to price the chair any lower than $51, since you would lose money on each sale. You’ll also need to charge enough to cover fixed costs. Of course, you don’t want to charge too much and risk losing business to better-priced competition. Using the variable cost formula will help you find the sweet spot between charging too much and too little, ensuring profitability for your business. Your company’s break-even point is the number of units you need to sell in order to break even on your total expenses. Both your fixed and variable costs are essential for calculating your break-even point. It’s done like so: Fixed Costs / (Revenue – Variable Costs) = Break-Even Point Naturally, you’re taking steps to grow and expand your business in the future. If you’re looking to double your output next year, remember that variable costs increase as well. Calculating your variable costs from the very beginning will make it easier to create budgets and expansion plans later on. When you calculate your gross margin, net income, and net profit margin, you’ll need to factor your variable and fixed expenses into the formulas. Good variable expense analysis ensures you can calculate how scaling production up or down will impact the company’s bottom line. Lastly, variable cost analysis is useful when determining your company’s expense structure. The chair company could buy an essential piece of production machinery outright for $10,000 (this would make it a fixed cost), or could choose to pay $0.10 for every unit they produce with that machine, making it a variable cost. You’ll need variable cost data to make the right decision in this scenario, which will greatly impact profitability and leverage. Understanding variable vs. fixed costs is essential for businesses looking to scale production while still remaining profitable. So what’s the difference? Simply put, variable costs change. This refers to any expenses that fluctuate relative to the number of units the company produces, such as direct materials, direct labor, commissions, or utility costs. Fixed costs refer to expenses that do not change with production output, such as rent for your offices or salaries for permanent employees. Variable costs can add a layer of unpredictability to running your business. But with a firm grasp of the variable cost formula and how to calculate variable costs for your business, you can plan ahead, keep costs under control, and ensure that you’re setting your business up for growth and success. If you’re looking for support with tracking all the costs that go into making your business possible, FreshBooks accounting software can help. With in-depth expense tracking, powerful reporting features, and around-the-clock support, we can support your business as it scales up and reaches new heights. Try FreshBooks free today. Do you still have questions about variable costs and how they affect your business profitability? Read on for some frequently asked questions on the topic. Salaries are fixed costs because they don’t vary based on production or revenue. They are a regular, recurring expense and the amount paid out is set. However, if you pay commissions for every unit sold on top of a salary, they would be variable costs. Non-salaried labor can be a variable cost. If you pay based on billable hours, commissions, or piece-rate labor rates (when workers are paid based on how many units they produce), these would be considered variable costs. The same goes for staffing more hourly wage workers (or having them work more hours) to meet increased production goals. An example of a variable cost per unit would be if a company makes chairs. Each chair costs $25 in direct labor and $25 in direct materials to produce. This would mean the total variable cost per unit of a single chair would be $50. Yes, your total variable costs will increase as you produce more units. This is because variable costs are tied to the total quantity of units you produce. For example, if you produce 1 chair with a variable cost per unit of $50, your total variable costs would increase to $500 if you produced 10 chairs. Variable costs are not inherently good or bad—they are a reality of providing any kind of product or service to your customers. You should strive to keep variable cost per unit as low as possible since this will result in more profit per unit. But if your total variable costs are rising, you are producing more units—hopefully at a net profit. Reviewed by Kristen Slavin is a CPA with 16 years of experience, specializing in accounting, bookkeeping, and tax services for small businesses. A member of the CPA Association of BC, she also holds a Master’s Degree in Business Administration from Simon Fraser University. In her spare time, Kristen enjoys camping, hiking, and road tripping with her husband and two children. In 2022 Kristen founded K10 Accounting. The firm offers bookkeeping and accounting services for business and personal needs, as well as ERP consulting and audit assistance. RELATED ARTICLES Knowing the difference between expenses and revenue is the key to understanding the profitability of your business. As fixed and variable costs make up the cost structure of your business, understanding the fluctuation of expenses and how they tie into your sales volume can help you make sound business decisions that will ultimately drive profits. Businesses incur two types of costs: fixed costs and variable costs.Fixed costs remain the same throughout a specific period.Variable costs can increase or decrease based on the production or output of the business.Examples of fixed costs include rent, taxes, and insurance.Examples of variable costs include credit card fees, direct labor, and commission. Fixed costs and variable costs are the two main types of costs a business can incur when producing goods and services. Businesses use fixed costs for expenses that remain constant for a specific period, such as rent or loan payments, while variable costs are for expenses that change constantly, such as taxes, labor, and operational expenses. Fixed costs are generally easier to plan, manage, and budget for than variable costs. However, as a business owner, it is crucial to monitor and understand how both fixed and variable costs impact your business as they determine the price level of your goods and services. Businesses can have semi-variable costs, which include a combination of fixed and variable costs. An example of a semi-variable cost is a vehicle rental that is billed at a base rate plus a per-mile charge. Fixed Cost Variable Cost Remains constant for a specific period regardless of the output or volume of business activities Changes in proportion to the output or volume of business activities Also known as overhead, indirect, or supplementary costs Also known as direct costs or prime costs Fixed costs are time-related Variable costs are volume-related Examples include rent, insurance premiums, depreciation, and property taxes Examples include credit card fees, direct labor, commission, and part-time wages Fixed costs refer to predetermined expenses that will remain the same for a specific period and are not influenced by how the business is performing. Since most businesses will have certain fixed costs regardless of whether there is any business activity, they are easier to budget for as they stay the same throughout the financial year. A good way of determining what your fixed costs are is to think about the costs your business would incur if you had to temporarily close. As an example, you would still have to pay rent and insurance, which would be considered fixed costs. Other examples of fixed costs include: Telephone and internet costsLoan payments Variable costs, however, do not remain the same and are usually directly linked to business activities. These are based on the volume of goods or services produced and the business’s performance. Examples of variable expenses include: Direct laborTaxesOperational expenses Variable costs can be challenging to manage as they can vary from month to month, increase or decrease quickly, and have a more direct impact on profit than fixed costs. A business can also have discretionary expenses such as gifts, vacations, and entertainment costs. These are desirable, but you can choose whether to have them or not. When it comes to fixed and variable costs, a clear understanding of each is essential for identifying the correct price level for goods and services. Understanding how costs can change with fluctuations in volume and output levels can help refine your overall business strategy. Understanding the difference between fixed and variable costs can help a business owner identify economies of scale, which occur when a business makes cost reductions as it increases its level of production. By achieving economies of scale, a business can spread out fixed costs over a larger number of products or services and decrease variable costs in the process, resulting in significant cost advantages. Fixed and variable costs contribute to the ability of a business owner to get a clear picture of the cost structure of the business, which is why it’s important to understand the differences between these two cost types. Making informed decisions about business expenses can help drive profitability.   A business uses break-even analysis to determine when it will be able to cover all of its expenses and begin to make a profit. For example, a business may use this analysis to determine the number of products that need to be sold to cover its cost of production. Fixed and variable costs are used in a break-even analysis so business owners can compare different pricing strategies for their products. You can use this formula when calculating a break-even point: Variable expenses used in this analysis can include the raw materials or inventory involved in the production, whereas fixed costs can include rent for the production plant. Operating leverage measures the degree to which a business can increase operating income by increasing revenue. A business that generates sales with a high gross margin and low variable costs has high operating leverage. With a higher operating leverage, a business can generate more profit. Here is a formula for calculating operating leverage: Fixed costs typically stay the same for a specific period and they are often time-related. A good example of this is monthly rent payments. For example, a business rents a building for a fixed cost of $50,000 per month for five years. The rent will stay the same every month, regardless of the business’s profit or losses. Keep in mind that fixed costs may not be consistent in the long run. In the example above, the rent will stay the same until the business no longer occupies the space, or when the agreement comes to an end and the owner decides to increase the rent for the next rental period. In another example, let’s say a business has a fixed cost of $7,500 to rent a machine it uses to produce shoes. If the business does not produce any shoes for the month, it still has to pay $7,500 for the cost of renting the machine. Similarly, if the business produces 10,000 mugs, the cost of renting the machine stays the same. Variable costs change directly in relation to the output of a business, so when there is no output, there are no variable costs. A good example of variable costs is the operational expenses that increase or decrease based on the business activity. If a business grows, so will its expenses such as utility bills for electricity, gas, or water. Unlike fixed expenses, you can control variable costs to allow for more profits. Another example of variable costs would be if a business produces hats at $5 each. If the business produces 200 units, its variable cost would be $1,000. However, if the company does not produce any hats, it will not incur any variable costs for the production of the hats. Similarly, if it produces 1,000 hats, the variable cost would rise to $5,000. You can calculate the variable cost for a product by dividing the total variable expenses by the number of units for sale. To determine the fixed cost per unit, divide the total fixed cost by the number of units for sale. As semi-variable costs consist of both fixed and variable costs, you can separate the two by identifying which costs would remain constant, even with no change in the production output of your business. An example of a semi-variable cost can be the electricity bill for your business. It may cost you $2,000 a month to function at a basic level and keep the lights on, but during a busy month in which production increased significantly, your electricity bill for that month could increase to $2,500 or more. In terms of taking out loans, fixed interest rates are generally a better option than variable interest rates if you want to minimize risk. This is because variable rates can fluctuate monthly or quarterly and depend on economic conditions, which may change unexpectedly. By contrast, fixed rates never change for the duration of the loan. From an accounting perspective, fixed and variable costs will impact your financial statements. For instance, you can’t calculate cash flow or pretax income without considering these expenses. As a business owner, understanding fixed and variable expenses as part of your overall business expenses is crucial for developing your long-term financial plans. Continuously review income statements, balance sheets, and other financial statements to make the necessary adjustments and ensure that you do what’s best for your company at all times. Thanks for your feedback!