

# Fixed Costs

Fixed costs refer to the costs that accrue whether a firm generates sales or not. These costs are fixed and they are usually sunk. In other words, they have already been paid and the firm is just amortizing them over time.

Usually the fewer fixed costs a firm has the better the firm will be. When all costs are variable, a firm's profits will be very steady. Even if sales vary widely, the effect on profits will be minimal.

However, there are usually clear financial advantages to incurring fixed costs. A firm can usually lower its per unit cost if it incurs fixed costs. Doing so is considered using operating leverage.

Not all firms use operating leverage skillfully. There are firms that incur significant fixed costs and still have high total costs. And there are firms that keep fixed costs low and have low total costs (and high profit). Also, there are entire industries characterized by high fixed costs, and there are entire industries characterized by low fixed costs.

It behooves individual investors to understand the nature of fixed costs. And it behooves investors to determine how effectively various firms are using fixed costs and operating leverage.