

Variable Costs

Variable costs are those costs that go up as a firm produces more of its good or service. Variable costs vary with a firm's level of output.

Variable cost identification and analysis are very important. Firms maximize profits by producing just where marginal revenue equals marginal costs. It is very difficult for a firm to know what its marginal costs are if it does not first understand what its variable costs are. The first step in marginal cost analysis is decomposing costs into variable and fixed costs.

Incidentally, some costs are not pure variable costs or pure fixed costs. Some costs have a mix of both, and they should be studied and then allocated accordingly. Furthermore, not all variable costs are direct costs. Some variable costs are indirect costs.

It behooves investors to understand these concepts as well. If an investor can get some idea of the kind of variable costs, fixed costs, marginal costs, and marginal revenue curves a firm faces, those investors can more easily and effectively forecast what is in store for the firm, and they can more easily determine the firm's intrinsic value.