

Difference Between Discretionary and Committed Fixed Costs

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Key Difference - Discretionary vs Committed Fixed Costs

Fixed costs are costs that do not vary depending on the number of units produced; they consist of a significant portion of the total costs. Discretionary and committed fixed costs are two types of fixed costs often incurred by all types of companies. The key difference between discretionary and committed fixed costs is that **discretionary fixed costs are period specific costs that can be eliminated or reduced without having a direct impact on profitability** whereas **committed fixed costs are costs that a business has already made or obliged to make in the future.**

What are Discretionary Fixed Costs?

Discretionary fixed costs are referred to as period specific costs that can be eliminated or reduced without affecting the profitability directly. A discretionary fixed cost is also named as a **managed fixed cost**. Following are some common types of discretionary fixed costs.

- [Market research](#) and [advertising](#) campaigns
- [Training and development](#) programs for employees
- Research and development for specific products

The above expenditure is generally incurred by organizations which are subject to a [budget](#). Thus it can be argued that such expenses are fixed in nature. Further, these type of expenditure generally take an extended time to reap benefits and avoidance of such costs will not have a notable impact on profits in the short term.

E.g. ABC Company has planned to conduct training for its employees on quality and process improvement, and a cost of \$150,000 was assigned for this from the last year's budget. Due to some unforeseen cost increases, the total cost structure of ABC increased within this year where the company is compelled to save funds wherever possible. Thus, the management decided to postpone the employee training for some months.



Figure 01: Training and development is an example of discretionary fixed costs.

It should be noted that if a business continues to curtail or postpone discretionary fixed costs for a long time, generally exceeding one year, this will have a negative impact on the competitiveness of the business. For instance, in ABC Company above, lack of employee training can result in declining employee effectiveness. Therefore it is important for companies to ensure fixed costs are only curtailed over a relatively short period of time.

What are Committed Fixed Costs?

Committed fixed costs are costs that a business has already made or obliged to make in the future; thus they cannot be recovered. As a result, committed fixed costs are difficult to alter at the discretion of the management. The company should be aware which costs are committed costs when reviewing company expenditures for possible cost reductions.

Committed fixed costs may be a part of a legal agreement with a [supplier](#) or a [client](#), in which case, not honoring it may result in additional legal cost and reputation risks. Further, committed fixed costs are generally associated with a long-term agreement i.e. more than one year. Once such costs have been incurred, the company is required to make future payments.

E.g. XYZ is a furniture manufacturing company that plans to undertake a new order which will result in a net cash flow of \$ 255,000 within a period of one year. At present, XYZ operates at full capacity and does not have extra production capacity in its factory. Thus, if the company decides to proceed with the above order, XYZ

will have to rent out extra production premises for a period of one year for a total cost of \$ 84,000. This will be done by entering into a contract with the landlord.

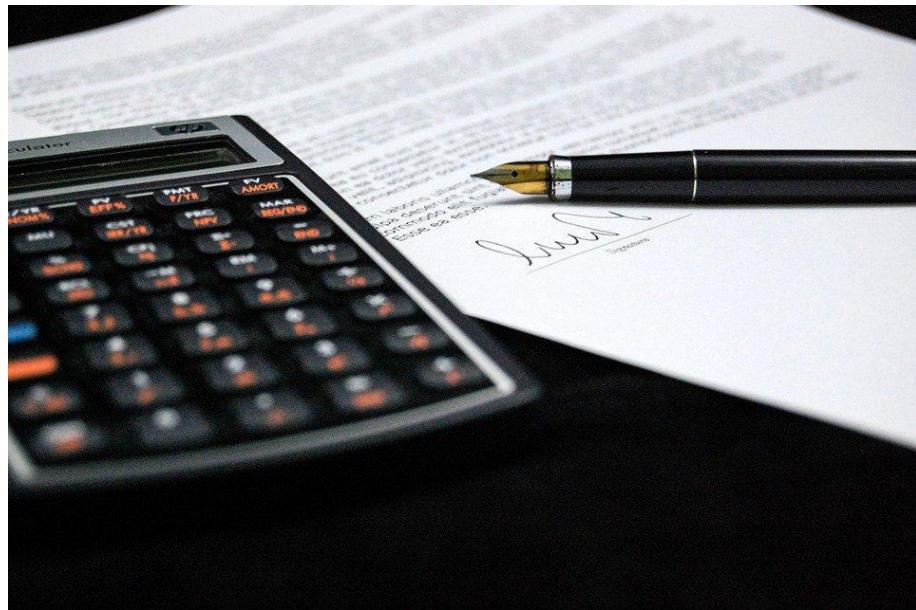


Figure 02: Committed fixed costs may be a part of a legal agreement.

What is the difference between Discretionary and Committed Fixed Costs?

Discretionary vs Committed Fixed Costs

Discretionary fixed costs are discretionary fixed costs are referred to as period specific costs that can be eliminated or reduced without having a direct impact on profitability.

Committed fixed costs are costs that a business has already made or obliged to make in the future, thus cannot be recovered.

Time Horizon

Discretionary fixed costs have a short-term planning horizon.

Committed fixed costs have a long-term planning horizon.

Consequences

Avoidance or reduction of a discretionary fixed cost for a relatively long period of time can adversely affect company's competitiveness

Not honoring the payment of committed fixed costs may result in legal allegations by the affected party.

Summary - Discretionary vs Committed Fixed Costs

The difference between discretionary and committed fixed costs depends on whether they can be postponed or reduced in the short term (discretionary fixed costs) or whether the company is bound legally or in any other way to honor them (committed fixed costs). Understanding of discretionary and committed fixed costs becomes important for companies to manage costs and allocate scarce resources efficiently and give priority to covering the committed fixed costs and then the discretionary fixed costs.

References:

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2. "Committed cost." AccountingTools. N.p., n.d. Web. [Available here](#). 09 June 2017.
3. "CHAPTER 3 MEASUREMENT OF COST BEHAVIOUR." SlidePlayer. N.p., n.d. Web. [Available here](#). 09 June 2017.

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