

ACCT 102 – Fundamentals of Accounting II
Chapter 21
Flexible Budgets and Standard Costs – Johnson

Purpose: In the last chapter we learned about the importance of budgets and how they can provide a financial blueprint. Now we look at the next major topic. In this chapter, we will focus on standard cost information and how it is used in accounting. We will also learn how to prepare flexible budgets and interpret the variances between budgets and actual costs.

Flexible Budgeting

The Budgetary Control Process – If our budgets were perfect, we wouldn't need this chapter because there would be no variances. We know, however, that many times the plans that we make aren't always exactly followed by the expected outcomes. When the results from what we initially planned don't happen exactly the way we thought, then differences or variances need to be identified and the reasons for them need to be interpreted so that any necessary corrective action can take place. There are four major steps involved in the budgetary control process:

1. Develop the budget based on planned objective (last chapter)
2. Compare actual results to budgeted amounts and analyze the differences
3. Take corrective and strategic actions if necessary
4. Establish new objectives and start the budgeting cycle over with new budgets

Fixed Budgets – These are also known as a “static” budgets, because the budget remains at the fixed levels that were used when the budget was created. It does not change, even though the considerations or plans that went into its development might change. Accurate results are tough to interpret with fixed budgets, because a budget that was based on 1,000 pizzas is going to be much different if you actually ended up only making 800 pizzas.

Flexible Budgets – These are budgets that “flex” or change with varying levels of activity. Most of the time flexible budgets correspond to actual levels of output. With our example, we would “flex” or adjust our budget to correspond with the actual output of 800 pizzas. This makes interpretation of the results much more meaningful. They help management evaluate performance. We will work on creating flexible budgets in class, but the strategy is to identify costs as either variable or fixed. Variable costs will change as the output changes, and fixed costs will remain the same. There is a good example of such a budget on Pg. 869 of our text. You will notice that the budget takes the form of a contribution margin income statement.

Favorable and Unfavorable Variances – The differences between the Budgeted Amounts and the Actual results will either be favorable or unfavorable. We will be using abbreviations as we work through the variances as follows:

- **F = Favorable** - When compared to budgeted amount, the actual cost or revenue contributes to a HIGHER income. (Actual revenues are higher than budgeted OR Actual costs are lower than budgeted.)

- **U = Unfavorable** - When compared to budgeted amount, the actual cost or revenue contributes to a LOWER income. (Actual revenues are lower than budgeted OR Actual costs are higher than budgeted.)

Standard Costs

Standard Costs – preset costs or costs developed for delivering a product or service under normal conditions. The “normal cost” of something. These costs are used to assess the reasonableness of operations and used to follow up with results that are not within “the norm.” (We have all kinds of standards around us. Colleges have g.p.a standards, our streets have speed limits, in golf we have “pars. These are the “norms” for producing goods.)

Identifying Standard Costs – There are many people involved in identifying how much something should cost. There are many studies done, and many interviews conducted. Standards are not adjusted just because they are not met. There must be compelling evidence to change a standard, like a worldwide price change in a raw material. We will practice calculating standards in class. Think about how much a Dominoes pizza cost and what would go into making that computation. Also, just because you miss the standard one month doesn’t mean it needs to be changed.

The Total Cost Variance – Also called CV; an amount that differs from what we planned.

$$\text{Formula: CV} = \text{Actual Cost (AC)} - \text{Standard Cost (SC)}$$

$$(\text{Actual Qty X Actual Price}) - (\text{Standard Qty X Std Price})$$

We can further break down this total cost variance into three components:

- DM Variances
- DL Variances
- FOH Variances

The Direct Materials Variances

If we have a variance in our direct materials results, then it’s due to one of two things – or both. We either used more or less materials in the production process and/or we didn’t get the price on the materials that we expected. We can measure these variances independently in order to take corrective action with the correct person. (That is, do we need to talk to the production manager, or do we need to talk to the receiving department who may have accepted bad raw materials or to the purchasing manager who didn’t get the best price available.) The Variances for Direct Materials are as follows:

DM Variances	
DM Quantity (SA <u>S</u>)	DM Price (SA <u>A</u>)
(Standard – Actual) X Stand Price Quantity	(Standard – Actual) X Actual Qty Price

The Direct Labor Variances

Labor Variances will exist if our level of efficiency was not in line with our expectations AND/OR if the cost of the labor was not in line with our expectations. Just as we did with materials, we will split up the variances to account for the Quantity of Labor (called the Efficiency or Time Variance) and the Price of labor (also called the Rate Variance.) The formulas are almost identical with just the terminology being different. (That is the quantity refers to number of hours and the price refers to the rate. SAME THING.)

Direct Labor Variances	
DL Efficiency (SA <u>S</u>)	DM Rate (SA <u>A</u>)
$(\text{Standard} - \text{Actual}) \times \text{Stand Rate}$ Time	$(\text{Standard} - \text{Actual}) \times \text{Actual time}$ Rate

The Overhead Variances – A Mixture of Variable and Fixed Costs

Think back to when we allocated the FOH out to the products. Our formula was “bucks”/basis where “bucks” was the amount of overhead for the period and the basis was something like DL hours, or DL cost, or Machine Hours. When we have a variance in FOH, one of two things (or both) happened. Either we didn’t estimate the “bucks” right, or our “basis” was not in line with our expectations. Remember that by definition FOH is comprised on INDIRECT costs. That means they can’t be specifically traced to the products (unlike DM and DL.) The FOH also consists of a mix of VC and FC. It’s much more difficult to assess reasons for variances.

Total FOH Cost Variance = Variable FOH Variance and Fixed FOH Variance
OR stated another way
Total FOH Cost Variance = Actual FOH incurred – Standard FOH applied

Variable FOH Variances	
“Efficiency”	“Spending”
$(\text{Std Hours} - \text{Actual Hours}) \times \text{VOH rate}$	$(\text{Std Var Rate} - \text{Actual Rate}) \times \text{Actual hours}$

Fixed FOH Variances	
“Volume”	“Spending”
The volume variance is strictly a measure Of capacity. Did you spread your fixed Costs over as many units as possible.	(If Fixed costs are truly fixed, then this variance would be a non-issue since Fixed costs should not vary from budget.

(Capacity – Earned @ Std) X Fixed OH Rate Actual FC – Budgeted FC

At or above capacity = Favorable

Anything below capacity = unfavorable

(When you think about the volume variance, think about the example of a party in class. The party is going to cost me \$100 in total. If only two of you showed up, that would cost me \$50 per student or per unit. But if all 40 of you showed up it would cost me \$2.50 per unit.)

Standard Costs – Other Uses

Standard cost applications can also be used in service companies. We have seen how standards can be used to measure efficiencies and inefficiencies. They can also be used to make journal entries (rather than relying on actual cost data). We will not cover these in this survey class, but if you are an accounting major, please read the materials and study the examples on page. 883/884 of your text.