ACCT 102 – Fundamentals of Acct II
Chapter 19 – Variable Costing and Performance Reporting

Purpose: The purpose of this handout is to help you distinguish between traditional "GAAP Costing," also known as absorption costing, and direct or variable costing which is the focus of this chapter.

You already know half of this chapter, but you just may not be familiar with the terminology. The traditional GAAP costing financial statements that we have been learning for awhile use a method called "absorption costing," or full costing, which means that product costs are fully absorbed and consist of direct materials, direct materials, and factory overhead. While this method is required for external reporting, and mandated by GAAP, it is sometimes not useful for internal reporting. It actually could cause us to make an incorrect managerial decision. In this chapter we will learn about an alternative method called variable costing.

Traditional GAAP Costing – Why Use It?

GAAP says we must use it for external reporting and for taxes.

We are used to it. It's what we have been learning.

Premise: All product costs are absorbed into the final cost of the product and eventually into COGS

$$\frac{\text{DM + DL+ All FOH}}{\text{Number of Units Produced}} = \text{Cost per Unit in finished goods}$$

Traditional Income Statement Format

Sales
- COGS
Gross Profit
-Operating Expenses
Net Income

Variable Costing (aka Direct Costing – Why Use it?

Can't use it for GAAP, but it's often helpful for internal decisions.

Focuses on the controllable costs.

We will learn how to use it.

Premise: Product costs are made up of DM, DL, and only the VOH.

Focuses on the direct costs, the ones we can control and that we see go into the product. It takes uncontrollable or fixed costs out of the equation when decisions are to be made. The cost of the product still include DM and DL, but only the variable OH is included in the cost of the product. **SO THE ONLY DIFFERENCE BETWEEN THESE TWO METHODS IS HOW THE FIXED FACTORY OVERHEAD IS TREATED.** (You will probably hear me say this 10 times before the class is out.) The fixed overhead is treated as a period cost and expensed immediately. Since the fixed costs aren't going to change based on a short term management decision, we remove them from the analysis.

Uses a Managerial or Contribution Margin Income Statement

Sales
<u>- All VC (Mnfg and selling)</u>
Contribution Margin
<u>- All FC (including Fixed OH and selling)</u>
Net Income

Three Different Conditions: We will demonstrate all three in class using the surfboard example.

When Units Produced = Units Sold
There will be **NO DIFFERENCE** between the net incomes using absorption versus variable costing. This is because 100% of the product costs are expensed in COGS since all the goods made were sold. The net incomes will be identical.

When Units Produced > Units Sold
Remember the only difference between these two methods is how the fixed factory overhead is treated. Under traditional/absorption costing, the overhead costs will be expensed only for the units sold, and absorbed into Finished Goods for the units not sold. However, under Variable costing, all of the fixed overhead is EXPENSED and treated as a period cost, so the two net incomes will be different? Can you figure out by how much? The traditional costing statement will have the higher net income. The variable costing will have more expense so it will have the lower net income. The difference between the two methods will be the amount of the fixed overhead per unit X the number of unsold units.

When Units Produced < Units Sold
Obviously this means that there is some inventory left over from the prior period. Guess what, the results are exactly opposite of those described above!

Why is this useful?
The role of variable costing can help management assess special offers, help them to decide whether to accept an order at a reduced selling price, and aid in other decision making.

Limitations
Absorption costing is mandated by GAAP. There are many reasons. One of the most important is that of the matching principle. In addition, one must be careful when net income is manipulated for other reasons, such as profit sharing bonuses etc.