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| Chapter 19 Outline |
| 1. **Introducing Variable Costing and Absorption Costing**
2. **Variable costing** includes direct materials, direct labor, and variable overhead costs in product costs. Useful for many managerial decisions but cannot be used for external reporting.
3. **Absorption costing** includes direct materials, direct labor, and both *variable* and *fixed* overhead costs in product costs. Required for external financial reporting under GAAP but can result in misleading product cost information and poor managerial decisions.
4. Both methods include direct materials, direct labor and variable overhead in product costs.

B. Key difference is in reporting of *fixed* overhead costs. C. Fixed overhead costs included in product costs under absorption costing but included in period expenses under variable costing.D. Product costs included in inventory until the goods are sold when they are then included in cost of goods sold.E. Period expenses reported as expenses immediately in the period they are incurred.D. **Computing Unit Product Cost** 1. Product cost per unit under absorption costing consists of direct labor, direct materials, variable overhead, and fixed overhead.2. Product cost per unit under variable costing consists of direct labor, direct materials, and variable overhead. Fixed overhead costs are reported as period costs and expensed in the period incurred. 3. Difference between costing methods is the exclusion of fixed overhead from product cost for variable costing.II. **Income Reporting** –Income differs between costing methods when inventory levels change.1. **Units Produced Equal Units Sold**
	* 1. The income statement under variable costing is a **contribution margin income statement.** Contribution margin is sales minus variable costs.
		2. **Variable cost of goods sold** is the direct materials, direct labor, and variable overhead costs for units sold. Absorption costing does not separate expenses into variable and fixed components.
		3. When units produced equals units sold, income is identical under both methods because fixed overhead expensed under variable costing is equal to the fixed overhead included in cost of goods sold under absorption costing.
2. **Units Produced Exceed Units Sold**
	* 1. When units produced exceeds units sold, there is a difference in total expenses and income.
		2. Under absorption costing, cost of goods sold is lower than the total expenses under variable costing.
		3. Income and ending finished goods inventory under absorption costing, is greater than under variable costing because of the fixed overhead cost included in finished goods inventory (asset) under absorption costing.
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| 1. **Units Produced are Less Than Units Sold**
	* 1. Beginning inventory under absorption costing is higher than under variable costing.
		2. When the beginning inventory is sold, the difference in inventory is included in cost of goods sold under absorption costing.
		3. Income under absorption costing is less than income under variable costing.
2. **Summarizing Income Reporting**
3. Differences in income are due to timing with which fixed overhead costs are reported in income under the two methods.
4. Income will be different whenever the quantity produced and quantity sold are different.
5. Income under absorption costing is higher when more units are produced than sold, and is lower when fewer units are produced than sold.
6. We normally see differences in income for these two methods extending over several years.
7. **Production and Pricing**
8. **Planning Production**
9. Many companies link manager bonuses to income computed under absorption costing since this is how income is reported to shareholders per GAAP, which can lead some managers to overproduce and create excess inventory.
10. Overproducing and creating excess inventory should not increase income, but under absorption costing income is greater if they produce more than they sell because the fixed overhead is assigned to ending inventory instead of being expensed as cost of goods sold. This incentive problem encourages inventory buildup which leads to increased costs in storage and obsolescence.
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| 1. Managers cannot increase income under variable costing by increasing production without increasing sales.
2. Under absorption costing, fixed overhead per unit is lower when more units are produced so fixed overhead cost is allocated to more units. If these excess units are not sold, the fixed overhead cost allocated to these units is not expensed until a future period when these units are sold.
3. Reported income under variable costing is not affected by production level changes because all fixed production costs are expensed in the year incurred. Under this method, companies increase income by selling more units since it is not by producing excess inventory.
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| 1. **Setting Target Prices**
2. Over the long run, the selling price must be high enough to cover all costs and still provide an acceptable return to owners.
3. We use a 3-step process to determine product selling prices:
	1. Determine the product cost per unit using absorption costing.
	2. Determine the target *markup* on product cost per unit.
	3. Add the target markup to the product cost to find the target selling price.
4. **Analyzing Special Orders**
5. Over the long run, prices must cover all fixed and variable costs, but over the short run, fixed costs do not change with changes in production levels.
6. Managers should accept special orders if the special-order price exceeds variable cost.
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| 1. **Variable Costing for Services**—variable costing also applies to service companies. Service companies do not produce inventory, differences in income from absorption and variable costing do not apply but a focus on variable costs can be useful in managerial decisions for service firms.
	* 1. Variable costs change for service firms as volume of services provided change.
		2. Fixed costs do not change as volume of services provided change.
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| **V.** **Decision Analysis—Contribution Margin Ratio**1. Variable costing is useful in analyzing performance of business decisions such as sales territories and product lines.
2. Compute a contribution margin ratio by dividing contribution margin by sales.
3. Contribution margin ratio is the percent of sales that remain after subtracting variable expenses.
4. A higher contribution margin ratio is better.
5. Analysis of contribution margin ratio by product line can impact managerial decisions such as:
6. Increasing selling price per unit.
7. Decreasing variable cost of goods sold per unit.
8. Increasing sales efforts.
9. **Converting Income Under Variable Costing to Absorption Costing**
	* 1. Companies can use variable costing for *internal* reporting and business decisions but must use absorption costing for *external* report and tax reporting.
		2. Can readily convert income under variable costing to absorption costing.
		3. Income under variable costing converted to income under absorption costing by adding fixed overhead cost in ending finished goods inventory and subtracting fixed overhead cost in beginning finished goods inventory.
		4. Differences between absorption costing income and variable costing income are smaller when:
10. Fixed overhead is a small percentage of total manufacturing costs.
11. Inventory levels are low as with just-in-time systems.
12. Inventory turnover is rapid. The more quickly inventory turns over, the greater proportion of product costs included in cost of goods sold relative to that remaining in ending inventory.
13. Period of analysis is long. Income differences between these two systems decrease as income is compared over longer periods.
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