Problem statement

* Prepare an IS with Absorbtion and variable costing methods, and discuss delta

Quantitative analysis

* Exhibit 1 shows budgeted and actual revenues and COGS. COGS have been adjusted to exclude SGAs, which are not inventoriable.
* Exhibit 2 shows how variances were calculated. Labor and materials provide favorable variances (less production = less variable costs), whereas manufacturing overhead variances are unfavorable since the final denominator level is smaller than the one used for budgeting.
* Exhibit 3 is the complete income statement. The row of total overheads has been left empty on purpose since all the overhead costs are already accounted for in COGS and variances.
* Exhibit 4 shows that the discount company’s request would generate a contribution margin of $5.75/unit (excluding Fixed cost). Since manufacturing these batches would not affect fixed costs already incurred, it is a profitable proposition.

Qualitative Analysis

* The difference of net income between the 2 costing methods is due to the fact that by using absorption method, companies can effectively inventorize fixed costs. Even though the costs are still physically incurred in the period, the matching concept of Financial Accounting states that revenues and costs should be reported on the same period; as such, absorbed fixed costs are buried in the company’s inventory account until either sold, or written off for various reasons (market changes, technological depreciation, theft, physical degradation over time, etc…). Cash flow statements would more closely resemble variable costing that income statements.
* Using absorption costing, the company beat it’s budget estimate (and most likely pleased shareholders with such a performance), but with variable costing, we can see that the company only met 37% of its budget estimates. This puts the company in a risky situation because costs already incurred are now in inventory, pressuring sales for future periods. If sales volumes do not significantly improve in the short term, the company can anticipate potential liquidity issues due to the fact that it is converting significant amount of cash into inventory.

Recommendation

* Regarding the discount company request, since the offer would generate additional profits, management should seriously consider it. Besides obvious financial benefits, it would also have the benefits of creating more job for employees, potentially future partnership opportunities with the reseller and ‘dilute’ the significant inventorization of costs for this period.
* In terms of costing system choices, the recommendation is to keep absorption costing for external reporting, but use variable costing for budgeting and setting management performance compensation.

Exhibit 1: Budgeted and Actual Revenues and COGS



Exhibit 2: Calculation of variances



Exhibit 3 – Income Statement



Exhibit 4: Assessment of the new offer

|  |  |
| --- | --- |
| Selling Price | 28.75 |
|  |  |
| Direct Labor | 9 |
| Material | 14 |
| Total Variable cost | 23 |
|  |  |
| Contribution Margin | 5.75 |