

“Traditional cost data tend to be irrelevant and mischievous. These systems of simple proportional divisions followed by allocations and reallocations do not provide data appropriate for managerial use in planning or controlling operations. Moreover, they tend to put such data as do exist in an inaccessible form. Unless other purposes for such data exist, the systems should be discontinued to save the clerical cost of operating them.”

- B. Goetz (p478 of text)

Criticism of Traditional Absorption Costing

- Theme of Chapter 10: Traditional absorption costing can result in poor operational decision making - specifically, it creates the incentive to overproduce.
- Why?
 - Under absorption costing, manufacturing can defer recognition of fixed manufacturing costs by building ending inventory rather than deducting those fixed costs in the year incurred. (product vs. period cost)

Key lessons

- Overproduction lowers average cost and
- It also encourages inventory building.
- The end result is the appearance of better earnings.

Reducing Overproduction: Decision Rights

To avoid the overproduction incentive, reduce the decision rights of the production managers

- Senior managers strictly monitor inventory levels
 - Remove production manager's right to build inventory level greater than amount authorized by top management

Just-In-Time (JIT) production so that customer orders drive inventory

- Remove production manager's right to build inventory level greater than amount ordered by customers

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Reducing Overproduction: Performance Evaluation

To reduce overproduction, modify the performance evaluation system

- Inventory holding charge against divisional profit
- Based on external stock price instead of financial accounting
 - Not good if privately-held or many different plants
- Variable instead of absorption costing

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Variable Costing: Defined

- Variable costing treats all fixed manufacturing costs as period costs to be deducted from net income (expensed) in the period incurred
- Under variable costing, only variable manufacturing costs flow through the inventory accounts
- Variable costing is also known as direct costing since the variable manufacturing costs consist of direct materials, direct labor, and variable overhead

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Comparing Absorption and Variable Costing

Similarities:

- Under both methods all fixed and variable manufacturing costs will eventually become expenses deducted in computing net income
- Variable manufacturing costs flow through finished goods inventory account and are expensed in the period goods are sold

Differences:

- Under absorption costing, fixed manufacturing overhead is a *product* cost and flows through inventory account and is expensed when goods are sold
- Under variable costing, fixed manufacturing overhead is *period* cost and expensed in period incurred

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Problem with VC: Classifying Fixed vs. Variable Overhead

Under both absorption and variable costing, managers have an incentive to defer costs by getting more costs into ending inventory rather than cost of goods sold expense in current period.

To defer costs under variable costing, managers can:

- Classify more overhead as variable rather than fixed so that variable cost per unit increases
- Produce more units than sell so that ending inventory increases and the variable costs associated with that ending inventory are deferred until next period.
- Do both of the above

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Problem with VC: Opportunity Cost of Capacity

Variable costing does not adequately measure the opportunity cost of using plant capacity for other purposes.

Although opportunity costs are inherently hard to measure, they are usually best estimated as a combination of fixed and variable costs.

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Beware of Unit Costs

- Unit costs are average costs that include some directly traceable costs and some allocated variable and fixed costs incurred.
- Unit costs \neq opportunity costs
because opportunity costs are estimates of foregone benefits from actions that could, but will not be undertaken (Chapter 1, p. 27).
- Unit costs \neq marginal costs
because marginal costs are the cost of producing one more unit rather than the average cost (Chapter 1, pp. 32-33).

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