Cost Accounting System (2)

Lecture (7) Week (8)

28 March 2020

Flexible Budgets, Overhead Cost Variances, and Management Control

3 Learning Objective (1)

Explain

The similarities and differences in planning variable overhead costs and fixed overhead costs

Planning of Variable and Fixed Overhead Costs

- Recall that Webb manufactures jackets example again to illustrate the planning and control of variable and fixed overhead costs
- Because we assume Webb's <u>only</u> costs are <u>manufacturing</u> costs, for simplicity we use the term "<u>overhead</u> costs" instead of "<u>manufacturing</u> <u>overhead</u> costs"

In this chapter

Webb's variable overhead costs include:

- Energy,
- Machine maintenance,
- Engineering support,
- Indirect materials.

Webb's fixed overhead costs include:

- Plant leasing costs,
- Depreciation on plant equipment, and
- Salaries of the plant managers.

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Planning Variable Overhead Costs

- To effectively plan variable overhead costs for a product or service, managers must:
- focus on the activities that <u>create</u> a <u>superior product</u> or service for their customers and
- eliminate activities that do not add value.

7 Consider *Sewing* to be an essential activity.

- **Sewing** to be an essential activity; therefore, <u>maintenance</u> activities for sewing machines, which are included in Webb's <u>variable</u> overhead costs, are also <u>essential</u> activities for which management must <u>plan</u>.
- Such maintenance should be done in a <u>cost-effective</u> way, such as by <u>scheduling</u> periodic equipment <u>maintenance</u> rather than waiting for sewing machines to break down.

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- For many companies today, it is *critical* to *plan* for ways to reduce the *consumption* of energy, a *rapidly growing* component of *variable overhead* costs.
- Webb installs smart meters in order to *monitor* energy use in real time and steer production operations away from peak consumption periods.

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Planning Fixed Overhead Costs

Planning fixed overhead costs is **similar** to planning **variable** overhead costs—undertake only **essential** activities and then **plan** to be efficient in that undertaking.

- But there is an *additional* strategic issue when it comes to planning *fixed* overhead costs including:
 - Choosing the *appropriate* level of *capacity*
 - Timing

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Differences in *Planning fixed* overhead costs compared with *variable* overhead costs

- 1. Choosing the *appropriate* level of *capacity*
- 2. Timing

1 1 1) Choosing the *Appropriate* Level of *Capacity*

- Choosing the *appropriate* level of *capacity* or investment that will *benefit* the company in the *long run*. Consider Webb's leasing of sewing machines
- Each of which has a fixed cost per year.
- Leasing too many machines will result in overcapacity and unnecessary fixed leasing costs.
- Leasing too few machines will result in:
 - O An *inability* to meet *demand*,
 - O Lost sales of jackets, and
 - Unhappy customers.

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2) Timing

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The planning of fixed overhead costs differs from the planning of variable overhead costs in another regard as well: *timing*.

- At the *start* of a *budget* period, management will have made most of the *decisions* determining the *level* of *fixed overhead* costs to be incurred.
- But it's the *day-to-day*, ongoing *operating decisions* that mainly determine the level of *variable overhead* costs incurred in that *period*.

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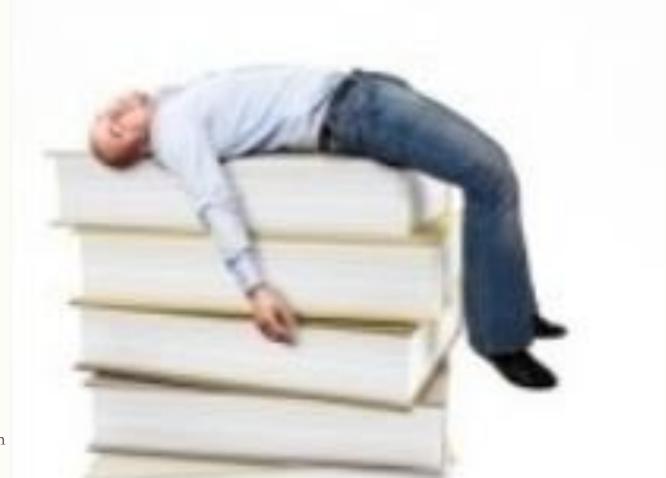
- For example, the *variable* overhead costs of *hospitals*, which include the costs of *disposable supplies*, *doses* of medication, suture packets, and medical waste *disposal*, are a function of the number and nature of procedures carried out, as well as the practice patterns of the *physicians*.
 - However, most of the costs of providing hospital service are fixed overhead costs—those related to:
 - o Buildings,
 - Equipment, and
 - o Salaried labor.
 - These costs are unrelated to a hospital's volume of activity

14 Thanks for your attention

Next lecture (8) week 9 develops budgeted variable overhead cost rates and budgeted fixed overhead cost rates

END OF LECTURE





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Fourth