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# *Cost Accounting System (2)*

*Lecture (7) Week (8)*

*28 March 2020*

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## Flexible Budgets, Overhead Cost Variances, and Management Control

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## *Learning Objective (1)*

*Explain*

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

# 4 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 only costs are manufacturing costs, for simplicity we use the term "overhead costs" instead of "manufacturing overhead costs"

## In this chapter

### **Webb's variable overhead costs include:**

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- ❖ 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

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

# 7 Consider *Sewing* to be an essential activity.

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

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## 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:
  - An *inability* to meet *demand*,
  - *Lost sales* of jackets, and
  - *Unhappy customers*.

## 2) Timing

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:
  - Buildings,
  - Equipment, and
  - 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

