**Instructor Notes – Chapter 6. Variable Costing**

1. Chapter 6 explains how to prepare income statements that identify profitability of departments or segments of the business. The focus may be on product lines, or on geographical areas. It is also technically about learning to compute product cost, and net income, using two methods: absorption costing and variable costing.
2. Actually, it is about understanding more about what it costs to operate your business, how those costs change in response to increases or decreases in production and sales, and how to present results of operations in a format that will help you make better decisions – increase profitability

Please refer to: M13-Chp-06-2-Introductory-problem-Variable-Costing.

1. In that problem, we have the following transactions.
 We invested $5,000 in the business to provide working capital.
 We rented a building filled with printing equipment for **($1,000 per month)** (including utilities).
 We purchased **cloth and printing supplies ($2,500).**
 We hired an employee and paid the employee a **salary ($2,000).
Thus, we spent $5,500 on manufacturing costs.**
2. We manufactured banners **(250 banners)** to be sold to fans of a local sports team.
In the first month, we spent $**5,500** to make 250 banners, giving us a **cost of $22 per banner.**We sold 200 banners at a selling price of **$30** each, providing revenue of **$6,000 (sales).**
Our cost of manufacturing the 200 banners that we sold was (200 x $22) **$4,400 (cost of sales)**

Our profit for the month was ($6,000, less $4,400) **$1,600 (profit).**

**We spent $5,500 to manufacture the banners, but only sold banners costing $4,400.
We had 50 banners on hand at end of month (cost of $22 each), total cost of $1,100 (asset).**

1. **Our cost to manufacture the banners: Total Cost Number Unit Cost** Rent on building and equipment $1,000 250 $4.00
 Cloth and printing supplies (ink) $2,500 250 $10.00
 Employee compensation (salary) $2,000 250 $8.00
 Total **$5,500** **250 $22.00**
2. The absorption-variable costing controversy is based on the question of whether fixed overhead is a part of the cost of producing inventory, or is simply an expense of the period.
Above, we considered rent on the building to be a production cost, and used it in the computation of the cost of the banners.
The $1,000 payment for rent is shown as part of the cost of sales (and expense) of $800 (200 banners sold at rent cost of $4.00 per banner). That goes on the income statement.
The balance sheet shows inventory (to be sold next period) of 50 banners. Those 50 banners have a total cost of $1,100, including an allocation of $200 for rent of building. (50 x $4.00)
3. With variable costing, we do not count fixed overhead (building rent) as a cost of production and do not count is as part of the cost of ending inventory.
4. With variable costing, the computations in No. 5 above would not include rent of $1,000.
Cost per banner would be $18.00 per banner (not $22.00).
Rent cost ($1,000) would be reported entirely in income statement as an expense of the period.
5. With absorption costing shown above, the Cost of rent is reported in two separate statements:
$800 as part of the cost of banners sold (income statement)

$200 as part of the cost of banners in ending inventory (balance sheet)

1. Absorption costing pushes some of the rent payment in January into the income statement of February when the remaining banners will be sold.
2. In the first accounting period, a manufacturing company with ending inventory will report more less income (or more loss) with a variable cost income statement.
3. Also, the unit cost under absorption costing will decrease if you increase the number of units produced.
With variable costing, the fixed overhead does not impact unit costs. But the key benefit for variable costing is that you focus first on variable costs, then on contribution margin, then on net income. See page 233 of textbook for income statement in the variable costing format, which provides better information on which to base short-run management decisions. **See: M13-Chp-02-4B-Manufacturing-Income-Statement-Format.**
(I have ignored the fact that employee salary is also a fixed manufacturing cost in this example.)