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Video Transcription: Absorption and Variable Costing – Part 2: The Reconciliation

Hi my name is Jason. In part one of this series, we looked at the differences between absorption costing and variable costing, and compiled the various profit statements for these two costing systems. This video will look at why the profits under the variable costing and the absorption costing statements will differ, as well as how the profit from the variable costing and the absorption costing system can be reconciled. This reconciliation allows management to gather additional information about the profitability of a company without having to draw up a different profit statement. Let us compare a profit statement using absorption costing and variable costing. We are expanding on our example in part one by looking at the financial information for three consecutive months, namely: January, February and March.

All costs, selling price and production information is the same as January that was consistent with what was discussed in part one. However, the number of units sold in February and March, differ. Have a look at the worksheet to familiarise yourself with the information again.

At this point, I would suggest that you pause the video and try to calculate the profit statements for the three months using both variable costing and absorption costing before you continue. Here is the absorption costing profit statement for the three months. Notice that the sales differ for the two months and as a result variable selling costs also differ. Total production costs are the same for each month as the same amount of units are manufactured every month. In February, we have a closing inventory, which becomes the opening inventory for March. Here, we have the variable costing profit statement. The same observation can be made here. If we compare the profits reported under the two costing systems, we notice that in February and March the profits differ.

Why did this happen? The only difference between the two systems is how the fixed manufacturing overhead is recorded; therefore, this must have caused the difference in the profits. Let us analyse how the fixed manufacturing overhead cost is recorded each month.

Since fixed manufacturing overheads have been absorbed into inventory product costs, we need to dig a little to find it in the profit statement. The total production costs of R3 140 000 are included in the cost of goods sold, which includes the fixed manufacturing overhead of R240 000. Fixed manufacturing overheads is absorbed in the product cost, this means that it will affect the cost at which inventory is recognised. Why is this important? Well, any inventory on-hand affects how cost of sales is determined. We can calculate the amount of fixed manufacturing overhead recorded in closing inventory of February and consequently the opening inventory of March. This amounts to 12 000, which is 100 units multiplied by R120. Now compare this to what appears in the variable costing profit statement.

Fixed manufacturing overheads do not affect production costs and therefore, do not affect inventory values. The fixed manufacturing overhead is recognised as a period cost under fixed costs. Let us summarise what we have seen. As R240 000 fixed manufacturing overheads are recorded in each period under both systems, this does not explain the difference between the profits. If you look closer, the only item that explains the difference in profits is the fixed manufacturing overhead absorbed into inventory (both opening and closing inventory).

So how does this affect profit? Remember that under absorption costing, fixed manufacturing overheads are recorded as part of the cost of the inventory. In February, the cost of the closing inventory, in other words, the unsold inventory, is higher under absorption costing. This will result in lower costs and therefore a higher profit under absorption costing. In March, the high cost of opening inventory is higher under absorption costing and this results in a lower profit when using the absorption costing system. How do we use this information to reconcile profits?

Absorbing fixed manufacturing overheads into the closing inventory results in the total fixed manufacturing overhead recorded for the period to decrease, as the fixed manufacturing overhead costs are recognised in a cost of sales in the next period. Profit will therefore be higher when compared to profit, using a variable costing statement. To calculate variable costing profits, we will have to subtract these fixed manufacturing overhead costs back from the absorption costing profit. Where fixed manufacturing overheads are absorbed in opening inventory, these fixed manufacturing overheads were incurred in the previous period but recognised in the current period when the goods are sold. The total fixed manufacturing overhead recorded in the current period is higher than under variable costing, which will result in lower profits. Therefore, in order to reconcile back to the variable costing profit, we need to add it.

Let us now use this reconciliation to reconcile profit in our own example. I have shown you how to reconcile profit under absorption costing to profit under variable costing statements. Now see if you can reconcile variable costing profit to absorption costing profit.

Opening inventory. When calculating cost of sales the presence of opening inventory increases cost of sales. Product cost is higher under absorption costing than variable costing and this will result in a higher cost of sales under absorption costing. A higher cost of sales decreases profit. Therefore, fixed manufacturing overheads in opening inventory causes absorption costing profit to be lower than variable costing profit, and to reconcile absorption costing profit to variable costing profit, we need to increase the absorption costing profit by the amount of the fixed manufacturing overhead absorbed in the opening inventory.

Closing inventory. When calculating cost of sales, the presence of closing inventory decreases the cost of sales. As our product cost is higher under absorption costing than variable costing, this will result in a lower cost of sales under absorption costing. A lower cost of sales increases profit. Therefore, fixed manufacturing overheads in closing inventory causes absorption costing profit to be higher than variable costing profit, and to reconcile absorption costing profit to variable costing profit, we need to decrease the absorption costing profit by the amount of the fixed manufacturing overhead absorbed in closing inventory.

The aim of this video was to understand the differences between the profits reported under absorption costing and variable costing, and when we can expect a difference. We can conclude that the difference in profit is due to the fixed manufacturing overhead, which is absorbed in the opening inventory and the closing inventory. In understanding this difference, we can reconcile the profits. It also highlighted some additional advantages to using variable costing.

Firstly, the profit for the period is not affected by changes in stock, other things remaining equal. Secondly, the impact of the fixed costs on profits is emphasised and then lastly, variable costing profit is closer to net cash flow, which is important for companies having cash flow problems.

In closing, remember that both systems can provide valuable information to managers.

Thank you.