

What is the Right Costing Method for Decisions?

Worksheet

For short-term decisions, variable (marginal) costing is preferred because it separates fixed and variable costs and shows the contribution margin; absorption costing is required for external financial reporting under GAAP/IFRS.

Questions

- Under absorption costing, if units produced exceed units sold, reported operating income is generally:
 - Higher than variable costing
 - Lower than variable costing
 - Identical to variable costing
 - Impossible to determine
- Which costing method is required for external financial reporting under GAAP/IFRS?
 - Variable costing
 - Absorption costing
 - Activity-based costing
 - Standard costing only
- In a special order decision with idle capacity, which cost is most relevant?
 - Fixed manufacturing overhead already incurred
 - Variable cost per unit
 - Historical average cost per unit
 - Total absorption cost per unit
- If units produced = units sold, absorption and variable costing operating income will be:
 - Equal
 - Absorption always higher
 - Variable always higher
 - Unrelated
- A company produces 12,000 units and sells 10,000 units; the fixed overhead rate is \$5/unit. Find the income difference.
- Production is 8,000 units, sales are 9,000 units, with a fixed overhead rate of \$4/unit.
- Regular price is \$50, variable cost is \$30 (contribution margin \$20). Should a special order at \$35/unit be accepted with idle capacity?
- Define: Variable costing vs absorption costing - key difference?
- Define: Which method is used for internal decision-making?
- Define: Formula for the income difference between the two methods?

Answer Key

1. A) Higher than variable costing - Some fixed overhead is deferred in ending inventory, inflating absorption income relative to variable costing.
2. B) Absorption costing - GAAP/IFRS require fixed manufacturing overhead to be included in inventory (absorption costing) for external reports.
3. B) Variable cost per unit - With idle capacity, fixed costs don't change; only variable (incremental) costs matter for the decision.
4. A) Equal - No change in inventory means no fixed overhead is deferred or released, so both methods report the same income.
5. $Q_p Q_s = 12,000 \ 10,000 = 2,000$ Difference = 2,000 $\$5 = \$10,000$ (absorption income is higher)
6. $Q_p Q_s = 8,000 \ 9,000 = 1,000$ Difference = 1,000 $\$4 = \$4,000$ (absorption income is lower)
7. Special order price (\$35) exceeds variable cost (\$30) Extra contribution of \$5/unit accept (fixed costs are already covered)
8. Variable costing expenses all fixed manufacturing overhead in the period incurred; absorption costing includes it in product cost/inventory.
9. Variable (marginal) costing, because it isolates the contribution margin and relevant variable costs.
10. (Units produced Units sold) Fixed overhead rate per unit.

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