

Fixed and Variable Costs

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Fixed and Variable Costs

- More cost terms.
- Fixed costs are costs that do not change with production levels.
- Examples include rent / mortgage costs, insurance, salaries of production personnel as opposed to hourly wages, and depreciation if straight-line is used.

Fixed and Variable Costs

- Variable costs are those costs that do vary with production levels.
- These costs fall into three primary categories.
 - Direct material – no production, no DM costs,
 - Direct labor – no production, no DL costs unless there is a labor agreement or legal issue, and

Fixed and Variable Costs

- Factory / manufacturing overhead.
- This is a complex issue not correctly addressed in textbook accounting. Some factory / manufacturing costs cease with the suspension of production, others continue.
- While material handlers and quality assurance may not be utilized, equipment repair and janitorial requirements may still remain.

Fixed and Variable Costs

- With factory / manufacturing overhead you need to evaluate what costs are fixed and what costs are variable.

Fixed and Variable Costs

- Fixed costs bring in the concept of economy of scale.
- While the variable cost does not change within the relevant range, the fixed costs are allocated to more units as production levels increase.

Direct material per unit:	\$12.75	\$12.75	\$12.75	\$12.75
Direct labor per unit:	\$14.85	\$14.85	\$14.85	\$14.85
Variable FOH / MOH per unit:	\$13.15	\$13.15	\$13.15	\$13.15
Variable cost per unit:	\$40.75	\$40.75	\$40.75	\$40.75
Production level:	1,000.00	1,500.00	2,000.00	2,500.00
Variable production costs:	\$40,750.00	\$61,125.00	\$81,500.00	\$101,875.00
Fixed FOH / MOH costs:	\$22,750.00	\$22,750.00	\$22,750.00	\$22,750.00
Total production costs:	\$63,500.00	\$83,875.00	\$104,250.00	\$124,625.00
Average cost per unit:	\$63.50	\$55.92	\$52.13	\$49.85
Average fixed cost per unit:	\$22.75	\$15.17	\$11.38	\$9.10

Fixed and Variable Costs

- The variable costs of manufacturing do not change per unit with production level changes.
- The last line of this table shows the allocation of fixed cost per unit as production levels change.

Direct material per unit:	\$12.75	\$12.75	\$12.75	\$12.75
Direct labor per unit:	\$14.85	\$14.85	\$14.85	\$14.85
Variable FOH / MOH per unit:	\$13.15	\$13.15	\$13.15	\$13.15
Variable cost per unit:	\$40.75	\$40.75	\$40.75	\$40.75
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Fixed and Variable Costs

- As production levels increase the amount of fixed overhead per unit allocated to each unit of production decreases.
- This economy of scale issue:
 - Allows you to reduce prices, or
 - Allows you to improve your net income.
 - Or, compromise, lower costs some and increase net income some.

Fixed and Variable Costs

The end.