

PROBLEM 5-22 Absorption and Variable Costing; Production Constant, Sales Fluctuate

[LO 5-1, LO 5-2, LO 5-3]

Sandi Scott obtained a patent on a small electronic device and organized Scott Products, Inc., to produce and sell the device. During the first month of operations, the device was very well received on the market, so Ms. Scott looked forward to a healthy profit. For this reason, she was surprised to see a loss for the month on her income statement. This statement was prepared by her accounting service, which takes great pride in providing its clients with timely financial data. The statement follows:

Scott Products, Inc. Income Statement		
Sales (40,000 units)		\$200,000
Variable expenses:		
Variable cost of goods sold	\$80,000	
Variable selling and administrative expenses ...	<u>30,000</u>	<u>110,000</u>
Contribution margin		90,000
Fixed expenses:		
Fixed manufacturing overhead	75,000	
Fixed selling and administrative expenses	<u>20,000</u>	<u>95,000</u>
Net operating loss		<u><u>\$ (5,000)</u></u>

Variable Costing and Segment Reporting: Tools for Management

Ms. Scott is discouraged over the loss shown for the month, particularly because she had planned to use the statement to encourage investors to purchase stock in the new company. A friend, who is a CPA, insists that the company should be using absorption costing rather than variable costing. He argues that if absorption costing had been used, the company would probably have reported a profit for the month.

Selected cost data relating to the product and to the first month of operations follow:

Units produced	50,000
Units sold	40,000
Variable costs per unit:	
Direct materials	\$1.00
Direct labor	\$0.80
Variable manufacturing overhead	\$0.20
Variable selling and administrative expenses	\$0.75

Required:

- Complete the following:
 - Compute the unit product cost under absorption costing.
 - Redo the company's income statement for the month using absorption costing.
 - Reconcile the variable and absorption costing net operating income (loss) figures.
- Was the CPA correct in suggesting that the company really earned a "profit" for the month? Explain.
- During the second month of operations, the company again produced 50,000 units but sold 60,000 units. (Assume no change in total fixed costs.)
 - Prepare a contribution format income statement for the month using variable costing.
 - Prepare an income statement for the month using absorption costing.
 - Reconcile the variable costing and absorption costing net operating incomes.