

Landau co. essay sample



**ASSIGN
BUSTER**

In early August, Terry Silver, the new marketing vice president of Landau Company, was studying the July income statement. Silver found the statement puzzling: July's sales had increased significantly over June's, yet income was lower in July than in June. Silver was certain that margins on Landau's products had not narrowed in July and therefore felt that there must be some mistake in the July statement.

When Silver asked the company's chief accountants, Meredith Wilcox, for an explanation, Wilcox stated that production in July was well below standard volume because of employee vacations. This had caused overhead to be underabsorbed, and a large unfavorable volume variance had been generated, which more than offset the added gross margin from the sales increase. It was company policy to charge company variances to the monthly income statement, and these production volume variances would all wash out by year's end, Wilcox had said.

Silver, who knew little about accounting, found this explanation to be "incomprehensible. With all the people in your department, I don't understand why you can't produce an income statement that reflects the economics of our business. In the company that I left to come here, if sales went up, profit went up. I don't see why that shouldn't be the case here, too."

As Wilcox left Silver's office, a presentation at a recent Institute of Management Accountants meeting came to Wilcox's mind. At that meeting the controller of Winjum Company had described that firm's variable costing system, which charged fixed overhead to income as a period expense and treated only variable production costs as inventoriable product costs.

Winjum's controller had stressed that, other things being equal, variable costing caused income to move with sales only, rather than being affected by both sales and production volume as was the case with full absorption costing systems.

Wilcox decided to recast the June and July income statements and balance sheets using variable costing. (The income statements as recast and as originally prepared, and the related inventory and retained earnings impacts, are shown in Exhibit 1.) Wilcox then showed these statements to Terry Silver, who responded, " Now that's more like it! I knew July was a better month for us than June, and your new ' variable costing' statements reflect that. Tell your boss [Landau's controller] that at the next meeting of the executive committee I'm going to suggest we change to this new method."

At the next executive committee meeting, Silver proposed adoption of variable costing for Landau's monthly internal income statements. The controller also supported this change, saying that it would eliminate the time consuming efforts of allocating fixed overhead to individual products. These allocations had only led to arguments between product managers and the accounting staff. The controller added that since variable costing segregated the costs of materials, direct labor, and variable overhead from fixed overhead costs, management's cost control efforts would be enhanced.

Silver also felt that the margin figures provided by the new approach would be more useful than the present ones comparing the profitability of individual products. To illustrate the point, Silver had worked out an

example. With full costing, two products in Landau's line, numbers 129 and 243, would appear as follows:

Standard ProductionSelling Unit Margin

ProductCost PriceMarginPercent

129\$2. 54\$4. 34\$1. 80\$41. 5

243\$3. 05\$5. 89\$2. 84\$48. 2

Thus, product 243 would appear to be more desirable one to sell. But on the proposed basis, the numbers were as follows:

Standard ProductionSelling Unit Margin

ProductCost PriceMarginPercent

129\$1. 38\$4. 34\$2. 96\$68. 2

243\$2. 37\$5. 89\$3. 52\$59. 8

According to Silver, these numbers made it clear that product 129 was the more profitable of the two. At this point, the treasurer spoke up. " If we use this new approach, the next thing we know you marketing types will be selling at your usual markup over variable costs. How are we going to pay the fixed costs then? Besides, in my 38 years of experience, it's the lack of control over long-run costs that can bankrupt a company. I'm opposed to any proposal that causes to take a myopic view of costs."

The president also had some concerns, having further considered the proposal. " In the first place if I add together the June and July pretax profit under each of these methods, I get almost \$117, 000 with the present method, but only \$99, 000 under the proposed method. While I'd be happy

to lower our reported profits from the standpoints of relations in our employee union and income taxes, I don't think it's a good idea as far as our owners and bankers are concerned. And I share Jamie's [the treasurer's] concern about controlling long-run costs. I think we should defer a decision on this matter until we fully understand all of the implications."

Questions:

1. Critique the various pros and cons of the variable costing proposal that were presented in the meeting. What arguments would you add?
2. Should Landau adopt variable costing for its monthly income statements?

EXHIBIT 1 Effects of Variable Costing

Income Statements

June and July

June July

Full Variable Full Variable

Costing Costing Costing Costing

Sales revenues \$865, 428 \$865, 428 \$931, 710 \$931, 710

Cost of sales at standard 484, 640 337, 517 521, 758 363, 367 Standard

gross margin 380, 788 527, 911 409, 952 568, 343

Production cost variance:*

Labor (16, 259) (16, 259) (11, 814) (11, 814)

Material 12, 416 12, 416 8, 972 8, 972

Overhead volume 1, 730 -(63, 779) -

Overhead spending 3, 604 3, 604 2, 832 2, 832

Actual gross margin 382, 279 527, 672 346, 163 568, 333

Fixed production overhead -192, 883 -192, 883

Selling and administrative 301, 250 301, 250 310, 351 310, 351 Income before taxes \$ 81, 029 \$ 33, 539 \$ 35, 812 \$ 65, 109

*Parentheses denote unfavorable (debit) variances.

Impact on Inventories and Retained Earnings

The only asset account affected by the difference in accounting method was Inventories; on the liabilities and owner's equity side, only Retained Earnings was affected. (There was no tax liability impact since variable costing was not permitted for income tax reporting purposes.)

As of June 30 As of July 31

Full Variable Full Variable

Costing Costing Costing Costing

Inventories \$1, 680, 291 \$1, 170, 203 \$1, 583, 817 \$1, 103, 016

Retained earnings \$3, 112, 980 \$2, 602, 892 \$3, 131, 602 \$2, 650, 801

Source:

Accounting: Text and Cases by Robert N. Anthony, David F. Hawkins and Kenneth A. Merchant, Thirteenth Edition.

Landau Company

Problem Statement

What costing System should Landau Company adopt to best depict the company's Income Statement?

Objectives

- To adapt an accurate costing system that would depict the monthly income statement of Landau Company.
- To cite the Pros and Cons of the chosen costing system.
- To enhance management's control efforts and present a rational and balance Income Statement.

Areas of Consideration

- The significant increase of sales in July over June, yet income was lower in July than in June.
- Lack of control over long-run costs that can bankrupt a company.
- Margins on Landau's products in June and July.
- The company is looking for a new approach for internal managerial purposes.

Alternative Courses of Action

1. Variable Costing System

Pros:

- Eliminates time consuming efforts of allocating fixed overhead to individual products.
- Management's cost control efforts would be enhanced.
- Useful in comparing the profitability of individual product.
- Avoids the complexities associated with manufacturing overhead.
- Removes fixed manufacturing overhead and treats it as a period cost and not as a product cost.
- Helps managers understand h manufacturing costs are being incurred
- Very valuable tool for management in making decision and often use for

internal reports. • Income figure is not affected by production thus overproduction can be prevented.

Cons:

- Selling the products at their usual mark up over variable costs.
- Volume variances will not appear due to no fixed overhead is applied to products.
- Not permitted for external reporting purposes.
- Almost no manufacturers use this procedure in published financial reports because it has not yet been functioned by the institutions like SEC and BIR.
- If fixed cost is not treated as cost of product lower selling price is set

EXECUTIVE SUMMARY

In the fast-paced World, companies are geared towards maintaining the stability of financial structure of the business to gain profit.

In this case, Income Statement states that July sales had substantially increased than June but income in July was lower over June. This dilemma was cited by Terry Silver the new marketing vice-president of Landau Company.

Over 38 years, company conveniently used Full Costing System for their Income Statement. The suggested shift in the system to Variable Costing System was considered by Meredith Wilcox Company's chief accountant after attending the meeting of the members of the group of Institute of Management Accountants. She recast the Income Statement and presented the same to Silver as areas of consideration.

The latter system, would eliminate the time consuming efforts of allocating fixed overhead to individual products & segregated cost of materials, direct labor and variable overhead from fixed overhead costs, Silver said. However, according to Jamie [the treasurer] system suggests lack of control over long-run costs that can bankrupt the company. The President and Treasurer shared the same light on the matter. Whereas proposal using Variable Costing approach was well thought-out and exceeds the idea that the system under variable costing, the profit for a period is not affected by changes in inventories. Other things remaining the same (i. e. selling prices, costs, sales mix, etc.), profits move in the same direction as sales when variable costing is in use.

In this case, Variable Costing System approach was recommended to answer the need of internal people to access the financial stability of the said company. The impact of fixed costs on profits is emphasized under the variable costing and contribution approach. The total amount of fixed costs appears explicitly on the income statement.