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Direct labor cost variance formula

The actual and standard quantities and prices for direct work for the production of 1,000 units are given in the following table. The total actual and standard direct labour costs are calculated by multiplying the number of hours by the interest rate, and the results are shown in the last row of the first two columns. Direct Work Cost Variance Actual Standard Difference Direct Work In Hours 5,100 5,000 100 Direct Work Rate Per Hour \$9.50 \$10.00 (\$0.50) Total Direct Work Cost \$48,450 - \$50,000 = - \$1,550 Difference Column Shows That 100 Additional Hours Were Used Vs. what was expected (unfavorable). It also shows that the actual price per hour was \$0.50 lower than normal cost (favorable). The total actual cost of direct labour costs was \$1,550 lower than the standard cost, which is a favorable result. Administrators can better address this situation if they have an analysis of the fluctuations between quantity and rate. Specifically, knowing the amount and direction of difference for each can help them take targeted steps to improve. The following table expands to include this additional information. The difference in hours is multiplied by the standard price per hour, showing an unfavorable direct variation in working time of \$1,000. This is offset by a larger favorable direct work rate fluctuation of \$2,550. The net variation in direct labour costs is still \$1,550 (favorable), but this additional analysis shows how time and percentage differences contributed to the overall variation. The following equations summarize the calculations for the variance of direct labour costs. Direct work time variance = (actual hours – standard hours) x standard percentage Direct work rate variance = (actual percentage – standard percentage) x actual hours Total work cost variance = direct work time variance + direct work rate variance Learning Goal Calculation and analysis of direct work variances. Question: In addition to investigating the causes of cost overruns for direct materials, the president of Jerry's Ice Cream wants to know why there have been cost overruns for direct work. What variances are used to analyze these types of direct labour cost overruns? Answer: Similar to direct material fluctuations, the direct work variance analysis includes two distinct variations: work rate variance and work efficiency variance. Work percentage variance is the difference between actual costs for direct work and budgeted costs based on templates. The variation in work efficiency is the between the actual number of direct hours worked and the direct working hours budgets that should have worked according to standards. At Jerry's Ice Cream, the actual figures for the year are as follows: Recall from the 10.1 Standard cost figure in Jerry's ice cream that the standard price for Jerry's is \$13 per direct hour of work and the standard direct working hours is 0.10 per unit. Figure 10.6 Direct Work Analysis for Jerry's Ice Cream shows how to calculate work rate and variations in effectiveness given actual results and standard information. Carefully examine this number before proceeding to the next section explaining these calculations in detail. Figure 10.6 Instant Work Variance Analysis for Jerry's Ice Cream Note: AH = Actual Hours of Direct Work. AR = Actual percentage obtained for direct work. SR = Standard coefficient for direct work. SH = Standard direct work hours for the actual activity level. *Normal hours 21,000 = Standard 0.10 hours per unit x 210,000 actual units produced and sold. **\$273,000 standard direct labor cost matches the flexible budget shown in Figure 10.2 Flexible Budget for Variable Production Cost at Jerry's Ice Cream. 1 † \$37,800 unfavorable work rate variation = \$283,500 - \$245,700. Variance is unfavorable because the actual rate of \$15 is higher than expected (budgeted) rate of \$13. • \$(27,300) favorable labor efficiency variance = \$245,700 - \$273,000. The variance is favorable because the actual hours of 18,900 are lower than the expected (budgeted) hours of 21,000. Question: The direct variation in the work rate answers the question, did we spend more or less on direct work than expected? If the variance is unfavorable, we've spent more than expected. If the variance is favorable, we spent less than expected. How is the work rate variance calculated? Answer: As shown in Figure 10.6 Direct work variance analysis for Jerry's ice cream, the work rate variance is the difference between actual working hours at the actual rate and actual working hours at the normal rate: Work rate variance = (AH x AR) – (AH x SR) Work percentage variance=(AHxAR)–(AHxSR)=(18,900x\$15)–(18,900x\$13)= \$37,800 unfavorable alternative calculation. Because we keep the actual hours constant and evaluate the difference between the actual percentage and the normal rate, the work rate variance calculation can be simplified as follows: Work Rate Variance = (AR – SR) x AH Work Rate Variance=(AR–SR)xAH=(\$15–\$13)×18,900= \$37,800 unfavorable Note that both approaches—direct work rate variance calculation and alternative calculation—yield the same result. As with direct material fluctuations, all positive fluctuations are unfavourable and all negative fluctuations are favourable. The work rate variance calculation previously presented shows the actual percentage paid for the task was \$15 time and standard rate was \$13. This results in an unfavorable variance, since the actual percentage was higher than the expected (budgeted) rate. Question: The immediate variation in work efficiency answers the question, have we used more or less direct hours of production work than expected? If the variance is unfavorable, we used more than expected. If the variance is favorable, we used less than expected. Expected. is the work efficiency variance calculated? Answer: As shown in Figure 10.6 Direct work variance analysis for Jerry's ice cream, the variation in work efficiency is the difference between actual working hours at the normal rate and standard hours at the normal rate: Work Performance Variance = (AH x SR) – (SH x SR) Work Performance Variance=(AHx SR)–(SHxSR)=(18,900x\$13)–(21,000x\$13)=\$(-27,300) favorable The 21,000 standard hours are the hours allowed given actual production. For Jerry's ice cream, the standard allows 0.10 hours of work per production unit. Thus, the 21,000 normal hours (SH) is 0.10 hours per unit x 210,000 units produced. Alternative calculation. Because we keep the standard constant value and evaluate the difference between actual working hours and standard working hours, the calculation of work efficiency variance can be simplified as follows: Work Performance Variance = (AH – SH) x work performance variance SR=(AH–SH)x SR =(18,900–21,000)×\$13=(\$(-27,300) favorable Note that both approaches—the variance calculation of direct work performance and the alternative calculation—yield the same result. The previously presented work efficiency variance calculation shows that 18,900 actual working hours is lower than the 21,000 budgeted hours. Clearly, this is favourable given that actual working hours were lower than expected (budgeted) hours. Question: Jerry's ice cream manager is interested in finding the cause of the unfavorable labor rate fluctuation of \$37,800. Jerry's Ice Cream might also choose to investigate the favorable labor efficiency variance of \$27,300. While this could be seen as good news for the company, management may want to know why this favorable fluctuation occurred. What could have caused the \$37,800 unfavorable variation in work rates and a \$27,300 favorable variation in job efficiency? Answer: Figure 10.7 Possible causes of direct work fluctuations for Jerry's ice cream contain some possible explanations for the variation in work rate (left group) and variation in work efficiency (right group). Figure 10.7 Possible causes of direct work fluctuations for Jerry's ice cream As previously reported, the cause of a variance may affect another variance. For example, many of the explanations shown in Figure 10.7 Possible causes of direct work fluctuations for Jerry's ice cream may also apply to favorable variation in the amount of materials. We have demonstrated how important it is for managers to know not only the cost of the work, but also the between budgeted labour costs and actual labour costs. This awareness helps managers make decisions that protect the financial health of their companies. Labor costs in the United Airlines airline industry asked a bankruptcy court to allow a one-off 4 percent pay cut for pilots, flight flight engineers, flight controllers and ticket agents. The pay cut was proposed to last as long as the company remained bankrupt and was expected to provide savings of about \$620 million. How will this unforeseen pay cut affect United's immediate variation in employment rates? The immediate job rate fluctuation would probably be favorable, perhaps altogether close to \$620 million, depending on how much of these savings management was expected when the budget was first introduced. After filing for Chapter 11 bankruptcy in December 2002, United cut close to \$5 million in annual expenses. As a result of these cost cuts, United was able to exit bankruptcy in 2006. Source: Associated Press, United may seek an end to Union conventions, USA Today, November 25, 2004. Jerry (president and owner), Tom (sales manager), Lynn (production manager), and Michelle (treasurer and auditor) were at the meeting described at the beginning of this chapter. Michelle was asked to find out why direct work and direct material costs were higher than the budget, even after taking into account the 5 percent increase in sales over the original budget. Lynn was surprised to learn that direct work and direct material costs were so high, especially since the actual materials used and the actual direct working hours were under budget. The group met again a week later to discuss the issue. As mentioned earlier, the variance analysis is the control phase of budgeting. Using variance analysis for direct materials and direct work, Jerry's ice cream was able to identify strengths in its activities (quantity of materials used and efficiency of direct labor force), and perhaps most importantly, Jerry was able to identify problem areas (price paid for materials and wages paid to employees). This information provides management with a way to monitor and control production costs. We then calculate and analyze variations in variable production costs. Basic standard takeaway costs are used to determine flexible budget for direct work. The flexible budget is compared to the actual cost and the difference is shown in the form of two fluctuations. The work rate variance focuses on wages paid for work and is defined as the difference between actual costs for direct work and budgeted costs based on standards. The variation in profitability focuses on the amount of hours of work used in production. It is defined as the difference between the actual number of direct working hours and the budget of direct working hours that should have worked by standards. Carol Cookies is expected to use 0.20 direct hours of work to produce 1 unit (lot) of the product at a cost of \$12 per hour. The actual results are for the previous year, which shows 390,000 batches of cookies were sold. The company's direct workforce worked 97,500 hours at \$11 an hour. Calculate the work rate and/or variances using the format shown in Figure 10.6 Direct work variance analysis for Jerry's ice cream. Use the alternative approach to calculate work rate and performance fluctuations, and compare the result with the result in Part 1. (Tip: variances must match.) You suggest several possible reasons for work rate and efficiency fluctuations. Solution for reviewing problem 10.4 As shown in the following, the work rate variance is \$(97,500) favorable, and the labor efficiency variance is \$234,000 unfavorable. Note: AH = Actual hours of direct work. AR = Actual percentage obtained for direct work. SR = Standard coefficient for direct work. SH = Standard direct work hours for the actual activity level.*Standard hours 78,000 = Standard 0.20 hours per unit x 390,000 actual units produced and sold. **\$936,000 standard direct labor cost matches the flexible budget shown in Note 10.18 Review Problem 10.2, Part 2. † \$(97,500) favorable work rate fluctuation = \$1,072,500 - \$1,170,000. The variance is favorable because the effective interest rate of \$11 is lower than the expected (budgeted) interest rate of \$12. • \$234,000 unfavorable labor efficiency variance = \$1,170,000 - \$936,000. The variance is unfavorable because the actual hours of 97,500 are higher than the expected (budgeted) hours of 78,000. The following are alternative calculations of direct work variance: Work Rate Variance=(AR–SR)xAH=(\$11–\$12)×97,500=(\$(-97,500) favorable (same as part 1) Work Efficiency Variance=(AH–SH)× SSR = ((97,500–78,000)× \$12=\$234,000 unfavorable (same as part 1) Possible causes of favorable work rate variation are A higher mix of newly recruited and unskilled workers caused hourly rates to be lower than expected; Product demand was lower than expected , thereby reducing the amount of overtime originally foreseen; A new employment contract was negotiated at lower pay rates than expected. Possible causes of adverse variation in job efficiency are a higher mix of unskilled workers than expected caused inefficiency; Cuts in training have reduced the expected efficiency of direct workers. Old equipment being dismantled caused workers to waste time waiting for repairs. Repairs.

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