Chapter 7

Marginal & Absorption Costing

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Marginal Cost & Marginal Costing

• Marginal cost is the variable cost of one unit of product or service.
Marginal Cost & Marginal Costing

- Marginal costing is an alternative method of costing to absorption costing. In marginal costing, only variable cost are charged as a cost of sale and a contribution is calculated (sales revenue – variable cost of sales).
Marginal Cost & Marginal Costing

- Closing inventories of WIP or finished goods are valued at marginal (variable) production cost. Fixed costs are treated as a period cost, and are charged in full to the profit or loss account of the accounting period in which they are incurred.
Contribution

- Contribution is an important measure in marginal costing, and it is calculated as the difference between sales value and marginal or variable cost of sales.
- Contribution is a useful and important concept in short term decision making for companies.
- Contribution is the difference between sales value & the marginal cost of sales.
Break Even Point (BEP)

• This is a point where there is no profit or no loss for the organization.

• When BEP is reached operating profit will increase by the variable cost unit for each additional unit sold.

• Margin of Safety (SOP) is a measure of surplus over the BEP in cost volume profit analysis.
Break Even Point (BEP)

- **BEP (unit)** = FC / Contribution per unit (SP – VC)
- **BEP ($) = FC + Target Profit / C.S Ratio**
- **C/S Ratio = (sales revenue - cost of sales) / sales revenue x 100.**
Principles of Marginal Costing

- Period fixed cost are the same, for any volume of sales and production.
- Profit measurement should therefore be based on an analysis of total contribution.
- When a unit of product is made, the extra costs incurred in its manufacture are the variable production cost.
Principles of Marginal Costing

• Under/over absorption is avoided.
• There is no apportionment of fixed cost.
• The size of contribution provides management with useful information about expected profits.
Marginal Costing & Absorption Costing & the Calculation of Profit

• In marginal costing, fixed production costs are treated as period costs and are written off as they are incurred. In absorption costing, fixed production costs are absorbed into the cost of units and are carried forward in inventory to be charged against sales for the next period.
Marginal Costing & Absorption Costing & the Calculation of Profit

• Inventory values using absorption costing are therefore greater than those calculated using marginal costing. OR

• Compare with marginal costing inventory value will always be lower than when using absorption costing, because in absorption costing fixed production costs are absorbed into the cost of units and are carried forward in inventory to be charged against sales for the next period.
## Marginal Costing & Absorption Costing & the Calculation of Profit

<table>
<thead>
<tr>
<th>Marginal costing</th>
<th>Absorption costing</th>
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<tbody>
<tr>
<td>Closing inventories are valued at marginal production cost.</td>
<td>Closing inventories are valued at full production cost.</td>
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<tr>
<td>Fixed costs are period costs</td>
<td>Fixed costs are absorbed into unit costs</td>
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<td>Cost of sales does not include a share of fixed OH</td>
<td>Cost of sales does include a share of fixed OH</td>
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Reconciling Profit

• Reported profit figures using marginal costing or absorption costing will differ if there is change in the level of inventories in the period. If production is equal to sales, there will be no difference in calculated profit using the costing methods.
Reconciling Profit

- The difference in profits reported under the two costing system is due to the different inventory valuation methods used.
Reconciling Profit

- If inventory levels increase between the beginning and end of a period, absorption costing will report the higher profit.
- If inventory levels decrease, absorption costing will report the lower profit.
Reconciling Profit

- If the volume of units produced exceeds the volume of units sold, then profits reports under absorption costing is higher than marginal costing.
Reconciling Profit – A shortcut

• A quick way to establish the difference in profit without going through the whole process of drawing up the income statements is as follows:

\[
\text{Difference in profit} = \text{change in inventory level} \times \text{OAR}
\]
Marginal Vs Absorption Costing

• Absorption costing is most often used for routine profit reporting and must be used for financial accounting purposes.

• Absorption costing should be used in preparing the financial statement of the company for external publication.
Marginal Vs Absorption Costing

• Marginal costing provide better management information for planning and decision making.
• In absorption costing closing inventory is valued in accordance with accounting standard.
• When sales fluctuates but production is constant, absorption costing smoothes out profit fluctuations, because it carries fixed OH forward in inventory to be matched against sales as they arise.
Marginal Vs Absorption Costing

• One of the main difference between absorption costing & marginal costing is inventory valuation using absorption costing includes a share of all production costs.
Thank You

Ibrahim Sameer

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