The uses of absorption and variable costing

Accounting is the most important concept of any business. Various organizations adapt various accounting concepts in order to match the requirement and pattern of the business. Costing is an integral part of the accounting concept because the same helps in determining the cost of a product and related expenses. Costing is termed to be the basic concept and all the accounting model is structured in lines with the several costing patterns.

There are different types of organizations prevalent in a market and different organizations adapt different costing pattern depending on the organizational needs and patterns. Different costing structures emphasise on different product patterns. There are several costing model prevalent in the market for example absorption costing, variable costing etc. In this assignment we are going to discuss about absorption and variable costing in details to give a brief idea about the same and their uses.

COST CONCEPTS

Cost measurement is integral part for any organization. Though the cost measurement the initial stage but lays the foundation of the whole accounting process and helps in monitoring and controlling the cost plan of a business. The costing should be properly analysed in order to study the different aspects and informations. This process can be termed as ‘ cost management’ which helps in planning the further operations and keeping a control on the cost pattern.

There are various types of costs which are segregated based on their characterestics and their stage of utilisation. In the following paragraphs the various types and the characterestics have been described.

OVERHEAD COSTS – signifies indirect costs which are not directly related to a specific product. For example factory rent and is attributable to all the products that is manufactured in that specific factory. This is because the factory rent is not applicable to a specific batch of product produced during a period of time, whereas, it is distributed among all the products.

MARGINAL COST – refers to the cost that relates to a specific product and hence, can be attributable on product basis. For example; the labour and material cost of a product.

ACTIVITY BASED COSTING (ABC) – is management based costing pattern whereby, different costing pattern, structure and details are collected and analysed on the basis of the nature and extent of the same. Under this pattern, different costs are assigned to different products and services based on the level of activities. ABC is often described as a method of improving the quality of management accounting information on several situations where conventional overhead allocation may produce overlapping or improper results.

An activity can be described as receiving goods, inspecting goods and storing goods. We have to work out the cost of the activities at the various stages of product manufacturing before allocating them to separate departments.

ACTIVITY BASED COSTING vs. Traditional Costing

ABC is comparatively a new concept and is a management based accounting whereby different costing pattern has been associated with different kinds of products. ABC involves several types of cost numbers used in job costing or process costing systems.

ABC considers activities as the fundamental cost objects whereas, traditional costing takes into consideration product or service as the cost object.

Further, traditional costing assumes that resources are consumed by products/services whereas; ABC assumes that products/services consumes activities which in tun consumes resources.

VARIABLE COSTING is also referred called marginal or direct costing), costs a product or service at the costs incurred to directly manufacture the product/provide the service, i. e. only including the variables costs. Variables costs are those costs that change as the level of production/sales changes. Examples are direct labour (more direct labour equals more production/sales, direct material more direct material equals more production/sales and so on.).

Mostly, organisations prepare their accounts based on variable costing principles since this format provides management with better information for internal decision-making. In addition, the variable costing also eradicate the factor of considering the same cost factor twice since it does not consider fixed manufacturing overhead.

Advantages

i) Helps in Internal managerial decisions

ii) Stock is undervalued

iii) The segregation of cost into different aspects and helps in analysing cost pattern

Disadvantage

i) It does not take into consideration of the fixed cost and hence, does not produce a detailed picture for tax computation and other managerial decisions

ABSORPTION COSTING is also known as full costing in certain cases. Under this system of costing, a product at the inventory will involve all the expenses incurred i. e. direct labour, direct material and both fixed and variable overhead. Therefore, in simple words, under this system of costing, at any given time, the cost of goods involves all the types of expenses involved with the production of the same.

Absorption costing (sometimes called full costing) includes fixed overhead in the cost of a product or service. Therefore, under absorption costing some method of allocating that overhead is required. Absorption costing is usually the required costing measurement method for reporting inventory in external financial reports.

Advantages:

i) Inclusion of Fixed Cost in production

ii) Helps in Internal managerial decisions and preparing financial accounts

iii) Is accepted in Inland Revenue

iv) It distorts stock valuation

v) Helps in computing taxation

Disadvantage:

i) It takes into account both the types of cost and hence, not used for management decisions

ii) Manipulations possible

ABSORPTION COSTNG vs. VARIABLE COSTING

Absorption costing takes into consideration all manufacturing costs i. e. direct materials, direct labour and both variable and fixed manufacturing overhead. In this process of costing, fixed overhead is treated as a product cost until the same is sold. It helps in functional analysis on

FOMULAE: (Sales – Absorption Cost of Goods Sold) = Gross Profit

Variable costing refers to the summation of variable manufacturing costs namely direct materials, direct labour, and variable manufacturing overhead.

FORMULAE: Contribution Margin = Variable Cost of Goods Sold + Variable Selling + Administrative Expenses and subtracted from Sales.

Behavioral Analysis of the Income Statement

Variable costing can also be used for Break-even Analysis

Rules about Absorption Costing Vs. Variable Costing.

UNIT SALES & PRODUCTION

a) If sales are variable and production constant.

If production is equal to sales, then absorption costing and variable costing will give the same amount of net income.

If production greater than sales, then Net Income under absorption costing will be greater than net income under variable costing

If production less than sales, then Net Income under absorption costing will be less than net income under variable costing

In the long-term process, net income will be equal under both costing methods.

b) If sales are constant and production is variable then:

Net income under variable costing does not fluctuate because of change in sales figures whereas, the same under absorption costing

Further, a numerical example has been analysed over here to give a brief idea about Absorption & Variable Costing.

Units Produced

200, 000

Sales Price

15. 00

Direct Materials Cost/Unit

4. 00

Direct Labour Cost/Unit

3. 00

Variable Manufacturing Cost/ unit

2. 00

Variable Sales Cost/Unit

1. 00

Fixed Manufacturing Overhead

200, 000

Fixed Selling Costs

100, 000

Unit Cost under Absorption Costing

Direct Materials Cost /Unit

$4. 00

Direct Labour Cost /Unit

$3. 00

Variable Manufacturing Cost /unit

$2. 00

Fixed Manufacturing Overhead/unit

$200, 000/ 200, 000 units $1. 00

$10. 00

Unit Cost under Variable Costing:

Direct Materials Cost per Unit

$4. 00

Direct Labour Cost Per Unit

$3. 00

Variable Manufacturing Cost Per unit

$2. 00

Total Cost Per Unit

$9. 00

CONCLUSION:

In the above paragraphs, an attempt has been made to put across an detailed idea about the accounting concepts of Variable Costing & Full or Absorption Costing. Besides, discussing aspects, advantages and disadvantages of the same, I have also used a numerical example to develop a better idea about the same. However, this assignment is subject to limitations in regard to knowledge, time and resources.