Marginal costing and absorption costing comparison

Marginal costing is also termed as variable costing, a technique of costing which includes only variable manufacturing costs, in the form of direct materials, direct labour, and variable manufacturing overheads while determining the cost per unit of a product. Where as Absorption costing, is a costing technique that includes all manufacturing costs, in the form of direct materials, direct labour, and both variable and fixed manufacturing overheads, while determining the cost per unit of a product. It is also referred to as the full- cost technique.

In the costing of product/service, a marginal costing technique considers the behavioural characteristics of costs (segregations of costs into fixed and variable elements), because per unit variable cost is fixed and total costs are variable in nature, where as total fixed costs are fixed and per unit fixed cost is variable in nature and furthermore variable costs are controllable in nature, while total fixed costs are un-controllable in nature. Marginal costing is useful for short-term planning, control and decision-making, particularly in a business where multi-products are produced. In marginal costing technique, the contribution is calculated after deducting variable costs from sales value with reference to each product or service, in order to calculate the total contribution from all products/services which are made towards the total fixed costs incurred by the business. As the fixed costs are treated as period costs, are deducted from total contribution to arrive at net profit.

In the context of costing of a product/service, an absorption costing considers a share of all costs incurred by a business to each of its products/services. In absorption costing technique; costs are classified according to their functions. The gross profit is calculated after deducting production costs from sales and from gross profit, costs incurred in relation to other business functions are deducted to arrive at the net profit.

Absorption costing gives better information for pricing products as it includes both variable and fixed costs.

Marginal costing may lead to lower prices being offered if the firm is operating below capacity. Customers may still expect these lower prices as demand/capacity increases.

Profit Statements under Marginal and Absorption Costing:

The net profit shown by marginal costing and absorption costing techniques may not be the same due to the different treatment of fixed manufacturing overheads. Marginal costing technique treats fixed manufacturing overheads as period costs, where as in absorption costing technique these are absorbed into the cost of goods produced and are only charged against profit in the period in which those goods are sold. In absorption costing income statement, adjustment pertaining to under or over-absorption of overheads is also made to arrive at the profit.

Terms explained:

Product and Period Costs:

1. Product costs: the costs of manufacturing the products;
2. Period costs: these are the costs other than product costs that are charged to, debited to, or written off to the income statement each period.