

# Absorption and marginal costing methods



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Absorption costing treats the costs of all manufacturing components (direct material, direct labour, variable overhead and fixed overhead) as inventoriable or product costs in accordance with generally accepted accounting principles (GAAP), (BARFIELD et al., 2001).

## **1. 2 Marginal Costing**

Variable costing is a cost accumulation method that includes only variable production costs (direct material, direct labour, and variable overhead) as product or inventoriable costs. (BARFIELD et al., 2001)

## **1. 3 Similarities between Both Methods**

Marginal costing      Absorption costing

Closing inventories are valued at marginal production cost.

Closing inventories are valued at full production cost.

Fixed costs are period costs. Fixed costs are absorbed into unit costs.

Cost of sales does not include a share of fixed overheads.

Cost of sales does include a share of fixed overheads

## **1. 4 Influences of Marginal and Absorption costing on the pricing policy**

1. Pricing decisions: Since marginal cost per unit is constant from period to period within a short span of time, firm decisions on pricing policy can be taken, If fixed cost is included, the unit cost will change from day to day depending upon the volume of output.

2. Overhead Variances: Overheads are recovered in costing on the pre-determined rates. This creates the problem of treatment of under or over-recovery of overhead, if fixed overhead were included Marginal costing avoids such under or over recovery of overheads.
3. True profit: It is argued that under the marginal costing technique, the stock of finished goods and work-in-progress are carried on marginal cost basis and the fixed expenses are written off to profit and loss account as period cost. This shows the true profit of the period.
4. Break-even analysis: Marginal costing helps in the preparation of break-even analysis, which shows the effect of increasing or decreasing production activity on the profitability of the company.
5. Control over expenditure: Segregation of expenses as fixed and variable helps the management to exercise control over expenditure. The management can compare the actual variable expenses with the budgeted variable expenses and take corrective action through, variance analysis.
6. Business decision-making: Marginal costing helps the management in taking a number of business decisions like make or buy, discontinuance of a particular product, replacement of machines etc.)  
(BRAGG, STEVEN M., 2007)

### **1. 4. 1 Influences of Marginal Costing**

It recognizes the importance of fixed costs in production;

This method is accepted by Inland Revenue as stock is not undervalued;

This method is always used to prepare financial accounts;

When production remains constant but sales fluctuate absorption costing will show less fluctuation in net profit and

Unlike marginal costing where fixed costs are agreed to change into variable cost, it is cost into the stock value hence distorting stock valuation.

(Accounting for management) (BRAGG, STEVEN M., 2007)

## **1. 4. 2 Influences of Absorption Costing**

(It is simple to operate.

There are no apportionments, which are frequently done on an arbitrary basis, of fixed costs. Many costs, such as the marketing director's salary, are indivisible by nature.

Fixed costs will be the same regardless of the volume of output, because they are period costs. It makes sense, therefore, to charge them in full as a cost to the period.

The cost to produce an extra unit is the variable production cost. It is realistic to value closing inventory items at this directly attributable cost.

Under or over absorption of overheads is avoided.

Marginal costing provides the best information for decision making.)

(KAPLAN, 2008)

Classifications of cost systems in terms of object: function, product (services) and behaviour, analysing probable causes of cost variances and offer directors the needed advice to improve performance.

## **2. Cost by Object**

### **2. 1. 1 Direct Cost**

Direct costs are costs which can be directly identified with a specific cost unit or cost centre. There are three main types of direct cost:

Direct materials for-example, cloth for making shirts

Direct labour for-example, the wages of the workers stitching the cloth to make the shirts

Direct expenses for-example, the cost of maintaining the sewing machine used to make the shirts.

### **2. 1. 2 Indirect Cost**

Indirect costs are costs which cannot be directly identified with a specific cost unit or cost centre. Examples of indirect costs include the following:

The total of indirect costs is known as overheads.

indirect materials these include materials that cannot be traced to an individual shirt, for example, cotton

indirect labour for example, the cost of a supervisor who supervises the shirt makers

Indirect expenses for example, the cost of renting the factory where the shirts are manufactured.

## **2. 2 Cost by Function**

### **2. 2. 1 Production Cost**

Production costs are the costs which are incurred when raw materials are converted into finished goods and part finished goods (work in progress).

### **3. 2. 2 Non-Production Cost**

Nonproduction costs are costs that are not directly associated with the production processes in a manufacturing organisation.

## **2. 3 Cost by behaviour**

### **2. 3. 1 Variable Cost**

Variable costs are costs that tend to vary in total with the level of activity. As activity levels increase then total variable costs will also increase.

Note that as total costs increase with activity levels, the cost per unit of variable costs remains constant.

Examples of variable costs include direct costs such as raw materials and direct labour

### **2. 3. 2 Fixed Cost**

A fixed cost is a cost which is incurred for an accounting period, and which, within certain activity levels remains constant.

Note that the total cost remains constant over a given level of activity but the cost per unit falls as the level of activity increases. (KAPLAN, 2008)

Examples of fixed costs:

- rent
- business rates
- Executive salaries.

### **2. 3. 3 Stepped Fix Cost**

This is a type of fixed cost that is only fixed within certain levels of activity.

Once the upper limit of an activity level is reached then a new higher level of fixed cost becomes relevant.

#### **Examples of stepped fixed costs:**

- Warehousing costs (as more space is required, more warehouses must be purchased or rented)
- Supervisors' wages (as the number of employees increases, more supervisors are required).

### **2. 3. 4 Semi Variable Cost**

Semi variable costs contain both fixed and variable cost elements and are therefore partly affected by fluctuations in the level of activity.

- Semi variable costs can be shown graphically as follows

Examples of semi variable costs:

- Electricity bills (fixed standing charge plus variable cost per unit of electricity consumed)
- Telephone bills (fixed line rental plus variable cost per call)

## 2. 4 Cause of Cost Variances

(Sales price variances may be caused by:

- unplanned price increases (sales price variance)
- unexpected fall in demand due to recession (sales volume variance)

Materials price variances may be caused by:

- supplies from different sources
- unexpected general price increases

Materials usage variances may be caused by:

- a higher or lower incidence of scrap
- an alteration to product design

Labour efficiency variances may be caused by:

- changes in working conditions or working methods, for example, better supervision
- consequences of the learning effect) (BPP, 2007)
- Responsibility accounting as a system of planning and control of the organisation.

## 3. Responsibility Centres

Responsibility accounting systems identify, measure, and report on the performance of people controlling the activities of responsibility centres.

Responsibility centre sari classified according to their manager's scope of authority and type of financial responsibility. Companies may define their organizational units in various ways based on management accountability for



one or more income-producing factors-costs, revenues, profits, and/or asset base. (BARFIELD et al., 2001)

### **3. 1 Cost Centres**

In a cost centre, the manager has the authority only to incur costs and is specifically evaluated on the basis of how well costs are controlled.

Theoretically, revenues cannot exist in a cost centre because the unit does not engage in revenue producing activity. Cost centres commonly include service and administrative departments. For example, the equipment maintenance centre in a hospital may be a cost centre because it does not charge for its services, but it does incur costs. (BARFIELD et al., 2001)

### **3. 2 Revenue Centre**

A revenue centre is strictly defined as an organizational unit for which a manager is accountable only for the generation of revenues and has no control over setting selling prices or budgeting costs. In many retail stores, the individual sales departments are considered independent units, and managers are evaluated based on the total revenues generated by their departments. Departmental managers, however, may not be given the authority to change selling prices to affect volume, and often they do not participate in the budgeting process. Thus, the departmental managers might have no impact on costs. (BARFIELD et al., 2001)

### **3. 3 Profit Centre**

In a profit centre, the manager is responsible for generating revenues and planning and controlling expenses related to current activity. (Expenses not under a profit centre manager's control are those related to long-term

investments in plant assets; such a situation creates a definitive need for separate evaluations of the subunit and the subunit's manager.) A profit centre manager's goal is to maximize the centre's net income. (BARFIELD et al., 2001)

### **3.4 Investment Centre**

An investment centre is an organizational unit in which the manager is responsible for generating revenues and planning and controlling expenses. In addition, the centre's manager has the authority to acquire, use, and dispose of plant assets in a manner that seeks to earn the highest feasible rate of return on the centre's asset base. (BARFIELD et al., 2001)