Difference between absorption and variable costing

Difference between Variable & Absorption Costing When it comes to managerial accounting, the way that information is presented can affect decision-making for a business. In a manufacturing environment, companies can use absorption costing or variable costing when accounting for the costs of products produced. While these methods are similar, they have some key differences that can impact the company. Absorption Costing * Absorption costing, also known as full costing is a method by which all of the expenses associated with producing a product are included in its cost.

With absorption costing, you include both the fixed and variable expenses in each individual unit. When the units are priced, any profit margin is added on top of this cost. This method simply breaks all of the costs incurred by the facility down into a per unit cost. Variable Costing * Variable costing is another method companies can use to account for the costs of items produced. With variable costing, the company only applies the variable costs to each unit. It does not apply the fixed costs involved with manufacturing to each unit.

Instead, those costs are applied in the year in which they are incurred by the manufacturing facility. This method subtracts out the fixed costs such as rent and insurance before calculating the per-unit cost. Absorption Considerations * Companies regularly use absorption costing because it provides them with a full cost for each item produced. Since the company knows that it has to pay the fixed costs associated with manufacturing, it figures that it might as well divide those costs into each individual unit so that a profit margin can be attached to them.

In some cases, the fixed costs associated with manufacturing can be difficult to attach to an individual product. Variable Considerations * Some companies use a variable costing method because they believe that it is more accurate. Proponents of variable costing argue that the fixed costs will be incurred regardless of how many units are sold. Therefore, it does not make sense to attach the fixed costs to each individual unit as this changes the unit cost, depending on how many units are manufactured.

However, without including the fixed costs, it can be difficult to make decisions based on variable costing data, since all of the information is not provided. Companies apply different costing techniques to keep track of the production of goods and services. Both absorption and costing techniques allow companies to obtain a complete picture of their financial standing. The application of these two methods allows the company to see everything from taxes and sales to inventories in manufactured goods to the cost of all expenses within the organization.

In other words, both absorption and variable costing techniques give companies a more accurate picture of how the company has performed financially. Absorption Costing * Absorption costing is also called full costing or the full absorption method. In absorption costing the company absorbs all of the manufacturing costs by the products produced. This means the price of every piece of finished inventory will include direct labor, direct materials and variable and fixed manufacturing overhead. Some of these costs include wages for workers to produce the product, materials used in producing a product and overhead costs.

Absorption costing is also used for external financial reporting and income tax reporting. Advantage and Disadvantage of Absorption Costing * The advantage of using absorption costing is that it can provide the company with a clear picture of the true cost of products including fixed manufacturing and overhead. Accountants use this method when preparing financial statements because this method accurately recognizes the importance of fixed costs in production. Another benefit of absorption costing is this method will show less fluctuation in net profits and distortion of stock evaluation.

The primary disadvantage of absorption costing is that this method is not a useful mechanism for management to make decisions, plan or control. Variable Costing * Variable costs are the direct function of production volume. This means that variable costs will rise and fall depending on production volume. Examples of variable costs include direct material costs, direct labor costs and variable factory overhead. Variable costs are part of the manufacturing process and will always vary according to the volume of production.

Fixed costs such as rent and management salaries are never included as part of the variable cost figure. Application * The costing method applied by the company will depend on a variety of factors. Both systems can benefit the company by providing a better understanding of the production process within the organization. Both costing methods also allow companies to show finances in a better light. This can benefit the company when showing external financial reports to investors or financial institutions.