

Topic 5

[week 7 and 8]

Absorption and Marginal Costing



Learning Outcomes

Upon completion of this topic, the students should be able to:

- **Calculate closing stock under absorption and marginal costing method**
- **Construct Income statement under absorption and marginal costing**
- **Describe the impacts on profit by using both methods**

Marginal Costing

Can be defined as the accounting system in which variable costs are charged to cost units and the fixed costs of the period are written off in full against the aggregate contribution. Contribution can be defined as the difference between sales and marginal or variable cost. It is also known as variable costing.

Uses of Marginal Costing

- **As a basis for providing information to management for planning and decision making. It is particularly appropriate for short-run decisions involving changes in volume or activity and the resulting cost changes.**
- **It can also be used in the routine cost accounting system for the calculation of costs and the valuation of stock.**

Marginal Costing and Absorption Costing

- **In absorption costing, all costs are absorbed into production and thus the operating statements do not distinguish between fixed and variable costs. Hence, the valuation of stocks and work-in-progress contains both fixed and variable elements.**
- **In marginal costing, fixed costs are not absorbed into the cost of production. They are treated as period costs and written off each period in the Costing Profit and Loss account. The effect of this is that finished goods and work-in-progress are valued at marginal cost only.**

Impact on Profits

- **By including fixed costs in stock valuation, absorption costing transfers some of the current period's fixed costs into the next period when they will be charged against the revenue derived from the stock carried forward [assuming it is sold]. Marginal costing always writes off all fixed costs in the period they are incurred.**
- **Therefore, in a period with increasing stocks, absorption costing will show higher profits than marginal costing. Conversely, in a period of decreasing stocks, marginal costing will show higher profits.**
- **This is entirely due to the treatment of fixed costs in the stock valuation.**

Arguments for Marginal Costing

- **Simple to operate**
- **No apportionments, which are frequently on an arbitrary basis, of fixed costs to products or departments**
- **Where sales are constant, but production fluctuates, marginal costing shows a constant net profit as compared to absorption costing**
- **Under or over absorption of overheads is almost entirely avoided**
- **Fixed costs are incurred on a time basis and therefore it is logical to write them off in the period they are incurred as in marginal costing**
- **Account prepared using marginal costing may nearly approach the cash flow position**

Arguments for Absorption Costing

- **Fixed costs are a substantial and increasing proportion of costs in modern industry. Production cannot be achieved without incurring fixed costs which thus form an inescapable part of the cost of production, so should be included in stock valuation**
- **Where production is constant but sales fluctuate, net profit fluctuations are less with absorption costing**
- **Where stock building is necessary part of the operations, the inclusion of fixed costs in stock valuation is necessary and desirable**
- **The calculation of marginal cost and the concentration upon contribution may lead to the firm setting prices which are below the total cost**