

Individual report

(Assessment Component 1)

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Introduction

The report will begin with discussing the differences between Marginal and Absorption costing techniques and will be mentioned their applicability and benefits. Marginal Costing Statement for each product will be prepared to calculate the contribution of each product towards the company. Based on the contribution calculated, an advice will be proposed whether the company should stop the production of Hoists and Mobile Beds. The report will also consider if the long-term profitability will improve if the company stops producing the products and other suggestions. Overall, the report aims to provide the information needed to make an informed decision about the future of the production of Hoists and Mobile Beds, using the Marginal Costing and Management Accounting techniques.

1. Marginal and Absorption Costing, differences between both techniques, their applicability and benefits.

1.1 Marginal Costing

Marginal costing is also known as variable costing, which includes only the variable costs that are included in the cost of production to goods or services. Variable costs vary of the level of production, which can be direct labour and direct materials. The fixed costs on the other hand are the rent, salaries or depreciation and they are not included in the cost of production. Marginal cost is often used in the short-term decision making because it provides information on the contribution, which is the difference between the sales revenue and variable costs. This helps companies to understand which products are actually making profit and if the price should be managed Drury and Tayles, (2021) For example, if one product has high contribution margin the company should make a decision to increase the production for more profit, but if another product has low contribution margin the company should stop producing it to reduce losses. Marginal costing can benefit companies a lot because it helps companies to understand if their products or services make profit and not a loss. This information can also help towards the decision of the products pricing, which can give an idea of how much sales they will need to cover the fixed costs. (Drury, 2012)

1.2 Absorption Costing

Absorption Costing is known also as full costing because it includes all the costs towards the making of a product or service. According to Marsh, (2012) unlike marginal costing, absorption costing includes not only the variable costs which are direct labour and direct materials, but also the fixed costs and these costs are used from the company whether they produce something or not. Some examples of fixed costs are wages of the employees, factory rent and rates, insurance and utilities. Absorption Costing is used most often for the long-term decision making because it gives more accurate understanding of the full costing of a product or service.

1.3 Key Differences

The main difference between both of the techniques is they treat fixed overheads differently. While Marginal Costing includes only the variable costs and does not consider fixed costs, on the other hand Absorption Costing includes all the costs in the production of a product or service.

Marginal Costing: the profit may appear higher because in marginal costing fixed costs are not taken into account. The calculation of the profit is made by using the contribution margin, where fixed overheads are not included. Marginal Costing show contribution per unit. The purpose is to show the importance of contribution to the product cost.

Absorption Costing: the profit is lower because it takes fixed costs into account. The calculation of the profit is made by using the gross margin, where fixed overheads are included. Absorption Costing show net profit per unit. The purpose is to show the accuracy of the product cost.

(Khatabook, 2023)

1.4 Key Benefits

Marginal Costing: the main advantage of Marginal Costing is that it helps companies to understand at what minimum price they should sell the products or services to cover the variable costs. It helps companies to understand what the contribution margin is. By using Marginal Costing companies determine the break-even point, and this point is where the company cover all the costs and indicate estimated profit or loss.

Absorption Costing: the main advantage of Absorption Costing is that it provides more accurate picture of the cost of production because it takes into account the fixed overheads that are used in the process. It makes calculating the profitability and pricing the products easier. (Javed, 2022)

2. Marginal Costing Statement for each product and total for December 2022

		Wheelchairs	Hoists	Mobile Beds	Total
Units sold		40	93	77	
Revenue		£20,100.00	£18,630.00	£19,302.00	£58,032.00
Costs					
	Direct Material	(£4,623.00)	(£6,893.10)	(£9,264.96)	(£20,781.06)
	Direct Labour	(£6,231.00)	(£7,824.60)	(£6,755.70)	(£20,811.30)
	Other Variable Expenses	(£2,211.00)	(£4,657.50)	(£3,088.32)	(£9,956.82)
	Contribution	7,035.00	745.20	193.02	6,482.82
	Fixed Overheads	(£6,030.00)	(£5,961.60)	(£7,334.76)	(£19,326.36)
Profit / (Loss)		£1,005.00	(£6,706.80)	(£7,141.74)	(£12,843.54)

3. Marginal Costing Statement if MSG stops making Hoists

		Wheelchairs	Mobile Beds	Total
Units sold		40	77	
Revenue		£20,100.00	£19,302.00	£39,402.00
Costs				
	Direct Material	(£4,623.00)	(£9,264.96)	(£13,887.96)
	Direct Labour	(£6,231.00)	(£6,755.70)	(£12,986.70)
	Other Variable Expenses	(£2,211.00)	(£3,088.32)	(£5,299.32)
	Contribution	£7,035.00	£193.02	£7,228.02
	Fixed Overheads	(£6,030.00)	(£7,334.76)	(£13,364.76)
Profit / (Loss)		£1,005.00	(£7,141.74)	(£6,136.74)

3.1 Decision if MSG should stop making Hoists

Based on the contribution calculated in (2.) the contribution of Hoists is negative, according to Nawaz, (2013) the company should stop producing a product that has negative contribution because the revenue it generates from the sales of it does not cover the variable costs, and the product is being sold at loss.

3.2 Reason

By stopping the production of the Hoists, MSG can focus and relocate the available resources towards producing the products with positive contribution. Since the contribution is negative it means the revenue generated from the product does not cover the variable costs and each product sold generates loss for the company.

4. Marginal Costing Statement if MSG stops making Mobile Beds

		Wheelchairs	Hoists	Total
Units sold		40	93	
Revenue		£20,100.00	£18,630.00	£38,730.00
Costs				
	Direct Material	(£4,623.00)	(£6,893.10)	(£11,516.10)
	Direct Labour	(£6,231.00)	(£7,824.60)	(£14,055.60)
	Other Variable Expenses	(£2,211.00)	(£4,657.50)	(£6,868.50)
	Contribution	(£7,035.00)	(£745.20)	(£6,289.80)
	Fixed Overheads	(£6,030.00)	(£5,961.60)	(£11,991.60)
Profit / (Loss)		£1,005.00	(£6,706.80)	(£5,701.80)

4.1 Decision if MSG should stop making Mobile Beds

Based on the calculated contribution in (2.) the contribution is positive but it's low, MSG should not stop producing the product, but they can consider make the selling price higher or lower the variable costs for better profit.

4.2 Reason

The contribution of the Mobile Beds is positive, which means the generated revenue from the sales of this product is higher than the variable costs. This means each product sold generates profit for the company.

5. Advise

Long-time profitability and growth if MSG cease Hoists and Mobile Beds. Since Hoists has a negative contribution, the company should consider cease the product because it has a negative impact on the profitability. Mobile Beds has positive contribution, but it is low so MSG should consider take actions and either try to decrease the variable costs or increase the sale cost of the product for a better profit. By stopping the production of Hoists, MSG can focus on the production of Mobile Beds which has a positive contribution.

However, MSG should consider carefully if they want to stop the production of Hoists because the issues that it can be caused are hurting the company reputation, losing their existing loyal customers and new ones. If the demand is high for Hoists, MSG should think of ways to reduce the variable costs for the production or increase sale price, to start making positive contribution instead of stop producing the product and lose customers.

Reference List:

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Javed, R. (2016) *Advantages and disadvantages of absorption costing, Accounting For Management*. Rashid Javed. Available at: <https://www.accountingformanagement.org/advantages-and-disadvantages-of-absorption-costing/> (Accessed: March 1, 2023).

Khatabook (2022) "Difference between marginal costing and absorption costing," *Khatabook*. Available at: <https://khatabook.com/blog/marginal-costing-vs-absorption-costing/> (Accessed: March 1, 2023).

Marsh, C. (2012) *Financial Management for Non-Financial Managers*. London, England: Kogan Page.

Nawaz, M., 2013. An Insight Into the Two Costing Technique: Absorption Costing and Marginal Costing. *BRAND. Broad Research in Accounting, Negotiation, and Distribution*, 4(1), pp.48-61.

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TASK B

DelhiCorner serves Indian Cuisine in Central Birmingham.

Marginal Costing is an accounting system where only variable costs are charged to a cost unit whilst fixed costs for example fixed rent and salaries are written off in full against the aggregate contribution in the period in which they were incurred (CIMA). By distinguishing between variable and fixed costs, **DelhiCorner** can then calculate contribution. Marginal costing and the concept of contribution are fundamental to the breakeven analysis or 'cost-volume-profit' (CVP) technique.

Fixed Overheads are £11,500. These include fixed rental and salaries for senior staff.

Variable cost per full meal is £40 and the selling price per plate is £65.

1. How many plates should DelhiCorner sell in order to break-even?

Selling Price Per Plate – Variable Cost Per Plate = Contribution Per Plate

(£65)	(£40)	(£25)
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Fixed Overheads ÷ Contribution Per Plate = Break Even Point

(£11,500)	(£25)	(460 Plates)
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DelhiCorner must sell 460 plates to break even.

2. How many plates should be sold by DelhiCorner in order to make a profit of £24,000.

$$\begin{array}{rcl} (\text{Profit} & + & \text{Fixed Overheads}) \div \text{Contribution Per Plate} \\ (£24,000) & & (£11,500) \qquad \qquad (£25) \end{array}$$

$$£35,500 \div £25 = 1,420 \text{ Plates}$$

DelhiCorner must sell 1,420 Plates to make a profit of £24,000.

3. Given that DelhiCorner will now incur an additional £5,000 annual advertising cost due to severe competition, calculate the revenue DelhiCorner should generate in order to make a profit of £18,200.

We add the advertising cost to the Fixed Overheads, which makes total £16,500 Fixed Overheads.

$$\begin{array}{rcl} (\text{Profit} & + & \text{Fixed Overheads}) \div \text{Contribution Per Plate} \\ (£18,200) & & (£16,500) \qquad \qquad (£25) \end{array}$$

$$£34,700 \div £25 = 1,388 \text{ Plates}$$

$$1,388 \times £25 = £34,700 \text{ Revenue in order to make a profit of £18,200.}$$

4. Critically discuss the limitations of the Break-Even/ Cost-Volume-Profit Analysis and its practical applicability in DelhiCorner. Please use reference of credible references and sources.

Cost-Volume-Profit analysis is a tool used from businesses to calculate the break even point, target profits and understand the relationship between cost, volume and profit. It is used to make informed decision about production, pricing and sales. Once break even point is reached everything after that is a profit.

Cost-Volume-Profit analysis has limitations and some of them are:

It is limited to a multi-product businesses like DelhiCorner because it is a restaurant, and it offers a lot of dishes, and they may have many variable costs. It will be difficult for the owner to use it because it has to be done for each dish. (Lewis, 2019)

Reference List:

Lewis, J. (2019) *Flexible budgets & overhead analysis solutions in managerial accounting, Small Business - Chron.com*. Chron.com. Available at: <https://smallbusiness.chron.com/flexible-budgets-overhead-analysis-solutions-managerial-accounting-31369.html> (Accessed: March 2, 2023).

1. Marginal Costing Statement
