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ABSORPTION COSTING AND MARGINAL COSTING

Absorption costing is a process where all overhead is absorbed into the cost of production. This overhead includes fixed and variable items.

Marginal costing (also known as variable costing which is true if applied to normal range), excludes any fixed costs from the absorption process and charges them as a period cost. "It is a method where variable costs are charged to cost units and the fixed costs attributable to the relevant period are written off against the contribution of that period."

Contribution = Sales Revenue – Marginal Cost

Marginal Cost = Direct labour Costs + Direct Material Costs
+ Direct Expenses + Variable Overheads.

Absorption and marginal costing compared

Absorption costing, which is used in financial accounts, absorbs all costs into production and consequently the valuation of stocks and work in progress contains both fixed and variable costs.

Marginal costing, which is used for planning and decision making, does not absorb fixed costs into the cost of production but they are treated as period costs and written off each period in the Profit and Loss account.

Consider the following data:

Bargepole Ltd in March produced 50,000 units of gamma. The relevant costs and revenues were as follows;

	£		£
Sales	200,000	Sales	200,000
Variable Prod.Cost	40,000	Var. cost of sales	—
Fixed Prod.Cost	30,000	Contribution	—
Admin/Selling Cost (fixed)	30,000	Fixed costs	—
		Production	—
		Net profit	—

Note that in the marginal costing statement, the contribution forms a pool from which fixed costs are met. Any surplus, once fixed costs are met is net profit.

Problems connected with the approaches;

PROBLEM 1 Activity changes

The absorption approach may cause some confusion if the activity level changes for the firm. For example, if the activity level is 50,000 units then;

Selling price per unit	£4
Prod. cost per unit	= £1.40
70,000/50,000	
Gross profit per unit	= £2.60

So the profit if 75,000 units are sold will be 75,000 x £2.60 -£30,000 = £165,000!? This is incorrect because fixed costs may not alter.

The profit statement using absorption costing would be

Sales 75,000 x £4	£
Production Cost	£300,000
Gross Profit	
Admin. + Selling Overheads	£30,000
Net Profit	

The difference is due to the incorrect treatment of the fixed cost.

The marginal approach presents a clearer picture:

Marginal cost per unit = _____ = _____
 hence the contribution per unit = _____ = _____

If the activity level is increased to 75,000 units then the expected profit would be:

and the profit statement would be:

Sales 75,000 x £4	£
Marginal cost	300,000
Contribution	
Fixed costs Production	30,000
Admin. + Selling	30,000
Net profit	60,000

Note how the marginal cost based profit statement takes account of the fact that variable costs may be the only costs that change when activity changes. Separation of the fixed costs as a period charge may thus make sense.

PROBLEM 2 Different profit figures.

Absorption costing profit statements may give different profit figures in certain circumstances:

Using the original Bargepole data, the revised profit statements, where only 40,000 units are sold and 10,000 units are held in closing stock, would be:

	Absorption Costing		Marginal Costing
	£	£	£
Sales 40,000 x £4	160,000	Sales 40,000 x £4	160,000
Cost of Production		Var. cost of Prod.	
Closing Stock	()	Closing Stock	()
Gross Profit		Contribution	
Admin. + Selling		Fixed Costs	
Overheads	30,000	Production	30,000
		Admin. + Selling	<u>30,000</u>
Net profit		Net Profit	

Note here that in using absorption costing some fixed overhead is carried forward to the next period in closing stock figures. Thus absorption cost profit statements may show higher profits when closing stocks increase.

Which method to use?

For normal routine costing;

Marginal costing

- simple to operate
- no apportionments which are often arbitrary anyway
- under/over absorption is avoided (see example)
- fixed costs do occur on a time basis and thus should be written off in like fashion
- the use of marginal costing more accurately reflects the cash flow position of the firm.

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Absorption costing

- marginal costing assumes that fixed costs are divorced from production
- where production is constant, but sales differ, then net profit fluctuations will be less with absorption costing than they are with marginal costing.
- where stock building as an integral part of operations e.g. fireworks, Christmas toys, then marginal costing will give many fictitious losses that are made up by huge profits in November and December etc.
- marginal costing basis with its concentration on contribution may lead to prices being set below that needed to keep the business going in the long run.
- SSAP 9 recommends the use of absorption costing in financial accounting because costs and revenues should be matched over a period when revenues arise, not when costs occur. Stock valuations should include production overheads incurred in the normal course of operations even if such overheads are time related.

Conclusion

Due to SSAP 9 absorption, costing must be the principle for financial accounting. However, for the purposes of decision making and planning marginal costing ideas may be crucial for finding effective solutions to problems.

