Marginal Costing

1. Conceptual Framework

Marginal costing is an accounting system in which variable costs are charged to cost unit and fixed costs of the period are written off in full against aggregate contribution. (Total income less total variable cost).

Its special value is in decision making.

Marginal, Variable, Direct are interchangeable.

1. Conceptual Framework

Features of Marginal Costing

- Costs are separated into the fixed and variable elements.
- Only variable costs are taken into account for valuation of stocks of work in progress and finished products.
- Fixed costs are charged to revenue during the period they are incurred.

1. Conceptual Framework

Features of Marginal Costing- contd.

- ☻ Prices are based on the marginal cost and contribution
- ☻ It combines the techniques of cost recording & cost reporting.
- ☻ Profitability of products and departments is determined on the basis of marginal contribution.
- ☻ The unit cost of a product means the average variable cost of the product.

2. Contribution

Under marginal costing all fixed overheads are charged to profit as a single figure. Hence in multi product firm, net profit per product is not available.

However data is available as to how much contribution each product is making to the firms fixed charges to make profit.

If total contribution is greater than the fixed costs, there is profit, if less, then there is loss.

2. Contribution

Composition under different circumstances :

Selling Price Contains Profit –

Contribution = Fixed Cost + Profit.

Selling Price at Cost –

Contribution = Fixed Cost.

Selling Price at a loss –

Contribution = Fixed Cost - Loss

3. Income Determination under Variable and Absorption Costing.

In traditional absorption costing, both variable and fixed costs are charged to the products. Hence selling price less cost shows profit / loss per product.

Under marginal costing Prime cost plus manufacturing overheads which are variable are charged to the product.

Profit is ascertained by charging the fixed expenses to the contribution.

3. Income Determination under Variable and Absorption Costing.

In marginal costing closing inventory has no element of fixed costs, as all fixed costs are charged to income of the period. Hence profit under variable and absorption costing differ.

3. Income Determination under Variable and Absorption Costing.

When quantity sold in a year is more than quantity produced;

√ in marginal costing all fixed costs of the year only are charged to the income of the period.

√ √ in absorption costing all fixed costs of the year plus those of the previous year included in opening stocks are also charged to income of the period.

3. Income Determination under Variable and Absorption Costing.

As a result, when quantity sold in a year is more than quantity produced, profit under marginal costing is more than that under absorption costing.

3. Income Determination under Variable and Absorption Costing.

And, when quantity sold in a year is less than quantity produced, under marginal costing full fixed cost of the year is charged to the income, but under absorption costing a part of the cost is included in closing stocks, and balance charged to the income.

3. Income Determination under Variable and Absorption Costing.

As a result, when quantity sold in a year is less than quantity produced, profit under marginal costing is less than that under absorption costing..

4. Application of Variable Costing.

Profit of a firm can be improved by

increasing volume.

increasing selling price.

decreasing variable costs. And

decreasing fixed costs.

The contribution ratio indicates the relative profitability of the different sectors of the business whenever there is a change in selling price, variable costs or sales mix.

4. Application of Variable Costing.

Cover is made in the factory at the cost of

Material	25	
Labour	5	
Overheads		
variable	8	
fixed	7	Total Rs 45.

The firm sells 15,000 units a week at Rs 60 each.

If price drops to Rs 53, how many units should be sold to retain profit level.

4. Application of Variable Costing.

Cover is made in the factory at the marginal cost of Rs 38 ((Total Cost Rs 45 less fixed overhead Rs 7)

Sales 15,000 x 60	= 900,000
Marginal Cost 15,000 x 38	= 570,000
Contribution 15,000x 22	= 330,000
Fixed Overheads 15,000 x 7	= 105,000
Profit	= 225,000

New Sales Price less by Rs 7, hence new contribution Rs 15.

To earn contribution of Rs 330,000, firm needs to sell 330,000 ÷ 15 = 38,000 units.

4. Application of Variable Costing.

Revised profit after price cut

Sales	38,000 x 53	=	2,014,000
Marginal Cost	38,000 x 38	=	1,444,000
Contribution	38,000x 15	=	330,000
Fixed Overheads	15,000 x 7	=	105,000
Profit		=	225,000

4. Application of Variable Costing.

- **Make or buy decisions:**

Marginal cost analysis renders useful assistance in decisions whether to make a particular item in the factory or buy it economically from outside.

If the proposal is to buy something erstwhile made in the factory, the purchase cost needs to be lesser than the marginal cost.

4. Application of Variable Costing.

- **Make or buy decisions: contd.**

  And if the proposal is to make something erstwhile purchased from outside , then the cost of making should include all the additional costs including additional depreciation if equipment is to be added to make the component. Then it is compared with purchase cost to take decision.

4. Application of Variable Costing.

► Make or buy decisions: contd.

Cover is made in the factory at the cost of

Material	25		
Labour	5		
Overheads			
variable	8		
fixed	7	Total	Rs 45.

Purchase Manager offers to buy Covers @ Rs 40.

What should the firm do?

4. Application of Variable Costing.

- **Make or buy decisions: contd.**

If the firm decides to buy, it spends Rs 40 extra; and saves Rs 38 (Total Cost Rs 45 less fixed overhead Rs 7)

Purchase Manager's offer is rejected.

4. Application of Variable Costing.

- **Closure of a department or discontinuation of a product:**

The department that gives least contribution should be discarded.

The product the gives maximum contribution be chosen and the one with the least contribution be discontinued.

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4. Application of Variable Costing.

- **Offering quotation:**

Especially while quoting to the Government Agency lower prices can be offered as price in the open market will not be affected.

Marginal cost is the lower limit & if price is quoted below the limit. Loss would be made.

4. Application of Variable Costing.

- **Accepting an Offer or Exporting below normal price:**

  Again if domestic prices are not going to be affected, the export price can be lowered, but must be above marginal cost to benefit from new expert orders.

This is the last chapter! Bye for now!

4. Application of Variable Costing.

- **Maintaining a desired level of profit:**

  If selling price is to be reduced due to Government Policy or to meet competition, revised contribution due the change allows you to decide how many units need to sold to retain profits earned prior to change..