

# **E-contents for Mcom 4th semester**

## **Vanijya Mahavidyalaya, Patna University**

**Subject: Advanced cost Accounting**

**Paper code: COMEC-2**

**Unit:3**

**Topic: MARGINAL COSTING**

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# # INTRODUCTION

Marginal costing is the technique of controlling by bringing out the relationship between profit and loss and volume. It is defined as the amount at any given volume of output by which aggregate costs can be changed if the volume of output is increased or decreased by one unit.

For example if a manufacturing firm produces 100 units at a cost Rs 300 and 101 units at a cost Rs 320 the cost of an additional unit will be Rs 20 which is marginal cost.

$$\text{Marginal cost} = \text{Variable cost}$$

## # Characteristics of marginal costing

- All elements of costs are classified into fixed and variable components.
- The marginal or variable costs are treated as the cost of product.
- Under marginal costing the value of finished goods and work in progress is also comprised only of marginal costs. Fixed costs are not considered for valuation of closing stock of finished goods and closing work in progress.
- Fixed costs are treated as period costs and are charged to profit and loss account for the period for which they are incurred.
- Prices are determined with reference to marginal costs and contribution margin.
- Profitability of departments and products is determined with reference to their contribution margin.

## # Advantages of marginal costing

- **Simplified pricing policy-** Marginal cost per unit is constant from period to period within a short span of time, firm decision on pricing can be taken.
- **Proper recovery of overhead-** Overheads are recovered in costing on the basis of predetermined rates. If fixed overheads are included on the basis of predetermined rates, there will be under recovery of overheads if production is less or if overheads are more and vice-versa. Marginal costing avoids such under or over recovery of overheads.



- **Shows realistic profit**- The stock of finished goods and work in progress are carried on marginal cost basis and the fixed expenses are written off to profit and loss account as period cost. This shows the true profit of the period.
- **More control over expenditure**- Segregation of expenses as fixed and variable helps the management to exercise control over expenditure. The management can compare the actual variable expenditure with the budgeted variable expenses and take corrective action through analysis of variances.
- **Helps in decision making**- It helps the management in taking a number of business decision like make or buy, discontinuance of a product, replacement of machines.
- **Short term profit planning**- It helps in short term profit planning by BEP charts.

## # Computation of unit product cost under marginal costing method or variable costing method

**Example:**

A small company that produces a single product has the following cost structure.

Number of units produced	Rs6,000
<b>Variable costs per unit:</b>	
Direct materials	Rs2
Direct labor	Rs4
Variable manufacturing overhead	Rs1
Variable selling and Administrative expenses	Rs3
<b>Fixed costs per year:</b>	
Fixed manufacturing overhead	Rs30,000
Fixed selling and administrative expenses	Rs10,000



Unit product Cost Variable Costing Method	
Direct materials	Rs2
Direct labor	Rs4
Variable manufacturing overhead	Rs1
Unit product cost	Rs7
(The Rs30,000 fixed manufacturing overhead will be charged off in total against income as a period expense along with selling and administrative expenses)	

## # Absorption costing

Absorption costing is a costing system which treats all cost of production as product costs, regardless whether they are variable or fixed.

## # Computation of unit product cost under Absorption costing method or full costing method





**Example:**

A small company that produces a single product has the following cost structure.

Number of units produced	Rs6,000
<b>Variable costs per unit:</b>	
Direct materials	Rs2
Direct labor	Rs4
Variable manufacturing overhead	Rs1
Variable selling and Administrative expenses	Rs3
<b>Fixed costs per year:</b>	
Fixed manufacturing overhead	Rs30,000
Fixed selling and administrative expenses	Rs10,000

**Managers**

<b>Unit product Cost Absorption Costing Method</b>	
Direct materials	Rs2
Direct labor	Rs4
Variable manufacturing overhead	Rs1
Total variable production cost	----- Rs7
Fixed manufacturing overhead	Rs5
Unit product cost	----- Rs12 =====



## # Income comparison under variable and Absorption costing:

Number of units produced each year	60,000
<b>Variable cost per unit:</b>	Rs2
Direct materials	Rs4
Direct labor	Rs1
Variable Manufacturing Overhead	Rs3
Variable selling and Administrative expenses	
<b>Fixed costs per year:</b>	Rs30,000
Fixed manufacturing overhead	Rs10,000
Fixed selling and administrative expenses	
Units in beginning inventory	0
Units produced	6,000
Units Sold	5,000
Units in ending inventory	1,000
Selling price per unit	Rs20
<b>Selling and administrative expenses:</b>	
Variable per unit	Rs3
Fixed per year	Rs10,000

Variable Costing Income Statement	
Sales (Rs5,000units×Rs20 per unit)	Rs100,000
<b>Less variable expenses:</b>	
Variable cost of goods sold:	
Beginning inventory	Rs0
Add variable manufacturing costs (1,000 units×Rs7 per unit)	Rs42,000
Goods available for sale	Rs42,000
Less ending inventory (1,000 units×Rs7 per unit)	Rs7,000
Variable cost of goods sold	Rs35,000
variable selling and administrative expenses (5,000 units × Rs3 per unit)	Rs15,000
	50,000
Contribution margin (Rs100,000 – Rs50,000)	50,000
<b>Less fixed expenses:</b>	
Fixed manufacturing overhead	Rs30,000
Fixed selling and administrative expenses	Rs10,000
	Rs40,000
Net operating Income (Rs50,000 – Rs40,000)	Rs10,000





Absorption Costing Income Statement	
Sales (5,000 units×Rs20 per unit)	Rs100,000
<b>Less cost of goods sold:</b>	
Beginning inventory	Rs0
Add Cost of goods manufactured (6,000 units×Rs12per unit)	Rs72,000
Goods avail able for sale	Rs72,000
Less ending inventory	Rs12,000
Cost of goods sold	Rs60,000
Gross Margin (Rs100,000 – Rs60,000)	Rs40,000
<b>Less selling and administrative expenses</b>	
Variable selling and administrative expenses (5,000 × 3)	Rs15,000
Fixed selling and administrative expenses	Rs10,000
	Rs25,000
Net operating income (Rs40,000 – Rs25,000)	Rs15,000

## # LIMITATION OF MARGINAL COSTING

- Difficulties in classifying fixed and variable elements.
- Dependence on key factors.



- Scope for low profitability.
- Faulty valuation
- Unpredictable nature of cost.
- Marginal costing ignores time factors and investment.
- Understating of work in progress.

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