Marginal Costing

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Marginal Costing

Marginal costing is a cost accounting technique that helps businesses determine the cost of producing one additional unit of a product or service. Marginal costing is also known as variable costing because it only considers the variable costs associated with producing an additional unit of a product or service, such as direct labour and direct materials.

Under marginal costing, fixed costs, such as rent and salaries, are considered period costs that are not directly related to the production of a specific unit. Instead, fixed costs are expensed in the period they are incurred. This differs from absorption costing, another cost accounting technique that allocates fixed costs to each unit produced.

Objectives Of Marginal Costing

- The marginal costing technique is crucial for any business aiming to optimize the production of goods or delivery of services.
- The concept technically means extra costs added to the production cost due to additional unit(s
- It helps companies determine the selling price of a product or service.

Advantages

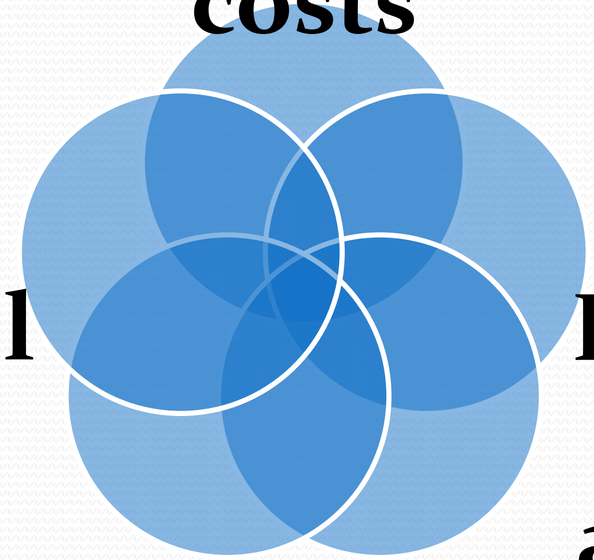
- Clear Cost-Volume-Profit Analys
- Effective Decision Makin
- Simplified Costing
- Efficient Cost Control

Advantages of Marginal Costing

- **Clear Cost-Volume-Profit Analysis**
- Marginal costing clearly explains the relationship between costs, volume, and profit. By distinguishing between fixed and variable costs, it becomes easier to calculate the contribution margin—the difference between sales revenue and variable costs. This information is crucial for determining the breakeven point and assessing the profitability of different product lines or services.
- **Effective Decision Making**
- Marginal costing aids decision-making by providing insights into various options' incremental costs and revenues. Marginal costing helps assess the impact on overall profitability. It can be evaluating the profitability of a new project, pricing decisions, or make-or-buy choices. It enables managers to make informed decisions by considering the incremental contribution of each option.

- **Simplified Costing**
- Unlike absorption costing, which allocates fixed overheads to products, marginal costing only considers variable costs directly attributable to production. This simplifies the costing process, making it easier to understand and apply. It also eliminates the complexities of apportioning fixed overheads, sometimes leading to misleading cost information.
- **Efficient Cost Control**
- It facilitates effective cost control by identifying and isolating variable costs. Managers can focus on managing and controlling these costs more directly, as they tend to be more controllable in the short term. By monitoring and analyzing variable costs, businesses can identify areas of cost overruns, implement cost-saving measures, and improve overall cost efficiency.

Disadvantages



Disadvantages of Marginal Costing

- **Doesn’t consider all costs:** This approach only considers variable costs and doesn’t consider fixed costs, such as rent and salaries. This can lead to an incomplete picture of a business’s costs and profitability.
- **Can be misleading:** It can be misleading in situations where fixed costs are high and production levels are low. In such cases, the marginal cost per unit may be high, leading to the incorrect conclusion that the product could be more profitable.

- **Difficult to allocate fixed costs:** This costing method doesn't allocate fixed costs to each unit produced. Hence, making it difficult to determine each unit's cost accurately.
- **Not suitable for long-term planning:** It is primarily a short-term planning tool and may not be suitable for long-term planning. In the long term, fixed costs may change and become variable, which could affect the profitability of products.
- **Doesn't account for inventory valuation:** This method needs to consider the value of inventory, which can lead to distorted profitability figures.

Features of Marginal Costing:

- (i) It is a technique of costing which is used to ascertain the marginal cost and to know the impact of variable cost on the volume of output.
- (ii) All costs are classified into fixed and variable cost on the basis of variability. Even semi fixed cost is segregated into fixed and variable cost.
- (iii) Variable costs alone are charged to production. Fixed costs are recovered from contribution.
- (iv) Valuation of stock of work in progress and finished goods is done on the basis of marginal cost.
- (v) Selling price is based on marginal cost plus the contribution.

TECHNIQUES

CONTRI BUTION → PROFIT VOLUME RATIO → BREAK EVEN POINT → MARGIN OF SAFETY

TOOLS AND TECHNIQUES OF MARGINAL COSTING

- Marginal costing is a technique of ascertaining cost used in any method of costing. According to this technique, variable costs are charged to cost units and the fixed cost attributable to the relevant period is written off in full against the contribution for that period. Contribution is the difference between sales value and variable cost. Thus, all expenses are classified under two groups, variable and fixed.

CONTRIBUTION

- Contribution margin of a product is the difference between the selling price and its variable cost. It is obtained by subtracting marginal cost from sales revenue of a given activity. The difference between sales revenue and variable cost is called contribution since it contributes towards fixed expenses and profit of the entire business. It is also known as 'unit contribution margin' or 'marginal contribution per unit'. Therefore, the character of contributions will have the following composition under different circumstances:
- **Selling price containing profit: Contribution = Fixed cost + Profit**
- **Selling price at Cost: Contribution = Fixed Cost**
- **Selling price at loss: Contribution = Fixed Cost – Loss**

PROFIT VOLUME RATIO

- The P/V Ratio shows percentage of contribution to the sales value i.e. margin as percentage of sales out of it the fixed cost is met and there is a profit.
- **Contribution = Sales Value × P/V Ratio**
- P/V ratio is a relative ratio. It cannot be adopted independently. If it is studied in an isolated way, it will not give much information. As fixed costs are not relevant in the calculation of P/V ratio, erroneous conclusions may be arrived.
- The Profit Volume Ratio can be calculated as follows:
- **PV Ratio = (Contribution/ Sales) x 100**
- **PV Ratio = (Changes in Profit/ Changes in Sales) x 100**
- **PV Ratio = 100 – Variable Cost Ratio**

BREAK EVEN POINT

- Break-even point is a point where the total sales or revenue are equal to total costs. In breakeven point, there is no profit or loss in the volume of sales. In other words, it is a point at which no profit no loss situation prevails in the operating activity of a business firm. This indicates that the break-even point is the minimum level of production at which total cost is recovered and no profit or no loss is sustained. The following fundamental formula is used to calculate break-even point:
- **Break-even Point = Fixed Cost/ P/V ratio**
- **Break-even Point (in units) = Fixed cost / Contribution per unit**

MARGIN OF SAFETY

- Margin of safety is the difference between the actual sales and sales at break-even point. Sales beyond break-even volume bring in profits. Such sales represent a margin of safety. Margin of safety is calculated as follows:
- **Margin of safety = Total sales – Break even sales**
- Margin of safety can also be calculated with the help of P/V ratio i.e.
- **Margin of safety = Profit/ P/V Ratio**
- Margin of safety can also be expressed as percentage of sales:
- **(Margin of safety/ Total sales)* 100**

- ***Thank You***