Chapter 8

Absorption Costing Vs. Variable Costing

There are two main techniques of cost ascertainment and income determination. Absorption costing and Variable Costing

The basic point of distinction between the two is regarding the treatment of fixed manufacturing overhead or fixed production overhead.

Absorption or Full Costing

It is a traditional method of income determination used for accounting purpose under which all manufacturing costs (variable or fixed) are treated as Product cost. In absorption costing all costs (both fixed and variable) are charge to product. The fixed factory overhead is absorbed in units produced at actual basis or at a rate pre-determine on the basis of normal capacity utilization.

Product Cost: These are inventoriable costs, which are included in the cost of product. It includes all manufacturing cost weather variable manufacturing costs or fixed manufacturing cost. For example - Direct Materials, Direct Labour and Factory Overhead (Fixed + Variable)

Period Cost: These are the cost which are not included in the cost of production. Non-manufacturing cost like administrative, selling and distribution overhead are treated as period Cost.

Marginal or Variable Costing

It is a managerial technique of income determination used for decision making under which only Variable manufacturing costs are treated as product cost and all fixed manufacturing costs and all non-manufacturing costs are treated as period cost. In variable costing, only variable costs are charge to products. Fixed costs are treated as period costs and charged to profit and Loss Account of the period.

Product Cost: These are inventoriable costs, which are included in the cost of product. It consider only variable production costs | manufacturing cost. For example - Direct Materials, Direct Labour and Variable Factory Overhead.

Period Cost: These are the cost which are not included in the cost of production. These are non-manufacturing cost. It includes fixed factory overhead, administrative, selling and distribution overhead.

Value of Product Cost and Closing Stock

Product cost is higher in absorption costing as compare to variable costing. It means closing stock also at a higher price in absorption costing as compare to variable costing.

Note: Non-production overheads | Non-manufacturing overhead (Administration, Selling & Distribution) are usually omitted from stock valuation because they are incurred after the stock has been brought to its present location and condition.

Profit under Absorption Costing and Variable Costing

Income Statement

(Under absorption Costing System)

Particulars	Total Rs.	Product A Rs.	Product B Rs.	Product C Rs.
Sales	XXXX	XXXX	XXXX	XXXX
Production Cost				
Direct Material Consumed				
Direct Labour Cost				
Variable Manufacturing Overhead				
Fixed Manufacturing Overhead				
Total Production Cost	XXXX	XXXX	XXXX	XXXX
Add: Opening Stock	XXXX	XXXX	XXXX	XXXX
Less: Closing Stock	XXXX	XXXX	XXXX	XXXX
	XXXX	XXXX	XXXX	XXXX
Production Cost of Goods sold	XXXX	XXXX	XXXX	XXXX
Add / (Less) :Under (or over) absorption of Fixed Manufacturing Overhead				
Add: Selling and Distribution Overhead				
Total Cost of Goods Sold	XXXX	XXXX	XXXX	XXXX
Profit [Sales – Total Cost]	XXXX	XXXX	XXXX	XXXX

Income Statement

(Under Variable Costing System)

Particulars	Total Rs.	Product A Rs.	Product B Rs.	Product C Rs.
Sales	XXXX	XXXX	XXXX	XXXX
Variable Manufacturing Cost	XXXX	XXXX	XXXX	XXXX
Add: Opening Stock	XXXX	XXXX	XXXX	XXXX
	XXXX	XXXX	XXXX	XXXX
Less: Closing stock	XXXX	XXXX	XXXX	XXXX
	XXXX	XXXX	XXXX	XXXX
Production Cost of Goods sold	XXXX	XXXX	XXXX	XXXX
Add: Variable Selling and Distribution Overhead	XXXX	XXXX	XXXX	XXXX
Total Variable Cost	XXXX	XXXX	XXXX	XXXX
Contribution [Sales – Total Variable Costs]	XXXX	XXXX	XXXX	XXXX
Less: Fixed Costs	XXXX	XXXX	XXXX	XXXX
Net Profit				

Example 1

Raj Ltd. furnishes the following information:
Production: 10,000 units
Sales: 5,000 units
Selling price: Rs.12 per unit
Variable cost: Rs.6 per unit
Fixed costs: Rs.40,000 per annum
Profit/loss under marginal costing method will be -

(a) Rs.10,000 (Profit)
(b) Rs.10,000 (Loss)
(c) Rs.20,000 (Profit)
(d) Rs.20,000 (Loss)

[CMA Inter December 2016]

Solution

	Rs.	Rs.
Sales 5,000 × 12		60,000
Variable Cost of goods produce 10,000 × 6 Less: Closing Stock 5,000 × 6	60,000 30,000	
Variable Cost of Goods Sold		30,000
Contribution (Sales – Variable Cost of Goods Sold)		30,000
Less: Fixed Cost		40,000
Loss under Marginal Costing		(10,000)

Difference in profit under Absorption Costing and Variable Costing:

Profit under absorption costing and variable costing may be different because of difference in the stock valuation.

Situation	Profit in variable costing	Profit in absorption costing
Production = Sales	Equal	Equal
Production > Sales	Lower	Higher
Production < Sales	Higher	Lower

PGT Commerce

KVS

1. Which is one is true?

(a) The valuation of stock is at a higher price in absorption costing as compared to marginal costing.
(b) Increase in selling, price will have no effect on margin of safety.
(c) Semi-variable costs form a part of product cost in marginal costing
(d) Profit-volume ratio indicates the relationship between profit and sales.

P.G.T. K.V.S. 2016

2. One of the basic differences between marginal costing and absorption costing is regarding the treatment of

(a) Direct material
(b) Variable overheads
(c) Fixed overheads
(d) Prime cost

P.G.T. K.V.S. 2017

DSSSB

1. Which cost known as periodical cost?

(a) Fixed cost
(b) Variable cost
(c) Revenue cost
(d) Marginal cost

DSSSB PGT (2015 Tier II)

Jharkhand PGT

1. Non-production overheads are usually omitted from stock valuation for which one of the following reasons?

(a) They are incurred after the stock has been brought to its present location and condition.
(b) They cannot be identified with individual products.
(c) They are fixed period costs.
(d) They are outside the control of production management.

Jharkhand PGT - 2017

M.Com (Entrance) Previous Year Questions

Theoretical Questions

1. What costs are treated as product costs under variable costing? *M.Com (Entrance 2012)*	
(a) Only direct costs (b) Only variable production costs	(c) All variable costs (d) All variable and fixed manufacturing costs
2. Profit under absorption costing will be higher than under marginal costing if: *M.Com (Entrance 2017)*	
(a) Produced units > Units sold (b) Production Units = Units sold	(c) Production Units < Units sold (d) Profit cannot be determined with given statement

Numerical Questions

1. **Following information is available of XYZ Limited for quarter ended June, 2017:**
Fixed cost Rs. 5,00,000
Variable cost Rs. 10 per unit
Selling price Rs. 15 per unit
Output level 1,50,000 units.
What will be the amount of profit earned during the quarter using the marginal costing technique? *M.Com (Entrance 2018)*

(a) Rs.2,50,000	(c) Rs.5,00,000
(b) Rs.7,50,000	(d) Rs.10,00,000

U.G.C. N.E.T. Previous Year Questions

1. **The profits calculated by marginal costing and absorption costing are different because of:**

(a) Capital and Revenue
(b) Opening Stock
(c) Valuation of Stock
(d) Closing Stock

UGC-NET Paper II (December 2005)