

# Accounting and Finance Innovations

## Chapter 7

### Techniques of Costing

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#### Introduction

Apart from different costing methods already discussed, various costing techniques are also used to find out costs. These techniques are categorized under the following heads.

#### Absorption Costing

Absorption costing, sometimes called full absorption costing or historical costing, is a managerial accounting method for capturing all cost associated with manufacturing a particular product. The direct and indirect costs, such as direct material, direct labour, rent and insurance, etc are accounted for using this method.

It is the ascertainment of costs after they have been incurred. It is defined as the "practice of charging all costs, both fixed and variable, to operations, processes or products". (Rao, 2000). It is required by generally accepted accounting principles (GAAP) for external reporting.

#### FORMAT

	N	N
Sales		XX
Less: Production Costs	X	
Opening Stock	X	
Direct Material	X	
Direct Labour	X	
Direct Expenses	X	
Variable Overhead	X	
Fixed Production Overhead	<u>X</u>	
Goods available for Sale	X	
Less: Closing Stock	<u>X</u>	
Add: Under Absorption	X	
Over absorption	<u>X</u>	<u>X</u>
Gross Profit		X
Less: Non production Cost:		
Selling and Distribution expenses	X	
Administrative expenses	X	
Other expenses (If any specify	<u>X</u>	<u>X</u>
Profit before tax		X
Less: Income tax		<u>X</u>
Not Profit after tax		<u><u>X</u></u>

#### Advantages of Absorption Costing

1. It is accepted by the Inland Revenue as stock is not undervalued.
2. The absorption costing technique is always used to prepare financial accounting statements.

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3. The absorption costing technique is often used to determine inventory values in accordance with International Financial Reporting Standards (IFRS).
4. It is also used to determine a profitable selling price that covers all costs of making each unit of product.
5. This costing technique recognizes the fact that each unit produced must cover (absorbed) its share of fixed overheads.
6. It adheres to matching principle by making sure that revenue instead of treating fixed overhead as a period costs.
7. It is more consistent with external reporting rules and regulations such as company laws and IFRS (International Financial Reporting Standards).
8. Produces a profit amounts that fluctuate less when production is constant but sales fluctuate. For instance in businesses that have seasonal sales.

### Disadvantages of Absorption Costing

1. It is not useful for management to use it to make decisions, control and planning because it emphasizes on total costs running the aggregate of both fixed and variable costs.
2. Besides, since under this technique the manager emphasizes on the total costs, ignoring the cost volume profit relationship. The manager therefore, needs to use its, his/her intuition for decision making.
3. This technique of costing can potentially mislead investors. This is because fixed costs are deducted from revenues unless all the manufactured products are sold, meaning that a company's profit level can appear better than it actually during a given accounting period.
4. There is difficulty in comparing and controlling costs.
5. Apportionment of overheads is arbitrarily done.
6. Fixed cost inclusion is not justified.

### Marginal Costing

According to CIMA official terminology, marginal costing is defined as "a principle whereby variable costs are charged to cost units and the fixed costs attributable to the relevant periods is written off in full against the contribution for that period. Thus, marginal costing is a technique used in writing cost information with much emphasis placed on the distinction between costs that vary with output and those that main unaffected regardless of changes in the level of output, so that the management may be able to see the effect which changes in the method and/or volume of production have on the profitability position of the organization.

Marginal costing is the technique of controlling by bringing out the relationship between profit and volume of production. It is useful in profit planning, because it enables management determine profitability at different level of production and sale. It is also useful in decision making especially in fixed of selling prices, export decision as well as make or buy decisions. This technique also known as direct costing or variable costing. Breakeven analysis and P/V ratio are useful techniques of marginal costing.

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## MARGINAL COSTING FORMAT

	₦	₦
Sales Revenue		XX
Less: Variable Cost of Production	X	
Opening Stock	X	
Direct Material	X	
Direct Labour	X	
Direct Expenses	X	
Variable Production Overhead Cost	<u>X</u>	
	X	
Less: Closing Stock	<u>X</u>	
Add: Variable Un-production Cost	X	
Selling and Distribution Cost	X	
Administration Cost	X	
Other Cost (if applicable)	X	<u>X</u>
Contribution		X
Less: Total Fixed Cost:		
Production	X	
Administration	X	
Selling	<u>X</u>	<u>X</u>
Net Profit		<u><u>X</u></u>

### Features of Marginal Costing

Following are the features of marginal costing.

1. Marginal costing is used to know the impact of variable cost on the volume of production or output.
2. Break-even analysis is an integral and important part of marginal costing.
3. Contribution of each product or department is a foundation to know the profitability of a product or department.
4. Addition of variable cost and profit to contribution is equal to selling price.
5. Marginal costing is the base of valuation of stock of finished product and work-in-progress.
6. Fixed cost is recovered from contribution and variable cost is charged to product.
7. Costs are classified on the basis of fixed and variable costs only. Even semi-fixed costs are segregated into fixed and variable cost.

### Basic Characteristics of Marginal Costing

1. It is a costing technique of analysis and presentation of cost rather than an independent of method of costing. It can be applied any other method or technique of costing such as standard costing and, budgeting and budgetary control.
2. Basically it involves differentiation of variable cost from fixed cost. It considers variable costs in its analysis.
3. It guides pricing and other managerial decisions on the basis of contribution which means the difference between sales and variable cost of sales.
4. The stock of finished goods and work-in-progress are valued at marginal cost.
5. Fixed costs are charged against the contribution earned during a period. No portion of fixed cost is carried forward to the next period.
6. The difference between contribution and fixed cost represents either profit or loss.

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## Marginal Costing Versus Absorption Costing

	Absorption Costing	Marginal Costing
1.	It is a costing system whereby all manufacturing costs, including variable and fixed costs are classified in the cost of product costs.	It is a costing technique whereby the marginal cost is charged to units cost while the fixed cost is completely written off against the contribution.
2.	Both variable and fixed costs are considered in the cost of the product.	Only variable costs are considered product cost and fixed costs are classified as period cost.
3.	Under absorption costing, contribution per unit is considered	Under marginal costing, net profit per unit is considered.
4.	Major consideration on the cost of each unit is given priority.	Major consideration on the cost of producing the next unit is given priority.
5.	Emphasizes overhead recovery	Emphasizes the calculation of the contribution of each unit.
6.	Overheads are classified into production, administration, distribution and selling overheads.	Overheads are classified into fixed and variable overheads.
7.	It is not easy to operate	It is easy to operate.
8.	It is GAAP compliant	It is not GAAP compliant
9.	It is useful for external reporting to the government, tax authorities and shareholders.	It is used for internal reporting particular to the management for decision making
10.	It is not very helpful in making managerial decisions.	It is very helpful in making decisions due to the fact that it, considers additional cost involved.
11.	Cost per unit is affected by variables in the opening and closing stock.	The cost per unit is not affected by variances in the opening and closing stock.
12.	Apportionment of overheads costs is arbitrary and this sometimes results to under and over absorption of overheads.	Because fixed costs are excluded, there is no arbitrary apportionment of overheads.

### ILLUSTRATION 1

Anero Limited Manufactures and sells a single product called Anenco Omega

Anenco Omega

₦

Selling Price

30

Direct Costs

8

### Details for the Months of September and October are as follows:

	September	October
Production	750 Units	1,000 Units
Sales	600 Units	1,150 Units
Fixed Production Overheads	₦4,500	₦4,500

The normal level of activity for both sales and production is 900 units per month. Fixed production overheads are budgeted as ₦4,500 per month and are absorbed on a unit basis.

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## Required:

Prepare for September and October profit statements showing stock valuation based on the following principles:

- Absorption Costing
- Marginal Costing
- Comment briefly on the Result

### Suggested Solution Anero Limited

#### (a) Profit Statements Using Absorption Costing

	September		October	
	₦	₦	₦	₦
Sales Revenue		18,000		
Cost of Goods Sold:				
Opening Stock	-		1,950	
Direct Costs	6,000		8,000	
Fixed Production Overhead	<u>3,750</u>		<u>5,000</u>	
	9,750		14,950	
Lessing Closing Stock	<u>1,950</u>		<u>-</u>	
	7,800		(500)	
Under/Over absorption of Production Overhead	<u>750</u>			
		8,550		<u>14,450</u>
Profit		<u>9,450</u>		<u>20,050</u>

Calculation of Fixed overhead absorption rate:

$$\frac{4,500}{900} = \text{₦}5$$

## Workings

Sales:	September	= 600 Units x ₦30	= ₦18,000
	October	= 1150 Units x ₦30	= ₦34,500
Direct Costs:	September	= 750 Units x ₦8	= ₦6,000
	October	= 1000 Units x ₦8	= ₦8,000
Fixed Production Overheads:	September	= 750 Units x ₦5	= ₦3,750
	October	= 1000 Units x ₦5	= ₦5,000
Under/Over absorption:	September	= ₦4,500 - ₦3,750	= ₦750
	October	= ₦4,500 - ₦5,000	= (₦500)
Closing Stock	September	= 150Units x (₦8 + ₦5,750)	= ₦1,950

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## (b) Profit Statement Using Marginal Costing

	September		October	
	₦	₦	₦	₦
Sales Revenue:		18,000		34,500
Variable Cost of goods sold:				
Opening Stock		-	1,200	
Direct Cost	<u>6,000</u>		8,000	
	6,000		9,200	
Less Closing Stock (150 x ₦8)	<u>1,200</u>	<u>4,800</u>	-	<u>9,200</u>
Contribution		13,200		25,300
Fixed Production Overhead	<u>4,500</u>			<u>4,500</u>
Profit	<u>8,700</u>			<u>20,800</u>

## (c) Brief Comments on the Result

Since the opening and closing stock are both zero, and the total profit for the two months remained the same under both techniques of costing products. In the month of September the profit was ₦750 when absorption costing technique was used. This is due to the fixed production overhead carried forward in the closing stock of the month of September (150 Units x ₦5). This carried over and charged to the month of October when the units must have been sold.

## Illustration 2

Manuchom Integrated Services manufactures and sells a single product. The following data were given for the year ended 31<sup>st</sup> March 2019 and 2020.

- (a)
- |                          |    |     |
|--------------------------|----|-----|
| Selling price per bottle |    | ₦15 |
| Direct Cost per bottle   |    |     |
| Material                 |    | ₦3  |
| Labour                   | ₦4 |     |
| Expenses                 |    | ₦3  |

Each carton of product contains 6 bottles

- (b) Total fixed overhead per annum is ₦240,000 and it is absorbed into production on the basis of cartons produced.

- (c)
- |                      |            |            |
|----------------------|------------|------------|
|                      | 31/03/2019 | 31/03/2020 |
| Sales (Cartons)      | 50,000     | 60,000     |
| Production (Cartons) | 65,000     | 62,000     |

- (d) The normal production per annum is 62,500 cartons.

### Required:

Prepare for each of the two years ending 31<sup>st</sup> March, 2019 and 2020, a profit statement base on the principles of

- (i) Absorption Costing
- (ii) Marginal Costing

(ICAN, Adapted)

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## Suggested Solution

### Manuchom Integrated Services

#### Profit Statement for the Year Ended 30<sup>th</sup> March 2019 Using Absorption Costing

	N'000	N'000
Sales (N15 x 6 x 50,000)		4,500
Less: Total Cost of Production:		
Material (N3 x 6 x 65,000)	1,170	
Labour (N4 x 6 x 65,000)	1,500	
Expenses (N3 x 6 x 65,000)	1,170	
Fixed Production Overhead (N3.84 x 65,000)	<u>249.6</u>	
	<u>4,149.6</u>	
Less: Closing Stock [N63.84 x 6 x 15,000 (65,000 – 50,000)]	<u>957.6</u>	
	319.2	
Add: Under absorbed Fixed Off	<u>9.6</u>	<u>3201.6</u>
Gross profit		1,298.4
Less Operating expenses		<u>—</u>
Net Profit		<u>1,298.4</u>

#### Profit Statement for the Year Ended 30/03/2019 Using Marginal Costing

	N'000	N'000
Sales (N15 x 6 x 50,000)		4,500
Less: Variable Cost:		
Materials (N3 x 6 x 65,000)	1,170	
Labour (N4 x 6 x 65,000)	1,500	
Expenses (N3 x 6 x 65,000)	<u>1,170</u>	
	<u>3,900</u>	
Less: Closing Stock [N60 x 15,000]	<u>900</u>	3,000
Contribution		1,500
Less: Total Fixed Production Cost		<u>240</u>
Gross profit		<u>1,260</u>
Net Profit		

#### Profit Statement for the Year Ended 30/03/2020 Using Absorption Costing

	N'000	N'000
Sales (N15 x 6 x 60,000)		5,400
Less: Cost of Production:		
Opening Stock (N63.84 x 15,000)	957.6	
Materials (N3 x 6 x 62,000)	116.6	
Labour (N4 x 6 x 62,000)	1488.0	
Expenses (N3 x 6 x 62,000)	116.6	
Fixed Production Overhead (N3.84 x 62,000)	<u>238.1</u>	
	2,916.9	
Less: Closing Stock [N63.84 x 17,000]	<u>1,085.3</u>	
Less: Over Absorbed Production Overhead	<u>1,831.6</u>	
	<u>1.9</u>	<u>1,829.7</u>
		<u>3,570.3</u>
Less: Operating expenses		<u>—</u>
Net Profit		<u>3,570.3</u>

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## Profit Statement for the Year Ended 30/03/2020 Using Absorption Costing

	N'000	N'000
Sales (N15 x 6 x 60,000)		5,400
Less: Variable Cost:		
Opening Stock (N60 x 15,000)	900	
Materials (N3 x 6 x 62,000)	1,116	
Labour (N4 x 6 x 62,000)	1,488	
Expenses (N3 x 6 x 62,000)	<u>1,116</u>	
	4,620	
Less: Closing Stock (N60 x 17,000)	<u>1,020</u>	<u>3,600</u>
Contribution		1,800
Net Profit		<u><u>1,560</u></u>

### 1. Calculation of Opening and Closing Stocks in Units

	30/03/2019	30/03/2020
	N	N
Opening Stock	—	15,000
Production:	65,000	62,000
	65,000	77,000
Less: Closing Stock	<u>15,000</u>	<u>17,000</u>
Sales	<u>50,000</u>	<u>60,000</u>
2. Selling price per carton = N15 x 6	= N900	
3. Fixed Production Overhead = $\frac{240,000}{62,500}$	= N3.84	

### 4. Absorption Costing Technique

	N	N
Total Cost Per Carton	3	
Direct Material per bottle	4	
Labour	<u>3</u>	
Expenses	10 x 6	= 60
Fixed Production Overhead		<u>3.84</u>
		<u>63.84</u>

### 5. Marginal Costing Per Carton

	N	N
Direct Material per bottle	3	
Labour	4	
Expenses	<u>4</u>	
	10 x 6	= 60

### 6.(i) Under/Over Absorption of Overhead Determination for the Year ended 30/03/2019

	N
Absorbed Overhead	240
Actual Overhead incurred (65,000 x N3.84) =	<u>249.6</u>
Under absorption of overhead	<u><u>9.6</u></u>

### (ii) Under/Over Absorption of Overhead Determination for the Year ended 30/03/2020

	N
Absorbed Overhead	240
Actual Overhead incurred (62,000 x N3.84) =	<u>238.1</u>
Under absorption of overhead	<u><u>9.6</u></u>

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## Facts About Under/Over Overhead Absorption

If the overheads absorbed are higher than the actual overhead incurred, it is called over absorption. If the overheads absorbed is lower than the actual overheads incurred during the accounting period, it is called under absorption.

**Note:** Under absorption is set right by the plus rate (Add back), while over absorption is adjusted by minus rate (deduct from) total costs of the period.

### Illustration 3

The budget of Nwamadi Ltd provides for the manufacture and sale of 15,000 electronic watches per month. The unit standard cost is made up of the following:

		₦
Direct Material	4.00	
Direct Labour	1.00	
Fixed Overhead		<u>2.50</u>
		<u>7.50</u>

The selling price per unit is ₦9.00

Production and sales quantities for periods 1 and 2 were as follows:

Periods	1	2
Production	15,000	15,000
Sales	12,000	18,000

### You are required to:

- (a) Prepare operating statements for each of the 1,000 periods:
  - (i) Using marginal costing technique, and
  - (ii) Using Absorption costing techniques
- (b) Comment on the differences of the two systems as regards
  - (i) Period profit
  - (ii) Stock valuation

### Suggested Solution

#### Nwamadi Ltd. Marginal Costing Statement of Income for Period 1

	₦	₦
Sales (12,000 x 9)		108,000
Less: Variable cost of Sales:		
Direct Materials (15,000 x 4)	60,000	
Direct Labour (15,000 x 1)	<u>15,000</u>	
	75,000	
Less: Closing Stock (3,000 x 5)	<u>15,000</u>	60,000
Contribution		48,000
Less: Fixed Overhead(15,000 x 2.5)		<u>37,500</u>
Profit		<u>10,500</u>

#### Period 2

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	₦	₦
Sales (₦18,000 x 9)		162,000
Less: Variable cost of Sales:		
Direct Materials (15,000 x ₦4)	60,000	
Direct Labour (15,000 x ₦1)	15,000	
Add Opening Stock (3,000 x ₦5)	<u>15,000</u>	<u>90,000</u>
Contribution		72,000
Less: Fixed Overhead(3,000 x 5)		<u>37,500</u>
Profit		<u>34,500</u>

### Nwamadi Ltd. Absorption Costing Statement of Income for Period 1

	₦	₦
Sales (₦12,000 x 9)		108,000
Less: Production cost of Sales:		
Direct Materials (15,000 x ₦4)	60,000	
Direct Labour (15,000 x ₦1)	15,000	
Fixed Production Overhead(15,000 x ₦2.5)	<u>37,500</u>	
Add Opening Stock	112,500	
Goods Available for Sales	—	
	_____	
Less: Closing Stock(3,000 x 7.5)	112,500	
	<u>22,500</u>	<u>90,000</u>
Profit		<u>18,000</u>

### Period 2

	₦	₦
Sales (₦9 x 12,000 )		108,000
Less: Production cost of Sales:		
Direct Materials (15,000 x ₦4)	60,000	
Direct Labour (15,000 x ₦1)	15,000	
Fixed Production(15,000 x ₦2.5)	<u>37,500</u>	
	112,500	
Add Opening Stock(3,000 x 7.5)	<u>22,500</u>	

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Less: Closing Stock	135,000	
	<u>          </u>	<u>135,000</u>
Profit		<u>27,000</u>

### b(i) Differences in the Periods Profits

The two techniques of costing showed different profit figures for each period. This is mainly due to how each technique treated fixed production overheads which invariably affected both the closing and opening stock values and the respective amounts charged against production cost of sales sold, hence affected the profit figures as well.

### b(ii) Differences in the Stock Valuation

A meticulous examination of the closing stock values in period 1 under the two costing approaches showed that the value under absorption costing (₦22,500) is greater than the value under the marginal costing approach (₦15,000).

Under the absorption costing = 3,000 x ₦7.50	=	₦22,500
Under marginal Costing = 3,000 x ₦5.00	=	₦15,000
		₦7,500
₦7,500 3000 Units		₦2.50

By the simple calculation, the real cause of the differences was the fixed production overhead (3,000 x ₦2.50) of the unsold stock included in the production cost under the absorption costing.

### Illustration

The following data is available for Boy Chemical Paints Ltd, which manufactures three brands of products, namely chemical X, chemical Y, and chemical Z, respectively for the month ended 30<sup>th</sup> October, 2020.

	Product X ₦'000	Product Y ₦'000	Product Z ₦'000	Total ₦'000
Sales	<u>273</u>	<u>759</u>	<u>121</u>	<u>1,153</u>
Variable Costs:				
Material	82	189	46	317
Laour	32	129	17	178
VOH	24	45	9	78
FOH	<u>46</u>	<u>136</u>	<u>17</u>	<u>199</u>
Total Cost	<u>184</u>	<u>499</u>	<u>89</u>	<u>772</u>
Profit	<u>89</u>	<u>260</u>	<u>32</u>	<u>381</u>

Product variable cost structures and the fixed overhead were budgeted, but the actual sales for October, 2020 were as follows:

Product	X	₦304,000
Product	Y	₦700,000
Product	Z	₦144,000

### Required:

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- (a) Present the Income Statement for the month of October in the same formal as the above.  
 (b) Use the contribution approach to explain the variance between budgeting and actual profits.

### Suggested Solution

#### Boy Chemical Paints Ltd.

#### (a) Income Statement for the Month Ended 30<sup>th</sup> October, 2020

	Product X N'000	Product Y N'000	Product Z N'000	Total N'000
Sales	<u>304</u>	<u>700</u>	<u>144</u>	<u>1,148</u>
Variable Costs:				
Material	82	189	46	317
Labour	32	129	17	178
VOH	24	45	9	78
FOH	<u>46</u>	<u>136</u>	<u>17</u>	<u>199</u>
	<u>184</u>	<u>499</u>	<u>89</u>	<u>772</u>
Profit	<u>120</u>	<u>201</u>	<u>55</u>	<u>376</u>

#### Marginal Costing Income Statement for the Month Ended 30<sup>th</sup> October, 2020

	Product X N'000	Product Y N'000	Product Z N'000	Total N'000
Sales	<u>304</u>	<u>700</u>	<u>144</u>	<u>1,148</u>
Variable Costs:				
Material	82	189	46	317
Laour	32	129	17	178
VOH	<u>24</u>	<u>45</u>	<u>9</u>	<u>78</u>
	138	363	72	573
Contribution	166	337	72	575
Less: FOH	<u>46</u>	<u>136</u>	<u>17</u>	<u>199</u>
Profit	<u>120</u>	<u>201</u>	<u>55</u>	<u>376</u>

#### Summary

Total Budgeted Profit	N381,000
Actual Realised Profit	<u>N376,000</u>
	<u>N 5,000</u>

The difference between the budgeted and actual profit from summary is five thousand naira (N5,000) and this was due to the fall in the budgeted amount of sales experienced during the period. When the absorption costing is adopted, fixed production overheads are charged together with the variable costs of production to the production for the period, this enables the fixed overheads component to be carried over to the next period stocks outstanding (either as completed goods or work in progress), that would e carried as closing stocks of the period.

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The implication of the above scenario is that for any particular period, it is only that portion of the fixed production overheads in the actual quantities of stocks sold during a particular period that would be recovered from sales. In the case of the usage of marginal costing, however, variable costs of production are charged only to production costs, the fixed production overheads component incurred in the period is separated and charged in full against the sales value of the period under this costing technique, no part of the fixed production overheads incurred in a period is carried over to the next period.

## Revision Exercise

1. What do you understand by the term marginal costing? List some of its benefits you know.
2. Enumerate and discuss the advantages of Absorption costing.
3. (a) Distinguish Absorption Costing from Marginal Costing.  
(b) How are stocks valued under each method?
4. What are the benefits of marginal costing? How does it help management of a firm in the production of sales of its products?
5. What are basic characteristics of marginal costing technique you know?
6. Write short notes on each of the following:
  - (a) Marginal Cost
  - (b) Marginal Costing
  - (c) Contribution Margin
  - (d) Margin of Safety
7. The following information have been extracted from the budgets and standard cost of ABC Ltd., a Company which manufactures and sells a single product.

	₦ Per Unit
Selling Price	45.00
Direct Materials Cost	10.00
Direct Wages Cost	4.00
Variable Overhead Cost	₦ 2.50

Fixed production overhead costs are budgeted at ₦400,000 per annum. Normal production levels are thought to be 320,000 units per annum.

Budgeted selling and distribution costs are as follows:

Variable	₦1.50 per unit sold
Fixed	₦80,000 per annum

Budgeted administration costs are ₦120,000 per annum

The following patterns of sales and production are expected during the First Six Months of 2019.

	April - June	July - Sept
Sales	₦60,000	₦90,000
Production (Units)	₦70,000	₦100,000

There is no opening stock on April 2019.

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## Required

Prepared Income Standard for each of the two quarters using

- (a) Marginal Costing, and
  - (b) Absorption Costing (CIMA Adopted)
8. The normal annual level of operations of ONWUGBUTA LTD. Is 90,000 cartons of a special lager upon which the production overhead absorption rate is calculated.

At the end of the of the accounting period the records revealed the following:

Production	95,000 Cartons
Sales	85,000 Cartons
Selling price	₦12.00
Fixed overhead budgeted and incurred	₦200,000
Production Costs	₦
Direct materials	2.50
Direct Labor	2.00
Variable Overhead	2.00
Selling and Distribution expenses:	
Fixed	₦50,000

Variable – 5% of sales revenue

There was no opening stock of finished goods. Works in progress at the beginning and the end of the period were the same.

You are required to prepare income statement for the year ended 30<sup>th</sup> June 2020 – based on:

- (a) Absorption Costing, and
- (b) Marginal Costing.

## References

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# **Accounting and Finance Innovations**

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