Marginal Costing

Definition: Marginal Costing is a costing technique wherein the marginal cost, i.e. variable cost is charged to units of cost, while the fixed cost for the period is completely written off against the contribution.

Marginal cost is the change in the total cost when the quantity produced is incremented by one. That is, it is the cost of producing one more unit of a good. For example, let us suppose:

Variable cost per unit = Rs 25
Fixed cost = Rs 1,00,000
Cost of 10,000 units = 25 × 10,000 = Rs 2,50,000
Total Cost of 10,000 units = Fixed Cost + Variable Cost
= 1,00,000 + 2,50,000
= Rs 3,50,000
Total cost of 10,001 units = 1,00,000 + 2,50,025
= Rs 3,50,025
Marginal Cost = 3,50,025 – 3,50,000
= Rs 25

The term **marginal cost implies the additional cost involved in producing an extra unit of output**, which can be reckoned by total variable cost assigned to one unit. It can be calculated as:

Marginal Cost = Direct Material + Direct Labor + Direct Expenses + Variable Overheads

Characteristics of Marginal Costing

- **Classification into Fixed and Variable Cost**: Costs are bifurcated, on the basis of variability into fixed cost and variable costs. In the same way, semi variable cost is separated.

- **Valuation of Stock**: While valuing the finished goods and work in progress, only variable cost are taken into account. However, the variable selling and distribution overheads are not included in the valuation of inventory.
- **Determination of Price**: The prices are determined on the basis of marginal cost and marginal contribution.
- **Profitability**: The ascertainment of departmental and product's profitability is based on the contribution margin.

In addition to the above characteristics, marginal costing system brings together the techniques of cost recording and reporting.

Features of Marginal Costing

Features of marginal costing are as follows:

- Marginal costing is used to know the impact of variable cost on the volume of production or output.
- Break-even analysis is an integral and important part of marginal costing.
- Contribution of each product or department is a foundation to know the profitability of the product or department.
- Addition of variable cost and profit to contribution is equal to selling price.
- Marginal costing is the base of valuation of stock of finished product and work in progress.
- Fixed cost is recovered from contribution and variable cost is charged to production.
- Costs are classified on the basis of fixed and variable costs only. Semi-fixed prices are also converted either as fixed cost or as variable cost.

Ascertainment of Profit under Marginal Cost

'Contribution' is a fund that is equal to the selling price of a product less marginal cost. Contribution may be described as follows:

Contribution = Selling Price – Marginal Cost

Contribution = Fixed Expenses + Profit

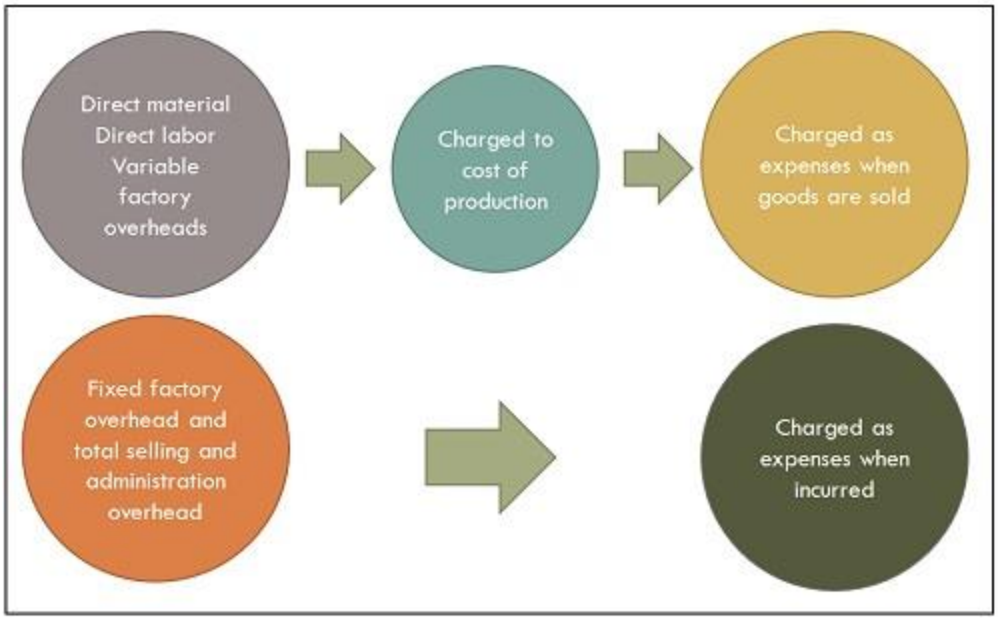
Contribution – Fixed Expenses = Profit

Income Statement under Marginal Costing

Income Statement For the year ended 31-03-2014		
Particulars	Amount	Total
Sales		25,00,000
Less: Variable Cost:		
Cost of goods manufactured	12,00,000	
Variable Selling Expenses	3,00,000	
Variable Administration Expenses	50,000	
		15,50,000
Contribution		9,50,000
Less: Fixed Cost:		
Fixed Administration Expenses	70,000	

Fixed Selling Expenses	1,30,000	2,00,000
		7,50,000

Marginal Costing Approach



The difference between product costs and period costs forms a basis for marginal costing technique, wherein only **variable cost is considered as the product cost while the fixed cost is deemed as a period cost**, which incurs during the period, irrespective of the level of activity.

Facts Concerning Marginal Costing

- **Cost Ascertainment**: The basis for ascertaining cost in marginal costing is the nature of cost, which gives an idea of the cost behavior, that has a great impact on the profitability of the firm.
- **Special technique**: It is not a unique method of costing, like contract costing, process costing, batch costing. But, marginal costing is a different type of technique, used by the managers for

the purpose of decision making. It provides a basis for understanding cost data so as to gauge the profitability of various products, processes and cost centers.

- **Decision Making**: It has a great role to play, in the field of decision making, as the changes in the level of activity pose a serious problem to the management of the undertaking.

Marginal Costing assists the managers in taking end number of business decisions, such as replacement of machines, discontinuing a product or service, etc. It also helps the management in ascertaining the appropriate level of activity, through break even analysis, that reflect the impact of increasing or decreasing production level, on the company's overall profit.

Advantages of Marginal Costing

The advantages of marginal costing are as follows:

- Easy to operate and simple to understand.
- Marginal costing is useful in profit planning; it is helpful to determine profitability at different level of production and sale.
- It is useful in decision making about fixation of selling price, export decision and make or buy decision.
- Break even analysis and P/V ratio are useful techniques of marginal costing.
- Evaluation of different departments is possible through marginal costing.
- By avoiding arbitrary allocation of fixed cost, it provides control over variable cost.
- Fixed overhead recovery rate is easy.
- Under marginal costing, valuation of inventory done at marginal cost. Therefore, it is not possible to carry forward illogical fixed overheads from one accounting period to the next period.
- Since fixed cost is not controllable in short period, it helps to concentrate in control over variable cost.