COST ACCOUNTING - MARGINAL COSTING

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:

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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
```

Need for Marginal Costing

Let us see why marginal costing is required:

- Variable cost per unit remains constant; any increase or decrease in production changes the total cost of output.
- Total fixed cost remains unchanged up to a certain level of production and does not vary with increase or decrease in production. It means the fixed cost remains constant in terms of total cost.
- Fixed expenses exclude from the total cost in marginal costing technique and provide us the same cost per unit up to a certain level of production.

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:

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Contribution                  = Selling Price – Marginal Cost
Contribution                  = Fixed Expenses + Profit
Contribution – Fixed Expenses = Profit
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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

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.