

Topic 4.

ALTERNATIVE

COSTING METHODS

Vera Butkouskaya



CONTENT

- 4.1. Absorption Costing
- 4.2. Variable Costing

Introduction

- Planning decisions typically include an analysis of how the considered options affects future reported profit.
- Increases in reported profit are the object of many decisions related to cost reduction.
- Reported profit is a key number in the performance evaluation of managers.



Introduction



- The reported profit number of manufacturing companies is affected by cost accounting choices related to the stock.

gross margin (GM) and contribution margin (CM)

Gross Margin = Revenues – Cost of goods sold

Contribution margin = Revenues – All variable costs

Variable vs. Absorption Costing

- **variable (direct) costing** VC and
- **absorption (full) costing** AC
- are two different methods of applying production costs to products or services

Matter of timing(?)

Variable (direct) Costing

- **Variable (direct) costing** is a method of stock costing in which
 - ▷ all variable manufacturing costs
 - ▷ are included as inventoriable costs.
 - ▷ All fixed manufacturing costs
 - ▷ are excluded from inventoriable costs;
 - ▷ *they are costs of the period in which they are incurred.*

Absorption (full) costing

- **Absorption (full) costing** is a method of stock costing in which
- all variable manufacturing costs and
- all fixed manufacturing costs
- are included as inventoriable costs.

Absorption costing



Direct materials

Direct labor

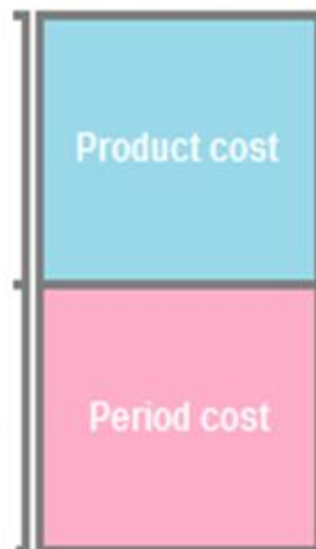
Variable manufacturing overhead

Fixed manufacturing overhead

Variable selling and administrative expenses

Fixed selling and administrative expenses

Variable costing



		Direct	Indirect
Same under both methods	Variable	Direct manufacturing cost	Indirect manufacturing
Differs under both methods	Fixed	Direct manufacturing cost	Indirect manufacturing

VC vs. FC

■ **VC**

- ▷ *Fixed Manufacturing costs are expensed in the period incurred.*
- ▷ *addresses the issue of absorption costing that allows income to rise as production rises.*
- ▷ *is used for decision making and performance evaluation.*

■ **AC**

- ▷ *fixed manufacturing costs are inventoried and are not expenses until the related units is sold.*
- ▷ *Is required for generally accepted accounting principles (GAAP) external reporting in most countries.*

Income statement VC

Revenues

- Total Variable costs*

= Contribution Margin

- Total Fixed costs

= Operating Profit

**Opening and closing stock should be taken into consideration*

Income statement AC

Revenues

- CoGS (Cost of Goods Sold)*

= Gross Margin

- Sales and Administrative costs

= Operating Profit

CoGS = Variable + Fixed manufacturing costs

**Opening and closing stock should be taken into consideration*

difference in operating profit between AC and VC

$$\left(\begin{array}{c} \text{Absorption-costing} \\ \text{operation} \\ \text{profit} \end{array} \right) - \left(\begin{array}{c} \text{Variable-costing} \\ \text{operation} \\ \text{profit} \end{array} \right) = \left(\begin{array}{c} \text{Fixed} \\ \text{manufacturing} \\ \text{costs in} \\ \text{closing stock} \end{array} \right) - \left(\begin{array}{c} \text{Fixed} \\ \text{manufacturing} \\ \text{costs in} \\ \text{opening stock} \end{array} \right)$$



*Bhimani A, Horngren CT, Datar SM and
Rajan M. Management and Cost
Accounting, 5/E. Financial Times Press
2012.*

Chapter 7.