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SEM-V

Subject
Cost and Works Accounting-III

Chapter 1
Marginal Costing
Remaining Theory

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Chapter 1st Marginal Costing

Remaining Theory

Advantages and disadvantages of marginal costing

Advantages of marginal costing

1) **Consistency**

The marginal cost per unit of output remains the same irrespective of the value of output

2) **Facilitates cost control**

By separating the fixed and variable cost marginal costing provides better means of controlling cost

3) **Valuable aid to management**

It helps the management with more appropriate information in talking vital business decisions like make or buy subcontracting export order pricing pricing under a recession of continue or discontinue a product etc

4) **Aid to profit planning**

The technique of marginal costing helps the management in profit planning the management canplan the volume of sales for earning required profit.

5) **Relative profitability**

In case of multiple product and multi line of business activities marginal costing facilitates the study of relative profitability of different products. It will show where the sales efforts should beconcentrated.

6) **Simple to understand and application**

Marginal costing method is simple in application and easy for exercise of cost control it is moreinformative and simple to understand.

Disadvantages or limitations of marginal costing

1)Difficulty in analyzing overheads

In marginal costing cost are to be classified into fixed and variable cost but it is not easy to classify all expenses into fixed and variable. it is very difficult to segregate semi variable expenses into fixed and variable.

2)Improper basis for pricing

In marginal costing prices are based on contribution which does not cover fixed cost this may prove dangerous in long term.

3)Ignore time factor

In marginal costing time factor is ignored for instance the marginal cost of two job may be identical but if one job takes twice as long to complete as the other the true cost of job taking longer time is higher than that of the other this is not disclosed by marginal costing.

4)Lack of standard for control

Marginal costing does not provide any standard for control purpose in fact budgetary control and standard costing are more effective tool in controlling cost.

5)Faulty conclusion

Exclusion of fixed overheads from cost may lead to erroneous conclusions it may create problems in inter firm comparison higher demand for salaries and other benefits by employees higher demand for tax by the government authorities etc

6)Useful in short term

The discussion between fixed and variable cost hold goods only in short in the long run however all cost become variable as in marginal costing only variable cost are considered it is useful for short-term assessment of profitability however long term assessment of profit can be correctly determined on full cost basis only.

7)Unacceptable by taxation activities

The income tax authorities do not recognise the marginal cost for inventory valuation.

Cost volume profit analysis

Cost volume profit analysis which is known as break even analysis is an extension of marginal costing. Break even analysis establishes the relationship between cost and profit with sales volume it represent a specific method of presenting and studying the interrelationship between cost volume and. It also helps in determination of that value of sales at which cost and revenues are in equilibrium the equilibrium point is often referred to as the break-even point. The breakeven point may be defined as that point of sales volume at which the total revenue is equal to the total . Briefly it is a no profit no loss point.

Cost volume profit analysis is a method of cost accounting that looks at the impact that variety levels of cost and volume have on operating. The cost volume profit analysis also commonly known as break even analysis looks to determine the break even profit for different sales volume and cost structures cost volume profit analysis is used to determine how changes in cost and volume affect the company’s operating income and net income.

Cost volume profit analysis requires that all the company's cost including manufacturer selling and administrative cost be identified as variable or fixed.

Definitions

“The study of the effects on future profits of changes in fixed cost and variable cost sales price quantity and mix.”

Assumptions

1) Cost-volume-profit analysis data are based upon certain ASM conditions which are really found in practice some of the basic assumptions of cvp analysis are given below
2) Cost can be classified into their fixed and variable components
3) The principles of cost variability is valid
4) Variable cost very proportionately with the volume changes
5) Fixed cost remain constant irrespective of the level of activity
6) Selling price does not change with the volume changes
7) There is no change in the general price level
8) Productivity per worker remain constant
9) Plant capacity and efficiency remain unaffected

Usefulness

1) It is simple tool employed to graphically represent complicated accounting data
2) It is more useful diagnostic tool
3) It provides basic information facilitating further studies on improving the profit
4) It is also used for analysing the risk of alternative actions
5) It is useful in marketing strategy also

Limitations

1) The applications of breakeven analysis to multi-product firm becomes very difficult
2) Since the break even analysis is a short run concept it has a limited application in the long range planning
3) The breakeven tool is static tool with very limited practical applications
4) It is very difficult if not impossible to separate cost into fixed and variable components

CVP formula

Break even sales volume = fixed cost/contribution margin Contribution margin ratio= contribution margin/sales

CVP analysis is also used when a company is trying to determine what level of sales is necessary to reach a specific level of income a so-called targeted income

Require sales in rupees= fixed cost + targeted income (Targeted Contribution) /contribution margin ratio

Required sales in unit= fixed cost + targeted income (Targeted Contribution) /contribution margin per unit

Application of managerial costing Technique /Use of marginal costing in Decision making

1) Key limiting factor analysis
2) Price fixation diversification
3) Make or buy decision
4) Selection of suitable product mix
5) Profit planning
6) Discontinuance of product line
7) Method of Alternative production
8) Contribution analysis
9) Accept or reject new order and subcontracting
10) Cessation of Temporary operation

Limiting factor

Every business organization tries to achieve maximum profit but there are always certain factors which do not allow the organization to earn more profit. These are the constraints of the business for example a company have very good sales network and cancel all the items produced but there may be shortage of raw materials which will limit the production to a certain extent sometimes all other factors may be favorable while cells become the problem. In this case sales become the limiting or key factor.

A key or limiting factor can therefore be defined as that factor which limits the desired volume of production when there is a key factor. The contribution per unit of that key factor is maximized so that we get the maximum advantage. To do this ascertainment of the key factor is essential if there is any mistake in finding out the key factor the decision based on it will go wrong.

Ethical and non-financial consideration relevant to decision making

1) Honesty
2) Integrity
3) Promises
4) Fairness
5) Respect
6) Accountability
7) Objectivity
8) Confidentiality
9) Professional Behavior

Consideration relevant to decision Making/ Requirements for Ethical decision making process

1) Competency /योग्यता

The ability to collect sufficient resources for a comfortable existence also ability to evaluate information develop alternative and foresee potential consequences and . it involving inspiring influencing collaborating and interacting with others to accomplish goals and build team effectiveness.

2) Consciousness

The awareness of internal and external existence to act consistently and apply moral convictions to daily behavior the state or activity that it is characterized by sensation emotion violation or thought mind in the broadest possible sense something in nature that is distinguished from the physical.

3) Commitment/वचनबद्धता

The desire to do the right things regardless of the cost willingness to give your time and energy to a job activity or something that you believe in.

4) Compathy/सहानुभूती

The sharing of another person’s feelings such as happiness sadness or pain to used the concept of compathy to describe the phenomenon whereby a person feels another’s pain.

Ethical decision making Process

1) Define the ethical problem
2) Collection of information
3) Analyze and evaluate the information
4) Consider and Examine Alternatives
5) Select the best alternatives and make a decision a
6) Actual implementation of Decision
7) Feedback and review the Action

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