SEMESTER IV----MANAGEMENT MAJOR

MARGINAL COST

Marginal cost is the change in the total cost that arises when the quantity produced is increased by one unit i.e. it is the cost of producing one more unit of good. In other words, marginal cost is the increase or decrease in total costs which results from producing or selling additional or fewer units of a product or from change in the method of production or distribution. In practice, this is measured by the total variable costs attributable to one unit. For example, if

Variable cost per unit	Rs 25
Fixed cost	Rs 1,00,000
Total cost of 10,000 units	Fixed cost + Variable cost =1,00,000 + (25x10,000) =1,00,000+2,50,000 =Rs 3,50,000
Total cost of 10,001 units	1,00,000 + (25 x10,001) =1,00,000+ 2,50,025 =Rs 3,50,025
Marginal cost	3,50,025-3,50,000 =Rs 25
Therefore, marginal cost	=variable cost

MARGINAL COSTING

According to ICMA, London "Marginal Costing is the ascertainment of marginal cost and of the effect of profit of changes in the volume or type of output, by differentiating between fixed costs and variable costs."

It separates the product costs i.e. variable costs from the period costs i.e. the fixed costs. The variable costs are then charged to units of cost while the fixed costs are written off against the contribution. It is a technique of cost accounting, used for the decision making by the managers. It also provides a basis for understanding costs and hence measure the profitability of various products, processes and cost centres.

ADVANTAGES OF MARGINAL COSTING

1. The technique of marginal costing is easy to understand. Based only on marginal costs, it is less complicated.
2. The problem of over or under absorption of overheads is avoided.
3. Separation of fixed and variable elements make the flexible budgetary control system effective and facilitates greater cost control.
4. It helps in both product planning and profit planning.
5. It facilitates the determination of relative efficiency of different products, departments etc.

LIMITATIONS OF MARGINAL COSTING

1. It is very difficult and arbitrary to classify all costs into fixed and variable.
2. It ignores the time factor.
3. Neither fixed cost nor variable costs remain constant always. This fact is ignored under marginal costing.
4. Pricing decisions cannot be based on contribution alone.
5. The technique is limited in its application to only those industries where large stocks have to be carried as work-in-progress e.g. contracting firms.

MANAGERIAL USES OF MARGINAL COSTING

1. **Cost Ascertainment:** It facilitates both recording and reporting of costs; and makes cost ascertainment easier by segregating cost into fixed and variable.
2. **Cost Control:** It enables management to exercise control over production cost and thereby affect efficiency.
3. **Decision Making:** The various tools of marginal costing viz. Contribution, BE charts, PV graphs, CVP analysis etc. can help the management in formulating effective business policies and take important decisions regarding matters like: a) Introduction of a new product, b) Make or Buy decisions, c) Pricing of products, d) Product mix etc.
4. **Profit Planning:** By helping the management in planning and evaluating performance, the technique of marginal costing helps in profit planning of an organisation. It also guides the management in determining the sale price to attain a desired level of profit.

SOME IMPORTANT TERMS

CONTRIBUTION: Contribution is the difference between sales and variable cost. It may be defined as the excess of selling price over variable cost per unit. It is the amount that is contributed towards fixed expenses and profit. Any excess of contribution over fixed costs is profit.

Contribution= Sales-Variable cost

PROFIT/VOLUME RATIO: Also known as 'contribution ratio' or 'margin ratio', the P/V ratio establishes the relation between contribution and sales. This ratio is very important to study the profitability of operations of a business.

P/V Ratio= Contribution/Sales

BREAK-EVEN POINT: It is the point of sales volume at which total revenue is equal to total cost. At this point, there is no profit, no loss.

BEP (in units) = Fixed costs/selling price p.u-variable cost p.u

BEP (in sales) = (Fixed costs/sales-variable cost) x sales

MARGIN OF SAFETY: It is the excess of actual or budgeted sales over the break-even sales. Thus, it is the difference between the actual sales and the break-even sales and represents the amount by which sales revenue can fall before a loss is incurred.

Margin of Safety= Total sales- Break-even sales

Or

Profit/PV ratio