MARGINAL COSTING & THROUGHPUT ACCOUNTING

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ABSORPTION COSTING

- Absorption costing, sometimes called “full costing,” is a managerial accounting method for capturing all costs associated with manufacturing a particular product. The direct and indirect costs, such as direct materials, direct labour, rent, and insurance, are accounted for by using this method.
- More suitable for small and medium enterprises producing a single product.

Limitations of Absorption costing

- Difficulty in comparison and control of cost
- Not helpful in managerial decisions
- A portion of fixed cost is carried over to subsequent accounting period as part of closing stock.
- Fixed cost inclusion in cost is not justified.
- Apportionment of fixed overheads by arbitrary methods. It depends on level of output which may vary from period to period.
- Not helpful for preparation of flexible budget

Marginal costing

- Marginal costing in economics and managerial accounting refers to an increase or decrease in the total cost of production due to a change in the quantity of the desired output.
- It is variable, depending on the inclusion of resources required to produce or deliver additional unit(s) of a product or service.
- Marginal costing is a technique of working of costing which is used in conjunction with other methods of costing (Process or job).
- Fixed and variable costs are kept separate at every stage. Semi – Variable costs are also separated into fixed and variable.

- As fixed costs are period costs, they are excluded from product cost or cost of production or cost of sales. Only variable costs are considered as the cost of the product.
- As fixed cost is period cost, they are charged to profit and loss account during the period in which they incurred. They are not carried forward to the next year‟s income.
- Marginal income or marginal contribution is known as the income or profit.
- The difference between the contribution and fixed costs is the net profit or loss.
- Fixed costs remains constant irrespective of the level of activity.
- Sales price and variable cost per unit remains the same.
- Cost volume profit relationship is fully employed to reveal the state of profitability at various levels of activity.

Advantages of Marginal Costing

- Simplicity
- Stock Valuation
- Meaningful Reporting
- Effect on Fixed Cost
- Profit Planning
- Cost Control and Cost Reduction
- Pricing Policy
- Helpful to Management

Limitations

- Classification of Cost
- Not Suitable for External Reporting
- Lack of Long – term Perspective
- Under Valuation of Stock
- Time factor ignored
- Production Aspect is Ignored
- Not Applicable in all Types of Business
- Misleading Picture
- More emphasis on sales

Assumptions

- All cost can be divided into fixed cost and variable cost
- Fixed cost remain constant
- Total variable cost vary but variable cost per unit does not vary
- selling price remain constant at different levels of activity
- Price of materials, labour costs etc. remain unchanged
- Volume of production is the only factor which influences the cost
- There is no stock

Absorption costing	Marginal costing
All cost at charged	Only **variable cost** is charged
Stock of Finished goods and WIP are valued at the **total cost**	stock and WIP are valued at **marginal cost**
Profit is the basis for decision making	**Contribution** is the basis for decision making
Suitable for **external** reporting	Suitable for **internal** reporting
Production **increase** cost per unit reduces	Cost per unit remains **same**
Not useful for decision making	**Useful** for decision making

Throughput Accounting

- The Theory of constraints (TOC) or throughput accounting (TA) is a system that tries to maximize the utility of these scarce resources, which in turn will increase the revenue or throughput.
- Labour cost varies according to time or period under time rate system, so the labour cost is treated as fixed cost under throughput accounting.
- Along with labour cost, variable manufacturing expense will also be difficult in practical applied. So only direct material cost will vary according to production.
- TA is relatively new in management accounting. It is an approach that identifies factors that limit an organization from reaching its goal, and then focuses on simple measures that drive behaviour in key areas towards reaching organizational goals.
- TA was proposed by Eliyahu M. Goldratt in early 1990s

- Throughput Accounting is the only accounting system that properly prioritizes the three main aspects of a business: Throughput (T), Investment(I), and Operating Expenses (OE).
- Throughput accounting is a process used in management accounting that focuses on a company's production efficiency. It looks at the rate at which a company converts its raw materials into finished goods and makes money from them.
- The purpose of throughput accounting is to identify any bottlenecks in a production process. This process allows companies to either eliminate those bottlenecks or use them as efficiently as possible.

Basic concepts of throughput accounting

- Concept 1 – direct labour cost is fixed cost or factory cost
- Concept 2- Maintain JIT by reducing stock
- Concept 3 – Determining profitability

BOTTLENECKS

- In throughput accounting the constraints are called bottlenecks.
- A bottleneck is a process in a chain of processes, such that its limited capacity reduces the capacity of the whole chain. The result of having a bottleneck are stalls in production, supply overstock, pressure from customers, and low employee morale.
- Bottlenecks can be shortage of machines capacity, lack of skilled staff, non- availability of particular materials and lack of product quality and reliability.

Advantages

- Increase the speed at which throughput is generated.
- It is an internal reporting tool.
- Helps to formulate the best possible production plan. This plan leads to maximum utilization of scarce resources and maximum profit.
- It helps closely understand contribution, production procedures, fixed cost behaviour, and variable costs.
- Throughput concepts can be applied quickly; it’s flexible in terms of application and greatly help in decision making.
- It’s rational and considers product demand while making a production plan.

Limitations

- It can be difficult to understand the concept of throughput accounting.
- It's not easy to compile small details like variable and fixed production elements.
- The concept is only applicable when you have bottleneck resources and multiple products.
- It's a short-term approach to profitability that does not consider long-term objectives that might be achieved by selling some other product mix rather than suggested by throughput.
- The application can be more complicated if there are multiple bottlenecks

Steps to improve throughput

- Review Your Existing Workflow
- Eliminate Bottlenecks
- Reduce Equipment Downtime
- Reduce Parts Rejection Rate
- Improve Employee Training
- Use Factory Automation

Problems in throughput accounting

- Excessive budget cuts
- lack of focus on non- bottlenecks
- Resistance from staff
- Conflicts
- Requires understanding
- Big Data collection and analysis
- Difficult behaviour of metric
- Frequent change in throughput
- Difficulty in determining of variable cost

Traditional Product costing	**Throughput accounting**
Production adds to value	Sale of the product adds value
Capacity utilisation of labour is the measure of efficiency	Production and maintenance of delivery dates is the measure of efficiency
Labour and certain cost are taken as variable cost	All cost except material cost are treated as fixed cost
Stock is valued at cost of production Product costing is used for short term decision	Stock is valued at material cost only Done for long term period to improve profit

- Throughput = Sale revenue from the product – Direct material costs
- The throughput accounting ratio is a metric often used in throughput accounting. This ratio looks at the return a company generates for each hour of work compared to its costs for the same time. Through the throughput accounting ratio, companies can determine the rate at which they are making income from selling their products.
- Throughput Accounting Ratio (TPAR) = Return per factory hour / Cost per factory hour
- Return per factory hour = Throughput per unit / Product's time taken for the limited resource.
- Cost per factory hour = Total factory cost / Total limited resource time available.