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Video Transcription: Absorption and Variable Costing – Part 1

Good Day, my name is Jason. This video will look at the differences between absorption costing and variable costing as well as the consequences of those differences. IFRS requires a company to use an absorption costing system for external reporting processes. Therefore, if a company were to use a variable costing system, it would be for internal purposes only and it would be used in addition to an absorption costing statement. Let's review the two different costing methods.

Firstly, absorption costing. Absorption costing is a costing system where all manufacturing costs, including both variable and fixed manufacturing overheads, are considered to be product costs and are included in the cost of inventory. Non-manufacturing costs are considered to be period costs and are expensed to the income statement in the period it has incurred.

The reasoning behind absorption costing is that all costs essential to the manufacturing of a product or the provision of a service should be included as a product cost. Consequently, revenues and costs are matched.

Variable costing differs in that only costs that vary with production are considered to be product costs. This means that the fixed manufacturing overheads are not considered to be a product cost. It is, instead, treated as a period cost and is expensed in full in the year it is incurred.

The reason behind variable costing is that it clearly demonstrates the behaviour of costs. As such, it can be used for decision-making tools, such as CVP analysis and relevant costing. Let's look at an example. Here we have the production and sales data in units. We have the variable costs per unit of production as well as the total fixed manufacturing overhead cost and the fixed manufacturing overhead per unit cost. We also have the non-manufacturing financial data and the selling price per unit.

Let's compile a profit statement using both absorption costing and variable costing. I would suggest that you pause the video now and see if you can do this exercise by yourself. As the focus of this video is not necessarily on compiling the statements, we will not go through this in great detail. An important step is determining the product costs under each system. This allows us to calculate the cost of production, as well as the value of the inventory on hand.

Remember that fixed manufacturing overheads are treated as a product cost under absorption costing, and as a period cost under variable costing. This means that the product cost per unit is higher under the absorption costing system, than a variable costing system. The product cost, using absorption costing, is R1 570 per unit produced. We have used a predetermined fixed manufacturing overhead rate to allocate fixed manufacturing overheads to each unit of production. The product cost, using variable costing, is R1 450. Notice the absence of the fixed manufacturing overhead. We can clearly see that the product cost, using absorption costing, is higher compared to the product cost when using variable costing.

Let's see what the profit statements look like. When we compare the two profit statements, a number of observations can be made: the difference in classification of costs affects the way the profit statement is laid out. Absorption costing separates costs in terms of whether they are manufacturing costs or not. All manufacturing costs are shown above the gross profit, and non-manufacturing costs are shown below the gross profit. Variable costing separates costs according to its behaviour, whether it is variable or fixed. We have both variable manufacturing and non-manufacturing costs above the contribution margin.

Absorption costing refers to gross profit, whereas variable costing refers to contribution margin. As the current production cost per unit differs, the total amount allocated to current production costs differ. Given that the reported profit is the same for both costing systems, then why bother with variable costing? Well, there are several advantages associated with using a variable costing statement.

Data required for CVP analysis and other decision-making tools can be taken directly from the contribution margin profit statement. Secondly, managers often assume that all unit costs are variable; this is incorrect as under the absorption costing, the product cost includes fixed and variable elements. Then lastly, with absorption costing, profitability can be obscured by arbitrary allocations or fixed costs.

Both costing systems can give valuable information if we understand the strengths and the weaknesses of each system. Remember that management accounting is about providing relevant and useful information to senior management to facilitate good decision-making. Very importantly, it will not always be the case that the profits under the two systems are equal. In our next video, we will explore this in a little bit more detail. We will also learn a very useful technique of reconciling profit between an absorption costing system and a variable costing system.