Methods of Costing

1. Marginal costing

Only the variable costs are included in the cost per unit.

Fixed costs (production overheads) are not included in the cost per unit.

Fixed costs are treated as time related (period costs) and are charged to the Income Statement as expenses for the period.

2. Absorption costing

All costs including production overheads are included in the cost per unit.

This is done by allocation, apportionment and absorption.

Absorption costing can lead to under/over absorption of overheads.

Direct Material
Direct labour
PRIME COST
Variable indirect production costs
MARGINAL COST
Rent
Fixed production overheads
ABSORPTION COST/ FULL PRODUCTION COST

3. Activity Based Costing (ABC)

3.1. Introduction

Historically overheads were absorbed on the basis of labour or machine hours, in a modern manufacturing environment the fixed costs can be huge and with high efficiencies the absorption rate can be over 250% of labour cost. Any small inaccuracies can lead to product costs being unrepresentative.

3.2. What is ABC?

The essence of ABC is that it is *activities* that cause costs, not products. Products consume activities. The important activities in a business are known as *cost drivers*.

3.3. Cost drivers

What causes the cost?

For long term variable costs volume related cost drivers will tend to be inappropriate. For example the number and cost of salaried production engineers is not a function of direct labour hours or machine hours but how many times a machine has to be set up for a production run. The activity which drives the cost is the number of set ups. The cost of dispatch department is caused by number of dispatches.

This contrasts with traditional absorption costing which absorbs all costs based on direct labour hours (or machine hours) and has no regard to the activity which caused the cost.

3.4. Calculating product cost