Theory Q&A

Chp14 Marginal

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Chp14. Marginal

Q&A

PYQ – 2021 Jul – Q6 b

(b) What is Margin of Safety? What does a large Margin of Safety indicates? How can you calculate Margin of Safety?

(b) **Margin of Safety:** The margin of safety can be defined as the difference between the expected level of sale and the breakeven sales.

The larger the margin of safety, the higher is the chances of making profits.

The Margin of Safety can be **calculated by** identifying the difference between the projected sales and breakeven sales in units multiplied by the contribution per unit. This is possible because, at the breakeven point all the fixed costs are recovered and any further contribution goes into the making of profits.

Margin of Safety = (Projected sales – Breakeven sales) in units x contribution per unit

It also can be calculated as:

$$\text{Margin of Safety} = \frac{\text{Profit}}{\text{P / V Ratio}}$$

PYQ – 2020 Nov – Q6 e

(e) Differentiate between "Marginal and Absorption Costing".

(e) Difference between Marginal costing and Absorption costing

S. No.	Marginal costing	Absorption costing
1.	Only variable costs are considered for product costing and inventory valuation.	Both fixed and variable costs are considered for product costing and inventory valuation.
2.	Fixed costs are regarded as period costs. The Profitability of different products is judged by their P/V ratio.	Fixed costs are charged to the cost of production. Each product bears a reasonable share of fixed cost and thus the profitability of a product is influenced by the apportionment of fixed costs.
3.	Cost data presented highlight the total contribution of each product.	Cost data are presented in conventional pattern. Net profit of each product is determined after subtracting fixed cost along with their variable costs.

PYQ – 2020 Nov – Q6 e

(e) Differentiate between "Marginal and Absorption Costing".

4.	The difference in the magnitude of opening stock and closing stock does not affect the unit cost of production.	The difference in the magnitude of opening stock and closing stock affects the unit cost of production due to the impact of related fixed cost.
5.	In case of marginal costing the cost per unit remains the same, irrespective of the production as it is valued at variable cost	In case of absorption costing the cost per unit reduces, as the production increases as it is fixed cost which reduces, whereas, the variable cost remains the same per unit.

PYQ – 2019 May – Q6 e

(e) What are the limitations of marginal costing?

(e) Limitations of Marginal Costing

(i) **Difficulty in classifying fixed and variable elements:** It is difficult to classify exactly the expenses into fixed and variable category. Most of the expenses are neither totally variable nor wholly fixed. For example, various amenities provided to workers may have no relation either to volume of production or time factor.

(ii) **Dependence on key factors:** Contribution of a product itself is not a guide for optimum profitability unless it is linked with the key factor.

(iii) **Scope for Low Profitability:** Sales staff may mistake marginal cost for total cost and sell at a price; which will result in loss or low profits. Hence, sales staff should be cautioned while giving marginal cost.

PYQ – 2019 May – Q6 e

(e) What are the limitations of marginal costing?

(iv) **Faulty valuation:** Overheads of fixed nature cannot altogether be excluded particularly in large contracts, while valuing the work-in- progress. In order to show the correct position fixed overheads have to be included in work-in-progress.

(v) **Unpredictable nature of Cost:** Some of the assumptions regarding the behaviour of various costs are not necessarily true in a realistic situation. For example, the assumption that fixed cost will remain static throughout is not correct. Fixed cost may change from one period to another. For example, salaries bill may go up because of annual increments or due to change in pay rate etc. The variable costs do not remain constant per unit of output. There may be changes in the prices of raw materials, wage rates etc. after a certain level of output has been reached due to shortage of material, shortage of skilled labour, concessions of bulk purchases etc.

(vi) **Marginal costing ignores time factor and investment:** The marginal cost of two jobs may be the same but the time taken for their completion and the cost of machines used may differ. The true cost of a job which takes longer time and uses costlier machine would be higher. This fact is not disclosed by marginal costing.

(vii) **Understating of W-I-P:** Under marginal costing stocks and work in progress are understated.