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DEPARTMENT OF

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Course Name:	Strategic Management Accounting **(BSA 3210)**
Course Level:	Year 3
Topic Four (4):	Product Costing and Financial reporting

4.0 Product Costing for External Reporting

4.0 Product Costing for External Reporting

4.1 Definition

Product costing is the systematic process of identifying, classifying, and accumulating all costs associated with producing a product or delivering a service. The resulting figures feed into both internal management decisions and external financial statements.

Product Cost: The total cost assigned to a unit of output, comprising direct materials, direct labour, and manufacturing overhead all costs required to bring a product to a saleable condition.

4.1.1 Why External Reporting Requires Product Costing

- Inventory Valuation: IAS 2 (Inventories) requires inventory to be reported at cost on the balance sheet. A systematic cost-assignment method is therefore mandatory.
- Cost of Goods Sold (COGS): The income statement deducts the cost of units sold from revenue. Accurate product costs underpin this figure.
- Compliance & Comparability: Regulators and investors require consistent, auditable cost data to compare performance across periods and entities.
- Gross & Operating Profit: Both profitability metrics depend directly on how product costs are measured and allocated.

4.1.2 ACCOUNTING REPORTS

4.1.2.1 Cost Schedules

Cost schedules are used to calculate the cost of producing products for a period of time.

The cost of goods amount is transferred to the finished goods inventory account during the period and is used in calculating cost of goods sold on the income statement.

Cost schedules are needed at regular intervals to enable managers to keep a check on what the business is spending.

Cost Schedules may be produced for the following areas:

- Wages and salaries
- Departmental costs
- Cost of sales
- Selling expenses
- Administration costs

Schedules may be split by PRODUCT or PROCESS, depending on the level detail required by management.

4.1.2.2 Budgets

Budgets are part of a company's planning system.

It is a set of interlinked plans that quantitatively describe an entity's projected future operations.

A budget is used as a yardstick against which to measure actual operating results, for the allocation of funding, and as a plan for future operations.

This may be a budget for the year ahead, showing projected sales, the costs involved in generating those sales, overheads and projected profit.

- Budgets may be produced for the business as a whole and for individual departments.
- The finance department will also produce a CASH FLOW BUDGET (or Cash Flow forecast) identifying the amounts of cash likely to come into and out of the business.

This will enable the department to identify potential problems and arrange overdraft facilities in advance.

4.1.2.3 Variance Reports

Once a budget is established, one of the main financial tasks is to explain variances between actual performance (Cost schedules) and the budget.

It may be things have changed from the budget. E.g Volume may have changed increased, or there may have been unexpected price increases.

- For example, if the cost of certain car parts and processes is greater than budget, then steps can be taken to reduce them and therefore keep the overall cost of producing the car down.

- Performance reports are made regularly and are usually on a monthly basis.

4.1.2.4 Working Capital reports

Working capital reports are needed to manage cash inflows and outflows.
An organisation's working capital is:

1. Inventory
2. Receivables
3. Payables
4. Cash

Inventory reports

Show the value of materials and finished products held in stock and the length of time they have been held for. Holding large amounts of inventory reduces the availability of cash because it is tied up in assets.

The business should monitor inventory to make sure it is converted into finished products and cash afterwards.

Receivables Reports

Show how much customers owe the business and how long the debt has been outstanding.

Holding large amounts of receivables reduces the availability of cash because it is tied up in assets.

By analysing receivables, decisions can be taken over which debts should be chased up.

Payables Reports

Show how much the business owes its suppliers and how long have debts been outstanding.

Delaying paying debts increases the availability of cash because it is not paid until necessary.

The business should pay its debts, but not so early that it does not make use of periods of credit, nor so late that it faces legal action for not paying what it owes.

Cash Reports

Cash reports

Businesses need cash to pay their debts.

Cash is created when raw materials are converted into products that are sold to customer.

Show how much cash and liquid assets the business has. It is important to ensure sufficient cash is available as required to pay business expenses and other commitments.

4.2. Different Ways of Collecting Costs

4. 2.1 Overview

The method used to collect and trace costs to products depends on the nature of the production process. The three principal systems are Job/Batch Costing, Process Costing, and Activity-Based Costing (ABC).

4.2.2 Job Costing

Costs are collected separately for each individual job, contract, or unique customer order. Used where each output is distinct.

Characteristics:

- Each job has its own cost card tracking direct materials issued, labour hours booked, and overhead absorbed.
- Industries: construction, printing, legal/audit services, bespoke manufacturing, film production.
- Costs are directly identifiable to the specific job high traceability.

A job cost sheet collects:

- Direct Materials: Priced using FIFO, weighted average, or standard cost.
- Direct Labour: Hours recorded on job time sheets × labour rate per hour.
- Production Overhead: OAR × actual activity used on the job (e.g., machine hours).

4.2.3 Batch Costing

A variant of job costing where a batch of identical units is treated as a single job. Total batch cost is accumulated, then divided by the number of units to give unit cost.

Formula: Cost per unit = $\frac{Total\ Batch\ Cost}{Number\ of\ Units\ in\ a\ batch}$

Example: A clothing manufacturer produces a batch of 2,000 shirts. If total batch cost = Ugx 10,000, then cost per shirt = Ugx 5.

- Suitable for: clothing, pharmaceuticals, consumer goods, food production.

4. 2.4 Process Costing

Used when production is continuous and output is homogeneous (units are identical). Costs accumulate by process/department and are averaged across all output.

Characteristics:

- Individual units cannot be distinguished; all units are identical.
- Costs collected per process, not per job.
- Industries: oil refining, chemicals, paints, cement, food processing.

Key concepts in process costing:

- **Normal Loss:** Expected, unavoidable wastage. Its cost is borne by good output (increases cost per unit of good output).
- **Abnormal Loss:** Loss above the normal expected level. Treated as a separate expense in the income statement.
- **Abnormal Gain:** Output above the expected level. Treated as income (negative cost).
- **Equivalent Units (EU):** WIP is converted to equivalent completed units to calculate an accurate cost per unit. E.g., 1,000 units 50% complete = 500 equivalent units.

Aspect	Job / Batch Costing	Process Costing
Output	Unique or batches of identical units	Continuous, homogeneous units
Cost Collection	Per job / per batch	Per process / department
Industries	Construction, printing, bespoke mfg.	Chemicals, oil, food, cement
Unit Cost	Total job cost ÷ units produced	Total process cost ÷ equivalent units
WIP Valuation	At actual costs incurred	Equivalent units × cost per EU

4. 2.5 Activity-Based Costing (ABC)

ABC assigns overhead costs to products based on the specific activities that cause (drive) those costs, rather than using a single volume-based OAR.

Traditional absorption costing spreads all overhead using one rate (e.g., per machine hour). ABC recognises that different products consume activities in very different proportions especially important in multi-product firms.

Steps in ABC:

5 Identify the major overhead cost pools (activities that cause costs to be incurred).

6 Identify the cost driver for each pool; the factor that causes the cost.

7 Calculate a cost driver rate: Total Cost Pool ÷ Total Cost Driver Volume.

8 Assign costs to products based on their consumption of each cost driver.

Activity / Cost Pool	Cost Driver	Example
Machine set-ups	Number of set-ups	A short-run product requiring many set-ups bears more cost
Purchasing / procurement	Number of purchase orders	Products with many components generate more orders
Quality inspection	Number of inspections	High-tolerance products inspected more frequently
Warehousing	Floor space occupied	Bulky products consume more warehouse resource

Advantages of ABC:

- More accurate overhead allocation where products have differing complexities.
- Highlights cost-inefficient activities, supports process improvement.
- Better information for pricing, product mix, and make-or-buy decisions.

Limitations of ABC:

- More complex and costly to implement and maintain.
- Requires extensive data collection on activities and drivers.
- May not be cost-justified for simple or single-product operations.

4.2 Absorption Costing (Full Costing); The Required Method

Absorption costing allocates both variable and fixed production costs to each unit of output. It is mandatory for external financial reporting under IAS 2 and GAAP.

Feature	Absorption Costing	Marginal (Variable) Costing
Definition	Charges all production costs; variable + fixed to products	Charges only variable production costs to products
Fixed OH Treatment	Included in unit product cost (absorbed)	Period cost; expensed in full each period
Inventory Valuation	Higher (includes fixed OH)	Lower (variable costs only)
Ext. Reporting?	YES, required by IAS 2 & GAAP	NO; not permitted for financial accounts
Best For	Financial statements, routine profit reporting	Internal decisions, budgeting, CVP analysis

Critical Rule: Absorption costing is mandatory for published financial statements. Marginal costing is not compliant with IAS 2 because it excludes fixed production overhead from inventory values.

4.2.1 The Cost Card Under Absorption Costing

A cost card (or cost sheet) builds up the full cost per unit step by step:

Cost Element	Ugx per unit	Cumulative
Direct Materials	X	
Direct Labour	X	
Direct Expenses	X	
PRIME COST		**X**
Variable Production Overhead	X	
Fixed Production Overhead (absorbed)	X	
PRODUCTION COST (Absorption)		**X**
Non-Production Overheads (selling, admin)	X	
TOTAL COST		**X**

4.2.2 The Overhead Absorption Rate (OAR)

Because fixed overhead is a bulk cost, it must be spread across units using a predetermined rate calculated from budgeted figures:

OAR = Budgeted Fixed Overhead ÷ Budgeted Activity Level

Common activity bases: Machine Hours, Direct Labour Hours, or Units of Output.

Example: Budgeted fixed overhead = Ugx 120,000; budgeted output = 20,000 units.

OAR = Ugx 6 per unit. Every unit produced absorbs Ugx 6 of fixed overhead into its cost.

4.2.3 Under- and Over-Absorption

Because the OAR uses budgeted figures, actual results rarely match exactly, creating a reconciling difference:

- Over-absorption: Actual overhead < absorbed overhead → favourable; added back to profit.
- Under-absorption: Actual overhead > absorbed overhead → adverse; deducted from profit.

Formula: Absorbed OH = OAR × Actual Activity Level. Difference between absorbed and actual OH is adjusted in the income statement.

4.3 Variable Costing: Effects on Operating Income

4.3.1 What Is Variable (Marginal) Costing?

Variable costing (marginal costing) treats only variable production costs as product costs. Fixed production overhead is charged in full to the income statement in the period it is incurred regardless of how many units are produced or remain in inventory.

Marginal costing is an alternative method of costing to absorption costing. In marginal costing, only variable costs are charged as a cost of sale. Sales revenue minus the variable cost of sales equals **contribution**, which is the contribution towards covering fixed costs and making a profit. Fixed costs are treated as a period cost, and are charged in full to the income statement of the accounting period in which they are incurred. Closing inventories of work in progress or finished goods are valued at marginal (variable) production cost.

Marginal cost is the cost of a unit of a product or service which would be avoided if that unit were not produced or provided. The marginal cost per unit is also called the variable cost per unit.

The marginal production cost per unit of an item usually consists of:

- direct materials
- direct labour
- variable production overheads

However, there may also be some direct production expense per unit.

Direct labour costs might be excluded from marginal costs when the work force is a given number of employees on a fixed wage or salary. Even so, it is not uncommon for direct labour to be treated as a variable cost, even when employees are paid a basic wage for a fixed working week. If in doubt, you should treat direct labour as a variable cost unless given clear indications to the contrary.

The **marginal cost of sales** consists of the marginal production cost of units sold plus the variable selling costs, which would include items such as sales commission, and possibly some variable distribution costs.

VARIABLE COSTING INCOME STATEMENT FORMAT
Sales Revenue
(Less) Variable Cost of Goods Sold
= CONTRIBUTION MARGIN
(Less) Fixed Production Overhead [period cost]
(Less) Fixed Selling & Administrative Overhead [period cost]
= OPERATING INCOME (NET PROFIT)

The principles of marginal costing

The principles of marginal costing are as follows.

(a) For any given period of time, fixed costs will be the same, for any volume of sales and production (provided that the level of activity is within the 'relevant range'). Therefore, by selling an extra item of product or service the following will happen.

- Revenue will increase by the sales value of the item sold.
- Costs will increase by the variable cost per unit.
- Profit will increase by the amount of contribution earned from the extra item.

(b) Similarly, if the volume of sales falls by one item, the profit will fall by the amount of contribution earned from the item.

(c) Profit measurement should therefore be based on an analysis of total contribution. Since fixed costs relate to a period of time, and do not change with increases or decreases in sales volume, it is misleading to charge units of sale with a share of fixed costs.

(d) When a unit of product is made, the extra costs incurred in its manufacture are the variable production costs. Fixed costs are unaffected, and no extra fixed costs are incurred when output is increased.

Before explaining marginal costing principles any further, it will be helpful to look at a numerical example.

4. 3.2 Contribution: The Central Concept

Contribution is of fundamental importance in marginal costing, and the term 'contribution' is really short for 'contribution towards covering fixed overheads and making a profit'.

Contribution = Sales Revenue − Variable Costs | Profit = Total Contribution − Fixed Costs

Contribution represents the amount remaining from sales after deducting all variable costs. It first covers fixed costs; any surplus is profit.

- **Contribution per unit** = Selling price per unit − Variable cost per unit
- **Total Contribution** = Contribution per unit × Units sold
- If Total Contribution > Fixed Costs → Profit
- If Total Contribution = Fixed Costs → Break-even (zero profit/loss)
- If Total Contribution < Fixed Costs → Loss

4.3.3 Marginal Production Cost per Unit

The marginal (variable) production cost per unit typically consists of:

- Direct materials
- Direct labour (treated as variable unless workforce is on a fixed salary)
- Variable production overheads

Note: If employees are paid a fixed wage regardless of output, direct labour may be classified as a fixed cost. However, the default convention is to treat direct labour as variable unless explicitly stated otherwise.

Marginal Cost of Sales = Marginal production cost of units sold + Variable selling costs (sales commission, variable distribution).

4. 3.4 How Production vs. Sales Levels Affect Operating Income

The fundamental difference between absorption and variable costing lies in how changing inventory levels affect reported profit. Under absorption costing, fixed overhead is 'stored' in inventory; under variable costing it is expensed immediately.

Scenario	Production = Sales	Production > Sales	Production < Sales
Inventory Change	No change	Inventory increases	Inventory decreases
Absorption Profit vs. Variable Profit	Equal	HIGHER than variable	LOWER than variable
Variable Profit vs. Absorption Profit	Equal	LOWER than absorption	HIGHER than absorption
Reason	All fixed OH expensed	Some fixed OH deferred in closing inventory	Deferred fixed OH released from opening inventory

4. 3.5 Reconciliation Formula

Absorption Profit = Variable Profit + (Fixed OH in Closing Inventory − Fixed OH in Opening Inventory)

Difference in Profit = OAR × (Units Produced − Units Sold)

Example 1: marginal costing principles

Bain Painkillers makes a drug called 'Relief', which has a variable production cost of Ugx 6 per unit and a sales price of Ugx 10 per unit. At the beginning of June 2021, there were no opening inventories and production during the month was 20,000 units. Fixed costs for the month were Ugx45,000 (production, administration, sales and distribution). There were no variable marketing costs.

Required

Calculate the contribution and profit for June 2021, using marginal costing principles, if sales were as follows.

(a) 10,000 Reliefs

(b) 15,000 Reliefs

(c) 20,000 Reliefs

Solution

The first stage in the profit calculation must be to identify the variable cost of sales, and then the contribution. Fixed costs are deducted from the total contribution to derive the profit. All closing inventories are valued at marginal production cost (Ugx 6 per unit).

Options	*10,000 Reliefs*		*15,000 Reliefs*		*20,000 Reliefs*	
	Ugx	**Ugx**	**Ugx**	**Ugx**	**Ugx**	**Ugx**
Sales (at Ugx10)		100,000		150,000		200,000
Opening inventory	0		0		0	
Variable production cost (20,000*6) = 120,000	120,000		120,000		120,000	
	120,000		120,000		120,000	
Less value of closing inventory (at marginal cost)	(20,000-10,000) = 10,000*6= 60,000		20,000-15,000) = 5,000*6= 30,000		20,000-20,000= 0 -	
Variable cost of sales		60,000		90,000		120,000
Contribution		40,000		60,000		80,000
Less fixed costs		45,000		45,000		45,000
Profit/(loss)		(5,000)		15,000		35,000
Profit/(loss) per unit		(5000)/10,000		15,000/15,000=		35,000/20,000
		Ugx (0.50)		Ugx 1		Ugx 1.75
Contribution per unit (SP-CP)		Ugx 10- Ugx 6 = Ugx 4		Ugx 4		Ugx 4

Profit per unit = Total profit / units sold

Contribution per unit = selling price – units' cost = Ugx 10- Ugx 6 = Ugx 4 Per unit

Break-Even Point (units) = Fixed Costs ÷ Contribution per unit

BEP = 45,000/4 = Ugx 11,250 Units

The conclusions to be drawn from this example are as follows.

(a) The profit per unit varies at differing levels of sales, because the average fixed overhead cost per unit changes with the volume of output and sales.

(b) The contribution per unit is constant at all levels of output and sales. Total contribution, which is the contribution per unit multiplied by the number of units sold, increases in direct proportion to the volume of sales.

(c) Since the contribution per unit does not change, the most effective way of calculating the expected profit at any level of output and sales would be as follows.

(i) First calculate the total contribution.

(ii) Then deduct fixed costs as a period charge in order to find the profit.

(d) In our example the expected profit from the sale of 17,000 Reliefs would be as follows.

Total contribution (17,000 * Ugx 4)	68,000
Less fixed costs	45,000
Profit	**Ugx**
23,000	

If total contribution exceeds fixed costs, a profit is made.

If total contribution exactly equals fixed costs, no profit and no loss is made. This is known as the

breakeven point.

If total contribution is less than fixed costs, there will be a loss.

4. 3.6 Break-Even Analysis (CVP)

Variable costing integrates naturally with Cost-Volume-Profit (CVP) analysis:

Break-Even Point (units) = Fixed Costs ÷ Contribution per unit

Break-Even Revenue = Fixed Costs ÷ C/S Ratio where C/S Ratio = Contribution ÷ Selling Price

Example 1: For Relief tablets: Break-even = Ugx 45,000 ÷ Ugx 4 = 11,250 units. At this level, total contribution exactly equals fixed costs and profit = Ugx 0.

Example 2: Marginal Costing

Wong makes two products, the Ping and the Pong. Information relating to each of these products for August 2021 is as follows.

		Ping		***Pong***
Opening inventory		**nil**		**nil**
Production (units)		15,000		6,000
Sales (units)		10,000		5,000
Sales price per unit		Ugx 20		Ugx 30
Unit costs Direct materials		Ugx 8		Ugx 14
Direct labour		4		2
Variable production Overheads	overhead	2		1
Variable sales overhead		2		3
Fixed costs for the month:			Ugx	
Production costs			40,000	
Administration costs			15,000	
Sales and distribution costs			25,000	

Required

(a) Using marginal costing principles, calculate the profit in August 2021.

(b) Calculate the profit if sales had been 15,000 units of Ping and 6,000 units of Pong.

Contribution from Pings (unit contribution = Ugx 20 – Ugx (8 + 4 + 2 + 2) = Ugx 4 * 10,000) = 40,000

Contribution from Pongs (unit contribution = Ugx 30 – Ugx (14 + 2 + 1 + 3) = Ugx 10 * 5,000 = 50,000

Total contribution
90,000

Fixed costs for the period (Ugx 40,000 + Ugx 15,000 + Ugx 25,000)	80,000
Profit	10,000

The value of marginal costing

The main arguments in favour of marginal costing are that:

(a) it recognises the distinction between fixed costs and variable costs, and the fact that as activity levels rise, only variable costs, not fixed costs, increase

(b) it recognises that fixed costs are time-related costs ('period costs') and it is therefore appropriate to charge them in full as a cost to the period in which they arise

Recognition of the distinction between fixed and variable costs has some value in profit measurement. Since fixed costs are not absorbed into product costs, marginal costing avoids the need to apply arbitrary bases of apportionment of overheads, or arbitrary bases for overhead absorption. Since fixed costs are a constant amount in each time period, profitability depends essentially on the amount of contribution earned.

Recognition of the distinction between fixed and variable costs, and particularly between fixed and variable overheads, assists managers to prepare more accurate budgets. Marginal costing techniques, even when not used for measuring historical profits, is widely-used in budgeting.

Conclusion: costing methods

This topic costing techniques for measuring product costs and profitability. A company might use any of these techniques for measuring profitability, and for comparing actual profits against the budget.

In addition, marginal costing techniques are applied for budgeting and management decision-making. An activity-based approach might also be adopted for budgeting ('activity-based budgeting').

4.4 Evaluation of Variable Costing

4. 4.1 Advantages of Variable Costing

(a) Clear Separation of Fixed and Variable Costs

- Makes cost behaviour explicit, enabling managers to understand the impact of volume changes on profit.
- Fixed costs are correctly seen as 'capacity costs' accruing with time, not with production output.
- Supports more accurate pricing, outsourcing, and product-mix decisions.

(b) Profit Reflects Sales; Not Production

- Under absorption costing, profit can be manipulated by over-producing (which defers fixed costs into closing inventory).
- Variable costing eliminates this distortion: profit tracks sales volume, making it a truer measure of trading performance.
- Managers cannot 'produce their way to profit' — a key strategic insight.

(c) Superior for Short-Term Decision Making

- Contribution analysis underpins relevant costing, make-or-buy, special order pricing, limiting factor analysis, and shutdown decisions.
- Fixed costs are sunk in the short run and therefore irrelevant to marginal decisions.
- Contribution per unit (or per limiting factor) directly guides resource allocation.

(d) Simpler and More Transparent

- No overhead absorption rate to calculate; no under- or over-absorption adjustments.
- Easier for non-accounting managers to understand and use in operational decisions.
- Results are less susceptible to manipulation via inventory build-up.

(e) Better for Budgeting and Flexible Budgeting

- Variable and fixed costs are budgeted separately, making flexible budget variances more meaningful.
- Widely used for budgeting even by companies that use absorption costing for external reporting.
- The principles of marginal costing are central to activity-based budgeting.

4. 4.2 Limitations and Criticisms of Variable Costing

(a) Non-Compliant with External Reporting Standards

- IAS 2 requires inventory to be valued at full production cost including fixed overhead. Variable costing fails this test.
- Cannot be used for statutory financial statements, tax calculations, or regulatory filings.
- Companies must maintain parallel records or convert variable costing results to absorption costing for reporting.

(b) Risk of Short-Term Thinking

- By treating fixed costs as period costs, managers may focus solely on contribution and ignore long-run recovery of fixed costs.
- Pricing decisions based only on marginal cost can lead to chronic underpricing and inability to cover total costs.
- In the long run, all costs — including fixed — must be recovered for the business to be viable.

(c) The Fixed/Variable Distinction Is Not Always Clear

- Many costs are semi-variable (mixed costs) and do not fit neatly into either category.
- Stepped-fixed costs increase at certain output thresholds, complicating classification.
- Incorrect cost classification undermines the reliability of variable costing results.

(d) Ignores Capacity Costs

- Absorption costing highlights idle capacity through under-absorption; variable costing does not make this visible.
- For capital-intensive industries, ignoring fixed overhead costs in unit cost can be strategically misleading.

4.4.3 Comparison: Which Method for Which Purpose?

Purpose	Absorption Costing	Variable Costing
External financial statements	Required (IAS 2 / GAAP)	Not permitted
Inventory valuation	Required	Not compliant
Internal management reports	Can be used	Often preferred
Budgeting & planning	Used	Often superior
CVP / break-even analysis	Less suitable	Ideal
Short-term pricing decisions	Less suitable	Better
Long-term pricing decisions	Better (full cost recovery)	Less suitable
Measuring capacity utilisation	Shows under/over absorption	Less visible

4. 4.4 The Value of Marginal Costing in Practice (from source material)

The main arguments in favour of marginal costing, as identified in the academic literature, are:

- ✓ It recognises the distinction between fixed and variable costs, and the fact that only variable costs increase as activity rises fixed costs are a constant in each time period.
- ✓ It recognises that fixed costs are time-related 'period costs' and it is therefore appropriate to charge them in full in the period in which they arise.
- ✓ Since fixed costs are not absorbed into product costs, marginal costing avoids the need to apply arbitrary bases of overhead apportionment a significant advantage in terms of objectivity.
- ✓ Since fixed costs are constant each period, profitability depends essentially on the amount of contribution earned making contribution the key performance driver.
- ✓ Marginal costing assists managers to prepare more accurate budgets by clearly distinguishing fixed and variable cost behaviour.

Key Formulas

1. Absorption costing is mandatory for external financial reports (IAS 2). Fixed production overhead MUST be included in inventory value.
2. Variable costing charges all fixed production overhead as a period cost, expensed in full in the period incurred, regardless of production levels.
3. When production > sales: absorption profit > variable profit (fixed OH deferred in closing inventory).
4. When production < sales: absorption profit < variable profit (deferred fixed OH released from opening inventory).
5. When production = sales: absorption profit = variable profit (no inventory change means no deferral).
6. Reconciliation: Difference in profit = OAR x (Production units - Sales units).
7. Contribution = Sales Revenue - Variable Costs. Contribution per unit is constant regardless of volume.
8. Profit = Total Contribution - Fixed Costs. Fixed costs are a constant deduction in each period.
9. Break-even = Fixed Costs / Contribution per unit. C/S Ratio = Contribution / Sales Revenue.
10. OAR = Budgeted Fixed OH / Budgeted Activity Level. Under/over absorption adjusted in income statement.
11. ABC allocates overhead by cost drivers and is more accurate for overhead-intensive, multi-product environments.
12. Variable costing is superior for internal decisions; absorption costing is required for external reporting.

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