

# ABSORPTION COSTING ADVANTAGES AND DISADVANTAGES

*Companies must choose between using absorption costing or variable costing in their accounting systems. Advantages and disadvantages come with either.*

Instead you subtract them from your revenue figure as a lump-sum expense. Absorption costing shows a decreased cost of sales and increased revenues of the company than the marginal or variable costing especially when inventory levels are rising. Distortion occurs because different bases of apportionment produce different allocation to products and affect different results. Various types of managerial problems, such as selection of production volume and optimum capacity utilization, selection of product-mix, whether to buy or manufacture, evaluation of performance, choice of alternatives can be solved only with the help of variable costing analysis. But in practice, many overhead costs are apportioned by using arbitrary methods. This causes income to be artificially inflated during periods when the number of units produced exceed the number sold. The pricing based on absorption costing similarly ensures that all costs are covered. The result is that losses will be reported during out of season periods and large profits will be reported in the periods when the goods are sold. The company evaluates each business opportunity using absorption costing as its base cost. These systems are used by many businesses, but they're not perfect. Ascertainment of Profit under Absorption Costing

### 3. Key Takeaways

The main advantage of absorption costing is that it is in compliance with GAAP and does a better job of accurately tracking profits than variable costing. Critics of absorption costing refer to this phenomenon as one that creates illusionary or phantom profits. However, activity-based costing, a non-absorption costing alternative, requires the identification of every activity that goes into producing a product and a determination of how these activities affect the overhead incurred. Under this technique, cost per unit remains same only when the level of output remains same. Once the product is eliminated the fixed overhead that has been allocated to it is redistributed to the remaining products. Accounts for All Production Costs Absorption costing takes into account all of the costs of production, not just the direct costs , as variable costing does. In the long term, reported income will be lower as the higher inventory costs are passed on to subsequent years. No Separation Of Costs There is no need to separate costs into variable costs and fixed costs in this system. Not Useful for Comparison of Product Lines Variable costing is more useful than absorption costing if a company wishes to compare the potential profitability of different product lines.