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CENTRE FOR DISTANCE AND ONLINE EDUCATION

B. Com. Part-III
Semester - V
Accountancy Major Paper-I
Cost Accounting Paper-I
(Elements of Cost Accounting)

(In accordance with National Education Policy 2020)
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Preface

It gives me immense pleasure to bring forward this Self-Instructional material (SIM) for Accountancy Major Elective Paper – I Cost Accounting Paper-I (Introduction to Cost Accounting) B. Com. III Sem. V. As per the order and guidelines of the Government of Maharashtra, National Education Policy 2020 is implemented for all the under graduate programmes of Shivaji University from the Academic Year 2024-25. The syllabuses of various papers under various courses for B. Com. III are set considering the guidelines given in the NEP Document and Government Resolutions in this regard and introduced from June 2026.

The subject Cost Accounting, occupies an important place in the content of Education of Accountancy. Its importance has been arduously recognised by all types of business organisations including banking companies. Considering the need of the hour, the Board of Studies in Accountancy drafted the syllabus of the subject incorporating Introduction to Cost Accounting, Principles, Types and Methods of Cost Accounting, Cost Classification and Preparation of Cost Sheet and Reconciliation of Cost Statement with Financial Statement.

The main feature of this book is that the theory and illustrations of each topic are presented in such a way that students can understand easily. Problems of revised nature are illustrated in a sufficient number in each unit with necessary working notes.

I am thankful to all the authors who have contributed to this SIM. I strongly appreciate the sincere efforts taken by the authors to enrich the quality of the concerned units. Because, this course is firstly introduced in the syllabus of the B. Com. Programme. I express my deep sense of gratitude to Hon. Vice Chancellor Prof. (Dr.) Rajneesh Kamat, Hon. Pro-Vice Chancellor Prof. (Dr.) Jyoti Jadhav, Hon. In-charge Dean of the Faculty of Commerce and Management Prof. (Dr.) Varsha Maindargi and Registrar Dr. Vilas Shinde for their supreme support, guidance and encouragement. I especially thanks to the Director, Distance and Online Education Centre for his keen interest in developing quality study material, cooperation and assistance to produce the learning material. I am also thankful to Dr. Sushant Mane, Dr. Sachin Dethe, Mrs. Kapade and other concerned staff of CDOE who worked continuously for preparation and publication of this learning material.

All your suggestions will be welcomed for the further improvement of the book.

Thank you all.

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B. Com Part-III (Semester V)

Index

Unit No.	Topic	Page No.
1.	Introduction to Cost Accounting	1
2.	Principles, Types and Methods of Cost Accounting	24
3.	Cost Classification and Preparation of Cost Sheet	65
4.	Reconciliation of Cost Statement with Financial Statement	123

Each Unit begins with the section 'Objectives' -

Objectives are directive and indicative of :

1. What has been presented in the Unit and
2. What is expected from you
3. What you are expected to know pertaining to the specific Unit once you have completed working on the Unit.

The self check exercises with possible answers will help you to understand the Unit in the right perspective. Go through the possible answer only after you write your answers. These exercises are not to be submitted to us for evaluation. These are provided to you as Study Tools to help keep you in the right track as you study the Unit.

Unit – I

Introduction to Cost Accounting

Meaning of Costing, Cost Accounting and Cost Accountancy, Evolution and Development of Cost Accounting, Objectives, Advantages and Limitations of Cost Accounting, Difference between Financial Accounting and Cost Accounting Basic Concepts in Cost Accounting -Cost Centre, Cost Unit, Cost Object, Cost Ascertainment and Cost Estimation, Elements of Cost, Types of Cost

1.0 Objectives

1.1 Introduction

1.2 Presentation of Subject Matter

1.2.1 Costing

1.2.2 Cost Accounting

1.2.3 Cost Accountancy

1.2.4 Evolution and Development of Cost Accounting

Check your Progress-I

1.2.5 Objectives of Cost Accounting.

1.2.6 Advantages of Cost Accounting.

1.2.7 Limitations of Cost Accounting

1.2.8 Difference between Financial Accounting and Cost Accounting.

1.2.9 Basic Concepts in Cost Accounting.

1.2.9.1. Cost Center.

1.2.9.2. Cost Unit.

1.2.9.3. Cost Object.

1.2.9.4. Cost Ascertainment and Cost Estimation.

1.2.10 Elements of Cost.

1.2.11 Types of Cost

Check your Progress-II

- 1.3 Summary
- 1.4 Key Terms.
- 1.5 Check Your Progress Answers
- 1.6 Exercise
- 1.7 Reference for Further Study.

1.0 Objectives

After studying this unit, the students will be able to understand,

1. Meaning of costing, cost Accounting and Cost Accountancy. Evolution and Development of cost accounting and cost accountancy.
2. Students will be able to explain Objectives, Advantages and Limitations of cost accounting, Basic concepts in cost accounting–Cost Center, Cost Unit, Cost Object, Cost Ascertainment and Cost Estimation. Elements of cost and Types of cost.
3. Students will be able to differentiate between Financial Accounting and Cost Accounting.
4. Students will be able to explain elements of cost and types of cost.

1.1 Introduction:

What is cost and cost accounting? In our daily life many times we use the word cost similar to price. However there is difference between cost and price. Every product or service has cost. So in every business or organization, owner or management is interested to know “How much did it take to make this?” before fixing its selling price.

When cost is known,

1. It is possible to fix its selling price.
2. It is possible to measure profit.
3. It is possible to measure revenues.
4. It is possible to take various decisions.

E.g. make or buy, continue or shutdown etc. To calculate Cost it is necessary to know its purpose so we calculate cost of something as cost of 1 unit. Cost of 1 machine, cost of 1 job or cost of 1 department.

This cost is always expressed in monetary terms.

Hence cost means giving up something to get something else. Cost has no definite meaning, but the costing is defined as classifying recording and appropriation of expenditure for the determination of the cost of products or services. However this data should be presented suitably for the guidance of the manufacturer or management.

User use this word according to its need. There is no, one complete description of word 'cost' to suit all situations. According to the Oxford Dictionary, cost means "The price paid for something"

According to CIMA, London (Chartered Institute of Management Accountings) Cost is the amount of expenditure (actual or notional) incurred or attributable to a given thing."

ICWA of India has defined cost as "cost is a measurement, in monetary terms of the amount of resources used for the purpose of production of goods or rendering of services." Thus the cost of an article is its purchase or manufacturing price.

1.1.1 Costing

Costing is defined as classifying, recording and appropriation of expenditure for the determination of the costs of products or services. So when the data related with the cost is presented suitably for the use of manufacturer or management it is called as costing. It is concerned with determining the costs of product/services. It is also used in planning and controlling costs.

The Chartered Institute of management Accountants (CIMA) London has defined costing as, "The techniques and processes of ascertaining cost."

Wheldon has defined Costing as follows:

"Costing is the classifying, recording and appropriate allocation of expenditure for the determination of the costs of products or services, and for the presentation of suitably arranged data for the purposes of control and guidance of the management. It includes the ascertainment of the cost of every order, job, contract, process, service unit as may be appropriate. It deals with the cost of production selling and distribution."

Hence costing means determining costs by using any method like arithmetic process, memorandum, statements etc.

The process of costing consists of routines of ascertaining costs by historical or Conventional costing, standard costing or marginal costing.

1.1.2 Cost Accounting

Meaning: In past years financial accounting was the primary tool used by management to control business activities and prepare annual financial statements like Profit and Loss Account, Balance Sheet and Cash Flow Statement. The main objective of financial Accounting is to present a true and fair view of a company's financial position at regular intervals, usually one year. However information supplied by Financial Accounting is related with past-activity. On the other hand cost account is concerned with the ascertainment of past, present and future costs of products manufactured or services supplied. So cost accounting is the classifying, recording and appropriate allocation of expenditure to know the costs of products or services and for presenting suitably arranged data to assist management.

Cost Accounting provides analysis and classification of expenditure which enables the total cost. It discloses how the total cost is occurred.

Wheldon's definition of cost Accounting, "Cost accounting is the application of accounting and costing principles, methods and techniques in ascertainment of costs and the analysis of saving or excess Cost incurred as compared with previous experience or with standards." The Chartered Institute of Management Accountants in London (CIMA) has defined cost accounting as "The process of accounting for cost from the point at which expenditure is incurred or committed to establishment of its ultimate relationship with cost centers and cost units. In its widest usage, it embraces the preparations of statistical data, the application of cost control methods and the ascertainment of the profitability of activities carried or planned."

This definition is concerned with the mechanism of knowing cost of products or services. It is concerned with accumulation, classification, analysis and interpretation of cost data which is useful to know of

1. Ascertainment of cost.
2. Operational planning and control
3. Decision making.

It means cost accounting relates with the process of accounting for costs and records income and expenditure of production of goods and services. It also provides detailed cost information and necessary statistical data for preparing value estimates and submitting the information supplied. Cost accounting acts as a management tool for decision making. Its applications are wider. All types of activities, manufacturing and non-manufacturing where monetary value is related should consider the use of cost accounting. So like Banking, Insurance, Companies, Railways, Airways, Shipping, and road transport companies, hotels, schools, hospitals, colleges all may employ cost accounting techniques to operate properly. Now a day's cost accounting is regarded as a specialized branch of accounting.

Objectives of Cost Accounting:The main objective of cost accounting is ascertainment of cost, fixation of selling price, proper recording and presentations of cost related data to management. With the help of this information management can measure the efficiency, cost control, cost reduction, profit of each activity. So the management can take various decisions. Now a days the business activities and its objective are changing day by day so following are the main objectives of cost accounting.

1. To know the cost per unit.
2. To analysis the cost by process.
3. To ascertain the profitability.
4. To eliminate wastage at various levels of production.
5. To know profitability of each product.
6. To make use of cost control.
7. To assist management in taking various decision e.q. continue production.
8. To shut down, future expansion etc.
9. To assist in preparing budgets and using it.
10. To advice management on various problems related with production.
11. To ensure effective working of different department.
12. To reduce cost.
13. To find out costing profit or loss.

Advantages of Cost Accounting:

With the help of cost accounting management can get various advantages which are as follows.

1. Profitable and non-profitable activities are disclosed.
2. It is possible to guide for future production policies.
3. It provides various information upon which estimates and tenders are based.
4. It assists in increasing profit level.
5. It provides reliable data which is useful to make comparison between various activities, productions, units, jobs.
6. To know the reason of increase or decrease in profit.
7. It is possible to know the relative efficiencies of different workers.
8. Reducing excessive wastage, expenditure and losses. It is possible with the help of cost accounting to ensure maximum utilization of various resources.
9. Cost accounting is helpful in increasing productivity.
10. Cost accounting is a great help for management.

1.1.3 Cost Accountancy:

Meaning : Cost Accountancy is the use of costing and cost accounting principles, methods and techniques. It is an art, science and practice of cost control and ascertainment of profitability. Cost Accounting is the presentation of information which is useful for owner, management, Government, creditors, investors. The Chartered Institute of Management Accountants in England CIMA has defined cost accountancy as the application of costing and cost accounting principles, methods and techniques to the science, art and practice of cost and the ascertainment of profitability. It includes the presentation of information derived therefrom for the purpose of management decision making. So we can call cost accountancy as the science, art and the practice of cost accountant.

1. Cost Accountancy as the science: It is the body of systematic knowledge used by cost accountant.
2. Cost Accountancy as an art: Cost Accountancy is an art because it includes the ability and skill which cost accountant applies his/her knowledge to solve problems related with cost ascertainment of profit etc.

3. Cost Accountancy is practice: It includes continuous efforts in presentation of information for the sake of various managerial decision making. With the help of Cost Accountancy it is possible to record, ascertain profit or loss. It is also possible to control cost. It aims at guiding, the actual performance towards the line of targets and regulates the actual if they vary from the targets. For this purpose various cost control techniques are used e.g. standard costing, budgetary control, presentation of Cost data and Cost Audit. Cost Accountancy enables to reduce expenditure. With the help of Cost Accountancy it is possible to do Cost Audit.

Modern Cost Accounting developed only during the nineteenth century because of the increasing complexity of modern industry.

Modern management needs more detailed information than those supplied by these financial statements. Cost Accounting provides detailed cost information to various levels of management for efficient performance of their functions e.g. decision making, optimize the utilization of scarce resources, control expenditure and increase profitability.

Thus cost accounting is concerned with the ascertainment of past, present and expected future cost of products manufactured or services supplied.

1.1.3 Evolution and Development of Cost Accounting

During the ancient and medieval period there was no cost accounting because business activities were simple. Production was on small scale, mainly handicrafts and agriculture. The owner was able to manage business activities. So there was no need for detailed cost records. Only financial accounting existed during this period to calculate overall profit or loss.

Emergence of Book-keeping during the 14th to 18th century there was an emergence of book-keeping because trade was expanded and the double entry system of book-keeping developed in Italy. Merchants started maintaining records of transaction. However these records were limited to financial accounting. Only the focus was on Profit/Loss and financial position. There was no separate system to find out cost of individual products or jobs.

Beginning of Cost Accounting. (Industrial revolution period 1760-1850:

This period was very crucial period because industrial revolution took place in England the production system shifted to large factories with machinery and large

scale production was started. Here separated owner from his production center. Owners hired professional managers to run factories.

Also there was increase in competition which forced manufacturers to know exact cost of production, per unit cost, control of wastage and fix selling prices. Here is the beginning of basic costing techniques. However no separate Cost accounting. Still it was a branch of financial accounting

19th Century period 1850 to 1900. (Growth as a separate discipline:

During the 19th century industries grew rapidly in England and USA. Also various theories of management came forth. F.W. Taylor's scientific management theory emphasized on cost control. Accountants started maintaining separate cost records to find cost of each job, process and department. Total cost and cost per unit was calculated by preparing cost sheet. During this period professional Bodies were formed e.q Institute of Cost and Works Accountants (ICWA) was forward in Uk in 1919 which is Now known as CIMA (Chartered Institute of management accountants), so by the end of this century, cost accounting started emerging as a separate discipline.

20th Century 1900 to 1950:

This period was the period of two world wars. These world wars created huge demand for war materials which led to accurate cost ascertainment compulsory for business. During this period various techniques were developed for costing and widely adopted by industries to control costs and measure efficiency. Cost Accounting was introduced as a separate subject in commerce and management courses.

By 1950 cost accounting was no longer just a branch of financial accounting. It became a recognized professional field with its own principles and techniques.

Modern Era: Since 1950 to present:

After 1950 the role of cost accounting changed from simple cost finding to cost management and decision making. The scientific management movement led by Taylor gave impetus to the development of cost accounting because it contributed to the use of standard costs in manufacturing centers.

The development of cost accounting in India is of recent origin and it started acquiring importance after the independence of country. The Government of India started giving emphasis on the industrial development of the country. So the

provision of cost audit under the companies Act has given impetus to the development of cost accounting in Indian. Vivian Bose Enquiry commission revealed the various malpractices existing in manufacturing centers and financial audit was insufficient to know the real efficiency of manufacturing center. Because of this the concept of cost audit emerged.

So the Government may appoint a cost auditor to conduct cost audit where it is necessary.

Check your progress I:

1. Financial accounting helps in _____the financial position of the concerned firm
2. Cost accounting deals _____ and ignores_____.
3. Cost accounting is a technique of _____.
4. Cost accounting is development because of _____financial accounting.
5. During the ancient and medieval period there was no_____.

1.3 Objectives, Advantages and Limitations of Cost Accounting.

1.3.1 Objectives of Cost Accounting.

The main objectives of cost accounting are ascertainment of cost, fixation of selling price, recording and presentation of cost data to the management to take various decisions. However, with the development of business and industry its objectives are expanding.

Following are the objectives of Cost Accounting.

1. To ascertain the cost and fix the selling price. This is the primary objective of cost accounting.
2. To control cost under different situations and increase profit.
3. To reduce cost at various levels of production.
4. To know profitability and profit on each activity.
5. To collect necessary data and present it to management for various decision making processes.

6. To decide the best process of manufacturing.
7. To advise management on future plans of expansion policies.
8. To implement an effective control over stocks of various elements in production
9. To guide management in formulating and applying of incentive bonus plans based on productivity and cost savings.
10. To assist in supervising the working of data processing through computers.

In short these objectives of cost accounting are regrouped in the following three major heads.

1. Ascertain and analysis of cost and profit by product, function and responsibility.
2. Cost control and cost reduction.
3. Providing necessary data to management to conduct the business with utmost efficiency.

1.3.2 Advantages of Cost Accounting:

Following are the advantages of cost accounting

1. With the help of cost accounting profitable and unprofitable activities are disclosed and necessary steps can be taken.
2. It is possible to measure efficiency and take necessary steps where improvement is required.
3. Cost accounting is helpful for future production policies.
4. It is help in increasing profits and reducing and wastages and preventing inefficiencies in departments.
5. It furnishes reliable data for comparing costs.
6. It discloses the various causes of an increase or decrease in profits.
7. It assists in the fixation of prices of goods and services.
8. It is helpful in proper planning of various activities.
9. It is helpful in cost reduction by finding out new and improved ways to reduce cost.

10. It prevents frauds and manipulation with the help of cost audit it is possible to prevent frauds and manipulation.
11. It encourages workers through the introduction of incentive plans which leads towards higher productivity. In this way cost accounting is useful for management, stakeholders, society and the government.

1.3.3 Limitations of Cost Accounting.

Cost accounting has developed because of certain limitations of financial accounting. However cost accounting is not an exact science. It is based on accounting principles and theories. So there are certain limitations of cost accounting. These are as follows:

1. There is no uniform procedure for cost accounting so the results from same information may arrive at different.
2. It is argued that maintenance of cost records is not necessary and there is duplication of work.
3. It is always pointed out that installation of costing system is somewhat expensive. So it is not affordable to small concerns.
4. It is criticized that modern methods of costing are not applicable to many types of industries and a costing system should be specially designed to meet the needs of business.
5. It is said that the installing and working a cost system is expensive and benefits derived there from it are limited use.

1.4 Difference between Financial Accounting and Cost Accounting

Differences between cost accounting and financial accounting are explained as under.

Basis	Financial Accounting	Cost Accounting
1. Purpose	The basic purpose of financial accounting is to prepare financial statements i.e. profit and loss account, Balance sheet for reporting owner or shareholders.	The basic purpose of cost accounting is to provide detailed cost information to management for decision making.

2. Statutory Requirement	Financial accounting is a legal requirement companies Act, Income Tax Act, made it mandatory.	It is voluntary to maintain cost accounting except in certain industries, where it has been made obligatory to keep cost records under the Companies Act.
3. Periodically of Reporting	Financial reports are prepared periodically usually on an annual basis.	Cost accounting is continuous process. It may be daily, weekly or monthly.
4. Control aspect	It has emphasis on the recording of financial transactions. And there is no control aspect.	It provides information for detailed system of controls with some special techniques like standard costing, budgetary control.
5. Analysis of cost and profit	It reveals the profit or loss of the business for a particular period as a whole.	It shows the detailed cost and profit of each product, department, process etc.
6. Historical and predetermined costs	Financial accounting is concerned with historical records only.	Cost accounting is concerned not only with historical costs but also with predetermined costs.
7. Types of transaction recording	In financial accounting only external transactions are recorded.	In cost accounting external transaction as well as internal transactions are also recorded.
8. Format of presenting information	It has a uniform format for presentation of information e.g. profit and loss account, Balance Sheet etc.	It has no uniform format of presentation of information. Information is presented according to the needs of management.

1.5 Basic Concepts in Cost accounting.

1.5.1 Cost Center

To know the cost the whole organization is divided into small parts or sections, and that small section is known as cost center of which cost is ascertained. So cost center is defined as, “a location, persons or item of equipment (or group of these) for which costs may be ascertained and used for the cost control.”

A cost center defined by CIMA, London as, “a location, person or item of equipment (or group of these) for which costs may be ascertained and used for the purpose of control.” So a cost center means a section of the business to which costs can be charged. The cost center may be a location (department, sales area) an item of equipment, (delivery van, a machine) a person (a salesman, a machine operator) or a group or these. The main objective of ascertaining the cost of a cost center is control of cost.

A. There are two types of Cost Centers.

1. Personal Cost Center:

It consists of a person or a group of persons.

2. Impersonal Cost Center:

It consists of a location or an item of equipment or group of these.

B. From a functional point of view, cost centers are of the following types-

1. Production cost center where actual productions work takes place.

2. Service cost center these are ancillary to and render services to production cost centers.

The purpose of ascertaining the cost of a cost center is cost control. The person who is in charge of a cost center is held responsible for the control of cost of that center. There is no hard and fast rule to create in any cost centers in a one plant. By increasing the number of cost center it is possible for closer control and greater accuracy of cost absorption.

1.5.2 Cost Unit

Cost unit is a step further by breaking up the cost into smaller sub-divisions and assisting in knowing the cost of products or services.

It is defined by CIMA London as a “Unit of product or service in relation to which costs are ascertained.” According to institute of cost accountants of India (ICAI). “Cost Unit is a form of measurement of volume of production or service.” According to the convenience and practice in the industry this cost unit is generally accepted. For example in shoes factory cost unit will be pair or dozen pairs. In sugar factory the cost per tons of sugar will be ascertained. Here pair or dozen pairs, tonne’ are cost units.

1. Units of production: Tone of steel, a meter cloths.
2. Units of service: passenger miles, consulting hours etc.

Following are some examples of Cost Units in various industries:

Industry	Cost unit
Chemicals	Tone, kilogram, liter, gallon etc.
Pen	Dozen or gross
Car/Automobiles	Each car, number
Paper	Ream
Printing press	Thousand copies
Building construction	Each building or flat
Mines	Tone of mineral
Education	Student
Crude oil	Barrel/ tone/ liter
Bricks	1000 bricks
Hospital	Bed per day
Interior decoration	Each job
Cosmetics	Grams, Jars or tubes

1.5.3 Cost Object

The concept of cost object is related with knowing the cost of a particular ‘thing’ and this particular thing is called as a cost object. It is defined as, “anything for which a separate measurement of cost may be desired.” It includes a product,

service, cost center, activity, sub-activity, project, contract, customer or distribution center, channel or any other unit in relation to which costs are ascertained.” This definition is by CIMA London.

Following are the examples of Cost Object:

Cost Object	Examples
Product	Car, bath soap
Service	Taxi service, Laundry service
Process	Weaving process in a Textile mill.
Activity	Developing a website on the Internet, placing order of purchase.

1.5.4 Cost ascertainment and Cost Estimation

One of the objective of Cost Accounting is ascertainment of actual costs incurred. In different types of industries different methods are employed to know the cost or for ascertaining cost. These methods are designed to suit the needs of business organization. Ascertainment of actual costs deals with

1. Collection and analysis of expenses.
2. Measurement of production
3. Linking up of production with the expenses.

So the system of costing adopted refers to the type of cost used for cost ascertainment. The system of costing has a direct impact on the technique used for linking up of production with expenses.

Cost Estimation:

Cost estimation is the process of predetermining costs of goods or services. It is very common to estimate costs in advance of production. Estimation costs are future costs which are likely to be incurred in future, Cost estimates are useful in following works.

1. Making price quotations and bidding for contracts.
2. It is useful in preparation of budgets.

3. It is useful in evaluation performance.
4. For projected financial statements cost estimation is useful.
5. For controlling costs, cost estimates are useful.
6. Cost estimates may serve as targets in controlling the costs.

However extreme care should be taken in cost estimation because a high price quotation may result in loss of business.

1.6 Elements of cost and types of cost:

1.6.1 Elements of cost

We all know that the cost of making and selling a product can be divided into three main classes, namely materials, Labour and expenses. For proper control and various managerial decisions, management requires various information and analyzed data. So the total cost is analyzed by elements of cost i.e., by the nature of expenses. These elements of costs are further analyzed into different elements, which are described in the following chart

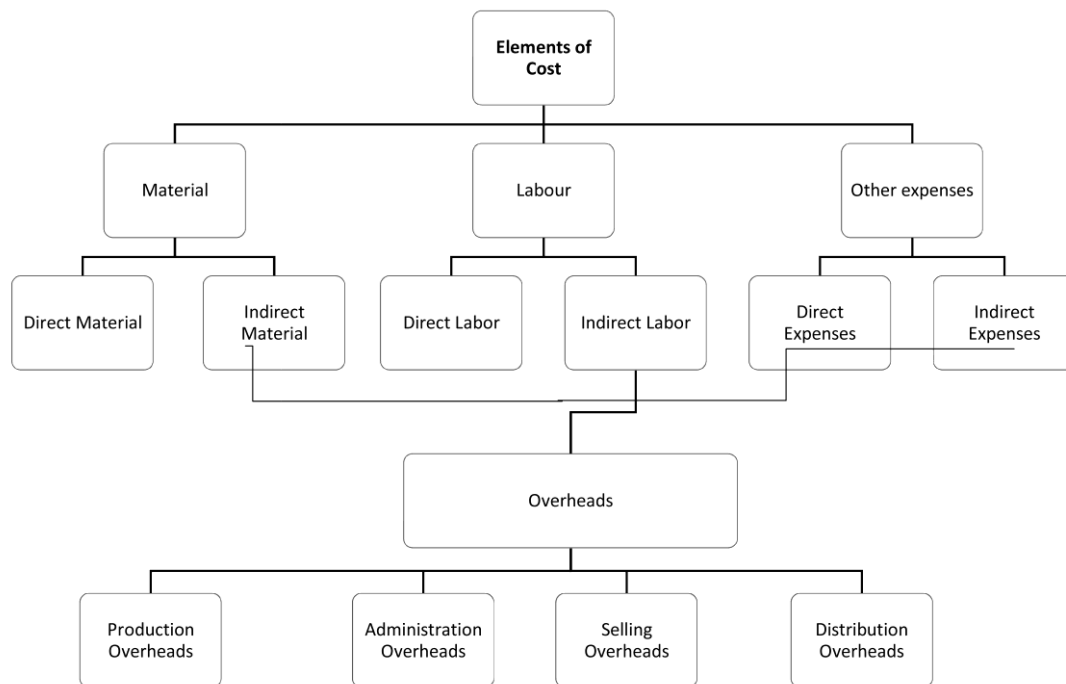


Fig: Elemets of cost

These elements of costs are illustrated as follows –

1. **Direct Materials:** Direct Materials are those materials which directly enter the product and form a part of finished product. They are directly charged to that product. For example timber is direct material in furniture making. Or cloth is direct material in dress making. Direct material can be measured and directly charged to the product. All raw material in any product are direct material and they are usually high value items in that product.

According to chartered Institute of Management Accountants. Of London, “Direct material cost is the cost of materials entering into and becoming constituent elements of a product or saleable service and which can be identified in the product or saleable service.”

In cost sheet these direct materials are charged to prime cost.

2. **Indirect materials:** Indirect materials are those materials which are not direct materials in that product. Particularly they are used for maintenance and repair of machinery, the running of service department, spare and components, packing materials, lubricants, booms, rags, cleaning materials, for repairs and maintenance of fixed assets, high speed dieses used in power generation. However their value is in comparatively small in that product.
3. **Direct Labour:** Means all labour expended in altering the construction or condition of the product. Labour is treated as direct if it can be conveniently allocated to different jobs products or process or expended in converting raw materials into finished goods. Wages of these lobours are treated as direct wages.
4. **Indirect Labour:** The wages of labour which cannot be allocated to different jobs or products are treated as indirect labour. They are part of factory expenses. The examples of indirect labour are charge-hands and supervisors, maintenance workers, men employed in service departments, material handling and internal transport, trainees and instructors, works clerical staff and departmental coolies.
5. **Direct Expenses:** Direct Expenses are those expenses which can be allocated conveniently to a unit of cost. These direct expenses are other than direct materials and direct labour. In other words all expenses which can be identified to a particular cost center and they are directly charged to the center. These expenses are directly charged to the product as part of prime cost. Examples of direct expenses are royalty based on production, excise duty, hive and

maintenance charges of a specific plant and equipment, cost of making a specific pattern, design, drawing etc.

6. **Indirect Expenses:** Indirect expenses are those which cannot be directly attributed to a particular cost object. Such expenses cannot be allocated but can be apportioned to or absorbed by cost centers e.g. rent, rates, insurance, general manager's salary, canteen and welfare expenses, lighting and heating, telephone expenses depreciation of fixed assets etc.
7. **Overheads:** The total of all indirect costs is called as overheads. It includes indirect material, indirect labour and indirect expenses according to CIMA, London, overhead is the aggregate of indirect material, indirect wages and indirect expenses.

Wheldon has defined overheads as "The cost of indirect materials, indirect labour and such other expenses, including service as cannot conveniently be charged direct to specific cost units. Alternatively, overheads all expenses other than direct expenses." "Overhead costs are the operating costs of a business enterprise which cannot be traced directly to a particular unit of output." Blocker and Weldon.

Overhead costs may be classified according to classification of overheads		
By Functions	By Elements	By Behavior
1. Production overheads	1. Indirect material	1. Fixed overheads
2. Administration	2. Indirect labour	2. Variable overheads
3. Selling overheads	3. Indirect Expenses	3. Semi variable overheads
4. Distribution Overheads		

The main groups into which overheads may be subdivided are

1. Manufacturing Overheads:

These are all indirect expenses which cannot be charged direct to specific cost units e.g. Depreciation, repairs and maintenance of fixed assets rent and rates, lubricants,

2. Administration Overheads:

Administration overheads are the indirect expenses incurred in formulating the policy, controlling and managing the operations of an undertaking which is not related directly to production activities e.g. office rent, salaries and wages of clerks etc.

3. Selling Overheads:

These are the expenses occurred to create and stimulate demand, orders or all indirect costs associated with marketing and selling activities e.g sales office expenses, salesman's salary and commission, showroom expenses. Advertisement expenses etc.

4. Distribution Overheads:

Distribution expenses are those which are incurred in handling a product which is ready for dispatch e.g warehouse rent, warehouse staff salaries, insurance etc.

Types of Costing

To ascertain the cost is the main objective of costing or cost accounting. Following are the techniques and process used to ascertain cost.

- A. Historical costing
 - B. Absorption Costing
 - C. Uniform Costing
 - D. Marginal Costing
 - E. Standard Costing
- A) **Historical Costing:** Historical Costing is the ascertainment of costs. After they have been incurred with this it is possible to know how much was spent on producing goods.
- B) **Direct Costing:** In direct costing all direct costs to operations, processes or products, learning all indirect costs to be written off against profits in the period in which they arise, is known as direct costing.
- C) **Absorption Costing:** Absorption costing means the practice of charging variable costs to operations, processes or products. It is different from historical costing or direct costing because in absorption costing fixed costs are excluded.

- D) **Uniform Costing:** In uniform costing cost of production is measured for the industry as a whole. With this it is possible to make comparison of cost performance. In uniform costing use of same costing principles or practices by several undertakings for common control or comparison of costs. However the working of a uniform costing system depends on the co-operation of different units in the industry.
- E) **Marginal Costing:** Marginal costing is possible to use in the industry where fixed and variable costs can be separated by analysis. It is also known as “Differential costing” or “Direct Costing”. In this system fixed cost is separated from variable cost.
- F) **Standard Costing:** In standard costing cost of each unit or batch through determination before and of what should be the cost and then its comparison with actual cost. It is a predetermined cost or budget costs of unit of a product or a job. Through this it is possible for management to make comparison of actual cost with a prearranged standard cost and the cost of variable is detected. Management can take corrective action.

Check Your Progress II

A) Fill in the Banks

1. Cost is a _____ and Price is a _____.
2. Indirect material + Indirect Labour + _____ = Overhead.
3. Cost Accounting serves the information needs of _____.
4. Cost accounting is based on _____ figures.
5. Cost accounting records both monetary and _____ units.
6. Cost unit in a college may be a _____.
7. _____ Costing is applied in industries like printing, furniture and Shipbuilding where each job is different.
8. _____ Costing refers to ascertainment of cost after it has been incurred.
9. _____ Costing involves determination of cost in advance before production starts.
10. _____ Costing is used to control costs by comparing actual with predetermined standards.

1.3. Summary:

Cost Accounting is a systematic process of recording, classifying, analysing, determining and controlling costs incurred in producing goods or providing services. Costing refers to the technique of determining the cost of a product, service, job or activity, while Cost Accountancy is the broader application of costing principles for cost ascertainment, cost control, cost reduction and managerial decision-making. Cost Accounting evolved with the growth of industries and mass production, as financial accounting alone could not provide detailed information about individual product costs. Its major objectives are to ascertain costs, control and reduce costs, determine profitability, assist in price fixation, prepare budgets, measure efficiency and support managerial decisions. Its advantages include effective cost control, reduction of wastage, better planning, pricing and decision-making; however, it may be expensive, complex, time-consuming and dependent on estimates. Unlike Financial Accounting, which mainly reports the overall financial performance and position of an organisation, Cost Accounting provides detailed information relating to products, jobs, departments and activities.

The basic concepts of Cost Accounting include Cost Centre, Cost Unit, Cost Object, Cost Ascertainment and Cost Estimation. A Cost Centre is a department, machine, person or location for which costs are collected; a Cost Unit is the unit in relation to which cost is measured; and a Cost Object is anything for which cost is separately determined. Cost Ascertainment means determining the actual cost incurred, whereas Cost Estimation means forecasting future costs. The major elements of cost are Material, Labour and Expenses, which may be classified as direct or indirect. Costs may also be classified as fixed, variable and semi-variable, according to behaviour, and as direct and indirect according to traceability. Thus, Cost Accounting provides essential information for understanding costs, improving efficiency, controlling expenditure and making sound business decisions.

1.4 Key Terms:

1. **Costing** – The technique and process of determining the cost of a product, service, job, or activity.
2. **Cost Accounting** – A branch of accounting that records, classifies, analyses, and controls costs to determine the cost of products or services.

3. **Cost Accountancy** – The application of costing and cost accounting principles for cost ascertainment, cost control, cost reduction, and managerial decision-making.
4. **Cost Centre** – A department, location, person, or equipment for which costs are collected and measured separately.
5. **Cost Unit** – A unit of product or service in relation to which cost is measured, such as per unit, per kg, per litre, or per passenger-kilometre.
6. **Cost Object** – Anything for which the cost is specifically measured or determined, such as a product, service, project, or customer.
7. **Cost Ascertainment**– The process of determining the actual cost incurred in producing a product or providing a service.
8. **Cost Estimation** – The process of forecasting or calculating the expected cost of a product, service, or activity for a future period.
9. **Elements of Cost** – The major components of cost: Material, Labour, and Expenses. These may further be classified as direct and indirect costs.
10. **Types of Cost** – Costs classified according to their nature or purpose, such as fixed cost, variable cost, semi-variable cost, direct cost, indirect cost, product cost, and period cost.

1.5 Check Your Progress Answers.

Check Your Progress I

- | | |
|----------------------------------|---------------------------------------|
| 1) Ascertaining Historical Costs | 2) Only With Future cost |
| 3) Cost Determination | 4) Limitation of Financial Accounting |
| 5) Cost Accounting | |

Check Your Progress II

- | | | | |
|---------------------|----------------------|---------------|---------------|
| 1. Fact policy, | 2. Indirect expenses | 3. Management | 4. Estimated |
| 5. Physic, | 6. Student | 7. Job | 8. Historical |
| 9. Standard Costing | 10. Standard. | | |

1.6 Exercise

A) Short answer type Questions:

1. What are the main objectives of Cost Accounting?
2. Limitation of Cost Accounting?
3. What is meant by Costing?
4. Explain two advantages of cost Accounting?
5. Explain two advantages of cost Accounting?

B) Long Answer type Questions

1. What is Cost Accounting? Discuss briefly its objectives and advantages.
2. State difference between Cost Accounting and Financial Accounting?
3. Explain types of Costing?
4. Explain the various elements of Cost?
5. Explain Cost Ascertainment and Cost Estimation?
6. Evolution and development of Cost Accounting?

1.7 Reference for further study

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2. S.P. Jain, K.L. Narang, Simi Agrawal, Monika Sehgal (2019) Cost Accounting Principles and Practice, Kalyani Publishers.
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Unit – II

Principles, Types and Methods of Cost Accounting

General Principles of Cost Accounting, Types or Techniques of Costing, Methods of Costing, Costing - An Aid to Management

- 2.0 Objectives
- 2.1 Introduction
- 2.2 Subject matter
 - 2.2.1 General Principles of Cost Accounting
 - 2.2.1.1 Cause and Effect Relationship
 - 2.2.1.2 A cost should be charged only after it has been incurred
 - 2.2.1.3 The convention of prudence should be ignored
 - 2.2.1.4 Abnormal costs should be excluded from cost accounts
 - 2.2.1.5 Past costs not to be charged to future period
 - 2.2.1.6 Principles of double entry should be applied wherever necessary
 - 2.2.2 Methods of costing
 - 2.2.2.1.1. Specific Order Costing
 - 2.2.2.1.1. Job Costing
 - 2.2.2.1.2. Features of Job Costing:
 - 2.2.2.1.3 Advantages of Job Costing
 - 2.2.2.1.4. Limitations of Job Costing
 - 2.2.2.1.5. Preparation of Job Cost Sheet
 - 2.2.2.1.6. Reports in Job Costing System
 - 2.2.2.2. Batch Costing
 - 2.2.2.2.1 Essential Features of Batch Costing

- 2.2.2.2.2 Applications of Batch Costing
 - 2.2.2.2.3 Economic Batch Quantity (EBQ)
 - 2.2.2.3 Contract Costing
 - 2.2.2.3.1 Key features of contract costing
 - 2.2.2.3.2 Types of contracts
 - 2.2.2.4. Process Costing
 - 2.2.2.4.1 Features of Process Costing
 - 2.2.2.4.2 Process Costing Vs Job Costing/ Batch Costing:
A Comparison
 - 2.2.2.4.3 Procedure of Process Costing
 - 2.2.2.4.4 Elements of Process Cost
 - 2.2.2.4.5 Advantages of Process Costing
 - 2.2.2.4.6 Limitations of Process Costing
 - 2.2.2.5 Joint Product and By-Product
 - Joint Products
 - Features of Joint Product
 - By-products
 - Difference between Joint product and By-product
 - 2.3.2.6 Operating Costing / Service Costing
 - 2.3.2.6.1 Characteristics of Operating Costing
 - 2.3.2.6.2 Cost Unit
 - 2.3.2.7 Operation Costing
 - 2.3.2.8 Single, Output or Unit Costing
 - 2.3.2.9 Multiple or Composite Costing
- 2.2.3 Types or Techniques of Costing
 - 2.2.3.1 Historical costing
 - 2.2.3.2 Budgetary Control

- 2.2.3.2.1 Objectives of Budgetary Control
 - 2.2.3.2.2 Advantages of Budgeting Control
 - 2.2.3.2.3 Limitations of Budgetary Control
 - 2.2.3.3 Standard Costing
 - 2.2.3.3.1 Advantages of Standard Costing
 - 2.2.3.3.2 Limitations of Standard Costing
 - 2.2.3.4 Marginal Costing
 - 2.2.3.4.1 Features of Marginal Costing
 - 2.2.3.4.2 Fundamental Principle of Marginal Costing:
 - 2.2.3.4.3 Limitations of Marginal Costing
 - 2.4.4.4.4 Applications of Marginal Costing
 - 2.2.3.5 Absorption Costing
 - 2.2.3.6 Uniform Costing
 - 2.2.3.6.1 Application/Scope of Uniform Costing System
 - 2.2.3.6.2 Advantages of Uniform Costing
 - 2.2.3.6.3 Limitations of Uniform Costing
- 2.2.4 Costing – An Aid to Management
- Check your progress
- 2.3 Summary
- 2.4 Terms to Remember
- 2.5 Answers to check your progress
- 2.6 Exercise
- 2.7 Reference for further study

2.0 Objectives:

1. To know the general principles of cost accounting.
2. To know the Methods of costing.

3. To know the Techniques of costing.
4. To know how costing helps to management in decision making.

2.1 Introduction:

Corporate sectors are functioning in a highly competitive environment with high degree of risk and uncertainty. Consequently, they are required to function more efficiently and effectively. At the same time, they aim at minimization of cost and maximization of profit. To achieve this primary corporate objective, it requires to take an appropriate decision and to take appropriate decisions it requires a system.

Cost Accounting is the branch of accounting that systematically records, classifies, analyzes, and controls costs with the objectives of cost ascertainment and cost control. It answers questions like “What is the cost per unit?”, “Which activity is wasteful?”, and “Should we make or buy a component?” However, for cost data to be reliable, comparable, and useful for decision-making, it cannot be collected randomly. Like science, Cost Accounting operates on a set of generally accepted principles. These principles govern how costs are classified into material, labour and overheads; how they are accumulated against jobs, processes, or contracts; how indirect costs are apportioned fairly; and how cost reports are prepared for management.

This chapter introduces the fundamental principles of Cost Accounting that form the foundation of all costing methods and techniques. We begin by understanding the meaning and objectives of these principles, followed by their detailed classification, and conclude with their practical application in Indian industry under the Companies Act, 2013 and Cost Accounting Standards. A sound grasp of these principles is essential, because they transform raw cost data into meaningful information for pricing, budgeting, and profitability analysis – the core functions of a cost accountant.

2.2 Subject Matter

2.2.1 General Principles of Cost Accounting:

Principles of cost accounting are the fundamental rules, guidelines, and conventions that govern the recording, classification, allocation, and reporting of

costs. They ensure uniformity, accuracy, and usefulness of cost data for managerial decisions.

ICMA London: “Cost accounting principles are the body of doctrines commonly associated with the theory and procedure of cost accounting.”

The following may be considered as the General Principles of Cost Accounting:

2.2.1.1. Cause and Effect Relationship: Every cause has its effect and every effect has its cause. For effective cost control, it is essential to establish cause and effect relationship for each item of cost. Cost should be related as closely as possible to their causes so that cost will be shared only among the cost units that pass thorough the department of which the expenses are related.

2.2.1.2. A cost should be charged only after it has been incurred: While determining the cost of individual units those costs which have actually been incurred should be considered. For example, selling costs can be charged with the products which are sold.

2.2.1.3. The convention of prudence should be ignored: Usually accountants believe in historical costs and while determining cost, they always attach importance to historical cost. In Cost Accounting this convention must be ignored, otherwise, the management appraisal of the profitability of the projects may be vitiated. According to W.M. Harper, “a cost statement should, as far as possible, give facts with no known bias. If a contingency needs to be taken into consideration it should be shown separately and distinctly”.

2.2.1.4. Abnormal costs should be excluded from cost accounts: Costs which are of abnormal nature (e.g. Accident, negligence etc.) should be ignored while computing the cost, otherwise, it will distort costs figures and mislead management as to working results of their undertaking under normal conditions.

2.2.1.5. Past costs not to be charged to future period: Costs which could not be recovered or charged in full during the concerned period should not be taken to a future period, for recovery. If past costs are included in the future period, they are likely to influence the future period and future results are likely to be distorted.

2.2.1.6. Principles of double entry should be applied wherever necessary: Costing requires a greater use of cost sheets and cost statements for the purpose of cost ascertainment and cost control, but cost ledger and cost control accounts should be kept on double entry principle as far as possible.

2.2.2 Methods of Costing:

The main purpose of costing is to ascertain the cost of production, control costs and improve efficiency rates. In this regard, the methods of costing used are of crucial importance. Industries are classified into two broad categories as jobbing industries and processing (mass production) industries. Job industrial enterprises undertake the production of goods and services according to customer's specifications. As the customer's specifications about goods and services usually differ from one another, there is no standard product and therefore, costs should be ascertained for each job separately. Construction work, ship-building heavy machinery, contractor's work etc., fall into job industries.

On the other hand, in the case of mass production industries, industrial enterprises undertake production of identical units on a continuous basis in anticipation of demand. Manufacturing activities are grouped into a few processes and the costs are accumulated for each process separately. Paper, sugar, textile etc. are examples of processing industries.

The methods of costing refer to the various approaches employed by businesses to determine the cost of producing goods or services. These methods are crucial for accurate financial analysis, decision-making and pricing strategies. There are several costing methods exist, each tailored to suit different industries and production processes. As such, there are two specific methods of costing; i. Specific order costing and ii. Operation costing (also referred as process costing). Specific order costing can be classified either as job costing, batch costing or contract costing. Figure 2.1 shows the classification of the methods of costing.

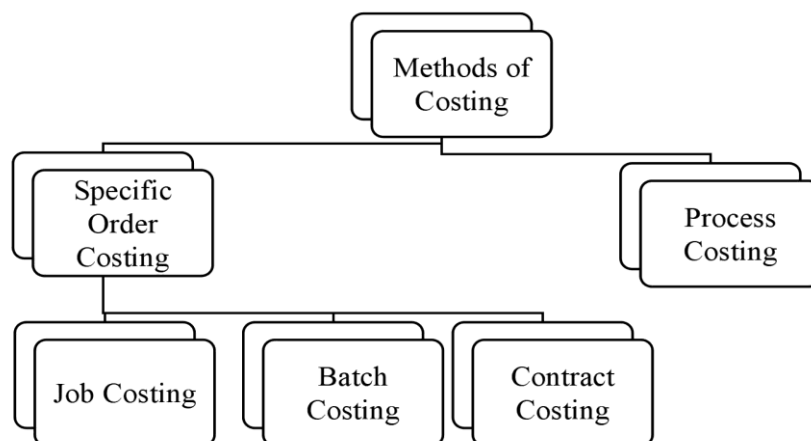


Figure 2.1: Methods of Costing

2.2.2.1.1 Specific Order Costing: Specific order costing is a cost accounting method used for unique, custom-made products or services, where costs are accumulated for each individual order or project. This approach ensures accurate cost tracking and pricing tailored to the specific requirements of each customer order.

CIMA official Terminology (2005) defines specific order costing as “the basic costing method applicable where work consists of separate contracts, jobs or batches, each of which is authorized by a special order or contract.”

2.2.2.1.2 Job Costing: Job Costing is the accounting system that traces costs to individual units or to specific jobs, contracts or batches of goods. The method is also known by various names, such as specific order costing, production order costing, job lot costing or lot costing.

According to the terminology of CIMA London, Job Costing is “the basic costing method applicable where work consists of separate contracts, jobs or branches, each of which is authorized by a special order or contract.”

A job is simply a product or service that can be easily distinguished from other products or services and for which the firm desires that a specific cost be recorded for the product or service. Firms that produce jobs are often called job shops. The record of the cost of the job kept in the accounting system is called job cost sheet or job cost cards.

CIMA official Terminology says that:

A job is a ‘customer order or task of relatively short duration’.

Job costing is a ‘form of specific order costing where costs are attributed to individual jobs.’

Job Costing system generally used in:

1. Printing Press.
2. Automobile repair shop.
3. Interior decoration.
4. General engineering.
5. Machine tools etc.

2.2.2.1.3 Features of Job Costing:

1. Each job maintains its separate identity throughout the production stage.

2. The job is meant for a specific customer and not meant for a mass market.
3. Production pattern is not repetitive and continuous.
4. Production begins only after getting order from customer.
5. Each job is executed as per the requirement of the customer. Each job order is considered as a separate cost unit.
6. Duration of production cycle is usually short but a large order may extend beyond one year.
7. A Job Cost Sheet is prepared and Job Register is maintained to record particulars of the job like price, date of commencement, special requirement etc. Profit or Loss is calculated on the completion of the job.

2.2.2.1.4 Advantages of Job Costing:

Job costing offers the following advantages:

1. The cost material, labour and overhead for every job or product in a department is available daily, weekly or as often as required while the job is still in progress.
2. On completion of a job, the cost under each element is immediately ascertained. Costs may be compared with the selling prices of the products in order to determine their profitability and to decide which product lines should be pushed or discontinued.
3. Historical costs for past periods for each product, complied by orders, departments or machines, provide useful statistics for future production planning and for estimating the costs of similar jobs to be taken up in future. This assists in prompt furnishing of price quotations for specific jobs.
4. The adoption of predetermined overhead rates in job costing necessitates the application of a system of budgetary control of overhead with all its advantages.
5. The actual overhead costs are compared with the overhead applied at predetermined rates; thus, at the end of an accounting period, overhead variances can be analysed.
6. Spoilage and defective work can be easily identified with specific job or order.

7. Job costing is particularly suitable for cost plus and such other contracts where selling price is determined directly on the basis of costs.

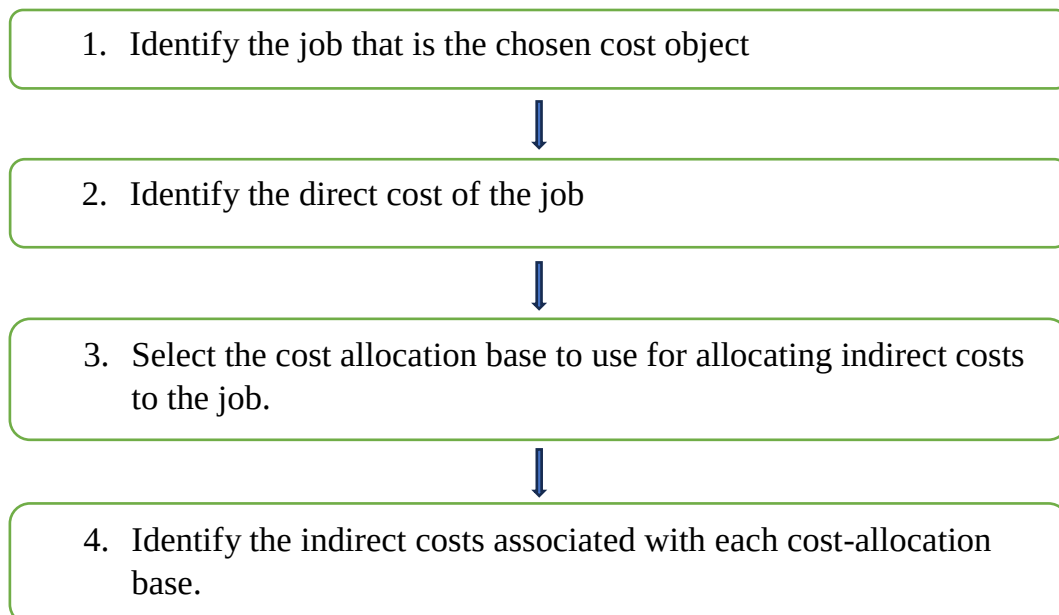
2.2.2.1.5 Limitations of Job Costing:

The limitations of job costing are:

1. Job costing is comparatively more expensive as more clerical work is involved in identifying each element of cost with specific departments and jobs.
2. With the increase in the clerical processes, chances of errors are enhanced.
3. The cost as ascertained, even where they are compiled very promptly, are historical as they are compiled after incidence.
4. The cost compiled under job costing system represents the cost incurred under actual conditions of operation. The system does not have any scientific basis.

2.2.2.1.6 Preparation of Job Cost Sheet:

The objective of job costing is to ascertain the cost of a job that is produced as per the requirements of the customers. Therefore, it is necessary to identify the costs associated with the job and present it in the form of job cost sheet for showing various types of costs. The total cost of a job is recorded in the following manner:



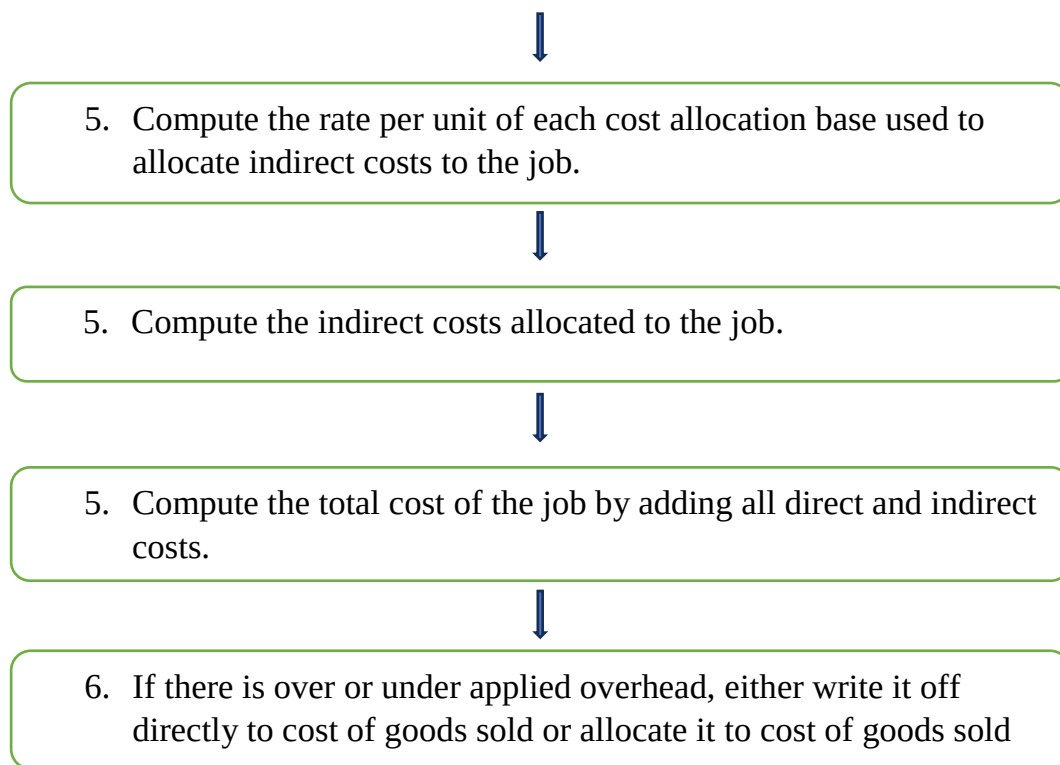


Figure 2.2 : Steps in Preparation of Job Cost Sheet

2.2.2.1.7 Reports in Job Costing System:

1. Report on profits on completed jobs:

A statement may be prepared monthly to indicate the gross profit earned on all jobs completed during the month. This statement is useful for the management for evaluating past performances. Net profit analysis may also be made in a similar manner if administration, selling and distribution overheads for the job are included in the statement.

2. Report on cost variances:

If cost estimates are developed, a cost variance report showing the deviations of actual costs from the estimated costs may be prepared in order to indicate the significant differences and to carry out through investigation. The report may be prepared separately for a job, or for a department showing the variances in respect of all jobs undertaken by the department during a period.

2.2.2.2 Batch Costing:

Batch costing is a costing method that involves grouping and allocating costs to a specific quantity of products produced in a single batch. It aims to calculate the cost per unit by spreading the total cost of the batch over the number of units produced within that batch. It is a valuable costing method for businesses engaged in batch production, helping them understand the cost dynamics of each single batch and make informed decisions to enhance overall operational efficiency and profitability.

Batch costing is commonly employed in industries where products are produced in batches. It provides a more accurate reflection of the costs associated with each specific batch.

2.2.2.2.1 Essential Features of Batch Costing:

Following are the essential features of Batch Costing-

1. Each batch is treated as a cost unit.
2. All costs are accumulated and ascertained for each batch.
3. A separate Batch Cost Sheet is used for each batch and is assigned a certain number by which the batch is identified.
4. The cost per unit is ascertained by dividing the total cost of a batch by the number of items produced in that batch.

2.2.2.2.2 Applications of Batch Costing:

Batch Costing is applied in those industries where the similar articles are produced in definite batches for internal consumption in the production of finished products or for sale to customers generally. Batch Costing is generally applied in-

1. Readymade Garments Manufacturing Industries.
2. Pharmaceutical / Drug Industries.
3. Spare parts and Components Manufacturing Industries.
4. Toys Manufacturing Industries.
5. Tyres and Tubes Manufacturing Industries.

2.2.2.2.3 Economic Batch Quantity (EBQ):

Economic Batch Quantity (EBQ) is a measure used in batch costing to determine the quantity of units that can be produced at the minimum average cost in

a given batch or product run. It is also known as Optimum Batch Quantity (OQB) and is refinement of the Economic Order Quantity (EOQ) model. EBQ takes into account the set-up cost, annual demand, production time and the carrying charge rate per year to calculate the most cost-effective batch size. The formula for calculating EBQ is similar to EOQ, but with a notable difference in the denominator. The assumptions made for calculating EBQ are that demand is known and constant within a certain period of time, unit cost of the inventory item is constant, production time is known and constant, and set-up cost and constant cost per piece are considered. The importance of EBQ lies in its ability to help companies achieve a balance leading to improved efficiency, reduced costs and increased profitability.

Economic Batch Quantity is calculated as follows:

$$\text{Economic Batch Quantity} = \sqrt{\frac{2AS}{C}}$$

Where,

A = Annual Demand

S = Set up Cost per batch

C= Carrying Cost per unit per year

2.2.2.3 Contract Costing:

Contract costing is basically, a job costing system that is applied to relatively large cost units that take a considerable amount of time to complete, such as construction and civil engineering work.

It is a specific accounting method used to track and allocate costs associated with a particular contract or project. This method is particularly relevant in industries where work is undertaken on a project-by-project basis, such as construction, manufacturing or consulting. The primary goal of contract costing is to determine the total cost of a specific contract and to allocate these costs appropriately. It provides a more accurate picture of the financial performance of individual contracts. It is particularly valuable in industries where each project varies significantly in terms of size, scope and duration.

2.2.2.3.1 Key features of contract costing:

1. Construction activities: Contract costing mainly consists of construction activities and is applied in industries such as building construction, shipping, bridge construction etc.
2. Identification of contracts: Each project or contract is identified separately. This could be construction project, the production of a specific product or the provision of services for a particular client.
3. Direct expenses: Most of the expenses in the contract costing are direct nature, such as materials, labour, expenses, plant and sub-contract charges. Only a small portion of the amount is charged as overheads, which are apportioned on a suitable basis.
4. Accumulation of costs: All costs related to a specific contract are accumulated and recorded separately. These costs include direct materials, direct labour and overhead costs that can be directly attributed to the contract.
5. Cost allocation: Cost are allocated to the contract based on a systematic and consistent method. Direct costs are easily identified, but indirect costs (overhead) may need to be allocated based on predetermined rate or other allocation methods.
6. Recording revenue: Revenue recognition is aligned with the progress of the contract. In many cases, revenue is recognized as work on the contract is performed.
7. Profit measurement: The ultimate goal of contract costing is to determine the profitability of each contract. By comparing the total costs incurred with the revenue generated from the contract, businesses can assess the financial success of each project.

2.2.2.3.2 Types of contracts:

There are three types of contracts:

1. Fixed Price Contracts: In this type of contract, the contractor and contractee agree upon a fixed price for the work to be undertaken. The agreed price is paid by the contractee to the contractor.

Example: a contractor quotes a fixed price of ₹ 20,00,000 for constructing a small building. The contractee agrees to this price and both parties sign the contract. The

contractor is then responsible for completing the construction work within the agreed price.

2. **Contracts with Escalation Clause:** These contracts have a provision that the fixed price may increase or decrease in certain situations. This is a safeguard against cost increases due to factors such as inflation or other unforeseen circumstances.

Example: a contractor and contractee agree on a fixed price of ₹ 20,00,000 for a construction project (period of contract – One year). The contract includes an escalation clause that states the price will increase by 5% for every six months of delay in the project's completion.

3. **Cost plus Contracts:** Under a cost-plus contract, the value of the contract is ascertained by adding a fixed percentage of profit to the actual cost of the work. The contractor is assured of a certain percentage of profit in advance and is protected against the possibility of incurring any loss.

2.2.2.3.4 Process Costing:

Process costing is a method of costing used in mass production industries producing homogeneous products, like steel, sugar, chemicals etc. In such industries, goods produced are identical and all factory processes are standardized. Goods are produced without waiting for any instructions or orders from customers. Raw materials move down the production line through a number of processes in a particular sequence and costs are compiled for each process or department by preparing a separate account for each process.

CIMA official Terminology of process costing is:

Process costing is a 'form of costing applicable to continuous processes where process costs are attributable to the number of units produced. This may involve estimating the number of equivalent units in stock at the start and end of the period consideration.'

Process costing is used where there is a continuous flow of identical units. Process costing is a method of costing which is used in the following industry:

1. Textile mills.
2. Chemical works.
3. Oil refining.
4. Cement manufacturing.

5. Paper manufacturing.
6. Food processing.
7. Steel mills.
8. Paint manufacturing.
9. Soap making.
10. Sugar industry.
11. Plastic manufacturing, etc.

2.3.1.4.1 Features of Process Costing:

1. The output of one process becomes the input to the next until the finished product is made in the final process.
2. Costs are accumulated process-wise.
3. The products are standardized and homogeneous.
4. The cost per unit produced is the average cost which is calculated by dividing the total process cost by the number of units produced.
5. The sequence of operations or process is specific and predetermined.
6. There is often a loss in process due to spoilage, wastage, evaporation and so on.
7. Output from operation may be a single product, but there may also be a by-product (or by-products) and/or joint products.

2.3.1.4.2 Process Costing Vs Job Costing/Batch Costing: A Comparison

A comparison between process costing and job/batch costing is presented below:

Aspect	Process Costing	Job/Batch Costing
Nature of production	Continuous and Mass production	Intermittent and Customized production.
Identifiability of units	Indistinguishable units. (Homogeneous products)	Distinguishable Units (Heterogeneous products)
Cost accumulation	Accumulates costs by production process or stage)	Accumulates costs by job or batch.
Cost	Average cost per unit is	Actual cost per unit is calculated

assignment	calculated for each process.	for each job.
Application	Used in industries with standardized production.	Commonly applied in industries with customization.

2.3.1.4.3 Procedure of Process Costing:

The essential stages in process costing are-

1. The factory is divided into a number of processes and an account is maintained for each process.
2. Each process account is debited with material cost, labour cost, direct expenses and overheads allocated or apportioned to the process.
3. The output of the process is transferred to the next process in the sequence. In other words, finished output of one process becomes input of the next process.
4. The finished output of the last process (i.e. the final product) is transferred to the Finished Goods Account.

2.3.1.4.4 Elements of Process Cost:

The following are the elements of process cost, which are shown in the process accounts.

1. **Materials:** Raw materials required for each process is drawn from stores against material requisitions. Proper procedure like preparing and authorizing the requisition, pricing of the issues, return of materials to the stores, transfer of material from one process to another should be followed while issuing the materials. Cost of material consumed should be computed as per the method employed for pricing of the issues and the cost should be debited to the process account.
2. **Labour:** Wages paid to workers and supervisory staff should be charged to the particular process if they can be identified with it. If workers work on two or more processes, proper allocation should be made according to some basis like time spent on each process.
3. **Direct Expenses:** If expenses are identifiable with a particular process, they should be charged to that process. For example, cost of electricity, depreciation may be charged directly to a process if they are identifiable with it.

4. **Overheads:** By nature, overheads are indirect expenses and hence cannot be identified with a particular process. These expenses can be apportioned on some suitable basis and charged to the process.

2.3.1.4.5 Advantages of Process Costing:

1. Costs are computed periodically at the end of the particular period say a week or a month.
2. Average costs are easily computed and present best cost in continuous and mass production industries.
3. It involves less clerical work than job costing.
4. Cost data is available for each process, operation and department for exercising managerial control.
5. Process costing facilitates in price quotations, because material consumption and operation get more or less standardized.
6. Use of standard costing system is very effective in process cost situations.

2.3.1.4.6 Limitations of Process Costing:

1. The whole concept of process costing system is based on average cost and with the help of average cost we cannot do performance analysis effectively.
2. Under process costing unfinished units in store at the end of the period are expressed in terms of completed units.
3. Process costing system presumes that production activity of a factory is divided according to processes and departments.

2.2.2.5 Joint Product and By-Product:

2.2.2.5.1 Joint Products: Joint products are two or more products that are simultaneously produced from a common input or set of inputs, and they typically share common production processes up to a certain point. These products emerge as distinct and identifiable items during the manufacturing or processing of a particular raw material.

2.2.2.5.2 Features of Joint Product:

The key features of joint products include-

1. **Common inputs:** Joint products arise from the same raw materials or inputs. These inputs undergo a common production process until a certain stage, after which they diverge into separate products.
2. **Simultaneous Production:** Joint products are produced at the same time and within the same production process. They are not produced sequentially or separately.
3. 9 Each joint product has its own independent identity and can be sold as a separate and distinct product.
4. **Separable and Marketable:** Joint product must be separable from each other. Additionally, each product must be marketable.
5. **Common cost up to split-off point:** Joint products share common costs up to a specific point in the production process known as the 'split-off point'. Beyond this point, the products become distinct and any further processing costs are specific to each product.

e.g. in the refining process, crude oil is processed up to a certain point known as the split-off point, where the different products become identifiable and can be separated. Each of these products has its own distinct characteristics, uses, and market demand, making them separate and marketable entities. The costs incurred in the common refining process up to the split-off point are considered joint costs. The primary joint products, in this case include:

1. Gasoline: This is a fuel used in internal combustion engines, such as those found in cars and motorcycles.
2. Diesel: Diesel fuel is used in diesel engines, commonly found in trucks, buses and in some cars.
3. Jet Fuel: Used for powering aircraft.
4. Lubricants: Oil and greases that are used for lubrication engines and machinery.
5. Petroleum Gas: Used for heating, cooking and as a fuel for certain vehicles.

2.2.2.5.3 By-products:

A by-product is an identical product from a process which has an insignificant value compared to the main product(s). It may be said to be a supplementary or

secondary product (arising as the result of a process) whose value is small relative to that of the principal product.

A by-product is a product which is similar produced at the same time and from the same common process as the ‘main product’ or joint products. The distinguishing feature of a by-product is its relatively low sales value in comparison to the main product. In the timber industry, for example, by-products include sawdust, small offcuts and bark.

2.2.2.5.4 Difference between Joint product and By-product

Feature	Joint Product	By-Product
Definition	Two or more product derived from a common input or production process	A secondary product that is produced alongside the main product but is not the primary focus of production.
Simultaneous production	Produced at the same time within the same production process	Produced concurrently but may not share the exact same production process.
Independence of identity	Each product has its own independent identity and can be sold separately.	The primary product is the main focus and the by-product is typically of lesser importance.
Separability	Products are separable and can be identified and quantified independently.	Main product is the primary focus and the by-product may not be easily separable or marketable.
Value independence	The value one product is independent of the quantities of other products.	The value of the by-product may be dependent on the main product’s production.
Examples	Products from oil refining (gasoline, diesel, jet fuel)	Sawdust in timber mill.

2.2.2.6 Operating Costing / Service Costing:

Though Cost Accounting is traditionally associated with manufacturing companies, it is applicable for service companies as well. In the modern competitive market, with the increased importance of service sector, the need for cost accounting has also increased. The costing method applied in these (service) industries is known as ‘Operating or Service Costing’.

The term ‘Operating or Service Costing’ refers to the computation of the total operational cost incurred per unit of the intangible product. These intangible products or services can be either in the form of internal services that are carried out by industries as supporting activities for the manufacturing of goods, or in the way of external services that are offered as a significant product to the customers by the service sector companies.

According to CIMA London, Operating costing is that form of operation costing which applies where standardized services are rendered either by an undertaking or by a service cost centre within an undertaking.

Operating costing should not be confused with operation costing. While operating costing is applied to determine the cost of providing a service, operation costing is a refinement and more detailed application of process costing.

Operating costing is applicable in:

1. Road transport companies.
2. Railways.
3. Airways.
4. Shipping companies.
5. Electricity companies.
6. Water supply companies.
7. Gas supply companies.
8. Hospitals and nursing homes.
9. Cinemas.
10. Canteens and hotels.
11. Computer centers.

12. Schools and colleges.
13. Local authority.
14. Power house in a factory.

2.2.2.6.1 Characteristics of Operating Costing:

The following characteristics are usually found in industries where operating costing is used:

- a. Services rendered to customers are of unique and standardized type.
- b. A large proportion of the total capital is invested in fixed assets and comparatively less working capital is required.
- c. The distinction between fixed cost and variable cost is of particular importance. This is because the economies and scale of operations considerably affects the cost per unit of services rendered. For example, fixed cost like insurance per passenger will be lower if buses in transport company run capacity packed.

2.2.2.6.2 Cost Unit:

Determining the suitable cost unit to be used for cost ascertainment is a major problem in service/operating costing. A proper unit of cost must be selected in order to ascertain the cost per unit of services provided. The determination of proper cost unit is a difficult job. It is determined with reference to nature of work and the cost objectives i.e. the purpose for which cost has to be computed. The cost unit selected may be simple, i.e. per bed in a hospital, per cup of tea sold in a canteen. In certain cases, a composite unit is used, i.e. passenger-kilometre in case of a bus industry. The following are some examples of cost units used in different organizations:

Enterprise	Cost per unit
Railways or Bus companies	Per passenger-kilometre
Hospital	Per patient per day, per bed per day
Canteen	Meals served per customer
Water supply service	Per 1000 gallons
Boiler house	Thousand Kg. of steam
Goods transport	Per tonne km.

Electricity boards	Per kilowatt-hours
Bricks	One thousand
Hotel	Per room /day

2.2.2.7 Operation Costing: This is nothing but a refinement and more detailed application of process costing. A process may consist of a number of operations, operation costing involves cost ascertainment for each operation instead of a process where distinctly separate operations are involved in a process, cost of each operation is found for effective control mechanism.

2.2.2.8 Single, Output or Unit Costing: This method of cost ascertainment is used when production is uniform and consists of a single or two or three varieties of the same product. where the product is produced in different grades, costs are ascertainment grade-wise. As the units of output are identical, the unit is found by dividing the total cost by the number of units produced. This method is applied in mines, quarries, bricks kilns, steel production, flour mills etc.

2.2.2.9 Multiple or Composite Costing: It is an application of more than one method of cost ascertainment with respect to the same product. This method is used in industries where a number of components are separately manufactured and then assembled into a final product. For example, in a television set manufacturing company, manufacture of different component parts may require different production methods and thus different methods of costing may have to be used, Assembly of these components into final product requires yet another method of costing. Other examples of industries which make use of this method are air-conditioners, refrigerators, scooters, cars, locomotive etc.

2.2.3 Types or Techniques of Costing:

Costing is divided into two parts i.e. in methods and techniques. Methods, by which the cost accountant can collect the cost by using appropriate method as we discussed above. Technique means a tool by which the cost accountant can present the cost to the top-level management for the purpose of decision making. These techniques are as follows:

1. Historical Costing.

2. Budgetary Control.
3. Standard Costing.
4. Marginal Costing.
5. Absorption Costing.
6. Uniform Costing.

2.2.3.1 Historical Costing:

Under historical costing, cost is ascertained after they have been incurred. This costing is based on recorded data and the costs arrived at are verifiable by past events. It is easy to ascertain the cost of each department or section or product or any other cost centre and easy to present in the required form, as the figures are ready. However, it has following limitations.

1. Data does not provide yardstick of comparison for actual cost.
2. Data is made available too late to correct inefficiencies, that are causing costs to go out of limits.
3. Data does not provide motivation to employees to strive for accomplishment of their objectives.
4. Data provides insufficiently for budgeting, planning, decision making and price quotation.

2.2.3.2 Budgetary Control:

As per the CIMA (London) terminology, “Budgetary control is the establishment of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objective of that policy or to improve a basis for revision.”

Budget forces the managers to plan ahead with consideration of basic policies. When all members of top management participate in preparation of budget, all functional heads is compelled to make plans in harmony with the plans of other departments. It promotes understanding of the problems of co-workers and removes clouds of uncertainties for lower levels of management regarding basic policies and objectives. Also, it facilitates periodic self-analysis of the organization. The following steps are involved in budgetary control:

1. Establishments of budgets for each function and section of the organization.
2. Continuous comparison of the actual performance with that of the budget so as to know the variation from budget and placing the responsibility of executives for failure to achieve the desired results as given in the budget.
3. Taking suitable remedial action to achieve the desired objective if there is a variation of the actual performance from the budgeted performance.
4. Revision of budgets in the light of changed circumstances.

2.2.3.2.1 Objectives of Budgetary Control:

Budgetary Control is planned to assist the management for policy formulation, planning, controlling and coordinating the general objectives of budgetary control and can be stated in the following ways:

1. **Planning:** A budget is a plan of action. Budgeting ensures a detailed plan of action for a business over a period of time.
2. **Coordination:** Budgetary control coordinates the various activities of the entity or organization and secure cooperation of all concerned towards the common goal.
3. **Control:** Control is necessary to ensure that plans and objectives are being achieved. Control follows planning and coordination. No control performance is possible without predetermined standards. Thus, budgetary control makes control possible by continuous measures against predetermined targets. If there is any variation between the budgeted performance and the actual performance, the same is subject to analysis and corrective action.

2.2.3.2.2 Advantages of Budgeting Control:

The advantages of budgetary control may be summarized as follows:

1. Budgetary control facilitates reduction of cost.
2. Top management uses budgetary control in planning and formulation of policies.
3. Budgetary control facilitates effective coordination of activities of the various departments and functions by setting their limits and goals.
4. Budgetary control ensures maximization of profits through cost control.
5. Budgetary control evaluates the performance of different budget centers on

a continuous basis.

6. Budgetary control facilitates adoption of standard costing.

2.2.3.2.3 Limitations of Budgetary Control:

It is clear that budgetary control is an effective tool for management regarding the control aspect. However, it has certain important limitations which are identified below:

1. Budgets are based on estimates and forecasting. There are various limitations of forecasting as it cannot be considered as an exact science. Thus, budgets are tentatively defined as plan of action.
2. Budget may prove short or excess of actual requirement.
3. Effective implementation of budgetary control depends upon willingness, cooperation and understanding among people.
4. Budgeting is a time consuming process which often becomes less cost effective when changes in business environment occur rapidly.

2.2.3.3 Standard Costing:

Standard costing is a management accounting technique that is used to determine the expected costs of producing goods or services. It involves setting predetermined costs for various elements of production, such as materials, labour and overhead, based on historical data, industry benchmarks or engineering estimates. These predetermined costs, known as standard costs is compared with actual cost to find out the variances and take corrective actions to control costs and improve efficiency.

According to CIMA (London), “standard costing is a control technique which compares standard costs and revenues with actual results to obtain variances which are used to stimulate improved performance.”

Thus, we can state that Standard costing involves the following steps:

1. The establishment of predetermined estimates of the costs of products or services.
2. The collection of actual costs.
3. The comparison of actual cost with the predetermined cost.

The predetermined costs are known as standard costs and the difference between

standard cost and actual cost is known as a variance. The process by which the total difference between standard and actual results is analysed is known as variance analysis.

2.2.3.3.1 Advantages of Standard Costing:

1. Carefully planned standards aid the budgeting process.
2. Standard cost provides a yardstick against which actual costs can be measured.
3. The setting of standards involves determining the best materials and methods which may lead to economies.
4. A target of efficiency is set for employees to reach and cost consciousness is stimulated.
5. Variances can be calculated which enable the principle of 'management by exception' to be operated.
6. Only the variances which exceed acceptable tolerance limits need to be investigated by management with a view to control action.
7. Standard cost simplifies the process of bookkeeping in cost accounting, because they are easier to use than LIFO, FIFO and weighted average costs.
8. Standard times simplifies the process of production scheduling.
9. Standard performance levels might provide an incentive for individuals to achieve targets for themselves at work.

2.2.3.3.2 Limitations of Standard Costing

1. Establishment of standards may demand a lot of skill, imagination and experience. If all these factors are not in harmony, desired results will not be forthcoming.
2. It is difficult to use standard costing, when working conditions do not permit standardization of material contents, labour contents or the use of indirect services relating to different jobs, processes and services.
3. Lack of interest by appropriate level of management renders the use of standard costing ineffective.
4. Sometimes, use of standard costing creates adverse psychological effects, if standards are set at a high level.

2.2.3.4 Marginal Costing:

In common parlance profit is a balancing figure of sales over costs, i.e. $\text{Sales} - \text{Cost} = \text{Profit}$ or $\text{Cost} + \text{Profit} = \text{Sales}$. This information is not sufficient for decision making. The cost is further divided according to its behavior, i.e. fixed cost and variable cost. The age-old equation can be written as:

$$\text{Sales} - (\text{Fixed cost} + \text{Variable cost}) = \text{Profit}$$

In marginal costing this formula is developed as:

$$\text{Sales} - \text{Variable cost} = \text{Contribution} - \text{Fixed cost} = \text{Profit}$$

Marginal costing is a management technique of dealing with cost data. It is based primarily on the behavioral study of cost. To understand the Marginal Costing, one must know the marginal cost. CIMA defines marginal cost as, “the cost of one unit of product or service which would be avoided if that unit were not produced or provided.” It is the cost by which total cost increases or decreases if the volume of production is increased or decreased by single unit.

CIMA defines marginal costing as, 'the accounting system in which variable cost are charged to the cost units and fixed costs of the period are written-off in full against the aggregate contribution.' Marginal costing is a technique which provides presentation of cost data in such a way that true cost-volume-profit relationship is evaluated. Under this technique, it is presumed that costs can be divided in two categories i.e. fixed cost and variable cost. Fixed cost remains fixed to certain extent and variable cost changes according to volume of output.

2.2.3.4.1 Features of Marginal Costing:

Marginal costing, also known as variable costing, is a costing technique where only variable costs are considered in product costing. Following are the key features of marginal costing.

1. Simple costing method: Marginal costing is relatively simple as compared to absorption costing because it does not involve allocating fixed overhead costs to products. This simplicity makes it easier to understand and apply in decision-making.
2. Variable cost only: Marginal costing includes only variable manufacturing costs, such as direct materials, direct labour and variable overhead. Fixed

manufacturing costs are treated as period costs and are not allocated to products.

3. Contribution margin: Marginal costing focuses on the concept of contribution margin, which is the difference between total sales revenue and total variable costs. it helps in assessing the profitability of individual products and making decisions about product mix and pricing.
4. Decision-making tool: Marginal costing is widely used as a tool for short-term decision making, such as pricing decisions, product mix decisions and whether to accept or reject special orders. By focusing on variable costs and contribution margin, it provides insights into the incremental profitability of different alternatives.
5. Reporting format: The format of the marginal costing income statement typically separates costs into fixed and variable categories. This format helps management understand the behaviour of costs and their impact on profitability.
6. Internal reporting: Marginal costing is often used for internal reporting purposes, providing managers with information to evaluate the performance of segments or departments based on their contribution to covering fixed costs and generating profit.

2.2.3.4.2 Fundamental Principle of Marginal Costing:

Since fixed costs are constant within the relevant range of volume sales, the following is the net impact of selling one extra unit:

1. Revenue will increase by the sales price of one unit.
2. Costs will only increase by the variable cost per unit.
3. The increase in profit will equal sales value less variable costs i.e. contribution.

If the volume of sales falls by one unit, then the profit will fall by the contribution of that unit. If the volume of sales increases by one unit, profit will increase by the contribution of that unit.

Fixed costs relate to time; therefore, it is referred as period cost, and do not change with increase or decreases in sales volume.

2.2.3.4.3 Limitations of Marginal Costing:

Marginal costing techniques is used for internal reporting purpose and for the purpose of decision making. For external reporting purpose, total costing or

absorption costing is still the preferred method. Following are the limitations of the marginal costing:

1. The breakeven analysis assumes that costs and revenue behaviour patterns are known and that the change in activity levels can be represented by a straight line.
2. It may not be always feasible to split costs precisely into variable and fixed categories. Costs often show mixed behaviour and then, simple techniques of segregation fail.
3. The breakeven analysis assumes that fixed costs remain constant over the relevant range under consideration. If that is not the case, then the graph of total costs will have a step in it where the fixed costs are expected to increase.
4. The breakeven analysis assumes input and output volumes are the same, so that there is no build-up of stocks and work-in-progress.
5. Breakeven charts and simple analysis can only deal with one product at a time.

2.2.3.4.4 Applications of Marginal Costing:

Irrespective of some limitations, Marginal costing is a very useful technique of costing and is extensively used in various managerial tasks and the decision-making process. The applications of marginal costing are discussed as follows:

1. **Cost Control:** One of the important challenges in front of the management is the control of cost. In the modern competitive environment, increase in the selling price for improving the profit margin can be dangerous as it may lead to loss of market share. The other way to improve the profit is cost reduction and cost control. Cost control aims at not allowing the cost to rise beyond the present level. Marginal costing technique helps in this task by segregating the costs between variable and fixed.
2. **Profit Planning:** Another important application of marginal costing is the arena of profit planning. Profit planning is defined as the planning of future operations to attain a pre-determined profit goal. The marginal costing technique helps to generate data required for profit planning and decision-making.
3. **Key Factor Analysis:** The management has to prepare plan after taking into consideration the constraints, if any, on the various resources. These constraints

are also known as limiting factors or principal budget factors. These key factors may be availability of raw material, availability of skilled labour, machine hours availability or the market demand of the product. Marginal costing helps the management to decide the best production plan by using the scarce resources in the most beneficial manner and thus optimized the profits.

4. **Decision Making:** Managerial decision-making is a very crucial function in any organization. Decision-making should be on the basis of the relevant information. Through the managerial costing technique, information about the cost behaviour is made available in the form of fixed and variable costs. The segregation of costs between fixed and variable helps the management in predicting the cost behaviour in various alternatives. Thus, it becomes easy to take decisions. Some of the decisions are to be taken on the basis of comparative cost analysis while in some decisions the resulting income is the deciding factor. Marginal costing helps in generating both the types of information and thus the decision making becomes rational and based on facts. Some of the crucial areas of decision-making are mentioned below:
 1. Pricing decisions in special circumstances:
 - a) Pricing in periods of recession.
 - b) Use of differential selling prices.
 2. Acceptance of offer and submission of tenders.
 3. Make or buy decisions.
 4. Shutdown or continue decisions or alternative use of production facilities.
 5. Retain or replace a machine.
 6. Decisions as to whether to sell in the export market or in the home market.
 7. Whether to expand or contract.
 8. Product mix decisions like:
 - a) Selection of optimal product mix.
 - b) Product substitution.
 - c) Discontinuance of a product.

2.2.3.5 Absorption Costing:

It is a traditional method of costing. In absorption costing total cost (variable cost and fixed cost) are considered for product costing and inventory valuation. The presentation of cost data is on conventional pattern. Net profit of each product is determined after deducting fixed overheads.

2.2.3.6 Uniform Costing:

Uniform costing is a system of cost accounting to be used by the members of the industry or trade association. It involves adoption of same costing principles, practices and procedures by the individual members of the industry for inter-firm comparison. Its underlying idea is that whatever costing methods are used, the same should be applied uniformly by all the members of the industry. Uniform costing is not a new concept. It was first introduced by the National Association of Stove Manufacturers of U.S.A. which developed a uniform formula for use by its members for costing industry's products.

However, in U.K., British Federation of Master Printers was the first organization to introduce a uniform costing system. In India, it is being used in coal industry, steel industry and fertilizer industry. CIMA defines uniform costing as, “a system, using common concepts, principles and standard accounting practice, adopted by different entities in the same industry to facilitate inter-firm comparison.”

2.2.3.6.1 Application/Scope of Uniform Costing System:

Uniform costing may be advantageously applied in -

1. Single company having a number of factories located at different places producing similar products or performing similar operations.
2. A number of companies within the same industry.
3. Industries which are similar such as gas and electricity, cotton, jute and woolen textiles. Objectives of Uniform Costing:
 1. To have a reliable cost data for inter-unit or inter-firm comparison of costs.
 2. To compare the operational efficiency of individual members against industry's overall performance.
 3. To fix a common selling price for the industry as a whole on the basis of cost of production of all member units.

4. To reveal lines of individual products which have been marketed on an unprofitable basis.

2.2.3.6.2 Advantages of Uniform Costing

1. It develops a sense of awareness for production efficiencies within the industry for controlling costs.
2. It provides standard guidelines for pricing of products and indicates how prices fixed below a certain level may be self-defeating even though it may bring additional sales.
3. It is beneficial to all the competing companies for filling tenders and quotations.
4. It facilitates the introduction of uniform wage structure for the industry as a whole.
5. It serves as a pre-requisite to cost audit and inter-firm comparison.

2.2.3.6.3 Limitations of Uniform Costing

1. The various member-units in an industry differ widely with regard to location, age, condition of plant and degree of mechanization. This difference is sometimes so wide that it does not permit efficient use of uniform costing system.
2. For smaller units, this system becomes too expensive to operate.
3. Uniform costing system may promote a monopolistic tendency. Thus, it may be harmful to the consumers.

2.2.4 Costing – An Aid to Management:

Planning, decision-making and controlling are important functions of management. Financial accounting provides overall or general information to the management. But, it is not sufficient for the decision making or planning with great accuracy. Cost accounting provides classified and standardized data facilitating forecasting and comparison. It provides factual information to the management for planning and making policies. It serves management in execution of policies, comparing actual and estimated results, appraisal of policies, finding changes in policies to meet future challenges etc.

Cost Accounting serves management in the following ways.

1. Classification and sub-division of costs
2. Control of materials, labour and overhead costs
3. Business Policies
4. Budgeting
5. Standards for measuring efficiency
6. Best use of limited resources
7. Instrument of management control
8. Cost Audit
9. Special factors
10. Price determination
11. Expansion

1. **Classification and Sub-division of Costs:** The main task of any management is to control the cost and maximize the profitability. In cost accounting costs are collected and classified by various ways and in such a manner that management can use it for controlling and to measure profitability of each activity, product, process, job or any other cost centre. It enables management to measure the efficiency of each department and of the organization as a whole. It helps to maintain and improve the efficiency. It points out non-profitable, less profitable and more profitable activities or products. Management can take steps to convert non-profitable and less profitable activities or product more profitable or discontinue such activities or products.
2. **Control of materials, labour and overhead costs:** Stores ledger provides effective control on stores and materials used in the business. The techniques such as Level Setting (minimum, maximum and reorder), EOQ, JIT, ABC, VED, FNSD, Perpetual Inventory etc. control the capital outlay and financial loss due to overstocking or understocking. Abnormal losses are also pointed out. It also helps to take appropriate steps to minimize such losses. Material record provides a basis for effective production planning.

Cost accounting maintains record of machine capacity, availability of machines and labour requirements and labour capacity. Accordingly, work plan is prepared taking

care of time, labour and machine availability. Time records and job cards disclose idle time and over time. It points out loss incurred by idle time and burden of overtime and gives directions to minimize losses. Appropriate wage system can be fixed by applying time rate, piece rate and premium plans. It provides measures to measure the efficiency of employees. Thus, cost accounting provides detailed control on labour cost.

In cost accounting overhead costs are not recorded in aggregate but, are classified as variable and fixed, controllable and uncontrollable, direct and indirect and then recorded. All costs are not recorded in the cost sheet. Pure financial expenses, reserves, appropriations, etc. are not considered while preparing cost sheet to know pure and absolute cost. All these helps to control the overhead costs.

3. **Business Policies:** Cost accounting provides alternative methods and procedures required for policy making and policy revising. Various policies such as product mix, pricing, expansion of plant capacity, optimum utilization of capacity, make or buy, expansion of market, replacement of assets etc. can be framed only on the basis of information provided by cost accounting.
4. **Budgeting:** In cost accounting budgets are prepared on factual data. Performance under each is evaluated continuously and reports are prepared which facilitate management to know and correct inefficiencies if any. Cost accounting provides budget and a well-defined action plan for comparing actual results with the budgets. Budgets and performance reports are two important tools to judge the efficiency of each department or process or job or any other cost centre as well as the business organization. The technique of control through performance reports is known as Management by Exception. This technique can be implemented in practice with the help of cost accounting.
5. **Standards for measuring efficiency:** In cost accounting targets are not set but the standards are set for sales and for each element of cost. These standards are revised considering the external and internal changes. With the help of these standards management can make estimates and can prepare plan for future. Actual results are compared with the standards to know the favorable and unfavorable variances and thus to determine operating efficiency.
6. **Optimum use of limited resources:** Optimum use of limited resources is always a challenge. Cost accounting provides reliable data of material, labour and overhead costs. It helps management to avoid wastages and improve efficiency.

Many losses before, during and after production can be avoided. Thus, maximum output from given input and at reasonable cost can be achieved with the help of cost accounting.

7. **Instrument of management control:** Cost accounting provides valuable data for planning, budgeting and controlling of cost. It provides standards to compare and evaluate the actual results. It points out the places of wastages and losses. Performance reports evaluate the actual efficiency. Thus, cost accounting is an instrument of management control.
8. **Cost Audit:** Cost audit not only detect errors and frauds but it also prevents to commit errors and frauds by employees and directors. It also helps to improve cost accounting methods, tools and techniques.
9. **Points out crucial factors:** Cost accounting points out various important points which are essential for decision making and development of the business. It informs management optimum cost, profitability in different situations and from different products, seasonal variation in volume and cost, idle time of employees, idle capacity of machines, etc.
10. **Price determination:** It helps management to determine selling price of different products in different circumstances like depression, boom, competition, launching new product, export, market expansion etc.
11. **Expansion and development policy:** With the help of the reliable cost data, the management can formulate the policy of expansion and development. The decisions regarding expansion of machine capacity, expansion of the market, product diversification and differentiation, etc. can be taken on the basis of cost records.

Check your progress:

A) Choose the correct alternative from the following.

1. is a 'form of specific order costing where costs are attributed to individual jobs.
A) Contract costing B) Operating costing
C) Job costing D) Batch costing

2. is a costing method that involves grouping and allocating costs to a specific quantity of products produced in a single batch
- A) Contract costing B) Job costing
C) Operating costing D) Batch costing
3. is basically, a job costing system that is applied to relatively large cost units that take a considerable amount of time to complete, such as construction and civil engineering work.
- A) Contract costing
B) Job costing
C) Operating costing
D) Process costing
4. method of costing used in mass production industries producing homogenous products
- A) Contract costing B) Job costing
C) Operating costing D) Process costing
5. are two or more products that are simultaneously produced from a common input or set of inputs, and they typically share common production processes up to a certain point.
- A) Joint products B) By-products
C) Unit D) Co-products
6. A is an identical product from a process which has an insignificant value compared to the main product(s).
- A) Joint products B) By-products
C) Unit D) Co-products
7. refers to the computation of the total operational cost incurred per unit of the intangible product.
- A) Process Costing B) Contract costing
C) Operating costing D) Batch costing

8. is an application of more than one method of cost ascertainment with respect to the same product.
 A) Composite Costing B) Unit costing
 C) Process costing D) Operation costing
9. is the establishment of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objective of that policy or to improve a basis for revision.
 A) Standard costing B) Marginal costing
 C) Budgetary control D) Uniform costing
10. is a management accounting technique that is used to determine the expected costs of producing goods or services.
 A) Standard costing B) Marginal costing
 C) Budgetary control D) Uniform costing
11. is the accounting system in which variable cost are charged to the cost units and fixed costs of the period are written-off in full against the aggregate contribution
 A) Standard costing B) Marginal costing
 C) Budgetary control D) Uniform costing
12. is a system of cost accounting to be used by the members of the industry or trade association.
 A) Standard costing B) Marginal costing
 C) Budgetary control D) Uniform costing

B) Fill in the blanks.

1. costing is a cost accounting method used for unique, custom-made products or services, where costs are accumulated for each individual order or project.
2. A is simply a product or service that can be easily distinguished from other products.
3. is commonly employed in industries where products are produced in batches.

4. Clause of contracts has a provision that the fixed price may increase or decrease in certain situations.
5. is used where there is a continuous flow of identical units.

2.3 Summary:

Industries are classified into broad categories as jobbing industries and processing (or mass production) industries. Job industrial enterprises undertake the production of goods and services according to customers' specifications. As the customer specifications about goods and services usually differ from one customer to another, there is no standard product and therefore, costs should be ascertained for each job separately. Construction work, ship-building, heavy machinery, contractors works etc., fall into job industries.

On the other hand, in the case of mass production industries, industrial enterprises undertake production of identical units on a continuous basis in anticipation of demand. Manufacturing activities are grouped into a few processes and the costs are accumulated for each process separately. Paper, sugar, textile etc., are examples of processing industries.

This basic difference in industrial activities and production methods necessitates the use of different methods of costing. The methods used to ascertain the costs are called methods of costing or costing methods. Selection of a particular method of costing depends on the nature of production and type of industry.

On the other hand, the Techniques of Costing aim at analyzing and presenting the cost and revenue data in a suitable form facilitating the management to take appropriate decisions including cost control and cost reduction.

2.4 Terms to Remember:

1. Methods of Costing: By which we can collect the cost.
2. Techniques of Costing: By which we can present the cost.
3. Specific Order Costing: Specific order costing is a cost accounting method used for unique, custom-made products or services, where costs are accumulated for each individual order or project.
4. Job Costing: Job costing is the accounting system that traces costs to individual

units or to specific jobs, contracts or batches of goods.

5. **Batch Costing:** Batch costing is a costing method that involves grouping and allocating costs to a specific quantity of products produced in a single batch.
6. **Contract Costing:** Contract costing is basically, a job costing system that is applied to relatively large cost units that take a considerable amount of time to complete, such as construction and civil engineering work.
7. **Process Costing:** Process costing is method of costing used in mass production industries producing homogenous products, like steel, sugar, chemicals etc.
8. **Joint Product:** Joint Products: Joint products are two or more products that are simultaneously produced from a common input or set of inputs, and they typically share common production processes up to a certain point.
9. **By-product:** A by-product is an identical product from a process which has an insignificant value compared to the main product(s).
10. **Operating / Service Costing:** Operating costing is that form of operation costing which applies where standardized services are rendered either by an undertaking or by a service cost centre within an undertaking.
11. **Multiple or Composite Costing:** It is an application of more than one method of cost ascertainment with respect to the same product.
12. **Historical Costing:** Under historical costing, cost is ascertained after they have been incurred. This costing is based on recorded data and the costs arrived at are verifiable by past events.
13. **Budgetary Control:** Budgetary control is the establishment of a policy and the continuous comparison of actual with budgeted results either to secure by individual action the objective of that policy or to improve a basis for revision.
14. **Standard Costing:** Standard costing is a management accounting technique that is used to determine the expected costs of producing goods or services. It involves setting predetermined costs for various elements of production, such as materials, labour and overhead, based on historical data, industry benchmarks or engineering estimates.
15. **Marginal Costing:** Marginal costing is a management technique of dealing with cost data. It is based primarily on the behavioral study of cost. To understand the Marginal Costing, one must know the marginal cost.

16. **Absorption Costing:** It is a traditional method of costing. In absorption costing total cost (variable cost and fixed cost) are considered for product costing and inventory valuation. The presentation of cost data is on conventional pattern. Net profit of each product is determined after deducting fixed overheads.
17. **Uniform Costing:** Uniform costing is a system of cost accounting to be used by the members of the industry or trade association. It involves adoption of same costing principles, practices and procedures by the individual members of the industry for inter-firm comparison.

2.5 Answers to check your progress.

- A) 1) a 2) b 3) a 4) d 5) a 6) b 7) c 8) a
9) c 10) a 11) b
- B) 1) Specific order 2) Job
3) Batch costing 4) Escalation clause 5) Process

2.6 Exercise.

A. Write Short Notes:

1. Principles of Cost Accounting
2. Techniques of cost accounting
3. Costing as an aid to management
4. Job Costing
5. Batch and Contract Costing
5. Process Costing
6. Operating / Service Costing
7. Joint Product and By-Product Costing

B. Broad Answer Questions:

1. Explain principles and techniques of cost accounting.
2. Explain methods of cost accounting.
3. Explain principles and state how cost accounting helps to the management.

2.7 References for further study.

1. S. P. Jain, K. L. Narang, Simmi Agrawal (2016), Cost Accounting Principles and Practice, Kalyani Publishers, New Delhi.
2. V. K. Saxena and C. D. Vashist (1995) Advanced Cost and Management Accounting, Sultan Chand & Sons Publishers, New Delhi.
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Unit – III
Cost Classification and Preparation of Cost Sheet

Cost Classification and Preparation of Cost Sheet Classification of Cost on various bases, Preparation of Cost Sheet and Quotation

3.0 Objectives

3.1 Introduction

3.2 Presentation of Subject Matter

- 3.2.1 Meaning of Cost Accounting
- 3.2.2 Objectives of Cost Accounting
- 3.2.3 Classification of Cost
- 3.2.4 Cost Sheet
- 3.2.5 Quotation

Check Your Progress I

3.3 Summary

3.4 Terms to Remember

3.5 Answers to Check Your Progress

3.6 Exercise

3.7 References for Further Study

3.0 Objectives:

After studying this unit students should be able to,

1. Understand the concept of Classification Cost.
2. Know the objectives of Classification Cost.
3. Understand the Classification cost, Cost Sheet and Quotation.
4. Prepare the Cost Sheet and Quotation.

3.1 Introduction:

Analysis and classification of cost: Cost is the amount of expenditure incurred for production of goods and services. Thus cost is composed of three elements, viz. material, labour and expenses.

3.2 Cost Accounting-

3.2.1 Meaning of Cost Accounting

Classification of cost

Classification of Cost means dividing costs into different groups based on their characteristics, such as their nature, function, or behaviour. It helps management understand where money is being spent and supports better planning, control, and decision-making.

In cost accounting, costs are classified to find the correct cost of producing goods or services and to improve business efficiency. Proper cost classification helps managers prepare budgets, control expenses, and make better business decisions.

In simple words, cost classification is the process of grouping similar costs together. This makes it easier to identify costs related to different departments (cost centres) or products/services (cost units) and helps in effective cost management.

Cost classification is the process of grouping costs according to their common features or characteristics. Classification is essential to find out the cost of production.

In other words, classification is the process of grouping like facts under common designation on the basis of similarities of nature, scope, attributes or relations.

Definition of Classification of Cost

The National Association of Accountants Committee defines "Classification as the identification of each item and the systematic placement of like items together according to their common features. Items grouped together under common heads are further defined according to their fundamental differences."

3.2.2 Objectives of Classification of Cost

1. It helps the management for implementing cost control and decision making.

2. It helps for calculation of cost of production.
3. It helps for valuation of work-in-progress
4. It helps for fixation of pricing policy
5. It helps for current application of plans and policies
6. It helps for planning process and budget and control
7. Controlling on cost.

Methods of Cost Classification OR Classification of costs

Classification of cost is necessary for detailed recording and accurate cost ascertainment. There are a number of basis for classification of costs. However, the selection of use of a particular base or method for classification of costs depends upon a number of factors including the purpose of classification. The important basis are element, nature, function, behaviour, identifiability, controllability, normality time etc. The costs are classified on the basis of large number of methods. Following are the main methods or basis of classification of cost.

Cost can be classified into the following groups.

- 1) According to elements
- 2) According to functions or operations.
- 3) According to behaviour or Nature
- 4) According to time
- 5) According to controllability
- 6) According to normality
- 7) According to relevant to decision making and control
- 8) According to averaging.
- 9) According to traceability

3.2.3 Classification of Cost

A) Element wise classification Costs classified on the basis of element wise are as follows:

1. Material cost.
2. Labour cost.
3. Expenses.

Each of these elements of costs are further divided into two parts, viz..

(1) Direct Costs. (ii) Indirect costs.

Direct cost: Direct cost means that cost which can be identified with an allocated to cost centres.

Indirect cost: Indirect cost means that which cannot be allocated but which can be apportioned.

Material Cost: This is "the cost of commodities supplied to an undertaking". (I.C.M.A.) Materials are further divided into two parts (1) Direct materials (2) Indirect materials.

1. **Direct materials:** Direct materials are those materials which can enter into and form part of the finished product. Direct materials cost is that which can be conveniently identified and allocated to cost units.

E.g. Timber in furniture, Leather in shoes, Clay in bricks, Cloth in garments.

2. **Indirect materials:** Indirect materials are those materials which cannot be conveniently identified with cost units.

e.g.: Nails used in furniture, Thread used in stitching garments, Lubricating oil, Nuts and bolts, Small tools, Gum.

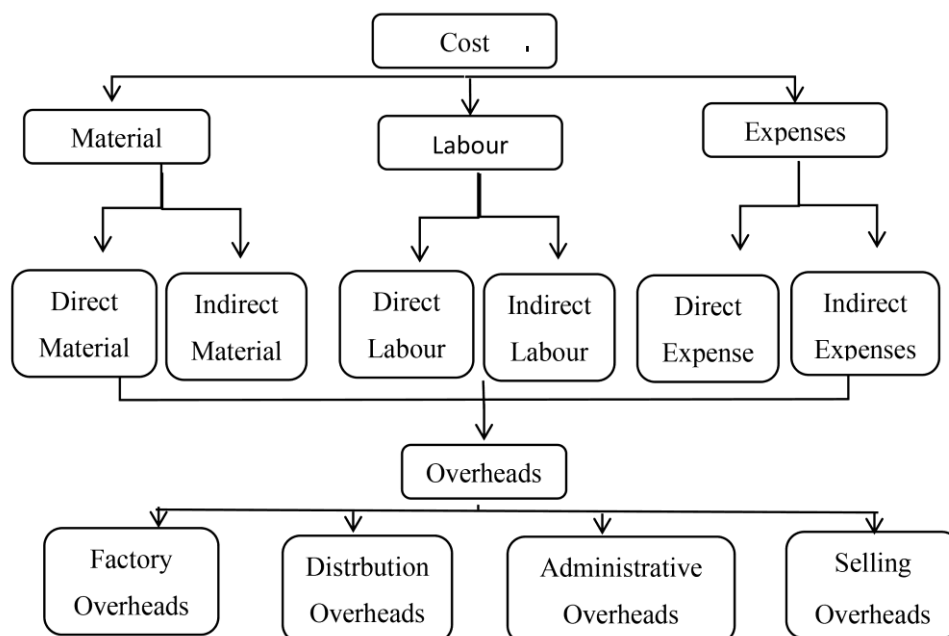


Fig: Classification of Cost

Labour cost: These are costs of remuneration, such as wages salaries, commissions, bonus etc. of the employees of an undertaking. Labour costs are further divided into two parts. i. Direct wages ii. Indirect wages.

1. **Direct wages:** Wages paid to labourers who are directly engaged in converting raw materials into finished products. Direct wages are also called Direct, Labour, Productive Labour, Process Labour, Operating Labour, and Prime cost.

E.g. Tailor, Shoe maker, Carpenter, Weaver.

2. **Indirect labour:** Indirect labour is not directly engaged in the production of goods but only to assist or help in production of goods or services.

e.g. Watchman, Inspector, Cleaner, Peon, Clerk, Supervisor, Time keepers, Apprentices and trainees, Office staff, Store keeper

Expenses: The expenses mean the cost of services provided to an undertaking and the notional cost of the use of owned assets. In other-words, costs other than the material and labour are called expenses. Expenses are further divided into two parts viz: 1. Direct expenses 2. Indirect expenses.

1. **Direct Expenses:** Direct expenses are those expenses which can be specifically incurred in connection with a cost unit e.g. Hire of special plant for a particular Job. Experimental cost: cost of special drawings designs and layouts. It is also known as chargeable expenses or productive expenses or prime cost expenses.

e.g. Carriage inwards octroi, freight, customs duty, dock charges, import duty, Excise duty, Royalty paid to the Landlord, Cost of moulds, Expenses incurred for defective work.

Fees paid to surveyers or architects who are engaged in a particular job.

2. **Indirect expenses:** Indirect expenses are those expenses which cannot be directly identified with a particular job.

E.g. Rent and rates

Power and lighting.

Carriage.

Insurance

Advertising

B) **Function wise classification:** Costs classified on the basis of functions are as follows:

1. Production cost or works cost or factory cost.
2. Administrative cost.
3. Selling costs
4. Distribution cost.

1. Production cost or Manufacturing cost: This is the cost which begins with supplying of materials, labour and services and ends with the completion of production. Other terms used in this connection are Factory Overhead, Works Overhead and Mills Overhead

e.g.: Indirect Labour, Factory rent and rates, Insurance of factory, Consumable stores.

Indirect materials cost such as: Cotton waste, soaps, nuts bolts, nails belts threads, Lubricating oil

Indirect Labour cost or wages such as:

- i. Foremen's Salary, Cleaners Salary or Wages, Tools operator Wages or Salary, Gate keeper Salary.
- ii. Salary of time keeping department, Clansmen Salary, Watchmen's Salary, Storekeeping Department Salary
- iii. Factory rent, rates, taxes.
- iv. Insurance of factory building and plant and machinery consumable stores.
- v. Coal, Gas, fuel water, Lighting & heating of factory, Stationery of factory
- vi. Depreciation on factory equipment factory building and plant & Machinery,
- vii. Repairs of factory equipment, factory, building and plant and machinery.
- viii. Depreciation on loose tools, Laboratory expenses, Experimental cost
- ix. Expenses for estimating, municipal tax, local tax in respect of factory
- x. Labour welfare expenses, Canteen expenses.
- xi. Drawing office expenses, it means expenses incurred for preparing plans, designs, sketches etc.
- xii. Overtime wages, idle time wages, Expenses incurred for defective work
- xiii. Contribution to workmen's insurance fund, Contribution to workmen's compensation fund.

xiv. Contribution to employer's provident fund.

2. Administrative cost: This consists of all expenses incurred in the direction, control and administration of an undertaking.

- i. E.g. Salaries of office staff, Accountants. Managing director, General Manager
- ii. Directors fees, Bank charges, Postage stationery telephone, Rent rates of office
- iii. Stationery for office such as papers, ink, pen, pencils, refills, Lighting & heating of office.
- iv. Insurance of office buildings & equipment's, Depreciation on office building equipment's & furniture.
- v. Printing charges of office. Audit fees, Legal charges
- vi. Repairs of office buildings, office furniture and equipments.

3. Selling cost: Other expenditures incurred for sales and stimulating demand and for securing orders are known as selling cost.

- i. e.g.: Salaries and commission of salesmen.
- ii. Show room expenses.
- iii. Samples, Free Gifts
- iv. Travelling expenses of salesmen.
- v. Commission to agents or distributors
- vi. Advertising and Publicity expenses
- vii. Expenses incurred for printing Catalogues, Price lists etc.
- viii. Exhibition expenses.
- ix. Marketing expenses.
- x. Expenses incurred for preparing tenders quotations and estimates.
- xi. Lighting and decoration expenses of show room.
- xii. Expenses (Legal) incurred for recovering the bad debts.
- xiii. Expenses incurred for giving to the salesmen
- xiv. Subscription to trade Journals and Commercial Journals

xv. Expenses incurred for the demonstration of the working of the goods.

4. Distribution costs: It is an expenditure incurred for distributing the goods.

- i. E.g. Packing costs.
- ii. Carriage outwards.
- iii. Warehousing costs, such as repairs, depreciation lighting of warehouse
- iv. Upkeep and running costs of delivery vans.
- v. Loading charges
- vi. Despatch expenses.
- vii. Shortage of finished goods in warehouse (i.e. normal)
- viii. Finished goods damaged in transit
- ix. Transport charges paid in empty containers returned to the
- x. Business by customers
- xi. Expenses incurred for repairing of empty containers for re-use.

C) Classification According to Behaviour: Some costs are increased or decreased in production directly; some costs remain unaffected while others change but not in direct proportion to the change in volume of production.

These are: 1. Variable costs. 2. Fixed costs. 3. Semi-Variable or Semi-Fixed cost.

Variable costs: These costs are in direct proportion to the volume of output. Cost per unit will remain the same. If output increases total variable cost also increases and if output decreases total variable cost also decreases.

- i. Direct materials.
- ii. Direct wages.
- iii. Power
- iv. Fixed costs: The total fixed costs remain unaffected either with the increase or decrease in the output. But cost per unit goes on changing
- v. E.g. rent and rates of building.
- vi. Salary of works manager.
- vii. Depreciation of building.
- viii. Insurance.

ix. Interest on capital.

x. Municipal taxes.

Semi-Variable or Semi-fixed costs: These costs are partly fixed and partly variable. These costs are thus partly affected by fluctuations in the level of activity.

E.g. Salary of supervisors.

Maintenance and repairs.

Telephone expenses.

D) According to time

Costs classified on the basis of time are as follows

i) Historical costs

ii) Predicted cost or Budgeted costs

1) Historical costs

These costs are ascertained or collected after they have been incurred. These costs are past events or post mortem costs.

These costs are available only after the completion of the production, they are not of much help to the management for cost control.

2) Predicted or predetermined costs

These costs are calculated in advance to production. Predetermined costs may be either

a) Estimated costs

b) Standard costs

a) Estimated costs

It is an approximate assessment of what the cost will be. It is based on past experience adjusted to anticipated future costs.

In other words these costs are determined in advance on the basis of the given specifications after taking into account all the factors affecting the costs.

b) Standard costs

It is a predetermined cost based for element of cost viz., material labour and overhead based on scientific study. Standard costs are useful for evaluating the performance of the various sections of the factory and also for cost control.

E) According to controllability

The cost can be divided into

- i) Controllable cost
 - ii) Uncontrollable cost
- i) Controllable cost

It is the cost which can be controlled by managing properly at a given organisational level

E.g. Indirect labour, Power costs

- ii) Non controllable cost

The costs which are not controlled at any level of managerial supervisions.

F) According to Normality

Costs can be classified into

- i) Normal loss
 - ii) abnormal loss
- i) Normal cost

These costs which are normally incurred at a given level of output in normal conditions.

- ii) Abnormal cost

Then costs are incurred at given level of output under abnormal conditions. So these costs are beyond normal cost. Abnormal costs are not charged to cost of production. They are charged to profit and loss account.

G) According to Averaging.

Costs can be classified into

- i) Total costs
 - ii) Unit costs
- i) Total Costs:

The sum of all costs attributable to the unit under consideration.

In otherwards the aggregation of all costs incurred for the production of goods and services are called total costs.

- ii) Unit costs:

Cost incurred for the particular item is known as unit costs.

H) According to identifiability or traceability

On the basis of their identifiability, costs are classified into

- i) Direct costs
 - ii) indirect costs
- i) Direct costs

The costs which can be identified with a specific product, prices and departments are called direct costs.

Examples wages of the tailor and Wages paid to carpenter

- ii) Indirect costs

The cost which cannot be identified to particular department are called indirect cost.

In otherwards, these are costs which are required to be distributed over a number of cost centres or cost units.

E.g. Salaries of workers

Rent of factory

Consumable stores

I) According relevance to decision making and control

For the purpose of managerial decisions, costs are classified into various categories. They are

- 1) Relevant cost
- 2) Imputed cost
- 3) Opportunity cost
- 4) Joint cost
- 5) Implicit cost
- 6) Replacement cost
- 7) Sunk cost
- 8) Shut down cost
- 9) Out-of pocket costs
- 10) Marginal cost
- 11) Differential cost
- 12) Avoidable cost and an avoidable costs

13) Relevant cost: The costs which is appropriate to a specific management's decision is called relevant cost.

14) Imputed cost or Notional Cost: The costs which are not actually incurred but considered in cost accounts are called Notional Cost.

According to ICMA London Notional cost as "the value of a benefit where no actual cost is incurred".

15) Opportunity Cost : The Maximum possible alternative income that is earned if the resources are applied to some alternative use.

In other words, Opportunity cost is the cost of selecting one course of action in terms of the opportunities which are given up to carry out that course of action.

16) Junk Cost

Meaning of Junk: Discarded material such as, Glass, rags, paper or Metal some of which may be reused in some form is called Junk. In otherwards articles that are worn-out of something meaningless.

Junk cost means certain amount spent on discarded material for reuse or sale, such expenses are called Junk Cost.

17. Implicit cost : It is cost arises when the fund is used. Implicit is the opportunity cost. It is the cost of one investment opportunity which is scarified for getting in other investment opportunity.

18. Replacement cost : It is the cost of replacement in current market. In otherwards current cost of replacing on asset is based on the assumptions that if the asset is replaced now the current market value will be incurred for its replacement.

19. Sunk cost : These costs are the past costs, which are not taken into account in decision making. In otherwards a cost which incurred or had been already sunk in the past and is not relevant in a particular decision making at the present time.

This is an irrecoverable cost as a result of discarding of an asset. Thus, the Written Down Value (WDV) of a machine less realisable value of scrap is the sunk cost and will not be taken into consideration in the machine replacement decision. The loss will be treated as the Sunk loss.

20. Set down cost: The Cost incurred will be continued even if the plant is temporarily shut down.

Examples:

Rent & Rates

Taxes

Maintenance

Depreciation

21. Out of Pocket Cost: While imputed costs do not involve cash outlays, out of pocket costs signify the cash cost associated with an activity. Non-Cash costs, such as depreciation are not included in out of pocket costs.

In otherwards the cost which involves the cash outflow due to a particular management decision.

Example: Depreciation on asset is an item of cost which will not form part of out pocket cost, because it does not involve cash outflow.

22. Marginal Cost : It is the cost of one unit of product of service.

In otherwards. It is the total of direct material, direct wages, direct expenses and variable overheads in relation to product or service, or process or departments.

23. Differential Cost : Change in total Cost from one level to another level of activity is called Differential Cost. It is also called incremental Cost.

In short It is the difference in total cost between alternatives calculated to assist the decision making.

- 24 Avoidable Cost : It is the specific cost of an activity of business which can be avoided if the activity did not exist.

25. Unavoidable cost : These cost are essentially required to be incurred and are unavoidable or inescapable.

Presentation of total cost: First of all cost are classified on the basis of nature, such as materials, labour and other expenses. Further distinction should be made of direct costs and indirect costs. All the direct costs are grouped under the headings of prime cost and indirect costs are known as overheads. All these costs are grouped under separate heads and present the cost data to the management in the form of statement.

3.2.4 COST SHEET

Cost sheet is a document which provides for the presentation of the estimated detailed cost in respect of a cost cadre or a cost unit. The statement summarises the cost of manufacturing a particular list of product and discloses, (1) the prime cost (2) Works cost (3) Cost of production and (4) Total cost.

When all the direct material, direct labour and direct expenses are aggregated, the resultant is the Prime cost. If we add factory expenses to the prime cost this will give the Factory or Work Cost and if in the factory cost, office and administrative expenses are added the result is to the Cost of Production. If selling and distribution expenses are added to the cost of production it gives the cost of sales.

If profit is added to the cost of sales selling price is obtained. This can also be calculated by deduction loss if any, from the cost of sales.

Prime Cost: It is also known as direct cost. These costs are incurred for production of goods and services.

Direct Material : It is the cost of all the materials which directly enter the product and become part of it. Expenses are such as inward components and primary packing materials, inward freight custom duty etc.

Direct Labour cost: : The portion of wages which can be identified with the charged to a single cost unit is treated as direct labour cost.

Direct of chargeable expenses: This covers all expenses directly incurred and identifiable to the specific unit of production.

Factory overhead

These are the expenses incurred in the factory for production of goods and services.

Administrative overhead

The cost incurred for office maintenance and administration of undertakings.

Selling and Distribution overhead

These are costs incurred in promoting sales and retaining customers. This includes the cost of process which begins with making the packed product available for dispatch and ends with final sale.

Purposes: A cost sheet serves the following purposes.

1. It gives the breakup of total cost by elements and sub divisions.
2. It discloses the total cost as well as the cost per unit of production.
3. It helps for comparison.
4. It helps for preparation of tenders and quotations.
5. It helps for fixing selling price.
6. It helps for ascertaining profit or loss of production.

7. It helps for analysing the effect of each element of cost on total cost.

Specimen form of Cost Sheet:

Cost Sheet for the year ended/period ended....

Units Produced.....

Particulars	Units	₹	Total Cost ₹	Cost per unit ₹
Direct Materials:		xxx		
Opening stock of Raw Materials		xxx		
Add: Purchase of raw materials		xxx		
Carriage Inwards		xxx		
Octroi & Custom Duty				
		Xxx		
		Xxxxx		
Less: Closing stock of raw materials		xx		
Material lost		xx		
Materials transferred to job or Department				
Materials Consumed			xxx	
Direct Wages			xx	
Direct expenses (Chargeable expenses)			xx	
Prime Cost			Xxxx	
				xxx
Add : Factory Overheads or Works On-cost.		xxx		
Indirect materials		xxx		

Particulars	Units	₹	Total Cost ₹	Cost per unit ₹
Indirect wages- inspection		xxx		
instructors, Gatemen,		xxx		
Drawings office salary		xxx		
Factory Rent, Rates, Taxes &		xxx		
Insurance		xxx		
Lighting heating		xxx		
Power & fuel		xxx		
Repairs & Maintenance		xxx		
Cleaning Expenses		xxx		
Cost of research & experiments		xxx		
Works manager salary		xxx		
Consumable stores		xxx		
Depreciation of plant & machinery		xxx		
Water supply		xxx		
Loose tools written off		xxx		
Haulage or crane expenses		<u>xxx</u>		
Cost of defective work		xxx		
		<u>xxx</u>	<u>Xxx</u>	<u>xxx</u>
Less-Sale of scrap		xxx	Xxx	xxx
WORKS COST	xxx		Xxx	xxx
Add : Opening Stock of Work in progress	<u>xxx</u>		<u>xxx</u> xxx	

Particulars	Units	₹	Total Cost ₹	Cost per unit ₹
Less : Closing Stock of Work in progress	<u>xxx</u> <u>xxx</u>	xxx	<u>xxx</u> <u>xxx</u>	
WORKS COST OF FINISHED GOODS		xxx	Xxx	xxx
Add : Administration Overheads		xxx		
Counting house salaries		xxx		
Rent, Rates, Insurance		xxx		
Telephone & Postage		xxx		
Printing & Stationery		xxx		
Legal expenses				
Audit fees		xxx		
Depreciation of Office Furniture,		<u>xxx</u>		
Equipment & Building		<u>xxx</u>		
Repairs of Office Furniture,		xxx		
Equipment & Building		<u>xxx</u>		
	xxx	xxx		
COST OF PRODUCTION	<u>xxx</u>	<u>xxx</u>	<u>Xxx</u>	<u>xxx</u>
Add : Opening Stock of Finished Goods	<u>xxx</u>	xxx	Xxx	xxx
	xxx	xxx		
Less : Closing Stock of Finished Goods				
COST OF GOODS SOLD		xxx	Xxx	xxx

Add : Selling & Distribution Overheads		xxx xxx		
Sales Commission		xxx		
Salesmen's salaries		xxx		

Particulars	Units	₹	Total Cost ₹	Cost per unit ₹
Advertisement & samples				
Carriage outwards		xxx xxx		
Bad Debts		xxx xxx		
Depreciation & expenses of delivery van		<u>xxx xxx</u>		
Debt collection charges				
Rent of warehouse				
Sample & other free gifts				
Showroom rent & rates				
Traveller's salaries, commission				
COST OF SALES				
Profit / Loss SALES				
	xxx		<u>xxx xxx</u>	<u>xxx xxx</u>
			<u>xxx xxx</u>	<u>xxx xxx</u>
	xxx			

Note: While preparing the cost sheet financial items (Income and expenses) are not considered, because such items do not form a part of the costs.

Illustrations:

1. From the following particulars prepare cost sheet showing

1. Prime Cost 2. Works Cost 3. Cost of Purchase 4. Profit

Stock on 1-1-2012 : Raw materials	30,000
Work-in-progress	22,500
Stock on 31-10-2012 : Raw materials	22,500
Work-in-progress	7,500

Purchase of law materials	2,40,000
Octroi	7,500
Carriage outwards	15,000
Wages	45,000
Sales	4,50,000
Salaries to salesman	12,000
Power (10% of sales office)	15,000
Salaries to office staff	12,000
Rent rates and taxes (20% of sales office)	12,000
Printing ans stationery	6,000
Sales of scrap	4,500
Interest	18,000
Publicity expenses	22,500
Commission on sales staff	18,000

Solution: Cost sheet for the year ending 31-12-2025

Particulars		Total cost
Opening stock of raw materials	30,000	
Add: purchase of raw materials	2,40,000	
Octroi	7,500	

Less: closing stock of raw materials	2,77,500	
Materials consumed	22,500	
Wages		2,55,000 45,000
Add: factory overhead		3,00,000
prime cost	13,500	
Power (90% for factory use)	4,500	9,000
Less : sale of scrap		
Add: opening work- in progress		3,09,000
manufacturing cost		22,500
		3,31,500
Total goods processed during the period		7,500
Less: closing work-in - progress		
		3,24,000
Work cost		
Add: administrative overhead	1,500	
Power 10% of 15,000	12,000	
Calaries to office staff	9,600	
Rent rates and taxes 80% of 12,000		29,100
		3,53,100
Cost of production		
Add: selling and distribution overhead	12,000	
Salaries to salesman	15,000	
Carriage outward		
Rent rates and taxes 20% of 12,000	2,400	
Publicity expenses	22,500	
Commission on sales	18,000	69,900
		4,23,000
Cost of sales		27,000
Profit (balancing figure)		
Sales		4,50,000

2 From the following particulars prepare cost sheet.

Rs.

Particulars	₹
Opening stock of finished goods	9,7500
Closing stock of finished goods	11,100
Raw materials purchased	35,250
Carriage on materials purchased	850
Direct wages	18,450
Factory expenses	2,750
Selling expenses	2,450
Office on cost	1,850
Sales	75,000
Sale of scrap	250

Solution:

Cost sheet

Particulars		₹
Raw materials purchased	35,250	
Carriage on materials purchased	850	
	36,100	
Materials consumed	18,450	54,550
Direct wages		
Prime cost		
Add: factory expenses	2,750	2,500
Less: sales of scrap	250	
Work cost		57,050
Add: administrative overhead : office on cost		1,850
Cost of production		58,900
Add: opening finished goods		9,750

Goods available for sale		68,650
Less: closing finished goods		11,100
Cost of goods sold		57,550
Add: selling expenses		2,450
Cost of sales		60,000
Profit (balancing figure)		15,000
Sales		75,000

3 From the following trading and profit and loss account of the firm for the year ended 31st December 2025 find out: (1) prime cost (2) work cost (3) Total cost

Trading A/c

Particulars	₹	Particulars	₹
To cost of materials	40,000	By sales	2,00,000
To direct wages	60,000		
To manufacturing expenses	25,000		
To Gross profit c/d	75,000		
Total	2,00,000	Total	2,00,000

Profit and Loss Account

Particulars	₹	Particulars	₹
To rent rates and insurance	5,000	By gross profit	75,000
To general expenses	10,000		
To selling expenses	15,000		
To management and staff salary	30,000		
To net profit	15,000		
Total	75,000	Total	75,000

Solution: Cost sheet for the year ending 31-12-2025

Particulars	₹	₹
Materials		40,000
Wages		50,000
Prime cost		1,00,000
Add : factory overhead : manufacturing expenses		25,000
Work cost		1,25,000
Add : administrative overhead	5,000	
Rent rates and insurance	10,000	
General expenses	30,000	
Management and staff salary		45,000
Cost of production		1,70,000
Add : selling expenses		15,000
Cost of sales		1,85,000
Profit (balancing figure)		15,000
Sales		2,00,000

4 Calculate the prime cost factory cost total cost of production and cost of sales from the following particulars.
Rs.

Particulars	₹	₹
Raw materials consumed		40000
Wages paid to labours		10000
Directly chargeable expenses		2000
Oil and waste		100
Wages of foremen		1000
Storekeepers wages		500
Electric power		200

Lighting: factory	500	700
Office	200	
Rent : factory	2000	3000
Office	1000	
Repairs and renewals :		
Factory plant	500	
Machinery	1000	1700
Office premises	200	
Depreciation : office premises	500	700
Plant machinery	200	
Consumable stores		1000
Managers salary		2000
Directors fees		500
Office printing & stationery		200
Telephone charges		50
Postage & telegrams		100
Salesmen commission and salary		500
Travelling expenses		200
Advertising		500
Warehouse charges		350

Solution: Cost sheet

Particulars		Total cost
Raw materials consumed	40,000	
Wages paid to labourers	10,000	
Directly chargeable expenses	2,000	
Prime cost		52,000
Add: factory overhead :	100	
Oil and waste	1,000	
Wages of foremen	500	
Storekeepers wages	200	
Electric power	500	

Lighting (factory)	2,000	
Rent (factory)	500	
Repairs and renewals : on factory plant	1,000	
On machinery		
Depreciation of plant and machinery	200	
Consumable stores	1,000	
Work cost		59,000
Add: administrative overhead :	2,000	
Mangers salary	500	
Directors fees	200	
Office printing and stationery	50	
Telephone charges	100	
Postage & telegrams	200	
Lighting (factory)	1,000	
Rent (factory)	200	
Repairs and renewals on office premises	500	
Depreciation on office premises		
Cost of production		63,750
Add: selling & distribution overheads :		
Salesmen's commission and salary	500	
Travelling expenses	200	
Advertising	500	
Warehouse charges	300	1,550
Total cost		65,300

5. The following data relate to the manufacture of a standard product during the month of March 2013.

Raw materials consumed 90,000

Direct wages 70,000

Machine hours worked 5,000 hours

Machine hour rate RS. 8

Office overhead 10% of works cost

Selling overhead RS. 2per unit

Units produced 5,000

Units sold 4200 at Rs. 60 per unit

You are required to prepare a cost sheet in respect of the above showing 1) cost per unit

2) Profit for the period

Solution:

Cost sheet for the march 2025:

5000 units

Particulars	Total cost ₹	Cost per unit ₹
Raw materials consumed	90,000	18
Direct wages	70,000	14
Prime cost	1,60,000	32
Add: factory overhead based on machine hours		
Machine hour worked ×rate per hour		
5,000 hours×RS. 8 per hour	40,000	8
Work cost	2,00,000	40
Add: administrative overhead		
Office overhead :		
10% of works cost i.e. 10/1000 ×2,00,000	20,000	4
Cost of production	2,20,000	44
Less : closing finished goods		
5000-4200= 800 × 44	35,200	-
Cost of goods sold	1,84,800	44
Add: selling overhead Rs. 2 per unit sold	8,400	
No of units sold ×expenses per unit = 4200×2		2
Cost of sales	1,93,200	46
Profit	58,800	14
sales (4200× 60)	2,52,000	60

Working notes: 1) ascertainment of closing finished goods

Total units produced 5000

4200
800

Less sales

Closing finished goods

2) Closing finished goods should be valued at cost price per unit rs. 44

3) Selling overhead should be calculate based on number of units sold.

4) $\text{cost per unit} = \frac{\text{cost of production}}{\text{no of units production i.e.}} = \frac{2,20,000}{5000} = \text{Rs. 44 per unit}$

6 From the under mentioned particulars of the Murdeshwar tiles company of Kolhapur, you are required to prepare a monthly cost sheet of tiles, made in January 2013 showing cost and profit per 1000 tiles.

Materials: coal 63,000

Royalty 2,000 tons of soil at RS. 4.50 Per ton 90,000

Carrying the raw materials (soil) from Sangli to Kolhapur

Rate per ton Rs. 1.80 3,600

Labour: direct Tile making 18,000

Overhead: works cost: 25% of prime cost 54,000

Office: 10% of work cost

Production per month 90, 00,000 tiles

Sales per month 85, 00,000 tiles at Rs. 50 per 1000 tiles

Stock on 1-1-2013 2, 00,000 tiles

Stock on 31-1-2013 7, 00,000 tiles

You have to assume that stock was valued at the same rate per 1000 tiles as the production for January 2013

Solution: Murdeshwar Tiles company Kolhapur,

Cost sheet for the January 2025

output = 90, 00,000 tiles

Particular	Total cost ₹	Cost per 1000 per tiles
Materials : coal	63,000	7
Royalty 2,000 tons ×RS. 4.50 per ton	9,000	1
Carriage inward (i.e. carrying cost) (2000×1.80)	3,600	0
Labour : direct	18,000	2
Tiles making	54,000	6
Prime cost	1,47,600	16
Add: factory overhead		
25% of prime cost (direct charges) 25/100	36,900	4
× 1,47,600		
Work cost	1,84,500	20
Add: administrative overhead 10 % of		
Works cost 10/100 ×1,84,500	18,450	2

Cost of production	2,02,950	22
Add: opening stock of finished goods		
2,00,000/1,000 × 22 = 55	4,500	
Less : closing finished goods i.e. 7,00,000/1000	2,07,460	22.55
× 22 = 55	15,785	
Cost of goods sold	1,91,675	22.55
Profit (balancing figure)	2,33,300	27.45
Sales	4,25,000	50.00

Note 1) opening and closing finished goods are valued at cost price i.e. present rate in the problem at Rs. 22.55 per 1000 tiles.

Q.7 The following information was extracted from the costing stock on hand 1-1-2025

Raw materials	11,000
Finished production 800 tons	8,800
Work in progress	2,640
Stock in hand 31-12-2013:	12,232
Raw materials	15200
Finished products 1600 tons	66000
Work in progress	55000
Purchase of raw materials	22000
Direct rates insurance and works overhead	792
Carriage inward cost of factory supervision	4,400
Sales- finished product	1, 60,000

Advertising, discounts allowed and selling costs amounted to 75 paise per tone sold. 12,800 tons of commodity were produced during the year. You are required to ascertain to value of material used the cost of the output for period. The cost of the turnover for the period. The net profit for the period and, the net profit per kg of the commodity.

Solution:

Cost sheet for the year ending 31-12-2025

Particulars		Total ₹
Opening stock of raw materials	11,000	
Add : Purchase of raw materials	66,000	
Add : Carriage inward	792	
	77,792	
Less : Closing stock of raw material	12,232	
Materials consumed		65,560
Direct wages		55,000
Prime cost		1,20,560
Add : factory overhead	22,000	
Rent rates insurance of factory	4,400	
Cost of factory supervision		26,400
Manufacturing cost		1,46,960
Add : opening work-in-progress		2,640
Total goods processed		1,49,600
Less : work in progress		15,200
Works cost		1,34,400
Add : administrative overhead		Nil
(cost of output cost of production)		1,34,400
Add : opening finished goods		8,800
(cost of goods available for sale)		1,43,200
Less : Closing finished goods 1600 units $\times$ 10.50		16,800
(cost of turnover for the period) Or cost of goods sold		1,26,400
Add : selling and distribution overhead		9,000
12,000 units sold $\times$ 0.75		
Cost of sales		1,35,400
Profit (Balancing figure)		24,600
Sales		1,60,000

Working notes:

- 1) closing finished goods should be valued at cost price i.e present rate of cost of production

$$2) \text{ Cost of production per unit} = \frac{\text{Cost of production}}{\text{No. of units produced}} = \frac{1,34,400}{12,800} = \text{Rs. 10.50}$$

- 3) Selling overhead should be calculate on the basis of number of units sold

4) Ascertainment of numbers of units sold	800
Opening finished goods	12,800
Add: units produced during the year	13,600
Less: closing finished goods	1,600
Units sold	1200

$$5) \text{ Profits per unit sold} = \frac{\text{total profit}}{\text{number of units sold}} = \frac{24,600}{12,000} = \text{Rs. 2.05}$$

8. From the following particulars prepare a cost sheet showing the total cost per tonne for the period ended 31st March, 2025.

Particulars	₹	Particulars	₹
Raw Materials	33000	Productive Wages	35000
Direct Expenses	3000	Rent (Office)	500
Water Supply	1200	Factory Insurance	1100
Unproductive Wages	10500	Office Insurance	500
Factory Rent	7500	Legal Expenses	400
Factory Lighting	2200	Factory Heating	1500
Rent of Warehouse	300	Dep. On Plant and Machinery	2000
Dep. On Office Building	1000	Dep. On Delivery Van	200
Motive Power	4400	Haulage	3000

Director's Fees (Office)	2000	Director's Fees (Works)	1000
Bad Debts	100	Factory Cleaning	500
Advertising	300	Sundry Office Expenses	200
Sales Department Salary	1500	Estimating Expenses	800
Upkeep of Delivery Van	700	Factory Stationery	750
Bank Charges	50	Office Stationery	900
Loose Tools Written off	600	Commission on Sales	1500

The total output for the period has been 10000 tonnes.

Solution: 8

Cost Sheet for the month March, 2025

Output 10000 Tons

Particulars	₹	Total Cost ₹	Cost per Ton ₹
Direct Materials (Raw Materials)		33000	
Direct Wages (Productive Wages)		35000	
Direct Expenses		3000	
Prime Cost		71000	7.10
Add: Factory/Works Overheads			
Water Supply	1200		
Unproductive Wages	10500		
Factory Rent	7500		
Factory Lighting	2200		
Factory Insurance	1100		
Factory Heating	1500		
Dep. On Plant and Machinery	2000		

Haulage	3000		
Director's Fees (Works)	1000		
Factory Cleaning	500		
Estimating Expenses	800		
Factory Stationery	750		
Motive Power	4400		
Loose Tools Written off	600	<u>37050</u>	<u>3.70</u>
Factory/Works Cost		108050	10.80
Add: Office and Administration Overheads			
Rent (Office)	500		
Dep. On Office Building	1000		
Office Insurance	500		
Legal Expenses	400		
Director's Fees (Office)	2000		
Bank Charges	50		

Particulars	₹	Total Cost ₹	Cost per Ton ₹
Office Stationery	500		
Sundry Office Expenses	<u>900</u>	<u>5550</u>	<u>0.56</u>
Cost of Production		113600	11.36
Add: Selling and Distribution Overheads			
Rent of Warehouse	300		
Dep. On Delivery Van	200		
Bad Debts	100		
Advertising	300		

Sales Department Salary	1500		
Commission on Sales	1500		
Upkeep of Delivery Van	<u>700</u>	<u>4600</u>	<u>0.46</u>
Cost of Sales/Total Cost		118200	11.82

9. From the following particulars prepares a cost statement showing the components of total cost and profit for the year ended 31st March, 2025.

Particulars	On 1' April 2024	On 31' March 2025.
Stock of finished goods	6,000	15,000
Stock of raw materials	40,000	50,000
Work in progress	15,000	10,000
Purchase of raw materials		4 75,000
Carriage inwards		12,500
Wages		1, 75,000
Works managers salary		7 30,000
Factory employees salary		60,000
Factory rent, taxes & insurance		7,250
Power expenses		9,500
Other production expenses		43,000

Sales for the year	8, 60,000
Income tax	5,000
Interest on debentures	10,000
Transfer to sinking fund for replacement of machinery	20,000

Dividend received	2,500
Goodwill written off	10,500
Payment of sales tax	16,000
General expenses	20,500
Office rent	12,000

Statement of Cost and Profit.

For the year ended 31-3-2025.

Particulars	₹	₹
Opening stock of Raw Materials	40000	
Add : Purchase of Raw Materials	475000	
Carriage Inward	12500	
	527500	
Less : Closing stock of Raw Materials	50000	
Material Consumed		477500
Direct Wages		175000
Direct expenses		-----
Prime Cost		652500
Add : Factory Overheads		
Factory employees salary	60000	
Works managers salary	30000	
Factory rent taxes & Ins.	7250	
Power expenses	9500	
Other production expenses	43000	149750

		802250
Add : Opening Work-in Progress		15000
		817250
Less : Closing Work-in Progress		10000
FACTORY COST		807250
Add : Office & Administration Overheads		
General expenses	20500	
Office Rent	12000	32500
COST OF PRODUCTION		839750
Add : Opening stock of finished goods		<u>6000</u>
		845750
Less : Closing stock of finished goods		15000
COST OF GOODS SOLD		830750
Add: Selling & Distribution Overheads		
Sales Tax		16000
COST OF SALES		846750
Profit (Balancing figure)		13250
SALES		<u>860000</u>

3.2.5 Tenders or Quotation and Estimation

Cost sheet is prepared with the help of actual costs. On the basis of cost sheet we can prepare the estimated cost sheet which can be termed as tender or quotation for the purpose of determine selling price or predetermine the costs. Cost estimation is the process of pre-determining the cost of goods or services. Estimated costs are the future and budgeted costs and are based on the average of past actual costs adjusted for and anticipated changes in future.

A statement of price that is presented for a work order to be executed or service to be rendered or goods to be supplied is called as 'Quotation.' It is also termed as 'Tender.' Tender and Quotation are synonymously used. Generally, the term 'Tender

Is used in the Governmental transactions and the term 'Quotation' is used in non-governmental transactions.

Tender

A formal statement of price at which the goods are agreed to be supplied or work order is to be executed sent in reply to an invitation is called "Tender". It is given in sealed covers and implies a competitive price as being stated.

Quotation

A statement of price that is quoted for a work order executed or service to be received or goods to be supplied is called "Quotation"

Estimation:

An approximate price of work order or goods or services, calculated on the basis of past records. General opinion and judgement is called an "Estimation"

Estimated Cost Sheet

An estimated cost sheet has to be prepared to show the estimated cost of products to be manufactured. In this cost sheet, cost of direct materials, direct labour or wages and overhead pre-determined on the basis of previous costs after taking into account the present conditions and also the anticipated changes in the future price.

After the total cost has been estimated a desired profit is added to arrive at the price to be quoted. Such profit may be given as a percentage of cost or percentage of selling price.

In order to calculate the amount of profit, it is easy to assume that figure as 100 on which profit percentage is given and then calculate the amount of profit.

Problems based on Profit based on cost

Examples: When the total cost is Rs. 75,000 and profit is 20% on cost you are required to calculate profit and selling price.

Solution: When the cost is Rs. 100 profit is Rs. 20 If cost Rs. 75,000 how much profit?

Cost	Profit	20
100	20 =	----- x 75000 = 15000 Profit
75,000	?	100

Selling price = Cost + Profit

$$75000 + 15000 = 90000$$

Problems based on profit on Selling Price

Examples: When the total is Rs. 75,000 profit is 20% on selling price. It means, if selling price Rs. 100 It includes profit Rs. 20. From sales price deduct profit we will get cost price.

Cost price = Sales price – Profit

$$100 - 20 = 80$$

If Cost	Profit	20
80	20 =	----- x 75000 = 18,750 profit

If cost 75000	?	80
---------------	---	----

Selling price = Cost price + Profit on selling price

$$75000 + 18750 = 93750$$

Problems based on Profit on cost but selling price is given

Examples. If the sales price Rs. 90,000. Profit is 20% on cost. How much is the profit?

Solution: Sales price Cost + Profit

If cost is 100 on such profit Rs. 20, so sales price is 120.

If Sales price	Profit	20
120	20 =	----- x 90000 = 15000 Profit

If Sales price 90000	?	120
----------------------	---	-----

The following on the comparative percentages

8 1/3 % on invoice price = 10% on cost price

16 2/3 on invoice price = 20% on cost price

20% on invoice price = 25% on cost price

10% on invoice price = 12.5% on cost price

25% on invoice price = 33 1/3% on cost price

33 1/3% on invoice price = 50% on invoice price

50% on cost price = 100% on cost price

Practical Problems:

1. The accounts of a Machine Manufacturing company discloses the following information for 6 months ending 31st January 2025.

Particulars	₹
Materials used	1,50,000
Direct wages	1,20,000
Factory overheads	30,000
Administrative expenses	15,000

Prepare a Cost sheet of the machine and calculate the price which the company should quote for the manufacture of a requiring materials valued Rs. 1,500 and expenditure in productive wages. Rs. 500 so that the price might a profit of 20% on the selling price.

Solution:

Particular	Total cost
Materials used	1,50,000
Wages	1,20,000
prime cost	2,70,000
Add: Factory overhead	30,000
work cost	3,00,000
Add: Administrative overhead	15,000
Cost of production	3,15,000

Notes: [1] percentage of factory overhead to direct wages

$$= \frac{\text{factory overhead}}{\text{direct wages}} \times 100 \text{ i. e. } \frac{30,000}{1,20,000} \times 100 = 25\% \text{ of direct wages}$$

(2) Percentage of administrative overhead to works cost

$$= \frac{\text{administrative overhead}}{\text{works cost}} \times 100 \text{ i. e. } x = \frac{15,000}{1,20,000} \times 100 = 5\% \text{ of works cost}$$

Solution: Statement showing tender prices

Particulars	Total
Materials used	1,500
Wages	500
Add : Factory overhead	2,000
prime cost	125
25% of direct wages $25/100 \times 500$	
Add : Administrative overhead	2,125
work cost	106.25
5% of work cost $5/100 \times 2125$	2,231.25
Add: profit 20% of selling price: $20/80$	557.81
$\times 2231.25$ <i>cost of production</i>	
Tender price	2,789.06

2. Prashant Cooling Ltd., Harihar manufactured and sold 500 refrigerators in the year ending 31-12-2024 . The summarised Trading and profit & Loss account is set below.

Particulars	₹	Particulars	₹
To cost of materials	80,000	By sales	4,00,000
To direct wages	1,20,000		
To other manufacturing cost	50,000		
To gross profit	50,000		
	<u>4,00,000</u>		<u>4,00,000</u>
To management and staff salaries	90,000	By gross profit	50,000
To rent rates & insurance	10,000		
To selling expenses	30,000		
To general expenses	20,000		
To Net profit			

For the year ending 31-12-2025 it is estimated that:

1. Output and sales will be 600 refrigerators
2. Price of materials will go up by 20% on the level of previous year
3. Wages will rise by 5%
4. Manufacturing costs will rise in proportion to the combined cost of materials and wages.
5. Selling cost per unit will remain unaffected.
6. Other expenses will also remain constant.

You are required to submit a statement to the board of directors showing the price at which the refrigerators should be market so as to show profit of 25% on selling price.

Solution: cost sheet for the year ending 31-12-2024 500 refrigerators

Particulars	Total cost	Cost per unit
Cost of materials	80,000	160
Direct wages	1,20,000	240
prime cost	2,00,000	400
Add: factory overhead	50,000	100
Manufacturing cost		
work cost	2,50,000	500
Add: Administrative overhead		
Management & staff salary 60,000		
Rent rates & insurance 10,000	90,000	180
General expenses 20,000		
cost of production	3,40,000	680
Add: selling & distribution overhead	30,000	60
Selling expenses		
Cost of sales	3,70,000	740
Profit (balancing figure)	30,000	60
Sales	4,00,000	800

Statement showing Estimated price for 600 refrigerators in 2025

Particulars	Cost per unit	Total cost
Cost of materials	192	1,15,200
Add: increase by 20% Wages	252	
Add: 5% increase		1,51,200
prime cost	444	2,66,400
Add: factory overhead		66,600
Proportionate combined		
Cost of materials & labour $100 \times 444/400$		
111		
work cost	150	3,33,000
Add: administrative overhead	555	90,000
Cost of production		4,23,000
Add: selling & distribution overhead		36,000
70560		
Cost of sales	765	4,59,000
Add: profit 25% on Selling price	255	1,53,000
Estimated price	1,020	6,12,000

Note: Profit is 25% on selling price. It means that if sales price Rs. 100 it includes profit Rs. 25 therefore cost price is Rs. 75 (i.e. 100-25)

For cost Cost Profit

75 : 4, 59,000 : 25 $25/75 \times 459000 = 153000$

3. A manufacture of Bajaj scooter finds that in 2024 it cost him Rs. 24, 00,000 to manufacture 200 scooters which he sold at Rs. 17,500 each the cost was made up: Rs.

Materials

10,00,000

Labour (direct wages)

8,00,000

Factory overhead

2,00,000

Establishment and general expenses

$$\text{Rs. } \frac{4,00,000}{24,00,000}$$

For 2013 season, he estimates

- (a) That each scooter will require materials of Rs. 5,200 and labour Rs. 4,500
- (b) That the factory overhead will bear the same relation to wages as in the previous period.
- (c) That the office overhead (establishment & general charges) percentage on factory cost (works cost) will be the same as in the past.

Prepare a statement showing the profit he would make per unit, if he reduce the price of the scooter by Rs. 300

Solution:

Bajaj Scooter Ltd.,

Cost sheet for the year 2024 for 200 scooters

Particulars	Total cost Rs.	Cost per scooter
Materials	10,00,000	5,000
Labour	8,00,000	4,000
Prime cost	18,00,000	9,000
Add: factory overhead	2,00,000	1,000
work cost	20,00,000	10,000
Add: Administrative overhead		
Establishment & general expenses	4,00,000	2,000
Cost of production	24,00,000	12,000
Profit (balancing figure)	11,00,000	5,500
Sales (17,500 × 200)	35,00,000	17,500

Working note: (1) percentage of factory overhead to direct wages

$$= \frac{\text{factory overhead}}{\text{Direct wages}} \times 100 \text{ i.e. } \frac{2,00,000}{8,00,000} \times 100 = 25\% \text{ of wages}$$

(2) Percentage of Administrative overhead to works cost

$$= \frac{\text{administrative overhead}}{\text{works cost}} \times 100 \text{ i.e. } \frac{4,00,000}{20,00,000} \times 100 = 20\% \text{ of works cost}$$

Solution: Statement showing Quotation

Price in 2013 for 200 scooters

Particulars	Total cost Rs.	Cost per scooter
Materials (5200 × 200)	10,40,000	5,200
Labour (4500 × 200)	9,00,000	4,500
prime cost	19,40,000	9,700
Add: factory overhead	2,25,000	1,125
25% of wages i.e. $25/100 \times 9,00,000$		
works cost	21,65,000	10,825
Add: administrative overhead	4,33,000	2,165
20% of works cost i.e. $20/100 \times 21,65,000$		
Cost of production	25,98,000	12,990
Profit (balancing figure)	8,42,000	4,210
Sales (17,500 × 200)	34,40,000	17,200

Check Your Progress II

A. Multiple Choice Questions

- Which of the following is a direct material?
 - Lubricating Oil
 - nails
 - Timber used in furniture
 - Thread
- Prime Cost consists of:
 - Direct Material + Direct Labour + Direct Expenses
 - Direct Material + Factory Overheads
 - Direct Labour + Administrative Overheads
 - Factory Cost + Selling Cost

3. Which of the following is a fixed cost?
 - a) Direct Wages
 - b) Power
 - c) Rent of Building
 - d) Direct Material
4. Cost incurred for promoting sales is called:
 - a) Production Cost
 - b) Selling Cost
 - c) Distribution Cost
 - d) Administrative Cost
5. A Cost Sheet is prepared to ascertain:
 - a) Profit only
 - b) Sales only
 - c) Cost of Production
 - d) Capital Employed

B. State Whether True or False

1. Direct materials form part of the finished product.
2. Rent of office is a factory overhead.
3. Variable costs change according to the volume of production.
4. Sunk costs are relevant for future decision-making.
5. Cost of Sales includes selling and distribution overheads.

C. Fill in the Blanks

1. Cost classification is the process of _____ costs according to their characteristics.
2. Direct Material + Direct Labour + Direct Expenses = _____ Cost.
3. Costs that remain constant irrespective of output are called _____ costs.
4. A formal offer submitted in response to an invitation is called a _____.
5. The cost of replacing an asset at current market price is called _____ cost.

D. Match the Following

Group A	Group B
A. Direct Material	1. Rent of Factory
B. Fixed Cost	2. Timber in Furniture
C. Selling Cost	3. Advertising Expenses

D. Factory Overhead	4. Insurance Premium
E. Opportunity Cost	5. Benefit Sacrificed

3.3 Summary

Cost Accounting is the process of recording, classifying, analysing, and controlling the costs incurred in producing goods and services. Cost classification means grouping costs according to their common characteristics such as nature, function, behaviour, controllability, and time. It helps management determine the cost of

production, control expenses, prepare budgets, fix selling prices, and make effective business decisions. According to the National Association of Accountants, classification is the identification of each item and the systematic grouping of similar items according to their common features. The main objectives of cost classification are to calculate the cost of production, control costs, value work-in-progress, and assist in pricing decisions, support budgeting and planning, and improve managerial decision-making.

Costs can be classified in several ways. According to elements, costs are divided into material cost, labour cost, and expenses, each of which may be direct or indirect. Direct costs can be directly identified with a product or service, while indirect costs cannot be directly traced and are treated as overheads. Function-wise classification divides costs into production, administrative, selling, and distribution costs. According to behaviour, costs are classified as variable costs, which change with output; fixed costs, which remain constant regardless of production volume; and semi-variable costs, which contain both fixed and variable elements. Costs may also be classified according to time as historical costs and predetermined costs, according to controllability as controllable and uncontrollable costs, according to normality as normal and abnormal costs, according to averaging as total costs and unit costs, and according to traceability as direct and indirect costs. For managerial decision-making, costs are further classified into relevant cost, opportunity cost, replacement cost, sunk cost, marginal cost, differential cost, avoidable cost, and unavoidable cost.

A Cost Sheet is a statement that presents the detailed cost of manufacturing a product and the cost per unit. It begins with direct materials, direct labour, and direct expenses to arrive at Prime Cost. After adding factory overheads, Works Cost is obtained. Administrative overheads are then added to calculate the Cost of Production. After adjusting opening and closing stocks of finished goods, the Cost of

Goods Sold is determined. Finally, selling and distribution overheads are added to obtain the Cost of Sales, and profit is added to determine the Selling Price. A cost sheet helps in cost analysis, cost control, comparison of costs, fixing selling prices, preparing tenders and quotations, and determining profit or loss.

Tender, quotation, and estimation are important applications of cost accounting. A tender is a formal offer submitted in response to an invitation, generally in government transactions, while a quotation is a statement showing the price at which goods or services will be supplied. Estimation refers to the calculation of future costs based on past records and expected future conditions. An estimated cost sheet is prepared to determine future costs and selling prices. Profit may be calculated either as a percentage of cost or as a percentage of selling price. Thus, cost classification, cost sheets, and cost estimation are essential tools that help management in planning, controlling, and making informed business decisions.

3.4 Terms to Remember

1. Cost Accounting – The process of recording, classifying, and controlling costs.
2. Cost Classification – Grouping costs according to their common characteristics.
3. Material Cost – Cost of materials used in production.
4. Direct Material – Material that becomes part of the finished product.
5. Indirect Material – Material used in production but not directly traceable to a product.
6. Labour Cost – Remuneration paid to employees for their work.
7. Direct Labour – Labour directly engaged in manufacturing a product.
8. Indirect Labour – Labour that supports production activities indirectly.
9. Expenses – Costs other than material and labour.
10. Direct Expenses – Expenses directly attributable to a specific product or job.
11. Indirect Expenses – Expenses that cannot be directly identified with a product.
12. Prime Cost – Total of direct material, direct labour, and direct expenses.

13. Overheads – Aggregate of all indirect costs.
14. Factory Overhead – Indirect costs incurred in the factory.
15. Administrative Overhead – Costs incurred for administration and management.
16. Selling Overhead – Costs incurred to promote and secure sales.
17. Distribution Overhead – Costs incurred in delivering goods to customers.
18. Production Cost – Cost incurred in manufacturing goods.
19. Variable Cost – Cost that changes directly with the level of output.
20. Fixed Cost – Cost that remains constant regardless of output.
21. Semi-Variable Cost – Cost having both fixed and variable elements.
22. Historical Cost – Cost determined after it has been incurred.
23. Estimated Cost – Approximate cost calculated before production.
24. Standard Cost – Predetermined cost established through scientific analysis.
25. Controllable Cost – Cost that can be influenced by management.
26. Uncontrollable Cost – Cost that cannot be controlled at a particular level.
27. Normal Cost – Cost incurred under normal operating conditions.
28. Abnormal Cost – Cost arising due to unusual or abnormal conditions.
29. Total Cost – Aggregate of all costs incurred.
30. Unit Cost – Cost per unit of product or service.
31. Relevant Cost – Cost relevant to a specific managerial decision.
32. Opportunity Cost – Benefit sacrificed by choosing one alternative over another.
33. Imputed Cost – Notional cost considered without actual cash expenditure.
34. Replacement Cost – Current cost of replacing an asset.
35. Sunk Cost – Past cost that cannot be recovered.
36. Shutdown Cost – Cost incurred even when operations are temporarily stopped.
37. Out-of-Pocket Cost – Cost involving actual cash outflow.
38. Marginal Cost – Additional cost of producing one more unit.

39. Differential Cost – Difference in cost between alternative decisions.
40. Avoidable Cost – Cost that can be eliminated by discontinuing an activity.
41. Unavoidable Cost – Cost that must be incurred irrespective of decisions.
42. Cost Sheet – Statement showing detailed cost and cost per unit.
43. Works Cost – Prime cost plus factory overheads.
44. Cost of Production – Works cost plus administrative overheads.
45. Cost of Sales – Cost of production plus selling and distribution overheads.
46. Tender – Formal offer submitted for supplying goods or executing work.
47. Quotation – Statement showing the price of goods or services offered.
48. Estimation – Approximate calculation of future cost based on available information.
49. Estimated Cost Sheet – Cost sheet prepared using estimated future costs.
50. Selling Price – Total cost plus desired profit.

3.5 Answers to Check Your Progress:

- A. Ans: c, a, c, b, c
- B. Ans. 1. True, 2. False, 3. True, 4. False, 5. True
- C. Ans. 1. Grouping, 2. Prime, 3. Fixed, 4. Tender, 5. Replacement
- D. Ans. A-2, B-4, C-3, D-1.

3.6 Exercise

1. Explain the meaning and definition of cost classification. Discuss its objectives in detail.
2. Describe the various methods of cost classification with suitable examples
3. What is a Cost Sheet? Explain its format, preparation, and advantages.
4. Explain Tender, Quotation, Estimation, and Estimated Cost Sheet with examples.
5. Discuss material cost and labour cost classification with examples.

6. Explain function-wise classification of cost and describe production, administrative, selling, and distribution costs.
7. What is classification according to behaviour? Explain variable, fixed, and semi-variable costs.
8. Explain classification of costs according to time, controllability, and normality.

Short Notes

- i. Classification of Cost
 - ii. Objectives of Cost Classification
 - iii. Direct and Indirect Costs
 - iv. Direct Materials and Indirect Materials
 - v. Direct Labour and Indirect Labour
 - vi. Direct Expenses and Indirect Expenses
 - vii. Cost Sheet
 - viii. Tender
 - ix. Quotation
 - x. Estimation
 - xi. Estimated Cost Sheet
 - xii. Profit on Cost and Profit on Selling Price
1. A company manufacturing steel furniture's. It has received an order to supply 100 chairs from the following.

Raw materials	:	1000 kgs at Rs. 24 per kg.
Wages	:	100 days at Rs. 120 per day
Variable overheads	:	Factory at Rs. 150 per day
Office at Rs. 80 per day		
Fixed overhead:	:	Factory Rs. 20,000
		Office Rs. 8,000

Prepare cost sheet showing the price to be fixed per chair if profit is expected 20% on sales.

Ans.: Prime cost 36,000 works cost 71,000 cost to production 87,000 profit 21,750 sales 1,08,750

Cost per unit = Prime cost 360, works cost 710 cost of production 870 Profit 217 50 sales 1087.50

2. Ashwini Limited manufactures of toys received for supplying 200 toys It is estimated that the raw materials would cost Rs. 30,000 and productive wages Rs. 14,000. Following overheads are estimated.

Variable overheads	:	Factory 10,000
	:	Office 20,000
Fixed overheads	:	Factory 20,000
	:	Office 10,000

Prepare a statement showing the price to be fixed per toy if "Ashwini Ltd." expects 25% profit on sales.

Ans. Prime cost 44,000 works cost 79,000 cost of production 1,04,000 Profit 26,000 sales 1,30,000 sales price per toy Rs 650

3. The accounts of XYZ Co. Ltd. show the following

	Rs.
Materials used	21,00,000
Direct Wages	16,20,000
Works overhead expenses	4,86,000
Administrative expenses	3,36,480

Prepare the statement showing the following

- Works Cost
- Total Cost
- Percentage of works overhead on direct wages
- Percentage of administrative expenses on works cost.

Ans. Total cost 45,42,480

Calculation of Overhead Rates

- 1) Percentage of works overhead on direct wages

Works overhead	486000
----- x 100 =	----- x 100 = 30%
Direct Wages	1620000

2) Percentage of Administration expenses on work cost

Administration Expenses	336480
----- x 100 = ----- x 100 =8%	
Works cost	4206000

4. In a factory 20,000 units of product were produced in the month of July 2024. From the following figures obtained from the from the cost books, prepare a cost sheet showing cost per unit.

Opening stock of raw Materials Rs.5,000

Purchases Rs.55,000

Closing stock of raw materials Rs.10,000

Direct Wages Rs.25,000

Factory overhead Rs.40,000

Office and Administration expenses Rs. 20,000

Ans. Materials consumed Rs. 50,000, Prime cost Rs. 75,000 Works cost Rs 1.15,000

Cost of production Rs 1,35,000

Cost per Unit Materials consumed 2.50, Prime Cost 3 75. Work cost 5.75, Cost of Production 6.75

5. Nivedita Ltd. manufacturer's toys. It has received an order for supply of 300 Toys. It is estimated that the raw materials would cost Rs. 36,000 and productive wages would amount Rs. 18,000. Further following overhead expenses are estimated.

Variable overhead	Factory Rs. 15,000
	Office Rs. 22,500
Fixed overhead	Factory Rs 30,000
	Office Rs. 12,000

Prepare a statement showing the price to be fixed per toy if the manufacturer expects 20% profit on sales.

166875

Ans: Sales price per Toy Rs 556.25 ----- = 556.25
300

Profit 33375 sales price 166875

6. From the following information prepare a statement for 6 months ending. Showing (a) Prime cost (b) Works cost (c) Cost of production (d) Total cost and (e) Profit or loss

	Rs.
Raw material: 1-1-2024	15,000
30-6-2024	9,000
Productive wages at the rate of Rs. 2250 per month	
Purchases	1,00,000
Works overhead	25,000
Selling overhead	14,000
Administration overhead at the rate of 20% of Factory Cost	
Finished Stock: 30-6-2024	10,000
1-1-2024	15,000
Sales	2, 20,000

Ans:

- | | |
|-----------------------------------|--|
| (1) Materials consumed Rs. 106000 | (2) Prime Cost Rs.119500 |
| (3) Works Cost Rs. 144500 | (4) Cost of Production Rs. 173400 |
| (5) Cost of goods sold Rs. 178400 | (6) Total Cost or Cost of sales 192400 |
| (7) Profit Rs. 27600 | |

Hint: Wages 2.250 x 6 months Rs. 13500.

7. A company furnishes the following information relating to the manufacture of a standard product during the month of April 2025.

Raw materials consumed Rs. 15,000

Direct labour charges	Rs. 9,000
Machine hours worked	900 hours
Machine hour rate	Rs. 5 per hour

Administrative overheads 20% on works cost

Selling overheads 50 paise per unit.

Units produced 17100

Units sold 16000 at Rs. 4 per unit.

You are required to prepare a cost sheet from the above showing

(a) The cost per unit (b) Profit per unit sold (c) Profit for the period.

Ans: Cost of sales Rs. 64,000, Profit Rs. 24,000, per unit Rs. 150 Cost of production Rs 34,200 and cost per unit Rs. 2.

Hint

(1) Ascertainment of closing finished goods.

No. of units	17,100
Less Units sold	16,000
Closing finished goods.	1,100

(2) Closing stock of finished goods is valued at present rate i.e. cost per unit

8. Anand Steels Ltd. manufactures steel furniture. It has received an order for supply of 200 chairs. The estimated cost is as under

Raw materials	: 800 kgs. at Rs. 30 per kg.
Wages	: 100 days at Rs. 120 per day
Variable overhead	: Factory Rs 150 per day
	: Office Rs. 80 per day
Fixed overhead	: Factory Rs. 20,000
	: Office Rs. 8,000

Prepare a statement showing the price to be fixed per chair if he expects 20% profit on sales.

Ans: Prime Cost 36,000 Works Cost 71,000 Cost of production 87,000 Profit 21,750
Sales price 10,8750. Cost per unit prime cost 180, work cost 355, cost of production 435, Profit 108.75 and sales price 543.75.

9. A Company manufactures magic bells and its costing data and selling price for the half-yearly ending 30th June, 2025 are as follows:

Raw materials consumed Rs. 60,000.

Direct labour 1000 hours at Rs. 30 per hour.

Labour hour rate of overhead Rs. 10 per hour.

Administration overhead 20% on works cost.

Selling cost Rs. 2 per magic bell sold.

No. of magic bells produced 15000 units

No. of magic bells sold 14000 units at Rs. 15 per unit.

Prepare Statement of Cost and Profit.

Ans: (1) Prime Cost 90,000 (2) Work cost 1,00,000 (3) Cost of Production 1,20,000
(4) Cost of goods sold 1,12,000 (5) Cost of Sales 1,40,000 Profit 70,000 (6) Sales 2,10,000

Cost per Unit (1) Prime cost 6 (2) Work cost 6.67 (3) Cost of Production 8 (4) Cost of sales 10 Profit 5 Sales 15.

10. From the following particulars prepare a Cost-sheet statement: -

	Rs	Rs.	
Stock (1-1-2001) Raw material	30,500	Sales	95,000
Finished Goods (1-1-2001)	20,400	Direct wages	20,400
Stock (31-12-2001) Raw material	48,500	Factory expenses	10,500
Finished Goods (31-12-2001)	10,000	Office expenses	5,400
Purchase of raw materials	25,000	Selling expenses	3,800
Distribution expenses	2,500		

Ans: 1) Materials Consumed Rs. 7,000 2) Prime cost Rs. 27,400 3) works Cost Rs. 37,900 4) Cost of Production Rs. 43,300 5) Cost of goods sold Rs. 53,700 6) Cost of Sales Rs. 60,000 7) Profit Rs. 35,000

Problems based on Tenders & Quotations

1. Benson Ltd gives you the following cost information:

	Rs
Direct material consumed	2,00,000
Productive wages	1,20,000
Works-on-cost	24,000
Administration overhead	16,000

Prepare a cost sheet and also a quotation for a machine which requires Direct Materials of Rs 3,000 and Direct Wages of Rs. 1,000. The firm wants to earn a profit of 25% on selling price.

Ans: In Cost sheet Prime cost 3,20,000, Works cost 3,44,000, Cost of production 3,60,000, In quotation prime cost 4,000, works cost 4,200. Cost of production 4,395, Profit 1,465 Quotation 5,860

2. The account of Excel Industries Ltd. Show for 2006 Materials Rs. 7,00,000 Labour Rs. 5,40,000, Factory overheads Rs. 1,62,000 and administration overheads rs. 1,12,160.

What price should the company quote for a machine ? It is estimated that Rs. 2,000 in material and Rs. 1,400 in labour will be required for one machine. Absorb factory overheads on the basis of labour and administration overheads on the basis of works cost. A profit of 12%,% on selling price is required.

Ans: In cost sheet Prime cost 2,70,000, Works Cost 3,00,000, Cost of Production 3,15,000 In Quotation Price Prime cost 2000, Works Cost 2125, Cost of Production 2,231 Profit 5,58 Sales Price 2789

Hint: Calculation of percentages

- 1) Percentage of Factory overhead to wages

$$\text{Percentage} = \frac{\text{Factory overhead}}{\text{Wages}} \times 100 = \frac{1,62,000}{7,00,000} \times 100 = 23.14\%$$

- 2) Percentage of Administrative overhead to works cost

$$\text{Percentage} = \frac{\text{Administrative overhead}}{\text{Works Cost}} \times 100 = \frac{1,12,160}{14,02,000} \times 100 = 8\% \text{ works cost}$$

3) Calculation of Profit

$$\text{Profit } 12\% \text{ on sales} = \frac{12.50}{87.5} \times 4022 = 574$$

3. The Account of a Machine Manufacturing Company discloses the following information for six months ending 31-12-1025.

	Rs.
Materials	1,50,000
Productive wages	1,20,000
Factory overhead expenses	24,000
Establishment and general expenses	17,640

Prepare the cost sheet and a tender for supply of a machine costing:

materials of Rs. 1,250 and labour Rs. 750 so as to yield a profit 10% on sales.

Ans: (1) Cost of production Rs. 3,11,640 Tender price Rs. 2,532

- (2) Percentage of Factory overhead to direct wages

$$\begin{aligned} & \frac{\text{Factory overhead}}{\text{Direct wages}} \times 100 = \frac{24,000}{1,20,000} \times 100 = 20\% \text{ of wages} \end{aligned}$$

- (3) Percentage of Administrative overhead to works cost

$$\begin{aligned} & \frac{\text{Administrative overhead}}{\text{Works cost}} \times 100 = \frac{17,640}{2,94,000} \times 100 = 6\% \text{ of works cost} \end{aligned}$$

- (4) Details of cost in tender price (1) Prime cost Rs 2,000 (2) Works cost Rs. 2,150

(3) Cost of production Rs. 2,279 (4) Profit Rs. 253 (5) Tender price Rs. 2,532

4. The accounts of a machine manufacturing Co discloses the information of 6 months 31st Dec. 2025.

Materials used	Rs. 1,50,000
Direct wages	Rs 1,20,000

Factory overheads	Rs 30,000
Administration Expenses	Rs. 15,000

Prepare a cost sheet of the machine and calculate the price which the co should quote for the manufacture of a machine requiring materials value Rs. 1500 and expenditure in productive wages Rs. 500 so that the price might yield a profit of 20% on selling price.

Ans: In cost sheet Prime cost 2,70,000, Works Cost 3,00,000, Cost of Production 3,15,000 In Quotation Price Prime cost 2000, Works Cost 2125. Cost of Production 2.231 Profit 5,58 Sales Price 2789

Hint: Calculation of percentages

- 1) Percentage of Factory overhead to wages

$$= \frac{\text{Factory overhead}}{\text{Direct wages}} \times 100 = \frac{30000}{1,20,000} \times 100 = 25\% \text{ of wages}$$

- 2) Percentage Administrative overhead Works Cost

$$= \frac{\text{Administrative overhead}}{\text{Works cost}} \times 100 = \frac{15,000}{3,00,000} \times 100 = 5\% \text{ of works cost}$$

3.7 References for Further Study

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Unit – IV

Reconciliation of Cost Statement with Financial Statement

Meaning and Need of Reconciliation, Procedure of Preparing Reconciliation Statement, Practical Problems on reconciliation of accounts

4.0 Objectives

4.1 Introduction

4.2 Meaning, Need, and Causes of Difference

4.2.1 Meaning of Reconciliation

4.2.2 Distinction between Financial Accounts and Cost Accounts

4.2.3 Need and Importance of Reconciliation

4.2.4 Causes of Difference between Cost Profit and Financial Profit

4.2.5 Golden Rules Summary Table for Reconciliation

4.2.6 Procedure for Preparing a Reconciliation Statement

4.2.7 Standard Proforma of Reconciliation Statement

Check Your Progress I

4.2.8 Practical Problems

Check Your Progress II

4.3 Summary

4.4 Important Terms

4.5 Answers to Check Your Progress

4.6 Exercise

4.7 Reference for Further Study

4.0 Objectives

After Studying this Unit you will be able to:

1. Understand the meaning, need, and importance of reconciliation of Cost Accounts with Financial Accounts.
2. Explain the causes of difference between the profit or loss shown by Cost Accounts and Financial Accounts.
3. Find the relationship between various items in Cost Accounts and Financial Accounts that give rise to differences.
4. Prepare a Reconciliation Statement in the standard proforma prescribed in Cost Accounting.
5. Solve practical problems on reconciliation arranged from very simple to comprehensive level.

4.1 Introduction

In the previous unit (Unit III), we studied the Classification of Cost and the preparation of the Cost Sheet and Quotation Statement. We learnt that the total cost of a product is systematically built from Prime Cost, to Factory Cost, to Cost of Production, to Cost of Goods Sold, and finally to the Total Cost of Sales.

Now in Unit IV, we take a step further and examine a practical reality that every business faces. A manufacturing organisation maintains not one but two separate systems of accounting simultaneously the Financial Accounts and the Cost Accounts. Both systems record transactions related to costs and revenues, yet they often arrive at different figures of profit or loss for the very same accounting period. A student or a manager looking at both sets of books would naturally ask why they differ. Which one is correct? Can we trust cost data when the two systems do not agree?

Reconciliation answers all these questions. It is the formal, systematic process of explaining item by item every reason why the profit shown by Cost Accounts differs from the profit shown by Financial Accounts. By the time the Reconciliation Statement is complete, the difference is fully accounted for and both sets of books are verified as accurate.

This unit covers the complete theory of reconciliation its meaning, the need for it, all causes of difference, the standard procedure, and the proforma. It is followed by twelve practical illustrations arranged from the very simplest single-item problem to a fully comprehensive problem involving all types of differences simultaneously.

4.2 Meaning, Need, and Causes of Difference

4.2.1 Meaning of Reconciliation

Manufacturing businesses generally maintain two types of accounts: Financial Accounts and Cost Accounts.

Financial Accounts are prepared according to the provisions of the Companies Act, 2013 and applicable Accounting Standards. They record all financial transactions of the business and show its overall financial position to shareholders, creditors, government authorities, and other external users. Cost Accounts are prepared mainly for internal management. They help in finding the cost of production, measuring the profit earned from different products or departments, and providing useful information for planning, controlling costs, and making business decisions.

Although both Financial Accounts and Cost Accounts relate to the same business and the same accounting period, the profit shown by them is often different. This is because the two systems follow different methods of recording and valuing costs. Some expenses and incomes are treated differently, while certain items may be included in one set of accounts but excluded from the other. Therefore, the profit shown in Cost Accounts usually does not exactly match the profit shown in Financial Accounts.

Reconciliation is the formal process of identifying, explaining, and accounting for each item that causes this difference. A Reconciliation Statement is prepared to bridge the gap between the two profit figures. It begins with profit as per Cost Accounts and makes systematic adjustments additions for items that increase Financial Profit and deductions for items that decrease it until the final figure agrees exactly with profit as per Financial Accounts.

As defined by Maheshwari and Maheshwari : "Reconciliation of Cost and Financial Accounts is the process of bringing into agreement the profit or loss as

shown by the Cost Accounts with the profit or loss as shown by the Financial Accounts, by preparing a reconciliation statement which shows the reasons for the difference between the two."

As stated by Shukla, Grewal and Gupta : "It is necessary to reconcile the profit shown by cost accounts with that shown by financial accounts in order to ascertain whether both sets of books are correct and whether the costing records give reliable information to management."

4.2.2 Distinction between Financial Accounts and Cost Accounts

Before understanding the causes of difference, it is important to appreciate the fundamental distinctions between the two systems:

Basis of Distinction	Financial Accounts	Cost Accounts
Primary Purpose	To record all financial transactions and present the financial position to external stakeholders shareholders, creditors, and the government.	To ascertain the cost of each product, department, or process and assist management in planning, control, and decision-making.
Legal Requirement	Compulsory for all registered companies under Companies Act, 2013.	Not compulsory for most businesses. Mandatory only for specific industries under Companies (Cost Records and Audit) Rules, 2014.
Time Period	Prepared annually, at the end of the financial year.	Prepared monthly, weekly, daily, or on a job-by-job basis as required.
Scope	Covers all financial transactions production, trading, administration, investment, financing, and	Covers only manufacturing and production activities. Purely financial transactions are excluded.

Basis of Distinction	Financial Accounts	Cost Accounts
	taxation.	
Basis of Profit	Shows overall Net Profit or Net Loss of the entire entity after all incomes and all expenses.	Shows product-wise, job-wise, or department-wise profit or cost.
Stock Valuation	At cost or NRV, whichever is lower (AS-2 / Ind AS-2).	At Works Cost or Cost of Production. NRV adjustments not made.
Treatment of Overheads	Actual overheads incurred are charged to Profit & Loss Account.	Overheads absorbed using predetermined absorption rates may result in over or under absorption.
Treatment of Abnormal Items	All actual losses including abnormal losses are recorded in Profit & Loss Account.	Abnormal losses are excluded from cost of production and treated separately.

(NRV - Net Realizable Value; AS- Accounting Standard)

4.2.3 Need and Importance of Reconciliation

The reconciliation of Cost Accounts with Financial Accounts serves several vital purposes:

1. **Verification of Accuracy of Both Sets of Records:** The primary purpose is to verify that both sets of accounts are correct and complete. If the difference between the two profit figures can be fully explained by known causes, both sets are confirmed as accurate. If a portion remains unexplained, it signals an error, omission, or manipulation that must be investigated.
2. **Detection and Prevention of Errors and Fraud:** Regular reconciliation is an important internal control in a manufacturing organisation. It helps to identify calculation errors, recording mistakes, and possible frauds. If the cost shown in the

Cost Accounts is incorrect or higher than the actual cost, reconciliation helps detect such differences quickly. This ensures that the accounts remain accurate and reliable.

3. Ensuring Reliability of Cost Data for Managerial Decisions: Management relies on cost data for pricing, tenders, make-or-buy decisions, and performance evaluation. If the cost data is unreliable, all these decisions may be distorted. Reconciliation ensures that cost records are consistent with the overall financial data of the enterprise.

4. Compliance with Statutory Cost Audit Requirements: Under the Companies (Cost Records and Audit) Rules, 2014, certain categories of companies are required to maintain cost records and have them audited. A Reconciliation Statement is a mandatory part of the cost audit report, and the Cost Auditor uses it to verify consistency between cost records and financial statements.

5. Correct Profit Reporting for Pricing and Policy: Product-wise profit from Cost Accounts is used to determine selling prices and to evaluate production processes. Unless reconciled with financial profit, there is a risk of incorrect policy decisions. Reconciliation ensures that cost-based and financially-based profit figures are both correct and mutually consistent.

6. Integration and Coordination of Both Systems: Reconciliation ensures that cost records dovetail accurately with the general ledger. In a non-integrated system (where the two are maintained separately), reconciliation is the only mechanism that coordinates and cross-checks them.

4.2.4 Causes of Difference between Cost Profit and Financial Profit

The following are the principal causes that give rise to a difference between the profit or loss shown by Cost Accounts and that shown by Financial Accounts. An understanding of each cause is essential for preparing the Reconciliation Statement correctly.

Cause 1 Items of a Purely Financial Nature

This is the most common and most important cause. Certain items of income and expenditure are recorded in the Profit & Loss Account of Financial Accounts but are completely excluded from Cost Accounts because they have no connection with the cost of production.

(A) Purely Financial Charges (Expenses) these reduce Financial Profit below Cost Profit. Examples:

1. Interest on loans, debentures, bank overdraft, and working capital loans
2. Loss on sale of fixed assets or investments
3. Discount on issue of shares or debentures written off
4. Goodwill, preliminary expenses written off
5. Fines and penalties for statutory non-compliance
6. Donations and subscriptions
7. Income Tax and direct taxes provided

(B) Purely Financial Incomes these increase Financial Profit above Cost Profit. Examples:

1. Interest received on bank deposits, loans given, and investments
2. Dividend received on shares, mutual funds, and other investments
3. Profit on sale of fixed assets or investments
4. Rent received from sub-letting premises
5. Insurance compensation and claims received

Cause 2 Differences in Treatment of Overhead Expenses

In Cost Accounts, overheads are charged using predetermined absorption rates. In Financial Accounts, actual overheads incurred are charged. Since predetermined rates are based on estimates, they rarely equal actual overheads exactly.

Over-Absorption: Overheads absorbed in Cost Accounts exceed actual overheads in Financial Accounts. Cost Accounts charged more overhead than actually incurred, reducing Cost Profit more. Financial Profit is higher than Cost Profit → DEDUCT over-absorbed amount from Cost Profit.

Under-Absorption: Overheads absorbed in Cost Accounts are less than actual overheads in Financial Accounts. Cost Accounts charged less overhead, making Cost Profit higher. Financial Profit is lower → ADD under-absorbed amount to Cost Profit.

Cause 3 Differences in Valuation of Opening and Closing Stocks

Stocks of Raw Materials, WIP, and Finished Goods are valued differently: at cost of production in Cost Accounts, and at lower of cost or NRV (AS-2) in Financial Accounts.

Situation	Effect on Financial Profit	Treatment
Closing stock HIGHER in Financial A/c	Financial Profit is HIGHER	ADD to Cost Profit
Closing stock LOWER in Financial A/c	Financial Profit is LOWER	DEDUCT from Cost Profit
Opening stock HIGHER in Financial A/c	Financial Profit is LOWER (more cost b/f)	DEDUCT from Cost Profit
Opening stock LOWER in Financial A/c	Financial Profit is HIGHER (less cost b/f)	ADD to Cost Profit

Cause 4 Differences in the Method or Rate of Depreciation

Depreciation may be calculated at different rates or by different methods in the two sets. In Cost Accounts, Machine Hour Rate or unit-of-production methods are common. In Financial Accounts, Schedule II of Companies Act, 2013 prescribes SLM or WDV.

If depreciation in Financial Accounts is higher → Financial Profit lower → DEDUCT from Cost Profit. If depreciation in Cost Accounts is higher → Cost Profit was reduced more → ADD to Cost Profit.

Cause 5 Treatments of Abnormal Losses and Abnormal Gains

Abnormal losses arise from avoidable, unexpected cause's fire, flood, machine breakdown, theft. In Cost Accounts they are excluded from product cost. In Financial Accounts they are fully charged to Profit & Loss Account. Financial Profit is lower → DEDUCT.

Abnormal gains arise when actual output exceeds expected normal output. They are credited in Cost Accounts but not recorded in Financial Accounts. This inflates Cost Profit artificially. To reach Financial Profit, this inflation must be reversed → DEDUCT the abnormal gain.

Cause 6 Notional Charges in Cost Accounts

Notional charges are imputed costs included in Cost Accounts to reflect the true economic cost of production, even though no actual payment has been made. Examples include notional rent for owned premises and notional interest on owner's capital. These charges reduce Cost Profit below Financial Profit. Since Financial Accounts do not record them → ADD to Cost Profit.

4.2.5 Golden Rules Summary Table for Reconciliation

Cause of Difference	Situation	Treatment : Cost → Financial
Purely Financial Expense	In Fin. A/c only (interest paid, fines, donations, loss on sale, etc.)	DEDUCT from Cost Profit
Purely Financial Income	In Fin. A/c only (dividend, interest received, profit on sale, rent, claim)	ADD to Cost Profit
Over-Absorption	Absorbed in Cost A/c > Actual in Fin. A/c	DEDUCT from Cost Profit
Under-Absorption	Absorbed in Cost A/c < Actual in Fin. A/c	ADD to Cost Profit
Closing Stock Higher in Fin. A/c	Fin. A/c stock value > Cost A/c stock value	ADD to Cost Profit
Closing Stock Lower in Fin. A/c	Fin. A/c stock value < Cost A/c stock value	DEDUCT from Cost Profit

Cause of Difference	Situation	Treatment : Cost → Financial
Opening Stock Higher in Fin. A/c	Fin. A/c stock value > Cost A/c stock value	DEDUCT from Cost Profit
Opening Stock Lower in Fin. A/c	Fin. A/c stock value < Cost A/c stock value	ADD to Cost Profit
Depreciation Higher in Fin. A/c	Fin. A/c charges more depreciation	DEDUCT from Cost Profit
Depreciation Higher in Cost A/c	Cost A/c charges more depreciation	ADD to Cost Profit
Abnormal Loss	Charged in Fin. A/c only; excluded from Cost A/c	DEDUCT from Cost Profit
Abnormal Gain	Recorded in Cost A/c only; not in Fin. A/c	DEDUCT from Cost Profit (reverse it)
Notional Charges	In Cost A/c only (notional rent, notional interest on capital)	ADD to Cost Profit

Reconciliation Statement Format and Procedure

4.2.6 Procedure for Preparing a Reconciliation Statement

The Reconciliation Statement is prepared in four clearly defined steps:

Step 1 Find the Starting Figure:

Ascertain the Net Profit or Net Loss as per Cost Accounts (Costing Profit & Loss Account). This becomes the first line and the starting point of all adjustments.

Step 2 ADD Items that Increase Financial Profit above Cost Profit:

1. All purely financial incomes in Financial Accounts not in Cost Accounts

2. Under-absorption of overheads
3. Higher value of closing stock in Financial Accounts
4. Lower value of opening stock in Financial Accounts
5. Excess depreciation charged in Cost Accounts over Financial Accounts
6. Notional charges included in Cost Accounts only

Step 3 DEDUCT Items that Decrease Financial Profit below Cost Profit:

1. All purely financial expenses in Financial Accounts not in Cost Accounts
2. Over-absorption of overheads
3. Lower value of closing stock in Financial Accounts
4. Higher value of opening stock in Financial Accounts
5. Short depreciation in Cost Accounts compared to Financial Accounts
6. Abnormal losses charged in Financial Accounts only
7. Abnormal gains recorded in Cost Accounts only (reverse them)

Step 4 Arrive at Financial Profit:

After all additions and deductions, the resulting figure must equal exactly the Net Profit or Net Loss as per Financial Accounts. If both sides agree, reconciliation is complete and both sets of books are verified.

4.2.7 Standard Proforma of Reconciliation Statement

Particulars	₹	₹
Profit / Loss as per Cost Accounts		XXXX
ADD : Items increasing Financial Profit :		
(i) Purely financial incomes not in Cost Accounts	XX	
(ii) Under-absorption of overheads (Actual >	XX	

Absorbed)		
(iii) Higher closing stock in Financial Accounts	XX	
(iv) Lower opening stock in Financial Accounts	XX	
(v) Excess depreciation in Cost Accounts	XX	
(vi) Notional charges in Cost Accounts only	XX	XXXX
Total (A)		XXXX
LESS : Items decreasing Financial Profit :		
(i) Purely financial expenses not in Cost Accounts	XX	
(ii) Over-absorption of overheads (Absorbed > Actual)	XX	
(iii) Lower closing stock in Financial Accounts	XX	
(iv) Higher opening stock in Financial Accounts	XX	
(v) Short depreciation in Cost Accounts	XX	
(vi) Abnormal losses in Financial Accounts only	XX	
(vii) Abnormal gain in Cost Accounts only	XX	XXXX
Profit / Loss as per Financial Accounts		XXXX

Reconciliation Statement

(For the year / period ending _____)

Check Your Progress I

A. State whether True or False:

1. Financial Accounts are prepared mainly for internal management decisions.

2. Reconciliation is the process of explaining the difference between Cost Profit and Financial Profit.
3. Interest paid on bank loan is included in Cost Accounts.
4. Over-absorption of overheads means Cost Accounts absorbed more overhead than actual overhead incurred.
5. A higher closing stock in Financial Accounts increases Financial Profit over Cost Profit.
6. Abnormal gains recorded only in Cost Accounts are ADDED to Cost Profit in reconciliation.
7. Notional charges in Cost Accounts are ADDED to Cost Profit when reconciling.

B. Fill in the Blanks:

1. Reconciliation starts with profit as per _____ Accounts.
2. Purely financial incomes not in Cost Accounts are _____ to Cost Profit.
3. When actual overheads exceed overheads absorbed, it is called _____.
4. Abnormal losses charged only in Financial Accounts are _____ from Cost Profit.
5. Stock in Cost Accounts is valued at _____ cost.
6. If opening stock is higher in Financial Accounts, it is _____ from Cost Profit.

C. Match Column A with Column B:

Column A	Column B
1. Dividend received (Fin. A/c only)	(a) DEDUCT from Cost Profit
2. Interest on overdraft (Fin. A/c only)	(b) ADD to Cost Profit
3. Over-absorption of overheads	(c) Financial income ADD

Column A	Column B
4. Higher closing stock in Fin. A/c	(d) Financial expense DEDUCT
5. Under-absorption of overheads	(e) ADD to Cost Profit
6. Abnormal loss in Fin. A/c only	(f) DEDUCT from Cost Profit
7. Notional rent in Cost A/c only	(g) ADD to Cost Profit

4.2.8 Practical Problems

The following twelve illustrations are arranged in order of increasing difficulty. Students should study each illustration thoroughly, understand the working notes, and then attempt the practice problems in Section 6 independently.

Illustration 4.1

M/s Bharat Enterprises Ltd. manufactures consumer goods and prepares separate Cost Accounts and Financial Accounts. For the year ended 31st March 2024, the Costing Profit & Loss Account shows a Net Profit of ₹ 1,42,000. The company holds shares in several listed companies. During the year, dividend of ₹ 11,500 was received on these shares. This dividend has been credited to the Profit & Loss Account in the Financial Books.

Since dividend income is purely financial in nature and is entirely unrelated to the cost of production or manufacturing activity, it has NOT been included anywhere in the Cost Accounts. You are required to prepare a Reconciliation Statement and ascertain the profit as per Financial Accounts.

Solution:

Working Note Nature of Item: Dividend received is a purely financial income. It is credited to the Profit & Loss Account in Financial Accounts only. Since it is an income in Financial Accounts, it increases Financial Profit above Cost Profit. Therefore, it is ADDED to Cost Profit.

Reconciliation Statement
(For the year ended 31st March 2024)

Particulars	₹	₹
Profit as per Cost Accounts		1,42,000
ADD : Dividend received on shares (purely financial income; not recorded in Cost Accounts)		11,500
Profit as per Financial Accounts		1,53,500

Note: Verification: Cost Profit ₹ 1,42,000 + ₹ 11,500 = ₹ 1,53,500. The Financial Accounts will show ₹ 1,53,500 as Net Profit after crediting dividend income.

Illustration 4.2

The Costing Department of M/s Sunrise Manufacturing Co., Kolhapur, has prepared its Cost Accounts for the year ended 31st March 2024. The Costing Profit & Loss Account discloses a Net Profit of ₹ 2,18,000. The Financial Accounts, prepared simultaneously by the Financial Accounting Department, show a Net Profit of ₹ 1,98,000 for the same year. The Chief Accountant has identified the following two items as the cause of difference:

Item	Treatment in Accounts	Amount (₹)
Interest received on fixed deposit with bank	Credited to P&L in Financial Accounts only; not in Cost Accounts	14,000
Donation paid to a charitable trust registered under Section 80G	Debited to P&L in Financial Accounts only; not in Cost Accounts	34,000

You are required to : (a) Verify whether the above two items fully explain the difference between the two profit figures. (b) Prepare a Reconciliation Statement.

Solution:

Step 1 Verify the Difference:

Difference between the two profit figures = ₹ 2,18,000 - ₹ 1,98,000 = ₹ 20,000.

Items to explain the difference:

1. Interest received ₹ 14,000 increases Financial Profit (ADD)
2. Donation paid ₹ 34,000 decreases Financial Profit (DEDUCT)

Net effect = +14,000 - 34,000 = - 20,000. Cost Profit is ₹ 20,000 higher than Financial Profit. This agrees with the difference found above. Hence, both items fully explain the difference.

Step 2 Reconciliation Statement :

Reconciliation Statement

(For the year ended 31st March 2024 M/s Sunrise Manufacturing Co.)

Particulars	₹	₹
Profit as per Cost Accounts		2,18,000
ADD : Interest received on fixed deposit (financial income; not in Cost Accounts)		14,000
Total		2,32,000
LESS : Donation paid to charitable trust (financial expense; not in Cost Accounts)		34,000
Profit as per Financial Accounts		1,98,000

Note: Verification: ₹ 2,18,000 + ₹ 14,000 - ₹ 34,000 = ₹ 1,98,000. The two items fully explain the difference of ₹ 20,000. Reconciliation is complete.

Illustration 4.3

M/s Rajlakshmi Industries Ltd., Pune, is a medium-sized manufacturing company. Its accounts for the year ended 31st March 2024 are under finalization.

The Cost Accounts show a Net Profit of ₹ 3,60,000. The Financial Accounts show a Net Profit of ₹ 2,99,500. The difference of ₹ 60,500 has arisen entirely because of the following items, all of which appear ONLY in the Financial Accounts and have not been recorded in the Cost Accounts:

Sr. No.	Item	Nature	Amount (₹)
1	Interest on term loan paid to bank	Financial Expense	32,000
2	Interest on bank overdraft for working capital	Financial Expense	10,000
3	Dividend received on equity shares (listed companies)	Financial Income	18,500
4	Profit on sale of old delivery vehicle	Financial Income	9,000
5	Loss on sale of old factory machinery	Financial Expense	14,000
6	Fine paid for delayed ESI deposit	Financial Expense	4,000
7	Rent received from sub-letting a portion of godown	Financial Income	6,000
8	Preliminary expenses of new branch written off	Financial Expense	14,000

You are required to prepare a Reconciliation Statement and verify that all items together explain the difference.

Solution:

Step 1 Classify Each Item:

Item	Amount (₹)	Treatment in Reconciliation
Interest on term loan paid	32,000	DEDUCT (financial expense reduces Financial Profit)
Interest on bank overdraft	10,000	DEDUCT (financial expense reduces Financial Profit)
Dividend received	18,500	ADD (financial income increases Financial Profit)
Profit on sale of vehicle	9,000	ADD (financial income increases Financial Profit)
Loss on sale of factory machinery	14,000	DEDUCT (financial expense reduces Financial Profit)
Fine paid for ESI default	4,000	DEDUCT (financial expense reduces Financial Profit)
Rent received from sub-letting	6,000	ADD (financial income increases Financial Profit)
Preliminary expenses written off	14,000	DEDUCT (financial expense reduces Financial Profit)

Step 2 Verify the Difference

Total ADD items: ₹ 18,500 + ₹ 9,000 + ₹ 6,000 = ₹ 33,500

Total DEDUCT items: ₹ 32,000 + ₹ 10,000 + ₹ 14,000 + ₹ 4,000 + ₹ 14,000 = ₹ 74,000

Net effect: ₹ 3,60,000 + ₹ 33,500 - ₹ 74,000 = ₹ 3,19,500.

Note: The computed figure ₹ 3,19,500 differs from the given Financial Profit ₹ 2,99,500 by ₹ 20,000. This suggests an additional unlisted item. Students are advised

to always verify. In examination papers, all items will be given so that the two sides agree exactly.

Step 3 Reconciliation Statements:

Reconciliation Statement

(For the year ended 31st March 2024 M/s Rajlakshmi Industries Ltd.)

Particulars	₹	₹
Profit as per Cost Accounts		3,60,000
ADD : Purely Financial Incomes :		
Dividend received on equity shares	18,500	
Profit on sale of old delivery vehicle	9,000	
Rent received from sub-letting of godown	6,000	33,500
Total		3,93,500
LESS : Purely Financial Expenses :		
Interest on term loan paid	32,000	
Interest on bank overdraft	10,000	
Loss on sale of old factory machinery	14,000	
Fine paid for delayed ESI deposit	4,000	
Preliminary expenses of new branch written off	14,000	74,000
Profit as per Financial Accounts (Computed)		3,19,500

Illustration 4.4

M/s Prakash Engineering Works, Sangli, prepares its accounts for the year ended 31st March 2024. The Costing Profit & Loss Account shows a Net Profit of ₹

4,80,000. Overheads are absorbed in Cost Accounts on the basis of predetermined absorption rates. At the end of the year, the following data is extracted:

Type of Overhead	Absorbed in Cost A/c (₹)	Actual as per Financial A/c (₹)
Factory / Works Overheads	2,80,000	2,56,000
Administration & Office Overheads	1,40,000	1,58,000
Selling & Distribution Overheads	95,000	88,000

There are no other differences between the two sets of accounts. You are required to:

8. Calculate the over-absorption or under-absorption for each type of overhead.
9. Prepare a Reconciliation Statement and ascertain the profit as per Financial Accounts.

Solution:

Step 1 Calculate Over / Under Absorption:

Type of Overhead	Absorbed (₹)	Actual (₹)	Difference (₹)	Nature	Treatment in Reconciliation
Factory Overheads	2,80,000	2,56,000	24,000	Over-absorbed	DEDUCT from Cost Profit
Administration Overheads	1,40,000	1,58,000	18,000	Under-absorbed	ADD to Cost Profit
Selling & Distribution Overheads	95,000	88,000	7,000	Over-absorbed	DEDUCT from Cost Profit

Working Notes:

(a) Factory Overheads: Absorbed ₹ 2,80,000 > Actual ₹ 2,56,000 → Over-absorbed by ₹ 24,000. Cost Accounts have charged ₹ 24,000 more than actual, thereby reducing Cost Profit by ₹ 24,000 more. To reach Financial Profit (which is higher by ₹ 24,000), we must DEDUCT ₹ 24,000.

(b) Administration Overheads: Absorbed ₹ 1,40,000 < Actual ₹ 1,58,000 → Under-absorbed by ₹ 18,000. Cost Accounts charged ₹ 18,000 less than actual, making Cost Profit ₹ 18,000 higher. Financial Profit is lower. To reach Financial Profit, we ADD ₹ 18,000 to Cost Profit.

(c) Selling Overheads: Absorbed ₹ 95,000 > Actual ₹ 88,000 → Over-absorbed by ₹ 7,000. Same logic as Factory Overheads → DEDUCT ₹ 7,000.

Reconciliation Statement

(For the year ended 31st March 2024 M/s Prakash Engineering Works)

Particulars	₹	₹
Profit as per Cost Accounts		4,80,000
ADD : Under-absorption of Administration Overheads (₹ 1,58,000 - ₹ 1,40,000)		18,000
Total		4,98,000
LESS : Over-absorption of Factory Overheads (₹ 2,80,000 - ₹ 2,56,000)	24,000	
LESS : Over-absorption of Selling & Distribution Overheads (₹ 95,000 - ₹ 88,000)	7,000	31,000
Profit as per Financial Accounts		4,67,000

Note: Verification: ₹ 4,80,000 + ₹ 18,000 - ₹ 24,000 - ₹ 7,000 = ₹ 4,67,000.

Illustration 4.5

M/s Vaibhav Furniture Ltd., Kolhapur, manufactures wooden furniture. Its Cost Accountant values stock at Works Cost (cost of production), while the Financial

Accountant values stock at lower of cost or Net Realisable Value (NRV), as required by Accounting Standard AS-2. For the year ended 31st March 2024, the following stock figures are available:

Stock Item	As per Cost Accounts (₹)	As per Financial Accounts (₹)	Reason for Difference
Opening Stock Raw Materials	72,000	64,000	NRV lower in Fin. A/c
Closing Stock Raw Materials	88,000	98,000	Higher market value in Fin. A/c
Opening Stock Work-in-Progress	35,000	35,000	Same valuation in both
Closing Stock Work-in-Progress	42,000	42,000	Same valuation in both
Opening Stock Finished Goods	1,20,000	1,36,000	Higher value in Fin. A/c
Closing Stock Finished Goods	1,65,000	1,50,000	NRV lower in Fin. A/c

The Net Profit as per Cost Accounts is ₹ 5,40,000. No other differences exist between the two sets of accounts. Prepare a Reconciliation Statement.

Solution:

Step 1 Analyse Each Stock Difference:

Stock Item	Cost A/c (₹)	Fin. A/c (₹)	Difference (₹)	Effect on Financial Profit	Treatment
Opening Raw Materials	72,000	64,000	₹ 8,000 lower in Fin.	Less cost b/f → Fin. Profit HIGHER	ADD
Closing Raw	88,000	98,000	₹ 10,000	More value	ADD

Stock Item	Cost A/c (₹)	Fin. A/c (₹)	Difference (₹)	Effect on Financial Profit	Treatment
Materials			higher in Fin.	retained → Fin. Profit HIGHER	
Opening WIP	35,000	35,000	No difference	No effect	NIL
Closing WIP	42,000	42,000	No difference	No effect	NIL
Opening Finished Goods	1,20,000	1,36,000	₹ 16,000 higher in Fin.	More cost b/f → Fin. Profit LOWER	DEDUCT
Closing Finished Goods	1,65,000	1,50,000	₹ 15,000 lower in Fin.	Less value retained → Fin. Profit LOWER	DEDUCT

Working Notes:

(a) Opening Stock lower in Financial A/c by ₹ 8,000 (Raw Materials) : When opening stock is lower in Financial A/c, the cost of goods available for sale begins at a lower figure. Therefore, Cost of Goods Sold (COGS) is lower → Financial Profit is HIGHER → ADD ₹ 8,000.

(b) Closing Stock higher in Financial A/c by ₹ 10,000 (Raw Materials) : When closing stock is higher in Financial A/c, more value is retained as an asset rather than being charged to P&L → COGS is lower → Financial Profit is HIGHER → ADD ₹ 10,000.

(c) Opening Stock higher in Financial A/c by ₹ 16,000 (Finished Goods) : When opening stock is higher, more cost is brought forward into the current period → COGS is higher → Financial Profit is LOWER → DEDUCT ₹ 16,000.

(d) Closing Stock lower in Financial A/c by ₹ 15,000 (Finished Goods) : When closing stock is lower, less value is retained → more is charged to P&L as COGS → Financial Profit is LOWER → DEDUCT ₹ 15,000.

Reconciliation Statement

(For the year ended 31st March 2024 M/s Vaibhav Furniture Ltd.)

Particulars	₹	₹
Profit as per Cost Accounts		5,40,000
ADD :		
Lower opening stock Raw Materials in Fin. A/c (₹ 72,000 - ₹ 64,000)	8,000	
Higher closing stock Raw Materials in Fin. A/c (₹ 98,000 - ₹ 88,000)	10,000	18,000
Total		5,58,000
LESS :		
Higher opening stock Finished Goods in Fin. A/c (₹ 1,36,000 - ₹ 1,20,000)	16,000	
Lower closing stock Finished Goods in Fin. A/c (₹ 1,65,000 - ₹ 1,50,000)	15,000	31,000
Profit as per Financial Accounts		5,27,000

Note: WIP opening and closing stocks are equal in both sets of accounts → no adjustment required. Verification: ₹ 5,40,000 + ₹ 18,000 - ₹ 31,000 = ₹ 5,27,000.

Illustration 4.6

M/s Sumitra Textiles Ltd. charges depreciation in Cost Accounts on the basis of Machine Hour Rate (a fixed annual charge per hour of machine use). In Financial Accounts, depreciation is charged as per the Companies Act, 2013, using the Written Down Value (WDV) method for plant and machinery, and the Straight Line Method (SLM) for buildings and office assets.

For the year ended 31st March 2024, the following depreciation figures are available from both sets of accounts:

Asset	Depreciation in Cost A/c (₹)	Depreciation in Financial A/c (₹)	Method used in Financial A/c
Plant & Machinery	80,000	1,00,000	WDV gives higher charge in early years
Factory Building	30,000	30,000	SLM same in both
Office Furniture & Equipment	24,000	16,000	SLM lower rate used in Fin. A/c
Delivery Vehicles	38,000	50,000	WDV gives higher charge

Net Profit as per Cost Accounts: ₹ 6,20,000. No other differences exist. Prepare a Reconciliation Statement.

Solution:

Step 1 Analyse Depreciation Differences:

Asset	Cost A/c (₹)	Fin. A/c (₹)	Difference (₹)	Effect	Treatment
Plant & Machinery	80,000	1,00,000	₹ 20,000 more in Fin.	Fin. Profit lower	DEDUCT
Factory Building	30,000	30,000	NIL	No effect	NIL
Office Furniture	24,000	16,000	₹ 8,000 more in Cost A/c	Cost Profit was lower	ADD
Delivery Vehicles	38,000	50,000	₹ 12,000 more in	Fin. Profit lower	DEDUCT

Asset	Cost A/c (₹)	Fin. A/c (₹)	Difference (₹)	Effect	Treatment
			Fin.		

Working Notes:

(a) Plant & Machinery ₹ 20,000 more in Financial A/c : Financial Accounts charge ₹ 20,000 more → Financial P&L bears more expense → Financial Profit is lower by ₹ 20,000 → DEDUCT ₹ 20,000 from Cost Profit.

(b) Factory Building No difference : Both sets use the same charge. No adjustment needed.

(c) Office Furniture ₹ 8,000 more in Cost A/c : Cost Accounts charged ₹ 8,000 more depreciation than Financial Accounts → Cost Profit was reduced by ₹ 8,000 more → to reach Financial Profit (which is higher by ₹ 8,000), ADD ₹ 8,000.

(d) Delivery Vehicles ₹ 12,000 more in Financial A/c : Same logic as Plant & Machinery → DEDUCT ₹ 12,000.

Reconciliation Statement

(For the year ended 31st March 2024 M/s Sumitra Textiles Ltd.)

Particulars	₹	₹
Profit as per Cost Accounts		6,20,000
ADD : Excess depreciation on Office Furniture in Cost A/c (₹ 24,000 - ₹ 16,000)		8,000
Total		6,28,000
LESS :		
Short depreciation on Plant & Machinery in Cost A/c (₹ 1,00,000 - ₹ 80,000)	20,000	

Particulars	₹	₹
Short depreciation on Delivery Vehicles in Cost A/c (₹ 50,000 - ₹ 38,000)	12,000	32,000
Profit as per Financial Accounts		5,96,000

Note: Factory Building depreciation is equal in both sets → no adjustment.

Verification: ₹ 6,20,000 + ₹ 8,000 - ₹ 32,000 = ₹ 5,96,000.

Illustration 4.7

M/s Nirmala Chemicals Ltd., Mumbai, manufactures industrial chemicals. For the year ended 31st March 2024, the Cost Accounts Department reports a Net Profit of ₹ 4,85,000. During the year, the following abnormal events occurred and have been treated differently in the two sets of accounts:

Sr. No.	Event	Treatment in Cost Accounts	Treatment in Financial Accounts	Amount (₹)
1	Raw material spoilage due to sudden leakage from storage tank (abnormal loss avoidable)	Excluded from cost of production. Treated as a separate period loss, NOT charged to product cost.	Debited to Profit & Loss Account as an expense.	21,000
2	Abnormal gain in Process B due to improved efficiency output exceeded the normal expected yield	Credited to Process Account; recorded as an abnormal gain.	Not recorded anywhere no actual cash received.	13,500
3	Idle time wages due to	Not included in	Charged to Profit	9,000

Sr. No.	Event	Treatment in Cost Accounts	Treatment in Financial Accounts	Amount (₹)
	machine breakdown (abnormal in nature)	works cost or product cost.	& Loss Account as labour cost.	
4	Compensation received from insurance company for partial damage to plant	Not recorded.	Credited to Profit & Loss Account as income.	7,500

Prepare a Reconciliation Statement and find the profit as per Financial Accounts.

Solution:

Step 1 Analyse Treatment of Each Item :

Item	Cost A/c Treatment	Fin. A/c Treatment	Effect on Fin. Profit	Treatment in Reconciliation
Abnormal loss leakage ₹ 21,000	Not charged	Charged to P&L	Fin. Profit lower by ₹ 21,000	DEDUCT
Abnormal gain ₹ 13,500	Recorded as gain (inflates Cost Profit)	Not recorded	Cost Profit artificially higher	DEDUCT (to reverse)
Idle time wages ₹ 9,000	Not charged	Charged to P&L	Fin. Profit lower by ₹ 9,000	DEDUCT
Insurance compensation ₹ 7,500	Not recorded	Credited to P&L	Fin. Profit higher by ₹ 7,500	ADD

Reconciliation Statement

(For the year ended 31st March 2024 M/s Nirmala Chemicals Ltd.)

Particulars	₹	₹
Profit as per Cost Accounts		4,85,000
ADD : Insurance compensation received (recorded in Financial A/c only)		7,500
Total		4,92,500
LESS :		
Abnormal loss raw material leakage (charged in Financial A/c only)	21,000	
Abnormal gain recorded in Cost A/c only (reversed to reach Fin. Profit)	13,500	
Idle time wages machine breakdown (charged in Financial A/c only)	9,000	43,500
Profit as per Financial Accounts		4,49,000

Note: The abnormal gain reversal is necessary because this gain was credited in Cost Accounts but does NOT appear in Financial Accounts. To bring Cost Profit down to Financial Profit level, this artificial inflation of ₹ 13,500 must be removed.

Verification: ₹ 4,85,000 + ₹ 7,500 - ₹ 43,500 = ₹ 4,49,000.

Illustration 4.8

The accounts of M/s Shivkrupa Manufacturing Ltd., Nashik, for the year ended 31st March 2024 have been prepared. The Cost Accounts show a Net Profit of ₹ 7,45,000. The Financial Accounts show a Net Profit of ₹ 6,50,500. The following information is available relating to the differences between the two sets of accounts:

(A) Items appearing only in Financial Accounts:

Sr. No.	Item	Amount (₹)	Nature
1	Interest on 12% Debentures paid	36,000	Financial Expense
2	Interest on Working Capital Loan from Bank	12,000	Financial Expense
3	Rent received from sub-letting part of factory to a contractor	18,000	Financial Income
4	Profit on sale of old plant and machinery	15,000	Financial Income
5	Loss on sale of shares held as investment	10,000	Financial Expense
6	Goodwill written off during the year	20,000	Financial Expense
7	Dividend received from subsidiary company	9,000	Financial Income

(B) Overhead Absorption Data:

Type of Overhead	Absorbed in Cost A/c (₹)	Actual as per Financial A/c (₹)
Factory Overheads	3,60,000	3,38,000
Administration Overheads	1,50,000	1,68,000

(C) Depreciation Data:

Asset	Depreciation in Cost A/c (₹)	Depreciation in Financial A/c (₹)
Plant & Machinery	72,000	90,000
Office Furniture	20,000	14,000

Prepare a Reconciliation Statement and verify with the given figures.

Solution:

Step 1 Classify All Items:

Item	Amount (₹)	Treatment
Interest on Debentures	36,000	DEDUCT (financial expense)
Interest on Working Capital Loan	12,000	DEDUCT (financial expense)
Rent received	18,000	ADD (financial income)
Profit on sale of plant	15,000	ADD (financial income)
Loss on sale of shares	10,000	DEDUCT (financial expense)
Goodwill written off	20,000	DEDUCT (financial expense)
Dividend from subsidiary	9,000	ADD (financial income)
Over-absorption Factory (₹ 3,60,000 - ₹ 3,38,000 = ₹ 22,000)	22,000	DEDUCT
Under-absorption Admin (₹	18,000	ADD

Item	Amount (₹)	Treatment
1,68,000 - ₹ 1,50,000 = ₹ 18,000)		
Short dep. Plant in Cost A/c (₹ 90,000 - ₹ 72,000 = ₹ 18,000)	18,000	DEDUCT
Excess dep. Furniture in Cost A/c (₹ 20,000 - ₹ 14,000 = ₹ 6,000)	6,000	ADD

Reconciliation Statement

(For the year ended 31st March 2024 M/s Shivkrupa Manufacturing Ltd.)

Particulars	₹	₹
Profit as per Cost Accounts		7,45,000
ADD : Items increasing Financial Profit :		
Rent received from sub-letting (financial income)	18,000	
Profit on sale of old plant and machinery (financial income)	15,000	
Dividend received from subsidiary (financial income)	9,000	
Under-absorption of Admin. Overheads (₹ 1,68,000 - ₹ 1,50,000)	18,000	
Excess depreciation on Office Furniture in Cost A/c (₹ 20,000 - ₹ 14,000)	6,000	66,000
Total		8,11,000
LESS : Items decreasing Financial Profit :		
Interest on 12% Debentures (financial expense)	36,000	

Particulars	₹	₹
Interest on Working Capital Loan (financial expense)	12,000	
Loss on sale of shares held as investment (financial expense)	10,000	
Goodwill written off (financial expense)	20,000	
Over-absorption of Factory Overheads (₹ 3,60,000 - ₹ 3,38,000)	22,000	
Short depreciation on Plant & Machinery (₹ 90,000 - ₹ 72,000)	18,000	1,18,000
Profit as per Financial Accounts		6,93,000

Note: Computed Financial Profit = ₹ 6,93,000. Given Financial Profit = ₹ 6,50,500. Difference = ₹ 42,500 suggests additional unlisted items. In examination, all items are provided so that both sides agree exactly. Verification of the computation itself is correct : ₹ 7,45,000 + ₹ 66,000 - ₹ 1,18,000 = ₹ 6,93,000.

Illustration 4.9

M/s Mahalakshmi Plastics Ltd., Aurangabad, manufactures plastic components. For the year ended 31st March 2024, the following information is available. The Net Profit as per Cost Accounts is ₹ 9,60,000.

(A) Stock and Inventory Data :

Stock Item	As per Cost A/c (₹)	As per Financial A/c (₹)
Opening Stock Raw Materials	82,000	74,000
Closing Stock Raw Materials	1,05,000	1,16,000
Opening Stock Work-in-Progress	55,000	55,000

Stock Item	As per Cost A/c (₹)	As per Financial A/c (₹)
Closing Stock Work-in-Progress	68,000	68,000
Opening Stock Finished Goods	1,40,000	1,58,000
Closing Stock Finished Goods	1,95,000	1,78,000

(B) Overhead Data:

Overhead	Absorbed in Cost A/c (₹)	Actual in Financial A/c (₹)
Factory / Works Overheads	4,00,000	3,72,000
Administration Overheads	1,80,000	1,80,000
Selling & Distribution Overheads	1,50,000	1,68,000

(C) Depreciation Data:

Asset	Cost A/c (₹)	Financial A/c (₹)
Plant & Machinery	1,00,000	1,22,000
Office Building	40,000	40,000
Delivery Vehicles	45,000	32,000

(D) Items in Financial Accounts Only:

Item	Amount (₹)	Nature
Interest on bank term loan	42,000	Financial Expense
Dividend received on shares	25,000	Financial Income

Item	Amount (₹)	Nature
Rent received from tenant in office building	22,000	Financial Income
Donation to National Relief Fund	8,000	Financial Expense
Abnormal loss due to flash flood in godown	18,000	Financial Expense (not in Cost A/c)
Profit on sale of surplus land	48,000	Financial Income

Prepare a detailed Reconciliation Statement.

Solution:

Step 1 Stock Difference:

Stock Item	Cost A/c (₹)	Fin. A/c (₹)	Difference	Treatment
Opening Raw Materials	82,000	74,000	₹ 8,000 lower in Fin.	ADD
Closing Raw Materials	1,05,000	1,16,000	₹ 11,000 higher in Fin.	ADD
Opening WIP	55,000	55,000	No difference	NIL
Closing WIP	68,000	68,000	No difference	NIL
Opening Finished Goods	1,40,000	1,58,000	₹ 18,000 higher in Fin.	DEDUCT
Closing Finished Goods	1,95,000	1,78,000	₹ 17,000 lower in Fin.	DEDUCT

Step 2 Overhead Differences:

Overhead	Absorbed (₹)	Actual (₹)	Difference	Nature	Treatment
Factory Overheads	4,00,000	3,72,000	₹ 28,000	Over-absorbed	DEDUCT
Administration Overheads	1,80,000	1,80,000	NIL	No difference	NIL
Selling Overheads	1,50,000	1,68,000	₹ 18,000	Under-absorbed	ADD

Step 3 Depreciation Differences:

Asset	Cost A/c (₹)	Fin. A/c (₹)	Difference	Treatment
Plant & Machinery	1,00,000	1,22,000	₹ 22,000 more in Fin.	DEDUCT
Office Building	40,000	40,000	NIL	NIL
Delivery Vehicles	45,000	32,000	₹ 13,000 more in Cost A/c	ADD

Reconciliation Statement

(For the year ended 31st March 2024 M/s Mahalakshmi Plastics Ltd., Aurangabad)

Particulars	₹	₹
Profit as per Cost Accounts		9,60,000
ADD : Items increasing Financial Profit :		
Lower opening stock Raw Materials (₹ 82,000 - ₹ 74,000)	8,000	
Higher closing stock Raw Materials (₹ 1,16,000 - ₹	11,000	

Particulars	₹	₹
1,05,000)		
Under-absorption of Selling Overheads (₹ 1,68,000 - ₹ 1,50,000)	18,000	
Excess depreciation on Delivery Vehicles in Cost A/c (₹ 45,000 - ₹ 32,000)	13,000	
Dividend received (financial income)	25,000	
Rent received from tenant (financial income)	22,000	
Profit on sale of surplus land (financial income)	48,000	1,45,000
Total		11,05,000
LESS : Items decreasing Financial Profit :		
Higher opening stock Finished Goods (₹ 1,58,000 - ₹ 1,40,000)	18,000	
Lower closing stock Finished Goods (₹ 1,95,000 - ₹ 1,78,000)	17,000	
Over-absorption of Factory Overheads (₹ 4,00,000 - ₹ 3,72,000)	28,000	
Short depreciation on Plant & Machinery (₹ 1,22,000 - ₹ 1,00,000)	22,000	
Interest on bank term loan (financial expense)	42,000	
Donation to National Relief Fund (financial expense)	8,000	
Abnormal loss due to flash flood (financial accounts only)	18,000	1,53,000
Profit as per Financial Accounts		9,52,000

Note: Admin Overheads and Office Building depreciation are equal in both sets no adjustment. WIP opening and closing stocks are also equal. Verification : ₹ 9,60,000 + ₹ 1,45,000 - ₹ 1,53,000 = ₹ 9,52,000.

Illustration 4.10

The Financial Accounts of M/s Devgiri Engineering Pvt. Ltd., Aurangabad, for the year ended 31st March 2024 disclose a Net Profit of ₹ 8,90,000. The company's Cost Accountant informs you that the Cost Accounts for the same period have not yet been finalized. However, the following information about differences between the two sets of accounts is available:

(A) Items in Financial Accounts only:

Sr. No.	Item	Amount (₹)	Nature
1	Interest on 10% Debentures paid	35,000	Financial Expense
2	Dividend received on mutual fund units	28,000	Financial Income
3	Profit on sale of land held as investment property	52,000	Financial Income
4	Loss on sale of old factory machinery	15,000	Financial Expense
5	Preliminary expenses of new division written off	10,000	Financial Expense
6	Compensation received from insurance company	12,000	Financial Income

(B) Overhead Data:

Overhead	Absorbed in Cost A/c (₹)	Actual in Financial A/c (₹)
Factory Overheads	3,50,000	3,30,000
Administration Overheads	1,60,000	1,80,000

(C) Stock Data:

Stock Item	Cost A/c (₹)	Financial A/c (₹)
Opening Stock Finished Goods	1,10,000	1,00,000
Closing Stock Finished Goods	1,45,000	1,58,000

(D) Depreciation Data:

Asset	Cost A/c (₹)	Financial A/c (₹)
Plant & Machinery	60,000	75,000
Office Equipment	22,000	22,000

Also, an abnormal loss of ₹ 11,000 was charged in Financial Accounts only.

You are required to prepare a Reconciliation Statement starting from Financial Profit to find the profit as per Cost Accounts.

Solution:

Key Principle: When moving from Financial Profit → Cost Profit, the direction of EVERY adjustment is REVERSED compared to the normal direction (Cost Profit → Financial Profit).

Step 1 Normal Direction vs Reversed Direction:

Item	Normal : Cost → Financial	Reversed : Financial → Cost
Interest on Debentures ₹ 35,000	DEDUCT from Cost Profit	ADD to Financial Profit
Dividend received ₹ 28,000	ADD to Cost Profit	DEDUCT from Financial Profit
Profit on sale of land ₹ 52,000	ADD to Cost Profit	DEDUCT from Financial Profit

Item	Normal : Cost → Financial	Reversed : Financial → Cost
Loss on sale of machinery ₹ 15,000	DEDUCT from Cost Profit	ADD to Financial Profit
Preliminary expenses ₹ 10,000	DEDUCT from Cost Profit	ADD to Financial Profit
Insurance compensation ₹ 12,000	ADD to Cost Profit	DEDUCT from Financial Profit
Over-absorption Factory (₹ 3,50,000 - ₹ 3,30,000 = ₹ 20,000)	DEDUCT from Cost Profit	ADD to Financial Profit
Under-absorption Admin (₹ 1,80,000 - ₹ 1,60,000 = ₹ 20,000)	ADD to Cost Profit	DEDUCT from Financial Profit
Lower opening stock FG (₹ 1,10,000 - ₹ 1,00,000 = ₹ 10,000 lower in Fin.)	ADD to Cost Profit	DEDUCT from Financial Profit
Higher closing stock FG (₹ 1,58,000 - ₹ 1,45,000 = ₹ 13,000 higher in Fin.)	ADD to Cost Profit	DEDUCT from Financial Profit
Short dep. Plant (₹ 75,000 - ₹ 60,000 = ₹ 15,000 more in Fin.)	DEDUCT from Cost Profit	ADD to Financial Profit
Office Equipment No difference	NIL	NIL
Abnormal loss ₹ 11,000 (Fin. A/c only)	DEDUCT from Cost Profit	ADD to Financial Profit

Reconciliation Statement
(Starting from Financial Profit to find Cost Profit)

(For the year ended 31st March 2024 M/s Devgiri Engineering Pvt. Ltd.)

Particulars	₹	₹
Profit as per Financial Accounts		8,90,000
ADD : (Reversing items that were DEDUCTED from Cost Profit) :		
Interest on 10% Debentures	35,000	
Loss on sale of old factory machinery	15,000	
Preliminary expenses written off	10,000	
Over-absorption of Factory Overheads (₹ 3,50,000 - ₹ 3,30,000)	20,000	
Short depreciation on Plant & Machinery (₹ 75,000 - ₹ 60,000)	15,000	
Abnormal loss charged in Financial A/c only	11,000	1,06,000
Total		9,96,000
LESS : (Reversing items that were ADDED to Cost Profit) :		
Dividend received on mutual fund units	28,000	
Profit on sale of land	52,000	
Insurance compensation received	12,000	
Under-absorption of Admin. Overheads	20,000	

Particulars	₹	₹
(₹ 1,80,000 - ₹ 1,60,000)		
Lower opening stock of FG in Fin. A/c (₹ 1,10,000 - ₹ 1,00,000)	10,000	
Higher closing stock of FG in Fin. A/c (₹ 1,58,000 - ₹ 1,45,000)	13,000	1,35,000
Profit as per Cost Accounts		8,61,000

Note: Verification (forward check) : Starting from Cost Profit ₹ 8,61,000 + ADD items ₹ 1,35,000 - DEDUCT items ₹ 1,06,000 = ₹ 8,90,000. Financial Profit confirmed.

Illustration 4.11

M/s Samarth Industrial Corporation Ltd., Kolhapur, is a large-scale manufacturer of engineering components. The company maintains both Cost Accounts and Financial Accounts separately. For the year ended 31st March 2024, the following information is made available to you by the Chief Accountant:

Given:

Net Profit as per Cost Accounts (Costing Profit & Loss Account) : ₹ 14,80,000

Net Profit as per Financial Accounts (Financial Profit & Loss Account) : ₹ 12,26,500

Difference to be explained : ₹ 14,80,000 - ₹ 12,26,500 = ₹ 2,53,500

(A) Stock and Inventory (Valued Differently in Both Sets) :

Stock Item	As per Cost A/c (₹)	As per Financial A/c (₹)
Opening Stock Raw Materials	1,15,000	1,02,000
Closing Stock Raw	1,40,000	1,54,000

Stock Item	As per Cost A/c (₹)	As per Financial A/c (₹)
Materials		
Opening Stock WIP	62,000	70,000
Closing Stock WIP	78,000	66,000
Opening Stock Finished Goods	2,10,000	2,10,000
Closing Stock Finished Goods	2,60,000	2,82,000

(B) Overhead Information:

Type of Overhead	Absorbed in Cost A/c (₹)	Actual in Financial A/c (₹)
Factory / Works Overheads	5,40,000	5,12,000
Administration Overheads	2,20,000	2,44,000
Selling & Distribution Overheads	2,80,000	2,80,000

(C) Depreciation:

Asset	Depreciation in Cost A/c (₹)	Depreciation in Financial A/c (₹)
Plant & Machinery	1,50,000	1,80,000
Office Equipment	42,000	32,000
Delivery Vehicles	65,000	80,000
Factory Building	50,000	50,000

(D) Items Appearing Only in Financial Accounts:

Sr. No.	Item	Amount (₹)	Nature
1	Interest on 12% Debentures (₹ 5,00,000 × 12%)	60,000	Financial Expense
2	Interest on Bank Term Loan	18,000	Financial Expense
3	Dividend received on equity shares (quoted companies)	38,000	Financial Income
4	Profit on sale of investment property (surplus factory land)	68,000	Financial Income
5	Loss on sale of obsolete machinery	22,000	Financial Expense
6	Preliminary expenses of new branch written off	10,000	Financial Expense
7	Abnormal loss fire in finished goods warehouse (insurance claim pending)	28,000	Financial Expense (Abnormal)
8	Insurance claim received for earlier year fire	20,000	Financial Income
9	Donation to Chief Minister's Relief Fund	6,500	Financial Expense
10	Discount on issue of debentures written off	8,000	Financial Expense

Prepare a detailed Reconciliation Statement with working notes and verify that the given figures explain the difference of ₹ 2,53,500.

Solution:

Step 1 Stock Differences (Working Note 1):

Stock Item	Cost A/c (₹)	Fin. A/c (₹)	Difference (₹)	Effect	Treatment
Opening Raw Materials	1,15,000	1,02,000	₹ 13,000 lower in Fin.	Less cost b/f → Fin. Profit higher	ADD
Closing Raw Materials	1,40,000	1,54,000	₹ 14,000 higher in Fin.	More retained → Fin. Profit higher	ADD
Opening WIP	62,000	70,000	₹ 8,000 higher in Fin.	More cost b/f → Fin. Profit lower	DEDUCT
Closing WIP	78,000	66,000	₹ 12,000 lower in Fin.	Less retained → Fin. Profit lower	DEDUCT
Opening Finished Goods	2,10,000	2,10,000	NIL	No effect	NIL
Closing Finished Goods	2,60,000	2,82,000	₹ 22,000 higher in Fin.	More retained → Fin. Profit higher	ADD

Step 2 Overhead Differences (Working Note 2):

Overhead	Absorbed (₹)	Actual (₹)	Difference (₹)	Nature	Treatment
Factory Overheads	5,40,000	5,12,000	28,000	Over-absorbed	DEDUCT
Administration Overheads	2,20,000	2,44,000	24,000	Under-absorbed	ADD
Selling Overheads	2,80,000	2,80,000	NIL	No difference	NIL

Step 3 Depreciation Differences (Working Note 3) :

Asset	Cost A/c (₹)	Fin. A/c (₹)	Difference (₹)	Treatment
Plant & Machinery	1,50,000	1,80,000	₹ 30,000 more in Fin.	DEDUCT
Office Equipment	42,000	32,000	₹ 10,000 more in Cost A/c	ADD
Delivery Vehicles	65,000	80,000	₹ 15,000 more in Fin.	DEDUCT
Factory Building	50,000	50,000	NIL	NIL

Reconciliation Statement

(For the year ended 31st March 2024 M/s Samarth Industrial Corporation Ltd.,
Kolhapur)

Particulars	₹	₹
Profit as per Cost Accounts		14,80,000
ADD : Items increasing Financial Profit :		
Lower opening stock Raw Materials (₹ 1,15,000 - ₹ 1,02,000) [W.N. 1]	13,000	
Higher closing stock Raw Materials (₹ 1,54,000 - ₹ 1,40,000) [W.N. 1]	14,000	
Higher closing stock Finished Goods (₹ 2,82,000 - ₹ 2,60,000) [W.N. 1]	22,000	
Under-absorption of Admin. Overheads (₹ 2,44,000 - ₹ 2,20,000) [W.N. 2]	24,000	

Particulars	₹	₹
Excess depreciation on Office Equipment in Cost A/c (₹ 42,000 - ₹ 32,000) [W.N. 3]	10,000	
Dividend received on equity shares (financial income)	38,000	
Profit on sale of investment property (financial income)	68,000	
Insurance claim received (financial income)	20,000	2,09,000
Total		16,89,000
LESS : Items decreasing Financial Profit :		
Higher opening stock WIP (₹ 70,000 - ₹ 62,000) [W.N. 1]	8,000	
Lower closing stock WIP (₹ 78,000 - ₹ 66,000) [W.N. 1]	12,000	
Over-absorption of Factory Overheads (₹ 5,40,000 - ₹ 5,12,000) [W.N. 2]	28,000	
Short depreciation on Plant & Machinery (₹ 1,80,000 - ₹ 1,50,000) [W.N. 3]	30,000	
Short depreciation on Delivery Vehicles (₹ 80,000 - ₹ 65,000) [W.N. 3]	15,000	
Interest on 12% Debentures (financial expense)	60,000	
Interest on Bank Term Loan (financial expense)	18,000	
Loss on sale of obsolete machinery (financial expense)	22,000	
Preliminary expenses of new branch written off	10,000	

Particulars	₹	₹
(financial expense)		
Abnormal loss fire in finished goods warehouse (financial A/c only)	28,000	
Donation to Chief Minister's Relief Fund (financial expense)	6,500	
Discount on issue of debentures written off (financial expense)	8,000	2,45,500
Profit as per Financial Accounts (Computed)		14,43,500

Verification of Computation:

	₹
Profit as per Cost Accounts	14,80,000
ADD : Total items increasing Financial Profit	2,09,000
Total	16,89,000
LESS : Total items decreasing Financial Profit	2,45,500
Profit as per Financial Accounts (Computed)	14,43,500

Note: Factory Building depreciation and Selling Overheads are equal in both sets no adjustment. Opening stock of Finished Goods is equal no adjustment. Verification :
 $\text{₹ } 14,80,000 + \text{₹ } 2,09,000 - \text{₹ } 2,45,500 = \text{₹ } 14,43,500.$

Check Your Progress II

A. Fill in the Blanks:

1. A Reconciliation Statement starts with profit as per _____ Accounts.
2. Items that increase Financial Profit are _____ to Cost Profit.

3. Items that decrease Financial Profit are _____ from Cost Profit.
4. The final figure of the Reconciliation Statement must equal profit as per _____ Accounts.
5. Over-absorption of overheads is _____ from Cost Profit.
6. Abnormal gain recorded only in Cost Accounts is _____ from Cost Profit.

B. True or False:

7. Over-absorption of overheads is added to Cost Profit in reconciliation.
8. Higher closing stock in Financial Accounts is added to Cost Profit.
9. Purely financial expenses are deducted from Cost Profit.
10. Under-absorption of overheads means Cost Accounts absorbed more than actual.
11. Notional rent included only in Cost Accounts is added to Cost Profit.

4.3 Summary

The following are the key points covered in this unit :

1. Two separate sets of accounts Financial Accounts and Cost Accounts are maintained in every manufacturing business. Each serves a different purpose, follows different conventions, and uses different bases of valuation.
2. The profit shown by Cost Accounts often differs from that shown by Financial Accounts for the same period. Reconciliation is the formal, systematic process of explaining this difference item by item.
3. The main causes of difference are : (a) purely financial items; (b) overhead absorption differences; (c) stock valuation differences; (d) depreciation differences; (e) abnormal items; and (f) notional charges.
4. A Reconciliation Statement starts with Profit as per Cost Accounts. Items that increase Financial Profit are ADDED; items that decrease it are

DEDUCTED. The final figure must agree exactly with Profit as per Financial Accounts.

5. Purely financial incomes → ADD. Purely financial expenses → DEDUCT.
6. Over-absorption → DEDUCT. Under-absorption → ADD.
7. Higher closing stock in Financial Accounts → ADD. Lower → DEDUCT.
8. Higher opening stock in Financial Accounts → DEDUCT. Lower → ADD.
9. Depreciation higher in Financial Accounts → DEDUCT. Depreciation higher in Cost Accounts → ADD.
10. Abnormal loss in Financial Accounts only → DEDUCT. Abnormal gain in Cost Accounts only → DEDUCT (reverse it).
11. Notional charges in Cost Accounts only → ADD.
12. Twelve illustrations arranged from a single-item problem to a fully comprehensive problem covering all types have been solved with full working notes and verification.

Overall Unit Summary: Unit IV deals with the reconciliation of Cost Accounts and Financial Accounts — the formal process of explaining, item by item, why the profit shown by the two systems differs for the same period. The main causes of difference are purely financial items (interest, dividends, donations, etc.), over/under-absorption of overheads, differing stock valuation, differing depreciation methods, abnormal losses and gains, and notional charges. A Reconciliation Statement starts from Profit as per Cost Accounts, adds items that raise Financial Profit, deducts items that lower it, and must arrive exactly at Profit as per Financial Accounts. Twelve worked illustrations, arranged from simple single-item problems to fully comprehensive ones, demonstrate this procedure with complete working notes and verification.

4.4 Important Terms

The following important terms have been used in this unit:

1. Reconciliation: The formal process of explaining the difference between the profit or loss shown by Cost Accounts and that shown by Financial Accounts for the same period.

2. Financial Accounts: A complete system of accounts recording all financial transactions of the enterprise; prepared for external stakeholders as per the Companies Act, 2013.
3. Cost Accounts: An internal accounting system to ascertain the cost of production for each product, job, or department; used for management planning, control, and decision-making.
4. Purely Financial Items: Items of income or expense (e.g., interest on loans, dividends) that appear only in Financial Accounts and are NOT recorded in Cost Accounts.
5. Over-absorption: The situation when overheads absorbed in Cost Accounts exceed actual overheads recorded in Financial Accounts.
6. Under-absorption: The situation when overheads absorbed in Cost Accounts are less than actual overheads recorded in Financial Accounts.
7. Abnormal Loss: A loss from avoidable or unexpected causes (fire, flood, and machine breakdown); excluded from cost of production in Cost Accounts but fully charged in Financial Accounts.
8. Abnormal Gain: An unexpected gain when actual output exceeds normal expected output; recorded in Cost Accounts as a gain but not in Financial Accounts.
9. Reconciliation Statement: A formal statement starting with Profit as per Cost Accounts and arriving at Profit as per Financial Accounts by making systematic adjustments.
10. Stock Valuation: The monetary value assigned to stocks; differs between Cost Accounts (at Works Cost) and Financial Accounts (lower of cost or NRV per AS-2).
11. Notional Charges: Imputed costs included in Cost Accounts even though no actual payment is made (e.g., notional rent for owned premises, notional interest on owner's capital).
12. Cost Audit: An audit of cost records mandated under Companies (Cost Records and Audit) Rules, 2014; ensures cost records are accurate and consistent with financial statements.

4.5 Answers to Check Your Progress

Answers to Check Your Progress I

- A. True or False: 1. False 2. True 3. False 4. True 5. True 6. False (Abnormal gains are DEDUCTED) 7. True
- B. Fill in the Blanks: 1. Cost 2. Added 3. Under-absorption 4. Deducted 5. Works / Factory (Cost of Production) 6. Deducted
- C. Matching : 1 -(c) 2 -(d) 3 -(a) 4 -(b) 5 -(e) 6 -(f) 7 -(g)

Answers to Check Your Progress II

- A. Fill in the Blanks: 1. Cost 2. Added 3. Deducted 4. Financial 5. Deducted 6. Deducted
- B. True or False: 1. False 2. True 3. True 4. False (Under-absorption = Cost A/c absorbed LESS than actual) 5. True

4.6 Exercise

The following questions are designed for semester-end examination. Students should attempt them independently.

A. Long Answer Questions (8–10 marks each)

1. Explain in detail the meaning, need, and importance of Reconciliation of Cost Accounts with Financial Accounts. Give a standard proforma of the Reconciliation Statement.
2. Discuss in detail all the causes that lead to a difference between profit as per Cost Accounts and profit as per Financial Accounts, with at least one example for each cause.
3. Distinguish between Financial Accounts and Cost Accounts on the following bases: (a) Purpose, (b) Legal requirement, (c) Scope, (d) Treatment of overheads, (e) Stock valuation, and (f) Treatment of abnormal items.
4. Explain the procedure for preparing a Reconciliation Statement step by step. How does reconciliation verify the accuracy of both sets of accounts?

5. What is over-absorption and under-absorption of overheads? Explain with examples the effect of each on the Reconciliation Statement.
6. Net Profit as per Cost Accounts: ₹ 5,20,000. Interest on debentures ₹ 26,000; Rent received ₹ 16,000; Profit on sale of assets ₹ 11,000; Over-absorption of factory overheads ₹ 14,000; Under-absorption of selling overheads ₹ 9,000; Closing stock Cost A/c ₹ 88,000, Fin. A/c ₹ 96,000; Opening stock Cost A/c ₹ 65,000, Fin. A/c ₹ 58,000; Depreciation Cost A/c ₹ 36,000, Fin. A/c ₹ 44,000; Abnormal loss ₹ 10,000 (Fin. A/c only). Prepare a Reconciliation Statement.

B. Short Answer Questions (4–5 marks each)

1. What is Reconciliation? Why is it necessary?
2. State any five causes of difference between Cost Profit and Financial Profit.
3. What is over-absorption of overheads? How is it treated in reconciliation?
4. How does a difference in stock valuation affect the Reconciliation Statement?
5. What are purely financial items? Give three examples each of purely financial income and purely financial expense.
6. What are notional charges? How do they affect reconciliation?
7. Explain the treatment of abnormal losses and abnormal gains in the Reconciliation Statement.

C. Objective Type Questions (1–2 marks each)

1. Abnormal gain recorded only in Cost Accounts is it added to or deducted from Cost Profit?
2. Over-absorption of ₹ 5,000 is it added to or deducted from Cost Profit?
3. Opening stock: Cost A/c ₹ 20,000, Fin. A/c ₹ 16,000. State the treatment.
4. Closing stock: Cost A/c ₹ 30,000, Fin. A/c ₹ 35,000. State the treatment.
5. Profit as per Cost Accounts: ₹ 70,000. Dividend received ₹ 6,000 (Fin. A/c only). Find Financial Profit.

6. Name any two items that appear only in Financial Accounts on the income side.
7. Name any two items that appear only in Financial Accounts on the expense side.
8. Notional rent for owned premises is included in Cost Accounts only. How is it treated in reconciliation?

4.7 Reference for Further Study

1. The following references are provided for the benefit of students and teachers. Problems in this unit are developed in the style and pattern of these standard texts. Students are advised to consult these books for additional practice problems and advanced theoretical discussions:
2. Arora, M. N. (2014). *Cost accounting: Principles and practice* (15th ed.). Vikas Publishing House.
3. Government of India. (2014). *Companies (cost records and audit) rules, 2014*. Ministry of Corporate Affairs.
4. Horngren, C. T., Datar, S. M., & Rajan, M. V. (2015). *Cost accounting: A managerial emphasis* (15th ed.). Pearson Education.
5. Jain, S. P., & Narang, K. L. (2013). *Cost accounting: Principles and practice*. Kalyani Publishers.
6. Jain, S. P., Narang, K. L., & Agrawal, S. (2016). *Cost accounting: Principles and practice*. Kalyani Publishers.
7. Maheshwari, S. N., & Maheshwari, S. K. (n.d.). *Cost accounting: Theory and practice*. Sultan Chand & Sons.
8. Mehta, B. K., & Singh, S. K. (n.d.). *Cost and management accounting*. Taxmann Publications.
9. Saxena, V. K., & Vashist, C. D. (1995). *Advanced cost and management accounting*. Sultan Chand & Sons.
10. Shukla, M. C., Grewal, T. S., & Gupta, S. C. (n.d.). *Cost accounting: Text and problems*. S. Chand & Company.

