

A Comparative Study of Direct Costing and Absorption Costing from Managerial Perspective

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Abstract : *Direct costing has now come of age and is providing to be an extremely valuable tool in planning and controlling operations in many large industrial companies. Direct costing product costs include only those manufacturing costs which closely related to the product and vary with production volume. Absorption costing charges all costs to production except those applicable to selling, general and administrative costs. Therefore, the costs of goods manufactured include total fixed factory overhead in addition to direct material, direct labor and variable factory overhead. Some part of fixed factory overhead is carried forward in both work-in-process and finished goods inventories until the product is completed and sold. In contrast, in direct costing fixed factory overhead is not carried forward because it is not considered as a product cost. It is classified as a period cost and charged against revenue in the period of incurrence. At present, there is disagreement among accountants that variable costing is not acceptable for any external financial reporting. However, if internal benefit can be established, the external requirements should not be a deterrent to the use of variable costing unless the cost of implementing the system exceeds the benefit. The merits of variable costing are attributed to the fact that it accounts for costs in a manner that parallels a firm's cost behavior and presumably provides management with better information. This study tries to give a brief idea about Absorption Costing and Direct Costing and identifies the areas where these two methods vary. In addition to that, discussion on use of both systems for different decision making by managers has made.*

Keywords: *Direct costing, Absorption costing, Fixed factory overhead, Contribution margin, and Cost of goods sold.*

Introduction

As a decision making tool direct costing occupies quite a mentionable place in Cost Accounting. The uses of direct costing in decision making are indispensable. Every phase of an organization's planning process is affected by direct costing both for internal and external purposes. There is no question among accountants that the separation of costs into their fixed and variable components is useful in management decision making. Therefore, Direct Costing is widely

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accepted for managerial planning and control. Direct costing can help to pinpoint responsibility according to organizational lines; individual performance can be evaluated on reliable and appropriate data on the basis of current period activity. Direct costing tends to provide greater control over period cost that might occur under Absorption costing.

The variable (direct) cost system was originated in response to the following type of situation. Suppose that, in comparison to 20x1 sales volumes, 20x2 sales are up. However, 20x2 net income is lower than 20x1, and management is puzzled as to why. Analysis reveals that 20x2 production was considerably below the 20x2 sales. The result, of course, is a decline in the inventory. Under full (absorption) costing the effect of this is to release against 20x2's revenue an amount of fixed cost that is greater than the amount incurred during 20x2. This is due to the fixed costs of preceding periods which have been included in the inventory and released when inventory is reduced. These phenomena can be explained from an accounting standpoint, but it is difficult to gain an understanding from the non-accountants' point of view. As a result of this type of situation, variable (direct) costing was proposed.

Variable (direct) costing, does not assign any fixed cost to production (including ending work in process and finished goods inventory). All fixed costs are accounted for as a period cost rather than a product cost. That is, these costs are charged off as an expense of the period in which they are incurred. As a result of this treatment, the production is assigned only the variable manufacturing costs (direct material, direct labor, and variable manufacturing overhead).

Using direct costing as the term to identify this concept might imply that only the direct product costs (direct material and direct labor) are assigned to production. But this is not the case. Thus some have suggested the use of term variable costing. This is better but should not infer that all variable costs are assigned to production. Variable selling and administrative costs are still considered period expenses. Variable costing should be viewed as applicable to a job order, process, or standard cost system. It is not an alternative to one of these systems but a modification.

Objectives

The main objectives of the study are: (i) to narrate the concept of Direct Costing; (ii) to focus on difference between Direct Costing and Absorption Costing; (iii) to explain debate over variable versus full absorption costing; and (iv) to highlight the advantages of Direct Costing over Absorption Costing in decision making.

Methodology

The study has been based on desk research, i.e., secondary sources. The secondary sources include available published articles, books, newspapers and online articles. To get an overview about the practice in Bangladesh, an experience survey of a number of corporate professional accountants has been conducted.

Overview of Direct and Absorption Costing

At least two methods can be used in manufacturing companies to value units of product for accounting purposes—absorption costing and variable costing¹. These methods differ only in how they treat fixed manufacturing overhead costs.

1. **Direct Costing.** Direct costing includes only variable production costs in product costs. Direct materials, direct labor and variable manufacturing overhead costs would ordinarily be included in product costs under direct costing. Fixed manufacturing overhead is not treated as a product cost under this method. Rather, fixed manufacturing overhead is treated as a period cost and is charged against income each period.
2. **Absorption Costing.** Absorption costing treats all production costs as product costs, regardless of whether they are variable or fixed. Under absorption costing, a portion of fixed manufacturing overhead is allocated to each unit of product.

Exhibit # 1-1: Summary and comparison of Accounting Costs- Full (Absorption) and Variable Costing

	Full (Absorption) Costing		Variable Costing	
	Product Cost	Period Cost	Product Cost	Period Cost
Direct Material	√		√	
Direct Labor	√		√	
Variable factory overhead (FOH)	√		√	
Fixed FOH	√			√
Variable Selling & Administrative		√		√
Fixed Selling & Administrative		√		√

Comparison of Absorption and Variable Costing

When comparing absorption costing and variable costing income statements, a number of points should be noted:

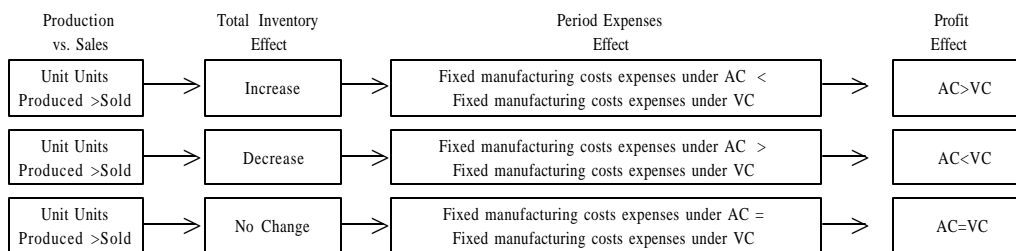
1. **Deferral of fixed manufacturing costs under absorption costing.** Under absorption costing, if inventories increase then a portion of the fixed manufacturing overhead costs of the current period is deferred to future periods in the inventory account. When the units are later taken out of inventory and sold, the deferred fixed costs flow through to the income statement as part of cost of goods sold.
2. **Differences in inventories under the two methods.** The ending inventory figures under the variable costing and absorption costing methods are different. Under variable costing, only the variable manufacturing costs are included in inventory. Under absorption costing, both variable and fixed manufacturing costs are included in inventory.
3. **Suitability for cost-volume-profit (CVP) analysis.** An absorption costing income statement is not well suited for providing data for CVP computations since it makes no distinction between fixed and variable costs. In contrast, the variable costing method classifies costs by behavior and is very useful in setting up CVP computations.

Extended Comparison of Income Data

Exhibits 1-3 and 1-4 in the *Appendix-A* present a comparison of absorption costing and direct costing income statements over four years in which production as well as sales varies. From these Exhibits, several generalizations can be drawn. For the purpose of these generalizations, it is assumed that fixed manufacturing overhead in total is fixed over the year and per unit variable costs are constant over the years.

1. **Production equals sales (no change in inventories).** When production equals sales, inventories do not change. If inventories do not change, then there is no change in the fixed manufacturing overhead costs in inventories under absorption costing. Therefore, under both costing methods all of the current fixed manufacturing overhead will flow through to the income statement as an expense. In the case of absorption costing it will be part of cost of goods sold. In the case of variable costing, it will be a period expense.
2. **Production exceeds sales (inventories increase).** When production exceeds sales, inventories grow. If inventories grow, then some of the current fixed manufacturing overhead costs will be deferred in inventories under absorption costing. Since all of the current fixed manufacturing overhead costs are expensed under variable costing, the net operating income reported under absorption costing will be greater than the net operating income reported under variable costing.
3. **Sales exceed production (inventories decrease).** When sales exceed production, inventories shrink. If inventories decrease, then some of the fixed manufacturing overhead costs that had been deferred in inventories in previous periods will be released to the income statement as part of cost of goods sold as well as all of the current fixed manufacturing overhead costs. Since only the current fixed manufacturing overhead costs are expensed under variable costing, the net operating income reported under absorption costing will be less than the net operating income reported under variable costing.
4. **Long-term differences in income.** Over an extended period of time, the cumulative net operating income figures reported under absorption costing and variable costing will be about the same; they will differ only by the amount of fixed manufacturing overhead cost in ending inventories under absorption costing. Cumulative net operating income figures will be identical whenever ending inventories are reduced to zero.
5. **Changes in production volume.** Variable costing net operating income *is not* affected by changes in production volume. On the other hand, absorption costing net operating income *is* affected by changes in production volume. For any given level of sales, net operating income under absorption costing will increase as the level of output increases and hence inventories increase.

Exhibit # 1-2: Differences between the financial statements under variable costing (VC) and absorption costing (AC)



Debate over which method to use

Development of GAAP (generally accepted accounting principles) included considerable debate about the proper treatment of fixed factory overhead costs in inventory valuation and income determination. Under absorption costing, fixed factory overhead is accounted for as a product cost rather than a period cost. Because revenues are not recognized until finished goods are sold, fixed factory overhead costs incurred to produce finished goods are expensed when the units are sold, (perhaps in the next accounting period) based on the “matching principle.” The portion of fixed factory overhead costs associated with producing finished goods is included in inventory as a current asset on the balance sheet.

In contrast, under direct costing, fixed factory overhead costs are expensed as incurred as period costs (like marketing or administrative costs). Only direct material, direct labor, and variable overhead costs are treated as product costs and included in inventory. Direct costing advocates note that fixed factory overhead costs incurred in an accounting period may have little relationship with the quantity of units produced; with the same fixed manufacturing costs, units produced could vary considerably from one accounting period to the next.

Schulte (1975) summarized the literature of the debate between the advocates for absorption costing and the advocates for direct costing. For the most part, the debate progressed in articles published in *The Accounting Review*, written by some of the most influential accounting scholars in the 1950s and early 1960s. Neilsen (1954) initiated the debate by questioning the reliability of the overhead allocations to products associated with absorption costing (total costing). Neilsen (1954: 90) favored direct costing for external reporting because it avoided the “questionable and arbitrary allocations of manufacturing expense to products.”

Brummet (1955: 441) countered with an argument in favor of absorption costing by stating the following:

... [W]hen it comes to an honest attempt for a clear reflection of income and at the same time a presentation of meaningful inventory valuations it is difficult if not impossible to defend the ‘direct costing’ concept.

Seiler (1959) answered with a more theoretical approach to justify using direct costing for external reporting. Seiler (1959: 63) argued that the best measure for the balance sheet inventory amount is one that represents working capital of the company tied up in unsold products. Fixed costs are beyond management’s short run control, while variable production costs require current managerial decisions that affect working capital. Therefore, only variable production costs reflect actual working capital tied up in inventory. Seiler (1959: 65) said that the effect of heavy investments in fixed costs and changes in such controllable costs as materials, labor, and variable manufacturing expenses need to be spotlighted in financial statements. Thus, he concludes that direct costing could meet those objectives well and is a better accounting method for external reporting.

Fess and Ferrara (1961: 601) continued the debate and supported the use of absorption costing by arguing that fixed costs are obviously as necessary to operations as any other costs. They argued that fixed costs are essential to the production process, and when consumed, must be considered as a part of the cost-revenue matching process inherent in income measurement. Horngren and Sorter (1961) countered by pointing out that variable costing is straightforward – fixed production costs possess no service potential. Additionally, they (1961, p. 91) said that the assumption underlying direct costing is consistent with the going concern postulate that underlies accounting for other costs.

Fremgen (1964: 44, 50) summarized the arguments for and against variable costing and concluded that “the conceptual differences between variable and full costing are so great that their concurrent general acceptance would not be in the best interest of financial statement readers or of the accounting profession.” Supporters of absorption costing won the debate; theoretical support from “the matching principle” convinced accountants to prepare financial statements using the absorption approach.

The debates about the desirability of absorption costing versus variable costing have gone on for decades. For the most part, differences on opinion stem from the search for a “conceptually superior” method of valuing inventory and measuring income in external financial statements. The most appropriate cost measure will usually be situation specific — it will depend on the nature of the decision, the nature of costs, the tastes of decision makers, and many other factors. The appropriate method will depend on the decision at hand.

Advantages of Direct Costing in Management Decision

The advantages of direct costing have generally been well recognized by top executives, production managers, marketing executives and cost analysts. Direct costing overcomes the principal problem of absorption costing, that is the distortion of the time relationship of Sales, Cost of Goods Sold and Net Income.

There are a number of advantages to using variable costing (and the contribution approach) in internal reports and analysis.

- 1. More useful for CVP analysis.** Variable costing statements provide data that are immediately useful for CVP analysis since they categorize costs on the basis of their behavior. In contrast, it is often difficult to rework absorption costing data so that they can be used in CVP analysis and in decisions.
- 2. Income is not affected by changes in production volume.** Under absorption costing, reported net operating income is affected by changes in production since fixed costs are spread across more or fewer units. This can distort income and may even result in income moving in an opposite direction from sales. This does not occur under variable costing.
- 3. Avoids misunderstandings concerning unit product costs.** Absorption costing unit product costs can be easily misinterpreted as variable costs since they are stated on a per unit basis. Such a misperception can lead to serious errors in making decisions. Variable costing avoids this problem since unit costs include only variable costs.

4. **Fixed costs are more visible.** The impact of fixed costs on profits is emphasized because the total amount of such costs for the period appears separately and is highlighted in the income statement rather than being buried in cost of goods sold and ending inventory.
5. **Understandability.** Managers should find it easier to understand variable costing reports because data are organized by behavior and because variable costing is much closer to cash flow.
6. **Control is facilitated.** Variable costing ties in with cost control methods such as flexible budgets.
7. **Incremental analysis is more straight-forward.** Variable cost corresponds closely with the current out-of-pocket expenditure necessary to produce and sell products and services and can, therefore, be used more readily in incremental analysis than absorption costing data. And since variable costing net operating income is closer to net cash flow than absorption costing net operating income, it is likely to be more useful to companies that have cash flow problems.

With all of these advantages, one might wonder why absorption costing continues to be used almost exclusively for external reporting and why it is the predominant choice for internal reports as well. This is partly due to tradition, but absorption costing is also attractive to many accountants and managers because they believe it better matches costs with revenues. Advocates of absorption costing argue that *all* manufacturing costs must be assigned to products in order to properly match the costs of producing units of product with the revenues from the units when they are sold. The fixed costs of depreciation, taxes, insurance, supervisory salaries, and so on, are just as essential to manufacturing products as are the variable costs.

External Reporting and Income Taxes

Direct costing is widely accepted for managerial planning and control. Exhibit # 1-5 outlines the detailed uses of direct costing system. It facilitates fixation of individual responsibility according to the organizational lines. Individual performance can be evaluated on the basis of reliable data. Operating reports can be prepared for every division of the concern and variances can be linked to particular individuals and functions.

But direct costing is not acceptable for financial reporting. A company that attempts to use variable costing on its external financial reports runs the risk that its auditors may not accept the financial statements as conforming to generally accepted accounting principles (GAAP). The reason is that it is not acceptable as explained by the accounting profession in Accounting Research Bulletin No. 43 (1953) issued by the AICPA (American Institute of Certified Public Accountants). At the end of the period it is required to pass a simple journal entry the data for external reporting. The only item that need to be adjusted are inventories, cost of goods manufactured and cost of goods sold for the amount of fixed factory overhead which was excluded from product costs under the Direct Costing method. Tax law on this issue is clear-cut. A form of absorption costing must be used when filling out income tax forms.

Top executives are typically evaluated based on the earnings reported to shareholders on the external financial reports. This creates a problem for top executives who might otherwise favor using variable costing for internal reports. They may feel that since they are evaluated based on absorption costing reports, decisions should also be based on absorption costing data.

Impact of JIT Inventory Methods

When companies use JIT (just-in-time) methods for controlling their operations, the distortions of income that can occur under absorption costing largely (or completely) disappear.

- 1. The cause of distortions in net operating income.** Erratic movements in net operating income under absorption costing and the differences in net operating income between absorption and variable costing can be traced to changing levels of inventory. When inventory levels are constant or negligible, absorption costing and variable costing methods yield the essentially same net operating income.
- 2. The JIT solution.** Under an ideally functioning JIT system, goods are produced strictly to customers' orders. Finished goods inventories almost disappear and work in process inventories are kept to a minimum. With little or no inventories, fixed manufacturing overhead costs cannot be shifted between periods under absorption costing. As a result, both variable and absorption costing will show essentially the same net operating income figure, and the net operating income under absorption costing will move in the same direction as movements in sales.

Conclusion

Under Direct Costing, period costs are accumulated and reported separately, as a deduction from contribution margin rather than lumped cost of sale. Period costs may not be expected to change within short period of time. As because many of these costs are programmed or budgeted in advance, e.g., advertising, research, supervision and these are controlled by management. Direct costing would provide better information about the relationship between sales, variable, and fixed manufacturing costs. That relationship is critical to operating risk and operating leverage.

Using absorption costing as the basis to report inventories under GAAP provides owners and managers of manufacturing companies the opportunity to manage reported earnings by managing finished goods inventories. Absorption costing allows a manager to smooth reported income from period to period by increasing or decreasing ending finished goods inventory. Increasing inventory would allocate more fixed factory overhead costs incurred in an accounting period to finished goods inventory (an asset) and less to cost of goods sold (an expense), thereby increasing reported net income for the accounting period. Reducing inventories would cause fixed factory overhead incurred in a previous accounting period to be recognized as cost of goods sold in the current accounting period and decrease reported net income for the period.

Advocates of variable costing argue that fixed manufacturing costs are not really the costs of any particular unit of product. These costs are incurred to have the *capacity* to make products during a particular period and will be incurred even if nothing is made during the period. Moreover, whether a unit is made or not, the fixed manufacturing costs will be exactly the same. Therefore, variable costing advocates argue that fixed manufacturing costs are not part

of the costs of producing a particular unit of product and thus the matching principle dictates that fixed manufacturing costs should be charged to the current period.

Ideally, investors and potential investors would prefer that managers and owners report earnings that fairly represent results of operations. However, absorption costing empowers managers and owners to manage earnings by manipulating finished goods inventories at the end of an accounting period. The initial direct costing versus absorption costing debate in the 1950s and 1960s recognized the opportunity absorption costing provided business executives to manage GAAP earnings through purposeful adjustment of finished goods inventories levels. At that time, the ability to manage earnings was minimized by the relatively low percentage of fixed manufacturing overhead in the product cost profile.

However, absorption costing is the generally accepted method for preparing mandatory external financial reports and income tax returns. Probably because of the cost and possible confusion of maintaining two separate costing systems—one for external reporting and one for internal reporting—most companies use absorption costing for both external and internal reports. According to the findings of an experience survey, it is found that Bangladeshi manufacturing companies, enlisted with the stock exchanges, follow absorption costing for product costing purpose and hence for external financial reporting and tax purposes. They follow direct costing mainly for CVP analysis and other internal decision-making purposes. □

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Endnote:

¹ Recently, another costing method is followed under a zero-inventory management which is referred to as **throughput costing** (also called **super-variable costing**). This is a method of inventory costing in which only direct material costs are included as inventoriable costs and all other costs are costs of the period in which they are incurred (Horngren, Datar and Foster, 2003: 295).

Assume that the XYZ Company produces one product and uses a Standard Cost System where by overhead is applied on the basis of direct costing labor hours. Labor hours at normal activity total 100,000. The following standards are in effect:

Direct Material	3 units @ Tk. 4.00	Tk. 12.00
Direct Labor	2 hours @ Tk. 3.00	6.00
Variable Factory Overhead	2 hours @ Tk. 4.00	8.00
Fixed Factory Overhead	2 hours @ Tk. 500	10.00
Total		Tk. 36.00

Assume the products sell for Tk. 40.00, the variable Selling Expenses amount to Tk. 0.50 per unit sold and fixed Selling and Administrative Costs total Tk. 15,000.

Exhibit#1-3: XYZ Company Comparative Cases -Full Absorption Costing

	20x1	20x2	20x3	20x4
Sales (units)	40,000	45,000	40,000	40,000
Production (units)	50,000	50,000	45,000	40,000
Sales @ Tk. 40.00	Tk.16,00,000	Tk.20,00,000	Tk.18,00,000	Tk. 16,00,000
Cost of Goods Sold:				
Beginning Inventory	0	Tk.360,000	Tk.180,000	0
Variable cost @Tk.26	Tk.13,00,000	Tk.11, 70,000	Tk.10,40,000	Tk.10,40,000
Applied fixed cost @Tk.10	5,00,000	4, 50,000	4,00,000	4,00,000
Total Manufacturing cost	Tk.18,00,000	Tk.16,20,000	Tk.14, 40,000	Tk.14,40,000
Cost of Goods Available for sale	Tk.18,00,000	Tk.19,80,000	Tk.16,20,000	Tk.14,40,000
Ending Inventory	3,60,000	1, 80,000	0	0
Unadjusted Cost of Goods Sold	Tk.14,40,000	Tk.18,00,000	Tk.16,20,000	Tk.14,40,000
Non Controllable (volume) Variance*	0	50,000	100,000	100,000
Cost of Goods Sold at actual	Tk.14,40,000	Tk.18, 50,000	Tk.17, 20,000	Tk.15,40,000
Gross Margin	Tk160,000	Tk150,000	Tk80,000	Tk60,000
Selling and Administrative Overhead:				
Variable @ Tk. 0.50	Tk.20,000	Tk.25,000	Tk.22,500	Tk.20, 000
Fixed	15,000	15,000	15,000	15,000
Total selling and administrative cost	Tk.35,000	Tk. 40,000	Tk.37,500	Tk.35, 000
Net Income	Tk.1, 25,000	Tk.1,10,000	Tk.42, 500	Tk.25, 000

Non Controllable Variance = Applied Fixed Cost-Budgeted Fixed Cost
 = Standard Hours Fixed Rate- Budgeted Fixed Cost
 Standard Hours Allowed = 2 X Production
 Budgeted Fixed Cost = fixed Rate X Divisor activity
 = Tk. 5X100, 000=Tk.500, 000

Thus Non Controllable Variance For:

20x1: 100,000X5-500,000
 20x2: 90,000X5-500,000
 20x3: 80,000X5-500,000
 20x4: 80,000X5-500,000

In the above example it is assumed that the beginning inventory is sufficient to permit sales to exceed production in any given case. Further, it is assumed that the standards used in the previous period were the same as those used in the current period. Finally, assume the firm did not incur any Variable Cost Variances.

Exhibit# 1-4: XYZ Company Comparative Cases -Direct Costing

	20x1	20x2	20x3	20x4
Sales (units)	40,000	45,000	40,000	40,000
Production (units)	50,000	50,000	45,000	40,000
Sales @ Tk. 40.00	Tk.16, 00,000	Tk.20, 00,000	Tk.18, 00,000	Tk.16,00,000
Variable Cost of Goods Sold:				
Beginning Inventory(units)	0	10,000	5,000	0
Beginning Inventory in Taka@ Tk.26	-	Tk.2,60,000	Tk.130,000	-
Variable Manufacturing Cost	Tk.13,00,000	Tk.11,70,000	Tk.10,40,00	Tk.10,40,000
Variable cost of Goods available for sale	Tk.13,00,000	Tk.14,30,000	Tk.11,70,000	Tk.10,40,000
Ending Inventory @Tk.26	2,60,000	1,30,000	0	0
Variable Manufacturing Cost	Tk.14,40,000	Tk.13,00,000	Tk.11,70,000	Tk.10,40,000
Selling & Admin. Cost	Tk.20,000	Tk.25, 000	Tk.22, 500	Tk.20, 000
Total variable cost	Tk.10, 60,000	Tk.13, 25,000	Tk.11,92,500	Tk.10,60,000
Contribution Margin	Tk.540,000	Tk.6,75,000	Tk.607,500	Tk.5,40,000
Fixed Costs:				
Manufacturing	Tk.500,000	Tk.500,000	Tk.500,000	Tk.5,00,000
Selling and Administrative	15,000	15,000	15,000	15,000
Total	Tk.515,000	Tk.515,000	Tk.515,000	Tk.5,15,000
Net Income	Tk.25,000	Tk.160,000	Tk.92,500	Tk.25,000

Exhibit # 1-5: The following chart shows the different uses of direct costing system:

