

Chapter - 3 Overheads / Expenses.

Direct Expenses: It is covered under CAS-10 issued by the Institute of Cost accountants of India.

Expenses related to manufacture of a product or rendering of a service, which can be identified or linked with the cost object other than direct material cost and direct Employee cost.

$$\text{Direct Expenses} = \text{Prime cost} - \text{Direct Material cost} - \text{Direct Employee Cost}$$

Items to be included in Direct Expenses:-

1. Costs which are directly traceable with the cost centre
2. Expenses incurred for the use of brought in resources.
3. Price variance if such expenses are accounted for at standard cost

Items to be excluded in Direct Expenses:-

1. If it is not directly traceable then it should be considered as an Overhead.
2. Finance cost is not a direct expenses.
3. Imputed cost.
4. Recoveries, credits, subsidy, grant, incentive or any other which reduces the cost.
5. Penalty, damages paid to any authorities.

Overheads - CAS-3

→ All Indirect costs are said to be overheads or burden costs or extra costs

↳ As per CAS-3 Overheads comprises of indirect Material, indirect Employee costs and indirect expenses which are not directly identifiable or allocable to a cost object in an economically feasible way.

→ Topics to be covered.

(a) Departmentalisation of Overheads:-

Distribution of overheads to individual departments is known as Departmentalisation of overheads.

(a) Allocation:- It refers to identification of overheads of particular department and direct assignment of overheads to that particular department.

As per CAS-3 "Allocation is, "Assigning a whole item of cost directly to a cost centre."

(b) Apportionment:-

Distribution of common overheads to different departments on reasonable basis is known as "Apportionment".

Overheads

Reasonable Basis

(i) Rents, rates, heating and lighting

Floor area, Size of the department.

(ii) Depreciation & insurance of plant & Machinery

Book value of fixed Assets.

(iii) canteen, factory, administration Expenses

Number of employees

(iv) Power

Horse power of Machinery

Types of distribution overheads:

- (i) Primary distribution of overheads
- (ii) Secondary distribution of overheads.

1. Primary Distribution of Overheads:-

Distribution of overheads to all the departments in an organisation. It is known as "primary distribution of overheads".

2. Secondary distribution of Overheads:-

Distribution of service department overheads to production departments is known as "Secondary distribution of Re-distribution of Overheads".

Methods to be followed in case of Secondary distribution of Overheads.

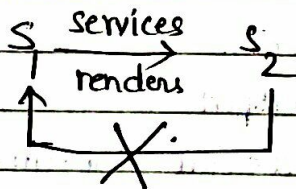
(i) Direct - Re distribution Method:-

This method is applicable in the case of independent services. i.e. NO services between service departments.

(ii) Step - Ladder method:-

→ This method is applicable in case of inter-dependent services

→ Here One service department services to the other service department but in return does not gain services from the other department.



→ Under this method we have to consider the service department that serves the highest departments is to be first distributed.

- We have to take the next highest service department to be distributed
- In this process no overheads are distributed to the already distributed service departments.

(iii) Reciprocal services or Cross Services:-

Under this there are three methods

- (i) Simultaneous equation method.
- (ii) Repeated distribution method
- (iii) Trial and error method.

Overhead Absorption or Overhead recovery rate

→ It refers to the method of charging a proportion of final production cost centre overheads onto a particular job on the basis of number of Labour hours or machine hours taken to complete the job

$$\text{Overhead recovery rate} = \frac{\text{Budgeted overheads}}{\text{Budgeted Bases}}$$

(i) Quantity Bases - Preferable as there are no fluctuations

(a) On the basis of Labour hours:-

$$\text{Overhead absorption rate} = \frac{\text{Budgeted overheads}}{\text{Budgeted labour hours}}$$

(b) On the basis of Machine hours.

$$\text{O.H. A.R} = \frac{\text{B.OH}}{\text{B. Machine hours}}$$

(c) On the basis of output

$$\text{O.H. A.R} = \frac{\text{B.O.H}}{\text{B. output}}$$

(d) On the basis of Raw material consumed.

$$\text{O.H. A.R} = \frac{\text{B.OH}}{\text{Raw material quantity}}$$

Cost Based Methods :-

(i) On the basis of Direct Material Cost

$$\text{O.H.A.R} = \frac{\text{Budgeted O.H} \times 100}{\text{Budgeted Material Cost}}$$

(ii) On the basis of Direct Labour Cost.

$$\text{O.H.A.R} = \frac{\text{Budgeted O.H} \times 100}{\text{Budgeted Material Cost}}$$

(iii) On the basis of Prime Cost

$$\text{O.H.A.R} = \frac{\text{B.O.H} \times 100}{\text{Budgeted Prime Cost}}$$

Methods / systems to evaluate Overhead absorption rate

(i) Blanket / single / Plant recovery rate system.

$$\text{Here: Overhead Absorption rate} = \frac{\text{Budgeted Overhead}}{\text{Budgeted Bases}}$$

(ii) Departmental recovery rate system:-

⇒ It is also known as Multiple recovery rate systems.

$$\text{Overhead Absorption rate} = \frac{\text{Departmental Budgeted Overhead}}{\text{Departmental Bases}}$$

Note :-

The two most accurate methods of recovering Overheads :-

(i) Direct Labour hours rate → Labour intensive jobs

(ii) Direct Machine hours rate → Machine intensive jobs.

Under or Over Recovery of Overheads and its treatments.

- ↳ The purpose is to maintain constant selling price.
- ↳ In the process of fixation of selling price; we don't consider actual overheads incurred as a result of its fluctuation of selling price arises.
- ↳ To evade this situation we ~~use~~ include overheads recovered for the calculation of selling price.

Calculation of Overheads recovered:-

Step-1:- Calculate Overhead recovery rate

$$O.H.A.R = \frac{B.O.H}{B.Bases}$$

Step-2:- Using the Overhead recovery rate we have to obtain Overheads recovered ~~from~~ using the formula.

$$\text{Overheads recovered} = \frac{\text{Actual}}{\text{Budgeted Base of Budgeted Taken in step-1}} \times O.H.A.R$$

Step-3:- Calculation of Under or Over recovery of overheads.

- ↳ The difference between Overheads incurred and Overheads recovered is known as "Under or Over recovery of Overheads".
- ↳ If the Overheads recovered is less than Overheads incurred then it is Under recovery of Overheads.
- ↳ If the Overheads recovered is more than Overheads incurred then it is Over recovery of Overheads.

Treatment of Under recovery or Over recovery of overheads

Method-1:- Carry forward to next year and set off against under or Over recovery of that year and following years.

Applicable to:- (i) Seasonal Establishments or
(ii) New Establishments.

Effect on Current year profit:- No effect.

Method-2:- Adjusted to Costing P&L a/c.

→ Under recovery of O.H → Debited } to Costing P&L a/c.
→ Over recovery of O.H → Credited }

Applicable:-

* If such over / under recovery of overheads is due to Abnormal reasons:

* If such amount is negligible.

Effect on Current year profit:-

(i) Under recovery → To such extent profit will decrease

(ii) Over recovery → To such extent profit will increase.

Method-3:- Use of supplementary rates method

→ We have to find supplementary rate and adjust the following

- (i) cost of sales
- (ii) closing stock of finished goods
- (iii) closing stock of work in progress.

→ For under recovery

↳ Positive supplementary rate

↳ Under recovery of O.H
Actual Base.

→ For Over recovery

↳ Negative supplementary rate

↳ Over recovery of O.H
Actual Base.

Effect on profit

Costing P&L a/c.

To Costing of sales	xxx	By closing stock of finished goods	xxx
		By closing stock of W.I.P	xxx
	xxx		xxx

* In case of under recovery cost shall be increased and the resultant amount shall be reduced from profit.

Profit to be decreased \Rightarrow Cost of sales - {cl. stock of finished goods + cl. stock of W.I.P}

* In case of over recovery cost shall be decreased and the resultant amount shall be ~~reduced~~ added to profit.

Profit to be added \Rightarrow Cost of sales - {cl. stock of finished goods + cl. stock of W.I.P}

Machine Hour Rate

Machine hour rate = $\frac{\text{Total overheads relating to Machine}}{\text{No. of effective machine hours for the same period.}}$

