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B.Com Honours

Semester I

Calicut University

Essentials of Cost Accounting

Course Code: COM1MN104 • Module 4 Notes

1. Accounting for Overheads: Classification and Apportionment

Overhead refers to the aggregate of indirect material, indirect labor, and indirect expenses. Because overheads cannot be directly traced to specific products, cost accountants must allocate and apportion them across various departments before absorbing them into unit costs. This final module covers overhead classification, departmental allocation, primary and secondary apportionment, absorption methods, under/over absorption, and the preparation of a comprehensive Cost Sheet.

Classification of Overheads

Overheads are classified on three bases:

- **Element-wise:** Indirect Material (factory lubricants), Indirect Labour (factory supervisor salary), and Indirect Expenses (factory rent).
- **Functional:** Factory Overheads (power, lighting), Administration Overheads (office salaries, legal fees), and Selling & Distribution Overheads (showroom expenses, delivery van fuel).
- **Behavioral:** Fixed Overheads (constant in total), Variable Overheads (vary with output), and Semi-Variable Overheads (partially fixed, partially variable).

Departmentalization: Allocation vs. Apportionment

Departmentalization involves dividing the factory into production departments (directly manufacturing, e.g., machining, assembly) and service departments (supporting production, e.g., maintenance, stores):

- **Allocation:** Charging the whole amount of a cost item directly to a specific department because it is exclusively consumed by that department (e.g., salary of assembly department manager).
- **Apportionment:** Distributing common overhead costs among multiple departments using a rational, equitable basis:

Overhead Expense Item	Most Logical Basis of Apportionment		
Rent, Rates, and Taxes	Floor area occupied by each department.	Factory Lighting & Heating	Floor area occupied or number of light points.
Power & Fuel (Heavy Machines)	Horsepower of machines or machine hours.	Depreciation of Machinery	Capital value of machinery in each department.
Canteen Expenses & Welfare	Number of employees in each department.	Fire Insurance of Building	Floor area occupied by each department.

Primary vs. Secondary Apportionment

- **Primary Distribution:** The process of allocating and apportioning overhead expenses to both production and service departments.
- **Secondary Distribution:** Re-apportioning the accumulated costs of service departments back to the production departments (since service departments do not directly manufacture products). Methods include: Direct Re-distribution, Step-Ladder method, and Reciprocal Service methods (Repeated Distribution, Simultaneous Equations).

2. Overhead Absorption and Under/Over Absorption

Once overheads are accumulated in production departments, they must be charged to the products passing through those departments (absorption).

Methods of Overhead Absorption

- **Percentage on Direct Material Cost:** $(\text{Factory Overheads} / \text{Material Cost}) \times 100$. Useful when material prices are stable.
- **Percentage on Direct Labour Cost:** $(\text{Factory Overheads} / \text{Labour Cost}) \times 100$. Best when labor rates are uniform.

- **Machine Hour Rate (MHR):** Dividing overheads of a department by the total operating machine hours. Highly accurate for automated factories.
- **Direct Labour Hour Rate:** Dividing overheads by total direct labor hours. Best for labor-intensive, hand-crafted production.

Under-Absorption and Over-Absorption

Overhead absorption rates are calculated using estimated/budgeted data. At year-end, actual overheads will differ from absorbed overheads:

- **Under-Absorption:** Actual Overheads > Absorbed Overheads (costs were under-charged to products, understating cost of production).
- **Over-Absorption:** Absorbed Overheads > Actual Overheads (costs were over-charged, overstating cost of production).
- **Treatment of Variances:**
 - If due to incorrect estimates: Adjust using a ****Supplementary Rate**** to correct the cost sheet.
 - If due to abnormal events (strikes, fire): Write off to ****Costing Profit & Loss Account****.
 - If minor or seasonal: Carry forward to the next accounting period.

3. Preparation of a Cost Sheet

A Cost Sheet is a periodic statement prepared to accumulate and summarize all elements of costs incurred by a business to manufacture a product. It presents the total cost and unit cost at different stages of production:

Structure of a Comprehensive Cost Sheet

Cost Element & Stage	How it is Calculated	Resulting Cost Stage
Direct Materials Consumed + Direct Labour + Direct Expenses	Sum of all direct manufacturing costs.	PRIME COST
Prime Cost + Factory/Works Overheads	Add factory overheads and adjust for opening/closing Work-in-Progress (WIP).	FACTORY / WORKS COST
Factory Cost + Administration Overheads (related to production)	Add administrative costs of managing the factory.	COST OF PRODUCTION
Cost of Production + Opening stock of Finished Goods - Closing stock	Adjust for finished inventory valuations.	COST OF GOODS SOLD (COGS)
COGS + Selling & Distribution Overheads	Add marketing, sales salaries, and delivery costs.	COST OF SALES (TOTAL COST)
Cost of Sales + Desired Profit margin	Add target profit markup to find value.	SALES REVENUE

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