Cost & Management Accounting

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Direct Expenses & Overheads

1. Direct Expense – those expenses which are easily identifiable and attributable to the individual units or jobs. All expenses other than direct material or direct labour which are incurred for a particular product or process

E.g. Royalty charged as a rate per unit; hire charges of a plant if used for a specific job; sub contract if job is for special processing; sales man's commission if it is based on value of units sold; freight; traveling, hotel, & other incidental expenses incurred on a particular contract; cost of making a design / pattern for a specific job; cost of any special process not forming part of normal manufacture

They are debited to direct expense account in financial books.

In Cost accounting records, direct expense account is credited and concerned account is debited.

2. Indirect Expense – incurred for common or joint objectives and therefore cannot be identified readily and specifically with a particular cost unit/ cost centre. It may/may not be allocated

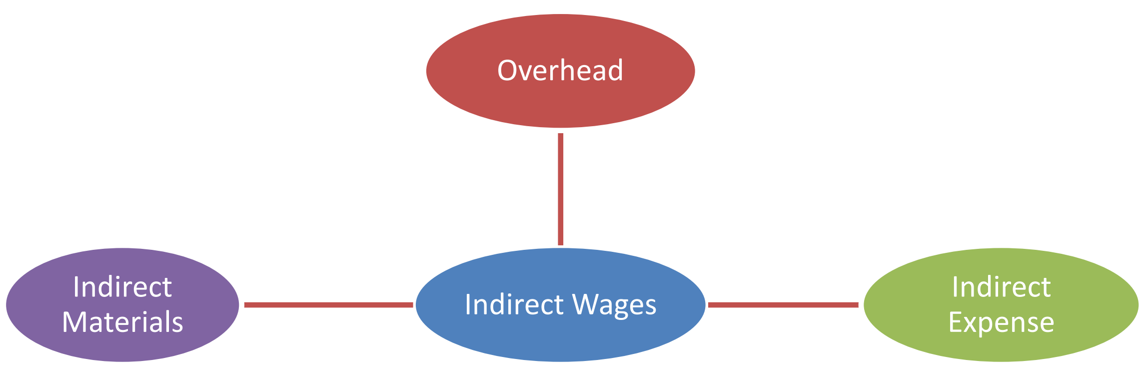
E.g. Rent & insurance of factory and office; Depreciation, repairs, maintenance of plants, machinery, furniture, building, etc.; power, fuel, lightening, heating of factory & office; advertising, legal charges, audit fees, bad debts, etc.

3. Expenses excluded from cost of production / sales: -

- pure finance matters -interest paid / received; dividend /rent received; profit /loss on sale of investment/company's property; transfer fees received
- appropriation of profit - income tax / dividend paid; transfer to sinking account; general reserve; excessive depreciation; goodwill / other fictitious asset written off

4. Notional Expense – Expenses that are usually incurred should be included in costs even if it is not required to pay. E.g. Rent for own premises

5. Overhead –expenditure on labour, materials, or services which cannot be economically identified with a specific saleable cost unit



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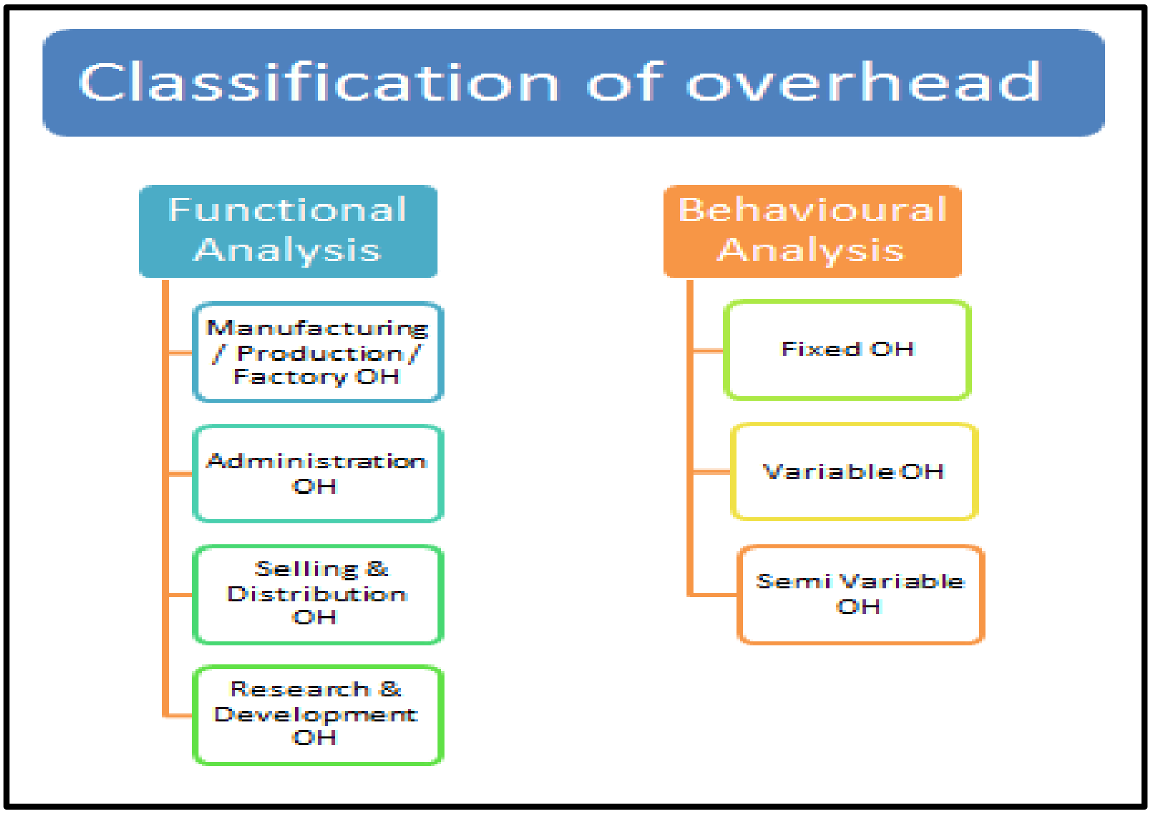


- *Production OH* – includes all indirect costs incurred for manufacturing / production division in a factory. A.k.a. Factory OH/cost or Works OH/ cost.
- *Administration OH*–sum of costs of general management, secretarial, accounting, & administrative services that cannot be directly related to production, marketing, research / development functions
- *Selling & Distribution OH* –Selling OH is the costs of seeking to create & stimulate demand & of securing orders. Distribution OH is the expenditure incurred in the process which begins with making the packed product available for dispatch and ends with making reconditioned returned packages if any for re use
- *Research & Development OH* – Research OH is incurred for new product/process of manufacturing. Development OH is incurred for putting research result on commercial basis
- *Fixed OH* – remains fixed in total irrespective of the volume of output / productivity. Uncontrollable as not influenced by managerial decisions except they are deliberately changed. FOH on unit cost decreases as production increases, and vice versa. E.g. insurance, rent, managerial remuneration
- *Variable OH* – vary in total in direct proportion to volume of output. But unit cost remains constant. E.g. Indirect material, indirect labour
- *Semi variable OH/Step Cost* – contains both fixed & variable element. Remains fixed within a certain activity level, after that they vary without having direct relationship with volume. E.g. Depreciation (time and wear & tear)

7. Methods of segregating Semi variable costs

Graphical Presentation

- observations i.r.o total costs at different levels of output are plotted on a graph with output on x axis & corresponding cost on y axis
- line is drawn passing through all the points
- points falling far behind the line are erratic & not considered
- a line is drawn parallely to x axis from the point were cost line touches y axis. This is fixed cost.
- Variable cost is the difference between total cost & fixed cost

Least Square

- line is drawn for number of observations with the help of statistical method
- Uses linear euation y= mx+c, m is VC p.u, c is total FC, y is TC, & x is volume of output
- varaiable charges = $\sum xy$ / $\sum x2$

Highest & Lowest Point

- output & highest & lowest level is compared with amount of expenses incurred at these different periods
- Variable costs p.u = Δ indirect expenses / Δ output

Analytical

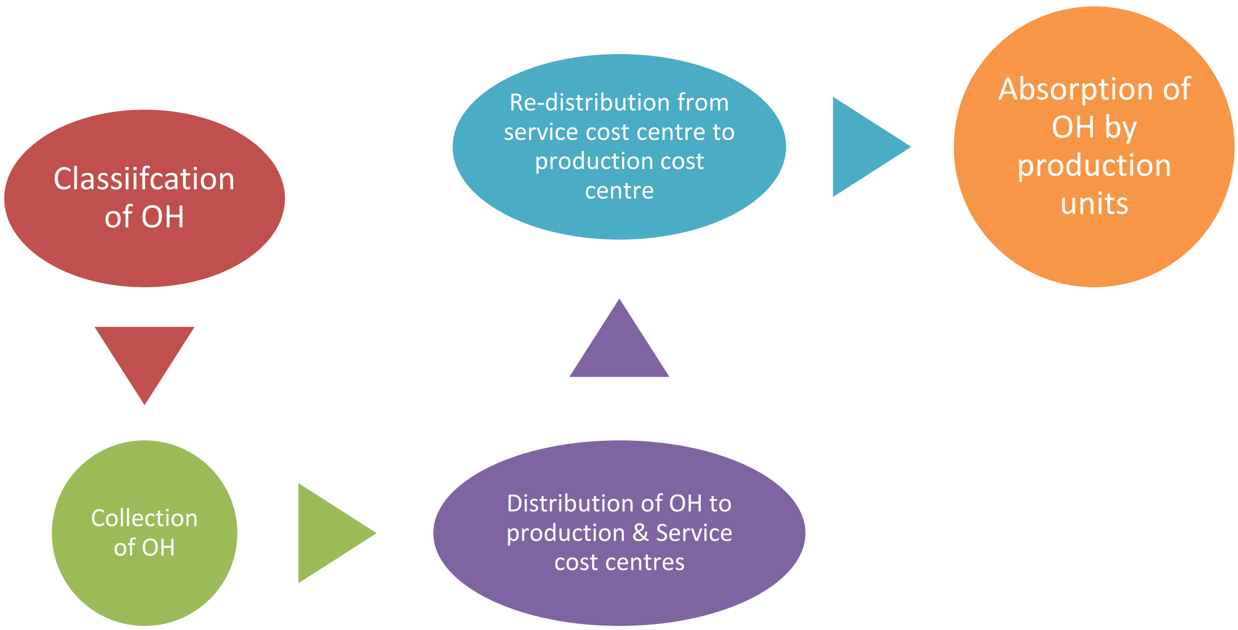
- dgree of variability is estimated for each item of semi variable expense.

Comparison by period / level of activity

- Output & exepnse at two levels are compared.
- Fixed OH remains same
- Varable OH = Δ amount of expenses / Δ activity / quantity

8. Advantages of classifying OH into Fixed & Variable – effective cost control, preparation of budget estimates, ascertaining marginal cost

9. Procedure for accounting and control of overhead



10. Apportionment of Overhead – distribution of OH among departments or cost centres on an equitable basis

(a) Primary distribution of OH – distributed based on some logical & reasonable basis. Some commonly used basis are

OH	Basis
Building rent/ rates & taxes, air conditioning	Floor area
Group insurance/ canteen/ESI general welfare / compensation & other fringe benefits	Number of employees / wages of each department
Insurance & depreciation of assets	Capital values
Works managers remuneration, overtime expense, cost of inter department transfers	Direct labour hours
Electric light	Number of light points
Electric power	Machine hours/ horse power of machines
Sales/Total cost	Audit fee
Store OH	Value / weight of direct material
Delivery expense	Weight, volume, tonne, mile

(b) Secondary distribution - Re – apportionment of service department OH. Criteria's used for secondary distribution are service/ use method, analysis /survey, ability to pay, efficiency / incentive method, general use of indices

OH	Basis
Building rent/ rates & taxes, air conditioning	Floor area
Group insurance/ canteen/ESI general welfare / compensation & other fringe benefits	Number of employees / wages of each department
Insurance & depreciation of assets	Capital values
Works managers remuneration, overtime expense, cost of inter department transfers	Direct labour hours
Electric light	Number of light points
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Sales/Total cost	Audit fee
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Methods of re-apportionment

Direct Distribution

- **cost of service is directly apportioned to production department**
- **Service from one service department to another service department is not considered**

Step Method

- cost of most serviceable department is first apportioned to other service departments & production dept.
- continue this process till the cost of last service department is apportioned.
- cost of last service department is apportioned among production department only

Reciprocal Service Method

- where two / more service departments render services to each other
- (a) Simulataneous Equation Method - ascertain true cost of service departments using simultaneous equations. Then distribute it among production departments on the basis of the given percenatges
- Repeated distribution method - service dept costs are apportioned over service & production dept based on given percentages. Process is repeated till the costs are exhausted
- Trial & error Method - cost of service department is apportioned to another service dept. their cost plus share received from first is aagained to first dept. Process continues till balancing figure becomes nil

11. Absorption of OH – charging of OH to individual products / jobs. OH absorption rates are estimated on the basis of –

- Amount of previous year/period
- Estimated expense & anticipated volume
- Actual cost / estimated cost

$$\text{Actual overhead rate} = \frac{\text{Actual overhead for the period}}{\text{Actual quantuty or value of the base for the period}}$$

$$\text{Pre-determined overhead rate} = \frac{\text{Budgeted overhead for the period}}{\text{Budgeted base for the period}}$$

$$\text{Blanket overhead rate} = \frac{\text{Overhead Cost for the entire factory}}{\text{Base for the period}}$$

$$\text{Overhead rate} = \frac{\text{Overhead cost allocated and apportioned to each cost centre}}{\text{Corresponing base}}$$

12. Methods of absorbing OH

a) Percentage of direct material cost –

$$\text{Overhead rate} = \frac{\text{Factory overheads}}{\text{Direct material cost}} \times 100$$

b) Percentage of prime cost

$$\text{Prime cost percentage rate} = \frac{\text{Amount of factory overheads}}{\text{Prime cost}} \times 100$$

c) Percentage of direct labour cost

$$\frac{\text{Manufacturing overhead expenses}}{\text{Direct wages or labour cost}} \times 100$$

d) Direct labour hr rate

e) Machine hour rate

$$\text{Machine hour rate} = \frac{\text{Amount of overheads}}{\text{Machine hours during a given period}}$$

f) Combined machine hr rate & direct labour hour rate

g) Rate per unit of production

13. Over or Under absorption of OH – if actual expense is lesser than amount applied, it is over absorption. If actual expense exceeds amount applied, it is under absorption. Amount relating to abnormal factors should be charged to costing P&L A/c, or the cost previously arrived has to be adjusted. At the end of the year, the balance in under/over absorbed overheads is transferred to an OH reserve / a suspense account.