OVERHEAD

Q.NO.1:-What do you mean by Overheads? How are overheads classified on the basis of functions?

Ans:-

Meaning:

- Direct costs are those which are identifiable with a cost object or a cost center while Indirect costs are not traceable to cost object or cost center.
- In other word, indirect costs cannot be linked with the product offered by the firm.
- If a firm manufactures only one product, all costs are direct but if more than one products are offered, the indirect costs incurred are not traceable with a particular product.
- So, while direct costs are allocable to a job, process, service, cost unit or a cost center, indirect costs cannot be so allocated.
- These indirect costs are called as 'Overhead' costs.
- Overhead= indirect materials + indirect labour + indirect expenses
- Examples of overhead expenses are rent, taxes, depreciation, maintenance, repairs, supervision, selling and distribution expenses, marketing expenses, factory lighting, printing stationery etc. In subsequent paragraphs, we will be discussing various aspects of overhead accounting.

Classification on the basis of Functions

i. **Manufacturing Overheads :-** Indirect expenses incurred for manufacturing are called as manufacturing overheads. For example, factory power, works manager's salary, factory insurance, depreciation of factory machinery and other fixed assets, indirect materials used in production etc. It should be noted that such expenditure is incurred for manufacturing but cannot be identified with the product units.

ii. **Administrative Overheads :-** Indirect expenses incurred for running the administration are known as Administrative Overheads. Examples of such overheads are, Office salaries, printing and stationery, Office telephone, Office rent, electricity used in the Office, salaries of administrative staff etc.

iii. **Selling and Distribution Overheads :-** Overheads incurred for getting orders from consumers are called as selling overheads. On the other hand, overheads incurred for execution of order are called as distribution overheads. Examples of selling overheads are, sales promotion expenses, marketing expenses, salesmen's salaries and commission, advertising expenses etc. Examples of distribution overheads are warehouse charges, transportation of outgoing goods, packing, commission of middlemen etc.

iv. **Research and Development Overheads :-** In the modern days, firms spend heavily on research and development. Expenses incurred on research and development are known as Research and Development overheads.

Q.NO.2:- How Overheads can be classified according to nature?

Ans:-

i. **Fixed Overheads :-** Fixed overheads are commonly described as those that do not vary in total amount with increase or decrease in production volume, for a given period of time, may be a year. Salaries, depreciation of fixed assets, property taxes, are some of the examples of fixed costs. Total fixed costs remain same irrespective of changes in volume of production but per unit of fixed cost is variable. It increases if production decreases while if production increases, it decreases

ii. **Variable Overheads:-** Variable overheads are those which go on increasing if production volume increases and go on decreasing if the volume decreases. Such increase or decrease may or may not be in the same proportion. Variable overheads are generally considered to be controllable as they are directly connected with the production.

iii. **Semi-variable Overheads :-**These types of overheads remain constant over a relatively short range of variation in output and then are abruptly changed to a new level. In other words, they remain same up to a certain level of output and after crossing that level, they start increasing. For example, supervisor's salary is treated as fixed but if a decision is taken to operate a second shift, additional supervisor may have to be appointed which results into increase in the salary of the supervisor. This indicates that it is a semi-variable overheads. Similarly, maintenance expenditure, fire insuranceare also semi-variable overheads.

Q.NO.3:-How overheads classified according to elements.

Ans:-

i. **Indirect Materials :-**Materials which cannot be identified with the given product unit of cost center is called as indirect materials. For example, lubricants used in a machine is an indirect material, similarly thread used to stitch clothes is also indirect material. Small nuts and bolts are also examples of indirect materials.

ii. Indirect Labor :- Wages and salaries paid to indirect workers, i.e. workers who are not directly engaged on the production are examples of indirect wages.

iii. Indirect Expenses:- Expenses such as rent and taxes, printing and stationery, power, insurance, electricity, marketing and selling expenses etc are the examples of indirect expenses.

Q.NO.4:-List the methods of segregation of Semi variable cost into fixed and variable.

Ans:-

Semi variable expenses usually have two parts – a fixed part and a variable part. By a systematic analysis, all semi variable expenses can be segregated into variable and fixed portions. The following methods can be applied for segregation of semi variable costs nto fixed and variable portions.

i. Graphical method or "Line of Best fit" method.
ii. Analytical method or Best Judgement Method.
iii. High or Low points method.
iv. Comparison by period or level of activity method.
v. Least squares method.

Q.NO.5:- Briefly explain the graphical method of segregating semi-variable expenses.

Ans:-

- Mark /Plot the total costs at different levels of output on a graph, with output on x-axis and Total costs on Y axis.
- Draw a line of best fit , which passes through all or most of the points, by careful judgement.
- Fixed cost is indicated at the point at which the line of best fit cuts the Y axis. A line parallet to the X-axis from this point in the Y-axis indicates the fixed cost portion.
- Compute variable cost any any level of output = Total cost- Fixed cost.

Q.NO.6:- write brief note on the analytical method of segregating semi-variable expenses.

Ans:-

- In this method , the variable portion of each item of semi-variable OH is estimated by analytical judgement.
- Variable portion may change from expenses to expenses – e.g. 20% variable portion in Telephone expenses, 45% variability in Repairs and Maintenance expenses etc.
- Compute fixed cost at any level of output= Total cost – variable cost.
- This method is used only as last resort, if all other methods of segregation fail.

Q.NO.7:-Write a short note on High and low Points method of segregating semi-variable costs.

Ans:-

- Determine the sales value and total cost at the highest volume and lowest volume .
- Compute variable costs as a % of sales value = Difference in Total costs/Difference in sales value x 100
- Compute variable costs at either highest or lowest column as sales x variable cost % computed above.
- Compute fixed costs = Total costs less variable costs as computed above.

Q.NO.8:- How are semi variable expenses segregated under the level of activity method?

Ans:-

- Determine the semi variable expenses at two different quantity (i.e. output) levels.
- Compute variable costs per unit= Difference in Total costs/Difference in Output Quantity
- Compute variable costs at either quantity level as Quantity x variable cost per unit.
- Compute fixed costs = Total costs less variable costs as computed above.

Q.NO.9:- Explain briefly the least Squares method.

Ans:-

- Under this method, Total costs are expressed by the Linear Equation Y = mx + c, where Y = Total costs, m=variable costs per unit, x= Output Quantity and c= Fixed cost.
- Substituting the values of y and x at different costs and levels of output , the equations are solved for m and c, to determine variable costs per unit and total fixed cost.

Q.NO.10:-Why should overheads be classified into fixed and variable.

Ans:-

i. **Control over expenses:-** Fixed costs are based on policy and relate to the period in which they are incurred. Hence it may be difficult to control them . But , variable costs relate to the level of activity, and can be controlled properly.

ii. **Budgeting and Estimates:-** OH classified into fixed and variable helps as a budgeting tool to forecast future movements in expenses. Estimates and Quotations can be prepared on the basis of such analysis.

iii. **Decision making:-** Since all costs are not fully fixed or fully variable, proper segregation is essential to know the behavior of total costs at different levels of output. Classification helps in understanding the pattern of total costs and take appropriate decisions. This technique of decision making is called Marginal costing or CVP analysis.

Q.NO.11:-What is departmentalization? What are the advantages of departmentalization?

Ans:

Meaning:

Departmentalization means creating departments in the firm so that the overhead expenses can be conveniently allocated or apportioned to these departments.

For efficient working and to facilitate the process of allocation, apportionment and reapportionment process, an organization is divided into number of departments like, machining, personnel, fabrication, assembling, maintenance, power, tool room, stores, accounts, costing etc and the overheads are collected, allocated or apportioned to these departments.

Advantages

i. **Proper allocation:-**Expenses that relate to a particular department will be estimated on an exact basis. Hence, the accuracy of estimation of overheads is higher.

ii. **Control:-** Availability of separate cost figures for each department facilitates control. For efficient control , the manager should know for each activity , how much should have been spent and how much is actually spent. If overall information is available , proper control or responsibility fixation can be done.

iii. **Proper Absorption:-** The processing times of different products in different departments may vary. Hence , expenses of each department should be known for ascertainment the appropriate share of OH expenses.

iv. **Cost ascertainment:-**A suitable method of costing can be followed differently for each department, e.g. Batch costing when a part is manufactured, but single or output costing when the product is assembled

Q.NO.12:- What is codification? What are its objectives?

Ans:-

Meaning	Objectives
Code is a system of symbols designed to be applied to a classified set of items to give a brief account reference , facilitating entry collation and analysis. Codification is a technique of intelligently describing in number /letters or a combination of both, the lengthy description of numerous cost accounting heads for ease of recording and controlling of the cost data generated.	i. To group items of similar nature that are amenable to apportionment of overhead expenses on the same basis. ii. To facilitate the task of allocation and apportionment of OH over different departments of cost centres. iii. To carry out an analysis of OH for control purposes. iv. To reduce the task of maintaining a large number of accounts. v. To assist the computerized accounting system in large firms.

Q.NO.13:-What are the methods of codification of overheads?

Ans:-

i. **Straight numbering system:-** Each type of expenditure is allotted a fixed number. This number is sometimes referred to as the standing order number , e.g. 10 – indirect materials , 11- indirect labour , etc.

ii. **Number Blocks system :-** A block of numbers is generally set aside or earmarked to indicate the major heads of expenditure e.g. 1- 50 for service labour, 51-100 for maintenance ,101-150 for fringe benefits , etc . Different type of expenses are accounted under this number block – e.g. 108- House Rent allowance, 109- Special cash allowance, 110- medical allowance, etc, within the Block 101-150 for fringe benefits.

iii. **Combination fo symbols and number :-** A code is developed using a combination of alphabets and numbers. The alphabet generally stands for the main head of expenditure and the number represents the concerned department e.g. if R stands for repairs and (1) and (2) are codes for factory and office respectively , R-1 will indicate factory Repairs while R-2 will indicate office Repairs.

iv. **Numerical code or field method:** A string of numbers is used for codification. The string of numbers , usually of nine digits, has specific sub – elements. For example, the first two digits may indicate the nature of expenses viz, variable or fixed. The next three digits may indicate head of expense , the next two digits may stand for the analysis of expenses and last two digits may indicate the cost Centres, e.g. 306387438 may be interpreted as 30- variable expenses, 638 – sales commission, 74- product x, 38 – sales department.

Of the above the field method is considered to be most advantageous for large organizations.

Q.NO.14:- What are the requirements of an efficient coding system? List its advantages.

Ans:-

Requirement for an efficient coding system	Advantages
i. Every number used in the code should be unique and certain, i.e. should be easily identified from the structure of the code.	i. The code is generally briefer than the account description. Hence coding saves time and improves storage capacity, in respect of manual and computerized system.
ii. Elasticity and comprehensiveness is necessary. It should be possible to identify a code for every item of cost and the coding system should be capable of expanding to accommodate new items.	ii. Codes facilitates easier data processing.
iii. The code should be brief and meaningful.	iii. Code helps in reducing ambiguity. If two professionals understands the same item of cost differently , a code will help them in clarifying the doubts.
iv. The maintenance of the coding system should be certrally controlled.	
v. It should not be possible for individuals to independently add codes to the existing coding system.	
vi. Codification system should be of the same length.	
vii. This makes errors easier to spot , and assists data processing.	

Q.NO.15:-What are the steps involved in study of manufacturing overheads.

Ans:-

i. **Collection of Overheads :-** Overheads collection is the process of recording each item of cost in the records maintained for the purpose of ascertainment of cost of each cost center or unit. The following are the source documents for collection of overheads.
i. Stores Requisition ii. Wages Sheet iii. Cash Book iv. Purchase Orders and Invoices
v. Journal Entries vi. Other Registers and Records

ii. **Classification:**
Overheads are classified according to nature, fixed and variable expenses. This facilitates decision making and proper budgeting.

iii. **Allocation :-**
- Charging cost to cost centers or cost units. Where a cost can be clearly identified with a cost center or cost unit, then it can be allocated to that particular cost center or unit.
- For example, electricity charges can be allocated to various departments if separate metres are installed, depreciation of machinery can be allocated to various departments as the machines can be identified, salary of stores clerk can be allocated to stores department, cost of coal used in boiler can be directly allocated to boiler house division.
- Thus allocation is a direct process of identifying overheads to the cost units or cost center.

iv. **Apportionment**
- If it is not possible to charge the overheads to a particular cost center or cost unit, they are to be apportioned to various departments on some suitable basis. This process is called as 'Apportionment' of overheads.

- For example, if separate meters are provided in each department, the electricity expenses can be allocated to various departments. However if separate meters are not provided, electricity expenses will have to be apportioned to the departments on some suitable basis like number of light points.
- Similarly rent will have to be apportioned to various departments on the basis of floor space, insurance of machinery on the basis of value of machinery, power on the basis of horsepower etc. A statement showing the apportionment of overheads is called as 'Primary Distribution Summary' of overheads.

v. **Reapportionment of Overheads :**

- The departments are broadly divided into Production Departments and Service Departments.
- Production Departments are the departments where actual production takes place .
- Service Departments are the departments which render services to the Production Departments.
- Stores Department, Maintenance Department, Human Resource Department, After Sales Service Departments are some of the examples of Service Departments.
- In Primary Distribution Summary, the overheads are apportioned to all the Departments, i.e. Production and Service.
- For the purpose of absorption it is necessary that the overheads of the service departments are reapportioned to the production departments. This process is called as preparation of 'Secondary Distribution Summary' of overheads.

Q.NO.16:- List some common expenses and the methods of apportioning the same.

Ans:

Common Expenses , i.e. overhead	Basis of Apportionment
Rent /Insurance of Building	Floor space
Factory lighting expenses	Number of light points or floor space
Depreciation and insurance of assets	Value of assets
Power for machines	Horse power
Indirect wages	Direct wages
Supervision	Time spent , or number of employees , or direct wages
Material handling expenses	Value of material consumed/Quantity of material consumed
Purchase department expenses	Number of purchase orders or value of purchases
Miscelleneous Production expenses	Direct wages
General administration expenses	Works cost
Personnel Department expenses	Number of employees
Credit department expenses	Value of credit sales
Carriage outwards/delivery expenses	Volume of units sold , weight or distance , etc.
Advertisement , sales commision etc	Sales (actual).
Sales assistants salaries	Time devoted for various products.

Q.NO.17:- What are the methods of re-apportionment of service department Expenses to Production Department? Of these which method is conceptually preferable?

Ans:-

i. **Non Reciprocal Methods/Direct distribution method :-** Under this method, the assumption is that while service departments render services to the production departments, they do not render services to each other. Hence their overheads are not apportioned to each other. The following methods are used under non reciprocal methods. exam. S1 serves P1, P2 & S2 serves P1 & P2.

ii. **Survey or analysis Method:-** This method is used where a suitable base is difficult to find or it would be too costly to select a method which is considered suitable. For example, the postage cost could be apportioned on a survey of postage used during a year.

iii. **Reciprocal Methods :-** Under this method, the assumption is that the service departments do render services to the production departments, they also render services to other service departments. In other words, the service department, S1 and S2 render services to each other besides rendering services to the production departments. Hence share of overhead expenses of S1 and S2 should be charged to each other along with the production departments. The following method are used under Reciprocal Methods.

a. Step Ladder Method or Step Method:

b. Simultaneous Equation Method.
c. Repeated distribution method.

Q.NO.18:- What are the various methods of Absorption of overheads?

Ans:

Meaning

The process of absorbing all overhead costs allocated or apportioned over a particular cost center or production department by the units produced.'

In simple words, absorption means charging equitable share of overhead expenses to the products.

As the overhead expenses are indirect expenses, the absorption is to be made on some suitable basis.

Absorption Rate = Overhead Expenses/ Units of the base selected.

A base selected may be any one of the basis given below.

Methods

(A) Direct Method

Production Unit Method :

- This method is used when all production units are similar to each other in all respects.
- Total overhead expenses are divided by total production units for computing the rate per unit of overheads and overheads are absorbed in the product units.
- This method is applicable when single product is produced or various products are similar in specification.
- The formula of absorption of overheads is as follows.
- Overhead absorption rate = Budgeted or Actual Overheads/Production Units

(B) Indirect Method

i. **Direct Material Cost :-**
   - Under this method, the overheads are absorbed on the basis of percentage of direct material cost.
   - The following formula is used for working out the overhead absorption percentage.
   - Budgeted or Actual Overhead Cost/ Direct Material Cost x 100

ii. **Direct Labour Cost Method :-**
   - This method is used in those organizations where labor is a dominant factor in the total cost.
   - Under this method, the following formula is used for calculating the overhead absorption rate.
   - Budgeted or Actual Overheads/ Direct Labor Cost X 100

iii. **Prime Cost Method :-**
   - This method is an improvement over the first two methods.
   - Under this method, the Prime Cost is taken as the base for calculating the percentage of absorption of by using the following formula.
   - Budgeted or Actual Overheads/ Prime Cost x100

iv. **Direct Labor Hour Method :**
   - Under this method, the rate of absorption is calculated by dividing the overhead expenses by the direct labor hours.
   - The formula is as follows.
   - Budgeted or Actual Overhead Expenses/Direct Labor Hours

v. **Machine Hour Rate :-**
   - Where machines are more dominant than labour, machine hour rate method is used.
   - CIMA defines machine hour rate as 'actual or predetermined rate of cost apportionment or overhead absorption, which is calculated by dividing the cost to be appropriated or absorbed by a number of hours for which a machine or machines are operated or expected to be operated'.
   - Machine hour rate is the cost of operating a machine on per hour basis.
   - The formula for calculating the machine hour rate is,
   - Budgeted or Actual Overhead Expenses/ Machine Hours

vi. **Selling Price Method :-** (Budgeted Overhead /Sales x 100)

- In this method, selling price of the products is used as a basis for absorbing the overheads. The logic used is that if the selling price is high, the product should bear higher overhead cost.
- Ratio of selling price is worked out and the overheads are absorbed.

Q.NO.19:- Explain the accounting treatment of under-over absorption of production overheads.

Ans:-

Meaning

- The rate of absorption may be either predetermined or historical.
- The meaning of this is that there may be a predetermined rate which is based on budgeted overhead expenses and budgeted units of base.
- Alternatively the rate may be based on historical data, i.e. actual overhead costs and actual units of the base.
- The main advantage of the historical rate is that there is no possibility of under/over absorption of overheads. If predetermined rate is used, there is every possibility of under or over absorption of overheads.

Corrective steps for over-under absorption/ accounting treatment

Once the under/over absorption is noticed, the following corrective steps are to be taken to rectify the same.

i. **Use of supplementary Rate :-** The under/over absorption can be rectified by using the supplementary rate. This rate is calculated by dividing the under/over absorbed amount of overheads by the units of the base. The rate so arrived is known to be supplementary rate. This method is suitable when the under/over absorption is due to normal reasons like price increase.

ii. **Carrying forward to future period:-** If the amount of under/over absorption of overheads is small, it may be carried forward to the future period hoping that it will be rectified in the future.

iii. **Writing off to Profit and Loss A/c :-**Amount of under/over absorption can be written off to Costing Profit and Loss Account and thus not reflected in the total costs. This method is followed when under/over absorption arises due to abnormal reasons like strike, panalties paid, defective planning etc. It should be noted that when the amount is small and immaterial , it is fully debited/credited to costing P/L account , irrespective of whether it is due to normal or abnormal reasons.

Q.NO.20:- Explain the treatment of the following items in cost accounts.

Ans:-

i. **Inspection Charges:** The inspection charges that can be identified with a product should be charged to that product. Inspection charges, which cannot be identified with a particular product should be treated as factory overheads and apportioned to production departments on some suitable basis like work done or inspection hours.

ii. **Design and Drawing Office Cost:** These costs are treated as direct costs if they can be identified with a particular job or product. However if these costs cannot be identified with a particular job, they are charged to different jobs on some suitable basis like number of drawings made, chargeable man hours etc. Drawing to be enclosed with sales orders may be treated as administration overheads.

iii. **Carriage:** Normally the carriage paid on incoming materials is treated as purchase cost. However if the carriage charges cover a large number of individual materials, it may be treated as an item of production overheads and spread over the different materials. Similarly material handling and storage expenses may be apportioned on the basis of value, weight, volume of materials or number of material requisitions.
Carriage outward shall be treated as production overhead

iv. **Canteen Expenses:** Generally canteens in various firms are run on subsidized basis. In such case the costs are treated as an item of factory overheads and apportioned to different cost centers on suitable basis like number of employees, amount of wages, number of meals served etc. The canteen receipts are credited and net costs are apportioned. On the other hand, if the canteens are run on 'no profit no loss' basis, the question of cost apportionment does not arise at all.

v. **Training Costs:** The costs incurred on training of employees are collected under different standing order numbers. The treatment of these costs depends on the amount of training expenses. If the amount is small or negligible, they are apportioned to different on suitable basis like number of employees trained. On the other hand, if the amount is heavy, training department is treated as a separate service center and then it is apportioned to other production and service departments on some suitable basis.

vi. **Installation Cost of Plant and Machinery:** When a new plant and machinery is installed, the cost of the installation of the same is capitalized and depreciation is charged as per the prescribed rates.

vii. **Set up Cost:** This cost can be treated as a direct cost if it is for a particular job or production order. If it is a common cost which means that it is not possible to identify it with a particular job or production order, it is treated as production order and apportioned to different jobs on suitable basis like setting up time etc.

viii. **Dismantling Cost of Plant and Machinery:** A plant and machinery may be dismantled due to sale as it may have become redundant or obsolete. This dismantling is permanent and hence the cost involved is added to the cost of asset dismantled and set off against any sale proceeds received on account of dismantling. On the other hand, if the dismantling is just for shifting the asset from one place to another, it may be treated as production overhead and apportioned/allocated to different cost centers.

ix. **Compensatory Payment to Workers:** Compensatory payment can be made regularly like gratuity. This will be treated as an item of overheads. If this payment is not of regular nature and is paid occasionally, the payment of compensation is estimated in advance and a proportionate amount is charged to overheads in each period on uniform basis.

x. **Repairs and Maintenance Cost:** Repairs and maintenance cost if paid as preventive maintenance is treated as overhead. The amount may be collected and charged to a separate department of 'Repairs and Maintenance'. This department is treated as a separate service center and the amount is apportioned to other cost centers on some suitable basis. If repairs and maintenance is extremely heavy, it is capitalized and written off with the asset as depreciation.

xi. **Lighting, heating, ventilation, air-conditioning Expenses:** This item is treated as an overhead and collected under a separate standing order number. If separate meters are installed in each department, this expenditure is allocated to various cost centers. On the other hand, if there are no separate meters, the amount is apportioned to various cost centers on some suitable basis like basis of wattage, number of electric points, floor area, cubic capacity, tonnage of air-conditioning, etc.

xii. **Cost of Small Tools:** One of the methods of treatment of the cost of small tools is to capitalize the cost and write off depreciation on the same. Depreciation is treated as an item of overheads. If there are any difficulties in treating this cost as a capital cost due to difficulty in ascertaining the life of small tools, the method followed is to charge the purchase price of small tools to a separate standing order number and distribute to other departments on some suitable basis and finally absorbed by products.

xiii. **Medical Expenses:** Cost of medical services are collected under separate standing order number and is apportioned to various cost centers on suitable basis like number of employees etc. If the amount spent is heavy, there may be a separate medical service department and the costs collected under that department. This amount is finally apportioned to other cost centers on suitable basis.

xiv. **Royalties and Patent Fees:** When royalties are paid for the right of use of patent process or component in the course of manufacturing, it is treated as production cost. On the other hand, if it is paid for use of right to sell, it is treated as selling overheads. When it is partially for production and partially for sale, the amount is apportioned between production and selling costs.

xv. **Director's Fees and Salaries:** This is part of administration overheads. However sometimes, this is apportioned between administration and selling and distribution overheads on the basis of time devoted.

xvi. **Bad Debts:** Bad Debt is a selling overhead and included in the same. However abnormal bad debts are excluded from cost accounts.

Inclusion view:-Bad debts should form part of S&D OH , especially when they arise in the normal course of trading. So Bad debts should be treated in cost accounting in the same way as any other selling and distribution cost.

Exclusion view:- Bad debts are financial losses, therefore should not be included in the cost of a particular job or product.

xvii. **Advertising Cost:** Advertising expenditure incurred for a specific product is charged to that product. Cost of general advertisement(routine adv. For number of products) is apportioned to different products on the basis of sales value. When advertising is a routine matter and is done for a specific product, the expenses should be charged to that product. If the amount is heavy, the expenses may be treated as deferred revenue expenditure and can be charged in three or four year.

Q.NO.21:- List some arguments in favour and against for including interest and financial charges as Overhead expenses.

Ans:-

Arguments in favour

i. **Total cost:-** Total cost cannot be computed unless interest is taken into account.

ii. **Capital as factor of production:-** Interest is the cost to be paid for use of capital, and capital is also a factor of production just as labour. Thus, if wages are included in cost, interest payment cannot be omitted.

iii. **Decision making:-** Wrong decision may be taken if interest is excluded in cost calculation. Where a decision regarding replacement of a machine is to be taken and interest is not considered on the money blocked on it , then decision may be wrong.

iv. **Inventory control:-** In inventory control , interest is an important item to be considered . Where large stocks are kept , the advantage of one time purchase is offset by increase in interest charges.

v. **Quotations:-** While submitting quotations for cost plus contracts, etc. interest must be taken into account.

Arguments against

i. **Differences in financial pattern:-** A firm having Proprietor's capital or Equity capital only will have no interest liability, whereas a firm working with Borrowed capital or debentures will have to pay a large amount of interest. Inclusion of interest distort cost comparison between these firms.

ii. **Quantum of Interest:-** Practical difficulty arises in (a) determination of the amount of capital on which interest should be calculated , (b) determination of working capital amounts at various points of time, (c) apportionment of interest to various departments (d) determination of the appropriate rate of interest.

iii. **Profit element:-** Inclusion of interest on Proprietor's capital in the cost of production , means overstating profits, since closing stock will be valued at a higher figure.

Conclusion:- Since there are practical difficulties in including interest as part of normal cost, it is suggested that while interest may be excluded from the regular cost sheet, cost calculations for other purposes or for decision making should include a proper amount of notional interest where the interest will be material.

Q.NO.22:-Write a short note on Depreciation included in overheads.

Ans:-

Treatment :

In cost accounting, depreciation is charged to the cost of production. Depreciation of assets used in the sales function are treated as selling overheads.

Reasons:

i. To show a true and fair view in the Balance sheet.
ii. To ascertain the true cost of production.
iii. To keep the asset intact by distributing losses/diminution in its value over a number of years.
iv. To keep capital intact & to make a provision out of the resources for replacement of the asset in future.