


OVERHEADS: MEANING AND CLASSIFICATION



Submitted by:
Dr. Jaspreet Kaur

Overheads

Overheads are business costs that are related to the day-to-day running of the business. Unlike operating expenses, overheads cannot be traced to a specific cost unit or business activity. Instead, they support the overall revenue-generating activities of the business.

1. Overhead refers to the ongoing costs to operate a business but excludes the direct costs  associated with creating a product or service.
2. Overhead can be fixed, variable, or a hybrid of both.
3. There exist different categories of overhead, such as factory, administrative and selling and distribution overheads, which includes costs related to managing a business.
4. The income statement reports overhead expenses.

Meaning and Definition of Overheads

Cost pertaining to a cost centre or cost unit may be divided into two portions direct and indirect. The indirect portion of the total cost constitutes the overhead cost which is the aggregate of indirect material cost, indirect wages and indirect expenses.

CIMA defines indirect cost as “expenditure on labour, materials or services which cannot be conveniently identified with a specific saleable cost per unit.”

Indirect costs are those costs which are incurred for the benefit of a number of cost centres or cost units. Indirect cost, therefore, cannot be conveniently identified with a particular cost centre or cost unit but it can be apportioned to or absorbed by cost centres or cost units.

Broadly speaking, any expenditure over and above prime cost is known as overhead. In general terms, overheads comprise all expenditure incurred for or in connection with the general organisation of the whole or part of the undertaking i.e. the cost of operating supplies and services used by the undertaking including the maintenance of capital assets. The terms ‘burden’, ‘supplementary costs’, ‘on costs’, ‘indirect expenses’ are used interchangeably for overhead.

Importance of overheads

In various five-year plans, industrialisation was given due importance. The result is that a large number of establishments have grown up both in the public and private sectors for mass production for which use of improved and costlier and special type of machines has become absolutely necessary. With the increasing trend towards plant automation, heavy expenditure is being incurred which cannot be charged directly to any particular unit and can be called as cost common to all units of production.

Overhead expenses being a significant proportion of the total cost have assumed an added importance and require analysis for purposes of cost ascertainment and control by function and for guidance in certain managerial decisions by the extent of the variability with production.

Overhead costs cannot be allocated but have to be suitably apportioned and then absorbed by suitable methods. The cost accountant is required to pay so much attention to the accounting of overhead cost as prudence choice of various bases used for apportionment and absorbing the overheads in the cost of products has to be made by him.

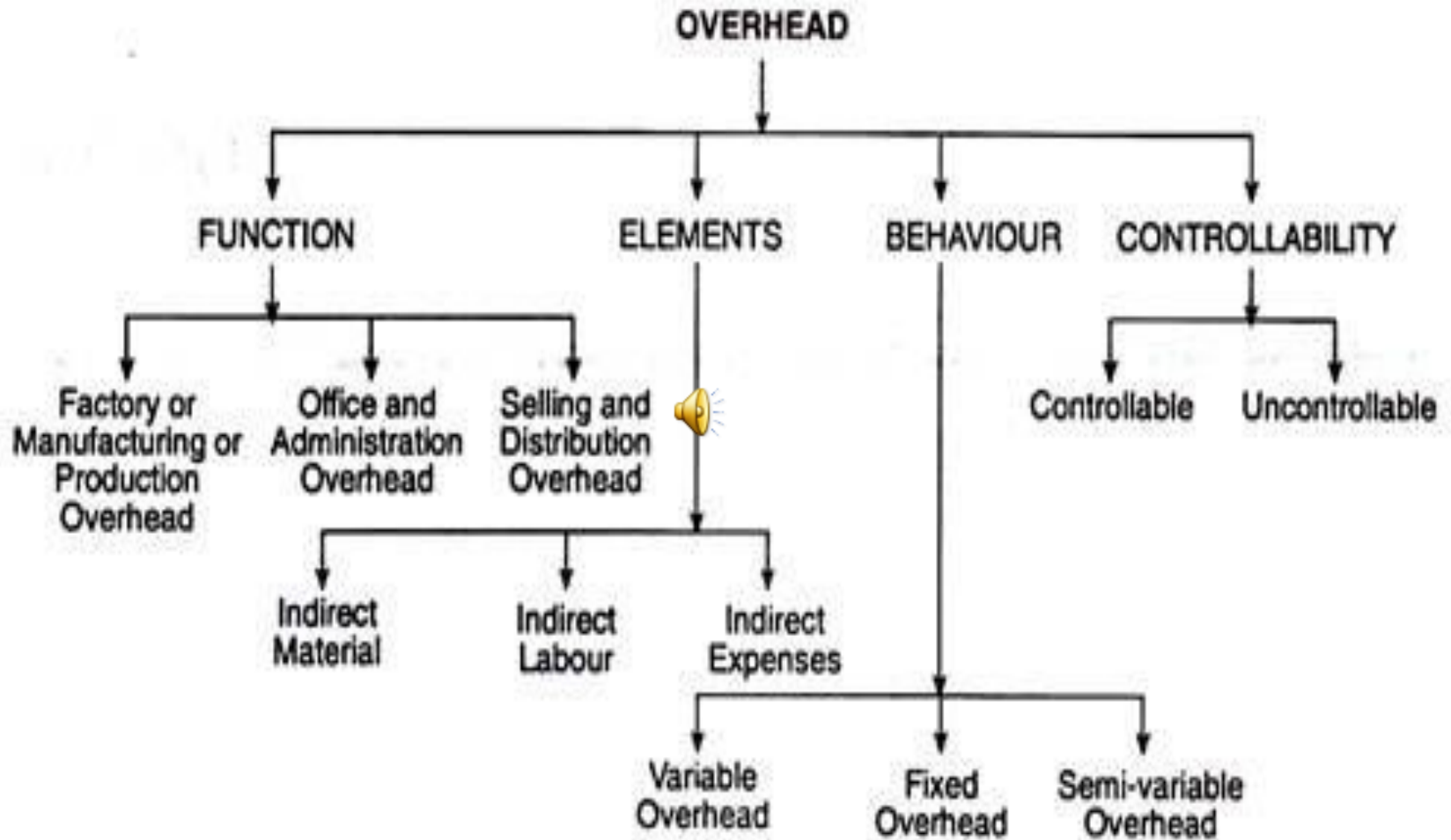


Are High Overhead Costs an Indication of Inefficiency? These days we find that overhead expenses are increasing in every organisation. Some people may have the feeling that high overhead costs are an indication of inefficiency. But this is not correct.

High overhead costs do not indicate inefficiency if it is accompanied by:

- (i) Large scale production or mass production;
- (ii) Increase in efficiency and productivity of labour;
- (iii) Less human efforts will be required because of automatic machines but more machine expenses will have to be incurred;
- (iv) More depreciation, maintenance expenditure and similar other items because of more use of machinery;
- (v) Improved methods of managerial control like work study, production control, cost and management accountancy techniques may reduce the direct cost but will increase the overhead costs.

Classification of Overheads



12.1: Classification of Overheads


Function wise classification of overheads

- (a) Factory or Manufacturing or Production Overhead:** These overheads include all indirect expenses (including indirect material, indirect labour, and indirect expenses) which are incurred for the purpose of production activities that starts from the procurement of materials and ends with the primary completion of the product, e.g., Depreciation on Plant and Machinery, Lighting and Heating, Insurance of Plant and Machinery, consumable stores, Cost of spare parts, Repairs of Plant and Machinery etc. These overheads also include expenses relating to factory administrations, e.g., Printing & Stationery, Postage and Telegram, Remuneration to directors, or other higher officers who are related to production process of the factory.
- (b) Office and Administration Overhead:** These overheads include all expenses relating to Office and Administration that cannot be directly related to the production but are indirectly related. In other words, expenses of this nature are: Directors' Remunerations, Office Rent and Taxes, Office Lighting, Printing and Stationery, Audit and Legal fees, Bank Charges, Salaries to staff etc.
- (c) Selling and Distribution Overheads:** Selling and Distributions expenses are those which are incurred for the purpose of selling activities.


These expenses includes:

- (a) Selling, and
- (b) Distributions expenses which further denote:
 - (a) Selling Expenses:** These expenses include: Advertisement expenses, Salesmen's salaries, Promotion expenses, Showrooms expenses, Travelling expenses of salesmen, cost of price list and catalogues, expenses, incurred for maintaining 'After Sale Service', etc
 - (b) Distribution Expenses:** These expenses include: Carriage Overhead, Godown Rent, Secon-dary Packing charges, Maintenance and running expenses of delivery vehicles, Reconditioning the empty containers returned by customers for re-use, etc.

Element wise classification of overheads

- (a) Indirect Materials:** Indirect materials include the following: Consumable Stores, Loose Tools, Fuel, Lubricating oil, cotton waste, loss arising from deterioration of stores, small tools for general use etc.
- (b) Indirect Labour:** Indirect labour includes the following: Salary to supervisory staff and works manager, payment for idle time, leave and holidays, salary  of foremen, employer's contributions to P.F., wages for maintenance workers, wages of store-keeper etc.
- (c) Indirect Expenses:** Indirect expenses include: Rent, Rates and Taxes, Insurance, Travelling expenses, Repairs and maintenance of Plant and Machinery, Depreciation on Plant and Machinery used for production purposes, Canteen expenses, Expenses relating to keep and handle stores, etc.

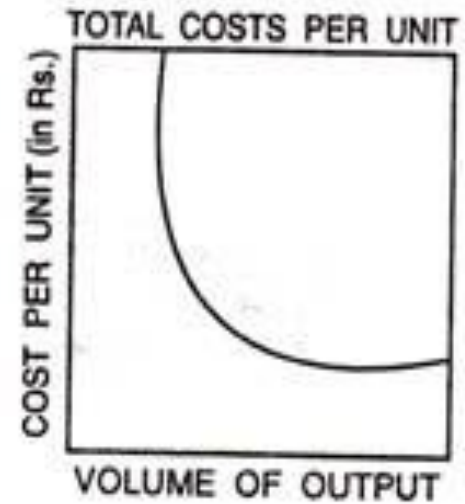
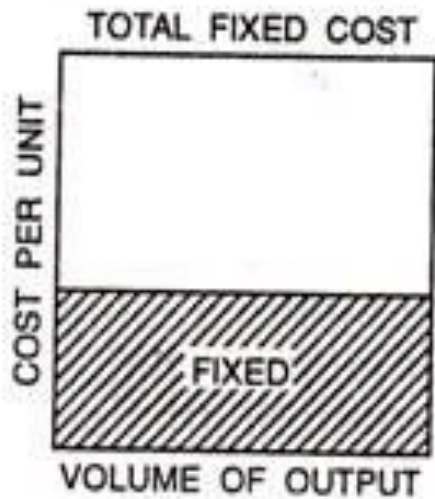
Behaviour Wise classification of overheads

(a) Variable Overhead: Variable overheads are those overheads which tend to vary directly with the change of the volume of output. It is stated that there is a linear relationship between the volume of output and the variable overheads. As variable overheads tend to vary with the volume of output, unit variable cost is likely to remain constant at all levels although the total variable overhead will vary with the volume of production. Examples are: indirect material, indirect labour, salesmen's commission, fuel, etc. 

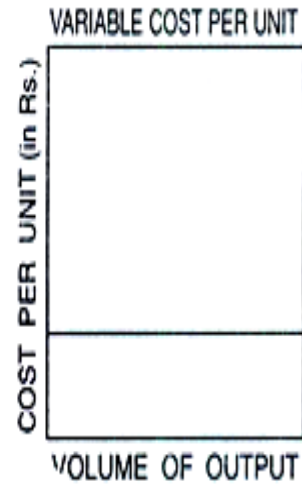
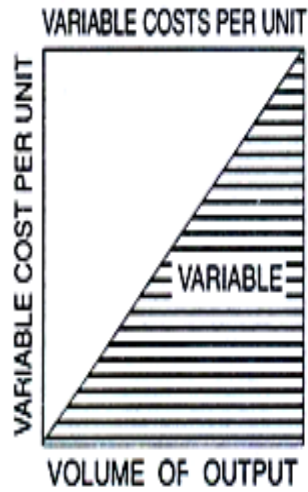
(b) Fixed Overhead: Fixed overheads are those overheads which do not vary with the volume of output within a certain range of activity and within a certain period of time. It is interesting to note that as the fixed overheads remain unaffected by the volume of output, per unit cost of a product will be decreased if the volume of output increases, and vice-versa in the opposite case.

Examples of fixed overheads are: Rent, Rates and Taxes, Salaries, Depreciation of Machinery and Building, Interest on Capital, Audit Fees, etc.

Fixed Overheads



Variable Overheads



The role of variable overhead and fixed overhead can better be represented with the help of the following diagram:

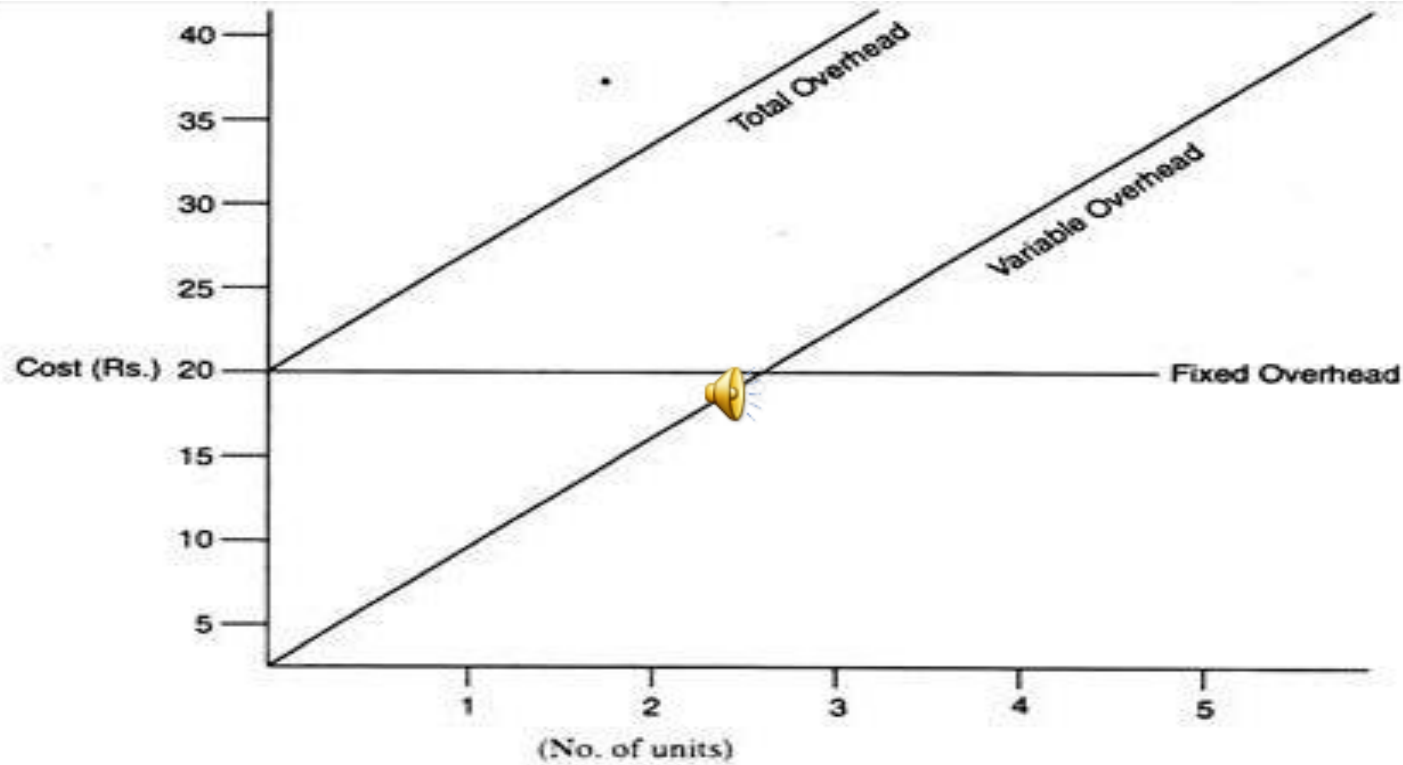


Fig. 12.2: Showing the total Overhead Cost (fixed and variable) Graph

<http://www.yourarticlelibrary.com/accounting/overheads/classification-of-overheads-4-categories/74467>

Example Consider the following example :
 Total fixed overhead Rs. 1,000
 Variable overhead per unit Rs. 5
 Range of output 1,000 units to 5,000 units.

The following table will highlight the above information:

Units	Total Fixed Overhead	Total Variable Overhead	Total Overhead (Col. 2) + (Col. 3)	Variable Overhead cost per unit	Fixed Overhead Cost per Unit Col. 6 = (Col. 2) ÷ (Col. 1)
1	2	3	4	5	6
	Rs.	Rs.	Rs.	Rs.	Rs.
1,000	1,000	5,000	6,000	5	1.00
2,000	1,000	10,000	11,000	5	0.50
3,000	1,000	15,000	16,000	5	0.33
4,000	1,000	20,000	21,000	5	0.25
5,000	1,000	25,000	26,000	5	0.20

(c) Semi-Variable Overheads: It has already been stated above that semi-variable overheads are those which partly vary with the volume of output and partly remain fixed at a certain level of activity. These overheads include: Depreciations on Plant and Machinery, Repairs and Maintenance of Plant and Machinery, etc. (for example, if the volume of output does not make any change widely, repairs and maintenance expenses remains fixed up to a certain level, but if the volume of production increases, addition expenditure may be incurred for repairs and maintenance. **The semi-variable overheads can be represented with the following graph:**

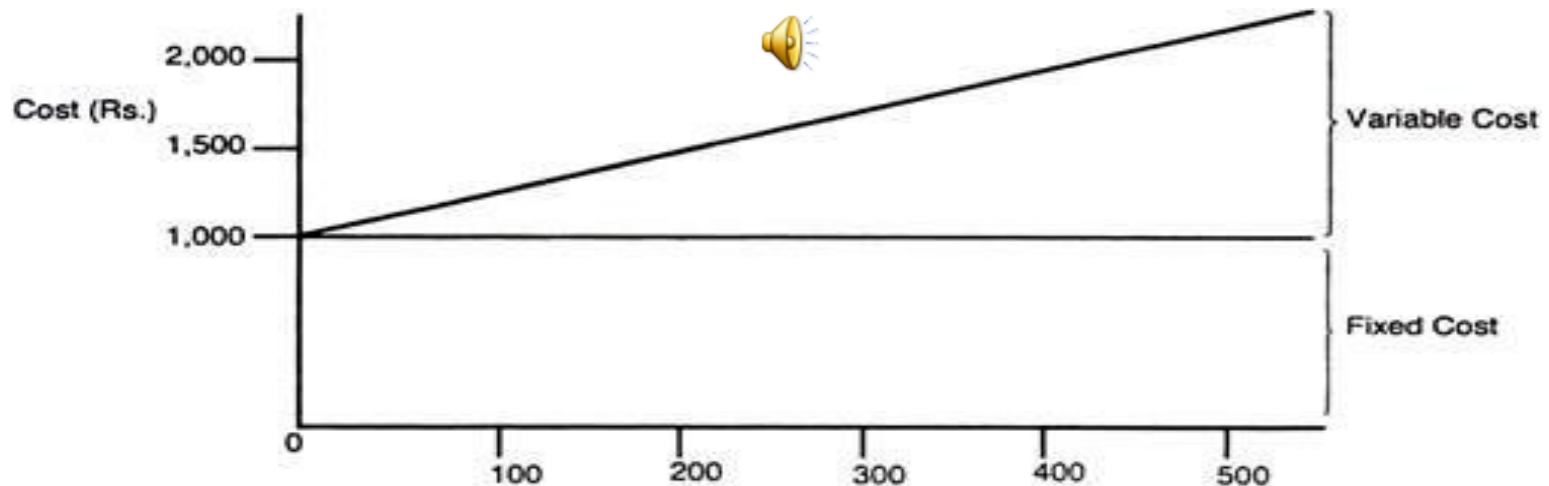
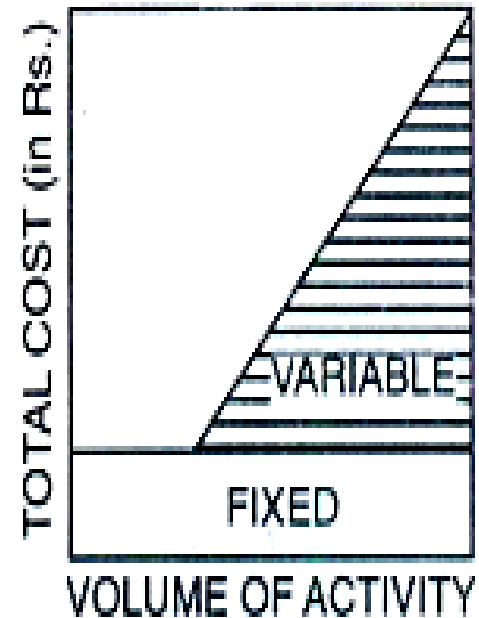
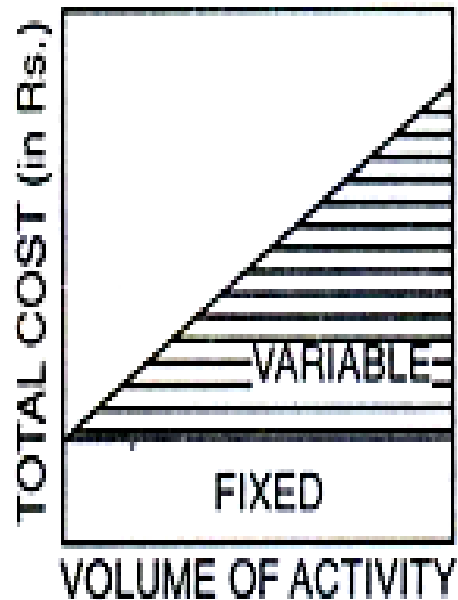


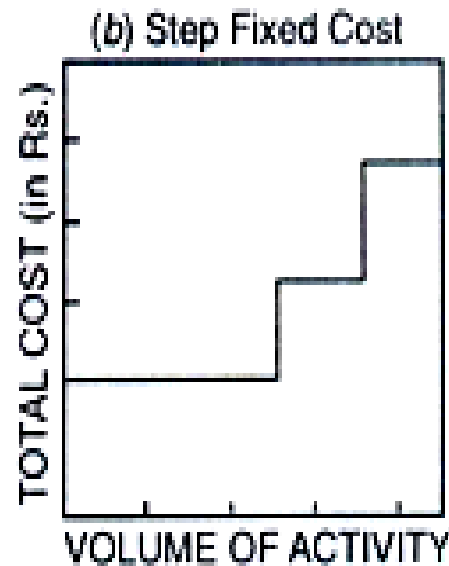
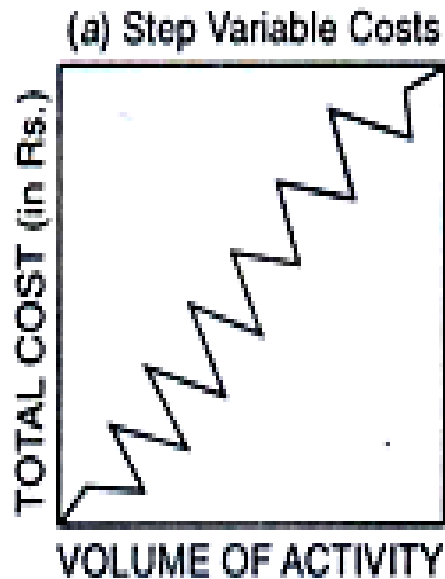
Fig. 12.3: Showing the Semi-variable Overhead Graph

(a) The first type shows semi-variable costs where variable element operates at all the levels as shown in the graphs given below:

(b) The second type shows semi-variable costs where variable element comes into operation after a certain level of activity level as shown in the graph given below:



Step Costs: These costs are the costs which increase in steps. These remain constant over various small ranges of output, but increase by discrete amounts as activity moves from one range to the next. Examples are canteen staff wages, supervisor's salary etc.



Controllability wise classification of overheads

- (a) Controllable:** Variable overheads are controllable as it tends to vary with the volume of output i.e., according to the needs of the management. 📢
- (b) Un-controllable:** Fixed overheads are treated as un-controllable overheads as these overheads cannot be controlled i.e., it does not depend on the volume of production.