UNIT 60 – USPC - Overhead Cost and Control

Overhead cost control is used by Small-business owners to monitor, distribute and reduce their overheads. Expenses that cannot be conveniently identified with a specific product or activity is termed as overhead. Unlike material and production labour, overhead is indirect and invisible part of producing product and service. Overhead costs can include administrative and rent expenses, transport expenses, subcontractors, utilities, office supplies, depreciation, and advertising. And while all these expenses seem normal, it does not mean they are necessary.

Reviewing the accounting theoretical literature, it has been demonstrated that overhead costs are expenses which cannot be easily recognized with a specific product or activity. Dissimilar to materials and production labour, overhead is an indistinguishable part of the refined product. Yet, overhead is a basic input into the production process just like raw materials. By understanding the nature of overhead costs, it becomes easier for business managers to control these expenses. Proper allocation of overhead costs among products, or departments, allows the manager to understand their firm's production costs. It also permits the manager to verify how much each product or segment of the firm is contributing to overall prosperity.

The Importance of Overhead Costs: Cost control is complex and significant aspects of a manager's job. Cost control is important because most of the cost savings goes directly to the bottom line. The distribution of overhead costs is vital when the firm has more than one product or activity or more than one department (area of business). Allocation of overhead costs is also more significant when company is considering adding, dropping, or changing the level of any business action. Overhead cost distribution enables the manager to determine the productivity of a product line, establish the monetary impacts of alternative business plans, and to value inventory. The standard of overhead cost allocation is that overhead costs should be charged to the areas of the firm which indirectly cause these costs to be incurred.

The control of overhead costs is mostly complicated. However, by determining direct labour and material expenses it becomes easier, therefore managers tend to focus on these costs. The successful control of overhead costs needs regular attention. Some managers do not believe

overhead costs when formulating pricing strategies. This could result in some products or activities not fully recovering their overhead costs. In long term period, unless other products are offsetting this insufficiency, this type of pricing strategy will not give profits to provide a return for the capital, management, and risk involved. It is imperative to recognize the concept of overhead costs when considering changes in the production process.

It can be understood that overhead costs are costs which cannot be directly recognized with a product or production activity. Overhead costs can be either fixed or variable. Some examples of fixed factory overhead costs include depreciation, interest, rent, insurance, taxes, advertising, maintenance, and the manager's salary. Variable overhead costs might include some categories of supplies, utilities, communication costs, receiving costs and miscellaneous labour costs. For the small business operation, most overhead costs tend to be fixed.

Steps to Control Overhead Expenses

There are numerous techniques to decrease overhead costs. These include:

1. Decreasing working capital
2. Implementing total quality management
3. Controlling sales costs
4. Studying maintenance costs
5. Decreasing transportation expenses

Working capital is defined as funds attached in production and inventories from the time when the unprocessed materials are purchased until the account is collected. When raw materials, inventories and accounts receivable are managed properly, it will decrease the working capital required by the firm and hence the overhead. Since most overhead costs are fixed, increased sales will apparently reduce per unit overhead. It is an aim of every manager to increase sales amount. However, volume is considered as saleable units. Mistakes, reworks and incorrectly filled orders increases costs and decrease saleable units. The payoff from implementing a total quality management system may be related to an increase in sales volume. To stay in business world, a firm must be customer oriented. However, it must also control the costs created by sales and promotional activities and use these funds effectively. Managers can decrease sales costs by relating sales incentives to the profitability in contrast to the sales price of the product.

Many accounting experts avowed that it is necessary to develop good and long-run plan for advertising and promotion which can also decrease sales expenses. It has been observed that sales efforts are unpredictable and sometimes fail to accomplish consequential results. A vigilant analysis of sales expenditures may permit reduction and reallocation of sales expenditures while increasing advertising efficiency. Maintenance and repairs are done in order to maintain equipment running. The general objective is to keep equipment in running condition in order to fulfil production goals. Remedial maintenance involves making minor changes in design, materials or construction. Predictive maintenance involves using sensing, measuring or control devices to identify and correct problems before a break-down occurs. Repairs explain maintenance work done to return equipment to production. Preventive maintenance involves work undertaken on a fixed schedule when corrective maintenance is not justified, predictive maintenance cannot be applied

and repair maintenance is too costly. Each type of maintenance has its own cost, but few managers fully consider their options to reduce maintenance costs. Recording repairs for each machine is imperative to control maintenance costs.

Small business must control overhead costs by determining the origin point of those costs. An overhead cost analysis can break these costs down into categories and analyse trends in these costs.

Main steps are as follows:

- Control energy costs: There should be energy efficient products.
- Inventory counts: It is recommended to avoid wrong and unnecessary inventory.
- Evaluate insurance such as options, policies and changes.
- Renegotiate interest terms
- Renegotiate rental terms
- Implement quality control system.
- Re- evaluate sales and marketing costs.
- Study maintenance costs.
- Decrease transportation costs.
- Increase employee efficiency such as outsourcing, automation and task consolidation.
- Focus on profit margin.
- Carefully listen to market and future trends.
- Ask employees for their suggestion to lessen cost.

Overhead Cost Controlling constituent facilitates company to plan, allocate, control, and monitor overhead costs. It is an important preparation for a strong profitability analysis, as well as for a precise product costing. By planning in the overhead area, company can specify standards that enable to control costs and assess internal activities.

Features

Overhead Cost Controlling is divided into the following areas.

Cost Element Accounting: Cost and Revenue Element Accounting details in which costs and revenues have been acquired. Accrual is calculated here for valuation differences and additional costs. Cost Accounting and Financial Accounting are also reconciled in Cost Element Accounting. This denotes that the tasks of Cost and Revenue Element Accounting stretch beyond the bounds of Overhead Cost Controlling.

Cost Centre Accounting: Cost Centre Accounting establishes where costs are incurred in the organization. In order to accomplish this goal, costs are assigned to the sub areas of the organization where they have the most influence.

By creating and assigning cost elements to cost centres, accountant experts make cost controlling possible as well as provide data for other application components in Controlling, such as Cost Object Controlling. They can also use various allocation methods for allocating the collected costs of the given cost centres to other controlling objects.

Internal orders: Overhead Orders are internal orders used either to observe overhead costs for a restricted period, or overhead incurred by executing a job, or for the long-term observation of specific parts of the overhead. Internal orders accumulate the plan and actual costs incurred, enabling accountant to control the costs constantly. They can also use internal orders to control a cost centre in more detail and assign budgets to jobs.

Activity-Based Costing: Activity-Based Costing offers a transaction-based and cross-functional approach for activity output in which several cost centres are involved. The importance is not on cost optimization in individual departments, but the entire organization. By allocating process quantities based on cost drivers, rather than using overhead calculation, cost allocation along the value chain becomes more source-based. Activity-Based Costing enables management to cost products more precisely in the overhead areas.

Some facts about overhead costs are that this cost cannot be directly traced to products. These are common costs. Overhead costs display drastically different cost behaviour. They comprise fixed, variable and semi variable costs. Overhead costs lack a functional relationship with volume of production. Individual items of overhead costs are not large enough to justify an elaborate control system (Pandey, 2009). Companies in competitive environment make extreme efforts to keep overhead costs low. They also face demands to increase resources to develop quality and customer service. Characteristically, a suitably conducted Overhead Review will recognize cost savings of between 20% and 25% of all controllable overhead costs. The main aim of an Overhead Review is to ensure that the services provided are to what customers, external or internal, require, reduce overhead costs to the lowest possible appropriate to deliver the desired service levels, re-balance resources, to support those areas of the business that are critical to its success at the expense of those areas that are less critical.

To summarize, overhead costs are the indirect and sometimes imperceptible costs related with producing a product or service, making sales more exciting than conserving expenses. But both are essential functions of the manager. Overhead costs, should be scrutinized on a consistently. Allocating overhead costs to departments within the company or to products within departments can help the manager to recognize unbeneficial aspects of the business. Break-even analysis can assist the managers to understand the implications of their overhead costs on their required sales volume, sales price or production structure.