

Factory overhead allocation method

[Business](#), [Management](#)



Overhead Allocation [pic] Overhead Allocation Overview In many businesses, the cost of overhead is substantially greater than direct costs, so the cost accountant must expend considerable attention on the proper method of allocating overhead to inventory. There are two types of overhead, which are administrative overhead and manufacturing overhead. Administrative overhead includes those costs not involved in the development or production of goods or services, such as the costs of front office administration and sales; this is essentially all overhead that is not included in manufacturing overhead.

Manufacturing overhead is all of the costs that a factory incurs, other than direct costs. You need to allocate the costs of manufacturing overhead to any inventory items that are classified as work-in-process or finished goods. Overhead is not allocated to raw materials inventory, since the operations giving rise to overhead costs only impact work-in-process and finished goods inventory.

The following items are usually included in manufacturing overhead: | Depreciation of factory equipment | Quality control and inspection | | Factory administration expenses | Rent, facility and equipment | | Indirect labor and production supervisory wages | Repair expenses | | Indirect materials and supplies | Rework labor, scrap and spoilage | | Maintenance, factory and production equipment | Taxes related to production assets | | Officer salaries related to production | Uncapitalized tools and equipment | | Production employees' benefits | Utilities | Definition of 'Applied Overhead'

A type of overhead that is recorded under the cost-accounting method. Applied overhead is a fixed charged to a specific production job or <https://assignbuster.com/factory-overhead-allocation-method/>

department within a company. Applied overhead stands in contrast to general overhead, such as utilities or rent. Other forms of applied overhead include depreciation and insurance. Definition of Actual Overhead: The actual overhead refers to the indirect manufacturing costs actually occurring and recorded. These include the manufacturing costs of electricity, gas, water, rent, property tax, production supervisors, depreciation, repairs, maintenance, and more. The applied overhead refers to the indirect manufacturing costs that have been assigned to the goods manufactured.

Manufacturing overhead is usually applied, assigned, or allocated by using a predetermined annual overhead rate. For example, a manufacturer might estimate that in its upcoming accounting year there will be \$2,000,000 of manufacturing overhead and 40,000 machine hours. As a result, this manufacturer sets its predetermined annual overhead rate at \$50 per machine hour. Since the future overhead costs and future number of machine hours were not known with certainty, and since the actual machine hours will not occur uniformly throughout the year, there will always be a difference between the actual overhead costs incurred and the amount of overhead applied to the manufactured goods.

Hopefully, the differences will be minimal at the end of the accounting year. APPLIED Overhead is computed using the predetermined overhead rate and is the amount of costs applied (or estimated) to be allocated (needed) for specific jobs. ACTUAL Overhead is found after the manufacturing process is complete which gives the actual amount of used/consumed resources (or total costs) that it needed to complete the job. The two amounts can then be compared afterward which is known as Under- or Overapplied Manufacturing

Overhead. When Manufacturing Overhead has a DEBIT balance, overhead is said to be UNDERAPPLIED, meaning that the overhead applied to work in process or to the certain job is LESS than the overhead incurred.

On the contrary, when manufacturing overhead has a CREDIT balance, overhead is OVERAPPLIED, meaning that the overhead assigned to work in process or to the certain job is GREATER than the overhead incurred. The typical procedure for allocating overhead is to accumulate all manufacturing overhead costs into one or more cost pools, and to then use an activity measure to apportion the overhead costs in the cost pools to inventory. Thus, the overhead allocation formula is: $\text{Cost pool} / \text{Total activity measure} = \text{Overhead allocation per unit}$ You can allocate overhead costs by any reasonable measure, as long as it is consistently applied across reporting periods. Common bases of allocation are direct labor hours charged against a product, or the amount of machine hours used during the production of a product.

The amount of allocation charged per unit is known as the overhead rate. The overhead rate can be expressed as a proportion, if both the numerator and denominator are in dollars. For example, ABC Company has total indirect costs of \$100, 000 and it decides to use the cost of its direct labor as the allocation measure. ABC incurs \$50, 000 of direct labor costs, so the overhead rate is calculated as: $\$100, 000 \text{ Indirect costs} / \$50, 000 \text{ Direct labor}$ The result is an overhead rate of 2. 0. Alternatively, if the denominator is not in dollars, then the overhead rate is expressed as a cost per allocation unit. For example, ABC Company decides to change its allocation measure to hours of machine time used.

ABC has 10, 000 hours of machine time usage, so the overhead rate is now calculated as: $\$100,000 \text{ Indirect costs} / 10,000 \text{ Machine hours}$ The result is an overhead rate of \$10.00 per machine hour. If the basis of allocation does not appear correct for certain types of overhead costs, it may make more sense to split the overhead into two or more overhead cost pools, and allocate each cost pool using a different basis of allocation. For example, if warehouse costs are more appropriately allocated based on the square footage consumed by various products, then store warehouse costs in a warehouse overhead cost pool, and allocate these costs based on square footage used.

Thus, far we have assumed that only actual overhead costs incurred are allocated. However, it is also possible to set up a standard overhead rate that you continue to use for multiple reporting periods, based on long-term expectations regarding how much overhead will be incurred and how many units will be produced. If the difference between actual overhead costs incurred and overhead allocated is small, you can charge the difference to the cost of goods sold. If the amount is material, then allocate the difference to both the cost of goods sold and inventory. Definition of 'Cost Of Goods Sold - COGS' The direct costs attributable to the production of the goods sold by a company.

This amount includes the cost of the materials used in creating the good along with the direct labor costs used to produce the good. It excludes indirect expenses such as distribution costs and sales force costs. COGS appears on the income statement and can be deducted from revenue to calculate a company's gross margin. Also referred to as " cost of sales. " Our

consent over The Topic: To determine the cost of goods we have to determine the factory overhead. Cost of goods are included all the costs occurred during the production including direct and indirect material, labor and all the factory overhead costs. We use allocation method to determine the factory overhead costs.

If we can't determine the factory overhead costs we can't find out the actual cost of the goods those are produced and the sale value we can't determine correctly. Because cost of a good is consisted with factory overhead costs. Factory overhead expenses should be determined otherwise understated rate of a good can occur. Because if we can't determine the factory overhead costs we can't actually determine the cost of a good that is prepared for sale. Allocation methods are used to determine factory overhead costs. Organizations use Applied or Actual factory overhead allocation methods to determine the Factory overhead costs. Cost of goods are lied with these factory overhead costs.

So if we need to determine the amount in which we need to sale a good we need to determine it's total manufacturing costs. Otherwise loss will occur. Conclusion: Cost of Goods sold is actually related with sales. And Allocation method is used to determine the factory overhead costs which is necessary to determine the costs o a good. We need to determine the factory overhead before the goods are sold. Because without calculating the factory overhead we can't determine the costs of a good and can't determine the amount in which we need to sale that good. That's why we use Allocation method to determine the factory overhead better than charging or crediting the difference to COGS.