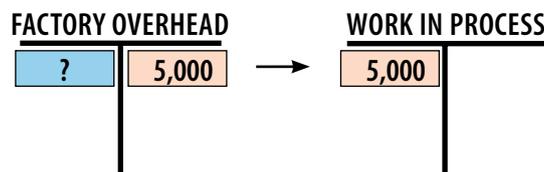


4 Accounting for Actual and Applied Overhead

A lot of this chapter has been devoted to discussing the application of overhead to production. Overhead is applied based on a predetermined formula, and considerable thought needs to be put into the appropriate basis (cost drivers) for making this allocation. An account called “Factory Overhead” is credited to reflect this overhead application to work in process.

But, what is the source of the debits to Factory Overhead?



4.1 The Factory Overhead Account

The Factory Overhead account is not a typical account. It does not represent an asset, liability, expense, or any other element of financial statements. Instead, it is a “suspense” or “clearing” account. Amounts go into the account and are then transferred out to other accounts. In this case, actual overhead goes in, and applied overhead goes out! The credits to this account are generated when overhead is applied to production; now focus on the debits which represent the actual amounts being spent on overhead.

4.2 Actual Overhead

As the cost components of overhead are actually incurred, the Factory Overhead account is debited, and the logically offsetting accounts are credited. The table below provides representative examples of factory overhead items.

EXAMPLE OVERHEAD ITEM	DEBIT	CREDIT
Indirect labor	Factory Overhead	Salaries Payable
Indirect material	Factory Overhead	Inventory or Supplies
Insurance	Factory Overhead	Prepaid Insurance
Factory depreciation	Factory Overhead	Accumulated Depreciation
Taxes	Factory Overhead	Taxes Payable
Utilities	Factory Overhead	Utilities Payable

The indirect labor would relate to the cost of factory staff not directly involved in production. This can include break-time of line workers, shop managers, maintenance, guards, and so forth. The indirect materials relates to supplies and components that are not a significant cost item. Importantly, selling and administrative costs not related to production (e.g., advertising, salaries for non-production related staff, sales commissions, rent of the corporate offices, etc.) are separately expensed, and are not part of factory overhead. A typical entry to record factory overhead costs would be as follows:

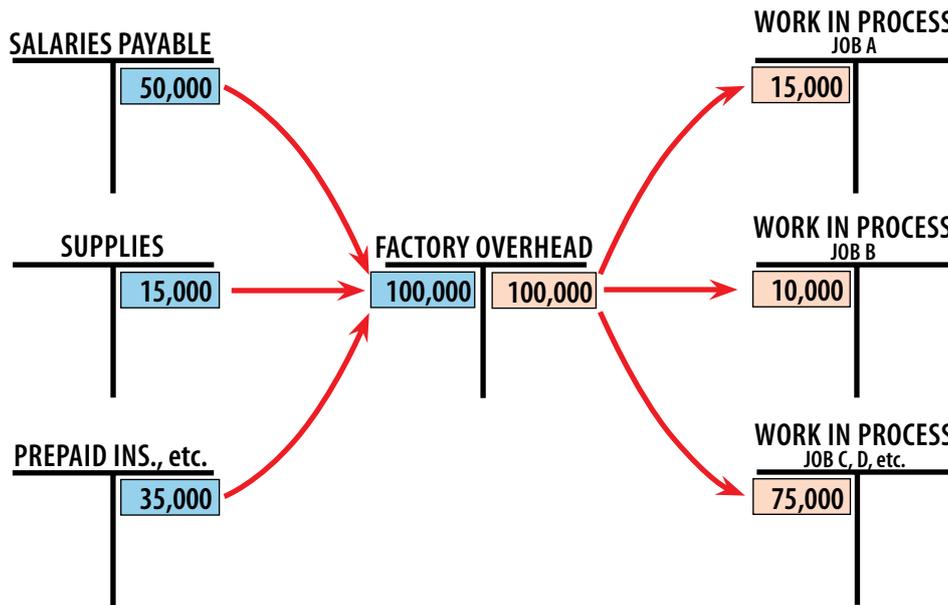
6-30-X3	Factory Overhead	100,000	
	Salaries Payable		50,000
	Supplies		15,000
	Prepaid Insurance		5,000
	Accumulated Depreciation		11,000
	Taxes Payable		9,000
	Utilities Payable		10,000
	<i>To record various factory overhead costs</i>		

4.3 The Balance of Factory Overhead

Since the Factory Overhead account is debited for actual overhead incurred and credited for allocated overhead, the general ledger account would appear as follows (the job costs are newly assumed for this illustration):

ACCOUNT: Factory Overhead				
Date	Description	Debit	Credit	Balance
June 5, 20X3	Allocated overhead to Job A		\$ 15,000	\$ 15,000
June 7, 20X3	Allocated overhead to Job B		10,000	25,000
June 8 to 30	Allocated overhead to Job C, D, etc.		75,000	100,000
June 30, 20X3	Recorded actual overhead (see entry)	\$ 100,000		-

The next graphic provides a visual representation of the cost flow associated with the Factory Overhead account. In this case, the applied overhead equaled the actual overhead, leaving a zero balance. This means that the predetermined allocation rate was exactly what was incurred during the period. More often than not, this level of perfection will not result.



4.4 Underapplied Overhead

A more likely outcome is that the applied overhead will not equal the actual overhead. The following graphic shows a case where \$100,000 of overhead was actually incurred, but only \$90,000 was applied.

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Sources: Keuzegids Master ranking 2013; Elsevier 'Beste Studies' ranking 2012; Financial Times Global Masters in Management ranking 2012

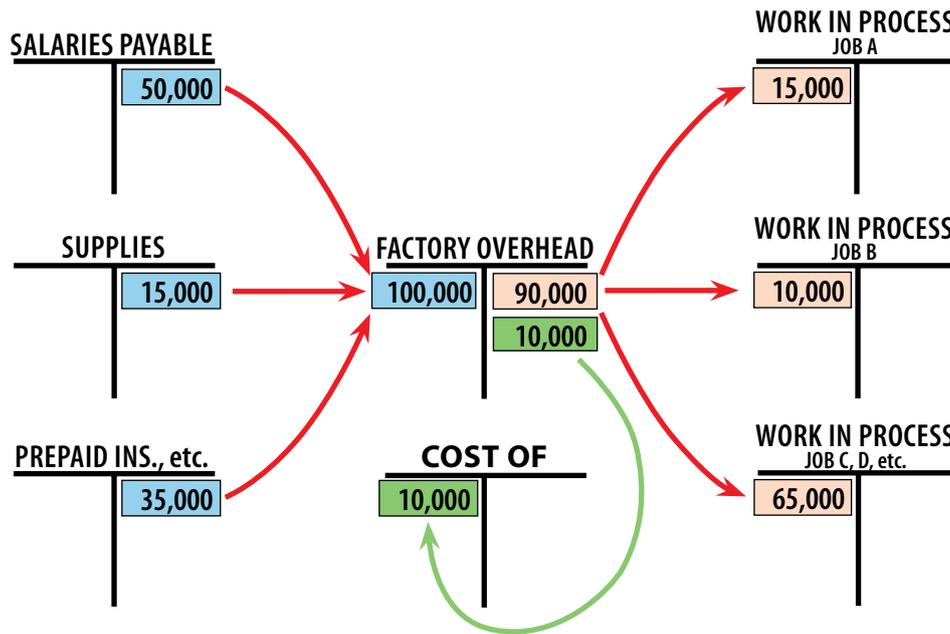
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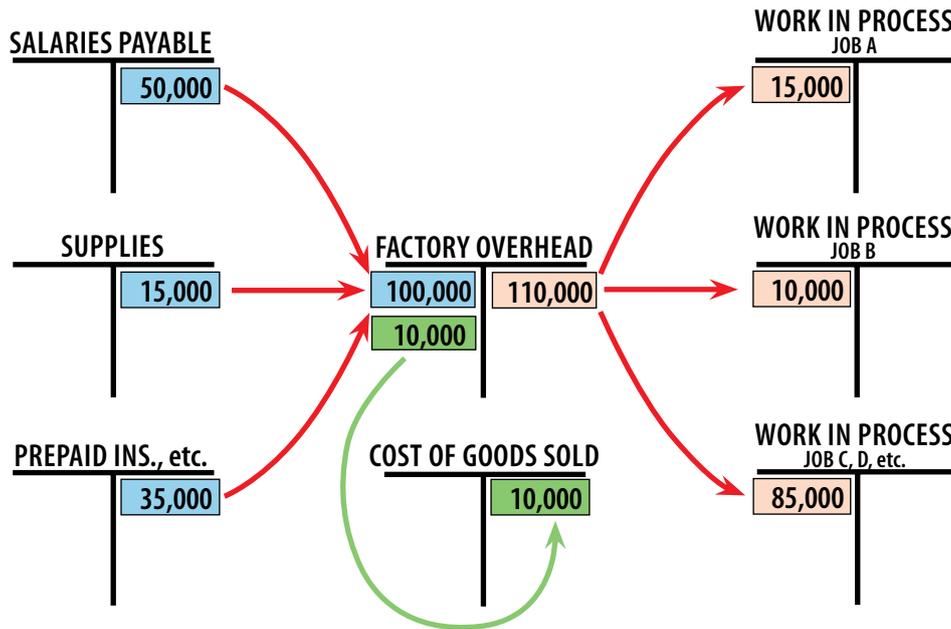
This situation is called “underapplied” overhead. It is said to be an “unfavorable” outcome, because not enough jobs were produced to absorb all of the overhead incurred. This might result from below normal levels of output, or overspending. In any event, the fact remains that more was spent than allocated. Because the Factory Overhead account is just a clearing account (not a financial statement account), the remaining balance must be transferred out. Several options are available for disposing of this amount, but one approach is to remove (credit) the underapplied amount and charge (debit) Cost of Goods Sold:

6-30-X3	Cost of Goods Sold	10,000	
	Factory Overhead		10,000
	<i>To transfer underapplied overhead to cost of goods sold</i>		

This entry has the effect of reducing income for the excessive overhead.

4.5 Overapplied Overhead

If the applied overhead exceeds the actual amount incurred, overhead is said to be “overapplied.” This is usually viewed as a favorable outcome, because less has been spent than anticipated for the level of achieved production.



The next journal entry shows the reduction of cost of goods sold to offset the amount of overapplied overhead:

6-30-X3	Factory Overhead	10,000	
	Cost of Goods Sold		10,000
	<i>To reduce cost of goods sold for the overapplied overhead</i>		

Always keep in mind that the goal is to “zero out” the Factory Overhead account and measure the actual cost incurred. In this last example, \$100,000 was actually spent and accounted for: \$110,000 charged to specific jobs and \$10,000 offset as a reduction in cost of goods sold.

These illustrations of the disposition of under- and overapplied overhead are typical, but not the only available solution. A more theoretically correct approach would be to reduce cost of goods sold, work in process inventory, and finished goods inventory on a pro-rata basis. However, this approach is clearly more cumbersome and can sometimes run afoul of the specific accounting rules discussed in the next paragraph. In a subsequent chapter, you will learn more about how to handle the “variances” arising from underapplied overhead.

4.6 Influence of GAAP

Although managerial accounting information is generally viewed as for internal use only, be mindful that many manufacturing companies do prepare external financial statements. And, generally accepted accounting principles dictate the form and content of those reports. For example, a specific Statement of the Financial Accounting Standards Board (SFAS No. 151) requires that underapplied overhead relating to idle facilities, wasted material, the allocation of fixed production overhead, and so forth, be charged to current period income by means similar to those just illustrated.



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