



WEBINT SERIES ON COST ACCOUNTING STANDARDS

Presentation on

CAS 3

PRODUCTION AND OPERATION OVERHEADS

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Overheads

Overheads comprise of costs of indirect materials, indirect employees and indirect expenses.

Classification of Overheads

Overheads shall be classified according to functions; works, administration, selling and distribution.

Works overheads, also known as **Production and Operation Overheads**, **Factory Overheads** or **Manufacturing Overheads**, shall be **the indirect costs** involved in the production of a product or in providing service.

Administrative overheads shall be the aggregate of cost of resources consumed in activities relating to **general management and administration** of an organisation.

Selling and Distribution overheads shall be the aggregate of cost of resources consumed in the **selling and distribution activities** of the organization.

Overheads

Relevant provisions in CRA-1

- In the updated CRA-1, prescribed by the Companies (Cost Records and Audit) Rules, 2014, principles for Overheads are explained in Clause 7.
- Earlier there were separate clauses in CRA-1. **Clause 7 for Overheads** and **Clause 8 for Administration Overheads**. Clause 8 was deleted in the latest amendment and all the principles were merged with Clause 7 on Overheads.

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Production and Operation Overheads

Objective

The objective of this standard is to bring uniformity and consistency in the principles and methods of determining the Production or Operation Overheads with reasonable accuracy.

Scope

This standard shall be applied to cost statements, which require classification, measurement, assignment, presentation and disclosure of Production or Operation Overheads including those requiring attestation.

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Production and Operation Overheads

Important Definitions

Absorption of Production or Operation Overheads: Assigning of Production or Operation Overheads to cost objects by means of appropriate absorption rate.

Overhead Absorption Rate = Production or Operation Overheads of the Activity divided by the volume of activity.

For example the rate obtained by dividing the overheads of a Machine Shop by machine hours.

Administrative Overheads: Cost of all activities relating to general management and administration of an entity.

Administrative overheads shall exclude production overheads, marketing overheads and finance cost. Production overheads includes administration cost relating to production, factory, works or manufacturing.

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Production and Operation Overheads

Important Definitions

Cost Centre: Any unit of an entity selected with a view **to accumulating all costs under that unit**. The unit can be division, department, section, group of plant and machinery, group of employees or combination of several units.

A cost center includes a process, function, activity, location, item of equipment, group of persons or any other unit in relation to which costs are accumulated.

Fixed Costs: Fixed costs are costs which **do not vary with the change in the volume of activity**. Fixed indirect costs are termed fixed overheads.

Imputed Cost: Notional cost, **not involving cash outlay**, computed for any purpose.

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Production and Operation Overheads

Important Definitions

Indirect Employee Cost: Employee cost, which **cannot be directly attributed** to a particular cost object.

Indirect Expenses: Expenses, which **cannot be directly attributed** to a particular cost object.

Indirect Material Cost: Material cost that **cannot be directly attributed** to a particular cost object.

Variable costs: Variable costs are the cost which **tends to directly vary with the volume** of activity.

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Production and Operation Overheads

Important Definitions

Production or Operation Overheads: Indirect costs involved in the production of a product or in providing service.

The terms Production Overheads, Operation Overheads, Factory Overheads, Works Overheads and Manufacturing Overheads denote the same meaning and are used interchangeably.

Production or Operation Overheads include administration cost relating to production, factory, works or manufacturing and providing of services.

In addition, Production or Operation Overheads shall also be **classified on the basis of behavior** such as variable Production or Operation Overheads, semi-variable Production or Operation Overheads and fixed Production or Operation Overheads.

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Production and Operation Overheads

Important Definitions

- Variable Production or Operation Overheads comprise of expenses which vary in proportion to the change of volume of production or activity or services provided.
- Semi Variable Costs are the costs that contain both fixed and variable elements. They partly change with the change in the level of activity.
- Fixed overhead are indirect costs which do not vary with the change in the volume of production or activity or service provided.

Examples of Production and Operation Overheads

Salaries for staff for production planning, technical supervision, factory administration etc., **normal idle time cost**, expenses for stores management, **consumable stores**, factory rent, **factory light**, fuel, power, repair, oil, gas and water, **security expenses in the factory**, labour welfare expenses, **dispensary and canteen expenses**, depreciation of plant and machineries, **repair and maintenance of factory building and plant & machineries**, insurance, **quality control** etc.

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Production and Operation Overheads

Important Definitions

Standard Cost: A ***predetermined cost of a product or service based on technical specifications and efficient operating conditions.***

Standard costs are used as scale of reference to compare the actual cost with the standard cost with a view to determine the variances, if any, and analyze the causes of variances and take proper measure to control them. Standard costs are also used for estimation.

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Production and Operation Overheads

Principles of Measurement

- *Production or Operation Overheads representing procurement of resources shall be determined **at invoice or agreed price including duties and taxes**, and other expenditure directly attributable thereto **net of discounts (other than cash discounts)**, taxes and duties refundable or to be credited.*
- *Production or Operation Overheads other than those referred to in earlier paragraph shall be determined on the **basis of cost incurred in connection therewith.***

In case of machinery spare fabricated internally or a repair job carried out internally, it will include cost incurred on material, employees and expenses.

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Production and Operation Overheads

Principles of Measurement

- *Any abnormal cost where it is material and quantifiable shall not form part of the Production or Operation Overheads.*
- *Production or Operation Overheads shall not include imputed cost.*
- *Production or Operation Overhead variances attributable to normal reasons shall be treated as part of Production or Operation Overheads. Overhead variances attributable to abnormal reasons shall be excluded from Production or Operation Overheads.*

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Production and Operation Overheads

Principles of Measurement

- *Any subsidy, Grant, Incentive or amount of similar nature received or receivable with respect to Production or Operation Overheads shall be reduced for ascertainment of the cost of the cost object to which such amounts are related.*
- *Fines, penalties, damages and similar levies paid or payable to statutory authorities or other third parties shall not form part of the Production or Operation Overheads.*
- *Credits or recoveries relating to the Production or Operation Overheads, material and quantifiable, shall be deducted from the total Production or Operation overheads to arrive at the net Production or Operation Overheads. Where the recovery exceeds the total Production or Operation Overheads, the balance recovery shall be treated as other income.*

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Production and Operation Overheads

Principles of Measurement

- *Any change in the cost accounting principles applied for the measurement of the Production or Operation Overheads shall be made only if, it is required by law or for compliance with the requirements of a cost accounting standard, or a change would result in a more appropriate preparation or presentation of cost statements of an entity.*

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Production and Operation Overheads

Assignment

- *While assigning Production or Operation Overheads, **traceability to a cost object in an economically feasible manner shall be the guiding principle.** The cost which can be traced directly to a cost object shall be directly assigned.*
- *Assignment of Production or Operation Overheads to the cost objects shall be based on **either of the following two principles;***
 - ***i) Cause and Effect** - Cause is the process or operation or activity and effect is the incurrence of cost.*
 - ***ii) Benefits received** – Production Overheads are to be apportioned to the various cost objects in proportion to the benefits received by them.*

In case of facilities created on a standby or ready to serve basis, the cost shall be assigned on the basis of expected benefits instead of actual.

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Assignment

- *Absorption of Production or Operation Overheads shall be as follows:*
 - *The variable Production or Operation Overheads shall be absorbed to products or services based on actual production.*
 - *The fixed Production or Operation Overheads shall be absorbed based on the normal capacity.*

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Presentation

- *Production or Operation Overheads shall be presented as **separate cost head.***
- *If material, **element wise and behavior wise details** of the Production or Operation Overheads shall be presented.*
- *Any under-absorption or over-absorption of Production or Operation Overheads **shall be presented in the reconciliation statement.***

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Disclosure

The cost statements shall disclose the following:

- *The **basis of assignment** of Production or Operation Overheads to the cost objects.*
- *Production or Operation Overheads incurred **in foreign exchange**.*
- *Production or Operation Overheads relating to resources **received from or supplied to related parties**.*
- *Any **Subsidy, Grant, Incentive or any amount of similar nature** received or receivable reduced from Production or Operation Overheads.*
- ***Credits or recoveries** relating to the Production or Operation Overheads.*
- *Any **abnormal cost** not forming part of the Production or Operation Overheads.*
- *Any **unabsorbed Production or Operation Overheads**.*

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Disclosure

- *Disclosures shall be made **only where material, significant and quantifiable.***
- *Disclosures shall be made **in the body of the Cost Statement** or as a foot note or as a separate schedule.*
- ***Any change in the cost accounting principles and methods** applied for the measurement and assignment of the Production or Operation Overheads during the period covered by the cost statement which has a material effect on the Production or Operation Overheads shall be disclosed. Where the effect of such change is not ascertainable wholly or partly the fact shall be indicated.*

THANKS !!