

## Improving the Nature and Classification of Overhead Costs

***Tashnazarova Dilfuza Samiddinovna***

*Doctoral Student, Samarkand institute of economics and service*

***Abstract.*** The article discusses the theoretical aspects of overhead costs, their importance for the formation of the cost of production and the problems of accounting. The classification of overhead costs according to various characteristics, including economic elements, functional role and variability of costs is given. Modern methods of accounting and distribution of overhead costs, such as the method of coefficients, step-by-step distribution and ABC-costing, are analyzed overhead costs associated with their variability and complexity of distribution, as well as the need to introduce modern information systems to improve the accuracy of accounting. In conclusion, recommendations are given for improving the methods of accounting and management of overhead costs at enterprises.

***Keywords:*** Overhead costs, classification of expenses, cost accounting, distribution methods, cost of production, ABC-costing, management accounting, production costs.

### Introduction

Improvement of the system of accounting for overhead costs plays an important role in increasing the efficiency of cost management at the enterprise. In today's business environment, companies are faced with the need for precise cost control to achieve high competitiveness and sustainable development. Overhead costs, being a significant part of total costs, require careful analysis and systematization for optimal distribution among production objects.

Overhead costs, as a rule, include costs that cannot be directly attributed to a specific product or service, which complicates their accounting and distribution. In most cases, such expenses cover various aspects of the production and non-production activities of the enterprise, which requires the use of special methods for their classification and accounting. Despite the importance of these costs, many companies face challenges in accurately valuing and allocating them, which can lead to distorted financial performance and complicate management decision-making.

The purpose of this article is to study modern approaches to the classification of overhead costs, to identify existing problems in their accounting and to suggest ways to improve the methods of their distribution. This will improve the accuracy of product cost estimates, improve cost control and create conditions for increasing financial transparency and management efficiency at the enterprise.

### Theoretical Aspects of Overhead Costs

Overhead costs are costs that arise in the course of the company's activities, but cannot be directly attributed to a specific product, service or work. Unlike direct costs, which can be clearly linked to a specific unit of output (e.g., raw materials or wages of production workers), overhead costs are allocated to multiple entities based on selected criteria.

The main characteristic of overhead costs is their indirect nature. These expenses include the cost of maintaining the general operating activities of the enterprise: maintenance of production and administrative premises, depreciation of equipment, payment for utilities and salaries of maintenance personnel. It is important to note that such costs are regular and continuous, regardless of how many products are produced or sold.

Direct costs are those costs that can be directly related to the production of specific products or services. An example of direct costs is the materials used in production, or the wages of employees directly involved in the manufacture of products. These costs can be easily taken into account in the cost of each unit of output.

Indirect costs, which include charges, cannot be directly linked to a unit of product or service. For example, electricity used to light an entire plant or depreciation of equipment that is used on multiple production lines are indirect costs. These costs need to be distributed among different products and services, which complicates the process of accounting for them.

The main difference between direct and indirect costs is the possibility of attributing costs to a specific object. Direct costs are easily associated with a specific product, while indirect costs require the use of allocation methods to ensure a fair assessment of their impact on the cost of production.

Overhead costs play a significant role in the formation of the cost of production, since they include all costs necessary to maintain the operation of the enterprise, but not directly related to the production process. The correct formation of the cost depends on the accuracy of accounting and distribution of overhead costs, which, in turn, affects pricing, profitability and overall financial stability of the company.

The formation of the cost of production is impossible without taking into account overhead costs, since these costs support the entire infrastructure and production processes at the enterprise. Even if overhead costs do not directly affect the production of a particular product, they ensure the functioning of all other aspects of the activity. Therefore, the distribution of these costs is an important step in determining the full cost of production.

Accurate assessment and rational distribution of overhead costs allow for a more objective assessment of the cost, which contributes to the correct determination of the pricing policy and increases the competitiveness of the company. Incorrect accounting of overhead costs can lead to over- or under-costing, which distorts the overall picture of financial indicators and can adversely affect the company's profit.

### **Classification of overhead costs**

Classification of overhead costs allows you to systematize them for the convenience of accounting, analysis and distribution to the cost of production. There are several approaches to classification, which depend on the goals of management accounting and the specifics of the company's activities.

#### **1. Classification by economic elements and functions of the enterprise**

Overhead costs can be classified both by their economic essence and by their functional role in the enterprise. These two approaches help to more accurately identify costs and take into account their impact on various aspects of the activity.

| <b>Expense group</b>             | <b>Examples</b>                                  | <b>Functional role</b>                 |
|----------------------------------|--|--|
| Depreciation of fixed assets     | Wear and tear of equipment, machinery, buildings | Production costs                       |
| Salaries of management personnel | Salaries of administration and service personnel | Administrative costs                   |
| Utilities                        | Electricity, water, heating, gas                 | Commercial and administrative expenses |
| Lease                            | Rental of premises and equipment                 | Production and administrative expenses |
| Repair                           | Repair of equipment, buildings                   | Production and administrative expenses |

This combined classification helps to better understand what economic resources overhead costs are spent on and what functional role they play in the enterprise.

## 2. Classification by Variability and Relation to Production

In order to predict and manage overheads, it is important to divide them into fixed and variable costs. It is also important to consider whether they relate directly to specific products or require distribution.

| Expense Type | Examples                            | Attitude to the process                  |
|--------------|-------------------------------------|--|
| Variables    | Costs of electricity, raw materials | Require distribution (indirect costs)    |
| Permanent    | Lease of premises, depreciation     | Do not require allocation (direct costs) |
| Managed      | Advertising, salaries of managers   | Managed                                  |
| Unmanaged    | Taxes, utility bills                | Unmanaged                                |

Variable costs increase with the growth of production, while fixed costs remain unchanged, regardless of output. Indirect costs should be fairly distributed among production facilities.

## 3. Classification by the level of controllability

Overhead costs can also be divided according to the degree of their controllability, which is important for making decisions on reducing costs and improving management efficiency.

| Expense Type | Examples                          |
|--------------|-----------------------------------|
| Managed      | Advertising, salaries of managers |
| Unmanaged    | Taxes, utility bills              |

This classification allows managers to focus on those costs that can be controlled and optimized to improve efficiency.

### Methods of accounting and allocation of overhead costs

Correct accounting and rational distribution of overhead costs are important aspects of the formation of the cost of production. Overhead costs cannot be directly related to a specific product or service, so they require allocation based on reasonable methods. Depending on the specifics of the enterprise and its production processes, various methods of accounting and distribution of overhead costs are used.

#### 1. Direct Distribution Method

This method is used when overheads can be directly attributed to specific departments or products based on specific metrics, such as the time spent on production or the quantity of products produced.

The main essence of the method is that indirect costs, such as depreciation of equipment, energy or rent, are distributed among cost objects based on the selected base, for example:

- Volume of products.
- Number of man-hours worked.
- Number of machine hours.

The direct distribution method is the simplest and is used in cases where enterprises have a small number of production processes or products.

#### 2. Method of distribution coefficients (bets)

This method is based on calculating the miscellaneous charge allocation rate based on the criterion that you select. The distribution rate is calculated using the formula:

$$\text{Ставка} = \frac{\text{Общая сумма накладных расходов}}{\text{База распределения}}$$

After that, each unit of production receives its share of overhead costs, depending on the amount of the base used. For example, if the allocation rate is 100 soums per machine-hour, and the product required 10 machine-hours, then the overhead costs for this product will be 1000 soums.

#### Example:

If the total overhead costs are 1,000,000 rubles and the total allocation base is 10,000 machine-hours,

the allocation rate will be 100 soums per machine-hour. If 200 machine-hours were spent on the production of product A, then the overhead costs for this product will be 20,000 rubles (200 machine-hours \* 100 soums).

### **3. Step-by-step distribution method**

The step-by-step distribution method is used for more complex enterprises, where different departments provide services to each other. In this method, the overhead of one service unit is first allocated to the other units, and then the remaining overhead is reallocated to the main production units.

**Example:** If the Energy department provides services to the Repair Department and Production, its overhead costs are allocated first to the Repair Department and Production. After that, the costs of the Repair Department are also redistributed among the production departments.

The step-by-step allocation method allows for a more accurate reflection of the interaction between departments and ensures a fair distribution of overhead costs.

### **4. Method of distribution by type of activity (ABC-costing)**

This method involves the distribution of overhead costs depending on the specific activities that were involved in the production of products. First, all activities in the enterprise are identified, and costs are calculated on their basis. Costs are then allocated to products or services based on how much each product has engaged certain activities.

ABC costing allows for a more accurate allocation of overhead costs, especially in enterprises with many different processes and products. This helps to avoid cost distortion, since overhead costs are not distributed evenly to all products, but only to those that require the use of specific resources.

### **5. Method of normative distribution**

Under this method, overhead costs are allocated on the basis of predetermined rates. These standards can be calculated on the basis of previous periods or on the basis of forecasts. The normative method is good because it allows you to plan and control overhead costs in advance, but there may be a need for adjustments if the actual data differ greatly from the planned ones.

Each of the considered methods has its own advantages and is used depending on the characteristics of the enterprise, the nature of production and the complexity of cost accounting. The choice of the method of allocation of overhead costs has a direct impact on the accuracy of the assessment of the cost of production and allows you to effectively manage costs. It is important that the chosen method is maximally adapted to the specifics of the business and allows you to ensure an objective distribution of product costs.

### **Problems in accounting and allocation of overhead costs**

Accounting and allocation of overhead costs in enterprises face a number of difficulties that have a significant impact on the accuracy of financial statements and management efficiency. One of the main problems is the difficulty of their exact attribution to specific cost objects, which is due to their indirect nature. Since overhead costs cannot be directly linked to a specific product or service, their allocation is based on arbitrary criteria, which can distort the real cost and complicate analysis.

An important challenge is the dynamic variability of overhead costs. Depending on the volume of production, seasonal fluctuations or external factors (e.g. changes in energy prices), these costs can vary considerably. This creates difficulties in forecasting and planning overheads, which, in turn, makes it difficult to form accurate budgets and cost calculations. The lack of stability in these indicators requires constant review and adjustment of accounting data, which increases the burden on accounting services.

Another major problem is the use of outdated or inaccurate methods of allocating overheads. Many enterprises still use the simplest methods of allocation, such as the ratio method or the proportional method, which may not reflect the actual use of resources by different types of products or services.

This is especially problematic for large companies with diverse production processes, where a homogeneous distribution of overhead costs across all products leads to significant distortions in accounting.

The need to adapt to International Financial Reporting Standards (IFRS) also creates additional complexities. These standards require enterprises to accurately and accurately account for all costs, including overheads, which requires a review of existing accounting methodologies and the introduction of more complex cost allocation systems. For many enterprises, the transition to IFRS standards becomes a problem due to the lack of the necessary resources and specialists, as well as the high complexity of the standards themselves.

In addition, the problem of accurate accounting of overhead costs is intensified when there are a large number of service departments, such as repair services, supply departments, logistics and others, which provide mutual services to each other. In such cases, traditional overhead accounting methods may not be able to cope with accurate cost allocation, leading to the need to use more complex methods such as the step allocation method or ABC costing.

The technical equipment of enterprises also plays an important role in the efficiency of accounting for overhead costs. Many companies use outdated information systems that do not allow automatic and prompt distribution of overhead costs to various cost objects. This creates additional risks of accounting errors and requires manual intervention, which increases the likelihood of data distortion.

In general, problems in accounting and allocation of overhead costs are due to both objective factors (complexity of indirect costs, their variability and diversity) and subjective ones (the use of outdated methods and insufficient technical equipment). The solution of these problems requires the use of modern accounting methods, optimization of internal processes and the introduction of information systems that will allow more accurate distribution of costs and improve the financial reporting of enterprises.

## **Conclusion**

Improving the accounting and classification of overhead costs is an important element in improving the efficiency of cost management in the enterprise. Overhead costs, being indirect, have a significant impact on the formation of the cost of products and services, which directly affects the financial results. However, their accounting and distribution are associated with a number of problems, such as the difficulty of accurately attributing to cost objects, the variability of the amount of expenses, and the lack of accuracy of traditional methods of distribution.

The development of the methodology for accounting for overhead costs should be aimed at applying more flexible and modern approaches, such as the method of coefficients, step distribution or ABC costing, which ensure a fair distribution of costs and an adequate reflection of the real cost of production. It is also important to take into account the specifics of the enterprise and the production process when choosing an accounting method in order to minimize the risks of data distortion.

In addition, the introduction of modern information systems that comply with international financial reporting standards is an important step in solving existing problems. Automation of accounting will reduce errors, reduce the load on accounting services and ensure transparency in the distribution of costs.

Thus, improving the nature and classification of overhead costs not only increases the accuracy of accounting and financial reporting, but also contributes to improving cost management, which is an important condition for increasing the competitiveness and sustainable development of the enterprise.

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