

## **Under/Over-Absorption of Overheads (Accounting Treatment)**

Overhead absorption can be done on

1. Actual basis, or
2. Predetermined rate or estimation basis

When Overhead absorption is done on Actual basis, then overhead absorbed will be equal to Actual overhead incurred, thus, there will be no Under or Over-Absorption of Overheads.

However, When Overhead absorption is done on estimation basis, then overhead absorbed can be i) equal to, ii) less than or iii) more than Actual overhead incurred, thus, there will be i) no Under or Over-Absorption of Overheads, ii) Under Absorption of Overheads, iii) Over-Absorption of Overheads, respectively.

- If Overhead absorbed = Actual overhead incurred, then there is **No Under or Over-Absorption** of Overheads
- If Overhead absorbed < Actual overhead incurred, then there is **Under-Absorption** of Overheads
- If Overhead absorbed > Actual overhead incurred, then there is **Over-Absorption** of Overheads

### **Treatment of Under/Over Absorption of overhead:**

The difference of Overhead absorbed and Actual overhead incurred can be the amount of Under-absorption and over-absorption, which can be treated in any one of the following ways:

1. The amount of under-or over-absorption can be **forwarded to the subsequent period**. This method is used by seasonal business firm.
2. The amount of under-or over-absorption can be **adjusted through a supplementary rate**. It is computed by dividing the amount of under – or over-absorption by the actual absorption base.

**Supplementary rate** =  $\frac{\text{Amount of under/over-absorption}}{\text{Actual Quantum of base}}$

Actual Quantum of base

In case of Under-absorption, the amount of under-absorption is added to cost units through this computed supplementary rate, while in case of over-absorption, the amount of over-absorption is subtracted from cost units (work-in-progress, finished goods stock and cost of goods sold) through this computed supplementary rate.

This method is used when the amount of under-or over-absorption is significant.

3. The amount of under-or over-absorption can be transferred to the **costing profit and loss account** to arrive at the accurate net profit for an accounting period. This method is used when the amount of under-or over-absorption is negligible or due to abnormal factors.