

Chapter 12 – Managing and Allocating Support Service Costs

Nearly every organisation – commercial, public, non-profit – contains two types of subunits or departments: support service and production.

Support service (or indirect) departments: Provide services internally within the organisation. Typical support service departments include human resources, finance and accounting.

Production (or line) departments: Provide goods and services to customers, clients or public citizens. The total resources used by the organisation to provide products externally include the costs of both types of departments; thus, organisations often allocate support service costs, which are the costs of resources supplied to provide support services, to their production departments to be counted as indirect or overhead costs.

This chapter applies

- a) the differences between support service and production departments,
- b) alternative support service cost allocation methods.

Cost management analysts from finance, accounting or operations departments most often are the professionals who prepare and analyse the information to support outsourcing decisions. The required information includes the knowledge base necessary to perform a service, the sensitivity of information needed to perform a service, the relative costs of a service, and the difficulty in finding, managing and keeping reliable, high-quality service providers. Whether to outsource any support service depends on the consideration of a combination of many quantitative and qualitative factors:

Knowledge base

Complex or unique organisations might have distinct procedures and cultures that external service providers could have difficulty understanding and supporting.

Sensitive information

Some organisations compete on the basis of their knowledge of technology or complex market and political situations. These firms might be reluctant to outsource support services, such as internal auditing, that would allow outsiders and potentially competitors to obtain their strategically important knowledge.

Reliable service providers

A less expensive outsourced service is not cost effective if its reliability and quality are low and adversely affect the organisation's ability to meet its objectives.

Relative costs

Many organisations see the outsourcing of support services as a means to increase budget flexibility and reduce current and long-term costs.

LO 1: Explain the importance of managing support service costs and the reasons these costs are allocated.

Customers accept products only if the value of the product meets or exceeds the prices charged.

How does the organisation manage its support service costs in the absence of competition? There are several cost-based, management approaches, two of which are discussed here.

- Charge internal customers nothing for support services and recover the costs of the services from general revenues. The advantage of this approach is that it is simple and inexpensive to operate because there is no need either to measure or charge for support service costs. Its disadvantage is that as long as internal customers perceive any positive value from free services, they may demand more service without regard to the costs to the organisation.
- Charge the costs of support services provided to internal customers and recover at least some of the costs from them.

Cost allocation: A systematic method of assigning the costs of resources to a department, product, or service when directly tracing costs is not possible – to charge support service costs to internal customers.

This second approach is common, but it also has disadvantages.

First, cost allocations are, by nature, arbitrary; they are, at best, discretionary and might not measure the uses of resources accurately.

Second, if internal customers are required to use internal services, they might spend valuable time negotiating and lobbying over fair prices, which could be an inefficient use of time and effort.

Furthermore, cost allocations can create incentives to use or not use the services inappropriately if the allocated costs are not closely associated with the actual consumption of resources.

Support service costs: The costs of the resources supplied by a support service department that are used to provide its support services.

Deciding who pays for internal support service costs

In many for-profit and other public organisations, cost allocations compute the charges from support service departments to production departments for services provided. These services may be paid for by production departments, either as a lump sum or on a per-unit of service used. Lump-sum payments are simpler to administer, but also can have an adverse effect of motivating production departments to demand more services than they need. The greatest impediment to using per-unit of service charges is the complexity of defining, measuring and accounting for units of many different services. In its full form, this approach is very similar in effect and cost to an ABC costing system, wherein the unit of service is a unit of activity.

Allocating service costs for decision making

Allocating service costs for pricing

Allocating service costs for cost-based contracting

Some organisations contract for work on a cost basis or cost-plus bases. In many cases, the appropriate cost allocation method is prescribed in the contract.

Allocating service costs for influencing behaviour

Managers often allocate costs to influence behaviour.

Allocating service costs for required reporting

In general, tax regulations and external financial reporting require allocating fixed and variable manufacturing overhead to the products of manufacturing firms.

All cost allocations of indirect, support service costs are at least somewhat arbitrary because they cannot precisely link resource spending and resource use.

The process of allocating service costs systematically follows several steps, each of which can affect the success of cost allocations. The steps, which are explained in detail in subsequent sections, follow:

1. Identify the categories and amounts of costs to be allocated to internal customers.
2. Choose the appropriate cost allocation base(s) for each cost category.
3. Select and use an appropriate method to compute cost allocation rates and cost allocations of service department costs.
4. Determine whether the cost allocations achieve the desired results; if they do not, begin the process again.

LO 2: Understand how to choose cost pools and to separate the cost of resources supplied for the cost of resources used.

Step 1: Identify the categories and amounts of costs to be allocated to internal customers.

Typically, organisations separate support-service costs by department into separate cost pools, which are the budgeted and actual spending amounts for distinct sets of resources.

Before allocating support-service department costs to user departments, we should first separate resources supplied from resources used. Only resources used should be allocated to user departments because users should be charged for services that they use. This argument states that users should not have to pay for the support service departments' unused capacity.

LO 3: Understand how to choose appropriate allocation bases.

Step 2: Choose the appropriate cost allocation base(s)

Cost allocation bases are factors that cost management analysts use to assign indirect costs to cost objects. Ideally, a cost allocation base reflects plausible correlation between resource spending and use, which is the combination of strong statistical correlation and economic rationale. The more closely the allocation base reflects a link between resource spending and use, the more useful allocated costs are likely to be for planning, decision making and influencing behaviour.

Indexed cost allocation bases: Combines multiple bases into a single index of services provided. Indexed cost allocation bases might be preferable to creating separate cost pools for each type of service activity when resources cannot be easily separated or traced to activities because they recognise that some measures are 'equivalent' to the previous allocation bases that, when added, expand the scope of work performed by each service department.

Step 3: Select and use an appropriate method to compute cost allocation rates and cost allocations of service department costs.

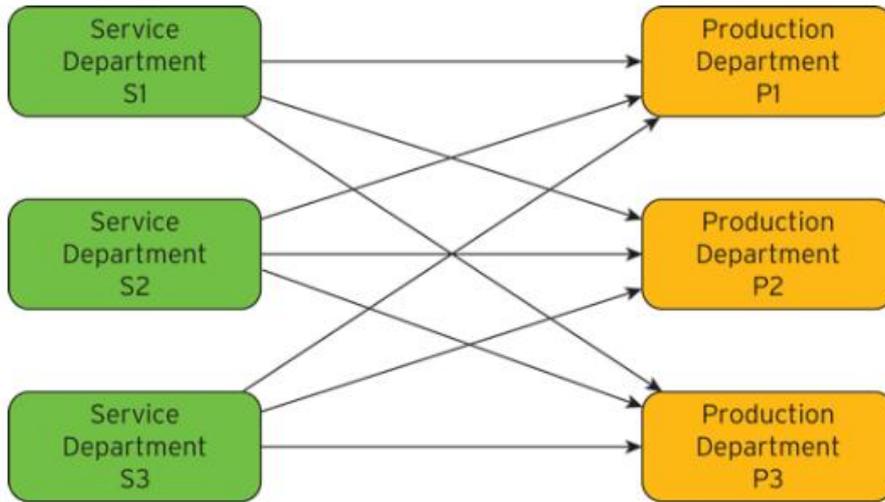
This section describes two commonly used methods to allocated support service costs:

- 1) The direct method and
- 2) The step method.

A third the reciprocal cost method, is conceptually more accurate than the two more common methods, but it is less used at this time. The reciprocal method could be used more in the future as cost management analysts gain familiarity with it.

LO 4: Allocate support service department costs using the direct method.

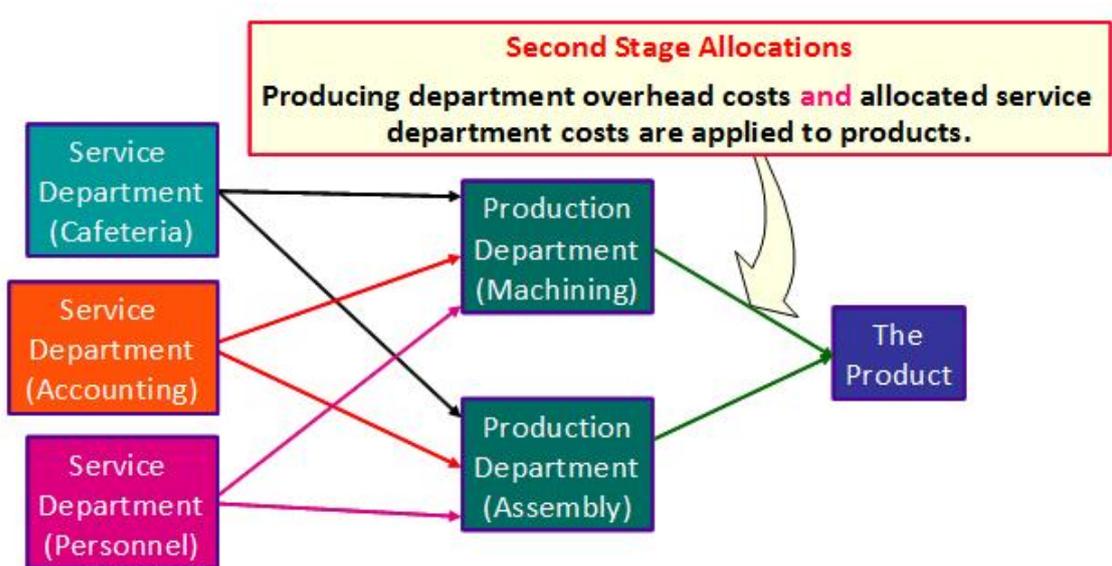
Direct method of cost allocation: Charges support service costs to production departments without making allocations among support service departments. The direct method does not consider the work done by a service department for other service departments or for itself.



The direct method allocates support-service department costs based only on the relative amounts of the total cost-allocation base in the various production departments. Because support costs are allocated directly, the order of allocation – which support cost is allocated first, second and so on – is irrelevant.

The direct method is the simplest method to use and to communicate.

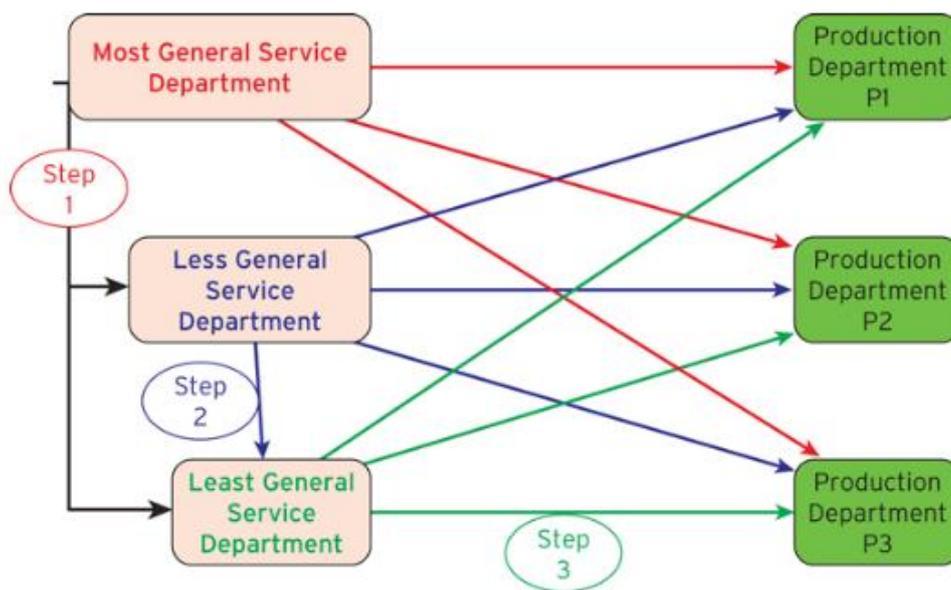
Second-stage cost allocation: The reallocation of service department costs and direct department costs to products.



LO 5: Allocate support service department costs using the step method.

The step method of cost allocation allocates support service department costs in ordered, sequential steps to production departments. The steps are:

1. Rank-order support service departments by the proportions of their total allocation bases in other support service departments. This creates an allocation order from the most general support service department to the least.
2. Allocate the costs from the most general support service department to the less general support service departments and to production departments. The allocation basis is the allocation base in all of these other departments, excluding the base in the most general support service department.
3. Repeat and allocate costs in order from the less general support service departments until all support service department costs are allocated to production departments. The step method thus uses as many sequential allocation steps as there are support service departments.



Unlike the direct method, the step method of cost allocation recognises that support service departments provide some services to their support services, as well as to production departments. Note that once the organisation makes an allocation from a more general support service department, no subsequent allocations are made back to that department. Whether the step method results in materially different cost allocations depends on the costs to be allocated and on the degrees of interactions among support service departments.

The step method is not necessarily better than the direct method. Many organisations use the direct method because of its comparative simplicity.

Reciprocal services: services provided among multiple support services.

LO 6: Evaluate the consequences of alternative cost allocations.

Step 4: Determine whether the cost allocations achieve the desired results.

Step 3 is very important because if a service department has too many resources for its work, cost allocation rates will be higher than customers will tolerate, unused capacity will be obvious.

What is the most effective way for an organisation to choose the method to allocate support service costs? Discussions about the 'best' approach to allocating support costs can waste valuable time and create dissension and lack of co-operation among departments. Awkward implementation of new cost allocations is bound to create distrust because affected departments will suspect that the motive is to 'steal' funds or profits. This could discredit the budget department and cause relations among departments to worsen.

On the other hand, discussions about cost allocations could increase information flow and co-operation if the negotiation process is open and all parties have an opportunity to participate and influence its outcome. An open evaluation of cost allocation approaches would consider accuracy, effects on departments, and relation of costs and benefits.

Accuracy: The precision in measurement, is both conceptual and empirical.

The direct method does not consider any interactions among service departments, whereas the step method considers some, and the reciprocal method is more thorough in this respect.

Conceptually, combining causal cost allocation bases and the reciprocal method should be the most accurate cost allocation approach, which measures the cost of support service resource usage with the least error. Likewise, the combination of the direct method and convenient cost allocation bases could be the least accurate reflection of resource spending, use and provision of services.

Consistency of cost allocation: The degree to which cost allocation bases fully allocate spending for support services, is related to accuracy, and is easier to establish than true cost or true cause-and-effect relationships. One could simulate cost allocations to departments using alternative departmental cost allocation base amounts.

Effects on behaviour

Another way to compare cost allocation approaches is to examine the behavioural effects of alternative distributions of cost allocations to production (and support service) departments. Cost allocations can have unintended effects. For example, department managers' performance evaluations might depend on their control of departmental costs, and they will be reluctant to change from cost allocations that they have understood and have accommodated in their departments' operations.

Effects on distributions of costs

Effects on performance evaluation

Effects on decision making

Effects on cost-plus contracts

As noted earlier, many organisations sell products on the basis of a cost-plus contract, which reimburses the seller of costs incurred plus a profit.

Cost-plus contracts give incentives to the supplier of the good or service to seek as much reimbursement as possible and, therefore, to allocate as much cost as possible to the product for which reimbursement is possible.

Because the support service costs cannot easily be directly attributed to a contract, allocation debates are common in cost-plus contracting. It is better to specify in the contract beforehand precisely how to define costs and how to make allocations.

A third consideration in the design of cost allocations is the relation of the costs of setting up, administering and maintain the cost allocation system and its benefits. Cost management analysts must realise that complex cost allocation systems are not only difficult and costly to design but also are costly to maintain.

LO 7: Allocate support service department costs using the reciprocal method.

The step and direct methods omit all or some of the costs of support services consumed by one service department that were provided by other service departments. The reciprocal method of cost allocation addresses these technical limitations by making a reciprocal cost allocation when support service departments provide reciprocal services, that is, they provide services to each other.

Reciprocal method: Recognises and allocates the costs of all services provided by any support service department, including those provided to other support service departments. If allocation bases are plausible, this method is conceptually the most accurate approach because it reflects the actual processes by which services are exchanged among the organisation's departments.

The reciprocal method first expresses the total costs of each service and production department in equation form:

Total departmental costs = Direct costs of the department + Service cost to be allocated to the department.

This creates one equation for each department in which the unknown element is the total departmental cost. This set of equations (one equation for each unknown total department cost) is then solved simultaneously. Solving all of the equations simultaneously accounts for all support service department allocations, including direct costs and reciprocal services provided by support service departments to each other. This algebraic approach is also known as the simultaneous solution method because it solves a system of equations simultaneously.

In a more realistic and complex situations (three or more reciprocal departments), analysts use matrix algebra to solve for unknown total department costs.