

Costing in Service Sector



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COSTING OF SERVICE SECTOR

Service sector companies provide services to their customers that are intangible. Service sector costing is a method of ascertaining costs of providing or operating a service. This method of costing is applied by those undertakings which provide services like schools, hotels, hospitals, canteens, transportation etc rather than production of commodities. Service sector costing has emerged as a separate method of costing due to the shortcomings in traditional costing methods to apply to this sector. Shortcomings of traditional costing method for this sector are:

1. No cost of goods sold;
2. No profit centre;
3. No break even analysis;
4. No pricing formulations;
5. Unlike inventories, no storage of services;
6. More emphasis on responsibility accounting.

Question

Explain the main characteristics of Service sector costing.

Answer

Main characteristics of service sector are:

1. **Activities are labour intensive:** The activities of service sector generally are labour intensive. The direct material cost is either small or non-existent.
2. **Cost-unit is usually difficult to define:** The selection of cost units usually, for service sector is difficult to ascertain as compared to the selection of cost unit for manufacturing sector.
3. **Product costs in service sector:** Costs are classified as product or period costs in manufacturing sector for various reasons. It is difficult to apply such classification to service sector since it is not possible to identify inventories that are intangible.

Question

Give an appropriate cost unit for each of the following service sectors:

1. Hotel
2. School
3. Hospital
4. Accounting firm
5. Transport
6. Staff Canteen
7. Machine maintenance
8. Computer Department

Answer

Respective Cost Units are:

1. Hotel - Bed nights available or occupied
2. School - Student hours or no. of full time students
3. Hospital - Patient-day / Room-day
4. Accounting firm - Client hours
5. Transport - Passenger-Kms, or Quintal km or tonne-km
6. Staff Canteen - No. of meals provided or no. of staff
7. Machine maintenance - Maintenance hours to user departments
8. Computer Department - Computer time to user departments.

Question

Discuss with examples, the basic costing methods to assign costs to services.

Answer

Generally the following methods are adopted to assign costs to services:

1. **Job costing method:** The cost of a particular service is obtained by assigning costs to a distinct identifiable service. e.g. Job Costing method is used in service sectors – like Accounting Firm, Advertisement campaign. Indirect costs may be allotted / apportioned on the basis of Activity Based Costing or such other suitable methods.

2. Process Costing method: Cost of a service is obtained by assigning costs to masses of similar unit and then computing cost / unit on an average basis. e.g. Retail banking, postal delivery, credit card etc.

3. Hybrid method: Combination of both (1) & (2) above.

The main cost components in service sector are labour hours and service overheads.

Question

"Customer profile is important in charging cost." Explain this statement in the light of customer costing in service sector. OR

How will you apply customer costing in service sector? Explain with suitable example.

Answer

The customer costing is a new approach to management. The central theme of this approach is customer satisfaction. In some service industries, such as public relations, the specific output of industry may be difficult to identify and even more difficult to quantify. Further there are multiple customers, identifying support activities i.e. common costs with particular customer may be more problematic. In such cases it is important to cost customer. An ABC analysis of customers' profitability provides valuable information to help management in pricing customer. For instance in banking sector, the activities for customers will include the following types:

1. Stopping a cheque
2. Withdrawal of cash
3. Updating of pass book
4. Issue of duplicate pass book
5. Returning a cheque because of insufficient funds
6. Clearing of a customer cheque.

Different customers or categories of customers use different amount of these activities and so customer profiles can be built up and customer can be charged according to the cost to serve them.

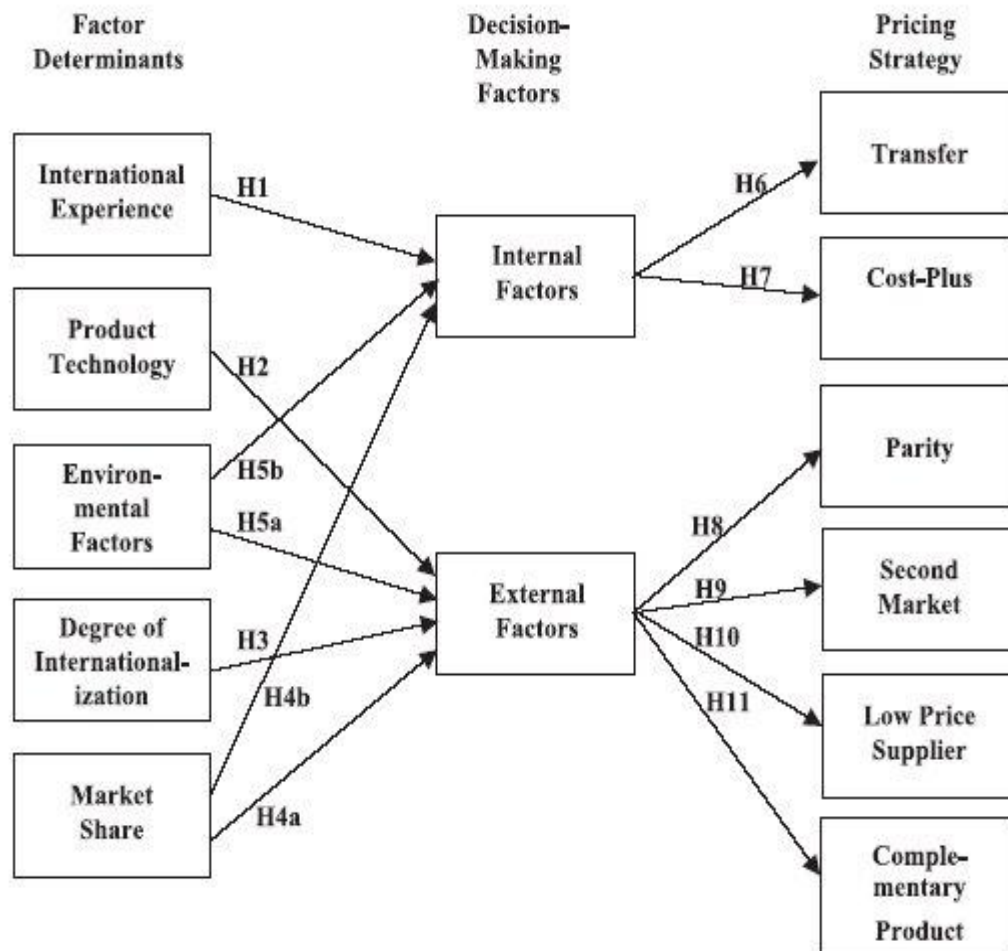
Customer profile is important in analyzing cost under the following categories

1. **Customer specific costs:** These are the direct and indirect cost of providing service to customer plus customer related cost assigned to each customer.

For example: cost of express courier service to a client who requests over-night delivery of some agreement.

2. **Customer – line categories:** These are the costs which are broken into broad categories of customers and not individual customers.

TRANSFER PRICING



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Transfer price is the notional value placed on goods and services transferred from one division to another division in a large organisation. Hence this is similar to sale but in this case there will not be any transfer title to goods as the transaction is within the same organisation. Thus, Transfer Price can be defined as the price charged for products exchanged in internal transactions between Sellers and Buyers within the same organisation.

Question

What are some goals of a 'transfer-pricing' system in an organization? OR Enumerate the main objects of 'transfer pricing.'

Answer

Transfer pricing is usually adopted with the following objectives / goals:

1. **Emphasis on Profits:** To create a sense of commercial attitude in those who are responsible for the performance of profit centres.
2. **Optimise Profits:** To optimise profits of the company by creation of responsibility accounting.
3. **Optimum Utilisation of Resources:** To enable the organisation to fully exploit the valuable and scarce resources.
4. **Motivates Managers for Effective Decision making:** provide information that motivates divisional managers to take good economic decisions that suit their divisions (as they will more autonomy and freedom under this system) which will improve the divisional profits and ultimately the profits of the company as a whole.
5. **Performance Evaluation:** Transfer pricing provide information which will be useful for evaluating the divisional performance.
6. **Goal congruence:** An efficient transfer pricing system can motivate divisional manager to make economic and rational decisions to achieve goal congruence, i.e. common objective.

Methods of Transfer Pricing: Transfer Pricing Methods are broadly classified into three methods; viz.

1. Cost based transfer pricing: Methods under this category are:

- a. At actual cost
 - b. At Marginal cost
 - c. At Standard cost
 - d. At cost of sales
 - e. At cost of sales plus
 - f. At opportunity cost
2. Market price: Methods under this category are:
- a. At market price
 - b. At prorating of profit on the basis contribution margins
 - c. At a specific discount over market price
 - d. At dual prices i.e. transfer prices will be different from market prices. In this case the transferor division is allowed to record transfer at full cost plus mark-up whereas transferee division may be charged only marginal cost. In this scenario, both divisions show profits and accordingly performance is evaluated. The drawbacks of this method are:
 - Both divisions show profits that are artificial and not real.
 - It creates confusion while calculating the profits of company as a whole. Profits of respective divisions cannot be directly added.
 - Divisions do not compete effectively.
 - e. Two Part Pricing: Under this method, transfers are made at marginal cost with a lump sum fixed amount per annum covering fixed costs and mark-up of transferring division. This will enable the transferee division to obtain materials at marginal costs at higher volumes.

3. Negotiated price.

The adoption of a particular method of transfer pricing depends on respective circumstances and will change from time to time depending on the views of the management.

Question

Briefly explain the concept of goal congruence.

Answer

Divisions functioning as profit centers strive to achieve maximum divisional

profits, either by internal transfers or from outside purchase. This may not match with the organisation's objective of maximum overall profits. Divisions may be commercial to advice overall objectives, where divisional decisions are in line with the overall best for the company, and this is goal congruence. Divisions at a disadvantage may be given due weightage while appraising their performance. Goal incongruence defeats the purpose of divisional profit centre system.

Question

Indicate the possible disadvantages of treating divisions as profit centres.

Answer

The Possible disadvantages of treating divisions as profit centres are as follows:

1. Short Term Focus: Divisions may compete with each other and may take decisions to increase profits at the expense of other divisions thereby overemphasizing short term results.
2. Disharmony: It may adversely affect co-operation between the divisions and lead to lack of harmony in achieving organizational goals.
3. Reduction in profits: It may lead to reduction in the company's overall total profits.
4. Duplication: The cost of activities, which are common to all divisions, may be greater for decentralized structure than that for centralized structure. It may thus result in duplication of staff activities.
5. Loss of Control: Top management loses control by delegating decision making to divisional managers. There are risks of mistakes committed by the divisional managers which the top management may avoid.
6. Ineffective Control: Series of control reports prepared for several departments may not be effective from the point of view of top management.
7. Transfer Pricing Problem: It will result in under utilisation of corporate competence and will lead to complications associated with transfer pricing problems.
8. Identity: It becomes difficult to identify and define precisely suitable profit centres.
9. It confuses division's results with manager's performance.

Question

What should be the basis of transfer pricing, if unit variable cost and unit selling price are not constant?

Answer

If unit variable cost and unit selling price are not constant then the main problem that would arise while fixing the transfer price of a product would be determined in following manner:

Optimum level for company: There would be an optimum level of output for a firm as a whole. This is so because there is a certain level of output beyond which its net revenue will not rise. The ideal transfer price under these circumstances will be that which will motivate these managers to produce at this level of output.

Decision from company viewpoint: In certain cases, some divisions of the firm might have to produce its output at a level less than its full capacity or optimum capacity. In such cases a transfer price may be imposed centrally, considering overall company profitability.

Question

1. *What will be the marketable transfer pricing procedure regarding the goods transferred under the following conditions (each condition is independent of the other)?*
 - a. *When divisions are not captives of internal divisions and the divisions are free to do business both internally and externally and when there are reasonably competitive external markets for the transferred products.*
 - b. *If the external market for the transferred good is not reasonably competitive.*
2. *Discuss the potential for maximization of income by a multinational through the use of transfer pricing mechanism.*

Answer

The Marketable Transfer Pricing Procedure will be as under:

1. When divisions are not captives of internal decisions and the divisions are free to do business both internally and externally and when there are

reasonably competitive external markets for the transferred products, then the most suitable transfer price would be, the market price, as it generally leads to optimal decisions.

In case, the external market for the transferred good is not reasonably competitive, following two situations may arise in this case.

- a. *If there is idle capacity*: Under this situation opportunity cost will be zero hence minimum transfer price should be equal to the additional outlay costs incurred upto the point of transfer (sometimes approximated by variable costs).
 - b. *If there is no idle capacity*: Under this situation opportunity cost should be added to outlay costs for determining minimum transfer price.
2. The potential for maximization of income by a multinational through the use of transfer pricing mechanism is based on the successful implementation of the following steps:
- a. Transfer pricing may be set relatively higher for affiliates in relatively high tax countries that purchase inputs from affiliates located in relatively low-tax countries. However, to curb these sorts of practices, the GAAR (General Anti Avoidance Rules) have been framed in India thereby making organisations to transfer at Arm's Length Prices.
 - b. Transfer prices to affiliates in countries which are subject to import duties for goods or services purchase may be set low so as to avoid host country taxes.
 - c. Transfer prices to an affiliate in a country that is encountering relatively high inflation may be set relatively high to avoid some of the adverse effects of local currency devaluation that are related to the high inflation.
 - d. Transfer prices may be set high for goods and services purchased by an affiliate operating in a country that has imposed restriction on the repatriation of income to foreign companies.
 - e. Transfer prices may be set low for an affiliate that is trying to establish a competitive advantage over a local company either to break into a market or to establish a higher share of the company's business.



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