5 Job Costing in Service, Not For-Profit, And Governmental Environments

The last hundred-plus years have been remarkable. A primarily agriculture-based world economy gave way to the industrial revolution. This revolution took root and continues to sweep around the globe. Following the growth in manufacturing has been an even greater proliferation of support and service roles. Perhaps as few as 10% of workforce members are now actively producing a tangible end product.

5.1 The Service Sector

Most employees in the private sector are engaged in nonmanufacturing activities like accounting, sales, computing, and administration. New businesses have developed in the areas of law, healthcare, food services, electronic information delivery, transportation, entertainment, and others. The not-for-profit sector is increasing; consider the size and scope of educational institutions, hospitals, foundations, and so forth. And, not to be forgotten, is the size and scope of governmental entities. Cities provide services like municipal infrastructure, fire, police, water utilities, and code enforcement. State and provincial governments may provide for the educational system, highways, and prisons. At the federal level, governments may provide military, welfare, transportation, and countless other services. It is no wonder that most people work in a nonmanufacturing role.

The job costing model presented in this chapter is generally suggestive of the idea that a "job" can be identified as some tangible product. But, that is not necessarily the case. This chapter opened with an illustration for Castle Electric. If you think deeper about that example, you will realize that most of what Jack Castle provided to his customers was a "service." But, the utilization of job costing methodologies was still highly relevant. The cost of services, whether provided in the private sector, not-for-profit, or governmental arenas, must be determined with some reasonable degree of accuracy. The growth, indeed dominance, of these sectors of the economy underscores the need to extend costing methods beyond the traditional manufacturing setting.

The concept of a "job" gives way to more abstract connotations: "client," "surgical procedure," "seat mile," "student credit hour," "fire call," or other measure of output. Clearly, direct materials become a less significant part of the overall picture. But, overhead can take on heightened levels of importance. Perhaps you have experienced a costly hospital stay. The itemized billing that follows usually includes some shocking components (e.g., $5 for an aspirin). These prices cannot be justified based on direct material cost alone. Clearly, the hospital has tremendous and costly overhead. In addition, you don't just pop an aspirin in the hospital as you would at home. The pill must be administered, documented, and billed; efforts which consume expensive labor time.

If costing methods are not employed correctly, the organization may find that it has underestimated its costs of services. This can lead to financial failure. On the other hand, many will question the cost drivers and methods of allocations that are used in service type activities. For instance, a city may determine that the full cost of a fire department is several hundred thousand dollars per residential house fire. This type of job costing could lead one to conclude that a fire department is not cost effective. The problem with this approach is that it ignores that one fire would quickly spread to an entire city without a suppression action by the fire department. And, firefighters save countless lives for which there can be no rational economic measure. So, what is the actual "job" and how are costs to be assigned to that "job?" This measurement problem is pervasive and challenging in the service sector.

5.2 Capacity Utilization

The root of the problem is that traditional job costing allocates overhead based on the expected output. In contrast, it may sometimes make more sense to charge individual jobs based on full capacity utilization, provided a plan is in place to maintain the financial viability of the organization. Capacity utilization refers to the degree to which an organization's output capabilities are being deployed or utilized.

To illustrate this concept, assume that a local ambulance service was capable of providing 30,000 calls per year, but only expected to make 10,000 actual calls. If the overhead of the ambulance company was $30,000,000, the overhead allocation would be either $3,000 per call (based on estimated activity) or $1,000 per call (based on full capacity utilization). If the entity set customer charges based on the $3,000 amount, it might soon find that it generates fewer calls, because people opt not to utilize the service. In essence, a handful of actual patients are put in the position of paying for the ambulance service that is available to everyone. A more logical approach might be to cost the service based on the $1,000 figure, and then recover the additional cost by some form of tax or fee that falls on all potential patrons of the ambulance service (whether they use it or not during a given time period).

These capacity utilization and costing considerations are in play for all organizations, but they seem to present a particularly vexing problem for the service sector. As a general rule, when overhead is allocated based on full capacity rather than expected output, one can expect considerable underapplied overhead. Managers need to be keenly aware of this as they plot their ultimate financial strategies. Great care must be taken to avoid dysfunctional decisions based on erroneously high or low costing. There are many theories and methods, but none of them replace a savvy decision made by a well informed manager who understands the nuances of job costing.