

Costing of social care services

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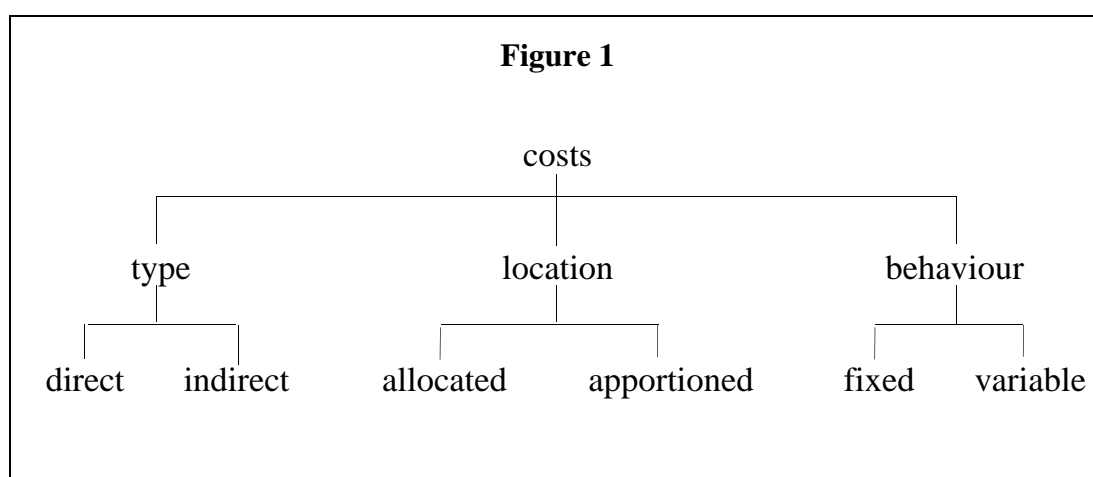
We would like to lead into this workshop discussion by briefly outlining some of the concepts which lie behind established costing techniques and considering their usefulness or appropriateness to a community care business.

Background

We begin by acknowledging that there is no such thing as the ‘definitive cost’ of anything, whether it be a service or a product or an event.

There is no such thing as the ‘cost’ of anything ... cost is what it is defined to be. [Chadwick and Magin, 1989]

Traditionally, costs have been classified along the following lines:



However, costing terms and abbreviations have been introduced over the years, which have tended to obscure the meaning of what they were setting out to measure or define. This brings us to the first unnecessary complication of costing – lack of accessibility for the lay reader.

Often, when we look at a set of cost data, terms are not defined, layout is fussily overcomplicated and we are left to decipher for ourselves what is, or is not, significant. The first plea is therefore to 'Keep It Simple!' If we need to use words or terms which are not in the Concise Oxford dictionary then let us at least add easily understood explanations for the uninitiated.

We also need to be very wary of over-simplistic classifications such as 'fixed costs' which are often not 'fixed' at all, or at least only fixed in the short term. Some 'fixed costs will vary with changes in output and others with changes in technology. A more accurate pattern for most organisations, of 'fixed' costs over a medium-term time period, is shown in Figure 2.

Figure 2 Fixed cost development patterns



Concepts

A quick glance through the literature reveals a wealth of costing methods to choose from. For example:

- Marginal costing, also known as 'variable costing'
- Absorption, otherwise known as 'full costing'
- Incremental costing
- Opportunity costing
- Transaction costing
- Activity Based Costing – ABC

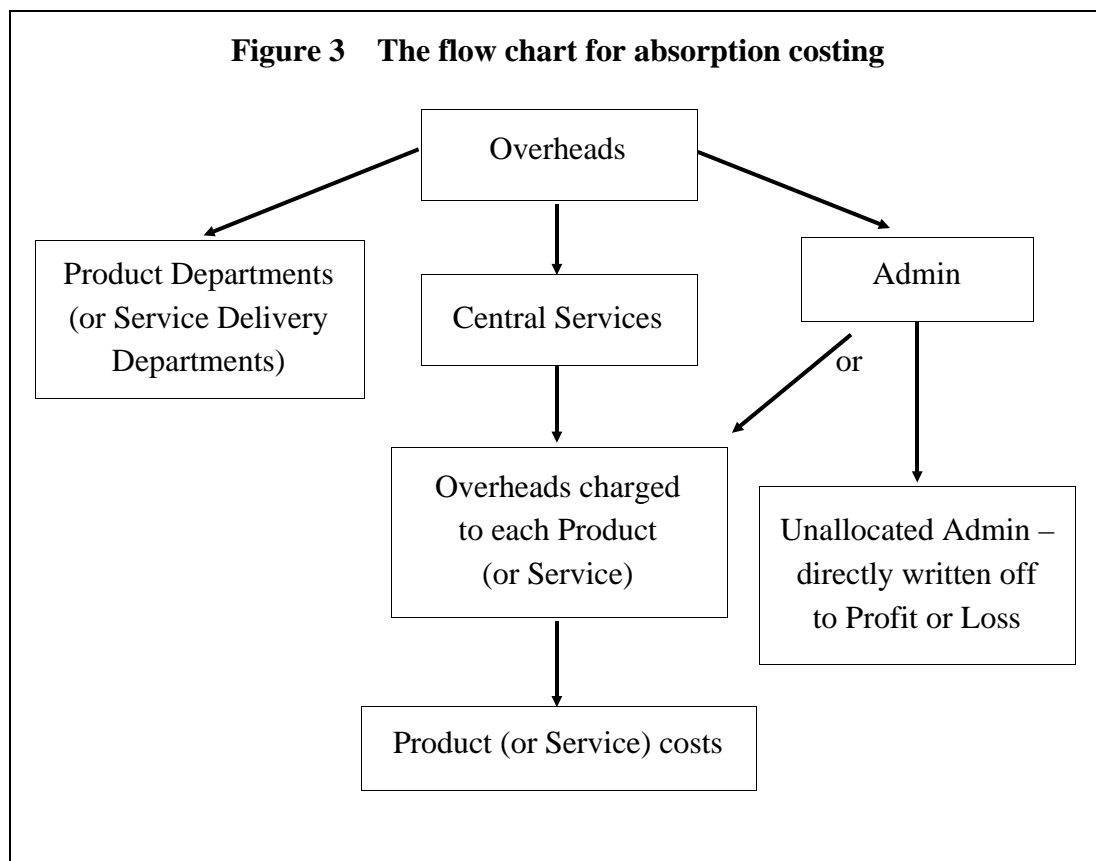
We propose to look at the first two and the last methods on the list. In doing so we are not trying to imply that other methods are not important.

Marginal costing attempts to separate variable costs from fixed costs. Having done so, it ascribes the variable costs to specific outputs. It treats the fixed costs as ‘period’ costs and writes them off to the period in which they are incurred.

In marginal costing:

$$\begin{aligned} \text{Sales minus variable costs} &= \text{contribution} \\ \text{and} \\ \text{Contribution minus fixed costs} &= \text{profit or loss} \\ &\quad (\text{surplus or shortfall}) \end{aligned}$$

Absorption costing attempts to allocate all, or most, of the overheads to cost centres and then absorbs these cost centres into the product or service costs, via some appropriate absorption rate.



In setting the absorption rates there is a need for several qualitative decisions to be made. The basis for each allocation has to be chosen and the charge-out-rate allocations for internal service departments need to be agreed by all concerned.

These two mainstay methods, marginal and absorption costing, use the same basic data, but they obviously produce completely different results.

Marginal costing is often chosen as a decision-making tool. Most people will be familiar with the conventional break-even chart which shows the points at which income moves through the fixed cost line and then through the variable costs, to reach profitability.

Absorption costs on the other hand are more often used for presenting results in formal reports and accounts.

Over the last few years *activity based costing (ABC)* has grown in importance as an alternative costing method and one which is sometimes felt to be more appropriate and conceptually satisfying.

Innes and Mitchell (1993) define ABC as a two-stage process:

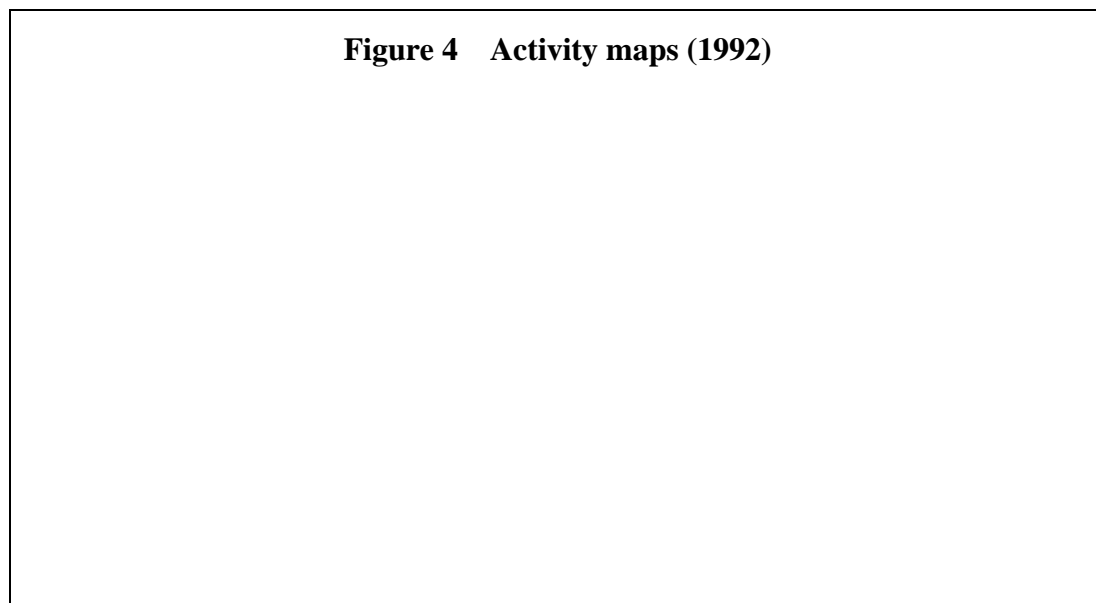
Stage 1

Involves the ‘pooling’ of overheads into different activities.-

Stage 2

Is the application of these ‘pools’ to products or services

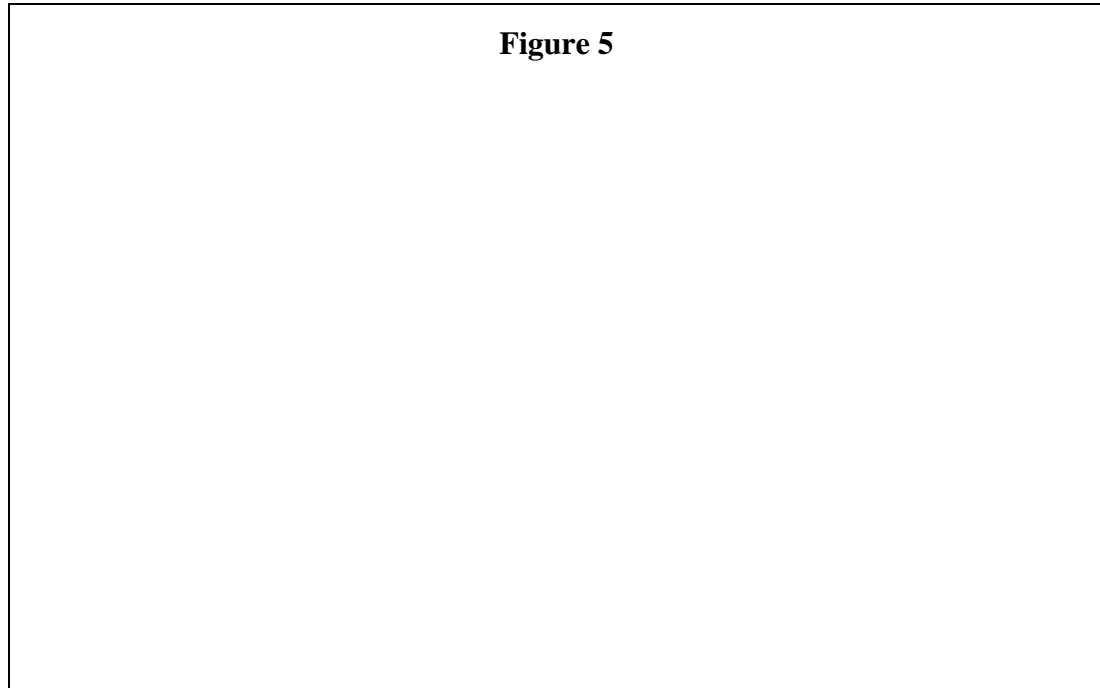
‘Activities’ do not follow the formal organisation chart, which is traditionally function based. Anyone setting out to use ABC needs to devote a fair amount of time to teasing out the fundamental activities of their organisation. In a complex organisation, the activity map will usually move across and through a large number of departments, as shown in Figure 4.



Activity headings which may emerge are, for example, quality control or contracts and purchasing. There is no preconceived activity list – this system depends above all on observation.

When the activity pools have been agreed and the appropriate costs of each activity gathered together, these cost pools are then allocated to products or services. This allocation is done through what are called ‘cost drivers’ – measures which are based upon the transactions underlying each activity.

Figure 5



ABC represents a fresh approach to costing which is said to reflect more accurately how resources are consumed. Insofar as it is a form of absorption costing it does give a good guide to long-term costs and there are examples from the private sector which have illustrated its capacity to reveal subsidised ‘products’ (Innes and Mitchell, 1993).

So far we have considered three types of costing methods which require us to make decisions about whether or not we should allocate overheads. We can choose whichever method we feel most closely reflects the business we are in and the decisions we are trying to reach. But many people are not familiar with costing method or theory. Their concern is about ‘costs’ under specific headings – the cost of x or y – by which they mean ‘how much will we have to pay for x or y?’

Let us consider some practical examples.

A department of a large organisation, sharing accommodation with other departments, wants to know how much it should allow for the cost of renting the space it occupies. There are complex formulae for determining rental costs in such circumstances, but a simple approach is to look at the problem from an opportunity cost perspective – what would it cost to rent (or buy) suitable equivalent accommodation? The answer would provide a

Figure 6 Graph of the rising costs of time-off and holidays and premium working rates

useful measure for rental. It would not, of course be a true picture of the costs to relocate; for that we would need to know the transaction costs involved.

The second example concerns a question often asked: ‘what are our staff costs per hour?’ The example in Figure 6 starts with a basic rate per hour, which we can call the flat rate, and shows how this will build up as an ‘effective rate’ per hour, with each additional on-cost or change in conditions of employment. Employers’ National Insurance, holiday pay, paid sickness entitlement and so on, can quickly increase the base rate by 40 per cent or more.

The appreciation by managers of such simple examples can go a long way towards minimising the dangers of taking figures at face value, particularly in the area of transfer pricing.

Transfer pricing

The growth of competitive tendering and the drive towards privatisation of services has put the art of comparative costing and transfer pricing under the microscope.

The objectives of transfer pricing are:

- to enable managers to make sound decisions;
- to produce reported results which are a reasonable measure of managerial performance;
- to ensure that departmental or divisional autonomy is not undermined.

Adelberg, writing in 1986, pointed out the need for four interrelated criteria in order to properly evaluate transfer pricing methods. They were *motivation, autonomy, performance evaluation and goal congruence*. The latter referred to actions which should be taken by ‘buyers’ and ‘sellers’ within an organisation that are suitable for their own departmental interests and at the same time in the interests of the organisation overall.

These seemingly straightforward concepts hide a minefield which is beyond the scope of this discussion. However, the point which we would wish to stress is that unless we have meaningful and relevant cost data we simply cannot place any faith in comparative analysis.

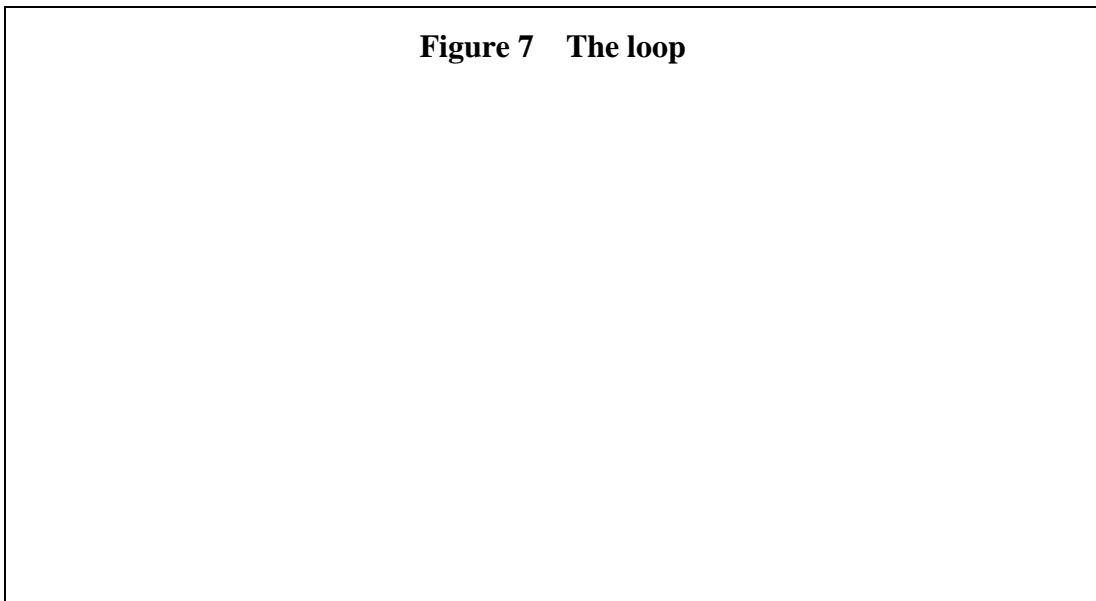
At a time when social services departments are talking about purchaser/provider splits and ‘buying in’ their in-house services, and when independent providers are having to trim their rates to compete in an ever-tightening market, then costing methods should be scrutinised carefully. Most accounting literature recommends that ‘current market price’ should be used as the transfer price equivalent, always assuming that a current market price exists for a particular stage. Great care should be taken with this bland recommendation. Current market price can often be an illusory and short-term yardstick.

Discussion

There are advantages and disadvantages for every system of costing we can name. There is no one system which is better than another and there is every reason to try to apply different systems to the same set of data.

Cost, price, demand and competition operate in a continuous interactive loop as illustrated in Figure 7.

Figure 7 The loop



It does seem that the concept of ABC has something to offer to the typical tightly-knit departmental structures of large complex organisations in both the public and independent sectors. Whether they are equally relevant to small-scale independent providers remains to be seen. ABC is nevertheless a form of absorption costing and the point of absorption costing is simply to make sure that all costs are covered. It is also a way of obtaining an accurate comparison with outside alternative suppliers.

Marginal costing might be a better guide to decision making, for example, on the effect of changes in volume on overall results. However, the reality of which costs are fixed and which are variable in a marginal costing model needs to be carefully assessed. Writing on this subject of contribution margin, Shank, 1990, said:

The contribution margin mentality will lead you to keep everything. It will lead you to add products, it will lead you to never drop anything, it will lead you to *always* make instead of buy.

Our conclusion is that there is room for a great deal of costing choice and experimentation in the area of community care. At the same time there is a need for more general education on costing and for greater clarity and easier access to cost information for staff at every level. One thing is certain – costing is too important to be left solely in the hands of our accountants.

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