I. **Appendix 11B: Service Department Charges** **(Slide #1 is a title slide)**

*Learning Objective 6: Charge operating departments for services provided by service departments.*

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A. Most large organizations have both **operating departments** and **service departments**. The central purposes of the organization are carried out in the operating departments. In contrast, service departments do not directly engage in operating activities. This appendix discusses **why** and **how** service department costs are allocated to operating departments.

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1. **Four reasons for allocating service department costs**
   * + 1. To encourage operating departments to **wisely use** service department resources.
       2. To provide operating departments with **more complete cost data** for making decisions.

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* + - 1. To help **measure the profitability** of operating departments.
      2. To create an **incentive** for service departments to operate efficiently.

ii. The service department charges considered in this appendix can be viewed as a **transfer price** that is charged for services provided by service departments to operating departments.

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#### B. Charging costs by behavior

1. Whenever possible, **variable and fixed service department costs should be charged separately** to provide more useful data for planning and control of departmental operations.

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1. A **variable cost** should be charged to consuming departments according to **whatever activity causes the incurrence of the cost**.

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1. A **fixed cost** should be allocated to consuming departments in predetermined **lump-sum amounts** that are based on either the department’s **peak-period** or **long-run average** servicing needs. Importantly, fixed cost allocations:

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1. Are based on the amount of **capacity** each consuming department requires.
2. **Should not vary** from period to period.

*Helpful Hint: Ask students why it is better to charge managers a lump sum for access to service departments rather than including a “markup” for fixed costs in the charge for the use of services. The answer is that if the charge for the use of services exceeds variable costs and excess capacity exists, managers will demand too little of the service from the standpoint of the company as a whole. This discussion can be used to reinforce ideas developed when covering transfer pricing.*

1. **Budgeted** variable and fixed service department costs (rather than **actual** costs) should be allocated to operating departments.

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1. Variable service department costs should be charged using a predetermined rate applied to the actual services consumed.
2. The lump-sum amount of fixed costs should be based on budgeted fixed costs, not actual fixed costs.

#### Sipco – an example

* + 1. Assuming the facts as shown with respect to Sipco, the **allocation of maintenance costs to the two operating departments would be as follows:**

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* + - 1. The **variable costs** would be allocated by multiplying the **budgeted variable rate** (**$0.60** per machine hour) by the **actual activity level** for each operating department.

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* + - 1. The **fixed costs** would be allocated by multiplying the **percent of peak-period capacity** for each operating department by the **budgeted amount of fixed costs** (**$200,000**).

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*Quick Check – allocating costs by behavior*

#### Pitfalls in allocating fixed costs

* + 1. Rather than charge fixed costs to using departments in predetermined lump-sum amounts, some companies allocate them using a **variable allocation base** that fluctuates from period to period.

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* + - 1. This is a pitfall because it creates a situation where the fixed costs allocated to one department **are heavily influenced by what happens in other departments**.
    1. **Sales dollars** is an example of a variable allocation base. It is a **poor choice** for an allocation base because sales dollars **fluctuate from period to period**, whereas the costs being allocated are often largely **fixed**.

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* + - 1. This creates a situation where the sales in one department will **influence** the service department costs allocated to another department.
    1. **Autos R Us – an example**
       1. Assume the facts as shown with respect to Autos R Us.

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* + - 1. The allocations of service department costs for **year one** are as shown. Notice:

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* + - * 1. The New Cars Department generated **50%** of total sales and was allocated **$40,000** of service department costs.
      1. The allocations of service department costs for **year** two are as shown. Notice:
         1. The New Cars Department **increased sales by $500,000** while the other departments’ sales remained **unchanged**.
         2. The allocation of service department costs to the New Cars Department increased by **$5,714** while it **decreased** in the other two departments.

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* + - * 1. The manager of the New Cars Department is likely to complain that as a result of his efforts to expand sales, he is being forced to **carry a larger share** of the service department costs.

*Helpful Hint: Ask students to suppose they are a division manager in a company that allocates fixed costs on the basis of actual sales. Ask if the fixed costs allocated to their division will depend on sales in other divisions. If they say yes, ask if this fair. There will probably be a chorus of no’s. Ask how this differs from grading on a curve. After some direction, they should conclude that if you do better on an exam than others, your grade will be higher and other students’ grade will be lower. However, if your sales increase relative to other divisions, the fixed costs allocated to you will increase and that allocated to other divisions will decrease.*