

Adsorption Costing or Full Costing

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Absorption Costing and the Measurement of Full Cost

Absorption costing, also known as full costing, can be defined as a method of accumulating all costs spent on the production of a particular product or service by taking into consideration both direct and indirect expenses. Under this method, all production costs are absorbed into the cost of the final product. These costs include direct raw materials, direct labor, variable overhead costs, and fixed overhead costs. In other words, absorption costing attempts to calculate the full cost of producing a good or delivering a service by including every major cost element involved in the production process.

The main purpose of absorption costing is to ensure that the price of a product reflects the complete cost of production. This is important because businesses need to know the real cost of making a product before deciding its selling price. For example, if a company only considers the cost of raw materials and direct labor but ignores rent, electricity, machinery depreciation, and supervision costs, the final price may be too low. This can lead to losses even when the product appears profitable. Therefore, absorption costing provides a broader and more complete picture of cost by including both fixed and variable production overheads.

Absorption costing is different from marginal costing. Marginal costing mainly focuses on variable costs. In marginal costing, only the variable cost of production is treated as part of the product cost, while fixed costs are charged against revenue for the period. Variable costs include direct materials, direct labor, direct expenses, and variable overheads. These costs change according to the level of output. For example, when more units are produced, more raw materials and labor may be required, so variable costs increase. When fewer units are produced, variable costs decrease. Therefore, marginal costing is useful for understanding how changes in production volume affect total cost and profit.

On the other hand, fixed costs remain constant within a certain range of activity, regardless of the number of units produced. Examples include rent, salaries of permanent staff, insurance, and depreciation of equipment. In absorption costing, fixed overheads are allocated to each unit produced, while in marginal costing, they are treated as period costs. This is why the two methods often produce different profit figures. Absorption costing may show a higher profit when inventory increases because some fixed overhead costs are carried forward in closing stock. Marginal costing, however, charges fixed costs immediately to the income statement, which may result in a different profit calculation.

Costing Methods and Managerial Decision Making

Different costing methods provide different values, which is why choosing the correct method is important. Absorption costing is useful when a business wants to know the full cost of production, especially for long-term pricing decisions. Marginal costing is useful for short-term decision-making, such as deciding whether to accept a special order, stop producing a product, or use limited resources more efficiently. Therefore, marginal costing should often be used alongside absorption costing rather than replacing it completely. Both methods provide valuable information, but they serve different purposes.

The issue of costing becomes even more complex in service organizations such as hospitals and healthcare systems. The provision of better healthcare at minimum cost is one of the major concerns in the National Health Service (NHS). Unlike manufacturing companies, hospitals do not produce simple physical products. Instead, they provide services that are often intangible, complex, and different from patient to patient. This makes costing more difficult because each patient may require different levels of care, different medical procedures, different staff involvement, and different resources.

Costing in the NHS can be challenging because most salaries, supplies, and services are spread across different departments. For example, a patient may receive care from doctors, nurses, laboratory staff, radiology departments, pharmacy units, and administrative staff. Each of these departments uses different resources, and the cost of these resources must be allocated properly. Some costs are direct and easy to identify, such as medical supplies used for a specific procedure or the salary cost of staff directly involved in patient care. Other costs are indirect, such as maintenance, administration, electricity, water, heating, and cleaning services. These indirect costs are necessary for running the hospital but are not always easy to assign to a specific patient or department.

Healthcare Cost Allocation and Service Pricing

The allocation method in healthcare costing is usually based on direct costs, indirect costs, and fixed expenses. Direct costs may include salaries of medical staff, medicines, surgical tools, and equipment used directly in treatment. Indirect costs may include administrative support, building maintenance, information systems, and general management. Fixed expenses such as electricity, water, rent, and equipment depreciation must also be considered. Absorption costing can be useful in this context because it attempts to include all these costs when calculating the full cost of healthcare services.

However, the use of absorption costing in healthcare also has limitations. Since healthcare services are highly variable, it can be difficult to decide how much fixed cost should be allocated to each patient or department. For example, two patients may be admitted to the same hospital, but one may require intensive care while the other may need only basic treatment. Allocating overhead costs fairly between these patients can be complicated. If the allocation method is inaccurate, it may lead to

misleading cost information and poor management decisions.

Labor cost is another important issue in healthcare costing. Hospitals are labor-intensive organizations because doctors, nurses, technicians, and support staff are essential for service delivery. There is increasing pressure to control labor costs, but appropriate costing of labor can be difficult. Some staff members work across different departments, while others may provide care to many patients in a single shift. This makes it difficult to calculate the exact labor cost attached to each service. Nevertheless, accurate labor costing is necessary for budgeting, planning, and resource allocation.

Marginal Costing and Hospital Resource Management

Marginal costing can also be useful in hospital management because it helps managers understand the variable cost of treating additional patients. For example, if a hospital already has fixed resources such as buildings, equipment, and permanent staff, the marginal cost of treating one additional patient may mainly include medicines, disposable supplies, and additional staff time. This information can help managers identify unproductive resources and make better decisions about utilization and distribution. Marginal costing can also support decisions about whether existing capacity is being used efficiently.

In the NHS, both absorption costing and marginal costing can support decision-making. Absorption costing helps managers understand the full cost of services and supports long-term planning, pricing, and budgeting. Marginal costing helps managers understand short-term cost behavior and the impact of changes in patient volume. Together, these methods can provide a more complete understanding of healthcare costs. Managers can then make better decisions about resource distribution, cost control, service improvement, and future planning. (Ellwood, 1995)

In conclusion, absorption costing or full costing is an important accounting method because it includes all direct and indirect costs involved in production or service delivery. It provides a complete view of cost by including direct materials, direct labor, variable overheads, and fixed overheads. Marginal costing, on the other hand, focuses mainly on variable costs and is useful for short-term decision-making. In complex service organizations such as the NHS, costing is difficult because healthcare services are intangible, resources are shared across departments, and patient needs vary. Therefore, both absorption costing and marginal costing are valuable tools for healthcare managers. When used properly, they can help improve cost control, resource utilization, and decision-making in public healthcare services. (Pyke, 1998)

References

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