

How Full Cost Recovery can have an impact on Third Sector Performance

Written by Karl George MBE (KgISS)

Introduction

Third Sector Organisations (TSO's) have an important role to play in the drive to improve public service delivery. The government has declared a commitment to increasing the role of the third sector in public services. However both TSO's and the government have noted that their relationship is not as effective as it might be. Funding processes having been a particular stumbling block¹. Finances will always be a critical aspect of the efficiency, longevity and performance of an organisation.

One way of translating high level commitments into practical applications is the process of reimbursing the full costs of service delivery. Indeed the National Council for Voluntary Organisations (NCVO) published its own report² and a key recommendation was to operate the principle of full cost recovery.

So what is full cost recovery? Before we take a look at the concept it would be useful to consider some of the fundamentals of cost accounting.

Cost Classification

A fundamental part of any cost accounting system is that it is able to provide accurate, timely and reliable costs for the organisation. TSO's are no exception and calculating the costs of services rendered is crucial to the effective running of the organisation but it is not straight forward. Let us take for example the central function costs of an organisation how do we accurately allocate a proportion of these costs to the various projects that they deliver? Understanding how to analyse costs and allocate them by referring to how they behave will help in maximising organisational efficiency. Whether the information relates to a particular

¹ National Audit Office – Home Office Working with the Third Sector – June 2005

² Shared Aspirations – The Role of the Voluntary and Community Sector in Improving the Funding Relationships with Government – June 2005

cost centre i.e. division, activity, project or department, the better the cost allocation, the better the analysis of the section identified.

A recent case with one of my clients illustrates how important this can be. The local authority carried out their routine audit of the accounts and after their standard queries, was not happy with the explanations for the allocation of costs. Because the organisation had not kept accurate records of the various costs that were accumulated and subsequently how they were allocated they were not able to answer the queries. The result was suspension of their income until the matters had been resolved. This led to serious implications with cash flow.

The first step then in the process of cost accounting is clarifying costs. A simple illustration of cost allocation is the bill you receive having taken your car to be serviced. The final bill may include the parts that were used in carrying out the service perhaps replacements for faulty parts, there may be a charge for the person(s) who actually carried out the work and you may also find a final element which is a proportion of the premises costs. When these are added together they provide the final bill. The table below shows some methods of classifying costs and some common examples.

Classification of Costs

| Classification | Example |
|------------------|--|
| Functional Costs | Manufacturing Operations Finance & Administration Sales & Marketing Research & Development Human Resources |
| Direct Costs | Expenditure can be directly identified with a specific unit. Materials that go directly in a product (The expenses that go directly to producing a particular project – the hiring of a consultant) |
| Prime Costs | Aggregate of direct materials, direct labour costs and direct expenses |
| Indirect Costs | Expenditure that cannot be directly identified with a specific unit. You must therefore try to share it on a reasonable basis. (General expenses like rent, light and heat, administration and marketing costs) |
| Product Costs | The costs of making or buying a stock item |
| Fixed Costs | Costs not affected by the level of activity. (The rent paid is fixed regardless of the number of employees or number of units produced) |
| Variable Costs | Costs which change in direct proportion to the level of activity. (Delegate packs for each delegate on a course) |
| Semi Variable | Display both fixed and variable elements. (A phone bill with standard line rental and variable costs for each call) |
| Avoidable | Costs that can be eliminated by changing your course of action. (Don't need a surveyor if you are not going to extend your building) |
| Unavoidable | Costs which will not change by changing course of action. (Paying for feasibility studies to determine the way forward) |

Cost Behaviour

The ways in which costs behave are an important part of how decisions are made about how to allocate them. To make the best decisions it is important to consider how costs will change as a result of the decisions made. The classification methods already discussed will help in determining how costs behave. We can consider costs to be entirely fixed, entirely variable or an element of both.

When preparing budgets, trying to control costs or simply reporting on historical activity this understanding of the cost behaviour will be a crucial aid. So what are some of the factors that affect cost behaviour?

Many costs are affected by the volume of activity. The greater the volume the greater the cost, but if I were attempting to derive what was driving the cost I would be careful to identify the correct activity. For example do my selling costs vary with the volume of my sales? I may pay a sales company for each delegate booked on my training course. Or are my selling costs affected by the value of sales I may have to pay a licence fee each time I deliver a

course based on the sales value. The nature of a cost may also determine how it will be treated. Is it a one-off annual audit of systems and process hence a fixed cost or a variable cost since the audit will be carried out each time there is a new client.

Cost Centres

Before we can allocate our costs we will have to find a home for them. A cost centre is an area of the organisation where costs can be gathered. The Association of Chief Executives of Voluntary Organisations in Partnership with New Philanthropy Capital has produced a useful programme to workout full cost recovery for TSO's. The suggested breakdowns used are as follows.

Premises and Office Costs (Rent, Maintenance, Utilities, Furniture, Computers etc)

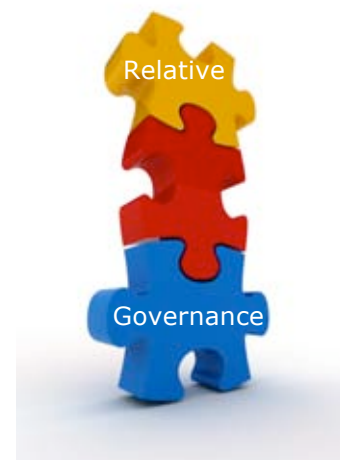
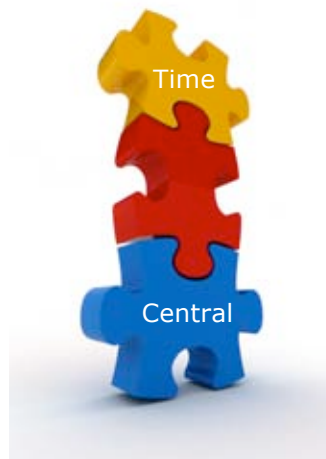
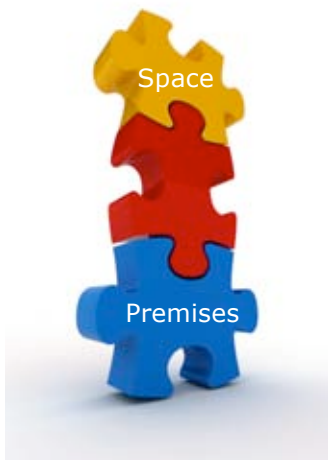
Central Function Costs (Finances & Admin, IT, Telephone, HR, Director etc)

Governance and Strategic Development Costs (Audit, Legal & Professional, Consultancy etc)

General Fundraising Costs (Fundraising, Marketing, Publicity etc)

Cost Allocation

Each organisation will try to find the best way to charge each item of cost to a cost centre. All overheads should be charged in full and costs can be built up for each cost centre. Cost allocation is a way of sharing the costs on a reasonable basis.



Conclusion

Funders should recognise that it is legitimate for providers to include the relevant element of overheads in their cost estimates³.

Full cost recovery is simply recovering all of the costs associated with delivering the services that an organisation delivers. This will not only include the direct costs but all the overheads. Let's look at the benefits of full cost recovery by using the **FUNDS** acronym.

FUNDING – The funding of an organisation should be determined by looking at the full costs of projects not just the direct costs to work towards more sustainable entities.

UNDERSTANDING – By carrying out the full cost recovery exercise doesn't mean all costs will be recovered but it will be a useful aid in understanding and comparing available funding proposals.

NEGOTIATE – A major advantage is the ability to negotiate with funders by having the relevant information about how costs have been derived.

DECIDE – Ultimately the decisions on whether to accept certain projects or tender for certain funds can be made with clarity.

SKILLS – Any tool that helps to develop the understanding of cost allocation and drivers of costs aids the development and management of the organization.

³ HM Treasury 2002 – Role of the Voluntary and Community Sector in Service Delivery, A Cross Cutting Review