

# Full cost recovery

*Many organisations in the voluntary and community sector struggle to make ends meet, especially in relation to funding overhead costs.*

These two lists demonstrate how recovering the full cost of delivering your services can help you cope with some of the financial pressures impacting on your organisation. This means full cost recovery is a tool you can use with the others to help your organisation become more financially sustainable.

## Key financial pressures

- Economic recession
- Reduction and competition for funds
- Failure to recover core costs
- Supporting statutory services with voluntary income

## Solutions

- Raise voluntary income
- Improve operational efficiency
- Cost reduction
- **Full cost recovery**

## Introduction to full cost recovery – some definitions

Broadly speaking there are two types of costs within organisations: direct and indirect (or overhead) costs.

- Direct costs are costs incurred as a direct result of carrying out a particular activity.
- Indirect costs are shared organisational costs which are difficult to apportion to a specific project or activity.

In most cases, it is possible to identify accurately the direct costs of a project or service. What is less clear is how to identify indirect costs and what share of these costs that should be allocated to the end product or service.

The process of sharing out the indirect costs among a number of products or services is called 'overhead absorption' or 'overhead recovery'. It can be a very arbitrary process; for example how much of an office worker's salary should be allocated to each service or product? It may be easier to simply to divide the total salary cost by the number of projects served, but this may not reflect the true cost of serving a project or product. It is essential that any funding for projects should cover the general overheads apportioned to those projects. Trying to allocate a fair proportion of overheads to each contract or service in this way is often referred to as full cost recovery.

## **What are the benefits of full cost recovery?**

Not only do organisations know the true level of funding they require, full cost recovery also provides a clear picture of how an activity will impact on the organisation, leading to better-informed decision-making.

### **Benefits**

By understanding the full costs of a project you can make better informed decisions on which projects you run, and how you will fund them. This is beneficial in a number of ways:

- If you are seeking grant funding you will know the exact amount you need to ask for.
- If you are applying to deliver a service for which there is a defined price you will be able to compare the funds available with your full costs of delivering that service.
- If you are in a competitive bidding situation it will help you decide if you want to bid, and at what level.

Where the funding available is below your full costs you can take an informed decision on whether to run the activity anyway knowing the exact level of subsidy that will be required from your organisation's unrestricted funds.

### **Implications of not understanding full costs**

Unstable community and voluntary organisations, skimping on their overhead costs, are not safe places for important activity. Planning for the future can become sidelined to make ends meet and the quality and longevity of services are put at risk.

ACEVO's Funding our Future: Core Costs Revisited identified key threats to:

#### **Sustainability**

Activities are in danger of taking place in organisations that have no long-term future, thus threatening the very activity itself.

#### **Good management**

Activities are likely to be managed less well than both the funder and the funded would like, because:

- The current regime is expensive. Seeking replacement funding is a capacity draining exercise. Also, when organisations lose staff as projects come to an end there is a need to re-recruit. This is costly and can lower overall staff morale.
- It does not encourage transparency; instead it encourages the complex and sometimes contrived renaming of activities and restructuring, even superficial reinvention, of organisations in pursuit of funding.

### **Public support**

The current climate risks public sympathy. It is dangerous to rely on unrestricted, donated income to meet backroom costs.

### **Innovation**

There will be a shortfall in innovation and development as voluntary organisations lack the resources to plan effectively for the future.

### **Independence**

Voluntary organisations will lose the ability to govern their own destiny, becoming funder led by devising projects simply to meet funding available.

### **Full cost recovery and the Compact**

A service should be priced and funded fairly. If an organisation can't recover its full costs then it has to use its other resources, often limited reserves, to subsidise the funding. Every time an organisation is not funded on the basis of full cost recovery it is a real risk to their long-term sustainability.

Funding on the basis of full cost recovery has been embedded as best practice.

Charity Commission guidance states that trustees have a duty to use charity assets as effectively as possible: *“Charities should always aim to recover the full cost of delivering services for public authorities, including administrative and overhead or ‘core’ costs.”*

The Compact, an agreement between government and the voluntary and community sector on how to work together better, states that the government should undertake to:

*“Recognise that when civil society organisations apply for a grant they can include appropriate and relevant overheads, including the costs associated with training and volunteer involvement.”*

## **Understanding your costs base**

It can take a while to work out what your costs are and then even longer trying to decide if the figure is good or bad.

### **Common costing practices**

- The most widespread practice is to add a fixed percentage, such as 10%, onto direct costs to cover overheads.
- Another is marginal cost funding where only the additional costs of running a project or service are funded.

- Often as much as organisations feel that funders will tolerate.
- Arbitrary prices that have no grounding in reality.
- Or, as an extreme: "we could always stop using the telephone or not take insurance!"

### **Types of overhead cost**

Overhead costs are not merely 'administration' costs that can be dispensed with: they are real costs associated with delivering the project effectively. Without overhead costs, it would be impossible to accomplish the organisation's programmes and, in order to protect the long term viability of the organisation, it may be essential to refuse some projects if the funder is too intransigent about contributing to overheads.

The following items are typical core or overhead costs:

- Fundraising
- Strategic direction
- Research and development
- Equipment
- Training
- Insurance
- Finance
- CEO
- Postage
- Premises
- Telephone
- Secretarial support
- Travel
- Recruitment
- Information and communications technology
- Human resources

It can be difficult to judge what a high overhead is, for example Mark Salway, Finance Director at CARE International, benchmarked five children's charities and found that overheads ranged from 8% to 31%. He commented that is difficult to ascertain whether 31% is high if, for instance, this is as a result of good quality social workers. CARE International itself aims to keep its overheads below 10% of programme delivery costs.

ACEVO's Funding Our Future II: Understand and allocate core costs explains why these overhead costs are necessary. Reasons include:

### **Compliance with regulatory bodies**

Voluntary organisations are obliged to comply with complex and sometimes overlapping regulations. Compliance is unavoidable yet costly - in terms of professional fees to legal and financial advisers, staff time, and preventing trustees from doing other, strategic and developmental work.

### **Income generation**

The cost of fundraising and of monitoring and evaluation, or of selling goods and services under contract, must be met by staff and often, in smaller organisations, the chief executive, reducing their capacity for other work. The short-term nature of funding is also costly, forcing organisations to seek replacement funding and often undergo expensive staff recruitment at the beginning of each funding cycle.

### **Support services**

The costs related to support staff, management, premises and equipment. Voluntary organisations have traditionally economised in this area but paring the costs of the plant can be counterproductive in any organisation: short-term savings, particularly in Information and Communications Technology (ICT), can damage long-term efficiency.

### **Responding to consultation**

The community and voluntary sector has largely welcomed the advent of greater opportunities to comment on government policy proposals and join task forces. Time spent doing this costs money however - whilst the cost of not taking part can also be high. Very few organisations that wish to hear the views of the sector are willing or able to absorb this consultation cost.

### **Governance, representation and user engagement**

Service-user involvement and an engaged trustee board are hallmarks of an open, learning organisation. But supporting the systems of representation and governance carries costs; whilst economising on such systems can lead to a greater non-monetary price being paid later on in the lifecycle.

### **Innovation and quality**

Voluntary organisations are involved in dealing with some of the most intractable and complex social issues. They need every ounce of creativity and skill. Yet a lack of appropriate funding prevents them from fully exploring new approaches to their work and from concentrating the necessary time on developing existing services.

Understanding the full costs of projects, or services, may not result in full cost recovery every time. However, calculating the full costs means you know the exact level of funding you will require. It will also give you a clear picture of how a particular project draws on the shared resources of your organisation.

## Cost allocation and putting full cost recovery into practice examples

In order to complete costing calculations, and establish an appropriate level of overheads for a project, we must first understand how to divide a cost used by one or more projects. This is called cost allocation.

Costs could be divided amongst different projects in a variety of ways:

- Headcount
- Time
- Floor space, or
- Expenditure

Essentially it does not matter how you choose to allocate costs as long as your cost 'drivers' e.g. floor space, time or headcount, are logical and clear. Much of the discussion with funders may centre on the appropriate basis for cost allocation. In fact, some funders will only allow certain bases and not others e.g. European Funding is almost entirely headcount based.

For example:

### Cost allocation

A hospice runs a drop in counselling centre and safe shelter for young adults sleeping rough. No other services are run from the building and these services occupy distinct and separate parts of the same building. Both services use electricity from the same bill and a social worker is on hand to provide counselling across both projects.

In order to appropriately cost the counselling centre project we would need to allocate a fair proportion of electricity usage and the social worker's costs.

Identify appropriate cost drivers for

- Electricity
- Social worker's costs

Imagine then that the total direct project costs for the counselling centre are £50,000 per annum, the electricity bill is an additional £1,000 and the social workers' wage plus National Insurance Contribution (NIC) and Pension contributions (in addition to the direct project costs) are an additional £25,000.

If the counselling centre takes 25% of floor area at the hospice, and the social worker spends 50% of her time on the counselling, then the appropriate full costs for the service (including an appropriate level of overheads) is:

<b>Costs</b>	£
Project costs	50,000
Overhead cost allocation	
Electricity bill 25% *£1,000	250
Social worker 50% *£25,000	12,500
<b>Project costs</b>	<b><u>62,750</u></b>

### Using the full cost recovery model

How this model be used to complete full cost recovery and ensure we receive a fair proportion of overheads for a project.

For example:

The Hospice in this example has a Board of Trustees, Director, Book-Keeper and general office administrator. These are overhead costs that cannot be directly identified with the counselling centre but without which the centre could not run. They all occupy the same building as the counselling centre and the only other project – the safe shelter project.

The direct costs of the counselling service has been previously identified as £62,750, including the electricity cost for the centre, and the cost for the social worker's time.

The costs for the additional items are as follows:

<b>Cost</b>	<b>£</b>
Board of Trustees	2,000
Director (including cost of NIC and pensions)	40,000
Book-Keeper (part-time)	12,000
Office Administration (including NIC)	15,000
All other overheads	75,000

Overall the counselling centre occupies 15% of the Director's time. The governance and strategic development costs for the centre are those represented by 30% of the Board of Trustees.

The safe shelter project costs (including electricity and remaining social worker costs) are £188,250 and there are no other services provided from the building.

In order to identify the full costs for the project we will have to allocate a proportion of all overhead and all overheads to the counselling centre, by:

Using our model we have the following structure:

- Direct costs
- Support costs
- Governance and strategic development costs

### **Step 1: Calculate direct costs**

Direct costs are as previously established in Example 1: £62,750

### **Step 2: Calculate support costs**

Support costs are 15% of the Director's time plus a proportion of other indirect costs (excluding Trustees).

We lack a basis to calculate the appropriate cost allocation for the Book-Keeper, Office Administration and 'All other overheads'. Our best approximation will be project expenditure and it is this which we use as a default.

In this case the counselling centre takes 25% of all costs i.e. Centre cost as a proportion of all project costs =  $\frac{£62,750}{£188,250 + £62,750}$

Calculating the support costs then becomes:

<b>Cost</b>	<b>£</b>
Director's time is 15% * 40,000	6,000
Book-keeper 25% * 12,000	3,000
Office Administrator 25% * 15,000	3,750
All other overheads 25% * 75,000	18,750
<b>Total support costs</b>	<b>31,500</b>



Governance and strategic development costs for this project alone are represented by 30% of the costs for the Board of Trustees.

This figure is  $30\% * £2,000 = £600$

Therefore the total overall project cost for the counselling centre is as follows

<b>Cost</b>	<b>£</b>
Direct cost	62,750
Support costs	31,500
Governance and strategic development costs	600
<b>Total costs</b>	<b>94,850</b>

### **Summary**

In order to ensure full cost recovery you need to complete a two-step process:

1. Account for all costs – Ensure that no costs are omitted and that you have appropriate information e.g. budgets and forecasts, with which to cost the project.
2. Allocate costs – Ensure that costs are allocated within a framework to appropriately cost direct project costs, support costs and governance and development costs, including a fair proportion of overheads.

The cost allocation method used must be consistent with prior years and transparent such that open communication between funder and funded can be completed to ensure an appropriate level of overheads are funded.

Many organisations that have adopted a full cost approach have found that the true cost of providing a service or activity is greater than the funding being offered. This information enables the organisation's managers to be more assertive when negotiating with funders or taking the strategic decisions to subsidise and/or fundraise to cover the loss.

### **Competitive bidding**

Many charities are bidding for work in a competitive environment, ensuring full cost recovery is just as important. By understanding costs a charity will be able to calculate an appropriate cost for the bid including a fair proportion of overheads. A decision can then be taken to bid to receive a surplus or deficit throughout the life of the contract.

If the funding available is less than your cost of delivery, you have to make a choice:

- Either don't do the work, or
- Fund the difference from another source.

Full cost recovery will help establish appropriate costs for the service and decide a strategic approach to bidding.

The cost allocation model shown in this section can also be used to allocate costs into the Statement of Recommended Practice (SORP 2005) categories. By appropriately allocating costs and ensuring full cost recovery for projects a Charity is better able to define:

- Costs of charitable activities (including support costs)
- Governance costs; and
- Costs of generating funds (including support costs).

This will provide a consistent model by which costs can be allocated within the statutory accounts.

### **Failing to recover overheads: an example**

In some cases, growing organisations fail to claim for the overheads that they are due on contracts. This may be due to lack of skills to calculate overheads correctly, or the want to grow their market share by undercutting other organisations – or it could simply be due to pure negligence.

Alternatively the organisation may have relied on an unrestricted core grant to get it established and now has no other diversified streams of income.

In extreme cases, existing overheads may be subsidised from new contract wins as growth occurs. As the organisation then heads towards 'steady state' this may lead to cashflow problems as they are unable to support overhead costs, now needing a larger amount of overheads to support itself than is being recovered on the contracts. This example explores this.

### **Swimmers of the World**

The charity Swimmers of the World provides grants to help build swimming pools round the world. They have expanded rapidly as various countries have used their services to build pools and have now been asked to set up lifesaving training courses by the FCO (Foreign and Commonwealth Office). They estimate that the direct costs for the training costs will be roughly £1 million per annum.

The overheads of the charity (including strategic development and governance costs) are budgeted as £0.5 million. This is 42% of all costs (not unusual for a small rapidly growing multi-country organisation).

A contract with the Department for International Development (DFID) provides £1 million (71%) of all income – a 30% (£0.3 million) overhead charge is taken by Swimmers of the World from this contract for overheads. There is no further income or expenditure other than that shown below. Reserves are £2 million, of which £1.95 million are fixed assets as physical swimming pools round the world.

The charity has been asked to bid for a new contract for lifesaving training courses from the FCO and the chief executive says that Swimmers of the World should put in for no more than 10% overheads – as that is all they will pay. As Finance Director you feel unhappy with this.

The budgeted breakdown of income and costs appears as follows for the next year:

<b>Income</b>	£	£
Core grant from Sport UK (unrestricted)	0.40	
Grant – DFID	1.00	
		1.40
<b>Expenditure</b>		
Accountable grant – direct costs of DFID grant	(0.70)	
Support costs	(0.40)	
Strategic development and governance costs	(0.10)	
		(1.20)
<b>Income less than expenditure</b>		
<b>Reserves as:</b>		<b>2.00</b>
Fixed assets	1.95	
General assets	0.5	

- What would you think about before bidding for the new FCO lifesaving contract (financial and operational)?

The key thing here is operational. Does the charity have the skills to undertake training contracts when it is used to building swimming pools? So many organisations fail to stick to what they are good at, and compromise against their core business as they see the 'money' not the delivery.

Does the organisation have the admin systems and resources to take on this contract? Is the cashflow sufficient? Many contracts are paid in arrears, and this could eat into reserves. Why do we maintain such large overhead costs – could these be reduced or made more efficient?

On the financial front – how do we equitably allocate costs to each project, specifically as we now have a large step-change in funding?

There are many more answers, all sensible... just remember you don't need to do any numbers to answer this question.

- If all grant income was restricted and any underspend due to be paid back to donors – how would this change the financial position of the charity before taking on the new contract?

The income and expenditure then becomes:

<b>Income</b>	Restricted £m	Unrestricted £m
Grant - DFID	0.70	0.30
	0.70	0.30
<b>Expenditure</b>		
Accountable grants - direct costs of DIFI grant	(0.70)	
Support costs	-	(0.40)
Strategic developemnt and governance costs	-	(0.10)
		(0.50)
<b>Income less that expenditure</b>	<b>0.00</b>	<b>(0.20)</b>
<b>Reserves B/F</b>		<b>0.05</b>
<b>Reserves C/F</b>		<b>(0.15)</b>

The loss of core grant from Sport UK means that the organisation can no longer cover its overheads and reserves and now negative and trading insolvently.

The question then becomes, can the new grant cover the loss in overhead recovery?

- Would you take the new contract or not?

The question then becomes, do you take the new contract or not and if so how much overhead to apportion to it?

If the core grant comes to an end because of quality issues then there are real problems – basically the organisation may not survive. Concentrating the charity on quality must come first before the charity can start to undertake new work. When is the core grant due to end?

If you don't take the new contract, you may have to cut costs. Equally you may have no charity if the DFID contract finishes as all your eggs are in one basket. It depends on the DFID contract and the allowable level of overhead recovery on this.

If you do take the new FCO contract you must be careful to cover overheads, absorb any new resource requirements and find an overhead rate acceptable to your donors.

One thing that is certain is that it is going to take a recovery rate greater than 10%. If you say no to the CEO and no to the grant this could seriously impact on the volume of work of the organisation.

Increasingly organisations are bottling their negotiations and just going for 10% recovery. In this scenario they would then end up in financial difficulties when either the core grant goes from Sport UK or the DFID contract finishes.

## **Full Cost Recovery Template – ACEVO and New Philanthropy Capital**

This page provides an introduction to the publication Full Cost Recovery: A guide and toolkit on cost allocation developed by New Philanthropy Capital and ACEVO. At its heart is a template that provides organisations with a method for understanding and calculating the full costs of projects, activities or services.

### **An introduction to the template**

- Provides a basis for organisations to cost a single activity, output or project.
- Calculates cost on the basis of average cost.
- Provides a framework to allocate costs.
- Illustrates how overhead costs.
- Does not prescribe levels of management overheads.
- Adheres to the principles behind the Chartered Institute of Public Finance and Accounting (CIPFA) guidance on best value accounting for local authorities.

As the template becomes widely used cross the sector, it will help organisations understand their costs - a process which will progressively undermine the idea that overhead costs are somehow separate from other costs.

Ultimately voluntary organisations must move wholesale to a system of average costing as the only sustainable basis for the sector in the long term. But this requires organisations to fully understand their costs - and to review them regularly and critically.

The template will help you to:

- Analyse and count costs
- Review costs, particularly overhead costs
- Allocate costs appropriately
- Fund costs.

### **How the template works**

The template helps you calculate the full costs of a project or service using the following process:

- Calculate the direct costs of the project or service.
- Calculate the total overhead costs for the whole organisation.
- Allocate a relevant share of each overhead cost to the project using a defensible method (cost driver).

Whilst use of the template will help organisations to understand their costs, it is then up to those organisations if they choose to show the results to funders in order to facilitate dialogue - there is no suggestion of compulsion.

It is also essential to grasp that the guide does not suggest appropriate levels of costs - it is a tool to help organisations document and allocate costs not an instruction on the levels of what those costs should be.

While not suggesting an appropriate level of costs the guide does look at types of cost. It suggests that organisations should include non-cash costs such as imputed rent on buildings which are owned by the charity and used in project delivery, and the cost of depreciation of equipment used in the delivery of particular outputs.

It also suggests that general, as well as direct, fundraising costs are apportioned to specific projects where necessary and suggests how this can be achieved. It's created as a tool rather than an instruction.

### **Principles behind the template**

#### **Cost drivers and cost allocation**

Central to the template's method is the concept of 'cost drivers', which are used to allocate costs.

A cost driver is a factor that affects total costs; i.e. causes them to increase or decrease, and which can therefore be used to determine a change in costs. For example, an organisation's premise and office costs are likely to be determined by the number of staff, as the number of staff increase so do the premise and office costs.

### **Average versus marginal costing**

Project costs can be calculated using either marginal costs or average costs.

- Average cost is the total cost of all services split by some determinant. For example, in a hospice the average cost would be all the total costs of running the hospice split by the number of beds.
- The marginal cost of an activity is only the additional cost incurred as a result of taking on that activity. For example, the marginal cost of an extra bed in a hospice would only be the cost of a bed, food and any additional nursing. The marginal cost does not include an appropriate share of overhead costs which is why the template uses average cost.

Average costs are likely to be higher as it includes more elements and establish the true 'unit cost' of a particular product. Average costs also have the advantage of closely approximating the costs, which could be saved in the long run if an organisation ceased one of its activities, which enables organisations to take more informed decisions.

Many organisations have been expanding their services on the basis of marginal costs, ignoring the growing strain on overheads. Using marginal cost means that many costs are mistakenly ignored resulting in a distorted cost structure. It also establishes a culture in both providers and purchasers (funded and funders) that this is an acceptable way of approaching funding. Marginal costing may be acceptable if the service is only to be delivered for a time-limited period or if it forms a very small part of the organisational whole. However it is clear that in the majority of cases it is detrimental to building strong, sustainable organisations.

Average costing provides a more complete picture of all costs involved in delivering the total outputs of the organisation and will lead to negotiations with funders that start from a much better knowledge base. In the current environment, funders often try to argue that they should pay only marginal costs (or make only limited contributions to overheads) and that the work they are funding should be sustainable and ongoing. This combination is unacceptable and has resulted in organisations persistently subsidising the provision of services - a problem exacerbated by organisations' lack of understanding of their costs.

### **Double funding**

Funders are keen to avoid double funding and some, such as public sector funders, are legally prohibited from doing so. A common concern is that where funders are contributing to overhead costs they will end up paying for other projects and thereby duplicate funds from other sources.

In the private sector, average cost is accepted as the basis for pricing and no subsidy is deemed to have occurred if prices are set equal to average price. This is an important consideration because it:

- Establishes that the voluntary sector is placed in a more demanding situation than private companies, and
- If an organisation has calculated and clearly communicated the average cost of an output and seeks funding on that basis, no funder should claim on any reasonable grounds to be subsidising other areas of work.

The template can help organisations understand, calculate and demonstrate what the full costs of an individual project, service, or activity are. Where part-funding has already been received, organisations will be able to demonstrate this ensuring that concerns over double funding will no longer exist.

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