

Basic Principles in Costing and Pricing Social Services



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Introduction

With new challenges in financial management facing the social service sector in Western Australia this paper attempts to provide some clarification around the concepts associated with costing and pricing of services. In essence the paper has two primary objectives, firstly to work through some of the jargon associated with costing and pricing by offering, and in some cases prescribing, a series of basic definitions and explanations related to the new social service procurement regime. Secondly, the paper aims to identify how costing and pricing sits within a broader financial management system - without overly complicating it or requiring material change to generally accepted processes.

Whilst some examples of modelling approaches are included, this paper is not designed to provide a distinct costing and pricing model as such. Don't go any further if you wanted a step-by-step guide to filling an empty spreadsheet. We're more interested in laying the groundwork with some basic concepts to ensure those of you yet to be burdened with an accounting degree have a chance of moving through funding applications and associated financial reporting with a modicum of reassurance you're on the right path.

Along the way we'll need to juggle some minor technical issues, but we'll be trying hard to stay within the realms of plain English as we touch on areas such as (very) basic accounting theory, Activity-based-costing, Cost Models and the Standard Chart of Accounts - all with a view to going some way to demystifying some of the financial management process.

Who am I and why am I here?

The paper is primarily aimed at those managers in the not-for-profit sector responsible for small-to-medium sized organisations or projects, with minimal knowledge of the technical issues associated with financial management, but with a good dose of common sense and operational skills.

The fact remains, whether we like it or not, recent government initiatives has meant all of us who work in, care about, represent or fund the not-for-profit sector in WA need to reconsider how we look at the sector's programs and services from a financial perspective. We can complain about it, or we can join in the fun and make a real difference to how it's done.

In essence, the new partnership approach to funding requires us to be able to speak the same, consistent language when it comes to our finances. We need to be able to explain our costs, understand the basis of our prices, analyse our overall financial result and most importantly portray the aspirations of our organisation in a structured manner. Whilst it may be a challenge

to move into a regime where we're asked to provide a *price* for a service we've been providing on a *cost* basis for potentially many years, it's actually not a huge leap from a financial perspective.

There is one very important point to understand from the outset: what's required under the new procurement regime does not have to cause mind-bending confusion and does not require strong accounting knowledge - both distinct wins for your personality. If you have a sound understanding of your organisation's services and a reasonable degree of common sense you can master it and use it improve your lot with your funding partners.

Because we're discussing principles and concepts, everything suggested in the following pages can fit within your current financial management system, however extensive or basic that might be. Some accounting software may need some hand-holding, but nothing particularly complicated or expensive. You can apply your own judgement as to how much detail you will need but overall this is evolution not revolution.

All of us who care about the sector's ongoing viability hope that costing and pricing methodologies become clearer and more consistent. At this stage of the game however we all need to sift through a few things, highlight areas of fluidity and move toward some generally agreed approaches over time, in partnership with funding agencies.

WACOSS and other peak bodies will also be working hard to lead and support this process, providing more information and more specific resources. You are not alone in this space, even if you choose to scream.

Working with an accountant's brain

We mentioned above that you do not need to be an accountant to get a handle on *costing and pricing*. But it does help in these early stages to venture into the accountant's rather structured brain – a scary world of grids, tags and beige safari suits - to pick out a little bit of theory. We can all appreciate how us accountants have muddied the generally clear waters of 'counting', but it seems, if we stretch our Latin, that by adding the 'ac' we mean 'counting in two's', or more specifically – counting twice.

We mention this because the whole basis of our bookkeeping, whether you live in the corporate, government or not-for-profit sector, is what's known as 'double-entry'. That in essence means every transaction is categorised or 'tagged' twice – *counted* twice if you will. Simply stated, we use one tag to explain the reason our financial position has changed and the other to update our overall financial position after the transaction is concluded. These 'tags' have traditionally taken the form of account numbers – you've no doubt run into them on expense reimbursement sheets or the like.

Let's take a simple example. Let's say you toddled off to the cafe to buy a coffee. You pass the nice person your money and receive coffee: *give* money - *get* coffee. In double-entry bookkeeping both sides of the exchange are tagged in the accounting system, i.e. what you *give* (money) and what you *get* (coffee). After you've processed the transaction, your accounting system will tell you what you spent the money on (coffee) and how much money you have left in the bank after you've bought the coffee (heaps). Quite clever. Boring, but clever. (By the way, for those of you that haven't nodded-off yet – the *gives* and *gets* also represent the dreaded *debits* and *credits* accountants refer to at dinner parties).

That's about as technical as we're going to get. But it's important to understand the basic theory of "tagging" transactions because it connects us to the actual processing being undertaken in our accounting system. When we build a costing model, for example, we are in essence predicting that tagging process (and hopefully even using the same tags). We don't have to worry about the technical side of double-entry bookkeeping but we're still predicting how our money will be used, that is: what will we purchase, for what purpose and when. Seeing this work as a prediction of a future action helps to keep our predictions nailed to the real world. If you can't see the actual purchase in your head, how can you reasonably estimate it? When you go for coffee, it's not hard to see what's likely to happen – the same approach should be taken when estimating our organisational or service costs.

If you have responsibility for an organisation, or a particular activity or service, it's highly likely you will be able to predict such things with a reasonable degree of accuracy; these are unlikely to be new or particularly challenging skills. The bigger challenge lay in understanding how your real-world knowledge can interact and be properly applied within the traditionally rather rigid world of the accountant. This paper is as much about starting to break down some of those barriers as it is about processes and methodologies. Some of the jargon may border on the technical, but we're backing you in, the idea is that if you can even partly appreciate the concepts that follow, and you're able to endure an ounce of accounting theory, you're well on the way to mastering the costing and pricing challenge.

Costing and Pricing – The Basics

This section acts as introduction to some of the more important concepts associated with costing and pricing and attempts to set some parameters around the various technical elements we need to understand before we can move forward. If we don't understand the building blocks it's unlikely anything we produce will be stable.

Costing v Pricing

Our primary aim then is to understand our costs, and apply that knowledge when making decisions on pricing our services. Understanding your real-world costs is without doubt the most important element in the costing-pricing-funding equation. Understanding your costs for each deliverable service sets you up to make decisions on pricing (as well as allocating eventual funding). The two centre-pieces (costing and pricing) are not inexplicably linked however; certainly you can choose to price a service with only a partial reference to its costs. However, if you choose to price a service without *any* knowledge of its costs, well it's likely you have a funding application due yesterday and it's Friday at 9pm.

So, the real challenge for any organisation - for each program or service - is this: how can I possibly be sure my costing is accurate enough to use as a price guide?

The Cost-Price family

Part of the challenge us accountants face in our struggle with normal people is the terminology we use, so here's an attempt to clarify a few definitions that we'll be using in the rest of the document. These are not technical terms as such, and the list is certainly not exhaustive, they're more designed to define the pieces of the puzzle.

Transaction:

A distinct and unique transfer of funds between people or organisations in exchange for a good or service (e.g. purchase of office stationary, wages paid, receipt of grant etc). The basis of all our financial information is simply a big collection of lots of individual transactions we already know and love.

Account:

The 'tag' used by an accounting system to categorise and group transactions by type - generally a combination of a number and name (e.g. 6-1000 Wages, 4-2000 Donations).

Accounts can be combined into *Standard Account Groups*, (i.e. summaries of *Accounts*) to assist consistency in applications, acquittals etc, across varying funders

Activity: The program or service the transaction is being undertaken to support (e.g. Program A, Campaign B, Service C). Activity-based-costing is the centrepiece of the methodology that follows.

Activities can also be grouped to assist reporting, however they are less likely to be standardised across the sector

Costing Model: A prediction of expenditure by *Account* for a particular *Activity* for a specified period, including associated logic and notes

Pricing Method: A pricing methodology used to predict or apply income to an *Activity* and its associated *Costing Model*, and provide a unit-price if required.

Budget: A summary of predicted income *and* expenditure by *Account* for a particular *Activity* or organisation, for a specified period.

Actuals: Historical summary of actual income and expenditure by *Account* for a particular *Activity* or organisation, for a specified period

Unfortunately it's easy to get a bit technical, even when throwing together a few definitions just to help us communicate clearly. So rather than spend more time on the jargon, let's move to how each part of the family could theoretically hang out together – the real-world stuff. Keep an eye on the above terms in *italics* as you read the following summary:

- We build a *Costing Model* for each *Activity* we feel is important or material enough to warrant one (more on *Activity* selection shortly)
- The *Costing Model* for each *Activity* is built by *Account* (or *Standard Account Group* depending on the level of complexity you wish to apply to the *Costing Model*).

- It is likely your *Costing Model* time period will be separated into months, then summarised by year(s). Again, this depends on the level of complexity you wish to apply. It is of course possible to build a *Costing Model* over any time period - week, fortnight, month or year.
- Associated with the *Costing Model* we may wish (or need) to add a *Pricing Method*, for the same *Activity* and time period.
- We can then summarise both the *Costing Model* and *Pricing Method* into a *Budget*, either for an *Activity* or a whole organisation (simply the addition of all the organisation's *Activity* budgets) for the specified time period.
- Depending on your funding contract documents, you may choose (or be required to) include all your modelling logic, just a price and/or a full budget.

The only orphan in the family above at this point is the *Actuals*. They're included here because in the real-world they are often the only thing we have to give us a starting point to build our *Costing Model*. They tell us our current *Account* and *Activity* (if we currently use them) structures, but more importantly they give us a nice summary of all our historical *transactions*, which in a lot of cases is a good indicator of the future.

Why all these fancy *Models*?

There is a huge risk in all this that we over-complicate the process and by doing so lose the very thing we're trying to achieve: easy-to-understand, accurate financial information efficiently produced. It's absolutely crucial as part of your assessment of your responsibilities to your funder(s) and other stakeholders that you apply a sensible level of complexity in predicting your costs, pricing your services and building budgets.

You should try and move through the detail until you're comfortable with a level of complexity that is appropriate for your organisation and its resources. Here are a few tips:

- A solid, uncomplicated *Budget*, with sound logic that is used by all relevant people will beat a complex *Costing/Pricing Model* that no one can understand any day. However, in some instances, reasonable detail is the only way we can build good solid overall *Budgets*. If your organisation is of a size that you feel you can produce a solid *Budget* without having complex models, go with it. However, it's unlikely that a solid overall *Budget* can be produced without a good understanding of your *Activity* structure (i.e. your individual programs and services) and without each *Activity* having its own *Budget* driven by reasonable logic.
- Don't play with software you don't understand, especially spreadsheets. Software should be seen as a tool, not unlike a calculator or the back-of-an-envelope. It's frustrating to see

people merrily throwing numbers at spreadsheets and waiting for an answer at bottom-right, without any idea of the formula structure and whether the logic is right. If you can't replicate the logic in your head or on paper, the spreadsheet will only hinder, not help. Try it – get out your calculator and see if you can replicate the answer in a particular spreadsheet formula – if you can't, stop the world until you can do so, or dump the spreadsheet. Robots don't make good funding applications.

- Keep an eye on materiality. If your funding is 10% of your overall income – is it really necessary to build a complex *Pricing Model* just because you can? Similarly, if your funding is 90% of your overall income its obviously pretty important you're comfortable with your numbers and the corresponding logic. Just applying some commonsense is a good start.

Keep in mind that *Models* – as we're using the term here – are a pre-cursor to budgets, they are the building blocks of a budget; they do not replace budgets. A *Costing Model* is a structured explanation of predicted costs. To more clearly interpret the way we're using the terms above: *Costing Models* predict expenditure, *Pricing Methods* predict and apply income. *Budgets* are a summary of both expenditure and income, including a net financial result, over a specified period.

Can you have a *Costing Model* without a *Budget* – yes of course. Individual models often exist to assist an application for funding and might then be dumped if the funding doesn't eventuate, never finding their way into a budget. Can you have budgets without *Models* – of course, just head straight to budgeting by each *Activity*, but you might just find that if you use *Models* you build yourself, they will serve you well in applying stronger logic to your budgets. This is because Budgets quickly become rows and columns of numbers, and as such they often don't provide the logic commentary and source information you may need to refer to when fine-tuning your estimates as time goes by.

The primary message here is that you can build your own *Models*; they do not have to be an alien-looking spreadsheet emailed by Mr Smartypants up the corridor – although that will work too if you understand it. Your own notes, estimates, calculations etc that you compile yourself all form part of your *Models*. As we'll find out later – it's all about the logic behind the numbers – not the numbers themselves. *Models* should be less about spreadsheets and more about understanding and collating the assumptions that underpin the numbers.

Best have a nice lie down now, but before you do, there are a couple of other important points to make. As a professional (and clever) manager you already have a responsibility to have sound financial management in place, including solid budgeting processes. You shouldn't see the above as doubling the workload – in fact if we all survive this, the structures and processes that evolve out of this new world can only help us to move our organisations forward.

The Engine Room – Activity & Account Structures

This section sets the scene for how costing and pricing works within an overall financial management framework. If we don't connect our costing and pricing approaches to our practical day-to-day financial processing and reporting we run the risk of immense inefficiency, additional workload and some very fancy spreadsheets that no one can use. There is little use in understanding how the financial aspects of an Activity might play out in theory if we can't replicate that in a real-world financial system.

Why use an Activity-based-costing structure?

Thus far, we have been espousing an approach which is broadly known as “Activity-based-costing”. In essence this is when all our *transactions* are attached to a relevant *Account* and *Activity*. Here are the top 10 reasons for using an Activity-based-costing approach in *Models*, *Budgets* and financial reporting for all organisations – big and small:

- It provides for financial information that mirrors the strategic and operational structure of an organisation
- It provides for a *real-world* budgeting and reporting regime for Boards and management, with less technical knowledge required
- It provides for an efficient way of reporting summarised outputs to stakeholders without revealing individual *Activity* performance
- It provides for a solid understanding of how resources are allocated across programs and services within an organisation
- It suits the volatility of the sector and the changing nature of individual programs and services
- It provides for more efficient acquittals and service agreement reporting
- It provides for layered authorisation of expenditure and clearer financial oversight
- It provides for individualised budgets and financial reports to be provided to relevant program/project managers
- It does not require expensive additional software or a change of bookkeeping approach
- It provides for an opportunity to build consistency in sector-wide reporting and future benchmarking
- It fits within broader agendas and will assist with the myriad of changes being requested of the sector from both National and State governments

That's eleven and we could go on...

What often emerges when discussing the virtues of *Activity-based-costing* with management of an organisation is the need to counteract two main arguments:

a) *“Financial information is hard enough; this will create another layer of complexity”*

and

b) *“We’ve been around a while and haven’t needed it yet”.*

Both quite reasonable comments, but we could add in response, to a) *“yes financial information can be hard to understand – that’s why we need a solid Activity-based-costing structure, which goes a long way to simplifying data and providing real-world information”.*

And to b) *“Yes, perhaps, but that was under the old government funding regime – the world has changed and you need to be ready”.*

There is no need to rattle on further, other than to say it just makes sense to understand your organisation by its components – its individual areas of *Activity*. You can then *Model* (if required) and *Budget* for each, report against those *budgets* to the relevant people, identify where additional resources could expand an *Activity* then kick-back and keep track of your overall organisation strategically and financially via each *Activity*. Everyone’s a winner.

How does Activity-based-costing work in practice?

We spoke earlier of the rather clever/boring ‘tagging’ process associated with each transaction and how in its bog-standard form, double-entry bookkeeping requires a double tag (the ‘give’ and ‘get’ tags via *Account* numbers). What we didn’t say at the time is that one side of this double tagging is often hidden by the accounting software, so that you find yourself only having to allocate one account number to the transaction; the software adds the second tag automatically based on the transaction type. By the way, that’s why normal people often don’t understand double-entry bookkeeping, even if they’ve been posting transactions for years, most of the time they don’t see both tags.

Activity-based-costing requires you to expand your coding approach to include an extra *Activity* tag. This additional one-sided tag (no dual tagging required) represents the *Activity* that a transaction relates to. Yes, every single transaction. Yep, every one. Nope, it doesn’t take very long and the extra processing cost is so minimal it’s immaterial relative to the benefits. The practical end result is the person posting the transaction into the accounting system needs to be provided with one extra code – an *Activity* code - in addition to the relevant *Account* number. Not a big ask.

The reason we code at the point of transaction is such an approach gives us the most detailed analysis possible and ensures every dollar of income or expenditure in your accounting system

that has an *Account* associated with it, also has an *Activity*. Posting both tags at the transaction-level also allows a single transaction to be split across more than one *Activity* and/or *Account* at the point of processing, an important issue for efficient and accurate bookkeeping. Even the most basic accounting software allows for this additional *Activity* tag, although some handle it better than others.

In case you were wondering, extra transaction tags are nothing new and are used in varying ways in financial management (we're suggesting two tags but many systems will handle an unlimited number). In larger software systems the extra tags often form part of a free-form tagging approach, where an *Account* can be combined with any number of extra tags, that might represent 'Cost-Centres', 'Departments', 'Categories', 'Locations', 'Programs' etc.

Should you decide to apply *Activity-based-costing* to your financial management you are doing nothing weird or loopy, just something that thousands of other NFP's have also done. It's just that normal people generally don't talk about it at dinner parties.

Using *Activity* and *Account* tags – why we need both.

We'll be chatting in more detail about *Account* structures shortly, but it's important at this stage that we're very clear about how an *Account* and *Activity* work together. As mentioned above, an *Account* is a tag that defines the good or service type (well it's actually more complicated than that but for our purposes that will suffice). It represents a generic description of what is being purchased or sold. 'Travel' is an example of an expense *Account*. 'Grants' is an example of an income *Account*.

An *Activity*, on the other hand is an additional secondary tag that defines the Program or Service that the transaction is being undertaken to support. 'Youth Support Initiative' might be an example of an *Activity*, so too "Family Outreach" etc. The *Activity* represents the real-world description of what program or service is being supported by a particular transaction.

It's important to understand that a transaction is tagged by a combination of any *Account* and any *Activity*. They are independent of each other but combine as required. A couple of examples: If the manager of the 'Youth Support Initiative' purchased an airline ticket - when the invoice for the ticket was processed in the accounting system the *Account* tag would be 'Travel' and the *Activity* tag "Youth Support Initiative". In the next payroll, the manager's salary would be posted to the "Salaries and Wages" *Account* but the *Activity* tag would remain "Youth Support Initiative". The *Account* reflects the generic income or expense 'type'; the *Activity* reflects the real-world program or service.

Many an organisation has been tempted to simply combine both the *Account* and *Activity* into a single *Account* tag, just by adding an extra description e.g. 'Travel – Youth Support'. This in theory is fine until you end up 35 travel accounts each with their own extra description. The

manager responsible for 'Youth Support Initiative' has no idea how to extract their travel expenditure from all the other accounts in the travel area, and certainly has no idea how their other relevant accounts are performing. Even in small organisations you end up with a list of *Accounts* that get muddled, quickly out-of-date and hard to report on.

The real beauty of using an *Activity-based-costing* structure is the efficiency it brings in reporting. It is very easy to extract a financial report for a particular *Activity*, that will show only income and expenditure *Accounts* with transactions relevant to that *Activity*. We can build *Models*, convert them into *Budgets* and report our *Actuals* for individual *Activities*, an *Activity Group* or the whole organisation clearly and efficiently.

In a nutshell, using a well structured generic *Accounts* list combined with an appropriate number of *Activities* is the most practical way to accommodate all stakeholders in an uncomplicated and efficient financial management system.

Identifying and Applying an Activity-based-costing structure

It is likely Harry Potter would be very good at this part, given the dark-art that is seemingly required in identifying an appropriate *Activity-based-costing* structure for an organisation. Whilst all NFPs' have a good handle on what they do in a real-world sense; that doesn't mean it's easy to immediately reflect that in a financial sense. Keep in mind we are trying to identify a series of programs and services that between them encompass everything your organisation does. We can then categorise them into *Activity Groups* reflecting their similar purpose. Here's a starting point:

- Look at your constitution and/or Strategic Plan if you have one. As a general rule, your *Activity* list starts with your organisation's outputs – your programs and services. These documents often portray them in a succinct manner.
- Look at your communication material and annual reports. When we prepare information for people outside the organisation we often draw together our work into bite-size chunks, perfect for identifying *Activities and Activity Groups*.
- Look at your operational and/or staff structure – often these reflect real-world programs and services, but they can also highlight campaigns or other work that are critical to the organisation's output, but may not be communicated as strongly to external stakeholders e.g. fundraising, membership, sponsorship etc.
- Identify Programs and Services that are individually funded as they will generally require separate *Activity* codes. This assists reporting and financial analysis throughout the program and acquittals if required at its conclusion.

- Don't neglect your Core operations / General Admin / Corporate Services – whatever term you use. It's absolutely critical that this area is considered an *Activity* in its own right - try running your organisation without it. But apart from that, you will need a solid understanding of your so-called 'core overhead' when building a *Costing Model* - more on that shortly.
- Activities should encompass not only those things you are doing now but should include programs or services you have aspirations to undertake. Whilst initially such *Activities* may only bob-up in *Models*, such an approach is an excellent way to prioritise your aspirations and communicate with all stakeholders (Boards, funders, members, staff) what you would do next if you had additional resources.
- Fine tuning your *Activity* list over time is normal. Often it takes a couple of years to apply a consistent approach to identifying and grouping *Activities*, but you've got to start somewhere. This is not an error, it's a sign that you've embraced *Activity* costing and you're simply finding the right balance. For what it's worth, generally we find organisations reduce the number of *Activities* over time, rather than increase them. Less is more in *Activity-based-costing*; as such it is worth continually challenging the *Activities* you've chosen and assessing whether the financial information is being used for each.

Managers of smaller NFP organisations may be reading this and finding it hard to practically connect to the above. It's often harder for smaller organisations to settle on an appropriate *Activity* structure, given the way resources (particularly staff and volunteers) are spread across different responsibilities. There's every chance the above points may still apply, but here are a couple of extra tips for our small (but mighty) NFP's when identifying *Activities*:

- Even the very small NFP's are likely to have at least two *Activities* – Core Operations and a specific program. The program is likely to be how you describe yourself to your clients and stakeholders. The Core operations are defined as those things that serve the program(s) more generally e.g. Executive officer, Board, rent, utilities, computers etc.
- If you feel after considering your primary program that you really can't identify a separate Core area, and that all your resources are singularly designed to support one and only one program, then of course it makes no sense to construct an *Activity-based-costing* structure for the sake of it. You would then simply use your *Accounts* list without separate *Activity* codes; producing just the one *Model* (if required) one *Budget* and one financial report that represents your whole organisation.
- If you elect not to use *Activity-based-costing*, be mindful when looking at expansion into new areas. Any new programs are likely to call on resources from your (one and only) other *Activity* and then by definition you should re-visit a potential new *Activity* structure, potentially encompassing Core, program A and program B.

- Be mindful that you are going deep enough into the analysis of your program(s) and service(s). Often managers suggest *Activity* coding is not for them because they only do “one program” - despite annual income of \$1 million. Whilst it’s great for an organisation to have a strong singular purpose, it’s often the case that a number of individual and independent *Activities* actually drive that purpose.

Having identified a series of *Activities* that represent the outputs, programs and core of your organisation, the next stage is to group them into categories that represent similar purpose. Most accounting systems will allow this process to be manipulated over time without any effect on history, i.e. you can move *Activities* from one *Activity Group* to another and retain all the transactional posting. Unlike *Account Groups*, which we’ll get to shortly, *Activity Groups* are not standardised, they are up to you to identify. In essence, they represent the broad output areas of your organisation - a select few descriptions that encompass all the *Activities* you previously designated. ‘Youth Services’ might be an identified *Activity Group* for all relevant Youth-focussed *Activities*, similarly, ‘Housing Support’, ‘Sector Development’ etc.

Activity Groupings in and of themselves are not a critical aspect of costing and pricing services given they come into play primarily in financial reporting. Nonetheless, they support an important element in the overall financial management system given they are used to summarise all *Activities* into a smaller number of easily-identifiable units. This can be an excellent way of communicating financial information to Boards and external stakeholders, where it is not appropriate or too complex to report by individual *Activity*.

Activity Groups, like their sister *Account Groups*, can be set-up in levels, whereby an *Activity Group* at ‘level 2’, for example, can be further grouped under other *Activity Groups* at ‘level 1’. The most basic accounting packages generally allow at least 3 levels of *Activity Groups*, each level able to be summarised by the level above.

Accounts, Account Groups and SCoA

Every organisation and every accounting system uses *Accounts*, which represent the transaction ‘tags’ we mentioned above. The specific list of *Accounts* is generally built to reflect the type and needs of the organisation over time. As we are dealing primarily with Income and Expenditure, we can say that our *Accounts* represent a generic description of the type of good or service the transaction refers to, e.g. Travel expense, Grant income etc. We also mentioned the importance of using *Activity* codes to compliment our *Accounts* list rather than attempt to combine Program or Service descriptors within the *Accounts* themselves.

Recently the Council of Australian Governments (COAG) decreed that all government agencies, when communicating with the NFP sector about financial information, should move toward a standardised list of account definitions, known as *The National Standard Chart of Accounts* ('SCoA'). Whilst in itself this seemed like a sound idea - and a number of NFP organisations have subsequently moved to a SCoA-based *Accounts* list - some issues have emerged that have blurred the practical use of the SCoA.

- The breadth and number of organisations in the NFP sector means even with all good intentions the SCoA can never cover the needs of all organisations and will always be limited to a good set of example *Accounts*. It should be recognised the SCoA is best used as a guide only, as applying it literally restricts an organisation in building an *Accounts* list that reflects their practical needs.
- Converting current data files to a SCoA-based *Account* list can bring into play technical software issues best handled with care. This creates understandable caution amongst management in moving their *Accounts* list in line with SCoA.
- A real shortcoming of the SCoA is that it does not provide clear direction with regard *Account Groupings*. Clear and consistent *Account Groupings* are an integral part of any quality *Accounts* list given they enable financial reports to be produced at varying levels of detail from the same transactional data (regardless of whether the report is for an *Activity*, *Activity group* or organisation). The SCoA suggests some *Account Groupings* in the Balance Sheet and Income area but, disappointingly, it does not provide guidance in the Expenditure *Accounts*. The effect of this is that individual organisations are left to group their expenditure *Accounts* as they see fit, which simply defeats the purpose of standardising the *Accounts* list in the first place.

One can appreciate the difficulty in gathering enough momentum to implement something like a Standard Chart of Accounts – but having done that excellent work, it's just a damn shame we haven't been able to settle on a set of standardised *Account Groups* within that Chart. It could be argued we fell at the last hurdle and as such the whole race seems a waste of effort. Nonetheless it is worth pursuing this issue, and much coffee has been drunk in the cause of providing guidance about *Account Groups*, at least in WA, and further discussions are taking place in an effort to update the National SCoA to eventually include standardised *Account Groups*.

It may seem a bit pedantic to highlight this issue further, but it has the potential to have significant effect on the efficiency of the NFP sector for the following reasons:

- *Standard Account Groups* across the sector facilitates an opportunity for consistent reporting between all government agencies and NFP organisations – going some way to defeating the scourge of the sector – varying reporting/acquittal requirements across agencies.

- *Standard Account Groups* will allow a more structured set of financial reports for all stakeholders, including the expanded requirements that will exist under the new Australian Not-for-profit and Charities Commission (ACNC) legislation.
- *Standard Account Groups* will provide for an opportunity to build 'off-the-shelf' standardised cost and price models for broader use across the sector.

Our humble contribution to commencing that process is to suggest a *Cost Modelling* approach that acknowledges a set of *Standard Account Groups* initially recommended by the *WA Treasury Department* in its guidance notes to support the implementation of the National SCoA. These *Standard Account Groups* were developed in consultation with representatives from the WA NFP sector and serve as our sector's first attempt to provide some clarity in this area.

Whilst the suggested *Standard Account Groups* may not be the final product, they represent a good starting point, and it is our hope that some momentum is built around their ongoing use, because there is little doubt that finally settling on a set of *Standard Account Groups* would provide a real practical benefit to the sector and its financial reporting methodologies.

At the time of writing, those critical *Standard Account Groups* can be found, mapped to SCoA accounts, with some associated explanatory material at:

<http://www.treasury.wa.gov.au/cms/content.aspx?id=12676>

Costing and Pricing Models – Basic Concepts

This section attempts to move the discussions into more practical areas, by suggesting some tips and traps when building a Costing and/or Pricing Model. We openly admit that it is these practical guidelines are the most difficult to present in a manner that will cover the breadth of the sector. Indeed, it is hoped as more experience is gained by the sector in the practical aspects of the new funding regime that more specific guidelines and resources are developed and made available.

Driving the Logic Highway

In building *Costing Models* we often refer to logic-drivers; these can be defined as the assumptions, reasoning or logic behind an estimate of expenditure by *Account*. Most of this work is undertaken and held on spreadsheets, and handy little buggers they are, but we stress again, it's not about the form, it's about the content. A good list of logic-drivers written on the back of a beer coaster is better than a heap of spreadsheet formulae that no one can decipher. Own the logic behind your numbers and good things will become of you.

Let's say we are building a *Costing Model* for an *Activity* we've defined as "Youth Program A". If we are looking to estimate the wages expense, we may start by predicting the number of employees required for *the Activity*, their associated annual rates of pay including Super, workers compensation etc for one year, break our result into pay periods and insert into the *Costing Model* in the wages *Account* by month. Simplistically shown as:

Activity:	Youth Program A					
Account	Jul	Aug	Sep	Oct	Nov	Dec
6-1000 Wages	xxx	xxx	xxx	xxx	xxx	xxx

What is important here is not so much the resulting numbers but the logic behind the numbers, the capacity of individuals responsible for the program to understand that logic and for all parties to be able to refer to it during the *Activity* itself. For instance if actual wage costs emerge as being over budget, it's imperative you can analyse the original logic to ascertain whether the variance is likely to be ongoing or a minor timing issue.

The above is a simple example; however it is worth noting that we often prepare our *Costing Models*, not from the perspective of one specific *Activity*, but all our *Activities* at once. For

example; when estimating wages expense, we may start with all of the organisation's employees by position and calculate a cost per employee including Super, LSL, workers compensation insurance etc for one year as above. We can then, in theory, allocate each employee to an *Activity* (or apportion them across a series of *Activities*), break our result down into pay periods and insert into the *Costing Model* by *Account* (wages) by month for each *Activity*. In this example we have estimated our total organisational wages cost first and then allocated that total cost to each known *Activity*. This approach is known as a "top-down" cost estimate, the first example is known as a "bottom-up" cost estimate.

In a nutshell: a "top-down" cost estimate occurs when we calculate an organisation-wide expense for a particular *Account* and then allocate across our *Activities* as a whole. A "bottom-up" cost estimate occurs when we build up an estimate cost for all relevant *Accounts* one *Activity* at a time.

In the real-world, we often see more "top-down" cost estimation when organisations are undertaking annual budgets of known (and often funded) *Activities*, and more "bottom-up" cost estimation when applying for funding for a new *Activity*. The balance between the two is often a reflection of the organisation's complexity, its internal resources and relative financial management maturity. Both are appropriate, both can work well and both can be combined in the same *Costing Model*.

The lesson so far is, regardless of the approach, try to build reasonable (and understandable) logic behind your numbers, whether "bottom-up" or "top-down" and keep that logic on hand for future reference, whether that be spreadsheet-based or written.

How then, to build a set of 'reasonable (and understandable)' logic drivers that suits your organisation? It is not within the scope of this paper to identify all possible logic-drivers or methodologies, however here are some tips:

- Consider whether you need logic-drivers for each *Account*, or *Standard Account Group*? It may be that you are happy to create a "Personnel" expense logic-driver as we did above which includes employee oncost, rather than a driver for each *Account* within that *Standard Account Group* (wages, Super, W/comp etc). This will reduce the number of logic-drivers you need to build and allow for ease of understanding. The down-side is one logic-driver won't reflect a single *Account* which may make it more complicated to move the *Costing Model* into a full *Budget* later.
- Stay as 'big-picture' and as practical as the situation allows, very pedantic logic-drivers generally don't achieve much at the end of the day. Keep in mind you are often attempting to reasonably estimate future transactions as a whole across months, not individual transactions per se. For example a logic-driver for the "Travel and Accommodation" *Account Group*, might be as simple as: number of trips x cost/trip, or Km's travelled x \$rate.

- History can be a good logic-driver, particularly when a cost within an *Activity* is repetitive and stable. For example if we are predicting telephone use, it makes little sense to calculate the number of lines x calls x \$rate/call, if none of those variables have changed since last year – just use the actual numbers from last year and note the logic as such.
- Be prepared to be flexible across *Activities* as required. A new proposed *Activity* may require very specific Consultancy work, in which case individual contracts and rates may need to be estimated. In another *Activity*, Consultancy may simply be an allowance for work that may or may not be undertaken. Although it's the same Consultancy *Account*, the logic-driver can be very different per *Activity*.
- Talk, talk and talk about the logic driver first, not the number. The more people connected to an *Activity* who own the logic, the more who will own the resulting numbers. It's never particularly motivating to receive your own project's budget via email having had no input into its compilation.

Before moving onto indirect costs, it's worth a short word on in-kind and/or volunteer costs. These notional direct costs present a dilemma to the extent organisations are not inclined to simply ignore them because without volunteer support some funded *Activities* simply wouldn't exist. Depending on your viewpoint, funding can be seen to be supporting volunteers or volunteers can be seen to subsidise funding. There is no clear approach other than to say it would seem appropriate to include notional volunteer costs in their relevant *Activity* at a logical rate/hour and then price accordingly – i.e. deduct them from the price if funding is not requested or include them if it is. Using this approach ensures the 'real' costs are shown in the *Costing Model*, but still provides an opportunity to 'price them out' should that be the organisation's intention.

Head Over Heels

In examining logic-drivers and reflecting on how important it is to build *Costing Models* and *Budgets* by reasonable logic, we are generally speaking about direct costs – those costs which can be identified as associated with a specific *Activity*. Whilst we may build some logic based on organisation-wide expense (i.e. a “top-down” wages cost estimate), those costs are still considered to be incurred “directly” by each *Activity* – they are not re-allocated costs from another *Activity*.

It is critical in building an accurate *Costing Model* that we consider the full cost of the *Activity* including indirect costs – those expenses that are incurred by the organisation centrally, that need to be shared across all *Activities* to ensure full cost recovery and organisation sustainability. We will refer to such centrally incurred expenditure as “core overhead”.

Before we get into the detail of recovery of core overhead, we should be clear that we consider core overhead to be net of any funding specifically provided to cover those costs. You may disagree, in which case it's important you are able to justify that to funders who have access to your detail accounts, particularly if you are requesting short-term grant funding from the same funder that provides the core income.

It is reasonable to consider the arguments for recovering your core overhead in funded *Activities*. Being able to do so in a logical manner may mean a successful inclusion of those costs in a funding contract. Each organisation could no doubt present its own case, but here are three general reasons:

- The capacity of an organisation to provide consistent quality services to its clients and stakeholders is premised upon its medium-to-long term sustainability and the associated stability that affords in retaining staff and maintaining facilities and other resources. If recovery of core overhead is not achieved, the very existence of an organisation will be in doubt and its capacity to provide services will be directly affected.
- If an organisation cannot recover its core overhead via its funding agreements, it will need to do so via other means, i.e. other forms of revenue or reserves, which will mean redirection of resources away from operational areas and a reduced focus on quality service provision
- An organisation that can recover its core overhead across a number of funding agreements represents an efficient form of investment by funders, as individual programs, particularly those of a short-term nature, will not need to incur start-up costs and one-off expenses for each project.

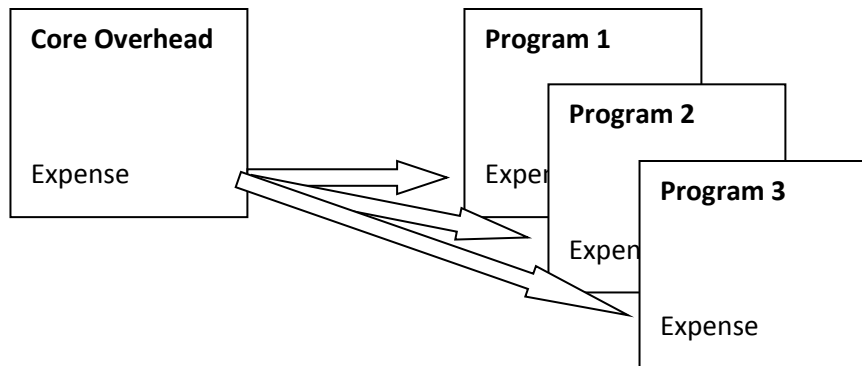
Before we look at methods of core overhead cost recovery it is worth recalling that we suggested above that the core overhead area should form part of your *Activity* identification – e.g. core operations / general admin / corporate services etc. Being identified as a distinct *Activity*, core overhead should have its own set of logic-drivers and a *Costing Model* and/or *Budget* and most likely, a solid history of *Actuals*. Whatever method of recovery is eventually used, the degree of recovery of core overhead is directly linked to our capacity to accurately estimate its total cost in the first place.

In determining the method for recovery of core overhead, we suggest two broad approaches:

The first approach reallocates a set amount of expense from the core overhead *Activity* into individual funded *Activities*. The recovery could be a set dollar amount or set percentage of the total estimated annual core overhead expense. This approach means the amount to be recovered is predetermined to reflect known funded *Activities* to be undertaken. As such, this

first approach is more suited to a stable, predictable environment where funding agreements are longer term and *Activities* are predictable.

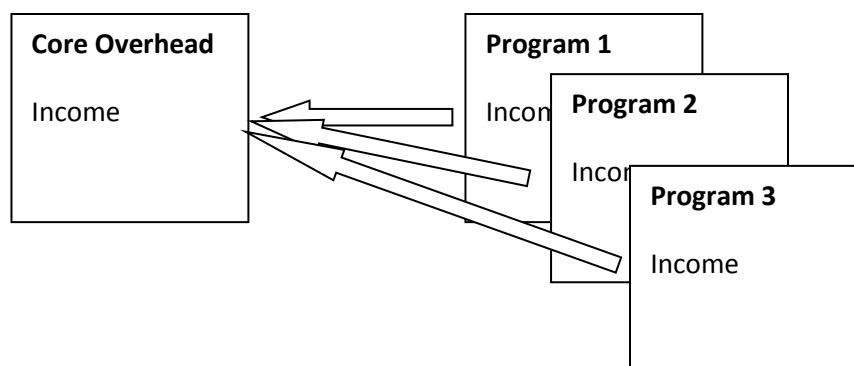
Simplified, this first approach would look like this:



Rather than reallocating expense, the second approach reallocates a portion of the income from the funded *Activity* back to core overhead. Rather than trying to recover a predetermined amount in total, this approach implies that each funded *Activity* must recover core overhead in proportion to its funding income. Often a percentage of funding is set as a benchmark or a cost per new employee – these are then used to build the initial *Costing Model* and to commence discussions with funding agencies. However it is calculated, the figure often has no direct reference to actual core overhead and is not meant to, but is considered within the bounds of what history suggests funders will accept.

This approach has inherent risk, in that it may be difficult to predict what funded *Activities* will come to fruition in any one period and as such, not all core overhead may be recovered. Nonetheless, the approach is widely used and generally suits organisations that have both ongoing and short-term funding agreements, preferably with cash reserves sufficient to cushion core overhead in times of volatile funding. It is also relevant for organisations that have a number of funding agreements falling due at varying times, to the extent that core overhead recovery becomes a “rolling” process across different financial periods, where the core overhead itself is also changing.

Simplified, the second approach would look like this:



You could of course reverse the allocation with the first example moving across income and the second across expense. What's more important to recognise is that in both cases, funds are reallocated across income *or* across expense. It is not recommended to reallocate funds *between* income and expense, i.e. creating an expense in the funded *Activity* and an income in core overhead. We recognise this is common practice, however unfortunately it's not good accounting practice. By way of explanation: those of you who have close friends in the audit fraternity may well have discussed this at dinner parties, but for the rest of us, we have to appreciate that auditors don't like it when we artificially increase income or expenditure past that of real life transactions. Given that core overhead recovery is an internal accounting entry between *Activities*, if we reallocate funds between income and expense it has the effect of increasing both for the organisation as a whole; a big no-no in the wonderful world of audit – and understandably so.

While we're rattling on a bit, another quick word on reality versus accounting. If you see a friendly accountant up the corridor, or meet your bookkeeper in the pub, don't miss the opportunity to ask whether they've done the entry for your program's core overhead recovery and where it appears on your financial report? It's not uncommon to see core overhead approved by funders, but then lost to the real world in a myriad of alien accounting entries. Indeed, such issues abound across NFP financial management, where the number crunching is considered some magical process which normal people couldn't possibly understand. Enough said, but now's a great time for the accountants, bookkeepers, managers and operations people to hang out together a bit more to ensure they all understand how the theory meets real-world and how everyone can benefit from clear and accurate financial reports.

Before we move on to pricing, it would be remiss not to add some practical evaluation of core overhead recovery. We certainly recognise it is not as simple as calculating an amount and including it in funding applications. Nor do we assume funders will automatically accept that a set percentage of the funding should be allocated to core overhead recovery. Whatever approach organisations are using to calculate their core overhead recovery, they often show that recovery as a series of notional expenses in the funding application; say rent, utilities, property, ICT etc, in an attempt to identify why the recovery is relevant to the service deliverable. Seemingly very few are prepared to simply call it "core overhead recovery".

All this is understandable and no one is expecting it to change any time soon - negotiations will and should take place; indeed the up-side of the new procurement regime is those negotiations should (in theory) take place in a more transparent and consistent manner – costs are costs and prices are prices. What we see as more important than a prescribed technique at this stage is that organisations develop their own clear and consistent methods of calculating core overhead recovery and include it in their funding applications - from that point-on negotiations should revolve around price/funding. We see no sense in including core overhead recovery in one application and excluding it from others, or indeed having a varying approach across different *Activities*.

If an organisation chooses to lower the price of a service to absorb its core overhead then so be it, it's another thing altogether to suggest some services incur core overhead and some don't. We feel that if both funders and service providers recognise this up-front, a clearer path to sustainable pricing is more likely to appear. For now however, whilst funding remains relatively predetermined and short-term and funders take varying approaches to core overhead recovery, we will continue to ask ourselves "what comes first - the core overhead or the core overhead recovery?"

So, what's the price then?

We mentioned at the outset that price should be an outcome of cost, i.e. decisions on the price of an *Activity* (let's swap the term to "service" for this part) should reflect the costs of that *Activity* (service). This seems fair enough; so to help us through this process we'll call on a fairly familiar term known as "margin". For our purposes, the margin is the difference between the cost of a service and its price. The term still applies whether a unit \$ cost or total \$ cost is the basis of a funding application.

We apply a *Pricing Method* to a particular service by asking ourselves what margin we would like to apply as a percentage of cost and whether the margin is variable across a service. 'Margin' and 'Pricing Method' are not directly interchangeable in all cases; because we may choose to exclude some costs from the margin uplift, e.g. we may prefer to show funders we are not making a margin on core recovery. Further, certain service deliverables may be excluded from margin uplift.

For now, let's keep it simple: a positive margin implies we will retain a surplus of funds at the conclusion of the service agreement, a zero margin implies we will neither lose nor make money, and a negative margin implies the organisation will subsidise the delivery of the service from other sources, or other issues are at play, such as the *Costing Model* includes notional volunteer costs not included in the price. So what's the right margin?

Before we get onto that, let's consider what might be a good theoretical starting point. If we take a particularly commercial approach to the process, a back of the envelope calculation would suggest a "return on investment" (i.e. profit) should be at least equivalent to return on cash if the same amount of money was placed in a bank deposit, say 5%, plus say 3% for risk and sustainability, another 2% for asset replacement and finally let's say 2% for a general contingency on costing. In theory then, if we got 12%+ margin we'd be travelling relatively well if we were in the commercial world. So is that the right margin?

Well, it's a trick question, there is no "right" margin; there is simply the margin you are able to negotiate. We don't operate in a commercial environment and are rarely given the opportunity to provide a simple price to deliver a prescribed service. Although it must be said that a particularly "commercial" procurement already exists in some areas of NFP service provision, in

which case the “double-digit” margin isn’t the worst place to start if you’re in that game. Even then, the margin you’re prepared to accept will depend on the size of the organisation, cash reserves, the degree to which other services are absorbing core overhead, the mission of your organisation etc.

Dealing in the small-to-medium funding areas however, things are often more fluid. Funders offer opportunities to submit applications but in many cases ‘price’ forms part of the discussions only as far as it represents the predetermined amount of funds available to achieve specified service deliverables. In that regard it is often not a discussion about the price for a particular service, but the service for a particular price. This is important, because a good strong knowledge of cost, and the corresponding logic-drivers for a service (including core overhead recovery) will be a wonderful ally to anyone having to “cut their service cloth” to suit a predetermined price.

A discussion as to whether costs can be reduced without directly effecting service provision is the same as a direct discussion about margin. If costs can’t be reduced, then an understanding of the degree of service reduction at varying funding levels is the next best thing. Many issues will come into play to varying degrees and all are dependent upon service type, the funding amount and the funding agency. Regardless, being able to model scenarios, or ‘what-ifs’, around varying logic-drivers and varying margins can seem complicated, but an in-depth knowledge of the *Costing Model* for a particular service will go a long way to ensuring the best possible outcome.

One of the prudent checks-and-balances before final pricing is to revisit the service deliverables within a funding application and to “map” those deliverables to expense areas in the *Costing Model*. This could be as straightforward as “deliverable A is mapped to employee A” or “Regional visits are mapped to Regional Travel expense”. In organisations where operational managers prepare the funding application and senior managers give final sign-off, this process of challenging the real-life aspects of the *Costing Model* before final pricing is an excellent way to share ownership of the *Costing Model* and give all parties confidence in its validity. Pricing/funding variations can then be negotiated within the context of what degree individual deliverables will be affected by price change.

Conclusion

The intention of this paper was to provide an introduction to some of the concepts and issues at play when a small-medium not-for-profit organisation enters into a funding application under the new government funding and procurement regime in WA.

It was noted from the outset that to do so without an understanding of how costing and pricing sits within the organisation's financial management system would create inefficiency. As such much of this paper has been focussed on providing an overview of a sound financial management framework and some of the ways individuals interact with it.

The overriding theme however has been that building strong costing and pricing models together with associated budgets is not about systems or procedures as much as instilling reasoning and strong logic around costs and price estimates. Regardless of the size of an organisation, the type of activity or the level of funding; ownership of the logic behind the numbers by all those involved in the provision of a service is by far the optimum way to produce accurate and relevant financial information and to encourage ongoing engagement with it.