**Basic Principles of Full Cost Accounting**
For the Business, Labor, and Agriculture Interim Committee
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## Introduction

Governments, responding to challenges to create efficiencies in service delivery, have begun to answer two important questions. The first is how much does a particular service really cost? And, inevitably, as decisionmakers face policy choices about privatization, the second is how much does it really cost the state to have one of its functions performed by a private provider? The answers to these questions both use the basic principles associated with full cost accounting and generally rest within a larger decisionmaking framework to decide how to provide the best service for the best value. Accordingly, the use of full cost accounting by government agencies has been increasing in recent years. Traditionally, governments use cash flow accounting that is designed to track the flow of current revenue. Full cost accounting, although consistent with generally accepted accounting principles, focuses on economic resources or assets and recognizes costs as resources are used, despite when the money is spent.

This paper attempts to outline the basic principles of full cost accounting that policymakers should consider as they try to identify the true costs of delivering a government service. Before delving into the principles, it should be noted that the International Federation of Accountants (IFAC) is conducting an exhaustive study on applying full cost accounting for governmental entities.[1] Although implementing full cost accounting would provide a tool for policymakers to review whether services should be provided in-house or contracted, the IFAC believes that this method offers a greater understanding of budgets and outlays regardless of any additional discussion of who should be providing a given service. Cost accounting has a number of management functions, including budgeting, cost control and reduction, setting prices and fees, performance measurement, and program evaluation. Achieving greater efficiencies in government activities seems to remain the primary goal.

How much does it cost?[2]

The total cost of providing a service in-house is known as the fully allocated cost. It is the sum of the direct costs plus a proportional share of organizational overhead, or indirect costs. When the direct and indirect costs are identified, the resulting amount represents the fully allocated costs, or total cost, of providing the service in-house. The formula is shown below.

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[1] Information on the IFAC study of full cost accounting can be found at the website: http://www.ifac.org.

[2] This information is taken from a number of different sources, most of whom have adopted the principles and definitions recognized by Dr. Lawrence Martin in a publication distributed by the Reason Foundation, How to Compare Costs Between In-House and Contracted Services.

**Direct Costs + Indirect Costs = Fully Allocated Cost (Price of the Service)**

## Direct Costs

*Direct Costs* are those items that only benefit and are only chargeable to the service. Commonly, these direct costs include:

- salaries;
- wages; and
- benefits of government employees working solely on delivering the service.

Direct costs also include:

- supplies;
- materials;
- travel;
- printing;
- rent;
- utilities;
- communications; and
- any other costs expended for the exclusive benefit of the service.

Within the direct cost component of the equation, some costs are occasionally overlooked. Although not exhaustive, these overlooked costs may include:

- interest;
- pension costs;
- staff training costs;
- property insurance costs; and
- facilities and equipment costs.

*Interest* on capital items purchased for the exclusive use of a service through some financial arrangement should be included in calculation of the direct cost of service delivery. An example of interest inclusion is the purchase of a piece of heavy equipment. If this purchase were financed, interest payments are typically taken from a government's general fund, but the interest cost should be included in the cost of providing a service.

*Pension costs* of government employees should also be included in the direct cost analysis. Even if pension plans are not fully funded, this cost is indeed a cost that affects the overall analysis and should be included.

## Indirect Costs

*Indirect Costs*, also referred to as *overhead costs*, are costs that benefit two or more government services or programs. The expenses of various administrative and support services that are necessary to the administration of the particular service also include support for additional services. The examples of indirect costs are the same as direct costs, with the only distinction being that these costs are not exclusively directed at a particular service.

Indirect costs are generally apportioned among government services using some allocation method. Agencies may assume that the indirect costs are proportional to the number of employees conducting the service, or they may assume that the costs are proportional to the total budget of the service. In essence, the indirect costs are related in size to some measurement of the direct cost of the service.

Can It Be Done for Less?

Experts in full cost accounting generally state that using this method to estimate savings that may be realized by privatizing a particular service is generally inappropriate. The amount saved is not the difference between the agencies fully allocated costs and the total contracting costs. Although there are many options within the privatization sphere, the most common is the private vendor contracting option. Again, many experts suggest that contracting does not result in a dollar-for-dollar reduction in overhead costs. If a governmental agency is considering employing a full cost accounting methodology to assist the agency in making an informed decision about privatization and any cost savings associated with privatization, the appropriate agency costs to use are avoidable costs.

**Avoidable Costs**

*Avoidable costs* are government costs that will not be incurred if the service, or a portion of the service, is contracted to private providers. Obviously, most of the direct costs attributable to the service are avoidable. Determining which government indirect costs are avoidable is a difficult task and subject to the judgment of the decisionmakers. There are, however, three factors that can be used to guide this process.

- *The determination of the public sector to reallocate resources effectively and efficiently.* In a private sector operation, the decision to discontinue or even contract a particular service function generally results in a rapid reallocation of resources to reduce overhead and maximize profit. Without the profit motivation being present in public agencies, the extent that overhead can be reduced through contracting is a product of the government's ability to restructure its mission and allocate resources toward different delivery functions.

- *The extent of the privatization efforts, in both the particular service area and any service area that are supported by the same government departments*. This consideration addresses the cumulative effect of privatization efforts. In essence, overhead may not be reduced in a service unit with a small number of employees unless several other small service functions, all related in some manner, were contracted as well. Separately, the contracts would have negligible impact; taken overall, the savings may be significant.

- *The time period that resource allocation is expected to occur*. In some cases, overhead may not be avoidable in the short-term, but may be avoidable in the long-term. An example would be a service contract that leaves an agency holding leases on storage or office space that is in excess of its need. Those leases must be paid, but, once the lease term expires, do not need to be renewed.

Emphasizing avoidable costs in a cost comparison is a product of full cost accounting. If governments seek to use full cost accounting principles to determine whether privatization efforts are in the best interest of service consumers, the principle equation is all avoidable costs minus total contracting costs.

**Avoidable Costs - Total Contracting Costs = Estimated Costs Savings**

**Costs of Contracting**

The total cost of contract service delivery is the sum of contractor costs, plus contract administration costs, plus an allowance for one-time conversion costs, minus offsetting revenue. The equation looks like this:

**(Contractor Costs + Contract Administration Costs + One-Time Conversion Costs) - Offsetting Revenue = Cost of Contract Service Delivery**

*Contractor Costs* are simply the total costs that a contractor proposes to charge for delivering a service.

*Contract Administration Costs* can be defined as all those activities performed by government from the time that the decision to contract is made to the time that final payment is made. Examples of these costs include:

- procurement;
- contract negotiations;
- contract award;
- processing amendment and change orders;
- resolution of disputes;
- processing contractor invoices;
- contract monitoring and evaluation.

*One-Time Conversion Costs* may be incurred in transferring a government service to the private sector provider. These costs are generally defined as personnel related costs, such as unemployment compensation, accrued annual or sick leave, and any other severance considerations that need to be accounted for given the possibility of terminating public employees.

A second conversion cost may be any material-related costs associated with the preparation and transfer of government property. The third conversion cost may typically consist of lease or rental agreements that must be terminated or the costs of unused or underused equipment that is not transferred or sold to private providers.

Finally, *offsetting revenue* is any new or enhanced revenue stream that will accrue to government as a result of contracting for a service. The increase in tax revenue is an offsetting revenue that must be deducted from the cost of contract service delivery.

**The Florida Model**[3]

The Florida House of Representatives Committee on Governmental Operations developed a cost comparison decisionmaking tool that is used for the express purpose of determining whether government services should be subject to a privatization program. What follows are the definitions that government agencies in Florida use to make their determination.

The Committee developed a worksheet that reflects an indepth consideration of costs associated with privatization, including any hidden costs. It divided the worksheet into three cost categories:

- Personnel Costs;
- Overhead and Administrative Support Costs; and
- Other Costs.

For the purposes of the analysis, Personnel Costs are made up of salaries, benefits, and other compensation.

Overhead and Administrative Support Costs have several subcategories, including:

- travel;
- materials and supplies;
- equipment;
- data processing services;
- communications;
- facilities; and
- other overhead.

Other Costs were divided into three subcategories:

- consultant fees;
- legal assistance; and
- impact on other state agencies.

Although there are some distinctions apparent between the general model identified by Martin and the model developed in Florida, the common principles and definitions are similar. In Florida's case, the goal of the Committee was to develop a mechanism to accurately reflect the

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[3] Privatization, Florida House of Representatives Committee on Governmental Operations, Final Report, December 1995.

true costs associated with conducting a service in-house so that decisionmakers could make a comparison between private providers and public providers. The Florida model uses the equation presented at the beginning of this paper.

**Personnel Costs + Overhead and Administrative Support Costs + Other Costs = Fully Allocated Costs**

## Conclusion

This paper represents the most basic elements of full cost accounting and a representation of the necessary factors that should be considered before determining the actual savings that might be realized by efforts to privatize certain governmental services.

Whether decisionmakers use this information to address competitive issues between private vendors and public organizations or as a disclosure method for determining how tax revenue is spent by government, the critical objectives are determining what the true cost of providing a service is and how that information can be used to provide for a more efficient delivery of that service.

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# BASIC PRINCIPLES OF FULL COST ACCOUNTING

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