



**full cost recovery**  
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The Finance Hub is delivering to the government's ChangeUp programme to create voluntary and community organisations that are effective and independent because they are financially sustainable.

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This briefing provides an introductory guide to the main principles of full cost recovery. It is aimed at policy-makers and practitioners, and funders of the third sector.

For policy-makers and practitioners, the briefing contains a simple stage by stage guide of how to calculate costs and decide what to include as overheads. The acevo 2004 template included in *Full cost recovery: A guide and toolkit on cost allocation* (see further information) is most relevant for this group.

For funders, the briefing includes a table offering advice on how to apply the principles of full cost recovery in various situations.

## What is full cost recovery?

The principle behind full cost recovery is simple. Full cost recovery means recovering the total costs of a project or activity, including the relevant proportion of all overhead costs.

Each project or service has costs directly associated with it, such as the cost of staff or equipment. It will also draw on the rest of an organisation's resources. For example, it might occupy some of a line manager's time and have some impact on some central functions, such as finance and IT (information technology).

Although it is possible to identify direct costs and overhead costs separately, full cost recovery works on the premise that both direct costs and a relevant portion of overheads are integral to the delivery of a service or project.

## Why is it important?

Full cost recovery is important for both funders and those being funded. For third sector organisations, it is about establishing sustainable funding that covers the true costs of delivery; for funders, it is about developing greater clarity around funding decisions and improving relationships with funded organisations, including charities, social enterprises and community interest companies.

A lack of financial understanding can prove highly damaging – between 2003 and 2005, one third of acevo members were forced to close down services due

to financial insecurities. There has historically been an under-investment in the sector, which has proved frustrating and detrimental to success.

The purpose of full cost recovery is to help third sector organisations have a better understanding of their costs. By calculating the full costs of each activity, organisations can make more informed decisions about both managing the costs and securing funding to recover them.

However, full cost recovery is a two-way process: it can only work if funders understand the principle and the rationale behind funding bids and applications they are presented with.

*All departments should ensure that the price of contracts reflects the full cost of the service, including the legitimate portion of overheads.*

HM Treasury, 2002 cross-cutting review,  
*The role of the voluntary sector in service delivery*

## The problem

For third sector organisations, the problem can be summarised by the lack of a rigorous, standardised cost allocation method. There have been problems in calculating costs, the conversion of overheads into projects, the lack of transparency in analysing and allocating costs, and the tendency for funders to adopt arbitrary percentages to deal with the matter.

For funders, there have been two main problems regarding full cost recovery. Questions have gathered around the issue of 'double funding' (the fear that another funder is also paying for overhead costs), and the appropriate level of overheads to pay. The application of a rigorous, standardised cost allocation method should answer both questions.

## Sources of help and solving the problem

In 2004, acevo developed the publication *Full cost recovery*, which contains a template on cost allocation, and has been commended by HM Treasury and the Compact Funding and Procurement Code. It is also available as a CD-ROM. The following is a simplified version of the process described in the template.

Further sources of advice, for both funders and organisations, are given at the end of the briefing.

# Implementing full cost recovery: a guide for third sector organisations

## Cost calculation

All organisations of any sector have overheads – sometimes referred to as ‘core costs’ – which fall into four areas:

- Management and leadership
- Infrastructure and accommodation
- Finance, governance and controls
- Strategic development

Organisations should follow four general stages in implementing full cost recovery:

## **ARAF – Analyse, Review, Allocate, Fund**

### **1 Analyse and count costs**

Determine what it will take to deliver the service, identify all the associated cost items and calculate the totals of these items.

### **2 Review costs, particularly your overheads**

Review your overheads and determine whether action is needed. This does not necessarily mean driving overheads down. You may feel you are not spending enough on some areas, for example planning, evaluation and professional development.

### **3 Allocate your costs appropriately**

Having calculated your total spend on overheads, allocate a relevant portion to the project or service. In the template we allocate each type of overhead – premises and office costs, central function costs and governance and strategic development costs – one step at a time, based on a ‘cost driver’ (the basis on which costs are allocated).

### **4 Fund your costs**

You should now develop a strategy for funding the total cost of the project. Decide whether to meet your costs through fundraising, contracts, grants, other income streams or a combination. If you know how much funding is available, the template helps to determine if this will cover the full cost of provision. If the amount of funding is not known, it helps to look at what general fundraising income will be required to cover the full costs and therefore what portion of your general fundraising you should allocate to the project.

More specifically, there are six stages to calculating the full costs of a project or service:

- 1 Calculate the direct project costs
- 2 Calculate the organisation's total overheads
- 3 Allocate office costs to central functions (IT, HR) and the project/service
- 4 Allocate central functions to the project/service and other activities, for example governance
- 5 Allocate other activities to projects
- 6 Allocate fundraising costs if needed

The template describes the actions for each stage in more detail.

## Value of using the template

The process should give organisations a more informed dialogue in all funding situations: understanding costs when grant-seeking, determining the viability of 'formula funding' (funding from a variety of sources), understanding bidding prices when competitive tendering, and identifying and plugging gaps in fundraising.

It is important to note that using the template doesn't *replace* funding negotiations, but should help inform them.

The template should also be recognised by all government funders, including local authorities and primary care trusts.

acevo recognises that progress has been limited and is keen to work with government funders to help increase understanding. Together with the Big Lottery Fund, we are in the process of developing a manual for funders, featuring case studies from local government and independent foundations.

## Case studies

### Full cost recovery in practice – third sector practitioners' perspective

The following case studies demonstrate both the value of implementing full cost recovery (case study 1) and the critical importance of gaining full cost recovery to ensure long-term survival (case study 2).

## 1 Community Network

Community Network, a national charity and company limited by guarantee, provides telephone conference call services to the third sector. It has 15 staff, of whom eight are full time, plus five trustees, and an income of nearly £500,000. It is based in rented accommodation in London, The service is available Monday to Sunday 8.30am – 10.30pm with PIN access outside these hours.

The Network has more than 800 regular users – organisations that range from large household name charities to small self-help and support groups. Approximately 50,000 individuals used the service last year.

Currently Community Network receives core funding from the Active Community Unit, Big Lottery Fund and Lloyds TSB Foundation, and project funding from the Department of Health. It also generates 46-50% of its income from conference sales.

In 2003 Essex County Council invited the Network to tender to provide conference call based support for carers across the county.

Community Network recognised a potential new, and replicable, income generating opportunity, and used the template to ensure an accurately costed and priced bid. Although at first glance the full cost recovery process didn't seem appropriate to its size or structure, it encouraged examination of the Network's existing methods and a more rigorous approach to cost allocation.

Community Network was successful with its bid and when it undertook an internal project review six months later the figures still stood up. Since then, using the same template, it has been awarded contracts for a further two years.

Initially it took considerable time and effort on behalf of the Chief Executive and Head of Finance – but building full cost recovery into its operational processes, including a review of its existing reserves policy, allowed the Network to take a more robust stance with both funders and clients by clearly demonstrating actual service costs.

[www.community-network.org](http://www.community-network.org)

## 2 Sue Ryder Care

### We Care: Who Pays?

Sue Ryder Care specialises in palliative care, neurological care and homecare. Alarmingly, the charity's latest survey found that none of its commissioners, which include primary care trusts and social services, pay the true cost of the basic care they commission. This is despite the government commitment in 2002 that, by April 2006, 'full cost recovery' should be in place for voluntary providers of care (*Cross cutting review: The role of the voluntary sector in service delivery* HM Treasury, 2002).

The current situation is unsustainable – Sue Ryder Care supports a £7 million shortfall in statutory funding for services commissioned by the state through regional commissioning.

Local commissioning inequalities perpetuate the 'postcode lottery' of hospice and neurological care services, and charities such as Sue Ryder Care are forced to use voluntary income from donations to meet statutory shortfalls instead of developing new services, maintaining facilities and offering extra support to those in need.

Sue Ryder Care is a specialist provider of modern healthcare, coping with a funding mechanism based on Victorian era philanthropy. While the state is providing payment in grant form, there is a feeling that it is doing charities a favour – when the bottom line is, if services are provided to an agreed standard why shouldn't costs of care be fully met?

Sue Ryder Care seeks to work in full and equitable partnership with the state and regional commissioners and work alongside its partners in the NHS to break down the barriers that prevent the voluntary sector playing a full role in providing the expert care the nation needs.

'We Care: Who Pays?' is a Sue Ryder Care campaign that asks government to look closely at the true cost of the care provided by the charity and, importantly, support measures to enable it and other voluntary sector providers to achieve full cost recovery.

[www.suerydercare.org/getinvolved/campaigns.asp](http://www.suerydercare.org/getinvolved/campaigns.asp)

## Implementing full cost recovery – principles

The following table is taken from *Full cost recovery: A manual for funders*, which formed part of a project acevo undertook with support from the Big Lottery Fund.

The table outlines eight key principles, their scope (to which funders they apply), and suggested actions to meet them.

Principle	Scope	Actions
<p><b>1 Define your relationship with funded organisations</b></p> <p>You will need to be clear about the type of funding you are providing. For example, priorities and practices in competitive tendering will differ from those involved in making strategic grants.</p> <p>Consider whether you are shopping for services, giving money in support of a particular cause, or investing in an organisation's development.</p>	<p>All funders</p>	<p>a Ideally, a third sector organisation (or a private company) bidding competitively for a contract should submit a price based on a clear understanding of the overhead costs it needs to cover, as well as the direct costs associated with delivering the contract. In general, however, the details of overhead costs would not be disclosed to the funder, nor should the funder seek more information than would normally be expected from a private sector supplier.</p> <p>i You should consider whether the potential price is sustainable; whether it reflects the actual cost of providing the services at value for money.</p> <p>ii Organisations may bid below cost with the aim of winning new business.</p> <p>b In the case of 'open book' funding for projects and services, such as grantmaking, where the process has to be transparent, costing rather than pricing is likely to be the more appropriate basis for funding decisions.</p>

*continued over*

Principle	Scope	Actions
<p><b>1 Define your relationship with funded organisations</b> continued</p>	<p>All funders</p>	<ul style="list-style-type: none"> <li>i You should ascertain that the funded organisation has allocated a reasonable and relevant proportion of its overhead costs to the bid. The method used should be clear, comprehensive and defensible, such as that detailed in the acevo template.</li> <li>ii In some cases you may wish to make a contribution towards costs, with the intention that other funders match it. In such cases you should be confident that the service is sustainable through additional income.</li> <li>c Where you are 'giving money in support of a particular cause', you may be one of many funders or donors contributing to an activity or range of activities, and may not be overly concerned with how the total cost has been calculated. Nevertheless, you may wish to ascertain whether the organisation has made proper provision for the full costs of the activity. If not, there is a risk that undertaking the activity will be a drain on other parts of the organisation's work.</li> <li>d Where you are 'investing in an organisation's development' you will normally provide unrestricted funding, so the question of overheads will not arise. However, if the organisation is undertaking specific activities supported by other funders, you may wish to ascertain that it has appropriate full cost recovery policies in place, so that your development funding is not unintentionally subsidising activities that should be fully funded by other funders.</li> </ul>

Principle	Scope	Actions
<p><b>2 Commit to the principle</b></p> <p>Publicly endorsing the principle of full cost recovery for funding projects, services or other outputs makes a powerful statement to internal and external audiences about your aims and philosophy as a funder.</p>	All funders	<ul style="list-style-type: none"> <li>a Consult the organisations you fund to establish the importance to them of full cost recovery and their level of expertise in allocating costs. Where there are skills gaps, examine how you can best provide, or signpost to, expert support. Ensure they understand and accept that full cost recovery may involve a reduction in the overall number of projects or services you are able to fund.</li> <li>b Determine how full cost recovery will support your organisation's aims and philosophy as a funder, for example through promoting sustainability in the organisations delivering the projects and services you support.</li> <li>c Make a public commitment to full cost recovery; this can help to generate the organisational momentum to implement it.</li> </ul>
<p><b>3 Know the rules</b></p> <p>Your organisation's purpose and governing principles will influence your funding practices. Make sure they are up to date and reflect good practice.</p>	All funders	<ul style="list-style-type: none"> <li>a Your organisation's directives from government, or your governing documents, may preclude you from funding certain types of activity or from supporting certain costs. <ul style="list-style-type: none"> <li>i You should review whether these rules enable you to support the full cost of projects and services.</li> <li>ii If they do not, explore whether they should be changed.</li> </ul> </li> </ul>
	Statutory funders	<ul style="list-style-type: none"> <li>b Establish how commitments in HM Treasury guidance, the Efficiency Review, the Compact, and other publications that mention full cost recovery already apply to you and interrelate with other procurement principles, such as Best Value.</li> </ul>

Principle	Scope	Actions
<p><b>4 Understand your role in the funding mix</b></p> <p>The interaction between statutory funders and independent funders can create complexities for full cost recovery. You should be aware of how this context affects you.</p>	All funders	<p>a Some funded organisations may provide additional services above and beyond what you are able to support financially, supplementing the available funding with their own voluntary income, reserves or matched funding. You and the funded organisation should reach a clear agreement on how the distinction is made, for example on the basis of statutory requirements. You should meet the full cost of the parts of the service, or level of service, you are funding.</p>
	Independent funders	<p>b Organisations receiving statutory funding below the full cost of their project or service may approach you to make up the shortfall. You should set a clear policy on this, seeking to establish whether such funding is:</p> <ul style="list-style-type: none"> <li>i complementary funding for (elements of) a service beyond the statutory requirements, which may later become a statutory service</li> <li>ii complementary funding to promote organisational development or innovation alongside service delivery</li> <li>iii a temporary subsidy for a statutory service, while the relevant statutory funder moves towards full cost recovery, or</li> <li>iv a permanent subsidy for a statutory service.</li> </ul>

Principle	Scope	Actions
<p><b>5 Know your field</b></p> <p>Understanding the types of output you typically fund will help you to implement full cost recovery.</p>	All funders	<p>a If you fund a number of organisations to deliver very similar services, benchmarking may be helpful in determining value for money. However, if you fund a wide variety of outputs, you should not waste time attempting to benchmark across disparate projects or organisations.</p>
	Statutory funders	<p>b Where you fund on the basis of a set tariff or fixed price, as in the Department of Health's 'payment by results' model, the tariff should be set at a realistic level, enabling efficient independent providers to cover their costs without external subsidy.</p>
<p><b>6 Be proportionate</b></p> <p>Where costings are disclosed, your processes for examining fully costed bids should be fit for purpose and proportionate, and not place excessive burdens on your organisation or those it funds.</p>	All funders	<p>a Work to establish a mature relationship with funded organisations, to enable you to resolve uncertainties and disagreements constructively, from a basis of trust. The stability provided by longer-term funding can be useful in generating such trust.</p> <p>b Keep the issue of full cost recovery in perspective when making funding decisions. You should not spend excessive time:</p> <ul style="list-style-type: none"> <li>i querying particular cost items</li> <li>ii deciding whether particular items count as overhead costs or direct costs.</li> </ul> <p>c Ensure your systems are fair, proportionate and fit for purpose, encouraging organisations to understand their own costs, rather than placing undue emphasis on your own analysis. Make sure you do not demand unrealistic levels of sophistication in applications relating to small projects or services.</p>

Principle	Scope	Actions
<p><b>6 Be proportionate</b> continued</p>	All funders	<p>d As organisations grow over time and take on additional work, they may achieve economies of scale and reduce the level of overheads necessary to support each project. You should recognise that the full cost of a project may change over time, and accept that the quoted cost can only ever be an estimate, based on a reasonable forecast of activity. You should not take on a funded organisation's business risks by asking for the cost to be recalculated whenever its activity increases or decreases.</p> <p>e Publish guidance for applicants to explain the approaches and methods of cost allocation you support and endorse, perhaps including the acevo template, and those you will not fund.</p>
<p><b>7 Manage change</b></p> <p>If you have not already implemented full cost recovery, you will need to manage its introduction across your organisation, developing the understanding and securing the commitment of relevant staff at all levels.</p>	All funders	<p>a Explain the principle of full cost recovery and its justification to secure buy-in across your organisation, from the board through to grantmaking or procurement officers. It will need to be owned and championed at senior level.</p> <p>b Develop a strategy for managing the implications of implementing full cost recovery. Provide a forum for staff and board members to discuss and resolve the challenges and risks involved.</p>

Principle	Scope	Actions
<p><b>7 Manage change</b> continued</p>	All funders	<p>c Train your frontline staff to implement the principle of full cost recovery in working with organisations. They should understand the meaning of full cost recovery, and know how to assess applications against the principle. Allow them a degree of flexibility and autonomy in interpreting the principle.</p>
<p><b>8 Consider the wider issues involved</b></p> <p>Full cost recovery is a key component in ensuring the sector's outputs are efficient and sustainable. Keep the bigger picture in mind when determining your policy on full cost recovery, and seek to spread good practice.</p>	All funders	<p>a Compare your own approach to full cost recovery with those of other funders, particularly those operating in comparable fields. See what you can learn from their approaches, and how you can influence other funders to improve practice.</p> <p>b Allowing organisations to generate a reasonable surplus on their funded activities is a long-term investment. It enables organisations to generate unrestricted funding for research, development and performance improvement.</p> <p>i It is therefore appropriate to allow organisations to generate a reasonable surplus in their contract-funded activities.</p> <p>ii You should permit organisations to include a reasonable and realistic margin to cover contingencies and risk in 'open book' arrangements.</p>

Source: *Full cost recovery: A manual for funders*, acevo/Big Lottery Fund, 2006.

## Conclusion

This briefing provides an introduction and overview of the main issues surrounding full cost recovery. It is important that both funders and organisations recognise the importance of this issue, and listen to each other's concerns.

## Further information

*Improving relationships with the third sector: Guidance to funders and purchasers*, HM Treasury, 2006

This revised document is intended to help government departments, non-departmental public bodies and other funding bodies that distribute public money to the third sector. The principles set out in the guidance are consistent with the undertakings contained in the Compact Funding and Procurement Code. The Chancellor has written the foreword; the epilogue is by Sir Sandy Bruce-Lockhart, chair of the Local Government Association.

Available from: [www.hm-treasury.gov.uk./spending\\_review/spend\\_ccr/spend\\_ccr\\_guidance.cfm](http://www.hm-treasury.gov.uk./spending_review/spend_ccr/spend_ccr_guidance.cfm)

*Decision Support Tool (DST)*

This web-based tool has been developed by the National Audit Office, in close collaboration with government. It is designed to take funders and purchasers through a structured series of decisions about the design of funding programmes, which will help to ensure that funding programmes both achieve their objectives and comply with the Compact Funding and Procurement Code. The DST is fully compatible with HM Treasury's *Guidance to funders and purchasers*. Available from the NAO website: [www.nao.org.uk/better\\_funding](http://www.nao.org.uk/better_funding)

*Full cost recovery: A guide and toolkit on cost allocation*, acevo/NPC, 2004

A guide and interactive toolkit that will help users calculate and understand the total cost of each of their activities, including an appropriate proportion of overhead costs. It is also available as an interactive CD-ROM which guides you through the cost allocation template electronically.

[www.acevo.org.uk/main/publications.php?content=pubcatalog](http://www.acevo.org.uk/main/publications.php?content=pubcatalog)

*Full cost recovery: A manual for funders*, acevo/Big Lottery Fund, 2006

acevo and the Big Lottery Fund will be publishing their manual in the autumn. It will be available as a free download from both organisations' websites.

[www.acevo.org.uk](http://www.acevo.org.uk)

[www.biglotteryfund.org.uk](http://www.biglotteryfund.org.uk)

## Funders

The following major funders assisted with case studies for the above manual:

[www.biglotteryfund.org.uk](http://www.biglotteryfund.org.uk)

[www.futurebuilders-england.org.uk](http://www.futurebuilders-england.org.uk)

[www.bridgehousegrants.org.uk](http://www.bridgehousegrants.org.uk)