# Full cost recovery

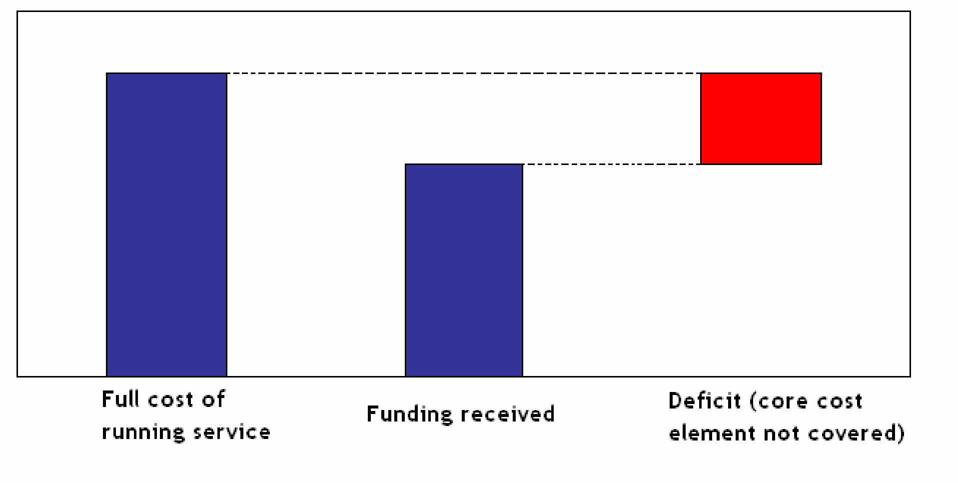
## What is full cost recovery?

Social enterprises trade for a social (or environmental) purpose. This means that your services or products address a specific issue in your community or meet a social, environmental or economic need. You also need to generate money from your products and services, whether you do this by selling to customers, delivering public sector contracts or by receiving a grant to run projects.

Ultimately, if you do not generate enough income, you will have difficulty in sustaining your enterprise financially and will not be able to continue to deliver its social impact. But how much is enough income? Ideally, social enterprises should be aiming to make a surplus or, at the very least, should aim to cover all the costs of providing their products or services. This process is termed full cost recovery.

Full cost recovery is the ability to recover the total cost of a service, project, activity or product, including some of the costs that are not directly related to the delivery of a specific project but are necessary to run the organisation. The idea is to avoid being at a loss financially or face a deficit because the full cost of running a service or delivering a product are not met. This term is often used in relation to grant or publicly funded initiatives.

**Deficit diagram**




## Why is it important?

Unfortunately there is a high incidence of social enterprises, together with voluntary and community organisations, not recovering their full costs.

There are a number of reasons why this might happen, including mainly:

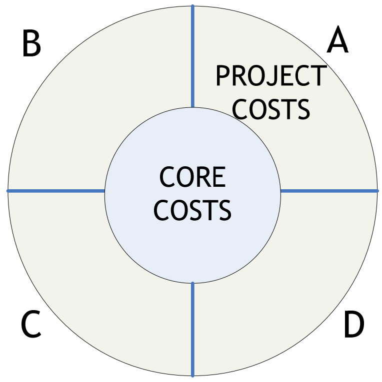
- Poor financial management – ie being unable to work out what the true costs are and therefore pricing products and services too low.
- Price competition – ie reducing prices to retain customers, market share or attract funders and commissioners through better value for money.

Even grant funded projects and organisations tend to have problems recovering full costs because funders tend to give grants only for projects and not for other associated costs such as those of running an organisation. This means that funders will pay for the direct costs associated with running a service or project (such as specific project staff, materials, venue hire, travel, etc) but not the core costs of running your organisation (such as office rent, general marketing, management salaries etc).

Since the issue of full cost recovery is often associated with grant funding this is what will be explored further here. However the same principles apply to recovering the costs of any business transaction.

## How does full cost recovery work?

The diagram below is designed help you to visualise an organisation as a donut ring. The ring is made up of a number of projects A, B, C and D, with the core costs in the centre being the costs of running your business (eg management costs, administration costs, IT, HR, and the cost of office premises), without which the projects cannot function.




The core costs will be used to support the projects in different ways and at different times. For instance IT support may be needed during specific phases of a project whereas management support may be needed throughout the lifetime of a project. Both IT and management support will also be needed for the general running of the organisation. For this reason, it can be difficult to associate and allocate the core costs of running an enterprise to a specific project activity.

Some funders believe that their role is to fund the social benefits of projects and not the core costs of an organisation. This attitude is changing but you should still be able to demonstrate to a funder the necessity of some core costs to run projects, and be able to show how these are apportioned to each project. The same is valid when quoting a customer - you should be able to factor-in all the costs of doing business to the price of your products or services.

## Understanding your true costs

If an organisation is unable to recover its core costs it remains financially vulnerable and may therefore end up with a very short life span because it won't be able to cover the its own costs of doing business.

There are methodologies, however, that your enterprise can use to have a better understanding of your true costs so that you can recover them fully. By calculating the full costs of each activity, you can plan in advance and make more informed decisions about managing costs and securing the right amount of funding, or charging the right price, to cover them.

**Common practice**

Traditionally organisations with an understanding of full cost recovery have used arbitrary methods to allocate costs to a project, for instance, by allocating 15 per cent of their organisation's total core costs to each project. However this usually does not reflect true costs accurately and can lead you to under budget by not allocating enough money to cover all your costs.

**Funder fear**

If costs are inaccurately apportioned across a number of projects funders may fear that they will be paying for core costs already covered by funding received for other projects. This is called 'double funding'. Funders therefore need reassurance that the method of allocation that an organisation uses for its core costs is appropriate. Similarly, if you double fund your costs you may end up being pricier than your competitors or out-price your customers.

## Ways to recover all your costs through full cost recovery

**1: Identify your costs: do you know what things cost you?**

You need to know what your costs are in order to recover them. To achieve this, you need to have systems in place that help you to understand and capture all your costs, including additional costs that are not always obvious, such as employers' national insurance contributions, pension contributions, travel expenses etc.

This can be quite a difficult task. Many organisations are not aware of all of the costs that impact them and even when they do, it requires discipline to capture each item. Future costs must be anticipated and current costs must be regularly updated because of external changes (eg cost of fuel).

You should therefore aim to have a good financial management system, processes and procedures, which are a pre-requisite for a successful and sustainable organisation. It is worth investing in such a system and having the personnel to manage it; this will also greatly reassure funders about your ability to manage funds received. If you make reference to investing in a system, is it worth mentioning which ones they might be.

**2: Differentiate direct project costs from core costs**

Here is an example:

| | |
|---|---|
| **Direct project costs** (specific to a project or activity) | • Recruitment of project staff who will be directly involved in the project, such as the project manager, trainers, etc.<br>• Salaries of project staff<br>• Project staff travel<br>• Training or project staff<br>• Projects materials and equipment<br>• Project monitoring and evaluation<br>• Project marketing<br>• Legal costs of the project<br>• Stationery and postage for the project<br>• Telephone costs for the project |
| **Core costs** (costs of running your organisation that are not included in direct project costs) | • Chief executive's salary and on-costs<br>• Administration salaries and on-costs<br>• Office and general accommodation costs<br>• Accounting and payroll costs<br>• Insurance for the organisation<br>• Website and internet<br>• General telephone costs<br>• Organisation's marketing and publicity costs<br>• Legal and professional fees for the organisation<br>• Training costs<br>• Depreciation of assets<br>• Costs associated with trustees |

Again, remember that care needs to be taken when allocating any costs from project to project - whether they are project costs or core costs sometimes depends on the nature of each project.

The length of the project will also make a difference. If the project is going to run for more than a year for instance you need to think about price inflation, future recruitment, pay rises, equipment purchases etc.

**3: Allocate your core costs to each of your projects**

Deciding how much of the costs of running your organisation (ie core costs) should be allocated to each of your projects is not always an easy process and is not an exact science. What is important, however, is that you do your best to be realistic and that you have a chosen methodology to allocate your core costs. Your enterprise will need to apply this methodology consistently across your projects and communicate this to funders so that they are reassured that there is no double counting of costs.

Using arbitrary methods is not recommended because it can lead to projects contributing too much or too little to an organisation's core costs (ie costs of running the business).

A potential solution is to look at how many people are working on each project. For example, if Project Red employs two people and Project Blue employs four people, then allocating 15 per cent of your core costs to each project would seem unfair. Instead, it would be logical to assume that more management time and more desk space is used to support Project Blue than Project Red, because it has more staff. You could therefore allocate 10 per cent on core costs to Project Red, and 20 per cent to Project blue.

There are also other methods or techniques that you can use, including the Big Lottery Fund and the ACEVO model.

**Big Lottery Fund**

The Big Lottery Fund application for funding, which is done online, takes organisations through a process that is helpful in understanding how to allocate costs to projects. It comes with a useful and practical spreadsheet (a web address is listed at the end of this guide).

**The ACEVO model**

Association of Chief Executives of Voluntary Organisations (ACEVO), a membership organisation for chief executives of the voluntary sector, has developed a methodology for full cost allocation that uses the following steps.

Firstly where possible direct costs are allocated to each project.

The remaining core costs are allocated between four main headings:

1. Management and leadership
2. Infrastructure and accommodation
3. Finance, governance and control
4. Strategic development

Management costs are then apportioned across each project and then to the three remaining core cost headings. The infrastructure costs are the apportioned across each project and then across the two remaining core cost headings. This is repeated until all the core costs have been apportioned across each project.

The ACEVO model comes with software that leads you through the process and there is a manual accompanying it. This method, however, may prove complicated for smaller organisations.

## Summary

To re-iterate, full cost recovery is associated with grant funding but it applies to all organisations, regardless of how they generate income.

It is good discipline to be totally aware of the costs in your organisation and how they are allocated to projects, products, services and other initiatives you may be involved with. All this information will be relevant whatever type of funding a social enterprise may seek to pursue.

Understanding the cost drivers associated with different projects will also help you to:

- Evaluate your projects more clearly
- Allow you to price your services better
- Allocate resources more efficiently.
- Ensure that you can deliver products and services on time and on budget
- Negotiate more effectively with your suppliers and customers
- Look at innovative ways to deliver within budget.

## Things to look out for with full cost recovery

- Ensure that your work around full cost recovery is not a stand alone process – it should apply to other areas of your business. Full cost recovery is part of developing a sustainable business strategy and ensuring that you can continue operating in the long term. Full cost recovery should be integral to your thinking around financial management, including cashflow and profit forecasts.

  Being able to fully recover costs on projects does not mean that you will be safe from having cashflow problems.

- Also bear in mind that if you are working with a funder, full cost recovery will not enable your organisation to generate a surplus or profits, but only to cover all the costs involved either directly or indirectly in delivering your funded project.

  However, social enterprises have more flexibility to generate surplus through trading (ie selling their products and services) by setting prices which allow not only to fully recover all costs, but also to generate a profit. This money can then be used as reserves, to develop new services and grow your business (see our guide on Costing and pricing your products and services for more details).

- You may realise that you are not able to fully recover your costs from a grant but you still want to carry out the project because of the social impact it creates. In this case, you need to find other ways to generate income to cover all your own costs.

- If you have been under-selling yourself, recovering all your costs may mean you have to change your prices and adapt them to your real costs.

  In the case of working with funders, and to avoid this scenario, you should aim to get them to understand all the costs you incur as an organisation in order to run the project successfully. Helping the funder understand all your costs will make them more likely to give you the right grant size for a project.

## Further information

**Visit the Big Lottery Fund website to access a full cost recovery spreadsheet:**
**www.biglotteryfund.org.uk/fcr-spreadsheet.xls**

**Visit the Association of Chief Executives of Voluntary Organisations (ACEVO) website to access their full cost recovery model:**
**www.acevo.org.uk**

**Read our guide on Costing and pricing your products and services:**
**www.bllondon.com/SocialEnterprise/Marketing/Salesandmarketing/costing-pricing.aspx**

**Read our guide on Developing a diversified funding strategy:**
**www.bllondon.com/SocialEnterprise/Fundingandfinance/Sourcingfinance/Developingadiversifiedfundingstrategy.aspx**