



Tasmania

**FULL COST ATTRIBUTION PRINCIPLES FOR  
LOCAL GOVERNMENT**

Department of Treasury and Finance

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# Full Cost Attribution Principles for Local Government

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## Chapter 1: Introduction

### ***Purpose of the Full Cost Attribution Principles***

These Principles have been prepared to assist the Local Government Sector in the implementation of the Full Cost Attribution (FCA) principles which are outlined in the Application of the National Competition Policy to Local Government, published in June 1996. The Principles focus on the steps that Councils need to follow to ensure that they are complying with the FCA model under the National Competition Policy (NCP). The principles are not definitive, all encompassing nor prescriptive. Rather, they are illustrative, such that Councils are able to apply the concepts to their individual circumstances.

The principles are not intended to reiterate papers and guidelines which have already been issued by Treasury on similar or related matters and should be read in conjunction with:

- *Application of the National Competition Policy to Local Government*, Policy Paper, issued by the Government of Tasmania in June 1996;
- *Guidelines for the Costing of Outputs*, issued by the Department of Treasury and Finance, Tasmania in June 1996;
- *National Competition Policy - Guidelines for Considering the Public Benefit under the National Competition Policy*, to be issued by the Department of Treasury and Finance (currently in draft format); and
- *National Competition Policy - Competitive Neutrality Principles Complaints Mechanism Statement of Processes*, to be issued by the Department of Treasury and Finance (currently in draft format).

Other documentation which should also be referred to includes:

- *Workbook and Explanatory Notes for Identification of Significant Business Activities*, issued by the Local Government Association of Tasmania in October 1996;
- *Wholesale Sales Tax Equivalent Regime - Discussion Paper on Framework and Methodology*, issued by Department of Treasury and Finance, Tasmania and Arthur Andersen, January 1995;
- *Wholesale Sales Tax Equivalence Regime - Guidelines on the Conduct of Sampling by Government Business Enterprises*, issued by Department of Treasury and Finance, Tasmania, April 1995; and
- related National Competition Council documentation.

### ***Terms of NCP***

At the April 1995 Council of Australian Governments (COAG) meeting, all Australian Heads of Government signed a number of Agreements designed to boost the competitiveness and growth prospects of the national economy into the future. The Agreements give effect to many of the recommendations contained in the Report into National Competition Policy chaired by Professor Hilmer which was released in August 1993.

One of the NCP Agreements, the "Competition Principles Agreement" (CPA), requires:

- consideration to be given to the introduction of a regime to oversee prices charged by government businesses that are monopoly, or near monopoly, suppliers of goods or services;
- government businesses to operate within a framework that ensures that they do not enjoy any net competitive advantage simply as a result of their public ownership (competitive neutrality);
- an independent review to be undertaken before either privatising, or introducing competition to, a traditional Government monopoly;
- the review and, where the Government considers it appropriate, the reform of all legislation that restricts competition by the year 2000; and
- consideration to be given to introducing a legislated right for third parties to negotiate access to essential infrastructure facilities.

Clause 7(1) of the CPA states that the principles regarding the application of the National Competition Policy set out in the Agreement, including that of competitive neutrality, also apply to Local Government, even though Local Governments were not signatories to the Agreement.

### ***Principles of Competitive Neutrality***

The competitive neutrality principles required under the CPA relate to removing any advantages a government business might otherwise enjoy as a result of its government ownership and any disadvantages which similarly may be imposed. The objective of the competitive neutrality principles is the elimination of resource allocation distortions arising out of public ownership of entities engaged in significant business activities.

Presently, there is a range of potential advantages and disadvantages that can arise from public ownership. For example:

### *Potential Advantages*

- Exemptions from Commonwealth, State and Local taxes;
- No requirement to return a profit, a return on investments or interest on internal borrowings;
- Tied clients and the opportunity to cross-subsidise commercial operations from Government funded departmental activities;
- Immunity from bankruptcy and the threat of take-over;
- Exemptions from various Commonwealth and State legislation applicable to private sector equivalent entities;
- Access to various corporate overheads free of charge or at reduced rates, including office accommodation, payroll services, human resource services, and marketing and information technology services;
- Cheaper costs of borrowing, where the business is perceived as being backed by an explicit or implicit Government guarantee; and
- Preferential input to tender specifications.

### *Potential Disadvantages*

- Difficulty in accessing taxation benefits of depreciation, investment allowances and other deductions (e.g. through the transfer of taxation losses);
- Public sector award conditions and higher public sector superannuation contributions;
- Lower degree of managerial autonomy, due to the requirement to comply with Ministerial directives;
- Higher accountability costs given the public sector's reporting and regulatory requirements;
- Lack of flexibility in reducing or restructuring corporate overheads;
- Constitutional and legal constraints, e.g. being subject to Freedom of Information and Ombudsman legislation;

- Lack of direct access to capital markets; and
- Requirement to undertake non-commercial activities.

### ***Application of the Full Cost Attribution Model***

The CPA provides two separate models of competitive neutrality. These are referred to as the "corporatisation" model and the "full cost attribution" model. The *Application of the National Competition Policy to Local Government* policy paper issued by the Government of Tasmania in June 1996 provides for a staged approach to the introduction of competitive neutrality. This staged approach involves:

- Councils identifying relevant business activities;
- Councils identifying which of these are significant business activities (SBAs);
- application of full cost attribution to those SBAs;
- identification of those SBAs which are potentially suitable for corporatisation;
- undertaking public benefit assessments of the corporatisation of those SBAs which are potentially suitable for corporatisation; and
- corporatisation of those SBAs where a public benefit assessment indicates that the benefits outweigh the costs of doing so.

The corporatisation model is beyond the scope of this paper. For additional information regarding the model, please refer to the *Application of the National Competition Policy to Local Government* policy paper.

The application of the full cost attribution model (FCA Model) is the focus of these principles.

### ***Timeframe for Implementation***

The timetable for the implementation of the *Application of the National Competition Policy to Local Government* has been suspended to enable the implementation of announcements contained in the Premier's *Directions Statement* concerning local government initiatives and proposed Council amalgamations.

The suspension of the implementation of NCP to local government will continue until such time as the new structure for Councils is finalised and the

amalgamation process completed. Once this has occurred, the implementation timetable and work undertaken to date in applying the competitive neutrality principles will be revised.

Notwithstanding the suspension of the implementation, these Guidelines have been released to ensure Councils are aware of the guidelines and processes associated with FCA.

Under the NCP Agreement, FCA need only apply to SBAs. However, Councils may choose to apply FCA to their non-SBA activities as well. The *Workbook and Explanatory Notes for Identification of Significant Business Activities*, issued by the Local Government Association of Tasmania (LGAT), explains the process of recognition of SBAs in detail.

### ***Complaints Mechanism***

The Government Prices Oversight Commission (GPOC) is responsible for overseeing the review of complaints against the application of the competitive neutrality principles within State and Local Government.

In accordance with the *Application of the National Competition Policy to Local Government* policy paper, GPOC will:

- only consider complaints by a person or business adversely affected by the failure to comply with the *Application of the National Competition Policy to Local Government* policy paper and any associated implementation guidelines;
- only consider complaints after the Council, against which the complaint is made, has had the opportunity to review its actions and respond;
- report on its findings jointly to the Minister for Finance and the Minister for Local Government; and
- make its recommendations public in an annual report.

### ***Costing versus Pricing***

These principles do not impose pricing obligations on Local Government but assist in the recognition of what is the fully attributed cost of an activity or function so that pricing decisions can be made in light of the full facts. Pricing decisions are dependent on a number of managerial assessments regarding the desired profit margin or rate of return which is required from a contract and prevailing market prices as well as the full cost of performing the activity, function or providing the service.

### ***Future Reviews of the Guidelines***

The Department of Treasury and Finance recognises the fact that costing is an evolving process. The Department of Treasury and Finance will continue to review these guidelines and, accordingly, Councils are invited to provide comments on the guidelines in the future. Legitimate written requests for revision of the guidelines will be considered in accordance with the same consultative approach adopted for the development of the initial guidelines.

It is also recognised that the process of Full Cost Attribution involves some element of estimation, eg. in the approach recommended for the calculation of income tax. Therefore, it should be understood that there is a trade-off between accuracy and the cost of implementation, such that whilst the recommended approach may have some shortcomings in reflecting what may otherwise be the true cost, the method adopted is more simple and easier to implement, with a corresponding saving in resources invested in its calculation.

## **Chapter 2: Background to Costing**

### ***Pre-Requisites for Full Cost Attribution***

One of the pre-requisites for the successful implementation of the FCA Model is the availability of accurate and comprehensive financial data. Councils have been required to comply with Australian Accounting Standard AAS 27 - "Financial Reporting by Local Governments" and other relevant accounting standards for a number of years in respect of their general purpose financial reports. As a result, Councils may already have in place sophisticated accounting systems or may have access to such systems.

Whilst the existing accounting systems of most Councils may provide the required level of accuracy for compliance with Accounting Standards, they may not provide the detailed dissection of expenditure required for FCA. A review of the ability of the accounting system of each Council to recognise the detailed dissection for FCA will need to be undertaken to determine the extent to which costs can be attributed to particular activities before a decision is made to use a supplementary costing system.

Accurate and consistent costing permits more informed price setting, the calculation of fair internal transfer prices and simplifies any future competitive tendering and contracting decisions. For the FCA Model to be effective, the accounting system adopted by a Council:

- must be based upon accrual accounting, which greatly improves the ability to properly cost activities;
- should reflect valuations of particular assets used at the activity level ie. provide for a factor representing the use of assets at the activity level;
- should enable compliance with Australian Accounting Standards and other generally accepted accounting principles in the preparation of the financial statements; and
- should enable transparency of information, such that costing information at activity level is capable of being linked to published financial statements.

### ***"Ringfencing" the Business Activities***

An effective form of organisational separation, or "ringfencing", is central to maintaining confidence in the legitimacy of FCA. This can be achieved by:

- separating the SBA to be costed from all aspects of service regulation and specification;

- introducing a degree of commercial autonomy to the SBA, including the discipline of a requirement to cover costs and return an appropriate profit; and
- enhancing the transparency of the relationship between the SBA and the rest of the Council's activities by requiring explicit identification and funding of any non-commercial objectives.

Where a Council competes with the private sector, the competitive neutrality principles require that any subsidies provided by the Council to the SBA are transparent in the Council's decision making process.

Whilst it is ideal to separate SBAs structurally to establish the fully attributed cost of an activity, in some instances the degree of separation may be limited to merely an accounting separation to enable the financial relationships between the various activities of the Council to become more transparent.

Councils should separate policy, regulatory and governance activity costs from operational or service delivery SBAs to ensure there is no conflict of interest or that business activities do not enjoy any regulatory advantage over their private sector competitors. Governance activity costs relate to the cost of operating a Council, eg. the election and poll costs, payments to councillors, the administration cost of supporting the councillors and the costs involved in policy formulation.

Whilst Councils are required to separate their SBAs for FCA purposes, management should take a total view to the operations of their business. For example, where internal service agreements form part of the cost allocation process care needs to be taken to ensure that behaviour which might be favourable to one SBA, but detrimental to the organisation as a whole, is not adopted.

### ***The Costing Concept***

Costing is the process of gathering and reporting information about the costs of providing an activity. There are several costing methodologies which will provide a cost for undertaking a business activity. Which methodology is the most appropriate to use will vary depending on the circumstances.

The methodology to be adopted by Councils as the basis for FCA, unless otherwise approved by the Local Government Office, after consultation with Treasury, is Activity Based Costing. Treasury's interpretation of the concept Activity Based Costing is more clearly explained in the following section.

### ***Activity Based Costing***

Activity Based Costing (ABC) ties particular expenses to particular goods or services, whilst minimising the arbitrary allocation of overhead costs. This is achieved by reviewing each of the organisational support or indirect costs and allocating each one to a direct good or service based on some logical criteria, whilst keeping in mind the materiality of the amounts involved.

As a guide for classification of activities within the jurisdiction of Local Government operations and the level to which FCA is to be applied, reference should be made to the Australian Bureau of Statistics classification of Local Government Services ABS Catalogue No. 5501.6.

Application of ABC may appear to increase the cost of production. However, when evaluating the resultant fully attributed cost, what is occurring is the true recognition of the cost of production, rather than viewing a function in terms of only its direct costs. That is, previously "hidden" costs become apparent.

It should be kept in mind that it is unlikely that there will be only one "right" costing answer that will apply to all Councils or to all situations within a Council. The purpose of the costing, the nature of the expenditure and the factors affecting the dollar total of the expenditure should always be considered.

The way that activities are costed is very important. Inappropriate costing may distort decision making at both the business activity and Council levels. From a Council perspective, incorrect definition or costing of activities may cause:

- under funding, following movement of an incorrectly costed activity and its associated budget from one activity to another;
- inappropriate allocation of internal resources; and
- inability to correctly identify opportunities for improved performance and efficiency.

Costing, based on activities performed, enables the fully attributed cost of an activity to be recognised and accounted for, and is the basis of the FCA Model outlined in this document. This is discussed more fully in Chapter 3.

### ***Costing Systems and the Allocation of Costs***

Costing of a SBA should incorporate all costs associated with that activity (non-cash as well as cash) and indirect costs such as building maintenance and financing costs which may be expensed to other areas of the Council outside the SBA. That is, costs should be on a full accrual basis rather than on a cash basis.

Councils should recognise costs on an activity basis rather than just on an expense classification basis. It is possible that such a system can be maintained outside of the Council's normal general ledger accounting system, for example via linked spreadsheets. To minimise manual reworking of information, the costing system should, to the maximum extent possible, be part of the main accounting system where the full cost attribution allocation is performed automatically.

When determining the allocation of costs, Councils need to fully understand how, and the extent to which, each of their functions are interrelated and consider the impact of each activity undertaken on other Council activities. The costing system should recognise these links.

The precise identification and allocation of such indirect costs, whilst ideally being allocated based on an appropriate and relevant basis, involves a trade-off between the cost of producing the information and its usefulness and accuracy. Councils need to adopt a level of accuracy that reflects the materiality involved in allocating indirect costs for FCA. However, the level of accuracy adopted should always be such as to ensure the results are not biased.

Generally, Councils should avoid assigning significant resources to the allocation of a small bundle of indirect costs at the expense of costing other major aspects.

To ensure the integrity of the FCA figures, it is important that all fully attributed costs should be allocated by properly documented processes and be capable of verification through independent assessment. All methods adopted and assumptions made should be clearly and explicitly stated. The costing process is discussed in more detail in Chapter 4.

## Chapter 3: Full Cost Attribution (FCA)

### ***Full Cost Attribution***

The fully attributed cost of an activity is the value of all resources consumed by a Council in the provision of that activity.

Fully attributed cost can conveniently be described as consisting of:

- i) operating costs (direct and indirect) per unit or period; ***plus***
- ii) capital costs (direct and indirect) per similar unit or period; ***plus***
- iii) competitive neutrality costs per similar unit or period.

#### ***i) Operating Costs***

Operating costs need to reflect both direct and indirect costs. Direct costs are directly related to an activity and include direct wages and materials where they are used solely for the purposes of the activity concerned. Indirect costs relate to the internal area of organisational support supplied by other areas of a Council to enable the delivery of the business activity. For further explanation of direct and indirect costs, refer to Appendix 1.

#### ***ii) Capital Costs***

The use of non-current assets involves two aspects of cost:

- costs associated with the use, consumption or dissipation of the asset over its useful life. In accounting terms, this is referred to as depreciation; and
- the opportunity cost of capital, (ie. the cost associated with the fact that capital is tied up in the non-current asset and is not able to be utilised elsewhere).

To achieve a true fully attributed cost which satisfies competitive neutrality principles, it is essential that the fully attributed cost contain an element to cover the non-current assets dissipated and the opportunity cost of capital which is tied up in the service which could otherwise be used elsewhere (ie. both aspects as mentioned above).

### *Assets Subject to Lease Arrangements*

Where Council assets used in a SBA are subject to an operating lease via a non-related third party under an arms length transaction, then the cost of the lease payments are to be included in the FCA. No provision or adjustment for the opportunity cost of capital will be required for these assets as the assumption is that the third party is already making a provision for a rate of return on the assets in the lease charge.

If assets are acquired via a finance lease with a non-related third party under an arms length transaction, then the transaction is, in substance, a borrowing. As such the lease payments comprise a component for interest and a component for the reduction in the lease liability. As the interest component is determined as a result of an arms length transaction, it is reasonable to assume that the lessor is effectively making its required rate of return on its capital. As such, it will not be necessary for the Council to calculate an opportunity cost of capital for these assets as to do so would result in double counting.

Where assets are subject to internal charging between business units of a Council, ie. not subject to an arms length transaction, the internal hire rate is not to be used as an equivalent operating lease charge. Rather, an actual depreciation and opportunity cost of capital will need to be calculated on the same basis as Council owned assets.

### *Council Owned Assets*

Where assets are owned by a Council and are used for the purposes of the SBA, recognition of the capital assets is achieved by including a component for depreciation of the assets in the fully attributed cost. Depreciation, based on the written down current cost of the assets, should be used when calculating the fully attributed cost.

### *Opportunity Cost of Capital*

The opportunity cost of capital, also referred to as “return on assets”, involves recognition of the fact that resources tied up in the assets could have been utilised elsewhere to generate returns. Calculation of the opportunity cost of capital should be based on the written down current cost of the non-current assets and working capital used by the activity, multiplied by a predetermined rate. Where debt (incurred either by borrowing or through an external, arms-length third party leasing arrangement) has been used to finance the purchase of an asset, the interest should be deducted before arriving at the opportunity cost of capital, if it has already been included in operating costs, to avoid any double counting.

The rates for calculating the opportunity cost of capital will be advised to Councils by the Local Government Office bi-annually, commencing 1 July 1997. The rates will be the result of consultation and agreement between the Treasury, Office of Local Government and Local Government Association of Tasmania. The rates may be subject to adjustment from time to time, based on prevailing market conditions.

The rates determined for a particular type of SBA will apply to all Councils undertaking the particular type of SBA under consideration. Separate rates will not be determined for different types or classes of assets utilised within the one SBA. Whilst it might be argued that separate rates should be provided for assets with markedly differing lives, this is not considered efficient or appropriate. Rather, the rate determined will be one which reflects the total risk involved in the overall SBA.

### ***iii) Competitive Neutrality Costs***

In addition to direct and indirect costs, competitive neutrality principles require that, when establishing FCA in SBAs where taxes, guarantee fees and regulations are currently not imposed on an activity, an equivalent component must be included in the costs. This will ensure that there is full attribution for these costs in establishing prices charged for goods and services. It should be noted, however, that these costs do not necessarily have to actually be incurred. That is, there is no requirement for taxes and guarantee fees to actually be paid, ie. they may be considered as notional costs.

### ***Taxation***

Whilst allowing for a component of taxation costs in FCA is important and represents a part of the overall objective in ensuring competitive neutrality, it should be noted that tax based adjustments are just a part of the fully attributed cost. Therefore, to the extent that taxation costs are relevant, identifiable and quantifiable, they should be included in the cost of an SBA.

Although it is recognised that these taxes may already be imposed on Councils, FCA requires that rather than these costs be charged to a Corporate or Administration level, these costs be included in the costs for the relevant SBAs which undertake the transactions attracting the imposition of the tax.

Examples of taxes and other legislative employment obligations which apply in the private sector and which should be considered when undertaking the FCA exercise are as follows:

- Income Tax
- Fringe Benefits Tax
- Stamp Duty
- Debits Tax
- Council Rates
- Sales Tax
- Payroll Tax
- FID
- Land Tax
- Workers' Compensation

### *Income Tax*

As Councils are exempt from the application of the *Income Tax Assessment Act 1936* (ITAA), Councils do not have in place any systems or processes to calculate income tax. However, under the competitive neutrality principles, Councils are required to factor income tax into the costs of their SBAs.

For FCA purposes, a simple approach regarding income tax is preferred, whereby taxation is calculated using the "Accounting Profit" method. Under this method, tax is the SBA's accounting profit multiplied by the current company tax rate.

Whilst it is recognised that the Accounting Profit approach involves some element of estimation and in some circumstances may differ from what might otherwise be costed if a more sophisticated approach is used, it should be understood that there is a trade-off between accuracy and the cost of implementation. The recommended approach may have some shortcomings in reflecting what may otherwise be the true cost. However, the method adopted is more simple and easier to implement, with a corresponding saving in resources invested in its calculation.

Whilst use of the Accounting Profit Model is preferred under these guidelines, Councils may adopt another model of calculation if approval by Treasury is received prior to implementation.

### *Wholesale Sales Tax*

There is a number of alternative models for implementing a wholesale sales tax equivalent regime, but it is recommended that the Multiple Average Sales Tax Equivalent Rate Model, be adopted. This model is the same model as being applied to the State's Government Business Enterprises. The Model is relatively simple to introduce and once established has very low administrative costs. Alternative models for calculating wholesale sales tax equivalent have high administration costs which may place Councils at a competitive disadvantage to private sector competitors.

To introduce the Multiple Average Sales Tax Equivalent Model, a Council must undertake a detailed review of purchases by the SBA to determine the amount and rates of wholesale sales tax which would have been paid by the SBA, had the Council have been subject to Commonwealth wholesale sales tax. An average rate, or rates, of sales tax is calculated from the sampling process which is then applied to future purchases.

For a detailed overview of the wholesale sales tax equivalent regime, reference should be made to the following papers:

- *Wholesale Sales Tax Equivalent Regime - Discussion Paper on Framework and Methodology*, and
- *Wholesale Sales Tax Equivalence Regime - Guidelines on the Conduct of Sampling by Government Business Enterprises*.

The Department of Treasury and Finance will provide advice to Councils on the implementation of the wholesale sales tax equivalent regime.

#### *Fringe Benefits Tax*

Due to the method of calculating Fringe Benefits Tax currently in use in Australia, (ie. applying a grossing up factor and the subsequent fringe benefits tax paid being an eligible deduction in the tax return for a tax paying entity), Government bodies not falling under a Commonwealth tax system or State tax equivalent regime incur a disadvantage because they are unable to utilise the tax deduction available to private enterprise. Accordingly, there is an additional cost for Government as a result of the grossing up of benefits.

As with all disadvantages imposed on Government as a result of its status of being Government, these should be removed from the calculation of the fully attributed cost of a SBA. Special recognition of factors such as the additional burden of fringe benefits tax, higher costs associated with defined benefit superannuation schemes etc. should all be removed, or alternatively, balanced against the advantages to arrive at a net position.

#### *Payroll Tax*

For FCA, allowance for an amount relating to payroll tax must be included where the payroll costs of the SBA exceeds the payroll tax threshold amount. When calculating the payroll costs, Councils should include any support staff not directly part of the SBA, but still providing a service to the SBA.

### *Stamp Duty*

When costing a SBA, Councils need to allow a component for stamp duty where transactions undertaken by a SBA would ordinarily attract a stamp duty liability. Such transactions include purchase or rental of real estate, leasing and finance arrangements.

### *Council Rates and Land Tax*

Where the premises from which the SBA operates, are owned by the Council or a related body/organisation, allowance needs to be made for the Council rates and land tax which would have been charged on those premises if the Council were not exempt from the payment of these imposts.

If the Council is currently renting the premises at which the SBA is undertaken from a non-related third party, it is reasonable to assume that the lessor should be recouping rates and land tax in the commercial rent charged. In this case no adjustment for rates and/or land tax should be necessary.

### *FID, Debits Tax*

To the extent that FID and Debits Tax costs are material for a SBA, based on the financial transactions which would be required to underpin such an activity, then allowance should be made for them in the costing exercise. However, as with all costs, materiality should be emphasised rather than simply the process.

### *Guarantee Fees*

The NCP requires Councils to impose on their SBAs a guarantee fee, which reflects the benefit, in terms of lower interest rates, which the activity derives from any guarantee which may be, either implicitly or explicitly, provided by the State or Local Government.

To the extent that the calculation of opportunity cost of capital captures a rate of return, provision for guarantee fees will not be necessary. However, to the extent provision is not made, an estimate of the amount is to be calculated.

### *Transparency of Costs*

FCA must be adopted to ensure that a Council is aware of the fully attributed cost of providing an SBA and can compare that cost with the cost of alternative suppliers. Any subsidies provided by a Council to a SBA must be transparent in the Council's decision making process.

By publishing costs and explicit subsidies in its annual report, a Council also ensures that such costs become transparent to both consumers and ratepayers.

## **Chapter 4: The Costing Process**

### ***Costing a Significant Business Activity***

Once a SBA has been identified, the steps to follow to determine the fully attributed cost of the SBA should always be the same. Only the type of SBA will change each time, not the steps taken in determining the cost.

This chapter provides an outline of the costing process and does not purport to be a complete guide to costing.

### ***The Costing Process***

The general process of costing and cost allocation involves a number of definable steps, as follows:

1. define the SBA (or service) for which a cost is required;
2. map the activity flows involved and identify any sub-activities and cost relationships which are associated with the SBA;
3. select and collect the direct costs that will be traced to the SBA;
4. decide which indirect costs will be allocated to the SBA, including the competitive neutrality costs, and, if there are any with common cost relationships, the groups in which they will be collected to facilitate allocation;
5. establish a cost allocation base for each of the cost groups; and
6. undertake the costing.

### ***Defining the SBA to be Costed***

It is essential that a clear and unambiguous definition of the SBA is undertaken before any other steps are undertaken. Without a clear definition of the SBA, it will be difficult to determine its fully attributed cost. A poorly defined SBA will hamper the determination of the true cost relationships of the activity and may result in an arbitrary cost allocation process, possibly causing a distortion in the cost figures.

Defining the SBA may appear relatively easy and straight forward. However, it is important to note that the whole process hinges on the accurate definition and identification of the activity. The point is demonstrated in the following example:

"An employee who maintains the gardens of a small local council considers herself to be quite a handy person. After completing the hedging surrounding the local playground and pruning the roses outside the council offices, she notices that the central fountain has been vandalised. She goes to the store room to collect some materials and proceeds to scrub off all the graffiti and replace about twenty tiles broken inside the fountain."

In determining the cost of garden maintenance, would the cost include the repair to the fountain? If gardening maintenance is viewed simply as gardening, then the answer is no. If it is viewed as total grounds maintenance, then the answer is yes.

This example illustrates the complexity that can be found in identifying an SBA and determining its costs.

### ***Relating Costs to the Relevant Accounting Period***

The way that SBAs are costed is very important. If not done properly, costings may be distorted and correspondingly distort decision making by the Council. As discussed above, incorrect definition or costing of SBAs may cause problems, including:

- under funding following the movement of an incorrectly costed activity and its associated budget from one area of Council activity to a different area of Council activity;
- inappropriate allocation of internal resources; and
- inability to identify correctly opportunities for improved performance and efficiency.

In addition, if costs are not allocated to, or across, the appropriate period or timeframe, resultant costs may be higher than they should be (if spread over too short a period or too few a number of instances of service), or lower than they should be (if not accrued correctly, costs may be included in another period, or not even be recognised as being relevant if the activity process is not adequately mapped out).

Whilst these points need to be taken into consideration when determining costs, it should be remembered that:

- the longer the period being costed, the simpler it should be to identify the relevant costs as they tend to become more direct than indirect;
- indirect costs, whilst requiring allocation to the SBA in question, should be subjectively apportioned to the relevant service on a basis which is practical, reasonable, rational and internally consistent. The method adopted to estimate indirect costs should be technically appropriate to the circumstances and clearly documented so that the cost data produced can be verified; and
- generally, Councils should avoid assigning significant resources to the allocation of a small bundle of indirect costs at the expense of other major aspects.

The reference to the allocation of indirect costs should also be interpreted as requiring Councils to incorporate the calculation and allocation of amounts relating to competitive neutrality costs, as appropriate.

### ***In Summary***

When applying these principles, it is important to remember that whatever the purpose of the costing exercise, the approach used and the assumptions made in deriving the costs must be explicitly stated.

Therefore, all costs must be verifiable, that is, capable of being confirmed through independent analysis.

## Appendix 1

### Cost Definitions

#### *Direct Costs*

Direct costs relate to the actual provision of services to a client, regardless of whether the client is internal or external. Direct costs include, but are not limited to, direct salaries and wages and dedicated materials and equipment.

A direct cost, as the name implies is able to be fully attributed to an activity based on its direct correlation to the activity's output.

#### *Indirect Costs*

Indirect costs relate to the internal areas of organisational support required to enable the organisation to deliver services to the community efficiently and effectively.

It is in the area of indirect costs that the decision as to whether particular costs should be included in an activity based costing allocation calculation or not becomes clouded. A Council's indirect costs might include some or all of the following, though, once again this list is not exhaustive:

- general administration
- promotion
- debt collection
- reception
- leasing
- training
- cleaning
- payroll
- records
- maintenance
- insurance
- information technology

Indirect costs are not able to be allocated as easily as direct costs but must be allocated based on some logical criteria. Some examples of bases of allocation of indirect costs include labour hours, number of full time equivalents, and square metres of space occupied. For further suggestions regarding the basis of allocation of indirect costs, please refer to the *Guidelines for the Costing of Outputs* document, prepared by the Budget Management Branch of Treasury. The advantages and disadvantages of the various methods of allocation are also discussed in this document. For further examples of direct and indirect costs, and how the concepts relate to each other to arrive at the fully attributed cost, please refer to Attachments 1 and 2.

## Type of Costs included for Full Cost Attribution

### *Possible Direct Costs*

Staffing Costs (including oncosts such as training and travel)

|   |                                    |
|---|------------------------------------|
| Base wage or salary                       | Overtime                           |
| Shift loading                             | Leave Loading                      |
| Superannuation                            | Retirement/severance benefits      |
| Other allowances (e.g. on call allowance) | Travel Expenses                    |
| Uniforms                                  | Training                           |
| Protective Clothing                       | Payroll Tax                        |
| Workers Compensation Insurance Premium    | Fringe Benefits Tax                |
| Housing                                   | Air Conditioning / water subsidies |
| Office Accommodation                      | Power                              |
| Equipment                                 | Stationery                         |
| Other office consumables                  |                                    |

Consumable supplies  
Office equipment  
Maintenance  
Depreciation  
Interest

### *Possible Indirect Costs*

Includes Corporate Services Costs

### *Capital Costs*

Opportunity Cost of Capital

### *Taxation*

State  
Income Tax Equivalent  
Wholesale Sales Tax Equivalent  
Capital Gains Tax Equivalent  
Land Tax  
FID  
Debits Tax  
Stamp Duties  
Motor Tax  
Franchise & Licence fees  
Guarantee fees  
Local Government  
Rates

**Attachment 2****Summary of various types of cost:**

## Direct Operating Costs

|  |         |
|--|---------|
| Direct Labour                                | xxxxxxx |
| Direct Materials, Services and Accommodation | xxxxxxx |

## Indirect Operating Costs

|                                 |         |
|---------------------------------|---------|
| Indirect Labour                 | xxxxxxx |
| Indirect Materials and Services | xxxxxxx |

## Capital Costs

|                             |         |
|-----------------------------|---------|
| Opportunity Cost of Capital | xxxxxxx |
|-----------------------------|---------|

|  |         |
|--|---------|
| Services and Resources received "free of charge" | xxxxxxx |
|--|---------|

|                              |         |
|------------------------------|---------|
| Competitive Neutrality Costs | xxxxxxx |
|------------------------------|---------|

|                       |                           |
|-----------------------|---------------------------|
| Fully Attributed Cost | -----<br>xxxxxxx<br>===== |
|-----------------------|---------------------------|