It's easier than ABC:

A back-to-basics approach to cost accounting

by Rod MacPherson, CMA

DESPITE THE INTRODUCTION OF A WHOLE NEW GENERATION OF VERY EXPENSIVE ENTERPRISE RESOURCE PLANNING (ERP) FINANCIAL SYSTEMS IN ALMOST ALL DEPARTMENTS AND AGENCIES WITHIN THE PAST DECADE, GOVERNMENT MANAGERS HAVE HAD LITTLE SUCCESS IN REPORTING ON THE TRUE COST OF THEIR PROGRAM ACTIVITIES, LET ALONE GAINING ACCESS TO VIEWS OF COST ACROSS MULTIPLE DIMENSIONS.

The Auditor General of Canada in her April 2003 report observed that departments and agencies need to produce information on program costs and results required for sound decision making and that they must bring together financial and non-financial performance information to link costs with actual or expected results. She said one of the first steps in ensuring high quality cost information for programs is to have the policies, systems and practices in place to properly capture such information. In addition, she commented that central direction is needed to ensure consistent application among departments and agencies.

Given these observations, and the advent of the Program Activity Architecture (PAA), Expenditure Review and External Charging Policy, the timing is right for Treasury Board of Canada Secretariat to promote a set of cost accounting standards and guidelines that would provide consistency in terms of cost accounting and reporting on program costs across the federal government. This would be very much like the leadership displayed by TBS when, in 1995, the federal government formalized the need to adopt basic accrual accounting concepts as a critical part of its Financial Information Strategy (FIS) to move to more transparent "financial" results in government and provide comparability with private sector practices, an exercise which is now virtually complete.

Basic principles

The solution to the need for improved cost visibility is not through the broad implementation of activity-based costing (ABC), which is very time-consuming and resource intensive, but through a cost accounting discipline rooted in "back to basics" nationally and internationally recognized management accounting principles. The two key methodological components of this cost accounting discipline are *cost classification* and *cost attribution/allocation*. These two cost accounting components will be explained through examples derived from activities carried out in the Department of Fisheries and Oceans (DFO).

Cost classification

Cost classification relates to how costs are initially classified within the chart of accounts. Costs are classified into one of two categories, direct or indirect.

A direct cost is a cost that is unequivocally attributable to a single cost object. A direct cost would not exist in the absence of the cost object. *Within DFO, direct costs will be those salaries and expenditures that are directly attributable to a given fishery, or fishery-related activity.*

An indirect cost is a cost that cannot be unequivocally attributed to a single cost object. An indirect cost is the cost of a resource shared by more than one cost object. *Indirect costs will be those salaries and expenditures that are not directly attributable to a single fishery, and that must be allocated through some sort of formula based on an analysis to establish relative use or consumption of these resources.*

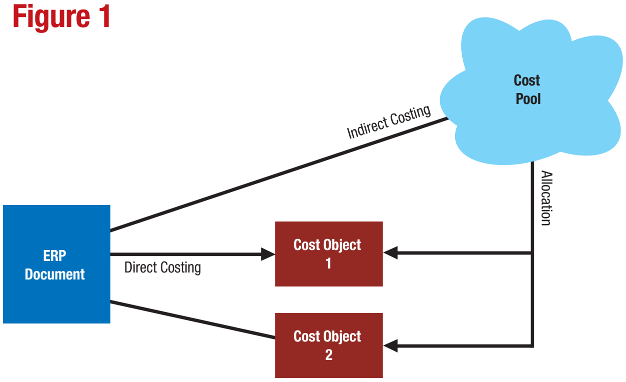
The Chart of Accounts of any department or agency should provide the flexibility to capture both types of resources (direct and indirect) so as to avoid the need for subjective judgment at the point of resource codification.

Cost re-assignment (attribution and allocation)

Once costs have been properly classified into their appropriate categories, it is then necessary to consider how to re-assign those indirect costs in such a way as to understand the "full cost" of fisheries programs, and their projects, activities and outputs.

Re-assignment of costs will occur under one of two conditions. Under one, costs are directly attributable to a specific activity or project, by virtue of being dedicated, or "directly shared" by a group of projects.

Figure 1



Resource codification occurs at the specific point where a line financial coding is determined for a specific or recurring economic event within the ERP system. The two most common scenarios requiring codification are the entry of an invoice and the determination of pay coding for a staff member. At both of these points, decisions need to be made in terms of how to "code" the transaction into the financial system. The importance of proper training for the people applying the coding cannot be understated, and their participation in the design of the coding framework is essential.

An example would be the assignment of the salaries of scientists who provide research services to a specific species or fisheries area. These scientists would be assigned to a specific fishery, or if working on more than one project would track their time against them, and the time would be used to "attribute" their salary to each of the projects. Attribution requires a "direct" link between the resource and the cost object.

Under the other, a resource is assigned to a common enabling pool of activities, and must be allocated to other organizations, activities or projects on a reasonable pro rata basis.

An example of this would be assignment of the salary costs of the accounts clerks in a regional office who are responsible for processing all of the accounts payable for several programs. These employee costs would be assigned to the clients of those activities (i.e., the internal clients) on a causal basis using a driver such as the number of invoices processed for each of the programs. In the assignment of indirect costs, selective use of Activity-Based Costing techniques may be appropriate.

Figure 1 illustrates how costs would flow through a cost assignment framework. Costs are initially classified into direct and indirect costs.

Once the initial classification has been performed, costs are then re-assigned to their eventual cost object (which are either program or management projects, activities, outputs, clients, outcomes, business lines or organizational units) based on a defensible, causal methodology.

The concept of allocating indirect (or corporate services) costs to program delivery is consistent with Canadian and internationally recognized management accounting standards, which essentially dictate that indirect costs should be allocated to products and services based on a causal factor.

The reality of corporate services, however, is that sometimes many different programs utilize common services, such as facilities and information management/information technology (IM/IT) services. As such, a deliberate design and approach is required to determine how these indirect resources relate to program delivery.

While most ERP systems can address the need for cost classification through their chart of accounts, many of them have limited or no functionality to support the allocation of indirect cost pools. This means that in the short-term, stand-alone solutions may be required to facilitate this. As the government moves towards a centralized ERP platform, this functionality combined with a solid set of management accounting principles will ensure that it can cost its programs on a fully transparent and consistent basis.

Rod MacPherson is a Certified Management Accountant who practices as a consulting cost accountant to public and private sector organizations. Mr. MacPherson is an expert in cost accounting system design and implementation, and has over 13 years of experience in government strategy and financial management. Rod can be reached at (902) 578 4724 or at rod@rodmacpherson.com.