

Unit Costing Tool

Notes on Cost of Capital

This item is treated as optional in the costing templates. Where the impact is likely to be less than material on the full cost rates, say 2% or less, it is recommended that it be omitted.

What is it and why is it relevant to NFP service providers?

The cost of capital refers to the opportunity cost of an investment made by an organisation, relating to the rate of return that the organisation could have earned at the same risk level as the investment that has been selected.

For example, where an organisation invests its funds into property to deliver services from, the opportunity cost would be quantified in terms of the return that could have been earned elsewhere, such as bank term deposits.

Why should this be part of the “full cost” of service when it isn’t included in our financials?

One of the objectives of recognising “full cost” is the financial sustainability of the service provider organisations. One aspect of financial sustainability is to ensure that the organisation’s capital resource base is maintained and not depleted.

Recognition of the opportunity cost of capital will assist in this respect, but, because it is an opportunity cost, it cannot be recorded as a financial transaction or balance. If the organisation is recovering this cost as part of its service charges, then it should be reflected as part of any resulting operating surplus.

How should the cost of capital be calculated for inclusion in full cost?

Commercial organisations have a target rate of return on capital that recognises the level of risk attributed to business activities and generates sufficient resources for dividend distribution to shareholders. While NFP organisations may face similar business risks, there are no dividends payable to members.

Consequently, it may be argued that a reasonable equivalent for cost of capital should be the opportunity cost of risk-free investments such as bank guaranteed term deposits or government bonds (currently around 5 to 6%). Having determined an appropriate rate, it should be applied to the organisation’s investment in service delivery facilities, preferably expressed in terms of replacement cost.



How are debt financed investments treated?

If borrowing expense has been allocated to the cost of service delivery, then the easiest approach may be to deduct the borrowing cost charged, adjusted to the determined rate of cost of capital, from the total cost of capital arrived at under the previous paragraph. For example, an investment of \$1 million @ 5% cost of capital = \$50,000. If borrowing costs of \$24,000 @8% are incurred and charged to the service, the cost of capital would be reduced by $5/8 \times \$24,000$, i.e. \$15,000.

How are rented and leased assets treated?

They should be excluded from cost of capital calculations. However, significant assets being acquired under a finance lease and nearing lease expiry may warrant attention.

For more information and access to the Unit Costing Tools, visit:

www.communitydoor.org.au/unit-costing-tool

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