

**Health Professions Council
Finance and Resources Committee 28 July 2006**

Costing Methodology

Executive Summary and Recommendations

Introduction

The HPC's internal auditor, PKF, has prepared the attached report on the HPC's costs, how they should be allocated and how they will change.

Decision

The Committee is asked to agree the recommendations made in the report.

Background information

Please refer to the attached report.

Resource implications

None.

Financial implications

To be advised.

Appendices

Health Professions Council Costing Review, 18 July 2006.

Date of paper

19 July 2006.



Accountants &
business advisers

Health Professions Council

Costing Review



18 July 2006



Accountants &
business advisers

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1 Executive Summary

Background

1.1 The Health Professions Council (HPC) was created by the Health Professions Order 2001. The HPC, an independent UK wide health regulator of health professionals, is a self-financing NDPB that has to cover its costs from three main sources of revenue:

- New and existing registrants;
- International applicants; and
- Grandparenting applicants.

1.2 The fees chargeable by the HPC are currently specified in The Health Professions Council (Registrations and Fees) Rules Order 2003 at the following levels:

- Registration - £60 per year (discounted 50% for first two years after graduation);
- Renewal and Re-admission - £60 per year;
- Restoration fee - £60 per year; and
- Scrutiny fee - £200 per application.

Terms of reference

1.3 The HPC has approached PKF to provide consultancy services to analyse its costs and thereby aims to answer a number of questions:

- What is the current cost of providing HPC's chargeable services?
- What are the direct costs?
- What are the indirect costs?
- What are the overhead costs?
- How should indirect costs be allocated?
- How should the overhead costs be allocated?
- How do these costs change with changes in demand?
- How will the costs rise in the next two years?

Our work and its recommendations

- 1.4 To consider possible solutions to the questions raised by the HPC we have used a modelling methodology to simulate scenarios for the allocation of direct, indirect and overhead costs to the services that HPC offers.
- 1.5 This work has been undertaken in MS Excel using core financial data and other explanations supplied by the HPC during the course of the assignment as detailed in later sections of the this report. Current HMT fees and charges guidance and other applicable examples of best practice have been used in preparing these models and subsequent recommendations.
- 1.6 Based on the cost allocations used in our modelling, and our understanding of the work undertaken by the HPC, it appears that the direct costs of all the services vary in relation to both the effort taken and the volume of activity with a relatively fixed base of indirect and overhead costs. Given the relative unit costs shown in the model this implies that registrations' cost more than renewals' and bespoke work, like grandparenting, are even more costly per unit.
- 1.7 In light of this overall finding we recommend that the HPC develops more appropriate regular costing approaches, to actively manage income and expenditure per service.
- 1.8 This overview of the key findings and recommendations contained within this report present substantial areas to be considered by the HPC and its Council prior to consultation on future fees.

2 Understanding the HPC

2.1 The following information has been provided or sourced by PKF to enable a clear understanding of the organisation and its current position regarding fees.

Background to fees

2.2 The setting of fees is governed by The Health Professions Order 2001 and fee levels are established by the HPC. This is currently being reviewed and fees are expected to change in line with a new Health Professions Order to be issued in 2007. HPC has advised us that based on indications of this Costing Review the HPC Finances and Resources Committee will be requested to recommend fee increases. HPC then plan to undertake a public consultation with the intention of introducing any fee increases by 9 July 2007.

2.3 The current fees set are as follows:

- Registration- £120 for two years (discounted 50% for graduates in first two years);
- Readmission- £120 every two years;
- Renewal - £120 every two years;
- International scrutiny - £200; and
- Grandparenting scrutiny- £200.

2.4 The existing fee structure came into effect on 9 July 2002 and was based on the historical financial data of the HPC's predecessor, the Council for Professions Supplementary to Medicine (CPSM) and forecasts of the cost of new services that would have to be provided under the legislation.

Financial Management arrangements

2.5 The HPC produces monthly management information which includes:

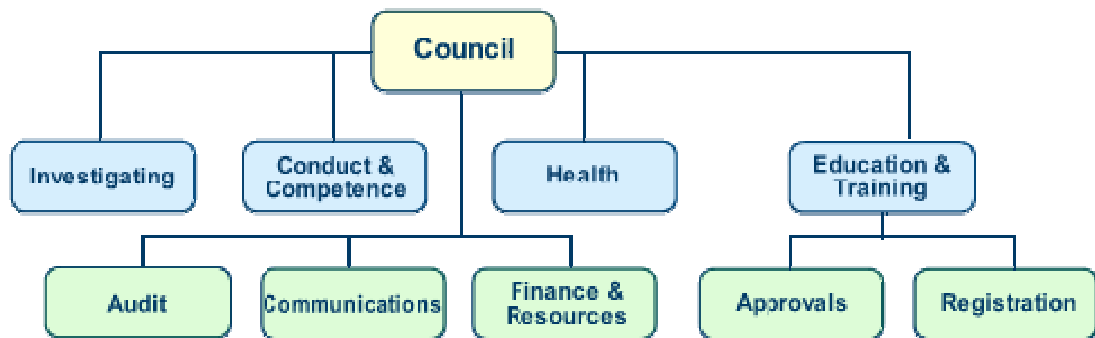
- Monthly departmental management accounts; and
- Monthly performance indicators.

2.6 The organisation uses Sage Line 100 to manage its accounts, using a chart of accounts that is consistent with both its departmental structure and its reporting classifications for Income and Expenditure.

Organisational Structure

2.7 The HPC is governed by a 27 member Council with a number of statutory and non-statutory committees, who are responsible for oversight of specific elements of the HPC through its Executive structure.

2.8 The Council is organised around a number of committees as follows:



Organisational aims and principles

2.9 The HPC operates to meet the following aims:

- Maintaining and publishing a public register of properly qualified professional registrants;
- Approving and upholding high standards of education and training, and Continuing Professional Development;
- Investigating complaints and taking appropriate action;
- Working in partnership with the public, and a range of other stakeholders including professional bodies; and
- Promoting awareness and understanding of the aims of the Council.

2.10 HPC aims to be a lean organisation that has fast, transparent systems and process enabling full accountability.

2.11 The HPC operates under six guiding principles which are:

- **Protecting the public:** The Council will have wide powers to deal effectively with individuals who pose an unacceptable risk to patients. It will have clear and well-published complaints and appeals procedures for the public and registrants. It will treat the health and welfare of patients as paramount;

- **Transparency** - there is public representation on the Council, which aims to operate a fast and transparent complaints procedure. The HPC will consult with key stakeholders and publish any standards and general guidance it develops;
- **Communication and responsiveness:** the HPC will develop meaningful accountability to the public and the health service, and inform and educate the public and registrants about its work;
- **Providing a high quality service:** the HPC will ensure that the needs of its customers are met, namely the public, patients, health professionals and the health service. It will seek and utilise regular feedback from its customers to enhance its services. It will support the training and development of HPC staff, as well as registrants;
- **Value for money:** the HPC will provide a value for money service for registrants and the public. It will be open and proactive in accounting to all its customer groups regarding its work; and
- **Working collaboratively:** the HPC will enable best practice in any one profession to be accessed by all. It will deliver an efficient and unified service as well as focusing on individual issues which are significantly different between professions.

Current member professions

2.12 The HPC currently regulates 13 health professions by means of a register, shown below. The majority of each of these professions have a single 'protected title' and therefore anyone using one of these titles must register with the HPC.

- Arts therapists
- Biomedical scientists
- Chiroprodists and podiatrists
- Clinical scientists
- Dietitians
- Occupational therapists
- Operating department practitioners
- Orthoptists
- Paramedics
- Physiotherapists

- Prosthetists and orthotists
- Radiographers
- Speech and language therapists.

Other relevant information about HPC

- 2.13 HPC received one grant from central government, which was related to the HPC's start-up costs.
- 2.14 The new legislation governing the HPC's fees is expected to come into effect on 9 July 2007. When the fees were previously set it is understood that a public commitment was made that the fees would not be increased until July 2007.
- 2.15 We understand that the HPC requires a process and methodology to establish indicative service costs to inform fees policy that can be used in the future and be dependable as a process if they were subject to external review.
- 2.16 The Operations Director estimates that the current ranking of least complex and costly service to most complex/costly chargeable service is as follows:
- Restoration;
 - International Registrant Registration (other documentation is checked during the Scrutiny stage, so the process is less complex than for UK Registrant Registrations);
 - Renewals;
 - Re-admissions;
 - UK Registrant Registrations (includes pass list and other documentation);
 - Grandparenting Scrutiny Route A (the easy route);
 - Grandparenting Scrutiny Route B (the complex route); and the highest effort per unit is
 - International Scrutiny.

3 Product costing guidance in the public sector

3.1 Information that the PKF methodology has considered and adopted from public sector guidance and current best practice is outlined below.

HM Treasury Fees and Charges Guide

3.2 Currently, the guide to setting fees and charges is HM Treasury Fees and Charges Guide 1992 which replaced a previous version released in 1983. It should be noted that a new guide is expected to be released later in 2006 although no definitive date has been given as yet.

3.3 This document gives guidance on costing and pricing of the products and services supplied by government departments, agencies, trading funds and other public bodies, offers guidance on how to calculate the cost of a service and how the charge for it should be related to cost.

3.4 The services offered by HPC are classed as a “statutory service”, where there is a provision in statute to recover a fee for a service and a minister, department, agency, NDPB, or NHS body is responsible for setting or approving a fee.

3.5 The guide states that the purpose of charging for services is to ensure that resources are allocated efficiently, and that charges should normally be set to recover the full cost of the service. It does concede that there may be cases in which ministers agree that a service should recover less than its full cost, and special considerations may apply to commercial services sold to the wider public sector or to the private sector.

3.6 The important, relevant messages from the guide are summarised below:

- A fee may be rounded even though this may produce a small surplus or deficit and in some cases the rates to be used to determine a particular cost may be provided centrally on an averaged basis and may not be recalculated each year;
- The first step is to define the service for which a charge is to be made;
- Each service should have a financial objective and the fees and charges made should be consistent with that objective. The financial objective should normally be full cost recovery;
- Where a body receives a contribution to its costs, perhaps from another part of the department or another department, and the charge is only set to recover the remaining costs, the contribution should be shown in its accounts as a subsidy;

- Full cost recovery requires recovery of full cost of providing the service, including the cost of capital (usually at a rate of 3.5 per cent in real terms, which is taken as the government's opportunity cost of capital). We understand that the HPC's cost of capital is approximately 6.5 per cent
- It is the responsibility of the body concerned to review its fees and charges in good time before the beginning of each financial year and to set them so as to meet the financial objective. Treasury approval of the fee level is only required where the statute requires it;
- Costs should normally be calculated on an accruals basis and include the total cost of all the resources used in supplying the service (sum of direct and indirect costs including superannuation, selling and distribution expenses, insurance, depreciation, and cost of capital.) Both cash costs and non-cash costs should be included. Costs should be actual wherever possible, with estimates or 'ready reckoners' information used where actuals are not available;
- Where bodies provide more than one service a separate analysis showing the financial objective, full cost, income, surplus/deficit and performance against the financial objective should be provided for each service in the notes to the accounts; and
- Each statutory service should have its own financial objective and be separately costed and charged for. The main steps are to forecast demand for the service, fully cost every component of the service and set fees accordingly to recover those full costs, or meet the financial objectives if different, within the year.

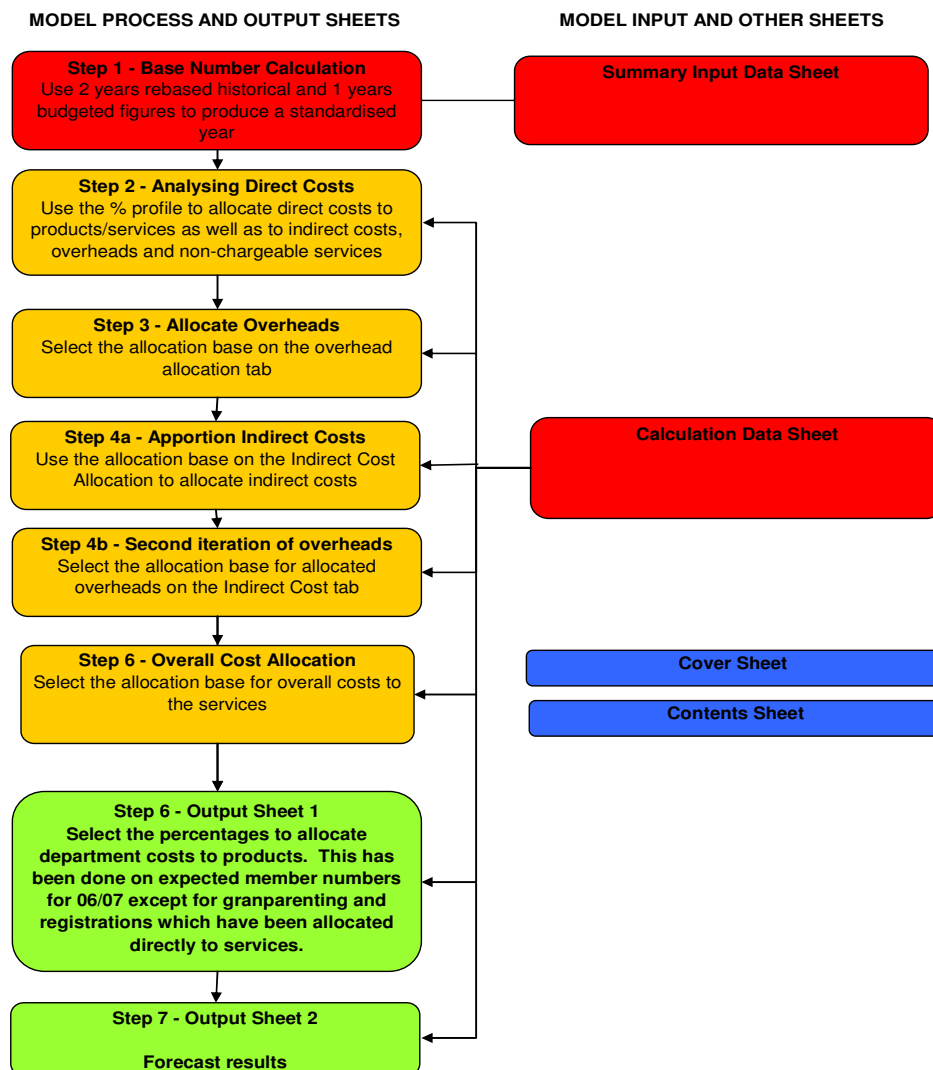
Best practice

- 3.7 PKF has been extensively involved with the Gambling Commission formerly the Gambling Board for Great Britain, which is a new regulator of similar size and self funding nature to the HPC. A complex MS Excel model (some 125 megabytes) has been derived over the last two years to model the costs process based on activities and the efforts of the organisation's resources. This work has been subject to a relatively high level of scrutiny and has recently been approved by the Department for Culture Media and Sport.
- 3.8 The Government Accounting Service (GAS), a division of HMT, now considers a process of activity based costing to be best practice for public sector organisations with a high percentage of employee and property costs, compared to total costs. They indicate that the costs of full activity based management (ABM) can often be unsuitable for organisations in the public sector and therefore recognise the value of a "lighter touch version" of ABM to be the most appropriate.

4 Costing methodology adopted and the key assumptions

Overview

- 4.1 Based on the terms of reference and allowable scope PKF developed and agreed a methodology for HPC costing that was fit for purpose as part of an initial review.
- 4.2 As previously indicated we have used a scenario modelling methodology to allow us to undertake this costing assignment. This modelling has been designed to create a high degree of flexibility, allowing the user to amend both data and assumptions in calculating overall costs of each department and of apportioning these costs to services. The methodology therefore follows the route of the model build and its population as illustrated below.



- 4.3 A brief user guide has been supplied for this model in Appendix 1.

Approach used

- 4.4 In line with our recent experiences of undertaking similar work with the Gambling Commission and both formal and informal Treasury guidance we have used a costing approach that:
- Extracts direct costs of services and other component costs such as overheads, indirect costs and non chargeable services;
 - Allocates any unabsorbed budgets, such as audit fees;
 - Iteration 1 - Reallocates fully absorbed indirect costs towards the activities/departments that use them;
 - Iteration 2 – Reallocates the results from iteration 1 into the services; and
 - Produces an indicative unit cost based on HPC forecast number of registrants.
- 4.5 We believe that this approach, while avoiding the complexity of full activity based costing is beyond simple absorption costing and is consistent with a mechanism that a self funding NDPB, without actual process costs, should adopt in reviewing and costing its fees.

Assumptions

- 4.6 In addition to the inherent constraints within this, the HPC's first costing review, the following assumptions have been discussed and approved by HPC management and are key to the costing model prepared:
- The budgetary and forecast financial figures provided and used accurately reflects the activities and costs of the HPC over the period considered;
 - The forecast number of registrants provided, and used, accurately reflects the increase in their numbers over the period considered;
 - The processes and effort involved in the handling of each of the professions is the same and that no cross-subsidisation exists between the professions;
 - That the following key inputs used in the model (indicated in red on the input sheets) are accurate for their purposes;
 - Retail Price Index;
 - Floor space per department;
 - Staff numbers per department;
 - Wages per department;

- Weighting of activities;
- That the following key model variables used in the models (indicated in light blue throughout the model) are accurate for their purposes;
 - Percentage allocation of direct, indirect, overhead and non-chargeable costs;
 - Overhead absorption drivers;
 - Percentage allocation used in 1st and 2nd iterations; and the
 - Basis of volumes used in unit cost calculation.

5 Key findings of this work

5.1 This is the first time that HPC have reviewed their cost of services against the income provided from fees since the original organisational design. This initial assignment has therefore raised a number of key findings and recommendations, which HPC should consider for adoption within the development of their future financial management systems. The key findings are summarised below in response to the questions raised in the terms of reference.

- **What is the current cost of providing HPC's chargeable services?** – Clearly the costs of the chargeable services are all of those costs excluding the non-chargeable costs estimated in the early stages of the model. In HPC's case this is relatively simple to describe in that it is the cost of the only non-chargeable service, the management of the investment portfolio. This activity has therefore been estimated as consuming a small element of the chief executive's, president's, council's and finance department's time (approximately 2%). On this basis the cost of non-chargeable services is £25,266 leaving £11,535,720 as the cost of chargeable services in the base year. As outlined within the detailed model and methodology appended to this report the base year comprises a composite of 2005 and 2006 actuals and 2007 budget figures, rebased to July 2007 terms.
- **What are the direct costs?** – The direct costs are those costs that can be unambiguously identified as directly relating to the services provided, on a wholly and exclusive basis. As such these are identified as the first allocation step in the model prepared. Any direct costs must be able to be directly related to a particular service.
- **What are the indirect costs?** – Having reviewed the construction of the budgets supplied we consider indirect costs to be those costs of a department that are neither directly related to services or overheads of the entire organisation. As such these are the core departmental costs in preparing fully absorbed departmental financial information.
- **What are the overhead costs?** – From the relatively detailed level of information considered it is suggested that an organisational overhead is a cost that is included within a departmental budget but relates to the whole organisation. Such a cost would be, for example, audit fees that are budgeted within the finance department.
- **How should indirect costs be allocated?** – As previously outlined we believe that the fully absorbed departmental costs should be iterated twice. Firstly, to allocate the fully absorbed departmental costs across the activities that use their effort, we have used departments as a proxy for activities. In the case of outward facing production

departments 100% of the costs will be directly allocated to themselves. In the case of an inward facing department such as finance the cost allocation is likely to be across a range of departments. In these cases we have chosen to use consistent cost drivers as the basis of allocation, such as employee numbers. Secondly, the departmental results of the first iteration should be allocated to services based on the estimate of time or effort involved. For this purpose we have used a driver known as weighted fee numbers (registrant numbers x estimated weighting).

- **How should the overhead costs be allocated?** – We believe organisational overheads should be fully absorbed into departments in advance of any activity or product based allocations. In this model we therefore allocate the few overheads across the departments using suitable cost drivers immediately after step 2, analysis of direct costs.
- **How do these costs change with changes in demand?** – With only two clear outward facing departments there is a significant amount of support work involved in the delivery of the chargeable services. These support costs should remain largely fixed if the current support arrangements are generally adequate given current levels of activity. In simple terms there appear to be limited variable costs, other than professional advisers, that are influenced by registrant numbers. However HPC's registrant numbers have grown steadily, as has the cost base, since creation and we would caution against further increases to the cost base without a reasonable certainty of the additional registrant forecast.
- **How will the costs rise in the next two years?** – As seen on output sheet 2 of the model the four largest costs to the HPC are employee costs, property costs, partner costs and professional advisers. While other costs are likely to increase in line with inflation, regardless of inflation these four costs need to be considered individually. HPC needs to ensure efficient growth to continue to meet its expectation of being a lean organisation.
 - With the planned addition of 22-26 Stannery Street, property costs will make a step change increase with additional transition costs, thereafter increasing in line with inflation.
 - Employee costs, the largest costs representing about one third of the totals costs, is forecast to increase at a rate beyond normal public sector or economy forecasts (nearly 10% each year as per the corporate plan supplied). This is a key area in ongoing cost and efficiency management for the HPC if it is to remain lean.

- Partner costs appear subject to contractual negotiations and are otherwise proportional to the number of registrants. Therefore if such negotiations are competitive within the market the increases should be considered efficient.
- The costs of professional advisers to the HPC, at about twenty two percent of total costs, are significant, and these are forecast to increase significantly over the next few years. At nearly £3 million per annum the HPC needs to manage these costs carefully.

Other findings

5.2 This assignment has resulted in a number of other findings that were not directly requested in the terms of reference but which have come to our notice. These include:

- In compiling the base year for the model a number of changes to the basis of budgeting have been identified that have generally been included as three year averages reducing any levels of inconsistencies, without having to examine every budget row for the last three years;
- Grandparenting and international scrutiny numbers are less easily identifiable than other costs, since one department handles both of these services and the estimated numbers for grandparenting applications are very low for next year which does not allow for an easy comparison. However, these costs may rise rapidly if and when new professions such as Applied Psychologists and various Healthcare Scientists join the HPC register;
- There are a large number of costs that are not easily allocated to the services, resulting from the many activities that are inward facing. The estimates used in such allocations could be reduced by the introduction of time recording by staff when working specifically on chargeable services. Any such time recording could be at a relatively high level or estimated by way of retrospective analysis by team leaders or managers;
- There will be a Continuing Professional Development (CPD) requirement in the future that will increase the costs of registrations, readmissions, and renewals significantly. HPC are currently investigating the possibility of implementing a CPD scheme as early as 2007. Therefore additional setup costs for this scheme are included with our model but the running costs of this are not taken into account largely because they are unknown;
- The organisation is growing in terms of member numbers, and HPC is expecting to take on more professions within the next year. This could create significant variances in any unit cost or forecast income figures. Historically this seems to have generated positive variances against plans; and

- The lack of a regular process to review and change fees incrementally, (say annually), could make this and subsequent consultation processes, where significant step change in fees results, more difficult to conduct. Our experience indicates that such stakeholder consultations are easier where a routine costing process is in place, and regular changes are made on such a basis.

6 Recommendations going forward

- 6.1 Having considered HPC budgets and costing arrangements for fees within the limited scope of this review we make a number of recommendations. Primarily we conclude that cross-subsidisation appears to exist across the services and that HPC should make plans to resolve this and develop a financial management regime that allows such issues to be identified and managed on a regular basis. We would advise that such a review is undertaken monthly or quarterly but as a minimum annually.
- 6.2 We also recommend that HPC carefully consider the activities it undertakes in line with its statutory remit as significant costs are being absorbed into the chargeable services and HPC needs to be able to justify these externally. Where HPC is obliged to undertake such work but where it is deemed not to be a chargeable service, grant in aid or similar might be sought.
- 6.3 In line with the government wider market agenda we would recommend HPC starts to consider the development of arrangements with the Privy Council or the Department as required to allow it to charge for wider market services in instances where there is a proven business case.
- 6.4 Based on the forecast registrant numbers and expenditure increases in the existing corporate plan, it is likely that the fees of HPC will on average have to increase. Importantly we have identified indications of significant differences in the underlying unit costs of the services offered. We understand the challenges that this may cause the organisation, particularly where initial fees are already discounted.
- 6.5 Based on this indicative costing work, using HPC agreed absorption allocations, and ignoring other pressures or any changes to the organisation, we provide the following cost and fees analysis:

	Current annual charge (£)	Indicative unit costs (£)
Registrations (excluding discounts)	60	385
Readmissions	60	99
Renewals	60	39
International	200	257
Grandparenting	200	392

- 6.6 As both the registrations and readmissions appear to be under charged any move towards the above indicative unit costs would result in substantial increases. In the interim the maintenance of the renewals charge at the existing levels would initially cushion the impact of any such increase (but this would need to be recognised as a continuation of cross-

subsidy). Regarding International and grandparenting fees the expected future volumes are low and hard to predict. However these services appear costly and possibly highly variable in effort required, so we would recommend individual pricing, based on an approach such as standard costing.

- 6.7 We believe that the HPC should have a system in place to allow the statutory instrument to incrementally increase the fees each year as required without excessive consultation. Any such arrangement should be supported by service by service income and expenditure management systems operating on a regular basis.
- 6.8 Limited time recording for all staff would allow for costs to be apportioned more easily to services. This would allow for more informed decision making in setting future fees. Any such change would be best implemented through a review and modification of the management information being planned, gathered and reported.
- 6.9 The model provided as part of our review, or a derivative should be updated as necessary and used to inform any future decisions on fee setting to comply with the fees and charges guidance.
- 6.10 The new HM Treasury fees and charges guidance, to be issued later this year, should be reviewed and taken into consideration within later stages of the current fee setting process.

APPENDIX 1 – Costing Model User Guide

Background to the Model

This document represents a limited user guide to the Costing Model prepared by PKF for the Health Professions Council. It does not attempt to be a fully comprehensive guide but rather gives the user of the model an introductory understanding of its structure and process. The assumptions for this model are contained in a separate report to the Health Professions Council. This model has been prepared solely for the use and benefit of the Health Professions Council. Neither its creators nor PKF accept or assume responsibility or duty of care to any third party.

The model has been prepared to allow a flexible approach in considering solutions to the questions raised in PKF's terms of reference, such as the basis of absorbing indirect costs?

Overview

The contents page details the different tabs of the spreadsheet with a brief description of each page however this short guide should assist in using the model and describes the logic used.

A colour coding system has been used as follows. All blue cells control the model and require the user to input value or select a profile, normally a percentage. All white cells indicate that the cell is the output of a calculation and all red cells indicate a number has been input from source data, such as HPC information provided to PKF. Where a percentage must be selected, and if it does not add up to the 100%, the cell will indicate this by highlighting the cell in red.

Step 1- Selecting the cost base

The initial step is to select a cost base for each individual cost category or code. The three years selected (2004/05, 2005/06, budgeted 2006/07) have been provided, and a calculation has been made, to restate all of the balances at July 2007 (using RPI) values as contained in the calculation data sheet.

For each cost code on this base cost sheet, a cost base must be selected from either "current budget", "three year average", or "other". The relevant value will then appear automatically, with the exception of when "other" is selected. In this case the amount must be entered manually and an explanation can be provided to justify this.

Step 2- Classifying direct costs

On the direct cost tab, all costs must be apportioned to either:

- Products/Services – for the direct costs of these products or services, particularly for outward facing departments; or
- As an indirect cost of the department – This represents the costs that are directly attributable to the department concerned but not to a product or service; or
- As a general overhead of the organisation – A cost contained within a departmental coding that is considered an overhead of the whole organisation, or

- As a non chargeable cost – Costs that relate to other work undertaken, such as managing the investment portfolio.

Step 3- Overheads apportioned

All costs identified as general overheads of the organisation must then be apportioned to each department using one of the allocation options provided. This can either be by “floor space”, “wages” per department, “staff numbers” or as “other”. Selecting “other” allows manual apportioning to departments whereas selecting all other options automatically allocates percentages.

Step 4 - Indirect costs apportioned

Indirect department costs must then be apportioned to other departments, as a proxy for activities. This is done using a basis of calculation similar to that in the overheads sheet of the model. The percentages of these apportionments will differ for each department as inward facing departments do not allocate their costs themselves. There are a few exceptions such as the registrations department which as an outward facing department must be apportioned to itself entirely. To add clarity to this process, the cells that must remain zero have been blacked out. Previously allocated overheads are also re-apportioned here to provide the same level of iteration.

Step 5 - Department costs apportioned to services.

The full cost of each department, after all other department costs have been absorbed, must then be apportioned directly to the services. Once again, a choice is given on allocation methods and “other” allows for a manual input of percentages.

Step 6 - Understanding the unit Costs

Levels of activity for three years (including both actual and expected) have been provided on the drop down menu on output sheet 1. Therefore by selecting a year or average, the unit cost per fee is automatically calculated. The total value of the organisation’s costs and uncharged costs are also displayed.

Step 7 – Looking forward

Based on the selection made in the recommended fees row of output sheet 1 in step 6, the output sheet 2 displays the forward looking organisational Income and Expenditures to allow the impact of fee changes to be considered. In this sheet increases or decreases to the fee levels can be controlled annually.

APPENDIX 2 – Costing Model (attached separately)