Chapter I

The Need for Cost Information

In a western city, the district attorney was angry. A court case had just been lost solely because a police officer failed to appear to testify. In another part of the city, the budget director was concerned at the size of the overtime bill for the police department. Across town, several representatives of a police union were complaining to the chief of police that requirements to appear in court to testify were consuming an inordinate portion of the off-duty time of patrol officers; even though they received overtime pay, the obligation to appear in court just to wait for a case to be called, when most likely it would be continued, seemed a complete waste of time. The police chief was no more pleased than the officers to whom he was talking. He pointed out that if an officer was on duty on a court date, the department had to cope with a reduced force on the streets since no replacements were available.

The budget director was the first to act. A budget analyst was assigned the task of studying the pattern and nature of police overtime expenditures and making recommendations that would reduce the overtime bill without cutting police protection. The analyst studied the activities for which overtime was paid and, based on the general dissatisfaction with the court appearance requirements and the high cost in overtime pay, decided to focus attention on this activity. The analyst then:

- discussed the situation with all affected parties,
- determined what was actually happening, and
- calculated the cost of the status quo.

Based on the realization that an officer's appearance was only necessary when the case actually went to trial, the analyst proposed a cooperative effort that would require:

- officers to be available by phone instead of at the court, and
- a clerk to phone the officers and either release them from appearing (if the case was continued) or request them to appear to testify.

In return for increased free time, the police agreed to accept a flat fee for court appearances instead of overtime pay, thus saving a considerable amount of money for the city. Since police officers were called to court only when they actually testified, both the police and the district attorney were pleased. Because fewer officers were called from daytime duty to appear in court, the chief was able to report an increase in productivity in his department with no increase in cost.

In an eastern city, a very different problem was solved using very similar costing techniques. Residents of the poorest section of the community complained to a council member that they were not receiving an equitable share of city services. The city did not maintain records that reflected the geographical distribution of city services and thus could not disprove the complaint. However, an analysis was conducted that determined:

- the existing conditions of housing, employment, and public safety,
- the services currently being delivered,
- the planned level of services in the near term, and
- the approximate cost of current services.

A factual report was prepared which summarized results of this study and indicated that, measured in per capita terms, the area in question was receiving at least a fair share of city resources. As a consequence of this cost analysis, the councillor decided that the complaints were unjustified and the situation was "depoliticized."

The Costing Process

The situations and solutions described above share several characteristics. In each case, one or more services were carefully defined and their respective costs established based on a combination of available data and educated estimates. The resolution of each problem involved acquiring an understanding of the services being performed and calculating the cost of delivering the services; each situation was resolved, at least in part, by performing a cost analysis.[1]

Cost analysis, as the term is used in this book, is the combined process of

- defining a service,
- establishing the volume of the service,
- settling on the *relevant cost concept* to address the perceived problem, and
- determining the cost of some alternative to the existing service deliver pattern.

As can be seen from the two examples given above—and as will be seen again and again in this book—a cost analysis can be the critical process needed to solve management problems.

Understanding exactly what makes up a service, how much of it you are providing and knowing what it costs to provide it are the touchstones of effective management. A systematic policy of analyzing the cost of services can provide an efficient mechanism for locating and solving service delivery problems before they become political footballs—or of deflating such footballs down to manageable dimensions by providing factual information which can be used as a basis for negotiation.

The Need for Cost Analysis

The financial condition of local governments varies widely from one jurisdiction to another. Some cities have experienced steady growth for decades, while others have had to cope

[1] There is a varied terminology used to describe what we call "cost analysis". Some writers focus on "cost accounting" but this usually means an over emphasis on total cost. As we shall see later in this book, total cost is a useful concept but it is only one cost concept among a number that are relevant to government decision making. (This may be why some writers in the private sector prefer "management accounting" as the term of choice.) Some writers prefer "cost finding" which is often described as a more ad hoc system than cost accounting. If you read ad hoc as "flexible" they are correct. Some writers in the field, in an effort to serve old wine in new bottles have concocted "activity based costing" which has the useful acronym "ABC". We prefer "cost analysis" because the term suggests that analytical thinking is an essential part of using cost information — which it truly is.

with static or declining populations and resources. In an expanding-resource environment, cost analysis can be used to encourage efficiency by associating inputs (costs) with outputs (services delivered).

It requires much greater skill to cut a budget than to increase one: people's jobs are at stake when budgets are cut, and it is a rare municipal service that does not have some constituency. In an environment characterized by diminishing resources, cost analysis can be used to provide the information necessary for sensibly cutting a budget instead of senselessly bludgeoning it.

Accounting and Cost Analysis

Generally accepted accounting principles (GAAP) have long acknowledge the value of cost information:

> "Cost is an important consideration in . . . providing for the equitable distribution of financial burden among interested parties. In these contexts, it is the full economic cost—not merely the current outlays—that is important. Thus a program that involves long-lived physical resources or future financial obligations has a cost that cannot be measured by reference only to short-term financial resources. These factors are relevant in determining the economic cost of the program." [2]

Cost analysis can be used to determine the "full economic cost" of governmental services (including indirect costs and depreciation).

As a process, cost analysis is management-oriented. It is used to provide information that may result in a change in the managerial environment. As such, cost analysis can be used as a diagnostic tool to detect (and/or solve) problems before they become major administrative headaches.

Cost analysis can be used by managers to

- measure productivity,
- determine unit costs,
- monitor the implementation of the annual budget,
- establish indirect cost rates for federal grant reimbursement,
- utilize life-cycle costing in procurement
- evaluate contracting with the private sector as an alternative to in-house provision of a service, and
- set fees and charges.

Cost analysis is a management process which can be used to provide information useful to effective decision-making. The focus of a cost analysis may be on the past—determining the cost of traffic control last year. It may be on the present—estimating the cost this year of collecting a ton of refuse. It may be on the future—forecasting the marginal cost of a

[2] National Council on Governmental Accounting, "Exposure Draft: Objectives of Accounting and Financial Reporting for Governmental Units" (Chicago: National Council on Governmental Accounting, 1981), p. 13

proposed mounted horse patrol for a downtown area. But whatever the time focus, the purpose of a cost analysis is always to improve the quality of information used in governmental decision making.

Cost Analysis and Cost Accounting

Cost analysis is similar to cost accounting in many ways, but is not identical to it. Cost accounting is “that method of accounting which provides for assembling and recording all of the elements of cost incurred to accomplish a purpose, to carry on an activity or operation, or to complete a unit of work or a specific job.” [3] The information that might be provided by a cost accounting system (if one is available) is used in cost analysis, but a cost analysis has the added dimension of a major focus on a definition of the service to be provided. In addition, cost analysis is used to provide information that will assist management in making decisions that will affect the future; past experience is used to provide a reasoned basis for change.

Cost Analysis: A Flexible Toolfor Changing Needs

A government is a complex entity whose needs change over time. It follows that managing a government requires flexibility and the ability to focus management resources on the changing problems that the government faces. Cost analysis can be a major tool in managing a government because cost information is—or should be—central to a wide range of administrative decisions.

Cost analysis provides flexibility because, in addition to reporting accounting information, it is used to study the services that the jurisdiction actually provides. Changes in service delivery will be reflected in a cost analysis. Few cost accounting systems would automatically capture the financial impact of a change in a service’s delivery pattern, because most cost accounting systems report information on programs—collections of services—rather than on individual services. Thus, cost analysis is more likely to identify the financial and service impacts of a change—from backyard pickup of refuse to sidewalk collection— than is cost accounting.

Cost Analysis and Evaluation of Services

The ability to cost-out a proposed service can have a salutory effect on the decision-making process with respect to whether or not to offer the service in question. Many policy makers, when presented with the facts of what it will really cost to provide a service may change their minds about a new service request that sounded good in the abstract. At a minimum, policy makers will be encouraged to reexamine the proposed service to determine the severity of the need and the extent of the assumed benefits.

In regard to existing services, costing can be an effective management tool in developing efficient delivery patterns. If a cost analysis of a service shows the cost of the service to be

[3] Municipal Finance Officers Association, “Governmental Accounting, Auditing, and Financial Reporting” (Chicago: Municipal Finance Officers Association), p. 59.A good service definition (i.e., specification or statement of work including tasks, frequencies and quality levels) will indicate as precisely and measurably as possible the type, level, and quality of service that is required; by doing so, it will permit the government or agency consumer to:

Communicate to the potential producer of the service (be it in-house staff or an outside bidder) what is expected and how performance will be evaluated.

too high in some respect (perhaps by comparison with other jurisdictions or the private sector), the existence of this fact alone might become a compelling force for change.

Costing a service over time can provide useful information about the trend in service delivery productivity. Using this process, productivity problems often can be located and resolved on a routine basis before a situation gets out of hand. Anticipatory management yields the greatest benefits and cost analysis is a major tool in such an approach.

Our Approach

The point of view of this book is from the position of a government manager who must make a cost-based decision, such as set a fee, evaluating the desirability of contracting a service out, determining the cost of expanding the delivery of a service, etc. As such, this book contains a minimum of technical accounting terminology and makes few assumptions about the nature of the accounting system in use.

Our focus is not on abstract calculations but on using the information contained in government accounting systems to help managers and program leaders to make decisions. We seek procedures that answer questions such as:

- How much should we charge for this service so that we are reimbursed for all the costs of providing it?
- Would it be more cost effective to contract out this service?
- If we increase/decrease the volume of this service, what impact on our costs will it have?
- What are the costs of this service that we must pay this year versus future years.
- If we change the volume of this service a little, what costs will not change? What costs will change and by how much?
- What costs for this service have already been paid?

Each of these questions arises in the on-going management of government but each requires a different approach to answer it correctly.

Because our focus is on decision making about service cost and levels we will base our approach on the document and financial process that decision makers are most familiar with: the budget.