A Guide to Costing and Pricing in the Scottish College Sector

Scottish Colleges Finance Network

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CONTENTS

A GUIDE TO COSTING AND PRICING IN THE SCOTTISH COLLEGE SECTOR

Part A – Executive Summary

A1.0 Background

The costing and pricing process is an essential element in ensuring any college achieves the quality of information required to enable fully effective decision-making in its strategic and operational planning.

Effective costing and pricing should foster the integration of financial and academic considerations, and ensure that decision making is better informed and that pricing decisions are taken using robust cost data. A better understanding of the cost of activities will help colleges to avoid inadvertently subsidising work which should at least be at 'full cost'. The college should be able to plan to have a balanced portfolio of costed activity with any loss leaders or mission-led activities being more than offset overall by gains in other areas.

This guide is split into two main sections: Costing and Pricing with a slightly different approach taken in each. More detailed guidance is provided in the key area of pricing to reflect the concern that the sector is less developed in that area. The costing section of the document is fairly pragmatic and gives some broad overall guidance on choosing a costing model and the likely factors to be considered in that decision. It is assumed that all colleges will have already made some decisions in respect of their costing models and will have internal staff members who are familiar with costing approaches; hence this section has been prepared with a summarised review of the potential models only. The second section on pricing is a more strategic section covering a wide range of issues which should be considered in adopting a pricing strategy. It is assumed at this stage that this is the area where colleges may gain greater use from this document, as the sector to date has had some difficulties in assessing the price for its activities and may have been under-pricing some of its products to date.

The overall purpose of this document is to provide a useful tool for colleges in reviewing their costing and pricing methodologies and strategies, and to assist in the development of enhanced costing and pricing methods where appropriate. It is also hoped that it will provide a baseline level for costing and pricing methods and strategies for the Scottish sector to ensure this important area in college financial planning has a consistent fundamental development and review process, whilst still allowing for the inherent required diversity in the actual methods employed by each college given the very broad range of activities being covered across the sector.

A2.0 Aims and Objectives of the Guide

This document aims to promote good practice in costing and pricing across Scotland's Colleges. With this background, it has the following objectives: -

- Where a college does not currently use a costing methodology, to provide guidance in implementing one.

- Where a college already uses a costing methodology, to encourage a review of that methodology to ensure it remains fit for purpose, and that there is a robust pricing process following on from the costing undertaken.

- To provide advice and guidance as to appropriate levels of detail to use in developing costing and pricing models, and for colleges to consider what is appropriate for them.

- To provide examples of good practice for costing systems in colleges.

- To provide guidance on college pricing strategy to assist colleges in making informed decisions on appropriate pricing across a range of college costed activities.

If the above objectives are met, all Scotland's Colleges should be able to demonstrate that they utilise a robust costing method(s) and a pricing strategy appropriate to their needs, and that these allow active cost management and cost recovery and support robust financial governance.

A3.0 Risks in Costing and Pricing

Not having an appropriate costing and pricing model can lead to poor decisions based on inadequate information.

Clearly, any college that does not consistently employ a robust and well-understood methodology for the costing and pricing of its services, be that at course level, or at any higher level, will be exposed to risk which will in the main part be financial but may also be reputational.

A4.0 Benefits of Effective Costing and Pricing

The benefits from employing an effective costing methodology and pricing strategy are clear: -

- It reduces financial risk in the college.

- It aids budget managers understanding of costing and pricing across the organisation.

- It promotes properly thought-out project proposals (including, potentially, at course-level) across the college

- It enables faster, more responsive decision-making.

A5.0 Implementation

To ensure that the costing and pricing methodology used by the institution is most effective, it is important to carefully consider its implementation and in particular to achieve “buy-in” from college staff. It should not be seen as a finance-only tool; otherwise it may become a paper exercise rather than a true management tool.

To ensure that the costing and pricing processes have full engagement across the institution, colleges may wish to involve a senior member of the teaching staff in their development to inform the processes and pricing strategy, and ensure they become embedded within the college ongoing planning and monitoring. It is good practice for the costing and pricing process to be endorsed and supported by the college management group.

A6.0 Conclusion

It is recognised that most colleges already use some form of costing and pricing mechanism. As colleges have traditionally focussed on cost recovery, however, it is generally accepted that there is some scope for development with regard to pricing strategies in the sector. While the first part of this document addresses costing, in the main it therefore considers issues connected to pricing.

It is also recognised that every college is different. A large urban college will likely have entirely different needs from a specialised rural college.

With these factors in mind, a number of different examples of practice are included. These are not intended to be prescriptive, rather they are intended to steer colleges in the direction of a practice that works for them.

It is hoped that this document will assist all colleges in reviewing their current costing and pricing methods and to assist colleges in recognising the importance of their costing and pricing strategies. It is suggested that all colleges should regularly review their approach to costing and pricing across the range of activities they provide.

It is also important that colleges take a longer term view of their future costing and pricing plans in order to support delivery of their medium to long term objectives.

Part B – Choosing the Costing Model

B 1.0 Introduction

One of the main purposes of a costing system is to attribute the full cost of a college to front line teaching provision. A robust costing system is required to ensure that management are able to fully understand the behaviour of costs in the college. This will facilitate strategic and operational planning in the college and will support the pricing strategy and policies discussed in **Part C**.

Costing is a topic that is generally well understood in the College sector. This section of the document therefore provides a summary of the key issues to be considered when a college is reviewing its approach to costing, focussing mainly on choosing the most appropriate costing model for that college and basis of allocation of overheads.

B2.0 Strategic Costing Issues

B2.1 Types of Costing Models

Cost allocation requires due consideration in nearly every organisation whether deciding how the costs of shared services should be allocated among departments or to courses, or how to allocate the costs of fixed assets.

Costs are allocated for different purposes, including predicting the economic effects of decisions, motivation (e.g. to discourage the use of estates resources), and for guiding pricing decisions.

A key step is therefore to identify the cost objectives as part of a wider college strategy. For example, if the college wishes to operate control or review costs at a micro level by allocating costs to individual courses, then this objective will drive the costing regime that needs to be in place to support it. If, however, a college operates at a macro level, i.e. departments must meet overall financial targets but have flexibility in how the curriculum delivery is resourced, then a simpler costing regime can be established.

It is stressed that there is no right answer and each college should determine its own objectives. The advantages of the macro model are its greater simplicity and pragmatism. It also costs less to maintain and is more easily understood. The disadvantages are it can lead to “false” price–setting as it relies on average costs and it has limitations for competitive bidding situations where it can be essential to know the true costs.

The advantages and disadvantages of the macro and micro approaches to costing are summarised below: -

“Macro-Costing Approach”

Advantages	Disadvantages
Simple	Non-specific
Pragmatic	Inflexible
Inexpensive	Limited for competitive bidding
Understandable	Cross subsidies may cause tensions
Costs can be fully recovered	Limited for value judgement
Equitable resource allocation	May result in ‘false’ price setting

“Micro-Costing Approach”

Advantages	Disadvantages
Value added approach	Often complex
Specific and dedicated to course level	Requires dedicated resource
Flexible	More sophisticated systems required
Eliminates cross-subsidies	More expensive
Allows competitive bidding	Labour intensive
Allows reliable price setting	May be difficult to interpret outputs

B2.2 Choosing a Costing Model

The two distinct types of costing models are as described above: a high-level macro model and a detailed micro model. There are several factors a college will need to take into account when choosing which broad type of costing model would be most appropriate and these are summarised in the table overleaf against the key contextual factors of size of college, maturity, administrative resources and management information systems.

Choosing A Costing Model

Contextual Factors	Macro	Micro
1. Size of College	Smaller colleges may have a relatively centralised management structure in place and this, along with lower levels of complexity, may make it more appropriate. However, smaller colleges may be less able to absorb uneconomic courses and the consequences of not implementing an effective costing system could potentially be higher in smaller colleges.	Larger colleges are likely to provide a wider range of courses and have a more *devolved* management structure in place. A detailed curriculum team costing approach may well be suited to larger organisations, as it will be able to cope with a more complex organisational structure.
2. Maturity	Colleges that have not introduced a robust costing model may decide to introduce a high level costing model in the first instance.	Colleges that already have some form of costing model in place may be able to progress costing by developing a more detailed costing methodology.
3. Administrative Resources	Colleges with tightly resourced finance sections may struggle to dedicate resources to more labour intensive models. It may also be necessary to consider the skill levels of non-finance staff in understanding the output from the costing system.	Colleges with better resourced finance sections will find it easier to introduce and operate a more complex/more detailed costing model.
4. Management Information Systems (MIS)	Colleges with less robust MIS may find it simpler to adopt the macro approach to costing where inputs will be restricted to the higher levels.	Colleges with good MIS will find it easier to introduce and operate a detailed costing model. A successful detailed costing model is likely to be highly dependant upon good financial and timetabling student activity data in particular.

There are other factors such as commitment from senior management, and the level of commercial activity carried out within any college that will also impact upon the choice of a costing model. Colleges will need to take all these factors, and others, into account when choosing a model. There is little benefit in developing a detailed costing model that will prove difficult to implement and operate in practice.

Annexes A and **B** compare examples of costing at a macro level and costing at a micro level.

B2.3 Link between Costing and Pricing

The link between costing and pricing can be summarised as follows: effective costing methods are essential to enable proper pricing decisions to be made. As stated below in the risks analysis, if costing methods are not appropriate and reliable then the college cannot assess the levels of its desired margins properly and will make uninformed pricing decisions. This is explored further in the pricing section of this document.

B2.4 Risk Management and Risk Analysis

The two main risks in choosing a costing model are that the information used for the costing model is not accurate or that the model selected is not at the correct level of detail. With respect to accuracy, naturally if the information used in the costing model is incorrect then this will affect the pricing decisions made, and will mean that the activity achieves less than its proper margin or is under priced. With respect to the detail of the chosen model, if the model is not detailed enough then it will not give the required management information to make decisions on which activities to pursue, however, if it is too detailed then it will become unwieldy and will not be able to be properly utilised or fall behind in its information provision. To prevent either of these risks materialising it is recommended that colleges review their costing models on a regular basis (at least every three years) to ensure they are adapted as required to any change in circumstances.

A Risk Prompt List is attached as **Annexe C** for information, and covers mainly pricing risk issues however also highlights costing risk issues.

B3.0 Operational Costing Issues

B3.1 Allocation of Overheads

All colleges have significant overhead costs that cannot always be easily directly attributed to teaching activity. Some examples include Human Resources, Advice & Guidance, Finance and Estates expenditure. The allocation of overheads to teaching departments is likely to be a key component of an effective costing system and is essential for calculating and understanding the full cost of teaching activity.

Colleges will have to select an overhead allocation method, and an appropriate allocation basis needs to be selected for each type of overhead expenditure. It is also necessary to decide upon an appropriate level for the allocation, for example overheads could be allocated to curriculum teams, cost centres or to course level.

B3.2 Allocation Method

The direct method of overhead allocation is the most straightforward and apportions overhead costs directly to teaching cost centres. This allows for these costs to be apportioned in one step and overhead departments are excluded from the apportionment. For example, the service the Finance department provides to the Estates department would not be apportioned to Estates, the whole cost of the finance department is apportioned to teaching cost centres only. This method is relatively easy to understand and implement but does have the drawback of not recognising reciprocal services between overhead departments.

Colleges may wish to implement more sophisticated methods of overhead apportionment. For example, the step method involves apportioning overhead department costs to other overhead departments as well as to teaching cost centres. Once the costs of one overhead department are fully allocated, that department is then eliminated from process to avoid return charges. Continuous apportionment methods allow for the appropriate allocation of the costs of each overhead department to all other departments resulting in many return charges. The process is re-iterated until the amounts involved become immaterial. A careful evaluation of these approaches is advised as the additional complexity may significantly outweigh any improvement in the accuracy of the apportionment.

B3.3 Basis of Allocation

A suitable allocation basis must be identified for all overhead costs; this can be done in varying degrees of detail. Overheads account for a significant proportion of the total unit cost; it is therefore important that the allocation is done in a transparent way.

The first step will normally be to identify all overhead costs that are to be allocated. The key elements that impact on costs are referred to as cost drivers. An appropriate cost driver or indicator of the cost driver must be chosen for each overhead cost.

The table below provides some simple examples of how overheads may be allocated: -

Overhead Department	Basis of Allocation
Estates	Occupied Floor Area
Finance	Gross Budget
Human Resources	Employee Headcount
Senior Management	Gross Budget
Marketing	Student Headcount

Allocating overheads on this basis should be fairly straightforward but does require some detailed information, as oversimplifying this process may result in the credibility of the costing system being undermined. For example, it may be difficult to justify allocating all overhead costs on the basis of, say, student activity levels. This type of broad brush approach does not take any account of the different demands certain types of activity place upon overhead departments.

B3.4 Deciding on the Overhead Allocation Method

Overall, it is viewed as extremely difficult for colleges to gain a full understanding of costs without allocating overhead costs at some level. There is a degree of trade-off between the accuracy of the apportionment and the complexity of the overhead allocation. It may well be that for most colleges, a basic direct allocation of overheads using one key indicator for each high level overhead cost should provide a reasonably accurate overhead allocation that will be transparent and easily understood.

Annexes B1 and **B2** show costing examples at a micro level with the former adopting a detailed overhead allocation method and the latter using an average overhead recovery rate.

Part C : Developing a Pricing Strategy

C1.0 Introduction

As noted previously, costing is generally well-understood, being based on internal measures. Pricing, however, allows for greater variation in its interpretation and is based on the college's view of its markets and the influence of those markets on its business. There are therefore a wider range of both strategic and operational pricing issues as compared to costing. This part of the document considers each of these in turn and develops the issues for consideration.

C2.0 Strategic Pricing Issues

C2.1 Pricing, Marketing and Strategic Planning

In today's financial climate it has become clear to many colleges that planned maximisation of income from non-traditional sources is an essential contribution to enhanced financial security; therefore, marketing and pricing should assume strategic importance by becoming delineated strategies, and not merely appendages to other elements of the strategic plan as may traditionally been the case.

The pricing strategy should set objectives for each of the main market areas identified in the strategic plan (e.g. teaching, consultancy). These objectives will then be translated into each planning unit's operational plans in a consistent and integrated approach. The cost recovery for these activities should be the base level and there may then be a range of pricing strategies for activities dependant on market groupings.

The Director of Finance (or equivalent) will normally have a key role in developing the pricing strategy and providing technical input and advice on financial issues. The head of the marketing function also holds a key developmental role and heads of teaching and service units must also be involved in the process of developing the pricing strategies. Such an approach also avoids the possibility of several parts of the institution competing with each other, duplicating effort in market research, and giving mixed messages to the outside world.

Development of pricing policies and strategies is a key element of moving from cost focused to market focused operations. Adoption of proper pricing and marketing techniques (the two are inextricably linked) should free colleagues to think imaginatively within a strategic framework and to maximise the revenue-earning potential to the benefit of the college.

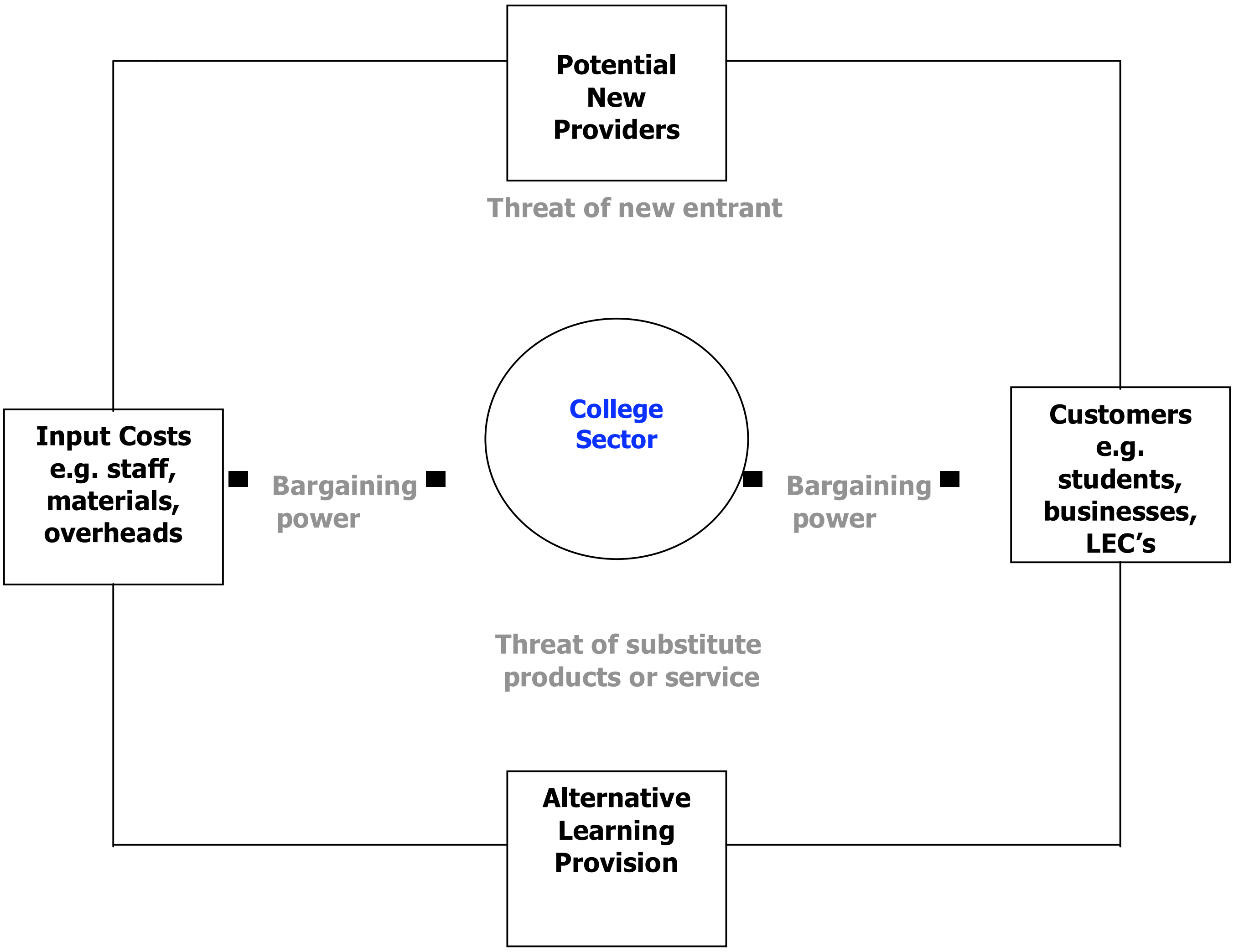
The link between costing and pricing becomes apparent as the increased awareness of the costs of different activities and different units should enable institutions to have a much clearer view of which areas are financially viable, and which are not. There may be many reasons why departments that do not appear financially strong should be maintained, in which case there should be an explicit decision to subsidise their activities from other sources.

C2.2 Market Analysis to Inform Pricing Decisions

To fully inform pricing decisions, market analysis should be undertaken to identify customers' needs, wants and attitudes. This is concerned with gathering information on, for example, demand, competition, market environment, the resources needed to deliver products to the market, and political, legal and other constraints. Marketing analysis is undertaken to identify marketing opportunities and to monitor, from time to time, market changes.

There are a number of models that can be applied to analysing the marketplace in the context of pricing.

The following analysis, adapted from Porter's 5 Forces Model is a means of identifying the forces that affect the level of competition in the sector. It is a useful tool from which a determination of strategic direction can be made. In particular, for colleges this would relate to the portfolio of products offered and strategic price setting.



Using a model such as this, a college might ask questions such as the following: -

- Where does demand for our services/products come from? (Who are we going to serve and what are our markets? What scope is there for growth or diversification?)

- Who are our competitors? (What do they offer? What do they charge? What are their strengths and weaknesses? What are their retention rates, employability, quality assessment and cost per student?)

- What is the market environment? (What are the social, political and economic conditions that have an impact on customer choice?)

- Do we have the necessary resources? What are the investment implications? (E.g. premises, equipment, staff, funding.)

- Are there any political or legal constraints?

Successful pricing also depends on understanding and recognising the value that customers place on an institution's courses and products, and then pricing the organisation's offerings appropriately. Pricing a course or product higher than its perceived value may have a negative effect and may reduce demand. On the other hand, a price that is perceived as being too low may appear indicative of inferior quality and may also have an adverse effect on demand for particular courses and, possibly, external perception of the college.

C2.3 Cross-subsidisation

Market factors sometimes permit pricing at a higher level than full cost. Taking the college's overall portfolio of activities into consideration, some activities may need to be *more* profitable in order to generate funds to support those priced at below full cost. When market factors suggest a price significantly below full cost, other strategic reasons need to be identified and agreed if the activity is to be justified. It is important that cross-subsidies are recognised and transparent, and that they are agreed as a necessary part of the strategic plan. Where subsidies are implicit rather than explicit, tensions can be created between different parts of the organisation.

C2.4 Risk Management and Risk Analysis

Each proposal brought forward within the pricing strategy should indicate which potential risks have been identified and evaluated. The impact and likelihood of potential risks should be measured, and the plan for the project should state how risks are to be dealt with and monitored, and what contingencies will be activated if the risk materialises.

A Risk Prompt List is attached as **Annexe C** for information, covering pricing risk issues (plus other risk issues relating costing and negotiation, etc)

C2.5 Supporting the Pricing Strategy

C2.5.1 Information requirements and systems

Effective information systems are key resources for making pricing decisions. In designing such systems, institutions should ensure that the information to be collected includes the following: -

- Full recording of direct and indirect costs – this information can be found in the internal accounting system, and helps in understanding the financial contribution from different types of activity.

- Data on customers, largest buyers – analyses of sales invoices and records of customers' orders should be easily available, for use as market data or mailings, for example.

- Marketing intelligence – data from external sources such as government agencies and private organisations.

- Student record systems – a full range of information about applications and enrolments on courses should be available.

- Market intelligence – for example, competitors' offerings, costs.

- Key performance data to confirm whether or not the strategic plan is succeeding or if there is a need to take corrective action.

C 2.5.2 Dissemination and Culture Change

For the pricing strategy to be successful, staff members involved in the dissemination process clearly need to understand the following: -

- cost methodology
- current pricing structure
- new pricing methodology
- interaction between the new pricing and costing methodologies
- institution's markets and customers
- availability of training within the institution

There may well be a need to change assumptions that have built up over many years. The pricing strategy may need to address the following: -

- reluctance to accept change
- lack of expertise / skills in negotiating / pricing

- lack of information (internal and external)
- number of staff groups involved in making pricing decisions
- reluctance to say no to potential or existing business which may not fit new strategy
- bureaucratic red tape inhibiting market responsiveness
- moving from a low price structure to a market-based structure

C2.6 Pricing Checklist

A Pricing Checklist is attached as **Annexe F** which provides a useful gap analysis tool to check that the college's pricing strategy is properly developed and resourced, and to check that business planning and risk management processes in relation to pricing are appropriate.

C2.7 Monitoring and Review

The pricing strategy should include a post-implementation review, carried out perhaps on an annual basis. The findings of the review should be reported to management. The review should assess the implementation outcomes to verify whether the strategy has achieved the desired results and has met the strategic outcome measures established by the institution.

The post-implementation review should assess and report on: -

- the extent to which the original objectives have been achieved

- any problem areas that may have a detrimental effect on the overall corporate plan

- the extent to which the pricing strategy remains relevant to the overall strategy of the institution

- changes to the external environment, including competitors and markets

- any lessons learned and changes or improvements to be made for the future

C3.0 Operational Pricing Issues

C3.1 Pricing Products and Services - Pricing Policies

The definition of a pricing policy can be stated as 'the framework of rules and constraints within which pricing decisions are taken'. Various pricing practices can be adopted but the general principles are common sense and the college's marketing advisor or manager will typically be a good source of further information.

In basic terms the college will select a pricing policy based upon its consideration of customer demand, cost and competition. The price will generally be placed between one that is too low to produce a surplus and one that is too high to attract custom, although there are exceptions. Costs set a price floor, the market will set a price ceiling, and competitors' prices/substitute products provide a pricing point of reference.

An example of a pricing policy which a college might adopt is one that aims to set prices that cover actual costs and make a surplus on any activity, the level of surplus reflecting what the market can bear. It is recognised that an institution may not be in control of prices for certain services, since most colleges operate in a variety of markets with often very different constraints in pricing. In this situation, if the funding provided does not meet the full, actual costs, then decisions need to be made which, in effect: -

- accept that the activity will be cross-subsidised
- reduce the costs of the service
- change the nature of the service delivered
- discontinue the service, or
- discourage a bid for a new service

C3.2 Type of activity

Commercial and other income-generating activities may require different pricing strategies. Knowledge-based activities such as consultancy and exploitation of intellectual property require different treatment to other activities such as conferences, residences or public use of institutional facilities.

(i) Overseas student fees

The overseas market is driven by active recruiting and reputation. Pricing is competitive, but may also reflect quality as perceived by customers. This is an area where careful market research is essential, but rewarding if a good reputation can be established. As teaching is a core activity, new college entrants into the overseas market need to ensure that their strategies are well researched, properly resourced and deliverable. Cost calculations for the proposal need to take proper account of items such as infrastructure costs which may be higher for foreign students.

(ii) Non-publicly funded courses

Colleges have considerable freedom to mount such courses. Again, there needs to be thorough research to ensure that the offering is not duplicated elsewhere, or to make sure that some special value-added feature can be offered. The same considerations apply as for overseas students, as UK students paying higher fees expect a high-quality experience.

(iii) Consultancy

Consultancy services should normally be provided at good commercial returns and will likely be subject to VAT. The case for providing consultancy services that do not cover the full cost of the activity is generally weak since consultancy or technical services often carry little in the way of indirect benefits. It is therefore important to ensure that college managers are aware of the true costs and cost recovery for different types of project.

(iv) Professional courses

Courses subject to validation by professional bodies may have a high cost where the body specifies class sizes, staff-student ratios and the level of facilities to be made available to students (e.g. textbooks and ICT). Provision may be negotiated, and the college will need to be aware of the risk of early termination, whether for poor performance or *potential contractual issues.*

(v) Short courses

Short (i.e. non-qualification) courses have been organised in the past at many colleges, for example, relating to their continuing education role or to capitalise on commercial opportunities. Funding may be available from a variety of sources for such courses; however, colleges need to be careful that full costs are calculated, so that subsidies are recognised and academic decisions taken in full knowledge of the financial implications.

(vi) Residences, catering, nurseries, conferences, bars and shops

There is a strong argument that prices should be based on cost-plus or market price. While it is perhaps natural to think that student facilities should be as cheap as possible for their users, where this is at the expense of funding that could be allocated for teaching, this requires careful consideration. In general, colleges should be careful to ensure that their core activities are not heavily subsidising useful but peripheral activities without a positive decision to do so.

(vii) Room and equipment hire

For public use of college facilities, much the same parameters apply as in the previous paragraph.

C3.3 Business Case Evaluation

This is the detailed evaluation of a project, be it a new programme, a new department, a spin-out company or a new building. The requirement for a business case or plan should be an integral part of the pricing and marketing strategies, and should be contained within any set of procedural guidelines for the evaluation of new projects. A standard format should be developed for business plans so that relevant information can be drawn together and expressed concisely and coherently. The clarity and extent of the information should be sufficient for an informed decision to be made as to whether the project should proceed. The business plan is also an essential document in providing an audit trail to show that decisions have been taken based on proper information.

There are several examples of formats for the financial elements of the business plans.

Two financial analysis models are attached as Annexes D and E to this paper. **Annexe D** gives an example of the financial analysis for an "Open" course i.e. one that is open to members of the general public. In the majority of cases these courses would typically be featured in a college prospectus. **Annexe E** gives an example for a "Closed" course i.e. a bespoke course that is funded by a sponsor such as a company who then nominate the attendees from within their staff.

C3.4 Negotiating and Legal Skills

It is good practice that staff members involved in potential negotiations must either be trained in negotiating skills or have easy access to those skills.

The acquisition of appropriate legal skills is often seen as an unnecessary overhead cost at a time when funds are scarce. Understandably, Colleges would prefer to allocate their resources to the core business, but the price of poor or absent legal advice can be high.

Examples of failures to negotiate contracts effectively include the following: -

- Suppliers or customers with superior negotiating skills who increased costs and/or decreased expected income, such that the project no longer recovered the full margin.

- Liabilities for non-performance were not clearly defined and the institution found itself unable to recover costs from a defaulting customer, thus decreasing expected income.

- Lack of confidentiality or intellectual property rights agreements resulting in a customer selling knowledge that could have been retained within the institution.

C3.5 Taxation

Where the pricing and marketing strategies imply the commercial use of products or services, taxation issues arise. The basic principle is straightforward: colleges currently have charitable status because their learning and teaching objectives are valid charitable objectives, however, any activity falling outside those core functions may give rise to a liability to taxation, both corporation tax on profits and VAT on trading income and expenditure.

In broad terms, this means that even commercially priced educational programmes are not taxed on their profits and are exempt from VAT, while consultancy contracts may be subject to VAT.

Taxation is a complex area, and most colleges retain consultants to advise them. It is not the purpose of this guide to discuss detailed implication, however, the business plan for any initiative should state clearly that the taxation implications of the proposal have been thoroughly examined and taken into account in costing and pricing the offering. The inclusion or exclusion of VAT, for example, can make a significant difference to a proposal's viability. Costs may be 17.5% more than estimated if VAT payable on supplies cannot be recovered. If VAT is payable on costs, but cannot be charged on income, then the margin is significantly squeezed.

Part D – Conclusions

The benefits from employing an effective costing methodology and pricing strategy were already highlighted in the executive summary and are stated again below: -

- It reduces financial risk in the college.

- It aids budget managers understanding of costing and pricing across the organisation.

- It promotes properly thought-out project proposals (including, potentially, at course-level) across the college

- It enables faster, more responsive decision-making.

Any college that does not consistently employ a robust and well-understood methodology for costing and pricing its services, be that at course level, or at any higher level, will be exposed to risk.

This document seeks to provide guidance on how to ensure that colleges have appropriate costing methodologies and pricing strategies, with the emphasis of the document being on pricing as this is believed to be an area requiring further development within the sector. There are, however, important decisions which each institution needs to make for itself in the implementation of its costing methods and pricing strategy. These range from level of costing approach and overhead allocation method selection, to which pricing policies will be used based on market analysis and the evaluation of potential risks of incorrect pricing. It is hoped that this document is a useful tool to enable institution to take these issues forward in the development of their costing models and pricing strategies.

Annexe A – Macro Costing Model

This methodology treats Central Support Services as Cost Centres and Teaching Departments as Profit Centres.

The level of profit each Department is expected to make is dependent on the level of surplus that the College has budgeted for. This percentage can then expressed as a “Cost/Income (C/I) Ratio”. In the example this Ratio has been set at 75%. Each Teaching Department is then free to operate variations on this for each of its Curriculum Teams as long as the overall percentage averages to 75%.

In attributing income, a notional price per SUM is calculated after deducting the cost of Central Support Services from the total receivable in respect of SUMs. All income, including notional value of the SUMs, and commercial courses is attributed to teams and set against the actual cost of delivery to give an actual C/I Ratio at the end of the year.

This model therefore allows Teaching Departments the freedom to respond to changes in demand for both commercial and non-commercial work, while working within a framework to achieve the college’s overall financial targets. The table below shows how this may be represented for a Teaching Department which meets its target, but with individual teams showing differing C/I Ratios.

Teaching Department X

	Curriculum Team A	**Curriculum Team B**	**Curriculum Team C**	**Curriculum Team D**	**Total**
No of WSUMS for Year	6950	5500	5780	1670	19900
Income for Year					
WSUMS	903,500	715,000	751,400	217,100	2,587,000
Commercial	85,000	195,000	100,000	135,000	515,000
Training Programmes	12,500	52,000	114,500	0	179,000
International	225,000	100,000	0	130,000	455,000
Servicing Out	10,000		5,000		15,000
Total Income for Year	**1,236,000**	**1,062,000**	**970,900**	**482,100**	**3,751,000**
Expenditure for Year					
Staffing	790,000	748,000	567,500	380,000	2,485,500
Supplies	32,000	14,390	44,800	29,700	120,890
Commercial Costs	8,800	20,000	10,400	14,000	53,200
Training Programme Costs	3,000	12,000	26,200		41,200
Servicing In(excl as not yet agreed)	20,000	4,000	10,000		34,000
Total Expenditure for Year	**853,800**	**798,390**	**658,900**	**423,700**	**2,734,790**
C/I Ratio for Year	**69%**	**75%**	**68%**	**88%**	**73%**

Annexe B1 - Micro Costing Model (using detailed overhead allocation method)

ANNEXE B (1)

Micro Costing System - Detailed Overhead Allocation

School	Division	Course Title	Direct Staff Costs	Direct Materials	Allocated School Overheads (i)	Allocated College Overheads (ii)	Total Cost	Pricing / Viability: Activity/ Fee Income	Other Income	Total Income	Contribution/ (deficit)
			(£)	(£)	(£)	(£)	(£)	(£)	(£)	(£)	(£)
Vocational	Construction										
		NQ Construction	43,000	4,000	13,000	40,000	**100,000**	102,000		**102,000**	**2,000**
		SVQ Modern Apprenticeship	35,000	4,000	13,000	40,000	**92,000**	70,000	25,000	**95,000**	**3,000**
		HNC Construction	43,000	4,000	13,000	40,000	**100,000**	102,000		**102,000**	**2,000**
		NQ Construction Crafts	43,000	4,000	13,000	40,000	**100,000**	97,000	5,000	**102,000**	**2,000**
		HNC Construction Management	43,000	4,000	13,000	40,000	**100,000**	90,000	5,000	**95,000**	**-5,000**
	Construction Total		**207,000**	**20,000**	**65,000**	**200,000**	**492,000**	**461,000**	**35,000**	**496,000**	**4,000**
Vocational	Hairdressing & Beauty Therapy										
		Access 3 Hairdressing Assistants	40,000	3,500	5,500	33,000	**82,000**	82,000	2,000	**84,000**	**2,000**
		Beauty Therapy SVQ	40,000	3,500	5,500	33,000	**82,000**	85,000	2,000	**87,000**	**5,000**
		Hairdressing SVQ Level 2	40,000	3,500	5,500	33,000	**82,000**	85,000	2,000	**87,000**	**5,000**
		Hairdressing SVQ Level 3	40,000	3,500	5,500	33,000	**82,000**	85,000	2,000	**87,000**	**5,000**
		HNC Beauty Therapy	40,000	3,500	5,500	33,000	**82,000**	85,000	2,500	**87,500**	**5,500**
		HND Beauty Therapy	40,000	3,500	5,500	33,000	**82,000**	85,000	2,500	**87,500**	**5,500**
	Hairdressing & Beauty Therapy Total		**240,000**	**21,000**	**33,000**	**198,000**	**492,000**	**507,000**	**13,000**	**520,000**	**28,000**

(i) Allocated School Overheads - This is an allocation of the Vocational School management costs to course level.

(ii) Allocated College Overheads - This is an allocation of central College overheads costs to course level.

Advantages

Provides detailed cost and income information to inform the Pricing Decision

Overheads allocated in a fair and transparent way

Highlights courses that are being cross-subsidised

Model can be simplified and operated at a Divisional or School level

Disadvantages

Time consuming to operate

Requires detailed information to facilitate detailed overhead allocation

May become complex and unwieldy if model is operated at course level

Annexe B2 - Micro Costing Model (using average overhead recovery rate)

ANNEXE B (2)

Micro Costing System - Recovery of Overheads based on Teaching Staff Hours

Calculation of Overhead Recovery Rate	
Direct Teaching Costs	
Teaching Staff Wages & Salaries	£6,100,000
Teaching Staff FTE	192
Average Annual Cost	£31,771
Average Hourly Rate (860 Contact Hours)	**£36.94**
Full Cost Recovery	
Total College Costs	£16,300,000
Teaching Staff FTE	192
Average Annual Cost per FTE	£84,896
Average Hourly Rate (860 Contact Hours)	**£98.72**

Course Cost	
Course Name	NQ Beauty Therapy
No. of Teaching Hours	860
Full Cost per Teaching Hour	£98.72
Total Course Cost (Full Cost Recovery)	**£84,896**

Course Pricing	
Anticipated No. of Students	23
Anticipated Direct Income	£3,000
Estimated number of Raw SUMs generated	460
Estimated Weighting Factor	0.9561
WSUMS Funding Value	£83,400
Surplus/(Deficit) After WSUMS Funding	**£1,505**

Advantages

Ensures overhead costs are fully allocated in a simple way
Model can be simplified and operated at a Divisional or School level
Relatively easy to understand and operate

Disadvantages

Overhead allocations to courses or divisions may not reflect actual usage of non-teaching staff resources consumed
Overhead allocation may lack credibility with budget holders

Annexe C – Risk Prompt List

1. Pricing may not be sufficiently competitive
Mitigating actions: reduce costs; redesign product/service
Early warning mechanisms: reduction in income; reduction in number of customers

2. Prices may be set too high or too low
Mitigating actions: understand the market; identify competitors; assess market position; establish break-even position; calculate direct and indirect costs of service/product; redesign product or service offering extra features which will justify a high price
Early warning mechanisms: reduction in income; reduction in number of customers

3. Costs may not be recovered to the expected level
Mitigating actions: gather accurate/reliable cost information; reduce costs
Early warning mechanisms: complaints about a lack of /poor costing information

4. VAT may not be charged where appropriate
Mitigating actions: review procedures, policies and procedures manual; staff training; availability of expertise
Early warning mechanisms: Inland Revenue findings

5. Service offered to customers may not be to a high enough standard
Mitigating actions: review facilities; staff training
Early warning mechanisms: customer complaints; reduced requests for consultancy, contract research

6. Inability to bid successfully for competitive funding
Mitigating actions: use specialist staff to advise on bidding process; peer/committee review of applications
Early warning mechanisms: post-bid exercise; feedback from funders of successful/lost bids

7. Loss of major contracts
Mitigating actions: monitor performance regularly; liaise with funders regularly; ensure that staff members are clear about contract deliverables
Early warning mechanisms: performance indicators; feedback from funders

8. Poor negotiation of contracts
Mitigating actions: increase expertise; staff training; dedicated adviser
Early warning mechanisms: loss of contracts; poor pricing decisions

9. Intellectual property disclosed/compromised before protected
Mitigating actions: policies for copyright and patents; confidentiality agreements for all staff
Early warning mechanisms: central monitoring of research activity in progress

10. Negligent advice given by institution's staff during consulting assignments
Mitigating actions: proper review procedures prior to advice being issued; training in risk management for staff involved in consulting; insurance cover
Early warning mechanisms: complaints from clients; monitoring of consultancy income

11. Breach of commercial contracts
Mitigating actions: review by legal advisers prior to signing; regular monitoring of progress
Early warning mechanisms: review of contract performance indicators

12. Potential for litigation
Mitigating actions: regular review of policies and procedures; careful drafting of contracts to avoid liability; review by legal advisers of all contracts prior to signing
Early warning mechanisms: feedback from staff

13. Failure to realise full commercial value of strengths or maximise all potential sources of income
Mitigating actions: ensure that staff fully understand IP rights; dedicated commercial department/adviser; regular review of activities by Board of Management
Early warning mechanisms: regular review of commercial income; information on the value each customer will attribute to purchasing service/product

14. Income due may not be invoiced correctly and on time
Mitigating actions: review invoicing procedures; policies and procedures manual
Early warning mechanisms: increase in bad debts

15. Invoice amounts may not be successfully collected
Mitigating actions: review debt collection procedures; policies and procedures manual
Early warning mechanisms: regular review of reports on outstanding debt

16. Current pricing practices may be in contravention of the institution's financial regulations
Mitigating actions: review procedures; policies and procedures manual; staff training
Early warning mechanisms: regular review of pricing practices

17. Sources of income may not be maximised
Mitigating actions: improve marketing; develop plans and monitor progress; use specialist commercial advisers; promote services; develop pricing strategy.
Early warning mechanisms: feedback from regular progress reports

18. Failure to break even on conference/catering provision and student accommodation
Mitigating actions: marketing of services; regular review of occupancy statistics; regular review of charges against local rented accommodation; consideration of uses in vacation period
Early warning mechanisms: central management accounts review; reports by manager of residences/conference activity

19. Failure to attract sufficiently high-quality student intakes
Mitigating actions: revise course portfolio; improve marketing; market research; monitor student application numbers and quality
Early warning mechanisms: falling number of applications of right quality

Annexe D – "Open" Course Model

Course Name:		
Course Code:		
<u>Course Costs</u>	<u>Box</u>	
Number of teaching hours	A	0
Standard Cost Per Teaching Hour		£XX.00
Total Course Costs		£0.00
Anticipated No of Students (YY as standard)	B	YY
Proposed Selling Price	C	£0.00
Proposed Direct Income		£0.00
Direct Surplus / (Deficit)		£0.00
Estimated number of raw SUM's generated	D	0
Estimated Value of Raw SUM's		£XXX.00
Estimated Weighting Factor	E	0
WSUM Funding Value		£0.00
Surplus / (Deficit) after WSUM's funding		£0.00

Head of Department ______________________________

Date ________________

Finance: ______________________________

Date ________________

Annexe E – "Closed" Course Model

Contract No: ___________

Course Details

Course Title: ______________________ **Dept** ______________

Customer Details
(Name, Address
Contact) ______________________________________

Proposed Start Date ______________ **Duration** ______________

Costing and Pricing

A	A1	Teaching	0	Hrs@	£XX	=	£0
	A2	Tech Supp	0	Hrs@		=	£0
	A3	Dev Time	0	Hrs@		=	£0
				Total Staffing Costs:			£0
B	B1	Enrolment					
	B2	Venue/Catering					
	B3	Stewart Hall					
	B4	Materials					
	B5	Marketing					
	B6	Travel and Subsistence					
	B7	Consultancy					
				Total Other Direct Costs:			£0
				Total Direct Costs:			£0
				Overhead Recovery			£0
				Price			£0

Invoice Instructions ______________________________________
(e.g Invoice in advance, Invoice quarterly, Invoice in full at course start date)

Approval

Costed By ______________ **Date** ______________
Authorised By ______________ **Date** ______________
Head of Department ______________ **Date** ______________

………

To be Completed by Finance Staff

A/C Code _____ **Cost Centre** ___ **Project Code** ________ **VAT** ______________

Annexe F – Pricing Checklist

Key Questions	Yes	No
Pricing, Marketing and Strategic Planning		
Are there clear objectives for the strategy?		
Have you considered how to embed pricing and marketing into institutional plans?		
Will this be a bottom-up process (individual operating units developing local strategies for pricing and marketing) or a top-down approach (considered at a corporate level and then engaging with operational units to see how each may contribute to the success of the whole)?		
Have you considered using a planning template to ensure that questions are addressed in a consistent form across the institution?		
Does the strategic plan contain contingency plans describing what action should be taken by the institution if any of its initiatives fail?		
Implementing a Pricing Strategy		
Have you involved all those concerned with developing the strategy or in making pricing decisions? Have you also communicated with other stakeholders (e.g. staff, students, external bodies)?		
Have the responsibilities for developing and operating the pricing and marketing strategy been defined and formally approved?		
Have you set out a clear timetable that is realistic and has appropriate review points?		
Have the resources to deliver the strategy been identified?		
Has the strategy been formally approved, since it will form part of the overall strategic plan?		
Has the strategy been widely disseminated and understood by those involved in making pricing decisions?		
Business Planning		
When bringing forward proposals, are departments expected to produce fully worked-through business plans?		
Have you considered providing business plan templates and named staff to support the formulation of these plans?		
Risk Management and Risk Analysis		
Do all proposals identify and evaluate any potential risks?		
For each proposal, is the impact and likelihood of potential risks measured and does the project plan state how risks are to be dealt with and monitored? What contingency will be activated if risks materialise?		

Annexe G – References

Costing and Pricing in Education: Are You Ready? – CIMA – January 2000

Developing a Pricing Strategy in Higher Education Institutions – Joint Costing and Pricing Steering Group (JCPSG) – July 2002

Exploring Corporate Strategy – Johnson, Scholes and Whittingham – November 2004

Marketing Management – Kotler and Lane Keller – March 2005

Annexe H – Working Group Membership

Iain Clark, Financial Controller, Motherwell College

James Gow, Chief Finance Officer, John Wheatley College

Peter Smith, Assistant Principal – Finance and Resources, Borders College

Janet Thomson, Assistant Principal Resources, Cardonald College

Gordon Weir, Assistant Principal, Adam Smith College