Annex A. Cost accounting approaches

Background

Chapter 3 of this report discussed the fact that, if an HEI undertakes an economic activity, it must levy market-appropriate charges for the use of its infrastructure and staffing in the delivery of that activity.

A market-appropriate charge is one that is sufficient to meet all of the costs of the activity, to ensure that there is no subsidy from state funding. That means the charge must cover the operational costs, the costs of capital, a return on equity and an appropriate mark-up or margin for profit.

Chapter 3 discussed the fact that charges may be differentiated between different services (such as different CET programmes), or the HEI may choose to offer all CET programmes at a flat rate.

This annex sets out the approaches that a HEI might use to ensure it complies with the requirement to avoid cross subsidy and to ensure that the economic activity does not receive a “favour” in the market and hence, does not distort the operation of the market and does not impair trade.

Permissibility of the "backwards from the end" approach

In practice, flat-rate charges are determined "backwards from the end". This approach appears to be justifiable on good grounds. In simple terms, calculating "backwards from the end" means that an undertaking determines the project costs and charges them to the client with a mark-up of, for example, 8%. The flat-rate charge is then passed on to the HEI. This means that the HEI has no possibility of exercising "forward control", i.e. checking the accuracy of the determination and increasing the flat-rate charge, if necessary, in advance. The HEI discovers the flat-rate charge only after the project has been completed and invoiced.

This problem recalls the determination of transfer prices between a parent undertaking and a subsidiary where the parent undertaking provides services to the subsidiary and the subsidiary provides a finished product or a service on that basis. This raises the question of the correct transfer price, particularly from the point of view of taxation.

As part of the 2008 corporate tax reform, Germany stipulated that if there are fully comparable “arm's length” values, the appropriate transfer price must be determined primarily according to the business case-related standard methods (§ 1(3) AStG [Taxation of Foreign Relations Act, *Gesetzes über die Besteuerung von Auslandsbeziehungen*]).

These standard methods are:

- the price comparison method;
- the resale price method;
- the cost-plus method.

These methods, shaped by tax law, fundamentally have no relevance for EU state aid rules. However, if they have become commonly used in business in Germany, even for tax reasons, then this practice will play a role in the economic aspects of EU state aid rules.

- The **price comparison method** – also known as the Comparable Uncontrolled Price Method (CUP) – is considered to be the standard method for determining transfer prices due to the immediacy with which the comparison price can be established. The method is to compare the price agreed for transactions between related parties with the price agreed for similar transactions between independent third parties (or between related parties and an independent third party who cannot be influenced by decisions made by the company or company owners (Vögele/Raab, 2015[1]))[1]. In other words, the appropriate transfer price is determined on the basis of comparable transactions between a service provider and an independent service recipient. The prerequisite for using the price comparison method is that the prices for the transaction in question are fully, or at least partially, comparable with those of the transaction drawn on for comparison.
- The **cost-plus method** (CPM) determines the appropriate transfer price in a two-step process. Based on the assumption that the manufacturing cost of a product or a performance represents its intrinsic exchange value, the cost price of the providing party is used as the starting point and an appropriate mark-up (a proxy for profit) is added (Vögele/Raab, 2015[1])[2]. The underlying idea behind the CPM is that a commercial enterprise can be economically viable in the long term only if its full costs (both variable and fixed costs) are covered and if a certain minimum profit can be achieved. This principle is also the foundation of the above norms of EU state aid.
- The **resale price method** (RPM) takes as its starting point the price for which an undertaking sells goods it has acquired from a related undertaking in the group to an independent purchaser. The starting point of the RPM is thus the price that the resale undertaking obtains on the market. The price of sale is reduced by a fair-market margin, the size of which is determined by the following three components: i) the costs incurred by the reseller; ii) the functions and risks assumed by the reseller during the supply or performance relationship with the related party; and iii) a reasonable profit mark-up for the reseller.

This last method – which is also recognised in Germany – can thus be said to think "backwards from the end", meaning that the approach is not completely devoid of economic foundations. As EU state rules also use a "backwards from the end" approach, the basic approach of the RPM method does not seem unreasonable.

Assessment in accordance with the principles of separate accounting

Even if it is permissible to use the approach of flat-rate charges, this does not mean that the flat-rate charge applied in an actual case or the basis of its calculation are reasonable. Each individual case needs to be assessed.

In this respect, all parties involved at the HEI will have to observe the principle of proper separate accounting. Essential elements of separate accounting are correct full-cost accounting and correct cost allocation. If a market price is not known for the economic activities of the HEI, it is important that the calculation of the quotation includes total costs with a profit mark-up. Full-cost accounting is a suitable cost-accounting system for ensuring that total cost is recognised. It consists of the following three components:

- **Cost type accounting**: Which costs have been incurred?
- **Cost centre accounting**: Where did the costs arise? The structure of cost centre accounting is based on the organisational units of the HEI (departments, institutions, etc.).
- **Cost unit accounting**: What were the costs incurred for? The individual projects and contracts are to be recorded as cost units.

It is well known in practice at HEIs, and especially in auditors' reports, that the costing must take place in several steps.

Preliminary costing

Anyone who engages in economic activities must, as a matter of principle, cost them in advance. This is a requirement in the sense of Point 25 of the R&D Framework, which assumes in the case of research services by an HEI – and *mutatis mutandi* also in the case of other economic activities by the HEI – *ex ante* costing (and not *ex post*, i.e. only after the project has been carried out).

The preliminary costing within the framework of the separate accounting includes direct and indirect costs, i.e. according to general principles, the costs directly attributable to an expected project are recorded and calculated with the internal overhead surcharge determined in-house by the HEI. This then results in a total price, which – with a profit mark-up – forms the basis of the calculation.

Final costing

In final costing, the **actual costs incurred** and **actual revenues** are compared with each other. When determining the actual costs, it should be noted that the overhead costs taken into account are not allocated using the overhead rates used in preliminary costing, but on the basis of the actual costs.

The HEI must be able to make a final cost calculation. To do this, the HEI may also need the co-operating undertaking to supply a statement of costs from which it is possible for the HEI to check whether the cost estimates were retrospectively correct in the relevant year, thus making it possible to adjust them for the future. This is crucial also because final costing has an impact on preliminary costing. This is because, if it becomes clear that the *ex ante* costing is no longer appropriate because the use of resources developed significantly differently than costed and was more intensive, then, from the point of view of EU state rules described above, the HEI must adjust its future costing.

References

Vögele/Borstell/Engeler (ed.) (2015), *Verrechnungspreise, 4. Auflage*. [1]

Notes

[1] *Vögele/Raab* in: Vögele/Borstell/Engeler, *Verrechnungspreise*, 4. *Auflage* 2015, *Kapitel D*. marginal 50 ff.
[2] *Vögele/Raab* in: Vögele/Borstell/Engeler, *Verrechnungspreise*, 4. *Auflage* 2015, *Kapitel D*. marginal 250 ff.

From:

Continuing Education and Training and the EU Framework on State Aid

Implications for the Public Higher Education Sector in Brandenburg

Access the complete publication at:
https://doi.org/10.1787/9ec6cb98-en

Please cite this chapter as:

OECD (2022), "Cost accounting approaches", in *Continuing Education and Training and the EU Framework on State Aid: Implications for the Public Higher Education Sector in Brandenburg*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/63955799-en