Magic Workbooks

Business Survival Manual

THE PITFALLS OF COST ALLOCATION

OR

See you later, Allocator...

Cost Allocation, as the name suggests, means that we have to divide expenses between two or more parties who have benefited from the expenditure in a way that will be justifiable and acceptable to all parties.

This general definition gives you some inkling of why cost allocation, although quite a simple matter in terms of the calculation processes involved, is not exactly a favorite subject with controllers or accountants.

The problem with cost allocation is that invariably one or more of the parties concerned will argue against their allotment of the expenses (*unjust … totally incompetent … far from reality… the work of a moron who knows nothing about the business… blah-blah-blah).* Add to that the fact that sometimes the criticism is even well-founded and impossible to refute – and you know why the whole allocation business can turn into a real pain in the neck.

This hatred of cost allocation and the endless political discussions surrounding it often leads to astounding attempts to circumnavigate the problem by producing direct costs: for example, a complicated (and costly!) system of little chip-cards for copy and fax machines, or an office supplies center with its own staff and software that ensures that every pencil gets debited to the exact cost center the person who ordered it belongs to.

No matter what the cost for the company – at least, and thank God, it's not cost allocation.

That's a bit like going from San Francisco to New York by way of Japan just to avoid Kansas. Who knows – Kansas might be a real cool place to look at out of your plane window; and most certainly it would be a cheaper and faster trip.

Add to that a hard truth: cost allocation is simply unavoidable. Not every little office cubicle can have its own rental contract or mail service agreement. The amount of paperwork required and the administrative expense would daunt even the most fanatic direct costing advocate!

Therefore, let's bravely face the unavoidable and have a peek at that hideous monster, Cost Allocation.

In the following paragraphs we are going to chart some sensible ways of hacking one's way through the allocation jungle.

By the way, it does not matter whether we talk of cost allocation between two individuals, several departments, administration fees between a holding company and its subsidiaries, or zone cost allocation between different cities or regions. The principles – and the pitfalls – will always be the same.

Let's look at an example:

Massun Ltd. is in the habit of charging its three subsidiary companies a yearly administrative fee which comprises rent, utilities and various services such as cafeteria, reception, accounting and controlling. This "fee" varies from year to year since it is not really a fixed fee but an allocation of all the costs incurred by Massun Ltd. in its holding function.

The negotiations concerning this fee have gone on for three months, the last controller in charge of these negotiations has just been hospitalized with a nervous breakdown, and you have been selected as a replacement. (Congratulations!)

What you start out with is this:

Total expenses to be allocated: **1.589.700**

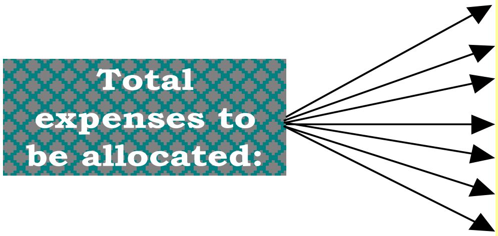
	Company	Allocation Factor		Allocation Amount
Thereof:	Company **1**	5.000	square feet	836.684
	Company **2**	3.500	square feet	585.679
	Company **3**	1.000	square feet	167.337
	Total	9.500		1.589.700

Needless to say, every single subsidiary CEO is ready to go to battle over this allocation and each one is armed with a wad of paper full of charts and graphs to refute every single assumption behind the allocation.

What do you do in order to get this settled as fast as possible and still have some spare time to visit your unlucky predecessor in hospital?

COST ALLOCATION RULE No. 1: SMALL IS BEAUTIFUL

1.589.700 in one lump sum is a lot to swallow at one go. So, you should start by breaking the total up into smaller components.



Cost type	Amount
Rent	480.000
Utilities	93.000
Cafeteria	210.000
Controlling	85.000
Accounting	65.000
Reception	44.800
....	.....
Total	**1.589.700**

Presenting a large sum as a total of many or at least several different items is not that much more work. Its effect in negotiating the whole is, however, very helpful. First of all, it makes the whole range of services included in the cost allocation transparent for all parties concerned. And secondly, there is a psychological benefit in negotiating: the cost-conscious CEO, who vehemently fights a 500.000 share of expenses, will be reluctant to make a fuss about a 500 share of, say, fire alarm expense.

If, compared to last year, a huge increase in cost has occurred it is also wise to put last year's figures beside the actual ones and point out where and why the increase has occurred.

Cost type	Last year	Actual	Variance	Notes
Rent	450.000	480.000	30.000	***Renewal of contract***
Utilities	93.000	93.000		
Cafeteria	200.000	210.000	10.000	***Refurbishment***
...	...	...	...	
Total	**1.589.700**	**1.629.700**	**40.000**	**2,52%**

COST ALLOCATION RULE No. 2: ONE IS NOT ENOUGH

Usually, in cost allocation discussions, the next big thing that everyone can find something to gripe about is the **allocation factor**, in our example square feet (of rental space).

Let's now move one step ahead of our critics and start by making a list of all allocation factors that we could possibly use.

List of Allocation Factors:

- Square feet
- Full-time employees
- Number of phones
- Number of PC's
- Revenue
- Profit / Loss

Now we work these allocation factors into an allocation factor matrix:

Allocation factor:	**Company 1**	**Company 2**	**Company …**	**TOTAL**
Square feet	5.000	3.500	….	9.500
Full-time employees	30	35	….	110
Number of phones	33	38	….	….
Number of PC's	12	….	….	….
Revenue	….	….	….	….
Profit / Loss	….	….	….	….
Payroll				
…	…	…	…	…

Our next step on the way to a cost allocation matrix is matching cost types to allocation factors, meaning that we try to find the best and most justifiable allocation factor from our list for every cost item we have to allocate.

Cost type		Allocation factor
Rent	⟺	square feet (sq.ft)
Cafeteria	⟺	full-time employees (FTE)
Phone expenses	⟺	Number of phones (#☎)
IT Service	⟺	Number of PC's (# PC)
...	⟺	...

As a final step, we build up our complete cost allocation matrix from all the previous steps. And it would look somewhat like this:

COMPLETE COST ALLOCATION MATRIX

Amount total	Cost type	Allocation factor:	Allocator total	Company 1	Company 2	Company ...	TOTAL
		sq.ft	9.500	5.000	3.500	0	9.500
480.000	***Rent***			253.000	177.000	---,--	480.000
93.000	***Utilities***			49.000	34.000	---,--	93.000
		FTE	110	30	35	0	0
210.000	***Cafeteria***			57.000	245.000	---,--	210.000
500.000	***Human Ressources***			136.000	---,--	---,--	500.000
120.000	.....			---,--	---,--	---,--	120.000
		# PC's	120	20	40	0	9.500
650.000	***IT-Services***			108.000	217.000	0	650.000
93.000	***...***			16.000	31.000	0	93.000
		....	....	....	....	....	....
...	***...***			---,--	---,--	---,--	---,--
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1.589.700	**TOTAL ALLOCATION**			**635.900**	**317.900**	**---,--**	**1.589.700**

This type of cost allocation matrix is obviously a much better basis for a discussion than our starting point (1 sum, 1 allocation factor).

Be prepared to have one or more of your assigned allocation factors changed by common consent of all the other parties, and be prepared to be presented with some new allocation factors that you had not thought of.

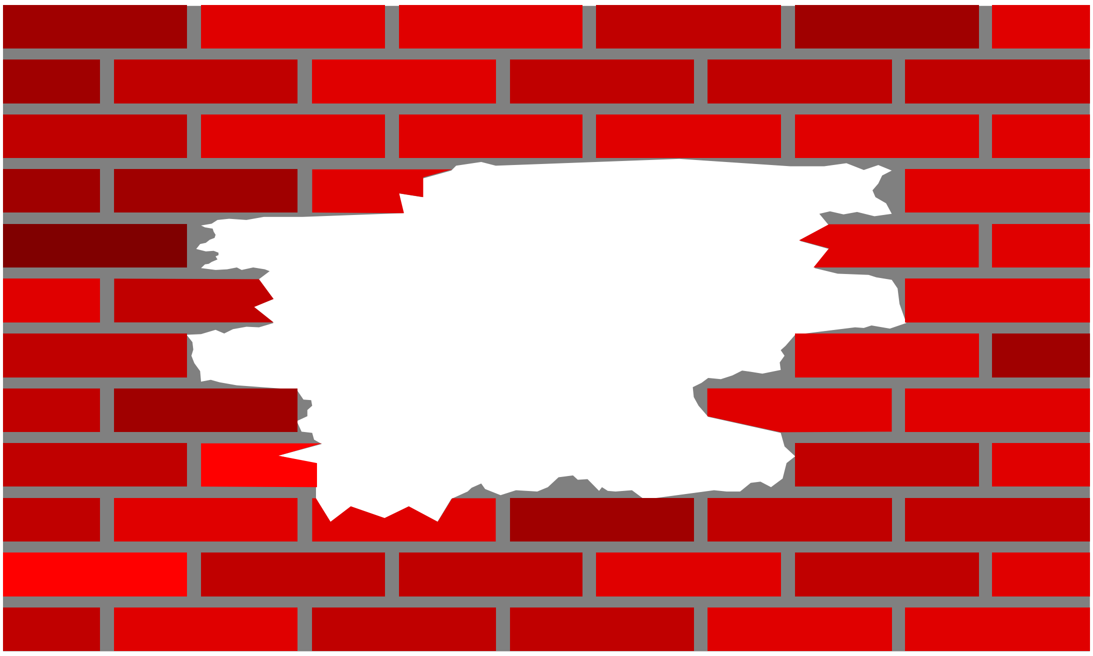
From the viewpoint of your need to get the matter settled, these are minor details – from the viewpoint of the parties who will have to bear these expenses, they may make all the difference between creative involvement and passive denial (plus a knife in your back at the earliest opportunity).

COST ALLOCATION RULE No. 3: FOREWARNED IS FOREARMED

Expenses that have to go through a cost allocation process should be budgeted and debited to the parties involved in monthly or quarterly installments.

Psychological good sense should also dictate that the budget amounts leave some room for unforeseen problems so that the allocation parties would usually be entitled to a refund at the end of the year instead of having to cough up an extra payment. A cost allocation process that ends with a refund for the parties concerned is far less likely to be talked to death before being settled (…*why bother, we're getting money back!).*

To End this with a Bang, not with a Whimper…



If cost allocation is more than an occasional nuisance in your work and before it drives you to bang your head against a wall, have a look at the following the following **MagicWorkbook®**:

CostAllocator the cost allocation tool

Builds a complete cost allocation matrix from your data for up to
15 cost types,
10 allocation factors, and
7 allocatees,
budget and actual figures.

Visit us for more information and a lot of interesting tools and reporting aids for your business survival:

www.magicworkbooks.com Turning Data into Information