Cost Allocation
Best Practices

Tuesday, June 5, 2012
8:30 am – 11:45 am

Presented by:
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Example – Let’s go to lunch

- 3 people have lunch:
  - 1 has steak for $21.00
  - 1 has a salad for $10.00
  - 1 has a cup of coffee for $2.00
  - Total = $33.00

- 3 people benefit from the cost of the lunch.

Cost allocation is a way to divide up the bill
Allocating Lunch

Possible Methods:

1. Divide by 3
2. Base it on the last time we had lunch
3. Base it on a plan we made a month ago when we decided to have lunch
4. Base it on each person’s annual salary, that is, the person who makes the most pays the most
5. Base it on the pro rata share of the cost of each person’s lunch

Allocating Lunch

Possible Methods, if this were 3 programs:

1. Divide by 3 – Equal Share
2. Base it on the last time we had lunch – History
3. Base it on a plan we made a month ago when we decided to have lunch – Budget
4. Base it on each person’s annual salary, that is, the person who makes the most pays the most – Size of Program
5. Base it on the pro rata share of the cost of each person’s lunch – Benefit Received – Actual
   (How would Actual be determined?)
Cost Allocation References

- 2 CFR Part 220 Attachment A, Cost Principles for Units of Government
- 2 CFR Part 230 Attachment A, Cost Principles for Nonprofit Organizations
- DHHS Grants Policy Statement
- Other funding sources may have cost allocation guidance

OMB Basic Criteria for the Allowability of Costs

1. Be reasonable and allocable
2. Authorized or not prohibited
3. Conform to limitations
4. Be consistent with other organization activities
5. Be determined in accordance with generally accepted accounting principles, as appropriate
6. Not be included as cost or match in any other federally funded program (current or prior)
7. Be net of all applicable credits
8. Be adequately documented
What is a “Reasonable Cost?”

A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the costs.

Guidelines for determining reasonable cost:

- Whether the cost is of a type generally recognized as ordinary and necessary for operation of the organization or the performance of the award.
- The restraints or requirements imposed by such factors as generally accepted sound business practices, arms length bargaining, federal and state laws and regulations, and terms and conditions of the award.
- Whether the individuals concerned acted with prudence in the circumstances, considering their responsibilities to the organization, its members, employees and clients, the public at large, and the Federal Government.
- Significant deviations from the established practices of the organization which may unjustifiably increase the award costs.

What is “Allocable Cost?”

A cost is allocable to a particular cost objective, such as a grant, contract, project, service, or other activity, in accordance with the relative benefits received. A cost is allocable to a federal award if it is treated consistently with other costs incurred for the same purpose in like circumstances if it:

1. Is incurred specifically for the award.
2. Benefits both the award and other work and can be distributed in reasonable proportion to the benefits received, or
3. Is necessary to the overall operation of the organization, although a direct relationship to any particular cost objective cannot be shown.

Any cost allocable to a particular award or other cost objective under these principles may not be shifted to other federal awards to overcome funding deficiencies, or to avoid restrictions imposed by law or by the terms of the award.
What is Cost Allocation?

Cost allocation is a method for fairly charging costs that benefit 2 or more cost objectives (e.g. Funding source, grant, contract, project, activity, etc.)

Examples of Funding sources:

- US DHHS
- State granting agency
- Local Foundation
- Fundraising activities

Examples of programs:

- CSBG
- Head Start
- LIHEAP
- ARRA Weatherization
- Basic Weatherization
- Elderly Nutrition
What is Cost Allocation?

Examples of agency-wide activities:

- Accounting
- Human Resources
- Facilities Management
- Information Technology

Examples of projects:

- Early Head Start and Head Start
- Adult and youth employment

Examples of program activities:

- Administration vs. Program costs
- Costs by location
Definitions

Indirect Cost (2 CFR Part 230 Attachment A. C.)

- Cost incurred for a common objective that cannot be readily identified with a particular fund or program
- Allocated using an approved indirect cost rate

Examples:
- Indirect cost pool expenses, for example:
  - Accounting department costs
  - Executive Director costs

Definitions

Direct Cost (2 CFR Part 230 Attachment A. B.)

- Identified with a particular final cost objective (award, project, activity, etc.)
- Costs that can be prorated individually as direct costs to each program using a base most appropriate to the cost being allocated

Examples:
- Supplies for a Head Start classroom
- Weatherization materials
- Costs for space shared by multiple programs
Allocate Costs Between...

Allocations can be between:

- **Funding sources**
  - DHHS and LA Workforce Commission

- **Programs from the same funding source**
  - Youth and adult

- **Categories within a program**
  - CSBG administrative and program
Indirect vs. Direct

There are 2 ways to do cost allocation:

1. Indirect Cost Rate – used to allocate indirect costs
2. Direct Costing Methods – used when all costs are treated as direct
   a. In other words, you have NO indirect costs

Indirect Cost Rate

- Device for determining in a reasonable manner the proportion of indirect costs each program should bear
  - Ratio of indirect costs and a direct cost base
  - (basically averaging of costs)

Direct Allocation Method

- Charge shared costs to programs based on an activity or non-monetary base (units, e.g. # employees, # transactions, # meals, # participants, etc.)
Indirect vs. Direct

Indirect Cost Rate
• Must receive approval from federal cognizant agency

Direct Allocation Method
• Federal approval not usually required
• Other funding sources may require approval (e.g. states)
Direct Costing Methods

“A cost that benefits 2 or more projects in proportions that cannot be determined because of the interrelationship of the work involved may be allocated... on any reasonable basis as long as the costs charged are allowable, allocable and reasonable...”

- HHS Grants Policy Statement, II-45

Direct Costing Plans

Method: Identify measures of activity that will fairly allocate costs

- Examples:
  - Number of employees to allocate costs of the Human Resources department
  - Number of accounting transactions to allocate costs of the Accounting Department
  - Number of square feet occupied to allocate building and maintenance costs, including the janitorial staff
Direct Costing Plans

How to do it?

• Allocate to programs when you record the expense using Distribution Codes

or

• Expense to a Cost Pool and allocate at the pool at the end of the month

Direct Allocation Plans – Distribution Codes

What: Determine each program’s share of a cost prior to incurring the cost

• Examples:
  – Rent, allocated based on percentage of square feet occupied
  – Classroom supplies allocated based on number of children
• Distribution codes work best when measures do not change from month to month
Direct Allocation Plans – Distribution Codes

How: Charge each program its share of the cost when transaction is processed for payment

- Examples:
  - Expense monthly rent payment to appropriate programs when payment is processed
  - Charge each classroom for supplies when they are purchased

Direct Allocation Plans – Cost Pools

What: Allocate pools of joint costs to benefiting programs at the end of a month

- Examples:
  - Costs of the Accounting Department
  - Costs of the Human Resources Department
- All related costs are combined and charged to programs in one journal entry
Direct Allocation Plans – Cost Pools

**How:** Determine bases that fairly reflect the benefit received

- Examples:
  - Facilities costs – Square feet occupied
  - Human Resource dept. costs – number of employees

Direct Allocation Method

Aggregate similar costs to create cost pools

- Examples:
  - Human Resources
  - Accounting
  - Information Technology Dept.
  - Facilities
  - Office of the Executive Director
<table>
<thead>
<tr>
<th>Personnel</th>
<th>Fiscal</th>
<th>Executive Director</th>
<th>IT</th>
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<tbody>
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<td>- Board expenses</td>
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### A Complication...

What about grants that disallow some costs or limit the amount of administrative costs you can charge?

You are required to charge *all* programs fairly and to follow your plan.

Therefore, charge all costs according to your plan and then record other revenue to offset unallowed costs.
**Changes During the Year**

Estimate the impact of new grants or loss of funding:

- Calculate changes in cost pools & distribution codes
  - Facilities: Will space allocations change?
  - HR: Will number of employees change?
    - In which departments?
  - Finance: Will number of transactions change?
  - How will client counts change?

**Changes During the Year**

- Run cost allocations based on new assumptions
- How will each grant/program be affected?
  - Will you need to apply for budget modifications?
  - Do program managers understand the impact of the changes?
Changes During the Year

Example:
If you allocate HR costs based on number of employees:

- Estimate total HR department costs based on new assumptions
- Calculate the new cost for the HR department for each program based on estimated number of employees
Indirect Cost Rates

General formula:

- Indirect cost pool ÷ Base = ICR

Costs in the indirect cost pool are:

- Allowable, and
- Benefit ALL programs

- NOT in the pool: capital expenditures, losses on awards, expenditures that benefit some but not all programs

Indirect Cost Rates

Bases:

- Salaries and wages
- Salaries, wages and fringe benefits
- Total direct costs minus some exclusions (capital expenditures, losses on awards)
Indirect Cost Rate Example – Total Direct Costs

Indirect Costs = $1,000,000
(Total Shared Costs Benefiting all Programs)

\[
\div \quad \text{Base} = $10,000,000
\]
(Adjusted Total Direct Costs)
Rate = 10%

How to use the rate:

- Head Start total direct costs = $2,300,000
- Head Start’s share of indirect = $2,300,000 \times 10\% = $230,000

- Fund Raising total direct costs = $100,000
- Fund Raising’s share of indirect = $100,000 \times 10\% = $10,000
### Indirect Cost Rate Example – Total Salaries, Wages and Benefits

Indirect Costs = $1,000,000  
(Total Shared Costs Benefiting all Programs)  
\[ \div \]  
Base = $8,000,000  
(Total Direct salaries, wages and benefits)  
Rate = 12.5%  

### Indirect Cost Rate Example – Total Salaries

Indirect = $1,000,000  
(Total Shared Costs Benefiting all Programs)  
\[ \div \]  
Base = $5,000,000  
(Total Direct salaries)  
Rate = 20%
Effect of Different Bases

Rate based on total adjusted expenses = 10%
Rate based on salaries, wage sand benefits = 12.5%
Rate based on salaries and wages = 20%

- Is rate one better than the others?
- No – they all produce the same results in total.
- The difference is in how they affect specific grants.

Types of Rates

**Predetermined** – Based on estimated costs to be incurred during the rate period (may be longer than 1 year)

- A predetermined rate is firm – not subject to adjustment
- May be issued when the cost negotiator has enough information and history to confidently predict the amount of indirect costs
Types of Rates

**Fixed rate with carry-forward** – Based on estimated costs to be incurred during the fiscal year
- Has aspects of predetermined and provisional rates but none of their drawbacks
- Not subject to retroactive adjustment
- The difference between estimated and actual costs is carried forward to the next year

**Provisional rate** – temporary rate issued for use during the fiscal year
- Adjusted to a final rate after year-end

**Final rate** – based on *actual* allowable costs and applied to the previous year
- Differences between a provisional and final rate may require adjustment to amounts charged to grants during the year
Types of Rates

**Fixed with carry-forward** rates are usually issued to units of government

**Provisional and final** rates are usually issued to nonprofits

Indirect Cost Rates

- An approved indirect cost rate will be accepted by federal funding sources unless prohibited or limited by statute
- But other funding sources (e.g. states) may or may not accept the rate
- Don’t switch to an indirect cost rate without checking first with your funding sources
  - Will they accept it?
Indirect Cost Rates

Common misunderstanding #1:

Having an ICR will get you more administrative money from your funding sources.

No –
It’s a method for allocating *actual* costs (except for predetermined rates).

Indirect Cost Rates

Common misunderstanding #2:

An indirect cost rate is required.

Not usually –
You can use other methods that are simple and straightforward as long as they fairly allocate costs.
Changes During the Year

Calculate your rate now based on new assumptions

- Estimate changes to the base:
  - New program hires
  - Total adjusted direct costs

- Estimate changes to the indirect cost pool
  - Impact of growth on:
    - HR
    - Finance
    - IT

Changes During the Year

Remember, your provisional rate will be adjusted for actual expenses at the end of the year.

Don’t apply your current provisional rate to the new funding.

*Calculate your estimated final rate and start using it as soon as you can!*

Recipients’ financial systems shall provide for…written procedures for determining the reasonableness, allocability, and allowability of costs in accordance with the provisions of the applicable Federal cost principles and the terms and conditions of the award.
Plan Guidelines

A cost allocation plan should be the simplest, most straightforward way to *fairly* allocate costs

The plan must *easily* communicate that the agency is distributing shared costs fairly and following the regulations

Cost Allocation Plans – Indirect Cost Rates

- Your ICR application and the rate negotiation agreement letter are the components of your plan
- Your auditor will audit your plan to ensure you are applying the rate to all funding sources appropriately
Plan Components – Direct Costing

Detailed information on the sources of revenue for each program
• Example: Head Start Grantee

Description of the costs to be allocated
• Example: Administrative services such as Human Resources and Accounting

Plan Components – Direct Costing

Description of the methods used to allocate costs
• Direct costing

Description of the bases for allocating costs
• Examples:
  – Activity base such as number of children
  – Number of employees
  – Etc.
Plan Components

Description of the process for allocation:

- **Who**: responsibilities for determining allowability and allocability
  - E.g. approving a purchase order or invoice indicates responsibility
- **How**: Through an allocation module in your accounting system, or on spreadsheets
- **When**: Timing of allocations (monthly)

Cost Allocation & Budgeting

1. Budget administrative functions
2. Use allocation methods to charge each program/activity for its share of budgeted administrative costs
3. Review the results:
   - Is each program carrying its fair share of administrative costs?
   - How will grant restrictions impact covering administrative costs?
CSBG and Budgeting – Best Practice

Prepare a detailed budget for CSBG administrative dollars:

- Using budget projections, plan how you will use CSBG funding.
  - Support for specific programs
    - Which programs?
    - How much per program?
  - Support for administrative functions
Cost Allocation OIG Audit Findings

Most common audit findings for cost allocation plans:

- Not allocating shared costs to all benefitting programs
- Not obtaining a new indirect cost rate annually
- Continuing to use a rate that is no longer in effect

Cost Allocation OIG Audit Findings

Most common audit findings for cost allocation plans (cont.):

- Not revising the cost allocation plan or indirect cost rate proposal to include the addition or loss of program
- Not maintaining supporting documentation
Cost Allocation Lessons Learned

1. If you have multiple funding sources, cost allocation is unavoidable.

2. You will never find a method that satisfies everyone.

3. When you apply for a grant that has little or no administrative money, plan how you will cover those costs before you get the grant.

Cost Allocation Lessons Learned

4. For direct costing, creativity counts!

5. The results of cost allocation may force you to critically review your administrative costs – are they too high?

6. If you change cost allocation methods, you will get different results.
Cost Allocation Lessons Learned

7. Communication with program managers is very important. They need to understand what will be charged to their grants and why.

8. Program managers may not perceive they receive value for allocation costs, so there can be cultural issues with cost allocation.

Summary

• Develop cost allocation methods that make sense for your organization
• Make sure your methods are allowable
• Involve senior managers, program managers and fiscal staff in cost allocation plan development
• Use your cost allocation plan as a planning tool to model how you can manage changes in funding and expenses
Thank You!
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