



Washington State Auditor's Office

Government that works for citizens

Cost Allocation

Cost allocation is a method to determine and assign the cost of central services to the internal-government users of those services. Cost allocation thereby enables local governments to more accurately account for the complete cost of the services it provides the public - and to better assess the fees it should charge them.

Included in cost allocation are direct and indirect costs.

- **Direct costs:** specifically identified with a particular cost objective.
- **Indirect costs:** incurred for common or joint purposes, benefiting more than one cost objective, not readily assignable to a specific cost objective.

Types of indirect costs

- Fringe benefits
- Central service costs; information technology, accounting, payroll, human resources, budget, facilities operating and maintenance costs, and other general and administrative expenses.
- Depreciation and use allowances.

Example allocation bases to equitably share costs to agencies or functions

- Payroll and personnel - number of employees
- Accounting – number of transactions
- Purchasing – number of transactions
- Facilities operating and maintenance costs – square feet, or number of employees in building

What is an indirect cost rate?

Ratio of indirect costs to a direct cost base

Example: if indirect costs = \$1,000 and direct costs = \$20,000, then indirect cost rate = $\$1,000/\$20,000$ or 5 percent

Common cost allocation problems

- No written policies or allocation plan
- Plan not recently updated
- Plan does not represent current operations
- Allocation method not fair and equitable
- Allocations based on unsupported estimates
- Estimates not reconciled to actual expenditures
- Budget allocations not reconciled to actual expenditures
- No support for allocation calculations

What is a cost allocation plan?

A cost allocation plan simply shares indirect costs across programs, activities, funds, departments, grants and other cost objectives.

The term “allocation” implies that there is no overly precise method available for charging a cost to a cost object, so the entity is using an approximate method for doing so. However, a cost allocation plan should be designed to provide a consistent, reasonable and equitable means to allocate costs. Inequitable allocations result in questionable charges to grants, utilities and restricted funds.

Why have a cost allocation plan?

- Promote fair and equitable sharing of indirect costs
- Recognize “full” cost of services
 - Performance measurement and benchmarking
 - Setting of user fees/tax subsidy levels
 - Activity-based management
- Better manage resources
- Allocate certain general fund costs to other funds that benefit
- Provide clear/concise method to develop budgets

Written cost allocation plans:

- Describe how the cost will be allocated
 - Identify the overhead cost center
 - Identify which costs are allocable and which are not
 - Identify the data sources used for allocation calculations
- Describe how the allocation methods are fair and equitable
 - Identify the relevant, up-to-date information that will be used
 - Identify the allocation factor for equitable cost distribution
 - Allocate to all benefiting funds and departments
- Identify the documentation required to support the allocations
 - Costs to operate each overhead cost center
 - How the level of service to each benefiting fund/department was determined
 - Amount charged to each benefiting fund/department

Example

Clerk-Treasurer

Time Study - Representative one month (20 days/160 hours)

Council meetings/minutes/prep	22
Voucher/warrants	28
Payroll	10
Utility bill processing	18
General cash receipting	18
Mail/general citizen inquiries	16
Utility receipting	20
Month end reports/accounting	18
Utility billing inquiries/complaints	10
Total	160
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Utility related hours (30%)	48
General Government related hours (70%)	112
Total	160

General guidelines

Non-grant activities: Any costs considered reasonable, justifiable, equitable and supportable. Cannot allocate costs that benefit the public at large. Please see comments regarding Office of Management and Budget (OMB) Circular A-87 below.

Grants

- Depends upon agreement
- Must comply with OMB Circular A-87 (prohibits costs that benefit the public at large, including the costs of elected officials)

Common approaches

- Prepare two different cost allocation plans
- May choose to use grant monies for direct costs only

Resources

- [Government Finance Officer Association's \(GFOA's\) Cost Analysis and Activity-Based Costing for Government, 2004.](http://www.gfoa.org/cost-analysis-and-activity-based-costing-government) - <http://www.gfoa.org/cost-analysis-and-activity-based-costing-government>
- GFOA's Best Practice – Measuring the Cost of Government Services: <http://www.gfoa.org/downloads/MeasuringtheCostofGovernmentService.pdf>
- OMB Circular A-87, Cost Principles for State, Local, and Indian Tribal Governments: http://www.whitehouse.gov/sites/default/files/omb/assets/agencyinformation_circulars_pdf/a87_2004.pdf
- A Guide for State, Local, and Indian Tribal Governments: Cost Principles and Procedures for Establishing Cost Allocation Plans and Indirect Cost Rates for Agreements with the Federal Government - Implementation Guide for OMB Circular A-87: http://www.nhtsa.gov/nhtsa/whatsup/TEA21/GrantMan/HTML/6041_SAFETEA-LU_ASMB_C-10_tag.pdf
- Part 3, Chapter 9, Section 5 of the Washington State Auditor's Budget, Accounting and Reporting Systems Manual for Cities, Counties and Special Purpose Districts (GAAP): http://www.sao.wa.gov/local/BarManual/Documents/GAAP_p3_OvrhdCost.pdf
- Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Audits - 2 CFR 200 subpart E - Cost Principles <https://www.gpo.gov/fdsys/pkg/CFR-2014-title2-vol1/xml/CFR-2014-title2-vol1-part200-subpartE.xml>
- 2 CFR Appendix V to Part 200 - State/Local Government and Indian Tribe-wide Central Service Cost Allocation Plans <https://www.gpo.gov/fdsys/granule/CFR-2014-title2-vol1/CFR-2014-title2-vol1-part200-appV/content-detail>
- 2 CFR Appendix VII to Part 200, States and Local Government and Indian Tribe Indirect Cost Proposals https://www.law.cornell.edu/cfr/text/2/appendix-VII_to_part_200