Cost Allocation

Management Matters: A PMFO Series

Chris Barnes: Hello. I'm Chris Barnes from the National Center on Program Management and Fiscal Operations, known as PMFO. On behalf of PMFO, I'd like to welcome you to this Management Matters presentation on cost allocation. My colleague Irina Katz and I will be your guides for this presentation. When PMFO staff make fiscal presentations at national and regional conferences, invariably, attendees ask questions about cost allocation. We've designed this session to answer those questions and to provide some basic information about what cost allocation is, why it is necessary, and how to develop and then manage a cost allocation plan.

For this Management Matters presentation, our goal is to: discuss reasons for cost allocation; deepen your knowledge of cost allocation; define key cost terms; and describe a step by step process for developing a cost allocation plan. Irina, why don't you get us started by telling us what cost allocation is?

Irina Katz: Thanks, Chris. Cost allocation is the process of assigning two or more programs the shared cost of an item or service. Organizations use cost allocation to ensure that costs are shared equitably across different funding sources and programs. It is important to note that cost allocation isn't necessary for programs with only one funding source because their costs aren't shared.

Cost allocation is necessary to assure that the federal government only bears its fair share of costs and isn't covering costs that aren't attributable to its programs. Head Start programs, along with other federally funded programs, are guided by federal regulations that are intended to protect taxpayer dollars. These regulations outline key fiscal principles, including those related to costs charged to federal awards. The cost principles state that to be allowable to a federal grant, costs must be: reasonable; allocable; be given consistent treatment across all funding sources; and conform to any limitations and exclusions outlined in the award.

Let's look a little deeper at some of these terms. Reasonable costs are those necessary for the performance of the award and are costs that a prudent person would pay the same amount for an item under similar circumstances. Allocable costs are those that are appropriately assigned because they benefit the program.

As mentioned earlier, federal regulations outline key principles pertaining to allowable costs. They are included in the cost principles outlined in the Code of Federal Regulations, also known as CFRs. Different regulations have been adopted for different kinds of organizations. It is important to know and follow the regulations that pertain to your kind of organization. These regulations can be found on the Early Childhood Learning and Knowledge Center, which serves as the Office of Head Start's website.

If your organization is an educational institution, it would be covered in 2 CFR Parts 215 and 220. If your organization is housed within a state, local, or tribal government, it would be covered by 2 CFR Part 225. And for nonprofit organizations, they would be covered by cost principles outlined in 2 CFR Part 230.

Chris, now I think you're going to identify the specific types of costs, right?

Chris: Yes. Thanks, Irina. Costs can be divided into two categories, direct costs and indirect costs. Let's first discuss direct costs. Direct costs are those costs that clearly and directly benefit the implementation of a program or service. Direct costs may pertain to just one program or award, or than one program or award. An example of shared direct costs would be salaries for direct service staff that serve a blended classroom of both Head Start and child care kids.

One of the challenges of cost allocation is establishing a reasonable basis for allocating various types of costs. We'll be talking about how to do this later in this presentation. Now let's look at some examples of a direct cost, both those that are charged to only one award and also those that are shared because they benefit two or more awards.

Here are some examples of direct costs. Some can simply be charged to a Head Start grant, while others may be shared with another funding source so they need to be cost allocated. Remember, direct costs that only benefit the Head Start program don't need to be allocated. An example would include furnishings and supplies in a Head Start-only classroom. Costs for transporting children on a bus are another example of direct costs. If the bus only transports Head Start children to and from the Head Start program, costs don't need to be allocated. However, if the bus is transporting both Head Start and non-Head Start children, bus costs must be allocated fairly between Head Start and the programs supporting the non-Head Start children.

Teacher salaries are also an example of direct costs. Again, if the teacher only serves Head Start children, no allocation is necessary as the salaries will be charged 100 percent to the Head Start grant. But if the teacher is in a blended classroom that serves both Head Start and non-Head Start children, the teacher's salary would need to be allocated appropriately based on the benefits afforded each funding source.

Irina: Programs that use a non-Head Start funding source, such as child care funds, to extend the hours that children receive services must distribute the cost of teacher salaries across the two programs. Similarly, programs serving children who are supported by multiple funding sources, such as state pre-K and Head Start in the same classroom, can allocate teacher salaries across both programs.

Chris: Yes, that's correct. Okay. Let's move on and talk about indirect costs. Indirect costs are incurred for common or joint objectives and cannot be readily identified with a particular project or program, but are necessary to the overall operation of the organization and the performance of its programs.

Here are some examples of indirect costs: the salary of an executive director of an organization that has multiple programs; the cost of auditing services for that organization; and the cost of administrative supplies used by administrative staff in the organization. Indirect costs are almost always administrative, so other examples include the salaries for the agency bookkeeper and the information technology services.

Indirect costs can be allocated; and many grantees choose to allocate all costs, both direct and indirect. Some programs choose to negotiate an indirect cost rate that applies a uniform rate for all items of cost, such as those noted above, which are difficult to otherwise apportion between awards. An indirect cost rate is simply the ratio of an organization's total indirect cost to its direct cost base, including non-federal share. If you're interested in exploring an indirect cost rate, you should contact your Regional Office. Indirect cost rates must be negotiated and approved by the cognizant federal agency, which for all nonprofit organizations is determined by calculating which federal agency provides the most grant funding.

We've talked about both direct and indirect costs. Now let's take a look at cost allocation plans. As a reminder, a cost allocation plan is needed when two or more funding sources are covering the cost of an item or service. Most Head Start grantees receive funding from multiple sources that benefit the children and families they serve, so they need a method or plan for how to allocate costs equitably. Here is an example of a common agency that is sharing costs between Head Start, state prekindergarten, child care, and after-school programs.

Irina: Chris, now let's talk about how to create a cost allocation plan. As with most plans, you should review them periodically to avoid common pitfalls and to ensure compliance with the cost principles. A cost allocation plan is the method developed by an organization receiving funding from more than one program which enables the organization to fairly and equitably allocate the shared costs of the organization to each of its programs. It is essentially a budget, or recipe, for shared costs. It should be a carefully thought out forecast of how shared costs and services are expected to benefit more than one program in your agency. As with any budget, the cost allocation plan should reflect as accurately as possible how shared costs and services will be charged to various funding sources.

Chris: Your cost allocation plan should accurately reflect the actual benefit to the program across service areas. A cost allocation plan is expected to be a reasonable, but rarely perfect, estimate of how you will utilize and charge shared costs and services. A written cost allocation plan is a clear best practice for effective fiscal management. As with any plan, they often change. So it's not enough to just develop a plan at the beginning of the year and forget about it. Throughout the year, you will want to evaluate whether your plan in actuality has changed and whether costs need to be allocated differently based on any significant changes. But we're getting ahead of ourselves.

Let's start from the beginning. Step one of your cost allocation plan is to identify all costs and services which benefit only one program. As we mentioned earlier, these do not have to be allocated. Then identify all costs and services shared between Head Start and Early Head Start or between either program and another type of program. Be aware that for a grantee that receives funds for both Head Start and Early Head Start, cost allocation will likely be necessary if you share any costs between the two programs, as costs for these services need to be tracked separately. For example, if you have a nurse who provides services to both Head Start and Early Head Start children, you will be allocating her salary between the two programs.

Irina: Once a grantee has identified shared expenses, leaders can begin to classify them. For each shared expense, determine if it is shared but can be distributed by benefit to each program or if it is shared but difficult to assign benefit to a particular program.

Chris: A couple of examples come to mind when I think about expenses that are not so easily allocated. The time an executive director or CEO spends on Head Start or Early Head Start activities, especially in large organizations, can be difficult to quantify. Also, the benefits to the Head Start program for other services, such as human resource management or auditing services, can be difficult to identify. In each case, developing an indirect cost rate may be the best option to cover these expenses. But remember, indirect cost rates must be negotiated and approved before you can use them.

Once the leadership or governing body of the Head Start or Early Head Start grantee decides to negotiate an indirect cost rate, the grantee should contact the Program Support Center, the business management arm of the federal Department of Health and Human Services. For grantees that choose not to use an indirect cost rate, administrative costs need to be identified and then directly allocated to the program through an appropriate cost allocation method.

A critical element of effective cost allocation is step number three, categorization. Initially, you should combine shared expenses into broad categories, such as: personnel, which includes salaries and fringe benefits; all facilities, including grantee owned, leased, donated properties; equipment, including buses; service contracts, for example janitorial and maintenance contracts; and finally, other shared expenses. By doing this, you are less likely to omit allocable activities and will be better able to justify your expenses during an audit or review.

Irina: The next step is to determine the basis for allocation. Within the broad categories, consider how the grantee operates its programs and how shared expenses vary within categories. Identify a reasonable basis for allocating costs within each category and variation; for example, hours worked, number of children served, or kinds of services provided. The basis for each category will typically, but not always, apply when tested across the entire category. For example, most buildings are allocated based on square footage and use, but if the building costs were shared entirely based on hours of use – Head Start eight hours per day and adult education two hours each evening – without regard for the amount of square footage used by each program, another basis would be more accurate.

Additionally, the grantee should be thinking about how expenses across categories might be grouped for simpler allocation. For example, in a shared building, you might allocate building costs based on square footage and usage. However, you could include the utilities for the building, maintenance of the building, insurance for it, the security system, and the salary of the building's janitor in the same allocation. Having an allocation plan in place is very helpful to grantees so that bills and invoices can be divided appropriately.

Chris: Once categories, variations, and a reasonable basis for allocation are identified, you are ready to create the cost allocation plan. The more thought you put into how the cost allocation plan will function, the more accurate the plan is likely to be. Some of the important information needed to create your plan includes: staffing functions for shared staff; identification of shared services and who or which program they benefit; assignment of square footage of facilities to specific programs; calculation of usage of shared spaces and other resources; and determination of usage of shared services by time or percentage.

Once planning is complete, the grantee applies all the decisions that have been made to actually develop applicable percentages or other simple allocation bases. Use of an Excel spreadsheet or its equivalent is recommend for each of these updates and changes. Don't forget that once you have a plan, you need to revisit it to assure that it continues to reflect your operations. As we know, plans change, and your methods for allocating costs need to reflect how you are actually delivering services.

Now, let's take a look at a couple of simple allocation methods that can result in a cost allocation plan for shared space and bus transportation. This Head Start and Early Head Start center shares space with an adult basic education program. The building is 10,000 square feet. The Head Start program uses 3,000 square feet for three Head Start classrooms. Its home-based Early Head Start program uses 2,000 square feet for offices for its home visitors and home-based managers. The adult basic ed program uses

2,000 square feet for classroom. A meeting room is regularly used by the Early Head Start program and adult education.

Note that adult education uses this 1,000 square foot meeting room 75 percent of the time, so is allocated 750 square feet for its use, compared to the 25 percent usage of the meeting room by Early Head Start program. A percentage of direct usage of space is determined and this percentage is then applied to allocate common areas of 2,000 square feet. You can think of these common areas as indirect costs. It's likely that these percentages can be used to allocate all occupancy costs for this building, including rental cost, utilities, janitorial services, and other occupancy costs.

Irina, why don't you show us a sample allocation plan for Head Start transportation services?

Irina: Okay, Chris. In this situation, a bus is used to transport 10 Head Start children and 20 public school children daily. The bus travels 240 miles a day doing three different routes. Cost per mile to transport children is $1.32 for a total cost of $316.80 a day. Based on the number of children receiving transportation benefits, which is 20 Head Start children and 40 public school children, a percentage is developed and applied to the daily cost of transporting Head Start and public school children to its programs.

You can imagine if Head Start were running year-round programs and the bus transportation was offered to these children in the summer that a new plan would need to be developed to cover the summer transportation, assuming that no other children receive the benefit for bus transportation. The considerations made in this allocation plan include the reason for use of each vehicle, operating costs, cost per mile, number of passengers, and the type of passenger.

Chris, can you summarize for us what goes into developing a cost allocation plan?

Chris: Sure, Irina. Define who, what, when, where, and how the agency provides services. Identify what costs need to be allocated. Categorize shared costs. Develop allocation methods based on actual agency operations. Periodically review your plan for accuracy and consistency. And update your plan as your plans change. For example, it is not unusual for a position to change or a grantee to restructure its staffing. If the grantee fails to revisit the cost allocation plan when a teacher moves from a shared classroom to an all Head Start classroom, this may create problems in the audit if her salary continues to be allocated to multiple funding sources. The bottom line is that your cost allocation plan must always reflect your best knowledge of an accurate assignment of shared costs.

Irina: Good point, Chris. This is where having an effective personnel activity report system that is reviewed regularly and is used as a basis for reviewing staff salary allocations will assist a grantee in picking up changes in staffing assignments.

Chris: Finally, there are some common red flags that indicate when programs are struggling with cost allocation. They include programs that they have: different categories of expenses allocated in the same way; Head Start and Early Head Start programs that are charged disproportionately or in response to losses of funding in other programs; allocations of similar expenses that vary from year to year; and double charging both direct and indirect costs.

In closing, we have some tips that will assist you in better managing cost allocation. Make sure that staff allocations match timesheets, payroll, and personnel activity reports. You also want to assure that allocations are consistent with the staff person's function outlined in their job description. Make sure that as you have changes in your program they are reflected in your allocation plan. A recent example might include staffing changes as a result of cuts due to sequestration. And finally, it's good practice to put your cost allocation plan in writing.

Thanks for joining us today. We hope you found this information helpful. If you have questions about this or other fiscal topics, you may contact us at PMFOinfo@edc.org.