

BEST PRACTICES IN COMMUNITY COLLEGE BUDGETING

ENHANCED BUDGETING PRACTICES

6B – Allocate Costs of Shared Support Services to Subunits to Better Understand the True Cost of Offering Services

SUMMARY

Key Points:

- Support services and facilities have an integral part in achieving a college's goals. Therefore, it is important to develop an allocation model to fairly and transparently distribute the costs of support services to the college's subunits.
- To determine which costs to allocate and by what basis to allocate, a college should develop an allocation model that takes into account the goals behind developing an allocation model and the cost and benefits to administer the allocation system.
- A college could develop a pricing system for internal services as part of its allocation model. This Best Practice references the general GFOA Best Practice on pricing internal services, which provides much greater detail on developing an internal pricing system.

Related Award Program Criteria:

- Criterion Enhanced A.1: Allocation transparency. The Applicant can provide an internal document, as Supplementary Material, that is available to stakeholders and which describe the allocation formulas in a way that is also understandable to the Judges.
- Criterion Enhanced A.2: Allocation rationale. In the Award Application, the Applicant can offer a compelling description of how its allocation strategy supports a strategic approach to budgeting.
- Criterion Enhanced A.3: Understandability to non-finance stakeholders. The Academic Officer can describe the allocation methods to the judges in the Award Interview.

INTRODUCTION

Support services and facilities are an integral part of achieving a community college's goals. Therefore, it is important that an allocation model is developed that is fair, understandable, accepted, and that does not incentivize counter-productive behavior.

Allocating fixed, support, and administrative costs (collectively referred to here as "shared services") has three basic functions in the college budgeting process: 1) to reveal the true cost of offering programs and services to clientele by accounting for the costs of the shared services those programs consume; 2) to govern demand for shared services and, hence, manage the cost of those services; and 3) to help ensure that the cost of shared services remains reasonable by making the cost to the organization more evident. The first function is the most important for optimally aligning resources with student achievement because it enables a college to make a more informed consideration of the cost-effectiveness of its programs.

This Best Practice document addresses:

- I. Developing an allocation model.
- II. Other resources to support developing an allocation model.

I. DEVELOPING AN ALLOCATION MODEL

An allocation model should be developed that fits the organization (e.g., a model might differ based on the number of campuses a college has), ties to the hierarchy of the college's programs and activities, and is pragmatic in which costs are allocated.

In determining which costs to allocate and by what basis to allocate, a college should consider the goals behind allocation and the management value the allocation system will provide. Both the materiality of the cost and recipients' degree of control over the expense should be considered. The following table generalizes this concept:

		Financial Materiality	
		Low	High
Control	Low	<p>Accounting Services These costs are least relevant for allocation. Decisions to not allocate, or to allocate based on a very rudimentary and uniform basis may be most appropriate.</p>	<p>Maintenance Cost allocation should be done, but with awareness that direct control is limited. Less specific usage measures will be possible; charges based on percent total FTE salaries or based on enrollment might be most practical.</p>
	High	<p>Office Supplies These costs are important to allocate, but overly precise usage measures will be difficult to manage with little incremental value. Internal pricing should be developed that is not overly granular, but adequately serves as a proxy for usage.</p>	<p>Laboratory Utilization Cost allocation should be done based on usage metrics designed specifically for the cost element and charged most precisely of all allocated costs to the subunits.</p>

Costs should be allocated to the same level of the organization for which budgeting and strategic planning is done. For example, if a college budgets at the department level, then cost allocation should be structured to the department level, as well. If programs are used as the basis for budgeting, then programs should be used for cost allocation. This will vary by college, but consistency is important.

II. OTHER RESOURCES TO SUPPORT DEVELOPMENT OF AN ALLOCATION MODEL

GFOA Best Practice on “Pricing Internal Services.” The GFOA has a general Best Practice (that is, one not written specifically for community colleges) on pricing internal services.¹ This provides additional guidance on how to develop a pricing system for internal services.

The GFOA recommends that governments follow these steps when considering an internal service pricing system:

Identify goals of internal service pricing. The initial step the GFOA recommends for governments is to identify the goals they hope to achieve through a pricing system for internal services. The goals will guide the design of the system. For example, if a government does not charge for a particular service based on customers' usage, then there may be an incentive to overuse the service. In this case, an internal service pricing goal may be to govern demand for a service.

Develop allocation strategy. After identifying the goals, the next step is to decide which internal services will be priced and allocated to user departments. The GFOA recommends differentiating between “market” services such as IT services (where the user departments are consumers) and those services that have more of a policy or regulatory character (such as budgeting and auditing).

Define level of costing detail. Governments need to determine the level of detail associated with costing services. This decision can be guided by an organization's willingness to develop a more complex internal services pricing system for a more accurate costing system. For example, a low level of detail may be sufficient for a costing system with limited goals, while a high level of detail might be needed for goals governing the demand for service.

Determine cost of service. After identifying internal services as having either a high or low level of detail, the organization will then determine the cost of the service. Common variables to consider include direct costs, interest costs from internal loans, and services used from other support services. Direct costs include personnel, materials, and supplies related to the service. Interest costs from internal loans apply if the internal service takes loans from other parts of the government. Lastly, if the service requires other support services, then indirect costs may apply. An IT service that uses payroll is one such example.

Decide basis of allocation. With the cost of the service decided, the organization will decide the bases for allocating costs from internal services to customers. In determining bases, general principles should be observed. The first principle is the cause-and-effect relationship, so that cost should be allocated based on usage or causal factors related to costs incurred by the service provider. The basis for allocation should also bear a relationship to the benefit the customer receives from the services. For example, “miles driven” might be a good measure of the benefit that police patrol receives from its vehicles whereas “hours used” might be better for public works. The third principle requires that users of the costing system see the method of cost allocation as fair and legitimate. Lastly, legal constraints need to be recognized when developing the basis for allocation.

Consider potential drawbacks. Governments should recognize potential drawbacks of internal costing systems and should consider mitigating strategies. Common potential drawbacks include a diminished trust between providers and customers, subverting processes or not using shared services, acrimony and debate over the charge system, and costs exceeding the benefits of the system.

Program costing strategy. This document provides a guide to developing a full-costing system for programs. The method described could also be applied to departments. Appendix 1 provides an overview of program costing strategy and provides step-by-step guidance on assigning cost.

Endnote

¹ Government Finance Officers Association, Best Practice, Pricing Internal Services (2013). Retrieved from <http://www.gfoa.org/downloads/GFOABestPracticePricingInternalServices.pdf>.

APPENDIX 1

GFOA PROGRAM COSTING STRATEGY

DEFINITIONS FOR FULL COSTING

Full Costs: The sum of direct and indirect costs.

Direct Costs: Direct costs are those that are wholly attributed to the production of a particular cost object, such as a service or good. For example, the compensation cost of the staff that works in a program providing a particular service to students would be a direct cost of that program.

Indirect Costs: The cost of a resource that is used for more than one purpose and cannot be easily traced to a single cost object is an indirect cost. The costs are tied indirectly to each purpose through allocation. Indirect costs can be for administrative services – services that benefit the organization as a whole, but do not tie directly to a single program. Examples include financial reporting or the CEO's office. Indirect costs can also be for services, supplies, and the use of capital assets that directly benefit specific activities, but aren't provided directly within the program because of efficiencies associated with centralization and shared services. Common examples are information technology and facility use.

Overhead Costs: Overhead costs are the ongoing expense of operating a program. The term overhead is usually used to group expenses that are necessary to the continued functioning of the program, but cannot be immediately associated with the products/services being provided to the public. Overhead costs can be direct or indirect, depending on how broad the cost object is and how the cost is measured. For example, a rent that can be traced directly to the cost object being measured is considered a direct cost.

GENERAL STEPS

Step 1: Define Cost Object. Define the object we wish to assign costs to. The Best Practices in Community College Budgeting describe that costs should be allocated to subunits of the colleges as circumstances and the management system of the college indicate is most appropriate. For instance, some colleges may wish to define the cost object as a program, while others might use departments or divisions.

Step 2: Assign Direct Costs to Cost Objects. As many costs as possible should be assigned directly to cost objects, keeping in mind the cost/benefit of collecting the data necessary to assign costs directly. For example, barcode scanners or other metering devices might make it cost effective to allocate usage of inventory or other supplies directly to cost objects. Also, it may be more cost effective to directly allocate larger expenses, simply because the investment required to directly allocate the cost has a larger payoff. Of course, the relation of the cost object (program) to the chart of accounts and existing accounting system is important in determining how easy it will be to allocate costs directly.

Also, exclude any one-time costs, such as capital, to make sure that you are capturing only ongoing direct expenditures related to a given cost object. However, you may assign the operating and maintenance costs of the assets employed by a cost object to the direct costs, if that assignment is logical and is consistent with the way these costs are being handled for other cost objects.

Keeping the above in mind, potential methods for assigning costs include:

- **Time recording systems.** Record amounts of time that individual employees spend on specific activities.
- **Activity studies.** Time and motion studies and time sampling.
- **Inventory records.** Record what withdrawn inventory was used for.
- **Records of equipment and capital asset usage.** Record how equipment and capital assets were used.
- **Accounting records.** Assign costs to cost objects in the general ledger as costs are incurred.
- **Estimates and judgment.** Managers estimate the total resources available and how much of that is used on transactions and processes within the cost object.

Step 3: Assign Indirect Costs to Cost Pools. The second step is to set up cost pools to accumulate indirect costs before they are allocated to cost objects. There are two essential types of cost pools: support centers and mission centers. Support centers are cost pools that exist solely to support other cost pools. Support centers should reflect the major internal services provided to support the direct services to the public. Examples of support centers include procurement services and payroll.

Mission centers are cost pools that are organized around major services provided directly to the public. Mission centers may or may not be the same as the college's organizational units. The goal is to define mission centers whose major activities (outputs and outcomes) are consistent with the cost objects for which the college ultimately wishes to define full costs. Accordingly, either departments or programs could be mission centers. The choice would depend on whether operational information was available that could be used as allocation factors (e.g., personnel, floor space, support service usage metrics – see below for more information on allocation bases). It may be wise to define support cost pools first, think about the allocation bases to use, and then decide which unit makes sense as the mission center.

In general, though, cost pools should group together costs that have the same or similar cause-and-effect relationship with the pool's cost allocation basis. For example, an information technology pool based on the number of personal computers in the customer department might be appropriate, assuming that IT service usage is best defined by the number of PCs present (e.g., some departments may require server processing power that may not be related to the number of PCs). A greater number of pools will lead to more accurate costing, since the activities represented by the pools would be more fine-grained and homogenous. However, a higher number of pools also leads to a more complex cost accounting system. Here are some examples of commonly used cost pools, along with potential bases for allocating cost.

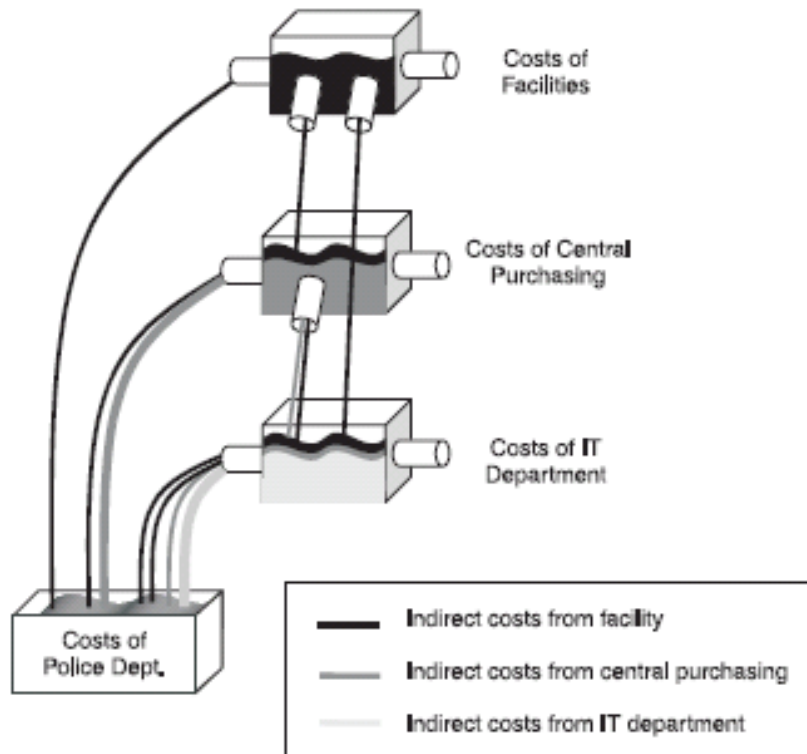
Cost Pool	Allocation Basis
Payroll processing	Number of employees, number of checks
Budgeting	Labor hours, size of budget
Insurance	Number of employees, experience
Legal services	Direct labor hours
Office space / rent	Square feet of space occupied
Procurement services	Number of P.O.s, dollar volumes, direct labor
Vehicle costs	Miles driven, hours used

Step 4: Allocate Support Center Costs to Mission Center. There are three tasks in this step.

- A. **Select an allocation base for each support cost pool.** There are a number of potential allocation bases. The base selected should be consistent with the purpose of the cost analysis and should not impose excessive data collection costs. The table above includes a number of examples. Below are some general concepts to support selecting bases.
 - **Cause-and-effect relationship.** Costs are allocated based on usage or causal factors relating to costs incurred by the government. For example, "miles driven" has an impact on the cost of vehicles.
 - **Benefit received.** Square footage of building occupied is an example of benefit received from facility services. Allocating the services of a CEO's office according to the size of budget might also be seen as indicative of the beneficial impact of the CEO (i.e., larger cost objects benefit more).

- **Fairness.** In any case, choose a method that will be seen as fair and legitimate by the users of the costing system. Whatever the allocation methodology, it is important that the finance or budget staff can prepare a reconciliation.
- B. **Calculate allocation rates.** Select a standard value such as average cost for the broader organization or an industry standard to serve as the cost allocation base so it can be used to allocate costs. For example, if the base is miles driven, then a rate might be \$0.45 per mile. To calculate the rate, divide the total costs in the support cost pool by the total amount of the cost allocation base in the cost pool (e.g., cost of the motor vehicle pool divided by the total mileage driven for the vehicles in the pool).
- C. **Allocate support center costs to mission centers.** There are three methods of allocating cost to mission centers. The methods are presented in increasing order of complexity. A college should choose a method by weighing the cost to administer increased complexity against the value to decision making provided by having more precise costing information.
- **Single step allocation.** Overhead costs are allocated directly to a mission center based on its estimated use of the overhead or benefit received. The single step method is simple to use, but only allocates to mission centers the support service costs that they directly use. For example, an IT department provides a support service and its cost is allocated to the departments that use it. The IT department also uses support services, such as facilities. When determining its own full costs, an IT department would include the cost of the support services it uses. However, when the departments that use IT services calculate their own full costs they would not include the support services that IT consumes, just the cost of the IT services itself. This makes the calculation simpler because the interlocking web of support services used by different mission centers (the departments in example) is ignored. Mission centers only take into account the cost of support services they use and do not account for the cost of support services used by the support service.
 - **Step-down method.** Under this method, support services costs are allocated both to the mission center and to other support pools. However, in the step-down method, costs do not flow between support pools – they flow in just one direction. Put another way, costs trickle down from one service to another (see the diagram that follows). For example, procurement services pool costs would be allocated to the IT cost pool, and a police/public safety mission pool would then be allocated the costs for its use of procurement services as well as the cost for its use of IT services (which now includes IT's share of procurement services). However, the cost IT services provided to procurement services would not be allocated back to the procurement cost pool. This limits the complexity of the cost allocation model, but it also means that the order of allocation is important because it may significantly affect the estimate of indirect costs. To illustrate, in the example just provided the IT department's "cost" would be inflated relative to procurement services. In order to attenuate this problem, a step-down allocation begins with the cost pool that serves most other pools and ends with the pool that receives the most from others.

Step-Down Allocation Method



- **Reciprocal allocation.** Indirect costs can be allocated between support pools. Thus this method can recognize mutual services provided among various support departments. This method is more complex to set up and administer, but avoids the problems of the step-down method.

Step 5: Distribute Mission Center Costs to Final Cost Objects. Costs can be allocated using process costing and project costing. Process costing allocates costs by a standard unit of work like payroll expenses, number of employees, or constituents served. Project costing is used when more unique units of work exist. For example, legal cases handled by an in-house attorney may be better charged based on the time spent on each case, rather than a standard rate. If the college makes its mission centers the same as its programs, this step is unnecessary.

In the inventory document, the indirect costs assigned from the mission center might be displayed separately from the direct costs of the cost object in order to provide flexibility to the users of the information.

SUMMARY OF COST ASSIGNMENT PROCESS

