

The Strategy and Tactics of Cost Allocation Structures, Part 2

Written by Nick Sanders
Thursday, 14 March 2013 00:00

Part 1 of this series can be found [here](#). In it we discussed the importance of designing your cost allocation structure to support your business strategy and customer requirements. Hopefully, we convinced you, our readership, that (a) this is an important topic, and (b) you haven't invested sufficient time or effort into ensuring that you're adequately addressing point (a).

This is not a topic that your accounting/finance function should be addressing in isolation. It requires input from stakeholders across the enterprise. For instance, your BD/marketeers need to be thinking about the nature of the contracts they'll be going after in the next two or three (or five) years. Designing and implementing a cost allocation structure is not something you want to mess with every single year; thus, today's structure needs to support tomorrow's business environment. And it's your BD/marketing folks who are in the best position to give you insight into what tomorrow's business environment is likely to look like.

And don't forget your IT folks. You may or may not implement your government cost accounting and allocation structure within your accounting system. If you're running CostPoint or Jamis, then it's not going to be a big deal either way. But if you're running SAP/R3—particularly if you're a big commercial firm that does things its own way—then you may be starting with the internal financials and then “worksheets away” from the General Ledger to get what you want for your government proposals, billings, and claims. Which is fine. But determine how much you're going to rely on your IT folks to automate the allocations and the calculations—and then keep their input in mind as you move forward.

Moving forward can be hard—particularly if you've already established a cost allocation structure that's aligned with your organization structure and are seeking to revamp it significantly. The way it's always been done is still the easiest road to travel on for almost everybody (even if it's now the wrong road), and so you're likely to get lots of push-back. Or—and this is even worse—you're going to get an ominous silence, followed by a bunch of managers with folded arms, determined to wait you out and then go back to their comfort zones. Then there are those people who will start bad-mouthing your efforts, pointing out how much money and resources you're spending to “reinvent the wheel that wasn't broken”—and that whisper campaign might even get uglier, with active attempts to sabotage your efforts.

Which is to say: this is an effort that involves change management, as well as subject matter expertise. You can design the greatest structure in creation, but if you don't get the rest of the company to buy into it, then you've failed. And change management is about communication.

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You need to get everybody involved and you need to get everybody to feel like they have a stake in the outcome.

And HR—you've got to make sure HR is actively involved, because you'll need their assistance in many areas. In some circumstances, you will be messing with the existing org structure, because it will have been decided to keep the org structure and the cost allocation structure in close alignment. In other circumstances, you'll be looking at different methods of accounting for fringe benefit costs, or labor costs, or SCA H&W costs. HR is going to care (rightfully) about those things. Exclude HR at your own peril.

Assuming you've got the right people involved, one of the first questions you'll want to answer is "how much costs need to be direct?" This is not at all an easy question. Indeed, it's a very deep question with far-reaching implications. It involves thinking about customer perceptions and the costs of accounting and the kind of culture the entity wants to create for itself.

On one extreme, most everything is a direct cost of one and only one contract. Yes, this can be done. In this type of culture, pretty much everybody is a direct employee with the ability (and need) to discretely charge to contracts. Only the residual labor that cannot be charged to a contract is charged as indirect labor. This is essentially activity-based accounting, with everybody charging based on some cost drivers. Accounts Payable charges direct based on which supplier invoices get paid that day. Accounts Receivable charges direct based on which customer invoices they generated that day, or which customer payments they processed. Et cetera.

In the foregoing scenario, indirect cost rates are kept as low as possible by maximizing the amount of direct costs. It's great if your customers are rate-sensitive. Your marketeers will love it.

The problem with the foregoing scenario is that you need to be able to estimate those direct costs before you incur them, during the bidding phase. If you have history, you can develop parametric estimating factors; but if not, then it's a crap-shoot what kind of "taxes" the so-called "non-productive back-office functions" will end up charging the contract.

In this scenario, you also see a lot of very small labor hour charges, which tend to drive the

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Contracting Officer's Representative batty. So you end up with a lot of questions that are difficult to answer. Even if there are no customer questions, you'll notice that you have a lot of folks spending too much time filling out timesheets and trying to drive their labor to contracts, so that they don't end up on the "poor utilization" reports.

Congratulations—you've just created a Darwinian "survival of fittest culture" where those who made friends in project/program management have charge numbers to record their time, whereas those who didn't, don't. And now everybody is a bean-counter, worried about how to drive their \$100 charge out of overhead.

On the other extreme, very few things are direct and many functions are indirect. For example, Contract Management and Supply Chain Management are indirect functions. Accounting and Finance are indirect functions. Security and HR and general management are indirect functions. Which is great because you only need to estimate the direct charges actually associated with the customer Statement of Work (SOW). Cost estimating is made dramatically easier, and the timecharging issues described above go away to a great extent.

But now you have other problems. For instance, your indirect rates are through the roof while your competitors' rates are dramatically lower. Regardless of the total cost involved, you suddenly seem a lot more expensive—*too expensive*, according to your BD folks. Your budgeting folks will spend inordinate time working through the Annual Operating Budget and trying to justify all the indirect expenses, in the face of dire warnings from the marketeers about all the business you'll be losing. And even if you manage to win the bids that your marketeers said were jeopardized by your too-high rates, your project/program managers will start telling the story about "unknown and uncontrollable indirect rates" that drove up their costs and eroded profit. And don't forget that, when times are tough, the first thing to go will be all the indirect heads that seemingly don't drive program execution.

Obviously, the right answer depends on input received from BD/marketing, Operations, project/program management, and HR. Executive management might also be interested in the kind of culture created by the strategic decisions made regarding cost allocation. Indeed, you need to survey all the stakeholders in order to find the answer that's right for your entity and its particular niche in the marketplace. More likely than not, you'll end up somewhere in the middle, with certain functions consigned to being entirely indirect, other functions determined to be fully direct, and some functions with the ability to charge direct in limited circumstances.

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In our experience, there are always functions that seem to generate questions and in-depth discussion.

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Finance looks like an indirect function, but what about the Finance folks working EVMS, which is tied to requirements of specific programs (but not others)? What about the Finance folks supporting a PMO on a full-time basis?

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Contracts can go either way. Which way will it go for your entity?

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Ditto for Supply Chain Management.

Regardless of your decisions, it will be important to (a) communicate the decisions that are made, and (b) ensure that the decisions are followed consistently. CAS 402 requires that the same cost must be either direct or indirect in similar circumstances—but not both. If you are going to determine that certain Finance functions (e.g., EVMS) are direct-charged, but that others (e.g., Annual Budgeting) are indirect, then you need to clearly spell-out which is which, and keep everybody on the same page. And if you determine that any function is a direct-charging function, then it must always be that way (in similar circumstances) *regardless of the impacts to your project/program budgets*.

. You cannot tell direct-charging people to start charging their labor to indirect accounts because the project or program can't afford them anymore.

Well, you *can*. But then you're going to have an investigation to support that will very likely result in a fairly substantial legal bill and a nice-sized legal settlement. We're going to assume you don't want that.

Okay. That's enough for today. In the next article, we'll explore the question: *What price precision*?

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