Management Matters: Cost Allocation

Introduction

Welcome!

My name is Liz and I will be your guide through this review of cost allocation principles.

Cost allocation can seem complicated but stay with me as we explore the why and how of cost allocation and cost allocation planning.

Let's look at cost allocation.

Cost allocation is the process of assigning the shared costs of a resource, good, or service. Head Start programs typically receive funding from multiple sources. How do you ensure the costs are share equitably across different funding sources? The answer is a cost allocation plan. Let's learn more.

Why Cost Allocation?

Why is cost allocation necessary?

Select all that apply.

Cost allocation assures federal funds are used:

- Solely for the programs designated, and that common costs are equitably shared
- To support a specific program when there are multiple funding sources
- For an intended program and no other federal funds are used for the same purpose

If you selected all three:

Correct. All of these are reasons why cost allocation is necessary.

If you did not select all three:

Incorrect. All of these are reasons why cost allocation is necessary.

Most Head Start grantees receive funding from multiple sources that support services to the children and families in their programs. The Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, or Uniform Guidance, require that programs develop a method or plan for how to allocate costs equitably.

45 CFR §75.100(c) of the Uniform Guidance provides the regulatory basis for cost allocation planning.

Definitions

Now, let's define some important terms that will help us understand cost allocation.

To be allowable to a federal award, the Uniform Guidance states that costs must:

- Be reasonable
- Be allocable
- Be given consistent treatment across all funding sources
- Conform to any limitations and exclusions outlined in an award
- Be necessary for the operation of the program

Grantees must also determine whether costs are direct or indirect.

To be reasonable, costs must be:

- Recognized as ordinary and necessary
- Comparable to market prices
- Meet sound business practices and arm's length bargaining
- Prudent in light of circumstances
- Meet established cost practices and be consistently applied

To be allocable, costs must be:

- Chargeable and assignable
- Beneficial and distributed using reasonable methods
- Necessary to the award

Administrative Cost Limitation:

- Allowable costs to develop and administer a Head Start program **cannot exceed 15 percent of the total approved program costs** which includes both federal costs and non-federal match
- The responsible HHS official **may grant a waiver** for each budget period if a delay or disruption to program services is caused by **circumstances beyond the agency's control**

Direct Costs

- Clearly and directly benefit the implementation of a program or service
- Pertain to just one program or award, or
- Shared across more than one program or award

Indirect Costs are classified within two broad categories:

- o Facilities or
- o Administration

Facilities includes

- Depreciation on buildings
- Equipment and capital improvement
- Interest on debt associated with certain buildings
- Operations and maintenance expenses

Administration includes

- General administration
- General expenses
- All other types of expenditures not listed specifically under one of the sub-categories of Facilities

Direct or Indirect?

Apply these definitions as you consider whether each of the following examples might be classified as a direct or indirect cost.

In each of the following examples, select if it is a direct or indirect cost.

Example 1

Furnishings and supplies for a Head Start-only classroom

Direct or Indirect?

If you selected *Direct*:

Yes! Classroom furnishings and supplies will benefit the implementation of services to Head Start children.

If you selected *Indirect*:

Oops, consider direct. Classroom furnishings and supplies will benefit the implementation of services to Head Start children.

Example 2

The salary of an executive director in an organization which has multiple programs

Direct or Indirect?

If you selected *Indirect*:

Correct. The executive director's salary does not directly benefit implementation of a service. However, the salary must be allocated across all programs operated by the organization.

If you selected *Direct*:

Incorrect. The executive director's salary does not directly benefit implementation of a service. However, the salary must be allocated across all programs operated by the organization.

Example 3

A teacher's salary in a classroom that serves Head Start and child care children

Direct or Indirect?

If you selected *Direct*:

Correct. The teacher's salary directly benefits the program's ability to provide services. However, the salary must be allocated between the multiple sources that fund the classroom.

If you selected *Indirect*:

Incorrect. The teacher's salary directly benefits the program's ability to provide services. However, the salary must be allocated between the multiple sources that fund the classroom.

Example 4

The cost of auditing services for a community action agency

Direct or Indirect?

If you selected *Indirect*:

Correct. Auditing costs are administrative in nature and benefit multiple programs. They must be allocated across multiple grant awards.

If you selected *Direct*:

Incorrect. Auditing costs are administrative in nature and benefit multiple programs. They must be allocated across multiple grant awards.

Summary

- Direct costs are assignable to a specific program. They directly benefit the implementation of at least one program.
- Indirect costs are shared costs. They are almost always administrative and are necessary to the overall operation of the organization.
- All types of costs can be allocated. Please note that non-federal match may also need to be allocated.
- Some programs choose to negotiate an indirect cost rate that applies a uniform rate for all items of cost. Grantees that have never had a negotiated indirect cost rate may elect to charge a 10 percent rate indefinitely. This is referred to as a *"de minimis"* rate.

- Negotiated indirect cost rates must be approved by the cognizant federal agency. Conversely, election and effective date of the de *minimis* rate should be reflected in the fiscal policies and procedures of the grantee and must be submitted along with the grant application. Consult your Office of Head Start Regional Office.

Cost Allocation Plan

A cost allocation plan is the method used to fairly and equitably allocate the shared costs of an organization to each of its programs. It is essentially a budget, a forecast of how shared costs and services are expected to benefit more than one program in an agency. As with any budget, it should be carefully thought out. It should reflect as accurately as possible how shared costs and services will be charged to various funding sources.

A cost allocation plan should accurately reflect the actual benefit to the program across service areas. It is expected to be a reasonable 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, cost allocation plans often change. 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 has changed and whether costs need to be allocated differently based on any significant changes.

Now let’s review the five steps to creating a Cost Allocation Plan.

Step 1: Identify direct and shared expenses.

Identify all costs and services which benefit only one program. These do not have to be allocated. Then, identify all costs and services shared between Head Start or Early Head Start and another type of program.

Step 2: Classify shared expenses.

Once you have 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
- Shared, but difficult to assign benefit to a particular program

Step 3: Categorize.

Initially, you should combine shared expenses into broad categories, such as:

- Personnel (e.g., salaries, fringe benefits)
- Facilities, including grantee-owned, leased, and donated properties
- Equipment, especially buses
- Service contracts (e.g., janitorial, maintenance)
- Other

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.

Step 4: Determine the basis for allocation.

Within the broad categories, consider how the organization operates its programs and how shared expenses vary within categories. Identify a reasonable basis for allocating costs within each category and variation, such as:

- Hours worked
- Numbers of children served
- Kinds of services provided

Step 5: Create the plan.

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 it will function, the more accurate the plan is likely to be.

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
- Determination of usage of shared services by time or percentage

Once planning is complete, you will apply all the decisions that have been made to develop applicable percentages or other simple allocation bases. Use of an Excel spreadsheet (or its equivalent) is recommended for ease of updates and changes.

Once you have a plan, you need to revisit it periodically to assure it continues to reflect your operations. As we know, plans change. Your methods for allocating costs need to reflect how you are actually delivering services. Please remember, the Cost Allocation Plan must be certified by a high level official, such as the Chief Financial Officer of the organization.

Now let's take a look at a couple of simple methods that can result in a cost allocation plan for shared space and bus transportation.

Scenario 1: Shared Facilities

This Head Start and Early Head Start (EHS) center shares space with an Adult Basic Education (Adult Ed) program. The building is 10,000 square feet. The Head Start program uses 3,000 square feet for three classrooms. The home-based EHS program uses 2,000 square feet for offices for its home visitors and home-based manager. The Adult Ed program uses 2,000 square feet for a classroom. A meeting room is regularly used by both the EHS program and Adult Ed. Note that Adult Ed uses this 1,000-square-foot meeting room 75% of the time, so is allocated 750 square feet for its use. This is compared to the 25% usage of the meeting room by the EHS 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 costs, utilities, janitorial services, and other occupancy costs.

Scenario 2: Transportation

A bus is used to transport 10 Head Start and 20 public school children daily. The bus travels 240 miles a day during 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 (20 for Head Start children and 40 for public school children), a percentage is developed and applied to the daily costs of transporting Head Start and public school children to the programs. You can imagine if Head Start were a year-round program and bus transportation was offered to these 10 children in the summer, a new plan would need to be developed to cover the summer transportation, assuming no children from another program received the benefit for bus transportation.

Considerations for Allocation of Buses and Vehicles include

- Reason for use of vehicle
- Operating cost
- Cost per mile
- Number of passengers
- Make-up of passengers

Grantees use various strategies to bring together different funding sources to support program goals, while maintaining accountability for the funds and complying with federal, state, and local requirements. Now let's talk about one specific example of cost allocation strategy called "***layered funding***."

Layered Funding

Cost Allocation for Early Head Start-Child Care Partnerships. Early Head Start-Child Care (EHS-CC) Partnerships use a particular kind of cost allocation referred to as "layered funding." EHS-CC Partnership programs use child care subsidy in addition to EHS funds to support children's learning. Costs in EHS-CC Partnership classrooms are allocated depending on the type of service and the individual child receiving the service.

Costs in Layer 1 are considered direct expenses and should be charged to the appropriate funding source. For instance, under most circumstances, the costs are directly charged and covered by child care subsidies and parent co-pays. However, if an enrolled family loses their subsidy, EHS-CC Partnership funds can be used to cover the loss of subsidy to the child care provider. This is considered a direct expense.

In Layer 2, service costs that are related broadly to the program, such as a playground or teacher training that benefits all children, can be directly expensed to the EHS-CC Partnership grant.

Costs associated with Layer 3 are shared expenses and need to be allocated to the appropriate funding source based on individual child enrollment. For those children enrolled in EHS-CC Partnership slots, the costs, such as diapers or infant formula, can be charged to the Partnership grant. For those children not enrolled in EHS-CC Partnership slots, but who are receiving those individual services, costs must be charged to another appropriate funding source.

While the layering concept reduces the need to allocate costs across the different funding sources, cost allocation is still necessary. If the proportion of EHS-CC Partnership-enrolled to non-EHS enrolled children is low, cost per child may be unreasonably high.

Here's another way to look at layered funding. The chart demonstrates how the three layers are funded for different children enrolled with the child care provider. Cost allocation is necessary in Layer 3, where costs must be allocated based on the eligibility of the child receiving the services.

Child	Layer 1 Core Child Care Services	Layer 2 Program Level Enhancements	Layer 3 Individual Child Services
EHS enrolled child with CC subsidy	CC subsidy	EHS	EHS
EHS enrolled child without CC subsidy	EHS	EHS	EHS
Non-EHS enrolled child	CC or other non-EHS resources	EHS and possible CCDF quality funds	Other non-EHS resources

Tips and Red Flags

Here are some tips that will assist you in better managing cost allocation.

Make sure:

- Allocation of staff time matches time sheets, payroll, and personnel activity records
- Allocation of staff time is consistent with the functions outlined in job descriptions
- As changes occur in your program, make sure they are reflected in the cost allocation plan
- And finally, it's necessary to put the cost allocation plan in writing

There are some common red flags that indicate when programs are struggling with cost allocation:

- Different categories of expenses are allocated in the same way
- Head Start and Early Head Start programs are charged disproportionately or in response to losses of funding in other programs
- Allocations of similar expenses vary from year to year
- Both direct and indirect costs are double charged for the same services

What We Covered

During this session, we covered what cost allocation is and why we do it. We identified the relevant regulations that govern cost allocation and defined key terms. We explored how to identify direct and indirect costs. We walked through the five steps to developing a cost allocation plan and explored the concept of layered funding in EHS-CC Partnership programs. We also identified some helpful tips and some red flags. Now, let's test your knowledge.

Test Your Knowledge

Take the following quiz to test your knowledge.

Quiz Question 1

True or False

Cost allocation assures federal funds are used to support a specific program when there are multiple funding sources.

Answer: True.

Cost allocation is necessary to assure the federal government bears only its fair share of costs, and only those attributable to its programs.

Quiz Question 2

True or False

Direct costs do not need to be allocated.

Answer: False.

Direct costs, when shared among programs, must be allocated to the programs they benefit.

Quiz Question 3

True or False

Administrative costs that are shared across multiple programs are called indirect costs.

Answer: True

Indirect costs are categorized as Facilities or Administration and must be allocated across the programs they benefit.

Quiz Question 4

Select all that apply

A cost allocation plan:

A. Is a method for allocating shared costs across programs
B. Should be a reasonable estimate of how you will utilize and charge shared costs and services
C. Should be reviewed throughout the year to respond to any changes
D. All of the above

Answer: D. All of the choices apply to cost allocation plans.

Quiz Question 5

Select one

Which of the following is not a step in developing a cost allocation plan?

A. Identify direct and shared expenses
B. Determine the basis for allocation
C. Categorize
D. Classify shared expenses
E. Engage the team

Answer: Engage the Team is not a step in developing a cost allocation plan.

Quiz Question 6

True or False

A cost allocation plan should be revisited regularly to ensure the methodology continues to reflect program operations.

Answer: True. As program functioning changes, the cost allocation plan should reflect those changes.

Quiz Question 7

True or False

Layered funding means that costs do not need to be allocated.

Answer: False.

Although the layered funding concept reduces the need to allocate, certain costs must still be allocated.

Quiz Question 8

True or False

Charging costs to Head Start when losses occur in another program is an acceptable practice**.**

Answer: False

Although a cost allocation plan needs to be reviewed regularly to ensure it reflects current operations, it is never acceptable to charge costs to Head Start that do not benefit implementation of Head Start services.

Congratulations! You did it! You have completed the Management Matters: Cost Allocation module.