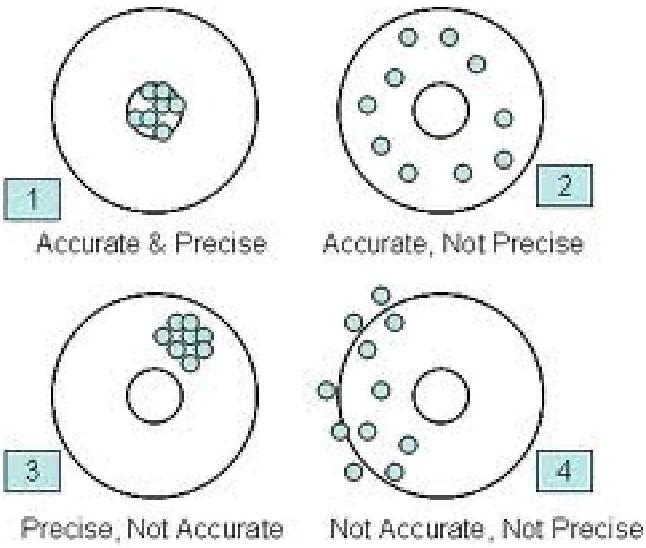

Part 1 of this series can be found **here** . We discussed why this is an important—nay, *critical* —topic for you, worthy of an investment of your time and expense.

Part 2 of this series can be found **here** . We discussed why you need input from a diverse group of stakeholders. You will want to solicit input from a number of diverse perspectives because your cost allocation decisions—including your decision regarding the emphasis you place on maximizing the amount of direct charges—can affect your corporate culture in perhaps unexpected ways.

In today's article we want to explore the concept of *precision* as it impacts cost allocation decisions. But before we do that, we've got to address your organization structure. Your organization structure is the starting point for your cost allocations.

The reason we start with your organization structure is that government contract cost accounting embraces the concept of *full absorption* costing. That phrase means that (simply put) all your costs need to be accounted for, and all indirect costs need to be allocated and absorbed by the benefiting "final cost objectives" of your cost accounting system. Your organization structure and its building blocks—whether you call them "cost centers' or "departments" or "whatevers"—is the framework within which you collect costs for budgeting and costing purposes. The first step in designing the cost allocation pools and bases is to examine your current organization structure and see how the business is managed and run from a budgetary and cost accumulation perspective.

This first step isn't too difficult—assuming you're already happy with your current organization structure. If one assumes that all your departments are grouped as you want them and that your management team is working together to get your projects and programs executed, then we can proceed directly to dollarizing those groupings and looking at appropriate allocation bases. If one assumes that you've thoughtfully organized your entity into logical groupings of functions and activities, and that there's a fairly clear relationship between the organization structure and how the business is managed, then we're good to go.

Based on our experience, this is a *huge* assumption that often turns out to be *wrong*.

If you're happy with your current org structure and believe it supports logical cost groupings and allocations, you can skip the next nine paragraphs. Otherwise, we suggest you keep reading.

You need to do is to look at your organization structure and make sure it reflects how you want to run your business, both now and in the near term future. This is not an easy task. If you've been in business for any length of time and have experienced a modicum of growth, it's more likely than not that you've got a patchwork org structure that reflects how individual leaders grew their empires, rather than how the business was intended to be managed. In other words, we suspect your org structure consists of a hodgepodge of individual fiefdoms, rather than being reflective of any particular management theory regarding how the business ought to be run.

For example, one of our past clients had several sales channels within its company. One focused on commercial services while another focused on government services. The purchasing department—which supported all procurements, both direct and indirect—was located in the commercial services group and reported up to the Commercial Services Vice President. This reporting relationship was the result of company history, and not at all the result of any conscious decision-making on behalf of the leadership team. We suggested that the purchasing department be moved into a corporate central services group, which reported to the CFO (there was no Chief Operating Officer at the time), so that its costs could be allocated cleanly to all sales channels that the function supported. That suggestion *did not go over well* with the Commercial VP.

The problem illustrated by the above anecdote is that changing the existing org structure will very likely be perceived as a threat to certain individual fiefdoms. Some “leaders” who see their corporate world as solely consisting of winners and losers may think that their empires are under threat, and thus they will set themselves in opposition to whatever org changes make logical senses from a cost allocation perspective.

Thus: it is important to have high-level sponsorship of the cost allocation structuring project. You will need somebody who can convene an Executive Steering Committee and push for what makes sense (in contrast to what’s perceived to be in the best political interests of certain stakeholders).

In the prior article, we asserted that executive leadership needed to be involved in the direct versus indirect decisions, because those decisions affect the corporate culture. The same is true for the organization structure discussion and resulting decisions. The org structure not only affects the cost allocation methodologies, but it should also reflect the business management philosophy of the leadership.

For smaller businesses seeking growth, sooner or later you will have to address the challenge of matrix management. Most, if not all, mid-size and larger government contractors have centralized certain functions in order to achieve cost efficiencies and standardize processes. Any company that’s contemplating performing a contract that contains the DFARS Business Systems administration clause(s) will be thinking about how to implement “adequate” business systems in areas such as Property Management, Purchasing, Earned Value Management, and Estimating. Those “business systems” require documentation and consistent application of policies and procedures, if they are to be deemed adequate by Government reviewers. The easiest means of accomplishing that goal is to put all the individuals performing those related functions/activities together, reporting to one leader who can hold them accountable for policy compliance. The individuals may report (on a “dotted line” basis) to the project/programs, but they are first and foremost part of a single group that operates in one way. In summary: centralized standards and decentralized deployment and execution. This concept is generally called “matrix management”.

The question about which activities/functions need to be centralized and then deployed on a dotted-line basis is fundamentally a question about the entity’s “run rules”—*i.e.*, how it operates on a day-to-day basis. Accordingly, reaching a consensus answer can entail a long and disputatious discussion. But as we said, sooner or later the topic needs to be discussed. Discussing it while also discussing cost allocations is as good timing as any.

Objectively evaluating the current organization chart and designing the future state organization chart is a "must do" if you want clean and logical cost allocations (and straightforward time charging, too). That doesn't make it an easy task. One past client went through 23 versions of organization structure before we found that that the stakeholders could, mostly, align and achieve consensus upon. *Twenty-three*. (We counted them.) Another client when through nine different structures, involving different levels of matrix management and cross-charging between operating groups, before it found one that was to its liking. And then it didn't like the rates that the "final" org structure produced—so it was back to the drawing board once again. This is a task that almost begs for a disinterested facilitator, one who can dispassionately identify the pros and cons of each structure that the discussion participants brainstorm.

Another question to be addressed in the org structure discussion is the number of cost centers/departments/*whatevers*. (Okay, we're calling them cost centers from now on. Your mileage may vary.) Why can't you just have one big corporate cost center and one big operations cost center? Answer: *you can*. But then you get one big cost allocation from Corporate to Operations, and there's no visibility into what the project/program teams are paying for. Consequently, many companies like to create individual cost centers for individual functions and/or activities, so as to promote visibility and budgetary control.

Which brings us, finally, to the topic at hand: *just how precise do you want to be?*

Many companies—especially those providing engineering services—are already very precise in their cost allocations and cross-functional charging. They often do this in the name of "fairness" or "determining the real profit and loss of each organization". They have already made sure that rent and occupancy expenses are allocated based on a pro rata share of occupied space. They have already made sure that communication expenses are charged to users based on actual usage. They have already broken-out their various IT-related functions into discrete cost groupings for charge-backs to cost centers based on complex algorithms that take into account both usage and storage. The HR function has been divided up and those individual costs are allocated separately. Ditto for Finance/Accounting. Ditto for Marketing/Business Development. They have parsed-out their costs into very small groupings, and each allocates on an individual basis, so that users receive only their "fair share" of costs based on benefits received.

Sounds great, doesn't it? Sounds like all the work's already been done.

Well, we here at Apogee Consulting, Inc. think it's a huge mistake. *Huge*.

The Federal rules applicable to cost allocations depend on whether or not the entity is subject to the Cost Accounting Standards (CAS). But even if CAS is in play, the rules are not terribly prescriptive. The general rule is provided by FAR 31.203(c)—which states:

The contractor shall accumulate indirect costs by logical cost groupings with due consideration of the reasons for incurring such costs. The contractor shall determine each grouping so as to permit use of an allocation base that is common to all cost objectives to which the grouping is to be allocated. The base selected shall allocate the grouping on the basis of the benefits accruing to intermediate and final cost objectives. *When substantially the same results can be achieved through less precise methods, the number and composition of cost groupings should be governed by practical considerations and should not unduly complicate the allocation.*

[Emphasis added.]

See that part we italicized above? Yeah, that's where we're going with this thought. Your cost allocation structure doesn't need to be so complicated. In fact, an overly complex cost allocation structure works against you.

While it may be desirable, on a superficial level, to have multiple detailed individual cost allocations, so as to determine "true profit and loss" by function, when you think about it we hope you'll see that there's a price to be paid for such precision.

First, let's think about the administrative cost associated with your multiple detailed individual cost allocations. You need accountants to make those journal entries each month; at a minimum you need accountants and programmers to make sure your fancy accounting system posts those entries each month. And what about budgeting? You've got to budget for each of those allocations, don't you? And then there's the variance analyses, where your people compare actual costs to budgeted costs, and try to figure out why there's a difference. All those efforts cost you money and efficiency.

Next, let's think about how your show all those multiple detailed individual cost allocations on your annual submission to establish final billing rates (popularly, but incorrectly, called the "incurred cost submission"). According to the DCAA's Adequacy Checklist, you must include a "cost schedule for each intermediary cost pool" and show "allocation base by recipient, the percentage of the total base for each recipient, and the dollars allocated to each recipient." In other words, your people will be spending a lot of time and effort showing those multiple detailed individual cost allocations and reconciling all the entries to the general ledger. If they don't show all the allocations in sufficient detail, your proposal will be determined to be inadequate for audit.

And whenever your cognizant DCAA FAO schedules you for an "incurred cost audit" you'll need to show the auditors all that detail all over again, with lots of supporting documentation. In other words, the more detailed your allocations, the more challenging the audit support will be.

For smaller companies looking to have DCAA tell them that their accounting system is "adequate" for cost reimbursement contracting, all those allocations pose a bigger challenge. Each one needs to be defended. Remember that FAR bit we quoted above? The bit about "logical cost groupings" and common allocation bases on the "basis of the benefits accruing" and all that stuff? You're going to have to convince a skeptical auditor that each one of those detailed allocations meets the criteria. If you can't do that, then your accounting system is not going to be found to be adequate. In other words, the more allocations you have, the more risk you have that your accounting system will be found to be inadequate.

And if you are CAS-covered, then the more allocations you have, the more risk you have that your actual practices will be noncompliant with your disclosed practices.

Truly, you only need the allocations that make sense for you to have to distribute centrally incurred costs to the benefiting cost objectives. The more cost allocations you have, the more you increase your risk profile in critical areas. This is not conjecture; we have actually witnessed this phenomenon.

We had this one client—a multi-national engineering services provider that generated more than a billion dollars in annual revenue. The company had several large cost-plus contracts. While it had had trouble in getting its annual rate submissions through audit, there had been no show-stoppers. Until the one day when DCAA told the Controller that the company's accounting system was inadequate because it couldn't support its intermediate allocations. The accountants simply could not document and reconcile the hundreds of individual detailed allocations used to make sure every business unit got charged for every service it used. There were too many allocations to document, and too much had been automated. They couldn't build the Schedules that DCAA demanded. And so the company's accounting system was found to be inadequate, as were all the pending proposals to establish final billing rates. And then the Controller moved on "for personal reasons."

In contrast, another very successful multi-national engineering services provider we've worked with doesn't even allocate Corporate costs to its business units. The business units—and by extension the project/program managers—are only held accountable for the gross margin they generate. In other words, they are held accountable for what they can control locally, and not for what they cannot control. Embedded with that philosophical decision was another decision to tie executive incentive compensation to the performance of the overall company, and not to the performance of any particular business unit. The company made the decision that there was too little benefit from multiple detailed allocations and too much cost and risk associated with them. They decided they would not pay the price associated with precise cost allocations. And they're doing quite well, in both commercial and governmental sales channels.

Precision has a price. More often than not, the price is too high to pay.

As the FAR states, "practical considerations" should govern your cost allocation decisions, and not abstract notions of precision and accuracy. If you want your benefiting projects/programs to pay for what they use, then you really want to make a decision to have as many costs as possible be direct costs. (See our Part 2 discussion for pros and cons of that decision.) If you've decided to make certain functions or activities indirect, then you have by definition surrendered some degree of precision. Let that be okay for your company. Keep the organization structure logical, keep the cost groupings to a reasonable minimum, and you'll find that you'll be happier with the results.

Next time we'll talk about segmentation and intermediate home offices, as well as GOCO's, special business units, and special facilities.