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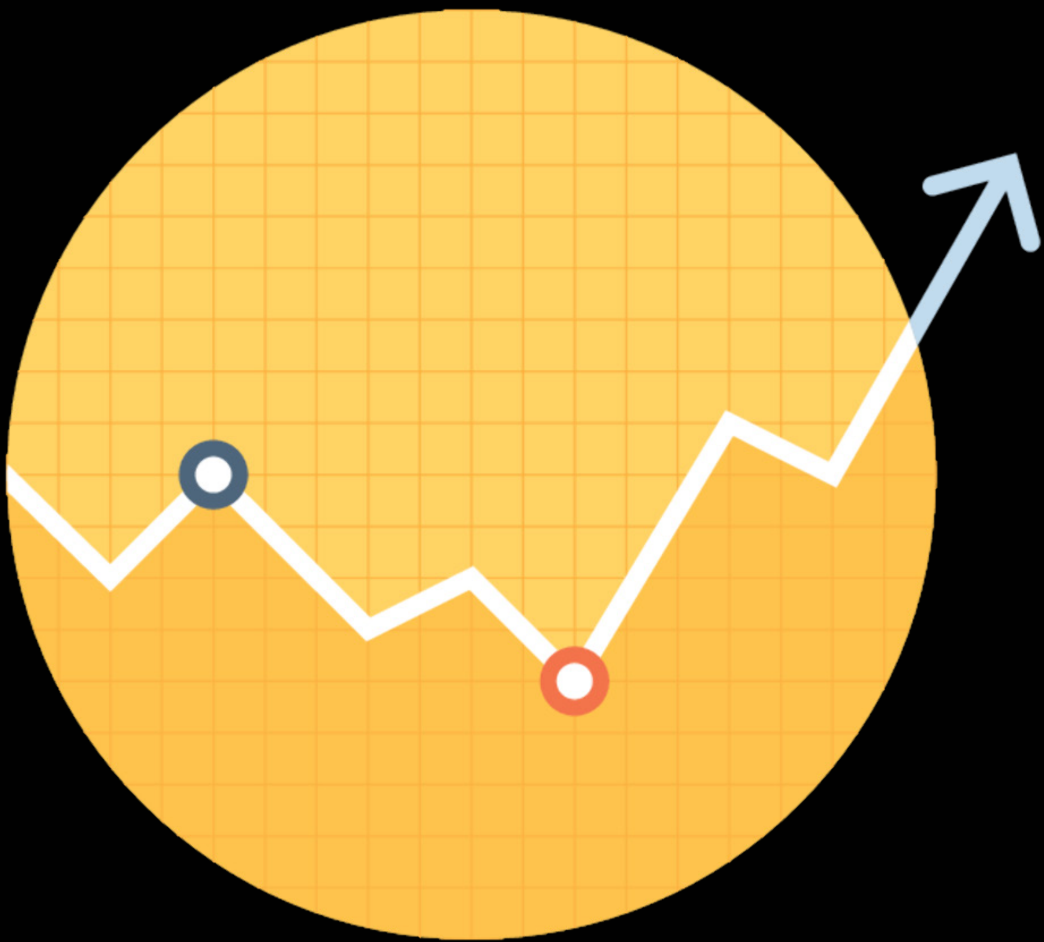

# Why do so many organisations struggle with cost allocation?

**Swiss Business Modelling**

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# Foreword


## Abstract

**"Is it a fixed cost or is it a variable cost?"** - It's both and it's neither, and time is really the only factor...

Business units sometimes share their frustrations about how expensive their corporate functions can be (IT, Finance, HR, Risk etc.) and, more specifically, why they feel they have little or no control over them. Many organisations commit exhaustive amounts of management time and millions of dollars trying to simplify and improve cost allocation processes, often without any noticeable benefit; and typically, they get worse!

When attempting to improve allocation environments, many organisations set out with good intentions ('standardised, simple and transparent') but these principles are quickly undermined as the needs of the different interest groups (business units, IT, tax and transfer pricing) are more deeply understood. This article explores 5 common reasons why cost allocation systems frequently fail in large corporates, and suggests ways in which organisations can be better set up for success.


## Introduction

In large organisations typically about 30-50% of their total costs are allocated (i.e. moved to another location or cost centre from which they were originally booked). Most of these are the costs of corporate functions (IT, Finance, HR, Risk etc) and these are rarely allocated just once, but rather allocated and re-allocated (on average 4.2 times) before being charged eventually to a business unit.

The process of cost allocation divides organisations as business units seek to protect their profitability by avoiding corporate charges.

**Improvement attempts:** On average global organisations revisit their end-to-end operating model every 2-3 years with the objective of making radical simplifications and resolve ongoing disputes around fairness of cost allocations. However, allocation improvement projects typically encounter stumbling blocks as complex inter-dependencies emerge, and the many different stakeholder groups each have their own requirements. We present here a list of five reasons why cost allocation environments fail, with an accompanying Deloitte view on what can be done to avoid failure.

# 5 reasons for Cost Allocation failure

| Reason | Deloitte View |
|---|---|
| **Reason 1: Wasting effort trying to find a more perfect allocation method**. Cost allocation teams invest excessive effort in trying to identify methods that appear to reflect the cost driver better, but in actual fact do not. For example, allocating the costs of an IT application using monthly user volume is not appropriate when the underlying costs are largely fixed (e.g. staff, software licences, hardware). | *Business units (receiving allocations of cost) tend to prefer consistency in charging, rather than greater accuracy which can risk volatility. Furthermore, organisations with fewer allocation methods (less than 10) spend less time maintaining their allocation environments and resolving disputes. Preparing cost allocations (extracting historical data, calculating percentages with accompanying governance) typically requires just three weeks of effort. More complex allocation methods drive significantly more effort and cost.* |
| **Reason 2: Too many services:** Large organisations often define too many services only to discover that 80% of the costs are concentrated in only 20% of the services. The cost of maintaining records for so many services quickly becomes uneconomic (e.g. the costs of maintaining service catalogues, service level reporting for both provider and receivers, and of managing disputes arising around service delivery). | *We observe instances where clients that have successfully reduced their service catalogue line items by over 90% have been able to eliminate hours of monthly service management and annual planning effort.* |
| **Reason 3: Categorising costs into fixed and variable is pointless:** Costs typically sit on a continuum and cannot be categorised as fully fixed or fully variable, since there are multiple factors that influence cost (Who own's the spend budget? How senior are they? Is the cost internal or third party?). Allocations fail when service providers split charges artificially into fixed and variable components for the sake of simplicity, when the underlying costs do not behave that way. | *For many functions 80-90% of costs are likely to be fixed contractually within an annual time frame (e.g. staff salaries, software licences, third party services). , and there can be large penalties (contract break clauses) or long lead times when attempting to manage costs down. The best way to manage the cost base of a service function is through successful business partnering and financial planning to understand future demand.* |
| **Reason 4: Trying to manage too many exceptions:** Despite attempts to standardise cost allocation, methods tend to allow too many exceptions (e.g. alternative allocation methods, deviations in charging). Often these are tolerated because business units lobby that such exceptions are necessary (e.g. arguing that there should be different allocation methods for business units deemed non-core). Lack of control and an audit trail commonly cause these arrangements to fail. | *Based on our experience there are few circumstances where exceptions are necessary and business units typically use exceptions as a mean to 'game' the system and try to distort cost allocations. Exceptions make cost allocations much less transparent and a well-designed system can eliminate the need for them altogether.* |
| **Reason 5: Trying to operate management reporting and allocations to legal entities separately:** Some organisations run parallel allocation processes in which business performance is measured (for management purposes) separately from statutory/legal entity reporting. This typically generates 'two versions of the truth' with limited ability for reconciliation between the two environments. | *Despite different stakeholder groups having slightly different needs (e.g. legal entities may require a mark-up to be applied if a service charge crosses geographies) it is much better to manage this process as part of the same allocation routine. Pain points generally occur when the two reporting systems are not synchronised.* |

# Conclusions

## Approach to Cost Allocations

Cost allocation is not a standalone activity and should be applied within the wider framework of financial forecasting, planning and analysis. When thinking about improving cost allocations, a range of factors should be considered. There needs be a shift away from the mindset of *'what allocation method is best?'* to a more holistic thinking around *'how can support functions provide the greatest value?'* When business partnering operates well, support functions are able to understand and anticipate business needs, to ensure that the services they provide align with corporate objectives… and the cost allocation 'noise' fades away!

## How we help our clients

At Deloitte, we are experienced in designing and implementing low cost, low complexity, cost allocation environments that support all stakeholder groups. Our approach revolves around:

- Performing rapid current state diagnoses to identify pain points and establish their underlying root causes
- Defining allocation objectives, priorities and principles, and ensuring they are in alignment with corporate strategy
- Implementing new systems and operating models (processes, governance, roles and responsibilities etc.)
- Financial modelling the impact of change and managing the communication with business units

## Outcomes

- A coherent end-to-end environment that aligns support functions with the needs of business and corporate strategy
- Materially improved cost allocation processes – fewer disputes, less cost and resources required to operate them
- Freeing up management time to spend on business-critical matters by reducing time-consuming disputes around allocation methods

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