

# F. Allocating corporate overhead costs to services

---

## Introduction

---

To manage ongoing financial sustainability effectively, councils should identify the services they deliver and understand the total cost of delivering them both individually and collectively. Understanding the full cost of delivering a service will help ensure that where possible, costs are appropriately recovered via a user pays mechanism (that is, fees, charges and recoverable works), competitive neutrality obligations are met for business activities, and the net cost of service delivery to be recovered via rates and charges is fully understood.

Service costing information incorporates all costs of delivering the service. This includes both direct and indirect (or overhead) costs. Councils should use costing systems and budget preparation processes to identify the full cost of delivering each service. A reasonable proportion of indirect costs should be allocated to services.

This document provides principles for the allocation of overhead costs, which can be adapted to support the size, systems and capabilities of individual councils.

When choosing an approach to cost allocation, simple approaches that do not require system changes or significant investment in technology are recommended.

## Principles of cost allocation

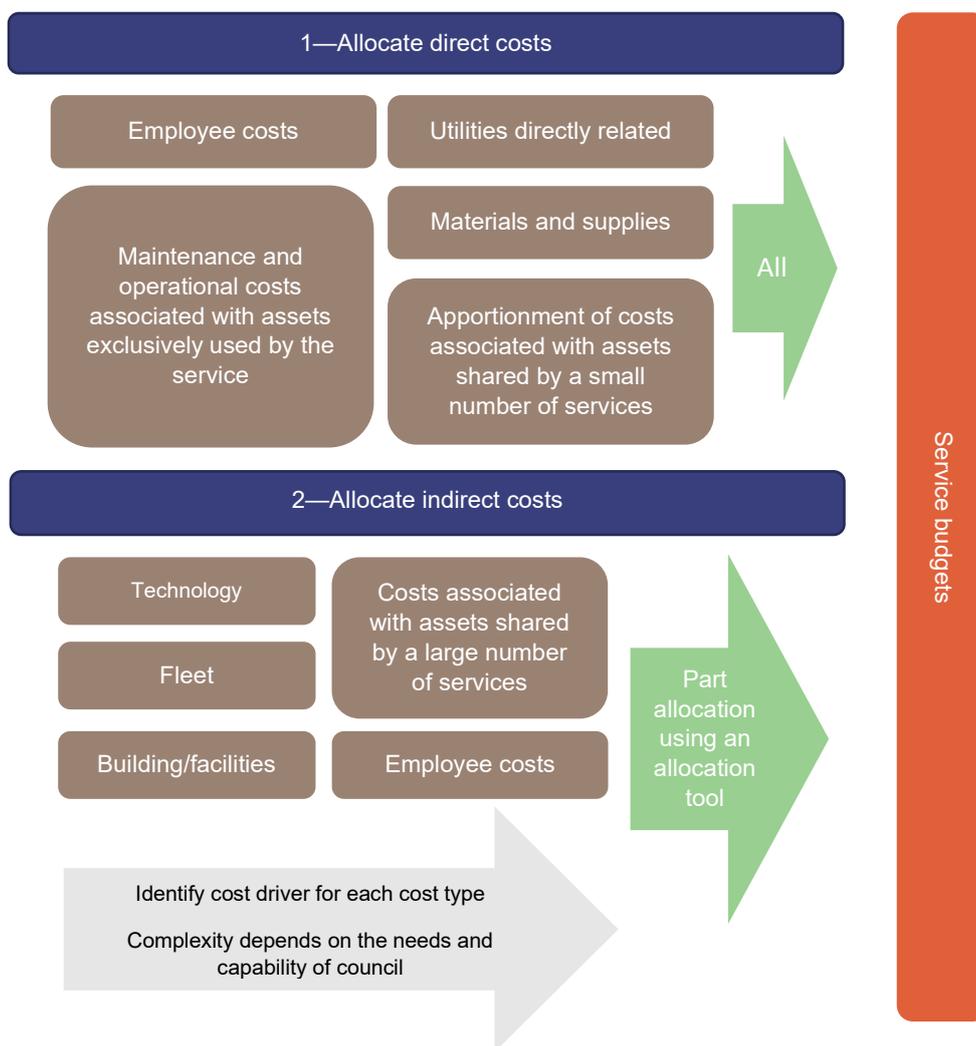
---

There are three key elements to identify the costs of a council service:

1. Define the service/s to be measured. This can include both internal and external services delivered by council or just external services provided by council.
2. Understand and allocate the direct costs of both internal and external services (that is, employee costs, materials and services, or depreciation).
3. Adopt a methodology for allocating indirect costs to the services. There are varying levels of complexity of internal cost allocation methodologies.



**Figure F1  
Allocation of costs**



Source: Queensland Audit Office.

## Direct costs

Direct costs are those that can be fully allocated to one service. Direct costs include:

- employee costs attributable to the service
- materials and service costs (including operating and maintenance costs, and utility costs such as electricity, waste and water) attributable to the service
- depreciation expense for single assets used to deliver the service.



## Allocation of costs associated with assets

Each council needs to set its own allocation rules for the costs associated with shared assets. These allocations would be required in situations where shared assets are not hired or costed to the service via internal charging. These costs include depreciation, operations and maintenance. There are three situations that may apply:

### 1. Exclusive use of an asset by a single service

The depreciation and other costs associated with the asset are included as a direct cost to a service (for example, swimming pool, road, library).

### 2. Assets used by a small number of services

Typically, if assets are shared by a small number of services then related costs can be directly apportioned to those services. These assets are usually not related to internal overhead activities but may represent specialised or specific assets used directly in the delivery of a service (for example, a depot facility shared by a water business and also a works department).

An apportionment methodology may include the use of a causal driver associated with the services such as time of use, number of employees, or floor space. The causal driver is set as part of the budget process and assessed periodically to ensure it continues to be a suitable driver for allocation.

### 3. Assets used by many services

If an asset is used by multiple services and the costs are not easily allocated directly (for example, a council administration building or information technology (IT) system), the costs associated with the asset are included as an indirect overhead allocation. The allocation methodology applied to other indirect costs will apply.

## Executive and governance costs

Councils incur costs relating to executive and compliance functions that are not related directly to service delivery to the community. Council would meet these costs even if they outsourced all functions.

Examples of these costs include:

- council meetings
- councillor and chief executive officer salaries (where they do not directly relate to delivery of a service)
- council election costs
- subscriptions to local authority associations and attendance at conferences and meetings
- preparation and publication of financial statements, budgets and annual reports.

There are two options for how to treat executive and governance costs:

1. treat the executive and governance costs as a direct service classification
2. deduct the identified executive and governance expenses prior to the allocation of indirect costs. Councils should document the costs they have identified as not relating to service delivery for exclusion from overhead calculations, as well as the reason why these costs are not related to service delivery.

Executive and governance costs should not be used as a balancing item for unallocated overheads.



## Indirect (or internal service) costs

Indirect (overhead) costs are all other services that are considered to not provide services direct to the community.

They usually relate to shared costs associated with the delivery of multiple services and council internal activities not able to be easily allocated directly to an external service. Examples include:

- costs for internal council services such as finance, procurement, human resources and payroll, and property services
- information technology
- stores and purchasing
- communications
- customer service
- fleet
- corporate building costs
- depreciation expenses for assets attributable to indirect services.

Indirect costs are assigned to services through an allocation approach or methodology. The cost allocation methodology is applied via an overhead cost allocation model.

## Steps for allocating indirect overhead costs

Councils should establish a methodology for allocating indirect overhead costs. Some of the methodologies are complex and resource intensive. It is important that each council adopts a methodology that is most appropriate for their capability and needs and that the costs and benefits of each method are analysed.

The methodology should include the elements in Figure F2.

**Figure F2**  
**Steps for allocating indirect overhead costs**



Source: Queensland Audit Office.

### 1. Identify overhead activities

The first step for any of the allocation methodologies is for councils to identify all of their overhead activities and the associated costs incurred in the delivery of these services. Examples of overhead activities include accounts payable, financial accounting, accounts receivable, payroll, governance, human resources, communications, asset management, insurance, and so on. Often, where overhead activities can be allocated using a similar methodology they can be grouped together for simplicity (for example, payroll, human resources and training activities).



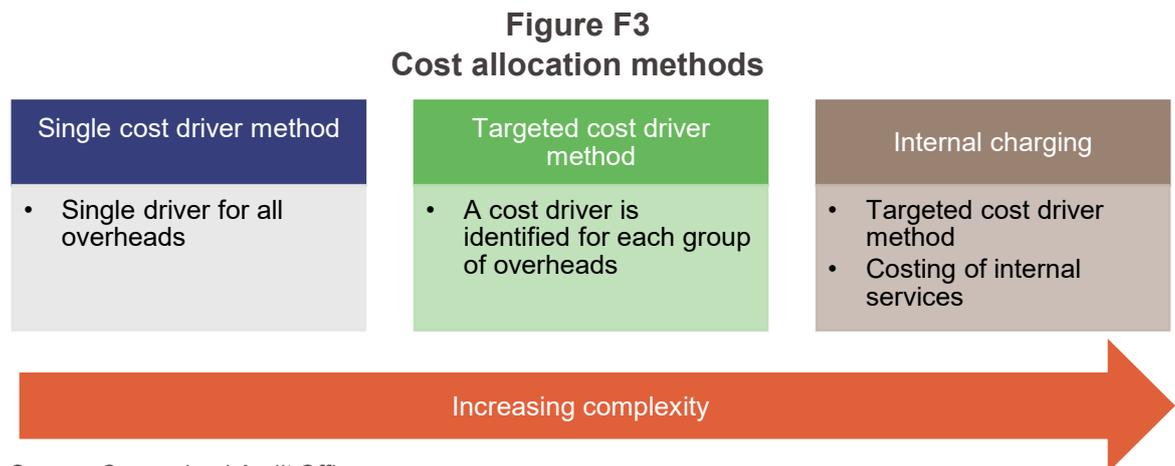
## 2. Identify the drivers to allocate overhead activity costs

A cost driver is the basis on which the overhead costs are allocated. A cost driver preferably has a cause–effect relationship and it provides the basis for allocation of overheads based on volume or activity. Councils should identify cost drivers that have a relationship to the overhead costs being allocated to ensure that they provide a reasonable reflection of how that overhead activity is being utilised. Examples of cost drivers suitable for councils include employee numbers, equipment/infrastructure use hours, floor space, and number of devices, and so on.

Councils will need to document the process they have undertaken in determining the cost drivers, as well as the basis for collecting information to apply the drivers across their services (for example, how they have recorded the number of purchase orders for the allocation of accounts payable overheads).

## 3. Allocate the overhead costs to services

There are varying methodologies available to allocate the grouped overhead costs to council services. The methodology used should reflect the existing systems of council, availability and capability of resources and the required level of costing precision required. The following three methodologies are common allocation methods, in order of increasing complexity.



Source: Queensland Audit Office.

### 4.1 Single cost driver method

Allocation of costs on a single cost driver basis is the simplistic approach to overhead cost allocation. This method uses a single cost-driver to allocate all overhead costs to each council service. Commonly used drivers include number of employees required to deliver the service, or proportion of budgeted expenditure required to deliver the service. Overhead costs are allocated to a service using the following formula:

$$\text{Direct service allocation} = \frac{\text{Overhead amount} * \text{Cost driver}}{\text{Total cost driver}}$$

This allocation method is simple to understand and is not resource intensive to apply. It can be used when there is limited data available and the service cost is not considered material. Councils will need to document the assumptions used in determining the cost-driver.

### 4.2 Targeted cost driver method

Allocation of costs using a targeted cost driver basis requires councils to identify cost drivers for each overhead activity (or group) they are allocating. This allocation method is more appropriate where council's direct services utilise several internal council services for support. Figure F4 includes some examples of overhead activities and their cost drivers.

**Figure F4**  
**Targeted cost driver examples**

Overhead costs	Cost drivers
Human resources, workplace health and safety, payroll tax	Full-time equivalent employees
Procurement	Number of contracts Number of purchase orders Number of invoices
Finance	Proportion of budgeted expenditure Estimated per cent of effort
Information technology	Number of devices used Hours signed into network Number of service requests issued
Accommodation, property maintenance, utilities, cleaning	Floor space occupied
Asset management (depreciation, consumables, repairs and maintenance)	Hours of plant use Value of plant used (i.e. differentiate between heavy and light equipment)
Telecommunications	Number of devices used

Source: Queensland Audit Office.

The internal support services of council that produce overhead costs to be allocated are also council services, which are necessary for the delivery of council objectives overall. Often costing models allocate costs between internal services prior to distribution to end user/direct services, which allows users of these services to assess their efficiency once final costs to be allocated are determined. These costing models become increasingly complex as overhead costs may perform multiple iterations of costs between overhead activities and direct services. For example, information technology costs might be first allocated to human resources, which are then allocated to the external service.

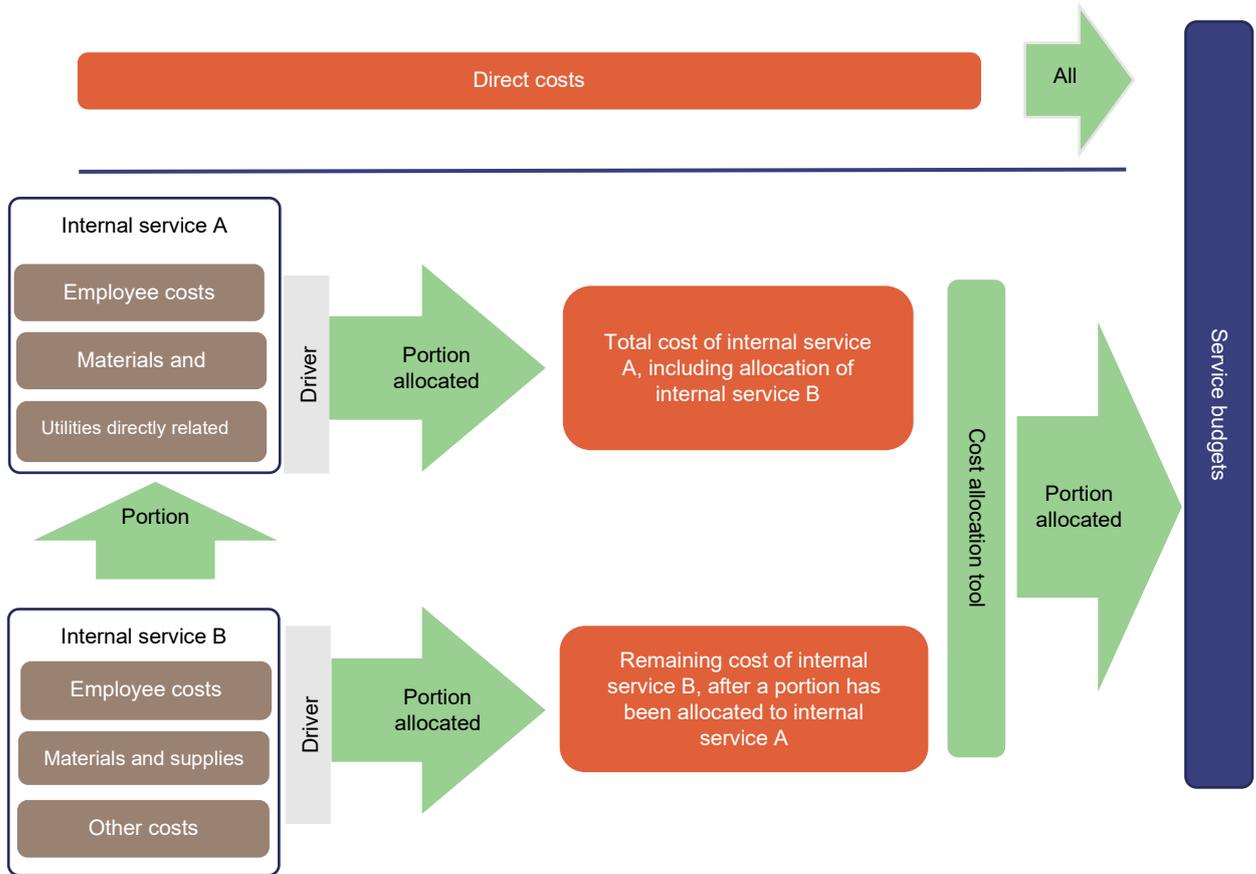
### 4.3 Internal charging

Allocation of costs via the direct charging of goods and/or services between council services is a more complex method that may be used. Unit rates for charging can be derived from activity-based costing or via overhead cost allocation model outputs, which charge according to actual rather than estimated usage of a particular council good or service.

Internal charging is the most complex of the cost allocation methods; however, it provides the greatest level of accuracy when determining cost allocation to end user/direct services.



**Figure F5**  
**Example of internal charging model**



Source: Queensland Audit Office.

## Monitoring and reporting of overhead costs

Councils should review their allocation model and methodology on, at least, an annual basis to ensure that the assumptions and drivers identified are still accurate for determining the cost of delivering each service to the community.

This will assist councils in understanding the costs incurred to deliver services to their local community, as well as identifying whether the fees they charge for these services are appropriate. This is particularly important where the service fee is required to be calculated using full cost pricing principles.

## Examples of cost allocations

### Single cost driver method

This is an example of allocating \$10 million of indirect costs to all services using a single cost driver method of number of full-time equivalent (FTE) employees.



**Figure F6**  
**Indirect cost allocation**

Service	Cost driver (# of FTEs)	Proportion of indirect costs	Total indirect costs allocated to the service
Service A	5	33%	\$3.33 million
Service B	10	66%	\$6.66 million
Total	15	100%	\$10.00 million

Source: Queensland Audit Office.

### Targeted cost driver method

In this targeted cost driver example, there are \$10 million of indirect costs comprising \$8 million for corporate costs and \$2 million for information communication and technology (ICT) costs. Council has identified that the most appropriate cost driver to allocate ICT's indirect costs is the number of computers each service uses and the most appropriate method to allocate corporate costs is the number of full-time equivalent employees. Council has two services it wishes to allocate these costs to (A and B).

**Figure F7**  
**ICT cost allocation**

Service	Cost driver (# of FTEs)	Proportion of employee costs to be allocated	Cost driver for ICT costs (# of computers)	Proportion of IT costs to be allocated
Service A	5	33%	5	71%
Service B	10	66%	2	29%
Total	15	100%	7	100%

Service	Corporate costs	ICT costs	Total costs
Service A	\$2.67 million	\$1.43 million	\$4.10 million
Service B	\$5.28 million	\$0.58 million	\$5.90 million
Total	\$8 million <sup>^</sup>	\$2 million <sup>*</sup>	\$10 million

Note: <sup>^</sup> Council identified a total of \$8 million of indirect corporate costs

<sup>\*</sup> Council identified a total of \$2 million of indirect ICT costs

Source: Queensland Audit Office.



## Case study

The following case study of a council-operated childcare service highlights how councils can make cost savings from understanding and analysing corporate overheads.

Key financial considerations:

- budgeted operating expenses \$3.4 million
- there are 24 full-time equivalent staff operating the service (17.56 per cent of total council support staff)
- the centre has 46 ICT devices on site (10.31 per cent of all council devices).

We used the following cost drivers to allocate the corporate overheads to the childcare service:

- number of full-time equivalent staff to allocate the corporate overheads of enterprise risk, stores and purchasing, and governance
- number of ICT devices to allocate ICT overheads.

Corporate overhead	Cost driver	Total budgeted cost	Percent of corporate costs for allocation	Corporate overhead costs for allocation
Corporate costs including administration, enterprise risk, stores and purchasing, and governance	Number of full-time equivalent staff	\$5.15 million	17.56%	\$0.90 million
Information communication and technology	Number of ICT devices	\$1.19 million	10.31%	\$0.12 million
<b>Total corporate costs to be allocated to the service</b>				<b>\$1.02 million</b>

Source: Queensland Audit Office.

We estimate that council was previously allocating \$0.06 million of corporate overheads to the service.

By allocating all overheads to the childcare service, expenses increase by \$0.96 million from council's existing budget.

