
# ALLOCATION METHODS

UNDERSTAND THE ALLOCATION METHODS AVAILABLE WHEN MODELLING COSTS IN MAGIC ORANGE

## THE NEED FOR CHARGEBACK COST ALLOCATIONS

**Most organizations run Shared Services units to realize economies of scale and unlock value by centralizing processes.**

In order for Business Units to determine true profitability, their usage of Shared Services must be determined. A charge back mechanism facilitates this and aids in driving organizationally aligned behavior. The most equitable and defendable basis for allocations is based on real world consumption.

Research shows:

- Up to 20% reduction in consumption where a price is associated with the use of a product or service[1]
- Typical Return on Investment in 8 months[2]

Furthermore, chargeback in context of Shared Services is to show the business:

- Services it consumes
- Cost of delivering these services
- Breaking the cost down to activities and resources involved in producing these services

1. *Todd Tucker. "The Forces of IT Economics", Technology Business Management: The Four Value Conversations CIOs Must Have With Their Businesses (2016). Print.*
2. *As experienced by businesses who have implemented the Magic Orange Cost Transparency solution.*

## SHARED SERVICES ALLOCATION METHODS

Historically, there have been three alternative methods for allocating service department costs. These methods differ in the extent to which they recognize that service departments provide services to other service departments as well as to production departments. All three methods ultimately allocate all service department costs to production departments; no costs remain in the service departments under any of the three methods.

### DIRECT METHOD

This method allocates each service department's total costs directly to the production departments and ignores the fact that service departments may also provide services to other service departments.

The Direct method provides the lowest level of accuracy for costing Shared Services.

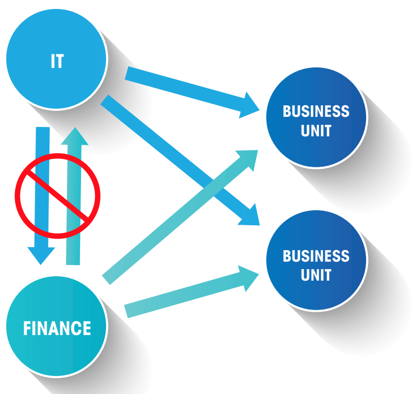


*Figure 1. Allocates support costs only to Operating Departments, no interaction between Support Departments prior to allocation.*

## WATERFALL OR STEP-DOWN METHOD

The step-down method is also called the sequential or Waterfall method. This method allocates the costs of some service departments to other service departments, but once a service department's costs have been allocated, no subsequent costs are allocated back to it.

While the Waterfall method provides better accuracy than the Direct method, it is still recognised to miss out material impact cost allocations.

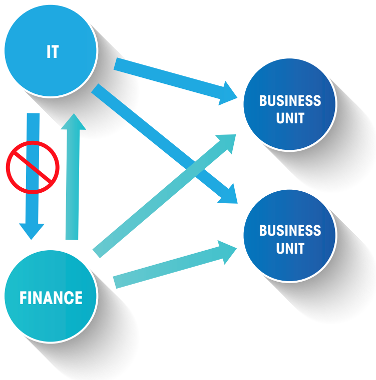


*Figure 2. Allocates support costs to other support departments and to operating departments that partially recognizes the mutual services provided among all support departments. One-way interaction between Support Departments prior to allocation.*

## HYBRID METHOD APPROACH

A pragmatic approach can be to employ direct, waterfall and reciprocal methods, choosing to implement reciprocal allocations where there is significant value in showing reciprocal cost relationships which would otherwise be hidden from consumers.

It is not uncommon to see an increase in reciprocal allocations being managed as businesses ramp up cost optimisation programmes due to positive cost efficiencies being experienced through increased transparency of realworld cost levers.

## RECIPROCAL METHOD

The reciprocal method is the most accurate of the three methods for allocating service department costs, because it recognizes reciprocal services among service departments.

In reality, most Shared Service units consume other Shared Service units (e.g. IT uses HR) or themselves (IT is typically the biggest consumer of IT). To reflect this cross usage the term reciprocal allocations is used.

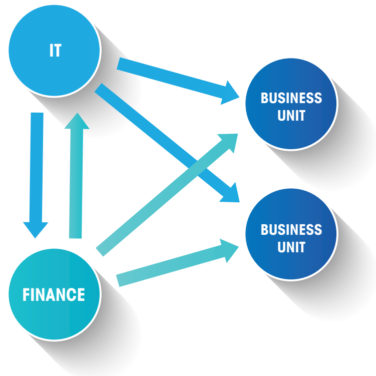


*Figure 3. Allocates support department costs to operating departments by fully recognizing the mutual services provided among all support departments. Full two-way interaction between Support Departments prior to allocation.*

Reciprocal allocations enable assignments of cross charging between the Shared Services. Thereby allowing the internal economy of an organisation to account for the processes or services they provide by charging each other. Each consumer of a process or service, whether a revenue generating business unit or a shared service, is able to see the individual processes and services, their consumption thereof, and the subsequent price they paid.

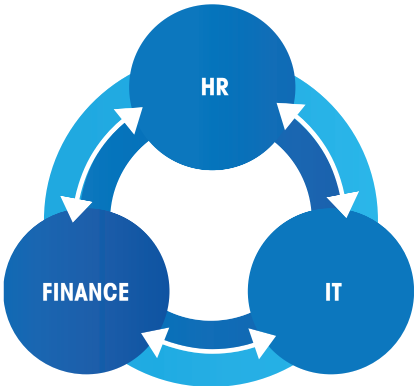


*Figure 4. As in real life, Shared Services areas use each other's services. I.E. HR uses IT & Finance, IT uses Finance & HR, Finance uses IT & HR.*

Historically reciprocal allocations have been viewed as complex because people struggled to design the required calculations in spreadsheets, leading to less accurate methods being popular such as direct or waterfall allocation methods.

Nowadays, technologies like Magic Orange have progressed significantly, allowing reciprocal allocations to be performed and managed with ease.

While reciprocal allocations are easy to setup, caution should be applied to how many reciprocal allocations are setup in a cost model. The main reason for this being that while the system is able to accurately calculate the effects of reciprocal allocations, the mathematics can be challenging to explain to business stakeholders not familiar with simultaneous equations.

## MORE ON RECIPROCAL ALLOCATION METHOD

**What is the business value of charging business fairly based on their realworld consumption of services?**

### COST EFFICIENCY AND COST OPTIMIZATION

In cost efficiency initiatives, key to conducting an informed cost reduction process, is understanding services provided, their price, excess operating capacity and their required inputs. Reciprocal allocations allow this analysis at all points of a value chain that represent reality and is not altered to accommodate a limitation in a toolset.

### FOSTER A RESPONSIBLE COST CULTURE

When costing a true value chain, the ability to influence consumption is kept as close to reality as possible. By charging recipients for what they use, one is able to empower their usage thereof and foster organizationally aligned behavior.

### UNDERSTAND THE TRUE COST INVOLVED OF RUNNING A SHARED SERVICE

In the absence of Shared Services being charged at a detailed level, the Total Cost of Ownership (TCO) of an application, process, or service is lost. For example, if a Finance team utilized a bespoke and expensive application, this insight would not be available to the detriment of the organization as a whole. Application TCO is typically the largest component of Technology spend which Business units consume. How would one know Technology was consuming resources efficiently if their internal consumption was not calculated?

### ACCURACY IN COSTING

Accuracy in costing is greatly improved through charging based on real world consumption and enables fact-based decision making. This improved accuracy is not at the expense of additional complexity. The primary focus within a value chain is allowing each product and service to accurately know their inputs. Business cases then become supported by facts instead of being based on estimates or instinct and potentially inaccurate. For example, what is the total cost of ownership for a physical server versus moving to Cloud?

### EASE OF USE

With reciprocal allocation there is no need to restrict data inputs. When applying a waterfall or non-reciprocal approach, users must understand and apply complex rule sets that imply certain business units can charge some areas but not others. Reciprocal allocations reflect real-world usage of services.

### DEPENDENCIES AND INTERRELATIONS ARE REALIZED

In creating a value chain which reflects real life consumption, a change to a service level or price of a service can be traced to an affected target or input. This enables powerful What If scenarios and moves the cost allocation from an arbitrary transfer of costs to a useful management tool.

### RECIPIENTS ARE SATISFIED AND HAVE TRUST IN THE PROCESS

When cross charging represents real life usage consumer trust in the process is increased as consumers relate their charge to actual volume of usage, not an involuntary allocation which is arbitrary calculated and divorced from reality.

## RECIPROCAL ALLOCATIONS WITHIN IT

The role of IT in businesses has significantly changed from what it was when activity-based costing was first adopted by businesses outside of the manufacturing sector.

Nowadays IT is frequently one of the most complex Shared Services departments in a business, delivering thousands of products, services, applications, projects and business competencies with many layers of interdependencies on each other. The advent of cloud technology means IT is also dealing with the complexity of hybrid computing - on-premise and cloud offerings.

This complexity often means there are significant services just within IT which have reciprocal cost allocation relationships. Below are examples of real IT reciprocal cost allocations.

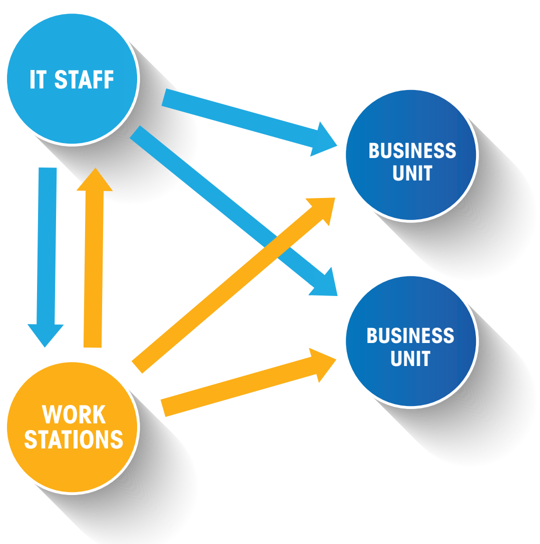


*Figure 5. IT provides workstations to the wider business but also consumes them.*

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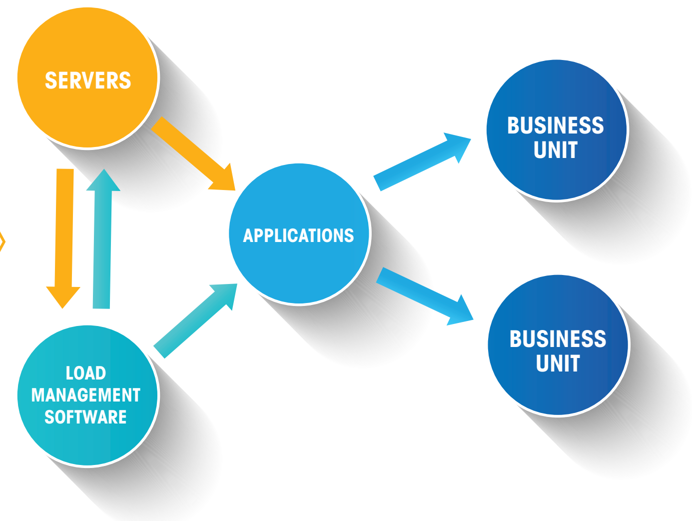



*Figure 6. Load Management software is needed to keep servers running smoothly as well as ensures applications are highly available.*

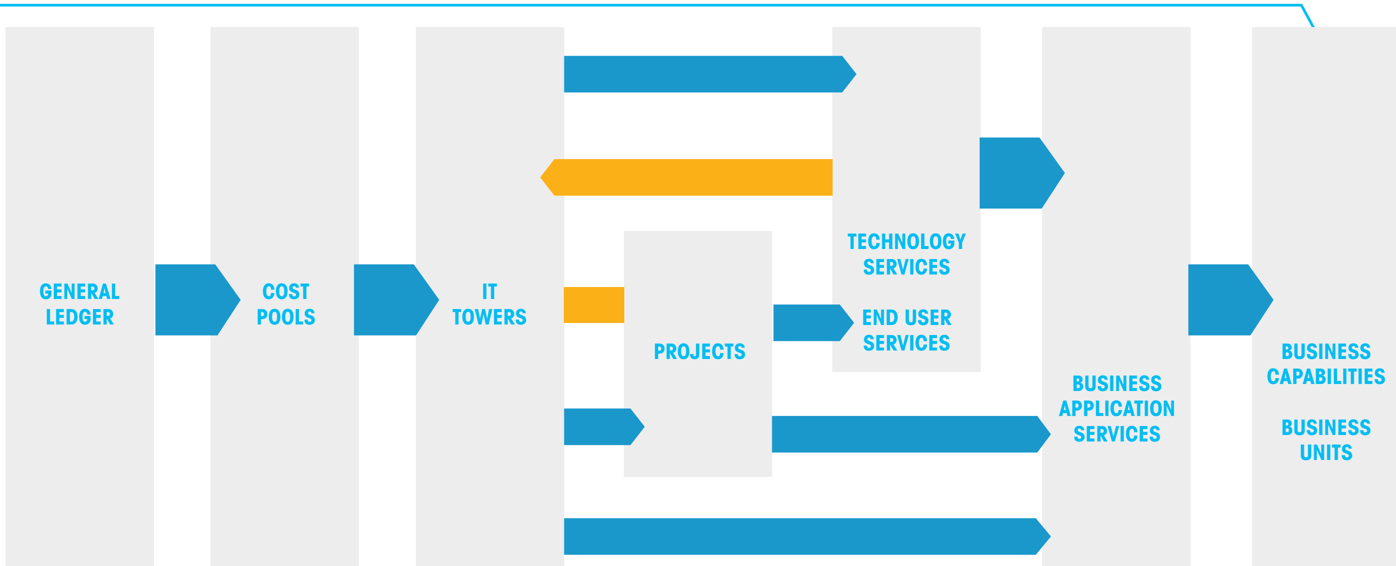



*Figure 7. IT nowadays is complex, with reciprocal consumption occurring within the IT value chain, highlighted above in orange.*

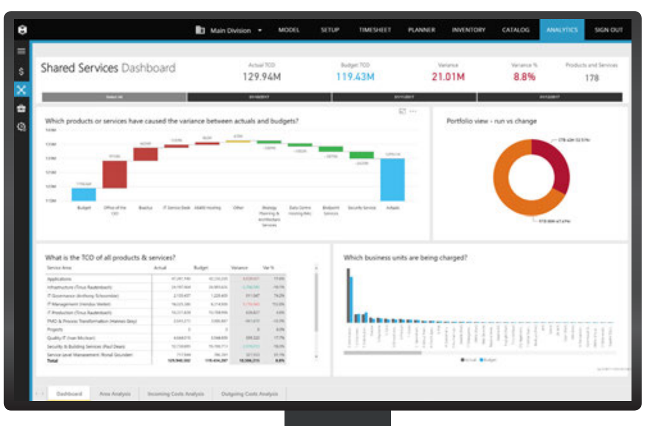
## ROBUST SOLUTION FOR ALLOCATION MODELLING

Magic Orange Cost Transparency supports all allocation configurations:

- **Direct Allocations**
- **Waterfall or Step-Down Allocations**
- **Reciprocal Allocations**
- **Hybrid Allocation Approach**

The differentiator with Magic Orange is the ability to effortlessly cater for all of the above methods and not restrict users to a particular method, based on limitations.

Magic Orange provides advisory services to clients to assist in deciding on the best above methodology to apply. This is based on the organizational structure, culture, strategy and reporting requirements associated with the chargeback needs of our clients.




# ABOUT MAGIC ORANGE

Magic Orange is a dynamic financial management solutions company made up of a team of dedicated professionals, consisting of Chartered Accountants and technology experts. Our team have been deeply involved in creating and implementing Cost Transparency solutions at large global financial, insurance and retail institutions. Magic Orange Cost Transparency is a powerful cloud based solution with international presence. We have offices in the United States, South Africa and via strategic partnerships hold international reach within Europe, the United Kingdom and Australia.

**Magic Orange has been successfully implemented at numerous enterprise clients. Should you wish to learn more about how this progressive cloud-based Cost Transparency solution can help to take control of costs and unlock optimization opportunities of your business...**

## CONTACT US

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