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KPMG International's initial analysis of survey results from global banks, indicates a consistent decrease in banks cost-to-income ratio (CIR) pre-COVID, followed by an increase during FY19-21 likely due to staff, technology costs, and loan loss provisioning. Recently, improvements in CIR have been observed, largely due to top-line gain from rising interest rates that have boosted profitability. However, with rising inflation, cost management has become more crucial for banks. Services and people costs tend to increase in line with inflation, and the risk of reduced income is becoming a reality in many countries due to the cost of living/borrowing crisis. While CIR and return on equity (ROE) are widely used to gauge bank performance, a deeper focus is needed to measure performance more broadly. By considering customer metrics such as the cost-to-serve (CTS) and full-time equivalents (FTE) per customer, banks can focus on productivity, efficiency, and profitability. Implementing new technologies, simplifying processes, and introducing efficiency initiatives can increase customer value. All Blogs Budgeting Resources Cost Allocation Methods Cost Allocation Basics Cost Allocation Account Analysis Allocation Base Cost Allocation BOOT CAMP - Financial Modeling (6 Hrs) Boot Camp: LEARN Financial Modeling in Just 6 Hours! Table Of Contents The cost allocation method is a process that facilitates identification and assignment of costs to products, departments, branches or programs based on certain criteria. When the allocation of costs is performed correctly, the business is able to account for its costs as well as trace them back to determine how they are making profits and losses. Thus, it is a very useful technique that helps the business to distribute its expenses among various products, services, and cost centres. If the costs are accurately attributed, then it leads to better pricing strategy, production planning, resource allocation, cost control, and overall financial management, which leads to an increase in profitability. The term cost allocation methods refer to the different techniques that a company may use in order to allocate or distribute its costs across its operations, products or cost centres, which leads to efficient and smooth running of the business, through maximum cost control. The cost allocation method starts with the identification of cost drivers. The cost drivers tend to change the level of the cost incurred by the business for any aligned or identified activity. The cost drivers are generally composed of a number of machine-hours, the number of direct labour and the count of payment processed, the count of purchase orders, and the count of invoices that are dispatched to the customers. The establishment of comprehensive joint cost allocation methods helps in fast decision making for the management as they tend to get access to the important data of cost allocation and utilization on periodic fronts. It additionally keeps labour staff motivated as the business tends to recognize the department or product line that is the most profitable department. Since the data on cost allocation becomes accessible to the management, it helps the management evaluate the department and the associated staff. It is to be noted that the selection of overhead cost allocation methods will depend on the type and nature of business, the size of operation, the kind of resource used and future planning. It is not necessary that the business will use only one method. It can use multiple and combination of techniques which will not only give a proper understanding of the costing situation but also guide the business regarding the next step. Given below are some important and widely used types of such joint cost allocation methods that exist in the corporate world. This is the starting step in the identification of costs, wherein the business attempts to find and classify the cost objects. The cost objects are required as it helps the business to determine effective costs on segregated levels. Additionally, such identification is also regarded as critical as the business or organization cannot go ahead with the process of cost allocation if the cost objects are not known and defined. The cost objects could be a project in the pipeline, product line, department, division, or entirely a new segregated brand. In parallel to this activity of determining the cost objects, the business identifies and determines the basis of the costs. The cost basis is basically the fundamental aspect basis allocation of costs that are performed on the cost objects. Once the cost objects are identified and established, the next step involves the addition or accumulation of the cost into a defined cost pool and allocate the cost objects. The cost accumulation could result in the creation of multiple categories wherein the costs aligned would be pooled and segregated basis the cost allocation method employed. This could result in several methods. The cost pools aligned with the basis could be composed of electricity usage, square footage, water usage, insurance, fuel consumption, motor vehicle insurance, and rent expenses. Basis the identified costs the business tends to finally establish some levels of cost objects. Such cost objects can be identified as direct costs. The direct costs help in segregating costs that have a direct impact on business profitability and can be attributed to the distinct product line or service line. They are not required to be aligned with the defined cost objects as the business knows the type of expenses that could be incurred in the production of specific services and products. There could be some costs that are not direct; rather, they indirectly impact the aligned cost function, product line, or department. Such costs are required for the facilitation of business operations and further be divided into fixed or variable costs. Such costs would, therefore, be identified and then simultaneously allocated to the identified cost objects within the business unit or the organization. The fixed costs are basically the cost that is business or department has to bear to sustain itself. The variable costs, on the other hand, are costs that the business may or may not bear and depends on the level of output. Such variable costs can increase or decrease in magnitude, and such costs are generally controllable by the business if identified with the correct cost objects. There could be overhead cost allocation methods as well, which are indirect and are not identified with the process of production or manufacturing. Such costs are not related to the material costs and labour costs that the business has to incur in the generation of services and finished goods. However, overhead costs if identified correctly with the cost pools, help the business in terms of selling the finished goods or services, and it helps in the production process. The overhead costs are levied on the expense account, and they should be comprehensively compensated irrespective of the fact whether the business is making sales on the services or finished products. Such costs are aligned with the administrative expenses as well as such expenses can be aligned to the legal expenses. The cost allocation methods basically focus in terms of accumulation of costs followed by the establishment of cost drivers and cost pools to establish cost objects further and then aligned such costs to the cost objects. Cost allocation is basically a critical task for the business as it helps the business in determining the effective profit and loss for themselves, and this attribute further helps the management to establish effective decision-making policy. Let us assume a company ABC Ltd, which is looking into its cost allocation and analysing areas that need better control and strategy. It produces two kinds of products, A and B. Total quantity produced for A is around 20000 and B is produced by 50000 units. It management has calculated that the total cost of production comes to \$150000. After identification it is seen that these include the cost or resource employment, usage of utility, purchase of various machinery, upgradation of software, procurement of raw materials, etc. Now they need to allocate it among both products, then we can say that for products A and B, the total cost would be as follows: Total cost = \$150000, Total production = 70000 units Therefore for A = $(150000/70000) * 20000 = 42,857$ For B = $(150000/70000) * 50000 = 107,143$ Thus, the above is a very simple calculation of allocation. However, the components may change and calculation may be more complex, depending the type of product, the various cost breakups and the operational process. The various methods explained above help in distributing the costs across the operations so that it enables the business to fairly align it across various outputs. But corporate cost allocation methods come with their own advantages and disadvantages. Let us look at the advantages first. Cost control - It is important for the business to have a proper control over its cost so that proper planning and revenue maximization can lead to profitability. The management of the business should take special care to select the correct common cost allocation methods of cost allocation so that the cost can be reduced. Decision making - A business needs proper decision making at every step. Correct strategy and planning are the key to success of the business. Reporting - This is the most important part, where financial details is reported in the statements that are widely viewed, used and analysed by investors, shareholders, and the management. Proper allocation of cost through corporate cost allocation methods reveals a clear and positive picture about the business, which not only make the company appear financially stable but also increase faith of stakeholders. Here are some disadvantages of the common cost allocation methods. Subjective - The entire process is very subjective in the sense that the methods are selected based on past experiences and historical results. This may lead to disagreements or misallocation and disputes. Complex process - There are multiple types of cost allocation methods, which are difficult to select, based on company operations and strategies. Moreover, even after selecting a method, using it is not very easy because it involves a number of assumptions, calculations, and analysis. Assumptions - It is quite obvious that there are a number of assumptions that are used in the process which may not be very realistic or related to actual usage of resource contribution. Inaccuracy - Due to complexity and assumptions used the ultimate result may not always be accurate. There may be deviations from expectation which may later lead to cost increase and requirement of new strategy to conduct the business. Cost involved - Any new method implementation requires some amount of cost. This is extra cost that the company has to bear and above all the management may not be sure of its positive result. Therefore, the skill and expertise employed for achievement of the objective involves cost. Thus, the above are some important advantages and disadvantages that should be kept in mind while selecting and implementing the different cost allocation methods. This has been a guide to What are Cost Allocation Methods & its Definition. Here we discuss the two broad cost allocation methods, i.e. explain them in detail. You can learn more about from the following articles - Contract Costing Step Cost Semi-Fixed Cost Factory Cost We have broad and deep industry expertise across the financial services ecosystem, giving us a fresh, forward-looking perspective. In this highly regulated industry, we can serve as a trusted adviser on your complex transformation projects. At Deloitte, we have tools to help build a better financial system - one which is more sustainable, digital, and accessible. So, whatever stage your business is in its transformation journey, we can advise you as you make connections. April 13, 2025 April 13, 2025 Steven Bragg Cost allocation is the process of assigning indirect or shared costs to different departments, products, services, or cost centers within an organization. Since some expenses—such as utilities, rent, or administrative salaries—benefit multiple areas of a business, cost allocation ensures these costs are fairly distributed based on a logical basis, such as usage, square footage, or labor hours. This helps in accurately measuring the true cost and profitability of each segment of the business, supporting better decision-making, budgeting, and performance evaluation. Proper cost allocation also ensures compliance with accounting standards and may be required for external reporting or cost reimbursement in regulated industries. How to Allocate Costs Various cost allocation methods are used to allocate factory overhead costs to units of production. Allocations are performed in order to create financial statements that are in compliance with the applicable accounting framework. The most common allocation methods are noted below, along with commentary about their advantages and disadvantages: Allocate based on direct labor. Overhead is applied based on the amount of direct labor consumed by a unit of production. This is an easy calculation, for there is usually an industrial engineering standard already in place that documents the amount of direct labor associated with a product. However, the amount of direct labor consumed may be far smaller than the amount of factory overhead, which can result in large allocations based on small amounts of direct labor cost. This can cause large swings in cost allocations if direct labor totals change by only a small amount. Allocate based on machine time used. Another favorite is cost allocations based on the amount of machine time used by a product. As was the case for direct labor, the reason for this popularity is that the standard amount of machine time used is already available in the form of industrial engineering documentation. Allocate based on square footage. It may be useful to separate out those overhead costs related to inventory storage, and allocate these costs based on the number of square feet of storage space used by each product. While this is a more accurate way to associate certain overhead costs with products, it can be difficult to track, especially when inventory levels are constantly changing. Another concern is that square footage is only two dimensional. A more accurate approach would be to allocate costs based on cubic feet of storage space consumed. Related Accounting Tools Courses Accounting for Inventory Activity-Based Costing Cost Accounting Fundamentals It is possible that corporate headquarters costs are to be allocated to the subsidiaries of a multi-division company. If so, a number of possible allocation methods have been used, which may be based on sales, profits, or headcount. These allocation options are as follows: Allocate based on sales. Costs are apportioned based on the net sales reported by each entity. Since high sales volume does not necessarily equate to high profits, this approach can result in a low-profit entity being burdened with a substantial corporate allocation. Allocate based on profits. Costs are allocated based on the profits generated by each subsidiary. A problem is that high-profit entities will be charged with the bulk of all corporate expenses, so their inherent profitability will not be overly apparent when their results are viewed on a fully-burdened basis. Allocate based on headcount. This is the most specious basis of allocation, for some entities can generate sales and profits with few staff, while others require massive numbers of employees. Also, a large number of low-paid employees might attract a large cost allocation, while another subsidiary with a much smaller number of higher-paid employees would attract a comparatively smaller charge. When deciding upon which cost allocation method to use, keep in mind that none of these methods will achieve a close relationship between the allocated costs and the cost objects to which they have been applied. Consequently, it is best to use the simplest method available, and not worry about a high level of allocation precision. Benefits of Cost Allocation There are multiple benefits associated with cost allocations, which are noted below: Improved cost visibility. Cost allocation provides a clearer understanding of where and how resources are being spent across departments, products, or projects. By assigning indirect costs to specific areas, organizations can see the true cost of operations. This visibility helps leaders make informed financial and strategic decisions. Enhanced decision-making. With accurate cost data, managers can evaluate the profitability and efficiency of different business units. This enables them to allocate budgets more effectively and identify underperforming areas. As a result, organizations can make smarter, data-driven decisions to boost overall performance. Fair budget distribution. Cost allocation ensures that shared resources and expenses are distributed fairly across departments based on usage or benefit received. This prevents one area from unfairly bearing more costs than it should. It also promotes accountability, as each department becomes responsible for its share of indirect expenses. Performance measurement. By allocating costs accurately, organizations can better assess the financial performance of each unit or function. This makes it easier to track efficiency, identify cost overruns, and evaluate return on investment. Managers can then take corrective action where needed to improve operations. Regulatory support. Many industries require transparent reporting of how costs are assigned, especially when dealing with government contracts or regulated pricing. Cost allocation supports compliance by providing clear documentation of expense distribution. This reduces the risk of regulatory issues or audit challenges. Related Articles Direct Allocation Method Reciprocal Method Step Allocation Method Volume-Based Allocation April 13, 2025 Steven Bragg Smooth operations lie at the heart of a successful business, and proper resource allocation plays a crucial role in achieving this. Cost allocation involves determining how to distribute a company's funds across various aspects of its operations. For instance, consider a fintech company that runs multiple applications; it has an app for online payments, another one for taxation, and one for budgeting. The company must allocate funds between each application to ensure better planning and performance analysis. Cost allocation helps to assess the usage of each application. For example, if the online payment app is most used, more resources will be allocated to ensure its smooth operation. This assists the company in understanding where its funds are being allocated and supports strategic financial decision-making. In this blog, we will discuss cost allocation meaning in detail and learn how to effectively carry out cost allocation, including best practices and real-life examples. Table of Contents What is Cost Allocation? Cost Allocation Methods Types of Allocated Costs How to do Cost Allocation? Examples of Cost Allocation Benefits of Cost Allocation Best Practices for Cost Allocation How Can HighRadius Help in the Effective Cash Allocation Process? FAQs Cost allocation involves identifying and distributing a company's costs across different cost objects, such as departments, products, or services, based on their usage or benefit. This process ensures that each segment accurately reflects the expenses incurred, leading to better financial analysis and decision-making. Cost allocation is important as it ensures that expenses are accurately distributed across different departments, projects, or products, reflecting the true cost of operations. This helps businesses identify which areas are profitable and which are underperforming, enabling informed decision-making. Manual Accounting Is Holding You Back! AI gives you 60% faster consolidation and real-time insights — stop the inefficiencies. Get Exclusive Ebook Different cost allocation methods are used depending on the business needs and the complexity of its operation. Here are some of the common cost allocation methods: The direct allocation method is the simplest and most straightforward approach to cost allocation. It involves directly assigning costs to the departments or products that incur them without any intermediate steps or redistribution. While this method is easy to implement, it may not always capture the full complexity of how resources are used, especially in organizations with intertwined services and departments. The step-down allocation method, also known as the sequential allocation method, allocates costs by progressively assigning them from one department to another. The process starts with the department that provides the most services to other departments and moves step-by-step downwards. This method recognizes the hierarchical nature of services provided between departments, offering a more systematic approach than direct allocation. The reciprocal allocation method takes into account the mutual resources exchanged between departments before allocating costs. This method reflects the complex, interdependent relationships among departments, leading to a more accurate distribution of costs. It is particularly valuable for organizations with highly interdependent departments, as it provides a more accurate reflection of how costs are shared and resources are utilized across the organization. Activity-based costing (ABC) allocates costs based on the activities that drive them rather than simply on the basis of departments or products. This method identifies key activities within an organization and assigns costs to products or services based on their consumption of these activities. By focusing on cost drivers, ABC offers a more nuanced and precise allocation of overhead costs, making it especially useful for complex, multi-product companies. Absorption costing, also known as full costing, is a method where all manufacturing costs, both fixed and variable, are allocated to the product units. This method ensures that each unit of production carries a portion of all production costs, which is important for external financial reporting. This method is widely used in financial accounting and tax reporting because it complies with Generally Accepted Accounting Principles (GAAP). Ebooks Uncover how AI can transform the record-to-report process for strategic insights! Impact of AI Predictive analysis Time & cost saving Download Ebook Cost allocation can be classified into different types based on how costs are distributed within an organization. Each type of allocated cost helps businesses understand and manage their expenses more effectively and efficiently. Here are the different types of allocated costs: Direct costs are expenses that can be directly attributed to a specific product, department, or project. Examples include raw materials, direct labor, and specific equipment used in production. These costs are straightforward to track and assign because they are directly involved in the production or execution of a specific activity. Indirect costs are expenses that cannot be traced directly to a single product, department, or project. Instead, they support multiple areas of the business and are often allocated across various departments or products. Examples include utilities, rent, and administrative salaries. Fixed costs are expenses that remain constant regardless of the level of production or business activity. These costs do not change with the volume of goods or services produced. Examples include rent, insurance, and salaries of permanent staff. Fixed costs are crucial for budgeting as they provide stability in expense planning, allowing businesses to forecast their financial needs more predictably. Variable costs fluctuate with the level of production or business activity. These costs increase as production grows and decrease when production slows. Examples include raw materials, production supplies, and shipping costs. Understanding variable costs helps businesses manage their production budgets and pricing strategies effectively, as these costs directly impact overall profitability. Operating costs are the ongoing expenses required to run the daily activities of a business. These include both fixed and variable costs necessary for maintaining business operations. Examples include rent, utilities, salaries, supplies, and maintenance. Tracking operating costs is essential for assessing the financial health of the business and ensuring that daily operations are funded adequately while maintaining profitability. Cost allocation involves a systematic process to distribute costs across different parts of a business. Here's a step-by-step guide on how to do it: Step 1: Identify costs - Start by identifying all the costs that need to be allocated. These can include direct costs (like raw materials) and indirect costs (like utilities and administrative expenses). Step 2: Determine cost objects - Define the cost objects, which are the items, departments, products, or services to which the costs will be allocated. For example, cost objects could be different departments within a company or various products being manufactured. Step 3: Select allocation bases - Choose appropriate allocation bases, which are the criteria used to distribute costs. This could be square footage for allocating rent, labor hours for distributing salaries, or machine hours for dividing equipment costs. The allocation base should closely reflect how the cost is consumed. Step 4: Allocate costs - Apply the selected allocation bases to distribute the costs among the identified cost objects. For instance, if rent is being allocated based on square footage, the cost would be divided proportionally based on how much space each department occupies. Step 5: Review and adjust. After allocating costs, review the allocations to ensure they are reasonable and reflect the actual use of resources. Make any necessary adjustments to improve accuracy. Step 6: Record and report. Finally, calculate the allocated costs and record them accurately in the accounting system. Ensure these costs are properly reflected in financial reports. This detailed information will be utilized by stakeholders for budgeting, pricing strategies, financial analysis, and critical decision-making processes. Ebooks Learn how to master month-end close accuracy with essential best practices and real-time insights. Month close challenges Best practices Actionable insights Download Ebook Let's take a closer look at the following example of cost allocation. This example provides a clear and detailed understanding of the costs associated with each product or service. By analyzing this example, you can understand how cost allocation works, how to optimize pricing strategies, and improve overall financial efficiency. Example 1: Let's consider a manufacturing company with two types of products: chairs and tables. The company incurs the following costs: Total cost of wood: \$10,000 Factory rent: \$5,000 Utilities: \$2,000 The company needs to allocate these costs to chairs and tables: Direct costs: The cost of wood is allocated based on usage. Chairs use 60% of the wood, and tables use 40%. Chairs: $10,000 * 60\% = 6,000$ Tables: $10,000 * 40\% = 4,000$ Indirect costs: Factory rent and utilities are allocated based on the space each product line occupies in the factory. Chairs use 70% of the space, and tables use 30%. Factory rent: Chairs: $5,000 * 70\% = 3,500$ Tables: $5,000 * 30\% = 1,500$ Utilities: Chairs: $2,000 * 70\% = 1,400$ Tables: $2,000 * 30\% = 600$ Total costs: Chairs: $6,000$ (wood) + $3,500$ (rent) + $1,400$ (utilities) = $10,900$ Tables: $4,000$ (wood) + $1,500$ (rent) + 600 (utilities) = $6,100$ Cost allocation offers several benefits for businesses, enhancing financial management and decision-making. Each method of cost allocation has its own advantages and is selected based on the specific business needs and structure of the business. Here are some of the benefits: Cost allocation helps businesses accurately determine the cost of products, services, or departments by distributing expenses appropriately. This ensures a clear picture of the true costs involved, aiding in more precise pricing and profit-loss analysis. By understanding how costs are allocated, businesses can create more accurate budgets and financial forecasts. This helps in planning for future expenses and allocating resources effectively to different areas of the business. With clear cost information, stakeholders can make more informed decisions about pricing, cost control, and resource allocation. This can lead to better strategic decisions, such as which products or services to focus on or discontinue. Accurate cost allocation contributes to more transparent financial statements and reports. This can improve stakeholder confidence, as investors, lenders, and other stakeholders get a clear view of the company's financial performance. Cost allocation allows businesses to assess the performance of different departments, products, or projects. By comparing allocated costs against revenues, businesses can identify areas of inefficiency and opportunities for improvement. Understanding how costs are distributed helps in identifying areas where expenses can be reduced or controlled. This can lead to better management of overhead and operational costs, ultimately improving profitability. Implementing best practices for cost allocation ensures accuracy, fairness, and transparency in financial reporting and decision-making. Here are some best practices to ensure appropriate cost allocation: Clearly identify and specify the cost objects to which costs will be allocated, such as departments or products. Choose allocation bases that reflect actual usage, like direct labor hours or square footage. Apply consistent cost allocation methods across similar cost types for reliability and comparability. Periodically assess and adjust cost allocation techniques to maintain accuracy. Keep detailed records of allocation methods and the rationale behind them to ensure transparency. Regularly review allocated costs to identify trends and control expenses. Automate and streamline cost allocation by utilizing accounting software. HighRadius offers a cloud-based Record to Report solution that helps accounting professionals streamline and automate the financial close process for businesses. We have helped accounting teams from around the globe with month-end closing, reconciliations, journal entry management, intercompany accounting, and financial reporting. Our Financial Close Software is designed to create detailed month-end close plans with specific close tasks that can be assigned to various accounting professionals, reducing the month-end close time by 30%. The workspace is connected and allows users to assign and track tasks for each close task category for input, review, and approval with the stakeholders. It allows users to extract and ingest data automatically, and use formulas on the data to process and transform it. Our Account Reconciliation Software provides an out-of-the-box formula set that can configure matching rules and match line-level transactions from multiple data sources and create templates to automate various transaction processing required for month-end close. Our solution has the ability to prepare and post journal entries, which will be automatically posted into the ERP, automating 70% of your account reconciliation process. Our AI-powered Anomaly Management Software helps accounting professionals identify and rectify potential 'Errors and Omissions' throughout the financial period so that teams can avoid the month-end rush. The AI algorithm continuously learns through a feedback loop which, in turn, reduces false anomalies. We empower accounting teams to work more efficiently, accurately, and collaboratively, enabling them to add greater value to their organizations' accounting processes. The purpose of cost allocation is to distribute expenses accurately across different departments, products, or projects to determine their true cost and profitability. This helps in budgeting, pricing, financial reporting, and decision-making, ensuring fair and informed resource management. A cost driver is a factor that causes changes in the cost of an activity or product. It directly influences the amount of cost incurred, such as the number of machine hours used, the volume of production, or the level of activity. Identifying cost drivers helps in accurate cost allocation and budgeting. An example of an allocated cost is factory rent. If a company operates multiple departments, the rent cost is distributed among them based on criteria like floor space used. This allocation ensures each department bears a fair share of the overall rent expense, reflecting their use of shared resources. Cost allocation is crucial for accurately determining the cost and profitability of products, services, or departments. It supports effective budgeting, pricing, and financial reporting by ensuring expenses are fairly distributed, leading to informed decision-making and efficient resource management. The direct allocation method is often considered the best for its simplicity and clarity. It assigns costs directly to specific products, services, or departments based on actual usage, ensuring straightforward and accurate cost tracking. This method is particularly useful for smaller organizations or simpler cost structures. A cost allocation plan is a structured approach to distributing costs among various departments, projects, or products. It outlines the methods and bases used for allocating expenses, ensuring that costs are fairly and accurately assigned to reflect their actual consumption and usage.