Allocating Overhead

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Many cooperative separate their functions into departments and track the performance and profitability of each unit. It is generally easy to allocate revenue and variable costs across departments. Departmental analysis necessitates allocated fixed or overhead expenses across the units. Some fixed costs are also easy to allocate. The ownership cost of the fertilizer application equipment can be assigned to the fertilizer department. Other expense, like the salaries of the main office staff, the central office building expenses and board of directors expenses cannot be attributed to a single department. Those are examples of indirect fixed expenses that must be allocated across departments. If overhead costs are not allocated, departmental profits appear inflated since all of the costs associated with the revenue are not accounted for.

There are a number of methods for allocating overhead costs. Overhead costs can be allocated based on sales, employee hours, or asset value. Different criteria can be used for different overhead expenses. For example, HR costs can be allocated based on salaries while insurance and property tax are allocated based on asset value. There is obviously a tradeoff between the most fair allocation and complexity in calculating the allocation. Managers and boards need to be cautious in analyzing departmental profits. The relative profitability of departments are impacted by the allocation method. The grain department may have more overhead based on sales while the fertilizer department captures more overhead based on employees. Cooperative leaders must also remember that overhead expenses will not disappear if a department is eliminated. Those expenses would be assigned to the remaining department.

One alternative for overhead cost allocation is to assign costs in proportion to the departments contribution margin. Accountants define the contribution as sales less variable costs, which is typically sales less cost of goods sold and sales expenses. I like to expand the concept by also removing direct fixed expenses. For example, removing the fixed cost of the application equipment from the fertilizer department's contribution margin. The result is the "contribution to indirect fixed costs and profits" for each department. The indirect overhead costs can then be allocated based on contribution margins to arrive at the bottom line for each department.

The contribution margin assigns more overhead expenses to the more profitable departments. That illustrates the fact that there is no perfectly fair method of allocating overhead. As the name implies, the contribution margin approach highlights the contribution of each department. As long as that contribution is positive, the cooperative is better off with the department than without it. Each department's performance can be assessed by tracking and benchmarking the contribution margins.

If you would like a copy of my factsheet, "Understanding and Allocating Overhead Expense" drop me an email at phil.kenkel@okstate.edu