

- 3.001 In this article we set out our views on the circumstances when it is reasonable, and not reasonable, to make changes to cost allocation models. In general, we expect departments to determine and report actual expenditure in their year-end financial statements using the same cost allocation models as were used when the *Estimates of Appropriations* were prepared.
- 3.002 In preparing the *Estimates* for each financial year, departments forecast the amount of expenditure that will be needed for each class of outputs. Some of the costs that will be incurred in producing a particular output class can be directly attributed to that class. Other costs (such as administration overheads) are more general and must be allocated between two or more output classes.
- 3.003 Costs that must be allocated are split up among the different output classes by means of a “cost allocation model”. The model applies one or more items of information (often information relating to specific costs) according to some formula that is believed to produce a fair allocation. For example, a department producing two output classes might record the number of working hours staff devoted to each output class in order to allocate direct labour costs between the two. And then allocate administrative overhead costs in the same proportion.
- 3.004 The purpose of appropriation is to set limits on the amount of expenditure that can be incurred in each category of expenditure, including each class of outputs. Any change to a cost allocation model on which an estimate of expenditure has been prepared may bring about a breach of the limits which Parliament has set.
- 3.005 The two circumstances where it might be appropriate to change a cost allocation model are:
- recognition during the course of the year that the model is seriously flawed and its continuing use would lead to unintended and undesirable results; and
 - authorisation of significant changes in policy or operational procedures after the *Estimates* have been finalised that change the logical basis of the model or require the collection of different cost allocation information (or both).

- 3.006 Occasionally we encounter examples of changes to cost allocation models, especially at the end of the financial year, which do not fall into either of the above categories. These changes may have the effect of appearing to improve the department's compliance with Parliament's appropriations.
- 3.007 For example, in 1995 a department unexpectedly found itself having to meet the cost of staff redundancies, payment of which would have caused expenditure in excess of appropriation on some output classes. However, it had estimated that it was going to underspend on other output classes. It therefore proposed to seek fiscally neutral transfers in the *Supplementary Estimates* from the underspent output classes to those that would otherwise be overspent. Unfortunately, due to an administrative oversight, the transfers were not made. Instead, the department made adjustments to its cost allocation model that had the effect of achieving 'unofficial' fiscally neutral transfers.
- 3.008 Departments that make unwarranted changes to their cost allocation models that materially affect their reported expenditure risk receiving a qualified audit opinion on their annual financial statements. The department in the example described above received a qualified audit opinion principally for other reasons – including generalised problems with cost allocation. However, the audit opinion could (and would) have been qualified solely on the grounds of the changes to the cost allocation model itself.

