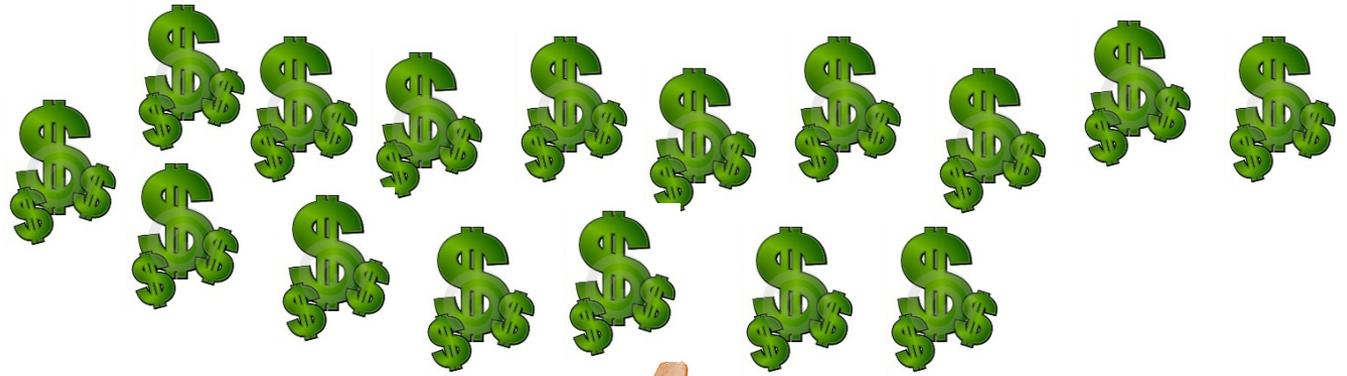




Indirect Costs



**Imagine a
company that
gets contracts
to make planes,
tanks, and
ships.**





Now that the company is producing products, making money, and paying bills, it has to figure how much it cost to perform each contract.

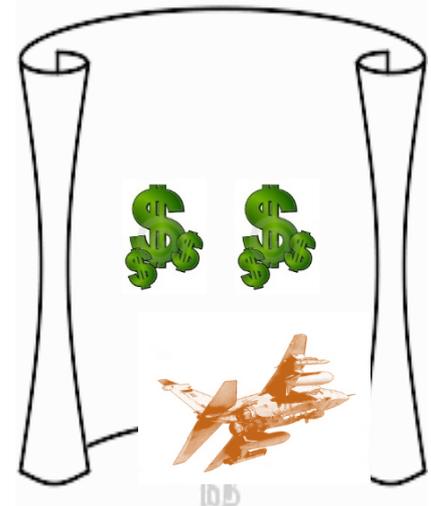
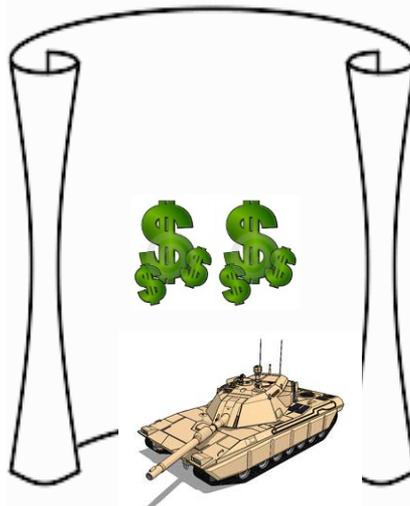
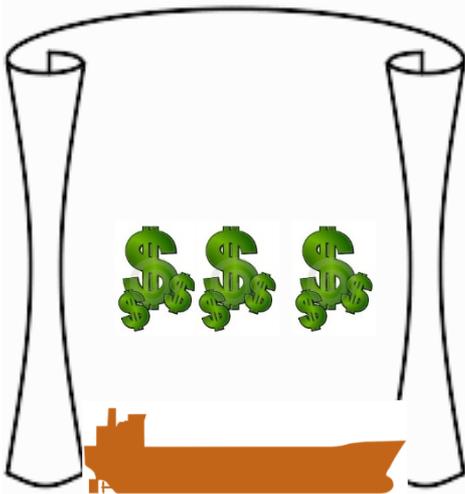


Indirect Costs



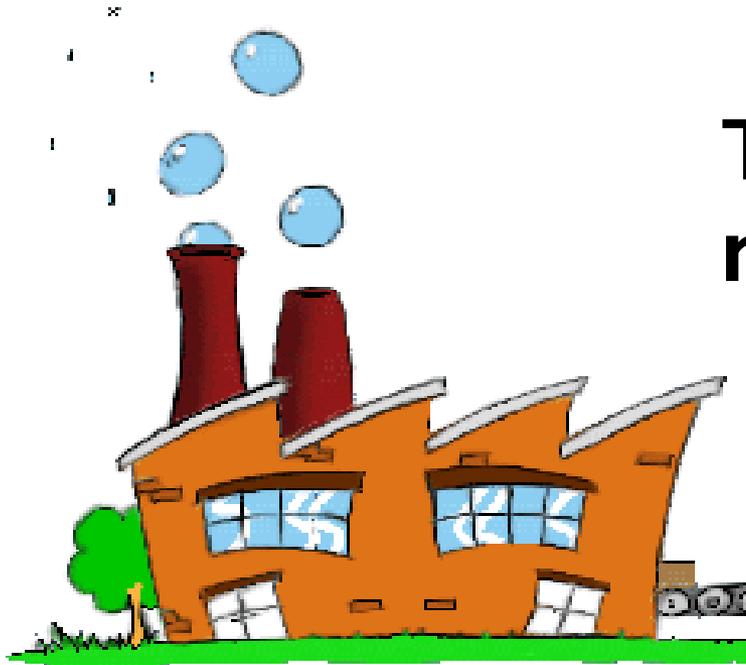


So how do the
Indirect Costs get
matched to contracts?





Before we match (allocate) indirect costs to contracts (cost centers) we must make sure *unallowable* costs have been removed

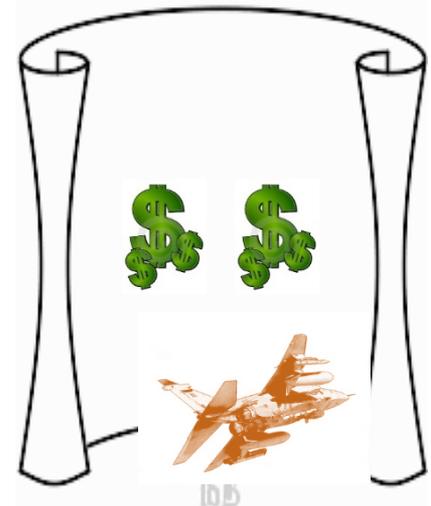
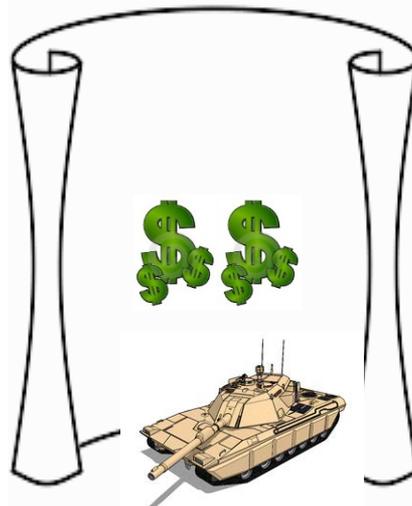
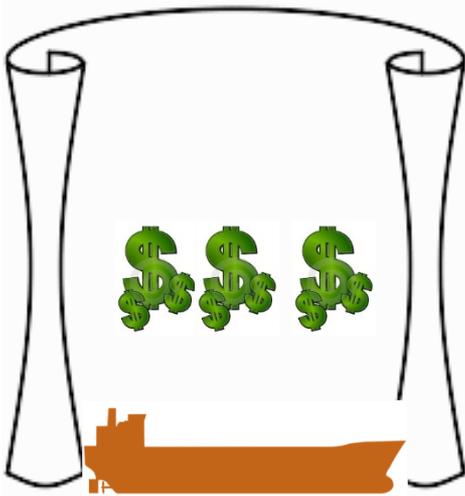


To be allowable, costs must be:

- **Reasonable**
- **Allocable**
- **Not legally prohibited**
- **Not contractually prohibited**
- **Meet FAR cost principles**



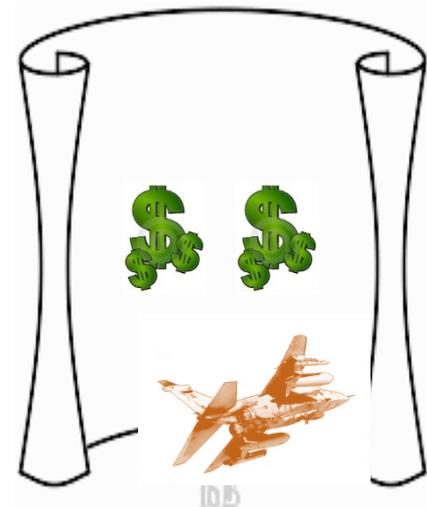
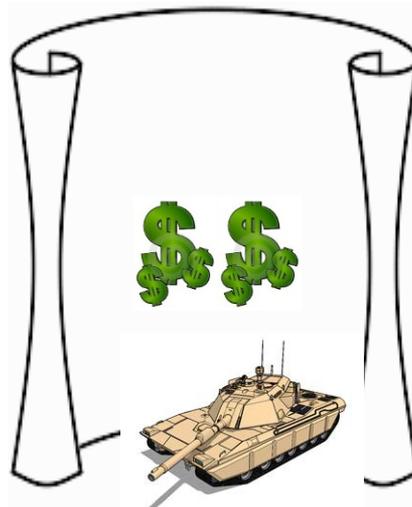
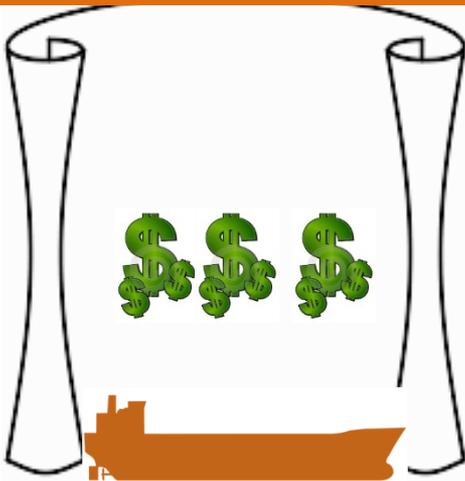
After we remove
unallowable indirects,
then what?





Dividing indirects equally amongst contracts wouldn't be equitable

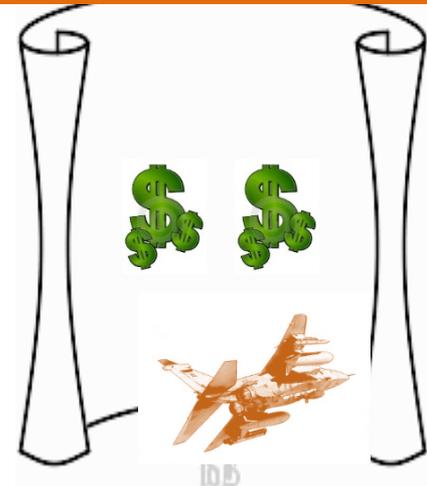
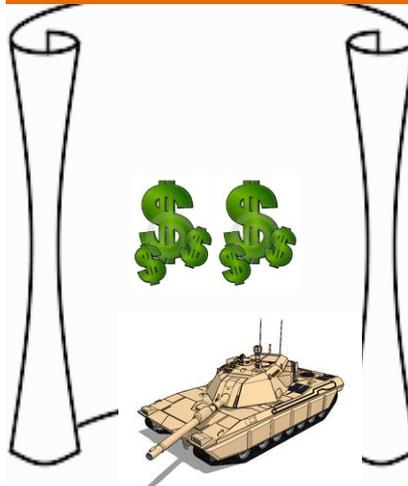
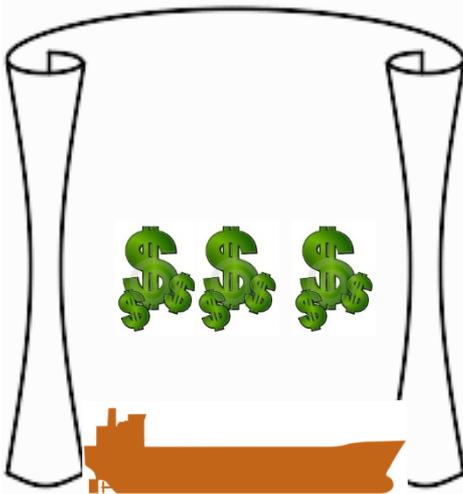
Some contracts are larger





Dividing indirects
proportionally wouldn't
be representative

Some contracts might benefit more from indirects





To make indirect costs easier to allocate to contracts, we group them into indirect cost pools

For example:

Indirect costs like warehousing and purchasing that support all material costs may be “pooled” into material overhead

Engineering training and software tools can be “pooled” into engineering overhead

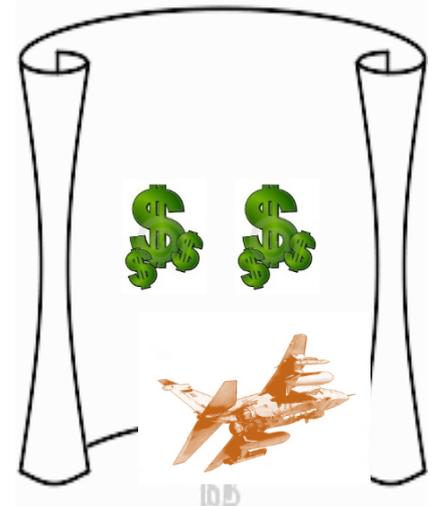
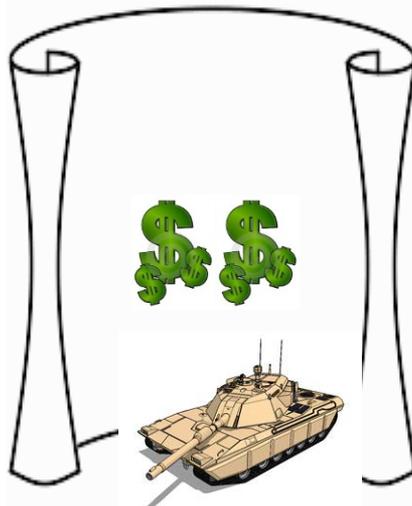
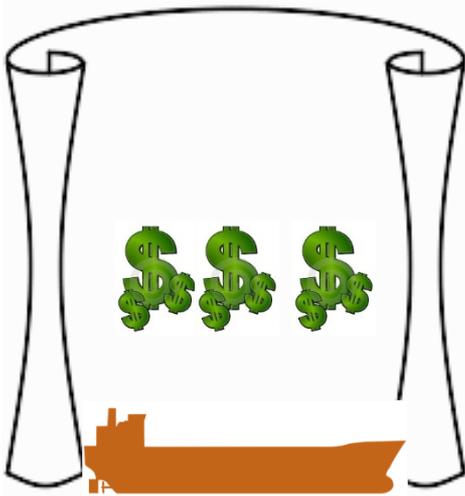
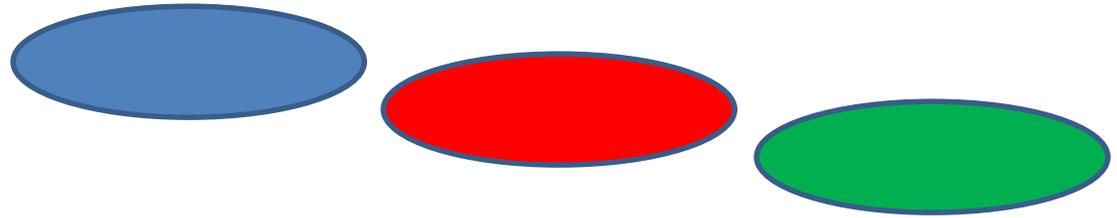
Factory costs like machinery upkeep may be “pooled” into manufacturing overhead

CONTRACTORS CHOOSE HOW TO ALLOCATE COSTS



Indirect costs are assigned to cost pools because they are similar

Homogeneity of Cost Pool: If pools allocate with the same impact as allocation of individual costs.

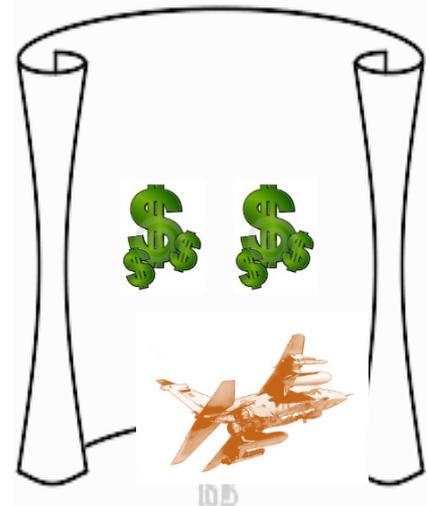
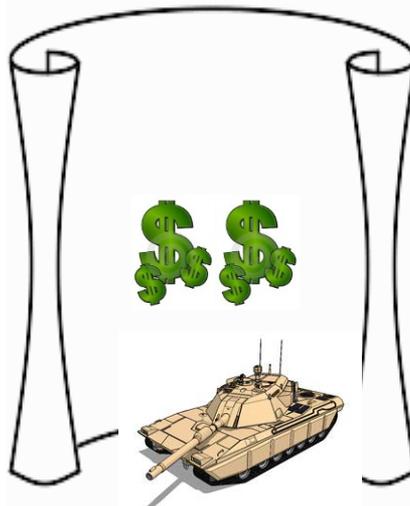
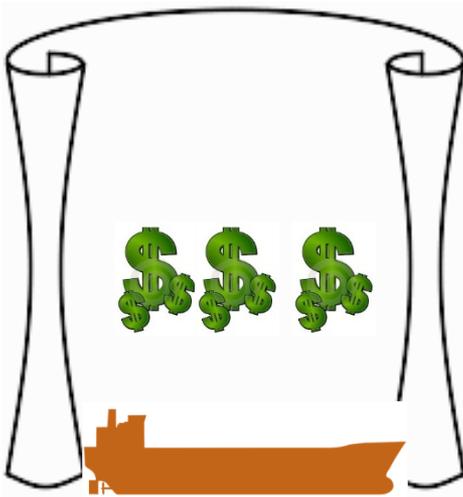




Material OH

Engineering OH

Manufacturing OH





Some indirect costs benefit the company as a whole; these are General and Administrative Costs

For example:

The President's salary supports the entire company and may be categorized as part of the general and administrative (G&A) indirect cost pool



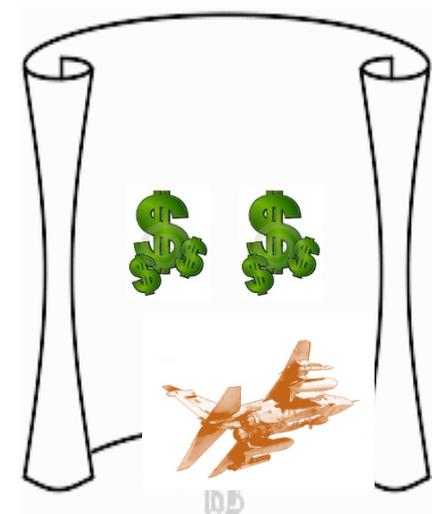
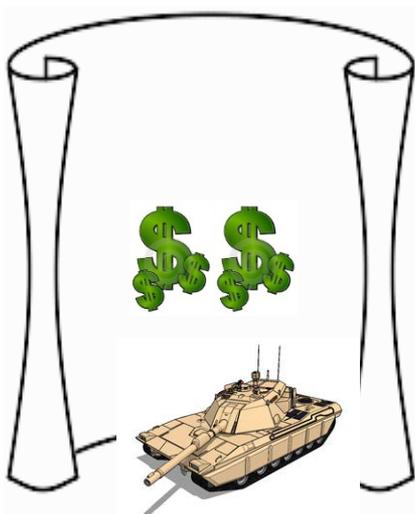
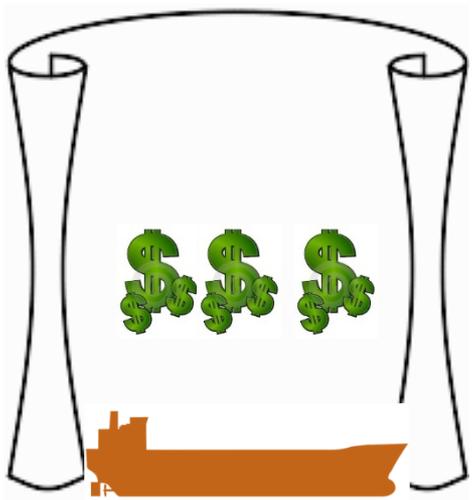
G&A

Material OH

Engineering OH

Manufacturing OH

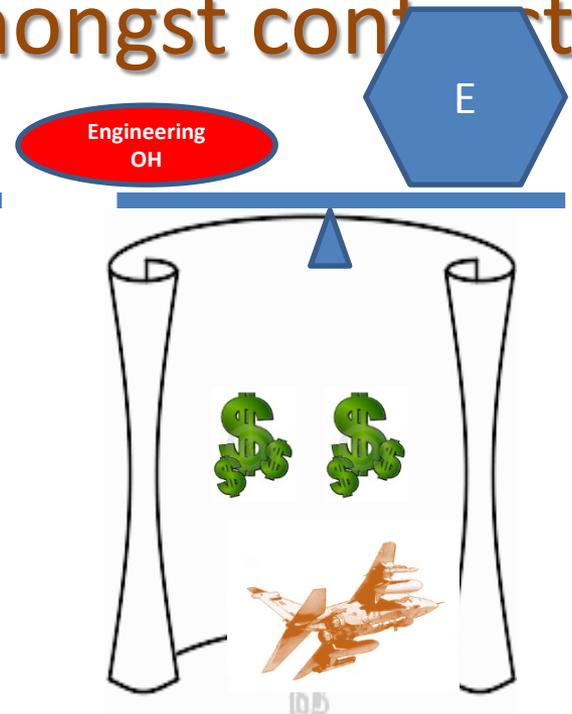
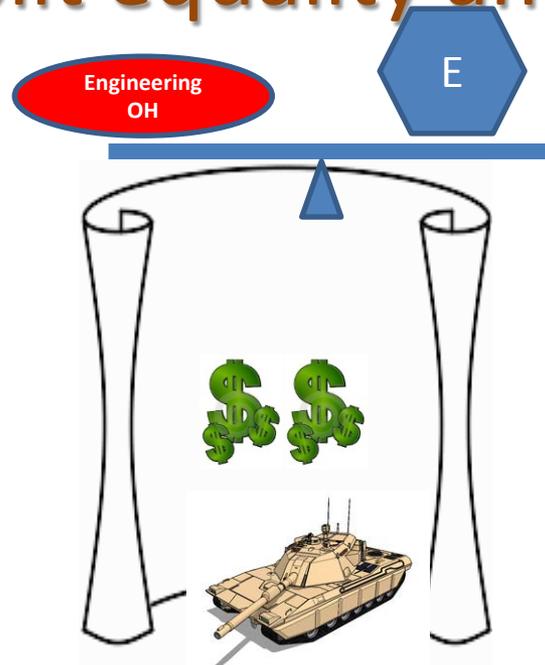
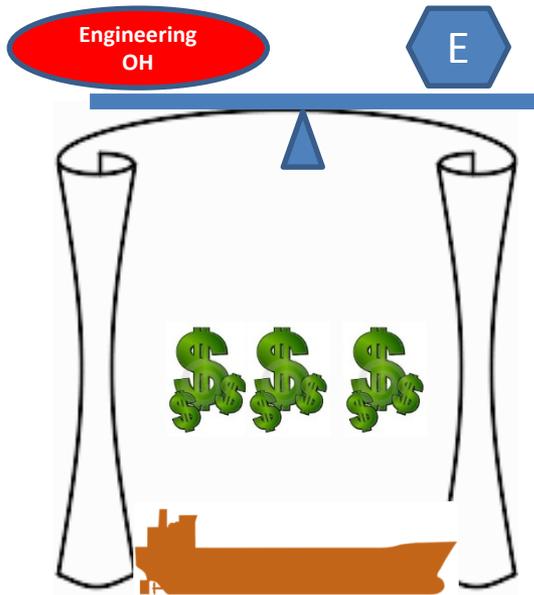
Now... how do we allocate the pooled indirect costs?





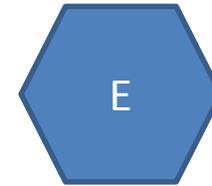
Engineering Overhead is *disproportionally* allocated to the engineering effort of each contract

Split equality amongst contracts?

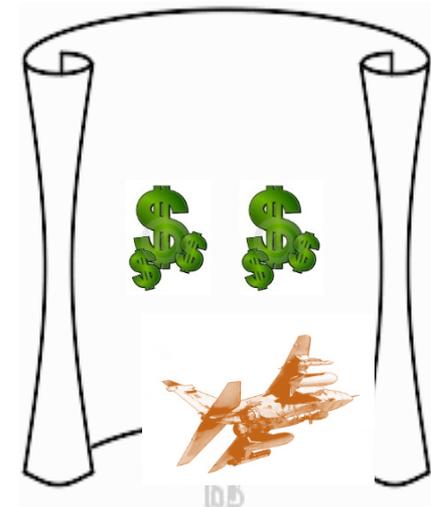
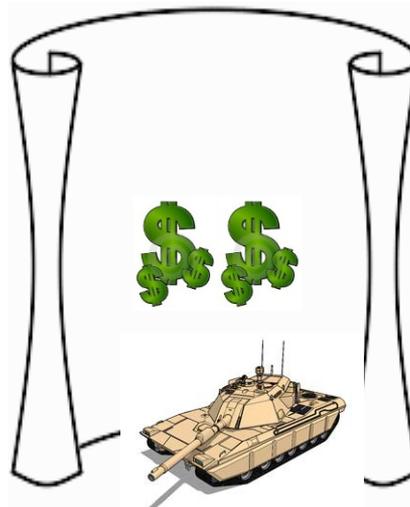
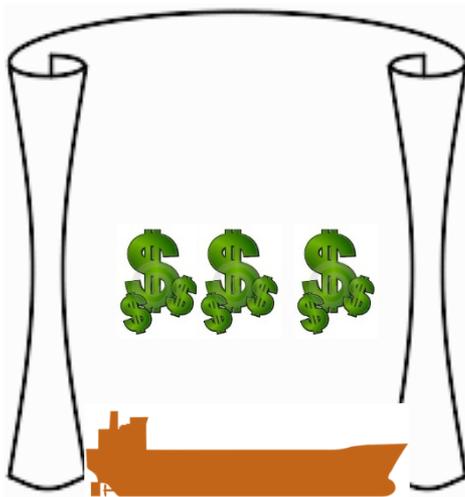




Engineering OH

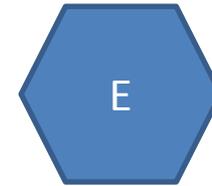


To determine allocation, look at the relationship companywide

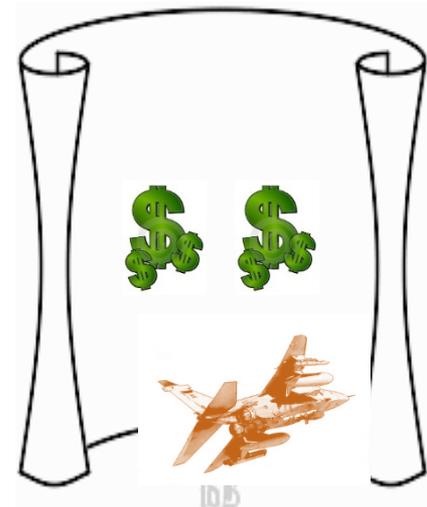
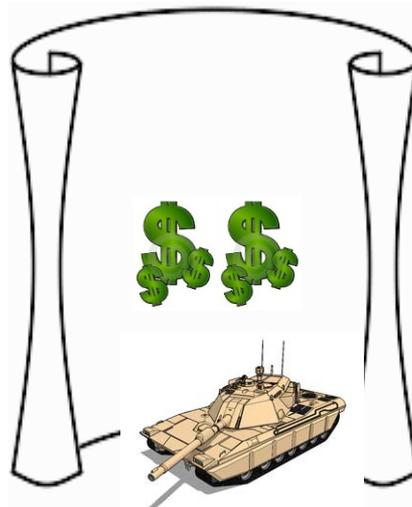
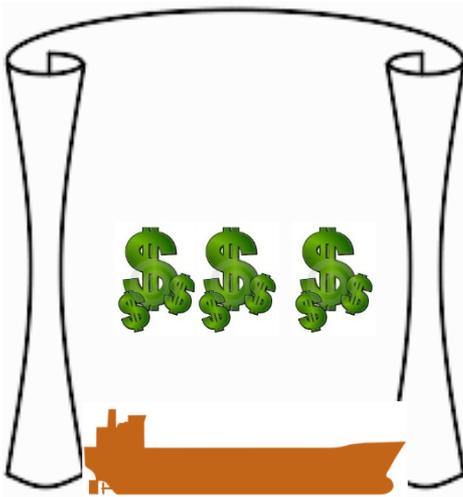




Engineering OH

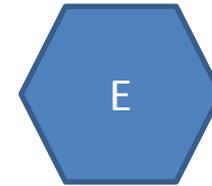


If for example **engineering OH** is half the size (50%) of the **engineering effort** company wide...

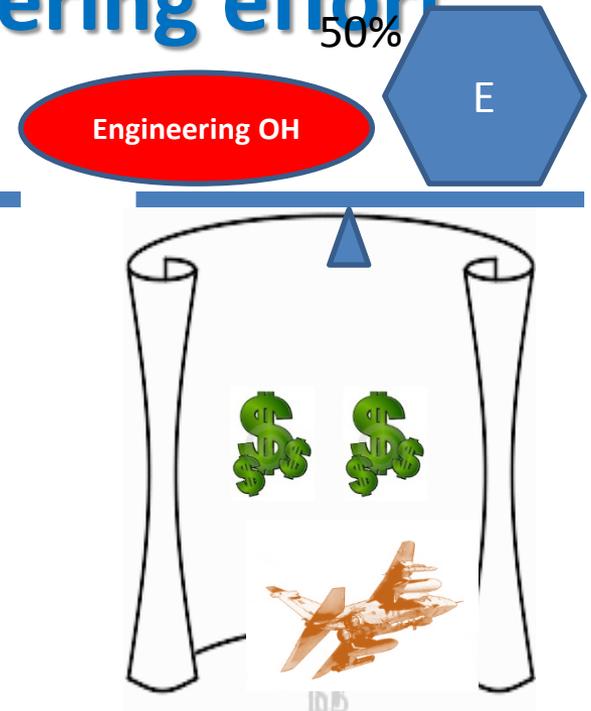
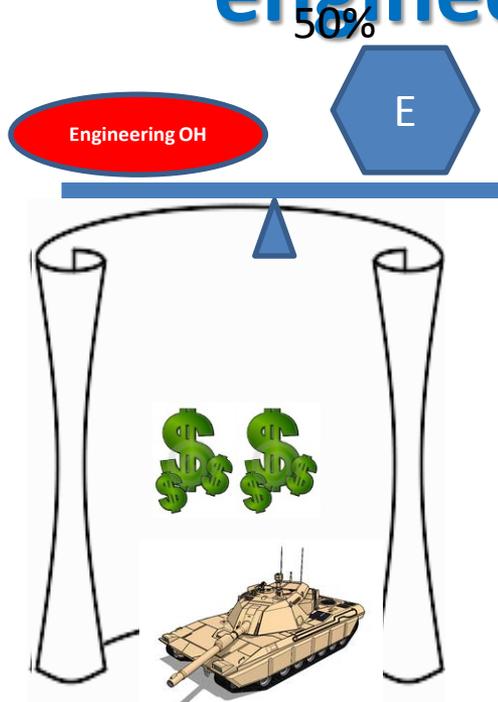
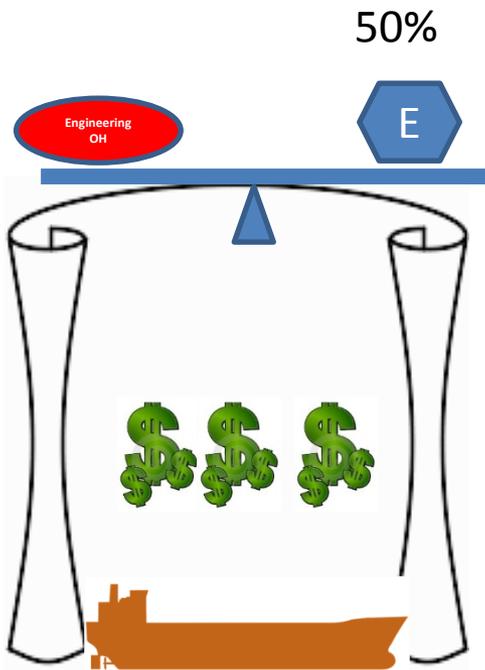




Engineering OH



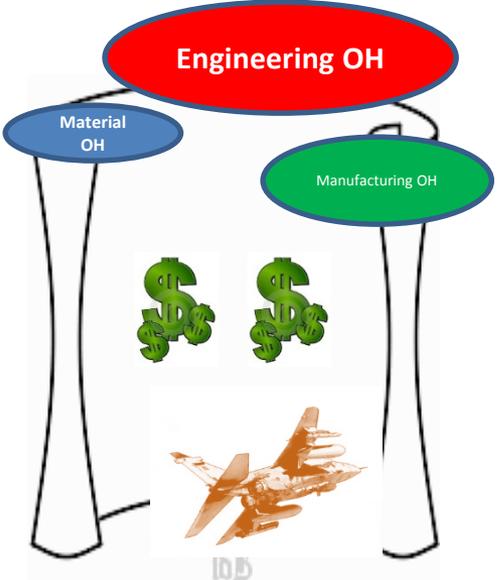
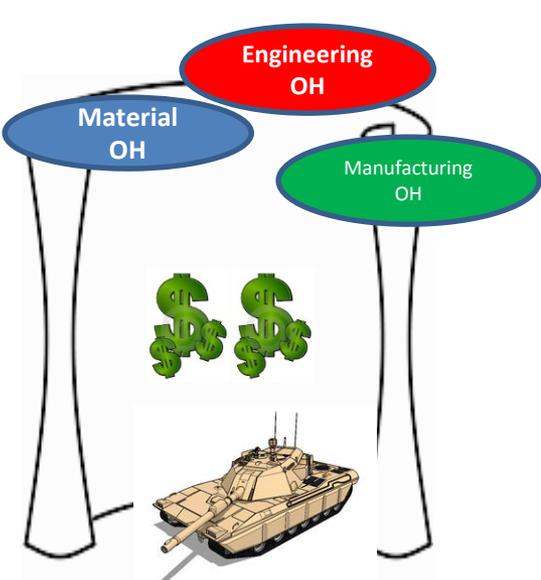
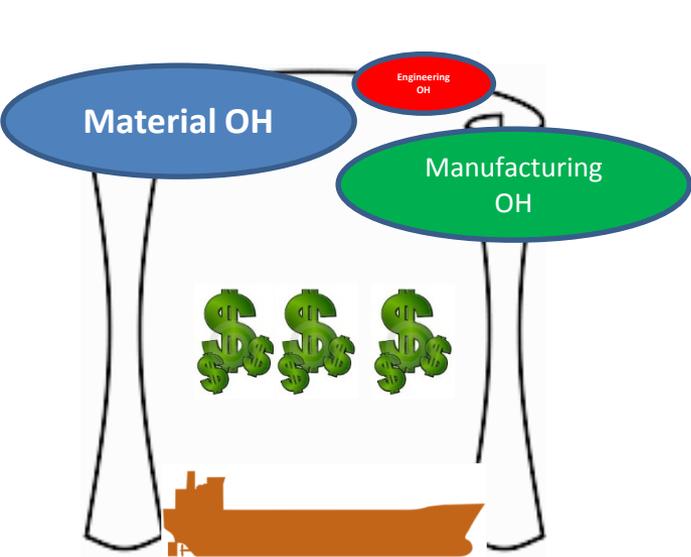
Then we have an **engineering OH** rate of 50% to apply to a basis of allocation (base) **engineering effort**





G&A

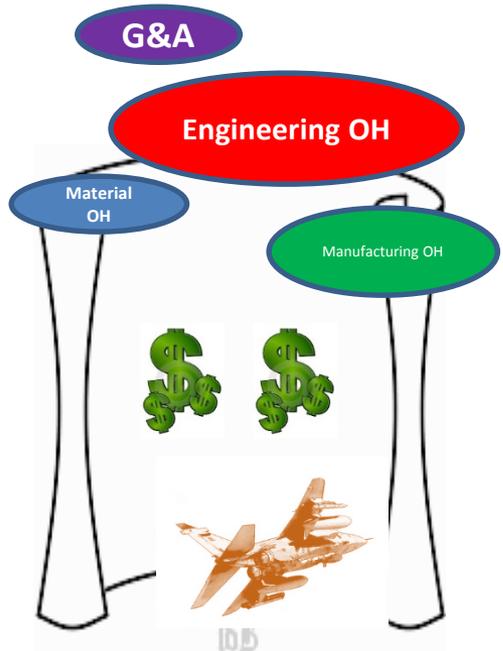
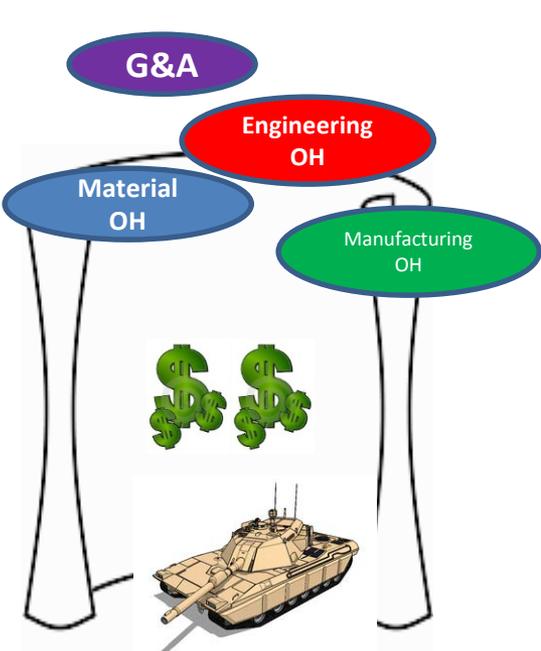
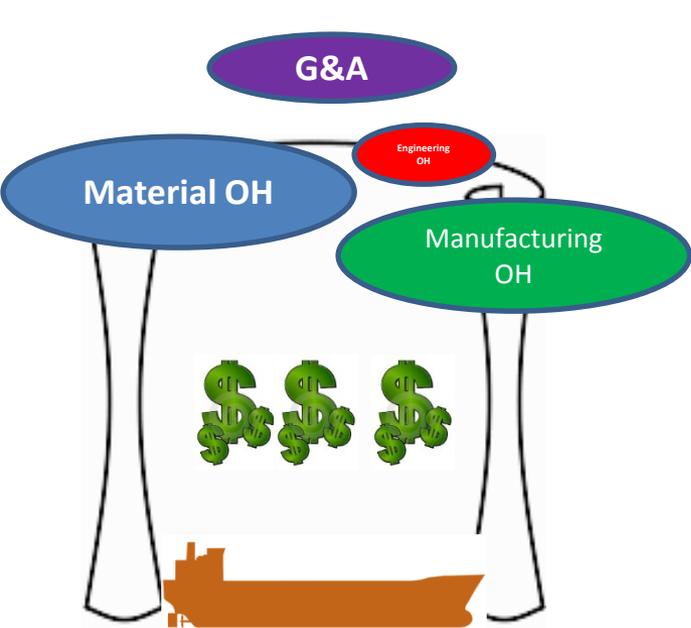
Overhead is applied to contracts depending on the basis of allocation for each contract

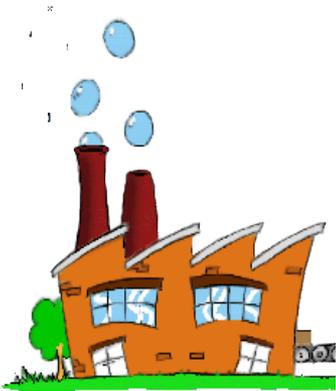




G&A

G&A allocation is proportional to total costs or a subset of total costs





Rates are determined comparing cost pools to a basis of allocation

Indirect Cost (Pool)		Rate	Basis of Allocation (Base)	
Engineering Overhead Costs	\$100		\$1,000	Engineering Labor Costs
Manufacturing Overhead Costs	\$800		\$200	Manufacturing Labor Costs
Material Overhead Costs	\$2,000		\$2,000	Material Costs
General and Administrative Costs	\$610		\$6,100	Total Direct and Indirect Costs



Dividing the pool of indirect costs by the allocation base...

Indirect Cost (Pool)		Rate	Basis of Allocation (Base)	
Engineering Overhead Costs	\$100	$\frac{100}{1000}$	\$1,000	Engineering Labor Costs
Manufacturing Overhead Costs	\$800	$\frac{800}{200}$	\$200	Manufacturing Labor Costs
Material Overhead Costs	\$2,000	$\frac{2,000}{2,000}$	\$2,000	Material Costs
General and Administrative Costs	\$610	$\frac{610}{6100}$	\$6,100	Total Direct and Indirect Costs



Dividing the pool of indirect costs by the allocation base produces a rate...typically a percentage.

Indirect Cost (Pool)		Rate	Basis of Allocation (Base)	
Engineering Overhead Costs	\$100	10%	\$1,000	Engineering Labor Costs
Manufacturing Overhead Costs	\$800	400%	\$200	Manufacturing Labor Costs
Material Overhead Costs	\$2,000	100%	\$2,000	Material Costs
General and Administrative Costs	\$610	10%	\$6,100	Total Direct and Indirect Costs



Rates are consistently applied to each contract specific basis of allocation

Allocated Indirect Cost		Rate	Basis of Allocation (Base)	
Engineering Overhead Costs		10%	\$500	Engineering Labor Costs
Manufacturing Overhead Costs		400%	\$100	Manufacturing Labor Costs
Material Overhead Costs		100%	\$500	Material Costs
General and Administrative Costs		10%	\$2,050	Total Direct and Indirect Costs



Rates are consistently applied to each contract specific basis of allocation

Allocated Indirect Cost		Rate	Basis of Allocation (Base)	
Engineering Overhead Costs	\$50	10%	\$500	Engineering Labor Costs
Manufacturing Overhead Costs	\$400	400%	\$100	Manufacturing Labor Costs
Material Overhead Costs	\$500	100%	\$500	Material Costs
General and Administrative Costs	\$205	10%	\$2,050	Total Direct and Indirect Costs



**For each contract,
indirect costs are
allocated
consistently**





The Cost Accounting Standards (CAS) provide guidance for allocation

- **CAS 401 - Consistency in Estimating, Accumulating and Reporting**
- **CAS 402 - Consistency in Allocating Costs Incurred for the Same Purpose**
- **CAS 410 - Allocation General and Administrative Expenses**
- **CAS 418 - Allocation of Direct and Indirect Costs**



The Federal Acquisition Regulation (FAR) provides guidance for allowability in FAR Subpart 31.2 -- Contracts With Commercial Organizations

- (1) Reasonableness**
- (2) Allocability**
- (3) CAS Standards**
- (4) Terms of the contract**
- (5) Any limitations set forth in FAR Subpart 31.2**



Indirect Costs