

## **Appendix N**

### **“Allocation of Costs to Contracts (Your Memo, 7 Jan 85) – Information Memorandum,” from Lt. Gen. Robert Russ, USAF, DCS/Research, Development and Acquisition to the Deputy Secretary of the Air Force for Financial Management, 15 January 1985**

An Air Force memorandum admitting that contractors use proportional allocation of overhead, not “equal allocation.” The proportional allocation is based on measures of the “direct effort” involved in producing an item – overhead is not allocated equally, or regardless of how much effort and value an item has.

Coincidentally, the memo mentions that Cost Accounting Standards – currently under siege by the defense industry – would ban the equal allocation of overhead except in “unlikely” circumstances.



DEPARTMENT OF THE AIR FORCE  
HEADQUARTERS UNITED STATES AIR FORCE  
WASHINGTON, D.C.

15 January 1985

MEMORANDUM FOR SAF/FM


SUBJECT: Allocation of Costs to Contracts (Your Memo, 7 Jan 85) -  
INFORMATION MEMORANDUM

We are sorry about the confusion which resulted from your request for examples of indirect/overhead cost allocations made on an equal allocation basis. However, our communication difficulties reflect conceptual misunderstandings which are widespread in the acquisition community. Differing uses of accounting terminology contribute to these misunderstandings.

Use of accounting terminology has been a particular problem in discussions of spare parts and support equipment pricing. The AFMAG used the term "cost allocation" in identifying the problem of assigning equal amounts of cost to items, regardless of the value of the items. However, further analysis revealed that this problem usually occurs because of distribution of direct cost rather than indirect cost allocations. Publicizing and correcting this distribution problem has been one of our primary pricing initiatives.

Our response to your original request provided examples of equal distribution of direct cost because that is where the problem occurs. Unfortunately, many people refer to this type of cost as "overhead". We hope that our response made it clear that we do not consider traditional indirect cost allocations to be the cause of non-value based pricing problems. In fact, the Cost Accounting Standards would only allow equal allocation of indirect cost in cases where a contractor's entire business base consisted of homogeneous products. This is an unlikely circumstance.

To answer your request directly, all of the contractors over which we have cognizance use some measure of direct effort as a basis for allocating indirect cost. These bases include labor hours, labor cost, and direct material cost. In the case of general and administrative (G&A) expense, the majority of contractors use total cost as an allocation base. Lockheed allocates G&A based on direct labor cost. Boeing, McDonnell-Douglas, and TRW use value added (total cost minus material and subcontract cost) as a basis for allocating G&A. We hope that this clarifies the practices of Air Force contractors regarding the allocation of indirect expense.

  
ROBERT D. RUSS, Lt Gen, USAF  
DCS/Research, Development  
and Acquisition