

## The Strategy and Tactics of Cost Allocation Structures, Part 5

Written by Nick Sanders  
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Part 1 of this series can be found [here](#) . We discussed why this is an important—nay, *critical*—topic for you, worthy of an investment of your time and expense.

Part 2 of this series can be found [here](#) . We discussed why you need input from a diverse group of stakeholders. You will want to solicit input from a number of diverse perspectives because your cost allocation decisions—including your decision regarding the emphasis you place on maximizing the amount of direct charges—can affect your corporate culture in perhaps unexpected ways.

Part 3 of this series can be found [here](#) . We discussed the importance of making sure the entity's organization structure reflected how the entity was being managed. We also discussed the notion that precision is not a synonym for accuracy; and that the benefit of precise cost allocations is often not worth the price to be paid, in terms of additional administrative burdens and risks of noncompliance.

Part 4 of this series can be found [here](#) . We discussed segmentation and how certain business units are afforded flexibility in their allocation structures in the DCAA Contract Audit Manual (CAM).

In today's article we want to discuss the little understood phenomenon of “special allocations.” We are going to focus on the practical aspects, not the theoretical aspects. If you want the theory, Karen Manos, of the firm Gibson, Dunn, has [the article](#) you want to read.

Without rehashing Ms. Manos' article, she notes that several Cost Accounting Standards discuss the use of special allocations—including CAS 403, 410, 418, and 420. Only CAS 410 requires the use of special allocations; the other standards are less prescriptive, stating that the contractor and the Cognizant Federal Agency Official (CFAO) “may agree” to the use of special allocations. Or not. (The Standards are silent with respect to what happens if the parties do not agree.)

Let's start at the beginning. What is a “special allocation”?

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A special allocation is a corrective allocation that makes an individual cost objective (allocation recipient) whole from use of the normal allocation methodology. For example, if the normal allocation methodology is to allocate G&A expense on a total cost input base, but one contract has a disproportionately large amount of (say) direct material dollars, that contract would receive too high an allocation of G&A expense, relative to the benefits received. In another example, if the normal allocation methodology is to allocate Corporate Home Office residual expenses (which include Legal) on a headcount base, but one segment has its own Legal department and receives no benefit from the Corporate Home Office Legal function, then if the segment's headcount was included in the allocation base, it would receive too high an allocation of Corporate HR costs, relative to the benefits received.

In other words, a special allocation is what you do when your standard cost accounting practices do not result in an equitable distribution of indirect costs.

As noted above, the only Standard that *requires* use of a special allocation is CAS 410. The requirement imposes a duty on CAS-covered contractors to evaluate the functions and activities in their business units' G&A expense pools and determine whether or not certain final cost objectives are receiving a disproportionate share of allocated G&A expenses, relative to benefits received. The ASBCA confirmed in the seminal

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decision (ASBCA No. 23883) that each contractor covered by CAS 410 has an affirmative responsibility to choose the proper G&A expense allocation base that is best representative of total activity being managed/supported by the G&A function. Even when the appropriate base is chosen, if there are outlier contracts, a special allocation must be used to correct disproportionate expense allocations.

In establishing your cost allocation structure, including indirect cost pools and allocation bases, care must be taken to ensure that the pools are logical and homogeneous, and that the allocation bases are appropriate. (See CAS 418 for more details on homogeneity and the hierarchy of allocation bases.) Often, one or more stakeholders stops the process, essentially via filibuster, by going into a long diatribe about how their operation or their contract is different, and will be harmed by imposition of the new allocation structure. These passionate pontifications are almost always based on customer financial considerations rather than an objective analysis of costs and benefits. Nonetheless, such concerns must be taken seriously and analyzed, to see if the allocation base chosen is the best one, and whether or not there are outliers that will have to be addressed via special allocations.

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To be clear, special allocations should be the exception rather than the rule. They are there to address real inequities and not to placate certain stakeholders. Government auditors look with skepticism on such “special” allocations, and Contracting Officers will expect to see a detailed Advance Agreement for their execution before you implement them. However, they are permissible. Indeed, in some circumstances they are even mandated. Thus, you need to keep them in mind when designing your cost allocation structure.

Designing your cost allocation structure is a non-trivial task, one that is worthy of your time and attention. It supports both your near-term and long-term business strategy. The wrong structure and the wrong allocation methods can be the source of enormous pain; but the right structure and the right allocation methods can be the source of competitive advantage.

We hope you’ve enjoyed this five-part series and gotten some value from it. If you’d like to explore this topic further, Apogee Consulting, Inc. is available to assist you.