

Demonstration Problem 4-1 Allocating Indirect Costs

My House / Your House



Assume a builder is building three houses simultaneously. The direct materials and direct labor costs for each house are shown below:

	House 1	House 2	House 3
Direct Materials	\$140,000	\$ 70,000	\$90,000
Direct Labor	210,000	130,000	60,000
Overhead	?	?	?

The building contractor's total indirect costs (such as supervisory salaries and indirect materials) are \$84,000.

Required

- Assume the builder allocates overhead (indirect) costs equally among the three houses. Determine the amount of overhead cost allocated to each house. Comment on whether this allocation scheme is reasonable. Explain why it may be inappropriate to use number of units as the allocation base.
- Assume instead that the builder allocates overhead costs based on total direct costs. Determine the amount of overhead cost allocated to each house. Compare the allocations determined in **requirement a** with the allocations determined in **requirement b**. Identify who will benefit and who will suffer if the builder uses the **requirement b** allocation method instead of allocating overhead equally.
- Assume that the \$84,000 of total overhead cost consists of \$63,000 of indirect materials and \$21,000 of fringe benefits. Decide what you believe is the most rational allocation scheme and use that scheme to allocate the overhead cost to the three houses.