

A GUIDE TO INDIRECT COST RATES IN GOVERNMENT CONTRACTING

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Introduction

Doing business with the Federal Government is a complex undertaking, but one that can be immensely fulfilling. The business leaders I have worked with choose to provide services, products, and solutions to the Federal Government out of a desire to help the country they love. Each of them have expertise in an area that is critical to

the success of our country and turning that expertise into tangible results for clients is what they would prefer to spend their time doing. However, successful government contracting firms understand that compliance with an extensive regulation framework is absolutely critical. One of the most important, and therefore one of the most regulated areas of compliance is the design, implementation, and maintenance of an indirect rate structure.

In the current 'lowest-price-technically-acceptable' (LPTA) environment, it is important to design an indirect rate structure that results in a competitive advantage when submitting proposals. The indirect rate structure should ensure that all indirect costs are allocated in a manner that is consistent with their benefit, without being too complex and/or administratively burdensome. This overview will provide some insightful tips to help navigate the compliance challenges associated with indirect rates.

Basic Information – Direct vs. Indirect Costs

When a government contractor incurs an expense, it is either a direct expense that can be identified with a specific cost objective or it is an indirect expense that benefits multiple cost objectives or the company as a whole. The Federal Acquisition Regulation (FAR) requires contractors to establish and consistently follow criteria for distinguishing between direct and indirect costs. To help make the determination regarding whether or not a cost is direct, ask "If we did not have this contract, would we still incur this cost?" A 'no' answer to this question indicates the cost is likely direct.

Cost Objective Definition

The FAR defines a "cost objective" as a "function", organization subdivision, contract or other work unit for which cost data are desired and for which provision is made to accumulate and measure the cost to processes, products, jobs, capitalized projects, etc." FAR 31.001.



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For a typical government contractor these expenses would include labor performed directly on a contract, travel to project status meetings, material consumed entirely on a project, subcontractors/consultants hired to work on a project, etc. Once classified as direct, a cost should consistently be treated as direct under the same circumstances.

All indirect cost can be classified as either overhead or general and administrative (G&A). Overhead includes all indirect cost incurred for the production of goods or services, while G&A expenses are the overall costs of running a business. Said another way, overhead expenses benefit more than one contract and G&A expenses are incurred for the common good of the company. Once identified, indirect costs must be distributed to contracts in reasonable proportion to the benefits received (FAR 31.201-4). This distribution is achieved through the use of Indirect Rates.

Example of Indirect Cost Flows



What Are Indirect Rates?

In order to arrive at an indirect cost rate, a company must first group all indirect costs into indirect rate pools. The only requirements under the FAR are that the allocation of indirect costs must be fair, reasonable, and equitable. This allows a great deal of latitude in determining where certain costs will be included in a given company's indirect rate structure. We'll see below, that this determination may have a significant impact on the ability to win contracts. Generally, companies create a fringe pool, an overhead pool, and a G&A pool. The overhead pool is commonly split further to segregate on-site and customer-site employees. Another common indirect rate pool reflects subcontractor & material handling expenses.

Once indirect rate pools have been established, each one must be given an allocation base so that an indirect rate may be calculated. An allocation base should result in a reasonable, logical, and consistent allocation of costs to contracts. For instance, total labor cost is an appropriate allocation base for a fringe rate pool due to the clear relationship between the two.

Calculation of Indirect Rates and Impact of Over or Under Running Rates

As we've shown, the calculation of indirect rates is simple math. It's how and why certain expenses are grouped together that can be complex. See below for tables that outline some basic traditional cost pools and the related allocation bases:

FRINGE	OVERHEAD	G&A
Examples: PTO, employer payroll taxes, medical insurance, company 401(k) contributions, etc.	Examples: Salaries/ wages of support and production personnel, facilities costs, supplies, etc.	Examples: Compensation of company executives plus related fringe, legal and professional fees, administrative personnel and costs, business insurance, company taxes (except federal income taxes), bid and proposal costs
Allocation Base: Labor (direct and indirect)	Allocation Base: Direct Labor + Fringe on Direct Labor	Allocation Base: All costs incurred by the Company less G&A costs (assumes a Total Cost Input (TCI)). Another alternative is a Value Added (VA) cost base, which includes all costs less G&A costs, materials and subcontractors. A VA base is appropriate when (1) a significant distortion in allocations result from inclusion of material and subcontract costs in the TCI base and (2) costs other than direct labor are significant measures of total activity.

It is certain that there will be a difference between the rates estimated for the year and the actual rates incurred. The estimated rates must be adjusted to actual periodically. The impact of this adjustment to companies with largely cost-reimbursable contracts is as follows:

- **Under-Running Rates** - Actual rates are lower than the estimated/approved rates. The company will be expected to reimburse the government for excess cash collected and is accounted for as a liability.
- **Over-Running Rates** - Actual rates are higher than the estimated/approved rates. The company can technically bill the government for the shortfall and is accounted for as an asset. Judgement is required in determining whether or not to bill for rate over-runs. The most important consideration is available funding, followed closely by health of the relationship with the customer. During the year and prior to a decision on whether or not to bill the over-run, the company will need to slow down operating expenses being incurred or they will be forced to support the negative cash flow through other means, such as line-of-credit borrowing.

Indirect Rates and the Contract Lifecycle

Indirect rates play an integral role in the financial health of the Company throughout the contract lifecycle.

Relationship of Forward Pricing, Billing, and Final Rates



Pertinent definitions and relationships include:

- **Forward Pricing Rates** - Indirect cost rates used to bid on contracts. Negotiated rates will be set for fixed price contracts. Cost type contracts will be adjusted based on Final Indirect Rates. The Forward Pricing Rate Structure should mirror the Final Indirect Rate Structure.
- **Provisional Billing Rates** - Indirect cost rates used to invoice the government on cost-reimbursable contracts. The rates generally differ from actual rates incurred throughout the year. The purpose of this measure is to ensure that the billing rates are as close as possible to the final indirect cost rates anticipated for the contractor's fiscal period, as adjusted for any unallowable costs (FAR 42.704).
- **Final Indirect Rates** - Indirect cost rates agreed upon by the Government and the contractor and are usually established after the close of the contractor's fiscal year to which it applies. The rates are not subject to change and are used to close contracts for final payment (FAR 2.101).

- **Forward Pricing Rates and Final Indirect Rates** - The rate structure proposed with Forward Pricing Rates and Final Indirect Rates should ultimately mirror each other. If Final Indirect Rates have been historically over-proposed when compared to the Forward Pricing Rates, the Forward Pricing Rates will be adjusted.
- **Forward Pricing Rates and Provisional Billing Rates** - Forward Pricing Rates and Provisional Billing Rates generally do not match, but in some instances do. The Forward Pricing Rates act as a baseline for the Provisional Billing Rates for the coming year. The cognizant federal official will adjust the Provisional Billing Rates as necessary, based on history and other relevant factors.
- **Provisional Billing Rates and Final Indirect Rates** - The purpose of the Provisional Billing Rates is to ensure the billing rates through the year are as close as possible to the Final Indirect Rates. Provisional Billing Rates are influenced by historical Final Indirect Rates.

It is imperative that a company have a robust forecasting process and that realistic inputs and assumptions be used to update historical actual indirect rates for use in new proposals and long-term contract proposals.

Why Are Rates Important?

Sounds simple, right - a company groups its costs and allocates them to contracts in a logical and consistent manner. So why is there so much time and attention paid to the development of indirect rate structures?

In short, the regulators are paying attention and the government contracting marketplace is very competitive. Indications that scrutiny is high include the recent passage of the 2016 NDAA (National Defense Authorization Act) which prohibits DCAA (Defense Contract Audit Agency) from performing any incurred cost audits for non-defense agencies unless DCAA certifies that it is current on incurred cost audit backlog (defined as 18 months of audit inventory). While passage of this act may not specifically indicate increased scrutiny (the backlog may be reduced by waiving certain audits as 'low-risk'), it does indicate bi-partisan interest in clearing the incurred cost backlog which means there will certainly be an increased level of incurred cost audits performed by a presumably more focused DCAA. Other indicators include Congressional pressures on Departments and Agencies to eliminate backlogs, cut waste, eliminate contingencies from Department of Defense (DOD) financial statements, and increase accountability (Section 1003 of the National Defense Authorization Act of 2010 (as amended) and Financial Improvement and Audit Readiness (FIAR) plan).

The enhanced congressional oversight has increased pressures on government agencies when executing contracts. For example, the Department of Defense's Better Buying Power (BBP) initiative's first two focus areas relate to cost accountability:

1. **Achieve Affordable Programs:** Conducting a program at a cost constrained by the maximum resources the Department can allocate for a capability. These resources include funding, schedule and manpower.



2. **Control Costs Throughout the Product Lifecycle:** The ability to understand and control future costs from a program's inception is critical to achieving affordability requirements.

Indirect costs can be a substantial percentage of a program's total contract costs. Variances between budgeted rates and actual rates create funding risks that may cause contract underfunding, delays, or cancellation.

Finally, as noted above, the government contracting marketplace is very competitive. A properly designed indirect rate structure can give a company a competitive advantage in the following areas:

1. **Successful Pricing:** A complete and accurate understanding of the true cost of an activity (i.e. a contract) is a critical success factor in building up costs to support effective pricing. Failure to properly allocate indirect costs results in improperly priced proposals (too high and you lose what you should have won, too low and you win a contract that does not contribute financially).
2. **Demonstrating Efficiencies:** Unfortunately there is a perception among some contracting officers that G&A expenses are administrative fluff. A G&A pool can be reduced by creation of service centers, which capture certain costs traditionally included in G&A pools, and reallocate them back to both overhead and G&A based on logical and consistent allocation bases. Common examples of expenses traditionally included in G&A are computer, human resources, contract administration, etc.
3. **Enhanced Business Practices:** One of the most important factors in maintaining an effective indirect rate structure is constant re-evaluation of the business, specifically including the nature and volume of contracts. As the business changes, so should the indirect rate structure. A common example are companies that significantly increase the proportion of pass-through costs (e.g. subcontractors and/or materials) causing G&A rates to become artificially low when the use of a separate subcontractor/material handling pool would have more correctly allocated costs to their final cost objectives. The application of the artificially low G&A rate becomes an issue when contracts awarded using this pricing become unprofitable as pass-through costs decline and the actual G&A rate increases quickly.

Final Thoughts

An important factor in a government contractor's success in the coming years will be its ability to develop and maintain an effective indirect cost structure that is compliant with requirements of the FAR, meets Department and Agency pressures for program cost accountability, and provides the company with a competitive advantage.



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