



Cost Principles, FAR Part 31 and Direct/Indirect Overhead 2023

Session 4: Indirect Rate Specifics

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Agenda

Recap

Basic Indirect Cost Pools

Advanced Cost Pools

Rates throughout the Contract Life Cycle



RECAP

FAR Part 31 Purpose

- Establish boundaries and parameters regarding allowable costs that can be negotiated and/or claimed under government contracts or subcontracts
- Key Philosophies Embedded in Cost Principles
 - Government does not want to share in costs that it does not cause nor derive a benefit from (“causal and beneficial”)
 - Equitable allocation or identification of costs to government contracts
 - Non-government programs should absorb their share of costs
 - Selected costs in FAR 31.205-XX identified as unallowable are theoretically not created by doing business with government, nor required to sustain contract performance

Indirect Rates Defined – Key Terminology

Allocation Base: Measure of activity such as direct labor dollars used to calculate indirect expense rates and assign costs to cost objectives

Direct costs: Costs associated solely with a specific final cost objective

Final cost objective: Cost objective which has allocated to it both direct and indirect costs and is a final accumulation point in the accounting system – generally a contract

Indirect costs: Costs that cannot be identified to a particular final cost objective and that benefit more than one final cost objective

Intermediate cost objective: Cost objective, created for more accurate allocations, consisting of indirect costs that are ultimately allocated to final cost objectives

Expense Pool: Grouping of homogeneous costs identified with two or more cost objectives; numerator of rate calculation

Indirect Rate: Percentage result of dividing expense pool by allocation base

Total cost input (TCI): All costs, less general & administrative expenses; a common allocation basis for G&A and used in related rate calculation

Indirect Costs

- After direct costs have been determined and charged directly to the contract or other work, indirect costs are those remaining to be allocated to intermediate or two or more final cost objectives.
- No final cost objective shall have allocated to it as an indirect cost any cost, if other costs incurred for the same purpose, in like circumstances, have been included as a direct cost of that or any other final cost objective.
- The contractor shall accumulate indirect costs by logical cost groupings

Allocability

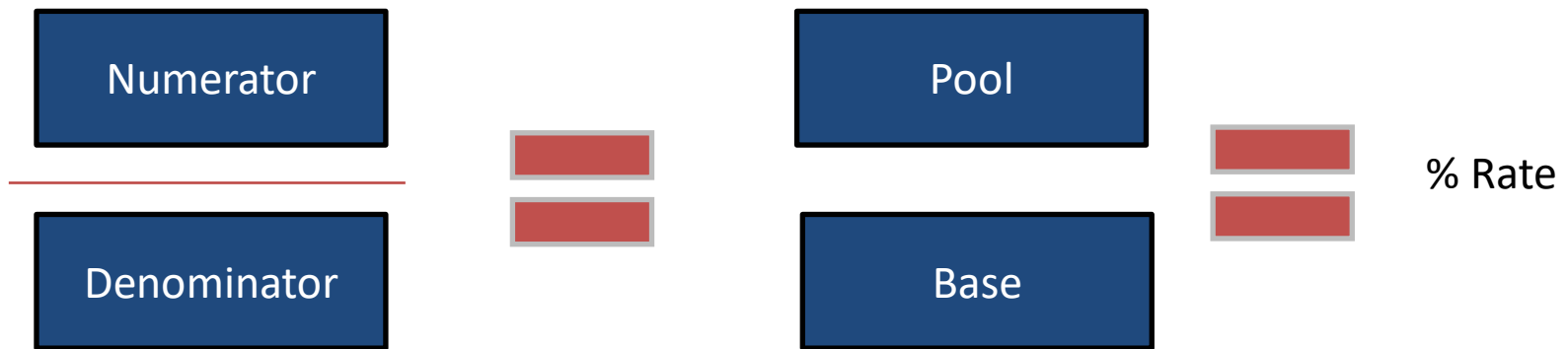
A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship.

A cost is allocable to a Government contract if it-

- Is incurred specifically for the contract (*But for rule*)
- Benefits both the contract and other work, and can be distributed to them in reasonable proportion to the benefits received (*Causal/Beneficial relationship*)
- Is necessary to the overall operation of the business, although a direct relationship to any particular cost objective cannot be shown (*G&A Expenses*)

BASIC INDIRECT POOLS

Rate Pool Basics



- If the base is steady but the pool decreases, the rate
- If the pool is constant and the base decreases, the rate



Fringe

Fringe costs are the cost related to maintaining an employee work force

- Employer payroll taxes
- Employer medical insurance premiums
- Worker's compensation
- 401k contributions (ER)
- Paid leave
- Paid holiday
- Training
- Tuition Assistance
- Fringe bases typically relate to labor
 - Total labor \$
 - Total labor hours
 - Direct Labor (common with A&E firms)

Fringe

Account Description	Account Balance
Vacation/PTO	\$30,000
Holiday	15,000
Sick Leave	25,000
401(k) ER	50,000
Worker's Compensati	25,000
Payroll taxes ER	100,575
State Unemployment	10,500
Federal Unemployme	10,500
Health Insurance ER	95,000
Life Insurance	50,000
Total Fringe Pool	\$411,575
Direct Labor	1,000,000
Indirect Labor	350,000
Total Fringe Base	1,350,000
Fringe Rate	30%

Overhead

Overhead costs are those to support multiple customers, products, or services. Typically, costs cannot be easily direct charged to a contract

- Project supervision
 - Training
 - **Bonuses**
 - Idle time of direct employee
 - Shop supplies
 - Equipment
-
- Typical overhead bases include
 - Direct labor \$ (including allocated fringe)
 - Total prime costs (DL+allocated Fringe+DM)
 - Machine hours (Manufacturing environment)

Overhead

Account Description	Account Balance
Management	\$100,000
Idle time	150,000
Allocated Fringe	76,218
Shop Supplies	50,000
Bonuses	15,000
Indirect Travel	5,000
Total Overhead Pool	\$396,218
Direct Labor	1,000,000
Allocated Fringe	304,870
Total Overhead Base	1,304,870
Overhead Rate	30%

G&A

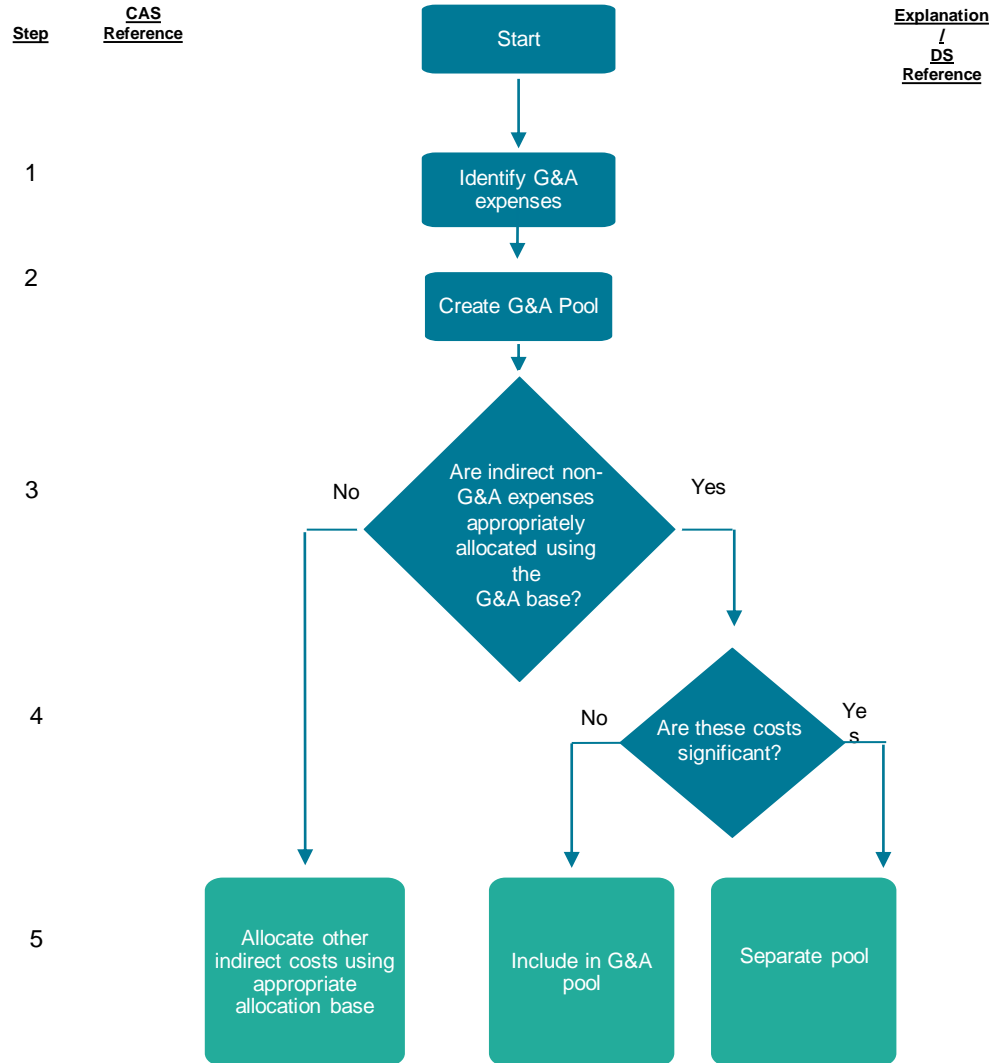
General & Administrative Costs are the costs incurred related to the general operation of a business. These costs are necessary for a company to stay in business and are not directly related to the performance of a program or group of programs.

- Finance & Accounting
- Legal
- Executive Leadership
- Public Relations
- General Insurance
- Treasury
- Typical G&A bases include
 - Total Cost Input
 - Value Add
 - Total Labor Cost

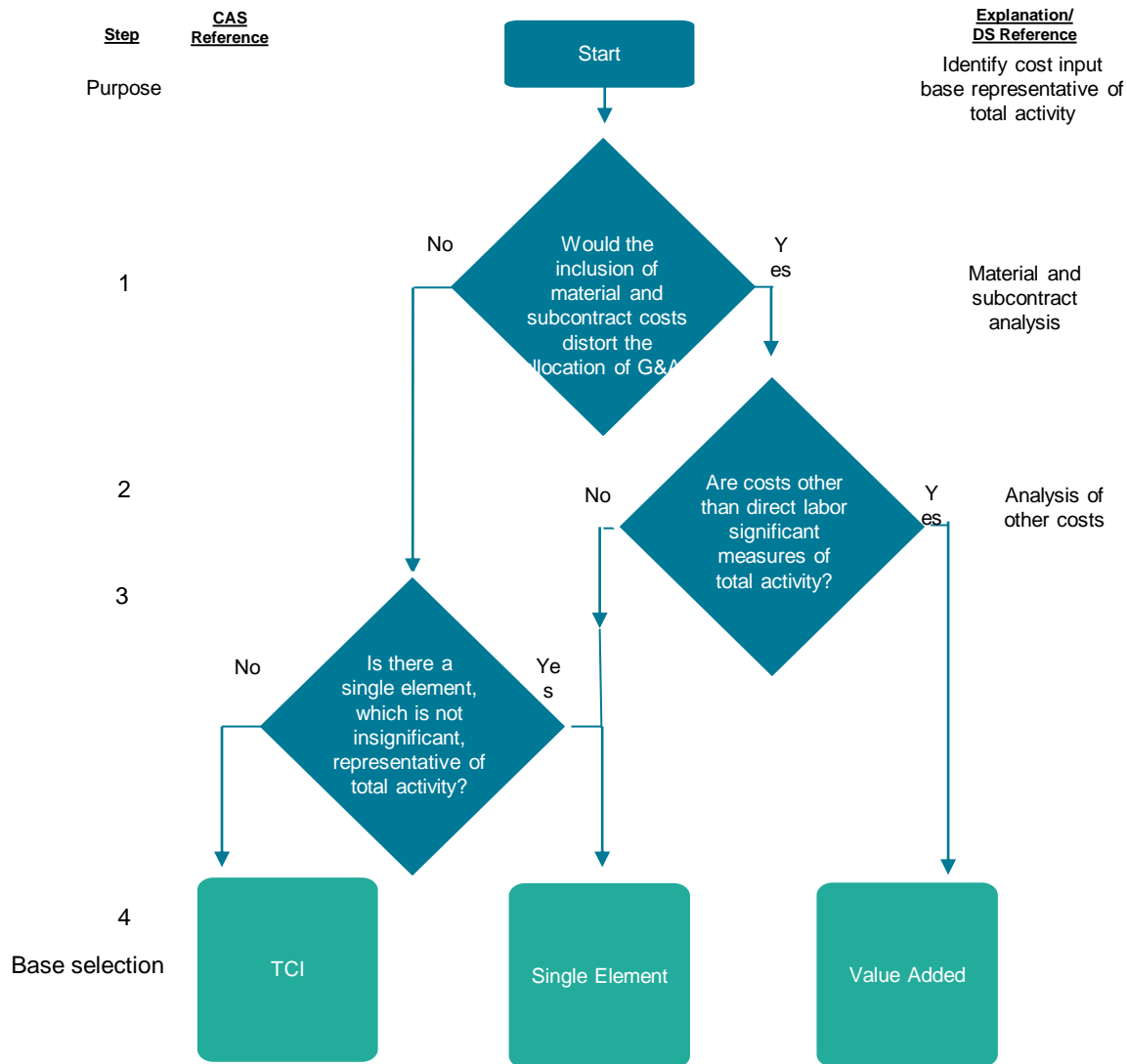
G&A

Cost Center	Account Description	Account Balance
Finance	Salary	\$100,000
Executive	Salary	100,000
Legal	Salary	100,000
	Allocated Fringe	79,660
	External Professional	35,000
	Business Insurance	35,000
	Dues & Subscriptions	10,500
	Bonuses	10,500
	Conferences	9,000
	Facilities	50,000
	Total G&A Pool	\$529,660
	Direct Labor & Allocat	1,265,532
	Overhead Pool	386,383
	Total G&A Base	1,651,915
	G&A Rate	32%

G&A Expense Pool Flowchart



G&A Allocation Base Flowchart



True or False

The government gets to dictate the allocation base of the G&A pool.

ADVANCED COST POOLS

IR&D & B&P

Independent Research & Development (IR&D) and Bid & Proposal (B&P) costs are generally allowable

- IR&D does not include government funded R&D
- Generally allocable to final cost objectives in the same manner as G&A
- Contractors should capture both IR&D and B&P costs in projects

Included in G&A pool

- Treated as direct expense so they receive applied Overhead
- Overhead applied in G&A pool and removed from G&A base

Flow of IR&D

Fringe			Overhead		
Account Description	Account Balance		Account Description	Account Balance	
Vacation/PTO	\$30,000		Management	\$100,000	
Holiday	15,000		Idle time	150,000	
Sick Leave	25,000		Allocated Fringe	66,170	
401(k) ER	50,000		Shop Supplies	50,000	
Worker's Compensation	25,000		Bonuses	15,000	
Payroll taxes ER	100,575		Indirect Travel	5,000	
State Unemployment	10,500		Total Overhead Pool	\$386,170	
Federal Unemployment	10,500				
Health Insurance ER	95,000		Direct Labor	1,000,000	
Life Insurance	50,000		Allocated Fringe	264,678	
Total Fringe Pool	\$411,575		Total Overhead Base	1,264,678	
Direct Labor	1,000,000		Overhead Rate	31%	
Indirect Labor	555,000				
Total Fringe Base	1,555,000				
Fringe Rate	26%				
G&A			Project 001 - IR&D		
Cost Center	Account Description	Account Balance	Account Description	Account Balance	
Finance	Salary	\$100,000	Labor	5,000	
Executive	Salary	100,000	Materials	2,000	
Legal	Salary	100,000	Applied Fringe	1,323	
	Allocated Fringe	79,404	Overhead	1,931	
	Project 001 - IR&D	10,254	Total IR&D Project Cost	10,254	
	External Professional Fees	35,000			
	Business Insurance	35,000			
	Dues & Subscriptions	10,500			
	Bonuses	10,500			
	Conferences	9,000			
	Facilities	50,000			
	Total G&A Pool	\$539,658			
			Check on Indirect Labor	\$555,000	
	Direct Labor & Allocated Fringe	1,264,678			
	Overhead Pool (Less OH applied to IR&D)	384,239			
	Total G&A Base	1,648,917			
	G&A Rate	33%			

IR&D & B&P

There are a number of Part 31 clauses FAR § 31.205-18 Independent Research and Development and Bid and Proposal Costs

- FAR § 31.205-23 Losses on Other Contracts
- FAR § 31.205-25 Manufacturing and Production Engineering Costs
- FAR § 31.205-32 Precontract Costs
- FAR § 31.205-38 Selling Costs
- FAR § 31.205-48 Research and Development Costs

IR&D – Tread Carefully

Contractor's must correctly classify their IR&D as either a contract cost or IR&D, B&P, selling, M&PE or other R&D effort

More importantly, pay extremely close attention to the data rights clauses in your contract. You want to be very careful about the IP and rights to data that you convey to the government

- Good legal counsel can assist with determining whether it's in your best interest to allocate these costs to the government

More Complex Structures

- As company's grow, they often implement more complex structures
- Complexity can be driven by types of products/services, locations, etc.
- Common examples include:
 - Creation of an IT pool
 - Allocation represents Usage (may allocate over # of devices)
 - Costs include personnel, telephone, internet, web services, etc.
 - Creation of facilities pool
 - Allocation typically represents usage, i.e., SF
 - Costs include personnel, rent, depreciation, maintenance, utilities, etc.
 - Other sample service centers include payroll, transportation, security, etc.
 - Multiple overhead rates
 - Multiple fringe rates

More Complex Structures

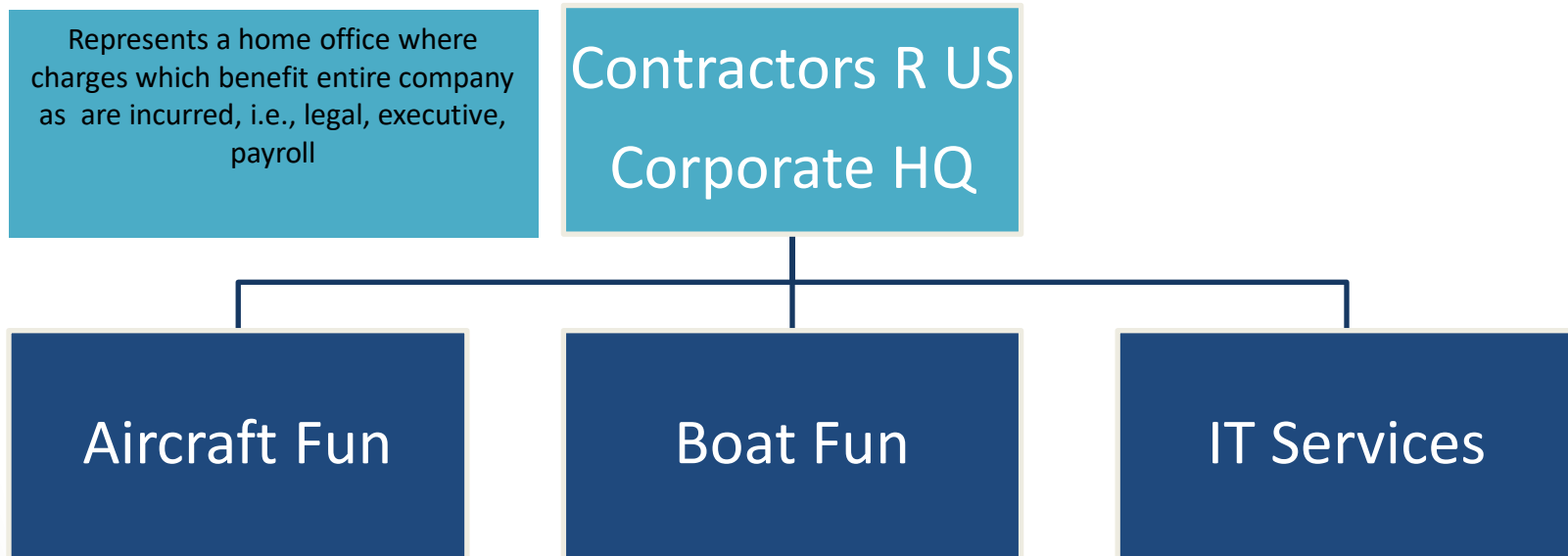
Guiding Principles

- KISS (Keep it simple stupid) and make sure you have the systems to support your allocations
- Align your general ledger structure with your rate structure
- Make sure your base and pool structures are easily identifiable and segregable
- Make sure you're the size of your base and pool is large enough to be stable. Too small of a base can lead to volatile indirect rates
- Align your rate structure with how you do work
- Do not change your rate structure for one contract

Material Handling

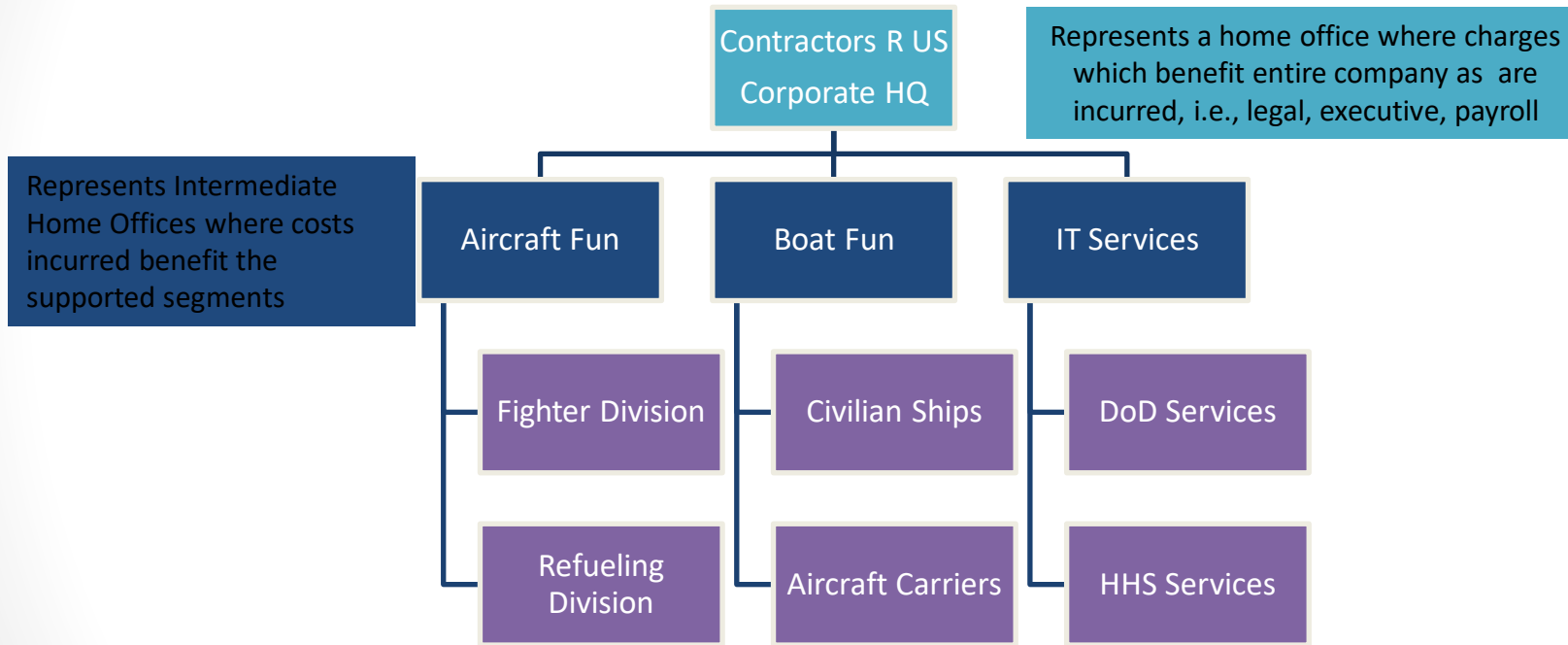
- Contractors with significant material and/or subcontractors often remove the costs related to administration and support from G&A and create a separate M&H rate
 - Government often questions the loading of these costs with the full G&A rate and it can be difficult to demonstrate the benefit to the government from that allocation
 - The G&A is then allocated over a Value Add base (TCI less subcontracts and materials)
- The new M&H pool includes costs such as subcontract administration, purchasing & payables
- The new M&H pool allocates over the cost of subcontracts and materials

Sample Home Office Structure



These boxes represent segments who receive allocations from the corporate Home Office.

Sample Home Office Structure With IHO



These boxes represent segments who receive allocations from the corporate Home Office.

Home Office & Intermediate Home Office Pools

- Home office expenses represent the corporate costs of entity which has multiple business segments or divisions
- Contractors must group costs into homogenous cost pools to allocate costs to the business segments (CAS 403)
- Generally, 3 types of home office expenses
 - Expenses incurred for specific segments
 - Expenses that have a clear relationship (i.e. measurable with reasonable objectivity) to two or more segments
 - Residual expenses

Home Office & Intermediate Home Office Pools

- Expenses that are incurred for specific segments are to be allocated directly to those segments
- Expenses that are not directly allocable should be grouped in logical and homogeneous expense pools and distributed over allocation bases reflecting the relationship of the expenses to the segments concerned
 - Centralized service functions are to be allocated to segments on the basis of the service furnished to or received by each segment. Examples include centrally performed personnel administration and centralized data processing.
 - Staff management or policy guidance functions shall be allocated to segments receiving more than a minimal benefit over a base (or bases) representative of the total specific activity being managed.
 - Line management shall be allocated only to the particular segment or group of segments which are being managed or supervised.
 - Central payments or accruals shall be allocated directly to segments to the extent that all such payments or accruals of a given type or class can be identified specifically with individual segments. Examples of central payments include pension, insurance, state and local taxes, payrolls, etc

Goal is to minimize the residual expenses to be allocated to segments

Residual Home Office Expenses

First a contractor must determine if the residual expenses are material

Materiality calculation:

- Compare the residual expense pool to the aggregate operating revenue of the segments
 - 3.35 percent of the first \$100 million
 - 0.95 percent of the next \$200 million
 - 0.30 percent of the next \$2.7 billion
 - 0.20 percent of amounts over \$3 billion

If the residual pool is material a 3 Factor Formula is prescribed

Residual Home Office Expenses

- The three-factor formula is the ratio of:
 - a segment's payroll dollars
 - operating revenue (net of interdivisional purchases)
 - average net book values of tangible capital assets and inventories (net of progress payment billings)
 - to the total corporate payroll dollars, operating revenue and tangible capital assets
- Not uncommon for services based companies to negotiate a 2FF

My Company has a home office pool:

- True
- False

RATES THROUGHOUT THE CONTRACT LIFECYCLE

Provisional billing rates

Provisional billing rates are often a contractor's first step into the world of indirect rates

Provisional billing rates are the indirect cost rates used to bill the government on cost-reimbursable contracts.

- These rates are calculated prior the start of a fiscal year based on budget
- Rates should be monitored throughout the year and adjusted if the variance is significant
- ***At the end of the fiscal year, the contractor performs a true up to actuals via the Incurred Cost Proposal (ICP)***
 - If the the contractor under ran its rates, it will owe the government money
 - If the contractor over ran its rates, it may be able to recover from the government

Provisional billing rate package

Provisional Billing Rate package should include:

- Proposed billing rate calculations (Pool and Base) with brief rationale
- Prior fiscal year (FY) pool and base
- Current FY to date pool and base
- Current FY budget pool and base, if available
- Comparative analysis with explanation of any significant differences



DCAA Review

DCAA review is not required but may be requested

Typically not a full audit

Steps may include:

- Compare proposed pool and base to prior year and year-to-date pool and bases.
- Review trend of questioned costs in relevant incurred cost audits and consider an adjustment for unallowable expenses in calculating current year provisional billing rates.

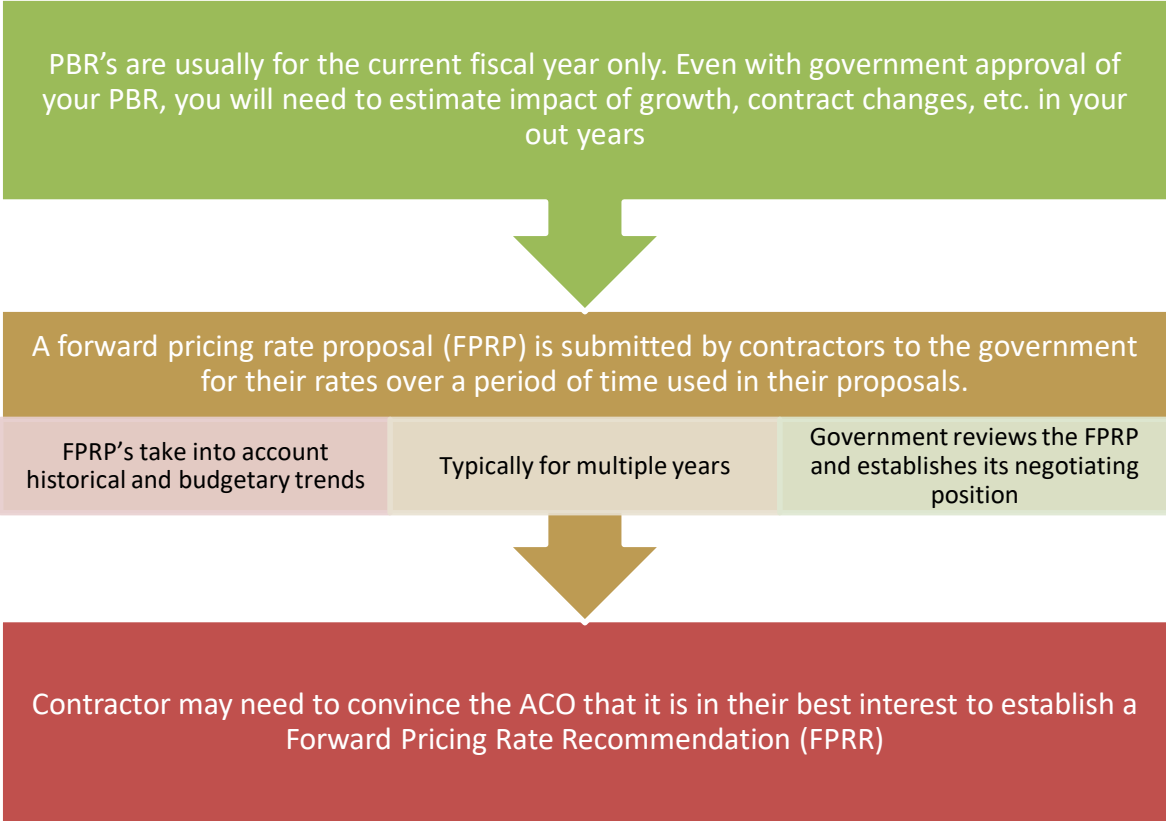


Provisional Billing rates

Challenges for contractors new to the PBR process:

- I don't have an ACO who do I submit my PBR to?
- I submitted my PBR but I haven't heard anything. What do I do?
- My prime contractor won't accept my PBR

PBR vs Forward Pricing Rate Proposal



FPRP Components

The contractor's FPRP should explain how rates were derived for the out years.

- For example, flat-lining of the out-year rates with no explanation of why the rates do not change is not adequate.
- Adjustments to out-year pools and bases should be made based on reasonable sales forecasts and the contractor's assumptions for changes to major groupings of costs (e.g., variable, semi-variable, and fixed).

The proposal should also contain "an appropriate level of documentation with any supporting data provided by the contractor."

- The ACO shall consider the specific contractor and pending contract awards in determining whether the contractor has provided documentation which adequately supports the contractor's FPRP.
- Smaller contractors may not develop detailed budgetary data because it is impractical for their organization.
- Smaller contractors often assert that historical costs are the most appropriate basis to estimate out-year rates. In these cases, the contractor should provide the necessary trend data with appropriate explanations to support a conclusion that historical costs are the most reasonable for forecasting out-year rates (FAR 15.406-3(e))

Forward Pricing Rate Adequacy

DFARS 215.403 contains instructions for the evaluation of FPRPs

Table 215.403-1 is the “Adequacy Checklist” that ACO’s evaluate the FPRP against

• https://www.acq.osd.mil/dpap/dars/dfars/html/current/215_4.htm-215.403-5

Contracting officers often request that the contractor complete the Checklist and submit it with the forward pricing rate proposal

ACOs shall complete an FPRR within 30 calendar days of the contractor’s adequate forward pricing rate proposal (FPRP) submission and strive to complete an FPRR within 60 days of the adequate FPRP submission

True or False

Contractors are required to submit a Forward Pricing Rate Proposal (FPRP)

Next Session

- Identification of Direct Costs
- Timekeeping Challenges
- Floorchecks and audits
- Direct Cost challenges
- Documenting Direct Costs

QUESTIONS?

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APPENDIX

Adequacy Checklist Layout

Item No.	Submission Item	Proposal Page No. (if applicable)	If not provided, Explain (may use continuation pages)
1-8		General Instructions	
9-11		Direct Labor	
12-21		Indirect Rates (Fringe, Overhead, G&A, etc.)	
22		Cost of Money (COM)	
23-24		Other	

	<u>SUBMISSION ITEM</u>	<u>PROPOSAL PAGE No. (if applicable)</u>	<u>If not provided, EXPLAIN (may use continuation pages)</u>
<u>GENERAL INSTRUCTIONS</u>			
1.	<p>Is there a properly completed first page of the proposal as specified by the contracting officer? Initial proposal elements include:</p> <ol style="list-style-type: none"> a. Name and address of contractor; b. Name and telephone number of point of contact; c. Period covered; d. The page of the proposal that addresses— <ol style="list-style-type: none"> 1. Whether your organization is subject to cost accounting standards (CAS); 2. Whether your organization has submitted a CAS Disclosure Statement, and whether it has been determined adequate; 3. Whether you have been notified that you are or may be in noncompliance with your Disclosure Statement or CAS (other than a noncompliance that the cognizant Federal agency official had determined to have an immaterial cost impact), and if yes, an explanation; 4. Whether any aspect of this proposal is inconsistent with your disclosed practices or applicable CAS, and, if so, an explanation; and whether the proposal is consistent with established estimating and accounting principles and procedures and FAR part 31, Cost Principles, and, if not, an explanation; e. The following statement: "This forward pricing rate proposal reflects our estimates, as of the date of submission entered in (f) below and conforms with Table 215.403-1. By submitting this proposal, we grant the Contracting Officer and authorized representative(s) the right to examine those records, which include books, documents, accounting procedures and practices, and other data, regardless of type and form or whether such supporting information is specifically referenced or included in the proposal as the basis for each estimate, that will permit an adequate evaluation of the proposed rates and factors."; f. Date of submission; and g. Name, title, and signature of authorized representative. 	Proposal Cover Page	

2.	Summary of proposed direct and indirect rates and factors, including the proposed pool and base costs for each proposed indirect rate and factor.	Immediately following the proposal cover page	
3.	<p>Table of Contents or index.</p> <p>a. Does the proposal include a table of contents or index identifying and referencing all supporting data accompanying or identified in the proposal?</p> <p>b. For supporting documentation not provided with the proposal, does the basis of each estimate in the proposal include the location of the documentation and the point of contact (custodian) name, phone number, and email address?</p>	Proposal Cover Page	

4.	<p>Does the proposal disclose known or anticipated changes in business activities or processes that could materially impact the proposed rates (if not previously provided)? For example—</p> <ul style="list-style-type: none"> a. Management initiatives to reduce costs; b. Changes in management objectives as a result of economic conditions and increased competitiveness; c. Changes in accounting policies, procedures, and practices including (i) reclassification of expenses from direct to indirect or vice versa; (ii) new methods of accumulating and allocating indirect costs and the related impact; and (iii) advance agreements; d. Company reorganizations (including acquisitions or divestitures); e. Shutdown of facilities; or f. Changes in business volume and/or contract mix/type. 		
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5.	Do proposed costs based on judgmental factors include an explanation of the estimating processes and methods used, including those used in projecting from known data?		
6.	Does the proposal show trends and budgetary data? Does the proposal provide an explanation of how the data, as well as any adjustments to the data, were used?		
7.	The proposal should reconcile to the supporting data referenced. If the proposal does not reconcile to the supporting data referenced, identify applicable page(s) and explain.		
8.	The proposal should be internally consistent. If the proposal is not internally consistent, identify applicable page(s) and explain.		

<u>Direct Labor</u>			
9.	<p>Direct Labor Rates Methodology and Basis of Each Estimate.</p> <p>a. Does the proposal include an explanation of the methodology used to develop the direct labor rates and identify the basis of each estimate?</p> <p>b. Does the proposal include or identify the location of the supporting documents for the base-period labor rates (e.g., payroll records)?</p>		
10.	Does the proposal identify escalation factors for the out-year labor rates, the costs to which escalation is applicable, and the basis of each factor used?		
11.	Does the proposal identify planned or anticipated changes in the composition of labor rates, labor categories, union agreements, headcounts, or other factors that could significantly impact the direct labor rates?		

Indirect Rates (Fringe, Overhead, G&A, etc.)			
	Indirect Rates Methodology and Basis of Each Estimate.		
12.	a. Does the proposal identify the basis of each estimate and provide an explanation of the methodology used to develop the indirect rates? b. Does the proposal include or identify the location of the supporting documents for the proposed rates?		
13.	Does the proposal identify indirect expenses by burden center, by cost element, by year (including any voluntary deletions, if applicable) in a format that is consistent with the accounting system used to accumulate actual expenses?		
14.	Does the proposal identify any contingencies?		
15.	Does the proposal identify planned or anticipated changes in the nature, type, or level of indirect costs, including fringe benefits?		
16.	Does the proposal identify corporate, home office, shared services, or other incoming allocated costs and the source for those costs, including location and point of contact (custodian) name, phone number, and email address?		
17.	Does the proposal separately identify all intermediate cost pools and provide a reconciliation to show where the costs will be allocated?		
18.	Does the proposal identify the escalation factors used to escalate indirect costs for the out-years, the costs to which escalation is applicable, and the basis of each factor used?		
19.	Does the proposal provide details of the development of the allocation base?		
20.	Does the proposal include or reference the supporting data for the allocation base such as program budgets, negotiation memoranda, proposals, contract values, etc.?		
21.	Does the proposal identify how the proposed allocation bases reconcile with its long range plans, strategic plan, operating budgets, sales forecasts, program budgets, etc.?		

Cost of Money (COM)			
22.	<p>Cost of Money.</p> <p>a. Are Cost of Money rates submitted on Form CASB-CMF, with the Treasury Rate used to compute COM identified and a summary of the net book value of assets, identified as distributed and non-distributed?</p> <p>b. Does the proposal identify the support for the Form CASB-CMF, for example, the underlying reports and records supporting the net book value of assets contained in the form?</p>		
OTHER			
23.	Does the proposal include a comparison of prior forecasted costs to actual results in the same format as the proposal and an <u>explanation/analysis of any differences?</u>		
24.	If this is a revision to a previous rate proposal or a forward pricing rate agreement, does the new proposal provide a summary of the changes in the circumstances or the facts that the contractor asserts require the change to the rates?		