Indirect Cost Rates
The hidden contract cost driver?

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1. Increase knowledge of indirect costs – why have them and how do they work

2. Enhance understanding – why and how indirect cost rates can change

3. Realize government decisions to delay or cancel programs can impact other programs

4. Grasp why increased indirect cost rates have a potential negative impact on many government contracts
Volume of government contracts – substantial percentage of DoD dollars are used for contracts

Indirect costs represent a large part of total contract costs

Indirect costs are important to contractors on all contracts, but most important to government on cost reimbursement contracts

Indirect cost rates can change—usually higher

Higher indirect cost rates usually = need more $ for the contract
A few basic terms and concepts.....

Key to focusing on Indirect Costs Rates and how they work.
Total Costs = Direct Costs + Indirect Costs

- Direct Labor Costs
- Direct Material Costs
- Other Direct Costs
- General & Admin (G&A) Costs
- Overhead Costs
- Indirect Costs
A contract or other work unit for which cost data are desired and provisions made in the accounting system to accumulate and measure costs.
A cost that can be tracked directly to one specific cost objective. Includes direct materials, direct labor and other costs traceable direct to that single cost objective.
A cost **not** directly identified with one specific cost object but identified with **two or more** cost objectives.

**Indirect Costs**
Indirect Cost Types

• Overhead Costs: Indirect costs that support a specific part or function of the company but not the entire company.

• General & Admin (G&A) Costs: Broad type of expense incurred by or allocated to a business unit for the general management and admin of the business as a whole.
<table>
<thead>
<tr>
<th>Definition:</th>
<th>A collection of indirect costs that are similar to each other.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Process:</td>
<td>Determine what makes the indirect costs similar; put similar costs in a named “account” (in the financial accounting records); and allocate cost pool to the benefiting cost objectives on pro rata share.</td>
</tr>
<tr>
<td>Why Have them?</td>
<td>Putting similar indirect costs together in a pool and spreading (allocating) those costs to cost objectives can be done with one mathematical calculation versus many.</td>
</tr>
</tbody>
</table>
Cost Pool Examples:

**Engineering Overhead** (includes cost of indirect engineering labor, fringe benefits relating to that labor, supplies for the engineers, etc.)

**Material Handling Overhead** (includes cost of equipment to move materials, warehouse labor storage, etc.)

**Facilities Overhead** (includes cost of building rent and maintenance, utilities, supplies for the building, etc.)

**General and Administrative (G&A)** (includes cost for senior managers, HR office, IT, controller, etc.)
Management of Indirect Costs

For Cost Reimbursement Contracts:

- Contractor is responsible for setting up indirect cost pool accounts and managing all indirect costs incurred on Defense contracts.

- Contractors are required to set up a minimum of two types of indirect cost pools for Defense contracts: “Overhead”: supports a specific part or function of company “G&A”: supports general operations of company rather than any one specific part.

- No maximum number of indirect cost pools, but……
•Considerations for establishing indirect cost pools and determining cost allocation basis (i.e., rates):

  ✓ The FAR [31-203(b)] requires indirect costs be accumulated by logical cost groupings.

  ✓ The CASB states “homogeneous costs” are to be aggregated in a separate cost pool.

  ✓ EVMS guidelines address indirect cost management – it is one of nine EVM business processes. Three of the thirty-two EVMS guidelines specially cover overhead management; recording and allocating indirect costs; and analyzing indirect cost variances.

  ✓ Allocation of cost pools should be done on a base common to all cost objectives to which the costs will be allocated.

Note: CASB=Cost Accounting Standards Board (unique to Federal Government)
Government allows contractors to use one or more of the following factors as the base to determine their indirect cost allocation rates:

<table>
<thead>
<tr>
<th><strong>Base</strong></th>
<th><strong>To Determine</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Labor Dollars, Direct Labor Hours</td>
<td>Manufacturing and Engineering Overhead</td>
</tr>
<tr>
<td>Direct Material Dollars</td>
<td>Material Handling</td>
</tr>
<tr>
<td>Total Cost Input (TCI) (All costs except G&amp;A)</td>
<td>G&amp;A Costs</td>
</tr>
</tbody>
</table>
Calculation of Indirect Cost Rate

Indirect Cost Rate *(For a Given Cost Pool) = \frac{\text{Total Indirect Costs in Given Pool}}{\text{Applicable Allocation Base}}

Examples

<table>
<thead>
<tr>
<th>*Cost Pool Types</th>
<th>*Applicable Allocation Base:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Manufacturing Overhead</td>
<td>- Direct Manufacturing Labor Dollars</td>
</tr>
<tr>
<td>Manufacturing Overhead</td>
<td>- Direct Manufacturing Labor Hours</td>
</tr>
<tr>
<td>Engineering Overhead</td>
<td>- Direct Engineering Labor Dollars</td>
</tr>
<tr>
<td>Engineering Overhead</td>
<td>- Direct Engineering Labor Hours</td>
</tr>
<tr>
<td>Material Handling</td>
<td>- Direct Materials Costs</td>
</tr>
<tr>
<td>G &amp; A Costs</td>
<td>- Total Cost Other than G&amp;A</td>
</tr>
</tbody>
</table>
Calculate the rates for each pool – with G&A rate based on a Total Cost Input basis

<table>
<thead>
<tr>
<th>Company XYZ has the following direct and indirect costs</th>
<th>Rate = Pool / Base</th>
</tr>
</thead>
<tbody>
<tr>
<td>Material Handling Expense Pool</td>
<td>$ 500</td>
</tr>
<tr>
<td>Direct Material Cost</td>
<td>$ 5,000</td>
</tr>
<tr>
<td>Engineering Overhead Expense Pool</td>
<td>$ 320</td>
</tr>
<tr>
<td>Engineering Direct Labor Cost</td>
<td>$ 400</td>
</tr>
<tr>
<td>Manufacturing Overhead Expense Pool</td>
<td>$ 5,200</td>
</tr>
<tr>
<td>Manufacturing Direct Labor Cost</td>
<td>$ 1,600</td>
</tr>
<tr>
<td>Other Direct Costs (ODC)</td>
<td>$ 1,000</td>
</tr>
<tr>
<td>Total Cost Input</td>
<td>$ 14,020</td>
</tr>
<tr>
<td>General &amp; Administrative Expense Pool</td>
<td>$ 1,680</td>
</tr>
</tbody>
</table>
# Allocation of Indirect Costs

Using rates previously calculated, develop the total cost of a program, project or product with indicated direct costs.

<table>
<thead>
<tr>
<th>Direct and Allocated Indirect Costs</th>
<th>Base x Rate = Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct Material Cost</td>
<td>$ 25.00</td>
</tr>
<tr>
<td>Allocated Material Handling Expenses</td>
<td>$ 2.50</td>
</tr>
<tr>
<td>$ 25 x 10 % = $ 2.50</td>
<td></td>
</tr>
<tr>
<td>Engineering Direct Labor Cost</td>
<td>$ 60.00</td>
</tr>
<tr>
<td>Allocated Engineering Overhead Expenses</td>
<td>$ 48.00</td>
</tr>
<tr>
<td>$ 60 x 80 % = $ 48.00</td>
<td></td>
</tr>
<tr>
<td>Manufacturing Direct Labor Cost</td>
<td>$ 50.00</td>
</tr>
<tr>
<td>Allocated Manufacturing Overhead Expenses</td>
<td>$ 162.50</td>
</tr>
<tr>
<td>$ 50 x 325 % = $ 162.50</td>
<td></td>
</tr>
<tr>
<td>Other Direct Costs (ODC)</td>
<td>$ 10.00</td>
</tr>
<tr>
<td>Total Cost Input</td>
<td>$ 358.00</td>
</tr>
<tr>
<td>Allocated General &amp; Administrative Expenses</td>
<td>$ 42.96</td>
</tr>
<tr>
<td>$ 358 x 12 % = $ 42.96</td>
<td></td>
</tr>
<tr>
<td>Total Cost for Program</td>
<td>$ 400.96</td>
</tr>
</tbody>
</table>

Applying the company-level rates for a specific project.
Computation of Total Cost of A Project
Cost Accounting for Direct and Indirect Costs

**Direct Materials**
- $25

**Direct Labor**
- Engineering: $60
- Manufacturing: $50

**Other Direct Costs**
- $10

**Direct Materials**
- $25.0

**DL - Engineering**
- $60.0

**DL - Manufacturing**
- $50.0

**Other Direct Costs**
- $10.0

**Total Direct Costs**
- $145.0

**Materials Handling**
- $25 x 10% = $2.5

**Indirect Engineering**
- $60 x 80% = $48.0

**Indirect Manufacturing**
- $50 x 325% = $162.5

**Materials Handling Overhead**
- $25 x 10% = $2.5

**General & Administrative Costs**
- $42.96

**Project Total Cost**
- $400.96

Applying the company-level rates for a specific project.
Quick Review

Types of Costs

Direct Costs

Indirect Costs

Indirect Cost Pools

Cost Objectives

Total Costs = Direct Costs + Indirect Costs
Total Project Cost

Direct Costs

Indirect Costs

A + B + C

Total Project Cost
Indirect Costs Allocation

Indirect Cost Rate = Pool/Allocation Base
Indirect Costs Allocation

Fixed Cost Example – Allocation Base: Square Footage

Indirect Costs

$120,000

A
20,000 SQ. FT

B
30,000 SQ. FT

C
10,000 SQ. FT

Indirect Cost Rate = Pool/Allocation Base

Rate = $120,000
60,000
= $2.00@sq.ft
Indirect Costs Allocation

Rate = $120,000 \[\frac{60,000}{60,000}\] = $2.00@sq.ft

\[
\begin{align*}
\text{Indirect Costs} & = 20,000 \text{ SQ. FT} \times 2.00 @ \text{sq.ft} \\
& = 30,000 \text{ SQ. FT} \times 2.00 @ \text{sq.ft}
\end{align*}
\]

\[
\begin{align*}
\text{Indirect Costs} & = 40,000 + 20,000 + 60,000 \\
& = \$120,000
\end{align*}
\]
Questions
Evolving Indirect Cost Rates

Rates Differ Depending on Phase of Contract

Proposal Phase

Performance Phase

Close-out Phase

Note: This concept applies only to cost reimbursement contracts.
These are “Future Indirect Rates”

• **Contractor submits to the government** –
  - A contract proposal per RFP
  - A Forward Pricing Rate proposal for:
    - Direct labor rates for various disciplines
    - Indirect cost rates based on total *estimated* revenues and indirect costs

• **Government evaluates contractor proposals**
• **Government and contractor negotiate both** the direct labor rates and indirect cost rates
• **“Agreed to”** rates become part of the contract
• **Result is Forward Pricing Rate Agreement (FPRA)**
These are “Billing Rates”

• Billing rates are:
  ✓ Applicable to *only* indirect costs
  ✓ Based on estimated indirect costs (e.g., overhead)
  ✓ Temporary and applicable during period of contract performance
  ✓ Adjusted during contract performance to reflect indirect costs *actually* incurred vs. estimates

• Importance of billing rates:
  ✓ Basis for invoices and payment to contractor
  ✓ Reimbursement of contractor’s actual indirect costs in timely manner
These are “End-of-Performance Actual Rates”

- Indirect cost pool accounts are audited to verify allowability of costs in that pool
- Valid indirect costs actually incurred are compared to indirect costs estimated during Proposal Phase and modified during Performance Phase
- “Actual” indirect rates computed based on “actual” indirect costs incurred – subject to negotiation between government and contractor
- Final contract price is based on actual direct costs incurred plus application of “actual” indirect rates = usually, higher costs

Contract close-out takes at least 5 to 7 years after award
On a Cost Reimbursement Contract, What Costs will the Government Reimburse the Contractor?

Answer: The government will pay all “allowable” costs

- Direct costs are generally allowable if they are reasonable
- Allowability issues generally occur with indirect costs

There is no commercial market equivalent to the concept of “allowable” costs
Why Indirect Cost Rates Change

Causes Internal to company—

- Lose focus on indirect costs—improperly managed
- Estimates of future business incorrect – revenue base used to develop estimates
- Increased material and labor costs due to inefficiencies—scrap, rework, turnover of personnel

Causes External to company—

- Government programs delayed – originally included in business base for developing estimates
- Government programs cancelled – same as programs delayed
- Vendors increase their prices
Impact of change……

If allocation base decreases – indirect cost rates increase

If allocation base increases – indirect cost rates decrease

Assuming Total Indirect Costs in a given pool remain unchanged.
Indirect Costs Allocation

Rate = $120,000 / 60,000 = $2.00@sq.ft

A
20,000 SQ. FT
X 2.00 @ sq.ft
$40,000

B
10,000 SQ. FT
X 2.00 @ sq.ft
$20,000

C
30,000 SQ. FT
X 2.00 @ sq.ft
$60,000

Indirect Costs = $120,000

= $40,000 + $20,000 + $60,000
Indirect Costs

$120,000 = $40,000 + $20,000 + $60,000

Rate = $120,000 / 30,000 = $4.00@sq.ft

Loss of Program/Revenue
Impact of Increased Rate Changes

**Contractor**

- Rate increase – impacts competitiveness
- Reduces profits or increases losses on fixed price contracts
- Affects Earned Value Management System

**Government**

- Fixed Price contracts – no cost impact
- Cost Reimbursement – contract costs increase; impacts budgets/funding; affects EAC calculations
Increased indirect rates usually equate to higher costs.

Depending on type of contract, higher rates could mean additional funding is required:

- **Cost Reimbursement** – Increased costs resulting in cost overruns and need for additional funds
- **FFP** – increased costs are borne by contractor; however, this may mean closer scrutiny due to contractor looking for ways to cut costs
Desired Results of Presentation

- Increased knowledge of indirect costs and their potential impact on contracts – usually means additional funding will be required, depending on type of contract.

- Enhanced understanding how indirect cost rates are calculated; the different types of indirect cost rates; and why they change.

- Understanding that government decisions regarding a program can impact a contractor through no fault of the contractor, which may impact other government programs.
QUESTIONS?

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DAU Mission

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- Mission assistance to acquisition organizations
- Online knowledge sharing resources
- Continuous learning assets
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CL Modules - Online, self-paced learning modules
Conferences - PEO / SYSCOM, Business Managers, DAU Acquisition Community Symposium

Knowledge Sharing
DAP - Online portal to Big A & HCI knowledge
ACC - DoD's online collaborative communities
Virtual Library - Online connection to DAU research collection

Mission Assistance
Consulting - Helping organizations solve complex acquisition problems
Targeted Training - Tailored organizational training
Rapid Deployment Training - On-site & online training on the latest AT&L policies

Formal & informal learning at the point of need