



A Beginner's Guide to Indirect Rates & Trends in Government Contracting

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Meet the Presenter



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Agenda

1. Introductions
2. Types of Cost
3. Direct and Indirect Costs and Rates
4. Cost Allowability
5. Trends and Hot Topics
6. Questions

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Types of Cost

- Direct Costs
- Indirect Costs

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Composition of Total Cost - FAR 31.201-1

- Direct cost - FAR 31.202
- Indirect cost - FAR 31.203
- Cost of Money – FAR 31.205-10



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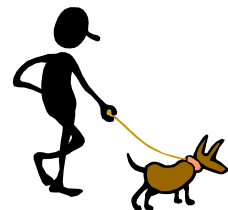
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Direct Cost - FAR 31.202

- A direct cost can be specifically identified with a particular final cost objective.
- Rule of 5. To be a direct cost, it must be:
 - able to be measured
 - capable of being accumulated
 - worth tracking
 - able to be estimated
 - able to be sold to the customer
- Similar costs incurred for the same purpose must also be a direct cost.
- Insignificant direct costs can be treated as indirect costs



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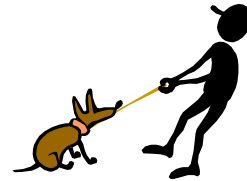
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Indirect Cost - FAR 31.203

- A cost not directly identified with a single final cost objective. Left over after all direct costs are assigned.
- Includes overhead and G&A
- Rule of 4. For indirect costs, you must be able to:
 - track pool and base
 - generate timely reports
 - project the rates with some certainty
 - sell the rates to a customer
- Similar costs incurred in similar circumstances must also be indirect.
- Must select an allocation base with a causal or beneficial relationship to the pooled costs.



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Indirect Cost Structures

- Established by contractor
- Dependent upon nature of business environment
 - Functional considerations
 - Off-site versus on-site considerations
 - Management informational needs
- Often more than one method is acceptable
- Should result in equitable distribution of indirect costs to final cost objectives

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More on indirect costs

- No fragmenting the base by removing individual elements
- All items properly includable in base to bear a pro rata share regardless of acceptance as Government contract costs
- Method may require revision for significant change in the nature of the business
- Offsite rates may be necessary for equitable distribution
- Fiscal year used for accumulation and distribution of indirect costs
- Exception for fiscal year changes due to business combinations

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Allocating Indirect Cost

- Use an allocation base common to all cost objectives to which the grouping is to be allocated
- Base has causal or beneficial relationship to cost grouping
- Number and composition of cost groupings
 - Should be governed by practical considerations
 - Should not unduly complicate the allocation

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Allocating Indirect Costs

- Pool – logical grouping of indirect costs with similar relationship to the cost objective(s)
- Base – direct activity that will be used to allocate pool costs (causal beneficial relationship)
- Allocation (Indirect) Rate – Pool divided by Base
- Same cost can not be in both pool and base

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Allocation of Indirect Costs

$$\text{rate} = \frac{\text{indirect-cost pool expenses}}{\text{allocation base}}$$

- Allocation of Overhead
 - Labor Based – Labor \$ or hours
 - Material Based – Material \$
- Allocation of General and Administrative Expenses
 - Total Cost Input
 - Value-Added Base
 - Single Element
- Wrap Rates

Direct Labor		1.00
Fringe	20%	<u>0.20</u>
Subtotal		1.20
Overhead	5%	<u>0.06</u>
Subtotal		1.26
G&A	25%	<u>0.32</u>
Wrap Rate		1.575

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Service Centers

- Service Center = Cost Pool
- Costs are allocated on some measureable element other than cost based on the use of the service
- Provides information on the cost of providing the service
- Costs may be allocated to contracts, other indirect pools, or other service centers
- Examples:
 - IT / Help Desk
 - Facilities
 - Accounts Payable
 - HR

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Home Office Expenses

- Costs need to be allocated on a base that reflects a causal or beneficial relationship
- Three steps to the allocation process:
 - Specific identification
 - Homogeneous cost pools
 - Three factor formula

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B&P and IR&D

- Bid and Proposal (B&P) and Independent Research and Development (IR&D) costs
 - B&P: Costs incurred to prepare, submit, and support contractor bids and proposals
 - IR&D: Costs for technical effort that is not sponsored by a contract, grant, or other arrangement and that falls in the area of basic and applied research and development
 - Costs consists of all direct labor, material, ODCs, and all applicable indirect and G&A costs
 - Most often allocated to contracts using the same base as used to allocate G&A

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Cost Allowability

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FAR Cost Principles are used:

- When cost or pricing data is submitted
- When cost analysis is performed
- When cost is used to establish a price for a contract or a contract modification

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Cost Allowability – FAR 31.201-2

- Reasonableness
- Allocability
- Standards of the CASB or GAAP
- Terms of the Contract
- Cost Principle limitations

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Reasonableness – FAR 31.201-3

- Definition
 - A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person in the conduct of a competitive business.
- Contractor has burden of proving reasonableness
- Normal concepts of reasonableness don't apply

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Allocability – FAR 31.201-4

- Definition
 - Is incurred specifically for the contract
 - Benefits both the contract and other work and can be reasonably distributed
 - Is necessary for overall operation of the business
- Often draws improper disallowances
- Titles such as 'Commercial Selling' lead to misunderstandings

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Allowability Requirements

- Contractor must maintain adequate accounting records – FAR 31.201(2)(c)
- Contractor must apply consistent practices – FAR 31.201(2)(b)
- Often subject to improper challenges due to poor chart of accounts or inadequate procedures.

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Credits - FAR 31.201-5

- Income, rebate, allowance or other credit
- Cost reduction or cash refund
- Special rules on pension adjustments and asset reversions

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Accounting for unallowable costs - FAR 31.201-6

- Contractor has a responsibility to account for unallowable costs
- Must have a mechanism for identifying unallowable costs
- FAR 31.201-6, CAS 405, FAR 52.216-7, FAR 42.703-2
- Certification Issues:
 - Directly associated costs
 - Access to unallowable cost detail
 - Include unallowable costs in proper base
- Responding to audit challenges

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Penalties for Unallowable Cost

- If unallowable on clear and convincing evidence:
 - Disallowed cost plus interest on any paid portion
- If known to be unallowable before proposal submission:
 - Disallowed cost plus interest on any paid portion
 - Additional two times unallowable cost
 - Other civil and criminal penalties provided by law

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Specific Cost Principles

- FAR Part 31 includes specific types of costs and their allowability and/or unallowability
- Can be broadly broken out into the following categories:
 - Personnel Costs
 - Project Related Costs
 - Selling and Marketing Costs
 - Organizational and M&A Costs
 - Other Costs

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Trends and Hot Topics

- DCAA Audit and Oversight Trends
- DCMA Audit and Oversight Trends
- Hot Topics

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DCAA Audit Priorities

- DCAA's current audit priorities include increased:
 - Defective Pricing Audits
 - Retrospective evaluation of proposal certified cost or pricing data to determine if what was certified was "accurate, complete and current" as of the date of price agreement
 - DCAA refers to the audits as Truth in Negotiations or "TIN" audits
 - CAS Compliance Audits
 - Business System Audits

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Audit Walk-throughs and Information Requests

- Government auditors appear to be increasingly requiring audit subject matter demonstration or walk-throughs after the entrance conference
- Additionally, their information requests are increasingly requiring contractors to prepare materials and summaries in support of audit information requests
 - This appears to be a practice of having the contractor prepare the auditor's required audit work papers
 - For example, contractor preparation of a description of its accounting system or specific process area rather than auditor preparation of summaries based upon their audit interviews and findings
 - While this may increase a contractor's workload required to support an audit, it also gives it increased control over the information provided and placed in the audit file and improve its accuracy

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Contractor Business Systems

- The audit threshold for what is asserted to be a “significant deficiency” remains quite low
- Significant deficiencies generally result in system disapprovals and contract payment withholding on DoD contracts
- We have been seeing increased instances of auditor assertions of significant deficiencies when the draft audit report is provided for contractor comments with no prior mention or warning
- The time required to resolve adverse business system audit adverse findings appears to be increasing with some findings unresolved, systems remaining disapproved and contract payment withholding continuing over two years later

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DCMA Oversight – Defective Pricing Audits

- The Pentagon has assigned DCMA responsibility for resolving defective pricing audits
- Defective pricing takes place if you are required to certify your proposal cost or pricing data and the government later finds that it was not “accurate, complete and current” as of the date of price agreement
 - Five key elements to have “defective pricing”
 - Facts are subject to defective pricing not assumptions (e.g., forecasted labor escalation rate)
- This is a risky process for contractors because:
 - There is sometimes subjective judgement involved in what is accurate, complete and/or current
 - Differences in opinion can become the basis for adverse findings, price reductions, penalties and potential claims of false claims or fraud

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DCAA Hot Topics

- DCAA experiencing staffing challenges
 - Consistently requires over 400 new auditors per year
 - Current workforce lowest in last five years
 - 15% of identified workload not completed due to low staffing levels
- Solutions offered include increased funding and investment in data analytics and technology
- Increase in in-person audits

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Other Hot Topics

- How is CAS compliance determined on an IDIQ contract and its underlying task orders?
- Commercial selling cost allocations
- Directly associated costs

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Questions?

The whole HR issue, regardless of how pressing it is in our profession, is not appropriate for a Valuations and Forensic Accounting Webinar. Whether are we CPA updates?

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Live Content Slide

When playing as a slideshow, this slide will display live content

Social Q&A for 14D. Government Contracting Update

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