



DCAA

DEFENSE CONTRACT AUDIT AGENCY

Overview of Indirect Costs and Rates

Today's Discussion

- Fundamental concepts related to indirect cost allocation.
 - Differences between overhead and G&A pools.
 - Understanding allocation bases.
 - Pool & Base relationship.
 - Significance of indirect rates.
- Steps in allocating indirect costs to contracts.
- Life cycle of indirect rates.
- Indirect Cost Rate Analysis.

What is a Final Cost Objective?

- The purpose for which costs are measured.
- A final accumulation point for all recorded costs.
- A product, contract, job, task, delivery order, etc.
 - Final cost objectives receive both direct and indirect costs.

Overview of Indirect Costs

- Reasonable and necessary costs of doing business.
- Cannot be directly identified with a single contract.
- Logically *pooled* into homogenous groupings.
- Allocated* equitably across all business activities, according to the benefits each gains from them.
- Allocated using a base which has a clear linkage to the pool.
- Any cost that is leftover after all direct costs have been identified and charged to the correct contract.

Indirect Costs



- To the extent that indirect costs are reasonable, allowable and allocable, they are a legitimate cost of doing business payable under a U.S. Government contract or grant.
- Costs incurred for the same purpose, in like circumstances, must be treated consistently for all contracts.

Indirect Costs

Common Cost Structures

- **Overhead Pools:**
 - Cost related to support of specific operations.
 - Manufacturing, Engineering, Material Handling, etc.
- **General & Administrative Pools:**
 - Management, financial, and other expenses incurred for the general management and administration of the business unit as a whole.
 - G&A, IR&D, B&P

Direct Vs. Indirect Costs*

Rent.....	Indirect
Freight on Direct Material.....	Direct
Packaging on a Contract.....	Direct
Supervisory Labor.....	Indirect
Property Tax.....	Indirect
Labor for a Job.....	Direct
New Hire Training.....	Indirect

*Represents the most common treatment for these costs; however, there may be acceptable exceptions.

Additional Examples

Contract Material.....	Direct
Contract Travel.....	Direct
Office Supplies.....	Indirect
President's Salary.....	Indirect
Other Items on a Job.....	Direct

*Represents the most common treatment for these costs; however, there may be acceptable exceptions.

Allocation Base

- A measure of direct contractor effort that can be used to allocate pool costs based on benefits accrued by the several cost objectives.
- A means to equitably allocate indirect costs to cost objectives.
- This is what the pool is being allocated to.

Base - Examples:

- Direct Labor (hours or dollars),
- Direct Materials,
- Head count,
- Total Cost Input or Value Added Base,
- Quantity of Computers,
- Number of Machine Hours,
- Square footage, etc.

Example of Total Cost Input

- Calculating a Total Cost Input (TCI) Base
 - + Contract Direct Labor
 - + Contract Direct Material
 - + Contract ODC
 - + Subcontract Costs
 - + Gross Overhead

= Total Cost Input

Example of Value Added

- What is the difference between TCI and Value Added Base?

+ Contract Direct Labor

~~- Contract Direct Material~~

+ Contract ODC

~~- Subcontract Costs~~

+ Gross Overhead

= Total Cost Input

Causal/Beneficial Relationship

If it were not for the base, the pool expense would not be incurred.

- No labor cost -- No fringe expense.
- No computers -- No computer service department.
- Significant decline in work -- Significant decline in pool expenses.
- No contracts -- Ultimate elimination of company.

Pool / Base Relationship

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Pool - *Expenses to be Allocated*

Base - *Caused the Expenses or
Benefits from the Expenses*

Indirect Rates

- Ratio between the total indirect expenses and some direct cost base.
- “Device” for determining fairly and conveniently what portion of indirect cost each contract should bear.
- Indirect cost rates are expressed in terms such as dollars per hour or percentage of cost.

Indirect Rates – Cont'd

- An Indirect Cost Rate by itself has very little meaning.
- The use of allocation bases and cost structures vary greatly among contractors.
- Indirect costs should not be compared between organizations at the rate level.
- The practice of direct or indirect charging is not an indicator of best value.

Allocation Example

- Which results in greater indirect cost allocation:
 - 25% rate applied to total cost, or
 - 75% rate applied to only direct labor costs?

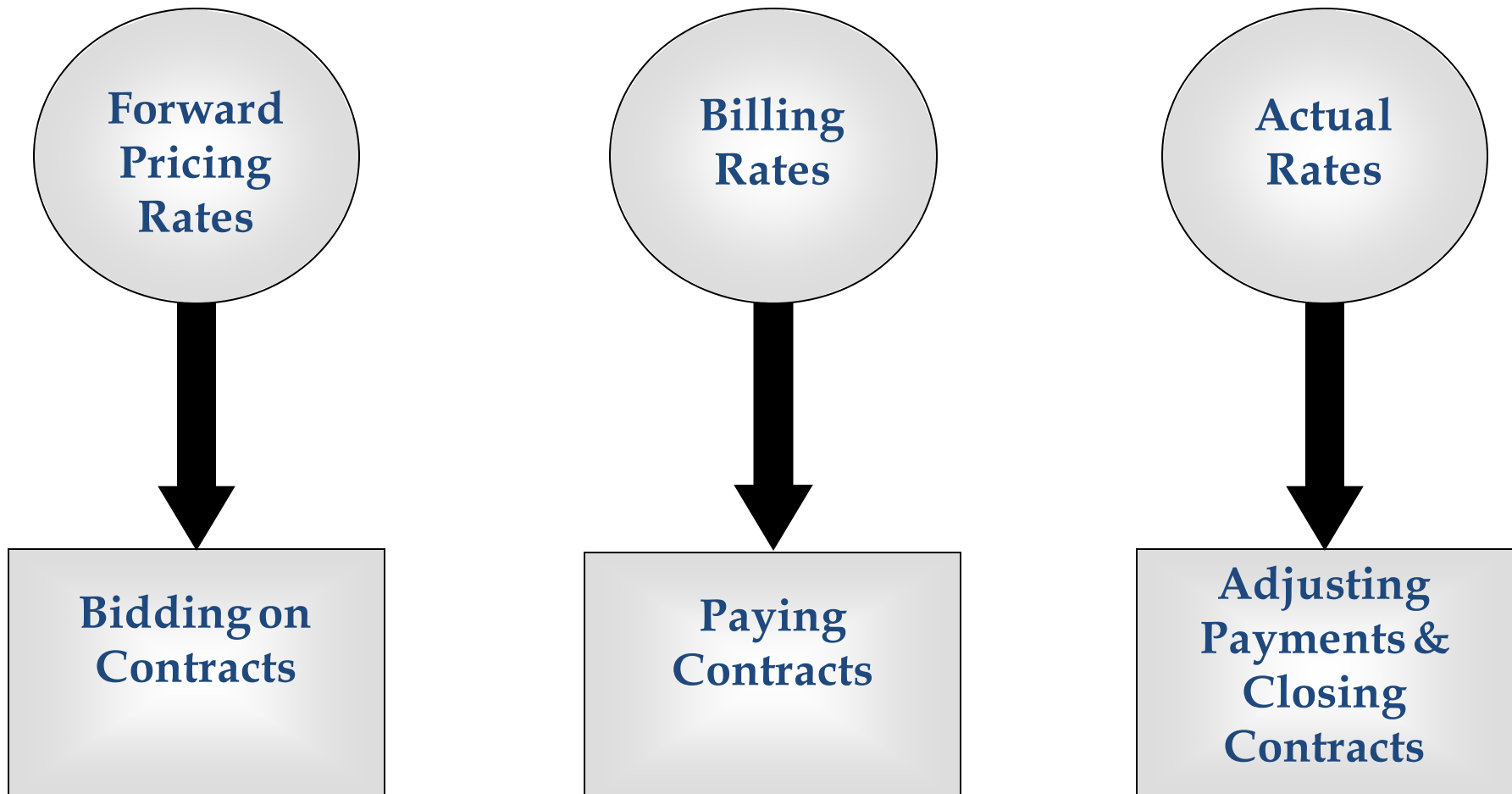
Cost Elements	Contractor ABC		Contractor XYZ
Direct Labor	\$100,000		\$100,000
Fringe Benefits	20,000		20,000
Subtotal	\$120,000		\$120,000
Direct Travel	\$80,000		\$80,000
Other Direct Cost	200,000		200,000
Equipment	40,000		40,000
Subcontracts	50,000		50,000
Total Direct Costs	\$490,000		\$490,000
Indirect Cost			
at 25%	\$122,500		
at 75%			\$75,000
Total Cost	\$612,500		\$565,000

Allocating Indirect Costs

(4 Step Process)

1. Accumulate Costs (Pool):
 - Homogeneous; Logical Cost Groupings.
2. Select Allocation Base:
 - Causal or Beneficial Relationship.
3. Rate Computation:
 - Pool divided by base.
4. Rate Application:
 - Rate x Base Cost (Per Contract).

Life Cycle of Indirect Rates



Flowchart of Indirect Cost Analysis



Identify Pools and Bases for Rate Development

- Typical costs found in common pools:

Material Handling	Acquisition (Purchasing) • Inbound transportation • Indirect labor • Employee related expenses (shift & overtime premiums, employee taxes, fringe benefits) • Receiving and inspection • Material handling and storage • Vendor quality assurance • Scrap sales credits • Inventory adjustments
Operations Overhead (e.g. Manufacturing, Engineering, Field Service, and Site Operations)	Indirect labor and supervision • Perishable tooling (primarily in manufacturing overhead) • Employees related expenses (shift & overtime premiums, employee taxes, fringe benefits) • Indirect material & supplies (small tools, grinding wheels, lubricating oils) • Fixed charges (e.g., depreciation, insurance, rent, property taxes) • Downtime of direct employees (training, vacation pay, regular pay) when not working on a specific contract/job
General & Administrative Expenses	General & executive office • Staff services (legal, accounting, public relations, financial) • Selling and marketing • Corporate or home office • Independent research and development (IR&D) • Bid and proposal (B&P) • Other miscellaneous activities related to overall business operation

- Secondary (Intermediate) cost pools.
e.g. Facility Expense, Fringe Benefits

Identify Inconsistencies & Weaknesses in Development

- Compare the proposed rate to other rates in the indirect cost allocation cycle.
- Are rate estimates updated as more information becomes available?
- Evaluate the accuracy of contractor's prior estimates.
- Are there any weaknesses in the contractor's estimating system?

Review Rate Development

1. Estimate Sales Volume for the Period.
2. Estimate Indirect Cost Allocation Bases for the Period.
3. Estimate Indirect Cost Pools for the Period.
4. Estimate Indirect Cost Rates for the Period.

Examine Proposed Rates

- An in-depth analysis of the pool and base is necessary to determine reasonableness of indirect rates.
- Focus on areas of greatest risk to the Government.
- Review the contents of pools and bases.
- Analyze the pool/base relationship.
- Evaluate the mathematical accuracy of rate calculations.
- Develop and document pricing position and make any necessary adjustments.

Rate Analysis to Consider

Indirect Cost Pools

Points to consider:

- Review the accuracy of the contractor's historical pool estimates in comparison to the actual pool costs for the same period?
- Consider any prior questioned costs reported by the cognizant auditor.
- Evaluate contents of the proposed pool to identify any unallowable costs that should be excluded.

Indirect Rate Analysis Issues and Solutions

Common Allowability Issues	Solution
Proposed expense amount is not reasonable.	Reduce the dollar amount of the indirect cost pool to reflect a more reasonable dollar value for that item.
Proposed pool expense should have been treated as a direct cost.	Subtract that cost from the total dollar value of the indirect cost pool, and ensure the cost is directly charged to the proper contract.
The same cost is also represented in another indirect pool or as a direct cost.	Develop pricing position recognizing the proposed cost in the area where the cost should be recognized and remove the cost from any other area to avoid double counting.
The proposed cost is not properly allocable to the pool under CAS or GAAP. (e.g. cost charged in the wrong accounting period)	Determine the proper accounting treatment and reallocate the cost in a manner that is consistent with CAS or GAAP.
Proposed pool cost is not allowable under FAR cost principles or terms of the solicitation/contract.	Reduce the dollar amount of the indirect cost pool.

Indirect Cost Rate Analysis

Indirect Allocation Bases

Points to consider:

- Did the contractor use the correct base period (generally one fiscal year)?
- Does the sales volume used to estimate the allocation base appear reasonable?
- Does the selected base include all costs associated with that base, whether allowable or not?
- Will the base result in a fair allocation of the costs in the indirect cost pool (causal/beneficial relationship)?
- How stable has the allocation base been over time?

Apply Rates in Pricing

- Apply estimated rate to the contract-related base.
- Ensure that the Indirect Rate is applied to the **appropriate base**.
- Do not apply the rate to cost categories not included in the base.
 - E.g. If contractor uses Value Added Base to calculate the G&A rate, the rate *should not* be applied to direct material and subcontract costs in the proposal.

Overhead Rate Example

		Gross	Voluntary Deletions	Claimed
Step 1	Overhead Pool			
	Salaries & Wages	\$ 4,000,000	\$ 700,000	\$ 3,300,000
	Marketing	200,000		200,000
	Vacation	3,000,000		3,000,000
	Employee Welfare	1,000,000		1,000,000
	Depreciation	200,000		200,000
	Total Overhead Pool	\$ 8,400,000	\$ 700,000	\$ 7,700,000
Step 2	Overhead Base			
	Direct Contract Labor	\$ 7,000,000	\$ -	\$ 7,000,000
Step 3	Overhead Rate	120%		110%
Step 4	Allocation of Overhead Expenses			
	Cost Objectives	Base Cost	Overhead Rate	Allocation of Cost
	Contract A (CPIF)	\$ 4,000,000	110%	\$ 4,400,000
	Contract B (FFP)	2,500,000	110%	2,750,000
	Contract C (Commercial)	500,000	110%	550,000
		\$ 7,000,000		\$ 7,700,000
		OH Base		Claimed OH

Exercise Solution

Case Problem

G&A

	Gross	Voluntary Deletions	Claimed
G&A Pool:	<u>\$ 6,450,000</u>	<u>\$ 450,000</u>	<u>\$ 6,000,000</u>
G&A Base			
Direct Contract Labor			\$ 9,000,000
Direct Contract Travel			250,000
Direct Contract Material			2,000,000
Other Direct Costs			450,000
Subcontracts			3,300,000
Subtotal (Direct Costs)			<u>\$ 15,000,000</u>
Gross G/L O/H			15,000,000
Total Cost Input			<u>\$ 30,000,000</u>
G&A Rate:			<u>20.00%</u>
Allocation of G&A Expenses			
Cost Objectives	Base Cost	G&A Rate	Allocation of Cost
Contract A (CPIF)	\$ 8,150,000	20.00%	\$ 1,630,000
Contract B (FFP)	16,725,000	20.00%	3,345,000
Contract C (Commercial)	3,625,000	20.00%	725,000
Unallowable	1,500,000	20.00%	300,000
	<u>\$ 30,000,000</u>		<u>\$ 6,000,000</u>

G&A Rate Example

		Gross	Voluntary Deletions	Claimed
Step 1	G&A Pool:			
	Salaries & Wages	\$ 2,600,000	\$ 300,000	\$ 2,300,000
	Education & Training	62,000		62,000
	Vacation	300,000		300,000
	Printing & Reproduction	30,000		30,000
	Office Supplies	8,000		8,000
	Total G&A Pool	\$ 3,000,000	\$ 300,000	\$ 2,700,000
Step 2	G&A Base			
	Direct Contract Labor			\$ 7,000,000
	Direct Contract Travel			150,000
	Direct Contract Material			2,800,000
	Other Direct Costs			200,000
	Subcontracts			1,450,000
	Subtotal (Direct Costs)			\$ 11,600,000
	Gross G/L O/H			8,400,000
	Total Cost Input			\$ 20,000,000
Step 3	G&A Rate:			13.50%
Step 4	Allocation of G&A Expenses			
	Cost Objectives	Base Cost	G&A Rate	Allocation of Cost
	Contract A (CPIF)	\$ 10,600,000	13.50%	\$ 1,431,000
	Contract B (FFP)	7,450,000	13.50%	1,005,750
	Contract C (Commercial)	1,250,000	13.50%	168,750
	Unallowable	700,000	13.50%	94,500
		\$ 20,000,000		\$ 2,700,000
		G&A Base		G&A Expense

DCAA Internet Resources

- Guidance

- Audit Process Overview – Information for Contractors Manual
- Directory of Audit Programs
- Contract Audit Manual
- Select Area of Cost Guidebook (FAR 31.205 Cost Principles)
- Links to Acquisition Regulations



- Checklists and Tools

- Cost of Money Rates
- Incurred Cost Electronically (ICE) Model
- Contractor Submission Portal
- Adequacy Checklists - Preaward Accounting System, Contract Pricing Proposal, Forward Pricing Rate Proposal, Incurred Cost Submission, Termination Settlement Proposal.

- Frequently Asked Questions For Contracting Officers, Contractors and COVID-19

Small Business Outreach Survey

We would love to hear about your recent experience with the DCAA Small Business Program, as we are committed to providing the best guidance possible and strengthening our nation's Defense Industrial Base. By participating in our survey, you will help us improve our courses, content and provide you with even better support as we continue to grow our program.



Questions/Comments



Katelyn Rigle

Financial Liaison Advisor- Small Business Coordinator

Headquarters – Operations Audit Liaison Division

8725 John J. Kingman Road

Fort Belvoir, VA 22060

VoIP: (571) 448-6376

E-mail: katelyn.a.rigle.civ@mail.mil