

# Advanced Indirect Rate Topics

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# Please Read

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# AGENDA

- FAR and CAS requirements for indirect rates
- Service centers
- Options for unallowable cost controls
- Achieving full cost recovery on government contracts
- Resources
- Questions and Answers

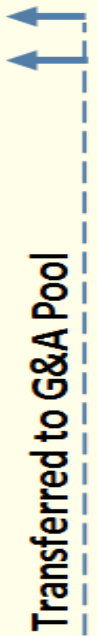


# FAR and CAS Requirements for Indirect Rates

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# Example Business Unit

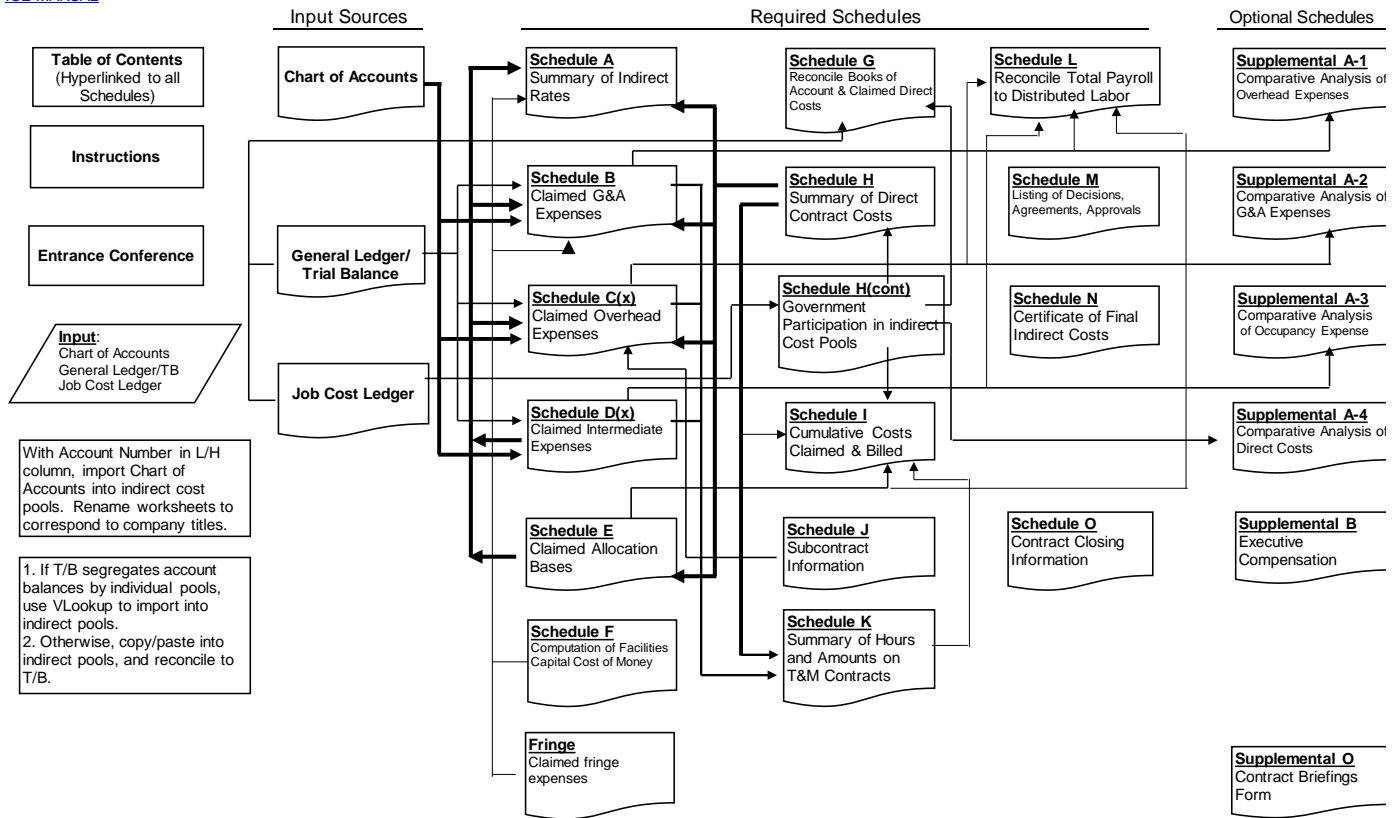
CONTRACTOR'S BUSINESS UNIT								
INDIRECT COSTS	G&A POOL	Segment General & Administrative Expenses						
		Selling and Marketing						
		Corporate Office Expense Allocation						
		Independent Research and Development Expenses (IR&D)						
		Bid and Proposal Expenses (B&P)						
	OVERHEAD COST POOLS							
	Engineering	Product A	Product B	Assembly	Fabrication	Tooling	Material Handling	Off-Site
SERVICE CENTERS				EXPENSE POOLS				
Computer Services	Industrial Engineering	Operations	Use and Occupancy		Fringe Benefits			
DIRECT COSTS	CONTRACT A -----		CONTRACT B -----		CONTRACT C -----		IR&D/B&P Projects -----	
	Direct Materials		Direct Materials		Direct Materials		Direct Materials	
	Direct Labor		Direct Labor		Direct Labor		Direct Labor	
	Subcontract		Subcontract		Subcontract		Subcontract	
Other Direct Costs		Other Direct Costs		Other Direct Costs		Other Direct Costs		



# Indirect Rates Can be Complex!

[ICE MANUAL](#)

Flow Chart Showing Linkages Between and Among the Various Worksheets



# FAR and CAS Requirements for Indirect Rates

FAR and CAS requirements relative to indirect rates is summarized as follows:

Indirect Cost	Number of Pools	FAR Requirements	CAS Requirements
<b>Intermediate Complexity</b>			
Fringe/Overhead	Depends	FAR 31.201-4, FAR 31.203	CAS 418
G&A	One	FAR 31.201-4, FAR 31.203	CAS 410
<b>Advanced Complexity</b>			
Home Office	Depends	FAR 31.201-4, FAR 31.203	CAS 403
IR&D/B&P	Depends	FAR 31.201-4, FAR 31.203	CAS 420
Service Centers	Depends	FAR 31.201-4, FAR 31.203	CAS 403/418
Standard Cost	N/A	FAR 31.201-1	CAS 407

# Definition of Indirect Costs

FAR 2.101 defines an indirect cost as “any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or an intermediate cost objective. ”

This does not state any cost that could be identified to a single cost objective.

Note: CAS 402 also does not require specific costs to be treated as either direct or indirect. The fundamental requirement is: “All costs incurred for the same purpose, in like circumstances, are either direct costs only or indirect costs only...”

So, when an auditor tells you a certain cost has to be treated as direct or indirect, they are wrong. This is up to the company to decide!





# FAR Requirements For Indirect Rates

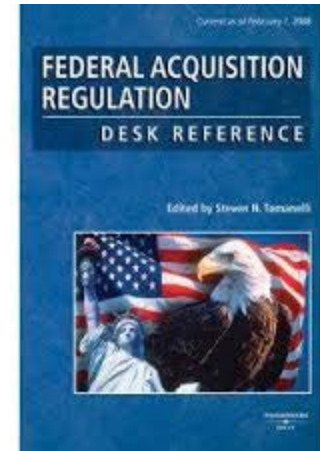
FAR sections related to indirect rates:

- FAR 31.201-4 (Determining Allocability)

Very general – discusses only the concept of equitability but provides no specifics on how to determine equitability

- FAR 31.203 (Indirect Costs)

FAR 31.203 (e) states: “The method of allocating indirect costs may require revision when there is a significant change in the nature of the business...”



# How to Establish and Document Equitability in Indirect Rates

So, where do we get the specifics on how to comply with equitability requirements of the FAR? One good source is CAS 418

The purpose of this Cost Accounting Standard is to:

- provide for consistent determination of direct and indirect costs
- provide guidance relating to the selection of allocation measures based on the beneficial or causal relationship between an indirect cost pool and cost objectives.

Note: Auditors will be thinking of CAS 418 when evaluating your indirect rates structure even if you are not CAS covered!



# CAS 418 Primary Requirements

## CAS 418 (Continued)

Beneficial or causal relationship:

1. If a material amount of the costs in a pool are costs of management or supervision of activities involving direct labor or direct material costs, a base shall be used which is representative of the activity being managed or supervised.
2. If the cost pool does not contain a material amount of the costs of management or supervision of activities involving direct labor or direct material costs, resource consumption can be specifically identified with cost objectives.



# Homogeneity in Indirect Rate Pools

*CAS 418 - Homogeneous indirect cost pools.*

- An indirect cost pool is homogeneous if each significant activity whose costs are included therein has the same or a similar beneficial or causal relationship to cost objectives as the other activities whose costs are included in the cost pool.
- It is also homogeneous if the allocation of the costs of the activities included in the cost pool result in an allocation to cost objectives which is not materially different from the allocation that would result if the costs of the activities were allocated separately.

Key Point: Homogeneity is all about the base. The key is that the pool shares a common relationship to the base.

# CAS 410 G&A Base Options

## CAS 410 - ALLOCATION OF BUSINESS UNIT GENERAL AND ADMINISTRATIVE EXPENSE

(48 CFR PART 9904.410)

Total Cost  
Input

- All costs excluding G&A pool costs

Value-  
Added

- Total Cost Input less subcontract and materials

Single  
Element

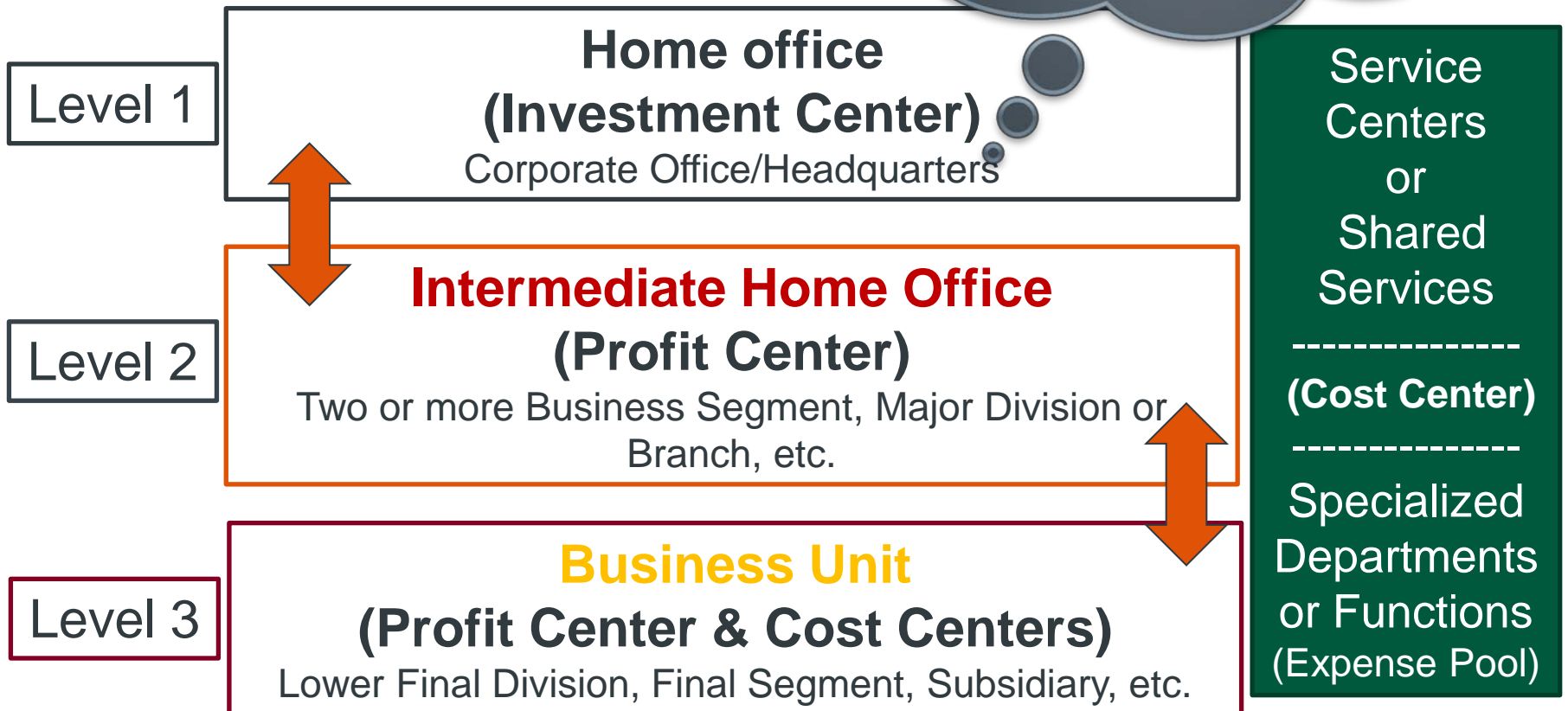
- A factor that represents the total activity of the Business Unit

# G&A Base Comparison Using TCI and Value Added

<b>General Ledger Summary</b>	<b>Amount</b>	<b>Total Cost Input</b>	<b>Value Added</b>
Direct Labor	1,000,000	1,000,000	1,000,000
Direct Material	250,000	250,000	
Subcontracts	1,750,000	1,750,000	
Other Direct Costs	200,000	200,000	200,000
Unbillable Other Direct Costs	50,000	50,000	50,000
Fringe Benefits on Direct Labor	400,000	400,000	400,000
Allowable Overhead Costs	1,000,000	1,000,000	1,000,000
Unallowable Overhead Costs	100,000	100,000	100,000
Allowable G&A Costs	1,100,000		
Unallowable G&A Costs	200,000		
Credit for Sale of Surplus Material*	(50,000)	(50,000)	
<b>TOTAL</b>	<b>6,000,000</b>	<b>4,700,000</b>	<b>2,750,000</b>
<b>G&amp;A Rate</b>		<b>23.40%</b>	<b>40.00%</b>
*Amount credited to government as a direct material adjustment			

# CAS 403 – Home Office Allocation

Levels of responsibility, control and communication within the structure



# CAS 403 Fundamental Requirements

## ***CAS 403 (Allocation of Home Offices to Segments)***

- Home office costs must be allocated based on the beneficial or causal relationship (like CAS 418), however CAS 403 is more prescriptive and provides specific allocation methods to be followed.
- **CAS 403-40(a)(1)** requires that home office expenses be allocated directly to segments to the maximum extent practical.
- **CAS 403-40(a)(1)** requires that expenses that are not directly allocated shall be grouped in logical and homogeneous expense pools
- **CAS 403-40(b)(1)**, **CAS 403-50(b)(1)**, and **CAS 403-60(a)**, require that centralized service functions shall be allocated on the basis of the service furnished to or received by each segment.
- **CAS 403** does not cover allocation of IR&D/B&P costs, (CAS 420 covers this)



# CAS 403 Residual Expense Requirements

(1) Residual expenses shall be allocated by means of a base representative of the total activity of such segments, except where paragraph (2) or (3) below applies.

(2) Residual expenses shall be allocated using 3 factor formula if the total amount of such expenses exceeds certain thresholds

(3) Where a particular segment receives significantly more or less benefit from residual expenses than would be reflected by the allocation of such expenses pursuant to paragraph (1) or (2) of this subsection, the Government and the contractor may agree to a special allocation of residual expenses

# CAS 403 Three Factor Formula

## ***CAS 403 -Residual Expense Requirements***

The Three Factor Formula is the average of payroll, operating revenue and average net book value (tangible assets plus inventories):

Segment	Payroll	Operating Revenue	Asset Net Book Value	Simple Average
A	35%	50%	30%	38%
B	25%	25%	60%	37%
C	40%	25%	10%	25%
Total	100%	100%	100%	100%



# CAS 403 Home Office Example

Home Office	Allocation Method Example	Intermediate Home Offices	Allocation Method Example	Segments
Centralized Service Functions		IHO1	Same method as Home Office	S1-1
				S1-2
Data Processing	Number of reports			
Personnel	Number of Personnel	IHO2	Same method as Home Office	S2-1
Purchasing	Number of Purchase Orders			S2-2
Staff Management Of Specific Activities		IHO3	Same method as Home Office	S3-1
Staff Management	Number of Personnel			
Policy Guidance	Depends on type of policy			S3-2
Line Management of Segments				
Segment Supervision	Personnel Supervised			
Central Payments or Accruals				
Pension Expense	Payroll \$			
Group Insurance	Payroll \$			
Residual Expenses	3 Factor Formula			
Note: IR&D/B&P discussed in CAS 420 section				

# CAS Requirements (continued)

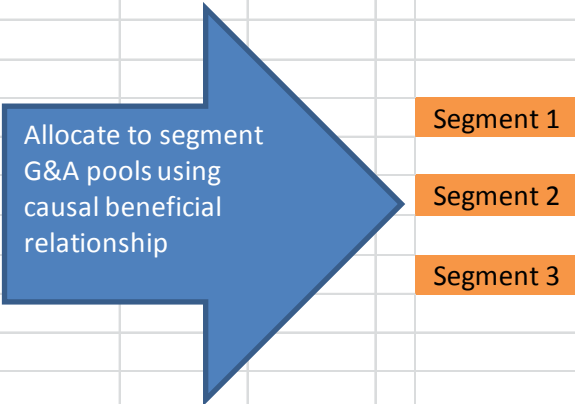
## ***CAS 420 (Accounting for independent research and development costs and bid and proposal costs)***

- Applies to IR&D/B&P at all levels, including home office
- The IR&D and B&P project costs shall include
  - costs, which if incurred in like circumstances for a final cost objective, would be treated as direct costs of that final cost objective, and
  - the indirect costs (fringe, overhead, etc., but not G&A) that would be allocable if the IR&D/B&P costs were direct costs.



# CAS 420 (IR&D/B&P) Example

Home Office	IHO Level	Segment Level							
Large IR&D Project	Large IR&D Project	Large IR&D Project							
Direct Costs	Direct Costs	Direct Costs							
Fringe	Fringe	Fringe							
Overhead	Overhead	Overhead							
Small IR&D Projects	Small IR&D Projects	Small IR&D Projects							
Direct Costs	Direct Costs	Direct Costs							
Fringe	Fringe	Fringe							
Overhead	Overhead	Overhead							
Large B&P Project	Large B&P Project	Large B&P Project							
Direct Costs	Direct Costs	Direct Costs							
Fringe	Fringe	Fringe							
Overhead	Overhead	Overhead							
Small B&P Projects	Small B&P Projects	Small B&P Projects							
Direct Costs	Direct Costs	Direct Costs							
Fringe	Fringe	Fringe							
Overhead	Overhead	Overhead							
Important questions:									
1. How do you know which segments benefit and in what proportion?									
2. What indirect rates are applied depending on who works on the project?									



# CAS 407 (Standard Costs)

- In accounting for direct costs a business unit shall use actual costs, except that—
- Standard costs for material and labor may be used as provided in CAS 407
- Whenever average cost or pre-established rates for labor are used, the variances, if material, shall be disposed of at least annually
- One of the biggest challenges to compliance is HOW the variances are disposed of.



# Standard Labor Rate Example

Position	Standard	Actual	Variance	Contract	Variance Disposition
	Rate	Rate			Pool
Technician 1	40	50	10	Commercial	Companywide Overhead
Technician 2	40	40	0	Commercial	Companywide Overhead
Technician 3	40	30	-10	Government CPFF	Companywide Overhead
	120	120	0		

## Questions:

1. If the company has one company wide overhead account where the labor variance is disposed, is this method equitable to the government?
2. How could they address the apparent inequity in the current practice?
3. If other variances for other labor categories offset this variance, can a case be made that their standard labor costing practices are compliant with CAS 407?



# Service Centers

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# Service Centers

- Some costs are attributable to multiple cost objectives.
- Use of Service Centers (intermediate pools) to allocate equitably in a casual/benefit relationship.
- SC allocation base should be the best representation of the casual relationship between costs and cost objectives; based on the use of service – head count, direct labor, number of copies, square footage, etc.
- Costs may be allocated directly to contracts, to indirect cost pools, or to other service centers.
- SC can more accurately allocate costs, but do increase complexity.

# Service Centers Examples

<b><u>Service Centers</u></b>	<b><u>Allocation Bases</u></b>
IT Service Center	Head count
Human Resources	Head count
Recruiting	# of Requisitions
Facilities	Sq footage or Head Count

# Service Centers Examples

Payroll Service Center					
Description	Balance	Adjustment	Claimed		
Payroll Taxes-Fica/Medicare	1,019,379	-	1,019,379		
Payroll Taxes - Suta	131,227	-	131,227		
Payroll Taxes - FUTA	9,525	-	9,525		
<b>Total Payroll Svc Ctr costs</b>	<b>1,160,131</b>	<b>-</b>	<b>1,160,131</b>		
Direct, Indirect and Bonus Time-off Allocated					
PR Svc Ctr Allocation	Dollars	Dollars	Total Base	% of Total	Amount
Full-time fringe	10,160,258	1,345,633	11,505,891	81.44%	944,813
Part-time fringe	410,983	-	410,983	2.91%	33,748
SCA-fringe	1,973,327	237,819	2,211,146	15.65%	181,570
	<b>12,544,568</b>	<b>1,583,453</b>	<b>14,128,021</b>	<b>100.00%</b>	<b>1,160,131</b>

# Service Centers Examples

<b>Fringe Rate Calculation</b>			
	<b>Full Time</b>	<b>Part Time</b>	<b>SCA Fringe</b>
<b>Fringe Pool</b>			
Holiday Expense	378,857	-	67,525
Health Insurance	1,162,112	-	370,782
Vision Insurance	50,071	-	-
Life & Disab Benefit	24,299	-	2,208
PTO	813,776	-	148,616
Bereavement	21,898	-	946
Workman's Compensation	78,397	7,606	99,408
401K Benefit	569,056	13,133	55,380
Payroll Svc Ctr	944,813	33,748	181,570
<b>Total Fringe Pool</b>	<b>4,043,279</b>	<b>54,487</b>	<b>926,435</b>
<b>Fringe Base</b>			
Contract Labor	7,609,782	237,338	1,973,327
B&P Labor	229,973	14,300	-
Indirect labor	2,320,501	69,346	-
<b>Total Fringe Base</b>	<b>10,160,256</b>	<b>320,984</b>	<b>1,973,327</b>
<b>Fringe Rate</b>	<b>39.80%</b>	<b>16.98%</b>	<b>46.95%</b>

# Service Centers Examples

Facility Service Center				
Facility Expenses	Balance	Adjustment	Claimed	
Rent	144,941	-	144,941	
Office Supplies	10,947	-	10,947	
Postage & Shipping	5,484	-	5,484	
Utilities Expense	7,916	-	7,916	
Telephone Exp	29,143	-	29,143	
Comp/Net Expense	175,808	-	175,808	
Janitorial	6,861	-	6,861	
Depr.Mach/Equip	98,997	-	98,997	
<b>Total Facility Expenses</b>	<b>480,097</b>	<b>-</b>	<b>480,097</b>	
Allocation base	Head Count	% of Total	Allocated Amount	
GA Labor	17	85.00%	408,082	Goes to G&A Pool
Subhandling Labor	3	15.00%	72,014	Goes to SH Pool
	20	100.00%	480,097	

# Options for Unallowable Cost Controls



# Options for Unallowable Cost Controls

- *Preventive controls that identify unallowables:*
  - *At the time of source document entry -*
    - *Expense review and approval controls*
    - *Account identification as unallowable*
  
  - *Prior to submission / filing*
    - *Invoice review controls to identify unallowable*
    - *Incurred Cost Submission preparation and review*
      - ❖ *Schedule N certification*

# Options for Unallowable Cost Controls

- ❑ *Detective controls performed annually*
  - *FAR 31.201-6 allows contractors to use statistical sampling techniques as a method of identifying and segregating unallowable costs:*
    - ❖ *Sample must be unbiased*
    - ❖ *Sample must represent universe*
    - ❖ *Large dollar and high risk transactions must be separately reviewed, and*
    - ❖ *Entire process must permit audit verification*
  - *Subject to an advance agreement with ACO*
  - *Without an advance agreement, it is the contractor's responsibility to prove method meets FAR criteria*



# Treatment of Unallowable Costs

- *Unallowable direct costs stay with the project, receive all the appropriate allocations, but are not claimed or billed*
- *Unallowable indirect costs (fringe or overhead) must be removed from the pool, but remain in the G&A base*
- *Unallowable G&A and all statutory unallowables must be removed from the G&A pool*
- ❑ Directly associated unallowable costs – one dollar of unallowable labor can become two dollars or more of total unallowable costs

# Expressly Unallowable Costs

- *FAR 31.001 definition* - “Expressly unallowable cost” means a particular item or type of cost which, under the express provisions of an applicable law, regulation, or contract, is specifically named and stated to be unallowable.
  
- *FAR 42.709-3 – obligates Contracting Officers to assess penalties on expressly unallowable indirect costs*
  
- *FAR 42.709-5 – Waiver of Penalty*
  - ❖ *Contractor withdraws certified incurred cost submission before the government initiates an audit*
  - ❖ *Expressly unallowable cost isn’t material - \$10,000 or less*
  - ❖ *Inclusion resulted from an unintentional error*

# Expressly Unallowable Costs

- ❑ Raytheon Co., ASBCA Nos. 57576 et al. (June 26, 2015)
- ❑ Appealed disputing “expressly unallowable” cost designation
- ❑ certain bonus and incentive compensation costs were not “**expressly**” unallowable under:
  - FAR 31.205-1 – Public Relations and advertising costs
  - FAR 31.205-22 – Lobbying and political activity costs
  - FAR 31.205-27 – Organization costs



# Achieving Full Cost Recovery on Government Contracts

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# Achieving full cost recovery – Best Practice Suggestions

Keep it simple!

- ❑ Unnecessary complexity in indirect structures costs companies due to:
  - Accounting costs
  - Audit support costs
  - Errors caused by overly complex cost allocation processes
  - Estimating processes that have to align with the indirect rate structure
  - Employee productivity decreases due to time spent tracking immaterial costs
  - GIGO (Garbage In/Garbage Out) – If you create a system with a lot of requirements but don't staff up for that, likely result is bad data in system!

# Achieving full cost recovery – Best Practice Suggestions

Be Safe!

- Regardless of whether your company is subject to CAS 418, design allocations that would comply with CAS 418
- Document the decisions that have been made and why these comply with FAR Part 31 and CAS 418 requirements
- If subject to full CAS coverage, consider the requirements of CAS 403, 410 and 420 discussed in this presentation
- Monitor actual cost performance and consider whether unexpected variances indicate that a change to accounting practices is needed
- Be able to defend causal benefit relationship

# Achieving full cost recovery – Best Practice Suggestions

## Monitor!

- Review actual indirect rates vs provisionals on a regular basis
- Monitor over/under billings per contract (Schedule I)
- Adjust provisional billing rates if there are significant variances and are no longer representative of final year end rates
  - ❖ FAR 42.704(c) and FAR 52.216-7(e) - Billing rates may be revised prospectively or retroactively by mutual agreement of CO or auditor and the contractor at either party's request to prevent substantial over or underpayment
  - ❖ Post rate variances – set materiality ceiling or post automatically
- Submit provisional billing rates request at least annually

# Achieving full cost recovery – Best Practice Suggestions

Understand cost relationships!

- To accurately assign costs to cost objectives, companies must thoroughly understand how incurrence of costs impacts the incurrence of other costs
- Develop an allocation structure that works for both internal reporting and government required indirect rate calculation
- Monitor for changes in cost relationships or business conditions that necessitate a change in cost allocation
- For TCI vs Value Added Base – Understand your subcontracts and carefully consider whether they should be in G&A base



# Achieving full cost recovery – Best Practice Suggestions

## Consider Cost Accounting in Contract Negotiations!

- Treatment of certain costs as direct or indirect per the contract could deviate from company practices resulting in potential CAS 402/418 violation
- It is best to negotiate contract terms to align with company standard accounting practices – otherwise, some costs may be non recoverable.



# Resources

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# RESOURCES

## **COHNREZNICK IS FOCUSED ON HELPING GOVERNMENT CONTRACTORS SUCCEED. TOWARD THAT END, WE HAVE SEVERAL RESOURCES YOU SHOULD LOOK INTO:**

- CohnReznick Insights ([www.cohnreznick.com/insights](http://www.cohnreznick.com/insights)): Provides CohnReznick's latest insights on business trends, regulatory developments, and economic issues. You can subscribe to receive Insights e-newsletters by email.
- CohnReznick Website ([www.cohnreznick.com](http://www.cohnreznick.com)): In addition to Insights, our website provides extensive information about all aspects of Accounting and Assurance, Tax, and Advisory services.
- CohnReznick GovCon360 ([www.govcon360.com](http://www.govcon360.com)): Keeps you up-to-date on the ever-changing regulatory environment that is government contracting. From reference materials to educational presentations and thought leadership pieces on industry matters, GovCon360 is a valuable resource for the Government contracting professional.



# QUESTIONS AND ANSWERS



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