

# Optimizing Your Indirect Rates: A Spring-Cleaning Approach

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# With You Today



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# Learning Objectives

- ▶ Define optimization and how it can be implemented for your indirect rates
- ▶ Highlight considerations of potential risks that may impair profitability and/or compliance
- ▶ Examine possible improvements to your current indirect rate structures
- ▶ Decide on the different approaches your organization can take to optimize its indirect rates

# Agenda



**Key Terminology**



**Indirect Rate Optimization**



**Spectrum of Considerations**



**Process for Evaluating Indirect Rates**



**Implications of Changing your Indirect Rates**



**Questions**

# Key Terminology



<b>DIRECT COST</b>	A <b>direct cost</b> “means any cost that is identified specifically with a particular final cost objective. Direct costs are not limited to items that are incorporated in the end product as material or labor. Costs identified specifically with a contract are direct costs of that contract. All costs identified specifically with other final cost objectives of the contractor are direct costs of those cost objectives.” (FAR 2.101).
<b>INDIRECT COST</b>	An <b>indirect cost</b> is “any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective.” (FAR 2.101).
<b>COST OBJECTIVE</b>	A <b>cost objective</b> is “a function, organizational subdivision, contract, Federal award, or other work unit for which cost data are desired and for which provision is made to accumulate and measure the costs of processes, projects, capitalized projects, jobs, etc.” (FAR 31.001).
<b>FINAL COST OBJECTIVE</b>	A <b>final cost objective</b> is “a cost objective that has allocated to it both direct and indirect costs and, in the contractor’s accumulation system, is one of the final accumulation points.” (FAR 31.001).
<b>INTERMEDIATE COST OBJECTIVE</b>	An <b>intermediate cost objective</b> is a cost objective that is used to accumulate indirect costs or service center costs that are subsequently allocated to one or more indirect cost pools and/or final cost objectives.



ALLOCATION	An <b>allocation</b> is an assignment or distribution of costs to one or more cost objectives. This includes both assignment of direct costs, as well as distribution of indirect costs.
INDIRECT COST (EXPENSE) POOL	An <b>indirect cost (expense) pool</b> is grouping of homogenous costs that jointly benefit two or more cost objectives. These costs are subsequently allocated over an allocation base.
INDIRECT COST ALLOCATION BASE	An <b>indirect cost allocation base</b> is a measure of a contractor's activity/effort that can be used to allocate indirect pool costs based on the benefits accrued by the cost objectives.
INDIRECT RATE	An <b>indirect rate</b> is a rate/percentage calculated by dividing an indirect cost pool by its indirect cost allocation base. This rate/percentage is applied to the indirect cost allocation base as a way to assign indirect costs to intermediate or final cost objectives.
UNALLOWABLE COSTS	An <b>unallowable cost</b> is “any cost that, under the provisions of any pertinent law, regulation, or contract, cannot be included in prices, cost-reimbursements, or settlements under a Government contract to which it is allocable.” (FAR 2.101).
CAUSAL-BENEFICIAL RELATIONSHIP	A <b>causal-beneficial relationship</b> for indirect rates describes the manner in which pooled costs should be allocated to cost objectives. These costs should be allocated reasonably and proportionately to the cost objectives to which they apply.

# Indirect Rate Optimization





# Indirect Rate Optimization

**Optimization is** designing and utilizing compliant indirect cost rates to:

- ▶ Maximize cost recovery
- ▶ Improve your competitive positioning

**Optimization is not** finding opportunities to inequitably shift costs from commercial to government contracts or from fixed price to cost type work



# Indirect Rate Optimization

## Primary Objectives:

- ▶ Maximize Cost Recovery
- ▶ Improve Competitive Positioning

## Key Considerations:

- ▶ Accuracy
- ▶ Administrative Burden
- ▶ Business Complexity
- ▶ Rate Structure
- ▶ Customer Preference & Industry Practice
- ▶ Compliance

# Indirect Rate Optimization: Regulatory Guidance

## Federal Acquisition Regulation (FAR)

- ▶ Subpart 2.1: Definitions
- ▶ Part 31: Contract Cost Principles and Procedures
- ▶ Subpart 42.7: Indirect Cost Rates
- ▶ 52.216-7: Allowable Cost and Payment Clause

## Cost Accounting Standards (CAS)

- ▶ CAS 401: Consistency in estimating, accumulating and reporting costs
- ▶ CAS 402: Consistency in allocating costs Incurred for the same purpose
- ▶ CAS 403: Allocation of home office expenses to segments
- ▶ CAS 405: Accounting for unallowable costs
- ▶ CAS 410: Accounting of business unit general and administrative expenses to final cost objectives
- ▶ CAS 418: Allocation of direct and indirect costs





# Indirect Rate Optimization

## How Does Compliance fit with Optimization?

- ▶ Optimization = Compliance, but Compliance  $\neq$  Optimization
- ▶ Optimization is much more than compliance
- ▶ Compliance is inherent in the key considerations of optimization
- ▶ Indirect rates are often developed only for compliance when their purpose is far broader



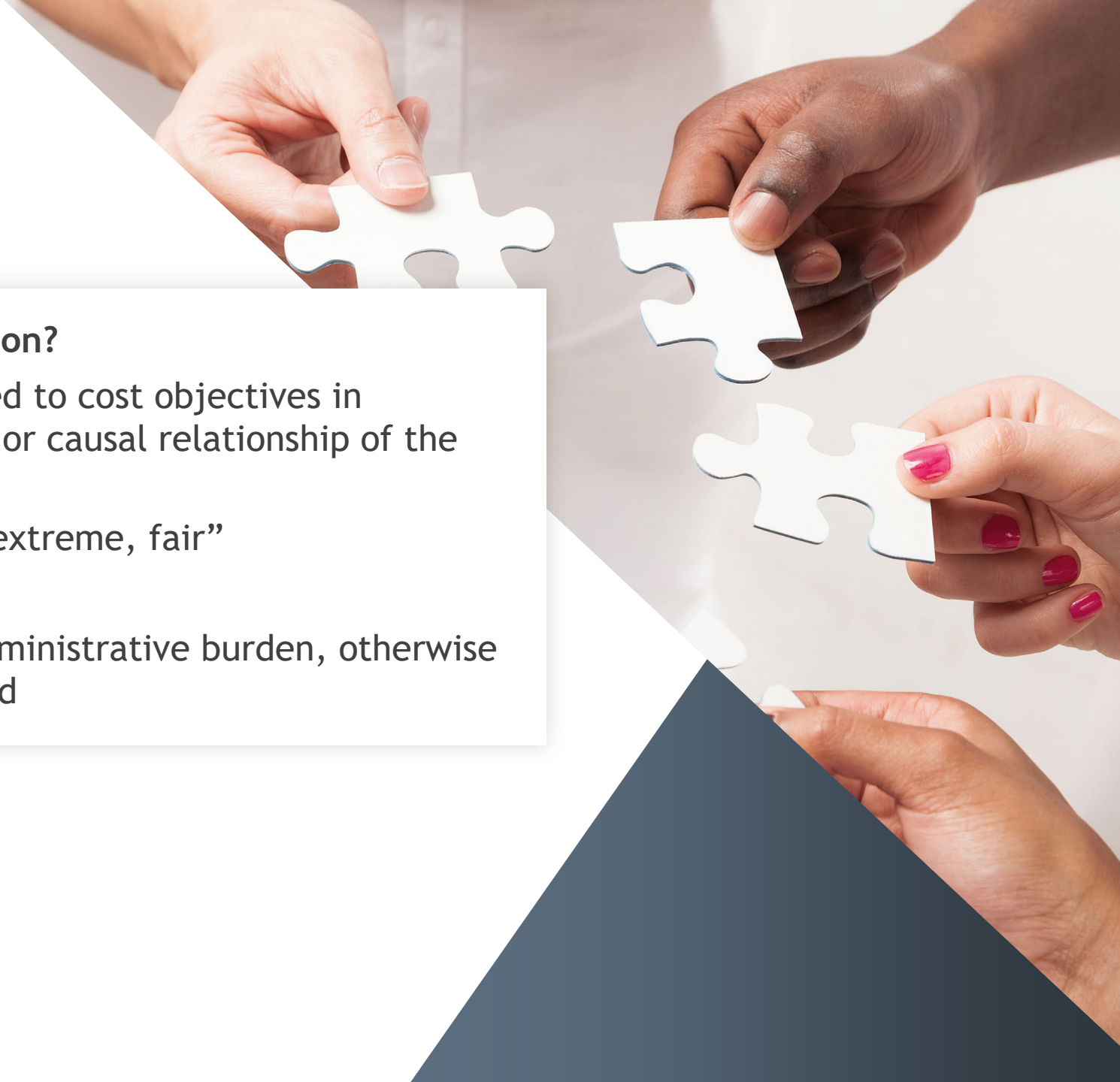
# Indirect Rate Optimization: Compliance as an Objective

## How does Compliance fit with Optimization?

- ▶ CAS 418: “Pooled costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled cost to cost objectives”
- ▶ Reasonable defined: “Not excessive or extreme, fair”

## Reasonableness is not precision

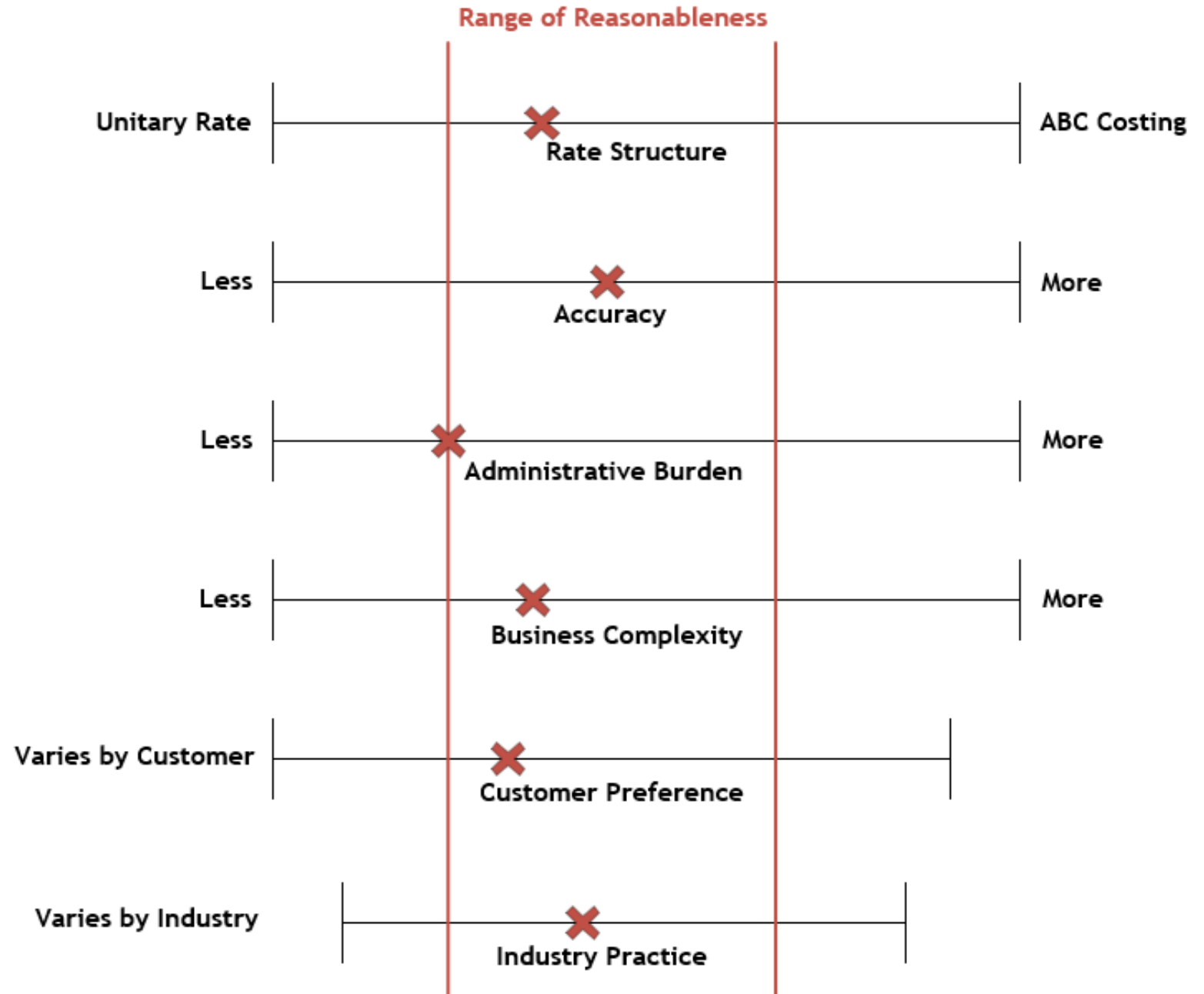
- ▶ It permits a balance of accuracy and administrative burden, otherwise Activity Based Costing would be required



# Spectrum of Considerations



## Spectrum of Considerations





# Cost Accounting Concepts

## ▶ Government Contract Cost Accounting Concepts

- Direct Costs
- Indirect Costs

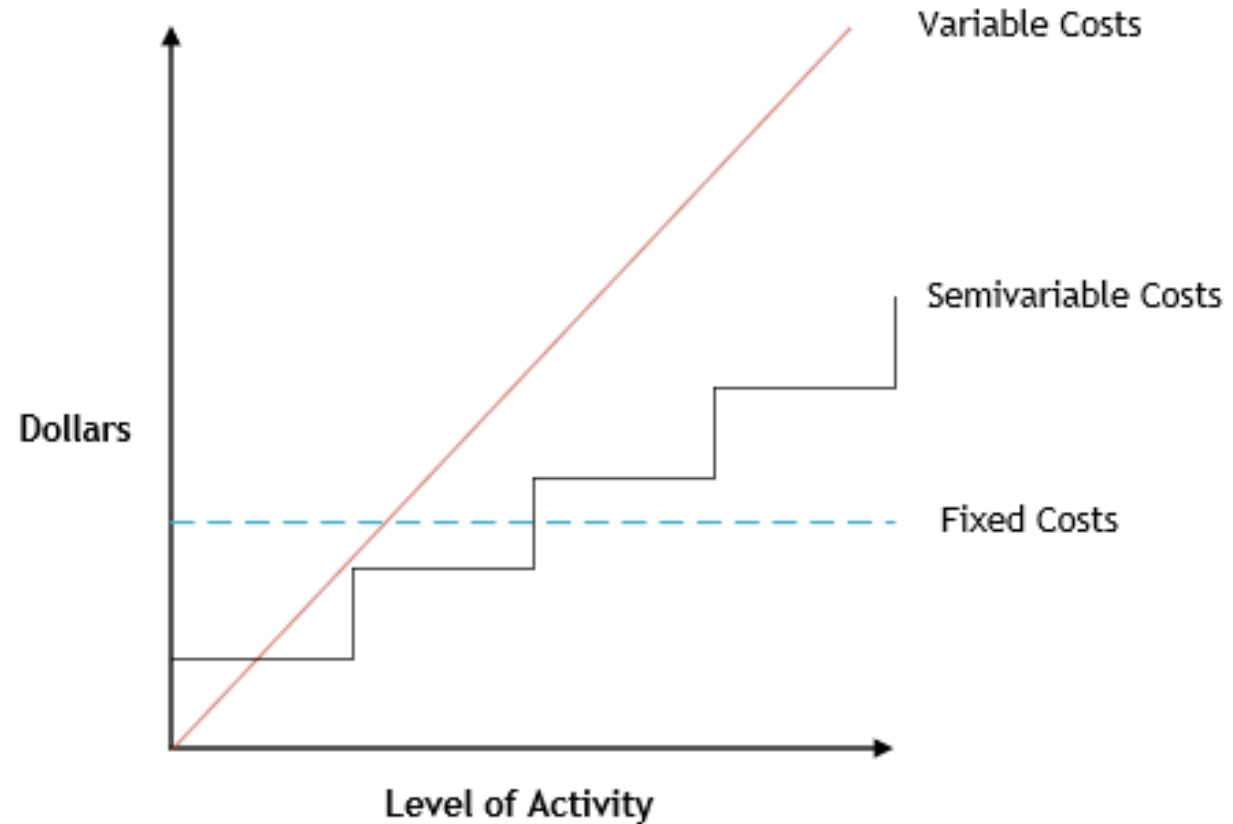
## ▶ Traditional Cost Accounting Concepts

- Variable Costs
- Fixed Costs

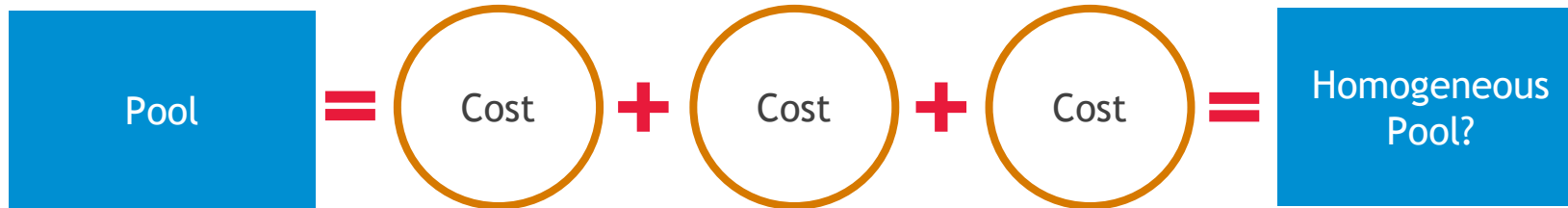
	Direct Costs	Indirect Costs
Variable Costs	Direct = Generally Variable	Strong Correlation to Variations in Business Activity
Fixed Costs	Direct = Rarely Fixed	Weak Correlation to Variations in Business Activity

# Cost Accounting & Homogeneity

- ▶ Consider homogeneity of different cost types
- ▶ Variable costs have a strong correlation to cost drivers, semi variable moderate correlation and fixed costs have a minimal correlation



# Analytical Tools



- ▶ **Homogeneous** - means composed of parts or elements that are of the same kind; essentially alike
- ▶ Homogeneity is not always a requirement (e.g., when inclusion of heterogeneous costs does not result in material inequity)

# Use Optimization

## Optimization applies to both Design and Uses of Indirect Cost Rates

- ▶ Government contract regulatory compliance
  - Forward Pricing Rates
  - Provisional Billing Rates
  - Final Incurred Cost Rates
- ▶ Business Management
  - Budgeting and Forecasting
  - Evaluating Business Performance
  - Earned Value Management
- ▶ Financial Accounting and Reporting



# Process for Evaluating Indirect Rates



# Process for Evaluating Indirect Rates - Scenario Analysis

- ▶ Define and document
  - Operating structure - Products, service lines, customers, contracts, organizational structure, and key resources consumed
  - Charging practices - direct, indirect, or varies
- ▶ Segregate unallowable costs and remove them from expense pools
  - Remember to include unallowable costs in allocation bases
- ▶ Evaluate cause and benefit themes
  - Identify causal beneficial relationships between indirect and direct costs
  - Determine cost drivers and appropriate allocation bases
- ▶ Accumulate indirect costs into logical and homogeneous groupings (pools)
- ▶ Model scenarios for consideration

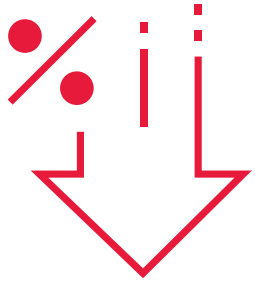
# Tactical Solutions

- ▶ Simplification of rate structure, if overly complex
- ▶ Expansion of indirect rates
  - Create additional Services Centers
  - Break out Overhead pools
  - Segment Business Lines
  - Special Allocations
- ▶ Modify allocation base of existing rates
  - Change G&A base from a TCI base to a value-added base
  - Allocated fringe in the Overhead base
- ▶ Engaging and empowering business unit management over design and use of rates



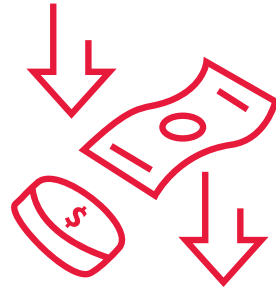


# Customer Perspective



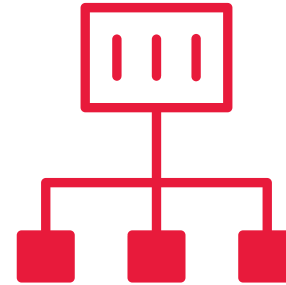
## LOWER RATES

May focus on rate percentages, not ultimate cost or price



## LOWEST PRICE

May not always consider best value



## SIMPLICITY

Simple rate structures are easier to understand



## DOCUMENTATION

Well-documented details on rate structures supports dealings with various government stakeholders

# Implications of Changing Your Indirect Rates



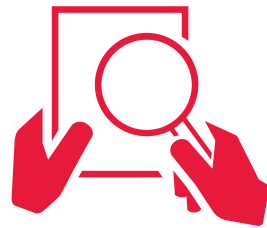
# Implications of Changing Your Indirect Rates

- ▶ Gauge customer reaction/concerns
- ▶ Train personnel on change
- ▶ Implement in accounting system
- ▶ Communicate with CO and Cognizant Auditors
- ▶ Prepare CAS Cost impact proposals (if subject to full CAS coverage)
- ▶ Model financial results under new structure

# Potential Risks That May Impair Profitability and Compliance



Poor forecasting of indirect rates resulting in lower margins or loss on fixed price and T&M contracts

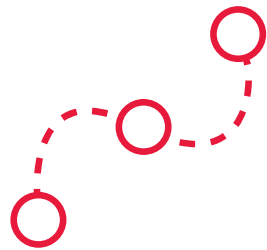


Lack of consistent monitoring of indirect rates throughout year resulting in a large variance between provisional billing rates and actual indirect rates

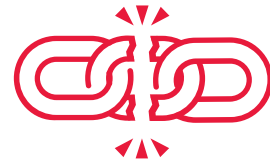


Overly complex rate structure/increased chance for human error

# Potential Risks That May Impair Profitability and Compliance



Overly simplified rate structures



Disconnect between causal or beneficial relationship between pool and base



Administrative burden/  
business complexity

# Application




**When is best time to  
employ these  
techniques?**

- ▶ There's no time like the present, but consider the following circumstances:
  - When your organizational structure changes
  - When you are evaluating acquisition targets
  - When you acquire another company or you are acquired
  - When your contract profile changes
  - When your company is going to change the ERP system
  - When you expand into additional service areas of product lines
- ▶ Don't wait til
  - Increased competition
  - Adverse economic conditions

# Questions?







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