Ch 2 - Evaluating Indirect Costs

2.0 Chapter Introduction

This chapter identifies points that you should consider as you evaluate the allocation of indirect costs to various cost objectives.

Analysis Responsibility (FAR 15.402, 15.404-2, and 15.407-3). Because indirect costs affect more than one contract, support from the cognizant auditor and administrative contracting officer (ACO) (when one is assigned) can be particularly important to your analysis. The auditor is the only Government Acquisition Team member with general access to the offeror's accounting records. The ACO is responsible for negotiating Forward Pricing Rate Agreements (FPRAs), including indirect cost rate agreements.

However, you must always remember that the contracting officer is ultimately responsibility for determining contract price reasonableness.

Note that Sections 2.1 through 2.5 of this chapter review material presented in Chapter 9 of *Cost Analysis* (Volume III). That material is presented in this chapter to facilitate understanding of unique issues related to contract billing and final indirect costs.

2.1 Examining Indirect Cost Importance, Composition, And Allowability

This section presents a brief review of indirect cost composition and the importance of indirect costs in contract pricing.

- 2.1.1 - Examining Indirect Cost Composition And Importance
- 2.1.2 - Examining The Allowability Of Indirect Costs

2.1.1 Examining Indirect Cost Composition And Importance

Indirect Cost Relationship to Cost Objectives (FAR 31.202(b) and 31.203). Indirect costs are known by many names. Generally, they are referred to as overhead or burden expense. Two types of cost are typically included in the category:

- Costs that **cannot** be specifically identified with the production or sale of a particular product or completion of a single contract. In accounting terms, these costs cannot be identified with a single final cost objective. Instead they are identified with two or more final cost objectives or an intermediate cost objective.

For example: The firm rents the plant where hundreds of different products are produced. The rent for that plant cannot be traced to any single product or contract, but none of the products could be made efficiently without the plant. The cost accountants, who maintain the general accounting ledgers of the firm support every operation of the firm, but their efforts cannot be traced directly to any single product or contract.

- Costs of minor dollar amounts that can be specifically identified with the production or sale of a particular product but are not because it is more practical to allocate them as indirect costs. In accounting terms, these direct costs of minor dollar value may be treated as indirect costs if the accounting treatment:
  - Is consistently applied to all cost objectives; and
  - Produces substantially the same results as treating the cost as a direct cost.

For example: This type of cost includes common hardware items, such as washers, rivets, and sandpaper. It would be possible to track the cost of these small-dollar items to specific products, but there is no reason to, as long as the cost allocation method is reasonable and consistently applied to all related cost objectives.

Composition of Indirect Costs. The term "indirect costs" covers a wide variety of cost categories and the costs involved are not all incurred for the same reasons. The number of indirect cost accounts in a single firm can range from one to hundreds. In general, indirect cost accounts fall into two broad categories:

- **Overhead**. These are indirect costs related to support of specific operations. Examples include:
  - Material overhead;
  - Manufacturing overhead;
  - Engineering overhead;
  - Field Service overhead; and
  - Site overhead.
- **General and Administrative (G&A) Expenses**. These are management, financial, and other expenses related to the general management and administration of the business unit as a whole. To be considered a G&A Expense of a business unit, the expenditure must be incurred by, or allocated to, the general business unit. Examples of G&A Expense include:

- Salary and other costs of the executive staff of the corporate or home office;
- Salary and other costs of such staff services as legal, accounting, public relations, and financial offices; and
- Selling and marketing expenses.

Indirect Cost Importance. While indirect costs are an important consideration in the analysis of most cost proposals, the share of total cost that they represent will vary from firm to firm and industry to industry. For example, expect indirect costs to represent a larger share of a cost proposal for industrial production than for contract services.

- Manufacturing operations typically require substantial investment in plant and equipment-the very type of spending that, in general, cannot be directly charged to any one product.
- Services typically do not require a similar level of investment in plant and equipment.

A recent study of large Defense contractors by the Institute for Defense Analysis (D-764, 1990) provides insight into the growing importance of indirect costs in large manufacturing firms. The data presented in the table below for 1974 and 1987 are actual data collected during the study. The figures for the year 2020 are extensions of the trends identified between 1974 and 1987 and are presented to highlight the implications of the identified trends for the future of Government contract pricing.

	Percent of Business		
Category of Cost	**1974**	**1987**	**2020[1]**
Direct Labor			
Manufacturing Labor	14	10	3
Engineering-Related[2]	11	14	20
Direct Material	32	26	15
Plant-wide Indirect Cost	43	50	62
Total Cost	100	100	100

[1] Projected data

[2] Engineering-related cost includes both engineering and other direct costs

The magnitude of indirect costs in a typical cost proposal emphasizes the importance of careful analysis of indirect costs in contract pricing. Furthermore, the above data indicate that thorough analysis of indirect costs can be expected to be even more important in the future.

2.1.2 Examining The Allowability Of Indirect Costs

Factors Affecting Cost Allowability (FAR 31.201-2). Because they cannot be identified with a single, final cost objective, indirect costs are particularly susceptible to charges that they are not allowable. For that reason, this section will present a brief review of the general criteria governing cost allowability. Remember, Government auditors and other specialists will make recommendations on cost allowability, but the ultimate decision rests with the contracting officer.

The factors that you must consider in determining whether a particular cost is allowable include:

- Cost reasonableness;
- Cost allocability to the contract;
- Requirements of cost accounting principles, practices, and standards;
- Limitations of applicable cost principles; and
- Terms of the contract.

Determining Cost Reasonableness (FAR 31.201-3). A cost is reasonable if, in its nature and amount, it does not exceed what a prudent person would pay in the conduct of competitive business.

Do not assume that a cost is reasonable just because the contractor has already incurred the cost. If you challenge the reasonableness of an incurred cost, the burden of proof shall be on the contractor to establish that the cost is reasonable.

If the answer to any of the following questions is "no", the cost involved is probably not reasonable:

- ***Is the type of cost generally recognized as necessary in conducting the contractor's business?***

- ***Is the cost consistent with sound business practice, law, regulation, and the principles of "arm's-length" bargaining?***
- ***Does the contractor's action reflect a responsible attitude toward the Government, other customers, the owners of the business, the employees, and the public-at-large?***
- ***Are the contractor's actions consistent with the contractor's established practices?***

Determining Cost Allocability (FAR 31.201-4). A cost is allocable if it is assignable or chargeable to one or more cost objectives on the basis of relative benefits received or other equitable relationship. Typically, we think of cost objectives as individual contracts or jobs. However, cost objectives can include other objectives, such as contractor independent research and development.

If you can answer "yes" to any of the following questions, the cost involved is probably allocable to the related cost objective:

- ***Was the cost specifically incurred for that cost objective?***
- ***If the cost benefits both the contract and other work, was the cost allocated to the cost objective in reasonable proportion to the benefits received?***
- ***Is the cost necessary for overall operation of the business even though a relationship any particular cost objectives cannot be shown?***

Accounting Principles, Practices, and Standards (FAR 31.201-2(a)(3), Subpart 42.7, and App B).

Three sources provide overall guidance on cost allowability. In order of precedence, they are:

- **Cost Accounting Standards.** The 19 Cost Accounting Standards (CAS) identified in the table below have been promulgated by the Cost Accounting Standards Board (CASB). When applicable, these Standards take precedence over all other forms of accounting guidance.

Compliance is required for all Government contracts unless an exemption applies. Exemptions include contracts awarded:

- Using sealed bidding;
- At a price of $500,000 or less;
- To a small business;
- For a commercial item; or
- For a firm-fixed price without submission of cost or pricing data.

Even when no exemption applies, contractors with less than $25 million in CAS-covered contracts may elect modified coverage which only requires compliance with CAS 401, 402, 405, and 406.

COST ACCOUNTING STANDARDS	
Accounting Concepts and Principles	
CAS 401	Consistency in Estimating, Accumulating, and Reporting Costs
CAS 402	Consistency in Allocating, Costs Incurred for the Same Purpose
CAS 405	Accounting for Unallowables
CAS 406	Cost Accounting Period
Allocation of Costs to Contracts	
CAS 403	Allocation of Home Office Expense
CAS 407	Use of Standard Cost Systems
CAS 410	Allocation of Business Unit G&A
CAS 418	Allocation of Direct and Indirect Costs
Identification and Assignment of Costs	
CAS 404	Capitalization of Tangible Assets
CAS 409	Depreciation of Tangible Assets
CAS 408	Accounting for Paid Absence
CAS 412	Composition & Measurement of Pension Costs
CAS 413	Adjustment & Allocation of Pension Costs
CAS 415	Accounting for Deferred Compensation
CAS 416	Accounting for Insurance Costs
CAS 411	Accounting for Acquisition Costs of Materials
CAS 420	Accounting for IR&D/B&P
Cost of Money	
CAS 414	Cost of Money as an Element of Facilities Capital
CAS 417	Cost of Money of Capital Assets under Construction

- **Federal Acquisition Regulation.** Many parts of the FAR provide accounting guidance that applies to all Government contracts. For example, FAR Subpart 42.7 prescribes policies and procedures for establishing indirect cost billing rates and final indirect cost rates. In some cases, FAR guidance requires all Government contractors to comply with the same accounting standards defined for CAS-covered contracts.
- **Generally Accepted Accounting Practices.** Generally Accepted Accounting Practices (GAAP) are non-regulatory accounting guidelines developed by Certified Public Accountants (CPAs). Accountants use GAAP in preparing and managing all business accounting records. As a result, they serve as the basis for the accounting systems used by Government contractors.

Guidance in the FAR and CAS generally build on GAAP. For example, the GAAP require accountants to maintain records by accounting period. CAS 406, Cost Accounting Period, prescribes that the accounting period will be one year, except in certain specific situations.

If the contractor is in compliance with applicable GAAP, FAR, and CAS requirements, you should be able to answer "yes" to the following questions:

- ***Does the cognizant Government auditor consider the offeror's accounting system adequate?***
- ***If the proposed contract is to be subject to modified CAS coverage, is the offeror in compliance with applicable Standards?***
- ***If the proposed contract is to be subject to full CAS coverage, is the offeror in compliance with applicable Standards and the firm's Disclosure Statement?***

Cost Principles. FAR 31.205 provides fifty cost principles for contracts with commercial organizations. Each cost principle defines a particular type of cost and establishes whether it is generally allowable, unallowable, or allowable with some restrictions.

- **Allowable Cost.** Costs are expressly identified as allowable as long as they meet the requirements of the other four tests of allowability (e.g., reasonableness). NOTE: Costs not addressed in the cost principles are also allowable if they meet the requirements of the other four tests of allowability.

- **Unallowable Cost.** Costs are expressly identified as unallowable. These costs cannot be included in cost estimates or contract cost reimbursements.
- **Allowable with Restrictions.** Costs are expressly identified as allowable (subject to the other four tests of allowability) but with some restriction (e.g., on the amount allowable).

The following table identifies the current cost principles in FAR 31.205, and summarizes the allowability of costs identified in the cost principle. Note that within the same general cost category, some costs may be allowable (A), others unallowable (UA), and still others allowable with restrictions (AWR). In addition, a particular principle may identify a cost as generally unallowable, but refer the reader to another principle that makes a particular element of that cost allowable.

Under FAR 31.205, are the following selected costs allowable?				
Selected Costs	**FAR Ref.**	**A**	**UA**	**AWR**
Alcoholic Beverages	31.205-51		X	
Asset Valuations Resulting from Business Combinations	31.205-52			X
Bad Debts	31.205-3		X	
Bonding Costs	31.205-4	X		
Compensation for Personal Services	31.205-6	X	X	X
Contingencies	31.205-7	X	X	
Contributions or Donations	31.205-8		X	
Cost of Money	31.205-10			X
Deferred Research & Development Costs	31.205-48		X	X
Depreciation	31.205-11			X
Economic Planning Costs	31.205-12	X	X	
Employee Morale, Health, Welfare, Food Service, & Dormitory Costs & Credits	31.205-13	X		X
Entertainment Costs	31.205-14		X	
Fines, Penalties, & Mischarging	31.205-15		X	X

Gains & Losses on Disposition of Depreciable Property or Other Capital Assets	31.205-16			X
Goodwill	31.205-49		X	
Idle Facilities & Idle Capacity Costs	31.205-17		X	X
Insurance & Indemnification	31.205-19	X	X	X
Interest & Other Financial Cost	31.205-20		X	X
IR&D/B&P Costs	31.205-18		X	X
Labor Relations Costs	31.205-21	X		
Legal & Other Proceedings Costs	31.205-47		X	X
Lobbying Costs (Executive)	31.205-50		X	
Lobbying Costs (Legislative)	31.205-22	X	X	
Losses on Other Contracts	31.205-23		X	
Maintenance & Repair Costs	31.205-24	X		
Manufacturing & Production Engineering Cost	31.205-25	X		
Material Costs	31.205-26	X		
Organization Costs	31.205-27		X	
Other Business Expenses	31.205-28	X		
Plant Protection	31.205-29	X		
Patent Costs	31.205-30	X	X	X
Plant Reconversion Costs	31.205-31		X	X
Precontract Costs	31.205-32			X
Professional & Consultant Service Costs	31.205-33	X	X	X
Public Relations & Advertising	31.205-1		X	X
Recruitment Costs	31.205-34	X	X	X
Relocation Costs	31.205-35	X	X	X
Rental Costs	31.205-36	X		X
Royalties & Other Costs for Use of Patents	31.205-37			X
Selling Costs	31.205-38	X	X	
Service & Warranty Costs	31.205-39	X		
Special Tooling & Special Test Equipment Cost	31.205-40			X

Taxes	31.205-41	X	X	
Termination Costs	31.205-42	X		X
Trade, Business, Technical, and Professional Activity Costs	31.205-43	X		X
Training & Education Costs	31.205-44	X	X	X
Transportation Costs	31.205-45	X		
Travel Costs	31.205-46			X

If the contractor is in compliance with the requirements of the FAR specific cost principles, you should be able to answer "yes" to the following questions:

- ***Are costs allowable under FAR Subpart 31.205?***
- ***Are questionable costs correctly classified using FAR Subpart 31.205 definitions?***
- ***Could the questionable cost be defined under more than one cost principle?***

Contract Terms (FAR 31.201-2(a)(4)). Specific types of cost are often addressed in the solicitation and contract. For example, while transportation costs are generally allowable, the contract could limit costs to the rates for a specific mode (e.g., 3rd class mail). **Contract terms can only be more restrictive than the other four tests of allowability, not less.** Contract terms **cannot** make an otherwise unallowable cost allowable.

If the contractor is in compliance with specific contract terms, you should be able to answer "yes" to the following question:

- ***Is the contractor complying with any specific contract language that dictates the treatment of certain costs?***

2.2 Identifying Pools And Bases For Rate Development

This section identifies points that you should consider as you identify the bases and pools needed to calculate the rates used to allocate indirect costs to various cost objectives.

Indirect Cost Allocation Rates. Since indirect costs are not directly related to a single cost objective, how do you know when they should be charged to a particular product? We use indirect cost rates. As a larger share of a contractor's direct effort (e.g., manufacturing) is required to produce a particular product, use of an indirect cost rate will assure that a larger share of the indirect costs that the contractor incurs in support of that direct effort (e.g., costs such as supervision, utilities, and maintenance) is charged to the contract.

Indirect Cost Rate Formula. The amount of indirect cost that is charged to a particular product is determined by the appropriate indirect cost rates (also known as overhead or burden rates). Indirect cost rates are expressed in terms such as dollars per hour or percentage of cost. Indirect cost rates are calculated for each accounting period by dividing a pool of indirect cost for the period by the allocation base (e.g. direct labor hours or direct labor cost) for the same period.

$$\text{Indirect Cost Rate} = \frac{\text{Indirect Cost Pool}}{\text{Indirect Cost Allocation Base}}$$

Once a rate is established, you can use it to determine the amount of indirect cost that should be allocated to the contract. Simply multiply the rate by the estimated or actual amount of the allocation base in the contract for that period. Contracts with a greater share of the allocation base (e.g., direct labor dollars) will be charged a greater share of the related indirect cost pool (e.g., manufacturing overhead). Contracts with a smaller share of the base will be charged a smaller share of the related indirect cost pool.

2.2.1 Identifying Indirect Cost Pools

Indirect Cost Pool Definition (FAR 31.203(b)). For each indirect cost rate, identify the ***INDIRECT COST POOL.***

Indirect Cost ***INDIRECT COST POOL***

Rate = Indirect Cost Allocation Base

An indirect cost pool is a logical grouping of indirect costs with a similar relationship to the cost objectives. For example, engineering overhead pools include indirect costs that are associated with engineering effort. Likewise, manufacturing overhead pools include indirect costs associated with manufacturing effort.

A properly developed indirect cost pool, should permit allocation of the included indirect costs in a manner similar to the allocation that would occur if the firm allocated each indirect cost separately.

For example: The firm could allocate the labor for maintenance of the building housing the firm's engineers and the electricity for the same building using two different indirect cost rates. Logically, both would be allocated based on the use of engineering services. Since both would use the same or similar allocation base, combining them into a pool (along with other engineering-related indirect costs) simplifies and clarifies the allocation process.

Primary Indirect Cost Pools. The indirect cost pools used to make the final allocation of indirect costs to cost objectives are known as primary pools. The table on the next page lists some of the more common primary pools and types of costs often found in each pool. A typical cost identified in the table with a particular pool (e.g., inbound transportation is identified with material overhead) could be:

- Combined with the related indirect costs into a single indirect cost pool (e.g., a single material overhead pool);
- Combined with some of the related indirect costs into one of several related indirect cost pools (e.g., indirect labor could be combined with one or two related expenses into a single pool).
- Allocated individually.

Remember that every firm's accounting system is different. The following list is only typical; do not regard it as the only correct way to group costs.

Common Primary Cost Pools and Typical Costs Found in Each	
Common Pools	**Typical Costs Found in the Pool**
Material Overhead	• 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 Expense	• 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

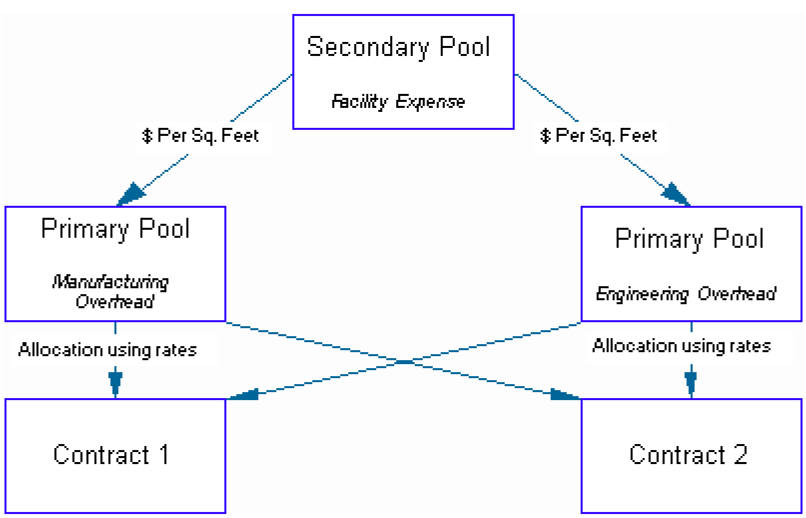
Secondary Indirect Cost Pools. A secondary pool is an intermediate pool that is used to allocate indirect costs to primary pools.

Some indirect costs obviously belong to one specific primary pool. For example, the salary of a manufacturing manager would logically be charged as part of a manufacturing overhead pool. The company president's salary would be part of the general and administrative cost pool. These costs therefore would appear only in the appropriate primary pool.

The proper account for other indirect costs may not be so obvious. For example, manufacturing and engineering share a building. Should facility expenses (e.g., building depreciation, utilities, and maintenance) be charged to engineering or manufacturing? The answer is that both should share the cost based on a causal or beneficial relationship with the cost involved. For example, facilities expenses could be allocated based on the share of available floor space occupied.

A reasonable share of each cost could be separately allocated to the appropriate primary pool, or the related costs could be grouped and allocated together. If the costs are grouped for allocation, the cost grouping is known as a secondary pool.

The figure below depicts the allocation of the expenses related to a shared facility based on the number of square feet occupied by each occupant. If engineering occupies 60 percent of the building, 60 percent of the facility-related expenses will be allocated to the engineering overhead pool. Forty percent will be allocated to the manufacturing overhead pool.

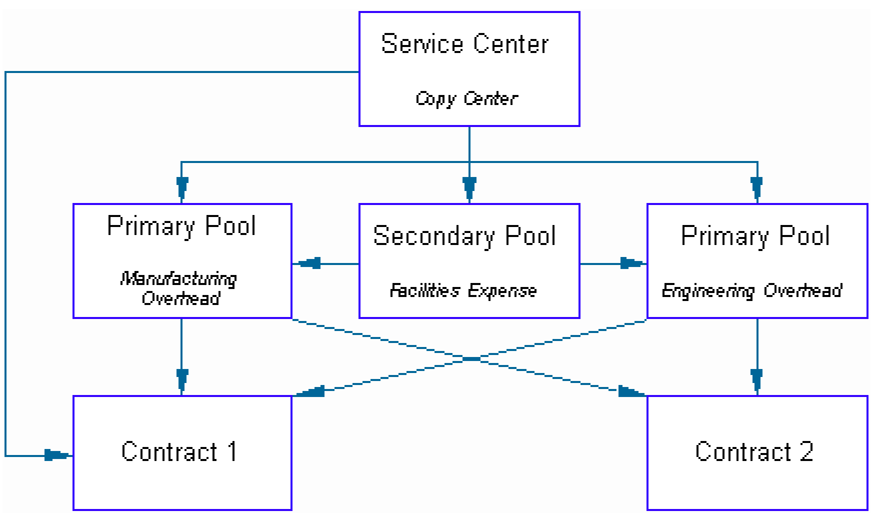


Service Centers. Service centers are unique in that they include costs that can be allocated as a direct cost or an indirect cost depending on the particular circumstances. Primary allocation concerns include identification of:

- The user of the service and
- The purpose of that use.

For example: Copy center costs may be allocated based on the number of copies reproduced.

- A copy of a manufacturing drawing might be charged to manufacturing overhead.
- A copy of an engineering report might be charged to engineering overhead.
- A copy of the facility manager's weekly calendar might be charged to the facilities secondary pool.
- A deliverable copy of a research report prepared for the Government might be charged as a direct cost.



Remember that the firm must clearly define how service center costs will be allocated. Definition of the circumstances related to each different type of accounting treatment is particularly important. Clear definition will help avoid erroneous double charges that occur when the firm charges a service center cost as a direct cost while charging the same or similar cost as an indirect cost.

Service Center Examples	
• Copy center • Business data processing • Photographic services • Reproduction services • Art services • Technical data processing services	• Communication services • Facility services • Motor pool services • Company aircraft services • Wind tunnels • Scientific computer operations

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2.2.2 Identifying Indirect Cost Allocation Bases

Indirect Cost Allocation Base Definition (FAR 31.203(b)). For each indirect cost rate, identify the ***INDIRECT COST ALLOCATION BASE.***

$$\text{Indirect Cost Rate} = \frac{\text{Indirect Cost Pool}}{\textbf{\textit{INDIRECT COST ALLOCATION BASE}}}$$

An indirect cost allocation base is some measure of direct contractor effort that can be used to allocate pool costs based on benefits accrued by the several cost objectives. Examples of typical bases:

- Direct labor hours
- Direct labor dollars
- Number of units produced
- Number of machine hours.

The type of base determines whether the indirect cost rate will take the form of a percentage or a dollar rate per unit of measure. The following are some common bases that could be used in manufacturing indirect cost allocation:

$$\text{Dollars per Direct Labor Hour} = \frac{\text{Pool Dollars}}{\text{Direct Labor Hours}}$$

$$\text{Percent of Direct Labor Dollars} = \frac{\text{Pool Dollars}}{\text{Direct Labor Hours}} \times 100$$

Dollars per Unit of $\frac{\text{Pool Dollars}}{}$

Production = # of Production Units

Dollars per Machine Hour = $\frac{\text{Pool Dollars}}{\text{Machine Hours}}$

Whatever the allocation base, the larger a contract's share of the allocation base for the accounting period, the larger the contract's share of the related indirect cost.

Selecting an Allocation Base. When selecting an allocation base for the indirect cost pool, firms consider the type of indirect costs in the pool and whether the base will provide a reasonable representation of the relative consumption of pooled indirect costs by direct cost activities. Each allocation base should be representative of the breadth of activities supported by the pooled indirect costs.

For example: If the firm's manufacturing operation is labor intensive and the pool is predominantly labor related (e.g., fringe benefit costs) the contractor will probably select a base related to labor effort for allocating manufacturing overhead costs. If the manufacturing operation is automated with little labor effort, the contractor will probably select a base related to the machinery use (e.g., machine hours).

Common Allocation Bases. The following table represents some of the more common bases and the type of pools that they are typically used to allocate:

	Types of Indirect Cost Pools					
Allocation Bases	**Manufacturing**	**Engineering**	**Field Service**	**Material**	**General & Administrative**	**Secondary Pools**
Total Cost Input [1]					·	
Cost of Value-Added [2]					·	
Direct Labor Dollars	·	·	·		·	
Direct Labor Hours	·	·	·		·	
Machine Hours	·					

Units of Product [3]	·					
# of Purchase Orders				·		
Direct Material Cost				·		
Total Payroll Dollars						·
Head Count						·
Square Footage						·

[1] **Also referred to as the "Cost of Goods Manufactured" or "Production Cost" during the accounting period. It typically includes all costs except general and administrative expense.**

[2] **Also referred to as "Conversion Cost." It is the sum of direct labor costs, other direct costs, and associated indirect costs.**

[3] **Units of Product refers to units of final product produced. It is only an acceptable base when final products are relatively homogeneous and represent a reasonable measure of benefit from the appropriate pool.**

2.3 Identifying Inconsistencies And Weaknesses In Rate Development

This section identifies points that you should consider as you evaluate the estimating process used by the contractor in indirect cost rate development.

- 2.3.1 - Identifying Cost Allocation Cycle Inconsistencies
- 2.3.2 - Identifying Apparent Rate Development Process Weaknesses

Importance of Accurate Indirect Cost Rate Estimates. Accurate indirect cost rate estimates are essential for effective cost analysis, because actual indirect cost rates will not be known until after the end of the accounting period. By that time, part or all of the contract effort will be complete.

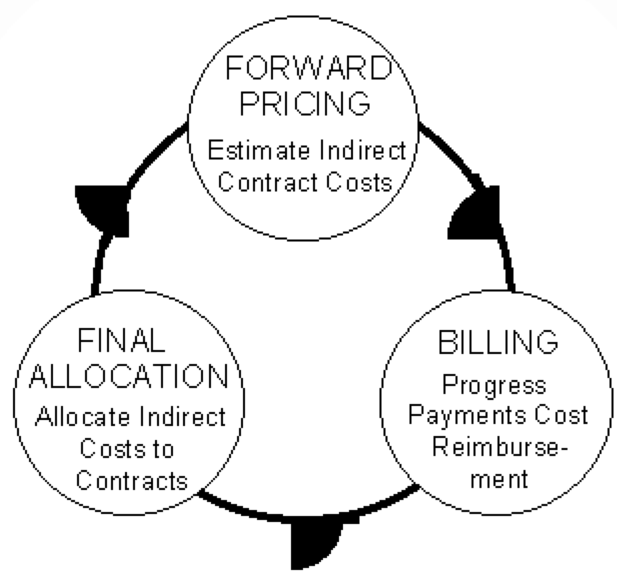
Rate estimates are used for forward pricing, as well as progress payments or cost-reimbursement. You and the contractor may even agree to use estimated quick-closeout indirect cost rates for final pricing of flexibly-priced contracts, before actual rates are known for certain.

Points to Consider. s you review the estimating process used by the contractor in indirect cost rate development:

- Identify apparent inconsistencies in the indirect cost allocation cycle.
- Identify apparent weaknesses in the indirect cost rate estimating process.
- Assure that concerns about the estimating process are well documented.

2.3.1 Identifying Cost Allocation Cycle Inconsistencies

Indirect Cost Allocation Cycle (FAR 15.407-3, 42.701, 42.704, and 42.705). Indirect cost allocation typically follows the cycle depicted in the following figure:



- **Forward Pricing**. During this phase, the contractor proposes forward pricing rates and uses those rates in contract proposal pricing. Initial estimates are often developed several years before the accounting period even begins. However, estimates should be updated as more accurate cost data become available. As part of your cost analysis, you must assure that all forward pricing rates used in contract pricing are reasonable.
- **Contract Billing**. When a contract involves progress payments or cost reimbursement, Government personnel must monitor contract billing rates to assure that payments or reimbursements based on those rates are reasonable. During each cost accounting period, rates should become increasingly accurate as more actual cost data become available. The contracting officer or auditor responsible for determining final indirect cost rates is also responsible for determining contract the billing rates.
- **Final Pricing**. After the cost accounting period is completed, contractors can calculate actual indirect cost rates to determine actual contract cost. For contracts that require final pricing (e.g., fixed-price incentive and cost-reimbursement contracts), the responsible contracting officer or auditor must determine final overhead rates for the contract. This determination will be based on the Government's evaluation of the final overhead rate proposal submitted by the contractor.

Unfortunately, months or years may be required to complete this process. Under certain conditions set forth in the FAR, you and the contractor may agree to use estimated quick-closeout indirect cost rates for final pricing of flexibly-priced contracts, before actual rates are known for certain (FAR 42.708(a)).

Rates Are Part of a Continuing Allocation Cycle. Remember that forward-pricing rates, billing rates, and final rates are all part of a continuing indirect cost allocation cycle.

- Forward pricing rates will affect budget decisions and the rates used in contract billing.
- Billing rate estimates will affect the need for cost adjustment during final contract pricing.
- Final rates can be used to measure the actual allocation of direct cost to a particular cost

objective. In addition, the data used to support final rates will become part of the data available for estimating forward pricing and billing rates for subsequent accounting periods.

Identifying Inconsistencies in Cost Allocation Cycle Information. As you review the estimating process used in rate development, identify any inconsistencies regarding the relationship between the proposed rates and related rates in the indirect cost allocation cycle. Ask questions such as the following:

- ***How does the proposed rate compare with other rates in the indirect cost allocation cycle?***

For example, proposed forward pricing rates and billing rates for the same accounting period should be identical or very similar.

- ***Has rate accuracy consistently improved throughout the allocation cycle?***

The relationship between past forward pricing rates and actual rates should provide information on the firm's past estimating accuracy. Billing rates near the end of the accounting period should be close to the actual rates experienced for the period. Quick closeout rates should be comparable to actual rates.

- ***Does the contractor update rate estimates as more information becomes available?***

Indirect cost rates for each accounting period are estimates until actual costs are determined after the end of the period. However, the rates should be updated as more information becomes available.

2.3.2 Identifying Apparent Rate Development Process Weaknesses

Review Information on the Steps Used to Estimate Indirect Cost Rates. Initial indirect cost rate estimates for a particular accounting period are generally developed before the period begins. In fact, contractors pricing long-term contracts are frequently required to forecast rates three to five years into the future. Rate estimates should be updated as more information becomes available, both before and during the accounting period to which the rate applies.

Review information submitted by the offeror regarding the steps used to estimate indirect cost rates for each accounting period. While the exact process will vary from firm to firm, the general process should follow four steps:

- **Estimate Sales Volume for the Period** -- the total goods and services that the firm expects to sell to ALL customers during each forecast period (e.g., fiscal year of the firm).
- **Estimate Indirect Cost Allocation Bases for the Period** -- the measures of direct contractor activity that will be used to allocate pool costs based on the benefits accrued by the several cost objectives. Measures can take the form of dollars, hours, or any other appropriate measure.
- **Estimate Indirect Cost Pools for the Period** -- logical groupings of indirect costs with a similar relationship to the cost objectives.
- **Estimate Indirect Cost Rates for the Period --** divide each indirect cost pool by the appropriate allocation base.

Review Information on Estimated Sales Volume for the Period. The starting point for any indirect cost rate estimate should be a sales forecast for the accounting period. An accurate estimate of volume is essential to estimating indirect cost rates, because indirect cost pools are typically composed primarily of fixed and semivariable costs. As fixed costs and the fixed component of semivariable costs are spread over more and more direct effort, indirect cost rates will decline. As a result, lower sales volume estimates will result in higher rates, and higher volume estimates will result in lower rates. Logically, contractors normally prefer to conservatively estimate business volume, so as not to under estimate cost. However if the contractor is too conservative, the result may be overly high indirect cost rates.

For a manufacturer, estimators will consider the production and sales for each product line. For services, estimators will consider the number of contracts that the firm expects to be awarded and the effort required to complete each contract. Separate forecasts are developed for each accounting period (normally one year).

As you review the offeror's sales estimate, ask questions such as the following:

- ***Is the sales forecast used for estimating indirect cost rates based on the best information available?***

Estimates made prior to the beginning of the accounting period may be based on relatively speculative data. However, estimates should become firmer as more detailed plans are formulated for the period. Estimates should become firmer still as actual sales data for the period become available.

- ***Does the sales forecast consider all work likely to benefit from the indirect cost pool?***

To produce accurate rates, forecasts **must** include **all** work projected to benefit from the indirect cost pool during the accounting period. Estimates should include all work that is on contract, options that may be exercised, proposals with a high probability of success, solicitations in hand, and other anticipated customer requirements.

Review Information on Estimated Indirect Cost Allocation Bases for the Period (FAR Table 15-2).

Next, the firm should translate the sales volume forecast into production or contract performance schedules. Given the projected schedules, the estimator can forecast total direct effort associated with operations during each forecast period. Estimates of the direct effort will include estimates of the direct labor and material requirements for the period. Estimates will also include the allocation base for each indirect cost rate.

For cost or pricing data submissions, FAR Table 15-2 requires that the proposal state how the offeror computed and applied indirect costs, including cost breakdowns, and showing trends and budget data, to provide a basis for evaluating the reasonableness of proposed rates.

That information should include:

- An estimate of the size of the allocation base.

- An explanation of how the allocation base was estimated.
- The date that the allocation base estimate was developed.
- Data on the historical trends in the allocation base.
- An explanation of any significant differences between the historical, proposed, and budgeted dollar values of the allocation base.

As you review the contractor's indirect cost allocation base estimate, ask questions such as the following:

- ***What is the relationship between the estimated indirect cost allocation base and the estimated sales volume?***

Make sure that you understand the relationship as described by the contractor. Document any unexplained differences between the relationship described by the contractor and observed historical relationships for further analysis.

- ***Are there any differences between the proposed indirect cost allocation base and related budget estimates?***

Many times the estimated indirect cost allocation base is different than the internal budget for the same category of cost. The firm may state that it wants to challenge managers and hold the difference in reserve. Make sure that you understand the contractor's rationale, as well as the realism of any differences between current estimates and historical trends.

- ***Have past differences between allocation base estimates and actual allocation bases for the same period been adequately explained?***

Look for patterns such as consistent under estimation of the allocation base. Document any unexplained differences for further analysis.

- ***Are the data used to develop the allocation base estimates accurate, complete, and current?***

By law, all cost or pricing data must be accurate, complete, and current. Information other than cost or pricing data should also be up to date. In particular, you should carefully review any allocation base involved in any allegations of defective pricing.

- ***Did the cognizant auditor or administrative contracting officer question any of the indirect cost allocation base estimates prepared by the contractor?***

Because indirect cost pools apply across a broad spectrum of contracts, the cognizant auditor and administrative contracting officer (when one is assigned) are normally most familiar with the factors affecting estimates.

Review Information on Estimated Indirect Cost Pools for the Periodi. Given the estimated volume of work to be performed, the firm should next estimate the likely size of each indirect cost pool. As described above, indirect cost pools are typically composed primarily of fixed and semivariable costs. As volume increases, variable indirect costs will increase. However, the indirect cost rate will normally decrease because the fixed portion of the pool will be spread over a larger volume.

As with the allocation base, the offeror must provide adequate supporting documentation. That documentation should include the following information:

- The estimated dollar value of the pool.
- An explanation of how the pool was estimated.
- The date that the pool estimate was developed.
- Data on historical trends in the pool.
- An explanation of any significant differences between the historical, proposed, and budgeted dollar values of the pool.

As you review the contractor's indirect cost pool estimate, ask questions such as the following:

- ***What is the relationship between the estimated indirect cost pool and the estimated sales volume?***

Make sure that you understand the relationship as described by the contractor. Document any unexplained differences between the relationship described by the contractor and observed historical relationships for further analysis.

- ***What is the relationship between the estimated indirect cost pool and the estimated allocation base?***

Make sure that you understand the historical trends in the relationship between the indirect cost allocation base and the indirect cost pool. You can use this relationship to identify significant changes in the estimated rate structure. Document any unexplained differences between the historical relationship and the proposed rates for further analysis.

- ***Are there any differences between the proposed indirect cost pool and related budget estimates?***

Make sure that you understand the contractor's rationale, as well as the realism of any differences between current estimates and historical trends.

- ***Have past differences between indirect cost pool estimates and actual pools for the same period been adequately explained?***

Look for patterns such as consistent over estimation of the pool. Document any unexplained differences for further analysis.

- ***Are the data used to develop the indirect cost pool estimates accurate, complete, and current?***

By law, all cost or pricing data must be accurate, complete, and current. Information other than cost or pricing data should also be up to date. In particular, you should carefully review any allocation base involved in any allegations of defective pricing.

- ***Did the cognizant auditor or administrative contracting officer question any of the indirect cost pool estimates prepared by the contractor?***

Because indirect cost pools apply across a broad spectrum of contracts, the cognizant auditor and administrative contracting officer (when one is assigned) are normally most familiar with the factors affecting estimates.

Review Information on Indirect Cost Rate Estimates for the Period. When the indirect cost allocation base and the indirect cost pool estimates have been completed, the only task remaining is to divide the estimated pool by the estimated allocation base to establish the indirect cost rate.

The table below presents rate forecasts for the next three years. Note that the base and pool estimates for material, engineering, and manufacturing, become the estimate of total cost input, the base for the G&A expense rate.

3-Year Indirect Cost Rate Estimates			
Estimate	**19X7**	**19X8**	**19X9**
Sales Estimate	1,000 Units	1,500 Units	1,300 Units
Direct Material	$14,145,921	$17,857,300	$14,762,049
Material Overhead	$1,361,000	$1,562,358	$1,564,992
Engineering Direct Labor	$1,582,300	$1,596,105	$1,669,141
Engineering Overhead	$1,023,500	$1,002,525	$1,060,045
Manufacturing Direct Labor	$1,467,200	$1,910,450	$1,811,992
Manufacturing Overhead	$3,679,850	$4,250,150	$4,292,500
Total Cost Input	$23,259,771	$28,178,888	$25,160,719
G&A Expense	$4,426,381	$4,875,614	$4,566,581
Total Cost	$27,686,152	$33,054,502	$29,727,300
Material Overhead Rate (With Direct Material Cost Base)	9.6%	8.7%	10.6 %
Engineering Overhead Rate (With Engineering Direct Labor Cost Base)	64.7%	62.8%	63.5%
Manufacturing Overhead Rate (With Manufacturing Direct Labor Cost Base)	250.8%	222.5%	236.9%

G&A Expense Rate (With Total Cost Input Base)	19.0%	17.3%	18.1%

Normally, you should expect more detail in support of rate calculations. Consider the requirements of FAR Table 15-2 whenever you establish requirements for cost or pricing data or information other than cost or pricing data in support of indirect costs rates.

Any contractor should be able to provide you with this level of data along with detailed rationale for rate projections. Most contractors will provide you with substantially more detailed data. Assure that any data submitted meet solicitation requirements.

As you review the contractor's rate calculation and the overall data submission, ask questions such as the following:

- ***Has the contractor's estimating system been refused approval by the cognizant auditor?***

An inadequate estimating system increases the risk that the system will not provide an adequate cost estimate.

- ***Does the overall data submission comply with the requirements of FAR and the solicitation?***

Any data submission that does not meet FAR or solicitation requirements deserves special attention during cost analysis.

2.4 Analyzing Estimated Rates

Caution for Indirect Cost Rate Analysis. When you analyze indirect cost rates, do not fall into the trap of looking at a rate and immediately determining that it is too high or too low without analysis of the indirect cost allocation base and indirect cost pool. A rate of 400 percent can be reasonable and a rate of 10 percent can be unreasonable depending on the base, types of costs in the pool, reasonableness of the costs in the pool, and the overall effect on total cost and the operations of the firm. Also avoid the trap of assuming that a rate for one firm is necessarily a good yardstick for evaluating the rates of other firms in the same industry and/or of the same size.

Steps for Indirect Cost Rate Analysis. There are six general steps that you should follow as you analyze indirect cost rate estimates:

1. Develop an analysis plan.
2. Identify unallowable costs.
3. Analyze the indirect cost allocation base estimate.
4. Convert the indirect cost allocation base and the indirect cost pool to constant-year dollars.
5. Analyze the base/pool relationship.
6. Develop and document your pricing position.

Develop an Analysis Plan (FAR 15.404-2(c)). Develop a plan that tailors your in-depth indirect cost analysis efforts to areas that demonstrate the greatest cost risk to the Government. Unless required by agency or local procedures, the plan need not be in writing, but it should consider the risk to Government in terms of dollars involved and probability that the rates developed by the contractor are reasonable estimates of actual indirect cost rates.

As you prepare your plan, your analysis of risk to the Government should include questions such as the following:

- ***Is there an existing Forward Pricing Rate Agreement (FPRA) or Forward Pricing Rate Recommendation (FPRR)?***

If there is an administrative contracting officer (ACO) assigned to the offeror, contact the ACO to determine if there is an FPRA or FPRR in place. If there is, the need for further rate analysis will be greatly reduced.

- ***Can you obtain information from a recent indirect cost rate audit?***

Audit information can greatly simplify the process of rate analysis when there is no FPRA or FPRR. However, an audit recommendation does not relieve the contracting officer from the responsibility to evaluate indirect cost rates. Contact the cognizant auditor to obtain information on any indirect cost rate audit performed within the last 12 months. When an audit is available, do not request a new indirect cost rate audit unless the contracting officer considers the previous audit inadequate for pricing the current contract. Reasons for requesting a new audit include:

- Substantial changes in the offeror's rate structure.
- Audit-identified weaknesses in the offeror's rate development and tracking procedures.
- Recent changes in the offeror's business volume.
- Recent changes in the offeror's production methods.

- ***Did your review of the indirect cost allocation cycle identify any inconsistencies in the relationship between related rates in the indirect cost allocation cycle?***

Inconsistencies in the relationship between the proposed rates and related rates in the indirect cost allocation cycle may indicate that the offeror is not properly updating and reevaluating rates throughout the cycle.

- ***Did your review identify any apparent weaknesses in the indirect cost rate estimating process?***

Any apparent weaknesses in the estimating process increases the cost risk to the Government. Normally, you should increase your analysis efforts in any areas with identified weaknesses.

- ***Have the offeror's estimates been accurate in the past?***

Any contractor can incorrectly estimate an indirect cost rate. However, if past rates have been poor estimates of actual indirect costs, the risk to the Government is greater than it is in situations where past estimates have been quite accurate. As you plan, consider both the size and the consistency of the overestimates.

For example: The following table examines the accuracy of historical rate estimates made in the year prior to the rate period:

Year Rate Projection Made	Rate Projected For	Projected Rate	Actual Rate	Subtract Actual Rate From the

				Projected Rate
19X5	19X6	259.1%	254.8%	4.3%
19X4	19X5	256.3%	251.8%	4.5%
19X3	19X4	260.0%	254.8%	5.2%

Note that the company overestimated this indirect cost rate in every year. The average overestimate was 1.8 percent, calculated as follows:

$$\frac{4.3 + 4.5 + 5.2}{254.8 + 251.8 + 254.8} = \frac{14.0}{761.4} = .018 \text{ (or 1.8 percent)}$$

If all company contracts during those three years were priced using the company estimated rate, customers would have been charged an average of $101.80 for every $100 in actual costs.

- ***How many dollars are at risk?***

Consider the cost of analysis and potential cost savings from the analysis. For example, it would make little sense to invest $30,000 in the analysis of a $20,000 indirect cost estimate.

- ***Does the indirect cost pool include a substantial amount of fixed cost?***

As the percentage of fixed indirect costs increases, the risk associated with inaccurate allocation base estimates also increases. When a relatively high percentage of indirect costs are fixed, the indirect cost rate can change dramatically with any change in the allocation base. When most indirect costs are variable, changes in the allocation base will have a less dramatic affect on the indirect cost rate.

Identify Unallowable Costs (FAR 31.201-6). Costs that are expressly unallowable or mutually agreed to be unallowable must be identified and excluded from any proposal, billing, or claim related to a Government contract. When an unallowable cost is incurred, any cost related to its incidence is also unallowable.

Contractors must identify unallowable indirect costs whenever indirect cost rates are proposed, established, revised, or adjusted. The detail and depth of records required as rate support must be adequate to establish and maintain visibility of the indirect cost.

Any indirect cost analysis should specifically identify unallowable costs to assure proper treatment in indirect cost rate development:

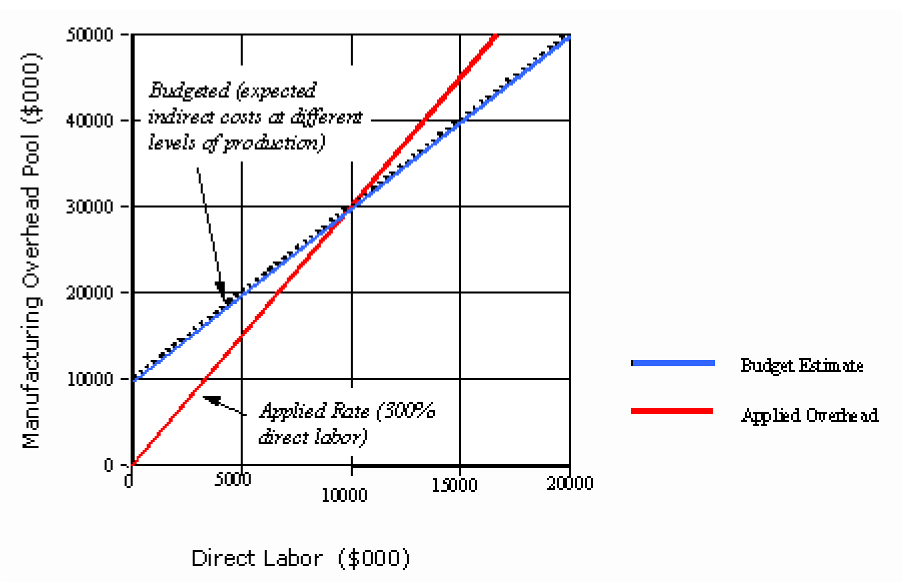
- Unallowable costs must be removed from any indirect cost pool estimate, because Government contracts cannot include unallowable costs.
- When allocation base estimates include unallowable costs, the unallowable costs must be considered in Government rate projections to assure proper allocation of costs across all cost objectives.

Consider the following tests for cost allowability identified in the following table as you perform your analysis (FAR 31.205):

Points to Consider When Analyzing Indirect Cost Allowability	
If:	**Then:**
The proposed indirect cost pool dollar amount is not reasonable	Reduce the dollar amount of the indirect cost pool to reflect a more reasonable dollar value for that item.
The proposed cost should have been treated as a direct cost (either against the proposed contract or another contract)	Subtract that cost from the total dollar value of the indirect cost pool, and ensure the cost is directly charged to the proper contract.
This cost belongs in a different indirect cost pool.	Subtract that cost from the proposed indirect cost pool and add it to the dollar value of the correct pool.
The same cost is also represented in another indirect pool, or as a direct cost, or as part of an estimating factor (e.g., a packaging or obsolescence factor)	Develop your pricing position recognizing the proposed cost in the area where the cost should be recognized and deleting it in the area where it should not be included in the proposal.

The proposed cost is not properly allocable, in part or in whole, to the pool under CAS or GAAP	Reallocate the cost in a manner that is consistent with appropriate CAS or GAAP requirements.
The proposed cost is not allowable, in part or in whole, under the FAR cost principles	Reduce the dollar amount of the indirect cost pool commensurably.
The proposed cost is not allowable, in whole or in part, under the terms and conditions of the contract	

Analyze the Allocation Base Estimate (FAR 31.203(b)). The rate allocation base should be selected so as to permit allocation of the indirect cost pool to the various cost objectives on the basis of benefits accruing to each cost objective. The size of the estimate is important because most indirect cost pools include fixed costs. As the size of the base increases, the rate will decrease because the fixed expenses are being spread over a larger base. As the size of the base decreases, the rate will increase because the fixed expenses are being spread over a smaller base. The result of an inaccurate estimate can be demonstrated through the use of the following figure:



The Applied Overhead line represents the negotiated indirect cost forward pricing rate (300% of direct labor dollars). The Budget Estimate line represents the firm's forecast of the pool at different levels of production. Note the following characteristics of the two lines:

- The Applied Overhead line passes through the origin, because indirect costs can only be charged if product is produced and sold. (300% of nothing equals nothing.)
- The Budget Estimate line has a positive intercept at $10 million. In other words, Manufacturing Overhead includes $10 million in fixed costs.
- The two lines intersect at the direct labor estimate of $10,000,000 for the year-the point at which a 300% rate would recover the budgeted $30,000,000 in indirect costs.

Note that, if the base is anything other than $10 million, use of the 300 percent rate will not equal the budgeted indirect cost.

If the base were actually $5 million at the end of the period, the actual indirect cost should be $20 million (according to budget estimates). If indirect costs for all contracts had been estimated using the 300 percent rate, only $15 million would be applied (charged) to the contracts. Indirect cost would be **under-applied** by $5 million ($20 million - $15 million). If the contracts were all firm fixed-price, that $5 million would come out of the contractor's profits.

If the base were actually $15 million at the end of the period, the actual indirect cost should be $40 million (according to budget estimates). If indirect costs for all contracts had been estimated using the 300 percent rate, $45 million would be applied to the contracts. Indirect cost would be **over-applied** by $5 million ($45 million - $40 million). If the contracts were all firm fixed-price, the result would be $5 million in additional profit.

Consider questions such as the following as you analyze indirect cost allocation bases (FAR 31.203(e) and App B, 9904.406-40):

- ***Did the offeror use the correct base period (e.g., one year)?***

The base period for allocating indirect costs is the cost accounting period during which such costs are incurred and accumulated for distribution to work performed during that period. Generally the base period is the contractor's fiscal year. A shorter period may be appropriate:

- For contracts in which performance involves only a minor portion of the fiscal year,
- When it is general practice in the industry to use a shorter period, or
- During a transitional cost accounting period as part of a change in fiscal year.

When a contract is performed over several accounting periods, analyze the indirect cost allocation base for each rate for each accounting period covered by the contract.

- ***Does the indirect cost allocation base include all costs associated with that base during the accounting period, whether allowable or not?***

Remember that unallowable costs must be excluded from any proposed indirect cost pool. However, all costs are part of the base-even the unallowables. For example, unallowable costs must be excluded from a manufacturing overhead pool. However, if manufacturing overhead is part of the allocation base for another indirect cost account (e.g., G&A expense) the unallowable costs must be added back into the base.

- ***Will the base result in a fair allocation of the costs in the indirect cost pool?***

Indirect costs must be accumulated by logical cost groupings with due consideration of the reasons for incurring such costs. The base should be selected so as to permit allocation of the grouping on the basis of benefits accruing to the several cost objectives.

For example, if the pool is largely labor related (such as fringe benefits), the base should be a measure of labor effort, such as direct labor hours or dollars. If the pool is largely machinery related (such as depreciation and maintenance), the base should relate to machinery use, such as direct machine hours.

- ***When was the base estimate made?***

If the offeror is estimating a base for the fiscal year, an estimate made mid-way through the fiscal year is likely to be more accurate than an estimate made at the beginning of the year. Likewise, an estimate made for the next fiscal year should normally be more reliable than an estimate for a period three years in the future.

- ***Does the sales volume used to estimate the allocation base appear reasonable?***

The offeror does not have perfect knowledge of what is going to happen in the future. Estimators must consider more than known sales volume for the period in estimate development. Typically, the offeror will consider the following business forecast elements:

  - Contracts in hand;
  - Options that may be exercised;
  - Proposals with a high probability of success [e.g., final proposal revisions (FPR)];
  - Solicitations in hand; and
  - Sales forecasts of future customer requirements;

Each element of the sales volume forecast should be assigned a probability of actual sale. Contracts in hand would be 100 percent. Other estimates would be assigned a lower "win" probability, based on an analysis of the probability of actually making the sale.

If the firm's sales consist of only a few large Government contracts, place less faith in contractor statistical estimates, and more faith on the best expressions of Government plans. When the total business activity of the firm includes a large number of relatively small orders, give greater credence to statistical projections that appear reasonable, given the available data.

- ***Does the allocation base estimate appear reasonable for the projected sales volume?***

Using historical data and other available information, determine if the proposed allocation base appears reasonable for the estimated sales volume. If you have any questions, seek information from the cognizant auditor or ACO.

- ***How stable has the allocation base been over time?***

Particularly with respect to small businesses that are heavily dependent on a few contracts, the base may be quite unstable. If such a firm loses only one contract, indirect rates on its remaining contracts might skyrocket. That would be particularly significant for proposed cost-reimbursement contracts. You may need to consider contract terms to protect the Government from the risk of unexpected, substantial changes in burden rates.

Convert the Base and Pool to Constant-Year Dollars. To analyze the historical relationship between the indirect cost allocation base and the indirect cost pool, you need to consider the changing value of the dollar. Unfortunately, it may be impossible for you to adjust for inflation when you are performing a summary level analysis, because there is rarely a single price index that you can use to adjust an entire indirect cost pool for inflation/deflation. There are typically too many different types of cost and cost behaviors included in indirect cost pools. For example, during a period of general inflation, depreciation will decline unless the contractor acquires new depreciable assets. The price of gasoline for company cars may rise rapidly as the cost of office supplies is declining.

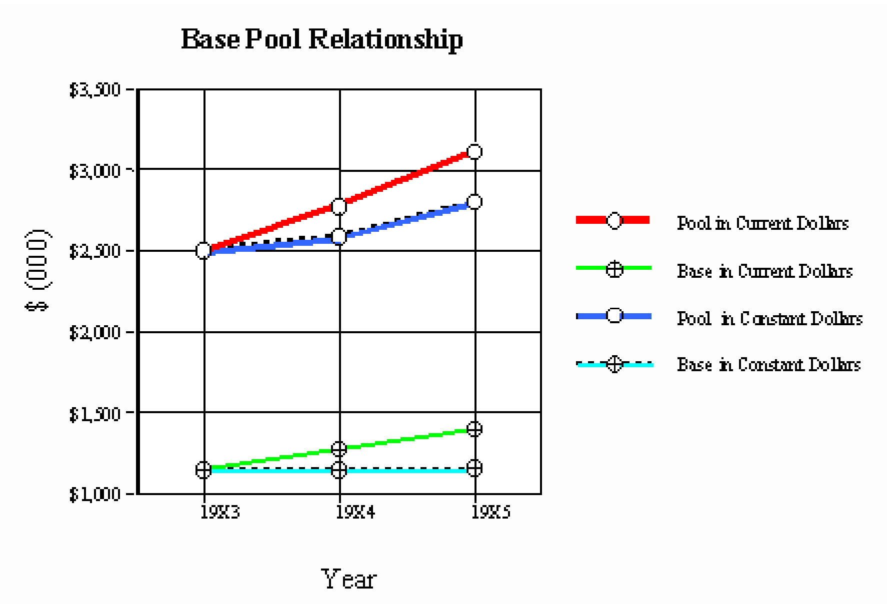
On the other hand, if you are performing a detailed analysis of individual elements of an indirect cost account, you should be able to identify one or more indexes to use in adjusting for the changing value of the dollar. If the contractor has adjusted costs for inflation and the contractor's index number selection is reasonable, use it. If you have any concerns about the contractor's adjustments for inflation, deal with them before proceeding with further analysis.

For example: The following actual costs for 19X3, 19X4, and 19X5 along with projected costs for 19X6 were taken from a contractor's proposal for an indirect pool:

		19X3 Actual)	**19X4 (Actual)**	**19X5 (Actual)**	**19X6 (Projected)**
Current-Year Dollars	**Pool**	$2,502,490	$2,768,851	$3,110,004	$3,510,141
	Base	$1,154,650	$1,270,115	$1,397,115	$1,536,839
	Rate	216.7%	218.0%	222.6%	228.4%
Constant-	**Pool**	$2,502,490	$2,590,650	$2,799,804	$2,996,000

Year Dollars (Adjusted For Inflation)	**Base**	$1,154,650	$1,153,900	$1,156,500	$1,155,000
	Rate	216.7%	224.5%	242.1%	259.4%

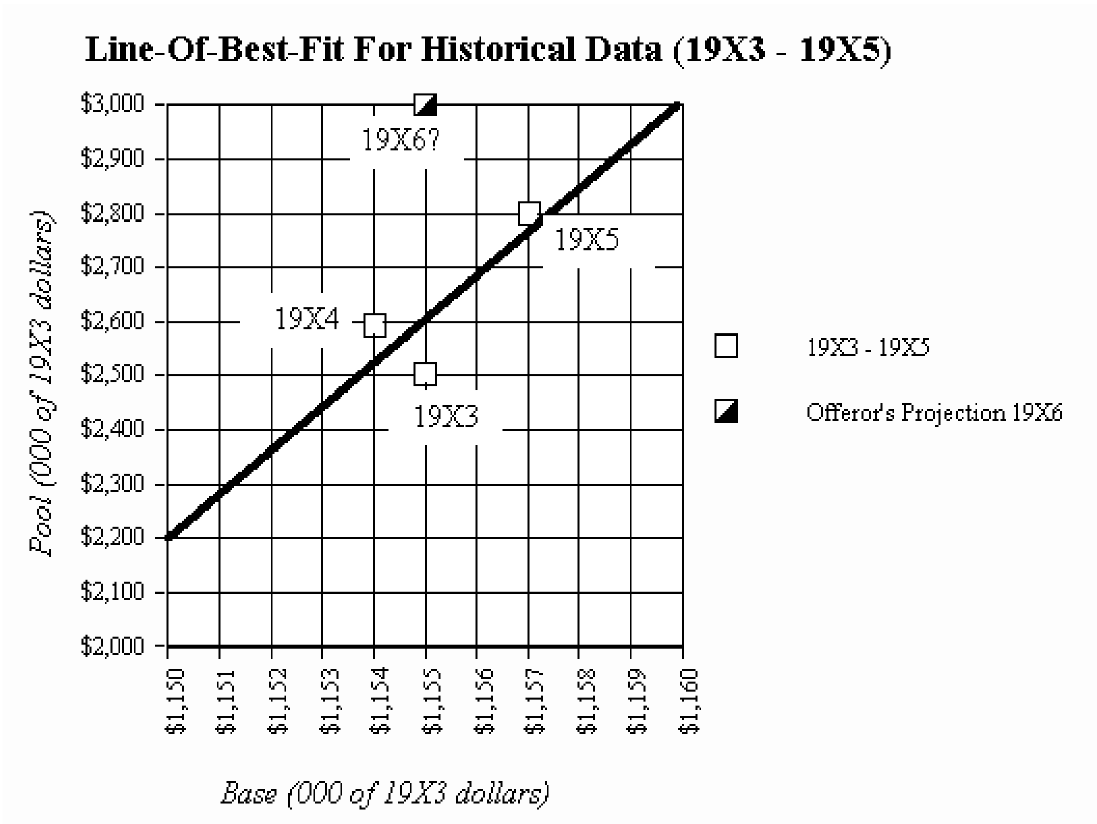
The following graph depicts the data presented in the above table. The solid lines depict independently the base and pool in current-year (unadjusted for inflation) dollars. The dotted lines depict the same information in constant-year (19X3) dollars.



Both the table and the graph show fluctuating base and pool dollars. However, inflation-adjusted data indicate that the inflation-adjusted indirect cost pool is increasing, while the inflation-adjusted allocation base is remaining relatively constant. Based on this analysis, it appears that inflation is masking real substantial growth in the rate.

Analyze the Pool/Base Relationship. Both the allocation base and indirect costs will normally change with increases or decreases in business activity. If you can determine the historic relationship between the allocation base and indirect costs, you can use that information to predict what the rate will be at various levels of the allocation base. If you can use regression analysis to quantify the relationship, you will be able to easily predict the indirect cost pool for any allocation base value.

You can analyze the overall relationship between the allocation base and the indirect cost pool, or examine the relationship between individual indirect cost accounts (e.g., office supplies) and the indirect cost allocation base. The following graph demonstrates application of this technique to the data on constant year dollars from the example on the previous page.



As you review the above graph, note that the proposed rate for 19X6 falls well above the value that you would project based on the historical base/pool relationship. When the contractor's estimate is substantially above or below the line, you should challenge the estimate. If the contractor refuses to reduce its rate and cannot explain the reasons for the difference, consider performing a more in-depth analysis.

As you examine the base/pool relationship, ask questions such as the following:

- ***Has the composition of the pool or base changed over time?***

Be alert to any changes in the composition of either the base or pool. The offeror may have automated. Automation would increase depreciation expense in the indirect cost pool while decreasing any base related to direct labor. Indirect cost rates could increase while combined direct and indirect costs decline.

- ***Has the indirect cost rate structure changed from the structure used for past contracts?***

A change in rate structure could result in costs being moved from one indirect cost pool to another. If your analysis indicates that changes have taken place ask the offeror for more information on the changes.

- ***Are changes in the rate consistent with the mix of fixed and variable costs in the indirect cost pool?***

If the indirect cost pool is primarily composed of variable costs, the rate should be relatively insensitive to changes in the allocation base that result from changes in sales volume. If the indirect cost pool is primarily composed of fixed costs, the rate should be more sensitive to changes to such changes.

Develop and Document Your Pricing Position. Develop and document your prenegotiation position, using the results of your analysis:

- If you accept the offeror's indirect cost rate estimate, document that acceptance.
- If you do not accept the indirect cost rate estimate, document your concerns with the estimate and develop your own prenegotiation position for costs covered by the estimate.
- If you can identify information that would permit you to perform a more accurate analysis of indirect cost rates, use the available information. Your analysis is not bound by the estimating methods used by the offeror.

2.5 Contract Forward Pricing

Indirect Cost Rates and Forward Pricing. One important use for indirect cost rate estimates is contract forward pricing. Contract pricing estimates of indirect costs for specific contracts and contract line items are developed by applying the estimated rate to the appropriate contract-related base. The indirect cost estimate will depend on both the rate and the size of the base related to contract performance.

Forward Pricing Rates (FAR 15.404-1(c), 15.404-2(a), and 15.404-2(d)). An indirect cost forward pricing rate is a rate that is used in prospective contract pricing. Actually you may encounter several different forward pricing rates as you develop your contract pricing position.

- **Proposed Forward Pricing Rates.** These are the indirect cost pricing rates proposed by the contractor. Depending on the contractor's participation in negotiated Government contracts, the firm may prepare a separate rate proposal or include all data supporting the proposed rate as part of the contract pricing proposal. These rates are the starting point for indirect cost rate analysis and contract pricing.
- **Audit Recommended Rates.** These are rates developed by Government audit personnel as a result of their review of the contractor's indirect cost rate proposal. The recommendation may result from the audit of the current contract proposal, a recent (within the last 12 months) contract proposal, or a separate indirect cost rate proposal. These are important recommendations, because auditors are the only members of the Government Acquisition Team that have general access to the contractor's accounting records. However, they are recommendations. You are still responsible for evaluating contract price reasonableness.
- **Forward Pricing Rate Recommendations.** Forward Pricing Rate Recommendations (FPRRs) are formal rate recommendations developed by the cognizant ACO for all Government buying activities. FPRRs are generally developed with assistance from the cognizant Government auditor.

When a contractor has a high volume of Government pricing actions, ACOs should consider establishing an FPRR:

- When the contractor refuses to submit a forward pricing rate agreement (FPRA) proposal or enter into an FPRA;
- During the period between cancellation of one FPRA and the establishment of a replacement FPRA; or
- During the period between agreement on an FPRA by Government/contractor negotiators and formal execution of the agreement.

Although FPRRs are only recommendations, you should not develop an independent position without first contacting the contract administration office that issued the FPRR. The contract administration office should be able to supply information supporting the reasonableness of the recommended rate. When negotiating a contract or contract modification for which cost or pricing data are required, consider inviting the ACO that issued the FPRR and cognizant auditor to attend negotiations concerning indirect cost rates.

- **Forward Pricing Rate Agreements** (FAR 15.407-3). Negotiating indirect rates tends to be time consuming and contentious. At contractor locations with significant Government business, the cognizant administrative contracting officer (ACO) should attempt to negotiate an FPRA.
    - An FPRA is a formal bilateral agreement that binds the contractor to propose the negotiated rates and the Government to accept them in pricing individual contracts. Each agreement includes provisions for canceling all or a portion of the agreement if circumstances change and the rate(s) are no longer valid representations of future costs.

The following process was used to develop the contract cost estimate presented above using the proposed 19X7 indirect cost rates:

- Estimate direct material and direct labor costs to perform the proposed contract, using appropriate estimating techniques.
- Multiply the proposed Material Dollar base by the Material Overhead Rate (9.6%), resulting in a contract Material Overhead estimate of $19,200.

- Multiply the proposed Engineering Labor Dollar base by the Engineering Overhead Rate (64.7%), resulting in a contract Engineering Overhead estimate of $3,235.
- Multiply the proposed Manufacturing Labor Dollar base by the Manufacturing Overhead Rate (250.8%), resulting in a contract Manufacturing Overhead estimate of $188,100.
- Total the proposed production input costs ($490,535).
- Multiply Total Cost Input by the proposed G&A Expense rate (19.0%), resulting in a contract G&A Expense estimate of $93,202.
- Add the estimated G&A Expense dollars to the Total Cost Input, resulting in a total proposed cost of $583,737.

Caution -- Assure that the Indirect Cost Rate Is Applied to the Appropriate Base

Apply each indirect cost rate to the appropriate allocation base. For example, if the direct labor costs from three departments-machining, fabricating, and assembly - are the base for the manufacturing overhead rate, you must multiply the sum total of **all** machining, fabricating, and assembly direct labor costs by the manufacturing overhead rate to estimate manufacturing overhead dollars.

On the other hand, do not apply the manufacturing overhead rate to cost categories not included in the base. You would not apply manufacturing overhead to field service labor cost if field service labor costs were not part of the allocation base used in developing the rate. **Only apply overhead rates to those elements included in the appropriate indirect cost allocation base.**

Sources of Estimate Differences. Differences between the contractor's estimate of indirect costs and your estimate can come from two sources-rate differences and proposed contract allocation base differences. You need to be aware of the sources of cost differences as you prepare for contract negotiations. Remember that even if you accept the contractor's proposed rate, your indirect cost objective will be lower than the costs proposed, if the base you are using is lower than the contractor's proposed base.

2.6 Contract Billing

This section examines factors that you should consider when establishing billing rates, adjusting billing rates, or evaluating costs related to contractor requests for progress payments or cost reimbursement.

- 2.6.1 - Establishing Billing Rates
- 2.6.2 - Adjusting Billing Rates
- 2.6.3 - Disallowing Contractor Costs

Need for Billing Rates. Analysis of indirect costs during contract pricing provides a snapshot of the indirect cost rate structure at one point in time during the Indirect Cost Cycle. However, that snapshot is only one estimate of indirect cost rates. That estimate could change at any time, as new information becomes available, until the accounting period is complete and rates are final.

For firm fixed-price contracts without progress payments, the contract price is fixed and it will not be affected by changes in the indirect cost rates. As a result, the responsibility for monitoring rates during contract performance rests with the contractor.

For firm fixed-price contracts with progress payments based on cost, the contract price is fixed but the amount of individual progress payments will depend in part on the indirect cost rates used for progress payment billing. For fixed-price incentive contracts and cost-reimbursement contracts, the amount paid during contract performance (progress payments and cost-reimbursement) will depend in part on the indirect cost rates used for billing. In these cases, the Government must establish and monitor billing rates.

2.6.1 Establishing Billing Rates

Billing Rate Definition (FAR 42.701 and 42.704(a)). The contracting officer (other cognizant Federal agency official) or auditor responsible for determining final indirect cost rates is responsible for determining the contract billing rate. A billing rate is an indirect cost rate established temporarily for interim reimbursement of incurred indirect costs and adjusted as necessary pending the establishment of final indirect cost rates.

Importance of a Reasonable Billing Rate. A billing rate that is too high will result in increased progress payments and cost reimbursement. The contractor will have the use of the Government's money interest-free until final contract pricing. For contracts that provide for price adjustment based on contract costs, estimates of final contract price will be inflated. That inflation could lead to poor management decisions to control costs or assure performance within available funds.

A billing rate that is too low will result in decreased progress payments and cost reimbursement. Contract performance may be affected by funds shortages. Contractor profits may be affected by the need to borrow to cover funds shortages and low profitability may drive firms away from Government contracting.

Basis for Rate Development (FAR 42.704(b)). If you are responsible for establishing interim billing rates, you may establish rates based on information resulting from recent review, previous rate audits or experience, or similar reliable data or experience or other contracting activities.

If you determine that the dollar value or contracts requiring the use of billing rates does not warrant submission of a detailed billing rate proposal, you may establish rates by making appropriate adjustments from the prior year's indirect cost rate experience to:

- Eliminate unallowable and non-recurring costs, and
- Reflect new or changed conditions.

Billing Rate Development (FAR 42.704(b)). The billing rate should be as close as possible to your projection of the contractor's final indirect cost rate for the period, adjusted for any unallowable costs.

- If the proposal is based on detailed data, complete a detailed proposal analysis following the steps previously outlined in this chapter. In fact, you should normally consider billing rates and forward pricing rates at the same time.
- As you determine the billing rate, consider:
  - Information resulting from recent review of contractor indirect cost rates;
  - The results of previous audits;

    - Your office's experience with the contractor; and
    - Similar reliable data or experience of other contracting activities.
- In making any required adjustments, consider all available data and apply appropriate quantitative techniques. Indirect cost experience from at least three accounting years and the use of regression analysis can be particularly useful in identifying non-recurring costs and making adjustments related to projected changes in production volume.
- Typically, billing rates should be the same as or slightly lower than current forward pricing rates.
    - When your analysis indicates a high probability that forward pricing rates are accurate estimates of final indirect costs, billing rates should normally be the same as current forward pricing rates.
    - When market or company uncertainty increase the risk that final indirect cost rates will be lower than current forward pricing rates, billing rates should normally be slightly lower than forward pricing rates. That will reduce the probability that the contractor will owe the Government money, when final indirect cost rates are determined.

2.6.2 Adjusting Billing Rates

Adjusting Rates When Forecasts Change (FAR 42.704(c)). Once billing rates are established, they may be prospectively or retroactively revised by mutual agreement of the responsible Government official and the contractor at either party's request, to prevent substantial overpayment or underpayment. Either the Government or the contractor may initiate a rate revision to prevent substantial overpayment or underpayment.

- If you are the contracting officer (or other cognizant Federal agency official) responsible for rate determination, consider initiating action to change billing rates whenever there is a change in final indirect cost rate forecasts. Initiate action when it appears that the projected rate change will have a substantial affect on final Government contract cost.

When you cannot reach agreement with the contractor, you may unilaterally determine billing rates

- When the contractor provides a certified final indirect cost rate proposal, you and the contractor may agree to revise billing rates to reflect the proposed indirect cost rates, as approved by the Government to reflect historically disallowed amount from prior year's audits, until the proposal has been audited and settled. The historical decrement will be determined by the cognizant contracting officer or the cognizant auditor.

Variances Causing Rate Changes. Remember that an indirect cost rate is the result of a simple calculation:

$$\text{Indirect Cost Rate} = \frac{\text{Indirect Cost Pool}}{\text{Indirect Cost Allocation Base}}$$

Using this equation, you can see that the rate will change if the indirect cost pool or the base change. Changes typically result from spending variances (e.g., an unexpected insurance rate increase) not related to changes in volume and volume variances (i.e. a decrease in electricity use related to a decrease in production).

- **Spending Variances.** An in-depth analysis of contractor accounting data is normally needed to identify all but the largest spending variances. For example, monthly costs (the prime indicator of spending variances) may need to be seasonalized to reflect normal cost patterns (e.g., direct hours down and paid absence up during December when most people are off for the holidays).

  - Because of the need for accounting expertise, cognizant Government auditor (as the Government's accounting expert) normally assume a lead role in identifying and analyzing spending variances.
  - Multifunctional support is often required from other members of the Government Acquisition Team, because a single contractor management decision can affect spending across a broad range of contractor operations.

For example: A substantial change in capital improvement spending could reasonably be expected to affect:

    - Projected depreciation expense (an indirect cost element);
    - Facilities Capital Cost of Money Factors calculated under Cost Accounting Standard 414; and
    - Contractor operations (e.g., worker productivity, make-or-buy decisions).
- **Volume Variances.** Any substantial differences between estimated rate base and actual base will result in a change in indirect cost rates, no matter how accurately costs have been predicted for the estimated volume.
    - Because day-to-day contracting activities (e.g. contract awards, changes, or terminations) provide the data essential for identification of volume variances, your observation and analysis of volume changes are particularly important.
    - Consider any variances from volume estimates used in developing billing rates, including changes in:
    - Contracts in hand;
    - Options that may be exercised;
    - Proposals with a high probability of success;
    - Solicitations in hand;
    - Sales forecasts of future customer requirements; or
    - Projected increases or decreases in inventory.

Adjusted Billing Rate Development (FAR 42.704(b)). When adjusting billing rates, consider how identified spending and volume variances will affect your estimates of final indirect cost rates. Remember that the billing rate should be as close as possible to your projection of the contractor's final indirect cost rate for the period, adjusted for any unallowable costs.

Recalculate Contract Costs Using the Adjusted Rates (FAR 42.704). When it is necessary to adjust billing rates to prevent substantial overpayment or underpayment, you should adjust contract costs using the following procedure as depicted in the table below.

- **Determine The Amounts Paid Under The Contract.** Determine the costs previously reimbursed or paid as progress payments.
- **Calculate Total Amounts Due Using The Adjusted Rates.** Calculate the total reimbursement or progress payment

amount due the contractor using the adjusted billing rates for the entire accounting period. If total contract costs include costs from other accounting periods, assure that you only adjust costs for the period affected by the rate adjustment.

- **Calculate The Net Amount Due The Contractor.** Subtract the costs previously reimbursed or paid as progress payments from the total amount calculated using the adjusted rates. The net difference is the amount currently due the contractor. If the net difference is positive, reimburse the contractor accordingly. If the net difference is negative, the contractor has been over-reimbursed and you should take appropriate action in accordance with agency procedures.

Contract Cost Reimbursement			
Costs Previously Reimbursed		**Costs To Date Using Current Billing Rates**	
Direct Material Cost	$100,000	Direct Material Cost	$120,000
Material Overhead @ 8.6%	$8,600	Material Overhead @ 8.2%	$9,840
Direct Labor Cost	$200,000	Direct Labor Cost	$275,000
Labor Overhead @ 130.0%	$260,000	Labor Overhead @ 132.0%	$363,000
Subtotal	$568,600	Subtotal	$767,840
G&A Expense @ 14.0%	$79,604	G&A Expense @ 12.5%	$95,980
Total Cost	$648,204	Total Cost	$863,820
Subtract Costs Previously Reimbursed from Costs to Date			$648,204
Balance Due the Contractor			$215,616

2.6.3 Disallowing Contractor Costs

Allowability of Contractor Costs (FAR 42.803). To be properly invoiced to a Government contract, a cost must be allowable. Remember that a cost is considered allowable under a specific contract if it is:

- Reasonable,
- Allocable to the contract,

- Properly accounted for under applicable accounting principles and standards,
- Not identified as unallowable under specific cost principles, and
- Not identified as unallowable under the terms of the contract.

Situations for Using a Notice of Intent to Disallow Costs (FAR 42.801, and 42.802).

Include the FAR clause 52.242-1, Notice Of Intent To Disallow Costs, in any solicitation or contract whenever you contemplate using a cost-reimbursement contract, a fixed-price incentive contract, or a contract providing for price redetermination.

Under that clause, you, as the contracting officer responsible for contract administration, may issue a Notice Of Intent To Disallow Costs incurred or planned for incurrence at any time during contract performance. However, before issuing the notice, you must make every reasonable effort to reach a satisfactory agreement through discussions with the contractor.

Do not use a Notice Of Intent To Disallow Costs to disallow invoiced costs. Only use the notice to advise the contractor as early as practicable during contract performance that a specific cost or type of cost is considered unallowable under the contract terms and to provide for timely resolution of any resulting disagreement.

Process for Using a Notice of Intent to Disallow Costs (FAR 42.801 and 52.242-1). Normally, the process of cost review and disallowance involves seven steps. However, your objective should be to obtain satisfactory resolution without actually completing all seven steps.

- **Identify Any Unallowable Cost.** The unallowable cost is usually identified through routine audit or cost monitoring activities of the contract administration team.
    - If the cognizant auditor identifies a cost as unallowable, assure that you understand the reason before proceeding further.

    - If you identify the cost as unallowable, you should coordinate your findings with the cognizant auditor before taking further action.
- **Attempt To Negotiate A Satisfactory Settlement.** Attempt to negotiate a satisfactory settlement through discussions with the contractor. To the extent practicable, coordinate with the cognizant auditor throughout the negotiation process.
- **Prepare a Notice Of Intent To Disallow Costs.** If you cannot reach agreement with the contractor, prepare the notice. As a minimum, the notice must:
    - Refer to the contract's Notice Of Intent To Disallow Costs clause;
    - State the contractor's name and list the numbers of the affected contracts;
    - Describe the costs to be disallowed, including estimated dollar value by item and applicable time periods, and state the reasons for the intended disallowance;
    - Describe the potential impact on billing rates and forward pricing rate agreements (FPRAs);
    - State the notice's effective date and the date by which written response must be received;
    - List the recipients of copies of the notice; and
    - Request the contractor to acknowledge receipt of the Notice.
- **Obtain Necessary Coordination.** Prior to issuing a notice affecting elements of indirect cost, coordinate the notice with the contracting officer responsible or auditor responsible for final indirect cost settlement. In the DoD, a corporate administrative contracting officer does not need to obtain the approval of individual ACOs to disallow items of corporate expense (DFARS 242.801).
- **Distribute The Notice Of Intent To Disallow Costs.** Send the notice to the contractor and obtain acknowledgment of receipt. In addition, provide copies of the notice to all contracting officers cognizant for any segment of the contractor's organization.
- **Act On Any Contractor Response.** If the contractor accepts the notice, no further action is necessary. If the contractor believes that the cost is allowable, it may submit a written response. You must act on that response within 60 days.
    - If the contractor provides convincing evidence that the cost is allowable, withdraw the Notice in writing.

    - If the contractor fails to provide convincing evidence that the cost is allowable, issue a written decision under the contract Disputes clause disallowing the cost.
    - If the contractor provides convincing evidence that part of the cost is allowable, issue a decision under the contract Disputes clause that a portion of the cost is not allowable.
- **Distribute Resulting Documents.**
    - Distribute the original copy of your action to withdraw a Notice Of Intent To Disallow Costs or a final decision to disallow costs to the contractor.
    - Distribute copies to all contracting officers cognizant of any segment of the contractor's organization.

Situations for Disallowing Incurred Costs (FAR 42.803). Cost-reimbursement contracts, the cost-reimbursement portion of fixed-price contracts, letter contracts that provide for reimbursement of costs, time-and-material contracts, and labor-hour contracts provide for disallowing costs during the course of performance after costs have been incurred.

Contracting Officer Procedures for Disallowing Incurred Costs (FAR 42.803(a), DFARS 225.870-5, 242.803, and DEAR 942.803(a)).

When you, as a contracting officer, receive vouchers directly from the contractor and, with or without auditor assistance, approve or disapprove them, conduct the process of disallowing costs in accordance with normal agency procedures. The following are two examples of agency procedures:

- In the DoD, contracting officer receipt of cost vouchers is only authorized for cost-reimbursement contracts with the Canadian Commercial Corporation (CCC).
    - Audits are automatically arranged by the Department of Supplies and Services (DSS), Canada.
    - Based on advice from DSS, the CCC will certify the invoice and forward it with the SF 1034, Public Voucher, to the ACO for further processing and transmittal to the disbursing office.

- In DOE, all vouchers and invoices are submitted to the contracting officer (or designee) for review and approval. If the examination raises a question concerning allowability of cost, the contracting officer must:
    - Hold informal discussions with the contractor as appropriate.
    - Issue a notice (e.g., letter or memo) to the contractor advising of the cost disallowed or to be disallowed and advising the contractor that it may:
    - Submit a written claim as to why the cost should be reimbursed, if it does not concur with the disallowance.
    - File a claim under the contract Disputes clause, which will be processed in accordance with disputes procedures if agreement cannot be reached.
    - Process the invoice or voucher for payment and advise the finance office to deduct the disallowed cost when scheduling the voucher for payment.

When authorized by agency regulations, the cognizant auditor may be authorized to (FAR 42.803(b) and DCAM 6-902c):

- Receive cost-reimbursement vouchers.
- Approve for payment those vouchers found to acceptable and forward them to the cognizant contracting, finance, or disbursing officer for payment, following agency procedures.
- Suspend payment of questionable costs.

If the auditor's examination of a voucher raises a question regarding the allowability of an invoiced cost, the auditor will follow agency procedures for disallowing that cost. Those procedures will generally include steps such as the following:

- **Withhold Payment Processing Pending Resolution.** The auditor will not process an invoice or voucher which includes a questioned cost until the issue of allowability is resolved.
- **Advise Cognizant Contracting Officer Of Pending Action.** The auditor will normally keep the cognizant contracting officer apprised of the issues affecting

cost allowability. If you are the cognizant contracting officer, provide the auditor with any available information which might support, refute, or modify the auditor's findings.

- **Conduct Informal Discussions With The Contractor.** The auditor may conduct informal discussions with the contractor to ensure that the auditor's conclusion is based on a proper understanding of the facts.
  - If the contractor convinces the auditor that the cost is allowable, the auditor will process the invoice or voucher for payment.
  - If the auditor convinces the contractor that the cost is unallowable, the auditor will normally permit the contractor to resubmit the invoice or voucher without the questioned cost.
  - If the auditor remains convinced that the cost is unallowable, but the contractor does not agree, the auditor should proceed to the next step below.
- **Issue Notice of Contract Costs Suspended and/or Disapproved.** If the auditor still believes that the cost is unallowable and is authorized to take this step under agency procedures, the auditor will issue a Notice of Contract Costs Suspended and/or Disapproved (e.g., a DCAA Form 1). The notice should identify claimed costs that are not considered reimbursable.
- **Distribute Notice of Contract Costs Suspended and/or Disapproved.** The auditor should distribute the notice simultaneously:
  - To the contractor (with a request for acknowledgment of contractor receipt
  - To the disbursing officer, with a copy
  - To the cognizant contracting officer.
- **Review Contractor Response.** If the contractor disagrees with the deduction from current payments, the contractor may:
  - Submit a written request for you, as the cognizant contracting officer, to consider whether the unreimbursed cost should be paid and to discuss the finding with contractor personnel.
  - File a claim under the Disputes clause.
  - Do both of the above.
- **Act On Any Contractor Claim.** When the contractor submits a claim under the Disputes clause of the contract, the contracting officer must issue a written decision as soon as practicable within the 60-day period required by the Disputes clause. If the

contractor still disagrees, the firm may appeal to the appropriate Board of Contract Appeals or the Claims Court.

2.7 Determining Final Indirect Costs

This section examines factors that you should consider when establishing and applying final indirect cost rates.

2.7.1 Establishing Final Rates

Final Indirect Cost Rates (FAR 42.701). A final indirect cost rate is a rate established and agreed upon by the Government and the contractor. It is not subject to change. It is usually established after the close of the contractor's fiscal year (unless the parties decide on a different period) to which it applies. In the case of cost-reimbursement contracts with educational institutions, the rate may be predetermined (i.e., established for a future period) on the basis of cost experience with similar contracts, together with supporting data.

Indirect Cost Rate Proposal (FAR 42.703-2, 52.216-7(d), 52.216-13(c), and 52.242-4). Each flexibly priced contract requires the contractor to submit proposed final indirect cost rates for each fiscal year, within six months after the expiration of its fiscal year (or by a later date under exceptional circumstances approved in writing by the contracting officer). The proposal must:

- Be submitted to the cognizant contracting officer (or cognizant Federal agency official) and auditor;
- Be based on the Contractor's actual cost experience for the period;
- Include adequate supporting data; and

- Include the Certificate of Final Indirect Costs described below unless the requirement is waived by the agency head (or designee).

Format for Certificate of Final Indirect Costs (FAR 52.242-4). To be acceptable, the completed certificate must read as shown below and be signed by an individual in the contractor's organization at a level no lower than vice president or chief financial officer of the business segment that submits the proposal:

CERTIFICATE OF FINAL INDIRECT COSTS

This is to certify that I have reviewed this proposal to establish final indirect cost rates and to the best of my knowledge and belief:

1. All costs included in this proposal ___(identify proposal and date)____ to establish final indirect cost rates for ___(identify period covered by rate)____ are allowable in accordance with the Federal Acquisition Regulation (FAR) and its supplements applicable to the contracts to which the final cost rates will apply; and
2. This proposal does not include any costs which are expressly unallowable under applicable cost principles of the FAR or its supplements.

Firm: ____

Signature: ____

Name of Corporation Official: ________________________

Title: ____

Date of Execution: ____

Failure to Submit a Certificate of Final Indirect Costs (FAR 42.703-2(c)). If the contractor has not certified its proposal for final indirect cost rates and a waiver is not appropriate, the contracting officer may unilaterally establish the final indirect cost rates.

In such situations, the responsible contracting officer should:

- Base the unilaterally-determined final indirect cost rate on audited historical data or other available data after excluding unallowable costs; and
- Set the unilaterally-determined rate low enough to ensure that unallowable costs will not be reimbursed.

False Certification (FAR 42.703-2(d)). Consult with Government legal counsel to determine appropriate action if you think that a contractor's Certificate of Final Indirect Costs is false.

Waiver of Final Indirect Cost Proposal Certification Requirement (FAR 42.703-2(b)). The agency head (or designee) may waive the indirect cost certification requirement when:

- A waiver is determined to be in the best interest of the United States, and
- The reasons for the determination are put in writing and made available to the public.

A waiver may be appropriate for a contract with a:

- Foreign government or international organization, such as subsidiary bodies of the North Atlantic Treaty Organization;
- State or local government that is subject to OMB Circular A-87; *Cost Principles for State and Local Governments*;
- Educational institution subject to OMB Circular A-21, *Cost Principles for Educational Institutions*; or
- Nonprofit organization subject to OMB Circular A-122, *Cost Principles for Nonprofit Organizations*.

Responsibility for Determining Final Indirect Cost Rates (FAR 42.705 and DEAR 942.705-1(a)(3)).

Final indirect costs must be established by using either the:

- Contracting officer determination procedure; or
- Auditor determination procedure.

Select the appropriate procedure following the guidelines below and applicable agency requirements. For example, the Department of Energy Acquisition Regulation (DEAR) directs the use of the contracting officer determination procedure for all final rates set by the Department of Energy.

Situations for Contracting Officer Determination (FAR 42.705-1(a)). Use the contracting officer determination procedure for business units:

- Of a multidivisional corporation under the cognizance of a corporate administrative contracting officer (CACO).
  - The CACO will be responsible for the rate determination.
  - Administrative contracting officers (ACOs) assigned to the individual business units will assist the CACO (as required).
  - Negotiations may be conducted on a coordinated or centralized basis, depending on the degree of centralization within the contractor's organization.
- Not under the cognizance of a CACO, but having a resident ACO. The resident ACO will be responsible for the determination. For this purpose, a nonresident ACO is considered as resident if at least 75 percent of the ACO's time is devoted to a single contractor.
- Not included above, when the contracting officer (or cognizant Federal agency official) determines that a contracting officer determination is appropriate under FAR and agency procedures.

Procedure for Contracting Officer Rate Determination (FAR 42.705-1(b), 52.216-7(d)(2), 52.216-13(c)(2), DCAAP 7641.90, and DCAM 6-603a).

As a contracting officer determining final overhead rates for business units, follow the steps identified below. For other contractors, see the appropriate FAR sections identified above.

- **Obtain The Contractor's Proposal.** Each flexibly priced contract requires the contractor to submit proposed final indirect cost rates for each fiscal year, six months after the expiration of its fiscal year. The contracting officer may grant a reasonable written extension for exceptional circumstances when requested by the contractor. Assure that the contractor submits a separate copy of the proposal to the cognizant auditor. Chapter 5 of DCAA Pamphlet 7641.90, Information for Contractors, provides a model incurred cost proposal.

- **Obtain A Proposal Audit.** Follow your agency procedures to obtain an audit of the contractor's indirect cost rate proposal from the cognizant auditor. Your request for audit support should identify any areas where you believe audit input is necessary to support final rate determination.
  - FAR requires the cognizant auditor to identification of any relevant advance agreements or restrictive terms affecting final indirect cost rates. The auditor should provide an analysis of other areas affecting final rate determination.
  - The audit should also include:
  - A review and evaluation of the contractor's system of internal control, including the means by which all echelons of management control the level of indirect cost;
  - A review of the composition and suitability of the allocation bases;
  - A review of the composition of the various indirect cost pools to ascertain whether they are logical and bear a reasonable relationship to the bases used for apportioning expenses to operations;
  - A review of selected indirect cost accounts;
  - A verification to the financial records; and
  - A verification of the mathematical accuracy of the rate computation.
- **Form A Government Negotiating Team.**
  - Include the:
  - Cognizant contracting officer (Team Head);
  - Cognizant auditor; and
  - Technical or functional personnel as required.
  - Invite contracting offices with significant dollar interest in the negotiations to participate in the negotiation and in the preliminary discussion of critical issues.

    - You should also invite individuals or offices that have provided significant input to the Government position.
- **Develop A Negotiation Position For Each Rate.** As you develop your negotiation position, seek relevant input from other members of the Government Negotiating Team. Do not resolve any questioned cost until you obtain:
    - Adequate documentation on the cost, and
    - The contract auditor's opinion on the allowability of the cost.
- **Conduct Negotiations With The Contractor.** Whenever possible, invite the contract auditor to serve as an advisor at any negotiation or meeting with the contractor. Request participation by other Government Negotiating Team members when needed to support negotiations.
- **Execute A Bilateral Final Indirect Cost Rate Agreement.** The bilateral agreement:
    - Should specify:
    - The agreed-upon final annual indirect cost rates,
    - The bases to which the rates apply,
    - The periods for which the rates apply,
    - Any specific indirect cost items treated as direct costs in the settlement, and
    - The affected contract(s) and/or subcontract(s), identifying any with advance agreements or special terms and the applicable rates.
    - Must not change any monetary ceiling, contract obligation, or specific cost allowance or disallowance provided for in any contract.
    - Is incorporated into each applicable contract upon execution.
    - Is binding on all agencies, unless otherwise specifically permitted by statute.
- **Prepare, Sign, And File A Negotiation Memorandum.** The memorandum must cover the following points:
    - The disposition of significant matters in the advisory audit report;
    - Reconciliation of all costs questioned, with identification of items and amounts allowed or disallowed in the final settlement, as well as period costing or allocation issues;
    - Reasons why any recommendations of the auditor or other Government advisors were not followed; and
    - Identification of cost or pricing data submitted during the negotiations and relied upon in reaching a settlement.

- **Distribute Resulting Documents** (FAR 42.706).
  - Distribute the executed copies of the agreement to:
  - The contractor;
  - Each affected contracting agency; and
  - The affected contract files.
  - Distribute copies of the negotiation memorandum (as appropriate) to:
  - The affected contracting office(s); and
  - Cognizant Government audit office(s).

Situations for Auditor Determination (FAR 42.705-2(a)). The cognizant Government auditor must establish final indirect cost rates in situations other than those identified above for contracting officer determination.

Audit determination may also be used in the situations designated for contracting officer (or cognizant Federal agency official) determination when the cognizant contracting officer and auditor agree that the indirect costs can be settled with little difficulty and any of the following circumstances apply:

- The business unit has primarily fixed-price contracts, with only minor involvement in cost-reimbursement contracts.
- The administrative cost of making a contracting officer determination would exceed the expected benefits.
- The business unit does not have a history of disputes and there are few cost problems.
- The contracting officer (or cognizant Federal agency official) and auditor agree that special circumstances require audit determination.

Procedure for Auditor Determination (FAR 42.705-2(b)). Under the auditor determination procedure assure that the contractor submits a final indirect cost rate proposal to both the cognizant auditor and the contracting officer.

The auditor will:

- Audit the proposal and seek agreement on indirect costs with the contractor.
- Prepare a bilateral indirect cost rate agreement between the auditor and the contractor that conforms to the requirements of the contracts involved.

- Execute the bilateral agreement with the contractor.
- Distribute executed copies of the agreement to the contractor and to each affected contracting agency. The auditor will also provide copies of the audit report to the affected contracting offices and Government audit offices.

Auditor and Contractor Fail to Agree (FAR 42.705-2(b)(2)(iii) and DFARS 242.705-2(b)(2)(iv)).

If the auditor cannot reach agreement with the contractor, the auditor will forward the audit report to the contracting officer (or Federal agency official) designated in the Directory of Contract Administration Services Components for final indirect rate determination.

Defense Contract Audit Agency Auditors will also issue a DCAA Form 1, Notice of Contract Costs Suspended and/or Disapproved. On the form, the auditor will detail the items of exception and advise the contractor that requests for reconsideration should be submitted in writing to the contracting officer.

Government and Contractor Fail to Agree (FAR 52.216-7(d)(5) and 52.216-13(c)(5)). If the contracting officer and the contractor fail to agree on a final indirect cost rate determination, that failure will be considered a dispute within the meaning of the contract Disputes clause. The dispute will be resolved under the provisions of that clause.

2.7.2 Establishing Quick Closeout Rates

Rationale for Quick Closeout. Final indirect cost rates cannot be determined until after the close of the cost accounting period. In fact, it may take years to establish final indirect cost rates. To speed contract closeout, the contracting officer responsible for contract closeout may use the quick-closeout procedure to negotiate the settlement of indirect costs for a specific contract in advance of the determination of final contract cost.

Criteria for Quick Closeout (FAR 42.708). The table below delineates the criteria that you must consider in determining when and how to use the quick-closeout procedure to establish final contract indirect cost.

Criteria For Use Of Quick Closeout Procedure	
Requirements For Procedure Use	**Remarks**
Contract must be physically complete.	All deliverables under the contract have been received and accepted. Only administrative contract closeout remains.
Unsettled indirect cost to be allocated must be relatively insignificant.	To be considered relatively insignificant: · Total unsettled indirect cost cannot exceed $1,000,000 on any one contract, and · Unless otherwise provided in agency procedures, cumulative unsettled indirect cost to be allocated through this procedure in any one year cannot exceed 15% of the estimated total unsettled indirect cost allocable to the contractor's cost-type contracts for that fiscal year.
Agreement must be reached on a reasonable estimate of allocable dollars.	Both the contracting officer responsible for contract closeout and the contractor must agree to the indirect costs to be allocated to the contract.
Determination of final indirect costs under the quick closeout procedure must be final for the contract it covers.	Use of the rates is final for covered contracts and no adjustment shall be made to other contracts for over/under recovery of costs applicable to a contract covered by the agreement.
Quick closeout rates shall not be considered a binding precedent for other contracts.	While the rates are binding for any contract covered, they are not considered a binding precedent affecting the establishment of final indirect cost rates for other contracts.

Procedure for Quick Closeout Rate Development. There is no guidance presented in the FAR as to how you should go about reaching reasonable quick closeout rates. However, the steps below present a framework that you can follow in negotiating a reasonable rate.

- **Obtain Contractor Final Rate Proposal.** While there is no FAR requirement to obtain a final rate proposal before negotiating quick closeout rates, the practical reality is that the only sound way to begin negotiations is with a contractor proposal, for several reasons:
  - It is difficult to negotiate rates without knowing the contractor's position.
  - The proposal summarizes the contractor's records on final indirect costs.
  - Requiring the proposal for quick closeout incentivizes timely submission of a proposal that can be used for final rate negotiations.
- **Develop Negotiation Objective.** Based on the contractor's proposal, develop a negotiation objective.
  - Normally, you will develop the objective without detailed audit or technical analysis. However, you should contact the cognizant auditor to determine if the auditor is currently aware of any substantial exceptions to the contractor's proposed rates.
  - Assuming that no substantial exceptions are noted, you can develop your objective using any reasonable approach including the following:
  - Adjust the proposed final settlement rate using a decrement factor developed from analysis of forward pricing and billing rates. It is reasonable to assume that the final audit will identify reductions similar to reductions noted in forward pricing and billing rate proposals.
  - Adjust the proposed final settlement rate using a decrement factor based on prior-year reductions from proposed settlement rates. The adjustment can be based on audit-recommended reductions, negotiated reductions, or some combination of the two.
- **Negotiate a Reasonable Rate.** Remember the goal is to obtain a reasonable rate.

    - The contractor may be willing to settle for a rate slightly lower than it might otherwise negotiate to obtain its money immediately.
    - On the other hand, it may be advantageous to the Government to settle for a rate slightly higher than it might otherwise negotiate to reduce the administrative costs of retaining an active contract that is physically complete.
- **Sign a Bilateral Agreement.** Sign a bilateral agreement with the contractor documenting:
    - The rates.
    - The contracts to which the rates apply.
    - That the use of the quick closeout rate is final for the contracts involved, and that differences between the quick closeout rates and final settlement rates cannot be shifted to other contracts.
    - That agreement on quick closeout rates does not set a binding precedent affecting the establishment of final indirect cost rates for other contracts.
- **Distribute the Agreement.** Promptly distribute the agreement to the contractor and each contracting officer affected.
- **Prepare a Negotiation Memorandum.** Prepare a memorandum documenting data considered during negotiations and the basis for your objective and the rates negotiated.

2.7.3 Obtaining And Reviewing Completion Invoices/Vouchers

Obtaining Completion Invoices/Vouchers (FAR 42.705(b), 52.216-7, and 52.216-13). Within 120 days after settlement of the final indirect cost rates or quick closeout rates covering the year in which a contract is physically complete (or longer, if approved in writing by the contracting officer), the contractor must submit a completion invoice or voucher to reflect the settled amounts and rates.

Typically, the data supporting the updated invoice or voucher will identify the:

- Total contract cost;
- Total previously billed; and
- Balance due or credit due.

The following example illustrates what the support for an updated cost-reimbursement voucher might look like.

Costs Reimbursed Using Interim Billing Rates		**Final Costs Using Final Indirect Rates**	
Direct Material Cost	$800,000	Direct Material Cost	$800,000
Material Overhead @ 8.2%	$65,600	Material Overhead @ 8.4%	$67,200
Direct Labor cost	$1,000,000	Direct Labor cost	$1,000,000
Labor Overhead @ 132.0%	$1,320,000	Labor Overhead @ 133.0%	$1,330,000
Subtotal	$3,185,600	Subtotal	$3,197,200
G&A Expense @ 12.4%	$395,014	G&A Expense @ 14.5%	$463,594
Total Cost	$3,580,614	Total Cost	$3,660,794
		Less Costs Previously Reimbursed	$3,580,614
		Balance Due the Contractor	$80,180

Completion Invoice/Voucher Review (FAR 42.803). Follow agency procedures in reviewing completion invoices/vouchers.

Auditor assistance in your review may be appropriate to assure that all costs are allowable and in accordance with the appropriate final indirect cost rate determination or quick closeout rate agreement.

2.7.4 Assessing Penalties For Unallowable Costs In Final Rate Proposals

Contracts Where Penalty Requirements Apply (FAR 42.709). The contracting officer has the general authority to assess a financial penalty against a contractor that includes unallowable indirect costs in:

- A final indirect cost rate proposal; or
- The final statement of costs incurred or to be incurred under a fixed-price incentive contract.

However, this authority does not apply to:

- Contracts that do not exceed $500,000;
- Fixed-price contracts without cost incentives; or
- Firm fixed-price contracts for the purchase of commercial items.

Contracting Officer Responsibilities (FAR 42.709-2). The cognizant contracting officer is responsible for:

- Determining whether penalties should be waived;
- Determining whether a penalty should be assessed;
- Assessing the appropriate penalty;
- Referring the matter to the appropriate criminal investigative organization for review and for appropriate coordination of remedies, if there is evidence that the contractor knowingly submitted unallowable costs.

Auditor Responsibilities (FAR 42.709-2(a)). The cognizant contract auditor, is responsible for:

- Recommending to the contracting officer which costs may be unallowable and subject to the penalties;
- Providing rationale and supporting documentation for any recommendation; and
- Referring the matter to the appropriate criminal investigative organization for review and for appropriate coordination of remedies, if there is evidence that the contractor knowingly submitted unallowable costs.

Penalty Amount (FAR 42.709-1). It is not necessary for unallowable costs to have been paid to the contractor in order for the contracting officer to assess a penalty.

The penalties summarized in the table below may be applied in addition to other administrative, civil, and criminal penalties provided by law.

If the indirect cost...	**The penalty is equal to:**
Is expressly unallowable under a cost principle in the FAR, or an executive agency supplement to the FAR, that defines the	· The amount of the disallowed costs allocated to applicable contracts based on the indirect cost

allowability of specific selected costs	proposal; plus · Interest on the paid portion (if any) of the disallowance.
Was determined to be unallowable for that contractor before proposal submission	· Two times the amount of the disallowed costs allocated to applicable contracts based on the indirect cost proposal; plus · Interest on the paid portion (if any) of the disallowance.

Evidence That a Cost Was Determined to Be Unallowable Before Proposal Submission (FAR 42.709-3(b)).

A prior determination of unallowability may be evidenced by any of the following:

- A DCAA Form 1, Notice of Contract Costs Suspended and/or Disapproved, or any similar notice which the contractor elected not to appeal and was not withdrawn by the cognizant Government agency;
- A contracting officer's final decision which was not appealed by the contractor;
- An executive agency Board of Contract Appeals or court decision involving the contractor, which upheld the cost disallowance; or
- A contracting officer determination or Government-contractor agreement of unallowability.

Computing Interest Due the Government (FAR 42.709-4). Compute interest on any portion of the unallowable cost already paid by the Government as follows:

- Consider the overpayment to have occurred, and interest to have begun accumulating, from the midpoint of the contractor fiscal year covered by the indirect cost proposal. Use an alternate equitable method if the cost was not paid evenly over the fiscal year.
- Use the interest rate specified by the Secretary of the Treasury pursuant to Public Law 92-41 (85 Stat.

97), available online at the Treasury Department's Bureau of Public Debt website.

- Compute interest from the date of overpayment to the date of the demand letter for payment of the penalty.
- Determine the paid portion of the disallowed costs in consultation with the cognizant contract auditor.

Demand for Payment (FAR 42.709-3). Unless the penalty requirements outlined above are waived, the cognizant contracting officer must issue a demand for payment of the appropriate penalty amount plus interest on the overpayment. This demand for payment is a final decision under the Disputes clause of the contract.

The demand for payment of the penalty is separate from and in addition to any demand for repayment of a disallowed cost previously paid by the Government.

Waiver of the Penalty (FAR 42.709-5). Waive the penalties above when:

- The contractor withdraws the proposal before the Government formally initiates an audit of the proposal and the contractor submits a revised proposal (an audit will be deemed to be formally initiated when the Government provides the contractor with written notice, or holds an entrance conference, indicating that audit work on a specific final indirect cost proposal has begun);
- The amount of the unallowable costs under the proposal which are subject to the penalty is $10,000 or less (i.e., if the amount of expressly or previously determined unallowable costs which would be allocated to the contracts specified is $10,000 or less); or
- The contractor demonstrates, to the contracting officer's satisfaction, that:
  - It has established policies and personnel training and an internal control and review system that provide assurance that unallowable costs subject to penalties are precluded from being included in the contractor's final indirect cost rate proposals. Evidence of such controls include:
  - The types of controls required for satisfactory participation in the Department of Defense sponsored self-governance programs,
  - Specific accounting controls over indirect costs,

- Compliance tests which demonstrate that the controls are effective, and
- Government audits which have not disclosed recurring instances of expressly unallowable costs); and
- The unallowable costs subject to the penalty were inadvertently incorporated into the proposal (i.e., their inclusion resulted from an unintentional error, notwithstanding the exercise of due care.