What Government Contractors Need to Know

Understanding Indirect Rates

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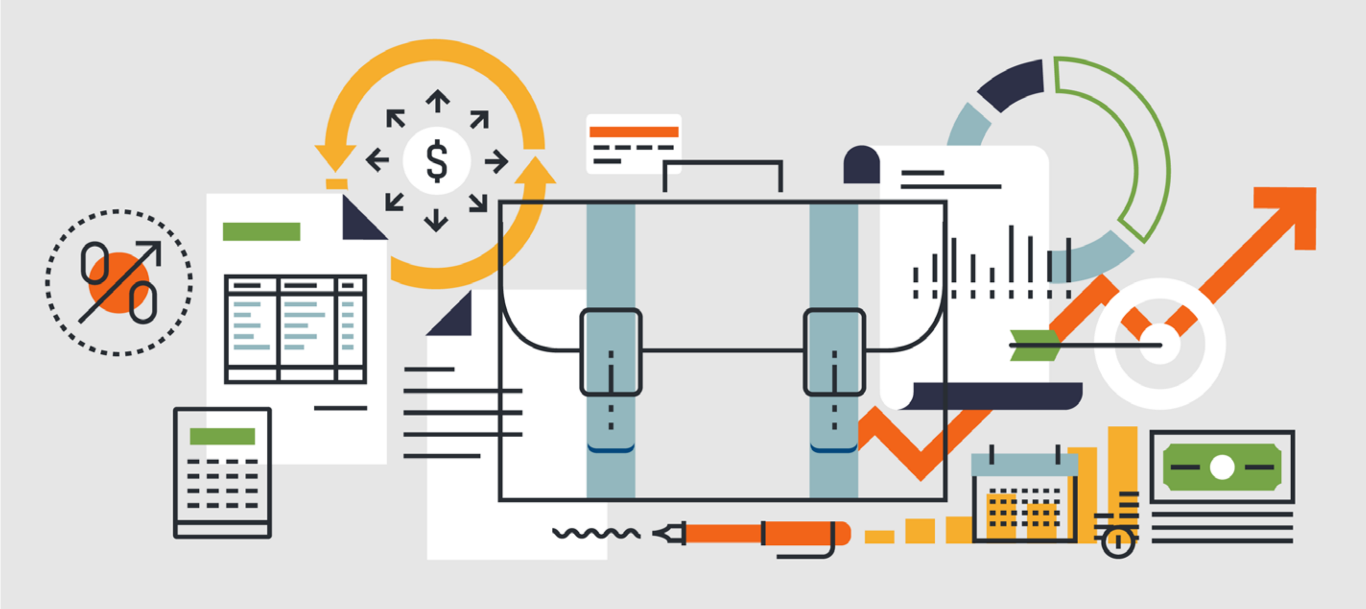
Introduction

Indirect rates can be one of the more confusing accounting concepts for government contractors to master. There are nuances with respect to indirect rates in cost accounting, contract pricing, and billing. Understanding how indirect rates apply to each of these areas will help you better manage government contracts and your business as a whole. Here's what you need to know.



INDIRECT RATES & Cost Accounting

Let's begin with the basic accounting concept of indirect rates. From the accountant's perspective an indirect rate is the ratio of the total costs contained in an indirect cost pool as it relates to its allocation base.

The purpose of the indirect rate is to equitably allocate the costs in an indirect cost pool amongst all contracts benefitting from that indirect cost pool.

Each contract shares fairly in the burden of those costs contained in the indirect cost pool.

EXAMPLE:

Allocation of Overhead Costs to Contracts Using Direct Labor as the Allocation Base.

Overhead costs are those indirect costs that support a particular business segment. For services oriented contracts with a direct labor function, overhead costs support the performance of contract work.

It is common to allocate the pool of overhead costs to contracts using direct labor as the allocation base.

Allocation Base:

Total Direct Labor

Consequently, each contract absorbs a portion of the total overhead based on its proportionate share of direct labor in relation to total direct labor.

Expressed mathematically, the Total Overhead Pool is divided by Total Direct Labor to determine the Overhead Rate.

$$\frac{\text{Total Overhead Pool}}{\text{Total Direct Labor}} = \text{Overhead Rate}$$

That Overhead Rate is then applied to Direct Labor on each contract to determine the share of Total Overhead absorbed by each contract.

$$\text{Overhead Rate} \times \text{Contract A Direct Labor} = \text{Contract A Total Overhead}$$

$$\text{Overhead Rate} \times \text{Contract B Direct Labor} = \text{Contract B Total Overhead}$$

From a cost accounting perspective, indirect rates are calculated for the purpose of allocating indirect costs amongst contracts.

INDIRECT RATES & **Contract Pricing**

Contract pricing is all about recovering costs and generating fees. Contracts must be priced so that funding is provided to recover the direct costs of performing the contract, the indirect costs to be allocated to the contract, and if all goes according to plan, make a profit.

Indirect rates with respect to contract pricing estimate the indirect costs that will be allocated to the contract during the period of performance. The estimated indirect rates are applied to the proposed direct costs so that the contract pricing will be sufficient to recover the proposed contract's share of the contractor's indirect cost burden.

It is important to note the distinction between historical indirect rates and prospective indirect rates.

HISTORICAL INDIRECT RATES

- **Measure actual activity that has already occurred**
- **Calculated based on accounting data that has been recorded in the contractor's books**

PROSPECTIVE INDIRECT RATES

- **Estimate future activity**
- **Calculated based on budgeting future business projections**

It is prospective indirect rates, rather than historical indirect rates, that should be used for contract pricing.

Because Prospective Indirect Rates are used in contract pricing, unanticipated events can easily occur and have a significant effect on a contractor's indirect rates and bottom line.

To mitigate against this, a contractor must maintain a well-managed budgeting function. With a detailed budget, a contractor is better equipped to calculate prospective indirect rates for contract pricing purposes.

From a contract pricing perspective, indirect rates estimate the indirect costs that will be associated with a contract during the period of performance in order to recover the contract's share of the indirect cost burden.

INDIRECT RATES &
Contract Billing

Indirect rates have a role in the billing of cost-reimbursement type contracts, and in certain circumstances, in the billing of time and materials (T&M) type contracts (when general & administrative, or G&A, can be applied to direct costs other than labor).

A distinctive characteristic of cost-type contracts with respect to billing is the use of provisional indirect rates. Final indirect rates are not known until all of the costs for the year are recorded and an Incurred Cost Proposal has been accepted by either DCAA or the Administrative Contracting Officer (ACO). Therefore, indirect costs are billed on cost-reimbursement type contracts on a provisional basis, subject to final determination.

Provisional Indirect Rates are agreed-upon estimates of the contractor's final indirect rates for a particular year. A contractor submits a Provisional Indirect Rate Proposal to either DCAA or the ACO of the contract (whichever of the two is tasked with the responsibility of determining final indirect rates pursuant to the contract).

A **Provisional Indirect Rate Proposal** typically includes

✔ Reports detailing:
- Prior Year Actual Indirect Rates
- Current Year-To-Date Indirect Rates
- Budget Year Indirect Rates

✔ A detailed listing of the costs contained in the cost pools and the corresponding allocation bases of each report

✔ Narrative explaining key details of significant budget assumptions used in developing budgeted rates

Once provisional indirect rates are established, the contractor must use them to bill the indirect costs on cost-reimbursement type contracts.

Given that the provisional indirect rates are estimates of the final actual indirect rates, there will likely be a difference between the amount of indirect costs billed and the amount of indirect costs actually incurred and allocated to the cost-type contract.

This difference is known as an **Indirect Rate Variance**. The variance must be settled with the customer prior to the closing of the contract. Consequently, contractors must monitor indirect rate variances and should carry either an asset (for an indirect rate variance receivable) or a liability (for an indirect rate variance payable) on its books.

From a billing perspective, indirect costs are billed according to the contractor's agreed upon provisional indirect rates for the year, and any indirect rate variance is settled with the customer upon closing out the contract.

Conclusion

A contractor should recognize the importance of a well-managed budgeting function within its business and should always be cognizant of its prospective indirect rates.

When pricing new work, it is important to understand that adding new work can place downward pressure on indirect rates. A well-managed budgeting function can enable the contractor to quantify that downward pressure on prospective indirect rates.

This knowledge gives contractors a strategic advantage when pricing new opportunities.

Conclusion

A contractor must also keep its books current so that it can monitor indirect rate variances on cost-reimbursement type contracts. By monitoring indirect rate variances, contractors can make important year-end decisions about spending so as to keep indirect rate variances under control.

ICAT™

ICAT is the Indirect Rates Solution for QuickBooks®

ICAT calculates indirect rates from your QuickBooks general ledger data, and seamlessly allocates indirect costs to contracts.

ICAT's Budget tool supports development of prospective indirect rates for contract pricing and provisional indirect rate proposals.

To determine final indirect rates, ICAT generates your Incurred Cost Proposal schedules with cost data automatically populated from QuickBooks.

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