Indirect Costs

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Today’s Discussion

- Fundamental concepts related to indirect cost allocation.
  - Differences between overhead and G&A pools.
  - Understanding allocation bases.
  - Pool & Base relationship.
  - Significance of indirect rates.
- Examples
- Summary
What is a Final Cost Objective?

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

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

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

- **Overhead Pools:**
  - Cost related to support of specific operations.
  - Manufacturing, Engineering, Material Handling, etc.

- **General & Administrative Pools:**
  - Management, financial, and other expenses incurred for the general management and administration of the business unit as a whole.
  - G&A, IR&D, B&P
## Direct Vs. Indirect Costs*

<table>
<thead>
<tr>
<th>Cost Element</th>
<th>Direct or Indirect?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rent</td>
<td>Indirect</td>
</tr>
<tr>
<td>Freight on Direct Material</td>
<td>Indirect</td>
</tr>
<tr>
<td>Packing on a Contract</td>
<td>Direct</td>
</tr>
<tr>
<td>Supervisory Labor</td>
<td>Indirect</td>
</tr>
<tr>
<td>Property Tax</td>
<td>Indirect</td>
</tr>
<tr>
<td>Labor for a Job/Contract</td>
<td>Direct</td>
</tr>
<tr>
<td>New Hire Training</td>
<td>Indirect</td>
</tr>
</tbody>
</table>

*Represents the most common treatment for these costs; however, there may be acceptable exceptions.
# Direct Vs. Indirect Costs*

<table>
<thead>
<tr>
<th>Cost Element</th>
<th>Direct or Indirect?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contract Material</td>
<td>Direct</td>
</tr>
<tr>
<td>Contract Travel</td>
<td>Direct</td>
</tr>
<tr>
<td>Office Supplies</td>
<td>Indirect</td>
</tr>
<tr>
<td>President’s Salary</td>
<td>Indirect</td>
</tr>
<tr>
<td>Property Tax</td>
<td>Indirect</td>
</tr>
<tr>
<td>Rent</td>
<td>Indirect</td>
</tr>
<tr>
<td>Utilities</td>
<td>Indirect</td>
</tr>
</tbody>
</table>

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

- A measure of direct contractor effort that can be used to allocate pool costs based on benefits accrued by the several cost objectives.

- A means to equitably allocate indirect costs to cost objectives.

- This is what the pool is being allocated to.
Base - Examples:

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

Calculating a Total Cost Input (TCI) Base

+ Contract Direct Labor
+ Contract Direct Material
+ Contract ODC
+ Subcontract Costs
+ Gross Overhead

= Total Cost Input
Example of a G&A Base

What is the difference between TCI and Value Added Base?

+ Contract Direct Labor
- Contract Direct Material
+ Contract ODC
- Subcontract Costs
+ Gross Overhead

= Value Added Base
Causal/Beneficial Relationship

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

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

\[
\text{Pool} - \text{Expenses to be Allocated} = \frac{\text{Base} - \text{Caused the Expenses or Benefits from the Expenses}}{\text{Causal/Beneficial Relationship}}
\]

---

Causal/Beneficial Relationship -- If it were not for the base, the pool expense would not be incurred.
# Overhead Rate Example

## Overhead Pool

<table>
<thead>
<tr>
<th>Acct. No.</th>
<th>Description</th>
<th>G/L</th>
<th>Adj</th>
<th>Claimed</th>
</tr>
</thead>
<tbody>
<tr>
<td>7001</td>
<td>Salaries &amp; Wages</td>
<td>33,060</td>
<td></td>
<td>33,060</td>
</tr>
<tr>
<td>7002</td>
<td>Postage &amp; Handling</td>
<td>6,235</td>
<td></td>
<td>6,235</td>
</tr>
<tr>
<td>7004</td>
<td>Small Equipment</td>
<td>878</td>
<td></td>
<td>878</td>
</tr>
<tr>
<td>7011</td>
<td>Equipment Rental</td>
<td>27,150</td>
<td></td>
<td>27,150</td>
</tr>
<tr>
<td>7016</td>
<td>Repairs/Maintenance</td>
<td>1,681</td>
<td></td>
<td>1,681</td>
</tr>
<tr>
<td>8421</td>
<td>Leave</td>
<td>20,181</td>
<td></td>
<td>20,181</td>
</tr>
<tr>
<td>8425</td>
<td>Severance Pay</td>
<td>32,419</td>
<td>(23,023)</td>
<td>9,396</td>
</tr>
<tr>
<td>8427</td>
<td>Taxes</td>
<td>23,612</td>
<td></td>
<td>23,612</td>
</tr>
<tr>
<td>8431</td>
<td>Workers' Compensation</td>
<td>3,311</td>
<td></td>
<td>3,311</td>
</tr>
<tr>
<td>8435</td>
<td>Health Insurance</td>
<td>31,097</td>
<td></td>
<td>31,097</td>
</tr>
<tr>
<td>8440</td>
<td>Life Insurance</td>
<td>6,833</td>
<td></td>
<td>6,833</td>
</tr>
<tr>
<td>8445</td>
<td>Pension Plan</td>
<td>58,320</td>
<td>(8,612)</td>
<td>49,708</td>
</tr>
<tr>
<td>8450</td>
<td>Miscellaneous</td>
<td>612</td>
<td></td>
<td>612</td>
</tr>
<tr>
<td><strong>Total OH Pool</strong></td>
<td></td>
<td>245,389</td>
<td>(31,635)</td>
<td>213,754</td>
</tr>
</tbody>
</table>

**OH Base:**
- Direct Labor: $633,012

**OH Rate**
\[
\frac{\text{OH Pool}}{\text{OH Base}} = \frac{213,754}{633,012} = 33.77\%
\]
# G&A Rate Example

## General & Administrative Pool

<table>
<thead>
<tr>
<th>Acct. No.</th>
<th>Description</th>
<th>G/L</th>
<th>Adj</th>
<th>Claimed</th>
</tr>
</thead>
<tbody>
<tr>
<td>8001</td>
<td>Salaries &amp; Wages</td>
<td>90,007</td>
<td>90,007</td>
<td></td>
</tr>
<tr>
<td>8320</td>
<td>Legal Fees</td>
<td>1,744</td>
<td>1,744</td>
<td></td>
</tr>
<tr>
<td>8501</td>
<td>Travel</td>
<td>12,987</td>
<td>(1,295)</td>
<td>11,692</td>
</tr>
<tr>
<td>8503</td>
<td>Entertainment</td>
<td>484</td>
<td>(484)</td>
<td>-</td>
</tr>
<tr>
<td>8505</td>
<td>Advertising &amp; Promotion</td>
<td>354</td>
<td>(287)</td>
<td>67</td>
</tr>
<tr>
<td>8522</td>
<td>Bad Debts</td>
<td>3,018</td>
<td>(3,018)</td>
<td>-</td>
</tr>
<tr>
<td>8527</td>
<td>Interest Expense</td>
<td>1,001</td>
<td>(1,001)</td>
<td>-</td>
</tr>
<tr>
<td>8521</td>
<td>Leave</td>
<td>2,321</td>
<td>2,321</td>
<td></td>
</tr>
<tr>
<td>8527</td>
<td>Taxes</td>
<td>3,815</td>
<td>3,815</td>
<td></td>
</tr>
<tr>
<td>8535</td>
<td>Health Insurance</td>
<td>8,912</td>
<td>8,912</td>
<td></td>
</tr>
<tr>
<td>8540</td>
<td>Life Insurance</td>
<td>1,087</td>
<td>1,087</td>
<td></td>
</tr>
<tr>
<td>8545</td>
<td>Pension Plan</td>
<td>12,318</td>
<td>(1,883)</td>
<td>10,435</td>
</tr>
<tr>
<td>8550</td>
<td>Miscellaneous</td>
<td>3,357</td>
<td>3,357</td>
<td></td>
</tr>
<tr>
<td><strong>Total G&amp;A Pool</strong></td>
<td></td>
<td>141,405</td>
<td>(7,968)</td>
<td>133,437</td>
</tr>
</tbody>
</table>

## G & A Base:

- **Direct Labor**: 633,012
- **Direct Travel**: 34,563
- **Direct Material**: 842,981
- **Other Direct Costs**: 172,105
- **Subcontracts**: 944,841
- **OH Expenditures**: 245,389

**Total G&A Base**: 2,872,891

## G&A Rate

\[
\text{G&A Rate} = \frac{\text{G&A Pool}}{\text{G&A Base}} = \frac{133,437}{2,872,891} = 4.64\%
\]
What is Cost Allocation?

Peanut Butter = Pool

SPREAD IT OVER THE

Bread = Base
Indirect Rates

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

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

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

https://www.dcaa.mil/Small-Business/
Questions/Comments