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Case Study…
NEW INDIRECT RATE STRUCTURE

(*Editor's Note. Our client, who provides a variety of professional services to the government, asked us to evaluate its current indirect rate structure after losing several competitions to lower priced bidders and winning other competitions in spite of offering higher prices than in the past., Contractor concluded that certain services were highly price sensitive while others services were not so believed he had to realign certain cost allocations. We will not disclose the name of our client nor divulge all the changes we recommended so as to disguise her identify. We will also not show the quantitative analyses we conducted so as to simply the presentation below.)*

Current Structure

Currently, Contractor maintains one overhead rate (that includes all fringe benefits in the overhead pool) applied to a direct labor cost base and a G&A rate applied on a total cost input base.

Challenge

There were two distinct business services – Engineering and Management Services (EMS) and Administration Services (AS), where some of EMS and all of AS was performed offsite at government facilities while some of EMS was performed on-site at company facilities. EMS was not price sensitive where existing and new clients were willing to pay relatively premium prices due to a long history of client satisfaction and shortage of similar services from competitors while AS was highly price sensitive where lots of competitors had to offer rock bottom burdened cost-based pricing to win awards.

Accounting Changes

Fringe Benefit Rate. The previous practice of accumulating all fringe benefit costs into the overhead pool was problematic – fringe benefits related to G&A labor were not allocated to those pools. The creation of multiple indirect costs pools – three overhead pools, G&A and cost centers (discussed below) precludes accumulating actual fringe benefit costs in any one pool. We suggested creating one company-wide fringe benefit rate – total fringe benefits divided by total employee salaries and wages – and applying that rate wherever the labor dollars went. The fringe benefits applicable to direct labor and indirect overhead labor would go into the overhead rates, fringe benefits applicable to indirect labor in the G&A and cost center pools will be applied to the indirect labor in each of those pools. Company fringe benefit costs will continue to be accumulated in separate expense accounts for financial reporting purposes where the fringe benefit rate will be used for government contract cost and pricing purposes only. This fringe benefit rate would allow fringe benefit costs to be allocated to the multiple indirect cost pools that have been created.

Allocation of Costs

It was decided that there would be three categories of labor services to be offered to the government for which indirect cost rates had to be computed: EMS On Site, EMS Off Site and AS. From a pricing strategy perspective, it would be desirable to allocate more indirect costs to EMS since it was relatively price insensitive and less costs to the highly competitive AS services if an acceptable cost allocation approach could be created. Two options were put forth by us on how to allocate costs to these three services.

1. Create two business segments – EMS and AS. Within the EMS segment, there would be separate onsite and offsite rates. This would provide the opportunity to allocate different amounts of costs to the two groups which would also allow each segment to have their own distinct allocation structure allowing even greater varied allocations. For example, AS segment might use only one rate since its only direct costs were almost exclusively direct labor while the EMS segment could use the current structure of overhead and G&A to apply to different elements of direct costs.

2. Maintain one Segment and create three overhead rates - EMS onsite, EMS offsite and AS. The G&A rate would remain the same.

♦ Pros and Cons of Each

1. Two Business Units. This alternative provides the maximum opportunity to develop different, distinct burden rates for each labor service category. Not only can different amounts of costs be allocated to each segment but once allocated to the segment, alternative rates within each business unit will provide additional flexibility. The disadvantage of this structure is that there may be difficulties in justifying each group as a business segment since it is questionable whether a layer of management and perceived independence of each segment can be claimed.

2. No Additional Business Units. This alternative has the same advantage as the two segments in as much as different amounts of costs can be allocated to the different service groups if each has their own overhead pool and base. Another advantage is it will not require the creation of business segments. The disadvantage is that it does not provide the maximum pricing flexibility of the two business unit alternative since there is not the opportunity to have a different rate structure for each segment.

Based on fears about the difficulty of justifying the creation of two separate business units, Contractor decided on the second alternative of creating three overhead rates.

Logical Cost Centers

Contractor has an excellent timekeeping system that clearly identifies hours of activity for all employees. As a result, all indirect labor costs could be accurately tracked and assigned to appropriate indirect cost pools, whether overhead, G&A or one of the five cost centers described below.

A word about allocation bases. Creation of cost pools required selection of allocation bases that would achieve the pricing objectives of maximizing costs to EMS and minimizing those to AS. In addition selecting a base should involve minimal administrative effort to generate, be accurate to avoid accusations that the base is inaccurate which can result in auditors questioning all allocations and be logical and common enough to minimize chances of being challenged. With Contractor, there is a wide variety of allocations bases that could be selected.

1. Facilities. All costs related to Contractor's offices – rent, utilities, office furniture, repair and maintenance would apply. I would argue that even desktop computers would qualify since they are part of the facility.

Allocation base. Since offsite employees do not use the office facilities, those costs would not be allocated to the two offsite overhead pools. Like other support costs, they would be allocated to other indirect pools where individuals use office facilities including other cost centers. Since there is no significant usage of space by any particular group of people, I would use headcount of all onsite people as the basis of allocation.

2. IT support. Indirect labor, fringe benefits, depreciation (e.g. servers), cell phones, information technology, supplies, fees and licenses, IPADs and allocable cost center costs.

Allocation base. I would recommend headcount as a surrogate allocation measurement to all indirect cost pools. It is defensible since number of people served is a logical basis.

3. Contracts/Subcontracts Management. Indirect labor, fringe benefits, travel and cost center allocations represent the majority of costs here.

Allocation base: I would recommend a base consisting of a weighted average of number of prime and subcontracts awarded. A quick and dirty analysis of support effort at Contractor indicated prime contracts (work with vendors, communications with government, etc.) require about four times the administrative effort than subcontracts. Since most prime contracts are awarded for EMS services a weighted average of 4 to one would allow the majority of these costs to be allocated to EMS. Number of prime and subcontracts is easily quantified and has a clear relationship to the indirect support costs.

4. Accounting/Finance. Indirect labor, fringe benefits, indirect travel, outside services, education and training, bank charges and allocable share of cost center costs.

Allocation base. Though many measures might be selected, none of which would represent the total activity, I would recommend headcount. Many of the functions of accounting – payroll, billings, job costing and vendor payments are related to headcount in a company where costs are driven by labor.

5. Employee Development. This cost center is oriented to HR activity related to hiring and recruiting, coaching, training and skills development. The expenses include indirect labor, fringe benefits,

indirect travel and allocable share of cost center expenses.

Allocation Base. Headcount. This base is logical since most activities of this cost center are oriented to individual employees.

Conclusion

Once the structure was decided on we used 2011 budget data to prepare provisional billing rates for 2011 and discussed how to implement the changes and communicate them to the government. After considering several options we decided to present the provisional billing rates to the government with a description of the accounting changes and decided to apply the new rates only prospectively, where the old rates would apply to work awarded before 2011. We are expecting inquiries and audits in the near future. Who knows – maybe we will have a new case study to present.

FAR CHANGES TO COST OR PRICING DATA

(*Editor's Note. It should be stressed that the contracting officer has significant discretion in obtaining information to make a determination that a proposed contract price is reasonable and contractors have considerable input potential in making this decision. Many times the government may go a little "overboard" in asking for too much data that an offeror may prefer not to provide. This conflict is particularly true in the cost and pricing area where COs may want to "cover all its bases" and ask for non-certified cost or pricing data or certified cost and pricing data when a contractor may have good reason to resist such requests. For example, the contractor may not want to have the burden of gathering information, avoid risk of audit opening other cans of worms or may want to negotiate a price based on market prices not cost. In addition to the above the contractor may have additional reasons to avoid submitting certified cost or pricing data to preclude future defective pricing audits, adjustments to contract prices or, at worse, fraud investigations that some defective pricing audits trigger. Familiarity with the hierarchy of information a CO may request, appreciation for mandated cautions about asking for unnecessary cost or pricing data and ability to suggest alternatives to still meet the CO's need to demonstrate price reasonableness provide contractors the ability to help shape the information that will be provided in support of proposed prices. We believe a solid understanding of the new rules about cost or pricing data will be most helpful where we summarize the new 19 page rule that changes many sections of the FAR. Our source of information was the actual rule change published in the Federal Register No. 53135, August 30, 2010.)*

The FAR Council has agreed to a final rule amending the Federal Acquisition Regulation to clarify the distinction between "certified cost or pricing data" (we will refer to this as "Certified CPD") and "data other than certified cost or pricing data" ("Data Other Than CPD") and to clarify when any cost or pricing data should be submitted. FAR Subpart 15.4 describes the contracting officer's (CO's) responsibility to purchase supplies and services at fair and reasonable prices and the use of data and information in meeting this requirement. This section incorporates the requirements of the Truth in Negotiations Act (TINA) which addresses the requirements for submission of cost or pricing data and the circumstances when this data must be certified as to their accuracy, completeness and currency.

The FAR Council believed this Subpart was not sufficiently clear and decided to change it. Specifically, it was confusing regarding the right of the government to request Data Other Than CPD, the obligation of the offeror to provide it and the definition of this term. The lack of clarity was due largely to definitions that overlap and are not identical to TINA. For example, the FAR defined costs or pricing data to mean Certified CPD while the TINA did not make certification part of the definition of cost or pricing data. This limitation led to confusion regarding the level of information a CO may request to establish price reasonableness and whether the cost elements must be certified. The confusion was exacerbated by the FAR's use of the third term "information other than cost or pricing data" making it difficult for COs and contractors to understand when and type of cost or pricing data that should be obtained.

Uncertainty also resulted from the policy regarding use of data to establish fairness and reasonableness of offered prices. FAR 15-402(a) has for many years cautioned COs not to obtain more information than is necessary which the FAR Council applauds. But it believed this section should also, but did not, expressly mention the underlying authority to collect Data Other Than CPD. The Council believed the absence of this latter authority may lead COs to mistakenly believe there is greater responsibility for avoiding unnecessary submission than there is to determine whether and how much data may be required in a given case to ensure reasonable prices are paid. Changes were made to ensure both – obtaining adequate data and taking appropriate care not to ask for more data than necessary – are equally important.

The Federal Register published a proposed rule April 23, 2007 to revise the FAR with respect to cost or pricing data and received many comments, some of the significant ones we will summarize here. Based on the comments, a public meeting was held Nov. 1, 2007 and after many deliberations the FAR Council has adopted a final rule that the Council highlighted as follows:

- Clarifies terminology used in the FAR to make it consistent with TINA, resulting in (i) refinement to the definition of cost or pricing data (ii) addition of a definition of Certified CPD (iii) the addition of a definition of Data Other Than CPD and (iv) deletion of the phrase "information other than cost or pricing data."

Certified CPD now means "cost or pricing data" that were required to be submitted in accordance with FAR 15.403-4 and 5 and have been certified or are required to be certified in accordance with 15.406-2. The certification states that "to the best of the person's knowledge and belief, the cost or pricing data are accurate, complete and current as of a date certain before contract award."

Cost or pricing data means all facts that, as of the date of price agreement or if applicable an earlier agreed to date, prudent buyers and sellers would be reasonably expected to affect price negotiations significantly. Cost or pricing data are factual, not judgmental, and are verifiable. While they do not indicate the accuracy of the contractor's judgment about estimated costs, they do include the data forming the basis for that judgment. Also cost or pricing data is more than historical accounting data; they are all the facts that can be reasonably expected to contribute to the soundness of estimates of future costs.

Data other than CPD means pricing data, costing data and judgmental information necessary for the CO to determine a fair and reasonable price. Such data may include the identical types of data as Certified CPD. However, additional data may now also include, for example, sales data and information reasonably required to explain the estimating process which may include judgmental factors applied and the mathematical or other methods used in the estimate including data in projecting from known data as well as the nature and amount of any contingencies.

- Clarifies responsibilities regarding the request for Data Other Than CPD both in cases when Certified CPD is required and when it is not. The change retains the current order preference for determining the type of cost or pricing data needed to establish reasonable prices when Certified CPD is not required.

FAR 15.402, pricing policies, provides that COs shall make sure its purchases are from responsible sources at fair and reasonable prices where to establish this reasonableness it will (1) obtain certified CPD when required by 15.403-4 along with data other than CPD as necessary (2) when Certified CPD is not required, obtain Data Other Than CPD as necessary using the following order of preference in determining the type of data needed: (i) no added data needed when price is based on adequate competition (ii) data related to prices (e.g. established catalog or market prices, sales to nongovernmental and governmental entities), relying first on data available within the government, second on data obtained from sources other than the offeror and third, if necessary, on data obtained by the offeror. When the third option is needed, such data will include, at a minimum, prices at which the same or similar items have been sold previously. The same section states the CO will "obtain the type and quantity of data necessary to establish a fair and reasonable price, but not more data than is necessary." It goes on to state such techniques as price analysis, cost analysis and/or cost realism analysis may be used to establish fair prices and if the data obtained cannot establish reasonableness then the CO will require additional data sufficient to establish reasonableness.

- Clarifies the instructions for offerors preparing contract pricing proposals when cost or pricing data are required so such instructions are consistent with clarified terminology.

The CO will specify in the solicitation (1) whether certified CPD is required (2) in lieu of submitting certified CPD the offer may request an exception (3) any requirement for Data Other Than CPD and (4) the requirement for necessary preaward or postaward access to offeror's records.

For submission of Certified CPD the CO may require it be in accordance with Table 15-2 of 15.408, specify an alternative format or permit submission in the contractor's format (except when cost data is submitted in support of a termination settlement proposal in Subpart 49.6). For the submission of Data Other Than CPD, the contractor's own format may be used unless the CO decides on a specific format. The format for submission of data supporting forward pricing rate agreements will be submitted "in a form acceptable to the contracting officer."

Instructions for submitting cost/price proposals when Certified CPD are required is documented in Table 15-2. The provision provides two notes: In Note 1, it states there is a clear distinction between submitting certified CPD and merely making books and records available without identification. The submittal requirement is met when actual certified CPD is submitted, "either actually or by specific identification to the contracting officer or authorized representative." The requirement for submission continues up to the agreement on price or an earlier agreed to date. The second note states that by submitting your proposal, you grant the CO or representative the right to examine records that formed the basis for the pricing proposal where the examination may take place anytime before award.

The General Instructions section of Table 15-2 has been amended to provide that your proposal will include a referenced index of all certified CPD and clearly state on your cover letter certified CPD is included. In addition there will be information reasonably required to explain your estimating process that will include judgmental factors applied and mathematical or other methods used in the estimate including those used in projecting from known data as well as the nature and amount of any contingencies.

Significant Comments and Responses

The following section which comprises the bulk of the federal register text provides additional insights into new requirements in the form of comments and responses. Significant issues are:

1. The proposed rule will result in COs by-passing normal market research and pricing techniques in favor of more TINA required cost or pricing data. *Response.* The final rule will protect against this by the proviso that only necessary data and information is to be sought. So though, "in theory this could include all elements described under FAR 15.408, Table 15-2, in most cases the data necessary…will fall short of this level of data."

2. Adding the terms "judgmental information" and "judgmental factors" to the definition of Data Other Than CPD will add additional required information that needs to be provided. *Response.* The responses do not seem to reduce this concern. It states that in situations where Certified CPD is required, the nature and amount of judgmental information cannot be certified because it is not factual but the existence of judgmental information is factual and hence certifiable. When defining Data Other Than CPD, data in support of an offer will "necessarily contain some information that is non-factual i.e. judgmental information." Though such information may not be certified it is still part of the cost or pricing data included in the cost data, whether certified or not. So now, not only is Data Other Than CPD expanded to included judgmental information, Table 15-2 has been revised to be consistent with the new definition. Now additional information in Table 15-2 will be expanded to include "any information reasonably required to explain the estimating process, including the judgmental factors applied and the mathematical factors applied or other methods used in the estimate, including those used in projecting from known data; and the nature and amount of any contingencies included in the proposed price."

3. Several comments were put forth regarding commercial items, including the following:

(a) Offerors of commercial items will be required to submit cost data in all instances. *Response.* The response is less than reassuring. It first seeks to reassure the concern is overstated and explains (i) commercial items are exempt from *certified* cost or pricing data requirements (ii) FAR 15.403-3(c)(2) sets limitations on the type of cost data or pricing data that can be requested regarding commercial items and (iii) the order of preference stated in FAR 15.402 provides that when a CO determines it can use price analysis to determine a fair price cost data will generally not be obtained for pricing commercial items. But the section ends by opening the cost or pricing data door wide stating that COs are to obtain that information needed to obtain fair and reasonable prices "which, in some cases, may include contract cost data (without certification) for commercial items."

(b) The rule will create confusion for acquiring commercial items by putting COs in a position where the only safe alternative will be to demand maximum amount of data from an offeror. *Response.* There is no fundamental change from the existing requirement for COs not to "obtain more data or information than is necessary." To the extent there are sufficient commercial sales of the item of the same or similar quantities, and the contractor provides that information when the government cannot obtain it through their normal market research then the validity of previous prices can be established.

IMPLEMENTING McKINSEY RECOMMENDED PRICING STRATEGIES

(*Editor's Note. The following article is a continuation of our series that discuss how important general business management* *ideas affect government contractors' practices. The idea addressed here is how businesses should price their products and services over their life cycles – from new product/service launch, through their midlife and final late-life phase. Though there are often constraints on pricing flexibility for government contractors, the rules do provide, as we often assert, considerable flexibility in pricing products and services sold to the government. For example, if goods and services can qualify as a commercial item or are competitively priced then prices offered to the government can mirror those offered to commercial clients. Even if prices are based on cost estimates, there is still considerable flexibility how costs are presented as we show in two articles in this issue (e.g. direct versus indirect costing, indirect rates, etc.) and provide examples here. The source of this article is from the McKinsey consulting firm's November 2010 issue of the McKinsey Quarterly as well as our attempt to understand its relevance to government contract pricing.*)

The article starts out by providing an example of the effects of poor pricing decisions. In the late 1990s the world's three independent producers of hard-disk drives invested over $6.5 billion in research and development where in the next decade the disks held more than a thousand-fold increase in bytes stored while the per unit price dropped 70 percent. Though they created enormous benefit for consumers, their great innovations resulted in net losses of $800 million. Individual companies and entire industries can suffer when they fail to grasp the importance of pricing products and services across their life cycle, especially when those life cycles are characterized by innovation.

The authors state two points are essential to price effectively during the life cycle of products and services. First, they need to manage the tradeoff between price and volume (or profit and market share) to realize maximum returns. Failure to understand customers' perceptions of value as the items change over their life leads to mistakes in pricing. Second, companies need to make pricing decisions in the context of their product/service portfolio because when they have many generations of items being sold, a price move for one can significantly affect other items.

The Launch Phase

Correctly setting the price when an item is first launched can affect the profit of the product over its life cycle. Three imperative exist at this stage: setting the launch price that maximizes the long-term capture of value, avoiding effects of older products that may "anchor" new service launches and working the product portfolio to maximize a company's advantage. The authors recommend conducting "scenario planning" where different pricing strategies are considered where potential responses by customers and competitors are considered and how those impact company earnings. This approach can help companies avoid common mistakes such as setting the launch price too low or high or reducing products' price too soon or not enough after launch. Careful adjustment of prices for existing products can minimize the degree they drag down prices for new ones.

For example, a medical device manufacturer launched new versions of all major products every 6-18 months where each version was either a significant innovation or a minor improvement. Each revision was priced a few percentages points above the existing one in an effort to encourage migration to the new one. The company would then drop the price of older products significantly (20-40 percent) while continuing to sell them over an extended period depending on demand and the company's desire to provide a lower cost alternative. This approach turned out badly where prices for new products were dragged down because there was little increased perceived value versus the old ones and the result was that the average price of each product line decreased every year despite huge R&D expenditures, with the result the company was rapidly innovating itself from a market leader to average performer. Once it recognized what was happening it eliminated "fire sales" on older products, changed the incentives of its sales force to support new cycle pricing strategies and carefully launched new products at great premiums.

Midlife Phase

Once an item has launched and gained stable market acceptance it has entered the midlife phase. This phase has great opportunities and great risk where companies can earn the greatest majority of its operating profit but can be subject to "me too" products and services appearing and price wars proliferating. Organizations usually make the mistake of not revisiting their price and volume tradeoffs during this phase nor conducting critical market analysis to fine tune their pricing, anticipate pricing triggers, monitor market conditions and consider new pricing approaches.

Firms should change prices carefully and analyze whether changes are appropriate (e.g. will lowering prices increase life cycle profits) and what is the most effective timing for making a change. A personal computer company conducted weekly market price tests where it implemented price cuts only when unit sales declined and tests showed a lower price would significantly increase unit sales. Managing prices this way rather than steadily reducing them added millions of dollars of additional operating profit over the lifetime of most of its computer models.

There are many midlife trigger events for pricing – internal ones (such as launch of a new model or change in a cost position) and external ones (price moves and product introductions by competitors or shifts in customer demand). Firms need to continuously monitor the market to anticipate these events. For example, the medical device company, after enjoying a period of exclusivity, decided to lower prices simply because that was its standard practice. When two competitors introduced similar products at higher prices, rather than raising prices to capture higher margin (or at least maintain them) the firm continued its discounting practices hurting profit and margins for everyone without gaining market share to make up for the loss in volume.

Strong performers need to always search out ways to capture value and create new midlife pricing models that can reinvigorate their products.

The late-life phase

Contrary to intuition, the late phase may be a good time to raise rather than lower prices. This may be because its fully loaded costs have increased or its inherent value for those remaining customers may have not decreased as much as it had for those customers who had moved on. Certain customers may be price insensitive because they are comfortable with the item or the company providing it, they may see more value in it or may not want to incur switching costs. A company needs to have a deep insight into the customers it is still serving. A semiconductor manufacturer recognized an older product still had more value to certain customers even after introducing a new product where it actually raised the price for the "legacy" product after the new product launch resulting in capturing $250 million in additional profits rather than following its usual practice of reducing prices for legacy products when their successors were launched.

Even if a company's first instinct is to discount older items because or just after a launch of a new one, excess markdowns can harm the new launches by making older products seem like better value. The semiconductor example above is a good way to exit older products, though risk of building up obsolete inventory must be considered. Another approach may be to simply eliminate items, which can simplify operations.

Inaccurate costing can lead to faulty decisions. For example an industrial equipment manufacturer ignored life cycle differences and spread its costs over all products making it appear that it was still making a reasonable profit on all items. A closer examination of costs in each phase showed that older products costs were substantially more than expected (many were even unprofitable) resulting in eliminating some while charging more for others.

Companies that master pricing do so across the three phases of an items life cycle – launch, midlife and late life – and make decisions in the context of adjacent products in their portfolios. In this way, these companies ensure they reap the full rewards of their innovations by creating price advantages for themselves.

Implications for Government Contractors

Marketing Analysis. The type of marketing analysis and scenario planning advocated here (not surprising since McKinsey offers these services) is woefully missing by government contractors though their prevalence in the private sector is widespread. Subscriber and online information has proliferated in recent years providing excellent data for price planning purposes. Such costs are allowable indirect costs of the company as a whole since they benefit the government in expanding the cost (i.e. sales) base so there should be minimal reasons not to invest in the type of marketing resources prevalent in profitable commercial firms. The type of scenario planning discussed by McKinsey can lead to long term profits. For example, if it appears that cost based pricing will not provide adequate opportunities for profitable pricing in the future the firm needs to take actions now that can justify non-cost based pricing in the future. Creating commercial item status, pursuing GSA multiple schedule rates or multiple agency offerings, encouraging competitive pricing opportunities, teaming with or acquiring low cost based firms or adding higher value to the items being offered can all provide flexibility for the pricing actions McKinsey recommends.

Volume versus Price. All businesses need to be thinking about what unit prices it wants to offer its customers especially when different volumes of sales are possible. If the item offered to the government qualifies as a commercial item (FAR Part 12) then a firm's commercial pricing practices can generally be duplicated in prices offered to the government. Just as volume dictates unit prices in the commercial world, the government offers contractors the opportunity to offer different prices for different volumes of product where these can be identified in proposals and formalized in the contract (e.g. FAR 52.211-18, Variation in Estimated Quantity). If cost base pricing is required, there are several ways of portraying costs that are volume sensitive. For example, some costs can be spread over all units while others may apply to the first batch. Or, decisions about direct versus indirect costs can affect how a given batch of items are costed.

Lowest price is not always good. Just as knee jerk actions to lower the prices hurt profit and margins in the commercial world similar offers of lower prices to the government, even if a firm has a lower cost structure, can lead to lower profit in the government world. We have seen companies (usually smaller) with lower costs come in at significantly lower offered prices, sometimes beating out larger, veteran companies. That commonly leads to urgent actions by larger companies to reduce their pricing at all cost, resulting in lower burdened rates that cannot be met even by the previously low cost smaller company. The equivalent of a price war ensues sometimes requiring offers of prices at below cost to win business.

Consider portfolio of products and services. The article's emphasis on showing how price decisions on one item can affect the profitability of all products and services offered demonstrates that different items may need to have different cost allocations made when price is based on cost. Fortunately, there is an arsenal of costing approaches that can provide considerable pricing flexibility. The case study above provides an excellent example of how costs and hence offered prices can be allocated to different services. Changing decisions about service life of assets or depreciation methods, use of fully depreciated or new facilities, buying higher priced inputs for greater quality or lower priced items for low cost are a few of examples of how to lower or raise cost-base prices on various phases.

Keeping prices of later phase items high. The insight about not necessarily lowering prices of older products can be easily handled by government contractors. If items are commercial, then there is a long history of presumably higher prices that were offered earlier in the life cycle of the products and services which can be used for showing pricing history. If price is cost based and the strategy is to keep prices of older products higher, then such decisions can be reflected in higher costs where there has been inflation of cost inputs, higher indirect rates if volume is decreasing and cost allocation practices we discussed in this issue provide considerable opportunities to demonstrate higher costs.

Perhaps the best way of keeping prices high is to provide increased value to clients. Extension of service and product offerings can provide longer life, greater volume and higher prices in phases with analysis conducted now. Creating higher premium niches (fast delivery of products and services, higher end offerings), teaming with others to provide greater offerings, etc. are all ways to extend the profitability of items. Establishing high levels of past performance ratings in the early phases will contribute to successful best value procurements in the future.

Find new ways to compute true costs. The article stresses the need to have an accurate picture of an items true costs, especially in later phases to be able to provide more creative pricing. Most firms use less than desirable methods of costing their products whether it be GAAP sanctioned accounting or costing in conformance with FAR and CAS. Companies should not be lulled into accepting that their costing methods provide a true picture of their costs. Accordingly, other method (e.g. ABC) should be used to identify the true cost drivers and cost elements of products and services being offered to clients.

Knowing Your Cost Principles and Cost Accounting Standards…

DIRECT AND INDIRECT COSTS

(*Editor's Note. While reading an interesting article in the May 2008 issue of CP&A Report by Darrell Oyer, we were struck by a footnote quoting results of a 1979 study by the CAS Board analyzing the practices of various contractors' treatment of a wide assortment of costs. We found both the results and discussion relevant to current issues we encounter in our consulting practice when helping clients decide how to treat specific types of costs. The following addresses the results of that 1979 report and also incorporates some of Mr. Oyer's remarks that we allude to.)*

Basic Rules

The Federal Acquisition Regulation and Cost Accounting Standards pretty much duplicate the requirements for distinguishing direct and indirect costs. The article addresses some of the key FAR and CAS rules affecting the distinction between direct and indirect costs that we summarize here. The FAR definition states "No final cost objective shall have allocated to it as a direct cost any cost or other costs incurred for the same purpose in like circumstances have been included in any indirect cost pool…" In the CAS definition, Direct cost means "any cost which is identified specifically with a particular final cost objective." Direct costs are not limited to those items incorporated in the end product such as material and labor where costs identified with other cost objectives are direct costs of those cost objectives.

Both the FAR and CAS emphasize that costs incurred for the same purpose under like circumstances are not to be charged direct to some final cost objectives and indirect to others. This concept is reinforced by CAS 402 which repeats the concept. The FAR also elaborates on the concept in addressing "double accounting" or "double charging" – "all costs specifically identified with other final cost objectives of the contractor are direct costs of those cost objectives and are not to be charged to the contract indirectly."

Same or different purpose. Oftentimes an analysis is needed for making direct/indirect determinations using the same purpose approach. The author provide several examples such as general tooling versus special tooling for a contract; general guard services versus special facility guard services for one contract; training courses benefitting all contracts versus training required for one contract; common-use software versus special purpose software needed for one contract; and general meeting versus contract-specific meetings.

Materiality. Both the FAR and CAS incorporate materiality concerns in the definitions stating that for "reasons of practicality" contractors may treat direct costs of "a minor dollar amount" as indirect as long as it is consistently applied and produces "substantially" the same result.

Blanket costs. "Blanket costs" are labor and material costs accumulated in an intermediate pool and reallocated to contracts as a direct cost. For example, small parts or inspection labor used in production and assembly meet the definition of a direct cost but because of the small dollar value or high number of transactions they are more efficiently allocated than discretely assigned to each final cost objective. Though the CAS describes blanket costs as being reallocated to final cost objectives as direct costs, in practice, such costs might be part of an indirect cost pool e.g. small parts included in a material handling pool.

Considerations for Making the Decision

In addition to complying with FAR and CAS requirements other issues to consider are:

1. Direct costs are specifically billable to customers. A direct charge allows dollar for dollar recovery plus a prorate share of indirect costs rather than the indirect costs only that may be subject to limitations.

2. Lowers indirect rates as more costs are classified direct. Rather than increasing costs by putting costs in indirect pools, allocating costs directly take those costs out of the pool and into the base resulting in a lower rate.

3. Less problems with cost allocations. The more costs are charged direct means less decisions on how to allocate indirect costs.

4. Greater precisions versus practicality. Extensive classifications of costs as direct definitely provides greater precision in allocating costs but involves more effort in classifying, recording and reporting costs. For example, reproduction costs can be allocated to all work, commercial and government, as indirect on say a direct labor base or allocated directly based on copies applicable to direct and indirect projects. Record keeping required to identify all costs in the pool and all copies made is often quite difficult where auditors commonly scrutinize these areas quite carefully and can disallow all reproduction costs when they find inaccuracies.

5. Resistance by customer. Direct cost allocation can draw attention to the fact it is direct where the customer may not want to pay for such items. Taking the reproduction example, customers might object to them as direct or disagree with the volume or unit prices used to cost copies. In such cases, especially during negotiations, a contractor may need to concede these costs, resulting in not recovering any costs rather than recovering a portion of those costs if they are a cost element in an indirect cost pool.

6. Relative benefit. Federal contracts may cause more or less costs to be incurred than say commercial contracts so the contractor may want to devise other means of allocating those costs proportionately than including them in an indirect cost pool. Using methods to allocate costs directly through either direct identification of those costs to a contract (e.g. subcontracting, travel) or a service center (e.g. copying, vehicles, computers) may provide better results.

The following reflects both the results of the CAS Board survey results as well as some comments by Mr. Oyer in his article.

Costs that are Generally Indirect

Some costs are generally charged indirect even though detailed accounting and tracking provide the opportunity to charge direct. For example, sale of scrap and salvage is usually credited to indirect costs to avoid the administrative burden of tracking such immaterial costs. While tracking purchasing and subcontract administrative functions directly on large contracts can be done relatively easily, such effort on smaller contracts are more difficult where, for example, employees accurately tracking their time spent can result in 20 time sheet entries every day, leading to allegations of improper labor recording. Though rarely used, the author suggests an interesting solution (we have recommended it ourselves several times): allocate purchasing and subcontract administration directly to the large contracts and allocate the costs for "non-major contracts" to a cost pool allocated only to those smaller contracts. The downside is dealing with another indirect cost rate and responding to allegations of CAS 402 noncompliance (the same costs are allocated directly and indirectly). The latter is not valid because one class of contracts is being charged its costs directly while the other class of contracts are being charged indirect for those costs – no contract receives both a direct and indirect allocation.

Training and computer operations were recorded indirect as well as rearrangement costs. Though not addressed in the report, DCAA informs its auditors that for items other than approved tooling, machinery and equipment and in the absence of specific contract coverage, the auditor is to question capital items. However, in practice, direct charging of equipment is not uncommon and often justified. For example, refrigerators needed to store specimens for a contract should be a direct charge where other work might not use refrigerators. Though they could be identified to specific contracts (some with significant administrative effort), overnight mailing, courier services, long distance phone calls, cell phones, faxes, copying, auto mileage, software, supplies and office space are usually charged indirect. The author is old enough (as well as I) to remember some of these costs were more costly than now where they might have been charged direct but lower costs and substitute alternatives make them indirect.

Costs That are Generally Direct

When material, the report indicated freight in and out, design engineering, drafting, shift premium, preproduction costs, line inspection, travel, packaging and preservation, royalties, warranty, rework and scrape work were generally charged direct. Recognizing that DCAA guidance states warranty costs are either direct or indirect auditors are advised to ensure that when they are in overhead to ensure the allocation base (e.g. direct labor) consists of only contracts having warranty provisions and when charged direct, ensure those same type of costs incurred on other contracts are excluded from overhead unless no cost duplication can be shown.

Some costs are almost exclusively charged direct such as subcontracts, trade discounts, refunds and allowances on purchases, purchased labor (on site and off-site), special tooling and special test equipment. For any capital items, such as special equipment and tooling charged direct DCAA advises that the contract authorizes it and that unauthorized costs not be included in other cost accounts such as material, supplies or fabrication.

Occasionally costs normally considered indirect are properly direct if unique contracting situations apply. The CAS report indicated certain employee related costs like health insurance, pension and vacation pay were charged direct about 10% of the time. This may be common for service contracts where employees are dedicated to a single contract and distinguishing between direct labor and indirect labor would be inconsequential because all labor would be charged direct to the contract. A case ruled that vacation pay charged direct was not prohibited if the resulting allocation was equitable.

Costs not Direct or Indirect

Several costs in the CAS report were not clearly direct or indirect. These costs included overtime premium, cash discounts, incoming material inspection, inventory adjustments and holiday differential pay. As for overtime premium payments, DCAA advises that though it is generally treated indirectly, it is acceptable as a direct cost when a contractor's established policy provides for it. The author states charging overtime premium indirect has some advantages: (1) if direct, a customer may fear a contractor schedules its overtime work for its contract while if indirect, there is no opportunity for such gamesmanship and (2) if direct, it will be highly visible during contract negotiations, creating objections and possible elimination from fixed price contracts. (*Editor's Note. Be aware that we are seeing increasing objections to inclusion of overtime premiums in overhead by many state agencies such as Departments of Transportation.*)

Minor cash discounts are almost always indirect and would be burdensome tracking them direct. Incoming inspections as a direct cost could be problematic, especially when material resources planning systems are used. The incoming material could be assigned to inventory or initially charged to a contract but subsequent transfers to other contracts having greater needs can create problems. Inventory adjustments may be difficult to track to specific contracts but some equitable adjustments would be needed if the inventory was used by multiple contracts. Holiday differential pay may be direct charged as an other direct cost or included in overhead (even fringe benefit pools). Including this cost in the labor rates, however, does not provide visibility that management may want for cost control while allocation directly can cause similar problems as those for overtime premium.

RECENT TRAVEL DECISIONS

(*Editor's Note. The following continues our effort to present new changes or decisions likely to affect contractors' travel expenses. Though only three parts of the Federal Travel Regulation explicitly applies to government contract employees – per diem rates, definitions of meals and incidentals and justification for payments up to 300% of per diem rates – many contractors choose to following federal travel regulations or certain contracts may call for incorporation of them.)*

$300 Upgrade Allows Reimbursement for Luggage Fees

Robert traveled from CA to MA where he used his personal frequent flyer mile account and paid a $300 fee to upgrade to first class for his round trip ticket. Under terms of the upgrade the airline waived the $20 per flight luggage fee but Robert sought reimbursement for his coach fare plus the $40 he would have paid for the luggage fee. The appeals board surprisingly agreed he was entitled to the $40 reimbursement ruling it can reasonably be ascertained that $40 of the $300 paid is attributable to the luggage fee. The Board stated it is not the intention of the FTR to penalize an employee for upgrading a ticket nor to provide the government a windfall of $40 (*Robert Barnes, CBCA 20730 TRAV*).

No Reimbursement for Clothes and Toiletries When Luggage is Lost

The employee was required to travel from Alabama to California to represent her agency at a technical panel and two subsequent meetings. When her luggage did not arrive she called her supervisor to receive verbal authorization to purchase toiletries and two dresses. In her appeal of the refusal to reimburse her, the Board ruled against her stating unless an agency has specific provisions under its appropriations act or other legislation, it may not use funds to purchase toiletries and articles of personal clothing that may be retained for personal use (*GSBCA 15030 TRAV*).

Mandatory Fee for Travel May be Paid

Parker rented an unfurnished apartment for his temporary duty and separately rented furniture on a monthly basis. The furniture rental agreement required Parker to either obtain third party insurance naming the furniture rental company as the payee or pay a monthly damage waiver fee where Parker chose the latter. The agency refused reimbursement for the fee citing a case where the GAO determined the renter's insurance for the protection of employee's personal property is not reimbursable because it is incurred for "the employee's personal choice and for his personal benefit." Parker disagreed and argued to the board that JTR, C4555-D.3 provides that rental agreements that offer no choice is reimbursable. The Board agreed the fee was reimbursable because it was a necessary expense incurred as part of the furniture rental agreement. It dismissed the case brought up by the agency because here Parker had no choice as to payment of the fee (*W. Scott Parker, CBCA 1961-TRAV*).

Regulation Changes

1. Following a recent decision, the JTR C4554-D is changed to provide that complimentary meals provided by a lodging establishment do not affect per diem as long as the room charge is the same with or without meals.

2. The General services Administration published a federal per diem rate, effective October 1, 2010, that has increased the standard lodging rate from $70 in 2010 to $77 in 2011. The standard reimbursement rate for meals and incidental expenses (M&IE) will stay at $46.

Car Rental Can be Used Instead of a Taxi

Hudson rented a one way car to drive 77 miles to the airport, reasoning it was cheaper than renting a taxi sufficient to carry his family's luggage. The agency refused reimbursement saying he should have taken a taxi where the Board ruled he was entitled to reimbursement noting taxi fare would have been $202,

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an airport shuttle $144 and the one way car rental was $125. The Board noted that FTR 301-10.402 provides the general method of transportations should be taxi or shuttle but section 450 provides for use of a rental car when doing so is advantageous to the government (*Hudson Minshewm, CBCA 2004-RELO*).

Blanket Policy Cannot Deny Individual Circumstances

Sukol made all reasonable attempts to sell her house (e.g. reduced price four times, switched brokers) and a few months prior to the normal two year window to sell an old home requested an extension, citing FTR 302-11.22 that provides federal agencies the discretion to extend the normal two-year window an additional two years for reasons beyond the control of the employee. Sukol stated reason was the "generally depressed real estate market" where the government said a slow real estate market does not constitute "extenuating circumstances" stating granting the extension would lead to obligations to make extensions to others resulting in more expenses. The Board sided with Sukol ruling the decision should have been made on individual circumstances of her situation not on blanket policy such as budget considerations. The Board cited three questions that must be considered in determining an employee's individual situation: (1) did extenuating circumstances prevent the sale within the two-year window (2) were these circumstances acceptable to the approving official and (3) were the expenses reasonably related to the change in duty location (*Judith Sukol, CBCA 2092-RELO*).

70 Mile Commute is Reimbursable

Robert was hired as a temporary employee for CNCS where the position required some work in Washington DC but Robert and CNCS believed most work could be conducted from his home, 70 miles from Washington DC. After his hire CNCS assigned new duties that required more regular travel to Washington DC where an internal audit found several documents saying his duty station was in DC and hence reimbursement was improper because an employee may not receive payment for travel to their official duty station. Robert protested saying it was an error to designate DC as his official duty station and the Board agreed saying a determination of a duty station must be based on "surrounding circumstances of an employee's hiring and work situation" where expectations of the parties are an "important factor." Here both Robert and CNCS believed his work would be conducted at his home (*Robert L. Shotwell, CBCA 1887-TRAV*).

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