

# Rates and Understanding the Rate Cycle

Presented By:

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# The Rate Cycle and Related Trivia

- ✧ Basics of Indirect Rates
- ✧ The Traditional Structures
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- ✧ Rate Trivia

# Basics of Rates



# Costs are of Two Primary Types

- ❖ Direct Costs are those attributable to a contract or job for a customer
  - “Caused” only by that contract or job, or
  - “Benefiting” only that contract or job
- ❖ Indirect Costs are those that cannot be associated solely with a job and need to be allocated across multiple jobs

# Rates are a Fraction

- ✿ The Numerator consists of a “pool” of (Indirect) costs to be allocated
- ✿ The Denominator consists of the related (Direct and some times Indirect) costs to be used as the allocation base
  - Examples:

$$\frac{\text{Fringe Costs of \$280K}}{\text{Labor Costs of \$1M}} = 28\% \text{ Fringe Rate}$$

$$\frac{\text{Overhead of \$400K}}{\text{Direct Labor of \$800K}} = 50\% \text{ Overhead Rate}$$

# The Components of a Rate are Related

- ✿ The pooled Indirect costs to be allocated should have a “Causal/Beneficial” relationship to the costs in the allocation base
- ✿ Sometimes that relationship is clear and common sense
- ✿ Sometimes the relationship is more esoteric
- ✿ Sometimes the relationship is specified in the regulations (as with the General and Administrative pool – G&A)

# Pool and Base Examples

- ❖ Fringe Benefit costs are often pooled and allocated over a base consisting of total labor
  - Some of that labor is in other pools (Overhead and G&A/B&P)
  - Some of it is in jobs to be billed to customers
- ❖ The labor in the allocation base “causes” and “benefits from” the costs in the Fringe Benefit pool
  - Payroll taxes and other payroll expenses
  - Paid absence expense (holiday, sick and vacation)
  - Health and welfare costs (health insurance, 401K/pension costs)
- ❖ Rule of thumb: In general, costs in the fringe pool should arise out of the employment relationship and not from activities or results

# Pool and Base Examples

- ❖ Pooled Overhead costs are often allocated over a base consisting of direct (and B&P) labor labor
  - Some of that labor is in other pools (the B&P in the G&A pool)
  - Most of it is in jobs to be billed to customers
- ❖ The labor in the allocation base “causes” and “benefits from” the costs in the Overhead pool
  - Supervision and training
  - Support and (often) IT costs
  - Incentives and morale costs
  - Facilities expense (heat, lights, rent, physical security)

# Pool and Base Examples

- ❖ Overhead costs are sometimes accumulated in two pools based on where the labor is worked
  - Labor worked on Customer sites
  - Labor worked on Company sites
- ❖ The labor in the allocation bases is similarly separated into Customer site Labor and Company site labor
- ❖ Costs are similar except for facilities
  - Supervision and training
  - Support and (often) IT costs
  - Incentives and morale costs
  - **Facilities expense (heat, lights, rent, physical security) – in the Company site pool, but not the Customer site pool**

# Pool and Base Examples

- ❖ G&A costs are those associated with running the company as a whole (just one pool)
  - Executive labor, fringe and associated facilities costs
  - Finance and accounting function and associated costs
  - Business licenses and taxes
- ❖ The allocation base for G&A is limited to a few choices by regulation:
  - Total Cost Input (TCI) – used by most smaller companies
  - Value Added – like TCI, but excludes material & subcontracts
  - Single Element – used primarily by consultants or very small companies

# The Traditional Structures



# The Single Rate Structure (1%)

- ✿ One rate applied to a single element (labor)
  - Pool contains all indirect costs
  - Base consists of all labor charged to jobs
- ✿ Rarely used by companies of more than a few employees

# The Two-Tier Structure (5% or less)

- ✦ A single pool for Fringe and Overhead (combined)
- ✦ A separate pool for G&A
- ✦ Not popular with auditors/contracting officers because they see it so seldom and don't understand it
- ✦ Another way to think about the Two-Tier Structure...
  - Fringe with a base of labor
  - Overhead with a base of labor
  - Since the bases are identical, the rates can simply be added...
    - A Fringe of 28%, plus
    - An Overhead of 50%, gives a combined rate of 78%
- ✦ Put all the costs in a single pool and the rate will be 78%

# The Three-Tier Structure (almost everyone else)

- ✿ A pool for Fringe with a base of labor
- ✿ A pool for Overhead with a base of labor or labor+fringe
- ✿ A pool for G&A with a base of either TCI or V-A
- ✿ Very popular with auditors/contracting officers because they see it so often and understand it (taught that way in school)

# Let's Make it Complicated (but still Three-Tier)

- ❖ Multiple Fringe pools (based on geography or employee classification)
- ❖ Multiple Overhead pools (based on geography, location type, or other)
- ❖ Still stuck with one G&A (probably on a V-A base)
  
- ❖ Why, oh why ?!?!?

# Detour...

- ✚ What's a "Wrap Rate"

- ✚ It's shorthand for ...

"What is the sell price of a dollar's worth of labor?"

- ✚ With a FR of 28%, OH of 50% and a G&A (TCI) of 15%, the wrap rate is  $(\$1 + \$0.28 + \$0.50) * 1.15 = \$2.05$  or a wrap rate of 2.05

- ✚ Every dollar's worth of labor sold will cost \$2.05 (no profit there yet)

# So... Why Make it Complicated?

❁ Company with 3 FR and 3 OH would have 9 wraps

<b>Multiple Matrix</b> <b>(15% G&amp;A)</b>		<b>Major Metro</b> <b>90%</b>	<b>Field Office</b> <b>55%</b>	<b>Customer Site</b> <b>12%</b>
<b>Full Fringe</b>	<b>36%</b>	<b>2.60</b>	<b>2.20</b>	<b>1.70</b>
<b>Reduced Fringe</b>	<b>22%</b>	<b>2.44</b>	<b>2.04</b>	<b>1.54</b>
<b>Minimum Fringe</b>	<b>14%</b>	<b>2.35</b>	<b>1.94</b>	<b>1.45</b>

# Developing Rates



# Step One - Pick a Structure

- ✿ Any structure will work – honest!
- ✿ The RIGHT structure is the one that your regulators are comfortable with, allows you to recover ALL your costs, and **you can WIN with**
- ✿ Advice
  - Stay mainstream all long as you can or unless there is a REALLY good reason not to
  - Don't complicate unnecessarily
  - Pick a structure with enough flexibility to work well for several years

# Estimate Indirect Costs by Element by Pool

- ✿ Do the estimates on an annual basis AT LEAST 90 days **before the year starts**
- ✿ A basic layout of elements by pool is available online from numerous sources including DCAA, NIH, CMS, NASA, etc.
- ✿ Advice
  - Stick with the recommended elements in the pools until there's a good reason for yours to be different from the templates
  - Get help with the first one (or two)
  - Remember, an estimate based on experience or judgment is better than leaving something out – don't hesitate to make one

# Estimate Direct Costs by Job and Element

- ✿ Do the estimates on an annual basis AT LEAST 90 days **before the year starts**
- ✿ Include all current work and estimate future work
  
- ✿ Advice
  - Estimate direct jobs in enough detail to be able to see the elements of cost (labor, travel, ODCs, subs, etc.)
  - With a few exceptions, the indirect costs are variable – if the work doesn't happen, the costs won't – so be aggressive
  - Get help with the first one (or two)

# Use Your Customers Model

- ✚ If your primary agency (or prime) customer has a preferred calculation model for rates, USE IT!
- ✚ Unless, of course, it doesn't fit the structure or pool elements you have chosen, then don't
  
- ✚ Advice
  - Don't reinvent the wheel - plagiarize!!!
  - Get a proven model from a friend or customer
  - Get help with the first one (or two)

# Prospective Rate Submissions



# Forward Pricing Rate Proposal (FPRP)

## Regulatory requirement

- Required to support negotiation of Forward Pricing Rate Agreement
  - Such agreements are administratively expensive and rare
  - Most FPRPs result in a Forward Pricing Rate *Recommendation* (FPRR)
- FAR 42.17 – Forward Pricing Rate Agreements
  - May be requested by the ACO or the contractor
  - ACO determines whether FPRA will be negotiated
  - ACO may require FPRP whether or not FPRA will be negotiated (this practice is encouraged by DOD policy)

# Forward Pricing Rate Proposal (FPRP)

## Due Date

- As established in the ACO request (typically 60 days before the beginning of the contractor FY)
- Not established by FAR
- Time is set to permit...
  - Audit by DCAA
  - Development of a negotiation position by the ACO
  - Negotiations
  - Drafting and execution of a bilateral agreement
- This process often (usually) ends with the audit

# Forward Pricing Rate Proposal (FPRP)

## Issues

- DCMA internal guidance requires an FPRA or (*if one cannot be established*) an FPRR for all contractors with more than \$200M in annual sales to the Government
- If an FPRA results, contractor is obligated to monitor and update all supporting data as changes occur
- The FPRA may be cancelled at the option of either party

# Provisional Indirect Billing Rates

## Regulatory requirement

- Requirement for provisional billing rates is in FAR 52.216-7(e), Allowable Cost and Payment (June 2011)
  - The clause provides that...

*“the Government shall reimburse the Contractor at billing rates established by the Contracting Officer or by an authorized representative (the cognizant auditor), subject to adjustment...”*
  - The clause further provides that the rates may be...

*“prospectively or retroactively revised by mutual agreement, at either party’s request, to prevent substantial overpayment or underpayment.”*

# Provisional Indirect Billing Rates

## Regulatory requirement (continued)

- Procedures for establishing rates are found at FAR 42.704, Billing Rates
  - The provision states...

*“The contracting officer (or cognizant Federal agency official) or auditor responsible under 42.705 for establishing the final indirect cost rates also shall be responsible for determining the billing rates.”*
  - For DOD contracts (or contractors audited by DCAA), that is now the ACO (per the DFARS Bus Sys Rule)
- Rates may be established based on experience, previous rate audits, or other reliable data

# Provisional Indirect Billing Rates

## Form & Substance

- Billing rate proposals should include...
  - Proposed billing rate calculations (Pool and Base)
  - PY Pool and Base amounts & rates
  - Current FY Budgeted Pool and Base amounts & rates
  - Explanation of significant differences between years
- Common proposal pitfalls
  - Including unallowable costs!
  - Just using the prior year rates
  - Failure to adjust for experience in the PY

# Provisional Indirect Billing Rates

## Due Date

- Prior to the beginning of the fiscal year you intend to use them – but no regulatory deadline – almost all ACO want 60 days
- Whenever established rates no longer approximate where you'll be at the end of the year

## Issues

- No response from the ACO on provisional rates
- No longer goes to DCAA – should be ACO (DOD)
- Most contractors don't re-submit throughout the year
- Some contractors don't submit PBRs at all!

# Why the FPRP & Provisionals Aren't the Same

## Purpose

- The FPRP provides a basis for negotiation of rates to be used in pricing all proposals for the coming year
- The provisional rate submission provides a basis for the rates to be used on all cost-reimbursable contracts and progress payment vouchers on fixed price contracts for the coming year

 The “current year” FPRP rates and the Provisional Rates should be the same - not required to be

# Why the FPRP & Provisionals Aren't the Same

## Differences

- The Defense Contract Audit Manual (DCAM) cautions auditors in DCAM 9-1206 that...

*“Because of the large degree of interdependence between billing rates and forward pricing rates for the current contractor fiscal year (CCFY), the auditor should expect both types of rates for the CCFY to be the same.”*

- It then goes on to say...

“Any significant differences between the rates must be fully explained and supported by the contractor.”

# Related (Non-Rate) Submissions



# Accounting System Description

- ❖ Required as part of the incurred cost proposal as supplemental schedule D for non-CAS contractors (see FAR 52.216-7(d)(2)(iv)(D)) – coordinate carefully with schedule M (org/accounting changes)
- ❖ Should also be included in all FPRPs and Provisional Billing Rate Proposals
  - Intended to provide a “road map” to the indirect pools and bases
  - Essential when pools or bases change in order to facilitate review of rates
- ❖ Should rarely exceed one or two pages

# CAS Disclosure Statement

- ❖ CAS-covered contractors specifically exempt from requirement of supplemental schedule D, but...
  - Summary description of allocation methodology including all pools and bases is highly desirable
    - Will facilitate review and approval
    - Must be carefully maintained to avoid discrepancies between description and CAS Disclosure Statement
  - References to most recent Disclosure Statement should be included including dates of review or approval and authorities

# Course Corrections & Revisions



# Corrections - Why & When

## When...

- Anytime actual year-to-date rates vary materially from provisional rates being billed,  
*AND*
- The rates being billed have the potential to result in significant over- *OR* under-payments
  - Within rate ceilings

# Corrections - Why & When

## ✿ Why again...

- FAR 3.10, Contractor Code of Business Ethics and Conduct, in 3.1003(a)(3), states...

*“If the contractor becomes aware that the Government has overpaid on a contract financing or invoice payment, the contractor shall remit the overpayment amount to the Government.”*

- Good news!
  - While 3.1003 does permit a contractor to be suspended and/or debarred for knowing failure to timely disclose a significant overpayment, that does NOT apply to progress payments or interim payments on cost-type contracts

# Year-End Revised Billing Rates/Invoices



# Corrections - Why & When

## Why...

- Uhhhhh, cash flow in the case of underpayments?

Just saying...

- Of course, there's also that pesky ethics thing in the unlikely event of overpayments

# Corrections - Why & When

## When...

- As soon as possible following year-end (recommended)
- DCAM 6-705.1(e) cautions auditors to...
  - “compare the interim billing rates with the year-end recorded allowable rates (considering any historical audit exceptions) to determine if the billing rates need to be adjusted.”
- The same provision admonishes auditors they...
  - “should not wait to receive the final indirect cost submission”
- and that...
  - “the comparison should be done as soon as practicable after the yearend closing.”

# Corrections - Why & When

## ✿ When...

- Upon submission of the incurred cost proposal (required)
- DCAM 6-705.2, Adjustment of Interim Indirect Cost Reimbursement, instructs auditors...

*“If claimed costs ... exceed billed costs, advise the contractor to submit an interim claim for the difference.”*

## But...

*“If billed costs exceed claimed costs, the contractor must appropriately adjust the next voucher or remit ... the difference.”*

# The Incurred Cost Proposal



# The Incurred Cost Proposal

## Regulatory Requirement

- FAR 42.705-1 gives the cognizant contracting officer (ACO for DOD) the responsibility for establishing indirect rates
- FAR 52.216-7 Allowable Cost and Payment Clause is the source of the submission requirement

# The Incurred Cost Proposal

## Form and Substance

- Prior to June, 2011, sole requirement was for the contractor to submit “an adequate final indirect cost rate proposal”
- For contracts awarded after June 2011 (or since modified to contain the June 2011 clause) the requirement is...
  - Substantially the same as the schedules contained in DCAA’s ICE model
  - Electronic submission is NOT mandatory

# The Incurred Cost Proposal

## Form and Substance (continued)

- Schedules formerly referred to in DCAA’s model and documents as “optional” are now considered “supplemental” and often demanded up front
- DCAA will examine for adequacy (checklist) but only the ACO or CO can reject

# The Incurred Cost Proposal

## Due date

- Six Months after year-end
- May request extensions in writing to contractor's ACO (not often granted, but no immediate consequences for late submission)

# The Incurred Cost Proposal

## Issues

- Rejected proposals
  - The recent Statute of Limitations (SOL) decisions have led to the rejection of many old proposals
  - Upon resubmission, DCAA consistently demands recertification of the claim in the mistaken belief that it will “restart the SOL clock”
  - Many proposals rejected for non-compliance with “new” schedule requirements even though submission pre-dates the new clause

# The Dreaded ICS Audit & Final Rate Negotiations



# ICP Audits & Final Rates

## Regulatory Requirement

- FAR 42.704 makes establishing final rates the responsibility of the contracting officer
- FAR 52.216-7(g) “At any time or times before final payment, the Contracting Officer may have the Contractor’s ... statements of cost audited”
- In DOD, final rates are delegated to the ACOs at DCMA
- DCMA Instruction 125 requires audit of ICP by DCAA prior to negotiation of final rates
- Audit of the ICP is NOT REQUIRED BY FAR

# ICP Audits & Final Rates

## Form and Substance

- DCAA audit program for ICPs is No. 10100, August 2013, and is posted at [www.DCAA.mil](http://www.DCAA.mil) (also adequacy checklist)
- Instruction governing ACO procedures for establishing final rates is DCMA Instruction 125 and is posted at [www.DCMA.mil](http://www.DCMA.mil)

# ICP Audits & Final Rates

## Due Dates

You're kidding, right?

Go directly to Issues – Do not pass GO  
Do not collect ANYTHING!

# ICP Audits & Final Rates

## Issues - Audits

- DCAA (alone) has more than 25,000 ICPs that need to be audited
- Approximately 19,000 are over-aged (3-years old or more)
- DCMA handbook establishes targets for final rate determinations as...
  - 27 months for major contractors (\$100M of ADV)
  - 36 months for non-major contractors (less than \$100M of ADV)
- Cleared less than 500 last year – received 2,500 new ones

# ICP Audits & Final Rates

## Issues – Common findings

- Adequacy
  - Not using the standard ICE model
  - Not including required schedules
  - Inadequate/incomplete contract briefs (used to be “optional”, now supplemental)
- Audit
  - Inadequate or missing documentation
  - Unreasonable executive compensation
  - Bonuses/Incentive compensation

# ICP Audits & Final Rates

## Issues - Statute of Limitations (SOL)

- Set by Contract Disputes Act (CDA) as six years from accrual of the claim
- “Accrual of the claim” defined in the FAR as “the date when all events, that fix alleged liability of either the Government or the contractor and permit assertion of the claim, were known or should have been known.”
- Recent court cases have established the date of submission of a “certified incurred cost proposal” as the date the Government’s claim to recovery of overpayments accrues

# ICP Audits & Final Rates

## Issues - Final Rate Negotiations

- ACO's (DOD) under SEVERE pressure to establish final rates and close old contracts
- Has led to “kangaroo court” negotiations and “take it or leave it” offers
- Current DCMA Instruction on final rate decisions (DCMA-INST 125, April 12, 2013) leave ACOs little or no discretion on questioned costs
- Instruction requires ACO to provide “Sound rationale for resolving each finding and recommendation made by DCAA”

# Rate Trivia & Issues



# Trends in Fringe

- ✿ Distinct trend toward multiple fringe rates to distinguish between full benefit/partial benefit employees
- ✿ A few company have as many as three rates...
  - A “full benefits” rate (typically full-time employees)
  - A “partial benefits” rate (primarily retired workers who may be full time, but do not desire benefits)
  - A “no benefits” rate (often part-time or occasional workers)

# More Trends in Fringe

- ❖ Despite the trend toward multiple pools, some companies are consolidating duplicative pools to make the pools larger and less volatile
- ❖ Some companies are seeking to create fringe pools based on geography

# Trends in Overhead

- ❖ Gradation of pools based on cost beyond simply company site/customer site
  - Some based on geography
  - Some based on broader factors
- ❖ Interesting example is a company that has three overheads...
  - Major Metro Area (high occupancy cost)
  - Field Office (lower occupancy cost)
  - Customer Site (No occupancy cost)

# More Trends in Overhead

- ✿ There is a distinct trend away from including fringe in the overhead base
- ✿ Multiple fringe rates with multiple overheads can cause applied overhead to vary based on the nature of the worker rather than the nature (location) of the work

# Trends in G&A

- ✿ Move away from Total Cost Input (TCI) towards Value Added (VA)...
  - Fueled at least partly by new cost principle in FAR Part 31 entitled “Excessive Pass-Through Costs”
  - Also motivated by cost pressure and LPTA when teams are necessary

# Trivia

- ✿ 70% of companies with revenues of \$100M or more have three or more fringe rates\*
- ✿ 95% of similar companies have three or more overhead rates (that drops to about 38% for companies less than \$100M and only about 25% have two)\*
- ✿ Over \$200M, about half of all contractors have a VA G&A base, below that it's less than 25%\*

\* Deltek CLARITY studies, 2010, 2011, 2012, 2013

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