

A large blue iceberg is shown floating in the ocean. The top of the iceberg is above the water line, while the vast majority of its mass is submerged below the surface. The background is a clear blue sky with a few clouds.

Exploring Indirect Costs



**Michael Dodds
And
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Definitions

- Direct Cost is any cost that is identified, specifically with a particular final cost objective
- Indirect Cost is any cost not directly identified with a single, final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective

<u>Overhead Costs</u>	<u>G&A</u>	<u>Intermediate Service Pools</u>
Cost which support a production function, e.g. Material O/H, Engineering O/H, Manufacturing O/H	Cost of doing business as a whole, e.g. Marketing/Sales Human Resource Accounting Department Travel	Cost which are captured/managed separately for distribution to other primary pools, e.g. Building Insurance Utilities and Rent Computer Services Support Copy Center Support

Direct or Indirect Costs

Direct Costs	Overhead	G&A	Intermediate Service Pools
Bulb Lens Case Circuit boards Fan Remote Control DIRECT MATERIALS	Wiring Shipping Screws Packaging Inventory Control Purchasing MAT'L O/H	R&D Marketing/Sales Management Travel Legal Customer Service HR	Utilities Building Insurance Rent Security Computer Services Copy Center
Design Technical Documents Test Spec Configuration ENGR DL	Test Equipment Supervisors & Clerical CAD Training ENGR O/H	Fringe Benefits Clerical Accounting Office Supplies	
Fabricators Quality Assemblers MGF DL	Supervisors & Clerical Training Jigs/fixtures MGF O/H	Transportation Training	

Charging/Recovering Costs

- After forming our business endeavor and subsequently indentifying and categorizing our costs – which costs do you believe are proper to recover (charge) from our customers?

All of these costs, including the indirect overhead and G&A costs, are necessary costs of doing business and need to be recovered from our customers.

- How will we charge our direct costs to our customers?

With a sufficient accounting system, we can charge each customer their direct material and labor costs. We will have material inventory records and time cards identifying these costs with our individual customers and their jobs (contracts).

- Since indirect costs, by definition, benefit multiple cost objectives, or customers, how will we fairly charge each customer for their fair share of these costs?

Indirect Costs

- Necessary costs of doing business
- Are properly allocable to each contract that benefits from that cost
- DCAA auditor or ACO is important to analysis
- Contracting Officer's responsibility for determining fairness and reasonableness

Indirect Cost Pools

- Logical grouping of indirect costs with a similar relationship
 - e.g. manufacturing overhead pools include indirect costs that are associated with manufacturing effort. What one contractor uses as an indirect cost rate has no bearing on another contractor's rate.

Overhead Pools

Common Pools	Typical Cost Found in the Pool
Material Overhead	<ul style="list-style-type: none"> • Purchasing costs • Inbound transportation • Indirect labor • Employee related expenses • Receiving and inspection • Material handling and storage
Operations Overhead (Manufacturing, Engineering, Field Operations)	<ul style="list-style-type: none"> • Indirect labor and supervision • Indirect material and supplies (tools, lubrication oils) • Employee related expenses (uniforms) • Fixed charges (depreciation, insurance, rent, taxes) • Training, conferences, technical meetings • Utilities

G&A Pool

Common Pools	Typical Cost Found in the Pool
G & A	<ul style="list-style-type: none">• General and executive office expenses• Staff services (legal, accounting, financial)• Marketing and sales expenses• Corporate or home office• Independent research and development (IR&D)• Bid and proposal (B&P)• Training, conferences, technical meetings• Travel expenses• Office supplies, stationary, printing, postage• Utilities• Other miscellaneous activities related to overall business operations

Service Center Pool

Common Pools	Typical Costs Found in the Pool
Service Center	<ul style="list-style-type: none">• Copy center• Business data processing• Photographic services• Reproduction services• Art services• Communication services• Facility services• Motor pool services• Company aircraft services• Wind tunnels• Technical data processing services• Scientific computer operations

Indirect Cost Allocation Base

- Some measure of direct contractor effort that can be used to allocate pool costs based on benefits accrued by the multiple cost objectives
- Examples of typical bases:
 - Direct labor hours
 - Direct labor dollars
 - Number of units produced
 - Number of machine hours

Calculate Indirect Cost Rates

$$\begin{array}{l} \text{Indirect} \\ \text{Cost} \\ \text{Rate} \end{array} = \frac{\text{Indirect Cost Pool}}{\text{Indirect Cost Allocation Base}}$$

Pool is always going to be \$, but base can be dollars, hours, etc.

If both pool & base are dollars, will need to multiple by 100 to get %.



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 - Two contracts of equal size?

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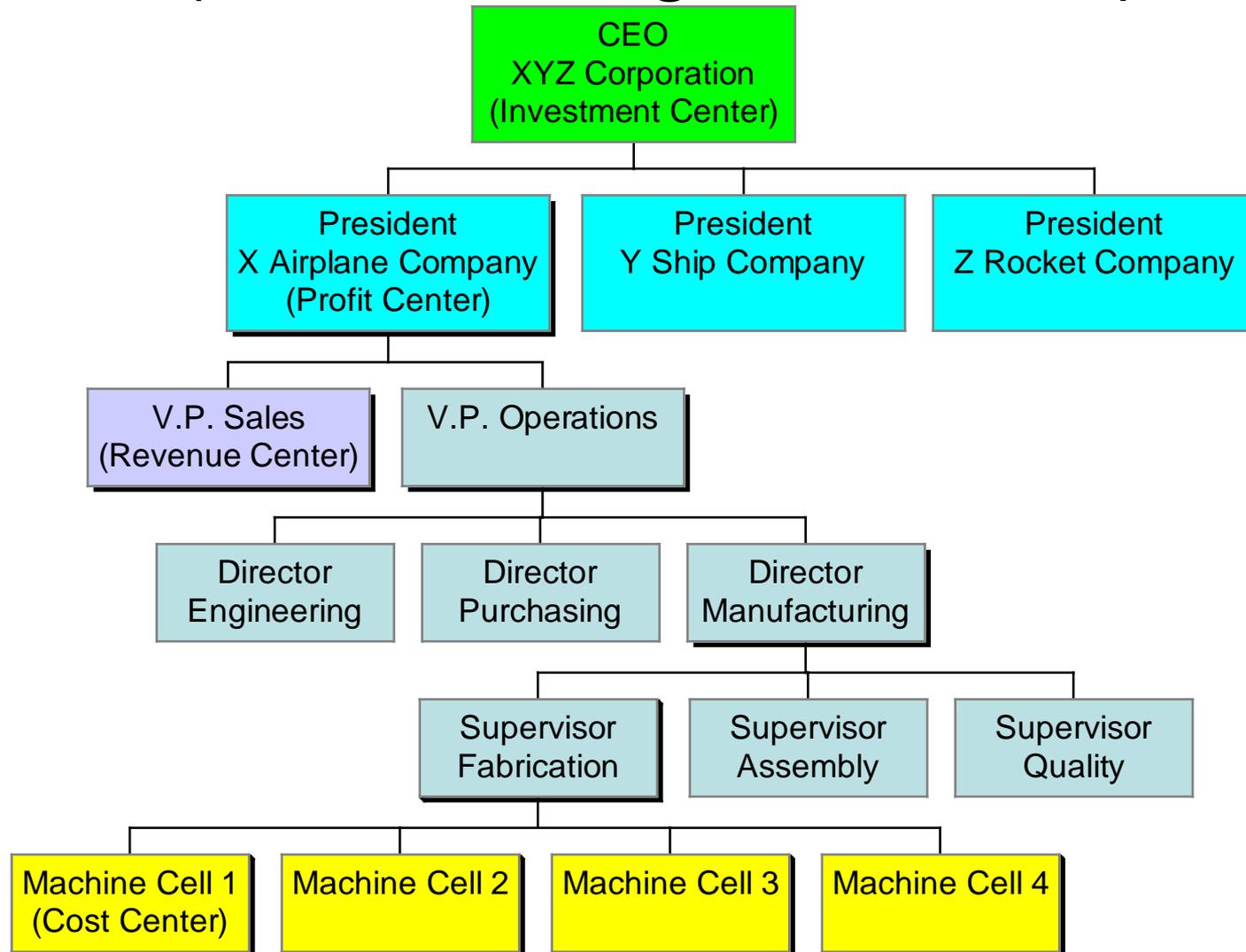
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Manufacturing Overhead Rate History and Projection					
Account Title		Actual 2004	Actual 2005	Actual 2006	Projected 2007
Pool	Salaries & Wages				
	Indirect Labor	\$1,338,330	\$1,236,259	\$1,395,245	\$1,443,095
	Additional Compensation	\$80,302	\$75,490	\$83,950	\$88,000
	Overtime Premium	\$13,214	\$15,744	\$11,296	\$14,500
	Sick Leave	\$65,575	\$64,717	\$67,742	\$72,130
	Holidays	\$79,164	\$82,041	\$83,006	\$86,080
	Suggestion Awards	\$310	\$450	\$423	\$500
	Vacations	\$140,272	\$130,223	\$147,891	\$153,300
	Personnel Expenses				
	Compensation Insurance	\$25,545	\$24,544	\$26,304	\$28,500
	SUTA/FUTA ¹	50,135	\$46,762	\$52,692	\$51,500
	FICA/Medicare	\$70,493	\$65,990	\$73,907	\$77,850
	Group Insurance	\$153,755	\$143,670	\$161,401	\$169,130
	Travel Expense	\$11,393	\$9,636	\$12,725	\$13,900
	Dues & Subscriptions	\$175	\$175	\$175	\$175
	Recruiting & Hiring	\$897	\$431	\$574	\$250
	Employee Relocation	\$4,290	\$3,891	\$3,562	\$4,400
	Employee Pension Fund				
	Salaried	\$25,174	\$25,062	\$26,350	\$28,500
	Hourly	\$62,321	\$58,132	\$65,497	\$68,700
	Training, Conferences, & Technical Meetings	\$418	\$407	\$539	\$457
	Educational Loans & Scholarships	\$400	\$400	\$400	\$400
	General Operating	\$495,059	\$475,564	\$509,839	\$525,000
Maintenance: Building	\$9,102	\$8,640	\$12,318	\$15,700	
Stationary, Printing, & Office Supplies	\$23,052	\$21,530	\$24,125	\$25,500	
Material O/H on Supplies	\$56,566	\$49,305	\$62,071	\$62,500	
Maintenance: Office Equipment	\$9,063	6,673	\$10,875	\$12,000	
Rearranging	\$418	\$2,128	\$3,523	\$3,600	
Other	\$3,314	\$3,198	\$2,635	\$2,500	
Heat, Light, & Power	\$470,946	\$446,971	\$489,123	\$507,200	
Telephone	\$32,382	\$30,414	\$33,874	\$35,000	
Fixed Charges					
Depreciation	\$187,118	\$178,625	\$175,641	\$181,850	
Equipment Rental	\$7,633	\$7,633	\$7,633	\$7,633	
Total Pool	\$3,416,816	\$3,214,705	\$3,545,336	\$3,679,850	
Base	Manufacturing Direct Labor Cost				
Assembly Labor	\$934,444	\$898,780	\$950,432	\$999,700	
Fabrication Labor	\$233,071	\$225,950	\$253,999	\$258,100	
Inspection Labor	\$173,372	\$180,928	\$203,500	\$209,400	
Total Base	\$1,340,887	\$1,305,658	\$1,407,931	\$1,467,200	
Rate	Manufacturing Overhead Rate	254.8%	246.2%	251.8%	250.8%

		General & Administrative Expense Rate History and Projection			
Account Title		Actual 2004	Actual 2005	Actual 2006	Projected 2007
Pool	Salaries & Wages				
	Indirect Labor	\$1,407,100	\$1,426,042	\$1,458,724	\$1,460,500
	Additional Compensation	\$125,431	\$120,410	\$152,691	\$155,000
	Overtime Premium	\$4,883	-0-	\$5,069	\$5,000
	Sick Leave	\$34,875	\$33,262	\$32,937	\$32,500
	Holidays	\$49,962	\$49,260	\$50,013	\$49,500
	Suggestion Awards	\$240	\$402	\$225	\$250
	Vacations	\$80,637	\$79,260	\$81,398	\$82,525
	Personnel Expenses				
	Compensation Insurance	\$1,025	\$902	\$1,103	\$1,200
	SUTA/FUTA	\$22,465	\$21,526	\$23,591	\$23,600
	FICA	\$31,419	\$28,620	\$31,519	\$32,000
	Group Insurance	\$29,008	\$28,942	\$29,226	\$29,300
	Travel Expense	\$62,513	\$70,001	\$64,987	\$67,000
	Dues & Subscriptions	\$2,375	\$2,210	\$2,119	\$2,500
	Recruiting	\$1,378	\$902	\$1,075	\$1,250
	Employee Relocation	\$566	\$2,125	\$1,974	\$1,500
	Employee Pension Fund				
	Salaried	\$33,097	\$31,625	\$34,123	\$35,000
	Hourly	\$17,632	\$15,260	\$17,956	\$18,500
	Training, Conferences, & Technical Meetings	\$7,003	\$8,102	\$7,536	\$7,500
	Courtesy Meal Expense	\$6,238	\$6,124	\$5,436	\$7,000
	Educational Loans & Scholarships	\$1,392	\$624	\$1,525	\$1,500
	Supplies				
	Operating	\$2,010	\$1,862	\$1,724	\$2,000
	Maintenance - Building	\$411	\$4,262	\$856	\$750
	Stationary, Printing, & Office Supplies	\$32,515	\$27,640	\$33,209	\$33,500
Postage	\$1,651	\$2,316	\$2,056	\$2,100	
Material O/H on Supplies	\$1,732	\$1,710	\$1,634	\$1,980	
Maintenance - Equipment	\$938	\$950	\$983	\$1,000	
Other	\$15,829	\$18,216	\$16,982	\$17,500	
Public Utilities					
Telephone	\$59,105	\$63,142	\$61,372	\$65,000	
Heat, Light, & Power	\$237,512	\$211,403	\$241,298	\$245,000	
Miscellaneous Income & Expense					
Legal & Auditing	\$16,714	\$18,260	\$10,945	\$15,000	
Professional Services	\$21,197	\$24,000	\$23,791	\$22,500	
Patent Expense	\$18,466	\$17,620	\$9,084	\$10,000	
Public Relations	\$12,155	\$14,670	\$14,172	\$15,000	
Interdivisional Transfers					
At Cost	(\$48,243)	-0-	-0-	-0-	
Corporate Expense					
Headquarters	\$1,556,956	\$1,467,024	\$1,673,824	\$1,700,000	
Fixed Charges					
Insurance Property	\$9,820	\$9,926	\$10,930	\$11,000	
Insurance Inventories	\$4,024	\$4,862	\$4,543	\$4,500	
Franchise Tax	\$268,495	\$260,126	\$246,624	\$265,000	
Rent - Equip	\$1,426	\$1,426	\$1,426	\$1,426	
Total Pool	\$4,131,952	\$4,075,014	\$4,358,680	\$4,426,381	

General & Administrative Expense Rate History and Projection (cont)					
Account Title		Actual 2004	Actual 2005	Actual 2006	Projected 2007
Base	Total Cost Input				
	Engineering Ovhd Expense	\$1,025,345	\$952,614	\$1,153,612	\$1,023,500
	Engineering Direct Labor	\$1,385,765	\$1,446,420	\$1,579,595	\$1,582,300
	Manufacturing Ovhd Expense	\$3,416,816	\$3,214,705	\$3,545,336	\$3,679,850
	Manufacturing Direct Labor	\$1,340,887	\$1,305,658	\$1,407,931	\$1,467,200
	Materials Ovhd Expense	\$1,234,456	\$1,205,621	\$1,296,179	\$1,361,000
	Direct Materials	\$13,056,987	\$13,042,160	\$13,484,836	\$14,145,921
	Total Base	\$21,460,256	\$21,167,178	\$22,467,489	\$23,259,771
Rate	G&A Rate	19.25%	19.25%	19.4%	19.0%

Company Rate Development (Annual Budget Exercise)



Base Implications on Rate

$$\downarrow R = \frac{P}{B} \uparrow$$

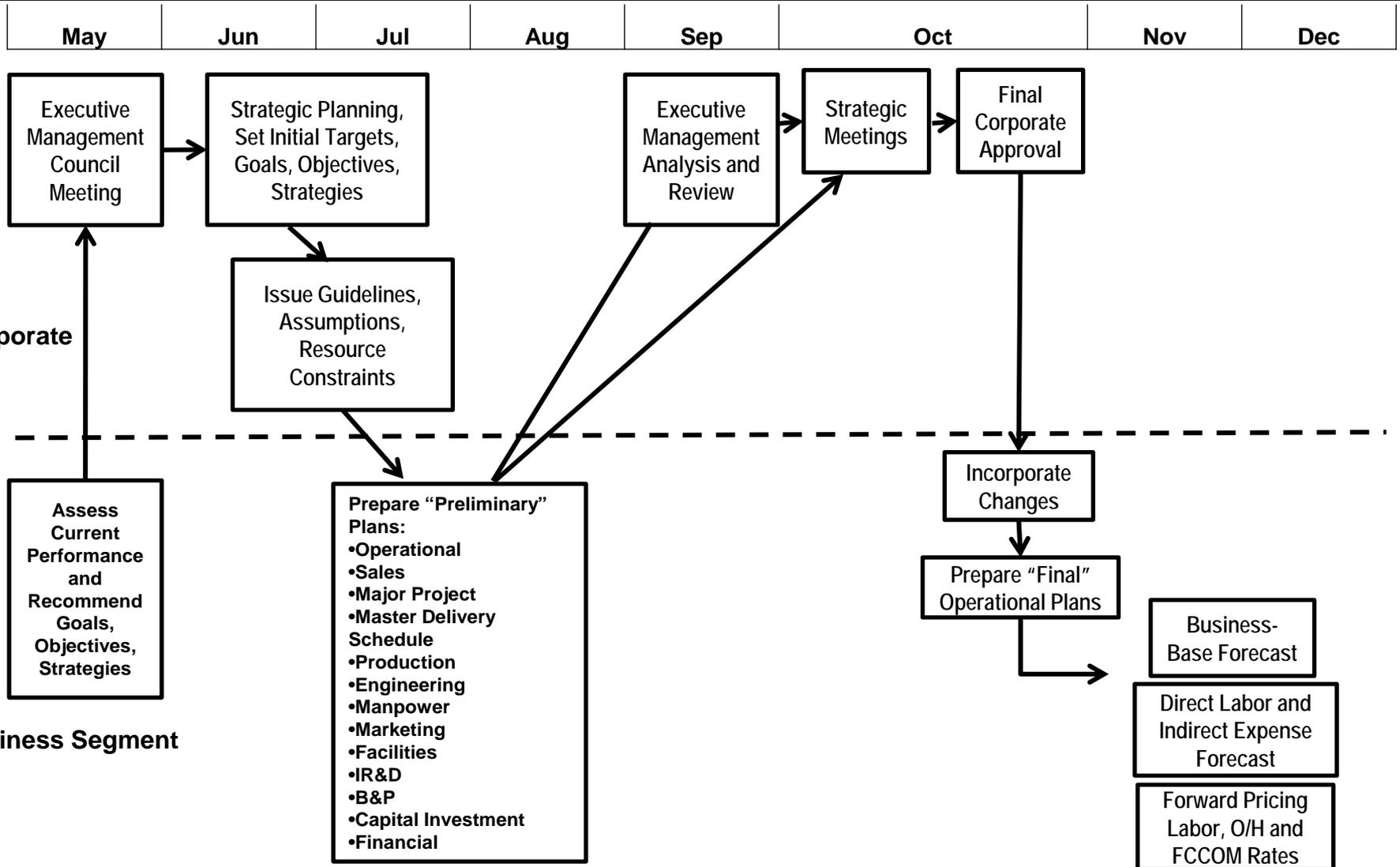
- Optimistic Base
- Decreases Rate
- Where might Contractor use?
 - Competitive
 - Cost Reimbursable
- Realism

$$\uparrow R = \frac{P}{B} \downarrow$$

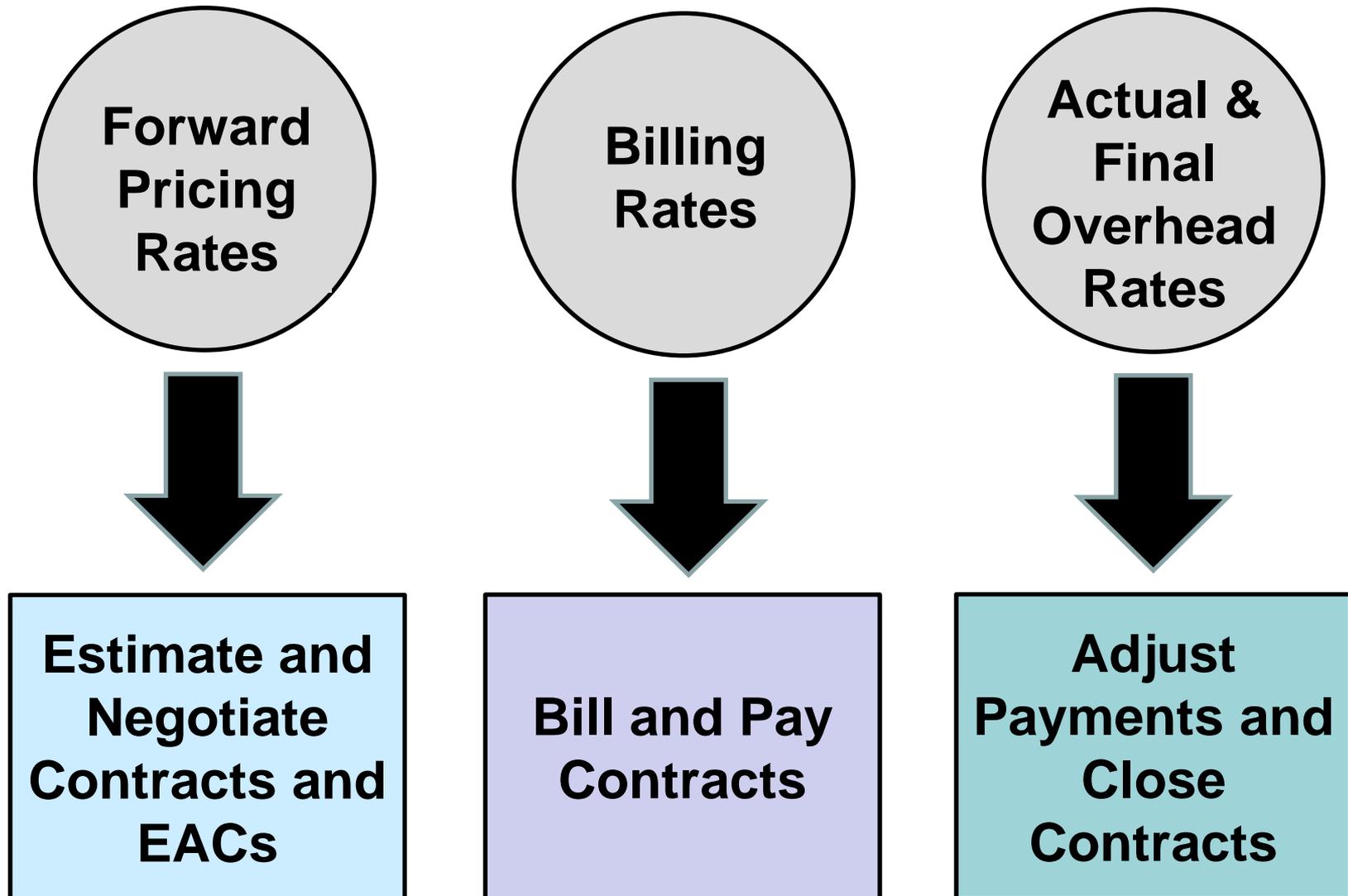
- Pessimistic Base
- Increases Rate
- Where might contractor use?
 - Sole Source
 - Fixed Price
- Reasonableness



Business Planning Process Typical Defense Contractor



Rate Application



Negotiated FPRA and Billing Rates

FPRA Rates (also Billing Rates)		
Direct Labor Rates and Basis		
Production Labor	\$ 40.00	Manufacturing Labor Hour
Engineering Labor	\$ 80.00	Engineering Labor Hour
Indirect Expense Rates and Basis		
Material Handling	5%	All Materials
Production O/H	150%	Production Labor Dollars
Engineering O/H	275%	Engineering Labor Dollars
G&A Expense	25%	Total Cost Input (all non-G&A contract costs)
Billed Costs During the Year		
Materials	\$ 2,000,000	Purchased supplies and subcontracted work
Material Handling	\$ 100,000	\$2,000,000 * 5%
Production Labor	\$ 4,000,000	100,000 hours * \$40/Hour
Production O/H	\$ 6,000,000	\$4,000,000 * 150%
Engineering Labor	\$ 1,000,000	12,500 hours * \$80/Hour
Engineering O/H	\$ 2,750,000	\$1,000,000 * 275%
Total Cost Input	\$ 15,850,000	Sum of costs above line
G&A Expense	\$ 3,962,500	\$15,850,000 * 25%
Total Cost	\$ 19,812,500	Cost Input + G&A

Negotiated Final Rates

Final Rates		
Direct Labor and Basis		
Production Labor	\$ 35.00	Manufacturing Labor Hour
Engineering Labor	\$ 90.00	Engineering Labor Hour
Indirect Expense Rates and Basis		
Material Handling	5%	All Materials
Production O/H	175%	Production Labor Dollars
Engineering O/H	200%	Engineering Labor Dollars
G&A Expense	23.5%	Total Cost Input (all non-G&A contract costs)
Actual Costs During the Year		
Materials	\$ 2,000,000	Purchased supplies and subcontracted work
Material Handling	\$ 100,000	$\$2,000,000 * 5\%$
Production Labor	\$ 3,500,000	100,000 hours * \$35/Hour
Production O/H	\$ 6,125,000	$\$3,500,000 * 175\%$
Engineering Labor	\$ 1,125,000	12500 * \$90/Hour
Engineering O/H	\$ 2,250,000	$\$1,170,000 * 200\%$
Total Cost Input	\$ 15,100,000	Sum of costs above line
G&A Expense	\$ 3,548,500	$\$15,850,000 * 23.5\%$
Total Cost	\$ 18,648,500	Cost Input + G&A

Difference Between Billed and Actual

Billing Adjustments Needed			
	Billed	Actual	Difference
Materials	\$ 2,000,000	\$ 2,000,000	\$0
Material Handling	\$ 100,000	\$ 100,000	\$0
Production Labor	\$ 4,000,000	\$ 3,500,000	(\$500,000)
Production O/H	\$ 6,000,000	\$ 6,125,000	\$125,000
Engineering Labor	\$ 1,000,000	\$ 1,125,000	\$125,000
Engineering O/H	\$ 2,750,000	\$ 2,250,000	(\$500,000)
Total Cost Input	\$ 15,850,000	\$ 15,100,000	(\$750,000)
G&A Expense	\$ 3,962,500	\$ 3,548,500	(\$414,000)
Total Cost	\$ 19,812,500	\$ 18,648,500	(\$1,164,000)

Are monies due to the contractor or the Government?

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