

An Introduction to Indirect Rates

Indirect Rates, huh? What are they good for?

With apologies to the 1970's Motown hit, one of the most common questions we get surrounds development and utility of indirect cost rates. Indirect costs are those that cannot easily be allocated discretely to a single project or across a number of projects. An indirect rate describes a mathematical ratio and its logical relation of indirect costs (the numerator) divided by the "base" (the denominator). In this manner, one or more "pools" of indirect costs can be allocated mathematically to all projects.

The framework for these allocation methods can be found in FAR Part 31 and other parts of the Code of Federal Regulations (CFR). In the simplest example, a single indirect rate consists of all indirect costs divided by all project costs, commonly called direct costs. Using this logic, for every dollar you spend on a project, you would apply the indirect rate to the project dollar to receive its calculated share of the indirect cost pool.

The single contract/grant conundrum

First time applicants for government contracts and grants may find the distinction between direct costs and indirect costs frivolous, since all costs are supporting a single contract or grant. That is a correct observation until the contractor or grantee receives another award or lands a non-governmental source of revenue. Firms having a single government award are an exception and as you'll read later on, it's a poor excuse to ignore the concept of indirect rates.

Budget and pricing

With few exceptions, indirect rates first confront new entrants to government funding during the proposal period with the submission of a project budget. Budget templates focus primarily on direct project costs. Indirect costs are typically reflected in terms of an indirect rate. Government agencies may limit these indirect rates, or they may suggest a "safe" rate below which no more questions are asked. For a new applicant, the key is knowing if you can afford to agree to a "safe" indirect rate, or any rate. Asked a different way, do the dollars calculated through your indirect rate cover your administrative costs over the life of the award? If a safe rate isn't feasible or offered, then an applicant may have to provide calculations supporting the indirect rate proposed.

This phase of government funding also introduces the concept of cost allowability and the prohibition of certain costs either as a direct cost or as a cost in the indirect pool. The details are voluminous, but it's fair to say the majority of common administrative costs are allowable. Those that aren't should be fairly obvious or at least reasonable since costs are ultimately funded by taxpayers.

Compliance

Once an award is made and the celebrations die down, indirect rates may become a central element in award compliance. In the contract environment, indirect rates play major role in managing cost reimbursement type contracts and some time and material contracts. You can read more of those details in other [ReliAscent White Papers](#) and on our [blog](#). It's fair to say the process of managing indirect rates in this contract environment is not trivial.

What may be surprising is that regulations expose grant awardees to similar compliance issues at a far earlier point in the government funding cycle compared to contract awards. This is particularly clear in the SBIR/STTR program where all Phase I contracts are Firm-Fixed Price and a relatively lower cost compliant environment than SBIR/STTR grants.

Economic engine

Setting the budget and compliance issues aside, developing and measuring indirect rates provides critical insight into a company's financial operations, especially when doing business with the government. Indirect rates are vital to growing a business and remaining cost competitive. Indirect rates are flexible enough to allow business expansion without sacrificing profits. Knowledge and the skilled application of indirect rates provides opportunities for growth and insight into job profitability.

Factors in designing Indirect Rates

Many factors play a role in determining the right indirect rate structure and rate amounts.

- **Business size** – Larger businesses will likely have more types of indirect rates than smaller firms.
- **Competitive environment** – If competitive pricing is an issue, selecting the most effective indirect rate structure is critical.
- **Number contracts/grants** – The more awards, the more opportunities to accommodate additional indirect costs.
- **Type of business** – Manufacturing firms tend to require more complex rate structures than services firms.
- **Agency customer (grant vs contract)** – Grant and contract agencies diverge in a number of respects in how they approach indirect rates.
- **Mix of commercial and government business** – The approach to indirect rates may be different if the majority of revenue is generated from commercial sources.
- **Project material and subcontractor volume** – The indirect rate structure will depend on the amount of non-labor project costs and how the firm is organized to acquire and manage these costs.

Types of Indirect Rates

Here are some examples of typical indirect rate structures:

Single Rate G&A/F&A* – As mentioned earlier, this is simply all indirect costs divided by direct costs.

Single Rate, Fringe as Direct – A modification of the single rate system, except a portion of costs considered fringe benefits may be allocated as a direct labor element. Fringe as direct is a technique that can be used with other rate structures.

Two Rate, Overhead and G&A/F&A – This system allocates more indirect costs to direct labor costs, leaving less to be allocated to non-labor project costs.

Modified G&A/F&A Base – For any rate structure, this is where no G&A is applied to non-labor project costs. Stated another way, non-labor project costs “pass-through” without G&A.

Material handling rate – A separate cost pool and rate can be used to measure the activity for buying project material and manage project subcontracts. This further lessens the G&A burden.

Multiple Rates - For larger firms with multiple locations, the number and complexity of indirect rates can be staggering.

Indirect Rates, *Huh*.

So back to the question – what are they good for? Understanding indirect rates must become a fact of life for firms having or seeking government funding. Financial success in this environment depends on avoiding regulatory and administrative traps along with optimizing your competitive position.

*General and Administration costs, Facilities and Administration in the grant realm

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