

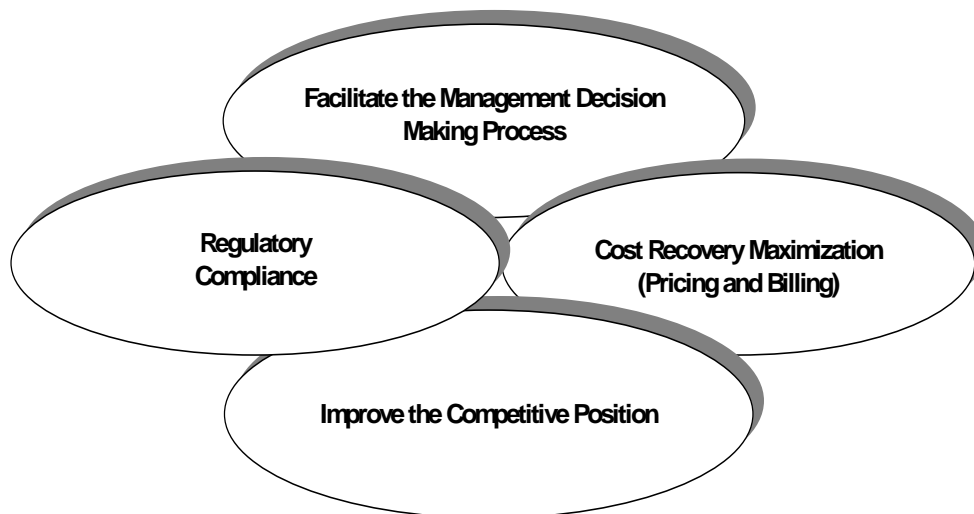
Business Tool for Success - Indirect Expense/Overhead Rate Structures

One of the least appreciated and most maligned tools in management's toolbox is the indirect expense or overhead rate structure. The indirect expense rate structure of an organization, whether for-profit or not-for-profit, whether service-oriented or a manufacturer or some combination of both should mirror the operational organization. A company's indirect rates have a pervasive effect on all of their contracts, on the level of revenue and profit realized and on the volume of cash flow. For these reasons indirect expense rates should be considered both a strategic and a tactical element of your business plan. It is more than just a by-product of the accounting and budgeting system. Your indirect rate structure must play a major role in supporting your strategic business model and must not be inconsistent with your businesses operating model.

Indirect rate structures are influenced by many factors and must reflect as accurately as possible the most –

- efficient operating structure of the organization,
- competitive allocation of costs to the organizations final cost objectives,
- realistic projections of the anticipated future direction of the organization,
- proper identification of the “true” cost of an organizations final cost objectives,
- meaningful information upon which management can base its decision making process,
- favorable cost recovery and cash flow scenario.

With all of this an organization's indirect rate structure must be compliant with all applicable Government regulations and the requirements established by the contract or



award.

The ultimate goal of your indirect expense rates should be to: (1) facilitate the management's decision making process; (2) identify opportunities to maximize cost recovery; (3) improve the organization's competitive position; and (4) maintain contract and/or regulatory compliance.

Indirect expenses including fringe costs, overhead costs and general and administrative expenses can represent well over two-thirds of a company's product or service cost. Management needs to know what something truly costs before they can make an educated decision regarding how it is to be handled. Do we want to continue delivering a particular line of service or product? Are we making money on it? What does it cost us? All questions requiring a good indirect cost structure and cost allocation system.

Cost recovery is the second reason for having a good indirect cost structure. We need to make sure we are pricing all of our allowable/recoverable costs into our products or services. Are we billing all of the costs incurred? Are we allocating them to the right products or services where they can best be recovered?

The third reason for having a good indirect cost structure is associated with the organization's competitive position. Are you selling goods and services for the right price? Is your most popular good or service losing money due too a flawed indirect cost allocation model? Without knowing the true costs of your products or services, you do not know whether pricing adjustments are required or if marketing initiatives should be abandoned, revised or emphasized.

Lastly regulatory compliance generally dictates the existence of a good cost allocation plan and representative indirect cost structure. If you do not have a good cost allocation plan, the odds are that you are not in compliance with the applicable regulatory requirements of the Federal Acquisition Regulation (FAR), the agency FAR supplements, the Cost Accounting Standards (CAS) or the applicable Office of Management and Budgets (OMB) circulars.

Developing a good indirect cost structure that is dynamic and that accurately reflects the strategic and tactical goals of the organization requires addressing many structural alternatives such as but not necessarily limited to:

- **Determining what functions are to be identified as direct costs and those that are to be identified as indirect.** *The larger the direct cost allocation base the lower the indirect expense rate.*
- **Determining the basis for indirect cost allocation.** *If you have a large subcontractor involvement you might want to consider allocating general and administrative costs over what is known as a "value-added" direct cost base to most accurately assign costs to final cost objectives.*
- **Deciding whether the indirect cost structure should be complex (e.g., multiple expense pools and allocation bases) or simple (e.g., single expense**

- pools and single allocation bases).** *Smaller more complex pool structures are more volatile and subject to changing conditions that may or may not be pertinent. Single rate pools are more easily understood, more consistent over time but tend to smear costs across products or services in what is referred to as the “peanut butter effect.”*
- **Establishing on-site (home office) rates and off-site (client site) rates to more accurately allocate company facility costs and provide for a lower off-site indirect rate.**
 - **Establishing a material-handling rate to apply to large material purchases or other direct costs on contracts where labor and/or subcontract efforts are not significant.** *Keeps the indirect cost pool allocated to direct labor at a lower level.*
 - **The allocation and recovery of Home or Corporate Office expenses allocated to the various business centers can recover costs generally not included in an indirect cost structure.**
 - **Determining the most equitable allocation process for “service centers” (e.g., reproduction, graphics, information technology, facilities, communication services, etc.) to interim or final cost objectives.**

Other considerations center around auditability and flexibility. The more complex the indirect rate structure the harder it is to understand and therefore to audit. The more complex structures are also more sensitive to changes in the business structure, the adding or deletion of operational centers and the changes in product or service composition. Simplified structures can accept changes with minimal impacts on the overall rates and are easily understood for auditing purposes. The trade off? Simplified indirect rate structures might not provide accurate product or services costing.

A final distinction must be made between the cost of a product or service and its price. Cost is the appropriate allocation and accumulation of actual or estimated costs against a final cost objective. Price is a management decision reflecting an anticipated return on investment (e.g., profit), the desire to be or play in the marketplace, negotiation and competitive pressures. Price may be determined based on cost and it may not. It is a decision of management that should be made knowing the actual “true” cost of the given product or service.

Sam Davidson, a principal with Gaffey & Associates, PLC, provided this article. If you would like to discuss your indirect expense rate structure and the maximization of indirect expenses recovery you can contact him at 703-748-5816 or via email at samuel.davidson@gaffeycpa.com.