

## **White Paper //** ***Unabsorbed or Mis-Allocated Indirect Expenses – The Eichleay Formula***

Claims for the recovery of unabsorbed or mis-allocated indirect expenses are not easy to comprehend. Such claims arise whenever the performance of a contract has been suspended, delayed or otherwise disrupted reducing the stream of direct costs upon which overhead or indirect costs are allocated. DCAA's "Audit Guidance Delay and Disruption Claims" states that: "A claim for unabsorbed overhead is really a request to recoup increased overhead costs allocated to other work because of the work stoppage which occurred on the delayed contract. Stated another way 'unabsorbed overhead is that amount of indirect expense actually incurred which would have been allocated to the contract had the delay not occurred, and is not recoverable in the revenue from any other work.' ("Government Contract Accounting". Howard W. Wright and James Bedingfield, 1979, page 347).



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	Year 1	Year 2	Year 3	Year 4
<b>Original Planned Performance</b>	<b>Basic Contract</b>	<b>Basic Contract</b>		
<b>Revised Contract Performance</b>	<b>Basic Contract</b>	<b>Mis-allocated Absorption Mods</b>	<b>Mods</b>	<b>Basic Contract</b>
<b>Absorption Status</b>	<b>Full Absorption</b>	<b>Partial Absorption Misallocation to Other Programs</b>		<b>Full Absorption</b>

**Eichleay Calculation:**

The most frequently used method of calculating the impact of delay and disruption on the absorption of overhead expenses is the Eichleay formula.<sup>1</sup> The Eichleay formula is designed to approximate a daily overhead rate for a contract that has been delayed. The daily overhead rate is then multiplied by the number of days of delay in order to determine the amount of recovery. A graphic depiction of the Eichleay formula is presented below.

In recent court decisions, the Federal Circuit not only confirmed that the recovery of unabsorbed overhead is valid where the government has delayed or disrupted a contractor’s performance, but also established a three-part test for determining when such recovery should be allowed.<sup>2</sup> First, a valid unabsorbed overhead claim requires proof of a “compensible delay”, meaning that the contractor must have experienced a delay or disruption, or series of delays or disruptions, of contract performance for which the government bears responsibility. Second, the contractor

<sup>1</sup> Eichleay Corp., ASBCA No. 5183, 60-2 BCA 2688

<sup>2</sup> Wickham Contracting Co., Inc. v. Fischer, 12 F.3d 1574 (Fed. Cir. 1994)



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must prove that it was on “standby” during the delay(s) or disruption(s). Third, the contractor must show that it was unable to take on additional work during the delay(s) or disruption(s). Once these three elements are established, the contractor is entitled to recover unabsorbed overhead as measured by the Eichleay formula; no other method of calculation may be used.

**Delays or disruptions** — The existence of compensible delays in the process of performing the contract for which the government takes responsibility must be proven.

**On “standby” during the delay(s) or disruption(s)** — The Federal Circuit Court has also established that “standby” status does not require proof of a total suspension of the contractor’s efforts, but may exist when the contractor’s performance has been significantly disrupted. “There is no requirement,” the court held, “that a contract be suspended before a contractor is entitled to recover under Eichleay. The uncertainty as to the duration of the delays and disruptions and a refusal to contractually adjust delivery requirements establishes the necessity to assume a “standby” condition, ready to resume work on the delayed project on very short notice.

**Unable to take on additional work during the delay(s) or disruption(s)** — As to the requirement to obtain replacement work, the courts have determined that, the inability to take on other work or significantly reduce indirect expenses is inferred once the contractor has satisfied the standby test and demonstrated that the actual length of delay in question was marked by uncertainty.<sup>3</sup>

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<sup>3</sup> Mech-Con Corp. v. West, 61 F.3d 883 (Fed. Cir. 1995)



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Original Delayed Contract Price <hr style="width: 50%; margin: 0 auto;"/> Total Billings For The Actual Delayed Contract Period	X	Indirect Expenses for the Actual Delayed Contract Period	=	Indirect Expenses Allocable To The Delayed Contract
Indirect Expenses Allocable To The Delayed Contract <hr style="width: 50%; margin: 0 auto;"/> Actual Days Of Delayed Contract Performance	=	Indirect Expenses Allocable To The Delayed Contract Per Day		
Daily Indirect Rate	X	Number of Days Delay	=	Unabsorbed Indirect Expenses

The Eichley calculation, utilizing an estimated amount of indirect expense allocable to the delayed or extended contract for each day of its actual period of contract performance, determines the estimated amount of indirect expense mis-allocated to other contractor business during the entire period of extension or delay. This estimated amount of mis-allocated indirect expense is based on the relationship of the subject contracts revenue to the total revenue for all contracts during the subject contracts performance period (subject contracts revenue divided by total revenue during the subject contracts performance period) times the indirect expenses incurred during the same period of time (equals the indirect expense allocable to the subject contract) divided by the total number of days of subject contract performance (indirect expense allocable to the subject contract per day) time the number of days of delay or contract extension.

A can be seen from this formula, the “Indirect Expense Allocable to the Delayed Contract” is only calculated to arrive at the “Indirect Expense Allocable to the Delayed Contract Per Day”.



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The same daily rate could be determined by dividing the total indirect expense for all contract performance by the total number of contract days (total number of days of contract performance on all contracts during the extended or delayed contract performance period). Depending on the number of contracts active during the delayed or extended contracts performance period, this could be a very extensive calculation. The Eichleay calculation simplifies this process by bringing the calculation down to the level of a single contract and the same amount of indirect expense per day would be calculated no matter what contract was used. It is important to recognize the purpose of this daily calculation and its application to the extended or delayed period of contract performance. It does not calculate the absolute indirect expense recovery on the contract in question.

To re-emphasize the validity of the recovery of unabsorbed indirect expenses, the contractor must answer the following questions.

1. Did the government, in any way, delay or disrupt performance of the contract (i.e., cause a compensable delay allowing adjustment to both contract schedule and price)?
2. Was there any uncertainty as to the length of the delay(s) or disruption(s) requiring the contractor to be in a “stand by” status, ready to resume full efforts as soon as the delay(s) or disruption(s) ended?
3. With all of the government-caused delay(s) and disruption(s) encountered, was any formal delivery relief granted by the government, or was it inferred that the contractor would have to respond immediately to any and all corrective actions and met the initial delivery requirements?

A “yes” answer to each of these questions would justify the recovery of unabsorbed overhead or indirect expenses.

The Eichleay calculation was originally established to address only fixed and semi-variable home office or G&A-type expenses under the assumption that variable expenses could be reduced or eliminated during periods of contract delay. Due to the uncertainty of the length of



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contract delay(s) and the “standby” status under which the contractor generally has to operate, variable indirect expenses could not be realistically reduced or eliminated and total indirect expenses are included in the Eichleay calculation.

<b>Unabsorbed Indirect Expense Calculation - Eichleay Method</b>
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Revenue Per Financial Statements (2/93 - 6/96)	\$42,470,636
Projected Revenue (7/96 - 11/96)	\$5,468,164
Total Revenue for Actual Contract Performance Period	<u>\$48,208,800</u>
Delayed Contract Revenue	\$11,207,021
Percent of Delayed Contract Revenue to the Total Revenue	23.24%
Total Actual Indirect Expenses (2/93 - 6/96)	\$5,881,137
Projected Indirect Expenses (7/96 - 11/96)	\$672,701
Total Indirect Expenses for the Actual Contract Performance Period	<u>\$6,553,838</u>
Percent of Delayed Contract Revenue to the Total Revenue	<u>23.24%</u>
Indirect Expenses Allocable to the Delayed Contract	\$1,523,112
Number of Actual Days of Delayed Contract Performance (46 Months times 30 Days Per Month)	1,380 Days
Indirect Expenses Allocable to the Delayed Contract Per Day	\$1,104 Per Day
Number of Actual Days of Delayed Contract Delay (22 Months times 30 Days Per Month)	660 Days
<b>Unabsorbed Indirect Expenses - Eichleay Method:</b>	
<b>(\$1,104 Per Day times 660 Days)</b>	<u><u><b>\$728,640</b></u></u>



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### **Adjustments to the Eichleay Calculation:**

In “Government Contract Changes” by Ralph C. Nash, Jr., he states that: “The [Eichleay] formula should not be used if the contractor has been fully compensated for its unabsorbed overhead through other pricing mechanisms. This principle was stated as follows in R.G. Beer Corp. ENGBCA 4885, 86-3 BCA ¶ 19012, 28 G. C. ¶ 301:

In most instances involving changed work, the percentage markup on direct costs is used and no further or alternative extended overhead award is considered necessary or appropriate, even where there is an extension of the completion date.... In such cases, the normal percentage relationship between direct and indirect costs is generally not distorted. Thus, where it is reasonably and equitably possible to compensate the contractor fully through the use of the customary, prevalent pricing method of burdening the contractor’s direct costs with its actual overhead rate, an award of unabsorbed/extended overhead is unwarranted... Only in unusual circumstances is compensation for unabsorbed/extended overhead recoverable for new work added pursuant to the “Changes” clause.

Of course, it would be unlikely that other pricing mechanisms would fully compensate the contractor for unabsorbed overhead if there were significant periods of time during contract performance where little or no work is accomplished. Thus, this principle has more frequently been applied to adjust the amount of unabsorbed overhead derived from the Eichleay formula than to completely preclude the use of the formula. This adjustment is normally accomplished by deducting the amount of home office overhead included in other pricing actions from the amount of unabsorbed overhead derived from the Eichleay formula.”

The DCAA Contract Audit Manual also supports this position on adjustment. The July 1997 Edition of the DCAA Contract Audit Manual states at Paragraph 12-805d: “Eichleay assumes a total work stoppage. It does not take into account the extent of the delay (i.e., total versus partial work stoppage). In cases of partial work stoppage, the number of days should be adjusted.”



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The January 1, 1998, edition of the DCAA Contract Audit Manual is silent on the adjustment of delay days for partial work stoppages, but suggests at Paragraph 12-805c. that: “A contractor receives overhead reimbursement for unplanned additional work as a part of change orders on the delayed contract performed during the suspension or delay period. The additional work should be credited against the contractor’s claim for unabsorbed overhead.”

The two types of adjustment, (1) reduction in delay days and (2) the recognition of additional indirect expense recovery during the delayed contract period of performance, can be seen in the following schedule. When adjusting the basic Eichleay calculation for additional indirect expense recovery during the delayed contracts period of performance it makes a significant difference when the adjustment is made. If the adjustment is made prior to the calculation of the daily indirect expense rate (Option #1), the amount of unabsorbed indirect expenses is higher than when the adjustment is made after the basic Eichleay calculation (Option #2). No guidance is presently provided as to when this adjustment should be made, but it inherently appears to be more accurate to make the ‘adjustment after the basic Eichleay calculation is made, and DCAA will probably opt for this position.

### **Additional Insights:**

A recent court decision (*West v. All State Boiler, Inc.*)<sup>4</sup> further defines the parameters under which a Contractor can justify Eichleay-based unabsorbed overhead recovery.

This case referenced the finding of *Fred R. Comb Co. v. U.S.*, 103 Ct.Cl. 174, 184 (1945) which stated: “Where the proportionate salary of home office staff attributable to a contract is ‘wasted’ because of a suspension by the government, the government is obligated to reimburse the Contractor for that waste.” It also refers to the period during which the government stops work on the contract as the “suspension period” and the additional time beyond the original deadline

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<sup>4</sup> Togo D. West, Jr., *Secretary of Veterans Affairs v. All State Boiler, Inc.*, U.S. Court of Appeals for the Federal Circuit, 6/25/98, 96-1093, 96-1094, 13711.

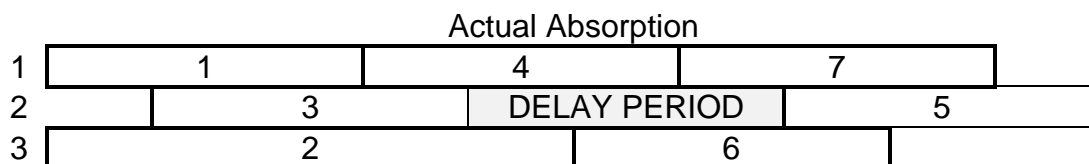
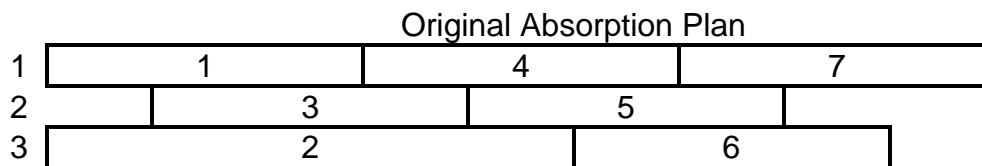


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necessary to complete performance of the contract as a result of the suspension period, as the “extension period.” This definition leads to the conclusion that no unabsorbed overhead can be recovered unless the period of suspension pushes completion of contract performance past the contractual completion date.

“Once the contract performance period extends beyond the initial deadline, indirect costs continue to accrue but the contractor has neither allocated them to the newly-extended contract nor is able to begin a new contract to absorb the next portion of these continuing costs. It is thus the period of performance required of the contractor beyond the anticipated end-date for which the contractor does not receive its indirect costs, for by continuing work on the delayed contract, the contractor is unable to begin work on the next new contract to which it would have allocated indirect costs for the next period. The ordinary course of the contractor’s business is thus interrupted by the suspension; where normally the contractor would begin the next contract, to which a new portion of its indirect costs would be attributable, it is forced to extend performance on the old, suspended contract, while additional indirect costs accrue with no additional revenue to support them.



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“On the other hand, where a government-caused suspension does not actually result in any extension of time for completion of the contract, i.e., the contract is completed on time as originally scheduled, the contractor suffers no injury. This is because, despite the delay, the contractor’s original estimate of the time required to complete performance remains accurate and the next contract can begin as anticipated.”

If a contractor intends, from the outset of the contract, to complete performance early, creating the period after which unabsorbed overhead may be recovered due to the suspension of the contract by the government, the contractor must show that it: (1) intended to complete the contract early; (2) had the capability to do so; and (3) actually would have completed early, but for the government’s actions.



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**Adjusted Unabsorbed Indirect Expense Calculation - Eichleay Method**

	Adjusted Delay Days	Adjusted For Additional Recovery	
		Option #1	Option #2
Revenue Per Financial Statements (2/93-11/96)	\$48,208,800	\$48,208,800	\$48,208,800
Delayed Contract Revenue	\$11,207,021	\$11,207,021	\$11,207,021
Percentage of Delayed Contract Revenue to Total Revenue	23.25%	23.25%	23.25%
Total Actual Indirect Expenses (2/93-11/96)	\$6,553,838	\$6,553,838	\$6,553,838
Indirect Expenses Allocable to Delayed Contract	\$1,523,560	\$1,523,560	\$1,523,560
Less: Indirect Expenses Recovered On Unplanned Work	\$0	\$553,258	\$0
Remaining Indirect Expenses Allocable to Delayed Contract	\$1,523,560	\$970,302	\$1,523,560
Number of Actual Days of Delayed Contract Performance	1,380	1,380	1,380
Indirect Expenses Allocable to the Delayed Contract Per Day	\$1,104	\$703	\$1,104
Number of Actual Days of Delayed Contract Delay	660	660	660
Partial Work Stoppage Adjustment	50.00%	100.00%	100.00%
Adjusted Days of Delayed Contract Delay	330	660	660
Unabsorbed Indirect Expenses - Eichleay Method	\$364,330	\$464,057	\$728,659
Less: Indirect Expenses Recovered On Unplanned Work			\$553,288
Unabsorbed Indirect Expenses - Eichleay Method			\$175,371



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