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The consequences of changing indirect rate structures

An increasing concern among government contractors is that their indirect rate structures are being challenged and restructured by government auditors during incurred cost audits. The impact can be substantial since the incurred cost review is usually years behind contract effort which, based on contract funding and ceiling limitations, may limit recovery of any increased costs as a result of the structure change.

The government is challenging changes to indirect rate structures based upon FAR 52.230-4, Consistency in Cost Accounting Practices, for Cost Accounting Standards (CAS)-covered contractors and FAR 31.201-3, Determining Reasonableness, for non-CAS-covered contractors. The issues involved, however, and the regulatory basis between CAS-covered and non-CAS-covered contracts are not entirely the same.

Non-CAS-covered contracts

The requirements are vague for contractors with non-CAS-covered contracts. When making organizational changes or accounting practice changes, there is no requirement to prepare a cost impact proposal or to provide any price adjustment to the government.

However, government auditors seeking to apply the same requirements as those under CAS to non-CAS-covered contracts have chosen Federal Acquisition Regulation (FAR) language as the basis for that approach. In particular, they have cited FAR 31.201-3(b)(4) which states that what is reasonable depends partially on significant deviations from the contractor's established practices. Some argue that forcing contractors to conduct cost impact analyses and provide cost adjustments similar to those under CAS misrepresents the FAR.

While inconsistent with the statutory scheme to single-out different requirements for CAS-covered contracts versus non-CAS-covered contracts, many government auditors refuse to reconsider the approach. Defense Contract Audit Agency (DCAA) regional management has directed its audit managers to ensure that the government is not assuming additional costs due to rate structure changes.

Consequently, instead of assessing whether or not the new rate structures provide the most equitable allocation of indirect costs in the current cost accounting period, many auditors refuse to approve new rate structures unless contractors conduct a cost impact analysis and prove that no additional costs will be allocated to government contracts. (Additional costs to the government have been interpreted to include reductions in contractors' costs on fixed-price and fixed-rate contracts.)

They have been taking this position regardless of whether contractors have made organizational changes or actual changes to accounting practices.

Notwithstanding that the new allocation structure is the most equitable, some auditors will not recommend that the affected contracting officers (CO) pay the increased indirect costs under the contractor's proposed rate structure unless the COs provide letters agreeing to pay the higher costs.

This appears to be inconsistent with DCAA's function to review the equity of contractors' overall cost accounting practices without favoring individual COs. In effect, DCAA is forcing COs bearing a greater share of costs under an existing rate structure to be unduly burdened while other contracts inappropriately benefit by not bearing their true allocation of costs.

DCAA would be taking this position despite the fact that both DCAA and the contractor would otherwise agree that the proposed rate structure results in a more equitable allocation of costs to all contracts in the contractors' business bases for the period in question.

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Non-CAS-covered contractors have much to consider when weighing potential changes in indirect rate structures. First, they should consider presenting proposed changes to their cognizant DCAA office and assess the preliminary feedback before investing much time and effort.

They should also prepare to explain in detail why the proposed structure results in a more equitable allocation of costs than the existing structure as well as demonstrate that the change is an organizational change versus an accounting practice change, warranting less stringent audit scrutiny under the current regulations even if the contracts were CAS-covered. Concurrently, contractors should decide if they:

- Should prepare a rough order of magnitude cost impact
- Are willing to pursue the matter with individual COs if requested by the auditors
- Want to take the matter through the dispute process

In any event, the issues raised in this article should be considered before moving forward with the decision to establish an effective cost allocation strategy and methodology.

CAS-covered contracts

Government contractors that have CAS-covered contracts are required to provide a cost impact proposal to the government whenever they make an accounting change. The government is protected from paying any increased costs as a result of the accounting change, and they are entitled to a price adjustment to the contract price to account for any negative cost impact. However, the industry and the government have been debating what constitutes an accounting change.

There is a consensus that an accounting change has occurred when a company modifies its indirect rate structure and therefore changes the base over which certain indirect costs are allocated to final cost objectives. An example is a change from a total cost input (TCI) general and administrative (G&A) base to a value-added G&A base which excludes material and subcontract costs.

A more difficult case is when the indirect rate structure has been changed, perhaps as a result of an organizational change, but the method (basis) of allocation has not changed. An example of this organizational change is when a contractor changes from two to three overhead rates, or vice versa, but continues to allocate those overhead costs to contracts using a direct labor base.

Most government auditors feel that this change warrants a cost impact proposal. Auditors will also want price adjustments for those contracts receiving the new overhead rate regardless of the fact that those overhead expenses are still allocated to the contract based on direct labor.

The Armed Services Board of Contract Appeals (ASBCA) provides the most authoritative case, Martin Marietta Nos. 38920, 41565, 9/4/92, which was upheld by the Federal Circuit Court of Appeals in February 1995. This case established the basis for evaluating whether an organizational change is a change in cost accounting practice.

In brief, for valid business reasons, the Martin Marietta Corporation (MMC) reorganized and dissolved one of its intermediate home offices (IHO), ASH. ASH collected home office-type costs for reallocations to five benefiting segments. MMC concurrently established a new IHO, I&CS, to collect and allocate costs to one of the previous ASH segments as well as a new segment.

As a result, I&CS management costs, previously allocated through ASH to five segments, are now allocated to only the two I&CS segments. This increased the costs incurred on a Federal Aviation Administration (FAA) contract in one of the I&CS segments. The FAA contracting officer requested a cost impact proposal. MMC refused to comply stating this was not an accounting change as determined by the CAS board.

The accounting method or technique used in determining the specific organizational groupings was the beneficial or causal relationship test. The alterations in the groupings resulted from changes in the beneficial or causal relationships between home office functions and various

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segments of the enterprise not from a change in the accounting method or technique used to determine the groupings.

Accordingly, they found no change in cost accounting practices in the revised groupings under the CAS definition of that term. The government stated that the changes in cost and segment groupings caused a flow of home office costs away from fixed-price work to cost-type work forcing the government to pay twice for the same home office costs. ASBCA responded that the CAS provisions did not address changes in effects on amounts of cost ultimately allocated to individual contracts but rather focused on changes in methods and techniques.

The CAS board, in response to the Circuit Court's upholding of the ASBCA finding for MMC, issued an advance notice of a proposed rulemaking (ANPRM) in April 1995. The ANPRM proposed revising the definitions and illustrations governing cost accounting practice changes to make it explicit that a change in grouping and accumulation of costs constitutes a change in cost accounting practice. Organizational changes must be evaluated on a case-by-case basis to determine if an accounting practice change has occurred.

The ANPRM proposes that the definition of a change to a cost accounting practice read, "A change in cost accounting practice would…occur after an organizational change if an ongoing function is transferred to a new or different indirect cost pool or allocation base or different indirect cost pools or allocation bases are combined or otherwise fragmented." Although DCAA originally had its auditors comply with the MMC decision, they have new guidance consistent with the ANPRM. DCAA now directs its auditors to limit reliance on the MMC ruling. They have also instructed auditors to evaluate organizational changes on a case-by-case basis.

Therefore, contractors with CAS-covered contracts who have made or are making organizational changes that affect the composition of indirect expense pools but continue to allocate those expenses on the same basis of allocation should document it as an organizational change consistent with the MMC case. Management should then consider the effort to document a cost impact analysis and, depending upon the results of that analysis, be prepared to present their position to the administrative contracting officer. There is some latitude permitted under the existing regulations in preparing a cost impact analysis provides the most authoritative case, Martin Marietta Nos. 38920, 41565, 9/4/92, which was upheld by the Federal Circuit Court of Appeals in February 1995. This case established the basis for evaluating whether an organizational change is a change in cost accounting practice.

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