UNANET WHITE PAPER

Winning More Business

With a Sound Indirect Rate Strategy

A review of indirect rates, wrap rates, cost pools, rate structures, and more for government contractors.

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Whether you are a new or experienced government contractor, optimizing your indirect rates year after year is a major challenge. However, your indirect rates can be the difference between winning new contracts and growing your business or being stagnant and losing opportunities. As your business evolves, so should your indirect rates. Evaluating your rates on a regular basis to ensure alignment with your company's strategic plan, while maximizing recovery of your allowable costs, is key for growing successful companies.

In this guide, we share tips for formulating rate strategies and explain the importance of understanding the market in which you do business, wrap rates, rate structure alternatives, and methods to lower the impact of your G&A rate when bidding.

UNDERSTANDING THE MARKET AND ALIGNING WITH STRATEGIC GOALS

The government contracting market's stability makes it a great place to do business. The U.S. government has a steady stream of funds available and is a very reliable payer. Annual funding levels are relatively stable, despite sequestration, government shutdowns, and other politics that affect the market. Federal funding for cutting-edge research provides exciting opportunities for new, emerging businesses.

Due to the many upsides of doing business with the government, a growing number of commercial businesses are entering the market space every day, which leads to more competition. Staying on top of acquisition priorities and understanding how your strategic plan aligns with government spending is critical to remaining competitive and being a successful contractor. Understanding your company's expertise and what makes you unique to meet the federal government's needs will help position your business for success.

Another important factor that impacts your success is the key personnel responsible for regularly measuring, monitoring, and reporting. It's not enough to budget and forecast the upcoming year's goals and expenditures; you must also have someone in charge of measuring actual performance against the plan. Does your company need to reinvest in itself and spend money on training or hiring new indirect personnel, rather than paying the government back? Do you need to restrict spending in order to try and shrink your pool costs and get back to the budgeted plan? Once the responsible party has measured and monitored the results, it is crucial that the information is shared with those involved in management decisions—for without that information, all of management's decisions are made in the dark.

As we like to say, step into the light of knowledge. With that, contractors will make informed decisions.

TIP: Having accurate forecasts over a prescribed horizon (typically three years) enables businesses to forecast the trajectory of the organization and strategize rate strategies that best suit the portfolio of the business. The right rate strategies can help you be competitive and win more business.

WRAP RATES

Wrap rates are a way to summarize your business's expected budgeted costs. Understanding how to structure and calculate your costs can yield you a different wrap rate. This can be helpful when your company diversifies into new lines of business and needs a different wrap rate.

TIP: Much can be learned by referencing FAR Part 31— Contract Cost Principles and Procedures. Take some time and study before setting up your cost pools.

A company's wrap rate is typically derived from the final stated indirect rates burdened onto the direct labor dollars. For companies with a typical fringe, overhead and G&A rate structure, the wrap rate formula is ($1*($1+fringe rate)*($1+overhead rate)*($1+G&A rate) = the break even wrap rate. This is the point from which you can begin to make business decisions based on the fee percentage that will be added for each different bid.

While the formula itself is not that complex, many factors can affect the burdens component of the rate. In order to stay competitive, wrap rates should be reviewed regularly (yearly at a minimum) to give your business the best possible opportunity to compete effectively. Companies should ask the following:

- How often do we rethink how our rates are being calculated?
- Do we review the costs in the pools?
- Should we consider service centers (intermediate pools?)
- Is it time to go from total cost input to value-added?
- Do we have the right number of overheads, or have we overcomplicated our rates?
- Is profitability measured at the project level, and who's responsible for monitoring that?

REFRESHER ON COMMON INDIRECT COST POOLS

Fringe: Statutory and discretionary costs for employees. These expenses are what helps companies retain the talent they hire. Examples include PTO and health insurance premiums.

Overhead: Costs required to support existing contracts, but which cannot be directly attributed to any specific business activity, product, or service. Examples include labor that manages all the direct personnel but does not work directly on contracts, training and conferences costs, equipment used for multiple contracts, and IT costs.

General and Administrative (G&A): Expenditures related to a business's daily operations, as well as back office operations that are not directly associated with production of goods or services. Examples include executive management costs, accounting fees, legal, business development, and service center costs.

Subcontractor and Material Handling: Costs to procure subs and materials for projects. These are typically for subcontract administration, accounts payable, purchasing department, etc.

Indirect cost rates will ensure that each contract receives its proper share of the indirect costs incurred in support of direct efforts. These rates are expressed as dollars per hour or percentage of cost, and should be calculated on a monthly basis by dividing a year to date pool of indirect costs by the allocation base (e.g. direct labor hours or direct labor dollars).

WHICH RATE STRUCTURE IS RIGHT FOR YOU?

Since the wild card in the wrap rate is the burden component, it is very important to strategize the right rate structures for your business. There are three common rate structures that are considered the "norm." Of these, the three-tiered structure is the most common for professional services and is popular with auditors/contracting officers. The following are the three most common rate structures.

Three-Tier Structure – Popular with auditors and professional service contractors.

- Fringe (single or multiple fringes)
- Overhead (one or multiple)
- G&A with a base of either total cost input (TCI) or value-added
- Preferred by most professional services government contractors

Example: DL x Fringe x Overhead x G&A = Break Even

Two-Tier Structure – Not as popular with auditors. Only limited contractors use this model. Often yields higher WRAP rate.

- Overhead single or multiple overheads
- G&A with a base of either total cost input (TCI) or value-added

Fringe is an intermediate pool that is allocated to both overhead and G&A. This pushes more costs to the pool and removes costs from the base, thus yielding a higher WRAP rate. Fringe is an intermediate cost pool and not a final indirect rate.

Example: DL x Overhead x G&A = Break Even

Single Pool/Single Element Structure – Used by about 1% of businesses.

- Used by joint ventures, startup companies, construction and manufacturing companies
- One pool for all the indirect costs, as most of the costs incurred by the business are charged direct

Example: DL x G&A = Break Even

There are always more advanced structures that your organization can utilize. Regardless of which structure you choose, you should work with a consulting partner to strategize about topics such as the best number of overheads you should have, goals for your G&A rate, and if you should have a subcontractor and material handling rate.

G&A CAN BE THE DIFFERENCE BETWEEN WINNING AND LOSING

To stay competitive, there are times when using additional methods to lower the G&A rate is necessary. It's an age old problem: what comes first, the chicken or the egg? The same applies to attaining a low G&A rate. In order to achieve a low rate, you must win more work to grow the base. But how do you win more work if you don't have an attractive and palatable G&A rate to begin with? Businesses with a slightly higher G&A rate can utilize discounted or impacted rates. Below are examples of when you should consider using one of these strategies:

Discounted G&A

When your actual G&A rate is high compared to competitors, offering to apply a discounted G&A rate to the subcontractor and consultant costs can be a wise move. For bidding and pricing strategy, you can discount the G&A on the subs when using a total cost input (TCI) G&A base. By doing this, you are self-imposing a ceiling on your G&A rate for that award when you bill your subcontractor costs. You can offer a discounted G&A rate on any pass-through item or cost. Just remember you will incur the full cost of the G&A burden—you won't be billing all of it!—which will affect the bottom line. Thus, be sure to run the calculations before submitting the discount.

Impacted G&A

When bidding on large awards that will significantly impact your base, remember to impact the budgeted rates with that award in order to use fair and competitive rates. Begin by recalculating your original budgeted indirect rates for this one effort or request for proposal (RFP), since this was not considered in the original budgeted costs. This should significantly increase the base for direct costs, which should yield lower rates. There are times when you may need to add in a different rate structure because of a specific bid/RFP, in which case you would again impact your existing budgeted rates to propose something new. If you win the effort, then you have to implement the proposed structure and rates. If you lose the effort, you can continue with the originally budgeted rates and structure for all upcoming bids/RFPs.

Greater caution is needed if the new contract would warrant a change to your rate structure. The bid could be on a new line of business that requires its own overhead rate or a new fringe rate. Perhaps this upcoming bid would tip the business into needing a home site and client or government site rate. The triggering bid varies for each company, so be sure to run the calculations and assess the impact to the existing contracts, as well as how it will shape and grow the business for the future. It's never wise to make a decision without having all the facts, and for us finance and accounting folks, we want to see the numbers.

RATE STRATEGY TIPS:

Consider the following and collaborate with your team to make sure your rates give you the best opportunity to grow a profitable business:

- Allocation of service centers: Consider using labor hours or labor dollars.
- Examine what costs are going in the G&A pool. What can be reclassified?
- Assess where you are booking costs for business development time for overhead personnel.
- SM&H pools often struggle to meet the budgeted number. Are there facility, IT, and bonus dollars that could follow labor into the pool?
- CAS-covered may lead to cost impact analysis, but it doesn't mean you can't revisit your structure.
- Joint venture (JV) has a different rate than your entity, and G&A pool costs are likely coming out of your entity for the JV.
- Do performance-based bonus dollars fall under the labor or in the fringe pool?
- Recruiting Costs: Follow the labor for which you are hiring. This will likely lead to most of the cost in the overhead pool(s).
- Be consistent when applying like costs, including office supplies and facility service centers.

CONCLUSION

The RIGHT structure for your business is the one that your customers are familiar with, allows you to maximize recovering your costs, and helps you ACHIEVE new business opportunities. Staying current on your indirect rates can put your business at an advantage and make your auditor/customer jobs easier. If your primary agency (or prime) customer has a preferred calculation model for rates, USE IT, as that might be a competitive differentiator in the bid process. Structures and pools have no requirement to be complicated, so don't complicate and keep your bases BIG. Think through and pick a structure with enough flexibility to sustain your growth and ability to win new contracts for your government contracting business.

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