

Selecting a G&A Base

Background

In general, Government contractors are constrained to use of three specific bases for allocation of the General and Administrative (G&A) costs of the organization. The bases are defined in Cost Accounting Standard 410 (48 FCR 9904.410), but are incorporated into the FAR in 31.203.2.

First and by far the most common of the three is the cost input base, often referred to as Total Cost Input or TCI. With the TCI base, all costs that are not G&A and not statutory unallowables (such as interest or Federal income tax) are part of the G&A base. It is also the simplest of the G&A bases and usually (but not always) accepted by Government auditors without any real question.

Second most common and growing in popularity is the Value Added G&A base. With this allocation base, material costs and certain subcontracts are excluded from allocation of G&A. Such costs may or may not be subject to allocation of other kinds of costs. Many firms using a value added G&A base collect the cost of purchasing, processing, and administering (but not managing) materials and subcontract purchases in a so-called Material Handling or Material & Subcontracts pool. These are often referred to as MH or M&S pools and the costs collected in such pools are applied to materials and subcontracts in lieu of G&A.

The third and somewhat rare G&A base is called Single Element. It is sometimes also referred to as a single pool allocation because the methodology involves collection of all indirect costs in a single pool and allocation of those costs over a single cost element (such as labor). Such a pool would include everything from fringe benefits to facilities costs to bid and proposal costs. It is intended for use by very small services companies – usually on a manual or semi-manual system – as an administrative convenience. It is rarely approved by auditors and is therefore only seen primarily in firms prior to their first audited contract.

The Government's Position on G&A Allocation Bases

In the regulation (FAR and CAS) and in the audit guidance (such as the Defense Contract Audit Manual or DCAM), the official position is that each company should use the allocation base for G&A that best reflects total business activity and, therefore, results in the most equitable allocation of G&A expense across all contract (both Government and commercial). In theory, the Government has no preference for one base over another so long as the resulting allocation is equitable.

In reality, the Government has traditionally been heavily biased toward the TCI base and resisted efforts of contractors to change to the VA base. Recent Government regulation, however, has been aimed at making “excessive pass-through costs” unallowable on Government contracts. Translation – the Government really doesn't want to pay for G&A on large subcontracts. (Please see separate whitepaper

on Excessive Pass-Through Costs) This has resulted in a slowly shifting attitude towards use of the VA base for allocation of G&A expense.

The new regulation on excessive pass-through costs has an exception in it specifically to allow the costs of Material Handling or Material & Subcontract rates. For this reason, many Government contractors currently using a TCI base are considering a switch to the VA base.

The Real Advantage of the Value Added G&A Base

Protecting the organization from exposure to disallowances under the excessive pass-through rules is all well and good, but there is a much more significant reason behind many of the decisions to switch. Namely, firms with a low pass-through rate get to “prime the team” more often than those who apply “full G&A” to their subs.

When that first teaming meeting takes place among firms considering a joint proposal in pursuit of a solicitation, the subject often turns to the team members’ pass-through rate. The total proposal of the team will be lowest if the team member with the lowest pass-through rate acts as the prime and everyone else is a sub. And, that firm usually gets to be the prime.

In today’s environment of reduced funding and general uncertainty, subcontractors are most likely to “take the hit” in a downturn or cutback whereas the prime is in a position to protect its own revenues and workforce.

No one wants to be a bridesmaid. Everyone wants to be the bride. Enter the VA G&A base and the smallest possible M&S pool.

Maximizing Flexibility

Switching to a VA G&A base can be a two-edged sword. If you stop applying G&A to subs mid-contract, it is possible to end up owing the Government money back in the form of what’s called a “cost impact” of the change. In addition, there are times when the subs efforts are indistinguishable from your own and should get an allocation of G&A expense.

For this reason, many firms maintain a cost category they refer to as “purchased services” which can include everything from temp labor to subcontractor employees that are integrated into the firm’s workforce. When such subcontractor employees perform right alongside the firm’s own employees and under the direction of the firm’s program manager, they should and do get an allocation of G&A expense. The trick is to distinguish between them.

These firms usually have a process by which the nature of the services to be performed by the subcontractor are examined at the outset of the arrangement and a determination made as to whether that subs costs will be included or excluded from the G&A base. That determination is typically revisited and documented at least annually during contract performance. Only those subcontracts where the services are (1) independently performed, (2) subject to management by the sub and not the prime, and

(3) provided directly to the end customer are excluded from the G&A base and received an “M&S” allocation.

In reality this determination is somewhat subjective and many subcontract arrangements will fall in the gray area in the middle. In these cases, it falls to the program manager to make the determination based on the day-to-day management and administration of the effort.

Summary

Most contractors can use the TCI base for allocation of G&A expense without fear of having that choice questioned by auditors. It is equally true, however, that most contractors can justify use of the Value Added G&A base if they choose. About one-third of all mid-size and larger contractors already use the VA G&A base. Almost all of the remainder use TCI. Virtually no mid-size or larger firms use a single element allocation base.

Among contractors with revenues of less than \$20M annually, the overwhelming majority use the TCI base. This may change over the next few years as TCI becomes less attractive due to the new excessive pass-through rules. Even among the smallest contractors, use of the single element base is rare – probably less than 5% of firms.

Those firms who choose to use the VA G&A base gain some competitive advantage with respect to costs when there are subcontractors in the proposal. They still have some measure of control, however, over which subcontracts are excluded from the G&A base and which are not.

Use of the Value Added base does introduce an additional level of complexity into the indirect cost allocation scheme of the firm and another pool to manage. Like everything else in the GovCon world, it's a tradeoff.

TANSTAAFL. From the U.S. Air Force Acronym dictionary – “There Ain't No Such Thing As A Free Lunch.”