

On December 10, 2009 the Defense Contract Audit Agency (DCAA) issued guidance to its auditors, reminding them that Congress had implemented statutory limits on the percentage of indirect costs that could be allowably allocated to DOD-issued contracts, grants, or cooperative agreements for purposes of pursuing “basic research.”

As the audit guidance stated, the FY2008 and FY 2009 DOD Appropriations Act stated—

Notwithstanding any other provision of law, none of the funds made available in

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this Act may be used to pay negotiated indirect cost rates on a contract, grant, or cooperative agreement (or similar arrangement) entered into by the Department of Defense and an entity in excess of 35 percent of the total cost of the contract, grant, or agreement (or similar arrangement): Provided, That this limitation shall apply only to contracts, grants, or cooperative agreements entered into after the date of the enactment of this Act using funds made available in this Act for basic research.

Existing DOD guidance defines the phrase “indirect costs of a prime awardee” as follows—

- **Universities**. All Facilities and Administration (F&A) costs as provided in the cost principles for educational institutions (see OMB Circular A-21/2 CFR Part 220).

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· **Non-profit Organizations.** Indirect costs are those as defined in disclosed and/or established accounting practices and as provided in the cost principles for non-profit organizations (see OMB Circular A-122/ 2 CFR Part 230) or FAR Part 31.2 for those Non-profit Organizations not subject to OMB Circular A-122 (see CFR Part 230.2(c)).

· **For-profit Organizations.** Indirect costs are those as defined in disclosed and/or established accounting practices and as provided in the cost principles at FAR Part 31.2.

The indirect cost limitation applies only to prime contractors; it does not flow down to subcontractors. Moreover (as the guidance stated), the limitation is not a cap on the contractor's indirect cost rates; instead, "the limitation restricts the amount of reimbursement for indirect costs ... to 35% of the total cost of the award."

The "total cost" of a contract, grant, or cooperative agreement is defined in the applicable cost principles called out for the affected entity (as noted above). For entities subject to the FAR Part 31 cost principles, the phrase "total cost" is defined (at 31.201-1) as follows—

(a) The total cost, including standard costs properly adjusted for applicable variances, of a contract is the sum of the direct and indirect costs allocable to the contract, incurred or to be incurred, plus any allocable cost of money pursuant to [31.205-10](#), less any allocable credits. In ascertaining what constitutes a cost, any generally accepted method of determining or estimating costs that is equitable and is consistently applied may be used.

(b) While the total cost of a contract includes all costs properly allocable to the contract, the allowable costs to the Government are limited to those allocable costs which are allowable pursuant to [Part 31](#) and applicable agency supplements.

To use the example provided in the audit guidance, the limitation is calculated as follows—

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On a \$100,000 award, \$35,000 in indirect costs is the maximum allowed per the limitation ( $\$100,000 \times 35\%$ ).

Contract vehicles that are subject to the limitation will contain a clause or other language that clearly notify the prime contractors of the applicable limit. For those wondering, “basic research” is defined in the FAR (at 2.101) as “research directed toward increasing knowledge in science. The primary aim of basic research is a fuller knowledge or understanding of the subject under study, rather than any practical application of that knowledge.”

Importantly, the limitation will not apply to contractors’ independent research and development (IR&D) activities, even though FAR 31.205-18 clearly states that the definition of IR&D includes basic research efforts. Since IR&D efforts expressly exclude activities that are “sponsored by a grant or required in the performance of a contract,” activities covered by the indirect cost limitation can never be IR&D. Instead—and as

the audit guidance clearly states—the limitation on indirect costs only applies to awards given by the DOD to a prime contractor. Period.

The DCAA audit guidance tells auditors –

Auditors should request recipients of “basic research” awards to demonstrate that award briefs (e.g., contract briefs) identify the subject indirect cost limitation as applicable. Also, auditors should verify that award recipients have a system in place that provides procedures to monitor charges on an award-by-award basis to ensure the 35 percent limitation is not exceeded.

Field Audit Offices should obtain from recipients ... performing research, a listing of awards ... subject to the

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limitation. During the normal course of audits, such as forward pricing proposals, annual incurred cost proposals, and interim and final billings submitted to the Government, auditors should review award briefings to identify the term or condition containing the limitation and test for compliance.

Accordingly, those entities receiving contracts, grants, or cooperative agreements from the DOD for basic research should be prepared for the audit procedures discussed above.

See the DCAA audit guidance [here](#).

# DCAA Audit Guidance Discusses Limits on Indirect Costs Allocated to Basic Research Contracts

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