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We see it all the time.

Everybody is worried about the future—especially in these times of budgetary uncertainty.

Commercial companies want to create a government sales channel. Government contractors want to move into commercial sales. Defense contractors want to generate orders with international customers, either through **FMS-type orders** or through direct sales to foreign governments.

Small businesses want to grow into large businesses. Companies with SBIR Phase 1 contracts want to get their Phase 2 contracts. Companies in the SBA's 8(a) program worry about what happens after they "graduate" from that safe harbor.

Companies with GSA Schedules want to branch out into contracting directly with the ordering agencies. Companies with firm, fixed-price contracts want to start bidding on cost-reimbursement type contracts. Companies who are not CAS-covered worry about what happens when they get their first CAS-covered contract award.

Everybody wants to move forward and grow. Of course they do! That's the business they're in, and they want to be successful. And a successful company, writ large, is what makes the economy successful. Let's be clear right now that we endorse corporate growth strategies.

But with growth comes risk.

We've **discussed** the phenomenon of commercial companies that dabble in government sales, and how they have an unfortunate tendency to screw-up their risk analyses. We've **also discussed** what happens to small businesses as they attempt to transition from SBIR Phase 1 to SBIR Phase 2. This website is rife with examples of companies—both large and small—that failed to fully appreciate the risks that they faced, and to invest to mitigate those risks.

Let's agree right now on the foundational precept that, as companies evolve and grow and move into new phases of bidding and program execution, they enter into a new risk profile that their historical success has not prepared them to fully appreciate. Risks change. New risks are introduced. Unprepared companies don't realize that they're playing with fire until they get burned—and the burn typically involves audit findings, government investigations, *qui tam* relator allegations, legal fees, and some type of large dollar legal settlements. Again: this website is rife with examples that support that assertion.

From a compliance perspective, companies are worried about new risks associated with growth. For example, companies winning larger DOD-funded contracts need to worry about the new **Business Systems** oversight regime. They face significant cash-flow reductions if any of their six "business systems" are found to be inadequate, based on "significant deficiencies" identified during audit. Companies with contracts containing the 52.203-13 clause need to worry about their ethics/business conduct programs, and making "mandatory disclosures" of certain violations. Companies with overseas operations have **FCPA risks**; and companies need to be concerned about risks associated with human trafficking. The list of risks goes on and on.

And that's not all.

Companies bidding on cost-reimbursement type contracts want DCAA to tell them that their accounting system is "adequate" (even though it's the Contracting Officer who makes that determination). Companies looking at upcoming Cost Accounting Standards coverage want somebody to write their Disclosure Statement for them.

And from a marketing/business development perspective, companies want their costs—and, in particular, their indirect rates—to be competitive in the marketplace.

We're going to focus on indirect rates. Indirect rates don't just impact your marketing folks' ability to sell your goods and services; they also impact your ability to obtain a determination that your accounting system is "adequate". Indirect rates impact your CAS compliance posture and they also play a significant role in what cost accounting practices you disclose in your Disclosure Statement. But that's not all: improperly allocated indirect costs could be a deemed a significant deficiency in one or more “business systems” and lead to reduced cash flow. Intentionally misallocated indirect costs **could be alleged** to be violations of the False Claims act, and might have to be disclosed under the requirements of the 52.203-13 clause.

Let’s agree right now that proper indirect cost allocations have a broad impact across multiple aspects of your business. And let’s agree that indirect cost allocations play a significant role in generating (or hopefully mitigating) many of the risks your company is facing. Let’s agree right now that this is a topic worthy of deep discussion—that getting it right is a crucial key to your continued success and business growth.

But let’s also agree that you’ve not devoted enough thought to the topic in the past. If you’re like many (most!) of our clients and employers over the past 30 years, you bitch and moan about your rates, but you haven’t invested the time and money into evaluating them and making them support your business strategy. We remember one client—a defense manufacturer—who hadn’t changed its factory overhead allocation base in more than 40 years, even though its manufacturing processes had changed significantly over that same period. It was still allocating factory overhead on a direct labor dollar base, even though direct labor dollars as a percentage of total manufacturing cost had shrunk to a vanishingly small percentage and was no longer a major cost driver, because of advances in factory automation. The company continued to use the same allocation methods because they had been found to be compliant two generations ago—and why fix the wheel if it ain’t broke? (Never mind the fact that the factory overhead rate was approaching 1,000 %.)

Let’s be honest about the situation. You treat your indirect rates the way most people treat the weather. As Mark Twain is alleged to have said, “*A great, great deal has been said about the weather … but very little has ever been done about it.*
” Respectfully, we think it’s past time for your to take a fresh look at your indirect rates and see if they are aligned with your business strategy and customer needs.

And by “look at your indirect rates,” we mean to say “look at your cost allocation structure.”

Whether you are a small or large business, your cost allocation structure needs to support your business strategy. As your company evolves and grows and moves into new phases of bidding and program execution, your cost allocation structure needs to evolve and grow as well. As you look at new office locations and multi-national operations and foreign sales, your cost allocation structure needs to change. As you look at adding new programs to your portfolio, your cost allocation structure needs to change. As you manage a mix of different contract types, with different reimbursement terms and perhaps different flavors of CAS coverage, your cost allocation structure needs to ensure that each contract receives an equitable share—no more, no less—of your indirect costs. As you support multiple customers with different perceptions of a “fair” indirect cost rate, your cost allocation structure needs to ensure that you are maximizing cost recovery.

The cost allocation structure needs to change because (a) it needs to support your changing cost profile and customer needs, and (b) it needs to remain compliant with applicable regulatory compliance requirements. If you think yesterday’s cost structure will be adequate to support tomorrow’s cost proposals, then we suspect you will be proven wrong.

In this series of articles, we will explore:

1. Direct versus Indirect. How much direct costing can you afford?

2. Cost allocation structures. What price precision?

3. Segmentation and intermediate home office structures.

4. GOCOs, special business units, and special facilities.

5. Special cost allocations permitted by CAS.

6.

The wisdom of establishing contract-specific rates for competitive reasons.

7. Any other related topics/questions submitted by you, our readership.

Stay tuned for more.