

# Using the Eichleay formula to recover unabsorbed indirect costs in a request for equitable adjustment

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Sequestration presents multiple challenges to many, including federal contractors. Methods like the Eichleay formula, especially in a request for equitable adjustment (REA), could help contractors minimize negative impacts, while also assisting to recoup some of the losses resulting from full or partial terminations.

## REA explained

An REA is a demand for financial contract adjustment to compensate the contractor or the government for changes made to a contract. The need for an REA is prompted by a change to the requirements of the contract, from changes

to the conditions surrounding that contract, or from partial or full termination for convenience. From the contractor's standpoint, careful preparation of an REA could make the difference between recovering substantial or all potential losses and being exposed to negative financial consequences.

Thorough preparation of an REA requires the contractor to evaluate three aspects of the contract's financial structure:

1. Direct costs
2. Indirect costs
3. Profit or fee commonly associated with risk

Brief considerations will be provided for direct costs and profit or fee before delving into indirect costs.

## Direct costs

Direct costs should be approached with long-term vision. Although this aspect of the adjustment may seem straightforward, it is important to bear several considerations in mind. For starters, direct costs should be reasonable. There are several public resources that will provide reasonability tests commonly used by the federal government. Second, substantial related costs and cumulative impact costs must be taken into account. Although the change or termination may pertain to labor hours as an example, that change in hours could have a domino effect impacting production costs, inventory costs and so on. Those related and cumulative costs have to be prudently defined and quantified. Third, the contractor should be keen on the fact that regulations surrounding unallowable costs carry through an REA even if those unallowable costs were incurred as a result of the change (i.e. interest expense on financing).

Finally, from a controls perspective, it would be advantageous to establish separate project codes once it becomes known that a change or termination is occurring. For costs that may have been incurred prior to that point, identification and reclassification of such costs would be acceptable with proper support.

## Profit or fee

Before starting on profit or fee, the contractor should first verify that the contract allows for it. There are several Federal Acquisition Regulations (FAR) clauses that exclude fee from adjustments. That said, profit or fee, for the most part, should remain consistent with the basic contract fee for an adjustment changing work that is similar in nature to the work on the basic contract. The change could be an addition, deletion, substitution or termination of work. In these cases of similar work, the adjustment should not benefit or detriment the contractor's profitability more or less than it would have been prior to the change. However, if the nature of the work brought on by the change is different, the fee may be considerably different. That change in fee would depend on costs incurred under the contract and risk factors associated with the adjustment.

## Indirect costs

In a typical indirect cost rate structure, indirect costs are absorbed by all direct costs through various allocation methods. The indirect cost allocation base during the accounting period will decrease if stoppage or delays for all or part of a contract effort occur. Unless the work subject to the stoppage or delay can be replaced with other work or the overhead pool can be reduced, the lower allocation base will increase the indirect cost rate for the period. Those higher indirect cost rates will be applied to other contracts, thereby increasing the cost of those contracts.

The contractor has the right to request equitable adjustment relief to cover such unabsorbed or extended overhead associated with government delays or work stoppages, provided the contractor can demonstrate that it necessarily suffered because the nature of the change or termination made it impossible or impractical to assume other work.

## Eichleay formula

There are various methods for estimating due relief for unabsorbed indirect cost. However, the Board of Contract Appeals and Courts has generally ruled that the Eichleay formula is the acceptable method for computing unabsorbed overhead resulting from government-caused stoppage or delay. For construction contracts, the Court of Appeals for the Federal Circuit has endorsed the formula's use, and likewise, the Armed Services Board of Contract Appeals supports this useful strategy in manufacturing and supply contracts.

Application of the Eichleay formula requires several assumptions:

- Overhead costs are all fixed
- The contractor cannot assume other work to substitute for the change or termination
- There is a complete stoppage of work
- The cost of the delay remains unchanged regardless of the percent of contract completion
- The facilities are operating at or very close to full capacity

The Eichleay formula is defined as :

$$\text{Unabsorbed indirect cost} = \frac{(A + B) \times C}{D} \times E$$

Where:

A = Total billings for the delayed contract between the date of delayed-contract award and the date of delayed-contract completion

B = Total company billings for all contracts between the date of delayed-contract award and the date of delayed-contract completion

C = Total fixed overhead between the date of delayed-contract award and the date of delayed-contract completion

D = Number of days of actual performance between the date of delayed-contract award and the date of delayed-contract completion

E = Number of days that performance was delayed

For variables, A, B, C, and D, estimates can be used when values are not yet known.

The Eichleay formula's objective is to quantify the portion of indirect costs intended to be absorbed by the delayed contract and then determine the amount of unabsorbed overhead corresponding to the duration of the delay.

There are cases where the Eichleay formula will not fully apply to the contractor's government-imposed work stoppage or delay. In those cases, adjustments must be made to the formula in order to yield a more equitable unabsorbed indirect cost result. Adjustments should be integrated in cases where the contractor managed to partially replace the work that was stopped or delayed, where there is only a partial work stoppage, and where facilities are not operating at full or near full capacity. Carefully documented rationale should accompany any adjustments to the formula.

## **Summary**

While sequestration may present federal government contractors with a challenging environment of change and operating adjustments, there are measures contractors can take to minimize risk and losses. The Eichleay formula presents one such opportunity for contractors to recover indirect costs equitably and in a timely manner. By utilizing this method, the contractor not only mitigates profitability risk, but also manages their contracts using more realistic cost data thereby improving indirect rate variances, cash positions, and overall, the financial management of the business.

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