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## Maximizing the Amount Firms Can Bill: The Influence of FAR in Setting Project Pricing

By Robert Mercado and Michelle Johnson | Thursday, July 23, 2020

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Architectural and engineering (AE) firms pursue work from the private and public sectors. For private sector projects, AE firms are awarded contracts based on project scope, proposed pricing and firm qualifications. In the public sector, however, AE firms are awarded contracts based almost exclusively on their qualifications.

Department of Transportation (DOT) projects are a model for public sector work. The DOTs are not allowed to request pricing from AE firms until after the project has been awarded. How, then, does a DOT ensure it is paying a reasonable price for the work that will be performed? The DOT's risk is protected by federal statute, under the Federal Acquisition Regulation (FAR).

AE firms that perform work for DOTs are required to follow the rules set forth in Part 31 of the FAR in determining the amount that can be charged for DOT projects. This determination is also based on whether the project is federally or state funded. Certain state DOTs have their own rules for determining the amounts allowed to be charged by AE firms; however, these rules typically incorporate or are similar to the federal rules. State rules relate only to work funded by that state; therefore, it is imperative that prior to pursuing a project with a DOT, AE firms must know where the project funding will come from—federal or state—to understand the amount that can be charged.

Once a project is awarded, a cost proposal is prepared by the AE firm. The cost proposal is usually broken down into seven categories, as follows:

- Direct Labor;
- Labor Overhead;
- Sub-Consultant Cost;
- Other Direct Costs;
- Fees;
- Facility Capital Cost of Money; and
- Direct Labor.

The direct labor (DL) breakdown details the number of hours expected to be performed by specific individuals or labor category, along with the rate per hour and estimated extrapolated cost for each. The rate for each person or employee category is based on the actual compensation for that employee or category, not including any overhead or profit.

## **LABOR OVERHEAD**

A labor overhead (LO) rate is based on the AE firm's fringe benefits and general overhead, also referred to as "indirect costs," for the preceding year. The indirect costs are adjusted by the specific rules set forth in the FAR, to come up with the rate that can be charged to the DOT. The labor overhead rate is calculated based on the adjusted indirect costs as a percentage of direct labor for the AE firm's preceding year-end. Some of the adjustments required to be made by FAR are as follows:

<b>Expense Type</b>	<b>Unallowable</b>
Advertising and marketing	Public relations, advertising, corporate image enhancement, and market planning costs including labor associated with these items
Dues and subscriptions	Political Action Committee (PAC) contributions/ lobbying fees and social club dues
Auto expense	Personal use of auto
Donations	All types of cash donations
Travel, meals, and entertainment	Must obtain lowest price for travel, amount in excess of lowest price unallowable, alcohol, and entertainment. Meals are required to have who, what, where, when, and why to ensure that the meal is a proper business expense otherwise unallowable.
Interest expense	All interest expense
Professional fees	Planning or executing the organization or reorganization of the corporate structure of a business, including mergers and acquisitions, resisting or planning to resist the reorganization of the corporate structure of a business or a change in the controlling interest in the ownership of a business and raising capital, legal fees for bad debt collection.
Employee health, welfare, and employee entertainment	Gifts to employees, recreation expenses are expressly unallowable unless they meet the following criteria: the claimed cost is for employee participation in a sports team or employee organization, the team or organization is company sponsored, the team's or organization's activity is designed to improve company loyalty, team work, or physical fitness.
Key-man life insurance	Not allowable when the Company is the beneficiary of the policy. Allowable to the extent costs are included in compensation of officers.
Rents under common control	Limited – rent costs for property under common control are allowable to the extent that the charges do not exceed the normal costs of ownership.

It is essential that AE firms have good internal controls for the recordkeeping associated with the items listed above. If the AE firm is not meticulous in its recordkeeping and it is determined that allowable and unallowable costs are not broken out when calculating the labor overhead rate, the allowable items can become unallowable, which will reduce the labor overhead rate.

### **SUB-CONSULTANT COST**

AE firms may have to subcontract certain parts of a project to an outside firm. These costs are incurred by the AE firm but are considered a straight pass-through to the DOT. Overhead and profit are not applied to these costs.

## **OTHER DIRECT COSTS**

Other direct costs are various costs that are direct to the project, such as mileage, tolls, meals, and lodging.

## **FEE**

The fee is the profit percentage charged on the project and is calculated based on the direct labor and labor overhead costs only. The fee is not charged against any other item in the cost proposal.

## **FACILITY CAPITAL COST OF MONEY**

Facility Capital Cost of Money (FCCM) is an allowable charge to the DOT for the use of the AE firm's fixed assets. The FCCM is calculated by using the average net book values of the current and prior year fixed assets of the AE firm multiplied by the average (two year) treasury rate for the applicable period. It is important to note that the depreciation of the fixed assets used must be based on the straight-line method to properly calculate the average net book value of the fixed assets. The amount of FCCM that can be charged to a project is based on a percentage of the direct labor charged to a project. The FCCM percentage is calculated each year based on the total direct labor incurred during the prior year divided by the FCCM rate.

## **MAXIMIZING THE AE FIRM'S FEE**

DOTs have the right—and often exercise it—to review the supporting documentation from the AE firm and the workpapers associated with the audit performed by a CPA, which is required by the DOT. To ensure that the AE firm can bill the DOT for the maximum amount allowable, it is essential the AE firm maintain proper accounting and documentation to support the proposed costs. The lack of proper internal controls on the recordkeeping of costs incurred can have a significant negative impact on the AE firm's ability to maximize the amount it can bill for the work performed.

Without a proper understanding of the rules and regulations set forth in the FAR, AE firms could find themselves in a contract that is not as profitable as they had anticipated or worse, a loser. Before an AE firm pursues public contracts, it should have a clear understanding of how the firm's books and records need to be maintained and what is considered allowable to be billed on a public project.



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