Engineering and Design Related Consultant Services
Compensation and Indirect Cost Rate
Question and Answer Guidance
September 22, 2010

Note: Unless indicated otherwise, questions and answers pertain to engineering and design related service contracts (as defined in 23 U.S.C. §112(b)(2)(A) and 23 CFR §172.3) using Federal-aid highway program funds and directly related to a construction project.[1]

1) **Question: When advertising for services, negotiating a contract, or establishing contract provisions, may a contracting agency request/establish limitations on payment of architectural/engineering (A/E) firm direct salaries and wages?**

   Answer: Yes, provided limitations or benchmarks are established in accordance with the Federal Acquisition Regulations (FAR) cost principles (48 CFR 31).

   Any limitations or benchmarking of direct salary rates or total compensation must be based upon a contracting agency's formal assessment performed to ensure consistency with the reasonableness provisions specified in the FAR cost principles (48 CFR §31.201-3 and 31.205-6(b)(2)). This assessment of reasonableness should include a variety of factors. Examples of considerations include current market conditions and reliable compensation surveys for employees or classifications of employees as well as other relevant factors such as size of company, type of industry, and geographic area or location (such as regional and statewide).

   An assessment consistent with the FAR cost principles would permit contracting agencies to establish direct salary compensation limitations or benchmarks based upon the objective consideration of the compensation factors discussed above. This assessment would determine what is reasonable for the subject work to be performed for the classification and experience of the employee performing the work, taking into consideration the factors identified above.

   State and local agency recipients of Federal grants are required to apply the FAR cost principles to determine the allowable costs for personal services contracts with commercial, for-profit entities (as specified in 49 CFR §18.22(b) of the Common Grant Rule). More information on compensation may be found in the FAR cost principles and Chapter 7 of the newly revised AASHTO Uniform Audit & Accounting Guide (http://audit.transportation.org/Pages/default.aspx).

[1] Section 174 of Public Law 109-115, the FY 2006 Appropriations Act, amended 23 U.S.C. §112(b)(2) (November 30, 2005), eliminating the ability for State and local agencies to use alternative or equivalent Brooks Act (40 U.S.C. §1101-1104) procedures. In accordance with these amendments, State and local agencies cannot place arbitrary across the board limits on direct salary rates or limits of any kind on indirect cost rates when awarding engineering and design related services contracts funded with Federal-aid highway funds under 23 U.S.C. §112(b)(2).

Moreover, arbitrary or across the board limitations or benchmarks on direct salary / wage rates or total compensation which do not consider the factors prescribed in the FAR cost principles are contrary to the requirements of the Brooks Act (40 U.S.C. §1104(a)), which requires fair and reasonable compensation considering the scope, complexity, professional nature, and value of the services to be rendered (as required in 23 U.S.C. §112(b)(2)). Additionally, if limitations or benchmarks on direct salary rates and total compensation are too low, it could limit the number of firms and the qualifications of the firms which submit proposals to perform work on projects. Furthermore, direct labor limitations or benchmarks not supported by the cost principles create associated disallowed indirect costs which effectively limits the calculated indirect cost rate, contrary to 23 U.S.C. §112(b)(2)(D) and 23 CFR §172.7(b).

2) **Question: May a contracting agency adjust a firm's audited and approved indirect cost rate, either through disallowance of certain cost items, or by reclassifying costs between direct and indirect cost categories?**

Answer: Generally, no. The allowability of costs on contracts is governed by the FAR cost principles (48 CFR 31) applicable to commercial, for-profit organizations (as specified in 49 CFR §18.22(b)).

As such, contracting agencies are not permitted to place limitations on indirect cost rates established in accordance with applicable FAR cost principles and must apply the firm's cognizant approved indirect cost rate for negotiation, administration, and payment of contracts for engineering and design related services that utilize Federal-aid highway program funding and directly relate to an ultimate construction project (as specified in 23 U.S.C. §112(b)(2)(C)-(D) and 23 CFR §172.7(b)).

Exclusion of cost elements, which are allowable under the FAR cost principles, from calculation or application of the indirect cost rate is essentially a ceiling on the firm's rate, and in direct conflict with 23 U.S.C. §112(b)(2)(D). For example, consistent with the FAR cost principles, FHWA has interpreted State and local income taxes as an allowable cost item in accordance with 48 CFR §31.205-41. As such, contracting agencies must allow such costs in the computation of a firm's indirect cost rate. Similarly, contracting agencies must treat the facilities cost of capital / cost of money as an allowable cost item in accordance with the FAR cost principles (as specified in 48 CFR §31.205-10).

Contracting agencies may, in limited circumstances, request minor reclassifications between direct and indirect cost elements for certain items in their contracts. Such reclassification requests must be based on a demonstrated concern over the appropriate allocability of costs to benefiting cost objectives (contracts), be included in a contracting agency's written contracting procedures, and be approved in accordance with 23 CFR §172.9(a).

3) **Question: May a contracting agency utilize a definition of compensation that differs from the Federal Acquisition Regulations (FAR) and have the ability to determine what costs will be allowed under compensation?**

Answer: No, compliance with the FAR cost principles (as specified in 48 CFR 31) is required.

Compliance with the FAR cost principles is required in the procurement, management, and administration of engineering and design related service contracts that utilize Federal-aid highway program funding (as specified in 23 U.S.C. §112(b)(2), 23 CFR §172.7, and 49 CFR §18.22(b)). As such, deviations from the definition of compensation, how total compensation is calculated, and more importantly, disallowance of associated costs as specifically provided for in the FAR cost principles is not permitted on engineering and design related consultant service contracts utilizing Federal-aid highway funding.

As stated in the response to Question No. 1, a contracting agency may limit or benchmark direct salary rates or total compensation based upon a formal assessment performed to ensure consistency with the FAR reasonableness provisions (as specified in 48 CFR §31.201-3 and 31.205-6(b)(2)).

4) **Question: May contracting agencies question the reasonableness of indirect cost/overhead rates for engineering and design related service contracts utilizing Federal-aid highway funding?**

Answer: Reasonableness is determined during the conduct of the indirect cost rate audit, conducted in accordance with Generally Accepted Audit Standards, and following the AASHTO Uniform Audit & Accounting Guide. Contracting agencies shall use and apply a cognizant approved indirect cost rate established in accordance with the FAR cost principles contained in 48 CFR 31 for the for the purposes of contract estimation, negotiation, administration, reporting, and contract payment and the rate shall not be limited by administrative or de facto ceilings of any kind (as specified in 23 U.S.C. §112(b)(2)(C)-(D) and 23 CFR §172.7(b)).

A contracting agency may not request or start negotiations of a lower indirect cost rate than was established by a cognizant approved audit. A lower indirect cost rate may be used only if proposed / submitted by the consultant firm, however the consultant's offer of a lower indirect cost rate shall not be a condition of qualification to be considered for the work or the contract award (see 23 CFR §172.7(b)).

The use of a statewide average indirect cost rate or average direct salary rates to initially scope or program a project is an acceptable method to estimate overall project costs and serve as an indicator of the level of effort moving forward. However, once the most highly qualified consultant is identified, contracting agencies must utilize the consultant's cognizant approved indirect cost rate and direct salary rates (which may be evaluated for reasonableness as stated in the response to

Question No.1) in establishing a revised independent cost estimate to be used in negotiating and administering contracts or contract amendments in accordance with the aforementioned Federal laws and regulations.

To enhance the quality of independent cost estimates and overall cost effectiveness of consultant contracts, the focus of negotiations should be on improving identification of the tasks to be performed, products to be produced, services to be provided, level of effort needed to complete those tasks, the classifications and experience of staff required to complete those tasks, and other direct contract costs.

Refer to Questions 8 through14 in Chapter 12 (pages 117-118) of the AASHTO Uniform Audit & Accounting Guide for a detailed discussion of the use of indirect cost rates other than as established through the cognizant approval process or when under dispute (as specified in 23 CFR §172.7(c)).

5) **Question: Is it possible for contracting agencies to cap a consultant's indirect cost rate or direct salary rates on engineering and design related service contracts that do <u>not</u> utilize Federal-aid highway funding?**

Answer: Yes, subject to State laws, policies, and procedures, State and local agencies may place a limitation on or benchmark a consultant's indirect cost rate and direct salary rates if the engineering and design related services contract does <u>not</u> involve Federal-aid highway funding.

The reasonableness provisions specified in the FAR cost principles (48 CFR §31.201-3 and 31.205-6(b)(2)) for determination of allowable costs for personal services of commercial, for-profit entities (as specified in 49 CFR §18.22(b)) apply only when any Federal grant funds are involved (see reasonableness discussion in the response to Question No. 1). Additionally, the indirect cost rate provisions of 23 U.S.C. §112(b)(2)(C)-(E) apply only when Federal-aid highway funding is participating on engineering and design related service contracts that directly relate to a highway construction project subject to the provisions of 23 U.S.C. §112(a).

However, the cost of consultant service contracts that utilize only State or local agency funding which were not procured, negotiated, or administered in accordance with applicable Federal and State laws and regulations would not subsequently be available to meet the non-Federal share of costs for subsequent phases of a federally funded project.

6) **Question: Does the method used to procure engineering and design related services influence the ability for a State or local agency to cap a consultant's indirect cost rate or the direct salary or total compensation of employees?**

Answer: Yes, subject to State laws, policies, and procedures, State and local agencies may be able to place a limitation or benchmark on a consultant's indirect

cost rate when using the small purchase procedures or noncompetitive negotiation (*e.g.* emergency procurement) procurement methods for engineering and design related services contracts that utilize Federal-aid highway program funding.

Small purchase procedures (as specified in 23 CFR §172.5(a)(2)) may only be used for engineering and design related services contracts whose total costs are below the lesser of the Federal $100,000 simplified acquisition threshold (as specified in 41 U.S.C. §403(11)) or the State's established threshold.

Non-competitive procurement (as specified in 23 CFR §172.5(a)(3)) may only be used under a limited set of established circumstances and requires a formal justification submittal to and approval from the FHWA.

Small purchase (23 CFR §172.5(a)(2)) and non-competitive negotiation (23 CFR §172.5(a)(3)) procurement methods are not required to follow a Brooks Act compliant qualifications-based selection process and therefore are not required to comply with the indirect cost rate provisions specified in 23 U.S.C. §112(b)(2)(C)-(E). For these procurement methods, the State or local agency must follow the same laws and procedures that it follows when using its own funds (as specified in 49 CFR §18.4 and 18.36(a)-(b)). When procuring property and services under a Federal grant, a State or local agency must complete the procurement in accordance with its own State or local laws, regulations, policies and procedures which are not in conflict with applicable Federal laws and regulations. When the State or local procedures are in conflict with Federal requirements, the Federal requirements prevail where use of Federal funds is involved.

As such, State and local agencies may negotiate indirect cost rates in accordance with applicable State and local laws, regulations, policies, and procedures when procuring engineering and design related services contracts under small purchase or non-competitive negotiation procedures.

Regardless of the procurement method utilized, State and local agencies may establish limitations or benchmarks on consultant direct salary rates or total compensation provided the limitations are established in accordance with the Federal Acquisition Regulations (FAR) cost principles (48 CFR 31). The reasonableness provisions specified in the FAR cost principles (48 CFR §31.201-3 and 31.205-6(b)(2)) for determination of allowable costs for personal services of commercial, for-profit entities (as required in 49 CFR §18.22(b) of the Common Grant Rule) apply when any Federal grant funds are involved. As such, limitation or benchmarking of direct salary rates or total compensation must be based upon a contracting agency's formal assessment to determine what are reasonable costs in accordance with the reasonableness provisions specified in the FAR cost principles (see reasonableness discussion in the response to Question No. 1).

7) **Question: Do the cognizant audit requirements apply to sub-consultant indirect cost rates on engineering and design related services contracts utilizing Federal-aid highway funding?**

Answer: No, the cognizant audit requirements do not apply to sub-consultant indirect cost rates.

Sub-consultants hired by the prime contractor do not fall under the requirements of 23 U.S.C. §112(b)(2)(C)-(D) and as such, their rates would not be subject to establishment via cognizant agency audit. However, as stated in 23 U.S.C. §112(b)(2)(B), subcontracts must comply with the FAR cost principles (as specified in 48 CFR 31). Again, as with all procurements for property and services under a Federal grant, State and local agencies must follow all State and local laws, regulations, policies, and procedures which are not in conflict with applicable Federal laws and regulations (as specified in 49 CFR §18.4 and 18.36(a)-(b)).

Although an audit of an indirect cost rate of a sub-consultant on a Federal-aid contract is not required under the aforementioned Federal laws and regulations, State and local agencies are not precluded from prescribing sub-consultant audit requirements in their laws, policies, and/or procedures. As such, and in accordance with a State's established audit risk assessment process (see Chapter 12 of the AASHTO Uniform Audit & Accounting Guide - http://audit.transportation.org/Pages/default.aspx), the requirement to audit or require sub-consultants to prepare an audit may be incorporated as an acceptable policy and/or procedure of a State or local agency consultant services program. Such policies and procedures, which are subject to approval by FHWA (as specified in 23 CFR §172.9(a)), may be warranted to ensure sub-consultant costs are properly accumulated and allowable in accordance with the FAR cost principles.