Understanding Indirect Costs

They may be hard to figure and even harder to recover- but they should never be overlooked.

By Henry Flood and Richard W. Phelps

While those who apply for grants sometimes assume that grant money will pay for everything they need to operate a program, experienced grants managers know better. The true cost of programs includes things like rent, utilities, IT support, bookkeeping, and even a portion of the grants manager's own salary—anything and everything necessary to keep the organization itself up and running. When expenses are shared among programs, or among functions within the organization (e.g., management, accounting, legal affairs), they are defined as indirect costs. Tracking and recovering those costs are among the biggest challenges that any grant administrator will face.

Because indirect costs inevitably benefit—or burden—all grant-funded programs, they should never be ignored. Pretending they don't matter can be very dangerous to an organization's fiscal health. Calculating the full cost of a program is a prerequisite to determining its relative importance within the organization as a whole, to preparing accurate budget forecasts and financial statements, to setting fees for program services, and-perhaps most importantly for grant administrators-to requesting reimbursement from grantmakers.

Of course, requesting reimbursement is not the same as getting it. Foundations and corporate grantmakers sometimes make minimal allowance, or no allowance at all, for the recovery of indirect costs. If you accept their grants, your organization may end up footing the entire bill for anything defined as "overhead." Government funders generally do make provision for indirect costs in their grant agreements, but rates of reimbursement vary significantly, even within the same funding agency.

If your organization is small enough, you may be able to determine indirect costs by calculating actual usage on a case-by-case basis. For example, staff may keep phone logs and time sheets, tracking long-distance calls or the hours they work on a particular grant-funded project. As for fair shares of things like rent, estimates could be calculated by measuring the square footage of the offices occupied by staff working on the program. Don't be surprised, however, if the onus of keeping accurate records soon proves overwhelming, or if certain "hidden" but real costs fall through the cracks.

In organizations with more than a few grant-funded programs, shared expenses are far too difficult to break down and continually track this way. It simply isn't practical. That's why for federal grants, which are the focus of this article, you need to negotiate an indirect cost rate with the funder-a reasonable rate of reimbursement that will, in theory at least, apply across the board.

To recover a fair share of indirect costs, you must prepare an indirect cost rate proposal in accord with government-issued guidance applying to state and local governments and Indian Tribes, nonprofit organizations, and colleges and universities.

This proposal must:

- Identify all activities carried on within each department and their associated costs regardless of funding source (i.e., organization-generated or externally funded).
- Identify costs allocated to departments through any central service allocation plan.
- Classify all activities within each department and their associated costs as "direct" or "indirect."
- Subtract from indirect costs those costs that are ineligible based on OMB regulatory guidance, agency regulations and statutory exclusions. (Excluded costs are typically capital expenditures, pass-through costs and costs that are specifically disallowed.)

What Type of Rate Should You Seek?

A variety of rates are possible to obtain. They are:

Provisional Rate: This is a temporary rate established for a prospective period of time and based on estimated costs until a final rate can be determined. A provisional rate is often sought by new organizations or by established organizations that have no prior federal grants or contracts. The provisional rate, which is based on estimated costs, is later revised to a final rate, based on operating experience.

Final Rate: This rate is established after an organization's actual costs for an operating period (normally a fiscal year) are known. When a final rate, based on audited financial statements, has been set, it is often lower than the provisional rate. Sometimes a provisional rate remains provisional for another year if there is evidence that there will be significant changes in funding levels or costs.

Predetermined Rate: This is a rate established for a specified period of time (usually one to three years) and it is not subject to adjustment. This kind of rate is used when financial data demonstrate a reasonable assurance that a reimbursement rate is likely to remain stable based on the organization's actual costs, both previous and forecasted.

Fixed Rate with Carry-Forward: This is a permanent rate established for a future (prospective) period of time. The funder reimburses at this rate, but after actual costs have been determined according to the recipient's accounting system and audited reports, the difference between fixed and actual is carried forward to a future period in order to adjust the fixed rate for under- or over-recovery of indirect costs. Indian tribes often seek this type of rate because the Indian Self Determination Act (25 USC 450) and the Indian Self Determination regulations (25 CFR Part 900) have special rules concerning under- and over-recovery of indirect costs which are designed to benefit and protect tribal organizations.

Special Rate: Special rates may be developed to deal with unique situations. They are often used by colleges and universities when indirect costs are different for on-campus and off-campus activities.

Multiple Indirect Cost Rates: These may be requested and negotiated in circumstances where a single organization-wide rate may not be appropriate. Multiple indirect cost rates should be considered when departments, divisions or programs use the services of the indirect cost pool disproportionately. The multiple rate approach provides a more versatile way to apportion administrative costs fairly among various grant- and contract-supported activities.

Calculation Methods

Once you and your accountant have determined the most appropriate rate to seek, you must figure out how your rate will be calculated. There are two base methods:

- **Direct Salaries and Wages** (which may or may not include some or all fringes)
- **Modified Total Direct Costs** (excluding capital costs, pass-through funding and unallowable costs).

Either method of calculation may be used to construct what is termed a simplified rate. A simplified rate determination is commonly used by small organizations and larger organizations where a single organization-wide rate is justified because the indirect cost burden attributed to programs and activities are roughly equal to one another, which means that each program or activity is covering a fair share of its costs. When these conditions are not true and one or more programs bear a disproportionate share of the indirect cost burden, multiple indirect cost rates are necessary.

To illustrate the calculation of a simplified indirect cost rate based on salaries and fringes, assume the following:

(A) An indirect cost pool of $200,000
(B) A salary and fringe total of $300,000.
To calculate the rate, you would divide (A) by (B), yielding an indirect cost rate of 66.66%.

To illustrate the calculation of a simplified indirect cost rate based on modified total direct costs, assume the following:

(A) An indirect cost pool of $200,000
(B) Total allowable direct costs of $600,000.
To calculate this rate, you would divide (A) by (B), yielding an indirect cost rate of 33.33%.

How Does a Rate Get Constructed?

As you can see, merely calculating the rate isn't hard. The real challenge lies in identifying and apportioning the costs that comprise your indirect cost pool. Here's how the Office of the Chief Financial Officer in the U.S. Department of Education suggests that you go about doing this:

1. Identify all the activities carried on by recipient department or unit, along with their attendant costs. (All activities must be included regardless of the source of funds used to pay for them.)

2. Incorporate those costs allocated to the departments or units through the central service cost allocation plan. A central service cost allocation plan is usually prepared by states and very large organizations with many departments and bureaus. These departments and bureaus benefit from the indirect costs of central services, such as accounting, grant administration, internal audit, and other indirect cost services of the organization.

3. Classify the activities and their costs as direct or indirect.

4. Remove from the pool of indirect costs any capital expenditures or other costs stipulated as unallowable in the relevant OMB Circular or according to program legislation.

5. Compute the rate by dividing the total remaining indirect costs by the direct cost base selected for distribution of the indirect costs. The most frequently used base is Modified Total Direct Costs (MTDC).

More detailed guidance on how to gather data and put together an indirect cost proposal is contained in Section II of the Department of Labor's Indirect Cost Rate Determination Guide, published by the Office of the Assistant Secretary for Administration and Management.

Multiple Indirect Costs

When your indirect costs benefit major programs disproportionately, or programs bear an unusual indirect cost burden relative to other programs, establishing a multiple indirect cost rate is more appropriate if not required. Published guidance from the Department of Health and Human Services states, "This method results in more definitive costing and should be used when operating differences between divisions or bureaus result in material differences in the use of resources and in costs."

In large organizations, indirect costs allocated from departments, together with central service allocations, are added to indirect costs incurred by each division or bureau to arrive at total indirect costs incurred by each division or bureau. A rate is then developed for each division or bureau by relating its indirect costs to its base (salaries and wages or modified total direct cost). Smaller organizations can have multiple rates, too, usually developed for each department or major program.

In approaching this task, keep in mind that you must establish a separate indirect cost pool for each department, and then calculate a department's rate by dividing the direct cost base for that department into its indirect pool.

Distribution Methodology

First, divide indirect costs into logical groups in order to minimize the number of groupings that will be allocated. For example:

Personnel Administration	$67,000
Finance	$225,000
Audit	$75,000
Purchasing	$140,000
Space	$40,000
Executive Management	$90,000
Insurance	$60,000
Legal	$75,000
Total Indirect Costs	**$772,000**

The next task is to develop a methodology for apportioning these costs to the indirect cost pools for each department that has grant-funded programs. For the purpose of this illustration, we'll assume the organization has three such departments: **Health Services**, **Education**, and **Social Services**. In establishing your allocation method, you should look at historical data to determine the most equitable approach. For example, *Personnel Administration*, *Executive Management*, and *Space* could be calculated on the basis of the number of employees in the department as a percentage of total employees. *Finance* and *Audit* could be calculated on the basis of the percentage of cash disbursements made for the department. *Purchasing* could be calculated on the basis of the percentage of purchase orders allocated to the department. *Insurance* could be calculated on the basis of the percentage of assets owned by the department. And *Legal* could be calculated as a percentage of total direct funding.

To allocate the indirect costs from the central pool to the indirect pools for each division, our first step would be to establish the allocation percentages using historical data. Sample percentages and the resulting indirect cost pools for each department are illustrated in the chart below.

	Health Services		Education		Social Services	
Personnel Admin.	55%	$36,850	30%	$20,000	15%	$10,150
Finance	40%	$90,000	30%	$67,500	30%	$67,500
Audit	40%	$30,000	30%	$22,500	30%	$22,500
Purchasing	25%	$35,000	40%	$56,000	35%	$49,000
Space	55%	$22,000	30%	$12,000	15%	$6,000
Executive Mgmt.	55%	$49,500	30%	$27,000	15%	$13,500
Insurance	30%	$18,000	60%	$36,000	10%	$6,000
Legal	60%	$45,000	20%	$15,000	20%	$15,000
TOTAL		$326,350		$256,000		$189,650

Now that each department has its own pool of indirect/overhead costs, the next step is to determine the direct cost base for each department and then divide that base into its respective pool, which will result in the indirect cost rate for that department. To come up with the rates illustrated in the chart below, we used total direct salaries and fringe for each department.

	Direct Salaries	Indirect Costs	Indirect Cost Rate
Health Services	$1,275,000	$326,350	25.60%
Education	$2,460,000	$256,000	10.41%
Social Services	$877,000	$189,650	21.62%

If you find that different departments use (absorb) overhead in disproportionate amounts, the multiple rate method should be used. Accountants and managers in large government agencies and larger nonprofit organizations know that certain types of activities and programs use more support functions than others. If that's true for your organization, you'll probably need to establish multiple rates.

Rate Agreement and Approving Agency

A completed indirect cost proposal is just that—a proposal. It must be accepted by a federal agency official empowered to approve the rate and issue a rate agreement that will be signed by both the approving agency and your organization.

Who is responsible for reviewing your indirect cost proposal and approving your rate? If you are a new grant recipient, it will usually be the agency that is awarding your funding. If your organization already has many federal grants, including first-time grants from a new funding source, your cognizant audit agency will review and approve your rate. Typically, this is the agency that awards the greatest share of your total grant and contract funding.

Unfortunately, an approved cost rate doesn't necessarily guarantee full cost recovery. Let's say you've done all the numbers, submitted your proposal, and have a fully executed indirect cost rate in hand approved by a federal agency. And let's say the agreement entitles you to recover indirect costs at an approved rate of 44%. You might assume that you will be reimbursed for indirect costs from all agencies consistently, since the agreement constitutes a government-wide rate. In practice however, you'll often get less than that 44%, and in some cases, nothing at all.

Why? Many federal grants now have caps of 20% on rate recovery, or caps of 20% on administration-including indirect costs. And some agencies will not allow indirect cost recovery at all.

Moreover, certain federal funders refuse to acknowledge eligible indirect costs at the time an award is negotiated even though such costs are clearly eligible. In other words, it's not all "by the book" and formulaic. You may have to accept a hard bargain, and sometimes, you may even have to walk away from a grant award if the amount of un-reimbursed indirect cost is so great that it jeopardizes your overall operations.

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