**Annex 11.1. Additional Information on Indirect Rates**

**Alternative Classifications of Direct and Indirect Cost Items**

Two definitions in use for nonprofit organizations in the United States are provided by the Financial Accounting Standards Board (FASB) and by the U.S. Office of Management and Budget (OMB).

FASB Statement of Financial Accounting Standards No. 117 requires nonprofit organizations to report expenses by “functional classification.” The two primary functional classifications are “program services” (direct project costs) and “supporting activities”(management and general administration, fund-raising, and membership development); they are defined as follows:

Program services are activities that result in goods and services being distributed to beneficiaries, customers, or members that fulfill the purposes or mission for which the organization exists. Supporting activities are all activities of a not-for-profit organization other than program services. Management and general activities include oversight, business management, general recordkeeping, budgeting, financing and related administrative activities, and all management and administration except for direct conduct of program services or fundraising activities. Fundraising activities include publicizing and conducting fundraising campaigns; maintaining donor mailing lists; conducting special fundraising events; preparing and distributing fundraising manuals, instructions and other materials; and conducting other activities involved with soliciting contributions from individuals, foundations, government agencies and others. Membership-development activities include soliciting for prospective members and membership dues, membership relations, and similar activities. (FASB Statement No. 117, paragraphs 27 and 28).

OMB Budget Circular A-122, *Cost Principles for Nonprofit Organizations,* provides the following definition of indirect costs for projects funded by the U.S. government (Attachment A, Paragraphs C.1–C.3):[[1]](#footnote-1)

1. Indirect costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective. [Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where the accounting treatment for such cost is consistently applied to all final cost objectives.] . . . After direct costs have been determined and assigned directly to awards or other work as appropriate, indirect costs are those remaining to be allocated to benefiting cost objectives. A cost may not be allocated to an award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to an award as a direct cost.

2. Because of the diverse characteristics and accounting practices of nonprofit organizations, it is not possible to specify the types of cost that may be classified as indirect cost in all situations. However, typical examples of indirect cost for many nonprofit organizations may include depreciation or use allowances on buildings and equipment, the costs of operating and maintaining facilities, and general administration and general expenses, such as the salaries and expenses of executive officers, personnel administration, and accounting.

3. Indirect costs shall be classified within two broad categories: “Facilities” and “Administration.” “Facilities” is defined as depreciation and use allowances on buildings, equipment and capital improvement, interest on debt associated with certain buildings, equipment and capital improvements, and operations and maintenance expenses. “Administration” is defined as general administration and general expenses such as the director’s office, accounting, personnel, library expenses, and all other types of expenditures not listed specifically under one of the subcategories of “Facilities” (including cross allocations from other pools, where applicable).

In addition, Attachment B to OMB Circular No. A-122 specifies categories of cost that are allowable, allowable under certain limitations or conditions, or unallowable for funding by U.S. government grants and contracts. Table A11.1.1 summarizes Attachment B.

Nonetheless, the above guidance still allows a range of differing practices and policies for allocating expenses among the indirect and direct cost categories. As a result, how expenses are allocated between categories varies widely from organization to organization. For example, time spent by the executive director developing and overseeing programs can legitimately be considered a program expense, yet some organizations will place the entire director’s salary into the indirect cost category. Similarly, while rent, utilities, insurance, supplies, and other general expenses are typically included in the indirect cost category, there may be circumstances in which it is more appropriate for an organization to allocate these costs directly to projects. Each organization needs to decide which expenses are legitimately programmatic and which are supportive in order to define its direct and indirect costs. The acceptability of these allocations by auditors and funders will depend on how reasonable and justifiable is the rationale for the decision.

**Case-by-Case Allocation of Indirect Costs**

The case-by-case method of allocating indirect costs is to determine a rate of actual usage for each activity in the organization. In its simplest forms, this approach can be used to account for costs that can easily be tracked. Examples of this approach include keeping track of long distance telephone calls, using a counter or log for photocopying, or using time sheets as a means of allocating the salary cost of managers and administrative staff (such as the executive director, financial manager, or administrative assistant) whose work benefits more than one program or activity. As shown by the example above, a different method can be adopted for each type of cost.

The advantage of this method is that it creates a strong connection between activities and the indirect costs that support them. The disadvantage, however, is that this approach can require a great deal of time-intensive record keeping, even for relatively minor costs. Further, even if complete records are kept, there will still be shared costs that cannot be precisely allocated. (For example, office space costs can be allocated on the basis of the work done by those occupying the space and the amount of space occupied. But how then should the cost of common space, such as hallways, be allocated? Similarly, local telephone service and Internet connections typically have fixed monthly costs, regardless of use, and so do not easily lend themselves to being tracked.)

As a result, most organizations do not rely solely on case-by-case allocation for distributing indirect costs. The choice of whether to rely on case-by-case allocation or use of an indirect cost rate (as described below) depends on two factors:

*Ease of record keeping.* Where automated systems can track costs by project with minimal effort (such as computerized tracking systems for long distance telephone calls or photocopies), using case-by-case allocation distributes costs more accurately.

*Variability of cost across projects.* Where costs vary significantly across projects, case-by-case allocation helps limit cross-subsidization of indirect costs. For example, if the typical project of an organization requires only a nominal number of photocopies, but one project requires a large number of copies (because of a requirement for large-scale distribution of reports, for example), case-by-case allocation will ensure the typical projects do not have to bear a disproportionate share of photocopy costs.

Because of the disadvantages outlined above, the indirect cost rate described in the text may be a more appropriate way to allocate those shared costs that cannot be easily allocated directly to specific activities or projects. That said, there are examples of organizations that use the case-by-case approach. One is the National Council of Family Affairs in Jordan.

# Types of Indirect Cost Rates

As described earlier in Chapter 11, the calculation of indirect cost rates is based on the ratio of indirect costs to a defined direct cost base. The actual ratio of indirect to direct costs can be known only after the accounting period (typically an organization’s fiscal year) for which the rate is defined has been completed; this is typically called a “final” rate. However, because both the organization and funders typically cannot wait until the accounting period is over to bill expenses and pay these bills, indirect rate structures based on a prospective analysis of costs (“provisional” rates or “predetermined” rates) are often used. These different kinds of rates are described below:

*Final rate.* A final indirect cost rate is established after an organization’s actual costs for a given accounting period are known. Once established, a final indirect cost rate is used to adjust the indirect costs initially claimed through provisional rates (see below). The adjustment to actual costs is for the period in which the actual costs were incurred and thus cannot be determined until the end of the period.

*Provisional rate.* A temporary indirect cost rate is established for a future prospective period to permit budgeting and billing/payment of expenses to/by funders until the actual indirect costs can be determined and a final rate established. The provisional rate is usually based on the planned budget of an organization (based on expected expenses and activities). A final rate for a particular year may also be used as a provisional rate in the ensuing year, if anticipated changes in funding levels or costs are expected to be small.

Because the provisional rate is based on the expected activity of the organization (which is likely to be somewhat different than the actual outcome), a provisional rate is subject to later adjustment by issuance of a final indirect cost rate based on actual indirect costs incurred. The organization may then need to either seek additional payment from funders (if the provisional rate was too low and there was under-recovery of indirect costs) or provide refunds to funders (if the provisional rate was too high and indirect costs were over-recovered) for the cost-reimbursement type of agreements between the organization and its funders.

Not all funders ask for this kind of post project reconciliation even when a provisional rate is accepted as the basis for payment.

*Predetermined rate.* A fixed rate is established for a specified current or future period and is not subject to adjustment. A predetermined rate may be used on contracts or grants where there is reasonable assurance that the rate is not likely to vary significantly from a rate based on the organization’s actual costs. This type of rate would be used where the organization has a consistent indirect cost rate over time (for example, because it has a very stable cost structure and funding).[[2]](#footnote-2) Organizations can incur significant financial risk in using this rate, particularly for projects lasting several years.

The use of provisional and final rates is preferable for most organizations for the following reasons:

actual indirect costs are allocated to projects in the period incurred, creating accurate cost information;

there are no prior period indirect costs carried into a future period to burden new or continuing funding;

all indirect costs are properly funded in the period incurred, creating no profit or loss for the organization;

the organization’s accounting system must determine actual costs each year, a capability that ultimately must exist to synchronize accounting, budgeting, and cost allocation; and

the actual cost of services or programs is determined annually and is therefore available for internal management and informed budgeting.

Table A11.1.1 Allowability of Costs under OMB Circular No. A-122

|  |  |  |
| --- | --- | --- |
| Allowable costs | Allowable costs (limited) | Unallowable costs |
| Bid and proposal costs  Bonding  Communications  Compensation for staff  Depreciation/use allowances  Employee morale/health/welfare  Independent research and development  Insurance and indemnification  Labor relations costs  Maintenance and repair costs  Materials and supplies  Meetings and conferences  Memberships, subscriptions, and professional activity costs  Page charges in professional journals  Participant support costs  Plant security costs  Professional service costs/consultant fees  Rental costs  Royalties/costs for use of patents and copyrights  Taxes  Training and education for staff  Transportation costs | Advertising and public relations  Defense/prosecution of criminal/civil proceedings  Equipment/capital improvements  Fringe benefits (including pensions)  Housing and personal living expenses  Idle facilities/idle capacity  Indirect costs associated with donated labor  Interest on debt for capital asset acquisition  Overtime  Patent costs  Pre-award costs  Profits/losses on disposition of depreciable property or other capital assets  Publication and printing costs  Rearrangement/alteration costs  Reconversion costs  Recruiting costs  Relocation costs for staff  Selling and marketing costs  Severance pay  Specialized facilities  Termination costs  Travel costs for staff  Travel costs for trustees | Alcoholic beverages  Bad debts  Contingency provisions  Contributions/donations to other organizations  Entertainment  Fines and penalties  Fundraising  Goods/services for personal use  Interest on borrowed capital  Investment management costs  Lobbying  Losses on other projects  Organization costs (in connection with establishment/reorganization) |

1. On December 26, 2013, OMB published a new “supercircular” that supersedes and streamlines requirements from OMB Circulars A-21, A-87, A-110, and A-122 (which have been placed in OMB guidance); Circulars A-89, A-102, and A-133; and the guidance in Circular A-50 on Single Audit Act follow-up. This new document is available online at <http://federalregister.gov/a/2013-30465>. As general guidance, however, A-122 remains a useful resource. [↑](#footnote-ref-1)
2. Another type of indirect cost rate is a “fixed rate with carry-forward.” In this structure, a fixed rate is established for a period of time to permit budgeting and billing/payment of expenses to/by funders. Actual costs are determined by the organization’s accounting system and the difference in indirect costs as calculated by the fixed indirect cost rate and actual indirect costs is carried forward to a future period (usually the organization’s fiscal year) in order to adjust the fixed rate in the next period for any over- or under-recovery of indirect costs. This structure would only be used where the structure of funding for an organization remains stable over time; otherwise, the structure could result in inappropriate allocation of indirect costs to funders because of the mismatch between a changing funding structure and the shifting of indirect cost recovery out of the period in which the costs were incurred. [↑](#footnote-ref-2)