

Cost Pools, Indirect Rates & Allocation Plans: Demystified



Navigate complexity.

**Maryland Workforce Association
2017 Raising the Bar Conference: Preconference Workshop**

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Introduction



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Brent is a partner in Baker Tilly's Government Contractor Advisory Services practice, located in Tyson's Corner, VA, and has over 20 years of government contract industry experience. He works with a broad array of public and private contractors and non-profit organizations providing consulting, accounting, auditing, and investigative services in a wide variety of industries including aerospace and defense, transportation, energy, healthcare, professional services, A&E, construction, and manufacturing.

The core of Brent's practice is helping clients avoid or resolve challenges and disputes involving complex cost accounting, contract pricing, and regulatory compliance matters arising under the Federal Acquisition Regulation, Cost Accounting Standards, the Truth in Negotiations Act, OMB Uniform Requirements for Federal Awards, and other accounting and contract pricing-related rules and regulations.

Agenda



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- Cost Allowability
- Word Salad: Sorting Out the Cost Allocation Terms
- Cost Allocation Plans vs. Indirect Cost Rates
- Indirect Cost Allocation/Rate Methods
 - Simplified Method
 - Multiple Allocation Base Method
 - Direct Allocation Method
- Types of Indirect Cost Rates
- Q&A

Cost Allowability



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To be allowable, a cost must -

- Be necessary and reasonable for the performance of the Federal award (both direct and indirect). Conform to any limitations or exclusions set forth in Section 200.4XX or the terms of a Federal award.
- Be consistent with policies and procedures that apply uniformly to all of the organizations activities.
- Be accounted for consistently for all awards as either a direct or indirect cost.
- Be determined in accordance with generally accepted accounting principles (GAAP).
- Not be included as part of the cost sharing or matching requirements of any other federally financed program in either the current or a prior period.
- Be adequately documented.

Cost Reasonableness



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A cost is reasonable if, in its **nature** and **amount**, it does not exceed that which would be incurred by a **prudent person** under the circumstances **prevailing at the time the decision was made** to incur the cost. This is particularly important when an organization is predominantly federally-funded.

Additional considerations include whether the cost is –

- Generally recognized as ordinary and necessary for the organization's or program's operation.
- Incurred pursuant to sound business practices, arm's-length bargaining, laws and regulations, and Federal award terms.
- Consistent with market prices for comparable goods or services for the geographic area.
- Consistent with the responsibilities to employees, the public at large, and the Federal government.
- The result of a significant deviation from established practices and policies, which may unjustifiably increase the Federal award's cost.

Cost Principles



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- Governed by 55 specific cost principles (2 CFR 200.420 – 475).
- These cost principles could be the subject of an all-day seminar, so outside of our scope today.
- However, a good rule of thumb (but not universally true): take off your grantee hat, and put on your taxpayer hat. As a taxpayer, would you approve of the Government spending your annual contribution to pay an organization for the particular cost in question?

If the answer is “no,” then the cost is most likely unallowable.

- Don't forget about “credits.” These are things like refunds, rebates, prompt payment discounts, etc. They must be applied to the cost to which they relate. These are not “other income” items.
- Unallowable costs must be identified and excluded from reimbursements, except **the costs of unallowable activities (i.e., fundraising, lobbying, etc.) must receive their fair share of allocated indirect costs.**

Cost Allocation Word Salad



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How many of you use these terms?

- Program costs vs. Administrative costs
- Specific costs vs. Common costs
- Direct costs vs. Indirect costs
- Reimbursable costs vs. Non-reimbursable costs

Each of these pairings has a genesis, a particular meaning, and a useful purpose...but they don't necessarily mean the same things.

Let's create some context. First in words, then in a picture.

Cost Allocation Word Salad (cont'd)



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Federal agencies, state and local governments, educational institutions, and non-profit organizations used these various terms, which created some confusion...

- **Program costs**: expenditures that are specifically identified with, or reasonably attributable to, a particular program. Program costs are generally not accumulated by funding source if more than one.
- **Administrative costs**: expenditures that cannot be identified with a particular program and are generally incurred in connection with running the overall organization.
- **Specific costs**: these are a sub-element of Program costs. They are expenditures specifically identified with a particular program. Some have interpreted this term as synonymous with Program costs, which is not correct.
- **Common (or Shared) costs**: these expenditures cannot be specifically identified to a program; rather they can be either reasonably attributed or allocated to a program. This classification may include some Program costs and Administrative costs.

Cost Allocation Word Salad (cont'd)



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The recent OMB Uniform Guidance consolidates these terms...

- **Direct costs:** expenditures that can be **identified specifically** with a particular final cost objective, such as a Federal award, or other internally or externally funded activity, or that can be **directly assigned** to such activities relatively easily with a high degree of accuracy. **Identification with the Federal award** rather than the nature of the goods and services involved **is the determining factor** in distinguishing direct from indirect (F&A) costs of Federal awards.
- **Indirect costs:** it is not possible to specify the types of cost which may be classified as indirect (F&A) cost in all situations. Indirect costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective.

After direct costs have been determined and assigned to awards or other work as appropriate, indirect costs are those remaining to be allocated to benefitting cost objectives.

Cost Allocation Word Salad (cont'd)



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Typical examples of indirect cost for many nonprofit organizations may include depreciation 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.

For major* and certain other** nonprofit organizations, indirect costs must be classified within two broad categories: “Facilities” and “Administration.”

- “Facilities” is defined as depreciation 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 and all other types of expenditures not listed specifically under one of the subcategories of “Facilities.”

** Major nonprofit organizations are those which receive more than \$10 million dollars in direct Federal funding.*

*** Smaller organizations with major functions that benefit different from indirect costs*

Cost Allocation Word Salad (cont'd)



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One more concept to close out our discussion on direct and indirect costs:

Direct cost \neq Reimbursable cost

Indirect cost \neq Non-reimbursable cost

- A non-reimbursable direct cost cannot be charged to an indirect cost pool.
- An indirect cost cannot be reimbursed a direct cost simply because a grant or funding source says it's permissible to do so.

MORE Cost Allocation Word Salad



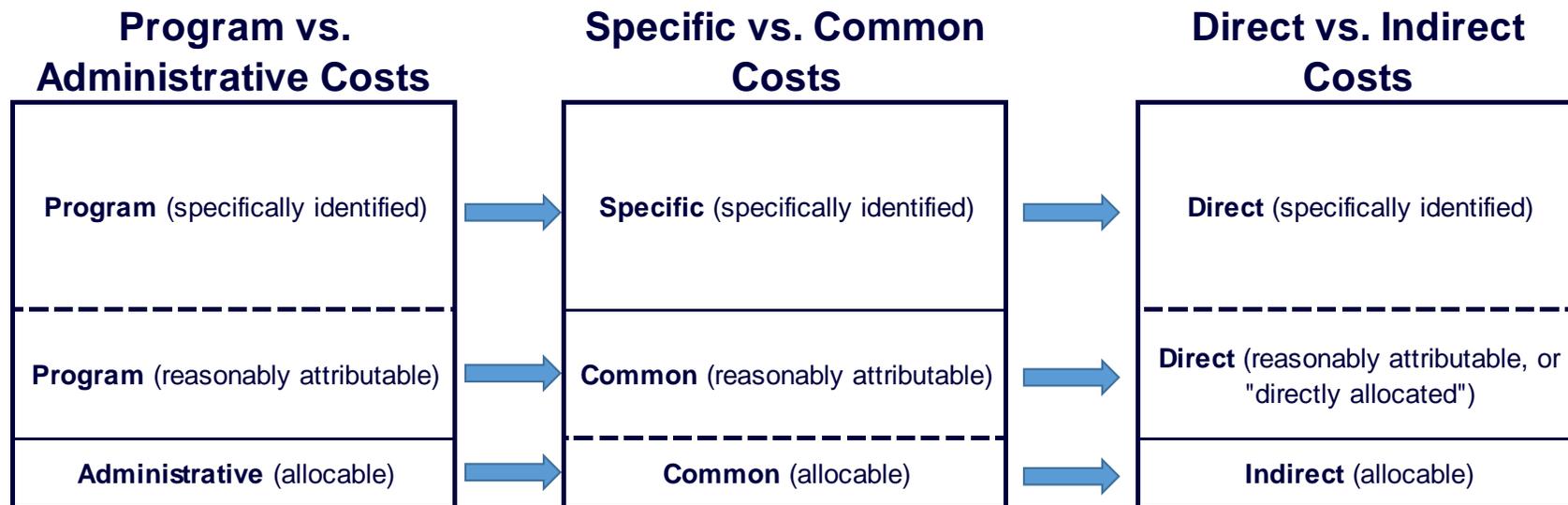
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- **Program:** the collection of activities that fulfills a particular purpose of mission. A program may have more than one funding source.
- **Funding Source:** represents the source of financial assistance to carry out a particular program. This may include government grants, private grants, or cost-sharing covered by the organization's fundraising activities.
- **Cost Objective:** a program, function, activity, award, organizational subdivision, contract, or work unit for which cost data are desired and for which provision is made to accumulate and measure the cost of processes, products, jobs, capital projects, etc. This seems to now be the OMB term synonymous to "**Major Function**" as used in Appendix IV to 2 CFR 200.
- **Final Cost Objective:** means a cost objective which has allocated to it both direct and indirect costs and, in the non-Federal entity's accumulation system, is one of the final accumulation points, such as a particular award, internal project, or other direct activity of a non-Federal entity.

Let's bring all of this together...

Bringing it all Together

The graphic below illustrates how to conceptualize the Word Salad:

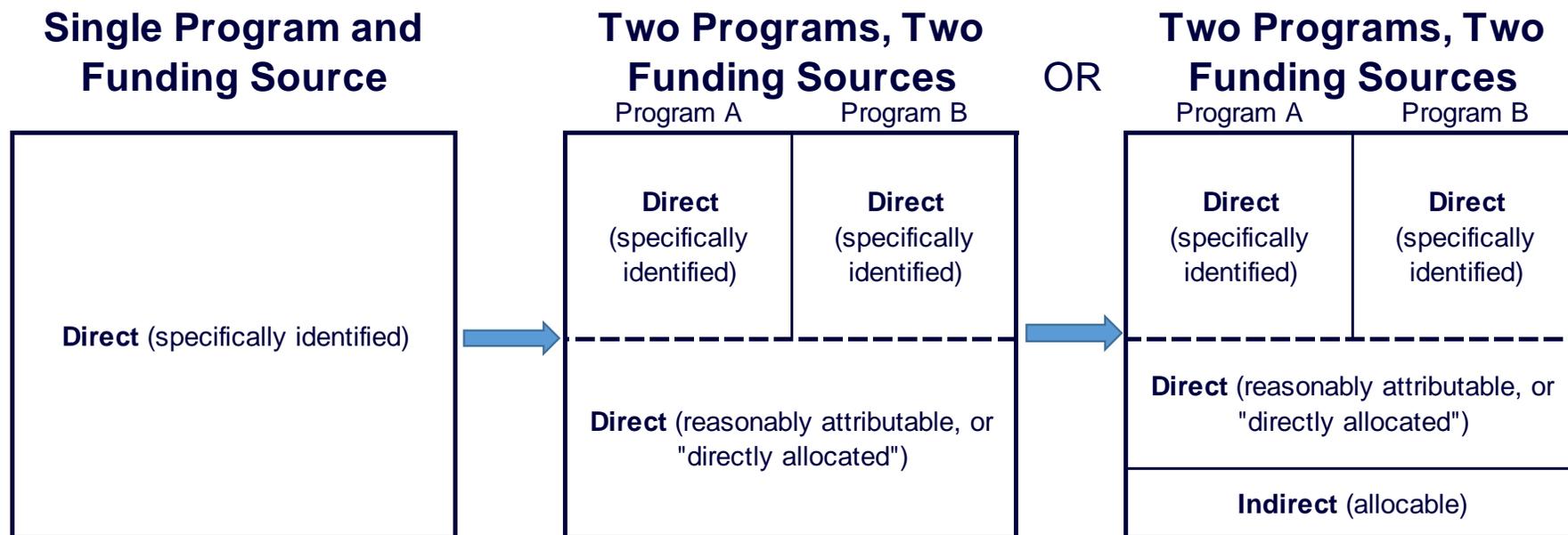


The net result of the recent OMB Uniform Guidance standardizes these terms and better aligns them with the Government's long-standing procurement terms.

Larger nonprofit organizations that perform contracts and grants must follow the procurement rules rather than the OMB grant rules.

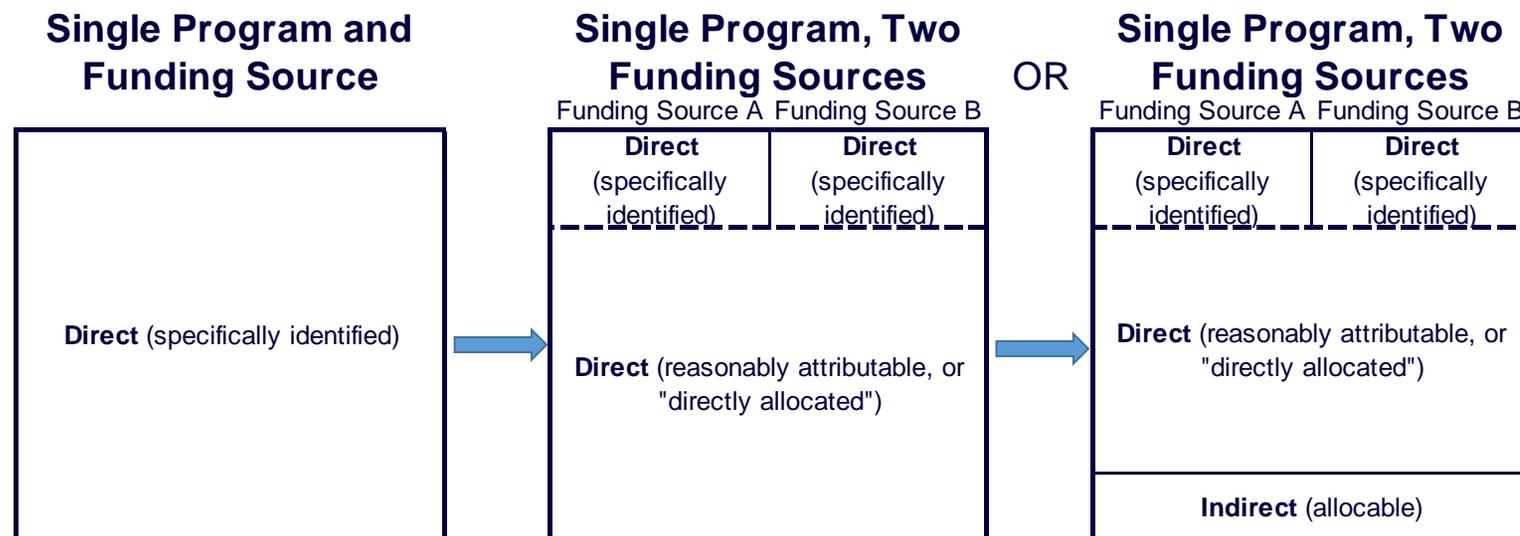
Same Costs by Different Names

This graphic illustrates how these cost accounting concepts might apply if the same organization incurs all the same costs, but under different circumstances (a new/different program):



Same Costs by Different Names (cont'd)

This graphic illustrates how the cost accounting concepts might apply if the same organization incurs all the same costs, but under different circumstances (this time, a new/different funding source for the same program):



Note that the relative amount of “direct” costs have decreased.

- Many resources consumed to perform a single program may not be readily identifiable to a particular funding source.
- Direct attribution or allocation of expenditures to funding sources can become burdensome.
- Organizations may elect to reduce the burden of direct allocations by treating certain costs as “indirect.”

Cost Allocation Plans vs. Indirect Cost Rates



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Cost allocation plans are required for State/Local Governments and Indian Tribes in connection with centralized service functions

Indirect cost rates are required for Institutions of Higher Education and not-for-profit organizations.

Both accomplish essentially the same objective: they demonstrate how the recipients of federal funds define indirect costs and allocate them to benefitting activities.

Cost allocation plans describe the nature of indirect functions/services, identify their costs, demonstrate the method of allocating them, and how much each benefitting activity receives. This forms the basis of the federal assistance received.

Indirect cost rates are similar, except the accumulated costs of indirect activities (facilities and administration) are presented as a percentage of an allocation base. Indirect cost rates facilitate annual federal assistance funding and billing/reimbursement during program performance.

Cost allocation plans can easily be used to determine indirect cost rates, and vice versa.

Indirect Cost Allocation and Rate Calculation Methods



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Simplified Method

May used by organizations with –

- One major cost objective (regardless of funding source(s))
- More than one major cost objective that benefit similarly from indirect costs
- Must have <\$10m in Federal funding

Indirect Rate Calculation Method

- Separately identify direct costs and indirect costs (net of applicable credits)
- Divide indirect costs by a distribution base, which could be:
 - Total direct costs, excluding capital expenditures and other distorting items such as contracts and subawards >\$25,000. (But wait...does this mean MTDC, even though it says total direct costs?)
 - Direct salaries & wages
 - Any other base that results in an equitable distribution of costs.

Indirect Cost Allocation and Rate Calculation Methods (cont'd)



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Multiple Allocation Base Method

Must be used by organizations with

- More than one major cost objective that benefit *differently* from indirect costs
- >\$10m in Federal funding
- But...there could be one more (simpler) option...

Indirect Rate Calculation Method

- Separately identify direct costs and indirect costs (net of applicable credits)
- Further segregate indirect costs into two groups: **facilities & administration**
- Further segregate **facilities** indirect costs into three groups: **depreciation, interest, and operations & maintenance**

Indirect Cost Allocation and Rate Calculation Methods (cont'd)



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Multiple Allocation Base Method (cont'd)

Allocate the four indirect cost groups (three facilities, one administration) to major cost objectives as follows

- Depreciation –
 - Dedicated space **directly** to major cost objectives
 - Assigned space in shared facilities based on **square footage**
 - Common space in shared facilities based on **user or organization-wide FTEs**
 - Parking lots and other capital improvements based on **user FTEs**
- Interest on debt related to facilities – same as depreciation
- Operations & Maintenance of facilities – same as depreciation
- Administration – Modified Total Cost (same as MTDC, but including allocated facilities costs)

Indirect Cost Allocation and Rate Calculation Methods (cont'd)



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Multiple Allocation Base Method (cont'd)

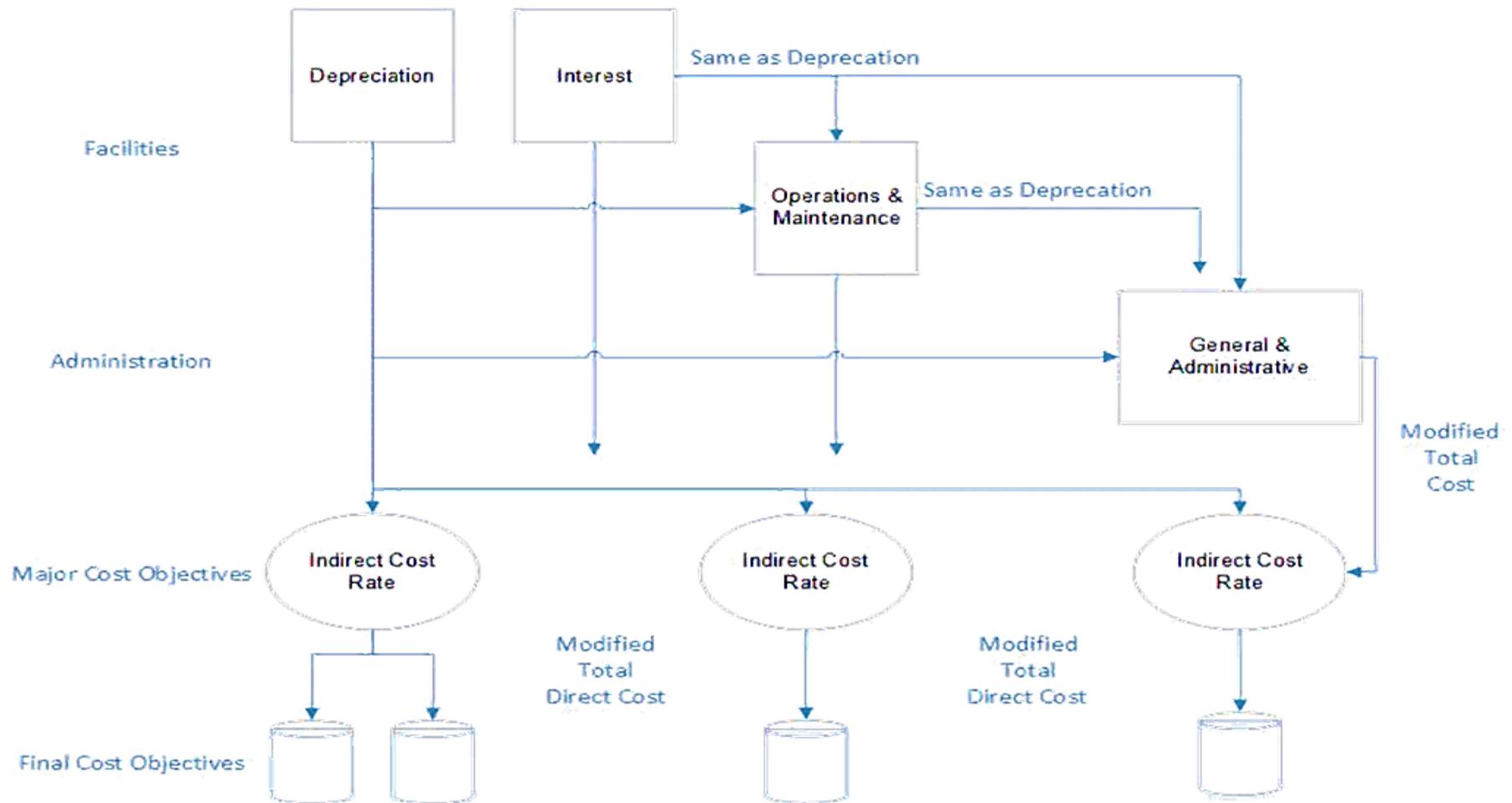
Facilities and Administration costs allocated to each major cost objective must be converted to an indirect cost rate:

- Group the allocated facilities and administration costs into a single cost pool
- Divide by Modified Total Direct Costs of all activities/programs/etc. (i.e., final cost objectives) of the major cost objective.

Modified Total Direct Cost means: all direct salaries and wages, applicable fringe benefits, materials and supplies, services, travel, and subawards and subcontracts up to the first \$25,000 of each subaward or subcontract (regardless of the period of performance of the subawards and subcontracts under the award). MTDC excludes equipment, capital expenditures, rental costs, and most pass-through-type costs.

Indirect Cost Allocation and Rate Calculation Methods (cont'd)

Multiple Allocation Base Method (cont'd)



Indirect Cost Allocation and Rate Calculation Methods (cont'd)



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Direct Allocation Method

May be used by organizations with

- More than one major cost objective that benefit *differently* from indirect costs
- >\$10m in Federal funding

Joint costs (i.e., facilities costs) must be prorated using a base that accurately measures the benefits provided to each Federal award or other activity. The bases must be established in accordance with reasonable criteria, and be supported by current data.

Indirect Rate Calculation Method

- Separately identify direct costs and indirect costs (net of applicable credits)
- Indirect costs = **administration** costs
- Use Simplified Method to calculate Indirect Cost Rate

Types of Indirect Cost Rates



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Predetermined rate: an indirect cost rate, applicable to a specified current or future period, usually the organization's fiscal year. The rate is based on an estimate of the costs to be incurred during the period. A predetermined rate is not subject to adjustment.

Fixed rate: an indirect cost rate which has the same characteristics as a predetermined rate, except that the difference between the estimated costs and the actual costs of the period covered by the rate is carried forward as an adjustment to the rate computation of a subsequent period.

Provisional rate or billing rate: a temporary indirect cost rate applicable to a specified period which is used for funding, interim reimbursement, and reporting indirect costs on Federal awards pending the establishment of a final rate for the period.

Final rate: an indirect cost rate applicable to a specified past period which is based on the actual costs of the period. A final rate is not subject to adjustment and is used to true-up provisional/billing rates and fixed rates

Questions?

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