Indirect Cost Allocation Considerations for Government Entities

Should a municipality develop an indirect cost allocation plan? There are many reasons they may want to including identifying the true cost of delivering services. However, the primary reason is usually recovery of overhead costs for grant funded programs. The decision as to whether or not to develop a plan is usually a simple question of cost versus benefit. Will the entity recover more in overhead than it costs to develop and maintain the plan? While this may appear to be a simple question, several factors need to be considered.

General guidance on cost allocation for federal grant funded programs is provided from the Office of Management and Budget (OMB) through various circulars. For educational institutions the cost principles are discussed in OMB Circular A-21. For state, local and Indian tribal governments, OMB Circular A-87 applies.

What are indirect costs? These are the costs for services shared by many programs within an entity. Frequently the terms “overhead” and “indirect” are used interchangeably. In OMB Circular A-87, indirect costs are defined as costs that are: “(a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved.” Essentially, indirect costs are all of the remaining costs after the direct costs have been charged.

While it is theoretically possible to recover all cost without an indirect cost allocation plan, for most entities this prospect would not be feasible. Some activities such as facilities maintenance, payroll, and information technology do not lend themselves to direct charging. The additional burden of separately tracking and directly charging these costs to the various programs would far outweigh the benefit. At the other end of the spectrum would be to completely ignore indirect costs. Aside from the obvious inability to recover overhead on grant funded programs, by failing to recognize the cost of overhead the entity does not know the true cost of delivering services. Policy makers are forced to make decisions as to what services will be provided without knowing the true cost.

Many entities underestimate the impact of indirect costs. In a climate of shrinking budgets and government continually being asked to do more with less, failing to recognize indirect costs can be a very costly mistake. Knowing the full cost of service is essential not only for requesting grant reimbursements but also for setting fees for services. A recent survey[1] of county cost allocation plans found an average indirect overhead rate of 24%.

As mentioned previously, the decision to implement a cost allocation plan is usually a question of whether or not the entity will recover more in overhead than it costs to develop and maintain the plan. Most organizations assume cost allocation plan development and maintenance will require significant resources. This may not necessarily be the case. Cost allocation models can range in complexity from a simple Excel™ spreadsheet to something more complex such as a full cost accounting module. Several vendors offer software specifically designed for calculating indirect overhead rates for federal grant reimbursements.

How complex does an allocation model need to be? The answer to this question depends on the complexity of the organization. A small city with annual expenditures of $10 million would not need anything more complex than a simple spreadsheet. In fact the OMB allows organizations receiving a small number of federal grants to use a simplified allocation methodology. The following excerpt from OMB circular A-87 describes the simplified allocation methodology:

> *"Where a grantee agency's major functions benefit from its indirect costs to approximately the same degree, the allocation of indirect costs may be accomplished by (1) classifying the grantee agency's total costs for the base period as either direct or indirect, and (2) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. The result of this process is an indirect cost rate which is used to distribute indirect costs to individual Federal awards. The rate should be expressed as the percentage which the total amount of allowable indirect costs bears to the base selected. This method should also be used where a governmental unit's department or agency has only one major function encompassing a number of individual projects or activities, and may be used where the level of Federal awards to that department or agency is relatively small."*

The simplified method, much like other allocation methods, allocates costs proportional to an allocation base. Because the simplified methodology uses a single allocation base such as total direct costs or total direct salaries and wages, the rate calculation is very simple. The simplified

[1] *Performance Audit of County Building Permit and Inspection Fees conducted on behalf of the Washington State Auditor's Office*

method also has the advantage of not requiring the entity to track a great deal of additional data. For the most part the rate can be calculated using existing financial reports.

More complex organizations, or organizations having indirect functions disproportionally benefiting various programs, may need to adopt a multiple allocation base methodology. The overall approach is similar to the simplified method in that costs are allocated proportional to a base. The difference is that costs are divided into multiple pools with a separate base assigned for each. Ideally the base selected correlates to the relative benefit received. For example, facilities costs could be allocated using square footage as a base. When appropriate allocation bases are selected, the multiple allocation base methodology does lead to more rational and reasonable allocations. However, the methodology does create an additional burden in tracking metrics used as allocation bases and increases the overall complexity of the allocation model.

Regardless of the allocation methodology utilized, certain costs cannot be charged to federal grants. Through the applicable circulars the OMB lists these unallowable costs. For example, while it is possible to recover the cost of capital assets through usage allowances or depreciation, the actual capital expenditure is not an allowable cost. Compliance with these restrictions requires the entity to track these disallowed costs to ensure they are not charged to federal grants. It should be noted that even if a cost is disallowed under the OMB circular, it can be charged if specifically addressed in the grant agreement.

Indirect costs are charged to the various programs through an overhead rate. These rates are generally expressed as either a percentage of direct salaries and wages or as a percentage of total direct expenditures. The organization has several different types of rates to choose from.

Provisional Rate – A temporary rate that applies for a specified period of time. This rate is used until the final rate is determined.

Final Rate – The final rate is calculated once the actual expenditures are known.

Fixed Rate – This rate also applies for a specified period of time but is not adjusted when the actual expenditures are known. Instead, any differences between the actual expenditures and the fixed rate are carried forward to the following period.

Predetermined Rate – This rate applies for a specified period of time and is not adjusted when the actual expenditures are known. There is no carry forward with a predetermined rate. These rates are negotiated with the cognizant agency.

While an indirect cost allocation plan does create additional responsibilities for an organization, for most the benefits outweigh the costs. With an average indirect overhead rate of 24% even organizations receiving a small amount of federal support would benefit. In addition to cost recovery from federal grants, organizations benefit from better decision making by knowing the true cost of service. For all but the smallest organizations, developing an indirect cost allocation plan makes good financial sense.

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