

H

B

6

0

8

WHY INDIRECT COSTS?

by: Carl Lake, Controller

Rural Alaska Community Action Program

Indirect costs have been called a number of things over the years: "administrative costs/charges," "overhead," "allowable costs" and "rip-off." Simply speaking, indirect costs are those costs of an organization that cannot be directly charged to any one grant or contract administered by that organization.

Nonprofit organizations are unique in that each and every piece of funding they receive must be accounted for separately and must have its own full set of accounting records. Expenditures under each grant or contract must be reported separately and funding agencies often require different financial and auditing restrictions. This requires the organization to develop complex and sometimes even cumbersome accounting systems to properly account for those dollars in a fiscally responsible fashion.

Some nonprofits are very simple units and, even though they may be very large in dollar volume, administer only one or two grants. Usually these "single-purpose" agencies do not require an indirect rate even though, like all organizations, they do have administrative costs. Since these administrative costs can be readily identified with the programs administered, they are normally charged directly to those program funds.

Other nonprofits are "multi-purpose" organizations which administer a multitude of diverse programs from a number of funding sources. They operate under the theory that it is more efficient in both economic and practical programmatic terms, for one agency to administer a number of programs than for each program to be operated by a separate entity. For example, while it may take \$600,000 to administer a \$7.5 million agency with 25 different grants or contracts, it is demonstrable that, if each grant or contract were provided to

a separate organization, the actual aggregate administrative costs could exceed well over one million dollars.

Because the multi-purpose agency administers a wide variety of grants and the administrative costs cannot be readily identified as applicable to each of the grants or contracts, the agency requires some type of cost allocation plan to allocate the administrative costs to the appropriate funds. Over the course of the last ten years, the Federal government has recognized that non-governmental agencies needed a simplified and unified method to allocate these costs. Therefore, it developed the rules outlined in OMB Circular A-122 (along with other governmental publications) to provide the procedures and principles for establishing and operating an indirect cost rate. Major Federal funding agencies have departments that are responsible for reviewing, negotiating, approving and monitoring indirect cost rates with nonprofit organizations. When an organization receives funding from more than one Federal agency, one of them (normally the one providing the most funding) is designated as the lead ("cognizant") agency. It is the responsibility of that agency to negotiate with the nonprofit to establish an indirect cost rate. The process for establishing an indirect cost rate is very simple in theory: one isolates all of the costs that cannot be charged directly to a grant, divides these costs by the total dollars available to the agency and the resulting figure should be the indirect rate. However, many factors have to be taken into consideration before a final determination is made. Some of the program funds may require demonstrably less administrative attention or management support than others and therefore should be excluded from the base of program dollars and treated as "pass-through" funds with a separate rate. Other funds may be handled at a different location from the main office and require separate treatment with an "off-site" rate. Still other costs, including capital equipment purchases, must be excluded from the program dollar base prior to any rate calculation. Also, the Federal government in its infinite wisdom, may place statutory restrictions on certain programs (eg., CETA, some Aging programs and Weatherization), limiting more than a certain percentage of total funds for administrative costs. This practice places

a greater burden on other funding sources, requiring them to pay more than their "fair share" of administrative costs. There are also grants (eg., some State grants and contracts) that refuse to pay any administrative costs, again adding a disproportionate burden to those funds that do participate in the payment of administrative costs. When these extreme limitations are placed on a program, the administering nonprofit is faced with the decision to simply refuse the program or to accept it and face consequences which, in the extreme, could mean bankruptcy.

There are also a variety of methods used in determining the types of costs that are to be included in the administrative or indirect costs pool. Some agencies, such as RurAL CAP, charge the various programs directly for costs such as rent, telephone (local and toll calls) utilities, janitorial services and copier costs. Since these costs are charged directly to individual grants (with the exception of those portions related directly to the administrative unit) they do not show up in the indirect pool. Consequently, all other things being equal, RurAL CAP would have a much lower indirect rate than other similar agencies. RurAL CAP makes the considerable effort to make these direct charges because some of its funding sources will not permit any allocation of indirect costs and this is the only way these funds can be utilized to pay their appropriate share of these proper administrative expenses.

Other nonprofits pool all of the above charges (with the possible exception of telephone toll charges and, sometimes, rent) into the indirect pool and charge each program its share through an indirect rate charge. This approach is based on the premise that all of the funds are paying proportionately the same share of the costs while receiving the same general benefits.

Another variance in the application of an indirect rate is the base against which one applies the rate. Some agencies simply apply the indirect rate against total program dollars expended while others apply the rate against another figure, such as direct program salaries. Therefore, an agency with an indirect rate of 56% against a direct salary base may not have an actual

rate higher than one with a 26% rate against all available program dollars.

All of the above variations must be taken into account when trying to compare one agency's indirect rate with another. One must also consider that an agency's administrative budget is relatively fixed over a rather wide range of dollar volume. If, for example, an agency's administrative costs are budgeted at \$800,000 with available program dollars of \$6.5 million, the administrative costs will probably stay the same if there is a three to four million dollar fluctuation in program dollars. In this (admittedly over-simplified) example, the indirect rate (if all exclusions and restrictions have been considered) would be 12.3%. If the agency lost \$3 million of funding, the effective indirect rate would be 22.9%. If funding increased by \$3 million, the indirect rate would be 8.4%. This is an over-simplification to be sure but it is important to note that a variety of factors are involved that affect the indirect rate.

There are also a number of factors involved to make sure that the agency does not receive more indirect dollars than it was entitled to for the fiscal year. In the above example, the agency would probably have negotiated a provisional rate of 12.3% from its primary (cognizant) funding source based on projections of costs prior to the beginning of its fiscal year. If additional funds were received during the year and these funds would drastically affect the provisional indirect rate, the agency would probably re-negotiate its rate with its cognizant agency, resulting in a lower rate for all affected funds. In any event, the provisional rate is reviewed by the agency's own auditors and, after audit, by the funding agency itself. If the nonprofit received more indirect funds than it was entitled to, it is required to repay these funds, usually in the form of a reduction in the following year's indirect rate. If the organization received less than it was entitled to, it is obligated to bill each of its funding sources for their share of the difference.

At no time does the organization "profit" from the indirect rate process. The entire procedure is fully monitored both by independent auditors, by officials of the cognizant agency, and by the organization's board of directors and senior management staff. If the nonprofit has under budgeted for necessary administrative costs or overestimated projected funding levels, it will operate in a cash deficient position for a considerable length of time. Renegotiation, recalculation, and reallocation of funds is eventually required (frequently post-facto) in order to bring the books into alignment with reality.

Most multi-purpose nonprofit organizations operate in a functional fashion with a mandated community-based board of directors and an administrative unit consisting of executive management, accounting/data processing, and clerical staff. Costs for these functions are normally considered indirect. The program departments are responsible for one or more grants or contracts and/or share the responsibility for some funds with other departments. To a large degree, the organizational structure is very similar to that of the State government, albeit on a smaller scale. The administrative unit of a nonprofit organization could be equated to the executive branch of State government while the board of directors is similar to the legislative branch. Within the State government at least a large portion of the costs of both the administrative and legislative branches could be considered indirect or administrative costs when related to the programs actually providing services to the citizens of Alaska.

Whatever name one applies, the functions of supervision and oversight are indirect costs, whether the costs are incurred by the State or a nonprofit organization. Skilled management personnel are necessary to administer the variety of funds which are the responsibility of an organization and an impartial body with power and authority to control the actions of that entity is likewise necessary. Like the old football argument concerning the relative importance of the line versus the back-field, you cannot have program operations without some type of policy direction and administrative support. It is recognized

by all nonprofit organizations that every effort must be made to keep administrative costs as low as possible so that as many of the agency's limited funds as possible are available for necessary programs and services. However, if administrative funds are reduced to a level that cannot support the retention of viable policy-making structures with skilled management and accounting personnel, the organization will eventually be unable to operate any program in a responsible and fiscally sound fashion.

If nonprofits were not available to administer programs designed to serve the needs of many of Alaska's citizens, the State would be required to operate these programs. This eventuality would not only increase the size of government (a trend that the current legislature is seeking to reverse), it would also increase its costs. Clearly, it is in the State's interest to use existing service delivery networks that are directly responsive and responsible to the people they serve. The acceptance of the necessity for indirect costs to support these structures, and the implementation of comprehensive and uniform policies for contracting with the nonprofit sector will increase the efficient use of State funds.