Indirect Costs

A Guide for Foundations and Nonprofit Organizations

Rand

ISBN: 0-8330-0708-4

The Rand Publication Series: The Report is the principal publication documenting and transmitting Rand's major research findings and final research results. The Rand Note reports other outputs of sponsored research for general distribution. Publications of The Rand Corporation do not necessarily reflect the opinions or policies of the sponsors of Rand research.

Published by The Rand Corporation

R-3376-COF

Indirect Costs

A Guide for Foundations and Nonprofit Organizations

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January 1986

Prepared in cooperation with
The Council on Foundations

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PREFACE

This guide was developed to provide the staffs of foundations and their nonprofit grant applicants with a basic understanding of the issues associated with indirect costs and with a framework for determining how such costs should be handled. It includes checklists to help guide the presentation and review of indirect costs in proposal budgets.

The guide was prepared jointly by The Rand Corporation and Coopers & Lybrand in cooperation with the Council on Foundations. Sponsors of the background work and publication of the guide include:

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The project team worked in cooperation with the Council on Foundations' Task Force on Indirect Costs, which was created in the fall of 1984 by James Joseph, President and Chief Executive Officer of the Council. Members of the Task Force are listed below:

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This guide has benefited from the input of many individuals, including project team members Rae Archibald, Kenneth Krug, and Albert Williams. It is based in large part on a briefing delivered by the authors to the Task Force at the April 1985 conference of the Council on Foundations in Washington, D.C. A revised briefing was delivered to the staff of The Ford Foundation in New York City in May 1985.

Several individuals contributed especially helpful reviews of earlier drafts of the guide: Diana List Cullen of the Charles Revson Foundation; John E. Craig, Jr., and Margaret E. Mahoney of the Commonwealth Fund; Stewart F. Campbell of the Alfred P. Sloan Foundation; Elizabeth T. Boris of the Council on Foundations, who consolidated the suggestions of several Task Force members; and Gene Fisher and Mary Vaiana of The Rand Corporation. Janet DeLand, also of Rand, provided valuable editorial assistance.

The authors of the guide express their appreciation to the institutions that supported the project and to all the individuals who responded to questions, reviewed briefings, and commented on drafts. Any errors that remain are, of course, the authors' own. Like other Rand publications, this guide does not necessarily reflect the policies or opinions of its sponsors.

SUMMARY

Indirect costs are costs for activities that benefit more than one project and for which it is difficult to determine how much each project should pay. Jointly beneficial activities present organizations with several policy problems: specifying which activities are to be handled as indirect costs, defining measures of their benefit, and ensuring that these costs are allocated equitably.

When a nonprofit organization applies to a foundation for support, misunderstandings concerning indirect cost policies can arise between grantmaker and grantseeker. The nonprofit's policies for handling indirect costs may not be evident to the foundation and may not be compatible with the foundation's policies for supporting such costs. Foundations and nonprofits often have difficulty communicating about indirect costs. Discussions are frequently conducted without a common understanding of indirect costs or a framework for assessing the many ways they are defined, distributed, and displayed in proposal budgets.

To determine the current range of perspectives, policies, and practices regarding indirect costs, we interviewed representatives of more than two dozen community, corporate, and private foundations encompassing a broad range of sizes, geographic locations, and funding interests. We also interviewed representatives of more than two dozen grant recipients, including service organizations, teaching colleges, research institutions and universities, and arts and performance groups.

This report is intended to help parties on both sides of the grantmaking process to better understand the policy issues associated with indirect costs. It examines the range of foundation and nonprofit concerns, practices, and policies regarding indirect costs; develops a common conceptual framework for understanding indirect costs; and provides guidelines for presenting and reviewing indirect costs in proposal budgets.

Misunderstandings about the handling of indirect costs arise from a variety of sources:

- Definitions of indirect costs vary. Because jointly beneficial costs are impractical to trace directly to projects, they are not a fixed set of costs. Each organization must make a policy decision concerning which costs to allocate on an indirect basis.

- Organizations may aggregate their indirect costs into "pools" before allocating them across the projects that they benefit. Pooling reduces the number of allocation decisions that must be made, but it obscures details that foundations may wish to see. Moreover, the contents of similarly titled pools may vary from one applicant to another.
- Methods of allocating indirect costs vary widely. The methods fall into two groups: case-by-case allocation and pro rata allocation. In the case-by-case method, indirect costs (or cost pools) are allocated by weighing various factors, such as estimated benefits from the activity, the project's ability to bear the cost, and the funding source's willingness to pay it. The pro rata method allocates each indirect cost or cost pool by applying an indirect cost rate, i.e., a ratio of indirect costs to some measure of activity or benefit.
- Budget formats vary widely, and it may be impossible to infer from the presentation how the applicant organization defines, aggregates, or allocates indirect costs.

Foundations and nonprofit grant applicants agree that indirect costs issues should not dominate or distort the grantmaking process. Nevertheless, they occasionally have different perspectives on the support of indirect costs.

Foundations want their grant recipients to have the resources required to fulfill their sponsored missions, but they may not wish their grants to be used to pay for activities that are not related directly to the goals of sponsored projects. Some foundations consider some indirect costs to be in this category.

Foundations vary in their support of indirect costs. Many foundations lack explicit or uniform policies concerning support of indirect costs, and existing policies do not always accord with practice. Many foundations respond fully to the requests of nonprofits for indirect cost support, while others have a policy of paying for no indirect costs. Some may pay more indirect costs than they realize because they do not understand how a grant applicant handles specific costs.

From the perspective of nonprofit grant applicants, indirect costs are necessary outlays that must be reimbursed. Nonprofits usually try to ensure that each project pays a share of each indirect cost that is commensurate with the benefit it derives. This often means ensuring that each funding source also pays its fair share.

Nonprofit organizations differ widely in their requests for support of indirect costs. Some may not request full support of indirect costs; some may not be aware that they may request such support; some overlook or underestimate costs; some are able to subsidize indirect costs by using other funds, such as endowment income or general support grants.

Given these wide variations, some misunderstandings must be expected to arise, but they can be minimized. The following questions can guide both nonprofit organizations and foundations in the presentation and evaluation of proposal budgets:

- Are all indirect costs represented?
- Are indirect costs explicitly identified?
- How are indirect costs aggregated?
- How have the indirect costs and cost pools been allocated?
- If the pro rata allocation method has been used, is the means of calculating the indirect cost rate specified?
- Which indirect costs will the foundation cover?
- Are the costs reasonable? Do they reflect the project's activities and the organization's mission? Are they comparable to costs at similar organizations in similar settings?
- Are the costs documentable?
- Is there any provision for adjusting the indirect cost support after the actual costs have been determined?

This checklist is not intended to prescribe how budgets should be formatted or policies formulated. Rather, it is intended to assure that foundations and nonprofit organizations attempting to communicate concerns regarding indirect costs can work within a common conceptual framework. In this way, nonprofit organizations will better understand the full costs of their projects, and foundations will better understand what they are actually funding.

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I. INTRODUCTION

Indirect costs are costs for activities that benefit more than one project and for which it is difficult to determine how much each project should pay. Jointly beneficial activities present organizations with several policy problems: specifying which activities are to be handled as indirect costs, defining measures of their benefit, and ensuring that these costs are allocated equitably.

When a nonprofit organization applies to a foundation for support, misunderstandings concerning policies for handling indirect costs can arise between grantmaker and grantseeker. The evaluation process for grant applications implicitly subjects the nonprofit's indirect cost policies to external review. These policies are often not evident to the foundation, and they may not be compatible with the foundation's own policies. For example, a nonprofit organization may request support for indirect costs that the foundation does not ordinarily cover. Moreover, many of the activities that an organization handles as indirect costs may not appear to directly support a given project's central purpose, even though they are clearly necessary—for example, administration and maintenance. If an organization does not have policies that distribute these costs equitably, some projects may unfairly benefit from the budgets of others.

A foundation and a nonprofit organization may have difficulty communicating about indirect costs. Grantor and grantee frequently lack a common understanding of indirect costs or a framework for assessing how they are defined, distributed, and displayed in proposal budgets. The result is often confusion and frustration.

This guide was developed to help parties on both sides of the grantmaking process better understand the policy issues and mechanisms associated with indirect costs. To determine the current range of perspectives, policies, and practices regarding indirect costs, we interviewed representatives of more than two dozen community, corporate, and private foundations encompassing a broad range of sizes, geographic locations, and funding interests. We also interviewed representatives of more than two dozen grant recipients, including service organizations, teaching colleges, research institutions and universities, and arts and performance groups.

The interviews revealed several sources of misunderstanding:

- Foundations and their prospective grantees frequently have different perspectives on indirect costs; for example, they may have different views on what constitutes a "reasonable" cost.
- Foundations vary in their support of indirect costs; many lack explicit or uniform policies, and the policies that do exist may not always accord with practice.
- Grant applicants' policies for defining, grouping, and allocating indirect costs vary widely, and many organizations lack clear policies.
- Budget formats also vary widely, and an organization's procedures for handling indirect costs may be impossible to infer from the presentation.

Representatives of both the foundations and the nonprofits we interviewed agreed that concerns about indirect costs should not dominate or distort the grantmaking process, yet the wide variation in indirect cost policies often leads to misunderstandings and policy conflicts between grantor and grantee.

This document is intended as a basic guide to the policy issue associated with the definition, allocation, and support of indirect costs. It is directed primarily at those staff members of foundations and nonprofit grantee organizations who prepare or review proposal budgets but who lack professional financial expertise.

The questions raised by our interviewees regarding indirect costs often reflected their respective roles as grantmakers and grantseekers. Foundation staff members, for example, asked:

- Why are some nonprofit grant applicants concerned about support for indirect costs?
- Why do indirect costs vary from one nonprofit to another?
- How do nonprofits allocate indirect costs so that each project and funding source pays its fair share?
- How are indirect cost rates determined, and why do those rates vary?
- Why do some proposal budgets appear to contain no indirect costs?

Grant applicant organizations, on the other hand, asked:

- Why are some foundations concerned about the indirect costs of their grant applicants?
- What indirect costs will foundations support?
- Why do some foundations limit the total indirect costs they will support in a project?

- How can we present indirect costs in proposal budgets so as to address foundation concerns?

This report attempts to provide straightforward answers to such questions by developing a conceptual framework to facilitate discussion of the issues associated with indirect costs. Section II examines the organizational policies that define and aggregate indirect costs. Section III explains two common methods of allocating such costs among projects. Section IV examines the use of indirect cost rates. Section V illustrates how indirect costs are typically presented in proposal budgets. Section VI examines foundation and grant applicant perspectives on the support of indirect costs and presents checklists that may be used to guide the presentation and review of indirect costs in proposal budgets.

We have not attempted to formulate specific policy recommendations. Because both foundations and grantees vary widely in their structures and missions, appropriate policies for supporting and handling indirect costs must be specifically tailored to accommodate this variation.

II. DEFINING AND AGGREGATING INDIRECT COSTS

Misunderstandings concerning indirect costs often arise between foundations and their nonprofit grant applicants because of variations in definitions and practices. A foundation and a nonprofit may not agree on what an indirect cost is, and they may not even realize that they disagree. This section examines the sources of such misunderstandings.

DIRECT VS. INDIRECT COSTS

The most conventional, and probably the most convenient, way of defining indirect costs is to distinguish them from direct costs. Table 1 illustrates this distinction.

Direct costs are those for activities or services that benefit specific projects, e.g., salaries for project staff and materials required for a particular project. Because these activities are easily traced to projects, their costs are usually charged to them directly on an item-by-item basis.

Table 1

DIRECT VS. INDIRECT COSTS

Direct Costs		Indirect Costs	
Characteristics	Examples	Characteristics	Examples
For activities that benefit single projects	Labor: project staff consultants	For activities that benefit multiple projects	Labor: maintenance personnel, executive officers
Benefits easily traced	Materials: items required for specific projects	Benefit to each project difficult to measure	Materials: misc. bulk supplies (pencils, pens, paper); materials for indirect labor
Directly charged on item-by-item basis		Allocated among projects according to equitable, practical benefit measure	

Indirect costs are those for activities or services that benefit more than one project. Their precise benefits to a specific project are often difficult or impossible to trace. For example, it may be difficult to determine precisely how the activities of the director of an institute benefit a specific project, even though everyone agrees that a benefit does accrue.

It is possible to justify the handling of almost any kind of cost as either direct or indirect. Labor costs, for example, can be indirect, as in the case of maintenance personnel and executive officers; or they can be direct, as in the case of project staff members. Similarly, materials such as miscellaneous common supplies purchased in bulk—pencils, pens, paper—are typically handled as indirect costs, while materials required for specific projects are charged as direct costs.

ORGANIZATIONAL POLICIES DEFINING INDIRECT COSTS

An organization must make policy decisions defining indirect and direct costs. Table 2 shows some typical direct and indirect costs and some items that may be handled either way. The costs of project staff, consultants, project supplies, project publications, and travel are usually charged directly to projects. Other costs are almost universally handled as indirect costs, e.g., utilities, rent, grounds maintenance, custodial services, and administrative staff. But there is a large gray area of items—such as telephone use, computer use, project clerical personnel, postage, stationery, office supplies, and office equipment—that are handled as direct charges by some organizations and as indirect costs by others.

Where an organization draws the line between direct and indirect costs represents a tradeoff between efficiency and equity. When many projects share an activity that is difficult to measure, it can become very expensive—and may in fact be impossible—to track precisely the benefit to each so that the cost can be charged directly. It may be more efficient to calculate the total costs of the shared item and then to specify a measure of each project's benefit by which to determine its fair share. Section III describes two methods for doing this.

In some cases, direct charging and indirect allocation may be combined. For example, long distance calls may be charged directly to projects, while other telephone charges are allocated among them as indirect costs. Projects that are expected to be "telephone intensive" may be charged directly for all telephone use to ensure that they pay their full share of the costs.

Table 2

A POLICY DECISION DISTINGUISHES BETWEEN DIRECT AND INDIRECT COSTS

Costs Usually Charged Directly	Costs Either Charged Directly or Allocated Indirectly	Costs Usually Allocated Indirectly
Project staff	Telephone charges	Utilities
Consultants	Computer use	Rent
Project supplies	Project clerical personnel	Grounds maintenance
Publications	Postage, stationery	Custodial services
Travel	Office equipment	Administrative staff
		Fringe benefits

Costs in the gray area can become points of contention between foundations and grant applicants. An organization may handle as indirect costs some items that a foundation prefers to see charged directly to projects. In such cases, the total indirect costs shown in a proposal budget may appear unreasonably high to the foundation. Unless the foundation and the applicant understand that this impression results from differing definitions, it may be difficult for them to negotiate effectively.

Once differences in definitions have been recognized, a nonprofit may be able to present the proposal budget in terms that are more familiar to the foundation. This can become a burdensome process, however, especially for nonprofits that deal with many foundations whose indirect cost support policies vary, and it is unlikely that many nonprofits will change their handling of indirect costs to accommodate different policies. Moreover, a nonprofit may not be free to change its indirect cost policies. An organization that relies heavily on one funding source, such as a federal agency, may define and handle indirect costs to meet that source's requirements. For example, the organization may be required to allocate indirect costs consistently across all projects to ensure equity.

POOLING INDIRECT COSTS

Not only do organizations define indirect costs differently, but many also group them differently before allocating them to projects. To reduce the number of allocation decisions that must be made, organizations often group related indirect costs into "cost pools." For example, it may be more efficient to combine the executive director's time with his secretary's time into an administration pool with other related costs, rather than trying to allocate their costs among individual projects. Operations and maintenance costs are also commonly pooled.

Pooling indirect costs in this manner can also lead to misunderstandings between foundations and grant applicants. Pools obscure details, and foundations may not be able to determine what indirect costs are included in a given pool. In addition, pools are defined differently in different organizations, and foundations may be unable to judge whether the support requested for a particular activity is reasonable or typical.

III. ALLOCATING INDIRECT COSTS

The central problem that indirect costs pose is that of measuring the benefits of activities they represent so that they can be allocated equitably among projects. Because these benefits are difficult to measure, the allocation of costs can only be approximate, whatever allocation method is used.

There are many allocation methods, but for simplicity we have grouped them into two categories: case-by-case allocation and pro rata allocation.

CASE-BY-CASE VS. PRO RATA ALLOCATION

Case-by-case allocation is based upon a judgment of each project's benefit from each indirect cost or cost pool. Other considerations may also be weighed, including the project's ability to cover costs, the funding source's willingness to cover certain costs, and the organization's overall financial situation. This method is typically used by organizations that lack (and may not need) advanced accounting capabilities. Case-by-case allocation produces specific solutions to specific problems, not a uniform methodology.

Pro rata allocation, by contrast, is based solely on uniformly applied measures of the benefits derived from indirect cost activities. Additional factors, such as a project's ability to bear indirect costs, are not considered.

Pro rata allocation typically has four steps:

1. Define a measure for each indirect cost that reflects the benefits of the service provided. For example, an appropriate measure for administrative costs might be direct salaries; square footage might be an appropriate measure for rental costs.
2. Group related indirect costs into cost pools. This step is optional, and not all indirect costs need be pooled. For pooling purposes, costs are considered related if they can be allocated to projects using the same measure of benefit. Both rent and utilities, for example, might be allocated on the basis of square footage.
3. Construct an "indirect cost rate" for each indirect cost or cost pool by determining the ratio of the organization's total costs

in that category to a selected "base" representing the total activity in the category. For example, an organization that handles rent as an indirect cost and pays $12,000 per year for 1,200 square feet of office space would have an indirect cost rate for rent of $10 per square foot. This is the ratio of total annual rent costs to a base of total square footage.

4. Allocate each indirect cost to projects on a pro rata basis by multiplying each project's share of the base by the appropriate indirect cost rate. A project with an annual rental rate of $10 per square foot that occupies 500 square feet would pay $5000 per year.

This methodology ensures that the indirect costs paid by each project are proportionate to the benefit received from the activities those costs represent. By using square footage as a measure of benefit for rent costs, an organization can ensure that a project that occupies a large share of floor space pays a proportionately large share of the rent. Similarly, if the costs of the personnel office are allocated on a per-head basis, projects with many staff members will pay more than projects with smaller staffs.

The pro rata allocation method is typically used by nonprofit organizations that frequently receive federal research grants. However, some other organizations also use it.

BUDGETS ILLUSTRATING THE ALLOCATION METHODS

To illustrate the differences between the case-by-case and pro rata allocation methods, let us compare three versions of a proposal budget for the same project for one year. One version illustrates the case-by-case method; the other two illustrate the pro rata method. To avoid implying that one method is necessarily more advantageous than another, all three budgets are shown to yield the same total project costs. However, because both allocation methods can yield only estimates, it is unlikely that the totals would be precisely the same in practice.

Table 3 shows a project budget for a youth service organization that allocates all indirect costs except fringe benefits on a case-by-case basis. Percentages of the annual personnel costs are shown in parentheses in terms of full-time equivalents (FTE); this hypothetical project, for example, will employ the equivalent of two full-time clinical social workers for one year. The FTE measure is used because the project may employ two workers full time or one full-time worker and two half-time workers, or some other combination.

Table 3

BUDGET FOR A YOUTH ORGANIZATION, ILLUSTRATING CASE-BY-CASE ALLOCATION

	Project Director (.50)	$ 14,000
	Clinical Social Workers (2.00)	35,000
	Community Liaison (1.00)	13,500
	Psychiatrist (.10)	7,000
*	Secretary (.50)	6,000
*	Fringe Benefits (18% of salaries)	13,600
	Educational Materials	600
	Travel (local mileage)	400
	Equipment	300
*	Office Supplies	200
*	Telephone ($40 for 10 mos.)	400
*	Duplicating	200
*	Postage	200
*	Used Typewriter	500
*	Malpractice Insurance	500
*	Answering Machine	1,000
*	Miscellaneous	6,600
	AMOUNT REQUESTED	$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

We have indicated costs that the organization defines as indirect costs with asterisks. Budgets do not always explicitly identify indirect costs, but for this example, we have assumed that we know the organization's internal policies defining such costs. A foundation attempting to evaluate a budget that does not identify indirect costs would have to ask the grant applicant for this information.

The amounts for each of the indirect costs listed (except for fringe benefits) have been determined individually by calculating each project's share on the basis of various criteria. These would include the project's benefit from the activity and perhaps the project's ability to bear the cost or the funding source's willingness to pay it. The budget does not make explicit the project's proportional share of each indirect cost item or the grounds for each allocation.

The amount for fringe benefits was derived using the pro rata allocation method, i.e., with an indirect cost rate. Fringe benefits are almost universally allocated as a percentage of direct project salaries and wages.

The second budget for the same project (shown in Table 4) allocates all the indirect costs by a pro rata allocation method. The organization has defined an appropriate measure of benefit for each indirect cost activity and applied this measure uniformly to determine each project's share of each cost. For example, the measure for secretarial support might be the number of personnel to be supported. Using such measures, the organization has established the project's proportionate share of each indirect cost. For all the indirect costs except the secretary and fringe benefits, these shares are shown parenthetically as percentages of the organization's total annual costs in that category. (Many

Table 4

BUDGET FOR A YOUTH ORGANIZATION, ILLUSTRATING PRO RATA ALLOCATION WITH RELATIVELY DISAGGREGATED INDIRECT COSTS

	Project Director (.50)	$ 14,000
	Clinical Social Workers (2.00)	35,000
	Community Liaison (1.00)	13,500
	Psychiatrist (.10)	7,000
*	Secretary (.50)	6,000
*	Fringe Benefits (18% of salaries)	13,600
	Educational Materials	600
	Travel (local mileage)	400
	Equipment	400
*	Office Supplies (30%)	300
*	Telephone (60%)	400
*	Duplicating (30%)	100
*	Postage (30%)	300
*	Used Typewriter (30%)	400
*	Malpractice Insurance (40%)	600
*	Answering Machine (30%)	900
*	Miscellaneous (30%)	6,500
	AMOUNT REQUESTED	$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

budgets, however, do not include this level of detail.) The percentages vary because appropriate measures for different items vary. Telephone costs may be based on number of extensions; malpractice insurance, on the percentage of professionals' time; office supplies, on the project's share of the organization's total direct costs (TDC). In addition, dollar amounts for some indirect costs vary from those in the previous budget for the same project; this would be the case, for example, with office supplies and postage. The estimates in Tables 3 and 4 differ because the two budgets were developed using different allocation methods. With the case-by-case method, the allocation decision includes many factors; with the pro rata method, a single measure is used to determine each project's share of each indirect cost.

The third budget (Table 5), also for the same project, again uses the pro rata allocation method, but most of the indirect costs have been aggregated into a single pool called General and Administration (G&A). This pool contains the office supplies, telephones, duplicating, postage, typewriter, insurance, answering machine, secretarial support, and miscellaneous costs listed in the preceding budget. As an equitable measure of benefit for the G&A pool, the organization has defined total

Table 5

BUDGET FOR A YOUTH ORGANIZATION, ILLUSTRATING PRO RATA ALLOCATION WITH HIGHLY AGGREGATED INDIRECT COSTS

	Project Director (.50)	$ 14,000
	Clinical Social Workers (2.00)	35,000
	Community Liaison (1.00)	13,500
	Psychiatrist (.10)	7,000
*	Fringe Benefits (18% of salaries)	12,500
	Educational Materials	600
	Travel (local mileage)	400
	Diagnostic Equipment	300
		83,300
*	G&A (20% of total direct costs)	16,700
	TOTAL COSTS	$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

project direct costs. Each project is then charged 20 percent of its total direct costs to cover indirect costs. This project is charged 20 percent of $83,300, or $16,700.

Fringe benefits are handled separately from the other indirect costs and are calculated using a base of direct project salaries rather than total direct project costs. Following conventional practice, fringe benefits are included in the sum for the project's total direct costs, because they are closely associated with direct salaries.

These three budgets, all for the same project, illustrate three problems in the allocation of indirect costs. First, organizations vary in the methods they use to allocate indirect costs equitably among projects and may mix methods. Second, it may be difficult to infer the organization's allocation methods from a project budget. And third, presentation practices may make it difficult to identify indirect costs in a single budget or to compare indirect costs between budgets. Section V addresses presentation practices in more detail.

IV. INDIRECT COST RATES

The pro rata allocation method can be difficult to understand and apply correctly. Particularly troublesome is the notion of an indirect cost rate (sometimes referred to as an overhead rate). This section examines in more detail how such rates are developed and used and explains some of the reasons for their apparent wide variation. We focus on organizations that aggregate their indirect costs into a single pool and thus have a single indirect cost rate.

CONSTRUCTING AN INDIRECT COST RATE

An indirect cost rate is a ratio of indirect costs to some measure of activity or benefit, i.e., a base. Once this ratio is established, an organization can ensure that every project pays its proportionate share of the indirect costs. Projects that are larger in terms of the measure chosen will pay a larger share than smaller projects.

To construct an indirect cost rate, the organization must first define and estimate its indirect costs and an appropriate base. Organizations with a single indirect cost pool commonly use total direct costs as the base; others may use total direct salaries and wages. When defining a base, an organization attempts to select a measure that will be both equitable and practical (not too expensive to calculate). Then the organization must estimate its total annual indirect costs and its level of direct activity.

An indirect cost rate is calculated as follows:

$$\textit{Indirect cost rate} = \frac{\textit{Total annual indirect costs in pool}}{\textit{Base}}$$

Suppose an organization has total annual indirect costs of \$100,000 in a single indirect cost pool, and suppose it defines its base as total annual salaries, which are \$200,000. The indirect cost rate is thus the ratio of \$100,000 to \$200,000, expressed as a percentage: 50 percent.

CALCULATING TOTAL PROJECT COST WITH AN INDIRECT COST RATE

After an indirect cost rate has been constructed, the calculation of total project costs is straightforward. The total project costs are the sum of direct costs plus indirect costs. Indirect costs are calculated by multiplying the project's share of the base by the indirect cost rate. For example, suppose a project is in an organization that has an indirect cost rate of 80 percent, using direct salaries and wages as the base. Suppose that the project has total direct costs of $100,000, of which $60,000 represents salaries and the remaining $40,000 represents nonpersonnel costs. The project's share of the organization's total base costs is $60,000. Multiplying the project's base costs by the indirect cost rate, 80 percent, yields the project's share of indirect costs, $48,000. This amount is added to the project's direct costs, for a total project cost of $148,000.

WHY INDIRECT COST RATES VARY

Preceding examples have used indirect cost rates of 20 percent, 50 percent, and 80 percent. This wide variation is realistic and has many causes:

- Costs of doing business vary regionally. Salaries, utilities, maintenance, and rent all cost more in New York City than they do in St. Paul, Minnesota.
- Different organizations differ in mission, structure, and resources and thus may have different kinds of support activities and different costs. For example, one organization may have a library and publications facilities; another may not.
- Organizations differ in the policies that define indirect costs. Costs charged directly at one institution may be handled as indirect costs at another.
- Organizations define cost pools—i.e., aggregate their indirect costs—differently.
- Organizations vary in their cost-recovery policies. Some are aggressive in their recovery of indirect costs, while others may cover their indirect costs through general fund-raising only.
- Organizations use different bases to calculate their indirect costs, e.g., total direct costs, salaries and wages plus personnel benefits, or simply salaries and wages. Since the indirect cost rate represents a ratio, changing either the numerator (the way in which indirect costs are defined) or the denominator (the measure of activity) will change the ratio.

DIFFERENT BASES PRODUCE DIFFERENT RATES

The examples below illustrate the variation in indirect cost rates that results from the use of different bases. Assume that an organization has the following annual costs:

Direct costs		$1,000,000
Salaries and wages (S&W)	$500,000	
Other direct	500,000	
Indirect costs		400,000
Total costs		$1,400,000

In the first example, the organization calculates its indirect cost rate using a base of total direct costs. In the second example, the same organization uses the smaller base of total direct salaries:

Example 1:
Base of total direct costs (TDC)

$$\frac{400{,}000\ (\textit{Indirect})}{1{,}000{,}000\ (\textit{Base})} \times 100$$

Indirect cost rate = 40%

Example 2:
Base of salaries and wages (S&W)

$$\frac{400{,}000\ (\textit{Indirect})}{500{,}000\ (\textit{Base})} \times 100$$

Indirect cost rate = 80%

The total annual costs and the total indirect costs of the organization remain the same under both scenarios. The indirect cost rates, however, differ dramatically. When the organization uses total direct costs of $1,000,000 as its base, the ratio of indirect costs to level of activity is $400,000 over $1,000,000, or 40 percent. When the organization uses salaries and wages, the base is only $500,000, and the ratio yields an 80 percent indirect cost rate. Thus, redefining the base doubles the indirect cost rate, even though the indirect costs and total costs have not changed.

This example holds an important lesson: *An indirect cost rate cannot be used as the sole basis for gauging an organization's cost-consciousness, efficiency, or performance.* Indirect cost rates are not designed for that purpose.

FEDERALLY REGULATED INDIRECT COST RATES

Organizations that are frequently sponsored by federal agencies may have federally regulated indirect cost rates. Such rates are calculated according to rigorous federal procurement regulations that vary somewhat by sponsor and type of activity. Once an organization becomes involved in this process, it loses a great deal of flexibility in its handling of indirect costs. The federal regulations in effect prescribe key aspects of the organization's accounting system. Moreover, they require that every project in the organization, whether federally funded or not, pay its share of indirect costs, and they stipulate that federal funds must not be used to cover the indirect costs of other projects. The federal indirect cost regulations do not specifically address management efficiency or effectiveness.

V. INDIRECT COSTS IN PROPOSAL BUDGETS

Project budgets vary in their presentation of indirect costs, and many presentations provide little or no information about the applicant's indirect cost policies. A budget may merge or fail to distinguish between indirect and direct costs. It may, for example, group costs into categories such as personnel and nonpersonnel without distinguishing indirect and direct costs within them.

Some budgets represent indirect costs in aggregations that differ from those used in the allocation process. For instance, an organization may group its indirect costs into five pools in the allocation process, but in its proposal budget it may simply aggregate them into a single line, labeled perhaps "indirect costs." Conversely, an organization may lump all of its costs into a single pool and then allocate them across projects; but in response to a funding source's request for a more detailed breakdown of indirect costs, it may disaggregate this lump sum in the budget, applying the same indirect cost rate to each line item.

Budgets may fail to explain or make explicit the allocation method used. The presentation may not make evident, for instance, whether a rate has been applied to estimate indirect costs; likewise, if a rate has been applied, its base may not be evident.

Finally, a budget may mix presentation methods. It may explicitly identify some indirect costs but not others. It may indicate rates for some indirect costs while handling others on a case-by-case basis. And it may aggregate some indirect costs and disaggregate others.

For all these reasons, it is often very difficult to evaluate or to compare indirect costs in budgets, particularly for foundations that do not have substantial experienced staff to handle this task.

ILLUSTRATIVE BUDGETS

Tables 6 through 12 show a series of budgets illustrating these variations. Tables 6 and 7 are alternative presentations of a proposal for a youth service project. (These budgets were also used in Section III to illustrate different allocation methods.) Tables 8, 9, and 10 show alternative presentations of a proposal budget for a research project. Tables 11 and 12 are alternative presentations of a proposal budget for an arts project. As in Section III, asterisks are used to indicate indirect costs in the budgets.

We have not attempted to comment on the relative effectiveness of the formats illustrated here or to set standards for budget formats. These examples are intended, rather, to show that commonly used formats vary greatly in the amount of information they provide on organizational policies for handling indirect costs and that this variation can require a special effort to ensure that indirect costs are clearly understood.

ALTERNATIVE PRESENTATIONS OF A YOUTH SERVICE PROJECT BUDGET

Our first illustrative budget, shown in Table 6, is for a youth service project. This budget includes indirect costs, but it does not explicitly identify them as such. It also does not indicate the allocation methods

Table 6

BUDGET FOR A YOUTH SERVICE PROJECT: EXAMPLE 1

	Project Director (.50)	$ 14,000
	Clinical Social Workers (2.00)	35,000
	Community Liaison (1.00)	13,500
	Psychiatrist (.10)	7,000
*	Secretary (.50)	6,000
*	Fringe Benefits	13,600
	Educational Materials	600
	Travel (local mileage)	400
	Equipment	300
*	Office Supplies	200
*	Telephone ($40 for 10 mos.)	400
*	Duplicating	200
*	Postage	200
*	Used Typewriter	500
*	Malpractice Insurance	500
*	Answering Machine	1,000
*	Miscellaneous	6,600
	AMOUNT REQUESTED	$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

used. A pro rata allocation was used to estimate this project's share of fringe benefits (based on a percentage of direct project salaries), and the case-by-case allocation method was used to estimate its share of the other indirect costs. The budget also fails to make explicit the considerations that led to the specific allocations of specific costs for the project: On what basis, for example, was it determined that the project would require the equivalent of half a secretary's time for a year? (The numbers in parentheses following personnel items indicate the percentage of the annual costs in terms of full-time equivalents (FTEs)—i.e., the equivalent of one person performing that activity for one year.) Similarly, the budget does not indicate the basis on which it was decided that this project should pay $200 for postage or what share of the organization's total postage costs the $200 represents.

Sections of the proposal that justify the budget might clarify such matters. Otherwise, the funding source must know the organization's policies to know which line items are indirect costs and how the organization has allocated them. It is not possible to infer this organization's definitions and allocation methods from the budget. Many of the indirect costs listed here—secretarial support and postage, for example—might be handled as direct costs by another organization.

The budget in Table 7 is for the same project and contains the same indirect cost categories. However, in this example the organization has aggregated and allocated these costs differently.

All of the indirect costs listed individually on the preceding budget—except fringe benefits—are aggregated here into a single pool called G&A (General and Administration). G&A is not labeled as an indirect cost, but this could be inferred, since G&A is a common title for an indirect cost pool. As a result of the pooling, this budget contains much less detail concerning indirect costs than the preceding example. Although G&A is a commonly used indirect cost pool, its precise contents vary from organization to organization.

In this second example, the pro rata method is used to allocate all indirect costs, not just fringe benefits. The budget does not indicate the allocation method explicitly, but again one could infer it. The fact that G&A costs comprise 20 percent of the total direct costs (TDC) suggests that the indirect costs were calculated by applying an indirect cost rate of 20 percent to a base of TDC. (By convention, TDC includes fringe benefits, since they are closely tied to direct salaries.)

Table 7

BUDGET FOR A YOUTH SERVICE PROJECT: EXAMPLE 2

	Project Director (.50)	$ 14,000
	Clinical Social Workers (2.00)	35,000
	Community Liaison (1.00)	13,500
	Psychiatrist (.10)	7,000
*	Fringe Benefits	12,500
	Educational Materials	600
	Travel (local mileage)	400
	Diagnostic Equipment	300
		83,300
*	G&A	16,700
	TOTAL COSTS	$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

ALTERNATIVE PRESENTATIONS OF A RESEARCH PROJECT BUDGET

Table 8 presents an illustrative budget proposal for a large research university or institute with federally sponsored research activities. Indirect costs are calculated by the pro rata allocation method, using a federally regulated indirect cost rate. The base used is modified total direct costs (MTDC), which by definition excludes the large subcontract of $26,000. (Again, fringe benefits are included in total direct costs.) This budget also specifies the percentage of the indirect cost rate that each component represents. Percentages are shown in parentheses for each indirect cost or cost pool. General Administration, for example, represents 6 percent of MTDC. Not all budgets of this type would break indirect costs down to this level of detail.

Table 9 presents an illustrative proposal budget from a college or an institute with few research activities (and no federally sponsored projects). The most striking difference between this budget and the budget in Table 8 is that the indirect cost rate is much lower here, even though total project costs are the same. How can this rate be so much lower? Recall that the rate represents a ratio of indirect costs to a measure of direct activity. This organization has lowered its rate by

Table 8

BUDGET FOR A RESEARCH PROJECT: EXAMPLE 1

Principal Investigator (.50)		$ 18,000
Senior Researcher (.50)		15,000
Research Assistant (.50)		8,000
* Fringe Benefits		10,000
Supplies and Materials		1,000
Computer Services		1,500
Travel (to conference)		500
SUBTOTAL [Modified total direct costs (MTDC)]		54,000
Subcontractor (details attached)		26,000
* Indirect costs (37% of MTDC)		20,000
* General Administration (6%)	$3,240	
* Department Administration (9%)	4,860	
* Sponsored Project Administration (3%)	1,620	
* Library (2%)	1,080	
* Building Use (2%)	1,080	
* Equipment Use (4%)	2,160	
* Maintenance & Operations (11%)	5,960	
TOTAL		$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

adjusting both the numerator and the denominator of that ratio. The numerator has been adjusted by redefining some of the indirect costs of Example 1 (Table 8) as direct costs (clerical assistance, publications, rent, phone, postage) so that they now appear as line items. The organization has also redefined the base as total direct costs (TDC), which includes the large subcontract. By making the numerator smaller and the denominator larger, the organization has changed its indirect cost rate and produced the apparently "low" indirect cost rate shown on the budget. This may have been done in response to a foundation policy specifying a cap on indirect costs, say, 9 or 10 percent of project direct costs. Several foundations have such policies.

Table 9

BUDGET FOR A RESEARCH PROJECT: EXAMPLE 2

Principal Investigator (.50)	$ 18,000
Senior Researcher (.50)	15,000
Research Associate (.50)	8,000
Clerical Associate (.60)	7,000
* Fringe Benefits	12,000
Subcontractor (details attached)	26,000
Supplies and Materials	1,000
Equipment	600
Travel (to conference)	500
Telephone	400
Postage	200
Publications	100
Computer Services	2,000
Rent (1 year; separate space needed)	1,800
SUBTOTAL [Total direct costs (TDC)]	92,600
* Indirect costs (8% of TDC)	7,400
TOTAL	$100,000

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

The budget in Table 10 for the same research project is presented in a very brief format that is common even in proposals from large universities. The budget merges direct and indirect costs and presents them in large aggregations: for instance, professional salaries and fringe benefits have been lumped together. The allocation methods used are also not indicated. Our interviews revealed that some foundation staff members believe that a project represented by such a budget actually has no indirect costs; this is a serious misconception. This budget has the same total project costs as the budgets in Tables 8 and 9 and the same indirect costs, even though the format of the presentation does not indicate how indirect costs have been defined and allocated.

Table 10

BUDGET FOR A RESEARCH PROJECT: EXAMPLE 3

Research Salaries	$ 51,250
Support Staff	8,750
Administration	6,800
Subcontractor (see attached)	26,000
Supplies and Equipment	1,800
Computing	2,000
Rent	1,800
Travel	500
Other (postage, publications, phone, reproduction)	1,100
TOTAL	$100,000

ALTERNATIVE PRESENTATIONS OF AN ARTS PROJECT BUDGET

Tables 11 and 12 present budgets for similar arts projects. Each budget specifies the percentage of total costs that will be covered by ticket sales. Funding sources usually request this information, and many require that ticket sales cover about 60 percent of total expenditures.

The budget in Table 11, more detailed than is typical, lists each indirect and direct cost as a separate line item; however, it does not specify indirect costs as such. Only by knowing the internal policies of the arts organization could one identify as indirect costs items such as the artistic director, the musical coordinator, the performance coordinator, fringe benefits, and administrative support. It also is not apparent from the budget whether these costs were allocated using the case-by-case or the pro rata method.

The budget in Table 12, more typical in format, presents project costs in fewer categories. However, indirect and direct costs have again not been distinguished. Indirect costs here include the artistic director, company manager, rehearsal studio, set supplies, office support, equipment, musical coordinator, and miscellaneous overhead. Several of these costs, such as company manager, are pooled under Administrative Support in the alternative budget. The allocation method is again not indicated.

The total project costs differ in the two budgets, illustrating what can happen when organizations lacking accounting expertise overlook

Table 11

BUDGET FOR AN ARTS PROJECT: EXAMPLE 1

	Dancer Fees	$ 28,000
	Musicians	4,000
*	Artistic Director	2,000
*	Musical Coordinator	2,000
	Costumer	1,500
*	Performance Coordinator	1,000
*	Fringe Benefits	750
	Costumes	400
	Programs	300
	Set Supplies	400
	Lighting Equipment Rental	300
	Theater Rental	500
	Theater Staff	200
	Box Office	300
	Set Transport and Setup	200
	Sound Operator	500
	Advertising	700
	Tickets	100
	Performing Rights	400
	Transportation (local)	300
*	Administrative Support (bookkeeping, office rent, company manager, audit, misc. supplies, furniture, etc.)	5,000
	TOTAL	$48,850
	Income:	
	Ticket Sales (50% of total)	< 24,425 >
	DEFICIT AND AMOUNT REQUESTED	$24,425

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

Table 12

BUDGET FOR AN ARTS PROJECT: EXAMPLE 2

	Dancer Fees	$ 28,000
	Musicians	4,000
*	Artistic Director	2,300
*	Company Manager	1,150
*	Rehearsal Studio	600
*	Set Supplies	500
*	Office Support	400
*	Equipment	600
	Costumer	1,500
*	Musical Coordinator	2,300
	Theater Rental	500
	Theater Staff	200
	Box Office	300
	Set Transport and Setup	200
	Sound Operator	500
*	Misc. Overhead	200
	TOTAL	$43,250
	Income:	
	Ticket Sales (64% of total)	< 27,680 >
	DEFICIT AND AMOUNT REQUESTED	$15,570

NOTE: Since proposal budgets do not consistently or commonly identify indirect costs as such, we have added asterisks to indicate how this hypothetical organization defines its indirect costs.

or misestimate costs. The project that looks more viable (Table 12), in the sense that ticket sales cover a higher percentage of total costs, may in fact be more risky because of weaker financial management.

All the budgets presented above illustrate commonly used formats. They vary greatly in the amount of information they provide concerning the handling of indirect costs, and foundations that are concerned about the support of indirect costs may want to encourage grant applicants to identify these costs more clearly. Foundation guidelines might, for example, specify that all indirect costs be collected under one heading or that the content of indirect cost pools be indicated in detail.

VI. GUIDELINES FOR PRESENTING AND REVIEWING INDIRECT COSTS IN PROPOSAL BUDGETS

This section presents guidelines for grant-applicant and foundation staffs that should help to avoid some of the misunderstandings resulting from the wide variation in proposal formats. The guidelines are presented in the form of two complementary checklists: one to guide grant applicant staffs as they prepare proposal budgets containing indirect costs, and the other to guide foundation staffs reviewing such budgets. These checklists presume an understanding of the issues concerning indirect costs, and each is prefaced with a discussion of the other staff's perspective on the handling and support of those costs.

THE FOUNDATION PERSPECTIVE ON INDIRECT COSTS

When staff members of a nonprofit organization develop the project budget for a grant application, they should have two goals in mind: (1) to ensure that all costs—including indirect costs—have been identified and accurately estimated, and (2) to present them in a way that an outsider can readily understand. Clear policies are needed for defining, aggregating, and allocating indirect costs, and the proposal staff must know and understand the policies of the foundation to which it is applying.

When foundations review proposals, they do not generally focus on indirect costs, nor do they base their funding decisions on those issues. Rather, they usually attempt to judge total costs in relationship to a project's inherent benefit.

Most foundations are willing to pay what they consider to be "reasonable" indirect costs. However, foundation policies concerning the support of indirect costs vary widely, and practice may vary even more widely because of imprecision in both the policies and budget presentations.

Many foundations customarily pay full indirect costs as budgeted in a proposal. Other foundations may pay only a portion of indirect costs—some indirect costs, e.g., fund-raising, may be disallowed. A foundation may be reluctant to pay the full indirect costs of a project in an organization to which it already provides general support, or it may have a policy that specifies a cap on the support of indirect costs.

Because of the wide variation in defining and allocating indirect costs, such policies may lack sufficient detail to be easily applied. For example, a foundation may limit support of indirect costs to 10 or 25 percent but not specify the base to which the rate should be applied.

In some cases, a foundation may decline to pay indirect costs; however, even in these cases, foundations may end up supporting indirect costs inadvertently. Foundations have funded projects in the past without being aware that the budgets contained indirect costs. Some of the sample budgets in Section V illustrate how this misunderstanding might arise.

Grant applicants are frequently concerned that foundation support may not cover the full indirect costs of their projects. Many foundation representatives, on the other hand, indicate that nonprofits should have incentives to keep indirect costs low. Foundation staffs typically feel that grants should not subsidize activities that are not related to the central purpose of the sponsored project. Examples offered only half-jokingly include lawn-mowing and window-washing, as well as recruitment efforts and staff required to administer grants. If a foundation questions such costs, a nonprofit may have to explain why they are needed or why it does not support them with other sources of revenue.

Foundation support of indirect costs may also vary with the nature of the grant applicant. Foundations are especially concerned with project resources when they deal with smaller organizations. The issue of unrelated costs arises chiefly with applicants that are primarily supported by government funding and with larger applicant organizations that have a wide range of activities, of which only a few fall within the foundation's range of interests.

The following guidelines for presenting indirect costs in proposal budgets do not attempt to prescribe how to format budgets or formulate policies. They are intended to help grant applicants design budgets that clearly represent the costs of their proposed projects.

A CHECKLIST FOR PRESENTING INDIRECT COSTS IN PROPOSAL BUDGETS

- **Are all costs represented?** Indirect costs are particularly easy to overlook because they are costs representing activities that benefit more than one project.
- **Are indirect costs identified as such?** Since organizations differ in their policies defining indirect costs, it may be important to indicate which costs your organization handles on an

indirect basis. You may wish to explain what has been handled as an indirect cost and why.

- **If indirect costs have been pooled, is the content of each pool evident?** Pooling may obscure a level of detail that interests a funding source, and because organizations vary in their policies for defining cost pools, a funding source may not be able to infer from even a familiar title (such as Administration) what a pool includes.
- **Is the allocation method evident?** If your organization uses a case-by-case method of allocating indirect costs, you may be asked to explain how you derived the estimates for specific indirect costs in the budgeted project. If your organization uses the pro rata method, you may be asked how the indirect cost rate was calculated, how recently you updated it, and/or what base was used. Answering these questions is particularly important if you feel that your rate may be perceived to be either atypically high or low.
- **Which costs will the foundation allow?** Some foundations have policies that specify costs that they will not support (general fund-raising is a common example of such a cost). You may wish to indicate what you have omitted from your budget in order to comply with a foundation's policies.
- **Are the project's costs reasonable?** Do the costs listed appear to reflect the project's activities and your organization's mission? Are they comparable to the costs of other organizations engaged in similar activities in similar areas? Do they reflect sound management practices?
- **Are the costs documentable?** A funding source may inquire about your accounting system.
- **Is there any provision for adjusting the indirect cost support after the actual costs have been determined?** Such provisions are especially important for small organizations with widely fluctuating funding levels that make it difficult to estimate indirect costs and to allocate them accurately among projects.
- **What other sources of funding or revenue does your organization have?** You may wish to indicate the extent to which your organization supports indirect costs with general revenue or general support grants.

THE NONPROFIT ORGANIZATION PERSPECTIVE ON INDIRECT COSTS

Foundation staff members reviewing proposal budgets are sometimes interested in how the applicant organization handles indirect costs. Some foundations, for example, have policies that place restrictions on the support of indirect costs. To assess an applicant's request for indirect cost support, the staff must examine those costs—both individually and in sum—in light of what they know about the applicant organization. This enables them to fund a level of indirect cost support that will permit the grantee to achieve its sponsored goals without financial difficulty.

Nonprofit grant applicants are most concerned, of course, with finding sufficient funds to pay their indirect costs. A nonprofit that fails to identify and fully recover its indirect costs may encounter financial difficulties that hamper its effectiveness and may threaten its existence.

Because indirect costs are shared costs, nonprofits usually want to ensure that all projects and all funding sources pay equitable portions of them. Nonprofit grantees whom we interviewed expressed concern that a given funding source may reimburse only that portion of a project's indirect costs that are perceived as incremental costs.[1] Unpredictable support of indirect costs may limit an organization to a short-term, project-to-project planning strategy. As a result, a nonprofit may institute a policy prohibiting projects from accepting grants that provide only partial support for indirect costs.

Requests for indirect cost support vary widely. Many nonprofits request full support of indirect costs for a project, either on a line-item basis (listing each cost) or as a lump sum. Surprisingly, perhaps, nonprofits do not always request full support; they may request partial support either inadvertently (most often) or intentionally.

Some nonprofits simply fail to identify or to calculate accurately their indirect costs. For example, a nonprofit may fail to include a project's share of its general administration or maintenance costs in the proposal budget. Many nonprofits do not have professional

[1]An incremental cost is the increase to an existing cost caused by the addition of a new activity. For example, suppose that three projects in an organization share the cost of a telephone system that they benefit from equally. A fourth project is added that derives equal benefit. Because its addition only slightly increases total costs for the telephone system, the new project may wish to pay only the small increase (the incremental cost) rather than the average cost paid by the other projects. Those projects, however, may wish the added project to pay a recalculated average cost so that their own shares will be reduced. In other situations, incremental costs can be greater than average costs. This would have been the case, for example, if the addition of the fourth project had necessitated the installation of a new telephone system.

financial staffs to prepare proposal budgets and must rely on administrators and project staff to identify and estimate costs by "brainstorming." For many nonprofit organizations, especially smaller ones, the problem of identifying and recovering indirect costs is compounded by uncertain funding levels that make it difficult to estimate indirect costs for a given proposal. Even when some costs are predictable, the organization may not know how many projects will be sharing them. In addition, some nonprofits are not aware that they can request support for indirect costs from funding sources.

A nonprofit may intentionally understate the indirect costs of a project in order to make the proposal look more attractive. Others may request only partial outside support of indirect costs because they are able to subsidize those costs using revenue from other sources, such as general support grants, endowment income, or, in the case of universities and colleges, alumni contributions.

The following guidelines for reviewing proposal budgets focus on indirect costs. Like the guidelines for grant applicants, they are not prescriptive. They presuppose that the foundation is concerned with how the grant applicant handles indirect costs, but they do not suggest directions for foundation policies regarding indirect cost support. They are intended to provide foundation staffs with a common framework within which to examine and compare budgets of widely varying formats. When a budget does not indicate clearly how the applicant handles indirect costs, and when indirect cost support is an issue, they can be used as a checklist for querying the grant applicant. They may also suggest ways in which a foundation might develop or modify its own guidelines on what applicants should include in proposal budgets.

A CHECKLIST FOR REVIEWING INDIRECT COSTS IN PROPOSAL BUDGETS

- **Do all costs appear to be represented?** Nonprofit organizations that lack accounting expertise may overlook some of the costs associated with a project. The resulting errors may jeopardize a project's success or even the organization itself.
- **Are indirect costs explicitly identified as such?** Policies defining indirect costs vary from organization to organization. Some budget formats do not indicate whether a given cost is direct or indirect; some budgets classify costs in ways that merge direct and indirect costs (e.g., as personnel and nonpersonnel costs).

- **How have the indirect costs been aggregated?** Nonprofit organizations vary in their policies for pooling indirect costs. Similar pools may have different titles, and pools with similar titles may contain different costs.
- **Is the allocation method evident and reasonable?** Case-by-case allocation and pro rata allocation are the two most common methods. In the case-by-case method, the organization allocates the project a share of an indirect cost (or cost pool) on the basis of certain criteria, such as the project's expected benefit from the cost, the project's ability to bear the cost, the funding source's willingness to support the cost, and the organization's overall financial situation. In the pro rata method, the organization allocates the project a share of the cost by applying an indirect cost rate.
- **If a pro rata allocation method has been used, is the means of calculating the rate specified?** The indirect cost rate is a ratio of indirect costs to a measure of the project's activity (the base). Rates vary widely for many reasons, including variations in how organizations define their indirect costs and their bases. Considered in isolation, a rate cannot be used to gauge the efficiency or cost-consciousness of an organization.
- **Do the organization's projects equitably share its indirect costs?** Is the allocation methodology consistently applied? If not, why not? Who pays any difference? To answer such questions, you may wish to look at the organization's total budget, including other sources of funds.
- **Are any costs unallowable?** Some foundations have policies that specify costs they will not support.
- **Are the individual and total costs reasonable?** Do the costs appear to reflect the project's activities and the organization's mission? Are they comparable to the costs of other organizations engaged in similar activities in similar areas?
- **Is there a reason for adjusting the indirect cost support after the actual costs have been determined?** A provision for adjusting cost support may be especially important for small organizations with widely fluctuating funding levels that make it difficult for them to estimate and allocate their indirect costs accurately. In some cases, a grantee may be required to return unused funds. Such a provision is mandatory for organizations operating under federal contract rules.

Because policies for handling indirect costs vary so widely, occasional misunderstandings between grantor and grantee must be expected. However, such misunderstandings can be minimized if the staffs on both sides of the grantmaking process share a framework for discussing the issues associated with indirect costs. This report provides the basic elements of such a framework. It should assist nonprofit organizations in identifying the full costs of their projects and help foundations to better understand what they are funding.

RAND/R-3376-COF