The In's and Out's of Indirect Costs: Not Just For Accountants

http://charitychannel.com/publish/templates/default.aspx?a=5608&template=print-article.htm

Wednesday, July 06, 2005
Contributed By Liz Nilsen, CFRE

As every nonprofit professional knows, securing operating funds for an organization is a critical, but often difficult, task. Securing those operating funds from a grant can be next to impossible, unless your organization is fortunate enough to have an "angel foundation" that knows your work well and wants to support your start-up efforts. Many new organizations' board members, on the other hand, are puzzled as to why you can't "go get a grant" to cover your basic operating expenses.

On the other hand, the unintended consequences of securing new grants for programs — particularly grants that are fairly large in the context of the organization's size — can be fatal. Almost overnight, the agency may have a great new program, with the staff they've always wanted to hire to run it…yet the Executive Director lies awake at night trying to figure out how to make sure the bookkeeper gets paid to write checks, or how to keep the lights on in the office.

This article isn't going to provide the "magic key" to getting a grant for operating funds — because there isn't one. However, having a good understanding of the concept of "indirect costs" can help both staff and board members better understand which costs can (and should) *legitimately* be requested in the context of a program proposal. A well-crafted indirect cost plan can help make the case to funders that dedicating a portion of their grant to "operating expenses" actually makes sense in the context of program delivery — even when their guidelines say "no operating grants." And if the agency is thinking about moving into the realm of federal funding, understanding the agency's indirect cost structure is the first step to making sure that they're ready to "play with the big boys."

As this article unfolds, it may seem that this is not an area for the grants professional, but rather for an accountant. Indeed, accountants have training in the principles outlined here. For many agencies however — particularly small ones — the grants professional may have the most at stake in understanding the seeming conundrum of indirect costs. Is it your job? No. Will it make your job easier to do and make your agency more successful? Yes. And, should you work with your accountant on this project? Absolutely.

What is an indirect cost?

Indirect costs (sometimes called overhead) are costs that your agency incurs that cannot be directly connected to a specific program. Another way of thinking about them is that they are costs that would continue to exist no matter which programs were operating at any point in time. Costs that usually fall into this category include:

- administrative and executive staff: the Executive Director, the director of finance, the receptionist, clerical staff not dedicated to specific programs
- office space used by those staff: rent, utilities
- equipment and contracts used by everyone: copiers, phone systems, janitorial service, etc.
- board of directors' expenses
- non-program-specific staff training
- agency liability insurance
- fundraising & marketing expenses

The In's and Out's of Indirect Costs: Not Just For Accountants

Internal vs. external thinking

Often a grants professional thinks about indirect costs only when faced with a proposal deadline and the need to put the proposal budget together. At that point, the question to be asked is usually, “Which costs are allowable?” In other words, the thinking about indirect costs tends to be externally-driven. A better place to begin—if we can get away from the hamster wheel of proposal deadlines—is to move to an internal agency perspective, and examine *all* the costs the agency incurs in the course of its operations. The “allowable” question should come later. For now, assume that there are no “unallowable” categories.

The most logical place to begin, now that you’re away from the wheel, is to take an agency’s financial records for the most recent year (or a budget), and list each expense, noting whether it is for a specific program, for more than one program, or for the agency as a whole. The following example is for a youth agency:

Program Director	$18,000	Stay in School
.5 FTE Admin Assistant	$12,000	Stay in School, Mentoring
Postage	$1,324	General

Allocation

The concept of allocation is vital in thinking about indirect costs. Allocation simply means dividing up an expense and assigning portions of it to various uses. Both direct and indirect costs can be allocated. In the example, above, the program director expense (direct) is allocated completely to the Stay in School program; the administrative assistant salary (direct) is allocated between the two programs, and the postage is (for the time being) “unallocated indirect expense.”

In some cases, unallocated costs can still be allocated between programs. Often, not all of the cost is actually indirect. There are two basic ways an agency can do this:

- *Record-keeping.* The agency could decide to start keeping track of expenses that can be allocated to specific programs. In the postage example, there could be a log next to the postage meter, and staff could list the postage used and the program/purpose. This is the most precise method of allocation, but it does require staff time and attention. There will still be a certain amount of postage used that really does not belong to a specific program and really is an indirect expense—for example, what about the postage used to pay the bills?
- *Percent of usage.* When it is too difficult to track expenses precisely with record-keeping, the agency can estimate the percent of resources dedicated to each program and use those percentages to split up unallocated costs. The percentage could be based on how much staff time each program “consumes,” or percent of square feet used by each program, or some other measure. In fact, you could theoretically have a different “basis of allocation” for each expense. If you are going to use this approach, you’ll need to carefully document how you came up with the percentages used. Again, you’ll have some expenses that are still indirect and should be listed as such.

No matter which approach (or combination of approaches) used, the objective should always be to find the *true cost* of each program, and to determine which costs that at first seem indirect are actually direct costs of the program.

The In's and Out's of Indirect Costs: Not Just For Accountants

Program Budgeting

With the newly-allocated costs in hand, the next step is a program-oriented budget that includes all costs. Fire up your spreadsheet program, and develop a budget with columns for each program and a column for the “leftover” indirect expenses. The budget narrative will probably be longer and should include documentation of the new direct costs. This budget may, or may not, be a budget that is submitted to a funder, but it will be valuable to both you as you prepare grant proposals and to the management of the organization.

The last column — the truly indirect costs — will likely be far less than your original tally of “administrative expenses.” Not only will it be a more accurate reflection of your program costs, it will be much more likely to gain the support of the key supporters of the organization who know the agency well and want to make sure its basic needs are met.

One final step: divide the total of the indirect column by the total of all expenditures. This percentage is the “ideal” indirect rate for the organization. In a perfect world, if each program re-couped this percentage back for overhead, the agency would be healthily self-sustaining. Unfortunately, the grants world is far from perfect.

(Note: when faced with that “ideal number,” the most common question is “how much is too much?” When is a percentage “too high?” The question is more than can be answered here. In general, somewhere in the 20% range is probably acceptable to most funders.)

Back to the Real World

So, how might this new understanding of the agency’s costs be used with various audiences? Even before a grant proposal is written, it might bring about internal changes--to re-evaluate the cost-effectiveness of some programs, or to change a fee structure, for example. Externally, its use will vary by the restrictions of the funding agency—to return to an earlier question, what is “allowable.” Funding sources usually use one of the following approaches:

A stated percentage, with some description of what should be included in the basis (sometimes called a “base”) for calculation. Here is the text from a request for proposal I recently read: “You may charge, for administrative costs, a fixed five percent of the total of the funds expended…this rate may be used without supporting documentation.” This is simple enough…although if the percentage allowed is low, as in this example, you might reconsider whether the agency can sustain this program. The value of this approach is that the agency knows ahead of time whether or not the available funding is sufficient or how much needs to be raised from other sources.

A range of percentages. “You may charge no more than 20% of the total of the funds expended for administrative costs.” In this case, the budget narrative will need to be clear about how the percentage used was calculated. A statement something like the following is usually sufficient:

“Indirect Costs: 20% of the total budget will defray indirect administrative costs for the program. These costs include liability insurance, computer maintenance, and human resources services such as payroll and benefits management. This percentage is based on historical financial data provided by the agency’s accountant.” In general, the more detail you can give about exactly what items the percentage covers, the better.

The In's and Out's of Indirect Costs: Not Just For Accountants

The program budget will help guide you in determining the percentage to use. Note that in some cases, the funding source will exclude certain items—either from the base, or by prohibiting you from using the indirect costs for certain expenses. In those cases, you'll need to spend some time with your spreadsheet to determine what rate is appropriate for the proposal.

A "Federally Approved Indirect Cost Rate." This is a rate that has previously been approved. Usually, the governmental agency that will make the first federal grant to an organization is the agency that works with the organization to set the rate (although in some cases, there is an automatic "default" to a particular federal agency). The process is complicated and long, but in the long run makes life much easier for the grants professional — the percentage can be applied without any justification at all in federal applications. Some non-federal funding agencies will also allow you to use a federally-approved rate. The federally-approved rate is subject to review and can be adjusted over time. If you think your organization needs an approved rate, work with the controller to pursue an application. If your organization is not large enough to have a controller, think twice about whether the organization is large enough to successfully manage a federal grant.

No indirect expenses allowed. The internal program budget is perhaps most helpful when the funding agency says that no indirect expenses are allowed (or when the percentage allowed is very small). The budget submitted should reflect as many direct costs as are justifiable.

Understanding indirect costs is hard work. It is, however, in the best interests both of your organization and your funders. The leaders of your organization will have a much clearer roadmap to use in describing the needs of your organization. Funders can ensure that their grants are truly directed to realizing the goals of the project. Your work determining the true cost of your programs helps ensure that both of those needs are met — so everyone will sleep better at night.

About the Contributor

Liz Nilsen, CFRE:
Institute for Advanced Learning & Research
150 Slayton Avenue
Danville, Virginia 24540
434.766.6766

Liz Nilsen's first development job, in 1985, was writing thank-you notes for a girls' school's Annual Fund, but she has stayed in the field anyhow. Since then, she has held positions at a number of organizations, primarily in the social services and education fields, overseeing direct mail, special events, phonathons, volunteer solicitation, prospect research and corporate and foundation work. She has also worked as an independent consultant. She is currently the Manager of Assessment & Outreach at the Institute for Advanced Learning & Research in Danville, Virginia, a regional initiative to jumpstart economic transformation in an "old economy" textile- and tobacco-dependent area. Her work at the IALR includes program planning, proposal preparation, grant management, and evaluation both of individual projects and overall organizational impact.

Contact: liz.nilsen@ialr.org