



DISTRICT OF COLUMBIA

OFFICE OF THE STATE SUPERINTENDENT OF

EDUCATION

MEMORANDUM

To: School Food Authorities

From: *Elizabeth Leach*
Elizabeth Leach
School Programs Manager

Date: December 30, 2016

Re: Indirect Cost Guidance

State Agency Memo
NSLP #3-17

USDA Food and Nutrition Services (FNS) has recently released [Indirect Costs, Guidance for State Agencies & School Food Authorities](#). An overview of information included in the guidance is outlined below. We have also attached the slides from USDA's Indirect Cost webinar as a resource for you. Please reach out to your designated Program Specialist with any questions.

Indirect cost guidance provides assistance to SFA business officials to ensure the nonprofit school food service account (NSFSA) funds are limited to those expenses that are reasonable, necessary, and allocable to provide quality meals for the NSLP and SBP. In general, the full cost of the NSLP and SBP includes both direct and indirect costs. Direct costs are incurred specifically for the NSLP and SBP, and can be readily identified to a particular school food service objective. Allocation of indirect cost is necessary because it identifies the portion of the costs benefitting the school food service.

The guidance provides information to State agencies and SFAs on program rules pertaining to:

- Definitions for both direct and indirect costs, including the proper classification of costs and discussion on the treatment of certain typical costs in the NSLP and SBP. Direct costs are discussed because direct and indirect costs are complementary;
- An overview of the Federal cost principles and explanation that all costs (direct or indirect) paid with funds from the NSFSA must be allowable. The guidance provides criteria that will aid an SFA in determining allowable costs and includes relevant examples;

- Information on how a school district's general fund recovers indirect costs from the NSFSA. This includes appropriate application of the indirect cost rate and the requirements for the SFA to determine the rate;
- Considerations for the SFA when assessing indirect costs charged to the NSFSA. This information includes how an SFA should address errors and the billing of previous years' indirect costs; and
- An overview of how the indirect cost rate is developed as relevant background information for SFAs. The information includes a discussion on appropriate uses of restricted or unrestricted indirect cost rates and adjustment of the rates.



Welcome to the Indirect Cost webinar. Presenting today will be Sandra Foss, Chris Lipsey, Wanda McNeil and Lynn Rodgers. The purpose of this webinar and the accompanying guidance is for State agencies and school food authorities (SFAs) to better understand the nature of direct and indirect costs and their role in the operation of the National School Lunch Program (NSLP) and the School Breakfast Program (SBP) and to describe the Federal requirements that State agencies and SFAs must comply with in the SMPs with respect to indirect costs. We will refer to the NSLP and SBP collectively as the School Meal Programs (SMPs) during this webinar. **If you have not yet discovered, FNS published an updated version of the Indirect Cost Guidance, this was published on Partnerweb on Sept. 30, 2016.**

Major SFA Responsibilities

- ▶ Management of the NSFSA
- ▶ Operate the NSFSA on a non-profit basis
- ▶ Safeguard Assets of the School Food Service
- ▶ Compliance with Federal and Program Regulations

One of the major responsibilities that comes with participation in the SMPs is the management of the nonprofit school food service account (NSFSA). Program regulations at 7 CFR 210.14 and 220.13(i) require an SFA to establish a NSFSA, in which all reimbursements and other revenues from all food service operations conducted by the SFA, which are principally for the benefit of school children, be retained and used only for the operation or improvement of the nonprofit school food service.

Therefore, the SFA must manage the NSFSA to accomplish two goals:

- 1) To ensure that the school food service operates on a nonprofit basis, and
- 2) To safeguard assets of the school food service and ensure that these assets are used only for authorized purposes.

The SFA is the steward of the NSFSA and the NSFSA maintains the funds available for the SMPs. Remember, the funds in the NSFSA are required to be spent solely on the SMPs. Therefore, it is important to monitor costs charged to this account. The SFA must ensure that only allowable costs are paid with NSFSA funds and that these costs are accurately classified as direct or indirect.

Because there are many demands made on the limited resources of an SFA's NSFSA, it is essential that SFAs adhere to Federal regulations and determine whether a cost

is allowable, allocable and charged appropriately as a direct or indirect. This must be done in order to safeguard the financial integrity of the NSFSA. The responsibility for compliance with Federal regulations is jointly shared by the State agency and the SFA.

Key Principles

- ▶ Understanding allowable costs;
- ▶ Compliance requirements to apply the Federal Cost Principles to the SMPs;
- ▶ How to appropriately charge direct or indirect costs to the NSFSFA; and,
- ▶ Safeguarding the financial integrity of the NSFSFA with respect to direct and indirect costs.

During this webinar, we will provide you with key principles to guide you as you begin to work with Indirect Costs. First, it is important to have a good understanding of allowable costs. If a cost is not allowable, it is not eligible to be paid for from the nonprofit school food service account. Later in this webinar we will discuss the criteria for determining whether or not a cost is allowable.

Next, you will need to understand the compliance requirements that pertain to applying the Federal Cost Principles to the SMPs. Non-compliance with Federal cost principles could result in non-Federal entities being prohibited from participating in or receiving federal assistance in the future. Assistance is available through State agencies and Regional Offices with questions pertaining to Indirect cost.

You will also need to know how to appropriately charge direct or indirect costs to the NSFSFA in order to safeguard its financial integrity. Classifying cost incorrectly could result in loss of revenue to the school food service account. The SFA, as the steward of the NSFSFA, is responsible for ensuring that the school food service pay for only those costs that are specifically incurred by the school food service. Indirect costs are shared among programs. Again, we will have additional discussion on the treatment of direct and indirect cost in the school food service later during this webinar.

Overview

- ▶ Determining Allowable Costs & the General Criteria for Allowable Costs
- ▶ Examples of Specific Allowable and Unallowable Costs
- ▶ Direct and Indirect Costs
- ▶ Developing and Applying an Indirect Cost Rate
- ▶ Indirect Cost Rates & Adjustment Methods

We will begin with a basic overview of the Federal Cost Principles. **These are found in the Uniform Administrative Requirements, Cost Principles, and Audit Requirements located at 2 CFR 200. The Cost Principles are found specifically in the 200.400 series also known as Subpart E.** After this overview, we will then discuss how to determine whether costs are allowable and also define direct and indirect costs and provide examples of both. Following we will learn to develop and apply indirect cost rates. Finally, we will discuss Indirect Cost Rates and adjustment methods. Because we have limited time during this webinar, we will primarily focus on cost allowability, determining the nature of costs, i.e. Direct or Indirect, and how to develop an Indirect Cost Rate.

Federal Cost Principles

- ▶ Establishes government-wide principles for determining allowable cost under contracts, grants, and other agreements within Federal programs.
- ▶ SMPs Program regulations require that any cost paid from the NSFSFA account meet the standards for allowable costs as outlined in the Federal cost principles.

Understanding allowable costs is necessary when learning about direct and indirect costs because all costs, whether charged directly or indirectly must be allowable. The Federal Office of Management and Budget, known as the OMB, establishes the principles for determining allowable costs to Federal assistance programs such as the SMPs. In order to be chargeable to a Federal grant or contract, a cost (whether a direct or indirect cost) must first be allowable.

The overall objective of the Federal cost principles is to establish government-wide principles for determining allowable costs under contracts, grants, and other agreements with the various entities that operate Federal programs.

While the Federal cost principles do not apply to claiming meal reimbursement under the SMPs, they do have meaning with respect to costs charged to the SFA's NSFSFA. SMPs Program regulations at 7 CFR 210.14(a) and 220.13(i) require that any cost paid from the NSFSFA meet the standards for allowable costs as set out in the Federal cost principles.

Therefore, an understanding of the Federal cost principles as well as USDA regulations, is critical to safeguarding the integrity of the NSFSFA.

Office of Management & Budget (OMB) Guidance

- ▶ Issued final guidance on administrative requirements, cost principles and audit requirements for federal awards.
- ▶ Provides general definitions regarding the applicability and allowability of different types of costs.
- ▶ Describes the different allocation methods available and the general criteria for charging costs as direct or indirect.

In 2013, the OMB issued final guidance on administrative requirements, cost principles and audit requirements for federal awards. Per the OMB website, this guidance supersedes requirements from OMB Circulars A-21, A-87, A-110 and A-122 (which have been placed in 2 C.F.R. Parts 220, 225, 215 and 230); Circulars A-89, A-102 and A-133.

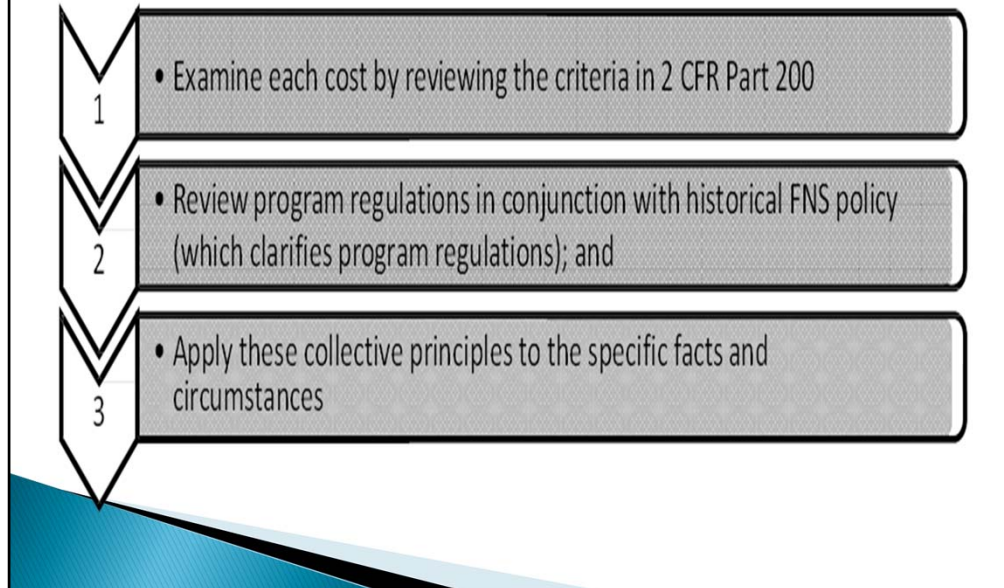
This new guidance provides general definitions regarding the applicability and allowability of different types of costs and also describes the different allocation methodologies that are available and the general criteria for charging costs as direct or indirect. Some costs are allowable only in one category or the other. It is essential that each item of cost incurred for the same purpose be treated consistently in like circumstances either as a direct or an indirect (F&A) cost in order to avoid possible double-charging of Federal awards. As mentioned earlier guidelines for determining direct and indirect (F&A) costs charged to Federal awards are provided in 2 CFR 200 Subpart E.

OMB– Special Considerations

Type of Organization that Receives an Award or Subaward:	Source of Applicable Cost Principles:
Special Considerations for States, Local Governments and Indian Tribes	2 CFR 200.416-.417
Special Considerations for Institutions of Higher Education	2 CFR 200.418-.419

OMB has also formulated a set of principles for each specific type of recipient organization. As detailed in the chart, cost principles for States, Local Governments and Indian Tribes are found in 2 CFR 200.416-.417. Institutions of Higher Education also have a set of cost principles that refer to them directly found in 2 CFR 200.418-.419. These principles refer to the costs incurred by states and local governments of behalf of the college or university and also to cost accounting standards and disclosure statements for those Institutions of Higher Education that receive aggregate Federal awards that total \$50 million or more.

2 CFR 200



SFAs should be familiar with 2 CFR 200 Subpart E in order to determine whether a cost is allowable. 2 CFR 200.403 provides factors affecting the allowability of costs and 2 CFR 200.404-.405 provide explanations of cost including reasonable costs and allocable costs. 2 CFR 200.407 lists those costs where prior written approval of the cognizant agency is required, and 2 CFR 200.421-.475 provides principles to be applied in establishing the allowability of selected items of costs.

In summary, two key points to remember are:

First, a cost would not be deemed an allowable charge to the NSFSAs by simply applying the general criteria outlined in 2 CFR 200 Subpart E because the cost must also conform to program-specific rules. For example, the NSLP regulations at 7 CFR 210.14(a) prohibit use of the SFA's NSFSAs to pay for the cost of purchasing land or buildings, unless otherwise approved by FNS; and second, a cost must be incurred in accordance with all applicable terms and conditions.

Criteria for Allowable Costs

- ▶ Necessary
- ▶ Reasonable
- ▶ Allocable
- ▶ Applied uniformly to both federally-financed and other activities of the non-federal entity
- ▶ Consistently treated as direct or indirect
- ▶ Determined in accordance with Generally Accepted Accounting Principles (GAAP)
- ▶ Not included as a cost or matching contribution of any other grant (except where allowed by Federal regulations)
- ▶ Adequately documented

2 CFR 200.403 lists factors that affect the allowability of costs. It is the SFA's responsibility to determine whether a cost meets the following criteria before the cost is paid from the school food service account:

Necessary - In order to be allowable, a cost must be necessary for the performance or administration of the funds provided by FNS to the State agency for the SMPs. A cost is necessary if the SMPs' authorizing statutory provisions, resulting program regulations or applicable FNS policy establish that the nonprofit school food service cannot be operated without incurring the cost. For example, a school food service cannot be operated without incurring the cost of appropriate food.

Reasonable - A cost is reasonable if, in its nature and amount, it does not exceed the cost that under the same circumstances a prudent person would also pay. The cost must be the result of sound business practice and competitive prices. For example, the cost of food is a reasonable cost to operate the nonprofit school food service if incurred according to these conditions.

Asking the following questions may help the SFA determine whether a cost is necessary and reasonable:

Does the cost contribute to achieving an objective of the SMPs?

Is the cost recognized as ordinary and necessary for the operation of the SMPs? Could the SMPs be carried out without incurring this cost?

Would a prudent person find the cost to be reasonable under the circumstances? **Other factors may include if the rate is fair, are there alternatives to consider in lieu of incurring the cost, and if the cost can be defended if questioned by the State agency, media, auditors, etc.?**

Allocable - A cost must be assigned to the programs or activity that benefit from that cost. Each cost objective must be charged proportionate with the benefit received. Depending on which program(s), function(s), and/or activity (ies) benefit from the cost, and the extent to which each benefited, a cost may be allocated to cost objective(s) through direct or indirect cost allocation. We will discuss cost allocation later in the webinar.

Be consistent with policies and procedures that apply uniformly to both federally-financed and other activities of the non-Federal entity. All costs must be treated consistently as direct or indirect.

An SFA must conduct transactions using Federal program funds in the same way that it conducts transactions with its own non-Federal funds. A cost item must be treated consistently as direct or indirect in all activities of the SFA unless legislation, regulations, or guidance from an awarding agency dictates otherwise. For instance, a cost may not be assigned to a Federal award as a direct cost if that same cost, incurred for the same purpose in similar circumstances, has been assigned to other Federal awards as an indirect cost.

Adequately documented - The record of a SMPs' operation must be able to stand on its own, without depending on augmentation, interpretation, or "spin" by the program operator.

Examples of Specific Allowable and Unallowable Costs

- ▶ Renovating a School Kitchen
- ▶ Building a School Kitchen
- ▶ Nutrition Education Materials
- ▶ Wellness Programs for SFA Employees
- ▶ Internal vs. External Maintenance Personnel

This slide lists a few examples of costs that may be considered either allowable or unallowable. Let's take a look at a couple of these examples on how FNS has historically treated certain costs in regards to allowability, based upon SMPs-specific regulations and FNS policy.

Renovating a School Kitchen

2 CFR 200.452, Maintenance and repair costs, identifies costs of normal repairs and alterations as allowable so long as they: (1) keep property in an efficient operating condition; (2) do not add to the permanent value of the property or appreciably prolong its intended life; and (3) are not otherwise included in rental or other agreements. Based on these principles, FNS has allowed limited renovations within the inside perimeter of a kitchen/cafeteria space with the required prior State agency approval (2 CFR 200.407 or FNS approval (7 CFR 210.14(a)).

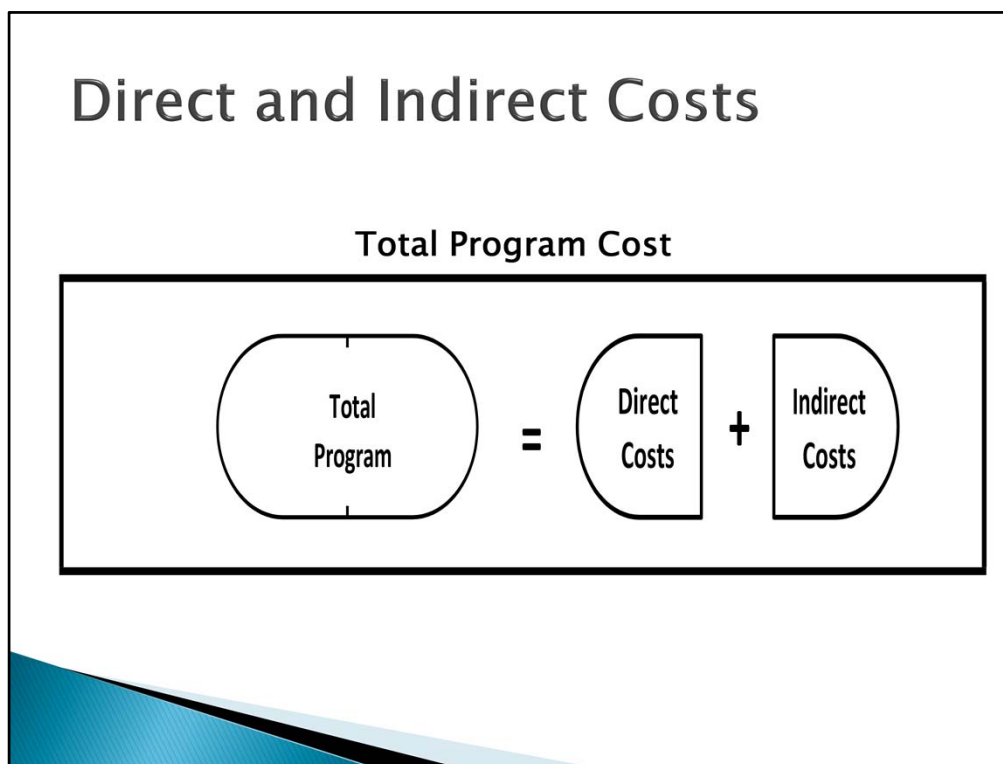
For example, renovating a kitchen by cutting away a portion of the wall to allow room for a walk-in refrigerator and related electrical wiring would be an allowable expense if the renovation is necessary to accommodate increased participation of students in the SMPs. However, it would be an unallowable expense if renovation of the kitchen was purely an aesthetic matter. Finally, the SFA cannot charge normal maintenance costs directly to the NSFSA if such costs are treated as indirect costs in other programs, functions, or activities of the school district. This case exemplifies the consistency criterion for an allowable cost, which we covered in the preceding slide.

Building a School Kitchen

SMPs regulations at 7 CFR 210.14(a) and 220.7(e) require that revenues received by the nonprofit school food service are to be used only for the operation or improvement of such food service, except that, such revenue shall not be used to purchase land or buildings unless otherwise approved by the FNS, or to construct buildings. Historically, FNS has not approved the cost of building purchases because program funds are made available to help support the costs of nutritional benefits for children in school settings and not to construct school related facilities. The goal is to ensure that an SFA maintains the necessary funding to operate the program as required by the SMPs' authorizing legislation and regulations, and that the NSFS is not used to cover major expenses that should be borne by the school district's general funds (i.e., capital infrastructure costs).

The costs of building a kitchen are analogous to the costs of constructing school buildings, which historically have been borne by the school district with general or capital improvement funds. Similarly, such capital infrastructure costs should be borne by the school district just as the school building and its contents should be.

Direct and Indirect Costs



Now that we have discussed how to determine whether a cost is allowable and able to be charged to the school food service account, now we will discuss how to classify such allowable costs.

The full cost of a program, function, or activity includes both direct and indirect costs. Consider the example above.

Direct costs are incurred specifically for a program or other cost objective, and can be readily identified to a particular objective such as school food service. Examples of direct costs in SMPs include, but are not limited to, food, the wages and salaries of the staff working in the school food service, and supplies specifically used in the school food service.

Indirect costs are incurred for the benefit of multiple programs, functions, or other cost objectives and therefore cannot be identified readily and specifically with a particular program or other cost objective. Indirect costs typically support administrative overhead functions such as fringe benefits, accounting, payroll, purchasing, facilities management, utilities, etc.

The determining factor in distinguishing a cost as direct or indirect, is the extent to which it can be identified with a specific program, function, or activity that benefits from the organization (i.e., SFA) that has incurred the cost rather than the nature of the goods and services themselves. State educational agencies (SEAs) and SFAs must make careful considerations in determining whether certain types of costs should be categorized as a

direct or indirect cost.

Direct Costs

- ▶ Can be identified specifically with a particular final cost objective
- ▶ Are exclusively attributable to the nonprofit school food service
- ▶ Can be substantiated through written documentation such as time cards, invoices, receipts, etc

Direct costs are those costs that can be identified specifically with a particular final cost objective, such as a Federal award, or other internally or externally funded activity, or that can be directly assigned to such activities relatively easily with a high degree of accuracy. This definition can be found in 2 CFR 200.413(a).

A good way of understanding “identified specifically” is for the SFA to ask the following question: Who benefitted from the SFA having incurred the cost (i.e., just school food service)?

Consider this example, a SFA clerical employee may spend half of his/her time maintaining records for the nonprofit school food service and the other half operating the student supply store. His/her compensation would be 50-percent allocable to each of two direct cost activities, the food service and student activities. While his/her compensation would not be exclusively attributable to either activity, neither would it be an indirect cost because it would have been assignable to direct cost activities “relatively easily with a high degree of accuracy.”

Granted, the SMPs regulations do not prescribe in detail every kind of cost that can be charged to the school food service. However, the SMPs regulations do outline the purpose of each program, requirements that must be met and, in some cases, prescribes certain aspects of that program’s operations. The SMPs objectives can be understood by reading and understanding authorizing statutes, program regulations, and FNS policy. Moreover, costs should generally be treated as indirect costs if: (1) they cannot be attributed to the

NSFSA in their entirety and (2) an allocable portion cannot be assigned to the NSFSA relatively easy and with a high degree of accuracy.

Some direct costs that are typically chargeable to the NSFSA are:

- Compensation of employees for the time devoted and identified to the school food service
- Cost of materials, acquired, consumed, or expended specifically to the performance of the school food service
- Equipment and other approved capital expenditures
- Travel expense incurred specifically to carry out the objectives of the SMPs
- Food for the school meals

Indirect Costs

- ▶ Those incurred for a common or joint purpose benefiting more than one cost objective, and not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved.

2 CFR 200.56 describes indirect costs as those “incurred for a common or joint purpose benefiting more than one cost objective, and not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved.”

There are two dimensions to indirect costs: (1) incurred for a common or joint purpose, and (2) not readily assignable to benefiting cost objectives without effort disproportionate to the results achieved. **It takes both dimensions to identify a cost as indirect.** It is their cumulative effect that necessitates the use of mathematical operations to allocate indirect costs to benefiting cost objectives. In the preceding slide, the clerical person’s compensation would not be charged to the indirect cost pool because it could be readily allocated to direct cost activities. Another example would be the headmaster of a private school who spends half of his/her time managing the school and the other half teaching in the classroom; the portion spent teaching benefits a direct cost activity (instruction) while the remaining 50-percent most likely benefits indirect cost activities (general administration, etc.).

Indirect costs are necessary for the general operation of the SFA. Due to their generic nature, however, indirect costs are not readily assignable to SMPs specific functions or activities. Indirect costs must therefore be assigned to benefitting programs and other cost objectives through a mathematical allocation process.

Direct and Indirect Costs

Direct Costs	Indirect Costs
Wages and salaries of food service workers	Payroll services
Cost of purchased foods	Human Resources
Food service supplies	Workers' compensation
Media promotional materials relating to the food service	Procurement
Capital expenditures relating to food service (e.g. food service equipment purchases)	Utilities such as gas, electricity, sewer, water, trash
	Superintendent's Office

Now that we've defined indirect and direct costs, let's look at the above chart which lists some common direct and indirect cost classifications. Again, indirect costs typically support administrative overhead functions such as fringe benefits, accounting, payroll, purchasing, facilities management, utilities while direct costs are incurred specifically for the food service only and not shared across other programs or functions.

Direct or Indirect?

- ▶ Does the cost benefit multiple programs or other cost objectives, or solely the school food service?
- ▶ Does the cost have a direct relationship to the school food service?
- ▶ What guidance do the Federal cost principles provide for this cost?
- ▶ How are similar costs treated in other cost objectives of the SFA?
- ▶ How has this cost been treated historically by the SFA?

Before we leave the section on determining direct or indirect cost, asking these questions may help to classify a cost as direct or indirect:

Does the cost benefit multiple programs or other cost objectives, or solely the school food service? If the former, this cost may be an Indirect Cost.

Does the cost have a direct relationship to the school food service? If yes, this cost would be a Direct Cost.

What guidance do the Federal cost principles provide for this cost? This will help in determining if the cost is allowable, which we have discussed earlier in the webinar.

How are similar costs treated in other cost objectives of the SFA? All costs must be treated consistently as direct or indirect. We will discuss this in the webinar.

How has this cost been treated historically by the SFA? This will help to provide you with valuable information on the treatment of the cost.

Cost Allocation

- ▶ Costs must be distributed proportionately amongst the cost objectives
- ▶ Necessary because it identifies the portion of the cost that has or will benefit the school food service.
- ▶ A cost allocable to the nonprofit school food service if it is treated consistently with other costs incurred for the same purposes.

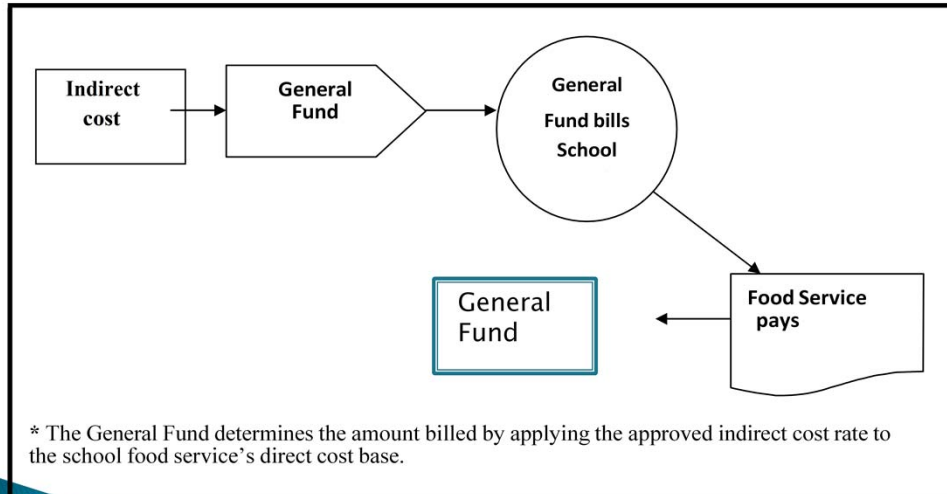
Let's look now at the cost allocation process. When a cost benefits two or more cost objectives, the cost must be allocated or distributed among them proportionately with the benefit each received from the cost. Allocation is necessary because it identifies the portion of the cost that has or will benefit the school food service. **However, a cost allocable to a particular Federal award or other cost objective under the Federal cost principles may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by regulations or terms of the Federal awards, or for other reasons; to do so would assign the cost to a cost objective that did not benefit from it.**

Under the Federal cost principles, a cost is allocable to a Federal award (i.e., the NSFS) if it is treated consistently with other costs incurred for the same purposes in like circumstances and if it meets the following criteria:

- It benefits both the Federal award and other work of the non-Federal entity, and can be distributed in proportions that may be approximated using reasonable methods; and,
- It is necessary to the overall operation of the non-Federal entity and is assignable in part to the Federal award, although a direct relationship to a particular cost objective cannot be shown.

General Fund Recovery

Example: General Fund Recovers Indirect Costs Benefitting Nonprofit School Food Service



A school district generally has two options to recover the indirect costs benefiting the school food service and other direct cost activities, yet paid from the general fund: (1) directing the general fund to rely on its own allotments, or (2) billing the program offices, such as the school food service, that claim Federal reimbursement from Federal and State awarding agencies.

In the example above, the General Fund paid the indirect costs (i.e. custodial, electricity). **The General Fund determines the amount billed by applying the approved indirect cost rate to the school food service's direct cost base, then bills the school district. The school district turns the bill over to the school food service who then reimburses the General Fund.**

I will now turn the next portion of the webinar over to Lynn Rogers Kuperman who will share more information on Developing an indirect Cost Rate.

Developing an Indirect Cost Rate

- ▶ Allowable costs, direct and indirect, must be identified in a consistent manner.
- ▶ The SEA and LEA must determine how to allocate these indirect costs across several Federal programs.
- ▶ The USDE is the cognizant agency for all SEAs and requires each SEA to negotiate an indirect cost methodology for each LEA.

Before we see how an indirect Cost Rate is developed, let's review the cost information briefly: First, a cost must be **allowable**, classified as either direct or indirect and identified in a consistent manner. Second for a cost to be considered allowable and charged to the school food service, it must be necessary, reasonable, allocable, and adequately documented.

The Local Education Agency (LEA) or school district must identify indirect costs by using the same methodology to allocate certain shared costs across the entire spectrum of its Federal programs. An LEA generally participates in several Federal programs, not just SMPs; therefore, the State Education Agency and LEA must determine how to allocate these indirect costs across several Federal programs.

The Federal cost principles exist in part because an LEA or other program operator would find it burdensome to use a different method of allocating shared costs to grants from each of its Federal awarding agencies.

The cognizant agency, speaks for all the Federal awarding agencies in negotiating across-the-board allocation methodology with the program operator. The cognizant Federal agency for all State Educational Agencies is the US Department of Education. Generally, the cognizant Federal agency negotiates a cost allocation document with the program operator; however, with respect to public school districts, the US Department of Education requires each State Education Agency to negotiate an indirect cost methodology for any LEA under its jurisdiction that requests one.

Developing an Indirect Cost Rate

- ▶ USDE → SEA = Agreement
- ▶ SEA → LEA ~ Indirect Cost Rate Proposal (ICRP)
- ▶ ICRP → Indirect Cost Rate

ICRP – a schedule documenting the formulation of the LEA’s indirect cost rate and direct cost base

The US Department of Education negotiates an agreement with each State Education Agency to establish the methodology the State Education Agency will use in negotiating indirect cost methodologies for its LEAs. Once US Department of Education approves the State Education Agency’s LEA methodology, a Delegation Agreement is signed by the US Department of Education and a State Education Agency official. Under this agreement, the State Education Agency generally distributes an indirect cost rate proposal (ICRP) form to its LEAs and uses the data collected to develop each LEA’s indirect cost rate. An LEA must prepare an Indirect Cost Rate Plan, and the State Education Agency must assign methodology based on it, before the LEA can claim reimbursement for indirect costs.

In preparing the Indirect Cost Rate Plan, all of the activities carried on by the school district and their accompanying costs must be identified. All activities must be included in the Indirect Cost Rate Plan, whether their costs are allowable or unallowable and regardless of funding source. The starting point for developing the Indirect Cost Rate Plan will be the LEA’s most recently audited financial statements, chart of accounts, and accounting records supporting those documents after any adjustments resulting from the audit have been made.

The end result of this process identifies all of the organization’s direct costs, indirect costs, indirect cost rate(s), and the direct cost base(s) to which the rates are applied.

Developing an Indirect Cost Rate

- 1) Identify all the activities carried on by the school district and their accompanying costs;
- 2) Eliminate all capital expenditures and other excluded costs;
- 3) Classify the activities and their costs as direct or indirect;
- 4) Eliminate from indirect costs those costs stipulated as unallowable by OMB guidance or program regulation; and,

This slide shows the steps required to develop an Indirect Cost Rate. The steps are:

- 1) Identify all the activities carried on by the school district and their accompanying costs;
- 2) Eliminate all capital expenditures and other excluded costs;
- 3) Classify the activities and their costs as direct or indirect;
- 4) Eliminate from indirect costs those costs stipulated as unallowable by OMB guidance or program regulation; and,
- 5)

Developing an Indirect Cost Rate

5) Compute the indirect cost rate by:

Dividing the total remaining indirect costs (indirect cost pool) by the direct cost base selected for distribution of the indirect costs.

The indirect cost pool is the sum of allowable indirect costs.

The direct cost base is the sum of allowable and unallowable costs that receives a benefit from the costs in the pool.

The last step is to:

5) Compute the indirect cost rate by dividing the total remaining indirect costs (indirect cost pool) by the direct cost base selected for distribution of the indirect costs. The indirect cost pool is the sum of allowable indirect costs. The direct cost base is the sum of allowable and unallowable costs that receives a benefit from the costs in the pool.

We will take a look at each step individually in the upcoming slides.

Step 1: Identify ALL Costs (allowable and unallowable)

NEW SCHOOL DISTRICT: EXPENDITURES BY FUNCTION		
Function Code	Account Title	Expenditures (\$)
1000	Instruction	900,000
2100	Student Services	75,000
2212	Curriculum Development	30,000
2213	Instructional Staff Training	20,000
2321	Office of the Superintendent	40,000
2510	Fiscal Services	10,000
2520	Procurement	10,000
2560	Public Relations	10,000
2570	Personnel (Human Resources)	15,000
2600	Plant Operation & Maintenance	125,000
2700	Student Transportation	165,000
3100	Food Services	100,000
TOTAL		\$1,500,000

The first step is to Identify ALL Costs (allowable and unallowable)

The expenditures are determined from the LEA's accounting system. The total cost, regardless of the funding source, must be identified for each function. This is confusing for many because costs not directly related to the school food service are accounted for in order to develop the indirect cost rate. However, an Indirect Cost Rate Plan is the methodology that substantiates a resulting indirect cost rate. Indirect Cost Rate Plan are required to identify all activities carried on within each LEA and their associated costs, regardless of funding source. The Indirect Cost Rate Plan is based on the LEA's total expenditures; therefore, all expenditures must be included in the plan.

In sample chart you will see the school district's expenditures by function, the function code, account title and total expenditures. Included with the costs you will find Food Service as well as other services within a district.

Step 2: Remove All Excluded Costs

NEW SCHOOL DISTRICT: EXPENDITURES BY FUNCTION				
<u>Function Code</u>	<u>Account Title</u>	<u>Old Total</u>	<u>Excluded Cost</u>	<u>New Total</u>
1000	Instruction	900,000	(100,000)	800,000
2100	Student Services	75,000		75,000
2212	Curriculum Development	30,000		30,000
2213	Instructional Staff Training	20,000		20,000
2321	Office of the Superintendent	40,000		40,000
2510	Fiscal Services	10,000		10,000
2520	Procurement	10,000		10,000
2560	Public Relations	10,000		10,000
2570	Personnel (Human Resources)	15,000		15,000
2600	Plant Operation & Maintenance	125,000		125,000
2700	Student Transportation	165,000	(90,000)	75,000
3100	Food Services	100,000	(90,000)	10,000
	TOTAL	1,500,000	(280,000)	1,220,000

The next step in developing an Indirect Cost rate Plan is to remove All Excluded Costs that would distort the final result. “Distorting items” should be excluded because they do not generate or benefit from the administrative overhead in the same manner as wages, salaries, etc. The expenditures by function are the same distorting items include (but are not limited to):

- Equipment purchases and other capital expenditures
- Payments to contractors beyond the first \$25,000 per contract
- Food purchases in the school food service
- Renovations and alterations, and
- Certain unallowable costs (e.g., fines, penalties, bad debts).

In this chart you will find the same example of LEA expenditures by function code, account title, total cost amount as well as the excluded cost amount, and a new total cost. You will see the LEA excluded: (1) \$100,000 in contract costs from Function 1000 (Instruction), (2) \$90,000 expended to purchase school buses from Function 2700 (Student Transportation), and (3) \$90,000 in food purchases from Function 3100 (Food Services) as these are considered distorting costs.

Distorting Items

- ▶ Capital Expenditures
- ▶ Contract Costs
- ▶ Food Costs

Let's look at these distorting costs for a moment.

Capital Expenditures: A capital expenditure is the cost of acquiring a capital asset (e.g., equipment, etc.). While purchasing equipment, for example, is a "cost," it is not a current operating expense because the LEA does not realize the entire benefit of the equipment's cost at the time of purchase; rather, the benefit is realized over a period of years as the equipment is used in operations. This benefit is measured by annual depreciation expense and is the reason why only a year's depreciation expense can be included in indirect cost computation.

Contract Costs: The cost of administering a procurement contract is substantially the same, whether the value of the contract is \$100,000 or \$100 million. The cost is presumed not to exceed \$25,000 per contract. Therefore, the value of each contract beyond the first \$25,000 must be excluded.

Food Costs: Like capital expenditures and contract costs, food purchases require minimal administrative support; therefore, they are excluded.

Step 3: Classify Costs as Direct or Indirect

NEW SCHOOL DISTRICT: EXPENDITURES BY FUNCTION				
Function Code	Account Title	Direct	Indirect	Total Costs
1000	Instruction	800,000		800,000
2100	Student Services	75,000		75,000
2212	Curriculum Development	30,000		30,000
2213	Instructional Staff Training	20,000		20,000
2321	Office of the Superintendent		40,000	40,000
2510	Fiscal Services		10,000	10,000
2520	Procurement		10,000	10,000
2560	Public Relations		10,000	10,000
2570	Personnel (Human Resources)		15,000	15,000
2600	Plant Operation & Maintenance		125,000	125,000
2700	Student Transportation	75,000		75,000
3100	Food Services	10,000		10,000
	TOTAL	1,010,000	210,000	\$1,220,000

Step 3 Classifies Costs as Direct or Indirect. The SFA makes this determination by following the accounting and reporting principles of the SEA which is in accordance with 2 CFR Part 200.

From this chart you will see a similar example of a school district's expenditure by function, function code, account title, but this chart identifies how the district classifies each cost as direct or indirect, which the total of each shown.

Step 4: Eliminate unallowable costs from the total indirect costs to obtain the Indirect Cost Pool

<u>Function Code</u>	<u>Account Title</u>	<u>Indirect</u>	<u>Unallowable</u>	<u>Indirect Cost Pool</u>	<u>Direct Cost</u>
1000	Instruction				800,000
2100	Student Services				75,000
2212	Curriculum Development				30,000
2213	Instructional Staff Training				20,000
2321	Office of the Superintendent	40,000	(8,000)	32,000	8,000
2510	Fiscal Services	10,000		10,000	
2520	Procurement	10,000		10,000	
2560	Public Relations	10,000	(2,000)	8,000	2,000
2570	Personnel (Human Resources)	15,000		15,000	
2600	Plant Operation & Maintenance	125,000		125,000	
2700	Student Transportation				75,000
3100	Food Services				10,000
	TOTAL	\$210,000	(\$10,000)	\$200,000	\$1,020,000

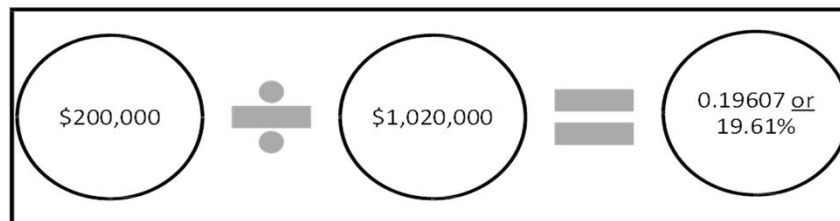
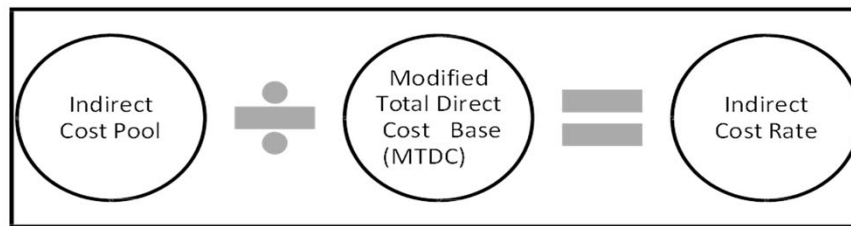
Step 4 Eliminates unallowable costs from the total indirect costs to obtain the Indirect Cost Pool

As we stated earlier, only allowable costs can be allocated to Federal assistance programs. Therefore, the next step is to remove all unallowable costs from the indirect cost pool. However, because the unallowable indirect costs remain part of the school district's total costs and benefit from the administrative overhead, these costs are included in the direct cost base. The result is a Modified Total Direct Costs (MTDC) base. As already noted, the MTDC base excludes "distorting items."

We will assume, for illustrative purposes that the New School District identified the following items as unallowable costs and consequently eliminated them from the indirect cost pool. The chart shows:

- \$2,000 in unallowable public relations costs from code 2560 (Public Relations). These costs were unallowable because they represented promotion of the district in general rather than specific program benefits or achievements.
- \$8,000 from code 2321 (Superintendent's Office). These costs were unallowable because they represented travel by the Superintendent for purposes that did not benefit Federal assistance programs.

Step 5: Calculate Indirect Cost Rate



As seen in the Table for Step 4, the indirect cost pool is \$200,000 and the Modified Total Direct Cost (MTDC) is \$1,020,000. **This information is important for the last step, calculating** the Indirect Cost Rate

The indirect cost rate is a ratio of the LEA's allowable indirect costs to its direct costs. The indirect cost rate benefits the LEA because general management and administrative costs are necessary for any program to exist. Without the benefit of an indirect cost rate, there would be no standard way for each program to contribute its share of the general management and administrative costs without spending significant staff time accounting for each activity.

It is important to note that this methodology generates the unrestricted (negotiated) indirect cost rate. Additional operations are necessary to generate the restricted rate. Additionally, the LEAs cannot receive reimbursement for indirect costs under programs funded by reimbursing allowable costs unless they have both the prescribed rate and prescribed base; each is useless without the other. Also, if the SEA has notified an SFA of its indirect cost rate but not the base, then the SFA must contact the SEA to obtain it. An SFA must never pay for indirect costs without first reviewing an approved indirect cost rate agreement. In other words, an SFA must not pay for indirect costs solely on the basis of the district providing an indirect cost rate.

Indirect Cost Rates & Adjustment Methods

- ▶ Unrestricted (Negotiated) Indirect Cost Rate

Formula Prescribed for Calculating Unrestricted (Negotiated) Rates

$$\text{Unrestricted/Negotiated Indirect Cost Rate} = \frac{\text{Indirect Cost Pool}}{\text{Direct Cost Base (allowable + unallowable costs)}}$$

As this slide shows, there are indirect cost rates and Adjustment methods. The State Education Agency generally assigns each LEA both an unrestricted rate and a restricted rate. We will discuss both types of indirect cost rates.

Unrestricted (Negotiated) Indirect Cost Rate

The SEA can approve the indirect cost rate that emerges from an LEA's Indirect Cost Rate Plan calculations. This rate is known as a *negotiated or unrestricted rate* because it is not limited by Federal restrictions. The unrestricted rate allows an LEA to recover the full cost of its Federal programs, including their fair share of the cost of its indirect cost activities.

Indirect Cost Rates & Adjustment Methods

▶ Restricted Indirect Cost Rate

Formula Prescribed for Calculating Restricted Rate

$$\text{Restricted Indirect Cost Rate} = \frac{\text{General Management Costs + Fixed Costs}}{\text{Other Expenditures}}$$

Restricted Indirect Cost Rate

The legislation that authorizes some Federal educational programs requires that Federal funds are made available for a program's enhancement but these federal funds are not to replace resources that State Education Agencies and LEAs have already been spending on its education programs before the inception of the Federal programs. The intent is to assist State Education Agencies and LEAs in achieving greater levels of benefits and services for its educational programs without withdrawing their previously dedicated resources in support of these activities. Federal funding for these programs must supplement, not supplant, dedicated non-Federal resources. In order to implement this "supplement-not-supplant" requirement, the US Department of Education requires State Education Agencies and LEAs to recalculate their indirect cost rates using a formula described in 34 CFR 76.564-.569. This formula generates a lower rate known as a restricted rate. Most restricted rates are single-digit. Applying the restricted rate results in a marginal distribution of administrative overhead costs required to implement Federal assistance programs.

The formula entails purging certain cost items from an SEA's or LEA's unrestricted indirect cost pool, and reclassifying them as direct costs. By excluding otherwise allowable costs from the indirect cost pool and adding them to the direct cost base, this operation generates a smaller numerator and larger denominator. The resulting calculation generates the lower, restricted rate.

As noted above, the LEA obtains the numerator of this formula by removing certain cost items from the indirect cost pool used in calculating the unrestricted rate, and reclassifying

them as direct costs. These purged and reclassified costs are those for which a State Education Agency or LEA remains responsible despite the availability of Federal funds. Examples include the salaries, fringe benefits, and other compensation of the Superintendent and Deputy or Associate Superintendents, and the cost of operating these officials' offices (such as travel, space occupancy, etc.). The costs that remain in the pool after this purge are classified as "General Management Costs" and "Fixed Costs." Let's discuss these.

Restricted Indirect Cost Rate

- ▶ General Management Costs
 - Accounting, HR, Payroll, Procurement Offices
- ▶ Fixed Costs
 - Wages, Salaries
- ▶ Other Expenditures
 - Sum of original direct cost base and items purged

General Management Costs are incurred for the direction and control of the organization as a whole. Examples include the costs of accounting, payroll, human resources, audit, and procurement offices. Occupancy and space maintenance costs associated with these services may also be included if justified by the results of a space allocation or use study.

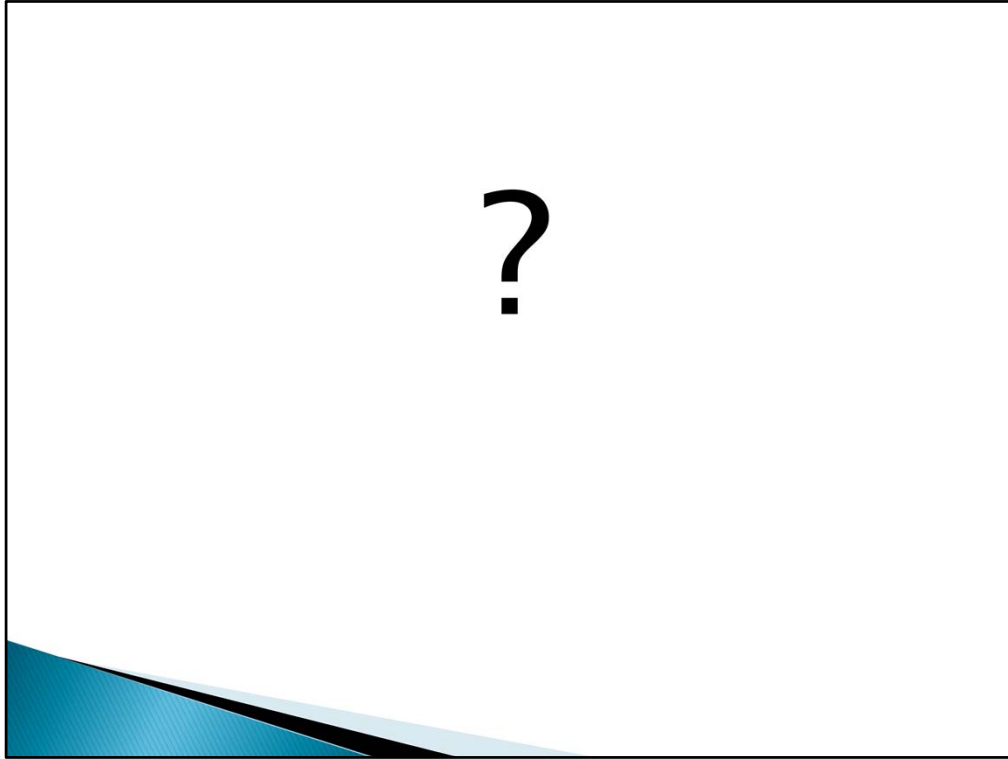
Fixed Costs consist of the SEA's or LEA's contributions to fringe benefits associated with wages and salaries that are charged as indirect costs.

The denominator in the formula ("Other Expenditures") is the sum of the original direct cost base used in calculating the unrestricted rate, and the cost items purged from the indirect cost pool and reclassified as direct costs.

The LEA must use the restricted rate to determine indirect costs allocable to those Federal educational programs whose authorizing statutes include the supplement-not-supplant language. This requirement thus prevents an LEA from recovering the full cost of those programs from the State. The LEA must absorb, from its own resources, the difference between indirect costs allocable to those programs under the restricted rate, and what those costs would have been if determined via the unrestricted rate. As already noted, States generally approve both an unrestricted rate and a restricted rate for each LEA under their jurisdiction.

Whether the general fund bills a direct cost activity, such as the school food service, for indirect costs at the restricted or unrestricted rate depends on the Federal programs

operated within that activity. If such programs' authorizing legislation includes the "supplement-not-supplant" language discussed earlier in this guidance, the restricted rate must be used. The legislation authorizing the SMPs does not contain such a requirement; therefore, the general fund may bill the school food service at the unrestricted rate. Some LEAs have nevertheless opted to support the food service by billing it at the restricted rate, which is lower. Once that choice has been made for a given fiscal year, the LEA must apply the selected rate consistently throughout that period.



We hope you have gained a better understanding of the information provided. The understand the guidance on allowable costs, direct and indirect costs, indirect cost rate plans, and rates, can be confusing to many. Therefore, we will take as many questions as possible during the remaining time. We will seek to answer these questions and record all questions for a future release of questions and answers, if needed.

Do we have any questions at this time?

Additional Resources

- ▶ Indirect Cost study. The study is located at www.fns.usda.gov/school-foodservice-indirect-cost-study.
- ▶ *Indirect Cost Q&As in the Guidance*, Sept. 30, 2016.
- ▶ Typical Costs and their Classification as Direct or Indirect

Thank you for participating on the Indirect Cost Guidance webinar this afternoon. We doubt we have answered all of your questions this afternoon, so we want to point you to a few resources to assist you.

In accordance with Section 307(b) of the Healthy, Hunger-Free Kids Act of 2010, the USDA Food and Nutrition Service conducted an indirect cost study. The study is located at www.fns.usda.gov/school-foodservice-indirect-cost-study.

General Provisions for Selected Items of Cost – 2 CFR 200.420-.475

Appendix C of the Guidance contains Indirect Cost Q&As

Appendix D of the Guidance contains Typical Costs and their Classification as Direct or Indirect