



Date: 12 April 2010

To: Citywide Nonprofit Monitoring Program Steering Committee Members

From: City Services Auditor Division, Controller's Office

Re: Nonprofit Indirect Cost Rates

The Controller's Office is issuing this memo in response to City department and nonprofit inquiries concerning nonprofit indirect cost rates. The findings and recommendations presented below are based on analysis of federal guidelines, best practices, and discussions with City departments; they are intended to act as a resource for City departments during indirect cost rate negotiations with nonprofit contractors. Please contact Nikhila Pai, 415-554-7511, if you have questions or comments.

Findings/Recommendations:

- 1. Indirect cost rates will differ citywide for legitimate reasons.** City indirect cost reimbursement rates must conform to the rules of external funders and the varying types of programs the City funds—it is impractical to set a single citywide rate. For example, federal funds passing through the City and fiscal intermediaries subcontracting services mandate low indirect cost reimbursement rates. However, childcare facilities or medical assistance contracts can merit the higher end of indirect cost reimbursement rates due to elevated administrative costs.
- 2. Indirect cost rates will differ within client service areas.** In addition to reasons based on funder or nature of fund dispersal, City departments may contract for similar client services at different indirect cost reimbursement rates. The size and complexity of a nonprofit influence the rate as economies of scale permit larger nonprofits to spread costs across multiple programs, resulting in lower actual indirect costs per program. Smaller nonprofits may spread costs across fewer programs, resulting in higher actual indirect costs. As the City needs nonprofits of all sizes to offer client services, departments should have the flexibility of a range of indirect cost rates to reimburse some or all indirect costs.
- 3. No single list can encompass the full extent of charges that may fall under an indirect cost category.** Nonprofit accounting practices coupled with a wide range of contracted services means no billable service can be interpreted universally—a standard cost can be billed as indirect, shared and direct depending on the services provided. For example, janitorial services for a business office may be billed as an indirect cost, but a food program required to meet health codes may bill janitorial services as a direct cost. OMB Circular A-122, a federal guideline to which nonprofits must adhere, states that “it is not possible to specify the types of costs which may be classified as indirect in all situations.” Although OMB A-122 provides a list of allowable/ unallowable costs within federal contracts, it only provides a list of *typical* examples that *could* be indirect.

4. **Departments should establish a policy for setting indirect cost rates.** A clear statement of the relationship between the City's indirect cost reimbursement rates and the nonprofit's actual indirect costs provides a foundation for both contractors and City contract officers during the negotiation process. A good department policy should state that the department's indirect cost reimbursement rate may fall below a nonprofit's actual indirect costs, and that indirect costs will be covered only up to a certain ceiling (e.g., 12% of contracted amount). Departments should consider different indirect cost reimbursement rate ceilings based on the size of the nonprofit (see the Human Services Agency policy <http://www.sfhsa.org/214.htm>), type of service, or level of administrative effort.
5. **Departments should review program cost center information in the pre-award period (e.g., during contract negotiations and/or solicitation).** The actual indirect costs of contracted programs, as allocated per federal standards set by OMB Circular A-122, may not be entirely recovered by the contract indirect cost reimbursement rate provided by the City. If actual indirect costs for a program exceed the City department's reimbursement, the program's cost center will show a loss unless offset by unrestricted or other funds earned by the organization. If the indirect cost recovery from all sources does not cover the actual indirect costs for the contracted program, the City department and contractor should reconsider the partnership and/or budget – City departments should not commit to funding a program that does not have adequate financial support.
6. **Departments should review cost allocation plans in the pre-award period.** This is a financial management best practice as per OMB Circular A-122. A cost allocation plan that includes shared costs in addition to direct and indirect costs better captures the true expense of a program allowing both nonprofits and City departments to truly know the resources needed to offer client services. Reviewing the cost allocation plan prior to the start of a contract offers departments an opportunity to approve a nonprofit's categorization of expenses and confirm that the application of indirect, direct and shared costs is consistent and reasonable. Cost allocation plans are a core requirement in the City's fiscal monitoring, and so early detection of concerns during negotiations will help the contractor to avoid findings and, possibly, cash flow problems later in the fiscal year.

Resources:

Cost Principals for Non-Profits, OMB Circular A-122 (Revised 2004)

<http://www.whitehouse.gov/omb/circulars/a122/a122.html>

- Explains how to create a cost allocation plan; direct and indirect costs; questionable costs
- Does not offer detailed policies—contractors and federal agencies are too unique

Cost Allocation Guidelines for Nonprofits, The Controllers Office (2005)

<http://www.sfgov.org/site/uploadedfiles/controller/csa/CAGuide.pdf>

- Summarizes concepts of OMB A-122, including indirect costs
- Establishes the City's definitions of cost allocation, direct, indirect and shared costs
- Provides examples of indirect cost allocation plans

Materials on Cost Allocation, Budgeting, and Indirect Cost Determination available on the [Controller's City Service Auditor Division, Resources for Nonprofits](#) website:

- Finance Guide for Nonprofits
http://www.sfgov.org/site/uploadedfiles/controller/reports/Finance_Guide_110104.pdf
- Demystifying Cost Allocations
http://www.sfgov.org/site/uploadedfiles/controller/csa/np/Feb07_wks.pdf
- Cost Allocation Methodologies—Power Point Presentations
<http://www.sfgov.org/site/uploadedfiles/controller/csa/costAllTrn.pdf>
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