

# Calculating Indirect Cost Rate for Non-Profits



Just like their commercial counterparts, nonprofit organizations need effective ways to manage their income and expenses if they want to reach their goals. And also like for-profit organizations, some nonprofits struggle with drawing a line between direct and indirect expenses. For these organizations, failing to accurately calculate and manage their *indirect cost rates* can have an adverse effect on their operational continuity, overall financial health, and ability to secure funding.

With various stakeholders demanding accurate results and sometimes complex cost allocations to make, calculating the indirect cost rate for a nonprofit can seem daunting. However, with careful planning and a clear understanding of the requirements involved, nonprofit organizations can provide accurate financial statements and secure the funds they need to support their programs and achieve

their organizational goals.

## Why Calculating Indirect Cost Rates Matters for Nonprofits

Nonprofit organizations obtain funding in a number of ways, including direct funding by their founder (private charities) and, more commonly, fundraising efforts public and private, including pursuing grants from the government and other sources.

Whatever the case, obtaining funding almost always comes with strings attached; namely, nonprofits need to account for how they're spending the money they receive—including both direct and indirect expenses.

Accurate financials not only demonstrate to investors, grant agencies, and other stakeholders that the money they've provided is being put to good use, but also help ensure the nonprofits get the funds they *actually need* to fund their activities and complete their stated goals.

Nonprofits often struggle to accurately calculate their indirect costs and the amount those costs contribute to their total spend (i.e., their indirect cost rate). As defined by Section 200.56 of the Code of Federal Regulations (CFR), indirect costs include all costs “incurred for a common or joint purpose benefitting more than one cost objective, and not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results achieved.”

Examples include:

- Human resources.
- Office Supplies.
- Insurance expenses.
- General administration and overhead.

- Utilities
- Accounting and auditing services.

In practice, these categorizations effectively boil down to support costs. For example, a nonprofit literacy organization's direct expenses will likely include salaries and benefits for tutors and instructors, books and other materials, and rent on facilities where reading programs take place. These expenses can be directly connected to a specific grant or other source of funding on financial documents, and allocated accordingly.

On the other hand, the program's accounting, IT, and marketing services support all the organization's programs and business activities (i.e., cost objectives), and so will be classified as indirect.

It can be difficult to connect these support costs to specific projects and programs without the right practices and tools. Other challenges nonprofits face in managing their indirect costs include:

- A lack of universal standards for indirect allocation rates and methodologies. Rate caps can be arbitrary, are often set by donors, and limit practical recovery of indirect costs.
- Different sources of funding can have different standards for allowable and non-allowable expenses.
- The Generally Accepted Accounting Principles (GAAP) provide no specific requirements or cost principles for indirect cost allocation. In general practice, allocation methodologies are often left to management's discretion.
- Donors can review and question allocations, demanding clarifications that effectively add to the total indirect costs generated by the organization.
- Requests for higher indirect cost reimbursement caps are often countered with pressure to recoup those costs through unrestricted fundraising activities rather than reimbursement from

donors/grantmakers/sponsoring agencies.

Despite these difficulties, it can be argued that accurately tracking and managing indirect costs is just as important (if not more so) than doing so for direct costs. Unmanaged, indirect costs can create an inaccurate representation of a nonprofit organization's ongoing financial performance and its current and future needs. This, in turn, can make it difficult for those organizations to obtain sufficient funding to support their programs and meet their obligations.

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## Indirect Cost Allocation: Essential Terms

In order to successfully navigate indirect cost calculations and allocation, it's helpful to understand the key terminology involved.

### Direct Costs:

Those costs specifically incurred in furthering a program objective, such as direct salaries, equipment, materials, etc. Direct costs that benefit two or more programs are known as *shared costs*.

### Indirect Costs:

Those costs incurred to support common or shared objectives and that cannot be readily connected to a specific final cost objective. These costs can be further broken into subtypes, including:

- Overhead costs, including facilities, staff, and equipment used for

programs.

- General and administrative costs (G&A costs), e.g. finance, accounting, executive director salary and benefits, administrative facilities, etc.
- Facilities and administrative costs (F&A costs), wherein facilities costs include use and depreciation of buildings and equipment, and administration costs are classified as G&A.

## Indirect Cost Rate:

The rate used to allocate indirect costs across programs. This rate is generally established during negotiations with the funding agency (for federal entities) or grantmaker, and is either specified in the award agreement itself or established in a separate document known as a Negotiated Indirect Cost Rate Agreement (NICRA).

The most basic formula for calculating a grantee's *actual* indirect cost rate is to divide total indirect costs (also called the *indirect cost pool*) by total direct costs (also called the *direct cost base*).

$$\text{Indirect Cost Pool} \div \text{Direct Cost Base} = \text{Indirect Cost Rate}$$

For example, if your organization's indirect cost rate is 34%, it incurs \$0.34 of indirect cost on every dollar of direct spend.

## Reasonable, Allocable, and Allowable (RAA)

In determining how to calculate and charge indirect costs, remember that all qualifying costs are:

- **Reasonable:** The cost supports operations. It is consistent, justifiable, and contributes to the organization's ability to conduct its mission. It is both ordinary and necessary.
- **Allocable:** The cost is connected to a cost objective and proportional to

the benefits received.

- **Allowable:** The cost meets the standards established by the funding body. These standards might include those set for federal grants by the Office of Management and Budget (OMB), Uniform Guidance Standards for Federal Awards (also set by the OMB), specific grant provisions from local governments, etc.

**Note:** While they support the overall survival and mission of the nonprofit organization, fundraising activities to secure funding beyond that awarded by the grantmaker, cognizant agency (i.e., the federal agency with the largest financial stake), etc. are generally *not* classified as allowable.

Lobbying costs, creating and maintaining donor mailing lists, special fundraising events, fundraising materials and related expenses, and any activities involving the direct and formal solicitation of additional funds from any source are all generally considered to be unallowable.

## What is the Average Indirect Cost Rate for Nonprofits?

While no two nonprofit organizations will have identical needs, structures, or budgets, an indirect cost rate of between ten and fifteen percent has served as a longstanding rule of thumb.

For non-federal entities who've never held a negotiated rate with the federal government, the "De Minimis" rate is set at 10% of the organization's Modified Total Direct Costs (MTDC).

However, 2016 research conducted by the Bridgespan Group found an average indirect cost rate of 40% for the organizations it surveyed.

This disparity is more than noteworthy; it is a compelling argument for nonprofits

to take the most accurate and complete indirect cost rate calculation approach possible.

Nonprofits operating under a flat cap of ten or even fifteen percent for estimated costs in their indirect spend can fall into a “starvation cycle,” wherein the nonprofit’s ability to cover the costs of doing business hampers growth, limits infrastructure investment, and can strain or even damage relationships between nonprofits and the donors, investors, and grantmakers that support them.

## Best Practices for Calculating Indirect Cost Rates for Nonprofits

Regardless of their mission, nonprofits can gain better control over their indirect costs, calculate them more accurately, and make better financial planning decisions by following a few simple best practices.

### 1. Understand Your Available Allocation Methods

CFR part 200.56 says “Indirect cost pools must be distributed to benefited cost objectives on bases that will produce an equitable result in consideration of relative benefits derived.”

Translated from grant-speak, this effectively means all indirect costs must be somehow connected to the programs and activities of the nonprofit organization allocating those costs, using a cost allocation plan (CAP).

Organizations approach allocation in a number of ways.

- **Direct allocation** charges programs for all costs directly, as determined by the direct base.
- **Simple allocation** (“Simple Method”) uses a single rate. Nonprofits whose indirect costs benefit all their programs to the same degree can

use the Simple Method.

- **The multiple allocation base method** involves either two or three rates.
  - Two-rate allocation separates fringe and overhead costs.
  - Three-rate allocation is used when indirect costs have varying benefits for major programs and functions. It's broken out by fringe, overhead, and G&A rates.

Let's compare each of these methods. Organization Z has two grants; one from federal funds, one from a non-federal source. Each grant supports one distinct program.

In a direct allocation model, an expense such as rent on a facility would be allocated to both grants based on the square footage (for example) used by each program.

The indirect cost pool would receive an allocation based on the square footage used for indirect purposes (e.g., an office for an IT contractor servicing both programs). Let's assume the total rent expense for the year is \$1,000,000, and the total square footage is 100,000 square feet.

Program A uses 50,000 square feet, Program B uses 40,000 square feet, and IT uses 10,000 square feet.

Program A is charged \$500,000 (50% of total square footage/occupancy).

Program B is charged \$400,000 (40% of total square footage/occupancy)

The indirect cost pool is charged \$100,000 (10% of the total square footage/occupancy).

In order for the cost allocations to be equitable and accurate, the direct cost base used (in this case, square footage) must be consistent and reasonably connected



to the benefit provided.

In a simple allocation model, the indirect rate can be applied to the total direct cost base. So if the NICRA for each grant sets the predetermined rate for indirect costs at 10%, and the total rent expenditure was \$1,000,000, then the indirect pool allocation would be \$200,000 ( $\$1,000,000 \times .20$  (two grants) = \$200,000).

In a multiple allocation base method, both the cost of the program itself and the square footage used by each program (as well as IT services) may be considered in calculating the direct base, as indicated by the demonstrable benefits provided to each group by a given expense.

Indirect costs will then be calculated as above, but further granulated to specify G&A, fringe benefits, overhead, etc. In this model, fringe benefits are allocated based on salary and wages, while overhead gets allocated to Modified Total Direct Costs (MTDC).

## 2. Establish Your Indirect Cost Rate Calculation Process

1. Gather financial data.
  1. Income and expense categories.
  2. Detailed budgets.
  3. Staff time sheets/work records, including compensation.
  4. Detailed information on funded programs.
  5. Any relevant grant and award agreements.
2. Define your funded programs.
  1. Separate activities into discrete programs as necessary.
  2. Establish cost centers for specific programs, G&A, and fundraising activities.
3. Identify direct and indirect costs.

1. Review **all** expense line items in the general ledger and classify as direct or indirect accordingly.
2. Provide detailed annotations for easy reference and auditing purposes.
4. Select your allocation method.
  1. Keep it simple and consistent.
  2. Common allocation methods include square footage, number of users, etc.
  3. Formalize your methodologies and processes in writing.
  4. Allocate **all** costs, including unallowable costs.
5. Allocate staff salaries and benefits.
  1. These will likely be your largest expense.
  2. Avoid allocating expenses based on job title.
  3. Be as accurate as possible; guessing is a recipe for disaster.
  4. If your executive director is working directly in one or more programs, be sure to allocate the time spent accordingly.
6. Allocate shared (direct and indirect) costs.
  1. Charge any costs that can be 100% allocated to either a specific program or funding source **or** 100% allocated to indirect costs directly to their corresponding cost centers.
  2. Track joint expenses over the accounting period in a generic department/cost center and then allocate them to their specific funding sources and cost centers (including the indirect cost pool) at the end of the period.
  3. Indirect cost pools are spread across all appropriate funding sources, using the appropriate cost base.
  4. Line-item allocation of indirect costs will reflect the appropriate cost base for each specific indirect line item.
7. Allocate joint costs (costs charged to both program activities and fundraising for the organization).
  1. To qualify as joint rather than fundraising costs, items must:

1. Include a specific call to action.
  2. Clarify the audience's need and ability to meet the call to action.
  3. Show how the action performed supports the organization's programs/mission.
8. Review your policy regularly.

### **3. Vigorously Monitor Allowable and Unallowable costs.**

Depending on your sources of funding, you'll likely spend a fair amount of time tracking what expenses are allowed and which aren't—particularly if your primary funder is a cognizant agency within the federal government. The OMB circular covering nonprofits provides exhaustive guidelines in this regard.

Whether your funding is federally awarded or from a private or corporate source, it's a good idea to stay abreast of what does and doesn't qualify for your indirect cost pool in any given fiscal year, as they can affect your final rate for indirect costs.

Note that unallowable costs aren't "forbidden," per se (and should appear in your total general expenses); they just can't be included in your indirect cost pool.

### **4. Invest in Procure-to-Pay Software**

You'll likely find it much easier to manage your financials and develop the controls and workflows needed for clear and accurate data with help from a comprehensive procure-to-pay solution.

With a best-in-class, bespoke solution such as Planergy, organizations of all sizes and types gain a range of benefits, including:

- Transparent and complete capture of all spend data.
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- Robotic process automation supported by artificial intelligence improves the accuracy, speed, and efficiency of all your spend activities, bringing your estimated costs and actual costs into alignment.
- Advanced analytics for real-time spend management and on-demand, audit-ready computation and reporting of critical financial data.
- Powerful data mining capabilities yield insights that help nonprofits:
  - Refine their workflows and optimize critical processes.
  - Boosting return on investment (ROI).
  - Create more accurate budgets and cost models to minimize waste and carry-forward.
  - Manage MTDC more effectively.
  - Manage cash flow and capital expenditures more effectively.
  - Negotiate more accurate and sustainable indirect cost rate proposals, cooperative agreements, and NICRAs for primary and subawards.
  - Shift from a cost-management model to one focused on total cost of ownership (TCO) and value creation.

## 5. Negotiate from a Position of Strength

Obtaining funding takes time, commitment, and tenacity. The process of creating your indirect cost proposal will be much easier. You'll also find it easier to secure a satisfactory indirect cost rate if you have clear and complete financial data for your organization (which, again, is itself much easier to obtain if you have the right software tools).

Accurate and clear financial statements will simplify requesting funds and securing a favorable negotiated rate. It'll also show potential donors, grantmakers, and investors awarding funds that your organization is accountable,

competent, and fully invested in securing the best possible return on *their* investment.

Don't forget to take advantage of resources provided by grantmakers and donors. USAID, for example, provides detailed indirect cost rate guidance for nonprofits, including explicit instructions on submitting a NICRA.

## 6. Avoid Common Allocation Errors

- Set, enforce, and regularly review cost allocation policies.
- Ensure all policies are formalized and in writing.
- Don't use unrestricted funds (or general funds) for allowable indirect costs.
- Avoid "double dipping," i.e. charging an expense to both direct and indirect costs.
- Set and enforce best practices for employee timesheet documentation; ensure hours are charged to appropriate funding sources to avoid having those costs disallowed.
- Ensure programs are being charged appropriately and fully; ensure you have a clear understanding of how your employees spend their time.

## Don't Let Unmanaged Indirect Costs Hamper Your Nonprofit's Performance

Even nonprofits need a clear view of, and control over, the cost of doing business if they want to succeed. By identifying, tracking, and accurately calculating your indirect cost rate, you can make sure your nonprofit produces accurate, audit-ready financials, meets stakeholder expectations, and has all the funding it needs to get the job done.

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