

## INDIRECT COSTS IN THE SCHOOL NUTRITION PROGRAMS

### I. Introduction.

The concept of indirect costs is set out in government-wide rules, called **cost principles**, for charging costs to Federal programs operated by non-federal entities. The Federal cost principles applicable to State agencies, public school districts, and public residential child care institutions (RCCIs) are found in OMB Circular A-87 (*Cost Principles for State, Local, and Indian Tribal Governments*). Let's begin by considering what A-87 has to say about indirect costs in the School Nutrition Programs (SNP).

#### A. Objectives of Federal Cost Principles:

##### 1. Allocation.

A cost must be lodged with the cost objective(s) (program(s), function(s), etc.) that benefit(s) from the program operator having incurred it. A cost that benefits two or more cost objectives must be distributed among them commensurate with the benefit each received from the cost. The process of achieving this is called "cost allocation." Allocation is necessary to identify the true cost of each program or other cost objective, and to ensure that each cost objective bears its fair share of shared costs.

##### 2. Recovery.

To recover a cost means to get someone else (generally the someone who benefited from our having incurred the cost) to pay us back for the resources we expended incurring the cost to begin with. As you know, a School Food Authority (SFA) operating the National School Lunch and School Breakfast Programs (NSLP & SBP) recovers most of the cost of producing paid meals from paying children, and most of the cost of serving free and reduced-price meals as reimbursement from its State agency. Without such cost recovery, the SFA's nonprofit food service would soon go bankrupt.

At a more generic level, an operator of a Federal program recovers the costs identified to that program by claiming reimbursement from its Federal or State awarding agency. The Federal cost principles are crafted to enable operators of Federal programs to do this.

While allocation may determine a program's full cost, funding restrictions or program-specific rules may preclude a program operator from recovering that full cost through Federal reimbursement. In such a case, the resulting deficit cannot be shifted to another Federal program in order to recover it. Costs properly allocable to a program must remain with that program, and the program operator must absorb any resulting deficit from other resources.

B. Federal Cost Principles' Applicability to the SNP:

The application of Federal cost principles to the SNP has both an external and an internal dimension.

1. **External Dimension:** Program Operator Recovers Program Cost From its Awarding Agency:

As you know, SNP rules require a school district or other SFA to claim NSLP & SBP reimbursement from its State awarding agency. However, an SFA's entitlement to such reimbursement is driven by the meals-times-rates formula rather than by the reimbursement of actual costs. The NSLP & SBP thus represent a departure from the general model, in that **an SFA does not recover program costs through program reimbursement! SFAs claim meals, not costs!** Therefore, recovering indirect costs allocable to the SNP by claiming reimbursement for them from the State agency is not an issue.

2. **Internal Dimension:** SFA's General Fund Seeks to Recover Cost of Services Rendered to School Food Service.

Indirect costs are typically administrative overhead costs that benefit multiple programs, functions, and organizational units of an SFA. Examples may include the costs of human resources, accounting, payroll, purchasing, facilities management, utilities, etc. These functions are generally accounted for in an SFA's General Fund (GF). The organizational units within the GF that provide these services and incur their costs cannot claim reimbursement from the

State agency themselves, since the SFA's program offices are the portal through which Federal program reimbursement payments enter the SFA. The GF thus has two options for recovering its costs: relying on its own appropriations, or billing the program offices that do claim Federal reimbursement from Federal and State awarding agencies. Many SFAs have recently turned to the second option and billed their nonprofit school food services for indirect costs. The appropriateness of their billings has become a matter of concern to many State and SFA officials.

## II. Cost Principles Basics.

### A. Allowable and Unallowable Costs.

A cost for which the Federal Cost Principles allow an awarding agency to reimburse a grantee/subgrantee under a Federal program is an **allowable cost**. Rules for allowing costs are found in Attachments A and B to A-87. Costs that don't conform to these rules are **unallowable costs**, which can never be charged to a Federal program. To be allowable, a cost must:

#### 1. **Benefit the cost objective to which it is charged.**

Attachment A of A-87 spells out criteria for determining a cost's benefit to programs, functions, and other cost objectives. Examples of such criteria include:

##### a. Reasonable and Necessary for Program Purposes

A cost is never allowable if incurring it is not **necessary** to carry out the purpose of the program. An allowable cost must also be **reasonable**. Attachment A defines a reasonable cost as one that a prudent person would opt to incur in like circumstances. For example, no one would question the necessity of serving an on-site meal to attendees at a SNP training conference where convenient, nearby eateries were not available. However, would the taxpayers deem it "reasonable" to serve the attendees filet mignon and caviar?

##### b. Net of Applicable Credits.

"Applicable credits" are items that offset (reduce) costs. Prime examples are purchase discounts, rebates, and refunds. If a transaction entails an

applicable credit, the program operator's actual cost is the purchase price minus the credit. That's the cost that must be charged to the program.

c. Documented.

A-87 actually says "adequately documented," but I don't like to quote that because I can't give a one-size-fits-all definition of "adequately." Suffice it to say that auditors and FNS reviewers will question costs for which a program operator cannot produce supporting documentation.

d. Conforms to Program-Specific Rules.

Regardless of what A-87 says, a cost must be incurred in accordance with terms and conditions stated in the regulations of the program to which it is charged (that is, in accordance with program-specific rules) in order to be allowed. A program operator must observe program-specific limitations on purposes for which program funds are made available, program-specific restrictions on specific items of cost, etc. For example, section 210.14(a) sets restrictions on the use of nonprofit school food service funds for buildings. Some programs' rules prohibit the reimbursement of indirect costs altogether.

**2. Conform to rules for specific items of cost.**

Attachment B to A-87 lists specific cost items and gives rules for charging them to Federal programs. Attachment B classifies costs as allowable, allowable with prior approval, or unallowable. If Attachment B identifies a cost item as allowable, that cost item must still pass muster under the Attachment A criteria in order to be allowed. That is, Attachment B may identify wages and salaries as allowable costs, but the compensation of a staffer whose duties do not benefit a program is never an allowable cost to that program.

a. Examples of specific allowable costs include:

(1) Wages & Salaries.

(2) Travel.

- (3) Training & Staff Development.
- (4) Supplies.
- (5) Meetings & Conferences.
- (6) Printing and Publication.

b. Examples of specific unallowable costs include:

- (1) Alcoholic Beverages.
- (2) Entertainment.
- (3) Costs of General Government.
- (4) Lobbying.
- (5) Contributions to Contingency Funds.

B. Direct and Indirect Costs.

1. A **direct cost** is one incurred specifically for a program or other cost objective. The clearest examples are wages & salaries of staff working in the program, and supplies purchased for use in the program.
2. An **indirect cost** is one incurred for the benefit of multiple programs, functions, or other cost objectives, and which cannot be directly charged to benefiting cost objectives without exerting effort disproportionate to results achieved. As already noted, indirect costs are typically administrative overhead costs such as the costs of human resources, accounting, payroll, purchasing, facilities management, utilities, etc.

Few costs are inherently direct or indirect; their classification generally depends on how they are treated in the SFA's accounting system. For example, SFAs in one State may treat their entire phone bills as indirect costs; while SFAs in another State may pick out the charges for long-distance calls, identify the cost objectives they benefited, and assign them as direct costs to those cost objectives.

C. Identification of Indirect Costs.

Indirect costs are generally assigned to benefiting programs through the application of a shorthand methodology called an “**indirect cost rate**.” Use of this methodology facilitates identifying and recovering the full cost of a program. This methodology has two dimensions: deriving the indirect cost rate, and then applying it in order to claim reimbursement for indirect costs.

1. Deriving the Rate.

In its simplest form, the rate is derived by dividing the **indirect cost pool** by an appropriate **direct cost base**. The indirect cost pool (numerator) is the sum of allowable indirect costs; unallowable indirect costs cannot be allocated to federally assisted programs. The base (denominator) must include both allowable and unallowable costs because they benefit equally from the allowable indirect costs in the pool. Direct cost bases most widely used are:

- a. Direct Wages & Salaries
- b. Modified Total Direct Costs (MTDC)

One obtains MTDC by excluding certain items from total direct costs. These are known as “distorting items” because they do not generate or benefit from administrative overhead the way wages & salaries, etc. do. Distorting items include (but are not limited to) capital expenditures, payments to contractors beyond the first \$25,000, and (at the SFA level) food costs.

2. Applying the Rate to Compute Actual Indirect Cost.

The decimal, or “rate,” resulting from this calculation is then applied each reporting period to the program’s base of actual direct costs in order to obtain actual allocable indirect costs.

D. Authorization to Use Indirect Cost Methodology.

To claim reimbursement for indirect costs, a program operator must prepare an Indirect Cost Rate Proposal (ICRP). The ICRP is a schedule that documents the formulation of the program operator’s indirect cost rate and direct cost base. It identifies the costs treated as direct and indirect in the program operator’s accounting system; crosswalks them from audited financial reports; separates costs

into the indirect cost pool and direct cost base; and shows the computation of the proposed rate. We'll look at the ICRP in more detail shortly.

Where required by A-87, a program operator must submit its ICRP to its cognizant Federal agency for review and approval. The indirect cost rate methodology is a government-wide requirement, and a program operator would find it complex and burdensome to use multiple methodologies to meet the needs of different awarding agencies. Therefore, the cognizant agency speaks for all the program operator's awarding agencies in negotiating an indirect cost rate that the program operator will use in claiming indirect costs under all its Federal awards (barring program-specific restrictions).

Public school districts form a variant to this principle. Regulations of the U.S. Department of Education (34 CFR section 76.561(b)) require a State educational agency (SEA) to negotiate indirect cost rates for any local educational agency (LEA), such as a public school district, that requests them. Thus, the SEA is the cognizant agency for LEAs under its jurisdiction.

The U.S. Department of Education negotiates an agreement with each SEA to establish the methodology the SEA will use in performing this function. Under that agreement, the SEA generally distributes an ICRP form to its LEAs and uses the data collected thereby to compute their indirect cost rates.

#### E. Restricted and Unrestricted Rates.

As a general rule, a Federal cognizant agency or SEA can approve whatever indirect cost rate emerges from a program operator's calculations. Such a rate is known as a **negotiated or unrestricted rate**. The unrestricted rate is crafted to enable a program operator to recover its Federal programs' fair share of the cost of its indirect cost activities.

The authorizing statutes of some Federal educational programs require exceptions to this general rule. They provide that Federal funds made available for those programs **supplement, but do not supplant**, resources that SEAs and LEAs were already spending on education before the inception of the Federal programs. The intent of this legislation is to assist SEAs and LEAs in achieving greater levels of benefits and services, without tempting them to withdraw their own support for these activities.

To implement the “Supplement-not-Supplant” requirement, the U.S. Department of Education requires SEAs and LEAs to recalculate their indirect cost rates using a formula described by 34 CFR sections 76.564 through 76.569. This formula entails excluding certain cost items from an LEA’s indirect cost pool and, in many cases, reclassifying them as direct costs. This generates a smaller numerator and larger denominator, hence a smaller decimal and a lower rate. Such rates are known as **restricted rates**. Most restricted rates are single-digit.

The requirement to use a restricted rate thus prevents an LEA from recovering the full cost of certain educational programs from its SEA. As already noted, the LEA must absorb the difference from its own resources.

An SEA will generally approve both an unrestricted rate and a restricted rate for an LEA. The **unrestricted rate** applies to school food service because the legislation authorizing the NSLP & SBP does not prescribe a supplement-not-supplant requirement for those programs.

### **III. Indirect Cost Methodology.**

#### **A. Deriving the Unrestricted Negotiated Rate.**

##### **Step 1. Begin with the SFA’s financial reports.**

Because the starting point for indirect cost rate calculations consists of the SFA’s official audited financial reports, the figures we’re going to compute will have a firm basis in objective reality. For illustrative purposes, let’s presume that the financial reports of the New School District included the following expenditures:

NEW SCHOOL DISTRICT  
FINANCIAL REPORT  
EXPENDITURES BY FUNCTIONAL CATEGORY

NCES 1/ FUNCTION CODE	<u>NCES TITLE</u>	<u>EXPENDITURES</u>
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

1/ National Center for Education Statistics

**Step 2:      Eliminate “excluded costs” from the calculation.**

Excluded costs are items whose inclusion would distort the final results. As already noted, examples of such distorting items include capital expenditures and contract costs in excess of \$25,000 per contract. The rationale for such exclusions is that:

- a.      A capital expenditure is the cost of purchasing a capital asset (land, buildings, equipment, etc.). While it is a “cost,” it is not a “current operating expense.” This is because the SFA realizes the benefit of a capital expenditure over a period of years that the capital asset is used in operations. This benefit is measured by annual depreciation expense or use allowance. Only a year’s depreciation expense or use allowance can be included in indirect cost computations.
  
- b.      The cost of administering a procurement contract is pretty much the same, whether the value of the contract is \$1,000 or \$10 million. That cost is presumed to be \$25,000 per contract. The value of

each contract beyond \$25,000 must therefore be excluded.

For illustrative purposes, let's presume the New School District identified the following distorting items that must be excluded:

- a. \$100,000 of the \$125,000 cost of a professional services contract awarded for instructional purposes (excluded from Function 1000 (Instruction)).
- b. A \$90,000 capital expenditure to acquire school buses (excluded from Function 2700 (Student Transportation)).
- c. Capital expenditures of \$15,000 for food service equipment (excluded from Function 3100 (Food Services)).
- d. Food costs totaling \$75,000 (excluded from Function 3100 (Food Services)).

The SFA's ICRP would present these exclusions as follows:

NEW SCHOOL DISTRICT  
INDIRECT COST RATE PROPOSAL  
ADJUSTMENTS FOR EXCLUDED COSTS

NCES FUNCTION CODE	NCES TITLE	OLD TOTAL COST	EXCLUDED COSTS	NEW TOTAL COST
1000	Instruction	\$900,000	(100,000)	\$800,000
2100	Student Services	75,000		75,000
2212	Curriculum Develop.	30,000		30,000
2213	Instruct. Staff Training	20,000		20,000
2321	Superintendent's Office	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	15,000		15,000
2600	Plant Operation & Maint.	125,000		125,000
2700	Student Transport.	165,000	(90,000)	75,000
3100	Food Services	100,000	(90,000)	10,000
	Total	\$1,500,000	\$280,000	\$1,220,000

**Step 3:      Classify costs as direct or indirect.**

An LEA generally makes this determination by following accounting and reporting instructions from the SEA. For illustrative purposes, let's assume that the New School District's SEA prescribes the following break-out between direct and indirect costs:

NEW SCHOOL DISTRICT  
INDIRECT COST RATE PROPOSAL  
DIRECT AND INDIRECT COSTS

NCES FUNCTION				
<u>CODE</u>	<u>NCES TITLE</u>	<u>DIRECT</u>	<u>INDIRECT</u>	<u>TOTAL</u>
1000	Instruction	\$800,000		\$800,000
2100	Student Services	75,000		75,000
2212	Curriculum Devel.	30,000		30,000
2213	Inst. Staff Training	20,000		20,000
2321	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		15,000	15,000
2600	Plant Op'n & Maint.		125,000	125,000
2700	Student Transport.	75,000		75,000
3100	Food Services	10,000		10,000
	Total	\$1,010,000	\$210,000	\$1,220,000

**Step 4:      Eliminate unallowable costs from the total indirect costs in order to obtain the Indirect Cost Pool.**

As we noted, only allowable costs can be allocated to Federal programs. Therefore, unallowable costs must be ejected from the indirect cost pool. These unallowable indirect costs go to the direct cost base because they are still part of the SFA's total cost and benefit from the costs remaining in the pool. For illustrative purposes, let's presume the New School District identified the need for the following adjustments in order to arrive at its Indirect Cost Pool:

- a.      Eliminated \$2,000 in unallowable public relations costs from code 2560 (Public Relations). These costs

were unallowable because they represented promotion of the SFA in general rather than specific program benefits or achievements.

- b. Eliminated \$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.

These adjustments are illustrated as follows:

NEW SCHOOL DISTRICT  
INDIRECT COST RATE PROPOSAL  
ELIMINATION OF UNALLOWABLE INDIRECT COSTS

<u>EXPENDITURES BY FUNCTION</u>	<u>INDIRECT COSTS</u>	<u>UNALLOW- ABLE</u>	INDIRECT <u>COST POOL</u>	<u>DIRECT COSTS</u>
Instruction				\$800,000
Student Services				75,000
Curriculum Devel.				30,000
Inst. Staff Tng.				20,000
Superintendent	40,000	(8,000)	32,000	8,000
Fiscal Services	10,000		10,000	
Procurement	10,000		10,000	
Public Relations	10,000	(2,000)	8,000	2,000
Personnel	15,000		15,000	
Plant Op'n. & Maint.	125,000		125,000	
Student Transp.				75,000
Food Services				10,000
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	\$210,000	(10,000)	\$200,000	\$1,020,000

This analysis thus leaves the New School District with an indirect cost pool of \$200,000 and a Modified Total Direct Cost (MTDC) base of \$1,020,000. They are now ready to derive the rate.

**Step 5: Divide the pool by the base to obtain the rate.**

We would compute the rate as follows:

$$\begin{aligned} &\text{Indirect Cost Pool/Direct Cost Base (MTDC)} = \\ &\$200,000/\$1,020,000 = \\ &0.19608 \text{ or } 19.61 \text{ percent of MTDC} \end{aligned}$$

This procedure generates the **unrestricted negotiated rate.**

Users of indirect cost rates need to be aware of a key point: they cannot claim reimbursement for indirect costs unless they have both the prescribed rate and the prescribed base. Either of these is useless without the other. If the SEA has notified an LEA of its rate but not the base, then the LEA should contact the SEA to obtain it.

**B. Identifying and Claiming Indirect Cost.**

In its simplest form, claiming indirect cost entails applying the prescribed rate to the sum of a program's actual direct costs in the prescribed base. We no longer claim reimbursement for allowable costs in the SNP, but let's presume, for illustrative purposes, that we still do. Let's also assume the New School District's nonprofit food service had actual total costs of \$14,000 and actual food costs of \$11,000 for the month of September. The SFA would compute its claim for indirect cost reimbursement as follows:

**Step 1: Eliminate Excluded Items.**

Total Food Service Cost.....	\$14,000
Less Food Cost .....	(11,000)
	-----
Amount Available for Direct and Indirect Costs...	\$3,000

**Step 2: Determine Amount Available to be Assessed Indirect Costs:**

$$\begin{aligned} &\text{Total Available for Direct \& Indirect / (1 + rate)} = \\ &\$3,000 / 1.1961 = \$2,508 \text{ to be assessed indirect costs} \end{aligned}$$

### **Step 3: Compute Indirect Cost Dollar Amount:**

This step entails multiplying the amount to be assessed indirect costs by the indirect cost rate, as follows:

$$\$2,508 * 0.1961 = \$492 \text{ indirect cost claimed}$$

#### **C. Erroneous Methods Used by Some SFAs.**

The School Nutrition Association's 2006 Indirect Costs Study identified erroneous methods used by some SFAs to bill their nonprofit school food services for services provided the General Fund. Examples included:

1. Designating the nonprofit food service's entire excess of revenues over expenses (that is, its "profit") as "indirect cost" and shifting it to the General Fund.
2. Setting "indirect costs" at a percentage of the SFA's Federal reimbursement.
3. Setting "indirect costs" at a percentage of the nonprofit food service's revenue.
4. Designating the custodians' wages and benefits as indirect cost.
5. Designating whatever amount the school district needed to balance its budget as "indirect cost."

What's wrong with these methods? There is no explicit Federal requirement that an SFA's GF use any particular method to recover the cost of services provided to program offices. How the SFA's GF recovers the cost of such services is a matter of each SFA's internal fiscal and accounting policies.

Nevertheless, there is a Federal requirement that an SFA safeguard the integrity of its nonprofit school food service. The definition of "Nonprofit school food service" at 7 CFR section 210.2 provides that "all of the revenue from [the nonprofit school food service] is used solely for the operation or improvement of such food services." If the GF bills the nonprofit food service for more than measurable costs of services that benefited the food service, the excess is not being used to operate or improve the food service. Rather, it is being used for services that benefit other

components of the SFA in violation of the aforementioned regulation.

Regulations of the U.S. Department of Education at 34 CFR section 76.560(b) require that “[a] grantee must have a current indirect cost rate agreement to charge indirect costs to a grant.” This means that the cognizant agency considers indirect cost methodology to be the prescribed method of measuring the benefit a grant or other cost objective receives from an LEA’s indirect cost activities. If the LEA cannot claim reimbursement for indirect costs by any other means (that is, the External Dimension), then its GF cannot use any other basis for recovering indirect costs from the food service and other program offices (that is, the Internal Dimension). See Appendix A (Excerpt From the *School District Flyer*, a Newsletter of the Arizona Office of the Auditor General) for a concise statement of this principle.

## **V. Conclusion.**

The School Nutrition community’s recently increased interest in indirect costs has been driven by problems with SFAs’ GFs billing their nonprofit food services for “indirect costs.” That is not inappropriate in and of itself; however, some SFAs have abused it by using the nonprofit food service as a cash cow. Indirect cost methodology is a complex business on which we do not expect local school food service directors to be experts. However, they do need to be sufficiently aware of indirect costing in general, and of the specific indirect cost methods authorized for their SFAs in particular, to be able to evaluate the reasonableness or propriety of billings they receive from their GFs for “indirect costs.” I hope this discussion has provided a basic understanding of indirect costs sufficient for them to do this.

## **VI. Questions.**

## APPENDIX A

### EXCERPT FROM THE *SCHOOL DISTRICT FLYER*, A NEWSLETTER OF THE ARIZONA OFFICE OF THE AUDITOR GENERAL (Issue 36, May 2007)

Question: What is the Indirect Costs Fund (570), and how can it be used?

Answer: The Indirect Costs Fund accounts for monies transferred from federal project funds and the Food Service Fund for the payment of administrative costs incurred. In those funds, expenditure object code 6910—Indirect Costs should be used when transferring these monies. Revenue object code 5200—Interfund Transfers-In should be used to record the monies transferred into the Indirect Costs Fund. **The amount transferred may not exceed the amount calculated using the indirect cost rate established by the Arizona Department of Education for the district and the maximum rate allowed by the particular federal project.** Expenditures from the Indirect Costs Fund should be for maintenance and operation purposes. Please note that object code 6910—Indirect Costs should be included as an interfund transfers-out for reporting purposes on the district's annual financial report and financial statements.

The journal entry below illustrates a transfer from a federal project fund to the Indirect Costs Fund.

100 100 6000 6910 Other Financing Uses—Indirect Costs \$500  
100 000 0000 0103 Cash on Deposit with County Treasurer 500  
570 000 0000 0103 Cash on Deposit with County Treasurer 500  
570 000 0000 5200 Other Financing Sources— Interfund  
Transfers In 500

## APPENDIX B – INDIRECT COST GLOSSARY

### I. Cost.

Resources given up in order to obtain a benefit. The full cost of a program is the sum of its direct and indirect costs. The Federal cost principles (OMB Circular A-87, etc.) set rules for charging these costs to Federal programs.

### II. Cost Objective.

A program, function, activity, or other category for which cost data are needed for decision-making and therefore collected. At a minimum, an SFA must treat the nonprofit school food service required by NSLP rules (7 CFR section 210.14(a)) as a cost objective. If the SFA performs food service functions that fall outside the nonprofit food service, such as catering for school activities, such functions comprise separate cost objectives.

Perhaps the simplest way to conceptualize cost objectives is to consider the SF-269 report. It consists of multiple columns, each of which captures data on a cost objective. The NSLP, SBP, SMP, and SAE appear as cost objectives in and of themselves. On the other hand, the SF-269 captures data on four cost objectives in the Child and Adult Care Food Program: Meal Reimbursement, Sponsor Administrative Costs, Audits, and Start-up Costs.

### III. Allowable and Unallowable Costs.

A cost for which the Federal Cost Principles allow an awarding agency to reimburse a grantee/subgrantee under a Federal grant/subgrant is an **allowable cost**. Rules for allowing costs are found in Attachments A and B to A-87. Costs that don't conform to these rules are **unallowable costs**, which can never be charged to a Federal grant.

#### A. Attachment A: Criteria for Allowing Costs as Charges to Grants.

To be allowable, a cost must **benefit the cost objective to which it is charged**. Attachment A of A-87 spells out criteria for determining a cost's benefit to cost objectives. These include (but are not limited to) the following:

##### 1. Reasonable and Necessary for Program Purposes

A cost is never allowable if incurring it is not **necessary** to carry out the purpose of the program. An allowable cost

must also be **reasonable**. A-87 defines a reasonable cost as one that a prudent person would opt to incur in like circumstances. For example, no one would question the cost of serving an on-site meal to attendees at a SNP training conference where convenient, nearby eateries were not available. However, would the taxpayers deem it “reasonable” to serve the attendees filet mignon and caviar?

2. Not charged or allocable to any other program

Remember, if a cost benefits another Federal program, it cannot be charged to the SNP simply to make good a deficiency in the other program account.

3. Prior Approval if Required

In some cases, a program operator must obtain its awarding agency’s written prior approval before incurring a cost. This is not because we’re control freaks, but because we need to protect the Government’s (and ultimately the taxpayers’) interest. The prime example is equipment. Equipment is generally a big-ticket item. If we buy a program operator a piece of expensive equipment up front, we put out a lot of Federal money and assume the risks of ownership (such as loss, damage, obsolescence, etc.) before the program has received any benefit from using the equipment. Giving prior approval provides us a modicum of control to mitigate these risks.

4. Treated consistently with non-grant transactions.

The SNP are State-administered, SFA-operated programs. This presumes that a State agency will require SFAs under its oversight to conduct SNP transactions according to the same rules and criteria that the SFAs follow in conducting transactions supported with State and local funds.

5. Net of Applicable Credits.

“Applicable credits” are items that offset (reduce) costs. Prime examples are purchase discounts, rebates, and refunds. If a transaction entails an applicable credit, the program operator’s actual cost is the purchase price minus the credit. That’s the cost that must be charged to the program.

6. Documented.

A-87 actually says “adequately documented,” but I don’t like to quote that because I can’t give a one-size-fits-all definition of “adequately.” Suffice it to say that auditors and FNS reviewers will question costs for which a program operator cannot produce supporting documentation.

7. Conforms to Program-Specific Rules.

Regardless of what A-87 says, a cost must be incurred in accordance with terms and conditions stated in program regulations (that is, in accordance with program-specific rules) in order to be allowed. A program operator must observe program-specific limitations on purposes for which program funds are made available, program-specific restrictions on specific items of cost, etc. For example:

- a. Section 210.14(a) sets restrictions on the use of nonprofit school food service funds for buildings.
- b. The use of restricted indirect cost rates precludes an SFA from recovering the full cost of operating certain Federal educational programs.

B. Attachment B: Rules for Specific Items of Cost.

Attachment B to A-87 lists specific cost items and gives rules for charging them to grants. Attachment B classifies costs as allowable, allowable with prior approval, or unallowable. If Attachment B identifies a cost item as allowable, that cost item must still pass muster under the Attachment A criteria in order to be allowed. That is, Attachment B may identify wages and salaries as allowable costs, but the compensation of a staffer whose duties do not benefit the SNP is never an allowable cost to the SNP.

1. Examples of Specific Allowable Costs.

- a. Wages & Salaries.
- b. Travel.
- c. Training & Staff Development.
- d. Supplies.

- e. Meetings & Conferences.
  - f. Printing and Publication.
2. Examples of Specific Unallowable Costs.
- a. Alcoholic Beverages.
  - b. Entertainment.
  - c. Costs of General Government.
  - d. Lobbying.
  - e. Contributions to Contingency Funds.

IV. Capital Expenditure.

An expenditure of resources to acquire capital assets, or to make enhancements to existing capital assets that materially increase their value and/or useful life. Capital assets are items of property that cost a substantial amount (set by the SFA's accounting policy) and have useful lives of a year or more. The prime examples are land, buildings, and equipment. As we've already noted, capital expenditures made with program funds require prior approval.

V. Direct Cost.

Cost incurred specifically for a program or other cost objective. The clearest examples are wages & salaries of staff working in the program, and supplies purchased for use in the program.

VI. Indirect Cost.

A. What are they?

Cost incurred for the benefit of multiple cost objectives, and which cannot be directly charged to benefiting cost objectives without exerting effort disproportionate to results achieved. As already noted, indirect costs are typically administrative overhead costs such as the costs of human resources, accounting, payroll, purchasing, facilities management, utilities, etc.

Few costs are inherently direct or indirect; their classification depends on how they are treated in the SFA's accounting

system. For example, SFAs in one State may include their entire phone bills in their indirect cost pools; while SFAs in another State may pick out the charges for long-distance calls, identify the cost objectives they benefited, and assign them as direct costs to those cost objectives.

B. How are they identified?

Indirect costs are generally assigned to benefiting cost objectives through the application of a shorthand methodology called an “indirect cost rate.”

VII. Indirect Cost Pool.

The sum of allowable indirect costs that will be allocated to cost objectives via an indirect cost rate. Since only allowable costs may be charged to Federal programs, only allowable indirect costs may be included in the pool. We pool the allowable indirect costs in order to derive the indirect cost rate.

VIII. Direct Cost Base.

The sum of allowable and unallowable direct costs that benefit from the SFA incurring the allowable costs in the indirect cost pool. One uses the direct cost base to compute the indirect cost rate. Direct cost bases most widely used are:

A. Direct Wages & Salaries

B. Modified Total Direct Costs (MTDC)

One obtains MTDC by excluding certain items from total direct costs. These are known as “distorting items” because they do not generate or benefit from administrative overhead the way wages & salaries, etc. do. Distorting items include (but are not limited to) capital expenditures, payments to subgrantees and contractors beyond the first \$25,000, and (at the SFA level) food costs. The theory behind excluding contract and subgrant costs beyond the first \$25,000 is that it costs about the same (\$25,000) to administer any contract or subgrant, regardless of its dollar value.

IX. Indirect Cost Rate.

A shorthand methodology for allocating allowable indirect costs to benefiting cost objectives. Its use facilitates identifying and

recovering the full cost of a program. Indirect cost rate methodology has two dimensions:

A. Deriving the Rate.

In its simplest form, the rate is derived by dividing the **indirect cost pool** by an appropriate **direct cost base**. The base (denominator) must include both allowable and unallowable direct costs because they benefit equally from the indirect costs in the pool (numerator).

B. Applying the Rate to Compute Actual Indirect Cost.

The decimal, or “rate,” resulting from this calculation is then applied each reporting period to the program’s actual direct costs.

X. Indirect Cost Rate Proposal (ICRP).

A schedule prepared by a program operator in order to: (a) document the formulation of its indirect cost rate, and (b) obtain authorization to use it in allocating and recovering program costs. The ICRP identifies the costs treated as direct and indirect in the program operator’s accounting system; crosswalks them from audited financial reports; separates costs into the indirect cost pool and direct cost base; and shows the computation of the proposed rate.

The general rule is that: (a) a program operator for which OMB has assigned a cognizant Federal agency submits its ICRP to that agency for review and approval; and (b) any other program operator maintains its ICRP on file for inspection during reviews and audits. However, school districts form an exception to this rule; regulations of the U.S. Department of Education (34 CFR section 76.561(b)) require a State educational agency (SEA) to negotiate indirect cost rates for any school district that requests them.

XI. Cognizant Federal Agency.

The Federal agency tasked with speaking to a program operator on behalf of all the program operator’s Federal awarding agencies on cross-cutting matters such as the negotiation of cost allocation documents. The indirect cost rate methodology is a government-wide requirement, and a program operator would find it complex and burdensome to use multiple methodologies to meet the needs of different awarding agencies. Therefore, the cognizant agency

negotiates an indirect cost rate that the program operator will use in claiming indirect costs under all its Federal awards (barring program-specific restrictions). As we just noted, the SEA performs this function for school districts under its oversight.

## XII. Restricted and Unrestricted Rates.

As a general rule, a Federal cognizant agency or SEA can approve whatever rate emerges from a program operator's indirect cost rate calculations. Such a rate is known as a **negotiated or unrestricted rate**. The unrestricted rate is crafted to enable a program operator to recover its Federal programs' fair share of the cost of its indirect cost activities

Nevertheless, the authorizing statutes of certain Federal educational programs require exceptions to this general rule. Such statutes provide that Federal funds made available thereunder **supplement, but do not supplant**, resources that SEAs and local educational agencies (LEAs) were already spending before the inception of the Federal programs. Compliance with these supplement-not-supplant provisions requires LEAs to exclude certain cost items from their indirect cost pools. The result is a smaller numerator, hence a smaller decimal and a lower rate. Such rates are known as **restricted rates**. The requirement to use a restricted rate thus prevents an LEA from recovering the full cost of certain educational programs from its SEA and other awarding agencies. As already noted, the LEA must absorb the difference from its own resources.

An SEA will generally approve both an unrestricted rate and a restricted rate for an LEA. The **unrestricted rate** applies to school food service because the legislation authorizing the NSLP & SBP does not prescribe a supplement-not-supplant requirement for those programs.

## APPENDIX C – INDIRECT COSTS IN A-133 AUDITS

### I. Audit Objectives.

Section 3.B. of the Single Audit Compliance Supplement directs auditors to examine a program operator's indirect costs in order to provide reasonable assurance that: (1) the indirect costs charged to Federal programs (that is, costs in the indirect cost pool) were allowable; and (2) the auditee identified those indirect costs by properly applying the methodology spelled out in its ICRP.

### II. Audit Procedures.

To accomplish the audit objectives, the Compliance Supplement instructs auditors to do the following:

- A. Test the auditee's internal controls over the preparation of the ICRP.
- B. Read the auditee's current Indirect Cost Rate Agreement to determine the terms in effect (indirect cost rate, direct cost base, etc.).
- C. Select a sample of claims for reimbursement and determine that:
  1. The rate used to determine indirect costs was the one prescribed in the rate agreement;
  2. The auditee had applied the rate to the direct cost base prescribed in the rate agreement;
  3. The dollar amounts actually claimed were the results obtained by applying the prescribed rate to the prescribed base; and
  4. The costs included in the direct cost base are consistent with those claimed in prior year years (that is, no cost previously treated as indirect is now being treated as direct).
  5. If the auditee was required to submit its ICRP to its cognizant Federal agency or SEA but did not, determine whether the auditee has other documentation to support its claims for indirect costs. If not, the auditor is directed to question the costs.

### III. Treatment of the ICRP.

The Compliance Supplement does not categorically require auditors to test auditees' ICRPs. However, it does offer guidance in cases where the audit is completed before completion of the ICRP. In such cases, the auditor is encouraged to perform interim testing to identify deficiencies in the ICRP-in-process that, if left uncorrected, would generate questioned costs in the next audit. Such interim testing may include examining costs in the indirect cost pool, the audit trail from the ICRP to the central services CAP, whether the direct cost base includes costs of all activities that benefit from the costs in the indirect cost pool, whether distorting items had been excluded, etc.

## APPENDIX D - RESOURCES

U.S. Department of Education, Office of the Chief Financial Officer (OCFO):

OCFO's Financial Improvement & Post-Audit Operations, "So You Want to Know About Indirect Costs,"

<http://www.ed.gov/about/offices/list/ocfo/fipao/abouticg/html>.

Questions and Answers (from *1998 U.S. Department of Education Indirect Cost Determination Guidance for State and Local Government Agencies* (the "Blue Book")),

<http://www.ed.gov/about/offices/list/ocfo/fipao/bluebookqas.html>

U.S. Department of Education, National Center for Education Statistics (NCES):

*Financial Accounting for Local and State School Systems*, 2003 Edition,

<http://nces.ed.gov/pubs2004/h2r2>.

U.S. Department of Health and Human Services, Program Support Center,  
Division of Cost Allocation:

Guidance on Implementing OMB Circular A-87, Publication ASMB C-10,

<http://rates.psc.gov/fms/dca/asmb%20c-10.pdf>

Office of Management & Budget (OMB) Grants Management Web Site  
(<http://www.whitehouse.gov/omb/grants>):

After accessing this site, select the menu item "Circulars." When the list of circulars appears, scroll down to the desired document and select it.

OMB Circular A-87 (*Cost Principles for State, Local, and Tribal Governments*).

OMB Circular A-133 (*Audits of States, Local Governments, and Non-Profit Organizations*).

*OMB Circular A-133 Compliance Supplement*. Part 3, section B gives generic guidance on auditing compliance with cost principles. Part 4 gives descriptions of Federal programs and guidance on auditing compliance with program-specific variants of the generic compliance requirements presented in Part 3. The description of the Child Nutrition Cluster begins on page 4-10.553-1.