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# Indirect Cost Rates and Cost Allocation Plans – What To Do and What Not To Do

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# Speaker Biography

**Chris Cortines** is a CPA who has worked for the Washington State Auditor's Office since 1993.

Through 2005, Chris supervised and managed financial, single and compliance audits of hundreds of Puget Sound area local governments. In 2006, Chris helped initiate the State Auditor's performance audit program. Since then, Chris has served in various roles, supporting the program and overseeing many performance audits of state agencies and local governments. Chris is presently the Principal Auditor for Local Government Performance Audits.

# Speaker Biography

**Vincent Stevens**, Vincent is a shareholder in the Not-for-Profit and Local Government Services Group of Clark Nuber. Vincent helps serve the firm's 650 not-for-profits and local government clients by providing specialized expertise in the areas of A-133 audits and federal compliance, indirect cost negotiations, and system solutions. He has provided professional services for not-for-profit and local government organizations since the beginning of his career. Vincent's primary focus is on serving health care, social service and life science not-for-profit and local government organizations. Vincent received a Bachelor of Science degree in accounting from Arizona State University.

Vincent regularly presents at the AICPA Not-for-Profit Industry Conference in Washington D.C., as well as, other local and national conferences.

Vincent enjoys spending time with his wife, four kids and four dogs.

# Session Objective

Provide the basics of indirect cost and cost allocation plan principles and learn about some of the leading practices and considerations that have come to light in a recent audit conducted by the Washington State Auditor's Office.

# Agenda

- I. Review Basic Principles
- II. Leading Practices and Common Pitfalls from the State Auditor's Office
- III. Questions and Comments

# I. Review Basic Principles

- Costs of **shared resources** must be allocated fairly
- Costs which are directly associated with specific projects/cost objectives are **Direct Costs**
- Costs which cannot readily be associated with specific projects/cost objectives are **Indirect Costs**

# Cost Principles

- OMB Circular **A-21** – Cost Principles for **Educational Institutions**
- OMB Circular **A-87** – Cost Principles for **State and Local Governments** and **Indian Tribal Governments**
- OMB Circular **A-122** – Cost Principles for **Nonprofit Institutions**
- **45 CFR Part 74, Appendix E** – Cost Principles for **Hospitals**
- **48 CFR Subpart 31.2** (Federal Acquisition Regulation) – Cost Principles for **Commercial Organizations**

# IDC Rates/Cost Allocation Plans Are Needed

- To provide a uniform method
  - Funding indirect costs
  - Charging indirect costs
- To provide an equitable allocation of indirect costs across all projects, funds and departments

# Excerpt From A-87

- Indirect costs are those that have been incurred for 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.

# Excerpt From A-87 (continued)

- After direct costs have been determined and assigned directly to awards or other work as appropriate, indirect costs are those remaining to be allocated to benefiting cost objectives. A cost may not be allocated to an award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to an award as a direct cost.

# Types of Indirect Costs

- Indirect Costs: Not easily identified with a specific project (Policy Decision)
  - Fringe benefits
  - Central service cost
  - G & A within the department or agency
  - Accounting and personnel within the dept. or agency
  - Depreciation and use allowances
  - Facilities operating and maintenance cost

# Example Allocation Bases to Allocate Shared Costs to Agencies or Functions

- Personnel – Number of Employees
- Accounting – Number of Transactions or Employees
- Purchasing – Number of Transactions
- Facilities operating and maintenance cost – square feet, Number of Employees or Salaries and wages

# Calculate Your Indirect Cost Rate

Indirect Cost Pool/Direct Cost Base =  
Indirect Rate

$$\$200,000/\$1,000,000 = 20\%$$

# Negotiating an Indirect Cost Rate

- Determine what type of rate, what method, and what direct base should be used

# Types of Rates

- Provisional rate
- Final rate
- Predetermined rate
- Fixed rate (with carry-forward provision)

# Indirect Cost Rate Methods

- Simplified allocation method
- Multiple allocation base method
- Special indirect cost rates

# Special Indirect Cost Rates

- Used when local government has circumstances where the use of any of the other methods would yield significantly unfair results based on the benefits derived
- Different Locations
- Level of administrative support required
- Nature of the facilities or other resources used

# Common Direct Bases

- Salaries and wages
- Modified total direct costs (MTDC)

# Modified Total Direct Costs (MTDC)

- Capital expenditures over threshold
- Sub-award and subcontract costs over \$25k
- Participant Support Costs
- Other distorting cost categories as agreed to by federal negotiator

# State Auditor's Office

## Leading Practices and Common Pitfalls

**April 18, 2011**

**Governmental Accounting and Auditing Conference  
Association of Government Accountants**

**Chris Cortines, CPA  
Principal Performance Auditor  
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STATE AUDITOR

# Performance audit of eight cities

We designed the performance audit to answer the following questions:

- Did selected cities share overhead costs among the General Fund and the utility funds in accordance with leading practices and state law?
- If not, why, and what was the impact on the General Fund, the utilities and utility ratepayers?

# Why did we conduct the audit?

- Cities are under increasing pressure to maintain critical services by shifting overhead costs from the General Fund onto municipal utility funds.
- Our audit showed that some cities should decrease their overhead charges to utilities, while others should increase those charges.
- We also conducted this audit to inform all local governments of practices they can use to fairly allocate overhead costs among various programs.

# Potential benefits from the audit

The report will discuss:

- Leading practices for sharing overhead legally and equitably among the General Fund and utility funds.
- General criteria and considerations when sharing overhead among funds and departments.
- The factors each city used for 11 common costs.

# What did the we look for?

## Whether the cities used the following leading practices:

- An up-to-date cost allocation method.
- Allocation factors that equitably distributed overhead.
- Charged actual costs or revised their estimates at least annually.
- Charged general government costs, such as those for economic development and elected officials, entirely to the General Fund.
- Assigned overhead costs to funds and departments *after* the costs were incurred.
- Charged overhead costs to *all* programs that received service or benefit, and *only* to those programs.

# What sources did we use?

## Sources to determine leading practices:

- U.S. Office of Management and Budget's Circular A-87 and its corresponding Implementation Guide.
- Study by the U.S. Government Accountability Office.
- Recent King County Superior Court ruling.
- Generally accepted accounting principles.
- Other performance audits that examined this same topic.
- Leading practices observed across the eight cities that were examined as part of this audit.

# What costs did we examine?

- Maintenance and janitorial
- Externally provided utilities
- Accounting
- Budget
- Payroll
- Human resources
- Information technology services
- Legal
- Insurance
- Accounts payable
- Purchasing
- **Other (discussion point)**

# Leading practices we identified

Overhead Cost Center	Leading Practices for Sharing Overhead
Maintenance and janitorial	Square footage
Electric and other utilities	Square footage
Accounting	Actual expenses, or number of GL transactions or total transactions processed
Budget	Actual expenses or actual FTE
Payroll	Actual FTE or payroll warrants
Human resources	Actual FTE
IT services	Number of computers, servers, databases or ports
Legal – indirect costs	Hours worked
Insurance	FTE, actual claims or loss history, square footage, property values insured, risk factors
Accounts payable	Voucher transaction count or invoices paid
Purchasing	Number of purchase orders, or purchase orders combined with number of bids
City council	Council agenda items
Mayor's office	Actual FTE and expenses

# Revenue sources for utilities

- Utilities are supported by customer rates, which are based on the cost of operating the utilities. When costs go up, utilities must charge customers more to cover those costs.

# Revenue sources for the general fund

- The General Fund is supported largely by sales tax and property tax, both of which are typically subject to voter-approved caps. When costs go up, tax rates typically don't. These revenue sources may support any city fund or operation, including the utilities and their share of city-wide overhead costs.

# Questions

## **Which statement is true?**

1. Charging overhead to the General Fund requires more justification and documentation than charging it to utilities.
2. Charging overhead to utilities requires more justification and documentation than charging it to the General Fund.

# Importance of getting it right

## **RCW 43.09.210 states in part:**

- *All service rendered by...from, one department...to another, shall be paid for at its true and full value by the department...receiving the same, and no department...shall benefit in any financial manner whatever by an appropriation or fund made for the support of another...*

# What does this mean?

- If cities use allocation factors and practices that result in an equitable sharing of overhead costs that truly benefit the funds being charged, they should not have to worry about complying with RCW 43.09.210.

# Observations from the recent audit

- Some cities did a very good job.
- Some charged estimated overhead costs but did not reconcile with actual costs at year's end.
- Some charged costs in advance or did not support costs charged.
- Some did not charge overhead to all of the funds and departments that benefited.
- Some charged questionable costs.

# Observations from the recent audit

- Some smaller cities could have charged their utilities additional overhead.
- Some used allocation factors that were simple but did not equitably share costs.
- Some did not regularly update the factors used to allocate costs, such as current square footage.

# Question

- When funds and departments that benefit from overhead are not charged for that overhead, what is the impact?

# General government costs

- Costs generated by elected officials and for activities such as economic development, small business development and worker training.
- Expenses that benefit the public at large, as opposed to those that support a city's various funds, departments and programs.
- Sometimes costs fall entirely into one category, sometimes both.

# General government costs

## Viewed similarly by multiple sources:

- GAAP
- OMB Circular A-87
- Other federal sources
- Recent court decisions
- RCW 35A.33.122
- RCW 35A.34.205
- RCW 35.33.123
- Local municipal codes

# We noted some questionable costs

## **The following costs were charged to utilities:**

- Economic development
- Apprenticeship programs
- Small business programs
- Mayor and council costs
- Legal fees for mentally ill
- Human services
- Charges that lacked sufficient support

# General observations

- The more questionable the overhead costs charged to the utilities, the higher the burden to document and demonstrate the appropriateness of those charges.
- It is not enough to show a benefit. Administrators must demonstrate the benefit is commensurate with the amount charged.
- An overhead pool may contain some costs that benefit utilities and other costs that don't. Only charge those that provide a true benefit.

# General observation

- In substance, inappropriate charges to the utility funds represent unlawful taxes that occur without public scrutiny. Although a city has authority to charge a business and occupation tax on its utility funds or to increase an existing tax, it must notify the public of its intent by referendum under the procedures spelled out in state law (RCW 35.21.706).

# Resource

## **U.S. Department of Health & Human Services**

A Guide For State, Local and Tribal Governments  
(Cost Principles and Procedures for Developing Cost  
Allocation Plans and Indirect Cost Rates for Agreements  
with the Federal Government) ASMB C-10

# Questions and comments

# Contacts

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