

Chapter 2. Cost Principles

Introduction

Cost principles define eligible costs for Formula Programs. It is important for the grantee to understand the cost principles and eligible costs, both in allocating costs to the federal grant directly and in providing guidance to subrecipients as they implement their programs.

Sources of Cost Principles

Cost principles applicable to state, local, and Indian tribal governments are covered in OMB Circular A-87. The cost principles applicable to nonprofit organizations receiving federal financial assistance originate from OMB Circular A-122. Most significant differences between these circulars have been eliminated in recent years.

In the following sections, some of the more important or unusual requirements of certain sections of A-87 and OMB A-122 will be highlighted.



LOOK AT YOUR AGENCY AND ASK...

Does your agency have a clearly defined set of standards and procedures for determining the reasonableness, allowability and allocability of costs incurred that is consistent with OMB A-87 or OMB A-122? Does your agency know which specific types of expenditures are prohibited under the CDBG, ESG, HOPWA or HOME programs? Does your agency have an indirect cost allocation plan or proposal?

Cost Allowability, Allocability, and Reasonableness

In order to be allowable under a federal award, costs must meet several criteria:

- ▶ The cost must be reasonable for the performance of the award and allocable to it. The terms "reasonable" and "allocable" are defined below.

construction, track and document per-square-foot costs for similar projects in your area. If your construction costs are not comparable, document why. For equipment, get price quotes from at least three vendors, and keep the quotes from all the vendors.

Allocability addresses the question, "Where do we put the cost?" It pertains to the relative benefit received from incurring the cost. Costs are considered to be allocable to a federal award if they fall into any one of the three categories:

1. Direct Costs—Costs that are incurred specifically to implement activities allowable in the award.

- ▶ *Example:* City of Centreville runs a homeowner rehabilitation program. Costs associated with taking in applications, inspecting the properties, writing cost estimates and the actual costs associated with making repairs are considered to be direct costs.
- ▶ *Example:* Support Services a nonprofit, runs a shelter for victims of domestic abuse. The shelter is located in building that is owned by the nonprofit. All expenses related to operating the building, such as utilities, repair and maintenance, janitorial services, are considered to be direct costs.

2. Shared Indirect Costs—Costs that benefit both the award and other work, and can be distributed in reasonable proportion to the benefits received.

- ▶ *Example:* The City of Centreville develops an informational brochure describing funds available from both HOME and CDBG programs it is running. The costs must be allocated to both programs.
- ▶ *Example:* Support Services Nonprofit has a program manager who oversees the operations of the shelter, as well as a transitional housing facility. Her salary and related expenses must be allocated to both programs.

3. Overhead Indirect Costs—Costs that are necessary to the overall operation of the organization, but for which no direct relationship to any particular program, or group of programs, can be shown.

- ▶ *Example:* The City of Centreville's City Manager manages staff throughout the city.
- ▶ *Example:* Support Services Nonprofit has an accounting staff that is housed at a rented facility. The accounting staff performs all accounting functions for all

Allowable and Unallowable Costs Under OMB A-87 and A-122

Item of Cost	OMB A-87 (Governmental Entities)		OMB A-122 (Subrecipients)	
	Unallowable	Allowable	Unallowable	Allowable
Accounting		✓	N/A	
Advertising		✓*		✓
Advisory councils		✓***	N/A	
Alcoholic beverages	✓		✓	
Audit services		✓*	N/A	
Automated electronic data processing		✓	N/A	
Bad debts	✓****		✓	
Bonding		✓		✓
Budgeting		✓	N/A	
Communication		✓		✓
Compensation, personnel services		✓*		✓
Contingency provisions/reserves	✓		✓	
Contributions (to others)	✓		✓	
Defense & prosecution of criminal & civil proceedings & claims		✓		✓
Depreciation, use allowance		✓		✓
Disbursing service		✓	N/A	
Donations (from others)		N/A	✓	
Employee morale, health, welfare		✓		✓
Entertainment	✓		✓	
Equipment		✓*		✓**
Fines, penalties		✓**		✓*
Fringe benefits	See Compensation			✓
Fund raising	✓		✓	
Investment management		✓*	✓	
Goods or services for personal use		N/A	✓	
Housing and personal living expense		N/A	✓	
Gains and losses on disposition of property		✓	N/A	
General government expenses	✓		N/A	
Idle facility, idle capacity		✓		✓*
Insurance & indemnification		✓		✓
Interest		✓		✓
Labor relations		N/A		✓
Lobbying	✓		✓	
Losses on other awards		N/A	✓	
Maintenance, operations, and repair		✓		✓
Materials, supplies		✓		✓
Memberships, meetings and conferences subscriptions, professional activity		✓		✓
Motor pools		✓	N/A	
Organization costs		N/A		✓**
Overtime, shift premiums	See Compensation			✓*
Page charges in professional journals (research)		N/A		✓
Participant support costs		N/A		✓**

continued on next page

Selected Items of Cost

Of the items of cost in the preceding table, some are easier to define and interpret than others. The following are details about the allowability of selected items of cost.

Advertising and Public Relations

Advertising costs include all costs associated with advertising media and their corollary administrative costs. Advertising media include magazines, newspapers, radio and television programs, direct mail, exhibits, and similar media. Advertising costs are allowable only when associated with:

- ▶ Marketing of specific programs.
- ▶ Recruitment of personnel required under the award, when considered in conjunction with all other recruitment costs.
- ▶ Procurement of goods and services for the performance of an award.
- ▶ Disposal of scrap or surplus materials acquired in the performance of the award, except when the organization is reimbursed for disposals at predetermined rate.
- ▶ Specific requirements of the award.

Public relations refers to community relations and includes those activities dedicated to maintaining the image of the organization or maintaining or promoting understanding and favorable relations with the community or public at large, or any segment of the public. The only public relations costs that are allowable are:

1. Costs specifically required by the award.
2. Costs of communicating with the public and press about specific activities or accomplishments that result from performance of sponsored awards.
3. Costs of conducting general liaison with news media and government public relations officers, to the extent such activities are limited to communications and liaison necessary to keep the public informed on matters of public concern, such as notices of contract/grant awards, financial matters, etc.

The first two categories of public relations costs are usually charged as direct costs of an award. The third category is generally charged as an indirect cost.

The cost of compensation is allowable to the extent that:

- ▶ Total compensation to individual employees is reasonable for the services rendered (as described below) and conforms to the established policy of the organization consistently applies to both federal and non-federal activities, and
- ▶ Charges to awards whether treated as direct or indirect costs are determined and supported in accordance with the provisions of applicable circulars, described later.



TWO STANDARDS OF REASONABLENESS

When an organization is predominantly engaged in activities other than those sponsored by the federal government, compensation for employees on federally-sponsored work will be considered reasonable to the extent that it is consistent with that paid for similar work in the organization's other activities.

Fringe benefits in the form of regular compensation paid to employees during periods of authorized absences from the job, such as vacation leave, sick leave, and military leave, are allowable, provided such costs are absorbed by all organization activities in proportion to the relative amount of time or effort actually devoted to each.

Fringe benefits in the form of employer contributions or expenses for social security, employee insurance, worker's compensation insurance, pension plan costs, and the like, are allowable, provided such benefits are granted in accordance with established written organization policies. Such benefits, whether treated as direct or indirect costs, are to be distributed to particular awards and other activities in a manner consistent with the pattern of benefits accruing to the individuals or group of employees whose salaries and wages are chargeable to such awards and other activities.

Additions to reserves under a self-insurance program for unemployment compensation or workers' compensation are allowable as long as they are reasonable estimates of such liabilities. Provisions for self-insured liabilities that do not become payable for more than one year after the provision is made may not exceed the present value of the liability.

Contingency Provisions

Contributions to contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, or intensity, or with an assurance of their happening, are unallowable.

Entertainment

Costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable. When traveling, meals are allowable up to the federal per diem rate.

Equipment and Other Capital Expenditures

Capital expenditures, which are not charged directly to a federal award, may be recovered through use allowances or depreciation.



Capital expenditures for equipment, including replacement equipment and improvements, which materially increase the value or

useful life of equipment or other assets are allowable as direct cost when approved by the awarding agency. Federal awarding agencies are authorized at their option to waive or delegate this approval requirement. Items of equipment with an acquisition cost of less than \$5,000 are considered to be supplies and are allowable as direct costs of federal awards without specific awarding agency approval.

The undepreciated portion of any equipment written off as a result of a change in capitalization levels may be recovered by:

CAPITAL EXPENDITURE means cost of an asset including the cost to put it in place, i.e., delivery and installation.

EQUIPMENT MEANS a tangible personal property having a useful life of more than one year and per unit acquisition cost equal to lesser of (a) the capitalization level established by the governmental unit, or (b) \$5,000.

Interest

The Circular A-87 rules regarding allowability of interest expenses were amended in October 1980. Effective October 1, 1980, financing cost (including interest) paid or incurred in connection with building acquisition, construction, or fabrication, reconstruction or remodeling, is allowable, subject to the following conditions:

- ▶ The financing is provided by a bona fide third party external to the governmental unit.
- ▶ The assets are used in support of federal awards.
- ▶ Earnings on debt service reserve funds or interest earned on borrowed funds pending payment of the construction or acquisition costs must be used to offset the current period's cost or the capitalized interest, as appropriate.

Pre-award Costs

Given that these are Formula Programs, and grantees know how much they are going to get before they actually sign their contract, HUD allows grantees to "pre-spend" up to 25% of their allocation on administration and project costs. These "pre-award costs" are allowable only to the extent that they would have been allowable if incurred after the date of the award. Also, the grantee must have an adopted Consolidated Plan and Action Plan that includes the activity, and have a completed environmental review.

The CDBG and HOME programs have special instructions involving pre-award costs. CDBG regs can be found in 24 CFR 570.200(h); HOME in 24 CFR 92.212.

Reconversion Costs

Reconversion costs are costs incurred in the restoration or rehabilitation of the governmental unit's facilities to approximately the same condition existing immediately prior to commencement of federal awards, less costs related to normal wear and tear. The costs are allowable.

Training

The cost of training provided for employee development is allowable.

grantee department, as well as those incurred by other departments in supplying goods, services, and facilities. To facilitate equitable distribution of indirect expenses to cost objectives serviced, it may be necessary to establish a number of pools of indirect costs within a governmental unit department or in other agencies providing services to a governmental unit departments. Indirect cost pools should be distributed to benefited cost objectives on bases that will produce an equitable result in consideration of relative benefits derived.

Indirect Cost Rates and Their Purpose

As discussed previously, indirect costs of an award are those costs that are not directly attributable to the award, i.e., once the award is closed such costs are reallocated to remaining activities rather than being eliminated altogether (direct costs). Indirect costs may include "shared/common costs" as well as "administration" costs, as defined by Generally Accepted Accounting Principles, or GAAP, and the OMB Circular A-87 and A-122.

Shared/Common Costs

Shared/common costs include costs that are necessary to operate all activities of the organization (i.e., supporting and program activities) that are not easily identifiable with a specific activity and benefit all such activities.

Example: Support Services Nonprofit operates all its program activities and supportive activities from one central location. Purchasing is done centrally. A postage machine and two copiers are used by all employees. Individual calls made by employees are not tracked by any coding system. In this situation, the shared/common costs include rent, utilities, building repair and maintenance, building security, central purchasing of office supplies, cost related to copiers, cost related to postage machines, telephone and similar type costs.

Administration Costs

Administration costs, as defined by GAAP and OMB, include costs necessary for the organization to operate as a going concern and stay in existence. They include oversight, business management, general record keeping, budgeting, financing, soliciting revenue, disseminating information about the organization and its activities,

Allocation of Indirect Costs and Determination of Indirect Cost Rates

OMB Circulars A-87 and A-122 describe three methods for nonprofit organizations and two methods for governmental entities for calculation of indirect cost rates. They include:

- ▶ Simplified allocation method (applicable to governmental entities and nonprofit organizations).
- ▶ Multiple allocation base method (applicable to governmental entities and nonprofit organizations).
- ▶ Direct allocation method (applicable to nonprofit organizations only).

Simplified allocation method is used by many small nonprofit organizations and by organizations whose major functions benefit from its indirect costs to approximately the same degree. The primary steps for calculating indirect cost rate under the simplified allocation method are as follows:

1. Identify all costs as either direct or indirect.
2. Exclude capital expenditures and other distorting items of cost, such as major subcontracts or subgrants.
3. Identify an equitable distribution base, such as total direct cost, direct labor, etc.
4. Calculate the rate by dividing total indirect costs by total direct costs.

Organizations receiving more than \$10 million in federal funding of direct costs in a fiscal year must break out total indirect costs into "facilities" and "administration."

Multiple Allocation Based Method can be significantly more complicated than the simplified allocation method. It is typically required of organizations where indirect costs benefit programs or activities of the organization to varying degrees. Under this method costs are classified into cost pools based on their homogeneity (i.e., costs that are of like character in terms of the functions they benefit). There is no limit to the number of cost pools. The multiple allocation based method takes the same logic introduced under the simplified method and extends it further to arrive at what should be more accurate and fair indirect cost rates. Examples of cost pools are:

- ▶ Fringe benefits.
- ▶ Occupancy costs.

(administration, fund raising, other direct functions) as direct costs using a base most appropriate to each particular cost.

Although Circular A-87 adopts the concept of the full allocation of indirect costs, there are some federal statutes that restrict the reimbursement of certain indirect costs. Where such restrictions exist, it may be necessary to develop a special rate for the affected award.

Types of Indirect Cost Rates

Once an indirect cost rate is approved for an organization, it may be applied differently depending on the type of indirect cost rate. Three types of indirect cost rates may be utilized:

1. **Provisional/Final Rates**—Provisional rates are temporary rates that are used for billing purposes during a period in which no reliable previous rate is available. These rates are adjusted to final rates at the conclusion of a fiscal period based on actual cost incurred. If provisional rates are higher than final rates, the organization owes money back to the federal agency. Likewise, if the final rates exceed provisional rates, the nonprofit organization will receive additional funds from the federal agency, as long as limitations of the award are not exceeded.
2. **Predetermined Rates**—Predetermined rates are fixed. They are not adjusted based on actual costs incurred.
3. **Fixed Rate with Carry-Forward**—Under this method, an organization may adjust its estimated rates to actual rates, however, it is not required to recover or pay back retroactive adjustments as it would under the provisional/final rates. Nor must it commit itself to a predetermined rate and potential for under-recovery that comes with that type of rate. Fixed rates with carry-forwards are typically used only with grant recipients with stable histories and long-term relationships with federal agencies.

Negotiation and Approval of Rates

Indirect cost rates are reviewed, negotiated, and approved by the cognizant federal agency. Once a rate has been agreed upon, it will be accepted and used by all federal agencies unless prohibited or limited by statute.

- ▶ Adjustments to allocated central service costs. This is not permitted where the total amount of the adjustment for a particular service, both federal and non-federal share, exceeds \$500,000.