BEST PRACTICES GUIDE FOR INDIRECT COSTING

BUREAU FOR MANAGEMENT (M)

OFFICE OF ACQUISITIONS AND ASSISTANCE
TEMPLATES SERIES

MAY 2012

Introduction

The purpose of this guide is to present best practices related to indirect costing. It defines indirect costs and describes how USAID can reduce indirect costs it pays under its awards, both acquisitions and assistance.

Audience

☒ Agreement Officer	☒ Agreement Officer's Representative
☒ Contracting Officer	☒ Contracting Officer's Representative
☒ Contract Specialist	☒ Program Analyst/Activity Manager
☒ Agreement Specialist	☒ Budget Officer

What are indirect costs

Indirect costs are costs which cannot be directly identified with a single contract or grant. The indirect costs are applied equitably across all of the business activities of the organization, according to the benefits each gains from them. Some examples of indirect costs are office space rental, utilities, and clerical and managerial staff salaries. To the extent that indirect costs are reasonable, allowable and allocable they are a legitimate cost of doing business payable under a U.S. Government contract or grant.

How rates are established

Responsibility for negotiating indirect cost rates with organizations doing business with the U.S. Government is specifically assigned. Each organization negotiates its indirect cost rates with one government agency which has been assigned cognizance. Usually the cognizant government agency is that agency which has the largest dollar volume of contracts with the firm or organization. The resulting Negotiated Indirect Cost Rate Agreement (NICRA) is binding on the entire government. The NICRA contains both final rates for past periods and provisional (billing rates) for current and future periods. A procurement office **may not negotiate a different rate or base of application** for an individual cost reimbursement contract or program. The provisional (billing) rate is established for use in reimbursing indirect costs under cost-reimbursement contracts and grants until a final rate can be established. The billing rate may be revised by the cognizant agency to prevent substantial overpayment or underpayment in the event of a significant change in the firm's business volume, but should not be revised during

individual contract or grant negotiations. A final indirect cost rate is established after the close of the contractor's fiscal year and once established is not subject to change.

Where to get indirect cost rate information

The Overhead and Special Costs and Contract Closeout Branch (OCC) of the Office Acquisition and Assistance has or can obtain, information on indirect cost rates for all U.S. organizations. It is the only office in the Agency with the authority to establish indirect cost rates for the U.S. organizations for which USAID has cognizance. OCC also maintains or can obtain information on indirect cost rates for U.S. firms and organizations that are under the cognizance of other federal agencies and acts as the USAID clearing house for this information. Contracting Officers and negotiators are reminded that indirect cost rates are sensitive information and should be protected as such and not divulged to other organizations. The responsibility for the issuance of NICRAs for non-U.S. based organizations rests with the **mission providing the preponderance of funding**. Revisions to rates for non-U.S. based organizations should be coordinated through the cognizant mission only and not on an individual contract or grant basis. Contracting officers should avail themselves of indirect cost rate support from OCC and audit support from the OIG and CAM branch when attempting to negotiate a NICRA for non U.S. based organizations.

Potential contractors or grantees are required to submit rate proposals and related materials (including audit reports or cognizant agency rate agreements) with their financial proposals. Negotiators should forward copies of these documents to OCC and obtain their assistance in determining appropriate indirect cost rates, except where the organization has established a current rate agreement with USAID or another federal agency.

OCC will obtain rates for organizations which do not provide rate agreements with their proposals. If the organization has never done business with USAID before or if verification is required then at a minimum the following information must be provided to OCC with the request for assistance:

(1) Type of Award
(2) Total Amount of Proposal
(3) Period of Performance
(4) Indirect Rates and Bases Being Proposed by the Contractor/Grantee
(5) Address, Phone No. and Contact Person at the Contractor/Grantee Office
(6) Cognizant Agency and Audit Office, if Known
(7) Any Other Factors Deemed Significant by the Contract Specialist or Contracting Officer

Negotiation memoranda should include reference to assistance from OCC, including the date and name of the OCC staff member who was consulted.

Award terms should reconcile with the NICRA

Generally, USAID awards should reflect the exact indirect cost rates established in the current governing NICRA. Only in exceptional circumstances should a cost reimbursement type USAID contract or grant contain an indirect cost rate which deviates from the government-wide NICRA rates for a U.S. firm. For example, an organization may propose an artificially low indirect cost rate and agree to cost share the difference between the proposed rate and actual rate. In this instance, a ceiling rate should be established at the proposed rate to preclude the organization from recovering its higher actual final rate. **Inclusion of such rates should have the prior approval of OCC**. While it is acceptable for the indirect cost "rate" incorporated into an award to vary from the established NICRA, it is **never acceptable** to negotiate a base of allocation that deviates from the NICRA determined allocation base. Organizations **should not be pressured** to change the terms of their established NICRA. If there are concerns about limiting indirect cost recovery they should not be addressed through the manipulation of the allocation base(s). For example, it is not appropriate to direct an organization to forgo the allocation of indirect costs to certain cost elements, such as subcontracts or travel, if their established indirect cost structure allows for it. In such circumstances, OCC should be consulted to help develop alternative solutions.

Ceiling rates

FAR 42.707 (b) lists other situations, in addition to cost-sharing arrangements, when it would be prudent to establish a final indirect cost rate ceiling in a contract or grant.

Realistic and equitable provisional and ceiling indirect cost rates should be negotiated and established in the contract schedule for each of the contractor's accounting periods during the term of the contract. Provisional rates may be less than, equal to, or, in special circumstances, more than proposed by the contractor. Care should be taken when establishing ceiling rates and generally OCC personnel should be consulted for help.

It is USAID policy that contractors or grantees that agree to an indirect cost rate ceiling that is less than the government-wide NICRA rate in a contract or grant for cost sharing or other reasons shall not recoup the amounts occasioned by the reduction in the rates on other agreements with the U.S. Government. **Therefore, the organization must agree in writing not to recoup the reduction in the rates on other contracts or grants with the U.S. Government - the reduction must be taken from profit, fee or other non-governmental sources of revenues. In any instance where an indirect cost rate other than that specified in the NICRA is to be used in a contract or grant the contractor/grantee is required to acknowledge the above stipulations by providing a written acknowledgement to USAID.** See the attached sample letter (Exhibit A) from the Contracting/Grant Officer to the contractor/grantee for signature acknowledging that fact.

The acknowledgement letter must be signed by an official who has the authority to bind the organization. Copies of each acknowledgement letter will be provided promptly to OCC by the Contracting/Grant Officer. In the case of for-profit firms, OCC will forward

a copy of the letter to the cognizant audit agency. Non-profit firms agree by signing the letter to provide a copy of it to their auditing firm. This will help to ensure that the organization is unable to recoup the costs on subsequent government contracts or grants.

Why indirect costs should not be compared at the rate level

It is generally not possible to compare indirect costs between organizations at the rate level, whether they are a for-profit or non-profit firm. Indirect costs must be compared at the cost level. An indirect cost rate by itself has very little meaning. To be meaningful you need to understand what the rate is being applied to when arriving at the applicable indirect costs for any given award. For example, a 75% rate could actually result in lower indirect costs applicable to a specific award than a 25% rate, depending on how the base of allocation is defined for each indirect cost rate. For example, assume organization ABC has a 25% rate that is applied to total costs while organization XYZ has a rate of 75% applied to only direct labor costs. Depending on the cost breakdown of a contract, 25% of total costs could indeed result in greater indirect costs being allocated to the award than 75% of only direct labor costs. (See Exhibit B) The use of allocation bases is not uniform and varies greatly among organizations. Thus, it is not possible to compare indirect costs at the rate level between any two vendors, unless their allocation bases are the same, which is rare. If a comparison of indirect costs between two vendors is desired, it must be done at the cost level, by multiplying the rate(s) by the defined allocation base(s). Only then can the vendor with the lower proposed indirect costs be identified.

Indirect costs should not be reviewed as part of any cost effective evaluation criteria

Indirect cost rates **should not** be considered in award decisions or negotiations since indirect cost rates are approved by the Government for standard application on all federal awards and by their nature do not compare across organizations, given the diverse accounting practices and methods for determining rates.

The practice of direct or indirect charging is not an indicator of best value. The ratio of indirect cost to direct cost or total cost varies and depends on many factors. It will be difficult if not impossible to get a definitive or measurable indicator for cost reasonableness since each organization has a different accounting/allocation methodology. That is to say there are numerous differences in both workforce and accounting classifications as to direct or indirect costs, as well as other variables such as the extent to which subcontractors are used, the structure of an organization, the expanding and declining business base for individual organizations, and the differing accounting methodology of one organization verses that of another. For example: one company may have a large labor overhead ratio to direct labor because it includes vacation and sick leave along with other types of overhead costs directly related to labor, while another organization will have a lower ratio because they direct charge vacation and sick leave. Neither practice is preferred over the other and both are equally acceptable. They are merely different.

Cost sharing issues

A cost-sharing arrangement may call for the contractor/grantee to participate in the cost of the contract/grant by accepting indirect cost rates lower than anticipated actual rates. If the objective in a particular program is to have the contractor/grantee organization share costs, such as might be the case with a PVO under a grant, the organization may agree to bill USAID for only a portion of the total amount of indirect costs which would be allocated to the particular award using its approved provisional rates in accordance with its governing NICRA, with the agreement that the remaining indirect costs will be counted towards meeting the PVO's cost share requirements. Such an agreement must, however, be clearly spelled out in the agreement showing that the indirect cost rates themselves are not changed from the NICRA. In such a case, negotiated final ceiling indirect cost rates should be included in the award.

Indirect cost rates for local NGOs – Direct vs. Indirect

Most local non-U.S. organizations have a handful of employees, few U.S. Government awards at one time and basic accounting systems. Indirect cost rates are generally not warranted unless an organization has many government awards at once necessitating a system to equitably allocate shared costs (i.e. indirect cost rates). Thus, it is generally best for local non-U.S. organizations to charge all costs direct when possible, rather than establish indirect cost rates. However, it is ultimately up to the management of the subject organization to determine if it will establish an indirect costing system. **If a firm meets the requirements for the establishment of indirect cost rates, including an adequate accounting system, then the proposed indirect cost rates should be honored.** USAID does not have a preference regarding the existence of an indirect costing system. The absence of an established NICRA should not be viewed as detrimental, while the existence of NICRA does not mean that firm is better than a firm without a NICRA. OCC personnel are available for assistance with such matters.

Effect of indirect cost rates on closeout and de-obligation

As a reminder, indirect cost rates must be finalized before final billing and closure can occur on any cost type contract/agreement that incorporates provisional rates. Thus, all residual funds under such awards should not be de-obligated until the requisite indirect cost rates are finalized. If there are significant residual funds remaining after the award expires, the amount of “excessive” residual funds should be determined and if material de-obligated. Care should be taken to ensure enough residual funds remain to cover any contingent liability resulting from final indirect cost rates being higher than established provisional rates. Generally, the organization should be contacted to obtain mutual agreement on the amount that can be safely de-obligated ahead of the routine closeout cycle.

Exhibit A

EXAMPLE LETTER

Contractor/Grantee
Address

SUBJECT: Deviation from the Negotiated Indirect Cost Rate
Agreement (NICRA)
Contract/Grant No.

Dear contractor/grantee:

The proposed subject contract or grant contains a deviation from the Negotiated Indirect Cost Rate Agreement (NICRA) between your firm/organization and the U.S. Government. The reduction in the agreed to NICRA rates is part of a cost-sharing or other ceiling arrangement. You must acknowledge by signing and returning this letter that the reduction in the indirect cost rate shall not be recouped on other contracts or grants with the U.S. Government - the reduction shall be taken from profit or fee.

If your organization is a for-profit firm, a copy of this letter containing your acknowledgment signature will be forwarded by the USAID Office of Acquisition and Assistance to your cognizant audit agency. If your organization is non-profit, your signature on this letter constitutes agreement that you shall forward a copy of this letter (with your signature) to your auditing firm prior to their next audit under OMB Circular A-133.

An officer with the authority to bind your organization must sign and date this letter in the space indicated below. This signature indicates acceptance of and compliance with the above stated conditions. Return one (1) copy of this signed letter to the undersigned Contracting/Grants Officer.

Sincerely,

Contracting/Grants Officer

CONTRACTOR/GRANTEE:

Name: ----------

Title: ----------

Date: ----------

Exhibit B

COMPARATIVE COSTS BETWEEN ORGANIZATIONS

Cost Elements	Company ABC	Company XYZ
Direct Labor	$100,000	$100,000
Fringe Benefits	$ 25,000	$ 25,000
Subtotal	$125,000	$125,000
Travel/Per Diem	$ 80,000	$ 80,000
Other Direct Cost	$200,000	$200,000
Equipment	$ 40,000	$ 40,000
Subcontracts	$ 50,000	$ 50,000
Total Direct		
Program Cost	$495,000	$495,000
Indirect Cost		
at 75%	$ 75,000	
at 25%		$123,750
Total Cost	$570,000	$618,750

Company ABC's rate applies to direct labor
Company XYZ's rate applies to total direct costs

As can be seen in this comparison, the lowest rate does not necessarily result in the lowest indirect costs applicable to an award.