

# CORE COSTS AND NGO SUSTAINABILITY

*Towards a Donor-NGO Consensus on the Importance of Proper  
Measurement, Control & Recovery of Indirect Costs*

**February 27, 2001  
Washington, DC**

***Alfredo Ortiz, Manager of Financial Services, PACT Inc.***



# Foreword

## **The Nature Conservancy's Institutional Development Approach**

In Latin America and the Caribbean, the Conservancy has sought to be a catalyst of local conservation efforts, rather than an implementing agency, to ensure that natural areas of high biodiversity enjoy a strong and competent constituency over the long term, through establishing successful working relationships and partnerships with local non-governmental organizations ("NGOs"), and with public institutions.

For conservation to be successful, protected areas must have strong national advocates, a powerful constituency, and effective in-country institutions dedicated to their protection. The Conservancy's Institutional Development Department has contributed to this vision by dedicating significant resources and energy to strengthen local conservation non-governmental organizations (NGOs) by fostering sound management, planning, board development, and financial stability through income generation from in-country sources.

Although many structurally based innovations have been successful in this arena, the Latin America and Caribbean Division's experience has been *that long term financial sustainability of conservation partners and initiatives has been an elusive goal*. Factors that hinder their ability to attain this financial sustainability include economic fluctuations and the limited development of private or public conservation philanthropic tradition.

## **Indirect Cost Recovery Rates**

The Institutional Development Department conducted financial surveys of partner institutions during 1998 to identify new opportunities to continue strengthening NGO financial stability. The financial surveys revealed that a significant source of deficits for 11 out of 12 NGOs was their inability to show and/or recuperate true indirect costs from projects. In other words, an NGO deficit grows every time it agrees to implement a project that pays insufficient indirect costs.

At the same time we surveyed partner institutions we interviewed donor agencies. In addition to issues of accountability, efficiency and transparency, the international funding community by and large believes that current levels of indirect cost funding are fair—either because of a perception that it is less expensive to operate in most developing nations or because donors don't want to encourage the creation of large bureaucracies. Therefore, NGOs are expected to be "lean" even if that entails unhealthy business practices and under recovered legitimate costs. In addition, many NGOs have project or donor accounting systems, which lack the sophistication to properly allocate common costs, thus making it very difficult for the donor community to determine its fair share of real overhead costs. As a result, local based NGOs in Latin America and the Caribbean that receive funding from international sources have long faced difficulties in negotiating with international donors to get them to provide adequate funding for core operations costs as a percentage of the overall project direct costs.

## **Purpose and Methodology**

The current study aims to provide both the donor and NGO communities with concrete data on real overhead rates, and on macro economic factors that have a direct impact on such rates. Moreover, as a desired result of this study we aimed to provide a methodology to better calculate NGO overhead rates.

PACT Inc. was chosen as the most suitable organization to conduct this study. A sampling of our in-country partners participated in an external audit to document their current overhead rates as a percentage of project direct costs. The audit examined overhead costs incurred each

year over a two-year period and compared them with direct costs incurred during the same period.

Partners in different geographic divisions were selected to allow a comparison of the indirect cost rates on a regional level. The study accounted for all costs that were overhead in nature, regardless of whether they were charged directly or indirectly as overhead.

### **Results and Next Steps**

PACT was successful in attaining the goal of creating a methodology to better identify and track indirect cost recovery rates. One of the main challenges faced was disclosure of confidential information by the participating institutions. It is a very sensitive issue. Therefore the current study is disseminating the methodology itself rather than the specific data collected from the participating institutions. A by-product that PACT created is a training module for the methodology to further disseminate and test it.

In addition, given the limited number of NGOs sampled and their geographic distribution, this study should be considered as a starting point to further analyze this situation. It is essential that further research be carried. Otherwise the donor community runs the risk of weakening emerging local institutions every time they approve a project that results in a deficit for the implementing organization.

### **Acknowledgments**

This was a challenging study to participate in, given the confidential nature of the data shared. We are grateful to the following institutions for participating in this initiative:

TIDE - Belize

Defensores de la Naturaleza – Guatemala

Fundacion Antisana – Ecuador

We are also extremely grateful to PACT for their creativity and for going well beyond the call of duty. PACT is currently employing this methodology to help its own partners evaluate their overhead realities.

The team in the Conservancy that lead the study was comprised by Patricia Leon former Director of NGO Self-Sufficiency Program; Randy Curtis, Director of Conservation Finance and Policy; Angel Cardenas, current Director of NGO Self-Sufficiency; Miriam Ostria, Finance Director for Central America; Nelson Giron, Finance Director for International; Kristan Beck, Director of International Finance; Elida Leon, Finance Director for Andean Region and Southern Cone; Rob Weary, Finance Director for the Caribbean; and Paul Hardy, Institutional Development Director for the Caribbean.

Scott Overall, an attorney assisting the NGO Ad Hoc Procurement Reform Group volunteered his time to review all the documents. His guidance and support greatly enhanced the outcome of this project.

We would also like to thank the generous support of the Summit Foundation and US-AID. This study would not have been possible without their commitment.

### **Patricia Leon**

**Former Director NGO Self-Sufficiency Program, TNC**

<b><u>TABLE OF CONTENTS</u></b>	<b><u>PAGE</u></b>
<b>Executive Summary</b>	<b>5</b>
Introduction	5
General Findings	6
<i>Summary</i>	6
<i>US PVOs Should Promote ICRs for Local Partners</i>	6
<i>Donors Should be More Lenient in NGO Development Stages</i>	6
<i>Broad Acceptance of OH Should Be Pursued with Donors</i>	7
<i>NGOs Should Explore More Creative Cost Recovery Methods</i>	7
TNC Partner Findings	7
Introduction to Chapters 1-3 & Key Questions	8
<b>Chapter 1—Overhead Basics</b>	<b>9</b>
Benefits of Indirect Cost Recovery	9
Purpose of Indirect Cost Rates	9
Basic Definitions	10
Examples of Indirect Costs	11
Mission Focused	14
Useful Starting Points	14
Legitimate Donor Concerns	16
Unrelated Costs	17
<b>Chapter 2—The Mechanics of Indirect Costs</b>	<b>20</b>
The Basic Formula	21
Effect of New Grants Won	22
Donor Overhead Caps	23
System Requirements and Cost Pools	25
<b>Chapter 3—Overhead Management</b>	<b>29</b>
Defining an Overhead Strategy	29
Economies of Scale	30
Expense Timing	32
Maintenance and Reporting	32
Distorting Items, Subgrants and Two-Tiered Rates	34
<b>Chapter 4—TNC Partner Results &amp; Next Steps</b>	<b>37</b>
TIDE	37
Fundación Antisana “Funan”	38
Fundación Defensores de La Naturaleza	38
Next Steps	39
<b>Annex 1—Step-by-Step Methodology</b>	<b>40</b>
Module 1—Salaries	40
Module 2—Benefits	42
Module 3—Other Direct, Indirect and Unallowable	44
Module 4—Calculation of Indirect Cost Ratio	46

## EXECUTIVE SUMMARY

### Introduction

This report presents the results of a study undertaken by Pact in collaboration with The Nature Conservancy (TNC) and the Summit Foundation. The study was born out of the NGO<sup>1</sup> Enterprises for the Environment Program, which assists NGOs to overcome the barriers to successful enterprise development. TNC recognized that many of its foreign-based NGO partners<sup>2</sup> were having difficulties covering core costs.<sup>3</sup> Some donors simply wouldn't pay for indirect program costs, while others placed arbitrary caps on these costs. The NGOs lacked a firm understanding of the nature of indirect costs themselves, and were therefore unable to communicate to donors the importance of funding these real costs.

The overarching purpose of this study and final report is to assist the NGO community to:

- ⇒ Attain a greater degree of financial stability through healthy business practices that allow them to properly recover their indirect costs.
- ⇒ Influence the wider donor community's funding practices to form more equitable partnerships with the local NGO community.

Specifically, The Nature Conservancy commissioned Pact to:

- ⇒ Elaborate a simple indirect cost methodology to be used by 3-5 NGO partners in Latin America to calculate their indirect cost rates for calendar years 1998 and 1999. The methodology must be easily understandable and applicable, focusing on usability over technical language.
- ⇒ Provide guidance to the NGO partners in calculating their rates for the years indicated and document the actual rates calculated.
- ⇒ Provide instruction on how to use prior year results as a tool for calculating a future year's provisional rate.
- ⇒ Produce a report, which will form a basis for attaining the overarching purpose as defined above.

The approach Pact has developed is consistent with, but not confined to, the US government's rules for non-profit organizations spending US government money. OMB Circular A-122 is a useful tool for understanding overhead principles in general—regardless of whether an NGO is subject to these rules. A-122 offers a basic logic that is relatively easy to understand and which is rooted in the principle of reasonableness—a subjective but standard principle that, generally speaking, transcends donor source<sup>4</sup>.

---

<sup>1</sup> NGO is an acronym for non-governmental organization.

<sup>2</sup> "Foreign based NGO partners" refers to transitional/developing country indigenous NGO partners (also referred to as local NGOs or local partners). More specifically it refers to their "partnership" with NGOs based in wealthier countries (referred to as PVOs, for example, in the US).

<sup>3</sup> Core costs, overhead, and indirect costs mean the same thing and will be used interchangeably throughout this report.

<sup>4</sup> That said, it is important to point out that this study follows a fiscally responsible "business management" perspective rather than a prescribed "US approach" as such (with the exception of Annex 1). The US approach as laid out in A-122 is primarily and logically concerned with protecting US government money—not primarily concerned with an NGO developing good systems for the NGO's benefit. For purposes of this report, the main concept to take from A-122 is the "reasonableness" principle (in the same vein as the "reasonable man" principle in law) with all of its grayness.

## **General Findings**

### ***Summary***

Indirect costs are vital organizational costs which are the *result* of taking on donor projects and which benefit those donors in an indirect way. Indirect Cost Rates (ICRs) are developed in order to be able to maximize real cost recovery, by having each funding source pay its fair share of indirect costs—ideally at the exact amount that the funded direct activities created the necessity or incurrence of the associated indirect costs (and expressed as a percentage, or ratio, of those direct costs). Indirect costs are real costs which don't go away simply because a donor won't pay for them. When not properly funded, an organization's time, effort and resources must be diverted from proper mission-driven, programmatic delivery, to searching for alternative ways to cover imperative core costs. This can reduce NGO capacity and effectiveness, ultimately harming the intended beneficiaries and other stakeholders.

Since reduced functional capacity cannot be what donors or NGOs intended, an effort needs to be made to bridge the gap in understanding of the nature and necessity of indirect costs. By recognizing that the ultimate intended beneficiary is neither the donor nor the NGO, but the stakeholder groups they represent, donors and NGOs may more readily join as true partners in development, working together to formalize some common working principles on overhead implementation. With this new-shared understanding increased efficiency can be realized, with the main benefit being felt at the ground level.

### ***US PVOs<sup>5</sup> should promote the understanding & development of ICRs for local partners***

Large donors are often much more reluctant to fund indirect costs for foreign-based local NGOs than for large established PVOs. Sometimes donors are even willing to pay large PVOs a significant management fee to act as grant managers for foreign-based organizations—organizations that the donor would rather not risk investment in otherwise. While this may sometimes be a necessary short-term solution, it is not a viable option in the long term. Local organizations are in a uniquely credible situation to deliver local development services more effectively than outside organizations. If true increased capacity of local organizations is a development goal of their larger foreign brethren, the foundation and systems for high capacity must be laid out from the first contacts these organizations have with each other. Proper financial management systems with indirect cost mechanisms are key building blocks with which to begin.

There are also risks to promoting this kind of proactive capacity building of local partners. The most obvious is the monitoring responsibility that a PVO must assume when a sub recipient establishes an Indirect Cost Rate. For example, if a donor grants funds to a large PVO, who proceeds to subgrant a portion to a local NGO—including for that NGO's indirect costs—the donor will typically hold the PVO responsible for the accuracy of both the sub recipient's direct and indirect cost expenditures. Although this is an added responsibility, proper training and mentoring on indirect costs will yield better long-term results than would neglecting to do so, ultimately contributing to a local NGO's capacity to manage donor funding independently.

### ***Donors should be more lenient in an NGO's development stages***

In chapter 3, the idea of economies of scale is discussed in detail. Specifically, it is noted that when defining an overhead strategy it is critical for both donors and recipients to understand that just as indirect costs are generally lower as a percentage of direct costs during periods of sustained growth, smaller NGOs will tend to have higher overhead rates in earlier stages of

---

<sup>5</sup> Private Voluntary Organization (PVO) is a special term developed by the US government, used to refer to US non-governmental organizations (NGOs). For practical purposes and for purposes of this report there is very little other difference between PVO & NGO except that PVO generally means large US NGO.

organizational life. This is due to lack of economies of scale when recovering fixed costs from a smaller donor base. This presents quite a quandary when NGOs are being judged on cost competitiveness, because donors may favor large NGOs over smaller ones strictly on price.

This is largely a function of market forces and while it may seem unfair, there are at least a couple of ways from which to approach this. The most obvious would be for an organization in its early stages of development to strive to be more effective in communicating other comparative advantages such as programmatic quality<sup>6</sup>. A second option would be for an organization to search out donors that fund “core grants”. Some donors offer grants specifically intended to fund indirect costs. This can be particularly useful in maintaining some level of cost competitiveness in the early development phase of an organization.

***Broad acceptance of overhead realities should be pursued with the donor community***

The range of interpretation and understanding of indirect cost principles among donors is extremely wide. Some donors accept the reality of indirect costs and simply wish to keep them under control, while other donors believe that overhead costs are unnecessary add-ons that are to be strictly avoided. The irony is that all of these donors have their own indirect costs, which are funded in different ways. Regardless of individual perspectives, indirect costs exist and must be addressed in a responsible way.

A concerted effort should be made by the NGO community to actively engage donors in a discussion on indirect cost realities, eventually resulting in a consensus on indirect cost assumptions and standards that reflect all perspectives on indirect cost issues. This paper should serve as a foundation for a stronger advocacy document to engage the donor community in dialog towards this consensus.

***NGOs should explore utilizing more creative cost allocation/recovery methods***

There are many different legitimate<sup>7</sup> methods for allocating indirect costs across different donors and projects. Although the “simple allocation method” prominently used in this report has the advantage of simplicity, it lacks the creativity and flexibility that exist in a well structured multiple allocation base method. As with any overhead allocation method it must be demonstrated that indirect costs are being distributed in the fairest possible manner against the direct cost source that necessitated their incurrence. As long as this condition is satisfied however, creative methods can be developed to form cost centers for different types of costs (travel or subcontracts for example), or possibly even units within an organization that can have more competitive overhead rates because they depend on, and consequently benefit from, the administrative functions of the organization to a measurably lesser degree.

Developing a simple method to allocate and recover indirect costs—especially in an organization that currently has no method—is a first priority before jumping into more complicated, creative methods. However, the advantages of multiple allocation base methods are worth exploring if an organization would benefit from a mix of different cost center structures.<sup>8</sup>

**TNC Partner Findings**

Three of The Nature Conservancy’s Latin American partners participated in the indirect cost study. The results for each organization are examined in more detail in Chapter 4. All three of

---

<sup>6</sup> Assuming the larger organization isn’t stronger in this area as well.

<sup>7</sup> Legitimate in that they distribute indirect costs in a fair manner. Unfortunately, the current definition of “legitimate methods” is “whatever method a particular donor accepts”.

<sup>8</sup> Besides formal changes in internal overhead structures, creative budgeting and use of fixed price contracts can also be used to properly recover indirect costs.

the organizations participating in this study have to some extent been able to attract funding to finance the direct costs of projects, but have found it increasingly difficult to convince the agencies of the need to also provide adequate financing for their operating, or “indirect” costs. The direct result of this is depletion of scarce resources on inadequately financed overhead costs.

Each of the three organizations was in a growth phase, albeit at different stages. Their overhead rates were high enough to imply that, although growing, they were not yet enjoying significant economies of scale. However, as funding bases continue to diversify, all of these organizations will find it harder and harder to recover indirect costs directly from donors. All three organizations are already at a stage of growth where evolving to a proper system of cost recovery is imperative.

The remainder of this report is laid out in four chapters and one annex. Chapters 1 through 3 focus on the nature of indirect costs in local non-profit organizations. Chapter 4 examines in detail, the results from the three TNC partners who participated in the study, as well as some recommended next steps. Finally, Annex 1 reproduces the step-by-step overhead calculation methodology developed by Pact and utilized by the TNC partners to compute their overhead rates when the study began. It is included for reference purposes only and is much more US government oriented than the study is in general.

I would like to offer my sincere gratitude to The Nature Conservancy and the Summit Foundation for the time and support required to complete this study. I'd also like to offer my sincere appreciation to TNC's partners who participated in this study. Without their hard work, sharing of sensitive internal cost detail, and general cooperation, this study would not have been possible.

*Alfredo Ortiz*  
[aortiz@pacthq.org](mailto:aortiz@pacthq.org)  
[www.pactworld.org](http://www.pactworld.org)

### ***Introduction to Chapters 1-3***

When this study was first commissioned, the methodology to calculate indirect costs laid out in Annex 1 was sent to the participants in the study, asking them to follow the methodology in calculating their indirect cost rates for the calendar years 1998 and 1999. When the initial response was slow, a follow up message was sent to the participants encouraging them to forward questions or concerns about the study to Pact. When the questions started coming in, it was noted that although most of the participants easily understood the methodology—or the “how” to calculate the rates—all seemed to lack a strong grasp of the “why”. They understood the need to recover costs for sustainability, but they lacked a clear understanding on the nature and intricacies of indirect costs and their management.

Chapters 1-3 cover the “why” in detail, along with a broader explanation of the “how”. Combined with the original methodology in Annex 1, an NGO should be able to more clearly confront its own indirect cost situation after a study of these chapters.

#### **Key Questions**

1. What are the benefits of an Indirect Cost Rate (ICR)?
2. How should indirect costs be allocated?
3. What is involved in proper overhead management?
4. What are the pros and cons of Pass-Through Indirect Cost Rates?
5. What is the donor environment regarding indirect costs?



## CHAPTER 1

### OVERHEAD BASICS

At a certain point in an organization's development process, it becomes necessary to establish a system for determining, tracking, and assigning certain costs to different cost centers, areas of work, and contracts within the organization. This need generally coincides with phases of sustained NGO growth, and eventually becomes a prerequisite for well-managed future growth. There are a variety of acceptable methods and systems for allocating indirect costs, as long as it can be demonstrated that the allocation of these costs is equitable and based on a well-documented justification.

#### **The Benefits of Proper Indirect Cost Recovery**

Pact has identified several drivers and attributes of financial performance. One of those attributes is proper understanding and management of indirect costs. Knowledge of which activities drive which costs, as well as which costs are at their bare minimum or where they may further be controlled, is extremely important. When costs are simply lumped together and then tracked after the fact rather than by advance planning, important investment or planned expenditure opportunities may be forgone—resulting in underutilized potential as well as liquidity problems. Cost allocation by type of cost is fundamental to responsible business operations.

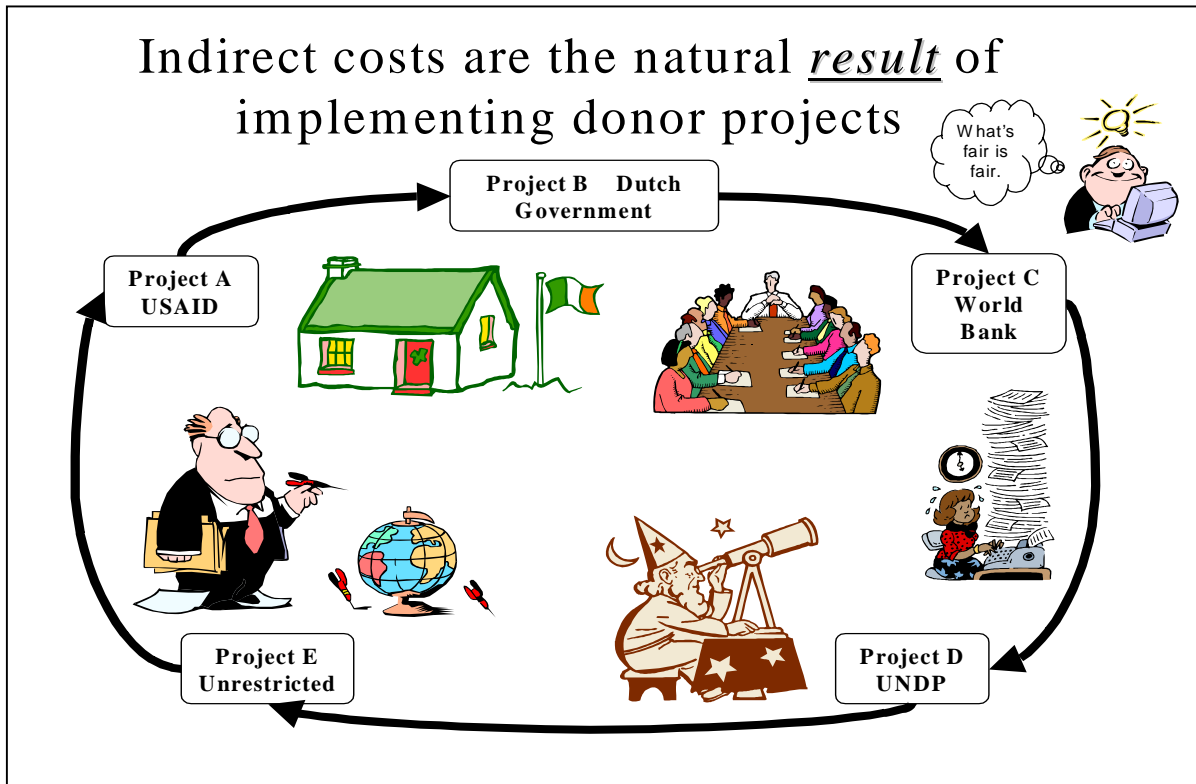
Besides the importance of separating, understanding and controlling costs for internal purposes, it is important to recognize that certain costs are necessary for the most basic level of operation—regardless of organization size. When an NGO is small and predominantly funded by a single or small number of donors, these donors often directly cover indirect costs. Even when donors do not explicitly cover these costs, they are often hidden in direct costs or eliminated by sacrificing necessary support such as accounting and administrative staff. As an NGO grows and diversifies its funding base however, it becomes impractical to directly charge individual donors with core operating costs that only indirectly benefit that donor. Similarly, it becomes more difficult to hide indirect costs in direct costs—an unwise option in any case.

There is another path however, which is to calculate an indirect cost ratio and convince donors to fund these costs as a percentage of their direct costs. If NGOs either neglect to pursue this option or if a donor will only fund indirect costs at a level that represents lower than actual indirect costs, these NGOs will incur deficits while attempting to recover the total amount of funding necessary to maintain their everyday operations.

#### **The Purpose of Indirect Cost Rates**

Indirect Cost Rates are developed in order to be able to ensure real cost recovery. When a donor approves an indirect cost rate, that donor is recognizing that there are real core, indirect costs associated with the implementation of the different grant or contract agreements between the donor and recipient. The donor is recognizing that the recipient can't simply implement a microcredit program for instance, without also paying office rent, some administrative functions, perhaps necessary executive salaries, etc. The recipient, through an indirect cost proposal, requests that each funding source pay a portion of these organizational "indirect costs", proportional to the benefit received—ideally at the exact amount that the funded direct activities created the necessity or incurrence of the associated indirect costs.

**Diagram 1 “The Logic of Indirect Costs”**



The reality that NGOs need to communicate to donors is that these costs are not elective, unrelated extra costs that NGOs are trying to pass on to unwitting donors. Rather, NGOs must communicate the reality that indirect costs are vital costs which are the *result* of taking on donor projects, and which benefit those donors, albeit in an indirect way.

**Basic Definitions**

$$Direct\ Costs + Indirect\ Costs + Unrelated/Unallowable\ Costs = Total\ Costs^9$$

**Direct Costs** are specifically identifiable with a final cost objective of an organization.<sup>10</sup> They are incurred in furtherance of an organization’s mission and are often in the form of the costs of direct activities in:

- ⇒ An award
- ⇒ A project
- ⇒ A service that an organization performs for pay or for its members
- ⇒ Some other direct **activity** of the organization.

<sup>9</sup> This formula is important because when dealing with indirect costs an organization must always have a complete accounting of all costs incurred by the organization—regardless of donor or cost center.

<sup>10</sup> In other words, costs are typically considered direct if an organization is spending funds on activities that directly pursue its mission—whether paying for salaries of staff working directly on a donor-funded or organization-funded (internally funded with unrestricted reserves) program, or paying for travel and other costs associated with those activities.

Direct costs are classified as department/project/activity level, as opposed to indirect costs, which are institution level. As a general rule, direct costs may be treated as indirect when that is the organization's stated policy, their amount is immaterial, and they are treated consistently<sup>11</sup>.

**Indirect costs** are common or joint costs—core costs—which are not readily identifiable with a final cost objective. Indirect costs still benefit—although indirectly—the organization and the donors that fund the organization. Indirect costs are institution level costs.

**Unrelated/Unallowable** costs are sometimes treated as direct, indirect, or sometimes excluded. Generally speaking they are either:

- ⇒ Unrelated (directly or indirectly) to a final cost objective, or,
- ⇒ Related somehow but specifically not permitted per donor rules.

Unrelated/Unallowable costs are classified as such not necessarily because they are improper or abnormal expenses. Rather, they are unrelated either directly or indirectly to the donors' projects. Examples of each will be given further below.

### **Examples of Indirect Costs**

Indirect costs can be generally described under the following groupings:

- ⇒ The management costs of all activity
- ⇒ The research and development capacity within voluntary organizations
- ⇒ The support services—meaning the premises, IT<sup>12</sup> and finance costs—as well as the administrative, personnel and training costs.<sup>13</sup>

More specifically, some of these costs, as shown in diagram 1 above, may include:

- Item 1 Office rent
- Item 2 Reasonable board of directors operating expenses
- Item 3 Financial and administrative staff not directly chargeable to projects
- Item 4 Moderate new business development/proposal writing
- Item 5 CEO salary and other similar costs not directly funded

The following chart offers further examples of common overhead costs. The costs are grouped by commonality amongst organizations and relevance to that organization's development stage<sup>14</sup>:

---

<sup>11</sup> This is specific to the US government's A-122 but follows the accounting "materiality" concept.

<sup>12</sup> Information Technology, [footnote added]

<sup>13</sup> Julia Unwin for ACEVO, *Who will Pay for Core Costs?*, ACEVO, ©1999, p2

<sup>14</sup> *Ibid.*, p.8 The chart was taken in its entirety from "*Who will Pay for Core Costs?*"

## COMMON OVERHEAD COSTS

Diagram 2

TYPE OF COST	PARTICULAR IMPORTANCE IN NGOs	IMPORTANCE IN STAGE OF DEVELOPMENT
Chief Executive	Needed in all	Needed at all stages
Financial management	Needed in all	Needed at all stages
Telephone, Fax Postage	Needed in all	Needed at all stages
Premises—Rent, Mortgage	Needed in nearly all	Sometimes minimized in early stages of an organization's life—but not likely to be a long term response
Associated...costs—heat/light	All	[Same]
Insurances	Needed in all	[Needed at all stages]
Associated staff costs, including insurance, pension...	All organizations employing staff	As soon as staff are employed
Equipment, IT, printing, etc	Needed in all but likely to increase as new activities are taken on	Particular investment in periods of growth
Premises management	Present in all organizations	Throughout
[Practical] Research and development <sup>15</sup>	Present in all	Particularly significant at early stages of an organization's life or at a period of planned or expected growth
[New business development]	Present in all	Maybe a greater percentage of the work done in the [early] development stages of an [organization's] life
Membership—support of the membership structure	Particular relevance for membership organizations	Needed at all stages
Governance—support of the trustee structure	All organizations	Needed at all stages
Project management	All	Needed at all stages
Monitoring and evaluation	All	Needed at all stages
Quality assurance	All	Needed at all stages
Travel and subsistence [while on legitimate overhead functions]	All	Needed at all stages
Staff training and supervision	All employing staff	Needed at all stages
Personnel functions	All employing staff	Needed at all stages
Accountancy and audit	All	Needed at all stages
Secretarial support	All	Needed at all stages
Corporate planning	All	Needed at all stages

<sup>15</sup> If the research and development is not contributing to new business development in the relative short term, it is likely a research project disguised as R&D. Such expenses do not benefit donors directly or indirectly (except a donor who chooses to fund it) and should not be hidden in overhead expenditures.

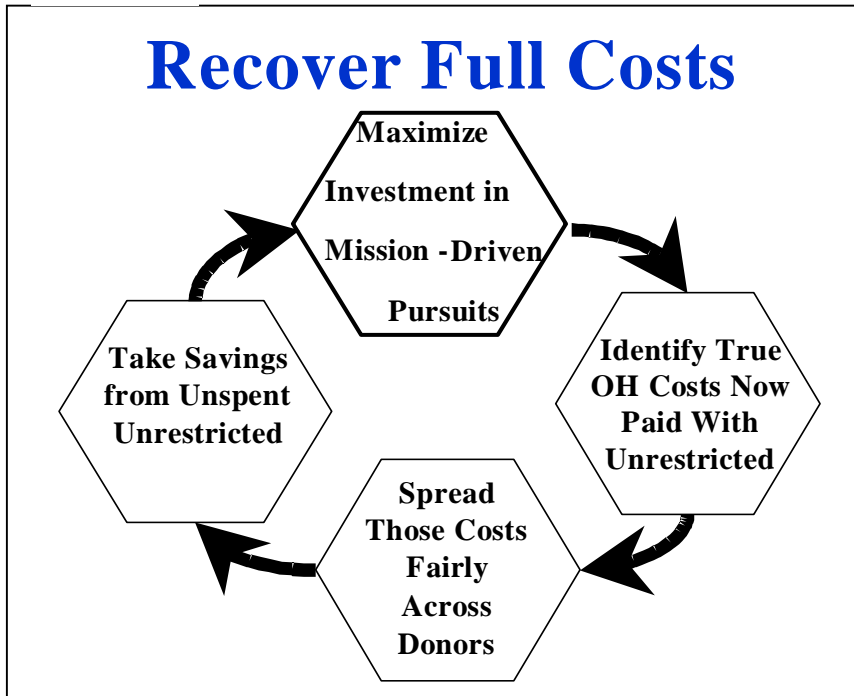
In a recent survey 69 US NGOs identified some of the following costs as being included in indirect costs<sup>16</sup>:

<b>TYPE OF COST</b>	<b>FREQUENCY IN INDIRECT COST POOL</b>
Executive Director	Thirty agencies include 90% or more, and eight agencies include 70-89%...
Program Staff	Forty-one agencies include some program staff costs in their indirect cost pool. The percentage varies from 3%-100%.
Administrative Staff	Forty-four agencies include 90%-100% of administrative staff costs in their indirect cost pool.
Finance Staff	Forty-four agencies include 100% of finance staff costs.
Field Office	Thirteen organizations allocate field office staff to their indirect cost pool. The percentage varies from 4% to 100%.
Recruitment	Thirty-five agencies include 100% of their recruitment costs in their indirect cost pool. Another nineteen include between 5-90%...
Training	Fifty-two agencies include training costs in their indirect cost pool: twenty-seven of the fifty-two charge 100% of all training costs to the indirect cost pool.
Staff Development	Thirty-three agencies include 100% of staff development costs in their indirect cost pool.
Regular Audit	Fifty-five agencies include 100% of their regular audit costs in their indirect cost pool.
A-133 Audit	Forty-five agencies include 100% of their A-133 audit costs in their indirect cost pool. <sup>17</sup>
Insurance	Forty-one agencies include 100% of insurance costs in their indirect cost pool.
Rent	Thirty-seven agencies include 100% of their rent costs in their indirect cost pool.
Telephone	Eighteen agencies include 100% of their telephone costs in their indirect cost pool. Seventeen include 50-90%...One...allocates just basic telephone charges to indirect.
Postage	Eighteen agencies allocate 100% of their postage costs to their indirect cost pool. Twenty-one...include percentages ranging from 50% to 95%.
[Photocopying]	Twenty-three agencies include 90-100% of their [photocopying] costs in their indirect cost pool.
Supplies	Twenty-two agencies include 100% of their supplies expenses in their indirect cost pool.
Bid and Proposal	Forty-two agencies include 100% of their bid and proposal [development] costs in their indirect cost pool.
Board of Directors	Fifty seven percent include 100% of their board costs in their indirect cost pool.
Meetings	Twenty-one agencies include 100% of their meeting costs in their indirect cost pool.

<sup>16</sup> Association of PVO Financial Managers, *Indirect Cost and Fringe Benefits Rate Survey Report for the Year 2000*, Association of PVOFM, ©2001, pgs. 2-3.

<sup>17</sup> A-133 audits are US government specific audits and are referenced here as an example of a government mandated audit.

Diagram 3



**Mission Focused**  
The logic continues that since these indirect costs are the result of donor-funded projects, they should be financed by the donors—in proportion to the indirect benefit received by the donor. As will be illustrated later, when indirect costs are not funded by donors they must be paid for by an organization’s own unrestricted reserves. This exhausts monies that are properly intended for advancing mission-driven pursuits. The diagram to the left illustrates this logic.

### Useful Starting Points

The Canadian International Development Agency (CIDA) highlights as a starting point the following key principles in establishing its overhead policy:

1. “It is recognized that overhead costs are a necessary part of an organization’s operations...and that the organization has a right to be compensated for some of this overhead as part of a CIDA ...agreement.
2. The calculation of the overhead rate should be profit neutral...to the organization (i.e. it should not contribute additional profit or surplus to the organization). [It should be based on actual cost recovery].
3. It is recognized that organizations have different or unique overhead rates depending on their operating environment, sector of expertise, organizational structure, etc...
4. The acceptable overhead rate should not reward an organization for an inefficient operation, and conversely it should not penalize an organization for efficient operations.”<sup>18</sup>

Similarly, a study by the Association of Chief Executives of Voluntary Organizations (ACEVO), a British PVO membership organization, argues for<sup>19</sup>:

- ⇒ A more transparent approach to describing core costs
- ⇒ A clear recognition that core costs are unavoidable
- ⇒ A recognition that pressure needs to be exerted to keep core costs low<sup>20</sup>
- ⇒ A recognition that there is a level below which core costs cannot reasonably fall without the funding and the funded organization incurring unacceptable risk.

<sup>18</sup> CIDA, *Standardization of the Overhead Rate Policy*, p 3, section E, Taken from website [http://www.acdi-cida.gc.ca/cida\\_ind.nsf/6df07336046c5ad58525679f004abace/3be710f0c612be0e852567f500697f80?OpenDocument](http://www.acdi-cida.gc.ca/cida_ind.nsf/6df07336046c5ad58525679f004abace/3be710f0c612be0e852567f500697f80?OpenDocument)

<sup>19</sup> Julia Unwin for ACEVO, *Who will Pay for Core Costs?*, ACEVO, ©1999, p3

<sup>20</sup> The study later goes on to note “that over zealous approaches to this strategy [may] damage the ability of the organization to achieve its mission.”

These are very useful starting points because they reflect donor mindsets that already realize that indirect costs are real, unavoidable costs.

Although indirect costs are very real, NGOs receiving funding from international donors have long found it difficult to convince these donors to provide adequate financing for these general operating costs.<sup>21</sup> Many donors have the perspective that indirect costs are entirely unrelated to their respective projects. This view is due to several factors including their own limited funding, lack of familiarity with the nature of indirect costs, and lack of proactive education of donors by recipients—upon whom the responsibility ultimately rests.

Some donors simply won't pay for indirect program costs, while others place arbitrary caps on these costs. Examples along the spectrum of donor regulations include:

- ⇒ The US government, which is relatively realistic and willing to fund its fair share of indirect costs. While its rules governing the mechanics and reporting of indirect costs are fairly rigid, its willingness to pay its fair share is proven in practice.
- ⇒ Dan (Danish) Church Aid funds a flat 10% administrative fee with virtually no strings attached, but this is usually much lower than actual overhead.
- ⇒ The Dutch Government, which places a cap of 7% on overhead costs.
- ⇒ UN agencies, which determine different rates in different situations.
- ⇒ The National Lottery Charities Board (NLCB) in Great Britain, which states that it funds “projects, not organizations”<sup>22</sup>. The NLCB uses the concept of “incremental costs” when judging its willingness to pay for indirect costs. The burden of proof rests on the grant recipient to demonstrate how the taking on of the NLCB funding has incrementally increased indirect costs. To the extent that a recipient can show that the electricity bill has gone up because of more office activity, for example, NLCB is willing to pay that incremental portion. This approach effectively precludes the NLCB from paying its fair share of “sunk” fixed costs such as rent and administrative salaries.
- ⇒ Other donors who simply don't pay indirect costs.

In the survey of US NGOs referenced earlier, “[w]hen asked what is done when funders won't pay their full indirect cost rate, fourteen agencies indicated they cost share [(make up the difference out of unrestricted)], six [find a way to] direct charge indirect costs, [and] four refuse the grant...depending on the funder and the amount of the grant.”<sup>23</sup>

The ACEVO study referenced earlier, posits: “the current funding environment is not conducive to good funding relationships [because]:

1. It does not allow for the creation of mature and stable voluntary organizations able to take opportunities and make a full contribution.
2. It does not encourage transparency, but rather encourages complex renaming of activities, and restructuring of organizations in pursuit of funding.
3. In turn this does not facilitate a creative or mature relationship between the funders and the funded....”<sup>24</sup>

---

<sup>21</sup> Usually expressed as a percentage of the total direct cost of their projects.

<sup>22</sup> Julia Unwin for ACEVO, *Who will Pay for Core Costs?*, ACEVO, ©1999, p25

<sup>23</sup> Association of PVO Financial Managers, *Indirect Cost and Fringe Benefits Rate Survey Report for the Year 2000*, Association of PVOFM, ©2001, p 9.

<sup>24</sup> *Ibid.*, p2

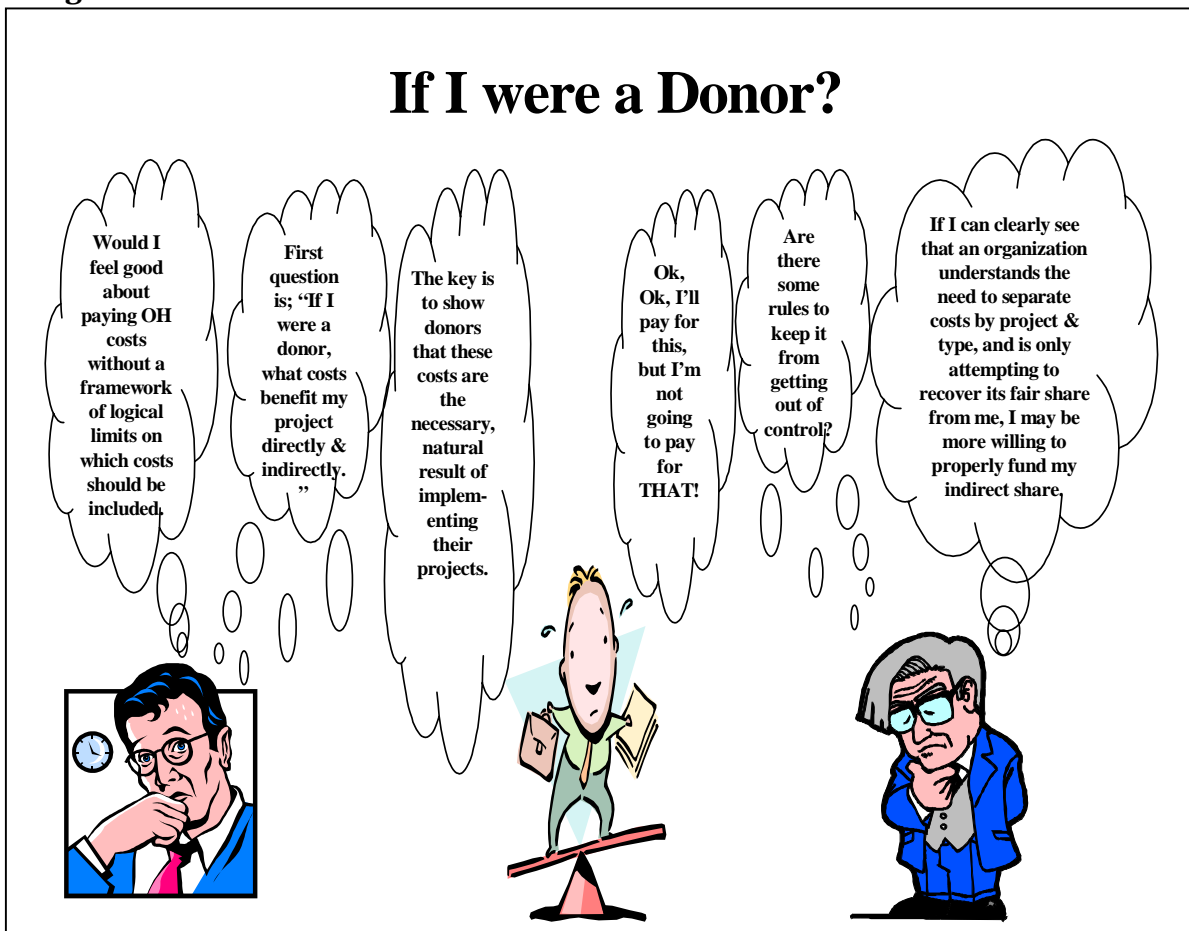
Unless donors and recipients carry on collaboratively and flexibly, as development partners, the ultimate loser is the intended beneficiary.

### Legitimate Donor Concerns

If donors are to be convinced that they should fund indirect costs, NGOs must recognize that donors will have real concerns that there be some formal rules governing what can and cannot be included in indirect costs. It must be made clear that NGO systems can handle the rigors of recognizing different types of costs and allocating them properly. NGOs must put themselves through the same litmus tests they would expect of a recipient of funds from their organizations.

When NGOs and donors think from each other's perspective and act as development partners, many funding barriers can be overcome. The following diagram illustrates the mindset NGOs and donors must enter into, in order to balance NGO needs with donor concerns and limitations:

Diagram 4



Evaluating overhead realities from one another's perspective is an important step, but actually moving to a more mature relationship between donors and recipients will require fundamental changes from both development partners. Some of those changes are listed in diagram 5 below<sup>25</sup>:

<sup>25</sup> The table was adapted from the list in *Who will Pay for Core Costs?*, ACEVO, ©1999, p3



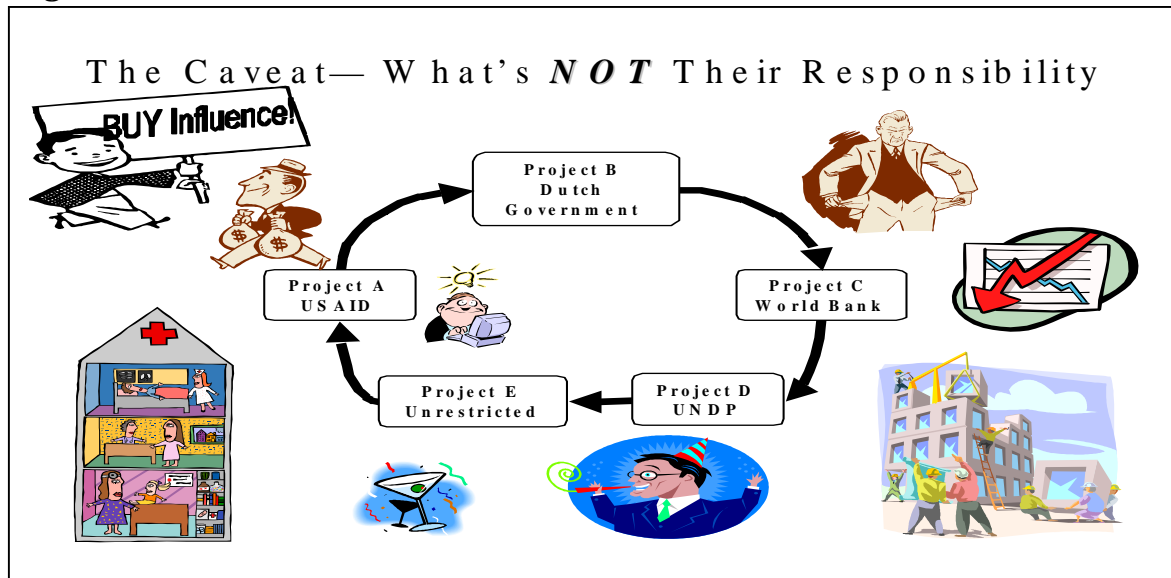
**Diagram 5**

	<b>NGOs</b>	<b>DONORS</b>	<b>BOTH</b>
1	Improve internal accounting, financial management and business planning.	Meet the overhead costs associated with managing a piece of work	Collaborate on standardized, but flexible overhead rules for adaptation across all donors and NGOs
2	Develop benchmarking on overhead costs	See their funding as a part of a program of long-term investment	Develop standards for partnership to maximize stewardship of development funding
3	Innovate in order to drive down overhead costs	Support the development of the management of voluntary organizations	Study common areas of duplication of effort, inefficiency or waste
4	Demonstrate [increased] effectiveness and capacity	Manage change within their portfolio of grants	
5	Develop their own ways of measuring effectiveness and organizational change	Develop new ways of evaluating effectiveness	

**Unrelated Costs**

This report has established that indirect costs are the result of implementing donor-funded projects and that they indirectly benefit those donors and should therefore be funded by them. However, there are also costs that donors shouldn't be asked to cover as indirect costs because they are not related to those donors in any way. Some of these costs are illustrated below:

**Diagram 6**



Direct costs were defined as specifically identifiable with a final cost objective of an organization. The items reflected above mostly represent direct activities that an organization elects to do with its money. They are unrelated to the donor's projects and their expenditure is neither directly nor indirectly necessary for the proper completion of the donor projects. They may be necessary activities, perhaps even required by the organization's mandate. They are direct,

unrelated activities however, and must not be charged to the donors as indirect costs. Examples from above include<sup>26</sup>:

- Item 1 Advertising, lobbying and other fundraising expenses
- Item 2 Shortfalls on other projects
- Item 3 Construction as a project (construction of an infirmary for example)
- Item 4 Entertainment expenses or expenses for personal use
- Item 5 Operating a pharmacy or infirmary as an activity

Although these planned activities are paid for by an organization's unrestricted reserves, their aggregate amount must be thought of as coming from a "donor" like any other project (for purposes of calculating overhead). The "donor" is an organization's unrestricted fund, which must be charged its fair share of the organization's overhead along with the other donors. The examples that follow include an organization's planned activities as being a separate donor called "unrestricted".

There are certainly gray areas between what is clearly an indirect cost and what is not. Much depends on what an organization wishes to argue should be considered a legitimate indirect cost for inclusion in that organization's indirect cost pool.<sup>27</sup> For instance, there are similarities between moderate new business development/proposal expenses, which are generally recoverable as indirect costs, and direct advertising, lobbying and fundraising, which are less

---

<sup>26</sup> These are clear planned activities that should not be charged to the overhead pool, but which must be included as direct costs in the ICR calculation. There are however, unplanned expenses, which the US government simply won't pay for and insists that they neither be included in direct nor indirect costs when calculating overhead. These include bad debts, entertainment costs, alcohol, and other similar costs, which are not planned, "unrelated" activities but which are nonetheless considered "unallowable" by US government standards and which therefore should be excluded entirely from the OH rate calculations (if the NGO is subject to US government rules).

Understanding the concept of unrelated costs is vital to understanding who is paying for what and subsequently how to track that. Unrelated costs are only "unallowable" in the A-122 sense in that they are unallowable to a certain project or donor, not necessarily in general. What this means in practice is that in the broadest sense nothing is "unallowable" because ultimately an organization may spend on what it chooses. From a donor perspective, the unrelated concept states exactly that: "Spend what you want, but at a minimum, do not charge me for things that are not related to my project in any way." This is a reasonable expectation. As mentioned in other areas of this report some of these items include personal expenses, expenses from other projects, and planned activities that are not overhead in nature that an organization elects to do but which are not needed to properly complete a donor-funded project (direct costs) or run the basic functions of your organization (overhead). If an organization wishes to spend on these items, most of which are completely legitimate, they of course may do so but they shouldn't expect an unrelated donor to pay for them. For planned activities, they may propose the activity to another donor, or pay for it with reserves that they have generated from including a return/fees in their contracts and agreements (once they begin doing this). **The main point is that overhead is not a fee but cost recovery.** Fees/returns cover, generally speaking, elective costs (whose legitimacy is defined by the NGO, not the donor) that are not overhead in nature. NGOs should not try to charge these costs to unwitting donors anyway, by including them in their indirect cost pools.

A-122 calls two different types of costs unallowable—1) unrelated costs as described above and 2) specifically unallowable costs, unallowable by decree, not necessarily by logic. When I give workshops on A-122 I call these very few costs (there are about 10 or so) "banned costs". They may or may not be related to a final cost objective, they may even be perfectly logical for a given project, but they have been banned nonetheless. These costs include alcohol, bad debts, organizational setup fees, etc. There are certainly gray areas but this is where I argue that if a cost can be proven to be directly, or indirectly related to a donor, the donor should be asked to pay for it. Justifying what items to include is the NGOs responsibility.

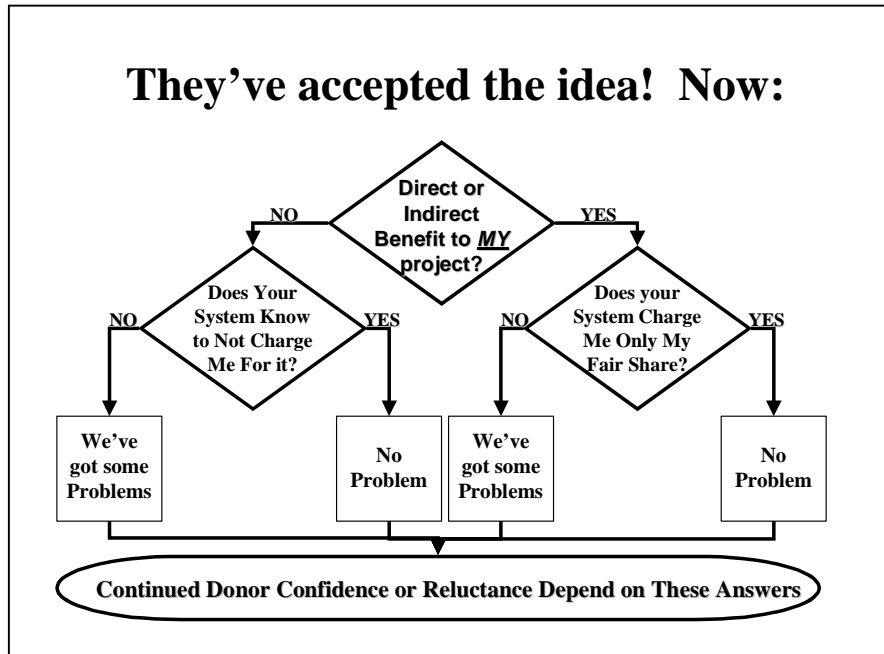
<sup>27</sup> This is referring to non-US government donors. The US government rules although fairly reasonable, are generally not negotiable.

likely to be accepted by some donors as legitimate indirect costs. Reasonableness, as always, is the key.<sup>28</sup>

It cannot be overstressed that educating donors on the importance of funding indirect costs is a two-way street. Consider the following diagram that assumes a donor has now agreed to fund an NGO's indirect costs. The responsibility remains with the NGO to properly manage this privilege.

Diagram 7

Once different costs are recognized by their nature, organizations can plan expenditures based on the availability of different types of funding. Proper cost recovery allows an organization to maximize its investment of unrestricted monies towards pursuing its mission. Both donors and recipients must be cognizant of balancing each other's expectations and needs as they work together to pursue their shared development goals.



<sup>28</sup> As noted throughout this report, overhead is about recovery of a type of costs, which, by their nature, are indirect. Overhead recovery is not a revenue source that can be spent in an unrestricted way. Many non-profits struggle with the question “how are we supposed to fund non-overhead items when we are a non-profit?” On the most basic level, the answer is simple. The term non-profit doesn't imply that an organization may not generate reserves by calculating a return in excess of costs on services it provides for organizations by whom it is contracted. A comparison between for profits and non-for profits is shown below:

	<b>FOR PROFIT</b>	<b>NON-FOR PROFIT</b>
<b>END GAME</b>	Maximize Profit	Pursue Mission
<b>MEANS</b>	Generate Revenues in Excess of Expenses	Same, including generation of revenues in excess of expenses (over and above cost recovery) through fees, loaded reimbursement rates and creative use of contract mechanisms such as fixed price contracts.
<b>HOW INCOME IS HANDLED</b>	Distributed Outside of Organization to Various Stakeholders	Reinvested in Mission
<b>CAVEAT</b>	For profit may engage in any activity that generates revenue.	Revenue generating activities <b>must</b> be related to the organization's mission or it could lose its non-profit status (because it is engaging in for profit behavior).
<b>LIMITATION WITH US GOVT.</b>	Cannot charge fees on grants—therefore pursue more contracts	Cannot charge fees on grants (on which many US NGOs depend). “Perfect Budgeting” must be achieved in order to properly recover costs, with no allowance for NGO growth funding.

From the table it is clear that the major similarity between the two is the need to generate revenue and the major difference is the way income is handled. Non-profits must generate income to survive just like any other business.

## CHAPTER 2

### THE MECHANICS OF INDIRECT COSTS

#### The Basic Formula

The numbers shown in the forthcoming diagrams are for illustrative purposes only and do not reflect actual figures for any NGO. The formula for a simple allocation method, with corresponding indirect cost breakdown, is as follows:

**Diagram 8**

Formula—Simple Method	
<u>Indirect Costs</u>	= Overhead % (ICR)
Direct Costs	
\$200,000 (IC)	= 20 % ICR
<u>\$1,000,000 (DC)</u>	
<i>• Total costs of \$1,200,000 include all departments &amp; activities of an organization.</i>	

**Diagram 9**

COST	ALLOCATION	
	Regular	Subgrant
<b>Rent &amp; Utilities</b>	24,000	-
<b>CEO</b>	48,000	-
<b>Controller</b>	29,000	-
<b>New Business Dev</b>	19,000	-
<b>Phone &amp; Other Direct Costs</b>	21,000	-
<b>Admin. Staff</b>	52,000	-
<b>Office Supplies</b>	7,000	-
	<b>\$ 200,000</b>	<b>\$ -</b>

In the simple allocation method indirect costs rates are shown as a ratio of total indirect costs divided by total direct costs. The figures were derived by estimating the likely indirect costs for the upcoming year (for which an indirect cost proposal is being submitted)<sup>29</sup>. These are real costs that an NGO anticipates incurring, regardless of whether they are properly funded by donors. There is a column for subgrants for when a two-tiered rate is calculated later on in this report.<sup>30</sup>

Just as indirect costs for the upcoming year were estimated, direct costs for the same period must also be estimated. Based on existing, as well as likely future donors, the \$1,000,000 in direct costs estimated earlier breaks down by donor as follows:

A. USAID	\$500,000
B. Dutch Government	\$175,000
C. World Bank	\$75,000
D. UNDP	\$0
<u>E. Unrestricted Activities</u>	<u>\$250,000</u>
<u>Total Direct</u>	<u>\$1,000,000</u>

<sup>29</sup> Please see section on “Maintenance and Reporting on page 32 for more detail.

<sup>30</sup> Subgrant overhead rates will also be referred to as “pass through” rates.

Below, the distribution of direct and indirect costs by donor, is examined:

**Diagram 10**

<b>Basic Example in USD\$\$</b>						
	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>	
	<b>USAID</b>	<b>Dutch Govt.</b>	<b>World Bank</b>	<b>UNDP</b>	<b>Unrestricted Activities</b>	<b>Total</b>
<b>Budget Line</b>	<b>50%</b>	<b>18%</b>	<b>8%</b>	<b>0%</b>	<b>25%</b>	<b>100%</b>
<b>Personnel &amp; Fringe</b>	300,000	100,000	50,000	-	200,000	\$ 650,000
<b>Other Direct Costs</b>	200,000	75,000	25,000	-	50,000	\$ 350,000
<b>Subgrants</b>	-	-	-	-	-	\$ -
<b>Total Direct Costs</b>	500,000	175,000	75,000	-	250,000	\$ 1,000,000
<b>Indirect Costs @ 20%</b>	100,000	35,000	15,000	-	50,000	\$ 200,000
<b>Total Costs</b>	<b>\$ 600,000</b>	<b>\$ 210,000</b>	<b>\$ 90,000</b>	<b>\$ -</b>	<b>\$ 300,000</b>	<b>\$ 1,200,000</b>

Is this a donor?

Note the % of activity per “donor” (“position” in our org)

What is each donor’s fair share of total?

In diagram 10, the fair share of each donor is clear. Each donor should be required to cover the indirect costs associated with their project’s “position” within the NGO in question. It was determined that the appropriate indirect cost rate was estimated at **20%** for the year in question. In this example, USAID is responsible for 50% of the total projected direct cost expenditures for the year. The argument then carries that USAID should cover 50% of the total indirect costs for the year if everything goes as planned. This 50% of total indirect cost expenditures is equal to \$100,000, which is **20%** of USAID’s total direct cost expenditures of \$500,000. Similarly, the World Bank’s project “position” in the example NGO is 8% of total anticipated direct cost expenditures for a total of \$75,000. World Bank is therefore responsible for 8% of the NGO’s total anticipated indirect cost expenditures—8% of \$200,000 is \$15,000 which is **20%** of World Bank’s total anticipated direct cost expenditure of \$75,000. Finally, the organization’s unrestricted “donor” is responsible for 25% of the total projected direct cost expenditures for the year—it holds a 25% “position” within the organization. 25% of total indirect cost expenditures of \$200,000 is equal to \$50,000, which is **20%** of total planned unrestricted direct cost expenditures of \$250,000.

The key terminology here is “fair share”. The amounts above reflect each donor’s fair share—regardless of whether they’re willing to pay for it or not.

### Effect of New Grants Won

But what happens now if an NGO wins a grant during the year and the figures change?<sup>31</sup> The likely actual rate has now changed to 16%, as shown in diagram's 11 and 12. This will be the new standard for determining "fair share"—which in diagram 13 now changes significantly.

**Diagram 11**

**We Won a Grant!**

- ⇒ UNDP Has awarded us a \$500,000 grant.
- ⇒ This grant will only cause marginal additional indirect cost incurrence.
- ⇒ Assume \$40,000 extra Indirect Costs (increased accounting support to help Controller)

$$\frac{\$240,000 \text{ (IC)}}{\$1,500,000 \text{ (DC)}} = 16 \% \text{ ICR}$$

- ⇒ Total costs of \$1,740,000 include all departments & activities of an organization.

**Diagram 12**

COST	ALLOCATION	
	Regular	Subgrant
Rent & Utilities	24,000	-
CEO	48,000	-
Controller	29,000	-
New Business Dev	19,000	-
Phone & Other Direct Cost	21,000	-
Admin & Accounting Staff	<b>92,000</b>	-
Office supplies	7,000	-
	<u>\$ 240,000</u>	<u>\$ -</u>

**Diagram 13**

**We won a Grant! Cont.**

Note the change in % of activity per "donor"

	A USAID	B Dutch Govt.	C World Bank	D UNDP	E Unrestricted Activities	Total
<b>Budget Line</b>	<b>33%</b>	<b>12%</b>	<b>5%</b>	<b>33%</b>	<b>17%</b>	<b>100%</b>
<b>Personnel &amp; Fringe</b>	300,000	100,000	50,000	400,000	200,000	<b>\$ 1,050,000</b>
<b>Other Direct Costs</b>	200,000	75,000	25,000	100,000	50,000	<b>\$ 450,000</b>
<b>Subgrants</b>	-	-	-	-	-	<b>\$ -</b>
<b>Total Direct Costs</b>	500,000	175,000	75,000	500,000	250,000	<b>\$ 1,500,000</b>
<b>Indirect Costs @ 16%</b>	80,000	28,000	12,000	80,000	40,000	<b>240,000</b>
<b>Total Costs</b>	<b>\$ 580,000</b>	<b>\$ 203,000</b>	<b>\$ 87,000</b>	<b>\$ 580,000</b>	<b>\$ 290,000</b>	<b>\$ 1,740,000</b>

Economies of Scale Argument: Indirect Costs Do NOT Automatically Increase in Proportion with Direct Costs.

Note how each donor's fair share has decreased.

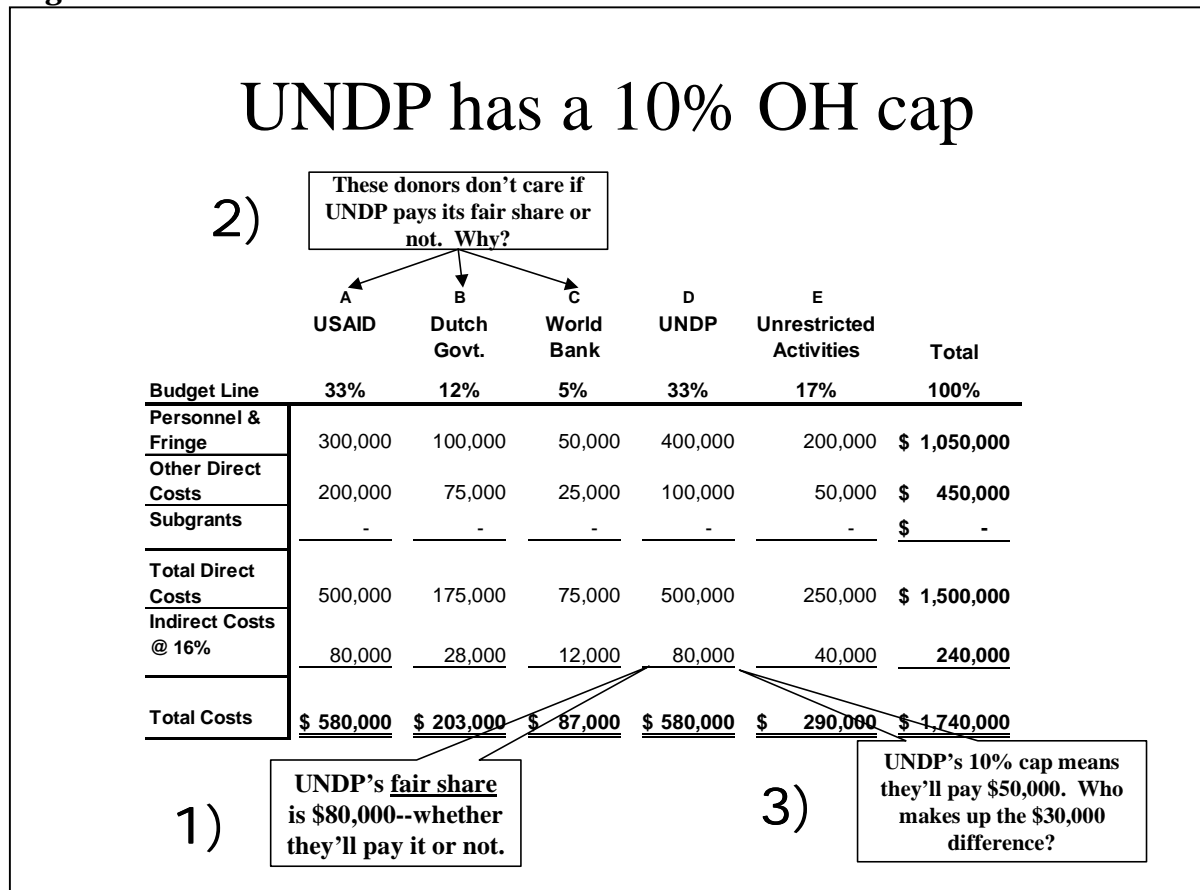
<sup>31</sup> Once a negotiated indirect cost rate (NICRA) has been accepted by USAID for example, an NGO's indirect rate doesn't automatically change at mid-year just because a new grant has been won. However, for year-end calculations, an NGO must be cognizant of the change in actual rate the new grant will cause.

Once again, the fair share of each donor is clear. Each donor should be required to cover the indirect costs associated with their project's "position" within the company. The appropriate indirect cost rate is now estimated at **16%**. With the addition of the UNDP grant, USAID is only responsible for 33% of the total projected direct cost expenditures for the year. Therefore, USAID should cover 33% of the total indirect costs for the year if everything goes as planned. This 33% of total indirect cost expenditures is equal to \$80,000 (which is \$20,000 less than before the UNDP grant was won), which is **16%** of USAID's total direct cost expenditures of \$500,000. Similarly, the World Bank's project "position" in the example organization is 5% of total anticipated direct cost expenditures for a total of \$75,000. World Bank is therefore responsible for 5% of the total anticipated indirect cost expenditures—5% of \$240,000 is \$12,000 which is **16%** of World Bank's total anticipated direct cost expenditure of \$75,000 (and \$3,000 less than before the UNDP grant was won).

### Donor Overhead Caps

Earlier it was established that indirect costs are real costs, which, generally speaking, have to be funded one way or another. The following diagram demonstrates the inherent difficulties when a donor is not willing to pay its fair share of indirect costs.

**Diagram 14**



The logic will be described in 3 steps as laid out in the diagram. The first point is simply to reiterate that the donors' fair share is calculated in proportion to their "position" in an NGO—the proportion to which a donor is responsible for the incurrence of an NGO's indirect costs. Whether a donor will pay its fair share or not is a different question, but determining the fair share is fairly straightforward. To illustrate:

- Item 1 In this case the UNDP fair share has been determined to be \$80,000.
- Item 2 USAID, the Dutch Government and World Bank “don’t care”<sup>32</sup> whether UNDP pays its fair share or not. Assuming these three have agreed to the NGO’s ICR, the **only** thing they care about with regard to the NGO’s indirect costs is that they only be charged **their** fair share and not a penny more. In other words, USAID’s only concern is that the NGO allocates its costs correctly and only charges them \$80,000 in indirect costs as the NGO spends the \$500,000 in direct project costs from the grant agreement. \$80,000 is USAID’s fair share and USAID will pay it—if another donor doesn’t pay its share that’s not USAID’s concern, as long as the NGO doesn’t try charging them for the shortfall.
- Item 3 UNDP’s fair share is \$80,000, but they have a 10% overhead cap that an NGO agrees to in their grant agreement. This means that UNDP will pay only \$50,000, leaving a \$30,000 deficit. Who makes up the difference? It has been demonstrated that it would be unfair to charge any of the other donors any more than their fair share—it’s not their fault that another donor won’t pay its fair share. Therefore, the NGO must make up the difference with its own unrestricted reserves.<sup>33</sup> This is why donor education on the nature of indirect costs is a huge priority.

NGOs should know what their financial situation is going into a bid or proposal. As mentioned in the executive summary, creative methods exist to recover indirect costs from donors with arbitrary caps—fixed price contracts being one method. However, there may be times where extremely strict guidelines and caps might preclude an organization from bidding on a project that the organization has a good chance of winning. This is of course a last resort that can hopefully be overcome in some legitimate, creative way. Knowingly entering into an agreement that an organization knows is under funded (directly or indirectly) however is irresponsible, unless the organization is doing it for other strategic purposes and has the funds to make up the shortfalls.

---

<sup>32</sup> The words “don’t care” are not to be taken literally; rather, they are used to highlight the fact that another donor’s shortfall isn’t this donor’s responsibility. However, all donors should be very concerned with other donors who pay less than their fair share of indirect costs, because under funding indirect costs can put a recipient in financial jeopardy and reduce institutional stability, thereby jeopardizing the organization’s work in general—including the work funded by donors who properly fund their fair share of overhead. It is therefore in everyone’s best interests that donors and recipients are all on the same page when it comes to funding indirect costs.

<sup>33</sup> However, donor flexibility by a more liberal donor may allow the deficit to be made up with some of its funding. While this is not common (and certainly not a solution to the larger problem) it may be a welcome aid for organizations with little to no reserves to cover this type of shortfall.



### System Requirements and Cost “Pools”

To get a good understanding of how common costs should be allocated in practice and what substantiation is required to support the allocations, it is important to understand the logic of cost pools. But first, what is the basic infrastructure of a solid system for tracking indirect costs? To handle donor expectations, accounting procedures and system must be able to:

- Separate and allocate funds by cost pool
- Properly estimate and track indirect costs
- Properly track direct costs by project/activity
- Pay for costs out of appropriate cost centers

Diagram 15

### NGO X DECEMBER 2000 EXPENSES

CATEGORY	DIRECT EXPENSES					INDIRECT	TOTAL	TYPICAL DOCUMENTATION
	USAID	DUTCH	WORLD BANK	UNDP	UNRESTRICTED	OVERHEAD		
CEO Salary	-	-	-	-	500	3,000	3,500	Timesheet
Controller Salary	300	-	-	-	400	1,300	2,000	Timesheet
Admin Salary	-	-	-	-	-	500	500	Timesheet
Program Coordinator 1--Sal	1,500	-	-	-	-	200	1,700	Timesheet
Program Coordinator 2--Sal	-	1,800	-	-	-	-	1,800	Timesheet
Program Coordinator 3--Sal	-	-	1,600	200	100	100	2,000	Timesheet
Program Coordinator 4--Sal	-	-	-	1,400	-	300	1,700	Timesheet
Phone, Fax Internet	25	30	50	40	45	30	220	Segregated Phone Bills
Office Supplies	-	20	-	-	20	75	115	Invoices
Vehicle 1--USAID	500	-	-	-	-	-	500	Vehicle Usage Log
Vehicle 2 General	15	25	30	25	20	385	500	
Rent	-	-	-	-	-	1,000	1,000	
<b>Total</b>	<b>\$ 2,340</b>	<b>\$ 1,875</b>	<b>\$ 1,680</b>	<b>\$ 1,665</b>	<b>\$ 1,085</b>	<b>\$ 6,890</b>	<b>\$ 15,535</b>	

*Notes:*

- 1 Timesheets must break time down by effort spent per cost center.
- 2 Phone system must either have a coding system for charging to projects or must be manually separated for entry into accounting system.
- 3 Supplies may generally be charged to indirect unless there is a practical way to allocate across projects, or, unless a purchase of supplies is for a specific project.
- 4 Vehicle usage must be documentable by cost center.
- 5 All documentation must be traceable from the accounting system.

A representative of the World Bank should be able (theoretically speaking) to walk into an NGO and inquire as to what were the charges to its project for a particular month and how those figures were derived. In the situation above, the World Bank can see that its project was charged \$1,600 for the Program Coordinator’s salary, \$50 for phone charges and \$30 for vehicle usage charges. If the World Bank representative inquired to see the documentation or “proof” of these charges, an NGO should be able to easily provide them with:

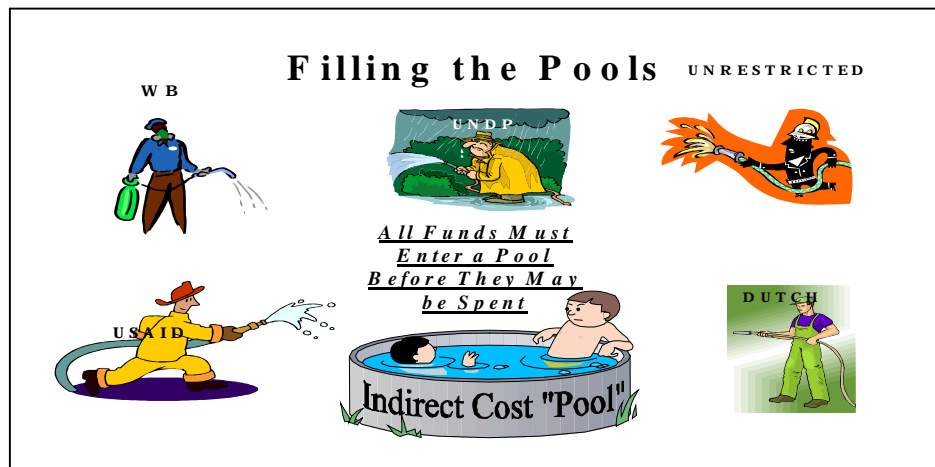
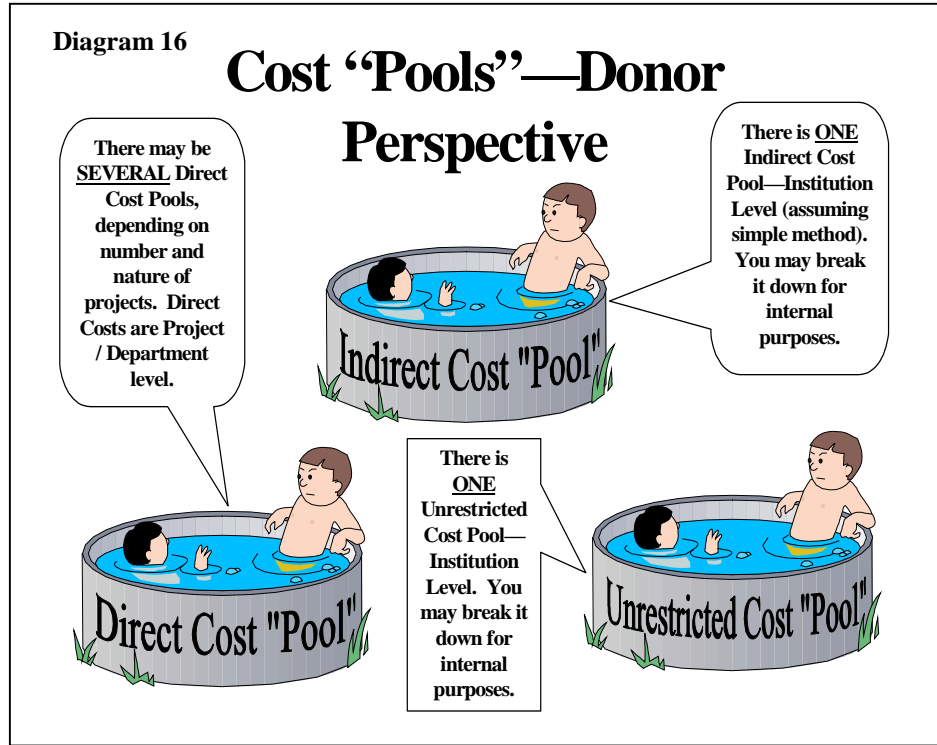
1. Timesheets for any and all personnel that charged time to its project
2. A segregated phone bill that assures that WB was only charged for calls associated with this WB project
3. A detailed vehicle log documenting the project use for which the vehicle charges were incurred.

If the accounting system cannot provide donors with this information or, more seriously, if it cannot provide the NGO itself with this information properly, a donor might have serious reservations about continuing funding direct costs and would be even more concerned about funding indirect costs. If an organization has difficulty properly segregating direct costs, it is unlikely that the organization will have a handle on indirect cost allocation. Thinking about cost allocations as cost “pools” helps to make more sense out of this.

What does a cost pool look like? An organization must be able to properly separate and allocate costs by cost pool. Of particular interest to a donor is what types of expenses are paid out of an NGO’s indirect cost pool. In OMB Circular A-122, the US government has defined what it thinks is appropriate to be paid for out of the indirect cost pool. Other donors have their own lists of what they deem to be “appropriate” costs for inclusion in indirect cost pools. The most

important thing to remember is that the *nature* of indirect costs is that they indirectly benefit donors’ investments in an organization. A direct activity that an organization elects to carry out does not benefit the donors’ projects nor is it indirect in nature. A donor must feel confident that such activities will not be paid out of the indirect cost pool—in other words charged to donors who neither requested (and certainly did not agree to pay for) such activities nor benefit from them. Those activities must either be paid for with unrestricted reserves or funded directly by a willing donor.

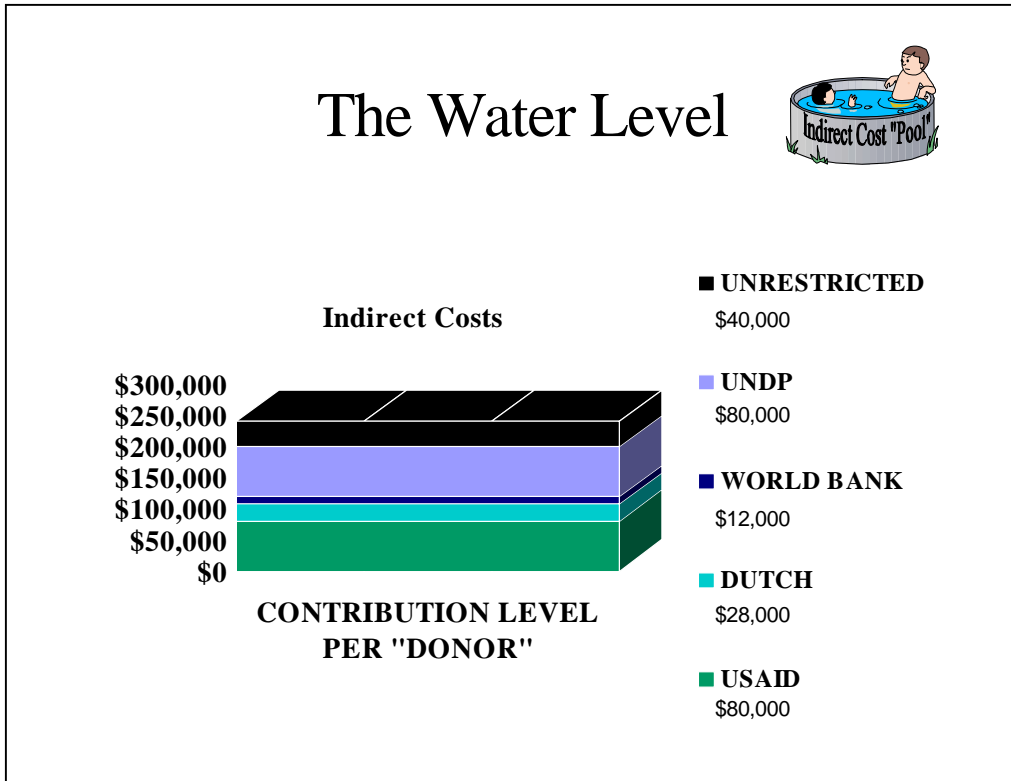
Before a cost can be incurred out of the indirect cost pool, there must be funds available in the pool to pay for it. Assuming each donor agrees to pay its fair share, a very literal example of how the indirect cost pool is funded is shown at right.



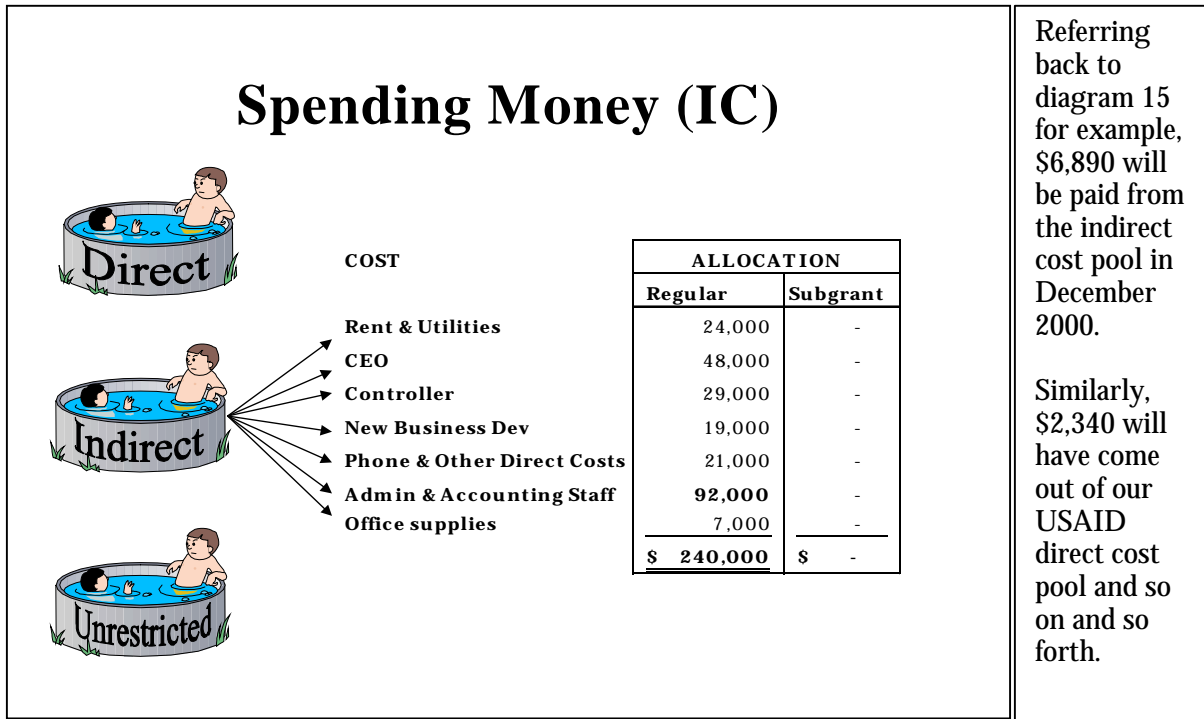
Once the indirect cost pool is properly funded from all donors, including the portion from unrestricted activities, it is ready for business.

As explained earlier, the amount of funding in an NGO's indirect cost pool from each donor should be directly proportional to that donor's "position" in the NGO.

The diagrams to the right and below demonstrate the position of each donor in an NGO's pool and how funds are spent from the pool.



**Diagram 19**



Theoretically speaking, a donor should be able to examine the records of a recipient and quickly determine what and how much has been charged to the project it funds. With advanced accounting systems and processes, properly separating costs by cost pool, NGOs will be able to convince donors of their ability to properly manage their investments.

## CHAPTER 3

### OVERHEAD MANAGEMENT

There are several key issues when it comes to overhead management. Four particularly pertinent issues will now be covered: defining an overhead strategy, economies of scale, expense timing, and maintenance and reporting.

#### Defining an Overhead Strategy

As previously mentioned, goals and potential benefits of developing an indirect cost rate include being able to better control costs, recovering full indirect costs instead of hiding them in direct costs, educating donors about the reality of legitimate indirect costs, and spreading indirect costs across all donors and funding sources. But before taking the leap into formulating an ICR an organization needs to have a very clear understanding of what its ICR “Strategy” and objectives are and why. Possible objectives include:

1. Increasing the recovery of indirect costs from donors rather than using unrestricted funds.
2. Simplifying its cost recovery practice (i.e. not having to hide indirect costs)
3. Decreasing an existing rate to become more cost competitive
4. Increasing existing rate to adjust to new realities<sup>34</sup>

“For the most part, bidders in a competitive market will strive to lower their indirect cost rate to the level that causes them not to lose contract/grant awards, which at the same time allows them to recover their full costs.”<sup>35</sup> All other things being equal, a business savvy donor will search out a recipient who will deliver the most *bang* per dollar.

Part of defining an overhead strategy is deciding which type of indirect cost rate to implement. While no one approach is ideal, there are many different methods for allocating indirect costs across different donors and projects. Besides the simple allocation method with a provisional rate that is used in most of the examples of this report, indirect costs can be distributed over multiple cost bases and under non-provisional reporting requirements. With any overhead allocation method, it must be demonstrated that indirect costs are being distributed in the fairest manner against the direct cost source that necessitated their incurrence. As mentioned in the Executive Summary, as long as this condition is satisfied, creative methods can be developed to form cost centers for certain types of costs (travel or subcontracts for example), or possibly even units within an organization that can have more competitive overhead rates because they depend on, and consequently benefit from, the administrative functions of the organization to a measurably lesser degree.

To a certain extent, simplicity must be balanced with accuracy<sup>36</sup>, and developing a simple method to allocate and recover indirect costs—especially in an organization that currently has

---

<sup>34</sup> List based on similar list from Robert E. Stross, *Restructuring Indirect Costs*, Center for Public Management, ©2000, p48.

<sup>35</sup> Robert E. Stross, *Restructuring Indirect Costs*, Center for Public Management, ©2000, p51.

<sup>36</sup> From a good business management point of view (not because a donor says so), accuracy, based on the NGO’s chosen method, takes priority. When selecting a method, preferred simplicity must be considered, but insistence on simplicity at the expense of accuracy will inevitably create diminishing returns due to general donor concerns and the inherent complexity involved in properly managing multiple grants. In the long term, the ability to be allowed less onerous reporting mechanisms will largely be based on how advanced a donor perceives an NGO’s reporting system to be. Ironically, the more advanced the system, the more likely the donor will be to require less detail and vice versa. Furthermore, it is the author’s view that

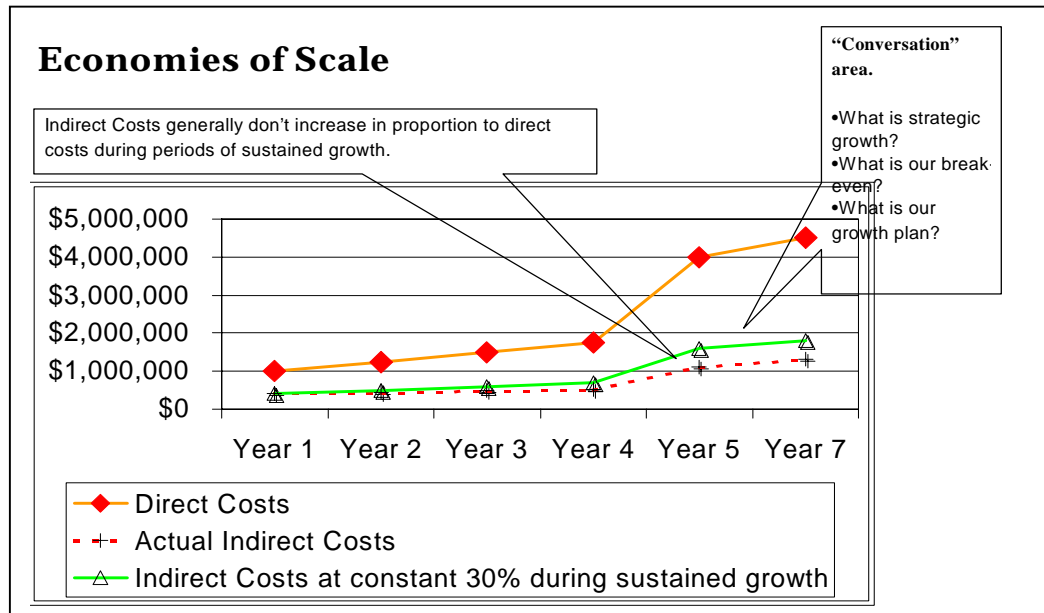
no method—perhaps takes priority over exploring inherently more complicated, albeit creative methods. However, the possible advantages of multiple allocation base methods are worth exploring if an organization would benefit from a mix of different cost center structures.

Proper funding of indirect costs is imperative. But improper funding of an organization’s indirect costs is logically more painful to an organization that has poor control over those costs than to one that has efficiently structured its costs. As the next section demonstrates, this equation is somewhat stacked against organizations still in their early development stage.

### Economies of Scale

It was noted in the diagram 13 that indirect costs do not increase in proportion to direct costs in times of sustained growth. The graph to the right demonstrates how this works.

Diagram 20



The reason this occurs is because a big component of indirect costs are fixed costs, which don’t increase when new grants are won. For instance, if a medium-sized organization suddenly wins a new grant, it doesn’t have to rent a new building or hire a new CEO for that grant.<sup>37</sup> Generally speaking, an NGO has to pay these costs whether it has one project or ten. For this reason, these costs don’t typically go up dollar for dollar with new direct costs.

As noted earlier, indirect costs are real costs whose incurrence must be rooted in the reasonableness principle and which must legitimately benefit all donor projects indirectly. What that means is that if an organization’s indirect costs continue being incurred at the same rate during periods of sustained growth, one of three things is likely happening:

1. The NGO is artificially “growing” into its indirect cost rate simply for purposes of maintaining the rate.
2. The NGO is scrambling to purchase “legitimate” overhead items in order to spend up to its rate.<sup>38</sup>

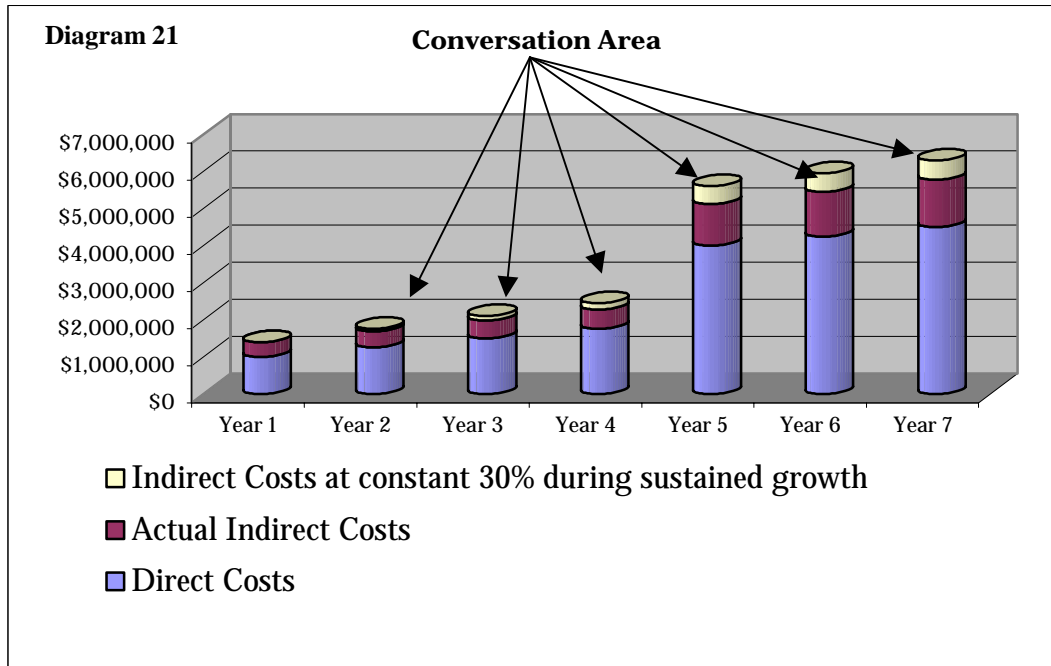
driven by better business models, donors are slowly moving towards reporting systems that stress accuracy over simplicity.

<sup>37</sup> Unless the grant or combination of grants is so large as to significantly alter the size of an organization. There are occasions in an organization’s life cycle where a building is outgrown or where significant numbers of new staff must be hired to service the grants.

<sup>38</sup> This is fairly hard to detect and is usually a mix of additional hiring and expenditures that may or may not turn out to have been good ideas (although by chance, not by planning), as well as ill-advised overhead

3. As part of its growth strategy, the NGO is properly and calculatedly spending on necessary expenditures, that donors would find reasonable.<sup>39</sup>

The possible surplus available to an NGO above expenses incurred with normal growth can be referred to as “The Conversation Area”:



What this shows is that total indirect costs (highlighted in red) increase as an organization grows. However, even additional spending doesn't bring the NGO up to the amount available at a constant 30% rate (for example). The regular increased spending is due to the growth inherent in taking on more projects. That means an NGO may have already added some new staff and bought some new computers for them, as well as increased certain other miscellaneous expenses. The yellow “conversation area” is the amount that would have to be spent to remain at the 30% level—an amount over and above an organization's regular growth rate. The reason this is termed the “conversation area” is because an in-depth conversation about how and or whether this surplus should be spent should take place before doing so. If an NGO elects to make a concerted effort to spend it, it should be on legitimate items that are in line with the NGO's strategic growth plan. In other words, right or wrong depends on whether the NGO is spending out of calculated need or simply because the NGO neglected to plan.

When defining an overhead strategy it is critical for both donors and recipients to understand that just as indirect costs are generally lower as a percentage of direct costs during periods of sustained growth, smaller NGOs will tend to have higher overhead rates in earlier stages of organizational life. This is due to lack of economies of scale when recovering fixed costs from a smaller donor base. This presents quite a quandary when NGOs are being judged on cost competitiveness. Ways to approach this issue are discussed in the Executive Summary.

---

expenditures, which would likely fail the reasonableness test if closely scrutinized. Difficult or easy to detect, it is no substitute for a proper growth strategy.

<sup>39</sup> This is unlikely in long periods of strong sustained growth because even additional well-planned expenditures will not likely be proportionally equal to additional direct costs expenditures.

**Expense Timing**

Timing of planned overhead expenses can impact an organization’s overhead rate significantly. As an NGO monitors its overhead expenditures throughout the year, particular attention should be paid to anticipated changes in the actual overhead rate for the upcoming year. For instance, assuming it is near year-end, an NGO has a provisional overhead rate of 30% and it appears that the NGO is going to finish the current year at an actual rate of 25%. Furthermore, after closely reviewing its projected project/funding pipeline for the upcoming year the NGO determines that its overhead rate is likely to be closer to 36% for next year. It would be a good idea to review planned overhead expenditures for the upcoming year to see if some of the needed purchases can be made this year, when the overhead rate is anticipated to be low, instead of the coming year, when it is going to be more difficult to keep the overhead at or near the provisional rate. This doesn’t mean an NGO should scramble to spend the probable unspent difference from this year as soon as possible. Rather, it means the NGO should be cognizant of fluctuations in project and expense cycles and time its expenses to its maximum benefit when possible.

**Maintenance and reporting**

The basic accounting for receipt of payment from a donor that advances money to carry out its projects is as follows<sup>40</sup>:

<b>Receipt of Funds</b>		
Cash (BS)	10,000	
Unearned Revenue (BS)		10,000

<b>Spending Funds</b>		
Office Rent (IS)	1,000	
Cash (BS)		1,000
Unearned Revenue (BS)	1,000	
Earned Revenue (IS)		1,000

Organizations with a US government established negotiated indirect cost rate (NICRA) must update their ICR every year unless they have established an exception of some sort. Each year, an organization must get its overhead rate audited in order to present the audited rate to the US government. This “audited rate” will be the final rate used to calculate actual overhead expenditures for the year.

Assuming that the provisional overhead rate has been approved and an organization has a calendar year business year, the overhead actions timeline would look something like this:

**Diagram 22**

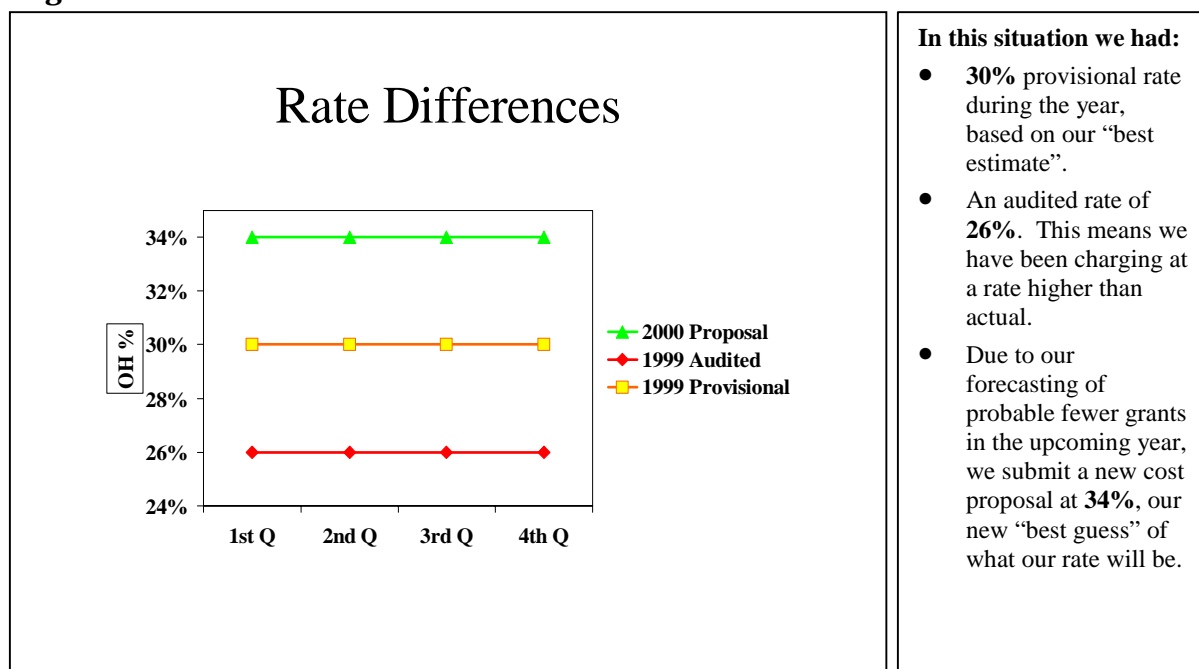
CURRENT YEAR OVERHEAD ACTIONS	Year 1				Year 2			
	1st Q	2nd Q	3rd Q	4th Q	1st Q	2nd Q	3rd Q	4th Q
1. Charge provisional 30% rate on all direct costs	Blue	Blue	Blue	Blue				
2. Pay for legitimate overhead items out of OH Cost Pool	Red	Red	Red	Red				
3. Contract to have Books audited for actual rate				Green	Green			
4. Adjust donor liability up or down					Light Blue			
5. Submit Report & New ICR Proposal To donor					Dark Blue			

<sup>40</sup> (BS) = Balance Sheet (IS) = Income Statement



The provisional overhead rate initially approved in an indirect cost proposal is essentially an organization’s best educated projection based on prior year actual results, adjusted for known variable factors in the upcoming year in question. As the following chart shows, as steps 3 through 5 in Diagram 22 above are followed, an organization may find itself dealing with 3 different overhead rates:

**Diagram 23**



**In this situation we had:**

- 30% provisional rate during the year, based on our “best estimate”.
- An audited rate of 26%. This means we have been charging at a rate higher than actual.
- Due to our forecasting of probable fewer grants in the upcoming year, we submit a new cost proposal at 34%, our new “best guess” of what our rate will be.

None of this is necessarily a problem as long as an organization is accurate in its reporting and not wildly off in its forecasting—which could lead to lack of donor confidence in the organization’s cost management and eventual donor reticence towards future funding.<sup>41</sup> The key is whether an organization’s accounting system is equipped to handle all the different possible contingencies.<sup>42</sup>

<sup>41</sup> Once an organization has decided whether to use a simple or multiple allocation base method, it may choose to pursue a predetermined rate (in lieu of a provisional rate) with its donors. A predetermined rate is basically a set percentage of indirect costs that are charged to each donor without the subsequent requirement of reporting an actual, audited rate. The benefit to this approach is simplicity, but predetermined rates can be a double-edged sword. This is because they rely enormously on an organization’s ability to accurately forecast the next one to three years—something only more sophisticated organizations can do with relative accuracy. If an organization underestimates its expenses it is simply out of luck because the rate is set. On the other hand, if the organization overestimates (and it is accepted by the donor), it reaps the benefit without repercussions. Provisional rates may be more burdensome, but they are also generally less risky.

<sup>42</sup> In the Indirect Cost survey mentioned earlier, “[a]gencies were asked how their actual rates compared to their provisional rates...8 agencies said actuals were lower,...3 higher,...and three...the same. The reasons given for the variation[s] were: Actual direct (base) was more [or less] than projected [61%], [a]ctual indirect was more or less than projected [33%], [l]owered rate to be competitive in competing for grants [6%].” **Taken from Association of PVOFM 2000 survey page 12.**

**Distorting items, Subgrants and Two Tiered Rates<sup>43</sup>**

The US government in its rules on overhead requires organizations to treat “distorting items” differently from regular expenses when calculating overhead. The logic behind this requirement is that certain items of cost do not generate the same use of indirect costs; they are more efficient in that they require minimal effort in their procurement or management. To include them as regular direct costs, charging full overhead on them would be to distort the indirect cost formula and charge a donor more than its fair share of indirect costs. Examples of possible distorting items include large subgrants, large equipment purchases and other large one-time procurements.

If an organization has a single overhead rate, the default rule in OMB (US government) A-122 states that the organization may only charge full overhead on the first \$25,000 of each subgrant (not per year, but total). It also states that large procurements must be left out of the equation entirely—that no overhead should be charged on them at all.

The key question for an organization is whether it would be worth developing a multiple-tiered rate in order to recover indirect costs on subgrant management. The formula, with corresponding indirect cost breakdown, is to the right and below.

**Diagram 25**

**Diagram 24**

**We Won a Subgrant!**

- ☞ USAID Has added a \$417,000 subgrant to our award.
- ☞ This grant will only cause marginal additional indirect cost incurrence.

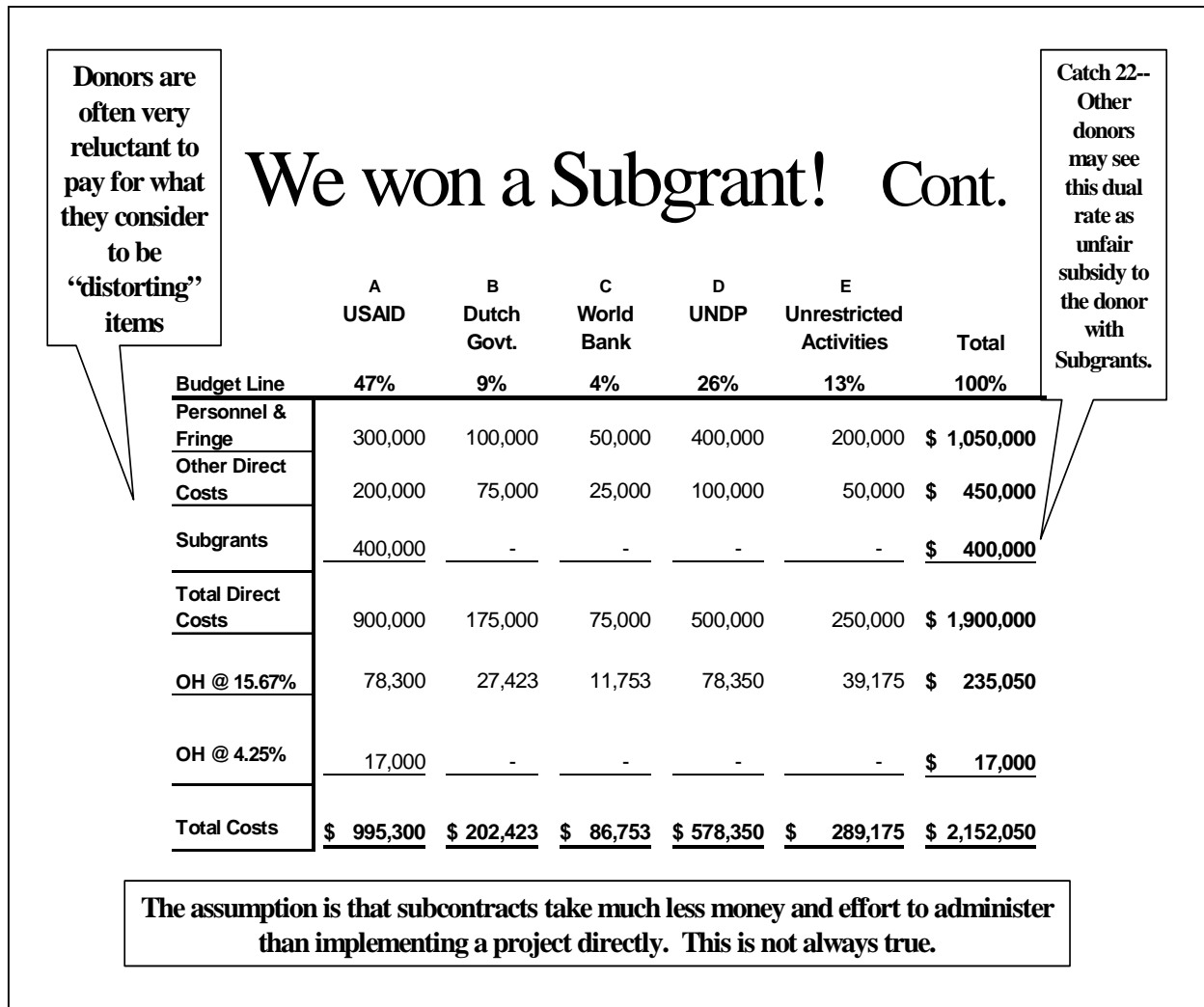
<b>Regular OH Rate</b>	<b>Subgrant Rate</b>
<u>\$235,000 (IC)</u>	<u>\$17,000 (IC)</u>
\$1,500,000 (DC)	\$400,000 (DC)
= 15.67 % ICR	= 4.25 % ICR

☞ Total costs of \$2,152,000 include all departments & activities of an organization.

<b>COST</b>	<b>ALLOCATION</b>		
	<b>Regular</b>	<b>Subgrant</b>	<b>Total</b>
<b>Rent &amp; Utilities</b>	24,000	-	24,000
<b>CEO</b>	46,000	2,000	48,000
<b>Controller</b>	26,000	3,000	29,000
<b>New Business Dev</b>	19,000	1,000	20,000
<b>Phone &amp; Other Direct Cost</b>	21,000	5,000	26,000
<b>Admin &amp; Accounting Staff</b>	92,000	4,000	96,000
<b>Office supplies</b>	7,000	2,000	9,000
	<u>\$ 235,000</u>	<u>\$ 17,000</u>	<u>\$ 252,000</u>

<sup>43</sup> Anything more than a single allocation base is considered a multiple allocation base. For purposes of the examples in this section, the sample organization has a “two-tiered” multiple allocation base method for allocating indirect costs.

**Diagram 26**



The key for an organization rests in the statement at the bottom of the diagram—how much unrecoverable money and effort is being expended as long as the organization is not able to charge overhead on its subgrant expenses? The following factors should be considered:

1. How much additional indirect cost incurrence is the result of the additional subgrants being managed?
  - a. Are the majority of typical support costs directly covered by the budget in the first place? If the accountant that is required to manage these grants is already fully covered as a direct cost for instance, he or she doesn't need to be paid out of overhead.
  - b. If an organization is “subgrant heavy” and incurs significant additional (over the amount of directly funded) expense in properly servicing its subgrants, the chances are a two-tiered rate may be necessary.
    - i. A comparison would still need to be made between the pros and cons between the single tier default under A-122 (overhead on the first \$25,000 of each subgrant), and establishing a separate “pass-through” overhead rate.
2. Of the additional amount, how much is already being covered by the regular overhead cost pool? This is not advocating hiding unrecovered subgrant overhead costs in regular

- overhead. Rather, it is highlighting the fact that it is very difficult to determine what percentage of certain fixed cost overhead items are now being shifted to cover subgrant overhead. Examples include rent, CEO and Controller time, and other expenses that are already fully covered out of the regular indirect cost pool.
3. If the total additional overhead amounts that are easily identifiable and would have to be covered with unrestricted funds are still relatively immaterial, it may not be worth establishing a two tiered rate to recover such a small amount.
    - a. This is because maintenance and reporting on a two-tiered rate can be significantly more complicated than that which is required to upkeep a single rate.<sup>44</sup>

---

<sup>44</sup> In the Indirect Cost survey mentioned earlier, “[f]our out of seventy-six agencies [surveyed] have a pass-through rate. **Taken from Association of PVOFM 2000 survey page 15.**

## CHAPTER 4

### TNC PARTNER RESULTS & NEXT STEPS

#### **Introduction**

Three of The Nature Conservancy's Latin American partners participated in the indirect cost study. The participants were Toledo Institute for Development and the Environment (TIDE) from Belize, Fundación Antisana "Funan" from Ecuador, and Fundación Defensores de La Naturaleza from Guatemala. TIDE and Defensores calculated their indirect cost and fringe benefit rates for 1998 and 1999, while "Funan" calculated its rate solely for 1999.

The results for each organization will now be examined with some basic inferences drawn as to the reasons behind the numbers. All indirect cost percentages are represented as a percentage of total direct costs.

#### ***TIDE***

The Toledo Institute for Development and Environment (TIDE) is an environmental NGO that was established in September 1997. Like most other NGOs, TIDE solicits funds from donor agencies both locally and abroad to finance its projects and operating costs. While TIDE has been able to attract funding to finance the direct costs of projects, it has found it increasingly difficult to convince the funding agencies of the need to also provide adequate financing for the operating or indirect costs.

Over the years, TIDE has requested between 5% and 15% of the total cost to finance operating costs of the various proposals that have been sent to different funding agencies. The percentage that was chosen at any particular time was based primarily on a subjective estimate of future indirect cost incurrence, without the analytical rigor and relative precision that methods such as the one proposed in this study would produce. The direct result of this is that TIDE has been depleting its scarce resources on overhead costs that are not adequately financed.

TIDE managed a single project in 1998, beginning the year with four employees and ending with seven. Seventy percent of the indirect expenses for the year were for salaries and benefits. TIDE's indirect cost rate was calculated at **36.94%** in 1998, relatively high for an organization with low total fixed costs. This is indicative of an NGO in early growth phase, with few donors to cover indirect costs. TIDE lacked economies of scale and funded its indirect costs directly from its sole donor.

In 1999, TIDE's project portfolio grew significantly, to 5 projects, and its staff grew to 16 persons. Although the funding base nearly doubled (in dollars), TIDE was still in a growth stage and was unable to develop real economies of scale. TIDE's indirect expenses increased at a faster pace than their project base, producing an overhead rate of **51.18%** in 1999. 63% of the indirect costs were in salaries, benefits and consultants.

While these real indirect expenses were funded one way or another—either by TIDE's own unrestricted reserves or directly by donors—TIDE clearly entered a full-fledged growth stage where evolving to a proper system of cost recovery has become imperative. If TIDE's growth rate continued similarly in 2000, it is very likely that some economies of scale began to show and the effective indirect cost rate would have gone down. In both years, office rent and other expenses that are typically classified as indirect costs, were mostly covered by direct funding. As

the growth continues, donors will become more reluctant to fund these costs directly. Longer-term sustainability will require proper cost planning and recovery as described in chapters 1-3.

#### ***FUNDACIÓN ANTISANA “FUNAN”***

The Fundación Antisana, FUNAN, is an Ecuadorian non-profit NGO located about 44 miles to the east of Quito. FUNAN was established on July 4<sup>th</sup> 1991 for the purposes of conserving and protecting the natural resources around the Antisana Volcano. The efforts of the members of FUNAN culminated in 1993 when the Ecuadorian government legalized the creation of the Antisana Ecological Reserve—120,000 hectares covering areas of desert to subtropical Andean forests.

FUNAN first began in 1991 with few employees and a very small budget. The prestige garnered from working in the reserves and in smaller projects in local communities, helped FUNAN's project and financing base grow to significantly higher levels in the late 90's. FUNAN implemented 13 different projects and calculated its indirect cost rate at **24.69%** in 1999. Its donors included the British Embassy, Phillip Morris, Plan International and others. Although the total grant amount per donor is relatively small, by spreading indirect costs over numerous donors, FUNAN appears to have achieved early signs of economies of scale.

FUNAN's total grant base is dominated by smaller grants. This puts FUNAN in a difficult situation in trying to recover the fair share of indirect costs from each donor, since donors with particularly small grants with FUNAN are likely reluctant to fund even a nominal share of their indirect costs. Because of this structural difficulty, FUNAN will need to be proactive in demonstrating its credibility and command of the subject of indirect costs if it is to be able to properly recover its indirect costs in the future. An established indirect cost rate would be ideal for FUNAN who could begin all new proposals by including its rate in its budgeting process. Because of the complex nature of managing many grants, FUNAN is at the point where not having an established indirect cost rate is bound to result in unrecovered indirect costs.

#### ***FUNDACIÓN DEFENSORES DE LA NATURALEZA***

The Fundación Defensores de la Naturaleza is a private, apolitical, non-profit foundation. Defensores was established in 1983 by a multidisciplinary group of individuals from various walks of national life, who were concerned with conservation and sustainable development in Guatemala.

The dollar value of Defensores' project base nearly doubled from 1998 to 1999.<sup>45</sup> Demonstrating the principle of economies of scale during this period of sustained growth, Defensores' overhead rate decreased from **36.10%** to **25.89%**.

Hypothetically speaking, if Defensores had an established indirect cost rate and a proper growth plan, it may have strategically chosen to make planned overhead expenditures in 1999 to improve its organizational capacity and strengthen its ability to do its work and win future awards. The expenditures might have been on legitimate training, computer and information technology upgrades, or other needed legitimate overhead expenses. It would have needed to weigh this against the risk of becoming uncompetitive, but it is important to note the importance of not only establishing the rate, but also employing it properly. With the inherent complexity in managing nearly 40 funders and/or projects in 1999, Defensores requires a formal system of indirect cost recovery/management immediately.

---

<sup>45</sup> Although the number of projects only slightly increased from 38 to 40, the average award size increased significantly.

## **Next Steps**

- ⇒ The TNC partners involved in this study calculated their indirect cost rates solely based on the methodology in Annex 1. The addition of the broad explanation in chapters 1-3 of “why” understanding indirect costs was so vital, adds a reference tool that may help the partners rethink their calculations and redesign their indirect cost recovery strategies. It would be worth examining the partners’ 2000 figures as well as engaging them in a lively discussion on the difficulties they have faced in trying to recover their indirect costs over the years. This could add a valuable qualitative side to partner participation that—due to distance limitations—was predominantly quantitative up to this point. This qualitative detail could serve as compelling evidence in persuading the donor community of the merits of the arguments in this report.
- ⇒ It is recommended that the qualitative data mentioned above be incorporated into the findings of this report, adding further TNC partners to the study in order to produce a more concise report specifically for the purposes of persuading the donor community to make progressive steps in funding indirect costs.
- ⇒ It is recommended that feedback on this final report be gathered from some large donors who have fairly liberal overhead reimbursement policies.
- ⇒ It is recommended that both TNC and Pact take formal steps to offer indirect cost calculation capacity to their local partners when appropriate.

## ANNEX 1

### STEP-BY-STEP METHODOLOGY

#### **Introduction**

The methodology laid out below was sent to the participants in the study along with accompanying spreadsheets<sup>46</sup>. The participants were asked to follow the methodology in calculating their indirect cost rates for the calendar years 1998 and 1999. This chapter is a more detailed “how” to calculate simple indirect cost rates. Slight changes have been made since the original methodology for purposes of consistency throughout the report.

#### **METHODOLOGY:**

The following four modules will detail an instructive, practical and simple way to calculate indirect cost ratios. In order to present the best possible orientation to the approach, spreadsheets with calculations, indicators and examples for each module are attached.

#### **MODULE # 1: SALARIES**

#### **INSTRUCTIONS:**

The purpose of this module is to determine the following:

- Sum total of salaries paid during the period January 1, 1998 - December 31, 1998, and January 1, 1999 - December 31, 1999. It is very important that it be understood that "salaries" are solely amounts paid to employees who are working under work contracts in accordance with the labor laws of the country and the personnel policies of the organization. Similarly, these “salaried” employees should be receiving benefits and/or compensation in accordance with the labor laws of the country and the benefits policies stipulated in the aforementioned personnel manual. Therefore, consultant payments, temporary work and/or any other type of payment for wage labor to workers not under contract (and thereby not receiving benefits as salaried employees) will not be included in this module.
- Of total salaries calculated above, estimate total salaries paid to employees to carry out functions or tasks that were *directly* associated with specific project or contract objectives during the time period being evaluated. This amount will form part of the direct expenses of the organization.
- In the same manner, estimate total salaries paid to employees to carry out functions or tasks that were *indirectly* associated with specific project or contract objectives. In other words, total salaries paid to employees carrying out functions that benefited the organization in general—not projects, contracts and programs specifically. This amount will form part of the indirect expenses of the organization.

#### **Criteria for estimating, distinguishing and separating direct salaries from indirect salaries:**

---

<sup>46</sup> The inclusion of this annex is for reference purposes only. For this reason, the spreadsheets that originally accompanied this phase of the study have not been included.



Within most organizations three categories of employees can be distinguished:

1. Employees who are carrying out functions specifically and directly related to the ultimate objective of one or several projects of the organization, and whose time is distributed between these projects totaling 100% of his or her total available time. This 100% will be prorated between the projects according to the effort dedicated to each one—expressed in percentages and amounts. For greater detail, please refer to the spreadsheet for Module # 1. (***Important note:*** all the modules presented/displayed in this study are based on the calendar year 1998. These modules will also have to be filled out for 1999, using the same criteria and guides.)
2. Employees who are carrying out functions that benefit the organization in general (indirectly to the projects), as well as functions directly related to the ultimate objective of one or several projects of the organization (effort dedicated directly to projects). In other words, of the 100% of an employee's available work time, a certain percentage is dedicated to functions benefiting the organization in general (indirect expenses), and the remainder is associated with specific project or contract objectives (direct expenses). The total 100% therefore needs to be separated under the headings of direct and indirect expenses—again in percentages and amounts. The percentage and amount dedicated to direct expenses will also be prorated between the projects of the organization according to the level of effort dedicated to each. For greater detail, please refer to the spreadsheet for Module # 1.
3. Employees who are dedicating 100% of their time to solely carry out functions that benefit the organization in general, and the organization's projects in an indirect way (solely indirect expenses). In this case, 100% of their time will be classified within the category of indirect expenses. For greater detail, please refer to the spreadsheet for Module # 1.

Examples of direct and indirect functions (to be used as a reference in the classification and estimation of the amounts and percentages of direct and indirect expenses).

**Example 1:** A biologist who is spending part of her time as acting Director of the Organization, while at the same time working directly on specific conservation projects (as a project biologist for example) funded by one of the organization's donors. 100% of her time will have to be distributed between the administrative functions of Director (indirect expenses) and direct functions of Project Biologist (direct expenses). Activities that the biologist would have to charge as indirect expenses would include development of the strategic plan for the organization, meeting with the Directors of the organization (Board of Directors meetings), researching and writing proposals to solicit funding, implementation of strategies and decisions that benefit the organization, etc.

**Example 2:** Two ecologists who are working directly towards ultimate project objectives as stipulated in the associated contract or grant agreement. To the extent that the total amount of their wages is approved in the budget, they will be able to charge 100% of their time to these projects and to consider these expenses as direct.

**Example 3:** Salaries for executive administrative and accounting staff, that do not have direct relation with the ultimate project objectives (who serve to benefit the organization in general and not projects specifically). These costs are considered indirect because they relate to the time dedicated to direct and administer the organization in general. Nevertheless, if in a given situation some of these employees carry out tasks very specific to a certain project and towards that project's ultimate objectives, they may be able to charge this time directly to the project

(direct expense). For example, in a project that required such and stipulated so in its budget, training in accounting and administrative processes, evaluation, technical assistance and/or training, etc. would be considered direct costs.

## **MODULE # 2: BENEFITS**

### **INSTRUCTIONS:**

The purpose of this module is to determine the following:

- Sum total of all benefits paid during the calendar years 1998 and 1999.
- List of each type of benefit paid according to the labor laws of each country and the benefits policies stipulated in the personnel manual of each organization.
- Calculate the Fringe Benefit Rate for 1998 and 1999.

### **Procedure to follow:**

1. Each organization will need to list all of the different types of benefits granted to their workers according to law and organization personnel policies.

**As a reference, some of the more common benefits are as follows:**

- Social Benefits:
    - Thirteenth month pay
    - Indemnification and/or severance
    - Advance warning of termination
    - Retirement pension
    - Merit bonuses
    - Vacation leave
    - Sick leave
    - Holiday leave
    - Other benefits
  - Contributions:
    - Employer's portion of Social Security
    - Employer's portion of education tax
    - Disability insurance
    - Medical insurance
    - Other contributions
  - Other Benefits:
    - Training allowance
    - Professional development
    - Others
2. Once all the different benefit-types and benefits are identified, it is time to calculate, or to obtain from accounting data, the sum total paid under each benefit heading. For this process, it is not necessary to make the distinction between direct and indirect expenses. Rather, it will only be necessary to calculate and verify the sum total of all benefits paid to employees in 1998 and 1999.

3. Having determined the sum total of benefits and benefits paid in 1998 and 1999, we then calculate the "Benefits Ratio"—the total benefits paid divided by total salaries paid, calculated by year. This ratio must be consistently and equitably applied to direct salaries (in the proportion of total direct cost salaries), and to indirect salaries (in the proportion of total indirect cost salaries) of the organization. Once the benefits ratio is calculated we can easily apply the percentage against total direct and indirect salaries as determined in Module #1.
4. The spreadsheet for Module # 2 should be filled in according to the instructions mentioned above, and along the lines of the illustrative example included in the spreadsheet itself. The total amount of salaries paid is shown in the example in Module # 1, Column B, and the figures for the example are fictitious.

## **MODULE # 3: ESTIMATION AND CLASSIFICATION OF OTHER DIRECT AND INDIRECT COSTS, AND UNALLOWABLE EXPENSES**

### **INSTRUCTIONS:**

The purpose of this module is as follows:

- To determine, via the chart of accounts of each organization, all other expense-types and expenses incurred in calendar years 1998 and 1999.
- In the same manner as for Salaries in Module #1, apply the criterion of ultimate project objective to estimate, identify and separate direct expenses from indirect expenses. Similarly, as soon as the total direct costs are calculated, they will need to be distributed between the organization's projects according to the respective cost centers.
- To identify expenses that are commonly not accepted by donor institutions and to subtract them from the total expenses.
- By means of the chart of accounts used as reference in Module #3 (calculation spreadsheet attached), the auditors will be able to classify and group the organization's expenses in a more simple and standardized way.

**The following examples are presented in order to reinforce the criteria for identifying and separating direct costs from indirect, and to identify unallowable costs:**

#### A. Direct Costs:

- Planned activities funded by an organization's unrestricted reserves. Since these costs neither directly nor indirectly benefit donor projects, but are in fact internally funded projects of their own right, they must be treated as direct costs and may not be paid for out of the overhead pool.
- Consultant's fees paid to individuals whose work has a direct relation to the delivery of a specific product or service, according to a specific grant award or project. These fees would be assigned directly to the project/cost center in agreement with the consultant invoice and terms of the consultant's contract.
- Special insurance to comply with civil responsibilities is treated as a direct cost when it contributes directly to the ultimate project objectives of the project (for example, vehicle insurance for a vehicle acquired in accordance with a specific award or agreement).
- Lawyer fees incurred for direct program activities.
- Data processing costs in relation to specific project activities (for example, the time dedicated to creating a database and/or spreadsheet for monitoring certain activities of the program in relation to its corresponding costs, in order to avoid overspending a project, and in order to be able to reach all the objectives of the program in accordance with the award).
- Travel costs that contribute directly to a specific program.
- Photocopying costs that contribute directly to a specific program.
- Office space that contributes directly to a specific program. These costs are calculated in proportion to the surface in square meters used for these purposes.
- Materials and supplies that contribute directly to a specific program objective.
- Publication costs that contribute directly to a specific program objective.
- Costs of the maintenance of vehicles that contribute to a program directly.
- Costs of telephone, postage and shipping, training, seminars and conferences that contribute directly to a specific program objective.

- Expenses of hiring employees to fill vacancies directly required by a project or program. This includes the costs of the vacancy announcements published in newspapers (most other advertising costs are not allowed).
- Vehicles, equipment and furniture, purchased with prior approval of donor (funding source) are treated as direct costs and are charged as expenses during the current year (they are generally not subject to depreciation).

#### B. Indirect Costs:

Indirect costs are costs that have been incurred to achieve common objectives or activities for the organization in general, that benefit donors indirectly, and that cannot be correlated with a specific, final cost objective. Such costs are assigned to a separate cost center, called "indirect cost funds". The following costs are examples of some of the more common indirect costs:

- Consulting services incurred for the operation of the organization in general, or with predominantly administrative aims (finances, personnel, etc).
- Insurance costs for the organization in general.
- Lawyer fees for services to the organization for its normal operations.
- Data processing services such as payroll, general fundraising, inventory of fixed assets, personnel data, etc.
- Audit costs for the organization's internal audit.
- Travel expenses for management or with administrative aims that favor the organization in general.
- Costs related to the preparation of proposals.
- Rent, supplies, printing, public services, mailings, publicity (hiring of indirect personnel only), telephone, publications, training, conferences, and maintenance costs for the entire organization.
- Cost of vehicles and equipment not approved by a donor for the specific use in a project, rather, purchased for the general use of the organization. In this case, depreciation must be accounted for in agreement with the norms of the respective organization.

#### C. Unallowable Costs:

Donor institutions often consider that certain costs should not qualify for reimbursement through grant awards and contracts. For example, USAID uses OMB Circular A-122 "Cost Principles for Nonprofit Organizations" as a guide in determining the allowability of costs incurred with US government funds. An organization must take responsibility to directly identify the unallowable costs they incur and to classify them as such. This will help avoid claiming reimbursement of unallowable costs as overhead from donors. Generally speaking, an efficient organization will establish separate account numbers to identify and track unallowable costs.

Certain costs are generally "specifically unallowable", depending on the donor. These expenses are rarely reimbursable by donor funds. However, although these expenses may be classified as unallowable, to the extent that these expenses represent planned activities of an organization, they must be included in direct costs when calculating indirect costs. This has the effect of lowering the overhead rate chargeable to donors by effectively spreading the overhead across one additional donor—an organization's unrestricted fund.

#### *Bad Debts*

Bad debts, including losses (real or estimated) that arise from uncollectable accounts and other claims, and the legal costs associated with their recovery, are not allowable by US government standards.

### *Provisions for contingencies*

The contributions to a contingency reserve or any similar provision for contingencies whose occurrence cannot be clearly foreseen with any reliability, and for which insurance to cover the same contingency is readily available, are not allowable.

### *Contributions*

Contributions and donations from the organization to others are not allowable.

### *Entertainment Costs*

Entertainment costs, social activities, ceremonies and related costs such as meals, housing, rentals, transportation, and gifts are generally not allowable.

### *Costs of interest, obtaining of funds and management of investments*

- a. Costs associated with interest on capital loans or the temporary use of donor funds, regardless of how they are classified, are not allowable.
- b. Fundraising costs, including financial campaigns, donations campaigns, gift requests and similar expenses incurred solely for the purposes of obtaining capital or contributions, are not allowable.
- c. The costs of investment advisers their personnel, and similar expenses incurred solely for the purpose of increasing investment income are not allowable.

### *Lobbying*

Lobbying costs, including all costs associated with establishing or administering a political party, campaign or political action committee, or to contribute to their expenses in order to influence the approval or modification of pending legislation (communicating with members or employees of the Congress, for example) are not allowable.

### *Costs of professional services*

The costs of legal, accounting and consultative services and other costs related to the defense or initiation of lawsuits are not allowable.

### *Costs of public information services*

The costs for public information services are generally allowable as direct costs, with prior donor approval.

Special care should be exercised when preparing an indirect cost proposal; to make sure that unallowable costs (which are not planned activities) have been excluded in the calculation.

## **MODULE # 4: CALCULATION OF INDIRECT COST RATIO**

### **INSTRUCTIONS:**

The three previous modules have highlighted the basic data needed to calculate the indirect cost ratio. This has basically consisted of identifying, separating, and estimating total direct, indirect and unallowable costs from the accounting books and the organization's chart of accounts.

Therefore, the purpose of this module is as follows:

By means of the work to this point, and the filling in of the three previous modules, to calculate the indirect cost ratio for 1998 and 1999.

**Procedure:**

Use the calculations spreadsheet in the attached Module # 4, and follow these following steps:

1. Extract from Module #1 the sum total of salaries, indirect salaries and direct salaries (total sum and by project).
  2. By means of the fringe benefits ratio calculated from Module #2, calculate total benefits, indirect benefits, and direct benefits (total sum and by project).
  3. List the remaining costs calculated in Module #3, according to the standardized chart of accounts. Indicate the sum total of expenses, direct expenses, indirect expenses and unallowable expenses (total sum and by project).
- ⇒ The ratio will be the result of dividing the total of indirect expenses by the total of direct expenses. See the example in the Module #4 spreadsheet for greater detail.