United States Department of Agriculture

Food and Nutrition Service

3101 Park Center Drive
Alexandria, VA 22302-1500

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SUBJECT: Child Nutrition Reauthorization 2010: Indirect Cost Guidance

TO: Regional Directors
Special Nutrition Programs
All Regions

State Directors
Child Nutrition Programs
All States

The Healthy, Hunger-Free Kids Act of 2010 (the Act), Public Law 111-296, requires Food and Nutrition Service (FNS) to provide guidance on program rules pertaining to indirect costs. The purpose of this memorandum is to provide guidance describing the Federal requirements State agencies (SA) and school food authorities (SFA) must comply with in the National School Lunch Program (NSLP) and School Breakfast Program (SBP) with respect to indirect costs.

Section 307(a) of the Act establishes the requirement to issue guidance providing assistance to ensure the nonprofit school food service account funds are limited to those expenses that are reasonable and necessary to provide quality meals for the NSLP and SBP. In general, the full cost of the NSLP and SBP include both direct and indirect costs. Direct costs are incurred specifically for the NSLP and SBP, and can be readily identified to a particular school food service objective. Allocation of indirect cost is necessary because it identifies the portion of the costs benefitting the school food service.

The guidance intends to provide the following information to SAs and SFAs on program rules pertaining to indirect costs:

- Definitions for both direct and indirect costs, including the proper classification of costs and discussion on the treatment of certain typical costs in the NSLP and SBP. Direct costs are discussed because direct and indirect costs are complementary;

- An overview of the Federal cost principles and explanation that all costs (direct or indirect) paid with funds from the nonprofit school food service account must be allowable. The guidance provides criteria that will aid an SFA in determining allowable costs and includes relevant examples;

- Information on how a school district's general fund recovers indirect costs from the nonprofit school food service account. This includes appropriate application of the indirect cost rate and the requirements for the SFA to determine the rate;

- Considerations for the SFA when assessing indirect costs charged to the nonprofit school food service account. This information includes how an SFA should address errors and the billing of previous years' indirect costs; and

- An overview of how the indirect cost rate is developed as relevant background information for SFAs. The information includes a discussion on appropriate uses of restricted or unrestricted indirect cost rates and adjustment of the rates.

SAs should direct any questions concerning the guidance to the appropriate FNS Regional Office. Regional Offices with questions should contact the Child Nutrition Division.

Original Signed

Cynthia Long
Director
Child Nutrition Division

Attachments

United States
Department of
Agriculture

Food and
Nutrition
Service

Indirect Costs

Guidance for State Agencies &

School Food Authorities

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Introduction & Overview

Introduction

This guidance was developed in accordance with Section 307 of the Healthy, Hunger-Free Kids Act of 2010, P.L. 111-296, to assist State agencies (SAs) and school food authorities (SFAs) in better understanding the nature of direct and indirect costs and their role in the operation of the National School Lunch Program (NSLP) and the School Breakfast Program (SBP) (collectively referred to as the School Meal Programs (SMPs) for the purposes of this guidance).[1]

One of the major responsibilities that accompany the decision to participate in the SMPs is the management of the nonprofit school food service account, which requires funds in those accounts to be spent solely on the SMPs. Program regulations at 7 CFR Parts 210.14 and 220.13(i) require an SFA to establish a nonprofit school food service account, in which all reimbursements and other revenues from all food service operations conducted by the SFA, principally for the benefit of school children, are retained and used **only** for the operation or improvement of the nonprofit school food service. Therefore, the SFA must maintain a nonprofit school food service account to accomplish two goals: 1) to ensure that the school food service operates on a nonprofit basis, and 2) to safeguard assets of the school food service and ensure that they are used only for authorized purposes. An SFA is the steward of the nonprofit school food service account that maintains the funds available for the SMPs. In that role, it is important to monitor costs charged to this account. The SFA is charged with ensuring that only allowable costs are paid with nonprofit school food service account funds and costs are properly classified as direct or indirect.

[1] This guidance primarily refers to the "school food authority or SFA" rather than the "local education agency or LEA". SMPs regulations at 7 CFR 210.2 and 220.2 define "School food authority" as the governing body responsible for administering one or more schools and with the legal authority to operate the SMPs. The "SFA" is usually the school district or the entity within the school district which operates school food service. However, the Child Nutrition and WIC Reauthorization Act of 2004, P.L. 108-265, used the term "local educational agency or LEA", a term commonly used by the U.S. Department of Education when referring to a school district and its operation of Federal education programs, in amendments to some SMPs statutory authorities. The terms "SFA" and "LEA" are not synonymous in definition or connotation. However, in order to make this guidance clear and simple, the term "SFA" is used primarily while LEA is used in discussing indirect cost rates (see, e.g., page 12 and Appendices 1- 3) .

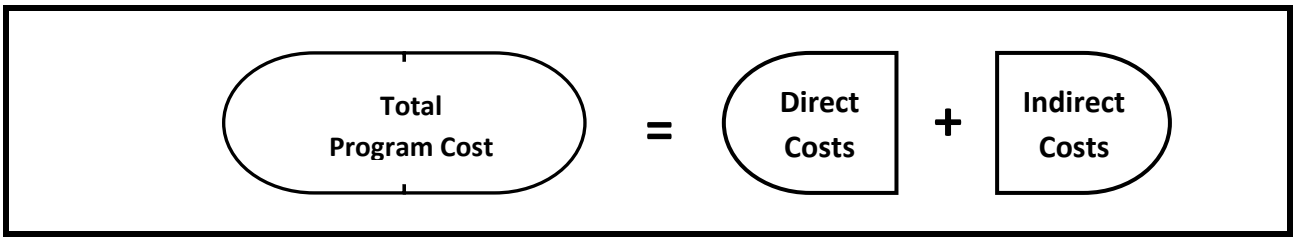
There are many demands made on the limited resources of an SFA's nonprofit school food service account. It is imperative that SFAs adhere to the Federal regulations and determine whether a cost is allowable, allocable and charged appropriately as a direct or indirect cost, in order to safeguard the financial integrity of the nonprofit school food service. This guidance has been developed to describe the Federal requirements that SAs and SFAs must comply with in the SMPs with respect to indirect costs. The responsibility for compliance with the Federal regulations is jointly shared by the SA and the SFA.

Before delving into in-depth information on direct and indirect costs in section *Cost Allocation and Recovery in the School Food Service*, a basic overview will be provided in this section on such costs, the Federal cost principles, and program regulations as this material is necessary and useful background information.

Basic Overview of Direct and Indirect Costs

In general, the full cost of a program, function or activity includes both direct and indirect costs. The determining factor in distinguishing a cost as direct or indirect is the extent to which it can be identified with a specific program, function, or activity that benefits from the organization (i.e., SFA) having incurred the cost rather than the nature of the goods and services themselves.

Total Program Cost



Direct costs are incurred specifically for a program or other cost objective[2], and can be readily identified to a particular objective such as school food service. Examples of direct costs in SMPs include, but are not limited to, food, the wages and salaries of the staff working in the school food service, and supplies specifically used in the school food service.

[2] "Cost objective" means a function, organizational subdivision, contract, grant, or other activity for which cost data are needed and for which costs are incurred.

Indirect costs are incurred for the benefit of multiple programs, functions, or other cost objectives and therefore cannot be identified readily and specifically with a particular program or other cost objective. They typically support administrative overhead functions such as fringe benefits, accounting, payroll, purchasing**,** facilities management, utilities, etc.

Examples of Typical Direct and Indirect Costs for SMPs

Direct Costs	Indirect Costs
Wages and salaries of food service workers Cost of purchased food Food service supplies Media/promotional materials relating to the food service Capital expenditures relating to food service (e.g., food service equipment purchases)	Payroll services Human resources Workers' compensation Procurement Gas Electricity Sewer Water Trash Superintendent's Office

Indirect costs are necessary for the general operation of the SFA. Due to their generic nature, however, indirect costs are not readily assignable to SMPs specific functions or activities. Indirect costs must therefore be assigned to benefitting programs and other cost objectives through an allocation process.

Allocation is a mathematical exercise used to assign indirect costs to particular programs and other cost objectives, such that each program or other cost objective bears a portion of the indirect costs that is commensurate with the benefit received from such costs. This methodology normally entails applying a **calculated indirect cost rate** to a **direct cost base**. These terms are explained in detail later in this guidance in section *Developing and Applying an Indirect Cost Rate*. Use of this methodology provides a shorthand approach to determining in a reasonable manner the proportion of indirect costs each program or other cost objective should bear.

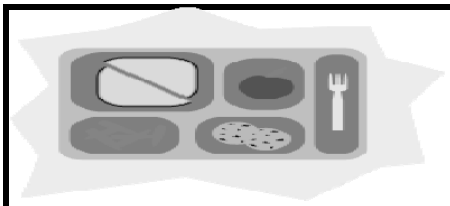
Please refer to Appendix 3, at the end of this guidance, for Q&As on indirect costs.

Basic Overview of Federal Cost Principles

Understanding direct and indirect costs requires not only a basic understanding of how the two terms are defined, but also a fundamental understanding of the Federal cost principles. The Office of Management and Budget (OMB) Cost Circulars establish the principles for determining allowable costs to Federal assistance programs (e.g., SMPs). In order to be chargeable to a Federal grant or contract, a cost (whether a direct or indirect cost) must be allowable.

The overall objective of the Federal cost principles is to establish government-wide principles for determining allowable costs under contracts, grants, and other agreements with the various entities that operate Federal programs. Unlike operators of other Federal programs who report **program costs** for reimbursement, the SFAs operating the SMPs do not bill their Federal awarding agency (USDA) for reimbursement of allowable costs. This is because an SFA's Federal funding reimbursement under the SMPs is determined solely by the **meals-times-rate funding formula**. In the SMPs, subgrantee SFAs report the number of paid, reduced-price, and free meals served (not program costs) to their SAs. To be reimbursable under the SMPs, each meal served must meet all the requirements set by program regulation.

Meals-times-Rate Funding Formula[3]



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***Rate of Reimbursement F/RP/P meals**

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SFA CLAIM:
F/RP/P MEALS

*Reimbursement Rates are the amounts of money SFAs will be reimbursed for each free (F), reduced price (RP), or paid meal (P) served.

While the Federal cost principles do not apply to claiming meal reimbursement under the SMPs, they do have meaning with respect to costs charged to the SFA's nonprofit school food service account. SMPs regulations at 7 CFR Parts 210.14(a) and 220.13(i) require that any cost paid from that account meet the standards for allowable costs set out in the Federal cost principles. In addition, the school food service may be subject to inter-fund billings for services rendered; such billings should be paid only if they

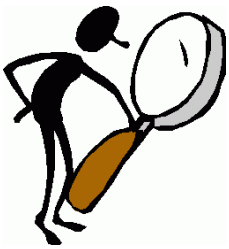
[3] An SFA's Federal funding reimbursement under the SMPs cannot exceed the amount generated by the meals-times-rate formula. The per-meal reimbursement rates have been the basis for computing SFAs' SMPs entitlement for decades, and are adjusted annually to reflect changes in the cost of living.

conform to the cost principles. For these reasons, an understanding of the Federal cost principles, as well as USDA regulations implementing them, is critical to safeguarding the integrity of the nonprofit school food service account.

OMB has formulated a set of principles for each specific type of recipient organization:

Type of Organization that Receives an Award or Subaward:	**Source of Applicable Cost Principles:**
State, local, or Indian Tribal government	2 CFR Part 225 (OMB Circular A-87)
Nonprofit Organization	2 CFR Part 230 (OMB Circular A-122)

OMB guidance for units of government (i.e., SAs, SFAs, public schools, public RCCIs, public sponsors) is posted at 2 CFR Part 225 (*Cost Principles for State, Local and Indian Tribal Governments*) or OMB Circular A-87 (A-87).[4] OMB guidance for nonprofit organizations, such as private schools and private RCCIs, is posted at 2 CFR Part 230 (*Cost Principles for Non-Profit Organizations*) or OMB Circular A-122.[5]



This guidance will refer to the regulatory cites rather than the circulars:

- A -87 *referred to as* 2 CFR Part 225;
- Attachment A of A-87 *referred to as* Appendix A of 2 CFR Part 225;
- Attachment B of A-87 *referred to as* Appendix B of 2 CFR Part 225; and,
- Attachment E of A-87 *referred to as* Appendix E of 2 CFR Part 225.

The OMB guidance provides general definitions regarding the applicability and allowability of different types of costs. They also describe the different allocation methodologies that can be used by a particular entity and the general criteria for charging costs as direct or indirect. Some costs are allowable only in one category or the other. Additional information on the Federal cost principles is provided in *Determining Allowable Costs & OMB Circular 2 CFR Part 225 (A-87)*.

[4] Historically, the OMB guidance has taken the form of Cost Circulars that outline the cost principles. More recently, however, OMB has codified the Circulars in regulatory form in order to promote more consistent application of the guidance, facilitate agencies' promulgation of implementing regulations and enable easier public access to the broadly applicable principles.

[5] This guidance focuses on the requirements of 2 CFR Part 225 rather than 2 CFR Part 230.

Basic Overview of Program Regulations

The program regulations also place restrictions on the use of nonprofit school food service funds. As stated in 7 CFR Parts 210.14 and 220.7, **SFAs operating nonprofit food services must adhere to the following requirements**:

1. SFAs must observe the restrictions on the use of nonprofit food service revenues so that all revenue is used for operating the meal service and/or improving its quality and efficiency. Revenue sources include (but are not limited to) Federal meal reimbursement, State meal reimbursement, children's and adults' payments for SMPs meals and a la carte items and interest.
    a. Revenue may be used for food, supplies, equipment and personnel used to operate the meal service;
    b. Revenue must not be used to purchase land and/or buildings, or to construct buildings, unless approved by FNS;

2. SFAs must limit the net cash resources[6] in order not to exceed 3 months average expenditures;

3. If SFAs have a surplus of over 3 months of average expenditures on hand they agree to:
    a. Lower the price of paid lunches; [7]
    b. Improve food quality;
    c. Make other improvements to the school meals operations;
    d. If there are no opportunities for the above three options, the SA can lower the rates of reimbursement to the SFA.

Topics in Remainder of Guidance

The remainder of the guidance will be structured in the following manner:

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[6] Net cash resources means all monies, as determined in accordance with the SA's established accounting system that are available to or have accrued to an SFA's nonprofit school food service at any given time, less cash payable. Such monies may include, but are not limited to, cash on hand, cash receivable, earnings on investments, cash on deposit and the value of stocks, bonds or other negotiable securities.

[7] Section 205 of the Healthy, Hunger-Free Kids Act of 2010, P.L. 111-296, amended Section 12 of the Richard B. Russell National School Lunch Act, 42 USC 1760, to require SFAs to establish minimum lunch prices for students not eligible for free or reduced price meals. The requirement of Section 205 became effective July 1, 2011.

- Information on the development and application of an indirect cost rate;
- In-depth overview of the Federal cost circulars and allowable costs;
- Explanation of cost allocation and recovery in the school food service including direct and indirect costs;
- Explanation of restricted and unrestricted indirect cost rates;
- Explanation of methods used to adjust indirect costs previously over-claimed or under-claimed; and
- Considerations when assessing indirect costs charged to the nonprofit school food service account.

Key Principles

The key principles this guidance hopes to impart include:

- Understanding allowable costs;
- Understanding the compliance requirements that pertain to applying the Federal Cost Principles to the SMPs;
- Understanding how to appropriately charge direct or indirect costs to the nonprofit school food service account; and
- Understanding how to safeguard the financial integrity of the nonprofit school food service account with respect to direct and indirect costs.

Note: The indirect cost guidance uses many examples to illustrate principles. **The examples provided in this guidance are not meant to imply that certain costs must be treated in the manner provided in the examples**. The treatment of a cost as direct or indirect is determined by the SFA's accounting system.

Developing and Applying an Indirect Cost Rate

This section provides a general and practical overview of how to develop and apply an indirect cost rate to ensure costs are allowable and properly classified as direct or indirect.

"SFA" vs. "Local Education Agency or LEA"

- The term "SFA" is used in this guidance to be more clear and simple. (Please see footnote 1 for detailed explanation.)
- U.S. Department of Education requires each State educational agency (SEA) to negotiate an indirect cost methodology for any "LEA" under its jurisdiction that requests one. **Therefore, the term "LEA" will be used in <u>this section</u>.**

Allowable costs, direct and indirect, must be identified in a consistent manner. An LEA must identify indirect costs by using the same methodology to allocate certain shared costs across the entire spectrum of its Federal programs. An LEA generally participates in several Federal programs, not just the SMPs, and the State educational agency (SEA) and LEA would need to determine how to allocate these indirect costs to the several Federal programs. The Federal cost principles (described in detail in the next section), exist in part because an LEA or other program operator would find it burdensome to use a different method of allocating shared costs to grants from each of its Federal awarding agencies.

In order to avoid this kind of scenario, a single Federal agency, referred to as the ***cognizant agency***, speaks for all the Federal awarding agencies in negotiating across-the-board allocation methodology with the program operator. The cognizant Federal agency for all SEAs is the U.S. Department of Education (ED). Generally, the cognizant Federal agency negotiates a cost allocation document with the program operator; however, with respect to public school districts, ED requires each SEA to negotiate an indirect cost methodology for any LEA under its jurisdiction that requests one. Therefore, the SEA is the *de facto* cognizant agency for this purpose for the LEAs under its jurisdiction.

ED negotiates an agreement with each SEA to establish the methodology the SEA will use in negotiating indirect cost methodologies for its LEAs. Once ED approves the SEA's LEA methodology, a Delegation Agreement is signed by ED and an SEA official. Under this agreement, the SEA generally distributes an

"**indirect cost rate proposal (ICRP)**" form to its LEAs and uses the data collected thereby to develop each LEA's indirect cost rate. The ICRP is a schedule documenting the formulation of the LEA's indirect cost rate and direct cost base; as such, it is the LEA's request for the establishment of an indirect cost methodology. A LEA must prepare an ICRP, and the SEA must assign methodology based on it, before the LEA can claim reimbursement for indirect costs. [8] The indirect cost rate agreements expire annually and it is imperative that LEAs use the most current approved rate for each fiscal year.

In preparing the ICRP, all of the activities carried on by the school district and their accompanying costs must be identified. All activities must be included in the ICRP, whether their costs are allowable or unallowable and regardless of funding source. The starting point for developing the ICRP will be the LEA's most recently audited financial statements, chart of accounts, and accounting records supporting those documents after any adjustments resulting from the audit have been made.

The LEA develops its ICRP via the following steps:

1) Identify all the activities carried on by the school district and their accompanying costs;
2) Eliminate all capital expenditures and other excluded costs;
3) Classify the activities and their costs as direct or indirect;
4) Eliminate from indirect costs those costs stipulated as unallowable by OMB guidance or program regulation; and,
5) Compute the indirect cost rate by dividing the total remaining indirect costs (**indirect cost pool**) by the **direct cost base** selected for distribution of the indirect costs. **The indirect cost pool is the sum of allowable indirect costs**. **The direct cost base is the sum of allowable and unallowable costs that receives a benefit from the costs in the pool**.

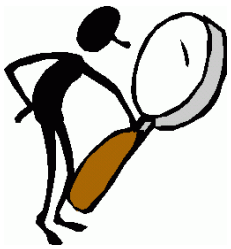
The end result of this process identifies all of the organization's direct costs, indirect costs, indirect cost rate(s), and the direct cost base(s) to which the rates are applied. The LEA should check with the SEA to learn more about how the indirect cost rate is developed, as the SEA may have additional requirements. *Please refer to Appendix 1, at the end of this guidance, for an illustrative and detailed example on developing an ICRP.*

[8] While SMPs reimbursement is not cost-driven, most Federal assistance programs operated by LEAs are funded by reimbursing allowable costs.

Summary

An ICRP requires substantiation and documentation, as set out in Appendix E to 2 CFR Part 225. Once the SEA approves the ICRP, the end result is an indirect cost rate agreement between the SEA and the LEA.[9]

An SFA may use funds from the nonprofit school food service account to only pay for allowable costs. Thus, the SFA must have two key pieces of information from the LEA regarding the indirect cost rate agreement: (1) the indirect cost rate (established for a specific fiscal year), and (2) the corresponding direct cost base. The direct cost base is necessary because the indirect cost rate can only be applied to items covered in the direct cost base.



Key Information In the Indirect Cost Rate Agreement:

The SEA may not issue an actual indirect cost rate agreement in hard copy (i.e., paper version); however, this information may be posted on the SEA's website.

The SFA will need the following information from the indirect cost agreement:

- Current and approved indirect cost rate (established for a specific fiscal year); and
- Corresponding direct cost base.

Remember: Indirect cost rate may be applied only to cost items in the base.

[9] The SEA may choose to not issue an indirect cost agreement in hard copy (i.e., paper version). This information is sometimes posted on the SEA's website.

Determining Allowable Costs & OMB Circular 2 CFR Part 225 (A-87)

As noted earlier, 2 CFR Part 225 establishes the Federal cost principles for State, local, and Indian Tribal governments. The cost principles, coupled with SMPs regulations and policy, provide guidance as to what types of costs are allowable charges to the nonprofit school food service account, and whether these costs are allocable as direct or indirect charges.[10] Regardless of whether a cost is allocable as indirect or direct, it must first be allowable.

Regardless of whether a cost is allocable as indirect or direct, it must be allowable based on the Federal cost principles in 2 CFR Part 225.

2 CFR Part 225 was drafted in a manner to apply to all situations where units of government (e.g., SAs, SFAs of public schools and public RCCIs, etc.) charge costs to grants provided by the Federal government. **Appendix A of 2 CFR Part 225** provides basic guidelines to determine if a cost is allowable, while **Appendix B** provides principles to be applied in establishing the allowability of specific items of cost. However, because the guidance provided in 2 CFR Part 225 is generic in nature and subject to interpretation, many SAs and SFAs struggle in determining whether certain costs concerning the nonprofit school food service are allowable.

Please refer to Appendix 6, at the end of this guidance, for a copy of 2 CFR Part 225 (including Appendices A, B and E).

General Criteria for Allowable Costs

[10] 2 CFR Part 230 (A-122) applies to nonprofit organizations, such as private schools and private RCCIs.

Appendix A of 2 CFR Part 225 provides a list of criteria for allowable costs. The SFA should first determine whether a cost meets the following criteria:

- Necessary;
- Reasonable;
- Allocable;
- Legal under State and local law;
- Conforms with Federal law, regulation, and grant terms;
- Consistently treated as direct or indirect;
- Determined in accordance with Generally Accepted Accounting Principles (GAAP); [11]
- Not included as a cost or matching contribution of any other grant (except where allowed by Federal regulations);
- Net of applicable credits; and,
- Adequately documented.

Below is additional guidance on several of these criteria as they relate to the SMPs.

Necessary and Reasonable

In order to be allowable, a cost must be necessary for the performance or administration of the funds provided by FNS to the SA for the SMPs. A cost is **necessary** if the SMPs' authorizing statutory provisions, resulting program regulations or applicable FNS policy establish that the nonprofit school food service cannot be operated without incurring the cost (e.g., a school food service cannot be operated without incurring the cost of appropriate food). A cost is **reasonable** if, in its nature and amount, it does not exceed that which would be incurred by a prudent person[12] under the circumstances prevailing at the time the decision was made to incur the cost. The cost must be the result of sound business practice and competitive prices. For example, the cost of food is a reasonable cost to operate the nonprofit school food service if incurred according to these conditions.

An SFA may ask the following questions to help determine whether a cost is necessary and reasonable:

- What are the particular objectives of the SMPs?

[11] See Attachment 5 for more information on GAAP.

[12] The prudent person standard requires each person to owe a duty to behave as a reasonable person would under the same or similar circumstances.

- How does the cost contribute to achieving an objective of the SMPs?
- Is the cost recognized as ordinary and necessary for the operation of the SMPs?
- Could the SMPs be carried out without incurring this cost?
- Would a prudent person find the cost to be reasonable under the circumstances?
- Would a taxpayer deem the cost to be reasonable in light of SMPs objectives?
- Is this cost charged at a fair rate, or do alternatives exist that may be more cost effective?
- Does the cost deviate significantly from the established practices of the SFA which may unjustifiably increase costs borne by the nonprofit school food service account?
- Could the SFA defend this purchase to the SA, the media, auditors, etc.?

Allocable

A cost must be assigned to the program(s), function(s), activity(ies) or other cost objective(s) that benefited from the school district having incurred it; and each cost objective must be charged commensurate with the benefit received. As already noted, cost allocation is the process of achieving that outcome. Depending on which program(s), function(s), and/or activity(ies) benefit from the cost, and the extent to which each benefited, a cost may be allocated to such cost objective(s) through direct or indirect cost allocation. For example, the salary of an employee whose duties consist solely of preparing and serving school meals is 100-percent allocable to the SFA's school food service, and is therefore treated as a direct cost. By contrast, the superintendent's salary benefits all programs, functions, and activities of the school district; the portion that benefits the school food service can be determined only through a mathematical allocation process which is the reason it is an indirect cost. **A cost allocable to a particular Federal award or other cost objective under the Federal cost principles may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by regulations or terms of the Federal awards, or for other reasons**. That is because such action would assign the cost to a cost objective that did not benefit from it.

Treated Consistently

An SFA must conduct transactions using Federal program funds in the same way that it conducts transactions with its own non-Federal funds. A cost item must be treated consistently as direct or indirect in all activities of the SFA unless legislation, regulations, or guidance from an awarding agency dictates otherwise. A cost may not be assigned to a Federal award as a direct cost if that same cost,

incurred for the same purpose, in similar circumstances, has been allocated to other Federal awards as an indirect cost.

Two examples to illustrate "treated consistently":

1. School district requires its custodians to record the distribution of their work hours on time cards that capture only two categories: "Kitchen & Cafeteria," and "Other." The portion recorded under "Kitchen & Cafeteria" is billed to the food service as a direct cost. The "Other" portion is treated as an indirect cost, no portion of which is allocated to the school food service. This would be considered inconsistent treatment of the cost of custodial services because only school food service is charged directly.

2. School food service staff carries out particular functions, such as procurement, that are also carried out by the SFA for other programs. The question that arises is whether the school food service is treated consistently because the salary of food service workers is a direct expense to the nonprofit school food service account (e.g., food service staff conducts procurement for food products) and the SFA also bills the school food service for the cost of procurement services as an indirect cost (e.g., SFA conducts procurement for paper products). There is no inconsistent treatment if the school food service receives an additional benefit from the indirect cost charged to the nonprofit school food service account (e.g., food service staff conducts procurement for food products and the SFA conducts procurement for paper products).

The treatment of cost as direct or indirect is determined by its treatment in the SFA's accounting system.

Net of Applicable Credits

Applicable credits refer to reductions of expenditure-type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs. Examples of applicable credits include, but are not limited to: purchase discounts, rebates, credits or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments of overpayments or erroneous charges. To the extent that such crediting accruing to or received by the SFA relates to an allowable cost, they must be

deducted from the cost charged to the SMPs. For example, SMPs regulations require that an SFA may only pay for costs in a cost-reimbursable contract that are net of all rebates, discounts, and other applicable credits. The SFA must also ensure receipt of adequate documentation prior to paying for such cost.

Adequately Documented

This criterion does not imply the existence of a one-size-fits-all definition of "adequately." It means, rather, that the record of a SMPs' operation must be able to stand on its own, without depending on augmentation, interpretation, or "spin" by the program operator.

Appendices A and B of 2 CFR Part 225

Additionally, an SFA should be familiar with both Appendices A and B of 2 CFR Part 225 in order to determine whether a cost is allowable. Appendix A of 2 CFR Part 225 provides rules for allowing or disallowing specific items of cost. Appendix B of 2 CFR Part 225 classifies costs in three categories: allowable, allowable with prior SA approval, or unallowable.[13] Therefore, Appendix B must be read in conjunction with Appendix A in order to determine whether a cost is allowable. In summary, **Appendix B conveys two key points**:

1. Even if Appendix B of 2 CFR Part 225 classifies a cost as allowable, that cost item must still satisfy the Appendix A criteria and conform to any program-specific limitations on purposes for which SMPs funds are made available in order to be allowable.
2. Appendix B's silence regarding a cost item does not mean that a cost item is either allowable or unallowable. The SFA must make such determinations by studying Appendix B's treatment of similar or related cost items.

The table below provides examples of cost items classified in each category (allowable, allowable with SA prior approval, or unallowable), based on the selected items of cost in Appendix B.

[13] With respect to allowable costs with prior SA approval, the SA may contact FNS Regional Office for guidance as needed.

Examples of Costs in Appendix B of 2 CFR Part 225

Allowable Costs	Allowable Cost with Prior SA Approval	Unallowable Costs
Wages & Salaries	Capital expenditures (equipment purchases, etc.)	Alcoholic Beverages
Travel		Entertainment
Training & Staff Development		Costs of General Government
Meeting & Conferences		Lobbying
Printing & Publication		Contributions to Contingency Funds
Supplies		Bad Debts

A cost would not be deemed an allowable charge to the nonprofit school food service account by simply applying the general criteria outlined in 2 CFR Part 225 because the cost must also conform to program-specific rules. For example, the NSLP regulations at 7 CFR Part 210.14(a) prohibit use of the SFA's nonprofit school food service account to pay for the cost of purchasing land or buildings, unless otherwise approved by FNS. A cost must be incurred in accordance with all applicable terms and conditions.

SFAs follow a multi-step process to determine whether funds from the nonprofit school food service account may be used for a certain cost:

1. • Examine each cost by reviewing the criteria in 2 CFR Part 225;
2. • Review program regulations in conjunction with historical FNS policy (which clarifies program regulations); and
3. • Apply these collective principles to the specific facts and circumstances regarding each cost.

Examples of Specific Allowable and Unallowable Costs

Next, guidance is provided on how FNS has historically treated certain costs in regards to allowability, based upon SMPs-specific regulations and FNS policy.

Renovating a School Kitchen

2 CFR Part 225, Appendix B, section 25, *Maintenance, operations and repairs,* identifies costs of normal repairs and alterations as allowable so long as they: (1) keep property in an efficient operating condition; (2) do not add to the permanent value of the property or appreciably prolong its intended life; and (3) are not otherwise included in rental costs or other charges for space. Based on these principles, FNS has allowed limited renovations **within the inside perimeter** of a kitchen/cafeteria space with the required prior SA approval.

For example, renovating a kitchen by cutting away a portion of the wall to allow room for a walk-in refrigerator and related electrical wiring would be an allowable expense if the renovation is necessary to accommodate increased participation of students in the SMPs. However, it would be an unallowable expense if renovation of the kitchen was purely an aesthetic matter.

Finally, the SFA cannot charge normal maintenance costs directly to the nonprofit school food service account if such costs are included in the school district's indirect cost pool.

Building a School Kitchen

SMPs regulations at 7 CFR Parts 210.14 and 220.7(e)(1) require that revenues received by the nonprofit school food service are to be used only for the operation or improvement of such food service, except that, such revenue shall not be used to purchase land or buildings, or to construct buildings, unless otherwise approved by the FNS. Historically, FNS has not approved the cost of building purchases because program funds are made available to help support the costs of nutritional benefits for children in school settings and not to construct school related facilities. The goal is to ensure that an SFA maintains the necessary funding to operate the program as required by the SMPs' authorizing legislation and regulations, and that the nonprofit school food service account is not used to cover major expenses that should be borne by the school district's general funds (i.e., capital infrastructure costs).

The costs of building a kitchen are analogous to the costs of constructing school buildings, which historically have been borne by the school district with general or capital improvement funds. Similarly, such capital infrastructure costs should be borne by the school district just as the school building and its contents should be.

Nutrition Education Materials

An SFA should weigh the pros and cons in order to determine whether funds from the nonprofit school food service account used to purchase nutrition education materials would better serve the children in

the SMPs than the purchase of more nutritious foods. Because FNS and other entities provide such nutritional material at no charge, an exceptional reason must exist to justify purchasing such material. An SFA must fully consider whether existing, available material can meet its need.

Wellness Programs for SFA Employees[14]

The objective of an employee wellness program is not employee entertainment or recreation, but for the purpose of greater productivity and reduced health care costs by enhancing the workforce's health and fitness. The U.S. Office of Personnel Management's (OPM) guidelines and the implementing physical fitness directives of Federal civilian agencies allow employees to use official duty time for one-time events or programs of relatively short duration. Therefore, the nonprofit school food service account can be used for one-time events or programs of short duration that promote employee health and physical fitness.

Additionally, the involvement of food service staff in activities of a wellness committee for SFA employees does not warrant charging the food service a disproportionate share of the cost of operating the committee. For example, the nonprofit school food service account can be directly charged for reasonable and necessary food service staff time devoted to the committee; however, it cannot be charged for time associated with other staff whose duties do not fall under the purview of the food service operations (e.g., nurse's time or a teacher's time). The cost associated with the time a nurse or teacher spends on a wellness committee, should never be allocable to the school food service operations as the cost is not allowable.

Internal versus External Maintenance Personnel

The school district's billings for basic services, such as replacing outlets or repairing water lines, must be reasonable. In some cases, internal maintenance department charges can cost more than the same service provided by an external service provider. There could be a variety of reasons for such policy, for example, union issues or safety concerns of exposing children in a school setting to maintenance workers who have not been screened in accordance with school district requirements.

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[14] Wellness programs for SFA employees **must not be confused** with local wellness policies to promote health and wellness in each school district which will allow schools to take an active role in promoting student wellness and preventing obesity through establishment of a local school wellness policy, as required by Section 9A of the Richard B. Russell National School Lunch Act, 42 U.S.C. 1758b.

However, the school district must review its policy to ensure the effect would not result in a payment from the nonprofit school food service account that is not commensurate with the value of the services provided by the school district. As we stated earlier, any expenditure of the nonprofit school food service account must be supported by documentation and substantiation of all charges. The SFA, as a steward of the nonprofit school food service account, must ensure that the cost is in accordance with the Federal cost principles. **A cost cannot be charged that is grossly disproportionate to the benefit the school food service received from the services provided**. For example, a school district requiring internal maintenance service to change all of the light bulbs in a kitchen at a rate of $600/hour appears to be grossly disproportionate to the benefit the food service receives for the services provided. Additionally, if the nonprofit school food service account is charged directly for the internal maintenance service, this cost cannot also be included as part of the indirect cost pool.

Cost Allocation and Recovery in the School Food Service

When a cost benefits two or more cost objectives, the cost must be allocated or distributed among them proportionate with the benefit each received from the cost. Allocation is necessary because it identifies the portion of the cost that has or will benefit the school food service. An allowable cost can be charged to the nonprofit school food service account as an indirect cost with appropriate documentation.

Actual indirect costs such as utility bills, janitorial services, trash services, etc., are often paid from the school district's general fund and then billed to the nonprofit school food service account. For example, unless the school district has separate meters or utility lines to serve the school food service, assigning the charges through indirect costs may be the only way to identify them as costs allocable to the nonprofit school food service. Additionally, a cost such as utilities that is typically an indirect cost could be charged as a direct cost if the SFA can substantiate through proper documentation the portion that is specifically attributed to the SMPs (e.g., if there was a separate meter for the kitchen and cafeteria). However, a cost item must be **treated consistently** as direct or indirect in all activities of the SFA unless legislation, regulations, or guidance from an awarding agency dictates otherwise. A cost may not be assigned to a Federal award as a direct cost if the same cost incurred for the same purpose, in similar circumstances, has been allocated to other awards as an indirect cost.

"Treated consistently"

A cost may not be assigned to a Federal award as a direct cost if the same cost incurred for the same purpose, in similar circumstances, has been allocated to other awards as an indirect cost.

For example, it is not consistent treatment to charge utilities as an indirect cost for all programs (e.g., separate meter for the kitchen and cafeteria) except the SMPs.

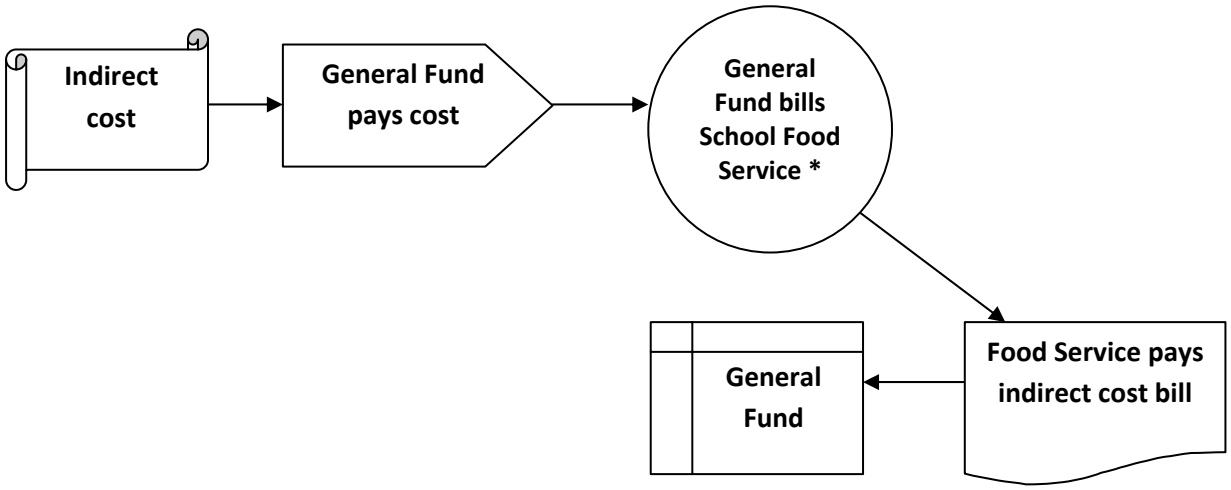
No matter how seemingly appropriate a cost appears to be (i.e., utilities, trash collection, janitorial services, etc.), costs may be charged to the nonprofit school food service account only with **appropriate**

documentation.[15] Under the Federal cost principles, a cost is **allocable** to a Federal award (i.e., SMPs) if it is treated consistently with other costs incurred for the same purposes in like circumstances and if it meets the following criteria:

- It benefits both the award and other awards, programs, or cost objectives and can be distributed in reasonable proportion to the benefits received by each; and,
- It is necessary to the overall operation of the program, although a direct relationship to a particular cost objective cannot be shown.

A school district generally has two options to recover the indirect costs benefiting the school food service and other direct cost activities, yet paid from the general fund: (1) directing the general fund to rely on its own allotments, or (2) billing the program offices, such as the school food service, that claim Federal reimbursement from Federal and State awarding agencies.

Example: General Fund Recovers Indirect Costs Benefitting Nonprofit School Food Service



***** The General Fund determines the amount billed by applying the approved indirect cost rate to the school food service's direct cost base.

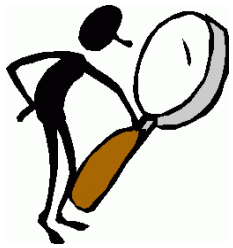
[15] SMPs regulations at 7 CFR Parts 210.23(c) and 220.7(e)(13) require that records must be retained for 3 years; except that if audit findings have not been resolved, the records shall be retained beyond the 3-year period as long as required for resolution of the issues raised by the audit.

Determining Direct and Indirect Costs

As explained earlier in *Determining Allowable Costs & OMB Circular 2 CFR Part 225 (A-87)*, 2 CFR Part 225 applies to all situations where State and local governments incur costs for Federal assistance programs. SEAs and SFAs must make careful considerations in determining whether certain types of costs should be categorized as a direct or indirect cost.

Direct Costs

As already noted, 2 CFR Part 225 describes direct costs as, "those that can be identified specifically with a particular final cost objective." (2 CFR Part 225, Appendix A, section E.1.) Many SFAs struggle with this description, especially when it comes to understanding "identified specifically." A good way of understanding "identified specifically" is for the SFA to ask the following question**: Who benefitted from the SFA having incurred the cost (i.e., just school food service)?** Granted, the SMPs regulations do not prescribe in detail every kind of cost that can be charged to the school food service. However, the SMPs regulations do outline the purpose of each program, requirements that must be met and, in some cases, prescribes certain aspect of that program's operations. The SMPs objectives can be understood by reading and understanding authorizing statutes, program regulations, and FNS policy. **Moreover, costs that cannot be exclusively attributable to the SMPs should generally be treated as indirect costs.**



Direct costs are those that:

- Are exclusively attributable to the nonprofit school food service, and;
- Can be substantiated through written documentation such as time cards, invoices, receipts, etc.

Appendix B of 2 CFR Part 225 provides examples of typical direct costs chargeable to the nonprofit school food service account:

- Compensation of employees for the time devoted and identified to the school food service

- School food service employees whose job function is entirely to meet the objectives of the SMPs (e.g., kitchen cooks, the school food service director, dieticians, cashiers, servers)
- An SFA should ask the following questions to determine whether such a cost is exclusively attributable to the school food service:
  - What are the job functions of an employee? Does he/she work exclusively in the school food service?
  - Does the employee also perform work not related to the school food service? Does the SFA have a process for documenting the distribution of that employee's time among cost objectives?
  - Does a cashier working to ring up foods in the cafeteria also sell books at the bookstore? If so, does the SFA have a process for documenting the distribution of that employee's time between the cafeteria and the bookstore?

- <u>Cost of materials, acquired, consumed, or expended specifically to the performance of the school food service</u>
  - An SFA should ask the following questions to determine whether such a cost is exclusively attributable to the school food service:
    - Will the item be used only for the school food service?
    - Is this an item that is generally purchased for use in school food service?
    - Can the SFA operate the school food service without purchasing this item?
    - For example, the cost of food items used to prepare nutritious meals for the SMPs is exclusively attributable to school food service.

- <u>Equipment and other approved capital expenditures</u>
  - For example, a POS (point of sale) system or software is used to record, track, and report on food/meal purchase transactions by many schools. The capital expenditures for a POS system may be allowed as a direct charge with prior SA approval.

- <u>Travel expense incurred specifically to carry out the objectives of the SMPs</u>
  - For example, a school food service director may need to travel for a national conference on child nutrition in the SMPs. This cost could be charged as an allowable direct expense with prior SA approval.

- Food for the school meals
  - For example, the cost of food items that have been procured in accordance with the Federal regulations for the SMPs can be charged as a direct cost.

Indirect Costs

As noted above, 2 CFR Part 225 describes indirect costs are those: "(a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved." (2 CFR Part 225, Appendix A, section F.1.) **Costs that can be allocated to multiple programs or other cost objectives are always an indirect cost**. Indirect costs are necessary to operate the school food service, even though a direct relationship to that activity cannot be shown.

In determining whether a cost should be charged as direct or indirect, the SFA is required to treat each item of cost in a **consistent manner** as a direct or indirect cost in accordance with the Federal cost principles. A cost may be assigned to the nonprofit school food service as a direct cost only if that cost item under the same circumstances has not been charged to other programs or cost objectives as an indirect cost. (2 CFR Part 225, Appendix A, section C.1.f.) For example, it is appropriate for a SFA that has relocated its school food service and several other of its activities from the main school building to an annex, to charge rent on the annex to the nonprofit school food service account only if the other activities relocated there are similarly charged.

Summary of Determining Direct and Indirect Costs

Questions to contemplate in determining whether a cost is direct or indirect include:

- Does the cost benefit multiple programs or other cost objectives, or solely the school food service?
- Does the cost have a direct relationship to the school food service?
- What guidance do the Federal cost principles provide for this cost?
- How are similar costs treated in other cost objectives of the SFA?
- How has this cost been treated historically by the SFA?

Examples of Various Costs

Guidance on various costs is provided to assist in determining whether a cost is properly classified as direct or indirect.

Custodial expenses

Custodial expenses generally include the costs of cleaning the entire school. The food service benefits from custodial services because the kitchen, food preparation, and food serving areas are also cleaned. However, the question arises of whether the custodial expense can be charged as a direct or indirect expense. As we stated earlier, for the custodial expense to be a direct cost, the cost must be identified specifically with a particular cost objective.

How would an SFA charge custodial expenses directly? Some SFAs document the hours that custodians work cleaning food service areas such as the kitchen, food preparation, and food serving areas through a time reporting system, such as that described in 2 CFR Part 225, Attachment B, section 8.h, *Support of salaries and wages*. The time reporting system provides the exact hours a custodian cleans the food service area and the rest of the school. The SFA then charges the custodial expenses for cleaning the school food service area as a direct expense.

Alternatively, the custodial expenses may be charged as an indirect cost to the school food service by including them in the indirect cost pool if a methodology or process for determining this item's direct relation to the school food service operations is not available. The key point to note is that the custodial expense may be charged as a direct or indirect cost, as long as it is treated consistently in all activities of the SFA. For example, this cost item may not be charged as a direct cost to the nonprofit school food service account if custodial expenses that benefited other programs, functions, and activities of the SFA were charged to such cost objectives as indirect costs. The reasoning is that it would not be equitable for the custodial expenses to be charged through a time reporting system solely for the school food service and not similarly for other programs.

Custodial expenses may be charged as a direct or indirect cost, as long as it is treated consistently in all activities of the SFA. An SFA may not charge custodial expenses as a direct cost to the school food service (e.g., through a time reporting system) and as an indirect cost for other programs.

Utility Expenses

The SFA in general and school food service in particular, need utilities such as electricity and gas to operate. While utility costs are often treated as indirect costs, they may be charged as a direct cost if there is a methodology to quantify exactly how much energy was utilized to prepare and serve meals. For example, the use of a separate utility meter for school food service would provide such quantification. The main point to note is that charges like utilities can be allocated directly or indirectly, depending on whether a methodology exists to specifically identify the amount of utilities attributable to the school food service.

Post-Retirement Health-Care Benefits

The indirect cost methodology applied to an SFA may call for allocating the cost of providing health-care benefits for retired SFA employees on the basis of numbers of employees. That is, this cost item may be allocated to a direct cost activity, such as the school food service, on the basis of its percentage of the SFA's total employees, or by applying a per-employee rate. However, if the school food service workforce is atypical of the SFA's workforce generally, this may not be an appropriate approach. Applying this methodology may actually overcharge the school food service if part-time employees, who are not eligible for post-retirement health-care benefits, comprise a disproportionate share of the school food service staff. The amount charged to the school food service for post-employment health-care costs would then be unreasonable based on the benefit the school food service received from this cost item. Possible remedies include:

1. Changing the allocation basis for this cost item from "number of employees" to "number of full-time employees."
2. Shifting the SFA's overall indirect cost methodology to the multiple allocation base method. This method is preferred when different direct cost activities benefit to significantly differing degrees from the same indirect cost activity (human resources, accounting, purchasing, payroll, audit, etc.). The SFA would first distribute the cost of each such administrative function or office to benefiting direct cost activities on a basis that fairly measures the benefit each direct cost activity received. For example, the cost of the purchasing function could be distributed on the basis of numbers of purchase orders issued. The total indirect costs allocated thereby to each direct cost activity are then totaled and a separate indirect cost rate calculated for each direct cost activity. The outcome would be one indirect cost rate for food service, another for instruction, etc. This is covered in 2 CFR Part 225, Appendix A, section F.1.; in Appendix E,

sections C.1.b. and C.3; and in DHHS Publication ASMB C-10, section 6.2.4 (pages 6-8 through 6-12).

Please refer to Appendix 4, at the end of this guidance, for a table of typical costs and their classification as a direct or indirect cost.

Consideration When Assessing Indirect Costs Charged to the Food Service

To avoid incorrect indirect costs charged to the nonprofit school food service account resulting from mathematical error or user assessment, the stewards of such account must be provided the necessary tools to verify and validate costs when necessary. It is best practice for the SFA to compare the approved indirect cost rate proposal (ICRP) and the approved indirect cost rate agreement. If the approved indirect cost rate and direct cost base are used, the SFA should compute the amount of indirect costs chargeable to the school food service and compare this result with the actual amount of indirect costs billed to the school food service to ensure no mathematical errors have occurred. After obtaining satisfaction that the LEA's approved methodology has been properly applied, if possible, the SFA should also review recent audits of the school district to determine if problems have been identified in the LEA's prior indirect cost rate calculations. The SFA also should be alert to **the following red-flag areas when reviewing the ICRP and the indirect cost rate computations**:

- Use of an unapproved rate or methodology;
- The allowability of the indirect costs included in the indirect cost pool;
- The inclusion of the same cost in both the indirect cost pool and direct cost base;
- Treating a cost inconsistently (i.e., in some cases the cost is direct and in others the same cost is indirect);
- Using undocumented costs in the indirect cost pool or direct cost base;
- The composition of the direct cost base (i.e., is the base stable and consistent); and,
- The mathematical accuracy of the computation of the indirect cost rate.

If errors are discovered, the appropriate officials should be notified and the ICRP and indirect cost methodology corrected as soon as possible. If the general fund has been shown to have inappropriately recovered indirect costs from the nonprofit school food service account, the SFA should document the amount of funds which must be restored to the nonprofit school food service account and make the appropriate accounting entries to the financial records of both the general fund and the nonprofit school food service account.

Steps an SFA should take if indirect costs charged to the nonprofit school food service account result from mathematical error or user assessment:

- The appropriate officials should be notified and the ICRP and indirect cost methodology corrected as soon as possible;
- If there is a disagreement between the SFA and the appropriate officials, the SA or SEA should be contacted to discuss the issue;** and
- The SFA should not pay for any costs resulting from the mathematical error or user assessment until the issue has been appropriately remedied.

**The SA or SEA should seek FNS' guidance, if needed, by contacting the appropriate FNS Regional Office.

Additionally, many school districts have never billed indirect costs to the nonprofit school food service account, either as a method of supporting the school food service or because the general fund contained enough funds to cover such costs. **It is unallowable to bill the nonprofit school food service account for indirect costs that were paid from the general fund in prior years unless an agreement exists to show that the district had been "loaning" the nonprofit school food service account funds to cover the indirect costs in one or more prior years.** This would require that an official "inter-fund" transaction had been posted to the accounting records of the general fund and the school food service each year that such a "loan" had been made. Such entries would consist of a receivable ("Due From School Food Service") in the general fund and an account payable ("Due to General Fund") in the nonprofit school food service account. Without such documentation evidencing prior-year inter-fund loans, the nonprofit school food service account should not be charged for prior year indirect costs. **There is no Federal requirement that prohibits an SFA from changing its internal fiscal policy regarding the recovery of indirect costs by those organizational units within the SFA that actually incur the costs. Absent a documented "inter-fund loan" as outlined above, however, an SFA may only change its policy to charge the nonprofit school food service account for indirect costs prospectively (that is, going forward for the next school year)**.

It is unallowable to bill the nonprofit school food service account for indirect costs that were previously paid from the general fund unless an agreement exists to show that the district had been "loaning" the nonprofit school food service account funds to cover the indirect costs in one or more prior years.

The SFA may only change its policy to charge the nonprofit school food service account for indirect costs prospectively.

Indirect Cost Rates & Adjustment Methods

The SEA generally assigns each LEA both an unrestricted rate and a restricted rate. Both types of indirect cost rates will be described below.

"SFA" vs. "Local Educational Agency or LEA"

- The term "SFA" is used in this guidance to be more clear and simple. (Please see footnote 1 for detailed explanation.)
- U.S. Department of Education requires each State educational agency (SEA) to negotiate an indirect cost methodology for any "LEA" under its jurisdiction that requests one. **Therefore, the term "LEA" and "SFA" will be used in the remainder of this section.**

Unrestricted (Negotiated) Indirect Cost Rates

The SEA can approve the indirect cost rate that emerges from an LEA's ICRP calculations. This rate is known as a **negotiated or unrestricted rate because it is not limited by Federal restrictions**. The unrestricted rate allows an LEA to recover the full cost of its Federal programs, including their fair share of the cost of its indirect cost activities.

Formula Prescribed for Calculating Unrestricted (Negotiated) Rates

$$\textbf{Unrestricted/Negotiated Indirect Cost Rate} = \frac{\textbf{Indirect Cost Pool}}{\textbf{Direct Cost Base (allowable + unallowable costs)}}$$

Restricted Indirect Cost Rates

The legislation authorizing some Federal educational programs requires that Federal funds are made available for a program's enhancement but do not replace resources that SEAs and LEAs had already been spending on education before the inception of the Federal programs. The intent is to assist SEAs and LEAs in achieving greater levels of benefits and services, without withdrawing their previously dedicated resources from supporting these activities. That is, Federal funding for these programs must supplement, not supplant, dedicated non-Federal resources. In order to implement this "supplement-not-supplant" requirement, ED requires SEAs and LEAs to recalculate their indirect cost rates using a formula described in 34 CFR Parts 76.564 -76.569. This formula generates a lower rate known as a

restricted rate. Most restricted rates are single-digit. Applying the restricted rate results in a marginal distribution of administrative overhead costs required to implement Federal assistance programs.

The formula entails purging certain cost items from an SEA's or LEA's unrestricted indirect cost pool, and reclassifying them as direct costs. By excluding otherwise allowable costs from the indirect cost pool and adding them to the direct cost base, this operation generates a smaller numerator and larger denominator. The resulting calculation generates the lower, restricted rate.

Formula Prescribed for Calculating Restricted Rate

$$\textbf{Restricted Indirect Cost Rate} = \frac{\text{General Management Costs + Fixed Costs}}{\text{Other Expenditures}}$$

As noted above, the LEA obtains the numerator of this formula by removing certain cost items from the indirect cost pool used in calculating the unrestricted rate, and reclassifying them as direct costs. These purged and reclassified costs are those for which an SEA or LEA remains responsible despite the availability of Federal funds. Examples include the salaries, fringe benefits, and other compensation of the Superintendent and Deputy or Associate Superintendents, and the cost of operating these officials' offices (such as travel, space occupancy, etc.). The costs that remain in the pool after this purge are classified as "General Management Costs" and "Fixed Costs."

> **General Management Costs** are incurred for the direction and control of the organization as a whole. Examples include the costs of accounting, payroll, human resources, audit, and procurement offices. Occupancy and space maintenance costs associated with these services may also be included if justified by the results of a space allocation or use study.
>
> **Fixed Costs** consist of the SEA's or LEA's contributions to fringe benefits associated with wages and salaries that are charged as indirect costs.

The denominator in the formula ("**Other Expenditures**") is the sum of the original direct cost base used in calculating the unrestricted rate, and the cost items purged from the indirect cost pool and reclassified as direct costs.

The LEA must use the restricted rate to determine indirect costs allocable to those Federal educational programs whose authorizing statutes include the supplement-not-supplant language. This requirement thus prevents an LEA from recovering the full cost of those programs from the State. The LEA must absorb, from its own resources, the difference between indirect costs allocable to those programs under the restricted rate, and what those costs would have been if determined via the unrestricted rate. As already noted, States generally approve both an unrestricted rate and a restricted rate for each LEA under their jurisdiction.

Appropriate Use of Unrestricted and Restricted Rates

As we explained in *Cost Allocation and Recovery in the School Food Service*, an SFA does not claim reimbursement for allowable direct and indirect costs. However, the general fund often bills the school food service for its share of the indirect costs by applying the State-approved indirect cost rate to the school food service's direct cost base. The billed amount generated thereby is the amount of indirect cost properly allocable to the school food service. Any billed amount in excess of that amount is properly allocable to other activities of the LEA, not to the school food service. Therefore, the portion of such billing that exceeds the properly allocable amount does not support the operation or improvement of the food service; and charging it to the school food service violates both the Federal Cost Principles and SMPs regulations at 7 CFR Parts 210.2, 210.14(a), 220.2 and 220.13(a).

Properly billed indirect costs:
The food service's share of indirect costs is determined by applying the approved indirect cost rate to the school food service's direct cost base.

- School food service is allowed to pay properly billed indirect costs with funds from the nonprofit school food service account; and
- School food service is not allowed to pay **<u>any amount in excess of the properly billed indirect costs</u>** (the portion that does not support the operation or improvement of the food service) with funds from the nonprofit school food serviced account.

Whether the general fund bills a direct cost activity, such as the school food service, for indirect costs at the restricted or unrestricted rate depends on the Federal programs operated within that activity. If such programs' authorizing legislation includes the "supplement-not-supplant" language discussed

earlier in this guidance, the restricted rate must be used. **The legislation authorizing the SMPs does not contain such a requirement; therefore, the general fund may bill the school food service at the unrestricted rate**. Some LEAs have nevertheless opted to support the food service by billing it at the restricted rate, which is lower. Once that choice has been made for a given fiscal year, however, the LEA must apply the selected rate consistently throughout that period.

If the general fund bills on the basis of an indirect cost rate, the LEA must have a current, negotiated indirect cost rate agreement in place and must bill in accordance with the methodology set out in such agreement. For example, an indirect cost rate agreement that sets an unrestricted rate of 12 percent of direct wages and salaries limits the general fund's billing to 12 percent of direct food service wages and salaries.

Capping Indirect Cost Rates

The legislation authorizing some Federal programs may impose caps on the indirect cost rates available to State and local agencies operating such programs. For example, the indirect costs chargeable to a program may be statutorily restricted to 5 percent of the Modified Total Direct Costs (MTDC) even though the program operator has an unrestricted indirect cost rate of 17 percent of MTDC. Such an indirect cost rate cap may not be arbitrarily imposed; rather, it must be required by legislation. As a practical matter, many LEAs cannot fully recoup all indirect costs allocable to programs in which the capping of indirect cost rates is required. However, as stated earlier, this does not justify reclassifying the unrecovered balance of the charges as a direct cost. Costs consistently treated as indirect may not be charged as direct in order to circumvent a statutory cap on the indirect cost rate, because doing so would violate the requirement to treat costs consistently as direct or indirect.

Adjustment Methods

An LEA may recover either more or less indirect cost in a fiscal year by applying its approved methodology than it actually incurred in that period. An LEA derives its indirect cost rate and direct cost base for use in each accounting period (fiscal year) from prior year audited financial statements. Consequently, the LEA identifies the indirect cost to be recovered in the current fiscal year by applying a rate derived from prior year costs to a base consisting of current year direct costs. Such "adding of apples to oranges" is unavoidable because audited financial statements are inherently retrospective; actual cost data for the 2011-2012 fiscal year are neither complete, final, nor validated by audit until

well into the 2012-2013 fiscal year. By then, the LEA is formulating its ICRP for the next year. Therefore, there is a two-year time lag between the LEA actually incurring indirect costs and those costs becoming available for use in formulating an ICRP.

Please refer to Appendix 2, at the end this guidance, for more information on appropriate methods for making adjustments to indirect charges.

Cost Allocation Plan and Indirect Cost Rate Audit Findings

Past audit findings have identified the inclusion of unallowable costs. Some examples are:

- Capital expenditures for an alarm and security system were included in the indirect cost pool. These costs were subsequently disallowed during the audit because capital expenditures can only be charged as a direct cost during the period in which the cost was incurred.

- Rental costs were questioned because the lease was not an arms-length transaction. These costs were allowed only up to the amount that would have been allowed had the title to the property been vested in the organization.

- Depreciation expenses were questioned because the computation of the expense incorrectly included the value of land. The depreciation expense was recalculated using the acquisition cost less the value of land.

- Lack of adequate documentation was provided to support charges to the indirect cost pool. Since indirect costs must be actual costs, an organization must have adequate documentation to support the costs included in the indirect cost pool. **As always, only costs which are necessary, reasonable, allocable, or properly documented can be charged either directly or indirectly.**

- Refunds were not properly credited to the indirect cost pool. Any reduction to a cost item included in the indirect cost pool must be credited to the pool.

- Cost of a grantee's automobile used for personal use was questioned. This cost required allocation between the allowable cost portion assignable to the grant and the portion that was not an allowable cost (i.e., personal use).

- A grantee paid the salary of an individual who worked exclusively on a direct function from the indirect cost pool. This cost was disallowed because it was a direct, not indirect cost.

Conclusion

In conclusion, the key principles this guidance hopes to impart include:

- Understanding allowable costs,
- Understanding how to appropriately charge direct or indirect costs,
- Understanding SMPs' indirect cost compliance requirements, and
- Understanding how to safeguard the financial integrity of the nonprofit school food service account with respect to direct and indirect costs.

SFAs with questions should refer to their respective SEA. Additionally, the Appendices to this guidance may provide pertinent information to SFAs, SEAs and SAs.

Section 307(b) of the Healthy, Hunger-Free Kids Act of 2010 requires FNS to conduct an indirect cost study. This guidance will be updated to include any necessary and pertinent information based on the findings of the indirect cost study. Specifically, **FNS anticipates updating the Q&As on indirect cost in Appendix 3 of this guidance**.

Appendix 1: Illustrative and Detailed Example on Developing an ICRP

Step 1: Identify ALL Costs (allowable and unallowable)

NEW SCHOOL DISTRICT: EXPENDITURES BY FUNCTION		
Function Code	Account Title	Expenditures ($)
1000	Instruction	900,000
2100	Student Services	75,000
2212	Curriculum Development	30,000
2213	Instructional Staff Training	20,000
2321	Office of the Superintendent	40,000
2510	Fiscal Services	10,000
2520	Procurement	10,000
2560	Public Relations	10,000
2570	Personnel (Human Resources)	15,000
2600	Plant Operation & Maintenance	125,000
2700	Student Transportation	165,000
3100	Food Services	100,000
TOTAL		$1,500,000

The expenditures are determined from the LEA's accounting system. The total cost, regardless of the funding source, must be identified for each function. This is confusing for many because costs not directly related to the school food service are accounted for in this methodology to derive the indirect cost rate. However, an Indirect Cost Rate Proposal (ICRP) is the methodology that substantiates a resulting indirect cost rate and ICRP's are required to identify all activities carried on within each LEA and their associated costs regardless of funding source. The ICRP is based on the LEA's total expenditures; therefore, all expenditures must be included in the ICRP.

Step 2: Remove All Excluded Costs

The next step is to exclude all costs that would distort the final result. "Distorting items" should be excluded because they do not generate or benefit from the administrative overhead in the same manner as wages, salaries, etc. Distorting items include (but are not limited to):

- Equipment purchases and other capital expenditures,
- Payments to contractors beyond the first $25,000,
- Food costs in the school food service,

- Renovations and alterations, and
- Certain unallowable costs (e.g., fines, penalties, bad debts).

NEW SCHOOL DISTRICT: EXPENDITURES BY FUNCTION				
Function Code	Account Title	Old Total Cost	**Excluded Cost**	New Total Cost
1000	Instruction	900,000	**(100,000)**	800,000
2100	Student Services	75,000		75,000
2212	Curriculum Development	30,000		30,000
2213	Instructional Staff Training	20,000		20,000
2321	Office of the Superintendent	40,000		40,000
2510	Fiscal Services	10,000		10,000
2520	Procurement	10,000		10,000
2560	Public Relations	10,000		10,000
2570	Personnel (Human Resources)	15,000		15,000
2600	Plant Operation & Maintenance	125,000		125,000
2700	Student Transportation	165,000	**(90,000)**	75,000
3100	Food Services	100,000	**(90,000)**	10,000
	TOTAL	**1,500,000**	**(280,000)**	**1,220,000**

In this example, the LEA excluded: (1) $100,000 in contract costs from Function 1000 (Instruction), (2) $90,000 expended to purchase school buses from Function 2700 (Student Transportation), and (3) $90,000 in food purchases from Function 3100 (Food Services).

The following paragraphs explain why these items are considered distorting items:

Capital Expenditures: A capital expenditure is the cost of acquiring a capital asset (e.g., land, buildings, equipment, etc.). While purchasing equipment, for example, is a "cost," it is not a current operating expense because the LEA does not realize the entire benefit of the equipment's cost at the time of purchase; rather, the benefit is realized over a period of years that the equipment is used in operations. This benefit is measured by annual depreciation expense or use allowance, and is the reason why only a year's depreciation expense or use allowance can be included in indirect cost computation.

Contract Costs: The cost of administering a procurement contract is substantially the same, whether the value of the contract is $100,000 or $100 million. The cost is presumed not to exceed $25,000 per contract. Therefore, the value of each contract beyond the first $25,000 must be excluded.

Food Costs: Like capital expenditures and contract costs, food purchases require minimal administrative support; therefore, they are excluded

Step 3: Classify Costs as Direct or Indirect

Next, the LEA/SFA determines whether each cost is a direct or indirect cost. The SFA makes this determination by following the accounting and reporting principles of the SEA which is in accordance with 2 CFR Part 225.

NEW SCHOOL DISTRICT: EXPENDITURES BY FUNCTION				
Function Code	Account Title	Direct	Indirect	Total Costs
1000	Instruction	800,000		800,000
2100	Student Services	75,000		75,000
2212	Curriculum Development	30,000		30,000
2213	Instructional Staff Training	20,000		20,000
2321	Office of the Superintendent		40,000	40,000
2510	Fiscal Services		10,000	10,000
2520	Procurement		10,000	10,000
2560	Public Relations		10,000	10,000
2570	Personnel (Human Resources)		15,000	15,000
2600	Plant Operation & Maintenance		125,000	125,000
2700	Student Transportation	75,000		75,000
3100	Food Services	10,000		10,000
	TOTAL	**1,010,000**	**210,000**	**$1,220,000**

Step 4: Eliminate unallowable costs from the total indirect costs to obtain the Indirect Cost Pool

As we stated earlier, only allowable costs can be allocated to Federal assistance programs. Therefore, the next step is to remove all unallowable costs from the indirect cost pool. However, the unallowable

indirect costs go to the direct cost base because they remain part of the school district's total costs and benefit from the administrative overhead.[16] This results in a **Modified Total Direct Costs (MTDC) base**. As already noted, the MTDC base excludes "distorting items."

We will assume, for illustrative purposes, that the New School District identified the following items as unallowable costs and consequently eliminated them from the indirect cost pool:

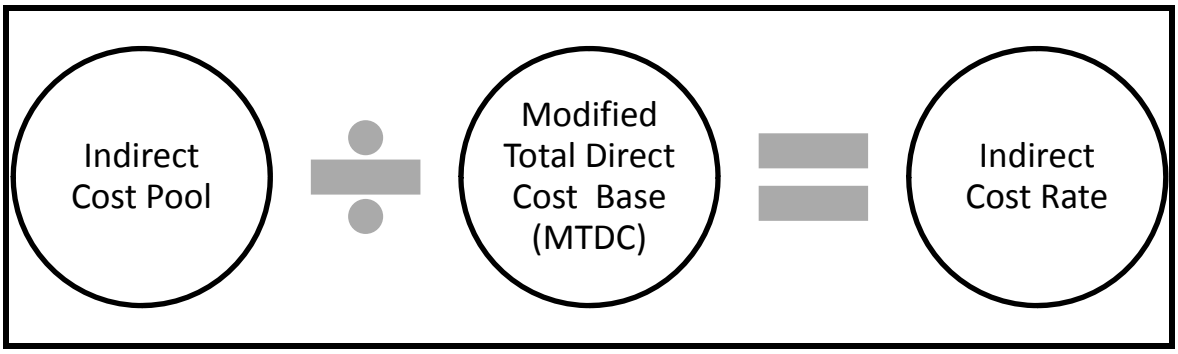
- $2,000 in unallowable public relations costs from code 2560 (Public Relations). These costs were unallowable because they represented promotion of the district in general rather than specific program benefits or achievements.
- $8,000 from code 2321 (Superintendent's Office). These costs were unallowable because they represented travel by the Superintendent for purposes that did not benefit Federal assistance programs.

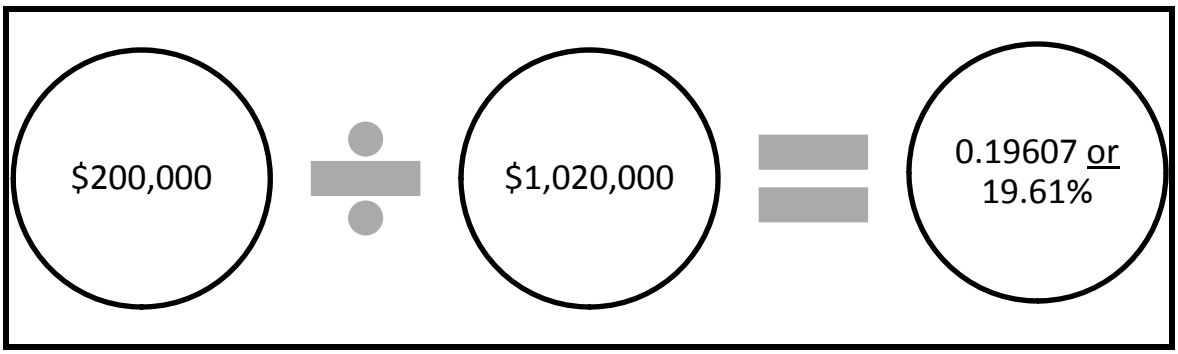
Function Code	Account Title	Indirect	Unallowable	Indirect Cost Pool	Direct Costs
1000	Instruction				800,000
2100	Student Services				75,000
2212	Curriculum Development				30,000
2213	Instructional Staff Training				20,000
2321	Office of the Superintendent	40,000	(8,000)	32,000	8,000
2510	Fiscal Services	10,000		10,000	
2520	Procurement	10,000		10,000	
2560	Public Relations	10,000	(2,000)	8,000	2,000
2570	Personnel (Human Resources)	15,000		15,000	
2600	Plant Operation & Maintenance	125,000		125,000	
2700	Student Transportation				75,000
3100	Food Services				10,000
	TOTAL	**$210,000**	**($10,000)**	**$200,000**	**$1,020,000**

Step 5: Calculate Indirect Cost Rate[17]

[16] Please refer to Attachment 3 of this guidance for examples which explain when costs should be included in the direct cost base (denominator) or excluded.

[17] The indirect cost methodology in this example uses MTDC as a direct cost base. Other bases, such as direct wages and salaries or direct wages, salaries, and benefits, are also often used.





As seen in the Table for Step 4, the indirect cost pool is $200,000 and the Modified Total Direct Cost (MTDC) is $1,020,000.

The indirect cost rate is a ratio of the LEA's indirect costs to its direct costs. The indirect cost rate benefits the LEA because general management and administrative costs are necessary for any program to exist. Without the benefit of an indirect cost rate, there would be no standard way for each program to contribute its share of the general management and administrative costs without spending significant staff time accounting for each activity.

It is important to note that this methodology generates the unrestricted (negotiated) indirect cost rate. Additional operations are necessary to generate the restricted rate. Additionally, the LEAs cannot receive reimbursement for indirect costs under programs funded by reimbursing allowable costs unless they have both the prescribed rate and prescribed base; each is useless without the other. Also, if the SEA has notified an SFA of its indirect cost rate but not the base, then the SFA must contact the SEA to obtain it. An SFA must never pay for indirect costs without first reviewing an approved indirect cost rate

agreement. In other words, an SFA must not pay for indirect costs solely on the basis of the district providing an indirect cost rate.

SFA must not pay for indirect costs without:

- Reviewing the indirect cost rate agreement,
- Ensuring the indirect cost rate agreement provides the indirect cost rate and direct cost base, and
- Ensuring that the approved indirect cost methodology was properly applied in the preparation of the bill.

***Remember**: The indirect cost rate can only be applied to cost items in the base.*

Appendix 2: Various Indirect Cost Rate Methods

The Federal cost principles provide remedies in the form of after-the-fact adjustments in cases where an LEA recovers either more or less indirect cost in a fiscal year by applying its approved methodology, than it actually incurred in that period. The following paragraphs summarize two commonly used adjustment methods: **Fixed Rate With Carry-Forward**, and **Provisional-Final**. The Fixed Rate With Carry-Forward method is preferred.

Fixed Rate With Carry-Forward

In a **Fixed Rate With Carry-Forward** methodology, the indirect cost rate assigned for the upcoming fiscal year remains stable or fixed. After the fiscal year ends, the actual indirect costs incurred in that period are compared with the amount of indirect costs recovered by applying the rate approved for use in that period. During the computation of the next period's indirect cost rate, the amount of any difference between indirect costs charged and indirect costs recovered is carried forward by subtracting any over-recovery from, or adding any under-recovery to, the indirect cost pool. The new rate thus takes into account the adjustment necessary so that over time the amount of indirect costs recovered equals the amount of indirect costs actually incurred.

Provisional-Final Methodology

Under the **Provisional-Final methodology**, the LEA and its SEA negotiate an estimate of indirect costs the LEA will incur in the upcoming fiscal year, and the SEA approves a temporary (provisional) rate, based on such estimates, for the LEA's use in that period. Similarly to the Fixed Rate With Carry-Forward method, the results of using the provisional rate become subject to adjustment after the close of the applicable fiscal year. The amount of indirect costs actually incurred during the fiscal year is compared with the amount of indirect costs charged by applying the provisional indirect cost rate, after the former becomes available. If no differences exist, the provisional rate is finalized. When a difference does exist, a new indirect cost rate is computed.

This method differs from the Fixed-Rate With Carry-Forward method in that required adjustments are made retroactively rather than rolled forward. The new, final rate is applied to the direct cost base and

any differences between the final and provisional rates are charged or credited (as applicable) to the indirect cost account. Because the final rate must be computed using the final cost data for the fiscal year, there can be a significant time delay between the assignment of the provisional rate and the issuance of a final rate. Any adjustments that must be made will result in amending accounting records from the prior period. The LEA must maintain and keep these accounting period records open and available. A provisional-final rate methodology can create reporting problems when the LEA is required to submit final cost reports for a particular federally funded program before the final rate is assigned.

Appendix 2a: Example of Fixed-Rate With Carry-Forward Adjustments

Transactions	FY 2006	FY 2008	FY 2010	FY 2012
Indirect Cost Pool: Departmental Carry-Forward Total		$8,241,470 -0- $8,241,470 2/	$9,663,476 464,589 $10,128,065 6/	$9,756,895 (113,139) 11/ $9,643,756 12/
Direct Cost Base		$174,674,112 2/	$195,720,60 7/	$199,895,960 12/
Fixed Rate		4.7 % 2/	5.17% 7/	4.82% 12/
Actual Indirect Cost Incurred: Departmental Carry-Forward Total	$8,241,470 1/ -0- $8,241,470	$9,663,476 3/	$9,756,895 464,589 $10,221,484 8/	
Indirect Cost Recovered		$9,198,887 4/	$10,334,623 9/	
(Over)/Under Recovery		$464,589 5/	(113,139) 10/	
Actual Direct Cost Incurred	$174,674,112 1/	$195,720,601 3/	$199,895,960 8/	

NOTES:

1/ In Fiscal Year (FY) 2006, the LEA incurred actual direct and indirect costs of $174,674,112 and $8,241,470, respectively.

2/ The LEA used actual costs incurred in FY 2006 to calculate the indirect cost rate to be used in FY 2008 ($8,241/470/$174,674,112 = 0.047 or 4.7%).

3/ In FY 2008, the LEA incurred actual direct and indirect costs of $195,720,601 and $9,663,476, respectively.

4/ In FY 2008, the LEA recovered (claimed reimbursement for) indirect costs of $9,198,887 by applying the rate to its base of actual direct costs incurred ($195,720,601 * 0.047 = $9,198,887).

5/ Since the LEA recovered less in indirect costs than it actually incurred in FY 2008, the LEA has an under-recovery of $464,589 ($9,663,476 incurred minus $9,198,887 recovered = $464,589 not recovered). The LEA will recover this amount by making a $464,589 carry-forward adjustment to its FY 2010 indirect cost pool.

6/ The LEA's FY 2010 carry-forward adjustment generates an indirect cost pool of $10,128,065. This figure is the sum of the $9,663,476 of indirect costs actually incurred in FY 2008, and the $464,589 not recovered in that period.

7/ The LEA calculates an indirect cost rate of 5.17% for use in FY 2010. ($10,128,065/$195,720,601 = 0.0517 or 5.17%)

8/ In FY 2010, the LEA incurred actual direct and indirect costs of $199,895,960 and $10,221,484, respectively. The indirect cost figure is the sum of $9,756,895 actually incurred in FY 2010 and the $464,589 carry-forward adjustment.

9/ In FY 2010, the LEA recovered (claimed reimbursement for) indirect costs of $10,334,623 by applying the rate to its base of actual direct costs incurred ($199,895,960 * 0.0517 = $10,334,623).

10/ The LEA recovered reimbursement for more indirect costs in FY 2010 than it actually incurred. It therefore has a negative carry-forward adjustment of $113,139 ($10,221,484 minus $10,334,623 = $(113,139)). The LEA will subtract this amount from its indirect cost pool when calculating its indirect cost rate for use in FY 2012.

11/ The LEA deducts $113,139 from its actual FY 2010 indirect costs in order to obtain the indirect cost pool it will use in calculating its indirect cost rate for FY 2012. The adjusted pool amounts to $9,643,756 ($9,756,895 minus $113,139).

12/ The LEA calculates an indirect cost rate of 4.82% for use in FY 2012. ($9,643,756/$199,895,960 = 0.0482 or 4.82%)

Appendix 3: Indirect Cost Q&As

1. Which entity is responsible for ensuring that direct and indirect costs are allocated properly?	**A1.** The responsibility for compliance with the Federal regulations is jointly shared by the SA and the SFA.
2. Can we charge indirect costs to a Federal grant if we do not have an indirect cost rate?	**A2.** No. A grantee must have a current indirect cost rate agreement to charge indirect costs to a grant. In most instances, an indirect cost rate is approved annually.
3. How do I get an indirect cost rate for my organization?	**A3.** School districts should contact their SEA.
4. Who approves the indirect cost rate?	**A4.** The SEA performs the duties of a cognizant agency for LEAs in each State.
5. What is a "cognizant" agency?	**A5.** The agency tasked with negotiating indirect cost methodologies for grantees. The cognizant agency negotiates with the grantee on behalf of all the grantee's awarding agencies in order to obtain one methodology that can be used consistently to assign indirect costs to the grantee's Federal awards. As already noted, the SEA performs these duties for LEAs within its State. Once a rate is established by the cognizant agency (SEA), it will be honored by other Federal agencies and grantor agencies. However, many Federal programs have limitations on the amount of indirect costs that may be claimed on a grant, so the actual indirect cost rate may not always be able to be used.
6. Can indirect costs represent unallowable costs?	**A6.** No. A cost must be allowable in order to be allocated to Federal programs as an indirect cost. The Federal cost principles provide guidance on allowable costs.

7. Are there any examples which explain when costs should be included in the direct cost base (denominator) or excluded?	**A7.** Example 1 The SEA receives a $1,000,000 award from a Federal agency. The purpose of the award is to have specific school districts conduct seminars on a new Federal program. The SA awards $100,000 to each of 10 school districts. Each of the school districts is responsible for payroll, issuing contracts and purchase orders, acquiring and paying for supplies, reimbursement for travel, and other similar administrative costs. The only efforts the SA spends on these awards are providing electronic payments and reviewing end-of-year financial reports. The $1,000,000 award is a "pass-through" and therefore excluded. There is minimal benefit to the SA from receipt of these funds. For each school district, the expenditures are part of the base for calculating the indirect cost rate. Example 2 The SA receives a $500,000 grant from a corporate endowment to improve mathematics instruction. The endowment does not allow indirect cost reimbursement under its grants. The SA hires five full-time staff with the funds and pays the salaries, fringe benefits, local travel, supplies, and other staff expenses. All expenses incurred under this endowment grant are included in the SA's base (except distorting items such as equipment purchases). It does not matter whether the endowment allows indirect costs or not. These costs benefit from the SA's allowable indirect costs (payroll, personnel, procurement, data processing, etc.). Therefore, in accordance with 2 CFR Part 225 the costs are included in the base. If not, the SA's other programs absorb an unfair portion of the costs of administering the endowment grant.
8. Are there instances that food purchases should be included (rather than excluded) in the indirect cost rate calculation? For example, a public school district operates a food service program and food is a significant direct cost to the program.	**A8.** Expenditures for food are generally referred to as "distorting items" since they do not generate administrative overhead or benefit from it, to the same degree as most other direct cost objects (such as wages and salaries). Such distorting items are excluded when calculating the rate and indirect cost reimbursement because the activities require minimal administrative support.

9. What does it meant that indirect costs must be treated consistently?	**A9.** The program operator must classify all similar costs in a consistent manner. The same cost item incurred under the same circumstances must be treated consistently as direct or indirect in all activities in which the program operator incurs that cost.
10. Is depreciation a direct or indirect cost?	**A10.** The classification of depreciation as a direct or indirect cost depends on the classification of the activity in which the depreciable property is being used. For example, depreciation expense on food service equipment can be specifically identified with the food service. Food service is a direct cost activity. Accordingly, depreciation expense on the equipment used in food service is also a direct cost. By contrast, depreciation expense on the school buildings and the buildings housing an SFA's administrative offices is an indirect cost because all activities of the SFA benefit from use of the buildings. The accounting policies of the SFA may also determine the classification of depreciation expense as direct or indirect.
11. Who should an SFA contact if it has questions on proper indirect cost charges or this indirect cost guidance?	**A11.** Contact the SEA. The SEA is responsible for LEA/SFA indirect cost oversight and provides guidance/instructions to LEAs/SFAs.
12. If the school district previously paid for indirect costs from the general fund, can it change its mind and retroactively charge the food service for indirect costs?	**A12.** It is unallowable to bill the nonprofit school food service account for indirect costs that were previously paid from the general fund unless an agreement exists to show that the district had been "loaning" the nonprofit school food service account funds to cover the indirect costs in one or more prior years.

13. Is it correct that school districts cannot recover the maximum indirect cost plus charge food service directly for something that is an indirect cost for other programs? **<u>Scenario:</u>** **The SEA calculates indirect cost rates (both restricted and unrestricted) for its LEAs. The unrestricted rate is applied to the child nutrition program. Some school districts want to recover the maximum amount of indirect cost from the food service (unrestricted rate times the qualifying expenditures), <u>and</u> charge the food service directly.**	**A13.** A consistency problem exists when the grantee does not treat "all" programs/activities in the same manner. The consistency principle applies "organization-wide," not just to particular programs or certain types of cost. Additionally, it is a concern that the practice described in the question, could result in over-charging of costs (an allocation of more than 100% of the total costs incurred). ASMB C-10, the Implementation Guide for OMB Circular A-87, provides guidance regarding consistency (see Item 2-11 in C-10).
14. Would the following scenario violate the consistency principle? **<u>Scenario:</u>** **A school is charging the child nutrition program for the electricity costs, based on an allocation formula that uses square footage. They are not charging any other Federal program directly for electricity. They are also recovering indirect costs from the child nutrition program, but at a rate lower than their allowable rate.**	**A14.** A grantee may choose to take a reduced rate. However, in accordance with 2 CFR Part 225, each item of cost must be treated consistently, in like circumstances, either as a direct or an indirect cost. Conversely, in the situation described, the grantee would be charging the same type of cost to different programs, using different allocation methods. That would violate the consistency principle.
15. Can an LEA decide that certifications in March and May for employees who are charged 100% to a single cost objective meet the requirement to provide "semi-annual" certifications?	**A15.** Reasonableness and prudence must be exercised when using periodic time certifications. If the certification is signed in March and May, then it would cover 10 months and 2 months, respectively. The phrase "periodic" is interpreted as referring to regular intervals and the provision in 2 CFR Part 225 which states in part "...will be prepared at least semi annually..." means at least every 6 months.

Appendix 4: Example of Typical Costs and their Classification as Direct or Indirect[18]

Category	Description	Supporting Documentation	Allowable or unallowable cost	Direct or Indirect Cost
Food/ Food Supplies	Items used to prepare meals for enrolled children	Vendor invoices and receipts	Allowable	Direct
Labor for food service	Wages & salaries of persons employed (full or part time) in operating the food service. May include such position titles as food service worker, food service supervisor, food service stock worker, etc.	Time cards; Multi-Fund Time Reports for employees whose duties benefit two or more funds	Allowable	Direct
Custodial Services	Clean kitchen/serving areas only	Time cards that identify the number of hours spent cleaning the kitchen, prep & serving areas	Allowable	Direct
Custodial Services	Cleans entire school, including kitchen/serving area	Time cards that do not break down time by area served	Allowable	Indirect
Maintenance Charges	Kitchen/serving area equipment/ materials repaired or replaced by in-house personnel	Job cost ticket or similar documentation that details labor costs incurred based on actual labor hours expended	Allowable	Direct*
Category	**Description**	**Supporting Documentation**	**Allowable or**	**Direct or Indirect**

[18] The treatment of a cost as direct or indirect is almost always driven by its treatment in the program operator's accounting system. Also, the SEA performs the duties of a cognizant agency for school districts; and the indirect cost methodology the SEA prescribes for a school district may call for direct-indirect distinctions other than those set out in this matrix. The SFA must defer to such instructions from the SEA, since their authority to issue them is based on Federal regulations published by the U.S. Department of Education.

			unallowable cost	Cost
Maintenance Charges	Equipment/materials in kitchen/serving areas repaired or replaced by external vendor	Vendor invoice	Allowable	Direct*[19]
Trash Collection	Picks up trash for school and kitchen/serving areas	Itemized vendor invoice that specifies cost for picking up trash in kitchen/serving areas	Allowable	Direct
Trash Collection	Picks up trash for school and kitchen/serving area	Vendor invoice is not itemized	Allowable	Indirect
Utilities (gas, electricity, water, etc.)	Meter for kitchen/serving area	Utility provider invoice or statement for utilities used in kitchen/serving area	Allowable	Direct
Utilities (gas, electricity, water, etc.)	One meter for the entire school	Utility provider invoice or statement for entire school	Allowable	Indirect
School accounting services	School front office personnel may be called upon to provide change, verify daily receipts, perform banking duties, etc.	Time card indicates specifically how much time was spent providing services to food service unit	Allowable	Direct
School accounting services	School front office personnel may be called upon to provide change, verify receipts, perform banking duties, etc.	Time distribution not documented	Allowable	Indirect

[19] *Both of these maintenance examples are identified as direct costs because the billings for maintenance services are specifically identifiable to the cost objectives (i.e., food service) that received the services.

Category	Description	Supporting Documentation	Allowable or unallowable cost	Direct or Indirect Cost
Payroll Services	Services that provide LEA-wide benefit	Time reports	Allowable	Indirect
Workers' Compensation	LEA provided benefits to workers who are injured during the course of their employment	Periodic contributions to a LEA-wide reserve or self-insurance fund for workers' compensation and other benefits. Claims paid from the fund as they arise.	Allowable	Indirect
Workers' Compensation	LEA provided benefits to workers who are injured during the course of their employment	Actual payments of Worker's Compensation claims to current or former employees (i.e., pay as you go)	Allowable	Direct **[20]
Post Retirement Health Benefits	LEA provided benefits to its retirees (medical, dental, and vision insurance)	Periodic contributions to a LEA-wide reserve or self-insurance fund for retirees' post-employment health care and other benefits; fund contributions determined on actuarial basis. Claims paid from the fund as they arise	Allowable	Indirect***
Post Retirement Health Benefits	LEA provided benefits to its retirees (medical, dental, and vision insurance)	Payments of health benefits claims to retirees or their health care providers	Allowable	Indirect***[21]
Information Technology Support	Services that provide LEA-wide benefits	LEA expenses are pooled	Allowable	Indirect

[20] ** Treated as a direct cost because it is specifically identifiable to a cost objective (i.e., food service) in which the employee was working when s/he was injured.

[21] ***Both of these post retirement health benefits are treated as indirect costs because allocating individual payments to retirees based on the cost objectives in which they worked in the course of their careers would be oppressively burdensome and therefore they are typically treated as an indirect cost.

Category	Description	Supporting Documentation	Allowable or unallowable cost	Direct or Indirect Cost
Information Technology Support	Services that benefit only the food service	Job cost ticket or similar documentation that details labor costs incurred based on actual labor hours	Allowable	Direct
Pest Control	Separate invoice for kitchen/serving/food storage areas	Itemized vendor invoice	Allowable	Direct
Pest Control	Invoice for services provided not itemized by area serviced, with separate charges for each	Vendor invoice (not itemized)	Allowable	Indirect
Transportation	To deliver food/prepared meals to schools (trucks deliver food and food supplies only)	Time cards, activity reports, job cost tickets	Allowable	Direct
Transportation	To deliver food/prepared meals and general school supplies to schools	Time cards, activity reports, job cost tickets	Allowable	Direct

Appendix 5: Overview of Generally Accepted Accounting Principles (GAAP) for School Districts

General . The criteria for an allowable cost set by the Federal Cost Principles include a requirement that the cost be determined in accordance with GAAP (except where the principles provide otherwise). This appendix provides an overview of GAAP as it relates to school districts.

What is GAAP?

Accounting is the art of capturing, analyzing, recording, summarizing, interpreting, and reporting financial information about an entity, such as a school district. GAAP consist of the accounting profession's rules for doing these things. If followed, GAAP enable users of financial information to rely on that information and, if necessary, compare the financial information reported by multiple entities.

How is GAAP established?

To be considered "generally accepted," an accounting principle must be widely used and have authoritative support. That support is provided by professional standard-setting bodies. The Financial Accounting Standards Board (FASB) sets standards for private-sector accounting, while the Governmental Accounting Standards Board (GASB) sets them for State, local, and tribal governments. Both boards conduct research on accounting issues, publish draft pronouncements based on their research, consider comments received on these drafts, and issue final statements of accounting principles. As governmental entities, school districts are under the GASB. The Association of School Business Officials (ASBO) publishes literature on applying GASB pronouncements to school districts.

How is financial information about a school district organized?

Financial information is recorded in accounts that break down into the following five categories:

Assets. An asset is something of value that the school district owns. Examples include cash, accounts receivable, inventories, pre-paid expenses, plant & equipment (often called "fixed assets"), etc.

Liabilities. A liability is a legally-enforceable debt that the school district owes. Liabilities may arise from operations (such as purchasing supplies on credit) or from borrowing for major projects (such as issuing bonds to raise cash for a new school building).

Equity. Equity is the difference between what the district owns (assets) and what it owes (liabilities). In the private sector, it bears such titles as Stockholders' Equity and Net Assets; in governmental accounting, it is called Fund Balance.

Revenues. Revenue is the inflow of assets without the creation of liabilities or the reduction of other assets. Examples of school district revenues include taxes, fees for participation in school activities, sales of food items in school cafeterias, donations, Federal and State grants, etc. Revenues are classified by source: Federal, State, Intermediate, and Local. Borrowing is not a revenue source; it is considered an "other financing source."

Expenditures. Expenditures are outflows of assets and/or the creation of liabilities to support school district operations. For example, the district must pay out cash to compensate its employees and contractors for their services. Expenditures are classified by object class, function, fund, etc. "Object class" refers to what they bought (goods or services); "function" refers to the purpose for which they bought it (instruction, student services, food service, etc.); and "fund" is explained below. Expenditures may support current operating expenses, or "other financing uses" such as the acquisition of land, buildings, equipment, or other capital assets. The acquisition of a capital asset is called a capital expenditure.

Every transaction affects at least two of these accounts. For example:

1. Sales of school meals and a la carte items to children and adults generate "Revenue From Local Sources" and increase the asset "Cash."

2. Claiming NSLP & SBP reimbursement from the State agency generates "Revenue From Federal Sources" and increases the asset "Due From State Agency" (a receivable). When the State agency pays the claim, the school district records an increase in the asset "Cash" and an offsetting decrease in the asset "Due From State Agency."

3. The acceptance of goods from a vendor increases the liability "Accounts Payable" and the expenditure object class "Supplies." Paying the vendor's invoice reduces both the asset "Cash" and the liability "Accounts Payable."

What is fund accounting?

A "fund" is a subdivision of a school district's accounts, which the district establishes for purposes of accounting control. A district establishes the number of funds it needs to achieve control. Every district has its General Fund. In addition, a district may establish: (1) special revenue funds to ensure that revenues that come with special conditions are used according to those conditions; (2) capital projects funds to control major projects, such as the construction of a new school building; (3) debt service funds to control the payment of principal and interest on borrowed money; (4) enterprise funds to control

transactions of business-like activities, such as the school food service; (5) internal service funds to control services provided to the district's own offices and units; and (6) pension funds to manage the district's pension liabilities. Each fund is a discrete accounting entity and uses a complete chart of accounts. One may conceptualize a district's fund structure as follows:

FUNDS

ACCOUNTS	General Fund	Special Revenue Funds	Capital Projects Funds	Debt Service Funds	Enterprise Funds	Internal Service Funds	Pension Trust Funds
ASSETS	x	x	X	x	X	x	x
LIABILITIES	x	x	X	x	X	x	x
EQUITY	x	x	X	x	X	x	x
REVENUES	x	x	X	x	X	x	x
EXPENDITURES	x	x	X	x	X	x	x

As accounting entities, funds can engage in transactions with each other. For example, the General Fund or an internal service fund may bill other funds for services rendered. Funds may also transfer assets to each other or borrow from each other. The lending fund records a receivable, "Due From ____ Fund," and the borrowing fund records a liability, "Due to _____ Fund." This reciprocal accounting maintains the integrity of the district's accounting system as a whole.

School food service is generally accounted for in an enterprise fund because it operates much like a business. Like a restaurant, a school food service serves meals to members of the public and charges for them according to a set fee schedule.

<u>How does a school district publish financial information about itself</u>?

A school district issues annual financial statements. Users of the financial information reported thereby include the School Board, bond underwriters, taxpayers' groups, advocacy groups, and the general public.

How does all this relate to the Federal Cost Principles?

As noted above, a cost charged to a Federal program must be determined according to GAAP unless the Federal Cost Principles provide otherwise. For example, consider the treatment of capital expenditures in 2 CFR Part 225:

1. GAAP call for an accounting entity to record the full acquisition cost of a capital asset as an asset, and allocate the cost over the asset's service life through a process called depreciation. The portion of the asset's cost allocated to each year of operations is an operating expense (depreciation expense) of that year. Since the entity's operations benefit from the asset's use over a multi-year period, recording its entire cost as an operating expense of the year it was acquired (that is, "expensing" the cost) would be misleading. Appendix B, section 11 of 2 CFR Part 225 sets rules for charging depreciation expense to Federal programs.

2. Section 15.b. of Appendix B to 2 CFR Part 225 authorizes a program operator to depart from GAAP by expensing a capital asset's acquisition cost to a Federal program in the year of acquisition, **provided** the program operator has obtained its awarding agency's prior approval to do so. This section also specifies that expensed capital expenditures are unallowable as indirect costs; capital expenditures may be treated as indirect costs only through the medium of depreciation expense.

Appendix 6: OMB Circular A-87 (2 CFR Part 225)

SUBJECT: Cost Principles for State, Local, and Indian Tribal Governments

1. ***Purpose.*** This Circular establishes principles and standards for determining costs for Federal awards carried out through grants, cost reimbursement contracts, and other agreements with State and local governments and federally recognized Indian tribal governments (governmental units).

2. ***Authority.*** This Circular is issued under the authority of the Budget and Accounting Act of 1921, as amended; the Budget and Accounting Procedures Act of 1950, as amended; the Chief Financial Officers Act of 1990; Reorganization Plan No. 2 of 1970; and Executive Order No. 11541 ("Prescribing the Duties of the Office of Management and Budget and the Domestic Policy Council in the Executive Office of the President").

3. ***Background.*** As part of the governmentwide grant streamlining effort under P.L. 106-107, Federal Financial Award Management Improvement Act of 1999, OMB led an interagency workgroup to simplify and make consistent, to the extent feasible, the various rules used to award Federal grants. An interagency task force was established in 2001 to review existing cost principles for Federal awards to State, local, and Indian tribal governments; Colleges and Universities; and Non-Profit organizations. The task force studied Selected Items of Cost in each of the three cost principles to determine which items of costs could be stated consistently and/or more clearly. A proposed revised Circular reflecting the results of those efforts was issued on August 12, 2002 at 67 FR 52558. Extensive comments on the proposed revisions, discussions with interest groups, and related developments were considered in developing this revision.

4. ***Rescissions.*** This Circular rescinds and supersedes Circular A 87, as amended, issued May 4, 1995.

5. ***Policy.*** This Circular establishes principles and standards to provide a uniform approach for determining costs and to promote effective program delivery, efficiency, and better relationships between governmental units and the Federal Government. The principles are for determining allowable costs only. They are not intended to identify the circumstances or to dictate the extent of Federal and governmental unit participation in the financing of a particular Federal award. Provision for profit or other increment above cost is outside the scope of this Circular.

6. ***Definitions.*** Definitions of key terms used in this Circular are contained in Attachment A, Section B.

7. ***Required Action.*** Agencies responsible for administering programs that involve cost reimbursement contracts, grants, and other agreements with governmental units shall issue regulations to implement the provisions of this Circular and its Attachments.

8. ***OMB Responsibilities.*** The Office of Management and Budget (OMB) will review agency regulations and implementation of this Circular, and will provide policy interpretations and assistance to insure effective and efficient implementation. Any exceptions will be subject to approval by OMB. Exceptions will only be made in particular cases where adequate justification is presented.

9. ***Information Contact.*** Further information concerning this Circular may be obtained by contacting the Office of Federal Financial Management, Financial Standards and Reporting Branch, Office of Management and Budget, Washington, DC 20503, telephone 202 395 3993.

10. ***Policy Review Date.*** OMB Circular A 87 will have a policy review three years from the date of issuance.

- Except as otherwise provided herein, these rules are effective June 9, 2004.

Attachment A General Principles for Determining Allowable Costs
Attachment B Selected Items of Cost

Attachment A to A-87

GENERAL PRINCIPLES FOR DETERMINING ALLOWABLE COSTS

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A. ***Purpose and Scope***

1. Objectives. This Attachment establishes principles for determining the allowable costs incurred by State, local, and federally recognized Indian tribal governments (governmental units) under grants, cost reimbursement contracts, and other agreements with the Federal Government (collectively referred to in this Circular as "Federal awards"). The principles are for the purpose of cost determination and are not intended to identify the circumstances or dictate the extent of Federal or governmental unit participation in the financing of a particular program or project. The principles are designed to provide that Federal awards bear their fair share of cost recognized under these principles except where restricted or prohibited by law. Provision for profit or other increment above cost is outside the scope of this Circular.

2. Policy guides.

a. The application of these principles is based on the fundamental premises that:

(1) Governmental units are responsible for the efficient and effective administration of Federal awards through the application of sound management practices.

(2) Governmental units assume responsibility for administering Federal funds in a manner

consistent with underlying agreements, program objectives, and the terms and conditions of the Federal award.

(3) Each governmental unit, in recognition of its own unique combination of staff, facilities, and experience, will have the primary responsibility for employing whatever form of organization and management techniques may be necessary to assure proper and efficient administration of Federal awards.

b. Federal agencies should work with States or localities which wish to test alternative mechanisms for paying costs for administering Federal programs. The Office of Management and Budget (OMB) encourages Federal agencies to test fee for service alternatives as a replacement for current cost reimbursement payment methods in response to the National Performance Review's (NPR) recommendation. The NPR recommended the fee for service approach to reduce the burden associated with maintaining systems for charging administrative costs to Federal programs and preparing and approving cost allocation plans. This approach should also increase incentives for administrative efficiencies and improve outcomes.

3. Application.

a. These principles will be applied by all Federal agencies in determining costs incurred by governmental units under Federal awards (including subawards) except those with (1) publicly financed educational institutions subject to OMB Circular A 21, "Cost Principles for Educational Institutions," and (2) programs administered by publicly owned hospitals and other providers of medical care that are subject to requirements promulgated by the sponsoring Federal agencies. However, this Circular does apply to all central service and department/agency costs that are allocated or billed to those educational institutions, hospitals, and other providers of medical care or services by other State and local government departments and agencies.

b. All subawards are subject to those Federal cost principles applicable to the particular organization concerned. Thus, if a subaward is to a governmental unit (other than a college, university or hospital), this Circular shall apply; if a subaward is to a commercial organization, the cost principles applicable to commercial organizations shall apply; if a subaward is to a college or university, Circular A 21 shall apply; if a subaward is to a hospital, the cost principles used by the Federal awarding agency for awards to hospitals shall apply, subject to the provisions of subsection A.3.a. of this Attachment; if a subaward is to some other non profit organization, Circular A 122, "Cost Principles for Non Profit Organizations," shall apply.

c. These principles shall be used as a guide in the pricing of fixed price arrangements where costs are used in determining the appropriate price.

d. Where a Federal contract awarded to a governmental unit incorporates a Cost Accounting Standards (CAS) clause, the requirements of that clause shall apply. In such cases, the governmental unit and the cognizant Federal agency shall establish an appropriate advance agreement on how the governmental unit will comply with applicable CAS requirements when estimating, accumulating and reporting costs under CAS covered contracts. The agreement shall indicate that OMB Circular A 87 requirements will be applied to other Federal awards. In all

cases, only one set of records needs to be maintained by the governmental unit.

e. Conditional exemptions.

(1) OMB authorizes conditional exemption from OMB administrative requirements and cost principles circulars for certain Federal programs with statutorily authorized consolidated planning and consolidated administrative funding, that are identified by a Federal agency and approved by the head of the Executive department or establishment. A Federal agency shall consult with OMB during its consideration of whether to grant such an exemption.

(2) To promote efficiency in State and local program administration, when Federal non entitlement programs with common purposes have specific statutorily authorized consolidated planning and consolidated administrative funding and where most of the State agency's resources come from non Federal sources, Federal agencies may exempt these covered State administered, non entitlement grant programs from certain OMB grants management requirements. The exemptions would be from all but the allocability of costs provisions of OMB Circulars A 87 (Attachment A, subsection C.3), "Cost Principles for State, Local, and Indian Tribal Governments," A 21 (Section C, subpart 4), "Cost Principles for Educational Institutions," and A 122 (Attachment A, subsection A.4), "Cost Principles for Non Profit Organizations," and from all of the administrative requirements provisions of OMB Circular A 110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals, and Other Non Profit Organizations," and the agencies' grants management common rule.

(3) When a Federal agency provides this flexibility, as a prerequisite to a State's exercising this option, a State must adopt its own written fiscal and administrative requirements for expending and accounting for all funds, which are consistent with the provisions of OMB Circular A 87, and extend such policies to all subrecipients. These fiscal and administrative requirements must be sufficiently specific to ensure that: funds are used in compliance with all applicable Federal statutory and regulatory provisions, costs are reasonable and necessary for operating these programs, and funds are not be used for general expenses required to carry out other responsibilities of a State or its subrecipients.

B. ***Definitions***

1. "Approval or authorization of the awarding or cognizant Federal agency" means documentation evidencing consent prior to incurring a specific cost. If such costs are specifically identified in a Federal award document, approval of the document constitutes approval of the costs. If the costs are covered by a State/local wide cost allocation plan or an indirect cost proposal, approval of the plan constitutes the approval.

2. "Award" means grants, cost reimbursement contracts and other agreements between a State, local and Indian tribal government and the Federal Government.

3. "Awarding agency" means (a) with respect to a grant, cooperative agreement, or cost reimbursement contract, the Federal agency, and (b) with respect to a subaward, the party that awarded the subaward.

4. "Central service cost allocation plan" means the documentation identifying, accumulating, and allocating or developing billing rates based on the allowable costs of services provided by a governmental unit on a centralized basis to its departments and agencies. The costs of these services may be allocated or billed to users.

5. "Claim" means a written demand or written assertion by the governmental unit or grantor seeking, as a matter of right, the payment of money in a sum certain, the adjustment or interpretation of award terms, or other relief arising under or relating to the award. A voucher, invoice or other routine request for payment that is not a dispute when submitted is not a claim. Appeals, such as those filed by a governmental unit in response to questioned audit costs, are not considered claims until a final management decision is made by the Federal awarding agency.

6. "Cognizant agency" means the Federal agency responsible for reviewing, negotiating, and approving cost allocation plans or indirect cost proposals developed under this Circular on behalf of all Federal agencies. OMB publishes a listing of cognizant agencies.

7. "Common Rule" means the "Uniform Administrative Requirements for Grants and Cooperative Agreements to State and Local Governments; Final Rule" originally issued at 53 FR 8034 8103 (March 11, 1988). Other common rules will be referred to by their specific titles.

8. "Contract" means a mutually binding legal relationship obligating the seller to furnish the supplies or services (including construction) and the buyer to pay for them. It includes all types of commitments that obligate the government to an expenditure of appropriated funds and that, except as otherwise authorized, are in writing. In addition to bilateral instruments, contracts include (but are not limited to): awards and notices of awards; job orders or task orders issued under basic ordering agreements; letter contracts; orders, such as purchase orders, under which the contract becomes effective by written acceptance or performance; and, bilateral contract modifications. Contracts do not include grants and cooperative agreements covered by 31 U.S.C. 6301 et seq.

9. "Cost" means an amount as determined on a cash, accrual, or other basis acceptable to the Federal awarding or cognizant agency. It does not include transfers to a general or similar fund.

10. "Cost allocation plan" means central service cost allocation plan, public assistance cost allocation plan, and indirect cost rate proposal. Each of these terms are further defined in this section.

11. "Cost objective" means a function, organizational subdivision, contract, grant, or other activity for which cost data are needed and for which costs are incurred.

12. "Federally recognized Indian tribal government" means the governing body or a governmental agency of any Indian tribe, band, nation, or other organized group or community (including any native village as defined in Section 3 of the Alaska Native Claims Settlement Act, 85 Stat. 688) certified by the Secretary of the Interior as eligible for the special programs and services provided through the Bureau of Indian Affairs.

13. "Governmental unit" means the entire State, local, or federally recognized Indian tribal government, including any component thereof. Components of governmental units may function independently of the governmental unit in accordance with the term of the award.

14. "Grantee department or agency" means the component of a State, local, or federally recognized Indian tribal government which is responsible for the performance or administration of all or some part of a Federal award.

15. "Indirect cost rate proposal" means the documentation prepared by a governmental unit or component thereof to substantiate its request for the establishment of an indirect cost rate as described in Attachment E of this Circular.

16. "Local government" means a county, municipality, city, town, township, local public authority, school district, special district, intrastate district, council of governments (whether or not incorporated as a non profit corporation under State law), any other regional or interstate government entity, or any agency or instrumentality of a local government.

17. "Public assistance cost allocation plan" means a narrative description of the procedures that will be used in identifying, measuring and allocating all administrative costs to all of the programs administered or supervised by State public assistance agencies as described in Attachment D of this Circular.

18. "State" means any of the several States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, or any agency or instrumentality of a State exclusive of local governments.

C. ***Basic Guidelines***

1. Factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria:

a. Be necessary and reasonable for proper and efficient performance and administration of Federal awards.

b. Be allocable to Federal awards under the provisions of this Circular.

c. Be authorized or not prohibited under State or local laws or regulations.

d. Conform to any limitations or exclusions set forth in these principles, Federal laws, terms and conditions of the Federal award, or other governing regulations as to types or amounts of cost items.

e. Be consistent with policies, regulations, and procedures that apply uniformly to both Federal awards and other activities of the governmental unit.

f. Be accorded consistent treatment. A cost may not be assigned to a Federal award as a direct cost if any other cost incurred for the same purpose in like circumstances has been allocated to the Federal award as an indirect cost.

g. Except as otherwise provided for in this Circular, be determined in accordance with generally accepted accounting principles.

h. Not be included as a cost or used to meet cost sharing or matching requirements of any other Federal award in either the current or a prior period, except as specifically provided by Federal law or regulation.

i. Be the net of all applicable credits.

j. Be adequately documented.

2. Reasonable costs. A cost is reasonable if, in its nature and amount, it does not exceed that which would be incurred by a prudent person under the circumstances prevailing at the time the decision was made to incur the cost. The question of reasonableness is particularly important when governmental units or components are predominately federally funded. In determining reasonableness of a given cost, consideration shall be given to:

a. Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the governmental unit or the performance of the Federal award.

b. The restraints or requirements imposed by such factors as: sound business practices; arms length bargaining; Federal, State and other laws and regulations; and, terms and conditions of the Federal award.

c. Market prices for comparable goods or services.

d. Whether the individuals concerned acted with prudence in the circumstances considering their responsibilities to the governmental unit, its employees, the public at large, and the Federal Government.

e. Significant deviations from the established practices of the governmental unit which may unjustifiably increase the Federal award's cost.

3. Allocable costs.

a. A cost is allocable to a particular cost objective if the goods or services involved are chargeable or assignable to such cost objective in accordance with relative benefits received.

b. All activities which benefit from the governmental unit's indirect cost, including unallowable activities and services donated to the governmental unit by third parties, will receive an appropriate allocation of indirect costs.

c. Any cost allocable to a particular Federal award or cost objective under the principles provided for in this Circular may not be charged to other Federal awards to overcome fund deficiencies, to avoid restrictions imposed by law or terms of the Federal awards, or for other reasons.

d. Where an accumulation of indirect costs will ultimately result in charges to a Federal award, a cost allocation plan will be required as described in Attachments C, D, and E.

4. Applicable credits.

a. Applicable credits refer to those receipts or reduction of expenditure type transactions that offset or reduce expense items allocable to Federal awards as direct or indirect costs. Examples of such transactions are: purchase discounts, rebates or allowances, recoveries or indemnities on losses, insurance refunds or rebates, and adjustments of overpayments or erroneous charges. To the extent that such credits accruing to or received by the governmental unit relate to allowable costs, they shall be credited to the Federal award either as a cost reduction or cash refund, as appropriate.

b. In some instances, the amounts received from the Federal Government to finance activities or service operations of the governmental unit should be treated as applicable credits. Specifically, the concept of netting such credit items (including any amounts used to meet cost sharing or matching requirements) should be recognized in determining the rates or amounts to be charged to Federal awards. (See Attachment B, item 11, "Depreciation and use allowances," for areas of potential application in the matter of Federal financing of activities.)

D. ***Composition of Cost***

1. Total cost. The total cost of Federal awards is comprised of the allowable direct cost of the program, plus its allocable portion of allowable indirect costs, less applicable credits.

2. Classification of costs. There is no universal rule for classifying certain costs as either direct or indirect under every accounting system. A cost may be direct with respect to some specific service or function, but indirect with respect to the Federal award or other final cost objective. Therefore, it is essential that each item of cost be treated consistently in like circumstances either as a direct or an indirect cost. Guidelines for determining direct and indirect costs charged to Federal awards are provided in the sections that follow.

E. ***Direct Costs***

1. General. Direct costs are those that can be identified specifically with a particular final cost objective.

2. Application. Typical direct costs chargeable to Federal awards are:

a. Compensation of employees for the time devoted and identified specifically to the performance of those awards.

b. Cost of materials acquired, consumed, or expended specifically for the purpose of those awards.

c. Equipment and other approved capital expenditures.

d. Travel expenses incurred specifically to carry out the award.

3. Minor items. Any direct cost of a minor amount may be treated as an indirect cost for reasons of practicality where such accounting treatment for that item of cost is consistently applied to all cost objectives.

F. ***Indirect Costs***

1. General. Indirect costs are those: (a) incurred for a common or joint purpose benefiting more than one cost objective, and (b) not readily assignable to the cost objectives specifically benefitted, without effort disproportionate to the results achieved. The term "indirect costs," as used herein, applies to costs of this type originating in the grantee department, as well as those incurred by other departments in supplying goods, services, and facilities. To facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect costs within a governmental unit department or in other agencies providing services to a governmental unit department. Indirect cost pools should be distributed to benefitted cost objectives on bases that will produce an equitable result in consideration of relative benefits derived.

2. Cost allocation plans and indirect cost proposals. Requirements for development and submission of cost allocation plans and indirect cost rate proposals are contained in Attachments C, D, and E.

3. Limitation on indirect or administrative costs.

a. In addition to restrictions contained in this Circular, there may be laws that further limit the amount of administrative or indirect cost allowed.

b. Amounts not recoverable as indirect costs or administrative costs under one Federal award may not be shifted to another Federal award, unless specifically authorized by Federal legislation or regulation.

G. ***Interagency Services.*** The cost of services provided by one agency to another within the governmental unit may include allowable direct costs of the service plus a pro rate share of indirect costs. A standard indirect cost allowance equal to ten percent of the direct salary and wage cost of providing the service (excluding overtime, shift premiums, and fringe benefits) may be used in lieu of determining the actual indirect costs of the service. These services do not include centralized services included in central service cost allocation plans as described in Attachment C.

H. ***Required Certifications.*** Each cost allocation plan or indirect cost rate proposal required by Attachments C and E must comply with the following:

1. No proposal to establish a cost allocation plan or an indirect cost rate, whether submitted to a Federal cognizant agency or maintained on file by the governmental unit, shall be acceptable unless such costs have been certified by the governmental unit using the Certificate of Cost Allocation Plan or Certificate of Indirect Costs as set forth in Attachments C and E. The certificate must be signed on behalf of the governmental unit by an individual at a level no lower than chief financial officer of the governmental unit that submits the proposal or component covered by the proposal.

2. No cost allocation plan or indirect cost rate shall be approved by the Federal Government unless the plan or rate proposal has been certified. Where it is necessary to establish a cost allocation plan or an indirect cost rate and the governmental unit has not submitted a certified proposal for establishing such a plan or rate in accordance with the requirements, the Federal Government may either disallow all indirect costs or unilaterally establish such a plan or rate. Such a plan or rate may be based upon audited historical data or such other data that have been furnished to the cognizant Federal agency and for which it can be demonstrated that all unallowable costs have been excluded. When a cost allocation plan or indirect cost rate is unilaterally established by the Federal Government because of failure of the governmental unit to submit a certified proposal, the plan or rate established will be set to ensure that potentially unallowable costs will not be reimbursed.

Attachment B of A-87

SELECTED ITEMS OF COST

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13. Employee morale, health, and welfare costs
14. Entertainment costs
15. Equipment and other capital expenditures
16. Fines and penalties
17. Fund raising and investment management costs
18. Gains and losses on disposition of depreciable property and other capital assets and substantial relocation of Federal programs
19. General government expenses
20. Goods or services for personal use
21. Idle facilities and idle capacity
22. Insurance and indemnification
23. Interest
24. Lobbying
25. Maintenance, operations, and repairs
26. Materials and supplies costs
27. Meetings and conferences
28. Memberships, subscriptions, and professional activity costs
29. Patent costs
30. Plant and homeland security costs
31. Pre award costs
32. Professional service costs
33. Proposal costs
34. Publication and printing costs
35. Rearrangement and alteration costs
36. Reconversion costs
37. Rental costs of building and equipment
38. Royalties and other costs for the use of patents
39. Selling and marketing

40. Taxes
41. Termination costs applicable to sponsored agreements
42. Training costs
43. Travel costs

Sections 1 through 43 provide principles to be applied in establishing the allowability or unallowability of certain items of cost. These principles apply whether a cost is treated as direct or indirect. A cost is allowable for Federal reimbursement only to the extent of benefits received by Federal awards and its conformance with the general policies and principles stated in Attachment A to this Circular. Failure to mention a particular item of cost in these sections is not intended to imply that it is either allowable or unallowable; rather, determination of allowability in each case should be based on the treatment or standards provided for similar or related items of cost.

1. ***Advertising and public relations costs.***

a. The term advertising costs means the costs of advertising media and corollary administrative costs.

   Advertising media include magazines, newspapers, radio and television, direct mail, exhibits, electronic or computer transmittals, and the like.

b. The term public relations includes community relations and means those activities dedicated to maintaining the image of the governmental unit or maintaining or promoting understanding and favorable relations with the community or public at large or any segment of the public.

c. The only allowable advertising costs are those which are solely for:

   (1) The recruitment of personnel required for the performance by the governmental unit of obligations arising under a Federal award ;

   (2) The procurement of goods and services for the performance of a Federal award;

   (3) The disposal of scrap or surplus materials acquired in the performance of a Federal award except when governmental units are reimbursed for disposal costs at a predetermined amount; or

   (4) Other specific purposes necessary to meet the requirements of the Federal award.

d. The only allowable public relations costs are:

   (1) Costs specifically required by the Federal award;

   (2) Costs of communicating with the public and press pertaining to specific activities or accomplishments which result from performance of Federal awards (these costs are considered necessary as part of the outreach effort for the Federal award); or

   (3) Costs of conducting general liaison with news media and government public relations

officers, to the extent that such activities are limited to communication and liaison necessary keep the public informed on matters of public concern, such as notices of Federal contract/grant awards, financial matters, etc.

e. Costs identified in subsections c and d if incurred for more than one Federal award or for both sponsored work and other work of the governmental unit, are allowable to the extent that the principles in Attachment A, sections E. ("Direct Costs") and F. ("Indirect Costs") are observed.

f. Unallowable advertising and public relations costs include the following:

(1) All advertising and public relations costs other than as specified in subsections c, d, and e;

(2) Costs of meetings, conventions, convocations, or other events related to other activities of the governmental unit, including:

(a) Costs of displays, demonstrations, and exhibits;

(b) Costs of meeting rooms, hospitality suites, and other special facilities used in conjunction with shows and other special events; and

(c) Salaries and wages of employees engaged in setting up and displaying exhibits, making demonstrations, and providing briefings;

(3) Costs of promotional items and memorabilia, including models, gifts, and souvenirs;

(4) Costs of advertising and public relations designed solely to promote the governmental unit.

2. ***Advisory councils.*** Costs incurred by advisory councils or committees are allowable as a direct cost where authorized by the Federal awarding agency or as an indirect cost where allocable to Federal awards.

3. ***Alcoholic beverages.*** Costs of alcoholic beverages are unallowable.

4. ***Audit costs and related services.***

a. The costs of audits required by, and performed in accordance with, the Single Audit Act, as implemented by Circular A-133, "Audits of States, Local Governments, and Non-Profit Organizations" are allowable. Also see 31 USC 7505(b) and section 230 ("Audit Costs") of Circular A-133.

b. Other audit costs are allowable if included in a cost allocation plan or indirect cost proposal, or if specifically approved by the awarding agency as a direct cost to an award.

c. The cost of agreed-upon procedures engagements to monitor subrecipients who are exempted from A-133 under section 200(d) are allowable, subject to the conditions listed in A-133, section 230 (b)(2).

5. ***Bad debts.*** Bad debts, including losses (whether actual or estimated) arising from uncollectable accounts and other claims, related collection costs, and related legal costs, are unallowable.

6. ***Bonding costs.***

a. Bonding costs arise when the Federal Government requires assurance against financial loss to itself or others by reason of the act or default of the governmental unit. They arise also in instances where the governmental unit requires similar assurance. Included are such bonds as bid, performance, payment, advance payment, infringement, and fidelity bonds.

b. Costs of bonding required pursuant to the terms of the award are allowable.

c. Costs of bonding required by the governmental unit in the general conduct of its operations are allowable to the extent that such bonding is in accordance with sound business practice and the rates and premiums are reasonable under the circumstances.

7. ***Communication costs.*** Costs incurred for telephone services, local and long distance telephone calls, telegrams, postage, messenger, electronic or computer transmittal services and the like are allowable.

8. ***Compensation for personal services.***

a. General. Compensation for personnel services includes all remuneration, paid currently or accrued, for services rendered during the period of performance under Federal awards, including but not necessarily limited to wages, salaries, and fringe benefits. The costs of such compensation are allowable to the extent that they satisfy the specific requirements of this Circular, and that the total compensation for individual employees:

(1) Is reasonable for the services rendered and conforms to the established policy of the governmental unit consistently applied to both Federal and non Federal activities;

(2) Follows an appointment made in accordance with a governmental unit's laws and rules and meets merit system or other requirements required by Federal law, where applicable; and

(3) Is determined and supported as provided in subsection h.

b. Reasonableness. Compensation for employees engaged in work on Federal awards will be considered reasonable to the extent that it is consistent with that paid for similar work in other activities of the governmental unit. In cases where the kinds of employees required for Federal awards are not found in the other activities of the governmental unit, compensation will be considered reasonable to the extent that it is comparable to that paid for similar work in the labor market in which the employing government competes for the kind of employees involved. Compensation surveys providing data representative of the labor market involved will be an

acceptable basis for evaluating reasonableness.

c. Unallowable costs. Costs which are unallowable under other sections of these principles shall not be allowable under this section solely on the basis that they constitute personnel compensation.

d. Fringe benefits.

(1) Fringe benefits are allowances and services provided by employers to their employees as compensation in addition to regular salaries and wages. Fringe benefits include, but are not limited to, the costs of leave, employee insurance, pensions, and unemployment benefit plans. Except as provided elsewhere in these principles, the costs of fringe benefits are allowable to the extent that the benefits are reasonable and are required by law, governmental unit employee agreement, or an established policy of the governmental unit.

(2) The cost of fringe benefits in the form of regular compensation paid to employees during periods of authorized absences from the job, such as for annual leave, sick leave, holidays, court leave, military leave, and other similar benefits, are allowable if: (a) they are provided under established written leave policies; (b) the costs are equitably allocated to all related activities, including Federal awards; and, (c) the accounting basis (cash or accrual) selected for costing each type of leave is consistently followed by the governmental unit.

(3) When a governmental unit uses the cash basis of accounting, the cost of leave is recognized in the period that the leave is taken and paid for. Payments for unused leave when an employee retires or terminates employment are allowable in the year of payment provided they are allocated as a general administrative expense to all activities of the governmental unit or component.

(4) The accrual basis may be only used for those types of leave for which a liability as defined by Generally Accepted Accounting Principles (GAAP) exists when the leave is earned. When a governmental unit uses the accrual basis of accounting, in accordance with GAAP, allowable leave costs are the lesser of the amount accrued or funded.

(5) The cost of fringe benefits in the form of employer contributions or expenses for social security; employee life, health, unemployment, and worker's compensation insurance (except as indicated in section 22, Insurance and indemnification); pension plan costs (see subsection e.); and other similar benefits are allowable, provided such benefits are granted under established written policies. Such benefits, whether treated as indirect costs or as direct costs, shall be allocated to Federal awards and all other activities in a manner consistent with the pattern of benefits attributable to the individuals or group(s) of employees whose salaries and wages are chargeable to such Federal awards and other activities.

e. Pension plan costs. Pension plan costs may be computed using a pay as you go method or an acceptable actuarial cost method in accordance with established written policies of the governmental unit.

(1) For pension plans financed on a pay as you go method, allowable costs will be limited to those representing actual payments to retirees or their beneficiaries.

(2) Pension costs calculated using an actuarial cost based method recognized by GAAP are allowable for a given fiscal year if they are funded for that year within six months after the end of that year. Costs funded after the six month period (or a later period agreed to by the cognizant agency) are allowable in the year funded. The cognizant agency may agree to an extension of the six month period if an appropriate adjustment is made to compensate for the timing of the charges to the Federal Government and related Federal reimbursement and the governmental unit's contribution to the pension fund. Adjustments may be made by cash refund or other equitable procedures to compensate the Federal Government for the time value of Federal reimbursements in excess of contributions to the pension fund.

(3) Amounts funded by the governmental unit in excess of the actuarially determined amount for a fiscal year may be used as the governmental unit's contribution in future periods.

(4) When a governmental unit converts to an acceptable actuarial cost method, as defined by GAAP, and funds pension costs in accordance with this method, the unfunded liability at the time of conversion shall be allowable if amortized over a period of years in accordance with GAAP.

(5) The Federal Government shall receive an equitable share of any previously allowed pension costs (including earnings thereon) which revert or inure to the governmental unit in the form of a refund, withdrawal, or other credit.

f. Post retirement health benefits. Post retirement health benefits (PRHB) refers to costs of health insurance or health services not included in a pension plan covered by subsection e. for retirees and their spouses, dependents, and survivors. PRHB costs may be computed using a pay as you go method or an acceptable actuarial cost method in accordance with established written polices of the governmental unit.

(1) For PRHB financed on a pay as you go method, allowable costs will be limited to those representing actual payments to retirees or their beneficiaries.

(2) PRHB costs calculated using an actuarial cost method recognized by GAAP are allowable if they are funded for that year within six months after the end of that year. Costs funded after the six month period (or a later period agreed to by the cognizant agency) are allowable in the year funded. The cognizant agency may agree to an extension of the six month period if an appropriate adjustment is made to compensate for the timing of the charges to the Federal Government and related Federal reimbursements and the governmental unit's contributions to the PRHB fund. Adjustments may be made by cash refund, reduction in current year's PRHB costs, or other equitable procedures to compensate the Federal Government for the time value of Federal reimbursements in excess of contributions to the PRHB fund.

(3) Amounts funded in excess of the actuarially determined amount for a fiscal year may be used as the government's contribution in a future period.

(4) When a governmental unit converts to an acceptable actuarial cost method and funds PRHB costs in accordance with this method, the initial unfunded liability attributable to prior years shall be allowable if amortized over a period of years in accordance with GAAP, or, if no such

GAAP period exists, over a period negotiated with the cognizant agency.

(5) To be allowable in the current year, the PRHB costs must be paid either to:

(a) An insurer or other benefit provider as current year costs or premiums, or

(b) An insurer or trustee to maintain a trust fund or reserve for the sole purpose of providing post retirement benefits to retirees and other beneficiaries.

(6) The Federal Government shall receive an equitable share of any amounts of previously allowed post retirement benefit costs (including earnings thereon) which revert or inure to the governmental unit in the form of a refund, withdrawal, or other credit.

g. Severance pay.

(1) Payments in addition to regular salaries and wages made to workers whose employment is being terminated are allowable to the extent that, in each case, they are required by (a) law, (b) employer employee agreement, or (c) established written policy.

(2) Severance payments (but not accruals) associated with normal turnover are allowable. Such payments shall be allocated to all activities of the governmental unit as an indirect cost.

(3) Abnormal or mass severance pay will be considered on a case by case basis and is allowable only if approved by the cognizant Federal agency.

h. Support of salaries and wages. These standards regarding time distribution are in addition to the standards for payroll documentation.

(1) Charges to Federal awards for salaries and wages, whether treated as direct or indirect costs, will be based on payrolls documented in accordance with generally accepted practice of the governmental unit and approved by a responsible official(s) of the governmental unit.

(2) No further documentation is required for the salaries and wages of employees who work in a single indirect cost activity.

(3) Where employees are expected to work solely on a single Federal award or cost objective, charges for their salaries and wages will be supported by periodic certifications that the employees worked solely on that program for the period covered by the certification. These certifications will be prepared at least semi annually and will be signed by the employee or supervisory official having first hand knowledge of the work performed by the employee.

(4) Where employees work on multiple activities or cost objectives, a distribution of their salaries or wages will be supported by personnel activity reports or equivalent documentation which meets the standards in subsection (5) unless a statistical sampling system (see subsection

(6)) or other substitute system has been approved by the cognizant Federal agency. Such documentary support will be required where employees work on:

(a) More than one Federal award,

(b) A Federal award and a non Federal award,

(c) An indirect cost activity and a direct cost activity,

(d) Two or more indirect activities which are allocated using different allocation bases, or

(e) An unallowable activity and a direct or indirect cost activity.

(5) Personnel activity reports or equivalent documentation must meet the following standards:

(a) They must reflect an after the fact distribution of the actual activity of each employee,

(b) They must account for the total activity for which each employee is compensated,

(c) They must be prepared at least monthly and must coincide with one or more pay periods, and

(d) They must be signed by the employee.

(e) Budget estimates or other distribution percentages determined before the services are performed do not qualify as support for charges to Federal awards but may be used for interim accounting purposes, provided that:

(i) The governmental unit's system for establishing the estimates produces reasonable approximations of the activity actually performed;

(ii) At least quarterly, comparisons of actual costs to budgeted distributions based on the monthly activity reports are made. Costs charged to Federal awards to reflect adjustments made as a result of the activity actually performed may be recorded annually if the quarterly comparisons show the differences between budgeted and actual costs are less than ten percent; and

(iii) The budget estimates or other distribution percentages are revised at least quarterly, if necessary, to reflect changed circumstances.

(6) Substitute systems for allocating salaries and wages to Federal awards may be used in place of activity reports. These systems are subject to approval if required by the cognizant agency. Such systems may include, but are not limited to, random moment sampling, case counts, or other quantifiable measures of employee effort.

(a) Substitute systems which use sampling methods (primarily for Temporary Assistance to Needy Families (TANF), Medicaid, and other public assistance programs) must meet acceptable statistical sampling standards including:

(i) The sampling universe must include all of the employees whose salaries and wages are to be allocated based on sample results except as provided in subsection (c);

(ii) The entire time period involved must be covered by the sample; and

(iii) The results must be statistically valid and applied to the period being sampled.

(b) Allocating charges for the sampled employees' supervisors, clerical and support staffs, based on the results of the sampled employees, will be acceptable.

(c) Less than full compliance with the statistical sampling standards noted in subsection (a) may be accepted by the cognizant agency if it concludes that the amounts to be allocated to Federal awards will be minimal, or if it concludes that the system proposed by the governmental unit will result in lower costs to Federal awards than a system which complies with the standards.
(7) Salaries and wages of employees used in meeting cost sharing or matching requirements of Federal awards must be supported in the same manner as those claimed as allowable costs under Federal awards.

i. Donated services.

(1) Donated or volunteer services may be furnished to a governmental unit by professional and technical personnel, consultants, and other skilled and unskilled labor. The value of these services is not reimbursable either as a direct or indirect cost. However, the value of donated services may be used to meet cost sharing or matching requirements in accordance with the provisions of the Common Rule.

(2) The value of donated services utilized in the performance of a direct cost activity shall, when material in amount, be considered in the determination of the governmental unit's indirect costs or rate(s) and, accordingly, shall be allocated a proportionate share of applicable indirect costs.

(3) To the extent feasible, donated services will be supported by the same methods used by the governmental unit to support the allocability of regular personnel services.

9. ***Contingency provisions.*** Contributions to a contingency reserve or any similar provision made for events the occurrence of which cannot be foretold with certainty as to time, intensity, or with an assurance of their happening, are unallowable. The term "contingency reserve" excludes self-insurance reserves (see Attachment B, section 22.c.), pension plan reserves (see Attachment B, section 8.e.), and post-retirement health and other benefit reserves (see Attachment B, section 8.f.) computed using acceptable actuarial cost methods.

10. ***Defense and prosecution of criminal and civil proceedings, and claims.***

a. The following costs are unallowable for contracts covered by 10 U.S.C. 2324(k), "Allowable costs under defense contracts."

   (1) Costs incurred in defense of any civil or criminal fraud proceeding or similar proceeding (including filing of false certification brought by the United States where the contractor is found liable or has pleaded nolo contendere to a charge of fraud or similar proceeding (including filing of a false certification).

   (2) Costs incurred by a contractor in connection with any criminal, civil or administrative proceedings commenced by the United States or a State to the extent provided in 10 U.S.C. 2324(k).

b. Legal expenses required in the administration of Federal programs are allowable. Legal expenses for prosecution of claims against the Federal Government are unallowable.

11. ***Depreciation and use allowances.***

a. Depreciation and use allowances are means of allocating the cost of fixed assets to periods benefiting from asset use. Compensation for the use of fixed assets on hand may be made through depreciation or use allowances. A combination of the two methods may not be used in connection with a single class of fixed assets (e.g., buildings, office equipment, computer equipment, etc.) except as provided for in subsection g. Except for enterprise funds and internal service funds that are included as part of a State/local cost allocation plan, classes of assets shall be determined on the same basis used for the government-wide financial statements.

b. The computation of depreciation or use allowances shall be based on the acquisition cost of the assets involved. Where actual cost records have not been maintained, a reasonable estimate of the original acquisition cost may be used. The value of an asset donated to the governmental unit by an unrelated third party shall be its fair market value at the time of donation. Governmental or quasi-governmental organizations located within the same State shall not be considered unrelated third parties for this purpose.

c. The computation of depreciation or use allowances will exclude:

   (1) The cost of land;

   (2) Any portion of the cost of buildings and equipment borne by or donated by the Federal

Government irrespective of where title was originally vested or where it presently resides; and

(3) Any portion of the cost of buildings and equipment contributed by or for the governmental unit, or a related donor organization, in satisfaction of a matching requirement.

d. Where the depreciation method is followed, the period of useful service (useful life) established in each case for usable capital assets must take into consideration such factors as type of construction, nature of the equipment used, historical usage patterns, technological developments, and the renewal and replacement policies of the governmental unit followed for the individual items or classes of assets involved. In the absence of clear evidence indicating that the expected consumption of the asset will be significantly greater in the early portions than in the later portions of its useful life, the straight line method of depreciation shall be used.

   Depreciation methods once used shall not be changed unless approved by the Federal cognizant or awarding agency. When the depreciation method is introduced for application to an asset previously subject to a use allowance, the annual depreciation charge thereon may not exceed the amount that would have resulted had the depreciation method been in effect from the date of acquisition of the asset. The combination of use allowances and depreciation applicable to the asset shall not exceed the total acquisition cost of the asset or fair market value at time of donation.

e. When the depreciation method is used for buildings, a building's shell may be segregated from the major component of the building (e.g., plumbing system, heating, and air conditioning system, etc.) and each major component depreciated over its estimated useful life, or the entire building (i.e., the shell and all components) may be treated as a single asset and depreciated over a single useful life.

f. Where the use allowance method is followed, the use allowance for buildings and improvements (including land improvements, such as paved parking areas, fences, and sidewalks) will be computed at an annual rate not exceeding two percent of acquisition costs. The use allowance for equipment will be computed at an annual rate not exceeding 6 2/3 percent of acquisition cost. When the use allowance method is used for buildings, the entire building must be treated as a single asset; the building's components (e.g., plumbing system, heating and air condition, etc.) cannot be segregated from the building's shell.

   The two percent limitation, however, need not be applied to equipment which is merely attached or fastened to the building but not permanently fixed to it and which is used as furnishings or decorations or for specialized purposes (e.g., dentist chairs and dental treatment units, counters, laboratory benches bolted to the floor, dishwashers, modular furniture, carpeting, etc.). Such equipment will be considered as not being permanently fixed to the building if it can be removed without the destruction of, or need for costly or extensive alterations or repairs, to the building or the equipment. Equipment that meets these criteria will be subject to the 6 2/3 percent equipment use allowance limitation.

g. A reasonable use allowance may be negotiated for any assets that are considered to be fully depreciated, after taking into consideration the amount of depreciation previously charged to the government, the estimated useful life remaining at the time of negotiation, the effect of any increased maintenance charges, decreased efficiency due to age, and any other factors

pertinent to the utilization of the asset for the purpose contemplated.

h. Charges for use allowances or depreciation must be supported by adequate property records. Physical inventories must be taken at least once every two years (a statistical sampling approach is acceptable) to ensure that assets exist, and are in use. Governmental units will manage equipment in accordance with State laws and procedures. When the depreciation method is followed, depreciation records indicating the amount of depreciation taken each period must also be maintained.

12. ***Donations and contributions.***

a. Contributions or donations rendered. Contributions or donations, including cash, property, and services, made by the governmental unit, regardless of the recipient, are unallowable.

b. Donated services received:

(1) Donated or volunteer services may be furnished to a governmental unit by professional and technical personnel, consultants, and other skilled and unskilled labor. The value of these services is not reimbursable either as a direct or indirect cost. However, the value of donated services may be used to meet cost sharing or matching requirements in accordance with the Federal Grants Management Common Rule.

(2) The value of donated services utilized in the performance of a direct cost activity shall, when material in amount, be considered in the determination of the governmental unit's indirect costs or rate(s) and, accordingly, shall be allocated a proportionate share of applicable indirect costs.

(3) To the extent feasible, donated services will be supported by the same methods used by the governmental unit to support the allocability of regular personnel services.

13. ***Employee morale, health, and welfare costs.***

a. The costs of employee information publications, health or first-aid clinics and/or infirmaries, recreational activities, employee counseling services, and any other expenses incurred in accordance with the governmental unit's established practice or custom for the improvement of working conditions, employer-employee relations, employee morale, and employee performance are allowable.

b. Such costs will be equitably apportioned to all activities of the governmental unit. Income generated from any of these activities will be offset against expenses.

14. ***Entertainment.*** Costs of entertainment, including amusement, diversion, and social activities and any costs directly associated with such costs (such as tickets to shows or sports events, meals, lodging, rentals, transportation, and gratuities) are unallowable.

15. ***Equipment and other capital expenditures.***

a. For purposes of this subsection 15, the following definitions apply:

(1) "Capital Expenditures" means expenditures for the acquisition cost of capital assets (equipment, buildings, land), or expenditures to make improvements to capital assets that materially increase their value or useful life. Acquisition cost means the cost of the asset including the cost to put it in place. Acquisition cost for equipment, for example, means the net invoice price of the equipment, including the cost of any modifications, attachments, accessories, or auxiliary apparatus necessary to make it usable for the purpose for which it is acquired. Ancillary charges, such as taxes, duty, protective in transit insurance, freight, and installation may be included in, or excluded from the acquisition cost in accordance with the governmental unit's regular accounting practices.

(2) "Equipment" means an article of nonexpendable, tangible personal property having a useful life of more than one year and an acquisition cost which equals or exceeds the lesser of the capitalization level established by the governmental unit for financial statement purposes, or $5000.

(3) "Special purpose equipment" means equipment which is used only for research, medical, scientific, or other technical activities. Examples of special purpose equipment include microscopes, x-ray machines, surgical instruments, and spectrometers.

(4) "General purpose equipment" means equipment, which is not limited to research, medical, scientific or other technical activities. Examples include office equipment and furnishings, modular offices, telephone networks, information technology equipment and systems, air conditioning equipment, reproduction and printing equipment, and motor vehicles.

b. The following rules of allowability shall apply to equipment and other capital expenditures:

(1) Capital expenditures for general purpose equipment, buildings, and land are unallowable as direct charges, except where approved in advance by the awarding agency.

(2) Capital expenditures for special purpose equipment are allowable as direct costs, provided that items with a unit cost of $5000 or more have the prior approval of the awarding agency.

(3) Capital expenditures for improvements to land, buildings, or equipment which materially increase their value or useful life are unallowable as a direct cost except with the prior approval of the awarding agency.

(4) When approved as a direct charge pursuant to Attachment B, section 15.b (1), (2), and (3) above, capital expenditures will be charged in the period in which the expenditure is incurred, or as otherwise determined appropriate and negotiated with the awarding agency. In addition, Federal awarding agencies are authorized at their option to waive or delegate the prior approval requirement.

(5) Equipment and other capital expenditures are unallowable as indirect costs. However, see section 11, Depreciation and use allowance, for rules on the allowability of use allowances or

depreciation on buildings, capital improvements, and equipment. Also, see section 37, Rental costs, concerning the allowability of rental costs for land, buildings, and equipment.

(6) The unamortized portion of any equipment written off as a result of a change in capitalization levels may be recovered by continuing to claim the otherwise allowable use allowances or depreciation on the equipment, or by amortizing the amount to be written off over a period of years negotiated with the cognizant agency.

(7) When replacing equipment purchased in whole or in part with Federal funds, the governmental unit may use the equipment to be replaced as a trade-in or sell the property and use the proceeds to offset the cost of the replacement property.

16. ***Fines and penalties.*** Fines, penalties, damages, and other settlements resulting from violations (or alleged violations) of, or failure of the governmental unit to comply with, Federal, State, local, or Indian tribal laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the Federal award or written instructions by the awarding agency authorizing in advance such payments.

17. ***Fund raising and investment management costs.***

a. Costs of organized fund raising, including financial campaigns, solicitation of gifts and bequests, and similar expenses incurred to raise capital or obtain contributions are unallowable, regardless of the purpose for which the funds will be used.

b. Costs of investment counsel and staff and similar expenses incurred to enhance income from investments are unallowable. However, such costs associated with investments covering pension, self insurance, or other funds which include Federal participation allowed by this Circular are allowable.

c. Fund raising and investment activities shall be allocated an appropriate share of indirect costs under the conditions described in subsection C.3.b. of Attachment A.

18. ***Gains and losses on disposition of depreciable property and other capital assets and substantial relocation of Federal programs.***

a. (1) Gains and losses on the sale, retirement, or other disposition of depreciable property shall be included in the year in which they occur as credits or charges to the asset cost grouping(s) in which the property was included. The amount of the gain or loss to be included as a credit or charge to the appropriate asset cost grouping(s) shall be the difference between the amount realized on the property and the undepreciated basis of the property.

(2) Gains and losses on the disposition of depreciable property shall not be recognized as a separate credit or charge under the following conditions:

(a) The gain or loss is processed through a depreciation account and is reflected in the depreciation allowable under sections 11 and 15.

(b) The property is given in exchange as part of the purchase price of a similar item and the gain or loss is taken into account in determining the depreciation cost basis of the new item.

(c) A loss results from the failure to maintain permissible insurance, except as otherwise provided in subsection 22.d.

(d) Compensation for the use of the property was provided through use allowances in lieu of depreciation.

b. Substantial relocation of Federal awards from a facility where the Federal Government participated in the financing to another facility prior to the expiration of the useful life of the financed facility requires Federal agency approval. The extent of the relocation, the amount of the Federal participation in the financing, and the depreciation charged to date may require negotiation of space charges for Federal awards.

c. Gains or losses of any nature arising from the sale or exchange of property other than the property covered in subsection a., e.g., land or included in the fair market value used in any adjustment resulting from a relocation of Federal awards covered in subsection b. shall be excluded in computing Federal award costs.

19. ***General government expenses.***

a. The general costs of government are unallowable (except as provided in Attachment B, section 43, Travel costs). These include:

(1) Salaries and expenses of the Office of the Governor of a State or the chief executive of a political subdivision or the chief executive of federally recognized Indian tribal government;

(2) Salaries and other expenses of a State legislature, tribal council, or similar local governmental body, such as a county supervisor, city council, school board, etc., whether incurred for purposes of legislation or executive direction;

(3) Costs of the judiciary branch of a government;

(4) Costs of prosecutorial activities unless treated as a direct cost to a specific program if authorized by program statute or regulation (however, this does not preclude the allowability of other legal activities of the Attorney General); and

(5) Costs of other general types of government services normally provided to the general public, such as fire and police, unless provided for as a direct cost under a program statute or

regulation.

b. For federally recognized Indian tribal governments and Councils Of Governments (COGs), the portion of salaries and expenses directly attributable to managing and operating Federal programs by the chief executive and his staff is allowable.

20. ***Goods or services for personal use.*** Costs of goods or services for personal use of the governmental unit's employees are unallowable regardless of whether the cost is reported as taxable income to the employees.

21. ***Idle facilities and idle capacity.***

a. As used in this section the following terms have the meanings set forth below:

(1) "Facilities" means land and buildings or any portion thereof, equipment individually or collectively, or any other tangible capital asset, wherever located, and whether owned or leased by the governmental unit.

(2) "Idle facilities" means completely unused facilities that are excess to the governmental unit's current needs.

(3) "Idle capacity" means the unused capacity of partially used facilities. It is the difference between: (a) that which a facility could achieve under 100 percent operating time on a one-shift basis less operating interruptions resulting from time lost for repairs, setups, unsatisfactory materials, and other normal delays; and (b) the extent to which the facility was actually used to meet demands during the accounting period. A multi-shift basis should be used if it can be shown that this amount of usage would normally be expected for the type of facility involved.

(4) "Cost of idle facilities or idle capacity" means costs such as maintenance, repair, housing, rent, and other related costs, e.g., insurance, interest, property taxes and depreciation or use allowances.

b. The costs of idle facilities are unallowable except to the extent that:

(1) They are necessary to meet fluctuations in workload; or

(2) Although not necessary to meet fluctuations in workload, they were necessary when acquired and are now idle because of changes in program requirements, efforts to achieve more economical operations, reorganization, termination, or other causes which could not have been reasonably foreseen. Under the exception stated in this subsection, costs of idle facilities are allowable for a reasonable period of time, ordinarily not to exceed one year, depending on the initiative taken to use, lease, or dispose of such facilities.

c. The costs of idle capacity are normal costs of doing business and are a factor in the normal fluctuations of usage or indirect cost rates from period to period. Such costs are allowable, provided that the capacity is reasonably anticipated to be necessary or was originally reasonable and is not subject to reduction or elimination by use on other Federal awards, subletting,

renting, or sale, in accordance with sound business, economic, or security practices. Widespread idle capacity throughout an entire facility or among a group of assets having substantially the same function may be considered idle facilities.

22. ***Insurance and indemnification.***

a. Costs of insurance required or approved and maintained, pursuant to the Federal award, are allowable.

b. Costs of other insurance in connection with the general conduct of activities are allowable subject to the following limitations:

(1) Types and extent and cost of coverage are in accordance with the governmental unit's policy and sound business practice.

(2) Costs of insurance or of contributions to any reserve covering the risk of loss of, or damage to, Federal Government property are unallowable except to the extent that the awarding agency has specifically required or approved such costs.

c. Actual losses which could have been covered by permissible insurance (through a self insurance program or otherwise) are unallowable, unless expressly provided for in the Federal award or as described below. However, the Federal Government will participate in actual losses of a self insurance fund that are in excess of reserves. Costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound management practice, and minor losses not covered by insurance, such as spoilage, breakage, and disappearance of small hand tools, which occur in the ordinary course of operations, are allowable.

d. Contributions to a reserve for certain self insurance programs including workers compensation, unemployment compensation, and severance pay are allowable subject to the following provisions:

(1) The type of coverage and the extent of coverage and the rates and premiums would have been allowed had insurance (including reinsurance) been purchased to cover the risks. However, provision for known or reasonably estimated self insured liabilities, which do not become payable for more than one year after the provision is made, shall not exceed the discounted present value of the liability. The rate used for discounting the liability must be determined by giving consideration to such factors as the governmental unit's settlement rate for those liabilities and its investment rate of return.

(2) Earnings or investment income on reserves must be credited to those reserves.

(3) Contributions to reserves must be based on sound actuarial principles using historical experience and reasonable assumptions. Reserve levels must be analyzed and updated at least biennially for each major risk being insured and take into account any reinsurance, coinsurance, etc. Reserve levels related to employee related coverages will normally be limited to the value of claims (a) submitted and adjudicated but not paid, (b) submitted but not adjudicated, and (c)

incurred but not submitted. Reserve levels in excess of the amounts based on the above must be identified and justified in the cost allocation plan or indirect cost rate proposal.

(4) Accounting records, actuarial studies, and cost allocations (or billings) must recognize any significant differences due to types of insured risk and losses generated by the various insured activities or agencies of the governmental unit. If individual departments or agencies of the governmental unit experience significantly different levels of claims for a particular risk, those differences are to be recognized by the use of separate allocations or other techniques resulting in an equitable allocation.

(5) Whenever funds are transferred from a self insurance reserve to other accounts (e.g., general fund), refunds shall be made to the Federal Government for its share of funds transferred, including earned or imputed interest from the date of transfer.

e. Actual claims paid to or on behalf of employees or former employees for workers' compensation, unemployment compensation, severance pay, and similar employee benefits (e.g., subsection 8.f. for post retirement health benefits), are allowable in the year of payment provided (1) the governmental unit follows a consistent costing policy and (2) they are allocated as a general administrative expense to all activities of the governmental unit.

f. Insurance refunds shall be credited against insurance costs in the year the refund is received.

g. Indemnification includes securing the governmental unit against liabilities to third persons and other losses not compensated by insurance or otherwise. The Federal Government is obligated to indemnify the governmental unit only to the extent expressly provided for in the Federal award, except as provided in subsection d.

h. Costs of commercial insurance that protects against the costs of the contractor for correction of the contractor's own defects in materials or workmanship are unallowable.

23. ***Interest.***

a. Costs incurred for interest on borrowed capital or the use of a governmental unit’s own funds, however represented, are unallowable except as specifically provided in subsection b. or authorized by Federal legislation.

b. Financing costs (including interest) paid or incurred which are associated with the otherwise allowable costs of building acquisition, construction, or fabrication, reconstruction or remodeling completed on or after October 1, 1980 is allowable subject to the conditions in (1) through (4) of this section 23.b. Financing costs (including interest) paid or incurred on or after September 1, 1995 for land or associated with otherwise allowable costs of equipment is allowable, subject to the conditions in (1) through (4).

(1) The financing is provided (from other than tax or user fee sources) by a bona fide third party external to the governmental unit;

(2) Thee assets are used in support of Federal awards;

(3) Earnings on debt service reserve funds or interest earned on borrowed funds pending payment of the construction or acquisition costs are used to offset the current period's cost or the capitalized interest, as appropriate. Earnings subject to being reported to the Federal Internal Revenue Service under arbitrage requirements are excludable.

(4) For debt arrangements over $1 million, unless the governmental unit makes an initial equity contribution to the asset purchase of 25 percent or more, the governmental unit shall reduce claims for interest cost by an amount equal to imputed interest earnings on excess cash flow, which is to be calculated as follows. Annually, non-Federal entities shall prepare a cumulative (from the inception of the project) report of monthly cash flows that includes inflows and outflows, regardless of the funding source. Inflows consist of depreciation expense, amortization of capitalized construction interest, and annual interest cost. For cash flow calculations, the annual inflow figures shall be divided by the number of months in the year (i.e., usually 12) that the building is in service for monthly amounts. Outflows consist of initial equity contributions, debt principal payments (less the pro rata share attributable to the unallowable costs of land) and interest payments. Where cumulative inflows exceed cumulative outflows, interest shall be calculated on the excess inflows for that period and be treated as a reduction to allowable interest cost. The rate of interest to be used to compute earnings on excess cash flows shall be the three-month Treasury bill closing rate as of the last business day of that month.

(5) Interest attributable to fully depreciated assets is unallowable.

24. ***Lobbying.***

a. General. The cost of certain influencing activities associated with obtaining grants, contracts, cooperative agreements, or loans is an unallowable cost. Lobbying with respect to certain grants, contracts, cooperative agreements, and loans shall be governed by the common rule, "New Restrictions on Lobbying" published at 55 FR 6736 (February 26, 1990), including definitions, and the Office of Management and Budget "Government wide Guidance for New Restrictions on Lobbying" and notices published at 54 FR 52306 (December 20, 1989), 55 FR 24540 (June 15, 1990), and 57 FR 1772 (January 15, 1992), respectively.

b. Executive lobbying costs. Costs incurred in attempting to improperly influence either directly or indirectly, an employee or officer of the Executive Branch of the Federal Government to give consideration or to act regarding a sponsored agreement or a regulatory matter are unallowable. Improper influence means any influence that induces or tends to induce a Federal employee or officer to give consideration or to act regarding a federally sponsored agreement or regulatory matter on any basis other than the merits of the matter.

25. ***Maintenance, operations, and repairs.*** Unless prohibited by law, the cost of utilities, insurance, security, janitorial services, elevator service, upkeep of grounds, necessary maintenance, normal repairs and alterations, and the like are allowable to the extent that they: (1) keep property (including Federal property, unless otherwise provided for) in an efficient operating condition, (2) do not add to the permanent value of property or appreciably prolong its intended life, and (3) are not otherwise included

in rental or other charges for space. Costs which add to the permanent value of property or appreciably prolong its intended life shall be treated as capital expenditures (see sections 11 and 15).

26. ***Materials and supplies costs.***

a. Costs incurred for materials, supplies, and fabricated parts necessary to carry out a Federal award are allowable.

b. Purchased materials and supplies shall be charged at their actual prices, net of applicable credits. Withdrawals from general stores or stockrooms should be charged at their actual net cost under any recognized method of pricing inventory withdrawals, consistently applied. Incoming transportation charges are a proper part of materials and supplies costs.

c. Only materials and supplies actually used for the performance of a Federal award may be charged as direct costs.

d. Where federally donated or furnished materials are used in performing the Federal award, such materials will be used without charge.

27. ***Meetings and conferences.*** Costs of meetings and conferences, the primary purpose of which is the dissemination of technical information, are allowable. This includes costs of meals, transportation, rental of facilities, speakers' fees, and other items incidental to such meetings or conferences. But see Attachment B, section 14, Entertainment costs.

28. ***Memberships, subscriptions, and professional activity costs.***

a. Costs of the governmental unit’s memberships in business, technical, and professional organizations are allowable.

b. Costs of the governmental unit’s subscriptions to business, professional, and technical periodicals are allowable.

c. Costs of membership in civic and community, social organizations are allowable as a direct cost with the approval of the Federal awarding agency.

d. Costs of membership in organizations substantially engaged in lobbying are unallowable.

29. ***Patent costs.***

a. The following costs relating to patent and copyright matters are allowable:

(i) cost of preparing disclosures, reports, and other documents required by the Federal award and of searching the art to the extent necessary to make such disclosures;

(ii) cost of preparing documents and any other patent costs in connection with the filing and

prosecution of a United States patent application where title or royalty-free license is required by the Federal Government to be conveyed to the Federal Government; and

(iii) general counseling services relating to patent and copyright matters, such as advice on patent and copyright laws, regulations, clauses, and employee agreements (but see Attachment B, sections 32, Professional service costs, and 38, Royalties and other costs for use of patents and copyrights).

b. The following costs related to patent and copyright matter are unallowable:

(i) Cost of preparing disclosures, reports, and other documents and of searching the art to the extent necessary to make disclosures not required by the award

(ii) Costs in connection with filing and prosecuting any foreign patent application, or (ii) any United States patent application, where the Federal award does not require conveying title or a royalty-free license to the Federal Government (but see Attachment B, section 38., Royalties and other costs for use of patents and copyrights).

30. ***Plant and homeland security costs.*** Necessary and reasonable expenses incurred for routine and homeland security to protect facilities, personnel, and work products are allowable. Such costs include, but are not limited to, wages and uniforms of personnel engaged in security activities; equipment; barriers; contractual security services; consultants; etc. Capital expenditures for homeland and plant security purposes are subject to section 15., Equipment and other capital expenditures, of this Circular.

31. ***Pre award costs.*** Pre award costs are those incurred prior to the effective date of the award directly pursuant to the negotiation and in anticipation of the award where such costs are necessary to comply with the proposed delivery schedule or period of performance. Such costs are allowable only to the extent that they would have been allowable if incurred after the date of the award and only with the written approval of the awarding agency.

32. ***Professional service costs.***

a. Costs of professional and consultant services rendered by persons who are members of a particular profession or possess a special skill, and who are not officers or employees of the governmental unit, are allowable, subject to subparagraphs b and c when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Federal Government.

In addition, legal and related services are limited under Attachment B, section 10.

b. In determining the allowability of costs in a particular case, no single factor or any special combination of factors is necessarily determinative. However, the following factors are relevant:

(1) The nature and scope of the service rendered in relation to the service required.

(2) The necessity of contracting for the service, considering the governmental unit's capability in the particular area.

(3) The past pattern of such costs, particularly in the years prior to Federal awards.

(4) The impact of Federal awards on the governmental unit's business (i.e., what new problems have arisen).

(5) Whether the proportion of Federal work to the governmental unit's total business is such as to influence the governmental unit in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under Federal grants and contracts.

(6) Whether the service can be performed more economically by direct employment rather than contracting.

(7) The qualifications of the individual or concern rendering the service and the customary fees charged, especially on non-Federal awards.

(8) Adequacy of the contractual agreement for the service (e.g., description of the service, estimate of time required, rate of compensation, and termination provisions).

c. In addition to the factors in subparagraph b, retainer fees to be allowable must be supported by available or rendered evidence of bona fide services available or rendered.

33. ***Proposal costs.*** Costs of preparing proposals for potential Federal awards are allowable. Proposal costs should normally be treated as indirect costs and should be allocated to all activities of the governmental unit utilizing the cost allocation plan and indirect cost rate proposal. However, proposal costs may be charged directly to Federal awards with the prior approval of the Federal awarding agency.

34. ***Publication and printing costs.***

a. Publication costs include the costs of printing (including the processes of composition, plate-making, press work, binding, and the end products produced by such processes), distribution, promotion, mailing, and general handling. Publication costs also include page charges in professional publications.

b. If these costs are not identifiable with a particular cost objective, they should be allocated as indirect costs to all benefiting activities of the governmental unit.

c. Page charges for professional journal publications are allowable as a necessary part of research costs where:

(1) The research papers report work supported by the Federal Government: and

(2) The charges are levied impartially on all research papers published by the journal, whether or not by federally sponsored authors

35. ***Rearrangement and alteration costs.*** Costs incurred for ordinary and normal rearrangement and alteration of facilities are allowable. Special arrangements and alterations costs incurred specifically for a Federal award are allowable with the prior approval of the Federal awarding agency.

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

37. ***Rental costs of buildings and equipment.***

a. Subject to the limitations described in subsections b. through d. of this section, rental costs are allowable to the extent that the rates are reasonable in light of such factors as: rental costs of comparable property, if any; market conditions in the area; alternatives available; and, the type, life expectancy, condition, and value of the property leased. Rental arrangements should be reviewed periodically to determine if circumstances have changed and other options are available.

b. Rental costs under "sale and lease back" arrangements are allowable only up to the amount that would be allowed had the governmental unit continued to own the property. This amount would include expenses such as depreciation or use allowance, maintenance, taxes, and insurance.

c. Rental costs under "less-than-arms-length" leases are allowable only up to the amount (as explained in Attachment B, section 37.b) that would be allowed had title to the property vested in the governmental unit. For this purpose, a less-than-arms-length lease is one under which one party to the lease agreement is able to control or substantially influence the actions of the other. Such leases include, but are not limited to those between (i) divisions of a governmental unit; (ii) governmental units under common control through common officers, directors, or members; and (iii) a governmental unit and a director, trustee, officer, or key employee of the governmental unit or his immediate family, either directly or through corporations, trusts, or similar arrangements in which they hold a controlling interest. For example, a governmental unit may establish a separate corporation for the sole purpose of owning property and leasing it back to the governmental unit.

d. Rental costs under leases which are required to be treated as capital leases under GAAP are allowable only up to the amount (as explained in subsection b) that would be allowed had the governmental unit purchased the property on the date the lease agreement was executed. The provisions of Financial Accounting Standards Board Statement 13, Accounting for Leases, shall be used to determine whether a lease is a capital lease. Interest costs related to capital leases are allowable to the extent they meet the criteria in Attachment B, section 23. Unallowable costs include amounts paid for profit, management fees, and taxes that would not have been incurred had the governmental unit purchased the facility.

38. ***Royalties and other costs for the use of patents.***

a. Royalties on a patent or copyright or amortization of the cost of acquiring by purchase a copyright, patent, or rights thereto, necessary for the proper performance of the award are allowable unless:

(1) The Federal Government has a license or the right to free use of the patent or copyright.

(2) The patent or copyright has been adjudicated to be invalid, or has been administratively determined to be invalid.

(3) The patent or copyright is considered to be unenforceable.

(4) The patent or copyright is expired.

b. Special care should be exercised in determining reasonableness where the royalties may have been arrived at as a result of less-than-arm's-length bargaining, e.g.:

(1) Royalties paid to persons, including corporations, affiliated with the governmental unit.

(2) Royalties paid to unaffiliated parties, including corporations, under an agreement entered into in contemplation that a Federal award would be made.

(3) Royalties paid under an agreement entered into after an award is made to a governmental unit.

c. In any case involving a patent or copyright formerly owned by the governmental unit, the amount of royalty allowed should not exceed the cost which would have been allowed had the governmental unit retained title thereto.

39. ***Selling and marketing.*** Costs of selling and marketing any products or services of the governmental unit are unallowable (unless allowed under Attachment B, section 1. as allowable public relations costs or under Attachment B, section 33. as allowable proposal costs.

40. ***Taxes.***

a. Taxes that a governmental unit is legally required to pay are allowable, except for self assessed taxes that disproportionately affect Federal programs or changes in tax policies that disproportionately affect Federal programs. This provision becomes effective for taxes paid during the governmental unit's first fiscal year that begins on or after January 1, 1998, and applies thereafter.

b. Gasoline taxes, motor vehicle fees, and other taxes that are in effect user fees for benefits provided to the Federal Government are allowable.

c. This provision does not restrict the authority of Federal agencies to identify taxes where Federal participation is inappropriate. Where the identification of the amount of unallowable taxes would require an inordinate amount of effort, the cognizant agency may accept a reasonable approximation thereof.

41. ***Termination costs applicable to sponsored agreements.*** Termination of awards generally gives rise to the incurrence of costs, or the need for special treatment of costs, which would not have arisen had the Federal award not been terminated. Cost principles covering these items are set forth below. They are to be used in conjunction with the other provisions of this Circular in termination situations.

a. The cost of items reasonably usable on the governmental unit's other work shall not be allowable unless the governmental unit submits evidence that it would not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the governmental unit, the awarding agency should consider the governmental unit's plans and orders for current and scheduled activity.

   Contemporaneous purchases of common items by the governmental unit shall be regarded as evidence that such items are reasonably usable on the governmental unit's other work. Any acceptance of common items as allocable to the terminated portion of the Federal award shall be limited to the extent that the quantities of such items on hand, in transit, and on order are in excess of the reasonable quantitative requirements of other work.

b. If in a particular case, despite all reasonable efforts by the governmental unit, certain costs cannot be discontinued immediately after the effective date of termination, such costs are generally allowable within the limitations set forth in this Circular, except that any such costs continuing after termination due to the negligent or willful failure of the governmental unit to discontinue such costs shall be unallowable.

c. Loss of useful value of special tooling, machinery, and equipment is generally allowable if:

   (1) Such special tooling, special machinery, or equipment is not reasonably capable of use in the other work of the governmental unit,

   (2) The interest of the Federal Government is protected by transfer of title or by other means deemed appropriate by the awarding agency, and

   (3) The loss of useful value for any one terminated Federal award is limited to that portion of the acquisition cost which bears the same ratio to the total acquisition cost as the terminated portion of the Federal award bears to the entire terminated Federal award and other Federal awards for which the special tooling, machinery, or equipment was acquired.

d. Rental costs under unexpired leases are generally allowable where clearly shown to have been reasonably necessary for the performance of the terminated Federal award less the residual value of such leases, if:

   (1) the amount of such rental claimed does not exceed the reasonable use value of the property leased for the period of the Federal award and such further period as may be reasonable, and

   (2) the governmental unit makes all reasonable efforts to terminate, assign, settle, or otherwise reduce the cost of such lease. There also may be included the cost of alterations of such leased property, provided such alterations were necessary for the performance of the Federal award,

and of reasonable restoration required by the provisions of the lease.

e. Settlement expenses including the following are generally allowable:

(1) Accounting, legal, clerical, and similar costs reasonably necessary for:

(a) The preparation and presentation to the awarding agency of settlement claims and supporting data with respect to the terminated portion of the Federal award, unless the termination is for default (see Subpart __.44 of the Grants Management Common Rule implementing OMB Circular A-102); and

(b) The termination and settlement of subawards.

(2) Reasonable costs for the storage, transportation, protection, and disposition of property provided by the Federal Government or acquired or produced for the Federal award, except when grantees or contractors are reimbursed for disposals at a predetermined amount in accordance with Subparts__.31 and ___.32 of the Grants Management Common Rule implementing OMB Circular A-102.

f. Claims under subawards, including the allocable portion of claims which are common to the Federal award, and to other work of the governmental unit are generally allowable.

An appropriate share of the governmental unit's indirect expense may be allocated to the amount of settlements with subcontractors and/or subgrantees, provided that the amount allocated is otherwise consistent with the basic guidelines contained in Attachment A. The indirect expense so allocated shall exclude the same and similar costs claimed directly or indirectly as settlement expenses.

42. ***Training costs.*** The cost of training provided for employee development is allowable.

43. ***Travel costs.***

a. General. Travel costs are the expenses for transportation, lodging, subsistence, and related items incurred by employees who are in travel status on official business of the governmental unit. Such costs may be charged on an actual cost basis, on a per diem or mileage basis in lieu of actual costs incurred, or on a combination of the two, provided the method used is applied to an entire trip and not to selected days of the trip, and results in charges consistent with those normally allowed in like circumstances in the governmental unit’s non-federally sponsored activities. Notwithstanding the provisions of Attachment B, section 19, General government expenses, travel costs of officials covered by that section are allowable with the prior approval of an awarding agency when they are specifically related to Federal awards.

b. Lodging and subsistence. Costs incurred by employees and officers for travel, including costs of lodging, other subsistence, and incidental expenses, shall be considered reasonable and allowable only to the extent such costs do not exceed charges normally allowed by the governmental unit in its regular operations as the result of the governmental unit's written travel policy. In the absence of an acceptable, written governmental unit policy regarding travel costs, the rates and amounts established under subchapter I of Chapter 57, Title 5, United States Code ("Travel and Subsistence Expenses; Mileage Allowances"), or by the Administrator of General Services, or by the President (or his or her designee) pursuant to any provisions of such subchapter shall apply to travel under Federal awards (48 CFR 31.205-46(a)).

c. Commercial air travel.

(1) Airfare costs in excess of the customary standard commercial airfare (coach or equivalent), Federal Government contract airfare (where authorized and available), or the lowest commercial discount airfare are unallowable except when such accommodations would:

(a) require circuitous routing;
(b) require travel during unreasonable hours;
(c) excessively prolong travel;
(d) result in additional costs that would offset the transportation savings; or
(e) offer accommodations not reasonably adequate for the traveler's medical needs. The governmental unit must justify and document these conditions on a case-by-case basis in order for the use of first-class airfare to be allowable in such cases.

(2) Unless a pattern of avoidance is detected, the Federal Government will generally not question a governmental unit's determinations that customary standard airfare or other discount airfare is unavailable for specific trips if the governmental unit can demonstrate either of the following: (a) that such airfare was not available in the specific case; or (b) that it is the governmental unit's overall practice to make routine use of such airfare.

d. Air travel by other than commercial carrier. Costs of travel by governmental unit-owned, -leased, or -chartered aircraft include the cost of lease, charter, operation (including personnel costs), maintenance, depreciation, insurance, and other related costs. The portion of such costs that exceeds the cost of allowable commercial air travel, as provided for in subsection c., is unallowable.

e. Foreign travel. Direct charges for foreign travel costs are allowable only when the travel has received prior approval of the awarding agency. Each separate foreign trip must receive such approval. For purposes of this provision, "foreign travel" includes any travel outside Canada, Mexico, the United States, and any United States territories and possessions. However, the term "foreign travel" for a governmental unit located in a foreign country means travel outside that country.

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STATE AND LOCAL INDIRECT COST RATE PROPOSALS

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A. ***General.***

1. Indirect costs are those that have been incurred for common or joint puroses. These costs benefit more than one cost objective and cannot be readily identified with a particular final cost objective without effort disproportionate to the results achieved. After direct costs have been determined and assigned directly to Federal awards and other activities as appropriate, indirect costs are those remaining to be allocated to benefitted cost objectives. A cost may not be allocated to a Federal award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to a Federal award as a direct cost.

2. Indirect costs include (a) the indirect costs originating in each department or agency of the governmental unit carrying out Federal awards and (b) the costs of central governmental services distributed through the central service cost allocation plan (as described in Attachment C) and not otherwise treated as direct costs.

3. Indirect costs are normally charged to Federal awards by the use of an indirect cost rate. A separate indirect cost rate(s) is usually necessary for each department or agency of the governmental unit claiming indirect costs under Federal awards. Guidelines and illustrations of indirect cost proposals are provided in a brochure published by the Department of Health and Human Services entitled "A Guide for State and Local Government Agencies: Cost Principles and Procedures for Establishing Cost Allocation Plans and Indirect Cost Rates for Grants and Contracts with the Federal Government." A copy of this brochure may be obtained from the Superintendent of Documents, U.S. Government Printing Office.

4. Because of the diverse characteristics and accounting practices of governmental units, the types of costs which may be classified as indirect costs cannot be specified in all situations. However, typical examples of indirect costs may include certain State/local wide central service costs, general administration of the grantee department or agency, accounting and personnel services performed within the grantee department or agency, depreciation or use allowances on buildings and equipment, the costs of operating and maintaining facilities, etc.

5. This Attachment does not apply to State public assistance agencies. These agencies should refer instead to Attachment D.

B. ***Definitions.***

1. "Indirect cost rate proposal" means the documentation prepared by a governmental unit or subdivision thereof to substantiate its request for the establishment of an indirect cost rate.

2. "Indirect cost rate" is a device for determining in a reasonable manner the proportion of indirect costs each program should bear. It is the ratio (expressed as a percentage) of the indirect costs to a direct cost base.

3. "Indirect cost pool" is the accumulated costs that jointly benefit two or more programs or other cost objectives.

4. "Base" means the accumulated direct costs (normally either total direct salaries and wages or total direct costs exclusive of any extraordinary or distorting expenditures) used to distribute indirect costs to individual Federal awards. The direct cost base selected should result in each award bearing a fair share of the indirect costs in reasonable relation to the benefits received from the costs.

5. "Predetermined rate" means an indirect cost rate, applicable to a specified current or future period, usually the governmental unit's fiscal year. This rate is based on an estimate of the costs to be incurred during the period. Except under very unusual circumstances, a predetermined rate is not subject to adjustment. (Because of legal constraints, predetermined rates are not permitted for Federal contracts; they may, however, be used for grants or cooperative agreements.) Predetermined rates may not be used by governmental units that have not submitted and negotiated the rate with the cognizant agency. In view of the potential advantages offered by this procedure, negotiation of predetermined rates for indirect costs for a period of two to four years should be the norm in those situations where the cost experience and other pertinent facts available are deemed sufficient to enable the parties involved to reach an informed judgment as to the probable level of indirect costs during the ensuing accounting periods.

6. "Fixed rate" means an indirect cost rate which has the same characteristics as a predetermined rate, except that the difference between the estimated costs and the actual, allowable costs of the period covered by the rate is carried forward as an adjustment to the rate computation of a subsequent period.

7. "Provisional rate" means a temporary indirect cost rate applicable to a specified period which is used for funding, interim reimbursement, and reporting indirect costs on Federal awards pending the establishment of a "final" rate for that period.

8. "Final rate" means an indirect cost rate applicable to a specified past period which is based on the actual allowable costs of the period. A final audited rate is not subject to adjustment.

9. "Base period" for the allocation of indirect costs is the period in which such costs are incurred and accumulated for allocation to activities performed in that period. The base period normally should coincide with the governmental unit's fiscal year, but in any event, shall be so selected as to avoid inequities in the allocation of costs.

C. ***Allocation of Indirect Costs and Determination of Indirect Cost Rates.***

1. General.

a. Where a governmental unit's department or agency has only one major function, or where all its major functions benefit from the indirect costs to approximately the same degree, the allocation of indirect costs and the computation of an indirect cost rate may be accomplished through simplified allocation procedures as described in subsection 2.

b. Where a governmental unit's department or agency has several major functions which benefit from its indirect costs in varying degrees, the allocation of indirect costs may require the accumulation of such costs into separate cost groupings which then are allocated individually to benefitted functions by means of a base which best measures the relative degree of benefit. The indirect costs allocated to each function are then distributed to individual awards and other

activities included in that function by means of an indirect cost rate(s).

c. Specific methods for allocating indirect costs and computing indirect cost rates along with the conditions under which each method should be used are described in subsections 2, 3 and 4.

2. Simplified method.

a. Where a grantee agency's major functions benefit from its indirect costs to approximately the same degree, the allocation of indirect costs may be accomplished by (1) classifying the grantee agency's total costs for the base period as either direct or indirect, and (2) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. The result of this process is an indirect cost rate which is used to distribute indirect costs to individual Federal awards. The rate should be expressed as the percentage which the total amount of allowable indirect costs bears to the base selected. This method should also be used where a governmental unit's department or agency has only one major function encompassing a number of individual projects or activities, and may be used where the level of Federal awards to that department or agency is relatively small.

b. Both the direct costs and the indirect costs shall exclude capital expenditures and unallowable costs. However, unallowable costs must be included in the direct costs if they represent activities to which indirect costs are properly allocable.

c. The distribution base may be (1) total direct costs (excluding capital expenditures and other distorting items, such as pass through funds, major subcontracts, etc.), (2) direct salaries and wages, or (3) another base which results in an equitable distribution.

3. Multiple allocation base method.

a. Where a grantee agency's indirect costs benefit its major functions in varying degrees, such costs shall be accumulated into separate cost groupings. Each grouping shall then be allocated individually to benefitted functions by means of a base which best measures the relative benefits.

b. The cost groupings should be established so as to permit the allocation of each grouping on the basis of benefits provided to the major functions. Each grouping should constitute a pool of expenses that are of like character in terms of the functions they benefit and in terms of the allocation base which best measures the relative benefits provided to each function. The number of separate groupings should be held within practical limits, taking into consideration the materiality of the amounts involved and the degree of precision needed.

c. Actual conditions must be taken into account in selecting the base to be used in allocating the expenses in each grouping to benefitted functions. When an allocation can be made by assignment of a cost grouping directly to the function benefitted, the allocation shall be made in that manner. When the expenses in a grouping are more general in nature, the allocation should be made through the use of a selected base which produces results that are equitable to both the Federal Government and the governmental unit. In general, any cost element or related

factor associated with the governmental unit's activities is potentially adaptable for use as an allocation base provided that: (1) it can readily be expressed in terms of dollars or other quantitative measures (total direct costs, direct salaries and wages, staff hours applied, square feet used, hours of usage, number of documents processed, population served, and the like), and (2) it is common to the benefitted functions during the base period.

d. Except where a special indirect cost rate(s) is required in accordance with subsection 4, the separate groupings of indirect costs allocated to each major function shall be aggregated and treated as a common pool for that function. The costs in the common pool shall then be distributed to individual Federal awards included in that function by use of a single indirect cost rate.

e. The distribution base used in computing the indirect cost rate for each function may be (1) total direct costs (excluding capital expenditures and other distorting items such as pass through funds, major subcontracts, etc.), (2) direct salaries and wages, or (3) another base which results in an equitable distribution. An indirect cost rate should be developed for each separate indirect cost pool developed. The rate in each case should be stated as the percentage relationship between the particular indirect cost pool and the distribution base identified with that pool.

4. Special indirect cost rates.

a. In some instances, a single indirect cost rate for all activities of a grantee department or agency or for each major function of the agency may not be appropriate. It may not take into account those different factors which may substantially affect the indirect costs applicable to a particular program or group of programs. The factors may include the physical location of the work, the level of administrative support required, the nature of the facilities or other resources employed, the organizational arrangements used, or any combination thereof. When a particular award is carried out in an environment which appears to generate a significantly different level of indirect costs, provisions should be made for a separate indirect cost pool applicable to that award. The separate indirect cost pool should be developed during the course of the regular allocation process, and the separate indirect cost rate resulting therefrom should be used, provided that: (1) the rate differs significantly from the rate which would have been developed under subsections 2. and 3., and (2) the award to which the rate would apply is material in amount.

b. Although this Circular adopts the concept of the full allocation of indirect costs, there are some Federal statutes which restrict the reimbursement of certain indirect costs. Where such restrictions exist, it may be necessary to develop a special rate for the affected award. Where a "restricted rate" is required, the procedure for developing a non restricted rate will be used except for the additional step of the elimination from the indirect cost pool those costs for which the law prohibits reimbursement.

D. ***Submission and Documentation of Proposals.***

1. Submission of indirect cost rate proposals.

a. All departments or agencies of the governmental unit desiring to claim indirect costs under Federal awards must prepare an indirect cost rate proposal and related documentation to support those costs. The proposal and related documentation must be retained for audit in accordance with the records retention requirements contained in the Common Rule.

b. A governmental unit for which a cognizant agency assignment has been specifically designated must submit its indirect cost rate proposal to its cognizant agency. The Office of Management and Budget (OMB) will periodically publish lists of governmental units identifying the appropriate Federal cognizant agencies. The cognizant agency for all governmental units or agencies not identified by OMB will be determined based on the Federal agency providing the largest amount of Federal funds. In these cases, a governmental unit must develop an indirect cost proposal in accordance with the requirements of this Circular and maintain the proposal and related supporting documentation for audit. These governmental units are not required to submit their proposals unless they are specifically requested to do so by the cognizant agency. Where a local government only receives funds as a sub recipient, the primary recipient will be responsible for negotiating and/or monitoring the sub recipient's plan.

c. Each Indian tribal government desiring reimbursement of indirect costs must submit its indirect cost proposal to the Department of the Interior (its cognizant Federal agency).

d. Indirect cost proposals must be developed (and, when required, submitted) within six months after the close of the governmental unit's fiscal year, unless an exception is approved by the cognizant Federal agency. If the proposed central service cost allocation plan for the same period has not been approved by that time, the indirect cost proposal may be prepared including an amount for central services that is based on the latest federally approved central service cost allocation plan. The difference between these central service amounts and the amounts ultimately approved will be compensated for by an adjustment in a subsequent period.

2. Documentation of proposals. The following shall be included with each indirect cost proposal:

a. The rates proposed, including subsidiary work sheets and other relevant data, cross referenced and reconciled to the financial data noted in subsection b. Allocated central service costs will be supported by the summary table included in the approved central service cost allocation plan. This summary table is not required to be submitted with the indirect cost proposal if the central service cost allocation plan for the same fiscal year has been approved by the cognizant agency and is available to the funding agency.

b. A copy of the financial data (financial statements, comprehensive annual financial report, executive budgets, accounting reports, etc.) upon which the rate is based. Adjustments resulting from the use of unaudited data will be recognized, where appropriate, by the Federal cognizant agency in a subsequent proposal.

c. The approximate amount of direct base costs incurred under Federal awards. These costs should be broken out between salaries and wages and other direct costs.

d. A chart showing the organizational structure of the agency during the period for which the proposal applies, along with a functional statement(s) noting the duties and/or responsibilities

of all units that comprise the agency. (Once this is submitted, only revisions need be submitted with subsequent proposals.)

3. Required certification. Each indirect cost rate proposal shall be accompanied by a certification in the following form:

CERTIFICATE OF INDIRECT COSTS

This is to certify that I have reviewed the indirect cost rate proposal submitted herewith and to the best of my knowledge and belief:

(1) All costs included in this proposal [identify date] to establish billing or final indirect costs rates for [identify period covered by rate] are allowable in accordance with the requirements of the Federal award(s) to which they apply and OMB Circular A 87, "Cost Principles for State, Local, and Indian Tribal Governments." Unallowable costs have been adjusted for in allocating costs as indicated in the cost allocation plan.

(2) All costs included in this proposal are properly allocable to Federal awards on the basis of a beneficial or causal relationship between the expenses incurred and the agreements to which they are allocated in accordance with applicable requirements. Further, the same costs that have been treated as indirect costs have not been claimed as direct costs. Similar types of costs have been accounted for consistently and the Federal Government will be notified of any accounting changes that would affect the predetermined rate.

I declare that the foregoing is true and correct.

Governmental Unit: _____

Signature: _____

Name of Official: _____

Title: _____

Date of Execution: _____

E. ***Negotiation and Approval of Rates.***

1. Indirect cost rates will be reviewed, negotiated, and approved by the cognizant Federal agency on a timely basis. Once a rate has been agreed upon, it will be accepted and used by all Federal agencies unless prohibited or limited by statute. Where a Federal funding agency has reason to believe that special operating factors affecting its awards necessitate special indirect cost rates, the funding agency will, prior to the time the rates are negotiated, notify the cognizant Federal agency.

2. The use of predetermined rates, if allowed, is encouraged where the cognizant agency has reasonable assurance based on past experience and reliable projection of the grantee agency's costs, that the rate is

not likely to exceed a rate based on actual costs. Long term agreements utilizing predetermined rates extending over two or more years are encouraged, where appropriate.

3. The results of each negotiation shall be formalized in a written agreement between the cognizant agency and the governmental unit. This agreement will be subject to re opening if the agreement is subsequently found to violate a statute, or the information upon which the plan was negotiated is later found to be materially incomplete or inaccurate. The agreed upon rates shall be made available to all Federal agencies for their use.

4. Refunds shall be made if proposals are later found to have included costs that (a) are unallowable (i) as specified by law or regulation, (ii) as identified in Attachment B of this Circular, or (iii) by the terms and conditions of Federal awards, or (b) are unallowable because they are clearly not allocable to Federal awards. These adjustments or refunds will be made regardless of the type of rate negotiated (predetermined, final, fixed, or provisional).

F. ***Other Policies.***

1. Fringe benefit rates. If overall fringe benefit rates are not approved for the governmental unit as part of the central service cost allocation plan, these rates will be reviewed, negotiated and approved for individual grantee agencies during the indirect cost negotiation process. In these cases, a proposed fringe benefit rate computation should accompany the indirect cost proposal. If fringe benefit rates are not used at the grantee agency level (i.e., the agency specifically identifies fringe benefit costs to individual employees), the governmental unit should so advise the cognizant agency.

2. Billed services provided by the grantee agency. In some cases, governmental units provide and bill for services similar to those covered by central service cost allocation plans (e.g., computer centers). Where this occurs, the governmental unit should be guided by the requirements in Attachment C relating to the development of billing rates and documentation requirements, and should advise the cognizant agency of any billed services. Reviews of these types of services (including reviews of costing/billing methodology, profits or losses, etc.) will be made on a case by case basis as warranted by the circumstances involved.

3. Indirect cost allocations not using rates. In certain situations, a governmental unit, because of the nature of its awards, may be required to develop a cost allocation plan that distributes indirect (and, in some cases, direct) costs to the specific funding sources. In these cases, a narrative cost allocation methodology should be developed, documented, maintained for audit, or submitted, as appropriate, to the cognizant agency for review, negotiation, and approval.

4. Appeals. If a dispute arises in a negotiation of an indirect cost rate (or other rate) between the cognizant agency and the governmental unit, the dispute shall be resolved in accordance with the appeals procedures of the cognizant agency.

5. Collection of unallowable costs and erroneous payments. Costs specifically identified as unallowable and charged to Federal awards either directly or indirectly will be refunded (including interest chargeable in accordance with applicable Federal agency regulations).

6. OMB assistance. To the extent that problems are encountered among the Federal agencies and/or governmental units in connection with the negotiation and approval process, OMB will lend assistance, as required, to resolve such problems in a timely manner.