

## SECTION IV

### Common Indirect Cost Problems

#### A. Introduction

This section presents examples of some common problems with organizations disclosed in OIG audits. The problems are summarized below under the following categories:

1. Timekeeping Systems
2. Consistent Treatment and Specific Identification of Costs
3. Costs of "Unallowable Activities" Credits
4. Indirect Cost Allocation Base
5. Expressly Unallowable Costs
6. Inter-organizational Transfers and Related-party Transactions
7. Lease Incentives and Advance Understandings
8. Budget Limitations Unsupported

#### B. Examples of Problems

##### 1. Timekeeping Systems

To be allowable, labor costs, whether charged directly or indirectly to DOL grants/contracts, must be based on accurate time sheets reflecting the actual activities of all employees. The time sheets must account for the "total activity" for which employees are compensated and which are required in fulfillment of their obligations to the organization. In many cases, a timekeeping system was either not used at all or was used for payroll purposes only (time and attendance and not for labor distribution purposes).

##### 2. Consistent Treatment and Specific Identification of Costs

To be allowable under DOL grants/contracts, costs must be treated consistently on all programs of the organization. OIG audits have disclosed numerous instances in which non-profit organizations have charged DOL grants and/or contracts, either directly or indirectly, for

- (1) costs specifically identifiable with programs and activities other than its DOL awards,
- (2) costs which were not treated consistently with other costs incurred for the same purpose in like circumstances.

##### 3. Costs of "Unallowable Activities"

Problems disclosed by recent OIG audits which related to so-called "unallowable activities" can usually be categorized in two areas.

- (1) First, not all costs associated with "unallowable activities" were properly charged as costs to the final cost objectives for such activities.
- (2) Second, because not all such costs were direct charged to "unallowable activities" cost objectives, an appropriate share of indirect costs was not allocated to these "unallowable activities." As a result, DOL and other Federal grants and contracts were allocated a disproportionate share of the organization's indirect costs.

OMB Circular A-122, Attachment A, paragraphs B.3 and B.4 provides that the costs of certain "unallowable activities" must be treated as direct costs (e.g., charged to separate final cost objectives) and allocated an equitable share of the organization's indirect costs.

Examples of unallowable activities include: services to members, maintenance of membership rolls, public relations, lobbying, and fund raising.

Even if an organization's own activities, non-DOL/non-government grants and/or contracts provide for little or no reimbursement of indirect costs, the full share of indirect costs must be allocated to such grants/contracts in accordance with OMB Circular A-122, Attachment A, paragraph A.4.b., which states that any costs allocable to other cost objectives may not be shifted to a Federal award to "overcome funding deficiencies."

4. Credits

OIG audits have disclosed that a number of non-profit organizations failed to reduce the total costs claimed under DOL grants/contracts by the amount of credits applicable to costs charged either directly or indirectly to the DOL grants/contracts. These credits were generated through various transactions, including fees for conferences held for the benefit of DOL programs, building rental operations, insurance credits or adjustments, data processing and office services performed for others, etc.

All receipts, refunds and adjustments applicable to direct costs charged to DOL grants/contracts must be credited to the DOL grants/contracts and those applicable to indirect costs must be credited to the appropriate indirect cost pools.

5. Indirect Cost Allocation Base

To meet the benefits received test, the allocation base must allocate indirect costs to all programs equitably. To ensure that this test is met, organizations must continuously evaluate whether the allocation base elements among all of its programs is proportionate to the benefits to be received from the indirect costs.

Many organizations use total direct personnel costs (salaries/wages, plus fringe benefit costs) as the allocation base to allocate indirect costs to their grants/contracts and other programs. Another cost allocation base commonly used is modified total direct costs.

In most instances, one of the above bases may allocate indirect costs in reasonable proportion to relative benefits received by the various cost objectives. In some cases, they may result in allocating a disproportionate share of the organizations' indirect costs to DOL grants. Use of an inappropriate base which does not allocate indirect costs on the basis of relative benefits received could result in substantial questioned costs.

6. Expressly Unallowable Costs

Indirect costs that are "expressly unallowable" are spelled out in OMB Circular A122, Attachment B, Selected Items of Cost. Common examples of expressly unallowable indirect costs include:

- Contributions
- Entertainment costs
- Fund raising
- Lobbying
- Professional service costs
- Public information service costs
- Bad Debts
- Legal Costs

7. Inter-Organizational Transfers and Related-Party Transactions

Supplies and services acquired from affiliates, related parties, and organizations under common control, must be based on the actual costs of the organizations providing the supplies and services. No profit should be included.

OIG audits disclosed that some organizations charged directly or indirectly to DOL grants/contracts, the "costs" of supplies and services which included "profits" and/or other mark-ups added by the affiliates, related parties and/or organizations under common control.

8. Lease Incentives and Advance Understandings

To be allowable, costs related to building or office leases must comply with OMB Circular A-122, Attachment A, paragraph A.2. In addition, a net present value (NPV) computation must be made to ensure that the present value of the total allowable lease expense does not exceed the total present value of the lease payments a grantee/contractor makes to its lessor. Also, non-profit organizations should enter into advance understandings with DOL with regard to capital leases and gains to be realized under capital leases in accordance with Attachment A, paragraph A.6.

In times of an oversupply of office space in certain metropolitan areas, developers/ owners may offer various incentives to prospective tenants to get them to sign long term leases, including substantial cash payments. OIG audits disclosed that nonprofit organizations are not accounting for the lease incentives in accordance with generally accepted accounting principles (GAAP), nor are they computing rent expense utilizing the NPV concept.

9. Budget Limitations

Non-profit organizations must adhere to any budget limitations incorporated into their grants/contracts. DOL grants/contracts limit reimbursements to grantees/contractors by incorporating a special clause titled "Budget Line Item Flexibility." This clause provides that no single line item of direct cost shall be increased or decreased in excess of 20 percent of the budget provided the total estimated cost of the grant/contract is not exceeded. The clause further provides that no increase in wages, salaries, and fringe benefits line items (including the mixture, number of hours or wages of personnel paid under the grant/contract) is permitted without the prior review and approval of the DOL Grant/Contracting Officer.

If a contract/grant specifically includes a ceiling rate(s), the indirect cost rate(s) or amount(s) which are indicated in the organization's indirect rate cost agreement, will be subject to the ceilings stipulated in the contract/grant agreement. The ceiling rate or the rate(s) cited in the organization's indirect rate cost agreement whichever is lower, will be used to determine the maximum allowable indirect cost on the contract or grant agreement.

The grantee/contractor must submit a proposal to establish a final rate within six months after their fiscal year end. Billings and charges to Federal awards must be adjusted if the final rate varies from the provisional rate. If the final rate is greater than the provisional rate and there are no funds available to cover the additional indirect costs, the organization may not recover all indirect costs. Conversely, if the final rate is less than the provisional rate, the organization will be required to pay back the difference to the funding agency.

10. Unsupported Costs

To be allowable, all direct costs and indirect costs must be adequately supported by source documentation which clearly shows the purposes and circumstance of the cost incurred. For example, canceled checks, credit card invoices and travel agents' invoices alone are not sufficient to determine whether the costs are chargeable as direct costs or indirect costs, and whether DOL grants/contracts received the benefit of the cost incurred.

In order to determine whether a cost is allowable under or allocable to a DOL grant/contract, the purpose and circumstance of the cost incurrence must be established. OIG audits disclosed that a large number of non-profit organizations did not have adequate documentation to support the allowability/allocability of the costs claimed or proposed.

Also, verbal approval from a Contracting/Grant Officer is insufficient documentation for supporting costs under a contract/grant. Any modifications to a contract/grant must be in writing and signed by both the Contracting/Grant Officer and the contractor/grantee.