

# Accounting for the Full Cost of Impactful Programs

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Calculating Indirect Costs for Your Nonprofit



BY DR. COLTON STRAWSER

Nonprofits do essential work throughout communities. From creating social change to supporting critical institutions, that essential work often comes with a cost—especially as the field has become more professionalized and systematized. To create social change, you often need to have financial investment.

For many years, there was a misconception regarding nonprofit operations that suggested organizations that spend the least are the ones that make the most significant impact. However, efficiency and effectiveness are not synonymous. Spending less does not always generate more impact—instead, underinvesting in an organization or a problem can simply perpetuate issues by affixing temporary charitable solutions to systemic problems. In other words, sometimes you have to spend more money to make a greater, more sustainable, impact.

Indirect costs, or costs such as rent and salaries that are not directly associated with a program or service, are essential to calculate for a variety of reasons. Calculating indirect costs helps organizations understand the total cost of providing a program, service, or support, ensuring that an organization is charging the right amount for programs, and crafting budgets for different projects appropriately so enough money is allocated or raised.

Also, nonprofits have unique budgeting situations. Some programs may be free to the public, they may be subsidized by philanthropic contributions, or they may be the total cost of a service. In many cases, a nonprofit cannot simply “raise prices” on programs and services provided to individuals since, within the nonprofit sector, those that paid for the service (i.e., donors) may not be the ones benefiting from or receiving the service (i.e., clients).

Cost allocation is key to the financial stability and viability of a nonprofit organization. This white paper provides an overview of indirect costs, how to calculate them, and why nonprofits want to ensure they are calculating indirect costs now and applying them to additional programs in the future.

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## Overview of Indirect Costs

Overhead, in the most common definition, is essentially all the costs of a nonprofit that are not tied to a specific program or service, such as supplies for an afterschool program or food for a meal program). Some examples of overhead costs include management and general salaries, costs related to facilities (e.g., electricity, gas, rent), fundraising expenses, and other expenses that are not directly tied to a specific program or service. In some instances, funders have only wanted to pay for program costs and do not consider salaries as part of the program—yet programs and services often need people to provide the programs.

Overhead is the total cost of doing business to provide a product or service ( $\text{Program Costs} / \text{Revenue}$ ), while indirect costs are those that are general expenses that may not be able to apply to a single program or service (e.g., rent, utilities, insurance, office supplies).

When creating a program budget, most nonprofits just include the direct program costs—or the costs associated directly with providing a program or service. However, without necessary expenses like rent, utilities, insurance, accounting fees, bank fees, marketing costs, and other expenses associated with how an organization can function, a nonprofit will likely be unable to provide a high-quality service. To illustrate direct and indirect costs, let's start with an example from a for-profit company.

### Jeff's Handcrafted Canoes

Each year, Jeff's Handcrafted Canoes sells 500 canoes around the Southern United States. Jeff knows how much wood each canoe requires, along with how long it takes his woodworkers to make the canoe. He uses this information to calculate the total direct costs associated with building a canoe. It costs Jeff \$500 in supplies and \$500 in labor to make a canoe. If he did not want to make a profit, he could just sell them for \$1,000, right?

### BENEFITS OF KNOWING YOUR INDIRECT COSTS

- Equitably spreads operating expenses across programs
- Useful in calculating the total cost to offer a program or service, not just the direct costs
- Follows industry best practices for allocating overhead costs, which allows organizations to communicate total costs of programs and services to funders and donors
- Fundraising can communicate the total amount that needs to be raised to support a project (e.g., direct cost per client is \$100, and the total cost may be \$150 per client)
- Allows organizations to bill reimbursement-based grants and contracts faster by charging the total cost of service rather than the direct cost of service (i.e., total operating budget vs. programmatic budget)
- Beneficial budgeting and forecasting tool to quickly run preliminary numbers for offering new programs and services based on project budget and utilization of an indirect cost rate

NO! The direct costs, or the costs associated with producing a product or service, are \$1,000, but Jeff has a lot of other expenses to pay so his company can sell canoes. Jeff needs to pay his salesperson to sell the canoes, make the mortgage payment on his woodshop, maintain and replace his woodworking tools, and cover the costs of his website where he takes the orders for most of his canoes. The annual expenses of everything

else not directly associated with the production of canoes are \$100,000 a year. Therefore, based on last year's sales numbers, Jeff believes he will sell 500 canoes next year, so he includes these indirect costs at \$200 a canoe. Jeff will reevaluate his indirect costs per canoe at the end of next year to project his indirect costs for the following year.

### Direct Costs = \$1,000/Canoe

### Indirect Costs = \$200/Canoe

Materials - \$500  
Labor - \$500

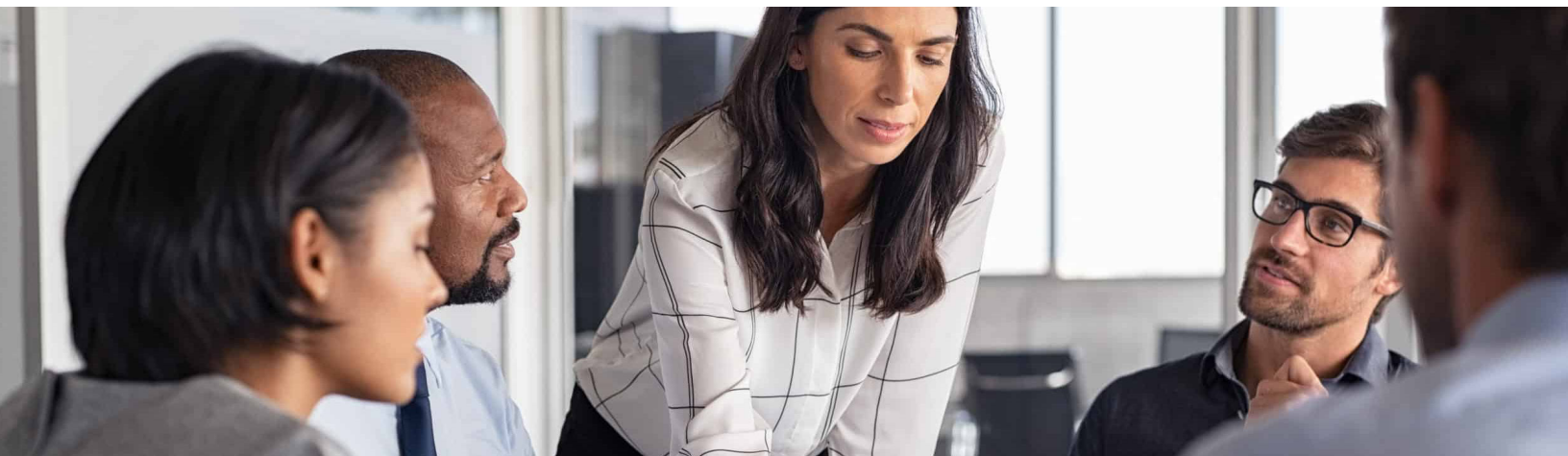
Salesperson  
Woodshop  
Tools & Equipment  
Website

Based on these numbers, the breakeven pricing for a canoe is \$1,200, not \$1,000. Jeff spends \$1,000 for his direct costs and \$200 for his indirect costs. If he wants to make a profit for long-term sustainability, he may want to charge \$2,000 per handcrafted canoe. Otherwise, if Jeff just broke even, he would be up the creek without a paddle if he needed additional capital for an expansion or important major repair.

#### A Note on Cost Allocation

Many nonprofit organizations often offer more than one program or service; therefore, employees often wear more than one program hat. When crafting a budget

that includes the total cost of a program, it is essential to allocate costs to the proper categories and programs. For example, a local community center offers a variety of programs to provide enrichment activities for seniors, an educational afterschool program focused on increasing literacy, and a food pantry to support community residents struggling with food insecurity. In the case of this community center, staff members are often tasked with helping to run a robust number of programs. The time spent on different programs is allocated to properly capture the total cost of a particular program, which allows grant applications to include necessary costs.



In the example below, the afterschool program could not be successful without the support of all four staff members. When creating the budget for the program, it is essential to include the cost of Amy’s salary because she is the coordinator. But to understand the total

cost of the program, they need to also include the appropriate percentage of her colleagues’ time since they directly support the program through curriculum development, activity coordination, and management of program assistants.

	<b>Regina Executive Director</b>	<b>David Program Director</b>	<b>Amy After-school Coordinator</b>	<b>Hannah Program Assistant</b>
<b>Senior Services</b>	15%	30%		25%
<b>After-school Program</b>	15%	30%	100%	25%
<b>Food Pantry</b>	10%	20%		50%
<b>Management (Indirect)</b>	60%	20%		

### Calculating the Full Cost

By allocating costs to the proper program or service, an organization can have a clear understanding of the total cost of maintaining, expanding, or eliminating an offering. Nonprofit accounting is sometimes complicated because, unlike in for-profit business, the individual paying for a service may not be the individual receiving the service. For example, a \$100 donation to the local food pantry may provide 25 meals, but those meals are going to clients instead of the donor. Hence, the example of Jeff’s canoes cannot be easily applied

because a nonprofit cannot simply raise the price on a product or service that it provides to clients for “free.”

Calculating the costs of programs and projecting program revenue is essential to understanding what a program will cost, how much an organization will charge, and where the potential difference will come from—such as grants, donations, or sponsorships—if a program is subsidized.

For example, a summer program may have a total cost of \$1,000 per student, but the organization subsidizes the program through donations and grants. So, families only have to pay \$250 for the summer, and some may qualify for special assistance to make the program free. Regardless of payment, the cost for each student will remain \$1,000; however, different funding sources may determine how much will be required from students to participate. In the case of a poor fundraising year, the program may have to either cut costs or raise its pricing to \$300 to provide the same experience.

“Every program, regardless of whether it is free to clients, is never free; therefore, the resources to support nonprofit services and its infrastructure are vital to being able to support individuals.”



## Indirect Cost Calculation

There are several ways that indirect costs can be calculated, but the following subsections outline two of the most common: Simplified Allocation Method and Direct Allocation Method.

### Simplified Allocation Method

The simplified allocation method—the easiest and most common way to calculate indirect costs—is where indirect costs are equally applied to all programs and services. The assumption is that all indirect costs equally benefit all programs. For example, the office supplies are used equally for all programs, the insurance covers

everything the same, and every program uses the same space in the building.

As an example, Kristen is an Executive Director of a local civic theater. She has been tasked with creating a comprehensive budget that includes indirect costs so she can ensure that all programs are profitable or designed to at least ensure a swan song doesn't happen for the organization anytime soon. The theater currently puts on four productions a year, and within this example, the indirect costs benefit all programs and services equally, so they will all take a share of the responsibility of covering the costs.

Direct Costs		Indirect Costs	
Play Licenses (4)	\$20,000	Executive Director	\$65,000
Costumes	\$25,000	Utilities	\$6,000
Show Advertising	\$10,000	Insurance	\$2,000
Director Stipends (4)	\$40,000	Fundraising	\$8,000
Set Supplies	\$15,000	Office Supplies	\$4,000
Artistic Director	\$50,000		
<b>Total Program Costs</b>	<b>\$160,000</b>	<b>Total Indirect Costs</b>	<b>\$85,000</b>

When creating the budget for her four upcoming shows, Kristen can use the simplified method to allocate the costs across the productions. The programmatic cost of each show is \$40,000 ( $\$160,000 / 4$  Shows), and the indirect cost is \$21,250 per show ( $\$85,000 / 4$  Shows),

with the organization's total budget being \$245,000 and the cost of each show being approximately \$61,250, including direct and indirect costs.

The 250-seat theater sells out all eight performances at each show with \$30 tickets (\$240,000), earns \$15,000 in concessions, and secures \$45,000 in sponsorship revenue—earning the organization \$300,000 in annual revenue. Indirect cost rates are often based on previous financials or detailed projected finances; however, Kristen does not think her budget will change next year, so she uses the prior year’s financial statements to create her budget. Therefore, her indirect rate is calculated below by evenly distributing the costs to all plays.

*Indirect Costs + Direct Costs / # of Shows = Per Show Cost (\$61,250)*

.....

*Total Indirect Costs / Total Direct Costs = Indirect Cost Rate (53.1%)*

.....

For a small organization, a larger indirect cost rate is perfectly fine, as many costs go into offering services—especially if those services use all costs equally. Indirect costs allow budgeting to be faster, and they allow an organization to understand what it needs to generate to cover the full cost of offering a program, not just the program fees. Kristen’s board is considering adding a special holiday show which would be the \$40,000 (Cost of Program) \* 53.1% (Indirect Cost Rate) = \$61,240. Instead of just calculating the program costs, using the simplified allocation method allows Kristen to have \$21,240 back in her operating budget to either support the additional office expenses of a new production, pay for temporary office staff to support the extra work, or place funds into an operating reserve for the future.

Within this scenario, many organizations would just add \$40,000 to their program budget and yell that the show must go on but allocating funding towards operating is important and allows an organization to become self-sustaining by ensuring that resources are appropriately allocated.



### Direct Allocation Method

Within organizations where some programs and services take more time and resources than others, it makes sense to charge indirect costs proportionally using an allocation base for justifying distributions. An allocation base is a factor used to determine the indirect cost rate, such as the number of employees, square footage usage in a building, and the number of items such as technology or supplies needed for each program. This method prevents large and expensive programs from overtaking the budgets of smaller or new programs.

Within the example below, the afterschool program takes up the most space in the building; therefore, it has an indirect rate of 62.5% for facilities, while the senior services programs only take up a small portion of the

building. Using a direct allocation method for indirect costs allows programs to foot their portion of the bill instead of splitting it equally.

### Space Allocation

	Senior Services (500 Sq Ft) 12.5%	Afterschool Program (2,500 Sq Ft) 62.5%	Food Pantry (1,000 Sq Ft) 25%	Total (4,000 Sq Ft) 100%
Occupancy (Rent/Mortgage)	\$10,000	\$50,000	\$20,000	\$80,000
Insurance	\$625	\$3,125	\$1,250	\$5,000
Maintenance	\$7,500	\$37,500	\$15,000	\$60,000
Direct Allocation	\$18,125	\$90,625	\$36,250	\$145,000

Let's assume the direct costs of all three programs are \$800,000, with the exact indirect costs for the facilities listed above. Using the simplified allocation (presented in the previous section), the organization's indirect rate is 18.125%. When using the direct allocation, each program is only paying for the space it occupies, resulting in the senior services program paying for its portion of the facility rather than using the same percentage for each program based on direct costs, which would be twice as much using the simplified method versus the direct method.

Program	Direct Costs	Direct Allocation	Simplified Allocation
Senior Services	\$200,000	\$18,125	\$36,250
Afterschool Program	\$450,000	\$90,625	\$81,563
Food Pantry	\$150,000	\$36,250	\$27,187
	\$800,000	\$145,000	\$145,000



To put this in other terms, one of your business colleagues has an office suite with 10 spaces available, and their staff currently occupies nine of the offices and offers to sublease one office to you. It would be unfair for you to pay for half of all the utilities, given that you only use one-tenth of the office. Sometimes splitting a bill evenly is not reasonable if you are not using the services equally.

If we go to dinner and split a pizza, then 50/50 is fair. But if you order a salad and I order the most expensive steak on the menu, it does not make sense for you to pay for half of my more expensive meal. In essence, the simplified method is splitting the bill, and the direct allocation is paying for what you ordered.

## Securing an Approved Indirect Cost Rate

Government funding opportunities will allow for different indirect costs, including some grants having a set indirect rate and others allowing an organization to use its approved indirect rate. This is where it gets complicated—you cannot have an approved indirect cost rate until you get approved for funding. A nonprofit organization should know its indirect rate regardless of whether it wants to pursue government funding opportunities. When an indirect rate needs to be approved for a grant, the nonprofit needs to determine which government agency is providing it with the most money—this is referred to as a *Cognizant Agency*.

When an organization receives its first grant, it will go through the indirect cost proposal process with its cognizant agency. Each agency posts guidelines for drafting an indirect cost proposal, and for the most part, they are very similar. When drafting the proposal, an organization will have to provide financial evidence as to how it determined its indirect rate. When crafting the budget for the initial government grant, it can include the organization's indirect cost, but until it is approved, it is a provisional rate.

### DEFINING COGNIZANT AGENCY

The cognizant agency for nonprofit organizations is determined by calculating which Federal agency provides the most grant funding. The Department of the Interior is the cognizant agency for all Indian tribal governments. For hospitals, Health and Human Services serves as the main cognizant agency.

Source

“If we go to dinner and split a pizza, then 50/50 is fair. But if you order a salad and I order the most expensive steak on the menu, it does not make sense for you to pay for half of my more expensive meal.”

In essence, the simplified method [of indirect cost calculation] is splitting the bill, and the direct allocation is paying for what you ordered.”

Once an organization has gone through the approval process with its cognizant agency, it will be able to use the approved rate in other funding proposals because all the agencies have reciprocity with one another's calculation method. Indirect cost rates are generally approved for one to three years, given that nothing drastically changes with the organization's finances.

As part of the indirect cost approval process, organizations have to adopt financial policies and procedures on how they categorize expenses (direct and indirect costs) and must follow other accounting guidelines. Organizations will have to provide financial statements and documentation of how expenses are allocated, and they will need to identify what is and is not included in the indirect cost calculation. Several items are not allowed to be charged to indirect costs of government grants; therefore, it is best that an organization prepares its documentation for indirect costs before applying so that it can allocate the correct amount in the grant budget.

Suppose an agency does not want to go through the process of getting an approved indirect rate or if the indirect rate is less than 10%. In that case, it can accept the de minimis, which allows an agency to apply an indirect cost of 10% without going through the process of seeking approval.

### Benefits of an Indirect Rate

Will an approved indirect rate get you additional funding? Unlikely. However, it will provide a few benefits that make accounting and billing easier. For example, a local homeless shelter currently charges \$30/night for its emergency shelter program without an approved indirect cost. The emergency shelter program operates during the winter to ensure that individuals experiencing homelessness have a warm, safe place to sleep for the night.

The shelter receives \$30,000 per year from the city to support the shelter, resulting in 1,000 nights being covered—enough to house 25 people for 40 nights. The shelter recently calculated its indirect cost at 18%, which results in the total cost being \$35.40 per night. As a result, the shelter has funding to provide nearly 850 nights, or enough to house 25 people for 34 nights.



The approved indirect cost rate is helpful to the agency as it can bill a more significant amount faster, which is essential since many government grants are paid on a reimbursement basis. The increased billing does not mean that the shelter has to serve fewer individuals, but that is an option. In addition, the shelter has a few opportunities:

- Serve fewer individuals and have the grant provide the total cost of the program, which will reduce the amount of tracking the shelter will have to do, saving six nights' worth of reporting and billing
- Secure additional funding through different channels to support the additional nights of the shelter, thus generating over \$5,000 in additional revenue
- Increase the funding provided by the city by providing evidence of an increased cost and having the grant amount increase

Many government-funded programs are also offered based on the financial need of an individual or their family. Many programs base service eligibility on the poverty guidelines, but in some cases, individuals that make just above the poverty line could greatly benefit from the program, too. If the program is government-funded, then an organization must follow those service guidelines. But this does not prevent an agency from providing the same service to someone if it is funded via a grant or donations. In this case, that individual is just not included in the reporting and billing of the government grant, yet they can still participate in the program through other funding sources.

Indirect rates are a cost associated with providing a program, and even if an organization covers its operating costs through fundraising, charging an indirect rate allows an organization to capture administrative fees that it can then use to cover the cost of individuals that may not be qualified to participate through government dollars but can still benefit as well. Using an indirect cost will allow funds to be flexible because after indirect costs are billed and paid, depending on the organization's policy, they are essentially unrestricted dollars. After all, when you charge indirect costs to a grant, it is a fee that is associated with providing a program, not an actual line item in the budget.

## Explaining Indirect Costs to Other Funders

Government agencies are familiar with indirect costs, but other funders may have trouble understanding their importance. Logically, indirect costs are simply the cost of doing business, and without those costs being covered, it would be challenging to offer impactful programs and services. While some funders are still stuck on only providing program support, an increasing number are coming around to provide operating support, and many more are becoming likely to fund indirect costs associated with the program it is interested in funding.



Some funders may directly stipulate that an applicant cannot include indirect costs, some indicate a limit such as 15%, and others will not even notice it in your program budget. It is important to review the funding guidelines of an application to understand what you can and cannot include.

“An indirect rate is simply a “tax” placed on a program to ensure it can be operationally supported. Without a building to have a program, staff to run the program, and money to keep the lights and heat on, it becomes challenging to run a good program.”

Below is a simplified example of a budget for an afterschool program that uses an indirect cost:

Item	Cost	Justification
Program Director	\$60,000	100% at \$60,000 per year
Program Assistants (3)	\$90,000	100% at \$30,000 per year (3)
Fringe Benefits	\$45,000	30% of base wage (includes taxes, insurance, and retirement)
Supplies	\$15,000	Supplies for homework help, art projects, and enrichment activities
Transportation	\$3,000	Bus rental for three field trips at \$1,000 per trip (includes rental and driver)
Evaluation	\$10,000	External Evaluator - \$10,000
<b>Direct Costs</b>	<b>\$223,000</b>	
<b>Indirect Costs</b>	<b>\$40,140</b>	18% - Covers facilities, administrative support, insurance, and other infrastructure/support costs
<b>Total Cost</b>	<b>\$263,140</b>	

When meeting with potential donors or funders, they may ask you what indirect costs are on your budget, so below are a few ways you can explain why the organization charges indirect costs to programs:

- “Indirect costs support the infrastructure that makes our programs successful, and without our internal support, we would not be able to offer impactful programs.”
- “Indirect costs are our way of equitably passing along organizational expenses to all programs to ensure that each component of our operations is financially covered and that we raise the proper funding for each program and service we offer.”

- “Our organization uses an indirect cost rate of 18% for all programs to equally distribute administrative costs such as staff support, occupancy, utilities, and insurance. These are necessary expenses to facilitate a successful project.”

Many times, donors and funders are open to covering costs associated with running impactful programs, but it is important that an organization justify the expenses both mathematically and logically. Including a statement rationalizing why an organization charges an indirect rate and how it was calculated will go a long way to making it a cost that funders and donors are willing to cover.

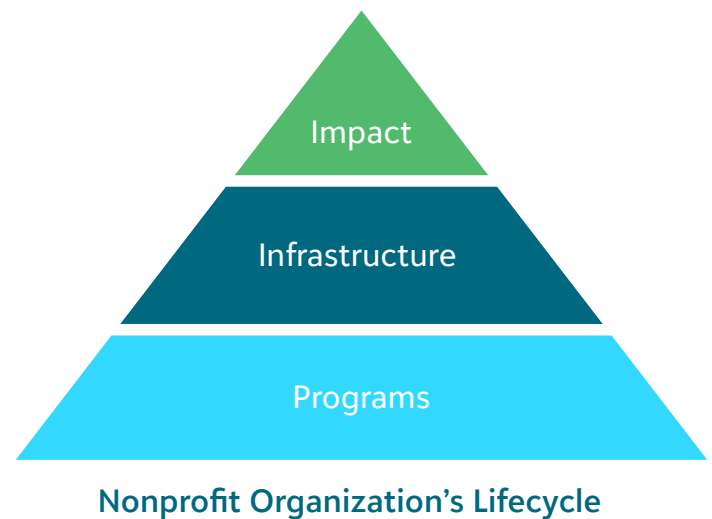


## Next Steps: Aligning Your Program and Operational Costs

Indirect costs, and overhead, are not bad words in the nonprofit sector. In the past, nonprofit organizations operated with a charity mindset where volunteers provided many programs and services, and budgets were minimal. As social problems have grown, organizations have had to adapt to take on systemic issues, address inequities, and advocate for social change. At the same time, nonprofits have faced additional regulatory and compliance requirements. To take on these responsibilities, nonprofits have had to become more professionalized. Because of that, the costs of providing services have increased.

Complex problems need comprehensive solutions to create change. Indirect costs allow organizations to adequately capture the funds necessary to create a robust program versus funding a program and then attempting to fund the infrastructure later. Indirect costs can help cover those necessary technology upgrades that are long overdue, support the hiring of additional support staff to alleviate the reporting burdens of program staff, and can help an organization have funding to cover the costs of raises and better benefits.

Raising money for nonprofit operations can be challenging since it is not the most exciting thing a donor can support. By establishing an indirect cost rate, nonprofits can better align program and operational costs to effectively fundraise and work to build stronger infrastructure support to have impactful programs and services. In a nonprofit organization's lifecycle, programs are the base, infrastructure is in the middle, and impact is the highest level. Without funding infrastructure, nonprofits will continue to struggle to achieve impact.





Consider calculating your organization's indirect cost rate using its most recent IRS Form 990. While you likely will need to seek clarification with your organization's accountant or auditor, nonetheless, this exercise is still helpful as a starting point. Within the 990, locate Part IX—Statement of Functional Expenses. To calculate the indirect cost, use the following calculation:

*Total Management and General Expenses + Total Fundraising Expenses / Total Expenses*

.....  
*(Column B, Line 25 + Column D, Line 25) / Column A, Line 25*  
.....

Now that you have a starting place, consider what charging this rate to your future programs could mean for sustainability. Including indirect costs in your grants could allow your organization to use philanthropic contributions for other activities, support new projects, build an endowment fund, or establish a rainy-day fund. Regardless of what you intend to do with your indirect cost rate, having one is a helpful tool for both internal planning and external fundraising.

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## About the Author

Dr. Colton Strawser is a nonprofit and philanthropic consultant and the President of Colton Strawser Consulting—a consulting firm that works with mission-driven organizations to develop the funding, data, and leadership skills necessary to create change.



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[Nonprofit Operational Reserves Toolkit: Building Sustainability for Your Organization: Download the Toolkit](#)

[Tough Remote Audit? 11 Tips to Radically Reshape Your Audit Approach: Download the Checklist](#)

[How to Save Time and Make Informed Decisions with Financial Edge NXT: Download the Quick Guide](#)

# Appendix A

## Government Grant Budget Template

Object Class Category	Federal Funds	Non-Federal Cash	Non-Federal In-Kind	TOTAL	Justification
Personnel					
Fringe Benefits					
Travel					
Equipment					
Supplies					
Contractual					
Construction					
Other					
Total Direct Charges					
Indirect Charges					
<b>TOTAL</b>					