

## COURSE 8, TUTORIAL 3

# WHAT ARE INDIRECT RATES AND HOW TO DEVELOP THEM?



To begin our discussion on how to calculate an **indirect rate**, let's start by reviewing the definition of direct vs indirect costs. A direct cost is one that you incur when doing work for a client—any client, whether it's a federal agency from which you have an SBIR or STTR award, or work for a private client. The most common direct cost is labor. This reflects the cost of the time that you and your employees have agreed to spend doing work for your client. By contrast, **indirect costs** are not directly accountable to a project, but represent the general costs of being in business. Rent, employer's portion of payroll taxes, your cell phone bill, and general management and accounting are examples of indirect costs. **An indirect rate** derived from these costs is unique to each company, and tends to change over time. This is especially true for small and startup companies. Therefore, NEVER use another entity's indirect rate and ALWAYS re-evaluate and adjust yours as conditions change in your small business.

### USE A STEP WISE APPROACH

The challenge is to estimate the appropriate **indirect rate** for your company so that you can use this in preparing the budget section of your SBIR/STTR proposals and work with any of your customers. This activity will help ensure that you cover all the costs of being in business. An indirect rate is always estimated for a period of time, typically a calendar or fiscal year. So let's get started

**The first thing you need to do is list ALL of your annual company costs.** You can start with the profit/loss or income statement in your accounting system, or your annual budget, or just your best guess of the categories in which you might incur costs during the coming year. Do the best you can—you can always amend as you learn more about your costs, especially if you are just a startup company now. Put the items in a column in an Excel spreadsheet as shown here. Please note

that we are listing every expense and not yet thinking in terms of direct and indirect costs.

**Next estimate your upcoming annual costs in each of the categories you listed.** Again, this might be based on your profit/loss or income statement for the most recent year, or taking the current year-to-date and projecting it out for a full 12 months. Or, if you are a start up and don't have any historical data, then just do the best you can to estimate the amount required for each category.

Some numbers will be easier to estimate than others; for example, if you just signed a lease, you know what your monthly rent will be. Other numbers will be harder to estimate, like total labor costs or how much subcontracting you'll need for next year's work. You won't know these numbers exactly—you just



do the best you can with imperfect information, and refine it as you learn more in the future. You will get better at estimating numbers as you accrue more history, but for now - do the best you can.

In this example, we have come to the conclusion that, in the coming calendar year, we will have a corporate budget of about \$473,000 including all of our known and expected costs.

**Now that you have estimated all of your annual costs, you are ready to start classifying them. To get started, create 4 more columns in your spreadsheet and label them as Direct, Indirect, Unallowable and Comments.** The first category is direct cost which is the cost of actually doing work for clients. The column labeled as indirect is where you place all of the general costs of being in business. The third and final cost category is “unallowable,” which is something we’ll delve into in the 4th module in this cost proposal series. Simply put, there are costs that the Federal government has said it won’t pay for. Therefore, these costs can’t go into the direct or indirect columns, but must be isolated from our indirect rate calculation. A fourth column is added just so we can make notes for our own use about how we derived certain numbers, or decided how to allocate something between the direct, indirect and unallowable columns.

**Now plug in or allocate the Total cost between the three columns: direct, indirect and unallowable costs.** Starting with labor, estimate what amount will be paid to employees while they are working on projects (direct) versus when they are doing general corporate activities which are considered as indirect. Note the indirect should also include any paid time off, such as vacation, holiday and sick leave. If you give an employee two weeks vacation, ten holidays, and five sick days, then that equals almost 10% of a work year, and therefore \$30,000 of the labor category should be put in the Indirect column just to cover this paid absence.

Payroll taxes are shown as being entirely allocated to the indirect category. There are some companies (and universities) that allocate some of these to the direct column, but we will keep this example as simple as possible.

There are other categories that have to be allocated between direct and indirect. For example, we plan to hire a consultant to work on one of our projects as directly billed labor, but also have one helping with our business plan, so we have to split the total consultant category into direct vs. indirect accordingly.

Travel is an interesting category. We expect to do some travel related to our project work as the agency may require all SBIR/STTR recipients to attend a meeting, or you may schedule a

kick off or progress meeting with the client, or you may need to travel to the subcontractor’s location). This travel, therefore, goes into the Direct column. But travel related to conference attendance goes under Indirect. Finally, we may have an employee with a physical impairment that requires her to fly first class, but the Federal government won’t pay for first class travel and therefore we will have some travel that is unallowable.

Finally, we show the entire independent research & development (IR&D) budget to be unallowable. This is because some Federal agencies, notably National Institutes of Health (NIH) and National Science Foundation (NSF), refuse to pay it, and therefore it is unallowable if we are submitting our SBIR/STTR proposal to either of those agencies. If we were submitting to the other agencies that does allow IR&D, then it would be moved to the Indirect column.

After doing the best we can to allocate each cost category to Direct, Indirect and/or Unallowable, we sum each column. Out of our \$473,000 annual budget, we expect that performing our direct work for clients will cost \$234,000, while our general costs of being in business (indirect) will total about \$228,000. Another \$11,000 cannot be billed to our clients if they are NIH or NSF, per the discussion above regarding IR&D. Once again, don’t expect perfection in your estimated allocation of any cost category between Direct, Indirect and Unallowables—do the best you can, and make revisions in the future as you learn more and/or as actual costs become clearer.

Once you’ve allocated all of your anticipated annual costs to the Direct, Indirect or Unallowable columns, and summed up each column, you can calculate your expected Indirect Rate. The math, as shown here is very simple:

Just take the total for the Indirect Cost column, that is \$228k and divide it by the total of the Direct Cost column (\$234k), which yields an indirect rate of 98%. As an alternative, and per an earlier example, you could take total Indirect Costs, that is \$228k and divided by just the Direct Labor cell (\$175k), and get an indirect rate of 130%. These two rates are equivalent: the first is 98% of all direct costs, and the second is 130% of just direct labor. You can use either rate in your cost proposal, just make sure that you multiply it times the right direct cost(s) and that you carefully read any guidance provided by the agency to which you will be submitting a proposal.

To help understand what we have said here: during the calendar year, if we bill a client \$1,000 in direct labor, we should bill them an additional \$1,300 in indirect costs. If we do this consistently, then when we have charged clients a total of \$175,000 in labor during the year, we will have also collected \$228,000 which will cover all of our indirect costs that we incur.

COSTS	Total	Direct	Indirect	Unallowable	Comments
Labor	\$300,000	\$175,000	\$125,000		Include paid time off in indirect
Payroll taxes	49,050		49,050		\$300K* (SSN+SUTA+FUTA)
Rent	24,000		24,000		\$2K/month
Office Supplies	6,000		6,000		\$500/month
Telecommunications	6,000		6,000		\$500/month
Consultants	15,000	10,000	5,000		Project related (\$10K) and mgmt. consultant (\$5K)
R&D Subcontractors	45,000	45,000			All working on projects
Travel	12,000	4,000	7,000	1,000	\$4K for project, \$7K marketing, \$1K (1st class airfare)
Insurance	950		950		Corporate liability @\$100/month
Independent R&D	10,000			10,000	Allowability depends on agency
Equipment/Furniture Depreciation	5,000		5,000		From Depreciation schedule of company equipment and furniture
<b>TOTAL</b>	<b>\$473,000</b>	<b>\$234,000</b>	<b>\$228,000</b>	<b>\$11,000</b>	<b>\$473,000</b>

**Indirect rate: Indirect as % of all direct costs 98%**

**Indirect rate: Indirect as % of only direct labor 130%**

## A FEW FINAL POINTS

We'll close with a few final points:

1. Once you have derived your indirect rate for the coming year, use it consistently for all projects you bid for that time period. In other words, your indirect rate should not change project-by-project, but should remain constant for a year and be used consistently.

2. The exceptions to #1 are:

a. Some agencies allow certain costs and others do not. The example above shows IR&D as unallowable, but it would be an allowed indirect cost at any SBIR/STTR agency except for NIH and NSF.

b. Your costs may change significantly during the year, and your indirect rate may change because of this. Or your estimates of certain costs may become more accurate after you derive your indirect rate for the year. Unfortunately, you generally cannot change your rate mid year or in the middle of a project. Therefore, your best course of action may be to adjust your expenditures to realign your costs with your original indirect rate for the year. In the above example, you

might put a moratorium on indirect travel if you see your indirect rate increasing because other costs are becoming higher than expected.

3. If you are submitting to NIH, and you do not have an approved Indirect rate, then they will not give you more than 40% of all direct costs.

4. Deriving your indirect rate will be challenging the first time, and therefore you may resist doing it. But it must be done, if you plan to receive SBIR/STTR awards (and besides, it is a good idea so you will make sure you are pricing all your services to all your clients such that you are at least covering costs). And once you've done it, it becomes a lot easier next time because it becomes a process of refinement and improvement.

Finally, what we have attempted to do here is demonstrate how to generate Indirect rates in the simplest terms. There are many rules, regulations, variations, and agency nuances, etc. that you will need to learn. But just get started with this simple approach. Later you can address those issues once you've got the basics squared away.