### Cost Principles for Nonprofit Organizations

The 2 CFR Part 200 establishes cost principles for determining costs applicable to federal awards with nonprofit organizations (NPOs). The principles are designed to ensure that the federal government bear its fair share of costs except where restricted or prohibited by law. These principles are used by all federal agencies in determining the allowable costs of work performed by NPOs under federal awards. Some NPOs must operate under federal cost principles applicable to for-profit entities located at 48 CFR section 31.2. A listing of these organizations is contained in Appendix VIII to 2 CFR Part 200.

In addition to the cost principles established by 2 CFR Part 200, Subpart E, the Cost Accounting Standards Board (CASB) has promulgated certain cost accounting standards (CAS) that must be followed by nonprofit organizations receiving procurement contracts that meet a defined dollar threshold. Generally, organizations are exempt from coverage under CAS unless they receive a single CAS-covered contract or subcontract of at least $7.5 million. After receipt of this trigger contract, CAS coverage is applied to all negotiated awards that exceed the Truth in Negotiations Act threshold, currently $700,000, unless they meet certain exemptions. These exemptions and the requirements of CAS can be found in 48 CFR chapter 99.

***Cognizant Agency for Indirect Costs***

The 2 CFR section 200.1 defines “cognizant agency for indirect costs” as the federal agency responsible for reviewing, negotiating, and approving cost allocation plans or indirect cost proposals on behalf of all federal agencies. References to the “cognizant agency for indirect costs” in this section are not equivalent to the cognizant agency for audit, which is defined in 2 CFR section 200.1. The 2 CFR Part 200, Appendix IV, paragraph C.2 clarifies that the cognizant agency for indirect costs is generally the federal agency with the largest direct dollar value of federal awards with an organization, unless different arrangements are agreed to by federal agencies.

*(Source: 2023 OMB Compliance Supplement Part 3)*

#### Allowable Costs – Direct and Indirect Costs

**Compliance Requirements – Direct Costs**

Direct costs are those costs that can be identified specifically with a particular final cost objective, such as a federal award, or other internally or externally funded activity, or that can be directly assigned to such activities relatively easily with a high degree of accuracy.

Costs incurred for the same purpose in like circumstances must be treated consistently as either direct or indirect (F&A) costs.

For nonprofit organizations, the cost of activities performed primarily as a service to members, clients, or the general public when significant and necessary to the organization’s mission must be treated as direct costs—whether or not allowable—and be allocated an equitable share of indirect costs. Examples can be found in 2 CFR section 200.413(f).

If the auditor identifies unallowable direct costs, the auditor should be aware that directly associated costs might have been charged. Directly associated costs are costs incurred solely as a result of incurring another cost that would not have been incurred if the other cost had not been incurred. For example, fringe benefits are directly associated with payroll costs. When a payroll cost is determined to be unallowable, then the directly associated fringe benefit would be determined unallowable as well.

**Compliance Requirements – Indirect Costs**

a. Indirect costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective. Direct costs of minor amounts may be treated as indirect costs under the conditions described in 2 CFR section 200.413(d). After direct costs have been determined and assigned directly to awards or other work, as appropriate, indirect costs are those remaining to be allocated to benefitting 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. If an organization receives more than $10 million in direct federal funding in a fiscal year, a breakout of the indirect cost component into two broad categories, Facilities and Administration, as defined in 2 CFR section 200.414(a), is required.

b. Indirect cost rate proposals (ICRPs) are used to either establish predetermined rates, fixed rates with carry-forward provision, provisional, or final rates (2 CFR Part 200, Appendix IV, paragraph C.1).

(1) *Predetermined rate* means an indirect cost rate, applicable to a specified current or future period, usually the organization's fiscal year. The rate is based on an estimate of the costs to be incurred during the period. A predetermined rate is not subject to adjustment.

(2) *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 costs of the period covered by the rate is carried forward as an adjustment to the rate computation of a subsequent period.

(3) *Provisional rate or billing 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 the period.

(4) *Final rate* means an indirect cost rate applicable to a specified past period which is based on the actual costs of the period. A final rate is not subject to adjustment.

c. Some federal awards may contain cost limitations on recovery of indirect costs that differ from the federally negotiated indirect cost rates. In these cases, the indirect cost rate will be specified in the award, as described in 2 CFR sections 200.210(a)(15) and 200.331(a)(1)(xiii).

d. To recover indirect costs, NPOs prepare ICRPs for the cognizant agency for indirect costs. NPOs that have not previously established indirect costs rates and are not using the de minimis indirect cost rate must submit an ICRP immediately upon notification that a federal award has been made and, in no event, later than three months after the effective date of the award. NPOs that have previously established indirect cost rates must submit a new ICRP within six months after the close of each fiscal year. The ICRP is the documentation prepared by an organization to substantiate its claims for the reimbursement of indirect costs. The proposal provides the basis for the review and negotiation leading to the establishment of an organization’s indirect cost rate. NPOs can select one of three different methods to allocate indirect costs and compute the indirect cost rate.

(1) *Simplified Allocation Method* – Where an organization’s major functions benefit from its indirect costs to approximately the same degree, the allocation of indirect costs may be accomplished by (a) separating the organization’s total costs for the base period as either direct or indirect, and (b) dividing the total allowable indirect costs (net of applicable credits) by an equitable distribution base. A full discussion of the simplified allocation method can be found in 2 CFR Part 200, Appendix IV, paragraph B.2.

(2) *Multiple Allocation Base Method* – Where an organization’s indirect costs benefit its major functions in varying degrees, indirect costs must be accumulated into separate cost groupings, as described in 2 CFR Part 200, Appendix IV, paragraph B.3.b. Each grouping must then be allocated individually to benefiting functions by means of a base that best measures the relative benefits. The allocation bases for each grouping are described in 2 CFR Part 200, Appendix IV, paragraph B.3.c. A full discussion of the multiple allocation base method can be found in 2 CFR Part 200, Appendix IV, paragraph B.3.

(3) *Direct Allocation Method* – Some NPOs treat all costs as direct costs except general administration and general expenses. These organizations generally separate their costs into three basic categories: (a) general administration and general expenses, (b) fundraising, and (c) other direct functions (including projects performed under federal awards). Joint costs, such as depreciation, rental costs, operation and maintenance of facilities, telephone expenses, and the like are prorated individually as direct costs to each category and to each award or other activity using a base most appropriate to the particular cost being prorated. A full discussion of the direct allocation base method can be found in 2 CFR Part 200, Appendix IV, paragraph B.4.

*(Source: 2023 OMB Compliance Supplement Part 3)*

#### Audit Objectives and Control Testing – Allowable Costs – Direct and Indirect Costs

**Audit Objectives: Direct Costs**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by 2 CFR section 200.514(c).
2. Determine whether the organization complied with the provisions of 2 CFR Part 200 and CAS (if applicable) as follows:
3. Direct charges to federal awards were for allowable costs.
4. Unallowable costs determined to be direct costs were included in the allocation base for the purpose of computing an indirect cost rate.

**Audit Objectives: Indirect Costs**

1. Obtain an understanding of internal controls, assess risk, and test internal controls as required by 2 CFR section 200.514(c).
2. Determine whether the NPO charged indirect costs to federal awards in compliance with the cost principles in 2 CFR Part 200, Subpart E, Appendix IV, and CAS (if applicable), and in accordance with any negotiated rate agreements and specific award conditions/limitations.

*(Source: 2023 OMB Compliance Supplement Part 3)*

**Control Documentation and Testing**

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| *Auditors should clearly document what control procedures address the compliance requirement. Reference or link to documentation or where testing was performed.*  **Basis for the control** *(Ex. reports, resources, etc. providing information needed to understand requirements and prevent or identify and correct errors)*:  **Control Procedure** *(Description of how auditee uses the “Basis” to prevent, or identify and correct or detect errors)*:  **Person(s) responsible for performing the control procedure** *(Title)*:  **Description of evidence documenting the control was applied** *(i.e. sampling unit)*: |

#### Suggested Substantive Audit Procedures – Compliance – Direct and Indirect Costs

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| Consider the results of control testing above in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.  *(Source: 2023 OMB Compliance Supplement Part 3)*  ***Direct Costs***  Test direct costs charged to federal awards with the following criteria:   1. Costs were approved by the federal awarding agency, if required. (See 2 CFR section 200.407 for items of cost that require prior written approval and Exhibit 1, Selected Items of Cost, in this part of the Supplement.) 2. Costs were necessary and reasonable for the performance of the federal award and allocable under the principles of 2 CFR 200, Subpart E. 3. Costs conformed to any limitations or exclusions set forth in 2 CFR 200, Subpart E, or in the federal award as to types or amount of cost items. 4. Costs were consistent with policies and procedures that apply uniformly to both federally financed and other activities of the NPO. 5. Costs were accorded consistent treatment. Cost were not assigned to a federal award as a direct cost if any other cost incurred for the same purpose in like circumstances was allocated to a federal award as an indirect cost. 6. Costs were not included as a cost of any other federally financed program in either the current or a prior period. 7. Costs were not used to meet the cost-sharing or matching requirements of another federal program, except where authorized by federal statute. 8. Costs were adequately documented.   ***Indirect Costs***   1. Test whether indirect costs comply with the following criteria: 2. Conform to the allowability of cost provisions in 2 CFR Part 200, Subpart E. 3. Are supported by appropriate documentation, such as purchase orders, receiving reports, contractor invoices, canceled checks, and time and attendance records that meet the documentation standards of 2 CFR section 200.430(i), and are correctly charged as to account, amount, and period. 4. Are calculated in conformity with generally accepted accounting principles or CAS, as required. 5. Are not used to meet cost-sharing or matching requirements of other federally supported activities. 6. Be given consistent accounting treatment within and between accounting periods. Consistency in accounting requires that costs incurred for the same purpose, in like circumstances, be treated as either direct costs only or indirect costs only with respect to final cost objectives. 7. *For NPOs that charge indirect costs to federal awards based on federally negotiated rates,* obtain the current indirect cost rate agreement, including the proposal used in the negotiation of the agreement, and determine the type of rates (i.e., pre-determined, fixed rate, provisional rate, or final rate as described in 2 CFR Part 200, Appendix IV, section C) and terms in effect for the year being audited. 8. If a fixed rate agreement with carry-forward provisions has been negotiated with the cognizant agency for indirect cost, determine that the difference between the estimated indirect costs and the actual indirect costs of the period was correctly calculated and carried forward to the rate computation in the current year. 9. If a provisional rate was used to bill for indirect costs, determine whether a final rate has been negotiated and appropriate billing adjustments have been made based on the final negotiated rate.   c. *For NPOs that charge indirect costs to federal awards based on rates that are not federally negotiated*, review the ICRP or methodology used to allocate indirect costs for the year being audited to ensure it meets the requirements of 2 CFR Part 200, Subpart E, and CAS, when applicable, to verify the following.   1. Indirect costs are charged uniformly to both federally funded and other activities of the NPO and are consistent with the NPO’s policies and procedures. 2. Costs in the indirect costs pool are allowable and the composition of the pool allows allocation over a base that is best suited for assigning the pool of indirect costs to cost objectives in accordance with the benefits received. 3. The allocation base provides for an equitable allocation of indirect costs and include unallowable costs, as appropriate, so that unallowable costs will receive their proportionate share of indirect costs. 4. Costs have been given consistent accounting treatment within and between accounting periods. 5. The cost of activities performed primarily as a service to members, clients, or the general public when significant and necessary to the NPO’s mission are treated as direct costs—whether or not allowable—and are allocated an equitable share of indirect costs. See examples in 2 CFR section 200.413(f).   d. Select a sample of claims for indirect cost reimbursement:  Verify that the rates used where in accordance with the terms and conditions of the award and the amounts claimed were applied to the appropriate base.  *Auditors must include results of this testing in the Section B - Audit Implications Summary of the FACCR.* |

#### Special Requirements – Disclosure Statements (DS-1) Required by Cost Accounting Standards

**Compliance Requirements – CAS and Disclosure Statements**

a. Pub. L. No. 100-679 (41 USC 422) requires certain contractors and subcontractors (which includes NPOs) to comply with CAS and to disclose in writing and follow consistently their cost accounting practices.

b. The 48 CFR section 9903.201-1 (FAR appendix) describes the rules for determining whether a proposed contract or subcontract is exempt from CAS. Negotiated contracts not exempt in accordance with 48 CFR section 9903.201-1(b) are subject to CAS. A CAS-covered contract may be subject to either full or modified coverage. The rules for determining whether full or modified coverage applies are in 48 CFR section 9903.201-2 (FAR appendix).

(1) Full coverage requires that a business unit comply with all the CAS specified in 48 CFR Part 9904 that are in effect on the date of the contract award and with any CAS that become applicable because of later award of a CAS-covered contract. Full coverage applies to contractor business units that (a) receive a single CAS-covered contract award of $50 million or more; or (b) receive $50 million or more in net CAS-covered awards during their preceding cost accounting period (48 CFR section 9903.201- 2(a)).

(2) Modified CAS coverage requires only that the contractor comply with Standard 9904.401, Consistency in Estimating, Accumulating, and Reporting Costs; Standard 9904.402, Consistency in Allocating Costs Incurred for the Same Purpose; Standard 9904.405, Accounting for Unallowable Costs; and Standard 9904.406, Cost Accounting Standard— Cost Accounting Period. Modified, rather, than full, CAS coverage may be applied to a covered contract of less than $50 million awarded to a business unit that received less than $50 million in net CAS-covered awards in the immediately preceding cost accounting period.

c. The 48 CFR section 9903.202 (FAR Appendix) describes the general Disclosure Statement requirements. A Disclosure Statement is a written description of a contractor’s cost accounting practices and procedures and are required under the following circumstances:

(1) Any business unit that is selected to receive a CAS-covered contract or subcontract of $50 million or more must submit a Disclosure Statement before award.

(2) Any company which, together with its segments, receive net awards of negotiated prime contracts and subcontracts subject to CAS totaling $50 million or more in its most recent cost accounting period, must submit a Disclosure Statement before award of its first CAS-covered contract in the immediately following cost accounting period.

#### Audit Objectives and Control Testing – CAS and Disclosure Statements

**Audit Objectives – CAS and Disclosure Statements**

a. Determine whether the NPO’s Disclosure Statement (including amendments) is current, accurate, complete, and properly filed with the cognizant federal Administrative Contracting Officer in accordance with 48 CFR section 9903.202- 5.

b. Determine whether the NPO’s actual accounting practices are consistent with its disclosed practices.

c. Determine whether the NPO’s accounting practices, for direct and indirect costs, are compliant with CAS, based on its required CAS coverage (full or modified).

*(Source: 2023 OMB Compliance Supplement Part 3)*

**Control Documentation and Testing**

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| *Auditors should clearly document what control procedures address the compliance requirement. Reference or link to documentation or where testing was performed.*  **Basis for the control** *(Ex. reports, resources, etc. providing information needed to understand requirements and prevent or identify and correct errors)*:  **Control Procedure** *(Description of how auditee uses the “Basis” to prevent, or identify and correct or detect errors)*:  **Person(s) responsible for performing the control procedure** *(Title)*:  **Description of evidence documenting the control was applied** *(i.e. sampling unit)*: |

#### Suggested Substantive Audit Procedures – Compliance – CAS and Disclosure Statements

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| Consider the results of control testing above in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.  *(Source: 2023 OMB Compliance Supplement Part 3)*   1. Ascertain whether the NPO has any CAS-covered contract or subcontracts. If so, determine which type of CAS coverage is applicable (full or modified) and if a Disclosure Statement is required to be submitted to the cognizant agency for indirect cost. 2. If a Disclosure Statement is required, obtain a copy and any amendments: 3. Determine if the cognizant agency for indirect costs has approved the Disclosure Statement and/or has been appropriately notified of changes in the cost accounting practices that occurred during the year to which indirect cost rate agreements are being applied. 4. Test whether the NPO’s actual accounting practices are consistent with the disclosed practices. 5. Test the NPO’s actual accounting practices for direct and indirect costs are compliant with applicable CAS.   *Auditors must include results of this testing in the Section B - Audit Implications Summary of the FACCR.* |

#### Allowable Costs – Special Requirements – Internal Service, Central Service, Pension, or Similar Activities or Funds

**Compliance Requirements**

NPOs using internal service, central service, pension, or similar activities or funds must follow the applicable cost principles found in 2 CFR Part 200.

#### Audit Objectives and Control Testing – Internal Service, Central Service, Pension, or Similar Activities or Funds

**Audit Objectives**

1. Obtain an understanding of internal control, assess risk, and test internal control as required by 2 CFR section 200.514(c).
2. Determine whether charges made from internal service, central service, pension, or similar activities or funds are in accordance with 2 CFR Part 200.

*(Source: 2023 OMB Compliance Supplement Part 3)*

**Control Documentation and Testing**

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| *Auditors should clearly document what control procedures address the compliance requirement. Reference or link to documentation or where testing was performed.*  **Basis for the control** *(Ex. reports, resources, etc. providing information needed to understand requirements and prevent or identify and correct errors)*:  **Control Procedure** *(Description of how auditee uses the “Basis” to prevent, or identify and correct or detect errors)*:  **Person(s) responsible for performing the control procedure** *(Title)*:  **Description of evidence documenting the control was applied** *(i.e. sampling unit)*: |

#### Suggested Substantive Audit Procedures – Compliance – Internal Service, Central Service, Pension, or Similar Activities or Funds

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| Consider the results of control testing above in assessing the risk of noncompliance. Use this as the basis for determining the nature, timing, and extent (e.g., number of transactions to be selected) of substantive tests of compliance.  *(Source: 2023 OMB Compliance Supplement Part 3)*   1. For activities accounted for in separate funds, ascertain if (1) retained earnings/fund balances (including reserves) were computed in accordance with 2 CFR Part 200; (2) working capital reserves were not excessive in amount (generally not greater than 60 days for cash expenses for normal operations incurred for the period exclusive of depreciation, capital costs and debt principal costs); and (3) refunds were made to the federal government for its share of any amounts transferred or borrowed from internal service, central service, pension, insurance, or other similar activities or funds for purposes other than to meet the operating liabilities, including interest on debt, of the fund.   b. Test that all users of services are billed in a consistent manner.  c. Test that billing rates exclude unallowable costs, in accordance with 2 CFR Part 200.  d. Test, where activities are not accounted for in separate funds, that billing rates (or charges) are developed based on actual costs and were adjusted to eliminate profits.  e. For NPOs that have self-insurance and certain types of fringe benefit programs (e.g., pension funds), ascertain if independent actuarial studies appropriate for such activities are performed at least biennially and that current period costs were allocated based on an appropriate study which is not over two years old.  *Auditors must include results of this testing in the Section B - Audit Implications Summary of the FACCR.* |