SECTION 4 - Principles for Determining Costs

SECTION 4

PRINCIPLES FOR DETERMINING COSTS

4.1 Introduction

This section of the manual promulgates principles and standards for determining contract costs. It applies primarily to cost-related contracts, although the underlying principles are designed to provide the basis for a uniform approach to determining costs and to promote greater efficiency and better relationships between the Department and the service provider community.

Scope

These principles are confined to the subject of cost determination and do not address the issue of profit or any increment above actual cost. They are designed to provide recognition of the full allocable cost of work under generally accepted accounting principles. The cost principles make no attempt to identify the circumstances or to dictate the extent of Department or provider agency participation in the financing of a particular program. Individual contracting divisions within the Department may choose, in accordance with established policies or current needs, to refrain from participating or to limit their participation in any given cost, notwithstanding the designation of the cost as "allowable" according to these principles.

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The successful application of these principles requires the development of a mutual understanding between representatives of the provider agency and the Department as to their scope, applicability, and interpretation. It is recognized that: (1) the arrangements for Department and provider agency participation in the financing of a program are properly the subject of contract negotiation; (2) each provider agency is expected to employ sound management practice in the fulfillment of its contractual obligation; and (3) each provider agency, in recognition of its own unique combination of staff, facilities, and experience, should be responsible for employing whatever form of organization and management techniques may be necessary to ensure proper and efficient administration.

Limitations

The contract cost and/or rate established based on these cost principles is/are subject to any applicable statutory or administrative limitations. In addition, acceptance of the provider agency's cost/rate is predicated on the condition that:

1. No costs other than those incurred by the provider agency were included in the contract budget as finally accepted and that such costs are allowable under the cost principles;

2. Similar types of costs have been accorded consistent accounting treatment; and

3. The information provided by the provider agency which was used as a basis for acceptance of the contract cost/rate is not subsequently found to be materially incomplete or inaccurate.

4.2 Basic Consideration

Composition of Total Operating Cost

The total operating cost of a program is the sum of the allowable direct and indirect (general and administrative) costs allocable to the program, less any applicable credits. In ascertaining what constitutes costs, any generally accepted accounting method of determining or estimating costs that is equitable under the circumstances may be used.

Factors Affecting Allowability of Costs

Factors to be considered in determining the allowability of individual items of cost include:

1. Reasonableness;

2. Allocability;

3. Application of those generally accepted accounting principles and practices appropriate to the particular circumstances; and

4. Any limitation or exclusion set forth in this document or otherwise included in the contract, as to types or amounts of cost items.

Definition of Reasonableness

A cost is reasonable if, in its nature or amount, it does not exceed that which would be incurred by an ordinarily prudent person in the conduct of competitive business. The question of the reasonableness of specific costs must be scrutinized with particular care in connection with provider agencies, or separate divisions thereof, which may not be subject to effective competitive restraints. What is reasonable depends upon a variety of considerations and circumstances involving both the nature and amount of the cost in question. In determining the reasonableness of a given cost, consideration must be given to:

1. Whether the cost is of a type generally recognized as ordinary and necessary for the operation of the provider agency or the performance of the contract;

2. The restraints or requirements imposed by such factors as generally accepted sound business practices, arm's length bargaining, federal and State laws and regulations, and contract terms and specifications;

3. The action that a prudent business person would take in the circumstances, considering responsibilities to the public at large, the government, provider agency employees, clients, shareholders or members, and the fulfillment of the purposes for which the provider agency was organized;

4. Significant deviations from the established practices of the provider agency that may unjustifiably increase the contract costs; and

5. Whether the cost is in excess of what would have been incurred in the absence of the Department contract.

Definition of Allocability

A cost is allocable if it is assignable or chargeable to a particular cost objective - such as a contract, project, product, service, process, or other major activity - in accordance with the relative benefits received or some other equitable relationship. Subject to the foregoing, a cost is allowable to a Department contract if it:

1. Is incurred specifically for the contract;

2. Benefits both the contract and other work and can be distributed to them in reasonable proportion to the benefit received; or

3. Is necessary to the overall operation of the provider agency, although a direct relationship to any particular cost objective cannot be shown.

Where a provider agency utilizes the Standards of Accounting and Financial Reporting for Voluntary Health and Welfare Organizations (or comparable generally accepted accounting standards peculiar to its structure or activity) to allocate costs to non-governmentally supported activities, it must also use such standards to allocate costs to government contracts.

Allowability of General and Administrative Costs

The Department recognizes that allowable general and administrative (G&A) costs are essential and legitimate costs of provider agencies and shall not adopt internal policies that arbitrarily or capriciously restrict or prohibit these costs. In instances where certain State appropriations and/or federal grants/contracts restrict or cap G&A costs, the Department will seek to fund these costs from discretionary funds at its disposal. If the Department is unable to provide funding, it is the provider agency's choice whether or not to accept such contractual obligations. Nothing in its policy precludes the Department from accepting State appropriations and/or federal grants/contracts that restrict G&A costs.

Applicable Credits

The term "applicable credits" refers to those receipts or reduction of expenditures which operate to offset or reduce expense items allocable to the contract as direct or indirect costs. Typical examples of such transactions are: purchase discounts, rebates or allowances, recoveries or indemnities on losses, sales of scrap or incidental services, insurance refunds, and adjustments of erroneous charges. In addition, funds from certain government-sponsored programs, such as Medicaid and the Child Nutrition Program, may offset specific costs in the contract budget and should be treated as applicable credits. The portion of any income, rebate, allowable, or other credit which is applicable to any allowable cost in the contract budget must reduce or offset that cost.

Revenue

Revenue is the total income generated by the provider agency by means of its programs and activities. Such income comes from various sources such as other government contracts and grants, payments from non-contract clients, foundation grants, contributions, third-party health insurance, fund-raising, investment income and miscellaneous sources and credits. The various types of revenue are:

1. Department Contract Generated Revenue which includes all income generated by the provider agency in connection with the delivery of contract services such as Department client fees, any interest, dividends, etc., earned on Department funds, third-party insurance, and Department client rental agreements.

2. Provider Agency Revenue Used as Cost Sharing which denotes provider agency participation in the cost of the programs funded under the Department's cost related or non-cost-related contract. Agencies are able to participate in the cost of programs from various sources of unrestricted and restricted funds. These revenues should be divided into two categories: a) required cost sharing; and b) voluntary/negotiated cost sharing.

    a. Required Cost Sharing

        (1) When the contract funds the delivery of less than 100 percent of the units of service in the program(s), the provider agency is required to identify the other funding sources, and the amount from these sources must be sufficient to cover that portion of the program(s) not funded by the Department.

        (2) When the Department designates a contract to be a Social Services Block Grant service (not training) contract, the specific cost sharing requirements for SSBG contracts are contained in Department Policy DCF.P6.01, Match Requirements for Social Services Block Grant Service Contracts.

        (3) When the Department designates a specific cost sharing requirement for a particular group of contracts.

    b. Voluntary/Negotiated Cost Sharing

        When other resources (income from endowments, fund raising, gifts) are available to reduce the cost of services delivered to contract clients, the amount of provider agency participation in the cost of the program(s) will be based on an agreement between the Department and the provider, taking into consideration the provider fund balances, the formal plans (as approved by the governing board) for deployment of fund balances and the provider's ability to generate the needed revenues.

3. Provider Agency Revenue Not Used As Cost Sharing includes all revenues received or generated by the provider which will not be used to reduce the cost of Department-funded programs, but which will be used to fund other budgeted costs.

   The Department recognizes that adequate working capital must be maintained by provider agencies in order to avoid cash flow problems. It also recognizes that unallowable costs (e.g., fundraising activities) must be sufficiently funded by the various unrestricted and restricted funding sources available to provider agencies. However, the Department will encourage reasonable cost sharing in contract programs when adequate funds exist. Other than the circumstances listed above, the Department does not usually impose specific match and cost sharing requirements.

4.3 Cost Objectives

For cost determination purposes, components of cost may be classified into two types: direct and indirect. This subsection addresses these two types of costs.

Direct Costs

A direct cost is any cost that can be identified specifically with a particular cost objective. Direct costs are not limited to items that are incorporated in the end product as material and labor. Costs identified specifically with the contract are direct costs of the contract and may be charged directly thereto. Costs identified specifically with other work of the provider agency are direct costs of that work and are not to be charged to the contract either directly or indirectly. Where the provider agency's established accounting system provides for the treatment of certain items of cost as direct costs, then the same items must be considered direct costs to all contracts, programs, and major activities and may not be included in the indirect cost pool.

Certain types of costs, or costs associated with certain activities, are not reimbursable as a charge to a Department contract. These unallowable costs or activities are discussed in General Standards for Unallowable Costs in this section. Even though a particular activity or cost is designated as unallowable for purposes of computing costs charged to the Department contract, it nonetheless must be treated as a direct cost or activity if a portion of the provider agency's indirect cost (as defined below) is properly allocable to it. The amount of indirect cost allocated must be in accordance with the principles outlined in the section entitled Indirect Costs. In general, an unallowable provider agency activity shall be treated as a direct function when it: (1) includes salaries of personnel; (2) occupies space; and (3) is serviced by an indirect cost grouping(s). Thus the costs associated with the following types of activities, when normal or necessary to a provider agency's primary mission, shall be treated as direct costs:

1. Maintenance of membership rolls, subscriptions, publications, and related functions;

2. Providing services and information to members, legislative or administrative bodies, or the public;

3. Promotion, lobbying, and other forms of public relations;

4. Meetings and conferences, except those convened to conduct the general administration of the agency;

5. Fund-raising;

6. Maintenance, protection, and investment of special funds not used in the operation of the agency;

7. Administration of group benefits on behalf of members or clients, including life and hospital insurance, annuity or retirement plans, financial aid, etc.;

8. Other activities performed primarily as a service to membership, clients, or the public.

This definition shall be applied to all items of cost of significant amount unless the provider agency demonstrates that the application of any different current practice achieves substantially the same results. Direct cost items of minor amounts may be allocated as indirect costs.

Indirect Costs

An indirect cost is one which, because of its incurrence for common or joint objectives, is not readily subject to treatment as a direct cost. Minor direct cost items may be considered to be indirect costs for reasons of practicality. After direct costs have been determined and charged directly to the contract or other work as appropriate, indirect costs are those that remain to be allocated. The overall objective is to allocate the indirect costs of the provider agency to its various major activities or cost objectives in reasonable proportion to the benefits provided. Because of the diverse natures and purposes of provider agencies, it is impractical to identify specifically those functions that constitute major activities for purposes of identifying and allocating indirect costs. Such identification will be dependent upon a provider agency's purpose-in-being, the services it renders, the amount of effort devoted to fund-raising activities, public relations, and membership activities, etc., as explained under Direct Costs above.

Indirect costs shall be accumulated by logical cost groupings with due consideration accorded to the reasons for incurring the costs. Each grouping should be determined so as to permit allocation of the grouping on the basis of the benefits accruing to the several cost objectives. Sub-grouping may be required where there is no single equitable distribution base for all the elements of cost constituting a group. Actual conditions must be taken into account in selecting the method or base to be used in allocating the expenses assembled under each of the individual cost groupings to the applicable cost objectives.

Where an allocation can be made by assignment of a cost grouping directly to the area benefited, the allocation should be made in that manner. Where the expenses under a cost grouping are more general in nature, the allocation to the cost objectives should be made through the use of a selected base which will produce results that are equitable both to the Department and the provider agency. In general, any cost element or cost-related factor associated with the provider's work is potentially adaptable for use as a distribution base provided: (1) it can readily be expressed in terms of dollars or other quantitative measure (total direct costs, direct salaries, person-hours applied, square feet utilized, hours of usage, number of documents processed, population served, and the like); and (2) it is common to the cost objectives during the base period. The essential consideration in selecting the distribution base in each instance is that it be the one best suited for assigning the pool of costs to the cost objectives in accordance with the relative benefits derived, a traceable cause and effect relationship, or logic.

The number and composition of the groupings should be governed by practical considerations and should be such as not to complicate the allocation unduly where substantially the same results are achieved through less precise methods.

A base period for allocation of indirect costs is the period during which such costs are incurred and accumulated for allocation to work performed within that period. The base period normally should coincide with the provider agency's fiscal year, but in any event the base period should be so selected as to avoid inequities in the allocation of costs.

Indirect Cost Pools

Subject to the following paragraph, indirect costs allocable to any provider agency's direct functions should be treated as a common pool, and the costs in such common pool should then be allocated by use of a single rate to the individual activities benefiting there from.

Each group of costs represents a cost center which is separately identified in the provider's chart of accounts and/or books of accounts (general ledger, etc.) and is where costs are assigned in the normal accounting process.

Once a cost center is broken out, it must be handled in a consistent manner in subsequent years. After a provider makes a more sophisticated delineation of cost centers, it cannot revert to a less sophisticated format.

In some instances, a single rate for use across the board on all provider agency activities may not be appropriate, since it would not take into account those different environmental factors which may affect substantially the indirect costs applicable to a particular segment of agency work. For this purpose, a particular segment of work may be that performed under a single contract or it may consist of work under a group of contracts performed in a common environment. The environmental factors are not limited to the physical location of the work. Other important factors are the level of administrative support required, the nature of the facilities or other resources employed, the scientific disciplines or technical skills involved, the organizational arrangements used, or any combination thereof. Where a particular segment of work is performed within an environment that appears to generate a significantly different level of indirect costs, provision should be made for a separate indirect cost pool applicable to such work. The separate indirect cost pool should be developed during the course of the regular allocation process, and the separate indirect cost rate resulting there from should be utilized provided it is determined that: (1) such indirect cost rate differs significantly from that which would have been obtained under a common pool as stated above; and (2) the volume of work to which such rate would apply is material in relation to other provider agency activity.

The Distribution Base

Indirect costs should be allocated to each applicable program or activity on a distribution base such as direct salaries and wages, total direct costs, or another basis which results in an equitable allocation. For this purpose, an indirect cost rate should be determined for a single or each of the separate indirect cost pools.

The rate in each case should be stated as the percentage of the base amount which is represented by the total amount of the particular indirect cost pool.

When reporting costs, the provider agency must meet the following minimum requirements:

1. The statistical base used to allocate each cost center must measure as accurately as possible the service rendered by that center to other cost centers.

2. The statistics used must be auditable and maintained on a continuous basis. Periodic time studies would only be acceptable where the samples are collected covering a minimum of two weeks in each quarter.

When a provider agency wishes to change its distribution base for a particular cost center or the order in which the cost centers are allocated, because it believes the change will result in more appropriate and more accurate allocations, the provider must make a written request to the Department for approval and must submit reasonable justification for such change prior to the beginning of the cost reporting period for which the change is to apply. The Department's approval of such a request will be furnished to the provider agency in writing. Where the Department approves the request, the change must be applied to the cost reporting period for which the request was made and to all subsequent cost reporting periods unless the Department approves a subsequent request for change. The effective date of the change will be the beginning of the cost reporting period for which the request was made.

The table on the following pages includes distribution bases classified as either acceptable or non-acceptable methods of allocating costs to the various cost centers or programs. Provider agencies must use only one of the alternative distribution bases. They must be able to demonstrate that the base chosen will produce appropriate and accurate results and that the statistics are auditable. The use of more than one statistical basis for allocating any cost center is not permitted.

Where a provider agency identifies other indirect cost centers and/or statistical bases which are not listed on the following table, these centers/bases must be submitted to the Department for approval.

<u>Simplified Allocation Method</u>

Where a provider agency's major functions benefit from its indirect costs to approximately the same degree, the allocation of indirect cost may be accomplished by: (1) separating the provider'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 contracts, programs or activities. 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 provider has only one major function encompassing a number of individual activities.

Both the direct costs and the indirect costs shall exclude capital expenditures and unallowable costs. However, unallowable costs which represent activities must be included in the direct costs under the conditions described above under Direct Costs.

The distribution base may be total direct costs (excluding capital expenditures), direct salaries and wages, or other base which results in an equitable distribution. The indirect cost rate developed under the above principles is applicable to all contracts, programs, and activities of the provider agency.

TABLE
INDIRECT COST DISTRIBUTION BASES

Cost Centers	Acceptable Bases	Non-Acceptable Bases*
1. Depreciation-buildings and fixtures	1. Square feet for total depreciation 2. Individual building depreciation allocated on square feet(a sub-schedule will be required to show these computations)	
2. Depreciation-movable equipment	1. Square feet 2. Actual depreciation by cost center	
3. Employee Health & Welfare Fringe Benefits	Gross salaries	Average number of employees and full-time equivalents
4. Administration and General	1. Total direct costs 2. Direct salaries	
5 Telephone (allowable costs only)	Number of non-client telephones	
6. Purchasing	1. Number of purchase orders 2. Dollar value of purchases (exclusive of fixed assets purchases)	
7. Admitting	Accumulated inpatient revenue - ancillary and routine (outpatient revenue should be included if outpatient admitting functions are performed)	Number of admissions (not allowable as it does not allocate any costs to ancillary departments)

* This represents bases that have been determined to be unacceptable, it is not meant to be all inclusive.

TABLE(cont'd)

Cost Centers	Acceptable Bases	Non-Acceptable Bases*
8. Client/Patient Accounting	Gross revenues	1. Number of documents posted 2. Number of client/patient days (not allowable due to exclusion of outpatients)
9. Operation of Plant	Square feet	
10. Maintenance of Plant	Square feet	Costed work orders
11. Laundry and Linen	1. Pounds of soiled laundry processed 2. Pounds of processed laundry issued 3. Itemized bills by department for Purchased service	
12. Housekeeping	1. Hours of service 2. Square feet of cost centers serviced	
13. Dietary – raw food	Number of meals served	
14. Cafeteria (allowable costs only)	1. Number of meals served 2. Sales value of meals sold 3. Number of employees	Salaries of employees
15. Nursing Service Administration	1. Actual hours of nursing service supervised 2. Number of employees supervised	1. Time studies 2. Salaries of employees

*This represents bases that have determined to be unacceptable, it is not meant to be all inclusive.

TABLE(cont'd)

Costs Centers	Acceptable Bases	Non-Acceptable Bases*
16. Medical Supplies and Expenses or Central Supplies and Services	1. Costed requisitions 2. Other special analysis of supplies Usage based on auditable records	
17. Pharmacy	1. Costed requisitions 2. Special study based on auditable records	
18. Medical Records	1. Percentage of time spent based on auditable records 2. Any other basis must include time spent for outpatient, doctors, nursery, and other special service areas (e.g.,ICU,CCU)	Number of admissions(not allowable since it does not reflect potential for other activities such as outpatient and nursery)
19. Social Services	Time spent in proving casework service for clients/patients in each center (including outpatients and special care, if applicable)	
20. Nursing School	Assigned time (hours) of student nursing service by department	
21. Intern and Resident School	Assigned hours of service by the department for interns and residents	

*This represents bases that have been determined to be unacceptable, it is not meant to be all inclusive.

4.5 Selected Items of Cost

Application of Principles and Procedures

Subject to limitations of the contracting division, costs shall be allowed to the extent that they are reasonable, allocable, and allowable (in accordance with subsection 4.6, Allowable Items of Cost - General Standards for Allowable Costs and 4.7, Unallowable Items of Cost - General Standards for Unallowable Costs), and to the extent that adequate funding exists. These criteria apply to all of the selected items of cost which follow, notwithstanding that particular guidance is provided in connection with certain specific items for emphasis or clarity.

Costs under any subcontract entered into by the provider agency are subject to the same principles as the primary contract.

Selected items of cost are treated in the following sections entitled General Standards for Allowable Costs and General Standards for Unallowable Costs. It should be noted that not every element of cost nor every situation that might arise is covered. Failure to treat any item of cost is not intended to imply that it is either allowable or unallowable. With respect to all items, whether or not specifically covered, determination of allowability shall be based on the principles and standards set forth in this document and, where appropriate, the treatment of similar related selected items.

Selected Items of Cost

Subsections 4.6 and 4.7 provide standards to be applied in establishing the allowability of certain items involved in determining costs. These standards should apply irrespective of whether a particular item of cost is properly treated as a direct or indirect cost. In case of a discrepancy between the provisions of a specific contract and the following standards, the provisions of the contract shall govern. Under any given contract, the reasonableness and allocability of certain items of costs may be difficult to determine. This is particularly true in connection with not-for-profit provider agencies, which are diverse in nature and often not subject to effective competitive restraints. In order to avoid possible subsequent disallowance or dispute based on unreasonableness or non-allocability, it is important that provider agencies entering into contracts with the Department seek agreement in advance of the incurrence of special or unusual costs in categories where reasonableness or allocability is difficult to determine. Such actions in which advance agreements may be particularly important are:

1. Compensation for personal services;
2. Consultant fees;
3. Deferred maintenance costs;
4. Excess facility costs;
5. Material, services, and supplies sold between agencies or divisions under common control;
6. Pre-award costs;
7. Publication and public information costs;
8. Royalties;

9. Training and educational costs;
10. Travel costs, as related to special or mass personnel movement, and to the class of air-travel accommodations allowable;
11. Negotiated use allowance for fully depreciated assets; and
12. Depreciation or use allowance on assets donated to the provider agency by third parties.

4.6 Allowable Items of Cost

General Standards for Allowable Costs

1. Advertising Costs

   a. Advertising costs means the costs of media services and associated costs. Media advertising includes magazines, newspapers, radio and television programs, direct mail, exhibits, and the like.

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

      (1) The recruitment of personnel when considered in conjunction with all other recruitment costs (as set forth in item 21);

      (2) The procurement of goods and services;

(3) The disposal of surplus materials acquired in the performance of the contract; or

(4) Specific requirements of the contract.

2. Bonding Costs

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

b. Costs of bonding pursuant to the terms of the contract are allowable.

c. Costs of bonding required by the provider agency 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.

3. Communication Costs

Costs incurred for telephone services, local and long distance telephone calls, telegrams, radiograms, postage, and the like are allowable provided that the costs are necessary, reasonable, and allocable to the contract.

4. Compensation for Personal Services

a. Definition

Compensation for personal services includes all compensation paid currently or accrued by the provider agency for services of employees rendered during the term of the contract (except as otherwise provided in paragraph g below). It includes, but is not limited to salaries, wages, directors' and executive committee members' fees, incentive awards, fringe benefits, pension plan costs, allowances for off-site pay, incentive pay, location allowances, hardship pay, and cost of living differentials.

b. Allowability

Except as otherwise specifically provided in this item, the costs of such compensation are allowable to the extent that:

(1) Total compensation to individual employees is reasonable for the services rendered and conforms to the established written policy of the provider agency consistently applied to both Department and non-Department activities; and

(2) Charges to contracts, whether treated as direct or indirect costs, are determined and supported as required in this item.

c. Reasonableness

(1) When the provider agency is predominantly engaged in activities other than those sponsored by the Department, compensation for employees on Department-sponsored work will be considered reasonable to the extent that it is consistent with that paid for similar work in the provider agency's other activities;

(2) When the provider agency is predominately engaged in Department-sponsored activities, and in cases where the kind of employees required for the Department activities are not found in the provider agency's other activities, compensation for employees on Department-sponsored work will be considered reasonable to the extent that it is comparable to that paid for similar work in the labor markets in which the provider agency competes for the kind of employees involved.

d. Special Considerations in Determining Allowability

Certain conditions require special consideration and possible limitations in determining costs where amounts or types of compensation appear unreasonable. Among such conditions are the following:

(1) Compensation to shareholders, members, trustees, directors, associates, officers, or the immediate families thereof.

Determination should be made that such compensation is reasonable for the actual personal services rendered and that it does not represent a distribution of earnings in excess of costs.

(2) Any change in a provider agency's compensation policy resulting in a substantial increase in the provider's level of compensation, particularly when it was concurrent with an increase in the ratio of Department awards to other provider activities, or any change in the treatment of allowability of specific types of compensation due to changes in Department policy.

e. Unallowable Costs

Costs which are allowable under other items of these cost principles shall not be allowable under this item solely on the basis that they constitute personal compensation.

f. Fringe Benefits

(1) Fringe benefits in the form of a regular compensation paid to employees during periods of authorized absences from the job, such as vacation leave, sick leave, military leave, and the like, are allowable

provided such costs are absorbed by all provider agency activities in proportion to the relative amount of time or effort actually devoted to each.

(2) Fringe benefits in the form of employer contributions or expenses for social security, employee insurance, workers' compensation insurance, pension plan costs (see paragraph g below), and the like are allowable provided such benefits are granted in accordance with established written provider policies. Such benefits, whether treated as indirect or direct costs, shall be distributed to particular contracts and other activities in a manner consistent with the pattern of benefits accruing to the individuals or group of employees whose salaries and wages are chargeable to such contracts and other activities.

(3) (a) Provisions for a reserve under a self-insurance program for unemployment compensation or workers' compensation are allowable to the extent that the provisions represent reasonable estimates of the liabilities for such compensation, and the types of coverage, extent of coverage, and rates and premiums would have been allowable had insurance been purchased to cover the risks. However, provisions for self-insured liabilities which do not become payable for more than one year after the provision is made shall not exceed the present value of the liability.

(b) Where a provider agency follows a consistent policy of expensing actual payments to, or on behalf of, employees or former employees for unemployment compensation or workers' compensation, such payments are allowable in the year of payment with the prior approval of the Department provided they are allocated to all activities of the provider.

(4) Costs of insurance on the lives of trustees, officers, or other employees holding positions of similar responsibility are allowable only to the extent that the insurance represents additional compensation. The costs of such insurance when the provider agency is named as beneficiary are unallowable.

g. Pension Plan Costs

(1) Costs of the provider agency's pension plan that are incurred in accordance with the established policies of the provider are allowable provided:

(a) Such policies meet the test of reasonableness;

(b) The methods of cost allocation are not discriminatory;

(c) The cost assigned to each fiscal year is determined in accordance with generally accepted accounting principles as prescribed in Accounting Principles Board Opinion No. 8 issued by the American Institute of Certified Public Accountants; and

(d) The cost assigned to a given fiscal year is funded for all plan participants within six months after the end of that year. However, increases to normal and past service pension costs caused by a delay in funding the actuarial liability beyond 30 days after each quarter of the year to which such costs are assignable are unallowable.

(2) Pension plan termination insurance premiums paid pursuant to the Employee Retirement Income Security Act of 1974 (Pub. L. 93-406) are allowable. Late payment charges on such premiums are unallowable.

(3) Excise taxes on accumulated funding deficiencies and other penalties imposed under the Employee Retirement Income Security Act are unallowable.

h. Incentive Compensation

Incentive compensation to employees based on cost reduction, or efficient performance, suggestion awards, safety awards, etc., are allowable to the extent that the overall compensation is determined to be reasonable and such costs are paid or accrued pursuant to: (1) an agreement entered into in good faith between the provider agency and the employees before the services were rendered; or (2) an established written plan followed by the provider agency so consistently as to imply, in effect, an agreement to make such payment.

i. Overtime, Extra-Pay Shift, and Multi-shift Premiums (See item 15)

j. Severance Pay (See item 23)

k. Training and Educational Costs (See item 26)

l. Support of Salaries and Wages

(1) Charges to contracts for salaries and wages, whether treated as direct or indirect costs, will be based on documented payrolls approved by a responsible official(s) of the provider agency. The distribution of salaries and wages must be supported by personnel activity reports as prescribed in subparagraph (2) below, except when a substitute system has been approved in writing by the Department.

(2) Reports reflecting the distribution of activity of each employee must be maintained for all staff members (professionals and nonprofessionals) whose compensation is charged, in whole or in part, directly to the contract. In addition, in order to support the allocation of indirect costs, such reports must also be maintained for other employees whose work involves two or more functions or activities if a distribution of their compensation between such functions or

activities is needed in the determination of the provider agency's indirect cost rate(s) (e.g., an employee engaged part-time in indirect activities and part-time in a direct function). Reports maintained to satisfy these requirements must meet the following standards:

(a) The reports must reflect an after-the-fact determination of the actual activity of each employee. Budget estimates (i.e., estimates determined before the services are performed) do not qualify as support for contract charges.

(b) Each report must account for the total activity for which employees are compensated and which is required in fulfillment of their obligations to the provider agency.

(c) The reports must be signed by the individual employee or by a responsible supervisory official having first-hand knowledge of the activities performed by the employee to attest that the distribution of activity represents a reasonable estimate of the actual work performed by the employee during the periods covered by the reports.

(d) The reports must be prepared at least monthly and must coincide with one or more pay periods.

(3) Charges for the salaries and wages of nonprofessional employees, in addition to the supporting documentation described in subparagraph (1) and (2) above, must also be supported by records indicating the total number of hours worked each day maintained in conformance with Department of Labor regulations implementing the Fair Labor Standards Act. For this purpose, the term "nonprofessional employee" shall have the same meaning as "non-exempt employee" under the Fair Labor Standards Act.

(4) Salaries & wages of employees used in meeting contract cost sharing or matching requirements must be supported in the same manner as salaries & wages claimed for reimbursement under the contract.

5. Depreciation and Use Allowances

a. Compensation for the use of buildings, other capital improvements, and equipment on hand may be made through depreciation or use allowances. However, except as provided in paragraph e below, 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).

b. The computation of depreciation or use allowances shall be based on the acquisition cost of the assets involved. The acquisition cost of an asset donated to the provider agency by a third party shall be its fair market value at the time of the donation.

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 any level of 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 provider in satisfaction of a statutory 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, technological developments in the particular program area and the renewal and replacement policies followed for the individual items or classes of assets involved. The method of depreciation used to assign the cost of an asset (or group of assets) to accounting periods shall reflect the pattern of consumption of the asset during its useful life. In the absence of clear evidence indicating that the expected consumption of the asset will be significantly greater or lesser in the early portions of its useful life than in the later portions, the straight-line method shall be presumed to be the appropriate method. Depreciation methods once used shall not be changed unless approved in advance by the Department. When the depreciation method is used for buildings, a building's shell may be segregated from each building component (plumbing system, heating, air conditioning, etc.) and each item 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.

e. When the depreciation method is used for a particular class of assets, no depreciation may be allowed on any such assets that, under paragraph d above, would be viewed as fully depreciated. However, a reasonable use allowance may be negotiated for such assets if warranted after taking into consideration the amount of depreciation previously charged to any level of government, the estimated useful life remaining at the time of negotiation, the effect of any increased maintenance charges or decreased efficiency due to age, and any other factors pertinent to the utilization of the asset for the purpose contemplated.

f. When a facility is sold, the revaluation of that facility often increases reimbursement for capital-related costs. The Department will limit the increase in capital-related reimbursement associated with the sale or transfer of real property, if the facility was previously used for a Department of Human Services program, and the owner was reimbursed for depreciation expense. The Department must ensure that State and federal funds are not used to pay for the same asset more than once. Therefore, reimbursement for capital-related costs to the new owner must be based on the historical cost (the cost to the original owner) or the purchase price, whichever is less.

(1) Reimbursement for depreciation expense must be based on the acquisition of the asset as entered on the books and records of the prior owner less any depreciation taken on the asset by the prior owner.

(2) The new owner's capital-related costs must be determined by using the same useful life and method of depreciation as used by the prior owner for reimbursement by the Department.

(3) The Department recognizes that the limitation on reimbursement of capital-related costs of revalued facilities may be circumvented by certain sale/leaseback or sale-rental agreements. The Department must determine the reasonableness of any lease and rental costs involving a depreciable asset which has undergone a change in ownership.

g. 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 cost. The use allowance for equipment will be computed at an annual rate not exceeding six and two-thirds 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 (plumbing system, etc.) cannot be segregated from the building's shell. The two percent limitation, however, need not be applied to equipment which is merely attached to the building but not permanently fixed to it and which is used as furnishings or decorations or for a specialized purpose (counters, examining tables bolted to the floor, dishwashers, carpeting, etc.). Such equipment will be considered as not being permanently fixed to the building if it can be removed without the need for costly or extensive alterations or repairs to the building or the equipment. Equipment that meets these criteria will be subject to the six and two-thirds percent equipment use allowance limitation.

h. Charges for depreciation or use allowances must be supported by adequate property records, and physical inventories must be taken at least once every two years (a statistical sampling basis is acceptable) to ensure that assets exist, are usable, and needed. When the depreciation method is followed, adequate depreciation records indicating the amount of depreciation taken each period must be maintained.

6. Employee Morale, Health, and Welfare Costs and Credits

The costs of in-house publications, health or first-aid clinics, infirmaries, recreational activities, employee counseling services, and other expenses incurred in accordance with the provider agency's established practice or custom for the improvement of working conditions, employer-employee relations, employee morale, and employee performance are allowable. Such costs must be equitably apportioned to all activities of the provider. Income generated from any of these activities will be credited to the cost thereof unless such income has been irrevocably set over to employee welfare organizations.

7. Fringe Benefits (See item 4f)

8. Insurance

   Insurance includes: (1) insurance that the provider agency is required to carry, or that is approved, under the terms of the contract; and (2) any other insurance that the provider maintains in connection with the general conduct of its operations. This item does not apply to insurance that represents fringe benefits for employees. (See item 4f and item 4g).

   a. Costs of insurance required or approved pursuant to the contract, and maintained by the provider agency, are allowable.

   b. Costs of other insurance maintained by the provider in connection with the general conduct of its operations are allowable subject to the following limitations:

      (1) Types and extent of coverage shall be in accordance with sound business practice, and the rates and premiums shall be reasonable under the circumstances.

      (2) Costs allowed for business interruption or other similar insurance shall be limited to exclude coverage of management fees or profit.

      (3) Costs of insurance or of any provisions for a reserve covering the risk of loss of or damage to Department property are allowable only to the extent that the provider agency is liable for such loss or damage.

      (4) Provisions for a reserve under a self-insurance program are allowable to the extent that types of coverage, extent of coverage, rates and premiums would have been allowed had insurance been purchased to cover the risk. 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 present value of the liability.

      (5) Costs of insurance on the lives of trustees, officers, or other employees holding positions of similar responsibilities are allowable only to the extent that the insurance represents additional compensation (see item 4f (4)). The cost of such insurance when the provider agency is identified as the beneficiary is unallowable.

   c. Actual losses which could have been covered by permissible insurance (through the purchase of insurance or a self-insurance program) are unallowable unless expressly provided for in the contract, except:

      (1) Costs incurred because of losses not covered under nominal deductible insurance coverage provided in keeping with sound business practice are allowable.

(2) Minor losses (such as spoilage, breakage, and disappearance of supplies) which occur in the ordinary course of doing business are allowable if not covered by insurance.

9. Interest Applicable to Depreciable Capital Assets

a. Definitions

As used in this item, the following terms have the meanings indicated:

(1) Interest means the cost incurred for the use of borrowed funds. Interest costs are generally paid at fixed intervals by the user.

(2) Interest on Capital Indebtedness means the cost incurred for funds borrowed for capital purposes, such as the acquisition of facilities, equipment, and capital improvements. Generally, loans for capital purposes are long-term loans.

(3) Interest on Current Indebtedness means the cost incurred for funds borrowed for a relatively short term, usually for one year or less. Current borrowing is usually for purposes such as working capital for normal operating expenses.

(4) Necessary with regard to interest on a loan, means that the loan must be for the acquisition of tangible capital assets of the provider agency and for a purpose reasonably related to the contract. For example, where funds are borrowed for purposes of investing in other than the provider's operations, interest expense is not allowable because such a loan is not considered necessary.

(5) Proper with regard to interest on a loan, means that the interest must be incurred at a rate not in excess of what a prudent borrower would have had to pay in an arm's length transaction in the money market when the loan was made. In addition, the interest must be paid to a lender not related to the provider agency through personal relationship or common ownership or control.

b. Allowability

Necessary and proper interest on capital indebtedness incurred for the acquisition of tangible capital assets that are depreciated on the provider agency's books and records is an allowable cost. Interest expense is not allowable for capital assets for which a use allowance is applied in lieu of depreciation. Provider agencies are encouraged to maintain adequate records necessary to permit the recording and charging of depreciation in accordance with generally accepted accounting principles and the governing principles for determining costs. Interest on non-capital assets and on current indebtedness is an unallowable cost. (See unallowable item 9a, Section 4.7)

To be allowable, interest on capital indebtedness must be: (1) necessary and proper for the acquisition of the provider's facilities or for any refinancing of loans to lower interest rates currently being paid on existing facilities (refinancing of fully paid-for-facilities or any refinancing for investment purposes is unallowable); (2) supported by evidence of an agreement that funds were borrowed and that payment of interest and repayment of the funds are required; (3) identifiable in the provider's accounting records; and (4) related to the reporting period in which the costs are incurred.

c. Other Factors Affecting Allowability:

(1) Mortgage Interest

A mortgage is a lien on assets given by a borrower to a lender as security for borrowed funds for which payment will be made over an extended period of time. Mortgage interest refers to the interest expense incurred by the borrower on a loan which is secured by a mortgage. Usually such loans are long-term loans for the acquisition of land, buildings, equipment, or other fixed assets.

Mortgage loans are customarily liquidated by means of periodic payments, usually monthly, over the term of the mortgage. The periodic payments usually cover both interest and principal. That portion of the payment which is for interest for the period, is allowable as a cost of the reporting period to which it is applicable. The principal portion of the payment is unallowable as a contract cost.

In addition to interest expense, other expenses are incurred in connection with mortgage transactions. These may include attorney's fees, recording costs, transfer taxes, and service charges which include finder's fees and placement fees. These costs, to the extent that they are reasonable, should be amortized over the life of the mortgage. The portion applicable to the reporting period is an allowable cost.

(2) Interest During Period of Construction

From time to time, provider agencies may borrow funds to construct facilities or to enlarge existing facilities. Usually construction of facilities extends over a long period of time, during which interest costs on the loan are incurred. Interest costs incurred during the period of construction must be capitalized as part of the cost of the facility. The period of construction is considered to extend to the date the facility is put into use.

If the construction is an addition to an existing facility, interest incurred during the construction period on funds borrowed to construct the addition must be capitalized as a cost of the addition. After the construction period, interest on the loan is allowable as an operating cost.

Where a bond issue is involved, any bond discount and expense, or bond premium amortized during the period of construction, is included in the capitalized cost of the facility constructed.

(3) Allocation of Interest

Where a loan is made to construct or acquire a number of buildings (or other fixed assets), the interest on the loan applies to the several assets acquired in proportion to the cost each asset bears to the total cost of the assets. If any building or other asset covered by the loan is not used for purposes related to the contract, the interest applicable to such asset is not allowable as a cost of the contract. The proportionate part of such interest applicable to assets used for the contract is an allowable cost.

Examples of fixed assets which might be purchased under a single loan agreement could be land, buildings, and equipment used by the provider in furnishing contract services, and additional land held for future expansion. The land purchased in anticipation of expansion would not be considered related to the contract.

(4) Interest on Loans from Lenders Related to the Provider

One of the requirements for interest to be considered proper is that it be paid to a lender not related through personal relationship or common ownership or control to the borrowing agency. Presence of any of these relationships could affect the bargaining process that usually accompanies the making of a loan and could thus be suggestive of an agreement for higher rates of interest or for unnecessary loans. This provision is intended to ensure that loans are legitimate and needed and that the interest rate is reasonable.

(5) Interest Paid to Partners, Stockholders, and Related Organizations

Generally, interest paid by the provider to partners (owners), stockholders, or related organizations of the provider is not allowable as a cost. Where an owner uses his/her own funds in a business, the funds are considered invested funds, or capital, rather than borrowed funds. Therefore, when a partner stockholder, or related organization makes a loan to a provider, and the interest on the loan is not allowable as a cost, the loan is considered as part of the equity capital of the provider.

(6) Owner(s) of Provider Agency on Governing Board of Lending Institutions

It may occur that owners of provider agencies serve as members of the governing board of a bank or other financial institution which lends money to the provider. A determination as to whether a personal relationship or control exists between the provider and lending institution will be based on the facts and circumstances of each case.

10. Labor Relations Costs

    Costs incurred in maintaining satisfactory relations between the provider agency and its employees, including costs of labor management committees, employee publications, and other related activities, are allowable.

11. Maintenance and Repair Costs

    Costs incurred for necessary maintenance, repair, or upkeep of buildings, and equipment (including government property, unless otherwise provided for) which neither add to the permanent value of the property nor appreciably prolong its intended life, but keep it in an efficient operating condition, are allowable. Costs incurred for improvements that add to the permanent value of the buildings and equipment or appreciably prolong their intended life shall be treated as capital expenditures (see item 5).

12. Materials and Supplies

    The costs of materials and supplies necessary to carry out the contract are allowable. Such costs should be charged at their actual prices after deducting all cash discounts, trade discounts, rebates, and allowances (i.e., applicable credits) received by the provider agency. Withdrawals from general stores or stockrooms should be charged at cost under any recognized method of pricing consistently applied. Incoming transportation charges may be a proper part of material cost. Materials and supplies charged as a direct cost should include only the materials and supplies actually used for the performance of the contract, and due credit should be given for any excess materials or supplies retained or returned to vendors.

13. Meetings and Conferences

    a. Costs associated with the conduct of meetings and conferences include the cost of facility rental, meals, speakers' fees, and the like (but see Unallowable Items of Cost, Section 4.7: item 5, Entertainment Costs, and item 12 Participant Support Costs).

    b. To the extent that these costs are identifiable with a particular cost objective, they should be charged to that objective. These costs are allowable provided they meet the general tests of allowability (see Section 4.2, Basic Considerations - Factors Affecting Allowability of Costs).

    c. Costs of meetings and conferences held to conduct the general administration of the provider agency are allowable.

14. Membership, Subscriptions, and Professional Activity Costs

    a. Costs of the provider agency's membership in civic, business, technical, and professional organizations are allowable.

b. Costs of the provider agency's subscriptions to civic, business, technical, and professional periodicals are allowable.

c. Cost of attendance at meetings and conferences sponsored by others, when the primary purpose is the dissemination of technical information, are allowable. This includes costs of meals, transportation, and other items incidental to such attendance.

15. Overtime, Extra-Pay Shift, and Multi-shift Premiums

    Premiums for overtime, extra-pay shifts, and multi-shift work are allowable only with the prior approval of the Department except:

    a. When necessary to cope with emergencies, such as those resulting from accidents, natural disasters, breakdowns of equipment, or occasional operational bottlenecks of a sporadic nature;

    b. When employees are performing indirect functions such as administration, maintenance, or accounting;

    c. In the performance of tests, laboratory procedures, or other similar operations which are continuous in nature and cannot reasonably be interrupted or otherwise completed.

    d. When lower overall cost to the Department will result.

16. Pension Plans (See item 4g)

17. Plant Security Costs

    Necessary expenses incurred to comply with Department security requirements or for facilities protection, including wages, uniforms, and equipment of personnel, are allowable.

18. 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 provider agency, are allowable subject to b, c, and d below, when reasonable in relation to the services rendered and when not contingent upon recovery of the costs from the Department.

    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 provider agency's capability in the particular area;

(3) The past pattern of such costs, particularly in years prior to Department contracts;

(4) The impact of Department contracts on the provider agency's business (i.e., what new problems have arisen);

(5) Whether the proportion of Department work to the provider agency's total business is such as to influence the provider in favor of incurring the cost, particularly where the services rendered are not of a continuing nature and have little relationship to work under the Department contract(s);

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

(7) The qualifications of the individual or concern rendering the service and the customary fees charged, especially on non-government contracts;

(8) The 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 paragraph b above, in order for retainer fees to be allowable they must be reasonably supported by evidence of bona fide services available or rendered.

d. Costs of legal, accounting, and consulting services, and related costs, incurred in connection with defense of antitrust suits, and the prosecution of claims against the government, are unallowable. Costs of legal, accounting, and consulting services, and related costs incurred in connection with patent infringement litigation or organization and reorganization are unallowable unless otherwise provided for in the contract.

19. Profits and Losses on Disposition of Depreciable Property or Other Capital Assets

a. (1) Gains and losses on sale, retirement, or other disposition of depreciable property shall be included in the year in which they occur as credits or charges to cost grouping(s) in which the depreciation applicable to such property was included. The amount of the gain or loss to be included as a credit or charge to the appropriate cost grouping(s) shall be the difference between the amount realized on the property and the un-depreciated 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 reserve account and is reflected in the depreciation allowable under item 5.

(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 item 8b (3).

(d) Compensation for the use of the property was provided through use in lieu of depreciation in accordance with item 5.

(e) Gains and losses arising from mass or extraordinary sales, retirements, or other dispositions shall be considered on a case-by-case basis.

b. Gains or losses of any nature arising from the sale or exchange of property other than the property covered in paragraph 19(a) above shall be excluded in computing contract costs.

20. Rearrangement and Alteration Costs

Costs incurred for ordinary or normal rearrangement and alteration of facilities are allowable. Special arrangements and alteration costs incurred specifically for the contract are allowable with the prior approval of the Department.

21. Recruiting Costs

The following recruiting costs are allowable: costs of "help-wanted" advertising, operating costs of an employment office, costs of operating an educational testing program, travel expenses including food and lodging of employees while engaged in recruiting personnel, and travel costs of applicants for interviews for prospective employment. Where the provider agency uses employment agencies, costs not in excess of standard commercial rates for such services are allowable.

22. Rental Costs

a. Subject to the limitations described in paragraph b through d of this item, 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.

b. Rental costs under sale and leaseback arrangements are allowable only up to the amount that would be allowed had the provider agency continued to own the property.

c. Rental costs under less-than-arm's-length leases are allowable only up to the amount that would be allowed had title to the property vested in the provider agency. For this purpose, a less-than-arm's-length lease is one under which one party to the lease agreement is able to control or influence substantially the actions of the other. Such leases include but are not limited to those between: (1) divisions of an agency; (2) agencies under common control through common officers, directors, or members; and (3) an agency and a director, trustee, officer, or key employee of the organization of his/her immediate family, either directly or through corporations, trusts, or similar arrangements in which they hold a controlling interest.

d. Rental costs under leases which create a material equity in the leased property are allowable only up to the amount that would be allowed had the provider agency purchased the property on the date the lease agreement was executed including depreciation and allowable interest expense (refer to item 9, Interest Applicable to Depreciable Capital Assets) or use allowances, maintenance, taxes, insurance, but excluding other unallowable costs. For this purpose, a material equity in the property exists if the lease is non-cancelable or is cancelable only upon the occurrence of some remote contingency and has one or more of the following characteristics:

   (1) The provider agency has the right to purchase the property for a price which at the beginning of the lease appears to be substantially less than the probable fair market value at the time it is permitted to purchase the property (commonly called a lease with a bargain purchase period);

   (2) Title to the property passes to the provider agency at some time during or after the lease period;

   (3) The term of the lease (initial term plus periods covered by bargain renewal options, if any) is equal to 75 percent or more of the economic life of the leased property (i.e., the period the property is expected to be economically usable by one or more users).

23. Severance Pay

a. Severance pay, also commonly referred to as dismissal wages, is a payment in addition to regular salaries and wages, by agencies to workers whose employment is being terminated. The cost of severance pay is allowable only to the extent that, in each case, it is required by:

   (1) Law;

   (2) Employer-employee agreement;

   (3) Established policy that constitutes, in effect, an implied agreement on the provider agency's part; or

   (4) Circumstances of the particular employment.

b. Costs of severance payments are divided into two categories as follows:

(1) Actual normal turnover severance payments shall be allocated to all provider agency activities; or where the agency provides for a reserve for normal severances, such method will be acceptable if the charge to current operations is reasonable in light of payments actually made for normal severance over a representative past period, and if amounts charged are allocated to all activities of the provider agency.

(2) Abnormal or mass severance pay is of such a conjectural nature that measurement of costs by means of an accrual will not achieve equity to both parties. Thus, accruals for this purpose are not allowable. However, the Department recognizes its obligation to participate, to the extent of its fair share, in any specific payment. Thus, allowability will be considered on a case-by-case basis in the event of occurrence.

24. Taxes

a. In general, taxes which the provider agency is required to pay and which are paid, or accrued in accordance with generally accepted accounting principles, and payments made to local governments in lieu of taxes which are commensurate with the local government services received, are allowable, except for:

(1) Taxes from which exemptions are available to the provider directly or which are available based on an exemption afforded the government, and in the latter case when the Department makes available the necessary exemption certificates;

(2) Special assessments on land that represent capital improvements; and

(3) Federal income taxes.

b. Any refund of taxes, and any payment to the provider agency of interest thereon, that were allowed as contract costs, will be credited either as a cost reduction or cash refund, as appropriate, to the Department.

25. Termination Costs

Contract terminations generally give rise to the incurrence of costs, or the need for special treatment of costs, that would not have arisen had the contract not been terminated. Cost principles covering these items are set forth below. However, if a contract is terminated for cause or default, costs resulting from termination are unallowable.

a. Common Items

The cost of items reasonably usable on the provider agency's other work shall not be allowable unless the provider submits evidence that it could not retain such items at cost without sustaining a loss. In deciding whether such items are reasonably usable on other work of the provider agency, the Department should consider the provider's plans and orders for current and scheduled activity. Contemporaneous purchases of common items by the provider shall be regarded as evidence that such items are reasonably usable on the provider's other work. Any acceptance of common items as allocable to the terminated portion of a project 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. Costs Continuing After Termination

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

c. Rental Costs

Rental costs under unexpired leases are generally allowable where clearly shown to have been reasonably necessary for the performance of the terminated contract 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 contract and such further period as may be reasonable; and

(2) The provider agency 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 contract, and of reasonable restoration required by the provisions of the lease.

d. Settlement Expenses

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 Department of settlement claims and supporting data with respect to the terminated portion of a project, and

(b) The termination and settlement of subcontracts.

(2) Reasonable costs for the storage, transportation, protection, and disposition of property provided by the Department or acquired or produced for the contract;

(3) Indirect costs related to salaries and wages incurred as settlement expenses in (1) and (2) above. Normally, such indirect costs shall be limited to fringe benefits, occupancy costs, and immediate supervision.

e. Subcontractor Claims

Subcontractor claims, including the allocable portion of claims which are common to the contract and to other work of the provider agency are generally allowable. An appropriate share of the provider's indirect expense may be allocated to the amount of the provider's indirect expense may be allocated to the amount of settlements with subcontractors, provided that the amount allocated is otherwise consistent with the basic guidelines contained in this section of the manual. The indirect expenses so allocated shall exclude the same and similar costs claimed directly or indirectly as settlement expenses.

26. Training and Educational Costs

a. Costs of preparation and maintenance of a program of instruction, including but not limited to on-the-job, classroom, and apprenticeship training, designed to increase the vocational effectiveness of employees are allowable. Such costs include training materials, textbooks, salaries or wages of trainees (excluding overtime compensation which might arise there from), and (1) salaries of the director of training and staff when the training program is conducted by the provider agency or (2) tuition and fees when the training is in an institution not operated by the provider.

b. Costs of part-time education, at an undergraduate or post-graduate college level, including that furnished at the provider's own facilities, are allowable only when the course or degree pursued is related to the field in which the employee is now working or may reasonably be expected to work, and are limited to:

(1) Training materials;

(2) Textbooks;

(3) Fees charged by the educational institution;

(4) Tuition charged by the educational institution, or in lieu of tuition, instructors' salaries and the related share of indirect costs of the educational institution to the extent that the sum thereof is not in excess of the tuition which would have been paid to the participating educational institution;

(5) Salaries and related costs of instructors who are employees of the provider agency;

(6) Straight-time compensation of each employee for time spent attending classes during working hours not in excess of 156 hours per year and only to the extent that circumstances do not permit the operation of

classes or attendance at classes after regular working hours; otherwise such compensation is unallowable.

c. Costs of tuition and fees, training materials, and textbooks (but not subsistence, salary, or any other emoluments) in connection with full-time education, including that furnished at the provider agency's own facilities, at a postgraduate (but not undergraduate) college level, are allowable only when the course or degree pursued is related to the field in which the employee is now working or may reasonably be expected to work, and only where the costs received the prior approval of the Department. Such costs are limited to the costs attributable to a total period not to exceed one school year for each employee so trained. In unusual cases the period may be extended.

d. Costs of attendance of up to 16 weeks per employee per year at specialized programs specifically designed to enhance the effectiveness of executives or managers or to prepare employees for such positions are allowable. Such costs include enrollment fees, training materials, textbooks and related charges, employees' salaries, subsistence, and travel. Costs allowable under this paragraph do not include those for courses that are part of a degree-oriented curriculum, which are allowable only to the extent set forth in b and c above.

e. Maintenance expenses and normal depreciation or fair rental on facilities owned or leased by the provider agency for training purposes are allowable to the extent set forth in allowable items 5, 11, and 22.

f. Contributions or donations to educational or training institutions, including the donation of facilities or other properties, and scholarships or fellowships, are unallowable.

g. Training and educational costs in excess of those otherwise allowable under paragraph b and c of this item may be allowed with prior approval of the Department. To be considered for approval, the provider agency must demonstrate that such costs are consistently incurred pursuant to an established training and education program, and that the course or degree pursued is related to the field in which the employee is now working or may reasonably be expected to work.

27. Transportation Costs

Transportation costs include freight, express, cartage, and postage charges related to goods purchased, in process, or delivered. These costs are allowable. When such costs can readily be identified with the items involved, they may be directly charged as transportation costs or added to the cost of such items (see item 12). Where identification with the materials received cannot readily be made, transportation costs may be charged to the appropriate indirect cost accounts if the provider agency follows a consistent, equitable procedure in this respect.

28. Travel Costs

    a. 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 provider agency. Travel costs are allowable, subject to paragraph b through e below, when they are directly attributable to specific work under the contract or are incurred in the normal course of administration of the provider agency.

    b. Travel costs may be charged on an actual 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 results in charges consistent with those normally allowed by the provider in its regular operations.

    c. The difference in cost between first-class and less than first-class air accommodations in unallowable except when less than first-class accommodations are not reasonably available to meet necessary mission requirements, such as where less than first-class accommodations would: (1) require circuitous routing; (2) require travel during unreasonable hours; (3) greatly increase the duration of the flight; (4) result in additional costs which would offset the transportation savings; or (5) offer accommodations which are not reasonably adequate for the medical needs of the traveler.

    d. Costs of personnel movement of a special or mass nature are allowable only with the prior written approval of the Department.

29. Vehicle Purchase or Replacement Costs

    The Provider Agency may request a new or replacement vehicle to be paid from monies under the contract only under the following conditions:

    1. The Provider Agency must request written approval from the Departmental Component to purchase or replace a vehicle and each request must be accompanied by the following supporting documentation. The request may be denied even if all supporting documentation is supplied. Documentation required includes:

        a. Explanation as to why the purchase or replacement of the vehicle is required to fulfill contractual obligations;

        b. Assurance that no one Provider Agency employee will be permanently assigned the vehicle;

        c. Assurance that the Provider Agency has sufficient funds to cover the vehicle's operating costs for the anticipated useful life of the vehicle;

        d. Submission of three (3)written bids for a comparable year, make, model, and option package;

e. If the vehicle is a replacement vehicle, documentation consistent with IV.E.2. below;

f. Any exceptions to the criteria and purchasing requirements IV.E.1.a.-e. will be dealt with on a case by case basis with the Departmental Component;

g. If the request is approved, the Provider Agency shall be required to purchase the vehicle from the lowest-priced Vendor consistent with IV.E.1.d.

2. The Provider Agency may request to replace an existing vehicle under any of the following conditions:

a. Odometer reading exceeds 125,000;

b. Vehicle age is 10 years or older;

c. Repair costs to maintain operational capacity of vehicle would exceed fifty (50) per cent of current Trade-In Blue Book value of vehicle;

d. Repair costs have exceeded fifty (50) per cent of the current Trade-In Blue Book value over the course of the past year;

e. Vehicle was involved in an accident and deemed "totaled" by the insurance carrier;

f. Upon written request, supported by sufficient documentation, the Departmental Component determines that the vehicle is no longer road worthy and is unsafe to drive;

3. If the Provider Agency receives approval to purchase a vehicle, the maximum cost of the vehicle, including all dealer fees and charges, may not exceed $30,000 per vehicle. This limitation does not apply to specialized or adaptive vehicles for handicapped consumers.

4. Vehicles shall be purchased and not leased; however, if a Provider Agency can provide justification as to why leasing a vehicle provides greater benefit to the Provider Agency and better use of the monies under this Contract, the Departmental Component may approve the leasing of a vehicle. All justifications shall be reviewed on a case by case basis and prior approval under the same or similar justification shall not bind the Departmental Component to approve a subsequent justification. If a Provider Agency receives approval to lease a vehicle, the Provider Agency shall subsequently provide the written request and all documentation

required by IV.E.1. as well as written assurance that the Provider Agency shall not use monies under a State Contract to pay for any lease agreement closing costs, including unusual wear and tear to the vehicle, or any excess mileage charges.

5. The portion of the Replacement Equipment's Acquisition Cost chargeable to the DCF contract is the net invoice unit price less the value of any Trade-In, proceeds from the sale of the original equipment, or funds received due to damage or loss of the equipment.

6. The Provider Agency has the option of supplementing the Trade-In or sale proceeds of the original Equipment with funds from another funding source. In such cases, the State will maintain an interest in only that portion of the Acquisition Cost of the Replacement Equipment paid with Department funds (Trade-In, sale proceeds, or proceeds from damage to or loss of equipment included).

4.7 Unallowable Items of Cost

General Standards for Unallowable Costs

1. Bad Debts

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

2. 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 allowable item 8, Section 4.6), pension funds (see allowable item 4 g Section 4.6), and reserves for normal severance pay (see allowable item 23 b(1), Section 4.6).

3. Contributions

   Contributions and donations by the provider agency to others are unallowable.

4. Donations

   a. Services Received

      (1) Donated or volunteer services may be furnished to the provider agency 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.

(2) The value of donated services utilized in the performance of a direct cost activity shall be considered in the determination of the provider agency's indirect cost rate(s) and, accordingly, shall be allocated a proportionate share of applicable indirect costs when the following circumstances exist:

(a) The aggregate value of the service is material;

(b) The services are supported by a significant amount of the indirect costs incurred by the provider agency;

(c) The direct cost activity is not pursued primarily for the benefit of the Department.

(3) In those instances where there is no basis for determining the fair market value of the service rendered, the provider agency and the Department shall negotiate an appropriate allocation of indirect costs to the services.

(4) When donated services directly benefit work under the contract, the indirect costs allocated to the services will be considered as a part of the total costs of such work. Such indirect costs may be reimbursed under the contract or used to meet cost sharing or matching requirements.

(5) Under certain conditions, the value of donated services may be used to meet cost sharing or matching requirements, subject to specific limitations contained in Department policy circulars.

(6) Fair market value of donated services shall be computed as follows:

(a) Rates for Volunteer Services

Rates for volunteers shall be consistent with those regular rates paid for similar work in other activities of the provider agency. In cases where the kinds of skills involved are not found in the other activities of the provider, the rates used shall be consistent with those paid for similar work in the labor market in which the provider competes for such skills.

(b) Services Donated by Other Organizations

When an outside employer donates the services of an employee, these services shall be valued at the employee's regular rate of pay (exclusive of fringe benefits and indirect costs) provided the services are in the same skill for which the employee is normally paid. If the services are not in the same skill, fair market value shall be computed in accordance with (6) (a) above.

b. Goods and Space

(1) Donated goods (i.e., expendable personal property/supplies) and donated use of space may be furnished to the provider agency. The value of the goods and space is not reimbursable either as a direct or indirect cost.

(2) Under certain conditions, the value of the donations may be used to meet cost sharing or matching requirements.

5. Entertainment Costs

Cost of amusement, diversion, social activities, ceremonials, and costs related thereto, such as meals, lodging, rentals, transportation, and gratuities, are unallowable (but see allowable items 6 and 14, Section 4.6).

6. Equipment and Other Capital Expenditures

a. As used in this item, the following terms have the meanings indicated:

(1) Equipment means an article of nonexpendable tangible personal property having a useful life of more than two years and an acquisition cost of $1,000 or more per unit. General purpose Equipment includes office Equipment, reproduction and printing Equipment, motor vehicles, and automated data processing Equipment , whether or not special modifications are needed to make the Equipment suitable for a particular purpose.

(2) Acquisition Cost means the net invoice unit price of an item of 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 shall be included in or excluded from acquisition cost in accordance with the provider agency's regular written accounting practices.

b. Capital expenditures for general purpose equipment are unallowable as a direct cost except with the prior approval of the Department (see Department Policy P4.05, Equipment).

c. Capital expenditures for land or buildings are unallowable as a direct cost.

d. 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 Department.

e. Equipment and other capital expenditures are unallowable as indirect costs. However, see allowable item 5, Section 4.6, for allowability of depreciation or use allowances on buildings, capital improvements, and equipment. Also, see allowable item 22, Section 4.6, for allowability of rental costs for land, buildings, and equipment. Lastly, see allowable item 29, Section 4.6, for allowability of vehicle purchase and replacement costs.

7. Fines and Penalties

Costs of fines and penalties resulting from violations of, or failure of the provider agency to comply with, federal, state, or local laws and regulations are unallowable except when incurred as a result of compliance with specific provisions of the contract or instructions in writing from the Department.

8. Idle Facilities and Idle Capacity

a. As used in this item, the following terms have the meanings indicated:

(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 provider agency.

(2) Idle Facilities means completely unused facilities that are excess to the provider agency'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 the 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 may be used if it can be shown that this amount of usage could 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., property taxes, insurance, and depreciation or use allowances).

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

(1) The facilities are necessary to meet fluctuations in workloads; or

(2) Although not necessary to meet fluctuations in workload, the facilities 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 subparagraph, costs of idle facilities are allowable for a reasonable period of time, ordinarily not to exceed one year, depending upon the initiative taken

to use, lease, or dispose of such facilities (but see allowable Section 4.6, item 25, b and c).

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

9. Interest, Fund-Raising, and Investment Management Costs

   a. Costs incurred for interest on non-capital asset items and current indebtedness are unallowable. With certain limitations, interest on loans for tangible, depreciable capital asset items is allowable (See Section 4.6, item 9).

   b. Costs of organized fund-raising, including financial campaigns, endowment drives, solicitation of gifts and bequests, and similar expenses incurred solely to raise capital or obtain contributions, are unallowable.

   c. Cost of investment counsel and staff and similar expenses incurred solely to enhance income from investments are unallowable.

   d. Fund-raising and investment activities shall be allocated an appropriate share of indirect costs in accordance with Subsection 4.3, Cost Objectives, Direct Costs and Indirect Costs.

10. Losses on Other Contracts or Grants

    Costs in excess of income on any contract or grant are unallowable as costs of any other contract or grant. This includes, but is not limited to the provider agency's contributed portion by reason of cost sharing agreements or any under-recoveries through negotiation of lump sums for, or ceilings on indirect costs.

11. Organization Costs

    Expenditures such as incorporation fees and fees to promoters, organizers, management consultants, brokers, attorneys, accountants, or investment counselors, whether or not employees of the provider agency, in connection with establishment or reorganization of a business, are unallowable except with prior approval of the Department.

12. Participant Support Costs

    Participant support costs are direct costs for items such as stipends or subsistence allowances, travel allowances, and registration fees paid to or on behalf of provider agency clients or trainees (but not employees) in connection with meetings, conferences, symposia, or training projects. These costs are allowable only with the prior approval of the Department.

13. Pre-Award Costs

    Costs incurred prior to the effective date of the contract, whether or not they would have been allowable thereunder if incurred after such date, are unallowable unless specifically set forth and identified in the contract.

14. Public Information Service Costs

    a. Public information service costs include the costs associated with pamphlets, news releases, and other forms of information services. Such costs are normally incurred to:

        (1) Inform or instruct individuals, groups, or the general public;

        (2) Interest individuals or groups in participating in a service program of the provider agency; or

        (3) Disseminate the results of sponsored and non-sponsored activities.

    b. Public information service costs are allowable as direct costs only with the prior approval of the Department. Such costs are unallowable as indirect costs.

15. Publication and Printing Cost

    a. Publication costs include the cost of printing (including the processes of composition, plate-making, press work, binding, and the end product produced by such processes), distribution, promotion, mailing, and general handling.

    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 provider agency.

    c. Publication and printing costs are unallowable as direct costs except with the prior approval of the Department.

4.8 Cost Accounting Standards - Consistency

The cost accounting standards - Consistency in Budgeting, Accumulating and Reporting Costs; and, Consistency in Allocating Costs Incurred For The Same Purpose - provide criteria for eliminating cost accounting alternatives which are unsound and weak. These standards are discussed below.

1. Consistency in Budgeting, Accumulating, and Reporting Costs

   Provider agency practices used in budgeting costs for a proposed contract must be consistent with the provider agency's cost accounting practices used in accumulating and reporting costs. Budgeting and accounting practices must be consistent in:

   a. The classification of elements or functions of cost as direct or indirect;

   b. The indirect cost pools to which each element or function of cost is charged or budgeted to be charged; and

   c. The methods of allocating indirect costs to the contract.

2. Consistency in Allocating Costs Incurred for the Same Purpose

   In order to avoid overcharging some cost objectives and to prevent double counting, each type of cost must be allocated to a contract or other cost objective only once and on only one basis. Double counting occurs most commonly when cost items are allocated directly to a cost objective, while the same cost items are included in indirect cost pools which are allocated to that cost objective.

3. Application of Standards

   In following these standards, the provider agency must:

   a. Prepare the contract budget consistently with the way in which it records and accumulates costs on its books and records;

   b. Prepare its fiscal-year-end expenditure report consistently with its method of preparing the contract budget; and

   c. Charge direct and indirect type costs to the contract consistently with the methods identified in the contract budget which, in turn, must be consistent with all other programs, contracts, and cost activities of the provider agency.