

Incentive-Based Budget Model Indirect Cost Recovery Allocation

The following information is intended to provide context for a discussion on allocating indirect cost recovery (ICR) within an incentive-based budget. This paper includes a general overview of ICR, data specific to UC Davis, and a proposed methodology to serve as a starting place for deciding the specific aspects of allocating indirect cost returns.

PRINCIPLES

Before delving into the specifics of allocating indirect cost recovery, it is important to reiterate the over-arching principles of the UC Davis budget process. These principles should help inform the decisions to be made on specific aspects of the budget model.

1. Establish a sustainable funding model with incentives that advance the Vision of Excellence and the 2020 Initiative.
2. Advance and encourage campus strengths and priorities such as interdisciplinary scholarship and internationalization, as well as boost economic development.
3. Be transparent, linking authority with accountability.
4. Be as simple as possible to understand, administer and implement; rely on common and easily available data sources.
5. Encourage creativity and responsible risk-taking while providing for reasonable reserves and oversight.
6. Balance local autonomy with a strong sense of unity in vision and values.
7. Provide mechanisms for investments in fresh ideas at all levels.
8. Provide for reasonable transitions and bridging strategies.

TERMINOLOGY

Unless otherwise stated, the term **unit** is intended to refer to the primary campus organizational units that are led by a dean, vice provost or vice chancellor. Universities that have implemented incentive-based budgets tend to allocate funds at the highest level. There is no expectation that funds be distributed to departments using the same methodology that drives allocations to the schools, colleges and divisions. However, the deans and vice chancellors will be asked to report on the use of funds, including description of allocations to departments and programs, as part of an annual campus budget process.

The term **award** is an agreement between a sponsor and the university, whereby the sponsor will provide support (partial or total) for research, scholarly or professional training, or a public service program.

The completion of an award will have direct and indirect costs associated with it. **Direct costs** are those costs that can be specifically identified with a particular activity and assigned to the activity relatively easily with a high degree of accuracy. Alternatively, **indirect costs** are costs related to the administrative processes and facilities necessary to support research activities but cannot be identified readily and specifically with a particular activity. Because indirect costs are, by definition, difficult to attribute to a particular award, a mechanism to charge sponsors for indirect costs is needed. Often, that mechanism is a reimbursement rate assessed on the direct costs of the award.

Indirect cost recovery (ICR) is the reimbursement paid by a research sponsor to cover some portion of indirect costs associated with the award. Put another way, the ICR is a reimbursement for expenditures already incurred by the campus to support research.

In general, ICR is generated by applying a reimbursement rate to the direct costs (e.g., salaries, supplies, travel) of an award. For federal awards, UC Davis negotiates **facilities and administrative cost rates (F&A rates)** with the Department of Health and Human Services. Currently, the on-campus F&A rate for organized research is 53.5%. Based on that rate, if an award incurs \$10,000 in direct costs, then the sponsor would be expected to pay \$5,350 in indirect costs (a total of \$15,350). However, certain expenses are not subject to the F&A rate, rates can vary by sponsor (e.g., USDA training grants), and there are some approved exceptions. The effective F&A rate at UC Davis (actual indirect costs generated divided by actual direct costs) is about 27% for federally sponsored research and about 23% for all sponsored research including private, local and state sponsors.

The **Principal Investigator (PI)** is the individual designated as head of a research project. To be eligible as a PI, the individual must be an academic appointee. It is also possible to have **Co-Principal Investigators (Co-PIs)** for a research project.

The **academic home** of an award refers to the school, college or division that is responsible for the principal investigator's academic appointment. This may be different than the **administrative home** of an award, which is based on where the administrative support for an award occurs such as an ORU or a research center or institute.

WHAT IS ICR AND HOW CAN IT BE SPENT?

As stated above, ICR is a reimbursement of expenditures to cover some portion of the indirect costs incurred as a function of completing a research award. Or, in contrast to tuition, ICR is not revenue but a repayment of costs already sustained.

A useful analogy is the reimbursement of expenses for the business use of a personal automobile. When an employee uses her car for a business trip, the university reimburses the employee at a standard rate per mile. When the employee receives the reimbursement, she is under no obligation to use the funds for auto-related expenses. Similarly, the campus is under no obligation to use the ICR in a certain way. Instead, we choose to distribute indirect cost recovery in a way that is associated with the research efforts of the campus.

ICR ALLOCATION WITHIN INCENTIVE-BASED BUDGETS

Incentive-based budgets are designed to allocate resources directly to the units or activities responsible for generating the funds. In general, universities with incentive-based budgets assume that ICR will be distributed to the unit responsible for the research activity less an assessment. The assessment will direct some portion of funds to central campus and to the administrative units that support research but do not generate ICR. This means that determining the assessment rate is, in part, a function of deciding which costs will be covered centrally and which will be borne directly by the units performing the research.

For example, the University of Washington assesses ICR at a rate of 65%, with 35% going to the unit that generated the funds. Their assessment rate is based on the fact that facilities costs and other administrative services (pre- and post-award support, payroll, purchasing) will continue to reside with central administrative units.

CURRENT ALLOCATION OF INDIRECT COST RECOVERY

Before discussing how ICR may be treated within an incentive-based budget, it is important to explain how ICR is currently allocated at UC Davis. This is made more complicated by the fact that the UC Office of the President (UCOP) recently altered some of its own policies which has ramifications for ICR.

Change of UCOP methodology

Through FY 2010-11, UCOP received all of the ICR generated by each campus. Some of the funds were retained by UCOP and used for systemwide functions, some were returned to the campus as ICR funds, and some were returned as general funds. For example, for FY 2010-11, approximately 77% of the indirect costs generated by UC Davis were returned to the campus (\$105 million generated vs. \$81 million returned). The other \$24 million was held by UCOP. Of that amount, UCOP used less than 6% (roughly \$6 million) to support systemwide programs. The balance (about \$18 million) was combined with other resources and allocated as state general funds (also known as 19900 funds); however, the campus was unable to distinguish the ICR funds from the larger pool of general funds.

Beginning in 2011-12, UCOP changed its methodology for allocating funds within the University and funding its own operations. This methodology change is known as the UC Funding Streams Initiative. Instead of keeping pieces of certain fund sources based on historical practices and

formulas, all funds generated by a campus will be retained by or returned to that campus. In exchange, UCOP will charge an assessment of 1.6% on the total net expenditures of each campus from the year two years prior (e.g., FY 2009-10 expenditures drive the FY 2011-12 assessment). The proceeds from the assessment will support UCOP's operations and other systemwide programs. For more information, see the BIA report **Incorporating UC Funding Streams into the Campus Budget**. The result in the change of methodology is that there will be additional ICR available for distribution in FY 2011-12.

Current Campus Allocation

The ICR distributed in a given year is based on what was paid by sponsors during the prior year. This means that the funds distributed in FY 2011-12 were generated by the campus in FY 2010-11. Currently, the campus allocates the ICR it receives to support research and other priorities using a variety of methodologies that have evolved over time. For a detailed listing of how ICR was distributed in 2010-11, refer to the ICR overview and sources and uses reports published by BIA: <http://budget.ucdavis.edu/analyses-reports-white-papers/indirect-cost-recovery>.

WHAT ARE WE TRYING TO INCENTIVIZE?

As pointed out in a study of how the Michigan budget model is perceived by campus citizens, it is important to be clear about the intent of the incentives that are created. As stated in the report, "incentives should work only *within* the units' strategy; they should neither constrain nor encourage behavior or initiatives that do not fit the units' strategy and mission."

Ideally, the allocation of ICR should

- Encourage units to maximize the indirect cost recovery generated by the research activity.
- Encourage cross-college collaboration.
- Encourage investment of ICR funds into programs and activities that advance academic goals.

The allocation of ICR should not

- Encourage behavior that is counter to the overall strategy and mission of the unit and the university.
- Create a barrier to interdisciplinary collaboration.

ADMINISTRATIVE VERSUS ACADEMIC HOME

Currently, the ICR that is distributed through the campus return program is based on the administrative home of the award. For example, if the account for a grant is administered by an organized research unit (ORU), the ICR flows to the Vice Chancellor of Research (ORUs report through the Office of Research), regardless of the fact that the PI's academic home might be in the School of Medicine or the College of Biological Sciences.

Therefore, one policy choice is whether to continue to base the assignment of ICR solely on the administrative home or not. Units already deal with this issue by spreading out an award across a series of accounts. One account may be in the administrative home (college A) and two other accounts may reside in the academic home of the Co-PIs (colleges B and C). This creates an additional layer of work to set up the accounts in the financial system, but it also allows for maximum flexibility when deciding on the appropriate split.

An alternative is to create a consistent allocation within the budget model for instances when the administrative home of the award and academic home of the PI are different - perhaps 75% to the administrative home and 25% to the academic home. This has the benefit of standardizing the split for the entire campus and reducing the need to create accounts across multiple units. However, to the extent that the 75-25 split is not applicable for a particular situation, units may still choose to divide funds across more than one account.

CATEGORICAL SET-ASIDES

ICR funds generated by projects related to buildings financed by Garamendi Funds will not be assessed to the extent that the ICR is used for Garamendi-eligible expenses (i.e., paying debt service, the operation and maintenance of plant (OMP), and some equipment and capital expenses). Any surplus funds not needed for these allowable expenses will be treated like all other ICR funds. At UC Davis, the Center for Comparative Medicine and the Genome and Biomedical Science Facility are Garamendi-financed buildings.

A similar set-aside exists for Specialized F&A Rates negotiated with the federal government. Currently, UC Davis has three specialized rates (A, B and C) that are used for research performed at the California National Primate Research Center. ICR generated by the B- and C-Rates are treated as program income and are not subject to an assessment by central campus. The A-Rate (or core grant rate) is treated like all other ICR funds.

Categorical set-asides will not be subject to an assessment as part of the campus budget model, but these programs will be subject to the UCOP assessment (1.6% of expenditures) as it relates to the Funding Streams Initiative.

PROPOSED REVENUE ALLOCATION

Table 1 is a proposed allocation of ICR for FY 2012-13 based on an estimate of almost \$92 million being available for distribution. Of that amount, 34% would be distributed to the units based on their generation of ICR, and approximately 66% would be allocated to central campus. This will be the first step towards an eventual 40%-60% split between the units and central campus, which could be further modified based on decisions as to what costs will continue to be borne at the center. First, let us look at the funding that would be provided to the units.

While it is true that the implementation of a new budget model, in and of itself, does not create new money, the ICR funds being provided to units are increasing for two reasons. First, units will see their ICR budget increase, but the increase will come with some new and offsetting costs. Second, as discussed earlier, the impact of the UCOP Funding Streams is that more ICR funds are available to the campus, and these funds do not carry offsetting costs with them.

Table 1 starts with an estimate of what each unit is expected to generate in ICR during 2011-12. Column b shows what each unit would receive assuming an overall allocation rate of 34%. Column c consolidates four items: funds received for the campus return program in 2011-12, decentralized benefits, base ICR funding and the OP tax. For example, currently, benefits paid from ICR funds are managed centrally. In the new budget model, units will cover the benefits costs out of the portion of ICR funds being returned. Units will also be expected to manage any program-specific base budget appropriations within the overall return. And, a portion of the funds being returned will be used to pay the new OP assessment on research expenditures. Put another way, column c is intended to represent each unit's current ICR spending.

Table 1: 2012-13 Hypothetical Distribution of 34% of ICR Generated (all dollars in thousands)					
	a	b (a x 34%)	c	d	e (b - c + d)
Unit	ESTIMATED Net ICR Generated in 2011-12*	Allocate 34% of ESTIMATED Net ICR Generated	Less 2011-12 Campus Return, Benefits, Base and OP Tax	Transition Funds	ESTIMATED Change from 2011-12
CA&ES	\$14,500	\$4,930	\$3,840		\$1,090
CBS	\$11,600	\$3,940	\$3,450		\$490
COE	\$9,200	\$3,130	\$2,540		\$590
HArCS	\$380	\$130	\$110		\$20
MPS	\$7,000	\$2,380	\$1,740		\$640
DSS	\$2,600	\$880	\$620		\$260
SOE	\$580	\$200	\$160		\$40
SOM	\$29,100	\$9,890	\$7,950	\$5,000	\$6,940
SVM	\$6,700	\$2,280	\$2,570	\$500	\$210
ORUs	\$10,000	\$3,400	\$2,710		\$690
TOTAL	\$91,660	\$31,160	\$25,690	\$5,500	\$10,970

*Less categorical set-asides, including ARRA, Garamendi, certain leases and specialized F&A rates

Column e compares the amount allocated (column b) to the current spending power (column c), including any transition funds (column d). For example, the College of Agricultural and Environmental Sciences (CA&ES) is estimated to generate \$14.5 million in ICR. Using a 34% return, almost \$5 million ($\$14.5 \text{ million} \times 35\%$) is allocated to the college. Their spending power for 2011-12 is almost \$4 million, which represents an increase of roughly \$1 million.

With 34% being allocated to the units, then 66% of the ICR generated is going to central campus. The uses of these funds fall into three main groups. First, some funds are used for research matching programs, graduate student support, faculty start-up packages and transition funding. The funds, allocated by the vice chancellor for research or the provost, will end up as part of unit budgets and account for about 26% of the 66%. Another portion is needed to satisfy existing debt service; this makes up another 20%. The final portion, currently less than 20%, is used to support the research infrastructure within the Office of Research and Administrative and Resource Management. See Appendix I for a flowchart of ICR.

While the allocation split between the units and central campus will be 34%-66% for FY 2012-13, the goal is to increase the percentage flowing to the units in the following year, so that, at a minimum, 40% will be allocated directly to the units and 60% to central campus. This will be made possible because some one-time funding allocated to the Schools of Medicine (SOM) and Veterinary Medicine (SVM) in FY 2012-13 will not continue in 2013-14. The one-time funding to the SOM and SVM is necessary, because the full implementation of the UC Funding Streams Initiative means that the Health System and SVM will be responsible for significantly higher assessments.

Further adjustments to the allocation split between the units and central campus are possible. But such modifications begin with a discussion of the types of costs and the degree to which those costs should be borne by central campus.

PROPOSED DETAILED METHODOLOGY

The following is a proposed methodology for allocating ICR. Any of the points presented are open for debate, discussion and clarification.

1. Net indirect cost recovery will be distributed to a school, college, division or office based on which unit was responsible for generating the funds.
2. Net ICR is equivalent to the total amount of ICR generated in the prior year less any categorical set-asides (e.g., Garamendi allowable expenses and Specialized F&A Rates).
3. The responsible unit is defined as the administrative home of the award (either the lead school, college or division dean or the vice chancellor-research for ORUs and some centralized research facilities).

4. For FY 2012-13, net ICR distributed to the units will be 34%. The balance of funds (66%) will be used to: (1) provide transition funds for the schools of medicine and veterinary medicine; (2) meet long-term commitments such as debt service; (3) to support investment priorities (e.g., faculty start-ups, graduate student support); and (4) to partially fund the administrative units that support research but do not generate ICR.
5. For FY 2013-14, net ICR distributed to the units will be 40% and the assessment rate will be 60%. The use of the assessment will be similar to what is described in #4 above, except the transition allocations will not continue.

APPENDIX I: Proposed Indirect Cost Recovery Flowchart

