CHA
Catholic Health Association of the United States

Community Benefit Reporting: *Indirect Costs*

Note: The information provided in this document does not constitute legal or tax advice. The information is provided for informational/educational purposes only. Please consult with counsel regarding your organization's particular circumstances.

The Catholic Health Association of the United States

For over 30 years, CHA has been the leading source of information and tools for planning and reporting hospital community benefit. In 2008, CHA's accounting system for reporting community benefit was used in the development of the IRS Form 990 Schedule H.

CHA represents more than 650 hospitals and 1,600 long-term care and other health facilities in all fifty states. Our hospitals were established to address health needs in their communities and that tradition continues today. Catholic hospitals are a critical source of care and services in their communities, including community-based services that address significant health and health-related needs reported as community benefit.

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COMMUNITY BENEFIT REPORTING: INDIRECT COSTS

For many years, the Catholic Health Association of the United States (CHA) has published guidelines to help hospitals plan and report community benefits. CHA is pleased to provide this resource, which contains information designed to help hospital organizations identify and report Indirect costs associated with community benefit programs and activities.

Both direct costs and reasonable indirect (or "overhead") costs should be included in the accounting for each type of community benefit. This view aligns with the IRS Form 990, Schedule H instructions.

Direct costs are typically directly assigned to each unique community benefit activity or program. Indirect costs are shared by multiple activities or programs, such as facilities and administration costs related to the organization's infrastructure (space, utilities, custodial services, security, information systems, and administration). Indirect costs are allocated to activities and programs rather than directly assigned.

This document is designed to help you calculate and apply indirect costs to community benefit activities and programs.

What you need to know

- Community benefit expenses include both direct and indirect costs. It's important to include indirect costs to align with Schedule H instructions and ensure a consistent, full accounting of community benefit expenses.
- Multiple data sources typically are available to determine an indirect cost rate that can be applied to community benefit activities, including Medicare Cost Reports, cost accounting systems, and special studies conducted by the finance department.
- Some hospital organizations place a cap on indirect costs so that the majority of the community benefit program expenses they report on Form 990, Schedule H are direct.
- Some hospital organizations also develop two indirect cost rates: one rate for programs based within the hospital facilities and a second, lower rate for programs that are carried out in the community.
- Approaches and considerations for calculating and applying indirect costs vary for each category of community benefit.

INDIRECT COSTS DEFINED

The IRS Form 990, Schedule H instructions include the following definitions[1]:

"Total community benefit expense" means the total gross expense of the activity incurred during the year, calculated by using the pertinent worksheets for each line item. "Total community benefit expense" includes both "direct costs" and "indirect costs."

"Direct costs" means salaries and benefits, supplies, and other expenses directly related to the actual conduct of each activity or program.

"Indirect costs" means costs that are shared by multiple activities or programs, such as facilities and administrative costs related to the organization's infrastructure (space, utilities, custodial services, security, information systems, administration, materials management, and others).

APPROACHES TO ESTIMATING INDIRECT COST RATES

Because indirect costs are typically shared, they need to be allocated across multiple activities or programs. The method used to allocate indirect costs may vary depending on the type of community benefit program or activity and the indirect costs involved in supporting that program or activity.

Cost accounting systems typically assign indirect costs to clinical programs based on sophisticated allocation techniques. In the absence of a cost accounting system, indirect cost rate(s) can be derived from sources such as the Medicare Cost Report and special studies conducted by the finance department.

Whatever indirect cost rates are used, the rate(s) should be reasonable, supportable, and documented. Please note: CHA does not recommend or suggest a specific rate for indirect costs; the example below is an illustration of the calculation.

EXAMPLE CALCULATION OF INDIRECT COSTS

An indirect cost rate typically is expressed as a percentage.

(Total Indirect and Direct Costs) / Direct Costs) – 1 = Indirect Cost Rate

Here is an example of these calculations:
total direct costs = $200,000, and total indirect costs = $30,000.

Indirect cost rate = (($30,000 + $200,000) / $200,000) – 1 = 0.15 or 15%

The indirect cost rate is then applied to the community benefit program direct costs as follows:

Program Direct Costs × (1 + Indirect Cost Rate) = Total Community Benefit Expense

Here is an example of these calculations using community benefit program direct costs = $1,500 and the indirect cost rate calculated above (0.15):

Total community benefit expense = $1,500 x (1+0.15) = $1,725

1 IRS Form 990, Schedule H instructions, available at: https://www.irs.gov/instructions/i990sh

CONSIDERATIONS WHEN DEVELOPING INDIRECT COST RATES

For the categories of financial assistance, Medicaid, other means-tested government programs, and subsidized health services, direct and indirect costs are generally included in a hospital's ratio of patient care cost to charges or in its cost accounting system. The IRS Form 990 Schedule H instructions include Worksheet 2, Ratio of Patient Care Cost to Charges. This worksheet starts with total operating expenses (which includes indirect costs) and then is adjusted to remove non-patient care expenses, Medicaid provider taxes and fees, and community benefit expenses (to avoid double-counting community benefit expenses). The IRS Form 990, Schedule H instructions provide guidance and rules for how to calculate this ratio. Because all patient care expenses – direct and indirect – are included in the denominator of the ratio of patient care cost to charges, a hospital using this ratio would not apply an indirect cost rate in determining the ratio.

For Schedule H community benefit categories that do not use a ratio of patient care costs to charges to calculate total expenses, it may be necessary to calculate and apply an indirect cost rate.

- Health professions education: The Medicare Cost Report (MCR) is the preferred source for determining the expenses of certain health professions education programs (e.g., graduate medical education, paramedical education) because the MCR documents direct expenses and also allocates allowable indirect costs to direct costs. For other health professions education programs, refer to the guidance below for community health improvement services and cash and in-kind donations.

- Cash and in-kind contributions for community benefit: CHA generally recommends not adding indirect costs to direct expenses for cash and in-kind contributions, particularly if staff costs for those involved in the grant-making process are included in community benefit operations / community health improvement services expenses.

- Community health improvement services and community building: CHA recommends using at least two indirect cost rates that reflect the location of each community health improvement service and community benefit activity: one rate for programs based within the hospital facility, and a second, lower rate for programs that are based in the community.

TIMING ISSUES

While some systems update their indirect rates at the end of their reporting years to reflect current-year expenses, others use prior-year information when calculating and applying indirect rates. These systems find that the rates do not change significantly from year to year.

OVERALL REASONABLENESS TEST

It is important to use a consistent method of determining and applying indirect rates, and to use reasonable and reproducible processes in doing so. Hospitals may impose a cap on indirect cost rates (particularly if/when indirect costs exceed direct costs); however, such a cap is not required by the Schedule H instructions. Indirect costs should reflect the reasonable allocation of "overhead" costs that are utilized by the applicable community benefit program or activity.

INDIRECT COSTS BY COMMUNITY BENEFIT CATEGORY

The following table provides recommendations for developing indirect cost rates for each category of community benefit. CHA recommends working with your finance team and tax and legal advisors in determining indirect costs. All indirect cost rates used, regardless of how they are calculated, should be reasonable, supportable and documented.

Financial Assistance

Indirect costs are included in the numerator of the "ratio of patient care cost to charges" or an organization's cost accounting system, so the organization would not apply a separate, indirect cost rate.

Medicaid and Other Means-Tested Government Programs

Indirect costs are included in the numerator of the "ratio of patient care cost to charges" or an organization's cost accounting system, so the organization would not apply a separate, indirect cost rate.

Community Health Improvement Services

Community health improvement services may take place in different locations, and the "overhead" expenses for these different locations vary.

To reflect the location and resources involved in the activity, calculate at least two indirect cost rates for community health initiatives based on the location where the activities/programs are delivered: one for initiatives that are "hospital-based" clinical programs and a second for initiatives delivered in non-hospital, community settings.

Indirect cost rates for each of these settings can be derived from Medicare Cost Reports or from the hospital's cost accounting system.

The Medicare Cost Report, Worksheet B, Part I, includes seven categories of "cost centers." Indirect (overhead) costs are accounted for in the general service cost center within Worksheet B, Part I, Column 0.

Note: Employee benefit costs, certain health professions education costs, and certain other direct costs (e.g., for pharmacy) are also included within the general service cost centers.

- When reporting community benefit expenses, employee benefit costs typically are considered direct costs; accordingly, those costs should be removed when calculating indirect cost rates.
- Health professions education costs are reported in full and shouldn't be double-counted in indirect cost rates.
- Within the Medicare Cost Report, there are other costs included within the general service cost centers that may be considered direct costs (e.g., pharmacy, radiology administration and/or ambulance service). If other direct costs are identified with the general service cost centers, these costs should also be added to direct costs when calculating indirect cost rates.

HOSPITAL-BASED PROGRAMS

When calculating the indirect cost rate for hospital-based programs, indirect costs and direct costs can be defined as follows:

Indirect Costs: Total general service costs MINUS health professions education costs MINUS employee benefits costs MINUS other direct costs identified

Direct Costs: Total costs for non-general service cost centers PLUS employee benefits costs PLUS other direct costs identified

The indirect cost rate = ((indirect PLUS direct costs) / direct costs) minus 1

COMMUNITY-BASED PROGRAMS

"Administrative and General" costs are reported in one row of the general service cost centers. When calculating the indirect cost rate for community-based programs, indirect and direct costs can be defined as follows:

Indirect Costs: "Administrative and general" costs

Direct Costs: Total costs for non-general service cost centers PLUS employee benefits costs PLUS other direct costs as identified.

As mentioned above, the rate would be calculated as follows:

The indirect cost rate = ((indirect PLUS direct costs) / direct costs) minus 1

The "community-based program" rate should generally be lower than the "hospital-based program" rate because it should exclude the costs of hospital buildings, the billing office, laundry, housekeeping, and other cost centers that apply only to hospital-based programs.

If an organization has a cost accounting system, indirect costs for community health improvement and other services may be determined based on reasonable allocations made by that system.

EXAMPLE USING THE MEDICARE COST REPORT:

The example below uses Worksheet B, Part I, Column 0 from the Medicare Cost Report to calculate indirect cost rates. The direct costs used to calculate indirect cost rates are the same for calculating the hospital-based indirect cost rate and the community-based indirect cost rate.

DIRECT COSTS		
Direct costs: *same for both rate calculations		
	Dollar amount	**Rows from Medicare Cost Report Worksheet B, Part I, Column 0**
Total costs		Row 202
Minus: general service cost centers		Rows 1-23
Total costs for non-general service cost centers		Total expenses MINUS general service cost centers
Plus: employee benefits		Row 4
Plus: other costs from the general service cost centers that were removed when calculating indirect costs		Review rows 1-23 for additional direct costs
Direct costs	**$ --**	

Note: Removing all general service cost centers costs removes employee benefits (row 4), health professions education (rows 20-23), and other costs that are identified as direct and not indirect.

INDIRECT COST RATE FOR HOSPITAL-BASED PROGRAMS		
Indirect costs, hospital-based programs	**Dollar amount**	**Rows from Medicare Cost Report Worksheet B, Part I, Column 0**
Total general service cost centers		Rows 1-23
Minus: health professions education		Rows 20-23
Minus: employee benefits		Row 4
Minus: other general service costs that do not indirectly impact the hospital's community benefit programming		Consider removing other general service cost centers (i.e., pharmacy, radiology administration and/or ambulance service) if you know that the cost center is not related to your specific community benefit programs
Total indirect costs, hospital-based programs	**$ --**	

Indirect cost rate for hospital-based programs =
((Indirect costs for hospital-based programs PLUS direct costs)/direct costs) minus 1

INDIRECT COST RATE FOR COMUNITY-BASED PROGRAMS		
Indirect costs, community-based programs	**Dollar amount**	**Rows from Medicare Cost Report Worksheet B, Part I, Column 0**
Administrative and general		Row 5*
Total indirect costs, community-based programs	$ --	

*Note: If Row 5 is broken out into multiple rows or lines, only capture the administrative and general expenses.

Indirect cost rate for community-based programs =
((Indirect costs for community-based programs PLUS direct costs)/direct costs) minus 1

Community Benefit Operations

Community benefit operations are overhead functions. A reasonable indirect cost rate that accounts for space used for community benefit operations and administrative oversight is appropriate.

Health Professions Education

The Medicare Cost Report is a preferred source for determining indirect cost rates for some health professions education activities (e.g., graduate medical education, and paramedical education). In the Medicare Cost Report (MCR), Worksheet B, Part I, column 0 includes the direct cost (before overhead) of programs for interns and residents and for paramedical education programs. MCR, Worksheet B Part I, Columns 20 through 23, Rows 202 in Worksheet B, Part I show the total cost of these programs, including both direct costs and allocated indirect costs.

For other health professions education programs, refer to the guidance for community health improvement services and cash and in-kind donations.

Subsidized Health Services

Indirect costs are included in the numerator of the "ratio of patient care cost to charges" or in an organization's cost accounting system, so the organization would not apply a separate indirect cost factor.

Research

Indirect costs for research programs should be based on guidelines and definitions established by the National Institutes of Health (NIH). Some organizations include indirect costs based on amounts or factors they submit for approval to NIH. Others include these costs based on rates actually approved by NIH. The indirect cost rate based on the amount submitted for approval is appropriate for purposes of community benefit accounting, so long as the rate follows NIH rules.

Cash and In-Kind Contributions for Community Benefit

The indirect cost rate for cash and in-kind contributions for community benefit should be minimal or zero if the organization has separately accounted for the cost of the grantmaking function as part of its community benefit operations. Accordingly, CHA generally recommends not adding an indirect rate to activities or programs in this category.

Community Building

See the community health improvement section, above.

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