DRAFT

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# Incentive-Based Budget Model
# Indirect Cost Recovery Allocation

***New or revised material is indicated by an asterisk.**

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 $15,530). 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 organized research unit (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. As such, the use of ICR funds is not restricted to any particular use.

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 distribute ICR 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 **UC Funding Streams** available here: [http://budget.ucdavis.edu/budget-model](http://budget.ucdavis.edu/budget-model). 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](http://budget.ucdavis.edu/analyses-reports-white-papers/indirect-cost-recovery).

***Allocating Funds to Deans and the Vice Chancellor of Research****

Beginning in 2011-12, ICR funds from the Campus Return Program were allocated at the level of the dean (for organized research units, funds are allocated to the Vice Chancellor of Research). This is a change from the past practice of allocating a portion of ICR directly to departments. The purpose of this policy change is to enable deans to manage a broader spectrum of resources for their unit. The expectation is that each dean will transparently manage and allocate the funds and provide for opportunities to increase formula and strategic allocations to departments.

The change in policy raised concerns about how the funds would be used by the dean and whether subsequent allocations would be sufficiently transparent. In response to these concerns, BIA asked each dean's office to share how they calculated the allocation to their departments and how the distribution was communicated. Each dean's office provided detailed information about their internal school/college/division process. To summarize, the 2011-12 allocations to departments from deans were computed and distributed as follows:

- Total ICR allocations to departments increased. In many cases, ICR funds were distributed at the same percentage as previous years and since there were more ICR funds available, the total amount distributed increased. In some cases, the total pool of funds allocated to departments was simply increased by a flat amount.

  - It is noteworthy that some deans made decisions to normalize the distribution of ICR as a single pool to reflect the new approach being taken by UCOP. The approach of using a single pool avoids some historical inequities, but in the short-term the shift creates differential results amongst departments.

- Deans shared the details of the distribution with department chairs and faculty members. This included amounts distributed to departments, what was retained by the dean's office and why.

Finally, the distribution of ICR will be part of the annual budget process, allowing the Provost to continue to be informed about how each unit makes use of and distributes the ICR funds that it receives.

**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."

***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 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 may be in one or more of the schools, colleges or divisions.

*The first version of this paper raised the issue of whether or not to continue to allocate ICR based solely on the administrative home of the award. Initial feedback has been divided. Some prefer the current methodology of relying only on the administrative home. Others advocate for a split between the administrative home and the academic home of the PI. A summary of both arguments is below.

**Rationale for the status quo (administrative home only)*

1. Organized Research Units (ORUs) and interdisciplinary centers rely heavily on indirect cost recovery to fund administrative support and infrastructure needs. A reduction in the proportion of funds flowing to them may diminish their ability to adequately support interdisciplinary research activities in the ORUs.

2. In the current environment, agreements already exist between the stakeholders of ORUs and large research centers. Because of these standing arrangements, there is reluctance to embed a distribution scheme in the budget model.

**Rationale for changing the current practice to a combination of administrative and academic homes*

1. The primary responsibility for providing funding for faculty recruitment and retention rests with the academic units. A greater proportion of the ICR would help them meet these obligations.

2. Instituting a formula that recognizes the administrative and academic homes provides a consistent and known baseline for how resources will be shared. To the extent that the campus formula is deemed insufficient, stakeholders retain the ability to negotiate an alternate agreement.

**Data concern*

It should be noted that allocating funds based on the academic home of the PI would require reliance on data that is not currently used to allocate resources and may contain inaccuracies. Every research award has one or more accounts in the campus financial system, Kuali. These accounts are used to record the direct and indirect expenditures of the award, and each account has a field to identify the PI. The concern is that, at the account level, the PI data may not be accurate. Before using this data to distribute ICR, units would need time to review each account and make any necessary corrections.

*Overall, including the academic home of the PI would have the effect of distributing fewer resources to the Office of Research and units with interdisciplinary research centers which would require a significant investment to maintain the core principle of reasonable transition strategies. Because of the potential impact to the Office of Research and interdisciplinary centers, ICR will continue to be distributed based solely on the administrative home of the award. The expectation is that as ICR levels increase so will the level of support from the ORUs (via the Vice Chancellor of Research) towards the recruitment and retention of faculty. This may be accomplished through a one-time exchange of ICR funds or on an on-going basis via a memorandum of understanding.

**CATEGORICAL SET-ASIDES***

*Categorical set-asides are projects or programs that have special treatment with respect to the distribution of their ICR funds. In general, programs that are currently regarded as set-asides will continue to be treated as such. This means that set-asides will not be subject to an assessment as part of the campus budget model. However, these programs will be subject to the UCOP assessment (1.6% of expenditures) as it relates to the Funding Streams Initiative.

One example of a categorical set-aside relates to 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.

*Another example of a set-aside relates to Garamendi funding. At UC Davis, the Center for Comparative Medicine (CCM) and the Genome and Biomedical Science Facility (GBSF) are Garamendi-financed buildings. This terminology comes from the state legislation that was authored by then-Senator Garamendi in 1990. The law (Section 15820.21 of the State Government Code) provides a mechanism for using the ICR that comes as the result of a new or renovated research facility to support the debt service and maintenance costs of the facility. As explained earlier, before 2011-12, UCOP retained a portion of the ICR generated by campus. The Garamendi program was an exception to this practice, and the ICR that came as a result of federal research was returned in full. As part of this special treatment, Garamendi-financed buildings were responsible for expenses that other buildings on campus were not, specifically debt service and operation and maintenance of plant (OMP) costs.

*Since the Office of the President no longer retains a portion of the funds, beginning in 2012-13, the Garamendi-related ICR will be treated more like other ICR funds and less like a set-aside. The funds will be shared 60%-40% between the Provost and the participating units, which is one year ahead of the rest of campus achieving a 60%-40% split. As part of receiving 60% of the ICR and to be more consistent with other buildings on campus, the debt service and the OMP costs will be the responsibility of the Provost. This also means that the recharge activities in GBSF will no longer collect ICR as a part of their recharge rates. From their 40% share of the ICR, the units will be responsible for things such as equipment purchases, administrative support, and the UCOP assessment.

**PROPOSED REVENUE ALLOCATION***

Table 1 is a proposed allocation of ICR for FY 2012-13 based on an estimate of about $94 million being available for distribution net of categorical set-asides. Of that amount, 34% (or about $32 million) would be distributed to the units based on their generation of ICR, and 66% (roughly $62 million) 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, ICR funding will grow, even after factoring in some new and offsetting costs that go with the change in funding. Second, as discussed earlier, the impact of the UCOP Funding Streams Initiative is that more ICR funds are available to the campus. While there is a tax associated with Funding Streams, the ICR needed to cover the tax on research expenditures (approximately $6 million) is less than the amount of ICR that UCOP used to retain (roughly $24 million).

*Table 1 starts with an estimate of what each unit will generate in ICR during 2011-12 – column b. ICR generated is based entirely on the administrative home of the account (see section on Administrative versus Academic Home). Column c subtracts the categorical set-asides for each unit. Because 40% of the ICR related to Garamendi-financed buildings will be distributed to the units, those funds are included in the set-aside amount (see section on Categorical Set-asides). Column d is the net of ICR generated and the categorical set-asides. This column is what is available for distribution per the budget model formula for ICR. Column e shows what each unit would receive assuming an allocation rate of 34%.

*Column f is a combination of three things: existing base ICR funding, decentralized benefits and the UCOP tax on research. Currently, benefits paid from some ICR funds are managed centrally. Beginning next year, units will cover these 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 UCOP assessment on research expenditures. Put another way, column f is intended to acknowledge each unit's obligations against ICR.

Column g is the ICR allocation net of costs and existing base budgets. Column h shows the amount that each unit received from the campus return program during 2011-12. Column i displays the one-year transition funds to be provided to the School of Medicine (SOM) and School of Veterinary Medicine (SVM) (see below for more details on the transition funding). Finally, column j represents the net change in ICR distributed from 2011-12 to 2012-13.

**Table 1: 2012-13 Indirect Cost Recovery (ICR) Distribution Estimate***
**Projections based on ICR generated from July 2011 to April 2012**
**Dollars in thousands**

| | Projected ICR Generated During 2011-12 | | | Projected Distribution for 2012-13 - New Budget Model | | | Comparison to 2011-12 Distribution | | |
|---|---|---|---|---|---|---|---|---|---|
| a | b | c | d = b + c | e = 34% x d | f | g = e + f | h | i | j = g - h + i |
| Unit | Projected ICR Generated | Less Categorical Set-asides[1] | Projected ICR Available for Distribution | Projected ICR Distributed to Unit | Less Benefits, Base Budget, UCOP Tax[2] | Net Allocation | 2011-12 Return Program | One-year Transition | Projected Net Change from 2011-12 |
| CA&ES | 15,700 | (500) | 15,200 | 5,170 | (1,180) | 3,990 | 2,092 | | 1,900 |
| CBS | 15,300 | (3,700) | 11,600 | 3,940 | (690) | 3,250 | 1,740 | | 1,510 |
| COE | 12,900 | (4,300) | 8,600 | 2,920 | (860) | 2,060 | 1,395 | | 670 |
| HArCS | 800 | 0 | 800 | 270 | (50) | 220 | 59 | | 160 |
| MPS | 8,700 | (400) | 8,300 | 2,820 | (530) | 2,290 | 1,117 | | 1,170 |
| DSS | 2,800 | (100) | 2,700 | 920 | (180) | 740 | 394 | | 350 |
| SOE | 900 | 0 | 900 | 310 | (60) | 250 | 86 | | 160 |
| GSM | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | 0 |
| LAW | 30 | 0 | 30 | 10 | (1) | 9 | 0 | | 10 |
| SOM | 38,300 | (9,100) | 29,200 | 9,930 | (2,720) | 7,210 | 5,206 | 5,000 | 7,000 |
| BIMSON | 100 | 0 | 100 | 30 | (10) | 20 | 0 | | 20 |
| SVM | 10,900 | (4,000) | 6,900 | 2,350 | (850) | 1,500 | 1,203 | 500 | 800 |
| **subtotal** | **106,430** | **(22,100)** | **84,330** | **28,670** | **(7,131)** | **21,539** | **13,292** | **5,500** | **13,750** |
| | | | | | | | | | |
| ORUs (VC-R) | 14,300 | (3,100) | 11,200 | 3,810 | (1,180) | 2,630 | 1,431 | | 1,200 |
| Library | 4 | 0 | 4 | 0 | 0 | 0 | 0 | | 0 |
| GRAD | 10 | 0 | 10 | 0 | 0 | 0 | 0 | | 0 |
| CHAN | 10 | 0 | 10 | 0 | 0 | 0 | 0 | | 0 |
| VCSA | 100 | 0 | 100 | 30 | (20) | 10 | 0 | | 10 |
| ARM | 100 | 0 | 100 | 30 | (10) | 20 | 0 | | 20 |
| **subtotal** | **14,524** | **(3,100)** | **11,424** | **3,870** | **(1,210)** | **2,660** | **1,431** | **0** | **1,230** |
| | | | | | | | | | |
| **Total** | **120,954** | **(25,200)** | **95,754** | **32,540** | **(8,341)** | **24,199** | **14,723** | **5,500** | **14,980** |

[1]Includes set-asides related to ARRA funding, Garamendi-financed buildings and specialized F&A rates.
[2]The UCOP Tax represents a unit's total tax liability related to ICR-generating research.

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. This funding, allocated by the Vice Chancellor of Research or the Provost, will end up as part of unit budgets and accounts for about 26% of ICR. 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 SOM and the SVM in FY 2012-13 will not continue in 2013-14. This one-time funding is necessary because the full implementation of the UC Funding Streams Initiative means that the Health System and the 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., 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), based on the assignment of the award in the accounting system. An award can be divided into smaller portions and have more than one administrative home.

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 SOM and the SVM; (2) meet long-term commitments such as debt service; (3) support investment priorities (e.g., faculty start-ups, graduate student support); and (4) 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