The Bridgespan Group

Momentum for Change: Ending the Nonprofit Starvation Cycle

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Collaborating to accelerate social impact

September 2019

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Introduction

Throughout modern history and around the globe, nonprofits, NGOs, and civil-society organizations have played an essential role in solving humanity's toughest problems.[1] Supported by a vast web of foundations, public funding, and private donors, these organizations take on challenges from extreme poverty to infectious disease to educational inequity.

However, as a sector, there is a problem in the way we fund these entities. Funding sources—national, state and local governments; multilateral and bilateral institutions; private foundations and individuals—are part of a complex system with inconsistent practices. Indirect-cost reimbursement, the specific focus of this paper, ranges from zero to a funder's "fair share."

Five foundations—the Ford Foundation, the William and Flora Hewlett Foundation, the MacArthur Foundation, the Open Society Foundations, and the David and Lucile Packard Foundation—formed a collaborative with The Bridgespan Group in 2016 to examine the problem of insufficient cost recovery. This paper shares what we have learned together, in hopes that it will be useful to the broader social sector.

We have found that despite funders' intentions, today's system is not consistently creating strong grantee organizations. In 2017, we examined the financial health of the 274 most highly cofunded nonprofits of the largest 15 US foundations. More than half suffered from frequent or chronic budget deficits, defined as at least two of the past five years. And 40 percent had fewer than three months of reserves in the bank to cushion financial shortfalls. In fact, 30 of the 274 organizations showed negative reserves—making them technically insolvent.

Why is this? Project grants, which represent more than three-quarters of US foundation giving and nearly all government funding globally, are the source of most of this under-funding.[2] While project grants are an essential tool in philanthropy, they routinely discount the core administrative and operational costs of delivering programs and services.

Over half of the 15 largest US foundations have a flat-rate indirect-cost reimbursement policy of 15 percent or less.[3] While state and local governments granting federal money are supposed to provide a minimum reimbursement rate of 10 percent, actual indirect-cost allowances are often lower and sometimes nonexistent.[4] Many global funders also restrict

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1 Throughout this report, the term nonprofits includes all types of nongovernmental organizations, both domestic and international.

2 Niki Jagpal and Kevin Laskowski, *The State of General Operating Support 2011* (Washington, DC: National Committee on Responsive Philanthropy, May 2013), https://www.issuelab.org/resource/the-state-of-general-operating-support-2011.html.

3 Based on policies as of December 2018.

4 US Office of Management and Budget, "2 CFR 200 — Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards," January 1, 2014.

grants to projects and tend to limit indirect-cost reimbursement to between 5 percent and 8 percent.[5]

Rigorous research confirms that grantees' actual indirect costs nearly always exceed these allocations. In a 2015 Bridgespan study of a large foundation's grantees, for instance, indirect costs ranged from 21 percent to 89 percent of direct program costs, with clear differences in cost structure by type of nonprofit. Nonprofit research labs, for example, had a median indirect-cost rate of 63 percent, two and a half times the 25 percent median rate of direct-service organizations. Similar variation exists in the private sector as well, where indirect-cost rates are not considered a measure of either effectiveness or efficiency. Indeed, for any enterprise, these figures simply reflect the mix of costs required to deliver results.

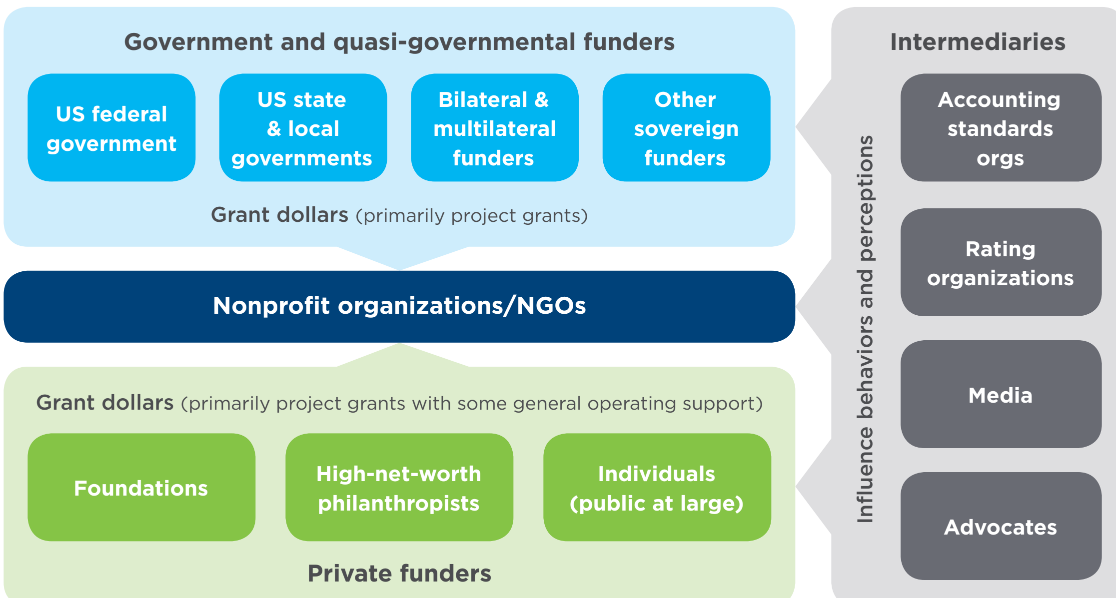
This report synthesizes an array of primary and secondary research documenting the progress made on understanding and addressing this issue. It also highlights the funder collaborative's recent efforts, which demonstrate momentum for change. Specifically, the presidents of the collaborative's member foundations have announced that they will be experimenting with a set of best practices and policies to combat the "starvation cycle" that undercuts the effectiveness of their grantees. They have also reached out by letter to small group of peer philanthropists, inviting them to help advance the work toward solutions. We share their learnings and experience with hopes for continued cross-sector collaboration, which we believe can improve cost recovery and strengthen the nonprofit sector for years to come.

We are grateful to the nearly 80 grantees that have explored the cost recovery challenge with us, as well as the financial experts and nonprofit intermediaries who have contributed to this collaboration, including BDO, CostTree, FMA, GuideStar, Humentum, Independent Sector, KPMG, Nonprofit Finance Fund, and Northern California Grantmakers, and many others who have researched this issue over the years.

5 Interviews conducted by Bridgespan in 2017. European Commission, "Financial Guidelines for Applicants," February 2016, https://ec.europa.eu/social/BlobServlet?docId=15128&langId=en.

I. Funder practice and public attitudes shape nonprofit indirect-cost policy

Nonprofits exist in a complicated marketplace, in part because they seek capital from a broad range of funders. As in any marketplace, some influential market makers set the rules. This section of the report primarily focuses on describing the indirect-cost-related policies, practices, and preferences of different funders. Later sections will describe the systemic and individual effects of this market on nonprofits, and the role that intermediaries have played in research and advocacy.



Source: The Bridgespan Group

Indirect-cost policies are a historical outgrowth of postwar US government policy

The practice of regulating indirect costs in project grants to nonprofits originates in the US government's approach to funding research and development at universities after World War II. In "The Economics of University Indirect Cost Reimbursement in Federal Research Grants," authors Noll and Rogerson explain that "the inherent difficulties in writing performance contracts for R&D" led the federal government to use cost accounting reimbursement for research projects. In the 1940s, agencies funding research began to place caps on indirect costs to curb spending on other university expenses. Ultimately, Congress became "directly involved in setting indirect-cost rates in 1958 by passing legislation that capped the indirect-cost rate at 15 percent."[6]

6 Roger Noll and William Rogerson, "The economics of university indirect cost reimbursement in federal research grants," in *Challenges to Research Universities*, ed. Roger Noll (Washington, DC: Brookings Institution Press, 1998), 117, http://www-siepr.stanford.edu/workp/swp97039.pdf.

The federal government has changed practice dramatically since 1958, embracing the "fair share" approach—that federal agencies pay their fair share of costs, including indirect costs. In 2014, the Office of Management and Budget (OMB) extended its policy to include federal money being passed through to nonprofits by state and local governments. This OMB Uniform Guidance now requires state and local governments to honor existing Negotiated Indirect Cost Rate Agreements (NICRA) when granting federal money to nonprofits or to provide a *de minimis* indirect-cost rate of 10 percent for organizations without a NICRA. However, the implementation of this guidance has been inconsistent, resulting in continued under-reimbursement of indirect cost at the state and local level.

Establishing terms: Costs

- **Direct costs:** Expenses directly attributable to a specific project.
- **Indirect costs:** Expenses not directly tied to a specific project but shared across multiple projects. Indirect costs are essential and inextricably tied to a nonprofit's ability to accomplish its goals.
- **Overhead:** Generally understood as administrative costs. Not an adequate substitute for the term "indirect costs," which is more expansive.
- **Indirect-cost rate:** Indirect costs expressed as a percentage of total direct costs.

Among private foundations, indirect-cost rate policies have been common for decades. A RAND report from the 1980s captures the variance in policies at that time: "Many foundations customarily pay full indirect cost as budgeted in a proposal. Other foundations may pay only a portion of...or specif[y] a cap on the support of indirect costs."[7] We spoke to some private grantmakers who introduced more formalized policies capping indirect costs in the 2000s in response to challenges with universities and a need for rules to simplify grantmaking.

While policies and practices have evolved, the absence of high-quality outcome and performance data persists and continues to drive cost-reimbursement policy today.

Today, funding is predominantly restricted or "project-based"

The vast majority of institutional funding is issued as restricted grants and contracts tied to specific projects and programs. The US government[8] and many global funders (i.e., multilaterals, bilaterals)[9] are almost exclusively project funders. Among US foundations, between roughly 70 to 90 percent of grantmaking dollars have been restricted over the last two decades.[10] Experts like Paul Brest and Garry Jenkins[11] suggest that this pattern is connected to the rise of strategic philanthropy and the notion that "impact is best

7 Rick Eden et al., *Indirect Costs: A Guide for Foundations and Nonprofit Organizations* (Santa Monica, CA: RAND Corporation 1986), https://www.rand.org/pubs/reports/R3376.html.

8 "Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, Part III," 78 Federal Register 78589, December 26, 2013, https://www.federalregister.gov/articles/2013/12/26/2013-30465/uniform-administrative-requirements-cost-principles-and-audit-requirements-for-federal-awards#h-5.

9 Rose Longhurst and Tim Boyes-Watson, *Cost recovery: what it means for CSOs*, Bond and Mango, February 2016, https://www.bond.org.uk/sites/default/files/resource-documents/cost-recovery-0216.pdf.

10 Niki Jagpal and Kevin Laskowski, "The State of General Operating Support," National Committee on Responsive Philanthropy, May 2013, https://www.ncrp.org/files/publications/PhilanthropicLandscape-StateofGeneralOperatingSupport2011.pdf.

11 Garry Jenkins, "Who's Afraid of Philanthrocapitalism?" *Case Western Law Review* 61, no. 3 (August 2011), https://scholarlycommons.law.case.edu/caselrev/vol61/iss3/4/.

achieved and measured through grantor-initiated projects."[12]

Funders who give general operating support (see callout below) represent only a fraction of overall funding in the social sector. Understanding current indirect-cost policies and practices is critical to recognizing the realities that nonprofits face in raising and aggregating capital in this marketplace.

Establishing terms: Funding types

- **Cost-minus:** Expense reimbursement from a "buyer" that does not cover the minimum expenses associated with the project being funded and, therefore, produces a deficit.
- **Fair share:** Expense reimbursement from a "buyer" that covers actual direct costs and a "fair" (or proportional) share of actual indirect costs associated with the project.
- **Full cost:** Coined by the Nonprofit Finance Fund, full cost offers an enterprise-level orientation to evaluating the costs (both operating expenses and balance-sheet investments) that an organization needs to "build" a strong enterprise and achieve measurable outcomes.

General operating support

Some funders eschew the distinction in cost categories entirely, opting for unrestricted general operating support. Paul Brest asserts that "general operating support is an investment in the grantee's overall expertise, strategy, management, and judgment."[13]

Grantmakers for Effective Organizations (GEO) has long advocated for funders to allow nonprofits to use unrestricted funding "as they see fit to address urgent and emerging issues, boost salaries and benefits, invest in technology and other infrastructure, strengthen communications and fundraising efforts and meet other operational needs."[14]

12 Paul Brest, "Smart Money," *Stanford Social Innovation Review*, Winter 2003, https://ssir.org/articles/entry/smart_money.

13 *Ibid.*

14 "Support Nonprofit Resilience: Financial Sustainability," GEO, https://www.geofunders.org/what-we-offer/the-smarter-grantmaking-playbook/support-nonprofit-resilience.

Today's indirect-cost-reimbursement policies are very diverse

Approaches to reimbursing, defining, and calculating direct and indirect costs on project grants vary significantly across the public and private funders that support nonprofit work.

	Federal government	State/local government	Bilaterals and multilaterals	Private foundations
Type	**Fair-share funder**	**Flat-rate funders**	**Varies, predominantly fair-share funders**	**Varies, predominately flat-rate funders**
Approach to indirect cost for nonprofits[15]	Reimburse actual indirect costs. For economic and ethical reasons, agencies "bear their fair share of cost."[16]	Fund no indirect costs or low indirect costs at levels that vary by program (typically 0-10%).	Tend to fund indirect costs at very low rates (typically 5–8%). Multilaterals overall average 5.5% indirect-cost reimbursement.[17]	Dominant approach for written policies is a flat indirect-cost rate of 10-15%.[18] Other approaches include flexible guidelines, program officer discretion, and general operating support.
Policy examples	Negotiated Indirect Cost Rate Agreement (NICRA):[19] Indirect-cost rate individually negotiated with each nonprofit awardee by primary contracting agency based on audit of nonprofit's costs	New York examples (2013):[20] • NYC Dept. of Education: 0% on universal pre-K • NYC Dept. of Health & Mental Hygiene: 2.3% on adolescent employment/education program • NYC Dept. of Homeless Services: 8.5% on shelters • NYS Education Dept.: 2.6-2.7% on community school, extended day school, and GED program • NYS Office for People with Developmental Disabilities: 9% for family support	• DFID (UK): Up to 7% • European Commission: Up to 7% • Global Fund: 1–7% • United Nations: 5–12% • World Bank and regional development banks (e.g., AfDB, IDB, ADB): Each NGO calculates its contracting rate including indirect costs	Selected foundation policies (December 2018): • California Endowment: 15% • Carnegie 15% • Ford: Minimum 20% • Gates: 15% • Helmsley: 10-20% • Hewlett: PO discretion • Kellogg: 15% • Lilly: 10% • MacArthur: 15% • Mellon: 0% • Moore: 12.5% • Packard: PO discretion • Templeton: 15%

15 Universities are often subject to separate policies.
16 "Uniform Administrative Requirements."
17 Longhurst and Boyes-Watson, *Cost Recovery*.
18 Jeri Eckhart-Queenan, Michael Etzel, and Sridhar Prasad, "Pay-What-It-Takes Philanthropy," *Stanford Social Innovation Review*, Summer 2016, https://ssir.org/articles/entry/pay_what_it_takes_philanthropy.
19 The organizations that receive large enough federal funds to warrant a NICRA tend to be larger organizations (including international NGOs, research institutions and universities). An organization and its primary granting or "cognizant agency" periodically renegotiate the NICRA based on a rigorous audit and allocation process. Each federal government agency uses their own procedure when determining NICRAs. Primary government agencies awarding NICRAs: DOD, ONR, OCA, USAID, HHS & NSF.
20 Human Services Council, *New York Nonprofits in the Aftermath of FEGS: A Call to Action*, March 2016, http://www.nysba.org/LessonsFromtheFEGSCollapse/.

The large number of low, flat-rate funders includes some of the most influential institutions in the global funding landscape (see table above). The European Commission (EC) is a prime example of a funder with a low indirect-cost rate that can inadvertently harm grantees. The EC is the primary funder for many NGOs in Europe; it has a 7 percent indirect-cost rate policy, provides short-term project grants, and offers no flexible or general support.[21] As one program officer noted, "one thing that is common among organizations receiving European Commission funding is that they can't survive without the funding, but they have many complaints."

Practices are also inconsistent and may vary from policy

While policy provides the framework for reimbursing indirect costs, day-to-day practices are what translate policy into action. Across funders and the social sector writ large, there is significant inconsistency in key language, term definitions, and methodological approaches. The Full Cost Project has documented these challenges in their work in California.[22] Regarding language and definitions, the most common terms include indirect costs, overhead, shared costs, administrative costs, core costs, full costs, true costs, and real costs. Each of these is defined differently by different funders (see Appendix A). In the social sector more broadly, even accounting-standards organizations do not have uniform definitions of these terms.

Moreover, there is evidence of a gap between how funders' indirect-cost policies are written and how they are implemented. In interviews with 10 well-known US foundations in 2016, leaders identified a range of approaches to working within their indirect-cost policies. Some expressed a preference for line-item budgeting of all costs, particularly when working on new or high-risk projects. Others engaged explicitly with a system of cross-subsidization: leaders acknowledged that their own restricted funding often does not fully cover costs and sought unrestricted funding from others to close the gap. Among their own key grantees, those same leaders acknowledged that their general operating support often plays the same role—closing the gap left by restricted funding from other donors.[23]

Individual program officers also take different approaches, as reflected in our interviews with program officers at several large global foundations. Some program officers were more stringent ("My experience with grantees is that they treat indirect cost like bonus money...Generally, I prefer a model in which I reimburse as much direct as possible with minimal indirect-cost reimbursement.") while others interpreted policy creatively to help reimburse grantees' costs. Those in the latter category often encourage grantees to "direct charge" and put as many of their indirect costs into direct as possible to maximize recovery. However, this strategy often runs up against the limitation of grant

21 Interviews conducted by Bridgespan in 2017.

22 Real Cost Project, *Barriers to Change: Phase One Report*, 2015, http://calnonprofits.org/images/Overcoming_Barriers_Phase_1_Report.pdf; Real Cost Project, *Overhead Madness: Research Summary*, 2015, https://www.weingartfnd.org/files/OVERHEAD-MADNESS.pdf.

23 Interviews conducted by Bridgespan in 2016.

budgets.[24] As one program officer based in Mexico put it, "It's one thing for me to tell a grantee to include time for the executive director in a grant, but at the end of the day they will receive the same amount of money. It's going to have to get deducted from somewhere else."[25]

Furthermore, many foundations do not have a written policy, which can contribute to greater uncertainty and variation in practice. A survey by Grantmakers for Effective Organizations (GEO) in 2014 found that three-quarters of the staffed grantmaking foundations that responded did not have a written indirect-cost policy. GEO's former vice president of member and partner engagement, Heather Peeler, explains that many program officers avoid taking advantage of that flexibility: "In the absence of clear policy, implicit guidelines and organizational tradition may take root…'We've always done it this way' becomes the standard response…and everyone misses out on the opportunity for a meaningful conversation about what it costs to achieve results."[26]

Institutional philosophies and pragmatic constraints shape indirect-cost policies and practices

A range of philosophical preferences and pragmatic constraints inform the policies and practices of any individual funder. In principle, endowed private funders have stewardship responsibilities to allocate scarce grantmaking capital to its highest and best use. Similarly, funders with accountability to the public are under pressure to demonstrate value for money in their budgeting. Both face the reality of scarcity, being asked to do more with less. Economic theory argues that funders should pay their proportional share of indirect costs in order to understand and manage costs, and make price and quality trade-offs as needed. But pragmatically, simplicity and fairness shape which policies an individual funder is actually able to implement.

Individual funders choose to optimize against these constraints in a variety of ways. For example, the United Kingdom's foreign aid agency, the Department for International Development (DFID), rationalized and reduced its own management structure and costs, offering themselves as a model for their grantees, reflecting the belief that nonprofits should have low overhead costs as a matter of good management.

24 We heard reports of similar behavior by European Commission program officers as well.

25 Quotes are drawn from conversations with program officers at three different foundations.

26 Heather Peeler, "The Truthiness About Overhead," GMNsight blog, December 27, 2014, http://www.gmnsight.org/the-truthiness-about-overhead/.

Public attitudes also shape the perception of "overhead"

In the social sector, "overhead" costs have often been characterized as markers of inefficiency. Organizations that rate nonprofits continue to rely on overhead-cost ratios from Form 990 data as part of their nonprofit performance-rating scales (e.g., Charity Navigator). And periodic scandals—in which high-profile organizations are accused of spending too much on executive salaries, fundraising, administration, or even engaging in outright fraud—have reinforced negative attitudes toward "overhead" (e.g., the James Irvine Foundation in 2003, Boys and Girls Clubs of America in 2010, Wounded Warrior Project in 2016).

Individual donors

Donations from individuals also constitute a significant source of revenue for nonprofits. While individuals primarily give unrestricted cash, there is evidence of "overhead aversion."

A 2014 study by UC Davis researchers reported that when donors were told that all their money would go directly to the cause (with overhead covered by another funder) they were 80 percent more likely to give.[27]

As a result, there is a widespread belief that indirect costs should typically remain below 10 to 15 percent of direct costs for nonprofits.

27 Uri Gneezy, Elizabeth A. Keenan, and Ayelet Gneezy, "Avoiding Overhead Aversion in Charity," *Science* 346, no. 6209 (October 2014), https://science.sciencemag.org/content/346/6209/632.abstract.

II. Prevailing indirect-cost policies and practices weaken nonprofits

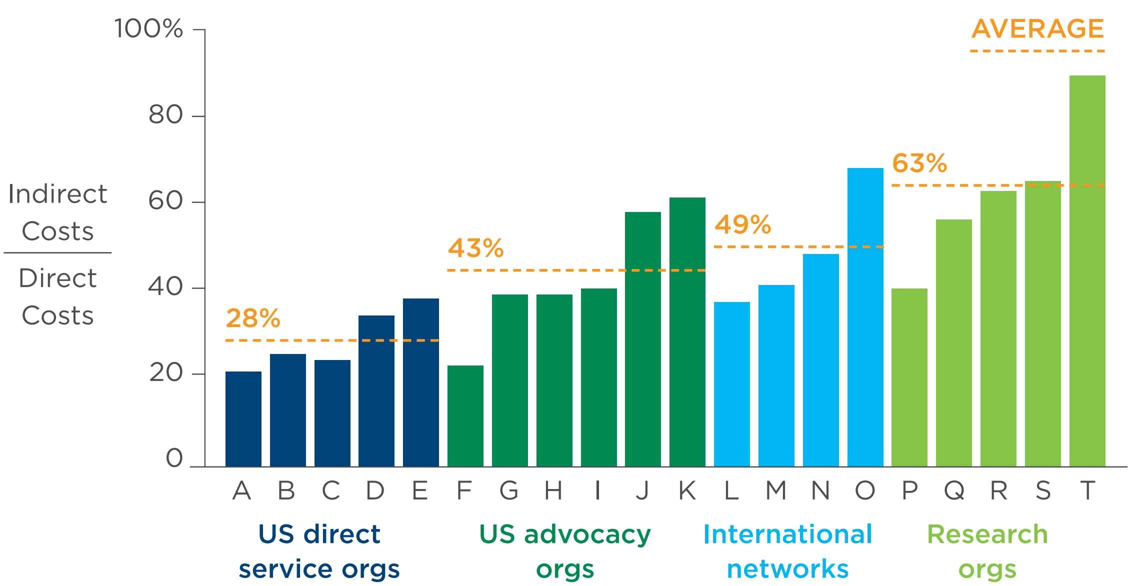
Nonprofits that rely on foundation, government, or global institutional funding face challenges to recovering and managing indirect costs within a complex marketplace. The result is that grantees strive to deliver strong results, but often at great institutional and personal cost. Put simply, today's system is not consistently creating strong grantee organizations. This section explores the effects of this system on nonprofits.

Project-based grants are usually "priced" at a loss, resulting in insufficient cost recovery

As discussed in the previous section, project-restricted grants are the norm in the social sector. These grants are typically "priced" by budgeting for the direct costs of the work plus a modest allocation for indirect costs. The most common indirect-cost-reimbursement policies are "flat rate" policies with indirect-cost rates of 15 percent or less on project grants (aligned with prevailing attitudes and beliefs). As of December 2018, more than half of the 15 largest US funders by endowment had policies of this type.

However, these common flat rate policies are too low to cover the actual indirect costs of most organizations. In 2015 Bridgespan conducted empirical analysis of the financials of a group of trusted nonprofit partners of a large foundation, finding that their indirect-cost rates varied significantly, and almost always exceeded 20 percent—often by a sizable margin (see chart).[28]

Indirect-cost rates vary significantly, and almost always exceed 20 percent



Note: Based on 2015 analysis of selected grantees of a large foundation.
Source: Bridgespan analysis

28 Eckhart-Queenan, Etzel, and Prasad, "Pay-What-It-Takes Philanthropy."

Therefore, the prevailing flat rate polices of 15 percent or less only cover a portion of most grantees' actual indirect costs. As a result, many of these project grants are priced at a loss with organizations losing money to execute the work.

Seventy percent of the CEOs of international NGOs—including the largest in the world—identify insufficient cost recovery as one of their most pressing problems.[29] In the Nonprofit Finance Fund (NFF) 2018 *State of the Sector Survey*, the top two most frequently cited organizational challenges among responding nonprofits were financial sustainability (62 percent) and funding full costs (57 percent). Additionally, over 90 percent of respondents report feeling underfunded by government funders as well as foundations.[30]

Certain solutions can lead a nonprofit to lose money in executing a project. For example, an organization may decide to "co-fund" an initiative, adding its own, usually unrestricted, capital to a funder's restricted project support. However, sector surveys suggest the decision to "co-fund" is less a choice than a pernicious pattern that reflects the bargaining power of funders. The Urban Institute found that government payments did not cover the full costs of providing agreed-upon services for 59 percent of nonprofits with budgets over $1 million.[31]

Insufficient cost recovery leads to financial weakness, distress, and risk of failure

Recovering costs is an important component of basic financial health for organizations. Hilda Polanco, founder and CEO of the nonprofit financial intermediary FMA, explains: "When there is a gap between what [an organization] raise[s] and what it costs to perform the work, a 'structural deficit' takes hold… that persistently drains resources from the organization… It's a roof that, by design, will collapse every single year."[32] Chronic underfunding of indirect costs therefore contributes to financial weakness in the social sector.

More starkly, a 2016 report by SeaChange and Oliver Wyman found that 10 percent of New York City nonprofits are technically insolvent, with 40 percent at financial risk with less than two months of operating costs in the bank. The authors concluded that "cost-minus" funding was at cause: "Most nonprofit funding…comes in the form of [state or local] government contracts or restricted grants that virtually guarantee a deficit."[33] Similarly, NFF's 2018 annual sector survey found that 24 percent of nonprofits ended 2017 in the red, and that this shortfall was usually unplanned.[34]

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29 Jeri Eckhart-Queenan, Jacob Allen, and Jari Tuomala, "Stop Starving Scale: Unlocking the Potential of Global NGOs," The Bridgespan Group, April 2013, https://www.bridgespan.org/insights/library/pay-what-it-takes/unlocking-the-potential-of-global-ngos.

30 Nonprofit Finance Fund, *State of the Nonprofit Sector: 2018 Survey*, https://nff.org/learn/survey.

31 Sarah Pettijohn et al., *Nonprofit-Government Contracts and Grants: Findings from the 2013 National Survey*, Urban Institute, December 2013, http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412962-Nonprofit-Government-Contracts-and-Grants-Findings-from-the-National-Survey.PDF.

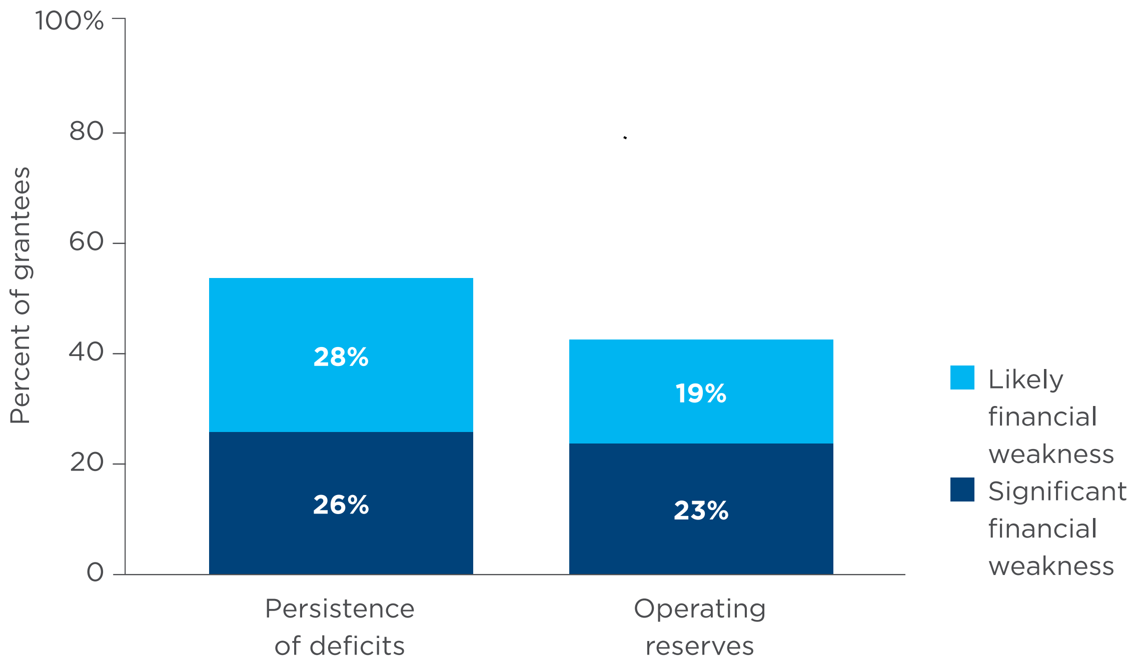
32 Nell Edgington, "What Nonprofit Sustainability Looks Like: An interview with Hilda Polanco," Social Velocity, February 21, 2017, https://www.socialvelocity.net/2017/02/21/what-nonprofit-sustainability-looks-like-an-interview-with-hilda-polanco/.

33 SeaChange Capital Partners and Oliver Wyman, *Risk Management for Nonprofits*, March 2016, http://seachangecap.org/wp-content/uploads/2016/03/SeaChange-Oliver-Wyman-Risk-Report.pdf.

34 Nonprofit Finance Fund, *State of the Nonprofit Sector*.

Empirical analysis by Bridgespan suggests that financial weakness extends to an even broader set of nonprofits. In 2017, Bridgespan analyzed key financial health indicators for 274 nonprofits that were among the top grantees (by total grant dollars) receiving funds from two or more of the top 15 US foundations (by endowment). Between 40 and 50 percent of these grantees showed signs of financial stress, with scarce operating reserves and/or persistent budget deficits. Twenty-six percent of grantees were close to insolvency (having run budget deficits in three of the last five years) and 23 percent had less than one month of operating reserves (see chart). In fact, 30 grantees were technically insolvent and had borrowed against restricted grants to fund critical expenses (see Appendix B).

Financial health analysis of top 274 co-funded grantees



Note: Based on 2017 analysis of the 274 nonprofits that were among the top grantees (by total grant dollars) receiving funds from two or more of the top 15 US foundations (by endowment). "Likely financial weakness" defined as two years of deficits over a five-year period and reserves between one and three months; "significant financial weakness" defined as three or more years of deficits over a five-year period and less than a month of reserves.
Source: Guidestar.org; NFF Financial SCAN; audited financial statements; Bridgespan analysis

Insolvency can lead to organizational failure. In 2015, Federation Employment & Guidance Service (FEGS)—one of New York's largest human services providers with an annual budget of $250 million—filed for bankruptcy, pointing to shortfalls in government contracts.[35] A number of high-profile distress mergers have also occurred in recent years, including the acquisition of AED by what is now FHI 360, and Save the Children's merger with Merlin. As one global program officer explained, limited cost recovery "has led to a hollowing out of civil society institutions...at a time when they are critically important."

35 Human Services Council, *New York Nonprofits*.

Organizations are unable to invest adequately in their own capacity

As a result of these dynamics, nonprofits are too often unable to invest enough in their own capacity. The Urban Institute found that among US nonprofits reporting insufficient government payments, 47 percent drew on their reserves and 28 percent reduced their number of employees to cover the gap.[36] Similarly, 34 percent of NGOs surveyed by InsideNGO reported diverting resources away from program improvements and expansion in order to cover gaps caused by insufficient indirect cost recovery.[37]

The Government Accountability Office (GAO) reported in 2010 that US nonprofits may "reduce the population served or the scope of services offered, and may forgo or delay physical infrastructure and technology improvements and staffing needs" in response to cost-minus funding. The GAO reinforced what many in the social sector have noted: due to their inability to recover costs from funders, nonprofits "often compromise vital 'back-office' functions, which over time can affect their ability to meet their missions."[38] One global program officer put it more viscerally: "Our human rights grantees [outside of the United States] face the question of which finger to chew off to make ends meet."

Wing et al. find that lack of reimbursement for overhead led to reduced investments in technology among large international NGOs, reducing productivity and effectiveness.[39] NGOs invested only half as much in technology as for-profit peers. One reason for this is that the same NGOs spent nearly 80 percent more on financial management and employed nearly twice as many staff as for-profit counterparts.[40]

Unintended consequences result as nonprofits adapt to recover costs

Grantees have developed a range of adaptive behaviors to recover costs. Individually, these adaptations are rational responses to a complex funding marketplace. Collectively, they create three challenges:

Underreporting and limited knowledge of costs: As Bridgespan's 2009 "Nonprofit Starvation Cycle" research details, unrealistic expectations around indirect costs create pressure on nonprofits to conform to low overhead rates: "In this context, nonprofits are reluctant to break ranks and be honest in their fundraising literature."[41] Urban Institute's review of IRS Form 990 data from more than 160,000 nonprofits found "substantial

36 Pettijohn et al., *Nonprofit-Government Contracts and Grants*.

37 InsideNGO, *Full Cost Recovery Project: Final Research Summary*, 2010. InsideNGO merged with Mango and LINGOs in 2017 to form Humentum.

38 United States Government Accountability Office, *Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices* GAO-10-477, May 2010, https://www.gao.gov/products/GAO-10-477.

39 Kennard Wing et al., "Paying for Not Paying for Overhead," *Foundation News and Commentary* 46, no. 3 (2005).

40 Eckhart-Queenan et al., "Stop Starving Scale."

41 Ann Goggins Gregory and Don Howard, "The Nonprofit Starvation Cycle," *Stanford Social Innovation Review*, Fall 2009, https://ssir.org/articles/entry/the_nonprofit_starvation_cycle.

inconsistency in the reporting of functional expenses,"[42] with the usual result of understating the organizations' administrative and fundraising cost. "Nonprofits are clearly responding to pressure from public and private sector funders to keep real and reported overhead costs low. In addition, nonprofits may be adapting to funder policies against funding adequate levels of overhead costs by classifying some such costs as program costs."[43]

In practice, underreporting can result in lack of knowledge of the costs of conducting business, impeding clear strategic decision making for nonprofits and funders alike. Weak financial management capabilities and unclear vision of cost structure and drivers at many organizations also contribute to this dynamic.[44] As Independent Sector CEO Dan Cardinali put it, "there is a deep responsibility to those in nonprofits to be bold and honest about 'what does it really take.' Nonprofits must get clarity about what we can accomplish and the resources required."[45]

High transaction costs: InsideNGO's Full Cost Recovery Project found that international NGOs actually experience "an increase in indirect costs as they work to accommodate indirect-cost restrictions." To comply with funder restrictions, they must often spend more on accounting and reporting systems, or spend more to raise additional unrestricted funds. Though harder to quantify, management time and attention required to negotiate and manage disparate terms and policies across a patchwork of individual grants also contributes to increased transaction costs.

Perverse incentives: Anecdotally, nonprofit CEOs have identified a range of incentives at odds with good decision making. Specific indirect-cost policies can encourage building new facilities, shifting the location of staff, or increasing reliance on sub-contracts regardless of their strategic value. For example, the use of sub-grants—paying other organizations to execute the work—is a common cost recovery tactic, but one that exposes organizations to substantial implementation risk and can "distort design simply to recoup costs," as one NGO leader explained.

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42 Thomas Pollak, Patrick Rooney, and Mark Hager, *Understanding Management and General Expenses in Nonprofits*, Overhead Cost Study Working Paper, 2001, https://www.semanticscholar.org/paper/Understanding-Management-and-General-Expenses-in-Pollak-Rooney/98ad6564313ff82ac6ad44817fef24ebe31fd999.

43 Center on Nonprofits and Philanthropy at Urban Institute and Center on Philanthropy at Indiana University, *The Quality of Financial Reporting by Nonprofits: Findings and Implications*, Nonprofit Overhead Cost Project Brief No 4, August 2004, https://www.urban.org/sites/default/files/publication/57736/311045-The-Quality-of-Financial-Reporting-by-Nonprofits.PDF.

44 Hilda Polanco of FMA points to several common challenges among leaders that make it harder for them to accurately price and fund their work, including unclear vision of costs to deliver services and associated revenue/cost drivers, a lack of focus on balance sheet health, and insufficient long-term financial planning (Edgington, "What Nonprofit Sustainability Looks Like.").

45 GuideStar Webinar, "How Much Does It Cost to Do Good: Conversations on Nonprofit Overhead, Part 2," December 19, 2016.

III. Several factors affect cost recovery for individual organizations

The systemic effects of today's indirect-cost-policy environment are outlined above. However, these dynamics affect individual organizations differently, and as a result, the adverse effects of insufficient cost recovery are not distributed equally across the sector. In 2016, through 60 nonprofit indirect-cost diagnostics and over 320 interviews across a variety of grantees and funders, Bridgespan identified four key factors that influence cost recovery (see Appendix C).[46] The first two—type of organization and funding model—are intrinsic. The latter two are more dynamic: financial acumen and social capital.

Success in recovering costs is linked more closely to factors unrelated to impact than to the work of the organization. We have observed an inequity among grantees that are able to capitalize on these factors. While some organizations are able to deploy adaptive techniques to survive in the current funding environment, others cannot—and struggle with cost recovery and poor financial health as a result.

Type of organization sets the "starting size" of the indirect cost gap

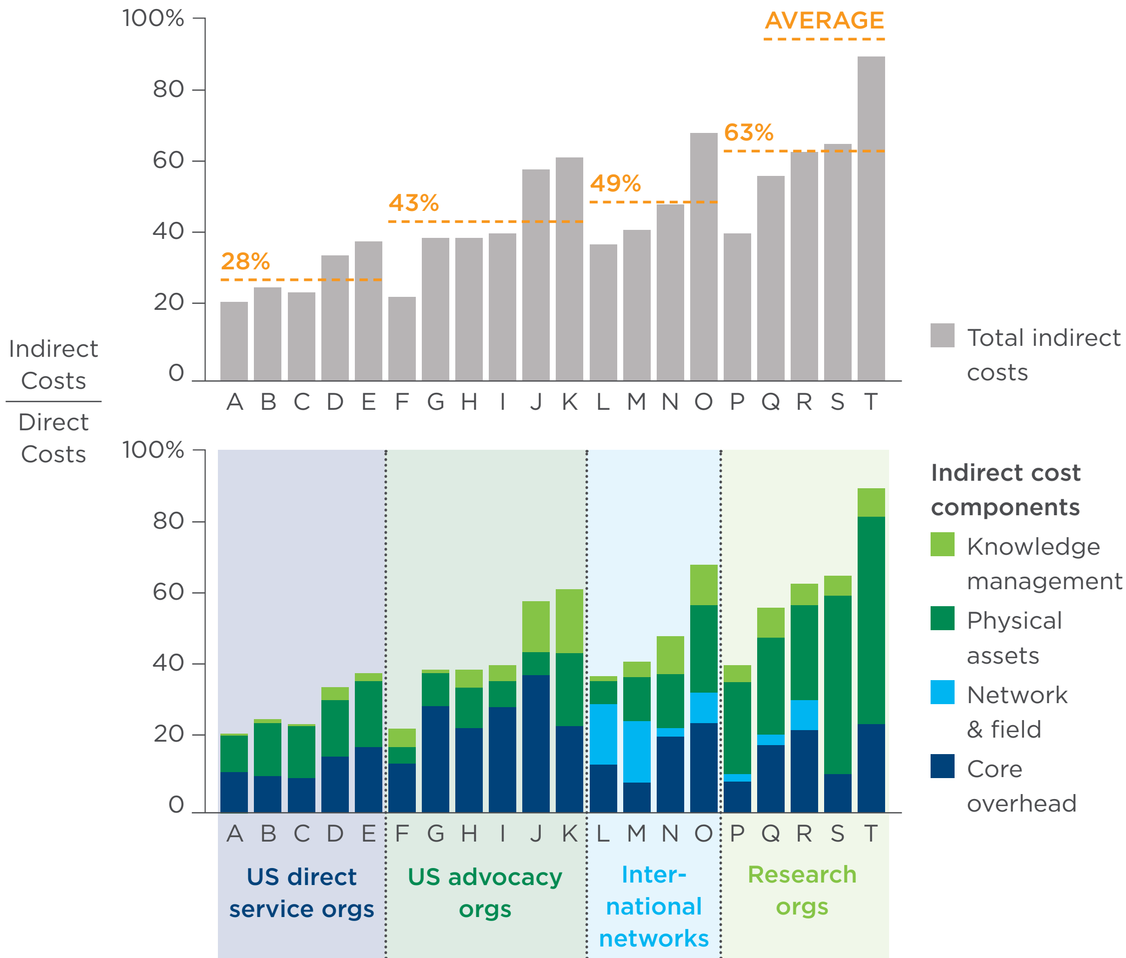
As discussed earlier, Bridgespan's research on cost structures of organizations reveals significant variation in indirect-cost rates across different types of nonprofits. The mix of direct and indirect costs required to deliver impact varies, as does the composition of indirect costs (see chart next page).

Some nonprofits, such as research organizations, require asset-intensive, shared capital investments (e.g., laboratory equipment). Others, like advocacy organizations, do not operate on a project basis, and therefore need robust centralized resources in order to remain responsive and accommodate the fluid, unpredictable nature of their work.

All else being equal, types of organizations characterized by higher indirect-cost rates face comparatively steeper cost-recovery challenges than those with lower rates. The "flat rate" indirect-cost-reimbursement policies used widely by foundations—typically 20 percent or less—already fall well below the actual indirect costs of most grantees; for organizations with a higher share of indirect costs, the funding gap created by cost-minus grantmaking is that much greater. In order to address shortfalls, these grantees need to raise or allocate more unrestricted resources.

46 Factors affecting cost recovery for individual organizations were surfaced through the 60 indirect cost diagnostics that Bridgespan conducted in 2016 (i.e., it does not include the 26 indirect cost verifications executed for the funder collaborative pilot in 2018). See Appendix C for further detail.

The composition of indirect costs varies across types of nonprofits



Note: Based on 2015 analysis of selected grantees of a large foundation.
Source: Bridgespan analysis

Funding model informs the nature of cost recovery challenges

How an organization raises its revenue—its "funding model"—significantly affects its ability to recover costs. Two factors are key: extent of cost-minus funding (i.e., grants that do not reimburse actual direct and indirect costs) and access to unrestricted capital.

For one global government-transparency organization, half of its funding is cost-minus, coming from multilaterals and sovereign funders like the European Commission, which provides roughly 7 percent reimbursement for indirect costs. "Despite the low indirect-cost rates, we know that taking UK and European government funding is also a means of gaining leverage to shape their broader development agenda in pursuit of our mission," said a leader of that government-transparency organization. "As a result, we try to get unrestricted funding from [named private foundations] to not hobble ourselves with restrictions."

Conversely, a prominent science-research organization struggles to cover its costs when receiving cost-minus project grants from foundations because it has almost no unrestricted capital. This grantee gets three-quarters of its funding from the federal government, receiving its "fair share" of indirect costs through a NICRA. As the CFO explained, "we don't have buckets of unrestricted money, and so we can't subsidize the work of foundations by chipping in to cover the additional cost of the work that they don't reimburse us for."

In short, cost recovery is more challenging for grantees whose primary revenue sources provide predominantly cost-minus and/or restricted project funding.

Financial acumen enables technical cost recovery strategies

The ways in which organizations allocate, account for, and present their finances enable different approaches to cost recovery. Two examples illustrate this range:

- One US think tank has invested in a highly detailed cost allocation system to attribute and directly charge as many expenses as possible to projects (including expense codes to track copier, printer, supplies, and timesheets for all administrative staff across 100 projects). According to the leadership of this organization, "we rethought how to allocate expenses—particularly within IT and front-end operations—because we were not covering very real expenses critical to our ability to accomplish the work." This approach has helped the organization build and sustain its capacity.
- Conversely, a grassroots workers'-rights organization receives primarily project-based funds but has limited knowledge of its costs and a CFO from the for-profit sector who is not familiar with the idiosyncrasies of accounting for multiple programs, grants, and locations. "We're really struggling with this and although we don't know how much, we know there is a gap between what we get and what it costs to execute," said a leader of this organization. The consequence has been underinvestment in critical capabilities: "The work gets done, but people burn out, and we have to make tradeoffs. For example, we don't have computers that are less than 12 years old. Everyone has to bring their personal laptop because we can't spend money on that. We're out there to help beneficiaries, but it prevents our staff from working efficiently and expanding our reach."

As these examples illustrate, grantees' understanding of their own cost structure varies. Organizations that are more financially sophisticated are better able to adopt systems and processes that enable the attribution of shared expenses to specific programs.

Social capital empowers some organizations to overcome cost recovery challenges

Finally, social capital can play an important role in an organization's ability to advocate for favorable funding terms. "Social capital" refers to the deployment of social, cultural, and/or economic power by the staff of an organization—including their social networks, personal information, and skillsets—to productive ends.

For example, a community-development nonprofit led by a former foundation program officer has been able to secure primarily unrestricted funding for operations. As the CEO explains: “I bring a lot of knowledge, relationships, experience, and expertise to bear and know how to navigate the system. We don’t suffer with this indirect cost issue.”

The CEO of a cultural organization serving an at-risk community of color painted a very different picture: “Organizations like ours, rooted in and predominantly serving communities of color, have been historically under-capitalized. Foundation program officers have asked us if our board members have connections to someone on their board or if we could get another foundation president to call theirs and encourage an investment. We don’t have those connections or networks, and so we can’t easily secure that kind of funding.”

Social capital can also affect a grantee’s willingness to be candid with funders about indirect-cost challenges for fear of jeopardizing their funding. NFF’s 2014 State of the Sector Report found that three-quarters of nonprofits surveyed did not feel they could have an open dialogue with their funders about their need for general operating support.[47] The Full Cost Project concluded that the “uneven power dynamic between grantmaker and grantee creates a culture where nonprofits feel they cannot be transparent on issues around financial challenges and the true cost of delivering services.”[48] These are likely to be magnified for less powerful organizations that already start from weaker bargaining positions in the grantmaking process.

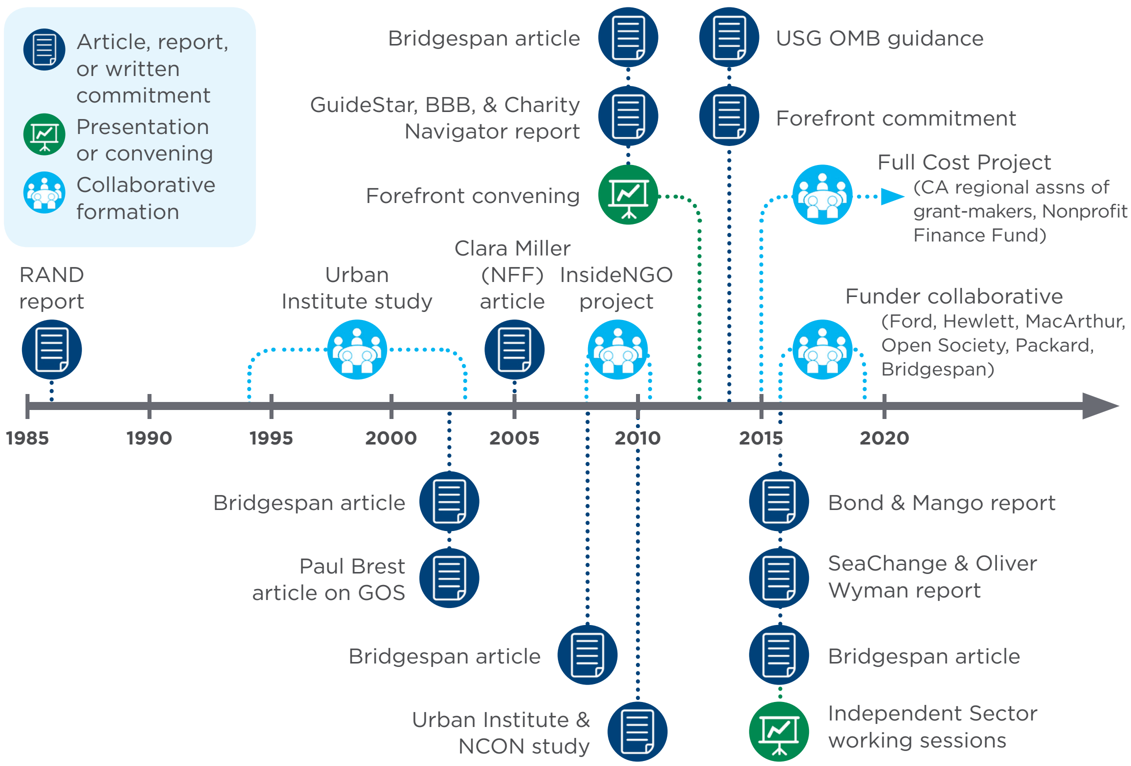
Improving understanding of cost recovery, among both funders and nonprofits, is critical to enabling more constructive communication and partnerships between grantors and grantees.

47 Nonprofit Finance Fund, *State of the Nonprofit Sector*.
48 Real Cost Project, *Barriers to Change*.

IV. A wide range of efforts have sought to understand and address insufficient cost recovery

Over the past few decades, a number of scholars and advocates have shed light on issues related to indirect cost recovery; their findings and efforts to change practice have informed the content in this report. The following offers a brief overview of that history.

Three decades of work on cost recovery



Note: Many others have contributed toward learning on this issue. The above represents a small, non-exhaustive selection of activities to help orient those less familiar with the landscape and chronology.
Source: The Bridgespan Group

Many have worked to establish a data-driven foundation for understanding the issue

As early as 1986, a RAND report highlighted the lack of shared language, definitions, and common policies on indirect costs. "A nonprofit that fails to identify and fully recover its indirect costs," noted the report, "may encounter financial difficulties that hamper its effectiveness and may threaten its existence." In addition, the "unpredictable support of indirect costs [by foundations] may limit an organization to a short-term, project-to-project planning strategy."[49]

49 Eden et al., *Indirect Costs*.

From 1994 to 2004, the Urban Institute Nonprofit Overhead Cost Study analyzed how nonprofits allocate and report costs.[50] It found that nonprofits struggle to accurately report their costs and, "to deal with the inadequate funding for administration, organizations resort to the strategies of *low pay, make do, and do without* that diminish organizational effectiveness."[51]

In 2009, Bridgespan's "Nonprofit Starvation Cycle" research pointed to unrealistic expectations about the costs of running a nonprofit. To align with funders' misconceptions, nonprofits sometimes misrepresent their costs. This, in turn, leads to funders having unrealistic expectations. Conforming to those expectations, nonprofits underinvest in basic capacities "leaving [them] so hungry for decent infrastructure that they can barely function as organizations—let alone serve their beneficiaries."[52]

This research was followed by a closer look at the effect on global NGOs in Bridgespan's 2013 article "Stop Starving Scale,"[53] which found that many large, international NGOs experience "fragmented growth that feeds the programmatic branches and starves the operational core." Since 2003's "Costs Are Cool,"[54] Bridgespan has stressed that organizations need to "fully understand their programmatic costs to make strategic decisions about the allocation of their resources."

Similar dynamics are playing out in Europe. In 2016, Mango published a cost-benchmarking study exploring the barriers to cost recovery among UK and internationally based NGOs. In addition to documenting the patterns of underfunding, Mango pointed to "an inadequate understanding of value for money for all stakeholders [and] a distortion of the market, where CSOs [Civil Society Organizations]

Recognizing the importance of government

Throughout the 2000s, much of the work on this issue focused on the relationship between foundations and grantees. But in 2010, the Urban Institute and the National Council of Nonprofits undertook the first comprehensive national study of the effect of government contracting policies and procedures on nonprofit human service providers. The report found that "insufficient government payments" of indirect costs frequently prevented nonprofits from covering their full program costs.[55] In 2013, a follow-up survey touched on a broader range of sectors (most except hospitals and higher education), finding that insufficient cost recovery was most problematic among human-services providers.

After the 2014 Office of Management and Budget (OMB) guidance, federal pass-through funds to state and local governments needed to cover at least some indirect costs. The National Council of Nonprofits (NCON) has focused on influencing state and local governments toward full implementation of that guidance. NCON calls on nonprofits to "own their costs," be transparent about their costs and finances, and advocate for their rights.

Focused on California, the Nonprofit Overhead Project (coordinated by CalNonprofits) also seeks adoption of the OMB Guidance while aiming to equip nonprofits with the training they need to engage in discussion about the costs of their outcomes.

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50 The project was a collaboration between the Center on Nonprofits and Philanthropy at Urban Institute and the Center on Philanthropy at Indiana University. They analyzed surveys, case studies, and Form 990 data to better understand how nonprofits report costs.

51 Center on Nonprofits and Philanthropy et al., *Getting What We Pay For*, https://www.urban.org/sites/default/files/publication/57731/311044-Getting-What-We-Pay-For.PDF.

52 Goggins Gregory and Howard, "The Nonprofit Starvation Cycle."

53 Eckhart-Queenan et al., "Stop Starving Scale."

54 Susan Colby and Abigail Rubin, "Costs Are Cool: The Strategic Value of Economic Clarity," The Bridgespan Group, December 2003, https://www.bridgespan.org/insights/library/funding-strategy/costs-are-cool-the-strategic-value-of-economic-cla.

55 Elizabeth T. Boris, Erwin de Leon, Katie Roeger, and Milena Nikolova, *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants*, Urban Institute, October 2010, http://webarchive.urban.org/publications/412227.html.

without large levels of unrestricted funding appear unduly uncompetitive."[56] Mango (now part of Humentum) continues to work with NGOs to understand and articulate their costs more clearly to inform budgeting and cost recovery.

Campaigns have spread the message that overhead is not a good measure of performance

In 2013, GuideStar, BBB Wise Giving Alliance, and Charity Navigator came together to launch the Overhead Myth campaign, advocating that "the percent of charity expenses that go to administrative and fundraising costs…is a poor measure of a charity's performance." They urged donors to "pay attention to other factors of nonprofit performance: transparency, governance, leadership, and results." In 2014, they published a "Letter to the Donors of America," calling for sharing data on performance and costs.

The Charity Defense Council has also launched public ad campaigns (including "I'm Overhead"), advocating for donors to evaluate nonprofits based on their impact and defending individual organizations in the media. Founder and President Dan Pallotta argues that adequate executive compensation and investments in fundraising are essential for achieving impact, especially since fundraising is the only form of capacity building that "multiplies itself."[57]

In 2016 and 2017, Independent Sector hosted a series of working sessions with a group of intermediaries and funders aimed at improving understanding of this issue, identifying opportunities for closer coordination, and developing a shared narrative that links cost recovery to organizational resilience and the effectiveness of the social sector as a whole.

Multiple efforts have engaged foundations and nonprofits

In 2013, Forefront (formerly Donors Forum) convened a cross-section of staff from smaller Midwest foundations to discuss barriers and potential solutions to funding indirect costs. Building upon these conversations, in 2014 Forefront began publicly advocating that "supporting the full costs of program outcomes requires support of all aspects of the organization."[58]

In the past several years, InsideNGO (now part of Humentum) has convened thought leaders, NGOs, and foundations to move the conversation beyond using NGOs' overhead ratio as the sole measure of mission success.

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56 Longhurst and Boyes-Watson, *Cost Recovery*.

57 Kate Torgovnick May, "A new way to judge nonprofits: Dan Pallotta at TED2013," TEDBlog, March 1, 2013, https://blog.ted.com/a-new-way-to-judge-nonprofits-dan-pallotta-at-ted2013/.

58 Valerie S. Lies, "Forefront's Commitment to Full-Cost Funding," June 10, 2014, https://myforefront.org/articles/forefronts-commitment-to-full-cost-funding/.

From 2015 to 2016, the three California Regional Associations of Grantmakers launched the Real Cost Project (now the Full Cost Project) with the dual goals of increasing the number of funders providing real-cost funding and building the skills and capacity of grantmakers.[59] Early convenings identified barriers to changing funding practices, including "a lack of well-defined policies to guide real cost evaluation and reimbursements, a reliance on individual staff members to make decisions around real cost funding, and funder practices driven and reinforced by cultural norms in the field."[60] The research concluded that changing cultural norms and practices will require both buy-in from foundation CEOs and engagement with grantees about the costs of achieving their outcomes.

In shifting from research to action, the Full Cost Project recognizes the limitations of debating overhead spending and focuses instead on the costs of achieving outcomes. The group seeks to change grantmaker culture by engaging senior leadership on this issue and addressing a "clear need for training" among foundation staff and nonprofit leaders.[61] To support this goal, NFF, the California Community Foundation, and the Weingart Foundation launched a related pilot project early in 2016 to explore how foundation staff and nonprofits can work together to better fund full costs. The pilot included financial training workshops, individual technical assistance and coaching, and convenings for 12 nonprofit grantees and foundation staff to help them understand and implement full cost concepts and methods.

Other foundations and intermediaries—like the Wallace Foundation, FMA, and InsideNGO (now part of Humentum)—have also focused on closing the financial skills gap through training. This work continues as studies suggest that extensive investments are required to achieve long-lasting changes in financial practices (see sidebar).[62]

Building financial management skills to understand and manage costs

Efforts to address cost-recovery issues are likely to require strengthening financial skills of both grantees and program officers. Evidence suggests that effective financial skill building is a long-term, team-based endeavor for both nonprofit leaders and grantmakers. An MDRC evaluation of the Wallace Foundation's Strengthening Financial Management in Out-Of-School Time initiative—in which financial management training was provided to a cohort of 25 youth-serving nonprofits in Chicago—found it required between 800 and 1,000 hours of executive, financial, and program staff time over two to three years to achieve long-lasting changes to financial practices.

Looking at the broad range of financial management resources available for nonprofits and foundations reveals wide variation in topic focus, delivery mechanism, and quality. Grantees are the main audience for these resources, with fewer offerings aimed at grantmakers. A smaller set of resources are focused directly on issues related to cost recovery (e.g., grantee training to develop project budgets that reflect total cost of work, grantmaker workshops on evaluating the impact of grants on grantee financial health) including those offered by NFF, Mango, InsideNGO, and FMA (the training provider for the Wallace Foundation's initiative).

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59 The Real Cost Project was executed by the California Regional Association of Grantmakers, a collaborative of Northern California Grantmakers, Southern California Grantmakers, and San Diego Grantmakers. The Project was funded by the California Community Foundation, The William and Flora Hewlett Foundation, The David and Lucile Packard Foundation, The Parker Foundation, The Ralph M. Parsons Foundation, and the Weingart Foundation. The Project is organized by David Greco, president and CEO at Social Sector Partners and a former vice president at NFF.

60 Real Cost Project, *Barriers to Change*.

61 Real Cost Project, *Increasing the Impact of Philanthropy in California*, August 2016, https://ncg.org/resources/real-cost-project-increasing-impact-philanthropy-california.

62 Karen Walker et al., *The Skills to Pay the Bills: An Evaluation of an Effort to Help Nonprofits Manage Their Finances*, MDRC, February 2015, https://www.mdrc.org/publication/skills-pay-bills.

In 2016, Bridgespan and five US foundations—Ford, Hewlett, MacArthur, Open Society, and Packard—launched a collaborative with the goal of identifying a shared, scalable solution to the problem of insufficient cost recovery among nonprofits. From 2016 to 2017, the funder collaborative developed a deeper understanding of the issue through analysis of funder portfolios and primary research with grantees, both to assess their indirect-cost rates and also to determine the factors affecting their cost recovery.[63] Based on the learnings from these activities—and with a view toward identifying a shared solution for paying fair share on project grants—the foundation presidents agreed to pilot third-party verification of grantee indirect-cost rates in 2018.

A 2018 pilot by a funder collaborative explored potential solutions

Through third-party verification of indirect-cost rates for 22 grantees, the funder collaborative's 2018 pilot assessed the viability of potential solutions for paying fair share. Considerations included pathways for integration into existing practice, process credibility and value, and ability to develop shared standards (see Appendix C).

The outcomes of the verification process reaffirmed key findings from Bridgespan's previous primary research with grantees. There was significant variation in cost structure across participating nonprofits; verified indirect-cost rates ranged from 12 to 60 percent. Additionally, in comparing verified grantee indirect-cost rates to the reimbursement rates in recent grants of the collaborative foundations, the pilot found that grantees' verified indirect-cost rates exceeded foundation allocations by an average of 17 percentage points.

From a process perspective, the pilot indicated that integrating third-party rate verification into existing practice is feasible. For example, verification could be added onto a grantee's existing audit process. Furthermore, verification was shown to be a relatively inexpensive and efficient process: the average pilot verification cost $21,000 and took just eight weeks to complete.

Those who participated in the pilot found the verification process valuable—nonprofits learned about their cost structures, and program officers developed a deeper understanding of their grantees. Ninety-five percent of pilot grantees found it easy to work with the verification partners, and 95 percent of program officers found verifications credible.

The verification partners—FMA and BDO/Humentum—developed their own costing and process standards for their work with grantees during the pilot. Reflecting on their respective approaches, these providers were enthusiastic about the possibility of reconciling their methodologies to produce a cohesive set of voluntary standards and shared definitions for use in indirect-cost rate calculation.

63 This report is a product of the funder collaborative's research efforts conducted by Bridgespan.

The five members of the funder collaborative have committed to overcoming the underfunding of grantees' indirect costs

After more than two years of research and analysis, the five members of the funder collaborative announced in September 2019 that they had agreed to experiment with a set of best practices and policies to combat the "starvation cycle" that undercuts the effectiveness of their grantees. The presidents of the Ford, Hewlett, MacArthur, Open Society, and Packard Foundations also reached out by letter to a small group of peer philanthropists, inviting them to help advance the work toward solutions.

Ford Foundation President Darren Walker characterized the presidents' unified commitment to change as a "breakthrough" in addressing chronic grantee underfunding. "As funders, we bear responsibility for the state of this funding ecosystem," said Walker. "It is only by working together that we are able to advance solutions that work beyond the walls of any one institution." "Five Foundations Address the 'Starvation Cycle'" in the *Chronicle of Philanthropy* details of the collaborative's "learning journey" and findings.[64]

The foundation presidents and their staffs understand that systemic change is hard to accomplish, no matter how compelling the data and rationale. It will require patience and persistence to alter deeply embedded policies and practices shared by countless foundations, government and multilateral funders, nonprofits, and the intermediaries.

The difficult work of implementing the presidents' proposed solutions to chronic nonprofit underfunding is just beginning. Thoughtful, long-term collaboration across the social sector will be crucial to sustaining momentum and ultimately putting an end to the "starvation cycle."

64 Jeri Eckhart-Queenan, Michael Etzel, and Julia Silverman, "Five Foundations Address the 'Starvation Cycle,'" Chronicle of Philanthropy, September 4, 2019, https://www.philanthropy.com/paid-article/five-foundations-address-the/293.

Appendices

Appendix A: Variation in language and definitions around indirect costs

Below is a list of the language and definitions used by campaigns and organizations that are addressing how nonprofit indirect costs should be funded. Note that the list is not exhaustive.

Campaign or organization	Language	Definition(s)
BBB Wise Giving	• Administrative costs	• None given
The Bridgespan Group	• Non-programmatic costs – Real costs, indirect costs (2016) – Overhead, indirect-cost rates (2009) – Full costs (2003) • Cost architecture • Allocation[65]	• Non-programmatic costs – **Indirect costs** (2016): All costs that are not directly attributable to a specific project, including all non-production costs, such as executive salaries, staff training, office space, equipment, research, travel, and technology (four sub-categories: administrative costs, network and field, physical assets, knowledge management); does not include fundraising – **Overhead** (2009): No clear definition; implied that it includes information technology systems, financial systems, skills training, fundraising processes, staff salaries, and other infrastructure costs[66] – **Full costs** (2003): Direct and indirect costs of program[67] • Cost architecture – **Main cost categories:** Fundamental cost categories (e.g., direct and indirect; program, shared program, and indirect) – **Cost taxonomy:** Structure and nomenclature for functional expenses; specifically, what line items are used, and how they are grouped together into cost families – **Cost assignment:** Designation of line items or cost families to a particular main cost category (e.g., non-programmatic office rents are assigned to indirect) • Allocation – **Allocation methods:** Specific approaches applied to spread costs from one cost category to another (e.g., how costs are allocated from the indirect or shared program main cost categories to a specific program) – **Allocation principles:** Shared guidelines for cost allocation that apply to multiple methods; intended to establish parameters for permissible approaches (e.g., specifying acceptable cost bases, identifying minimum requirements for input cost data, etc.)

65 Cost architecture and allocation definitions stem from materials prepared for a workshop of the funder collaborative held on September 26, 2017.

66 Goggins Gregory and Howard, "The Nonprofit Starvation Cycle."

67 Colby and Rubin, "Costs Are Cool."

Campaign or organization	Language	Definition(s)
Center for Effective Philanthropy	• Overhead	• None found
Charity Defense Council, Dan Pallotta	• Overhead	• None found
Charity Navigator	• Administrative expenses • Overhead	• **Administrative expenses:** "Percent of total budget that a charity spends on overhead, administrative staff and associated costs, and organizational meetings;" dividing a charity's administrative expenses by its total functional expenses yields this percentage (lower is better)[68] • Segments nonprofits into four groups (food banks, food pantries, and food distribution; fundraising organizations; community foundations; and museums) and has different guidelines for acceptable levels of administrative expenses[69]
FASB	• Supporting activities	• **Supporting activities:** All activities of a nonprofit other than program services (e.g., supervision, oversight, accounting, human resources, purchasing, program development); generally, supporting activities include the following activities: – Management and general activities – Fundraising activities – Membership development activities[70]
GEO	• General operating support	• **General operating support:** A grant in support of a nonprofit organization's mission rather than specific projects or programs; also the working capital nonprofits need to sustain their day-to-day operations
Independent Sector	• Core support • General operating support (2004)[71] • Overhead	• **Core support or general operating support** (2004): Funding directed to an organization's operations as a whole rather than to particular projects; may be used not only for the delivery of services or other activities directly in pursuit of the organization's mission, but also for administrative and fundraising expenses (overhead)
InsideNGO (now part of Humentum)	• Overhead • Indirect costs	• **Overhead:** Functions and activities necessary to conduct the affairs of the organization • **Indirect costs:** Program and overhead costs not needed to reach particular project objectives

68 "Glossary – Administrative Expenses," Charity Navigator, https://www.charitynavigator.org/index.cfm/bay/glossary.list/word/Administrative%20Expenses/print/1.htm?.

69 "Financial Score Conversions and Tables," Charity Navigator, https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48#.VxD-B3pVZpv.

70 FASB, *Proposed Accounting Standards Update: Not-for-Profit Entities (Topic 958) and Health Care Entities (Topic 954): Presentation of Financial Statements of Not-for-Profit Entities*, April 22, 2015.

71 Independent Sector, *Guidelines for the Funding of Nonprofit Organizations*, (Washington, DC: Independent Sector, 2004).

Campaign or organization	Language	Definition(s)
Leap of Reason, Mario Morino	• Overhead	• None given
National Council of Nonprofits	• Indirect costs • Full costs • Overhead	• **Indirect costs:** Rent, utilities, technology, administration, professional fees, and other expenses that are not tied to any one program but are vital to sustaining a healthy organization[72] • **Overhead:** Combination of "management," "general," and "fundraising" expenses[73]
Nonprofit Finance Fund	• Full costs	• **Full costs:** Day-to-day operating expenses, working capital, reserves, fixed asset additions, and debt principal repayment[74] • "What ends up classified as overhead is so open to interpretation, even manipulation, that we cannot provide a useful or consistent definition…"
Nonprofit Overhead Project (in CA)	• Overhead • Full costs	• **Overhead:** (management and general expenses plus fundraising expenses) divided by (management and general expenses plus fundraising expenses plus program services)[75] • Recognizes that these categories are often interpreted differently
Overhead Myth (GuideStar, Charity Navigator, BBB Wise Giving Alliance)	• Overhead ratio • Real costs • True costs	• **Overhead ratio:** Percentage of a nonprofit organization's expenses that is devoted to administrative costs and fundraising costs; calculated by adding administrative (IRS Form 990, Part IX, Line 25, Column C) and fundraising (IRS Form 990, Part IX, Line 25, Column D) costs and dividing by total expenses (IRS Form 990, Part IX, Line 25, Column A).[76] • Administrative expenses include investments in an organization's infrastructure and operations
Real Cost Project	• Real costs	• **Real costs:** Administrative and operating costs plus programmatic costs plus reserve and capital costs[77] • All of the necessary costs for a nonprofit organization to deliver on mission and to be sustainable over the long term
Real Costs Strategic Initiative-Forefront	• Full cost funding • Real costs[78] • Fully-funding the mission	• **Full costs:** Cost of doing business

72 National Council of Nonprofits, *Investing for Impact: Indirect Costs Are Essential for Success*, September 2013, https://www.councilofnonprofits.org/trends-policy-issues/investing-impact-indirect-costs-are-essential-success.

73 "(Mis)Understanding Overhead," National Council of Nonprofits, https://www.councilofnonprofits.org/tools-resources/misunderstanding-overhead.

74 Claire Knowlton, "Why Funding Overhead Is not the Real Issue: The Case to Cover Full Costs," *Nonprofit Quarterly*, Winter 2015, http://nonprofitquarterly.org/2016/01/25/why-funding-overhead-is-not-the-real-issue-the-case-to-cover-full-costs/.

75 What is overhead… and why does it matter?" CalNonprofits Nonprofit Overhead Project, http://calnonprofits.org/programs/overhead/about-the-nonprofit-overhead-project/what-is.

76 "Frequently Asked Questions," Overhead Myth, http://overheadmyth.com/faqs/#q1.

77 "What does 'real cost' mean?" Real Cost Project.

78 "Donors Forum's Real Costs Strategic Initiative Modes Forward," Forefront, June 25, 2015, https://myforefront.org/news/donors-forums-real-costs-strategic-initiative-moves-forward.

Campaign or organization	Language	Definition(s)
SeaChange	• Cost-minus funding	• **Cost-minus funding:** Government contracts or restricted grants to nonprofits that virtually guarantee a deficit. Government contracts create working capital needs because funding arrives after expenses paid and are subject to unpredictable delays in payment
Social Venture Partners, Paul Shoemaker	• Restricted funds	• **Restricted funds:** "Quite damaging dollars"
Urban Institute	• Organizational overhead • Admin expenses • Admin overhead costs[79]	• None given
USAID	• Negotiated Indirect Cost Rate Agreement (NICRA)	• **Indirect-cost rate:** Total allowable indirect costs divided by equitable distribution base • "Indirect costs are those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective (e.g., office space rental, utilities, and clerical and managerial staff salaries)...to facilitate equitable distribution of indirect expenses to the cost objectives served, it may be necessary to establish a number of pools of indirect (F&A) costs. Indirect (F&A) cost pools must be distributed to benefitted cost objectives on bases that will produce an equitable result in consideration of relative benefits derived." • *De minimis*–10% • "It is USAID's policy that grantees that agree to an indirect cost rate ceiling that is less than the government-wide NICRA rate in a contract or grant for cost sharing or other reasons shall not recoup the amounts occasioned by the reduction in the rates on other agreements with the U.S. Government."[80]
Health and Human Services	• Indirect-cost rate	• Refers applicants to OMB circular
Corporation for National and Community Service	• Indirect-cost rate	• Same language as OMB circular

79 Brice McKeever, Marcus Gaddy, and Elizaebth Boris, *Nonprofit-Government Contracts and Grants: California Findings*, Urban Institute, September 2015, https://www.urban.org/sites/default/files/alfresco/publication-pdfs/2000348-Nonprofit-Government-Contracts-and-Grants-California-Findings.pdf.

80 "An Indirect-Cost Rate Guide for Non-Profit Organizations," USAID, https://www.usaid.gov/work-usaid/resources-for-partners/indirect-cost-rate-guide-non-profit-organizations.

Campaign or organization	Language	Definition(s)
State government	• Indirect costs • Central service costs • General administration	Illustrative examples: • Massachusetts Community Block Grants: Up to 18% of the total grant amount can be used for general administrative expenses; these include such personnel costs as financial/secretarial support and a grant manager to oversee program operations, as well as certain non-personnel expenses such as telephone, copying charges, audit, and other "overhead" types of costs • Texas Dept. of Family and Protective Services: "An indirect-cost rate is a method for determining, in a reasonable manner, the proportion of indirect costs that each contract should bear. It is the ratio (expressed as a percentage) of the indirect costs to a direct cost base" • Contractors my use a NICRA or de minimus of 10%[81]
Bill & Melinda Gates Foundation	• Indirect costs	• **Indirect costs:** Overhead expenses or ongoing operational costs incurred by the applicant organization on behalf of the organization's activities and projects, but that are not easily identified with any specific project • Administrative or other expenses which are not directly allocable to a particular activity or project • Expenses related to general operations of an organization that are shared among projects and/or functions • Basic examples include executive oversight, existing facilities costs, accounting, grants management, legal expenses, utilities, and technology support • Indirect-cost rate varies from 0-15%; indirect cost reimbursement = rate (%)* total project costs (including personnel, subcontracts, supplies, equipment, etc.)[82]
Ford Foundation	• Overhead	• **Overhead:** Actual costs to administer a project[83]
Robert Wood Johnson Foundation	• Indirect costs	• **Indirect costs:** Those costs that are not easily identified but are necessary to conduct the grant, such as payroll processing, accounting support, human resource department costs, etc. It is also referred to as overhead. The RWJF standard rate is 12%[84]
Walmart Foundation	• Indirect costs	• **Indirect costs:** Non-program-related expenses; may not exceed 10% of the total program budget

81 "Contracting with DFPS: Contract Handbook, Chapter 5, Indirect-cost rates," Texas Department of Family and Protective Services..

82 "Indirect Cost Policy for Project Grants and Contracts for Applicable Organizations," Bill & Melinda Gates Foundation, https://docs.gatesfoundation.org/Documents/Indirect_Cost_Policy.pdf.

83 Darren Walker. "Moving the Ford Foundation Forward," Ford Foundation, November 8, 2015, https://www.fordfoundation.org/ideas/equals-change-blog/posts/moving-the-ford-foundation-forward/.

84 "Financial Glossary," Robert Wood Johnson Foundation, http://www.rwjf.org/en/how-we-work/grants/grantee-resources/reporting-and-accounting-information/financial-glossary.html.

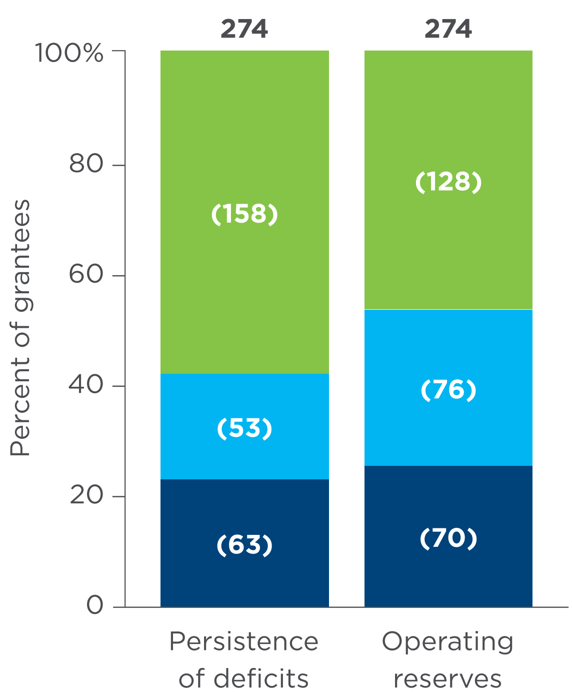
Appendix B: Portfolio analysis of top 15 foundations' grantees' financial health

Bridgespan analyzed the financial health of grantees of the top 15 US foundations (by endowment). The analysis included 274 nonprofits that were the most highly co-funded grantees—i.e., those receiving funding from more than one of the foundations—by grant dollars received from 2008 through 2014. Hospitals, universities, museums and other arts-related institutions, as well as organizations based outside of the United States or those without available data, were removed from the analysis.

Bridgespan examined financial indicators such as operating reserves and persistence of deficits. Results of this analysis are displayed and summarized below:

- 40 to 50 percent of grantees showing signs of financial stress
- 23 percent of grantees have less than one month of operating reserves. In fact, about 30 such organizations are technically insolvent and have borrowed against their restricted grants to fund critical expenses
- 26 percent of grantees have run deficits in at least three of the five years studied

Financial health indicator scores for major co-funded grantees of the top 15 US foundations



Scale for interpreting financial health data		
Scale	**Operating reserves**	**Persistence of deficits**
Baseline for financial health	3+ months	0 or 1 years
Likely financial weakness	1 ≤ x < 3	2 years
Significant financial weakness	< 1 month	3+ years

Note: *Green does not necessarily signify financial strength; it represents a baseline for financial health*

Note: Based on 2017 analysis of the 274 nonprofits that were among the top grantees (by total grant dollars) receiving funds from two or more of the top 15 US foundations (by endowment). Persistence of deficits examined over five years of data.
Source: Guidestar.org; NFF Financial SCAN; audited financial statements; Bridgespan analysis.

Appendix C: Primary research (2015-2018)

Funder research

To understand how funders engage with the issue of indirect cost, Bridgespan interviewed over 300 foundation staff across 20 foundations, including 40 percent of the top 20 US foundations. These conversations included in-depth discussions with program officers to learn more about the stakeholder dynamics and systemic barriers that make indirect cost recovery such a complex problem for both grantees and funders.

Indirect-cost diagnostic (2016)

The Bridgespan team dedicated over 1,000 hours to interviews with, and in-depth financial analysis of, diverse social sector organizations in order to hear grantee perspectives on the challenges of covering indirect costs and learn more about cost structures across a range of nonprofit segments.

Bridgespan's primary research efforts with grantees entailed:

- Conducting approximately 180 interviews with CEOs and finance staff members across 52 nonprofits
- Executing 60 indirect-cost diagnostics (note: multiple diagnostics were done for some of the 52 participating grantees in order to test the effects of methodological adaptations)

For reference, an indirect-cost diagnostic is an in-depth financial analysis to develop a customized, enterprise-level indirect-cost rate for a given nonprofit. This analysis modifies, classifies, and allocates costs to reflect the nonprofit's actual direct and indirect costs of executing its work. Bridgespan's diagnostic approach is outlined in the visual on the next page.

Tactically, the indirect-cost-diagnostic approach outlined in the visual required the following steps to execute:

- Up-front call with grantee finance staff member and CEO to learn about the organization, the type of work it does, experiences with funder indirect policies and systems, and process for this work
- Grantee finance staff member assembles financial data and other supporting documentation and shares with Bridgespan
- Bridgespan conducts first phase of cost analysis
- Bridgespan and grantee finance staff member hold a call to clarify any outstanding questions that arise from review of the data and materials
- As needed, there is additional data-sharing and discussion between Bridgespan and grantee staff member
- Bridgespan finalizes cost analysis, and then Bridgespan and grantee finance staff member hold a call (ideally including CEO) to review final analysis of indirect-cost rate

Indirect-cost diagnositc approach used in 2016 study

Inputs from organization

- **Documentation**
- **Interviews**

Diagnostic process

- Analyze inputs to understand program area definitions, overall cost structure, and current cost allocation methodology
- Isolate specific line items and categorize

Categories of cost

Indirect (shared) costs

All costs that are not directly attributable to a specific program, including:

- Investments in mission-critical capabilities and infrastructure
- Programmatic resources not dedicated to a specific program
  - For programmatic personnel and facilities resources, allocations to a specific program that are <10% are considered "shared"

Direct costs

Costs that are directly attributable to a specific program

- Personnel and facilities allocations to a specific program must be ≥10% in order to be considered direct

Indirect-cost rate calculation

Total indirect costs ÷ **Total direct costs**

Note: Methodology used in Bridgespan's 2016 indirect-cost diagnostic.
Source: The Bridgespan Group

Funder collaborative verification pilot (2018)

The central purpose of the funder collaborative's pilot was to test third-party indirect-cost rate verification as a method for pricing indirect-cost rate-based, project-restricted grants at actual cost. To execute the pilot, the collaborative partnered with a set of trusted financial experts: FMA, BDO, and Humentum. These third-party verification partners worked with a total of 22 of the collaborative foundations' grantees to establish and verify an indirect-cost rate for each participating nonprofit. Of the 22 participating grantees, four underwent "dual verification" by both FMA and BDO/Humentum, thus yielding a total of 26 verified rates.

The visuals below provide an overview of the pilot's design, the underlying learning goals, and the set of verified rates generated by the process:

Funder collaborative pilot overview

Stakeholder roles	
Funder Collaborative Steering Group	• Designed and coordinated the pilot, captured learnings and implications
Verification Partners	• Worked with grantees to verify indirect-cost rate; provided technical expertise, thought partnership, and support in learning capture
Grantees	• Provided data and collaborated to verify indirect-cost rates
Program Officers (POs)	• Helped in grantee selection, outreach, and onboarding; participated in kick-off and process-end calls with grantee

Pilot phases			
	January – February 2018	**January – June 2018**	**March – June 2018**
	Phase 1: Grantee Selection & Outreach	**Phase 2: Indirect-Cost-Rate Verification**	**Phase 3: Learning Capture**
Key activities	• Grantees invited to participate by foundation POs	• Partners worked with **22 grantees** to verify indirect-cost rates • Process duration varied from **5-12 weeks** (inclusive of time for partner analysis and data follow-up/clarification)	• Participants completed a learning survey • Learnings were discussed in a workshop and synthesized

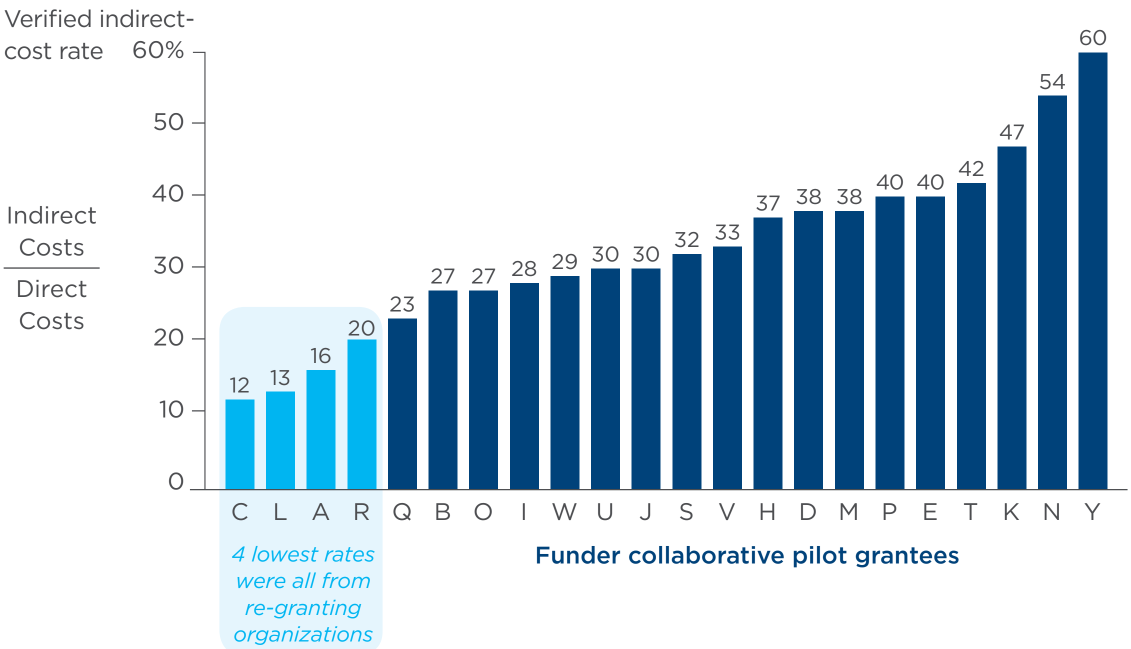
Source: The Bridgespan Group

The funder collaborative pilot was designed around four key learning goals

Pilot learning goals			
Experience and application of process	Substance of solution and standards		
1 Integrating verification into existing practice	2 Ensuring credibility & internal consistency	3 Assessing value of third-party verification	4 Developing standards
Specific learning questions			
• How does verification fit within foundation **grantmaking processes**? Within grantee **accounting practices**? • What **incremental resources** and/or staff time does the verification process require?	• Does verification of the same grantee by different third-party partners lead to **credible outcomes**? • For grantees with a NICRA* rate, is there **internal consistency** between that rate and the pilot verified rate? • Can the output of verification be used **consistently** across multiple foundations?	• Do grantees think the verification **process is valuable**? Do program officers? • Does verification **increase understanding** of organizational cost structure for grantees? For program officers?	• What is the **feasibility of developing** shared standards for third-party verification? • What **types of standards** might providers be able to align on (e.g., cost definitions, allocation methods, process templates)?

Note: For grantees with a US Government Negotiated Indirect Cost Rate Agreement (NICRA), the "crosswalk" from a grantee's NICRA rate to their pilot verified rate was approximated by removing fundraising costs from the pilot verified rate.
Source: The Bridgespan Group

Verified grantee indirect-cost rates ranged widely, with over half being at or above 30 percent



Note: For dual verification grantees, an average of the two independently calculated rates is reflected.
Source: BDO/Humentum and FMA verification results (2018).

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