Project grants have two kinds of costs: direct costs & indirect costs

Direct costs are the expenses directly attributable to a specific project.

Indirect costs are the shared program and overhead expenses that are not directly tied to a specific project.
The challenge: Insufficient indirect cost recovery among nonprofits/NGOs

**WHAT THE ORGANIZATION NEEDS…**

**Direct Costs**

**Indirect Costs**

**Actual Cost of Project**

**…WHAT IT TYPICALLY RECEIVES**

**Grant Amount**

**Funded Indirect Costs**

**Indirect Costs Left Unfunded**
UNDERSTANDING TRUE COSTS: AVOID THE DOOM LOOP

- Funding Does Not Cover Full Cost
- Lack of cash reserves
- Inability to Meet Demand/Mission
- Lack of Focus on Capacity Needs
12-ounce coffee = $3.00

Overhead & Profit
74%

Direct Cost
26%
(77¢)

- 32¢ Two shots of espresso
- 20¢ Steamed milk
- 15¢ Cup, lid, sleeve, stirrer
- 5-10¢ Rent, labor, utilities

Source: Matt Milletto, Vice President of the American Barista & Coffee School
For-profit transactions are directly assessed by the payer and the financial results

- Customer buys the service
- Customer evaluates experience
- Customer uses the service
- Business provides the service

Nonprofit transactions do not connect payer and service

- Donor(s) or payors pay for the service
- Nonprofit provides the service
- Recipient uses the service

Nonprofit/Funder interactions try to make up for absent feedback loop
The role of overhead in the nonprofit starvation cycle

- Misleading reporting & overhead “phobia”
- Unrealistic funder expectations
- Pressure on nonprofits to conform
“A vicious cycle is leaving nonprofits so hungry for decent infrastructure that they can barely function as organizations—let alone serve their beneficiaries.

The cycle starts with funders’ unrealistic expectations about how much running a nonprofit costs, and results in nonprofits’ misrepresenting their costs while skimping on vital systems—acts that feed funders’ skewed beliefs. To break the nonprofit starvation cycle, funders must take the lead.”

Timeline of sector efforts (1985-2016)

- 1985: Rand indirect costs report
- 1990: Urban Institute’s Nonprofit Overhead Cost Study
- 1995: Bridgespan’s Costs Are Cool
- 2000: Bridgespan’s Nonprofit Starvation Cycle
- 2005: InsideNGO’s Full Cost Recovery Project
- 2010: Bridgespan’s Stop Starving Scale
- 2013: GuideStar, BBB, & Charity Navigator’s Overhead Myth
- 2015: Forefront convening on IDC
- 2016: Full Cost Project
  - Northern California Grantmakers, San Diego Grantmakers, Southern California Grantmakers, and Nonprofit Finance Fund

Other key events:
- 2010: OMB Guidance on IDC reimbursement
- 2014: Forefront’s commitment to full cost funding
- 2016: Bond & Mango’s benchmarking and cost recovery report
- 2016: SeaChange & Oliver Wyman’s report on financial risk in NYC nonprofits
- 2016: Bridgespan’s Pay What It Takes Philanthropy
- 2016: Independent Sector hosts working sessions on overhead
- 2016: True Cost Project
  - Ford, Hewlett, Packard, Open Society, MacArthur, and The Bridgespan Group
True Cost Project

TCP Goals 2016-17:
- develop a deeper understanding of the issue through analysis of funder portfolios
- primary research with grantees to analyze their true indirect cost rates – interviews and in-depth financial analysis

TCP 2018
- Begin to test solutions – chiefly, the value of third-party verification (the TCP Pilot)

Findings
- most funding is project-based: 70-90% of grantmaking is restricted
- median indirect costs range from 25-65%
- the majority of private foundations have an indirect rate cap of 15 or 20%
UNDERSTANDING TRUE COSTS

2015 data

2016 data

Indirect costs
Direct costs

Unfunded costs
Highest amount typically paid by funders
Project-Restricted Grants:
*Most prevalent approach but often priced below actual costs*

>3/4 of US foundation giving is project-restricted

2/3 of largest US foundations cap indirect costs at ≤20%

Note: Indirect cost rate data represents policies (as of Dec. 2018) for the 15 largest US foundations by endowment (as of 2014, excluding place-based community foundations).
Bridgespan research: IDCs exceed 20%
Bridgespan research: 40-50% of grantees showing signs of financial stress

**FINANCIAL HEALTH INDICATOR SCORES FOR MAJOR CO-FUNDED GRANTEES OF TOP 15 U.S. FOUNDATIONS**

<table>
<thead>
<tr>
<th>Operating reserves</th>
<th>Persistence of deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td>274</td>
<td>274</td>
</tr>
<tr>
<td>(158)</td>
<td>(128)</td>
</tr>
<tr>
<td>(53)</td>
<td>(76)</td>
</tr>
<tr>
<td>(63)</td>
<td>(70)</td>
</tr>
</tbody>
</table>

**Scale for interpreting financial health data**

<table>
<thead>
<tr>
<th>Scale</th>
<th>Operating reserves</th>
<th>Persistence of deficits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baseline for financial health</td>
<td>3+ months</td>
<td>0 or 1 years</td>
</tr>
<tr>
<td>Likely financial weakness</td>
<td>1 ≤ x &lt; 3</td>
<td>2 years</td>
</tr>
<tr>
<td>Significant financial weakness</td>
<td>&lt;1 month</td>
<td>3+ years</td>
</tr>
</tbody>
</table>

*Note: Gray does not necessarily signify financial strength, it represents a baseline for financial health*

Source: GuideStar.org; NFF FinancialSCAN; Bridgespan analysis, audited financial statements
Pilot research: IDC rates range from 12-60%

Total indirect costs
Total direct costs

4 lowest rates were all from re-granting organizations.
Pilot research: IDC rates exceeded funder allocations by an average of 17% points

<table>
<thead>
<tr>
<th>TCP PILOT GRANTEES*</th>
<th>Percentage point difference between verified rate &amp; foundation indirect cost allocation</th>
<th>IDC rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>16%</td>
<td>0%</td>
</tr>
<tr>
<td>B</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td>Q</td>
<td>23%</td>
<td>1%</td>
</tr>
<tr>
<td>B</td>
<td>27%</td>
<td>1%</td>
</tr>
<tr>
<td>O</td>
<td>27%</td>
<td>1%</td>
</tr>
<tr>
<td>W</td>
<td>29%</td>
<td>2%</td>
</tr>
<tr>
<td>U</td>
<td>30%</td>
<td>3%</td>
</tr>
<tr>
<td>J</td>
<td>33%</td>
<td>5%</td>
</tr>
<tr>
<td>V</td>
<td>37%</td>
<td>7%</td>
</tr>
<tr>
<td>H</td>
<td>38%</td>
<td>8%</td>
</tr>
<tr>
<td>D</td>
<td>38%</td>
<td>8%</td>
</tr>
<tr>
<td>M</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>P</td>
<td>40%</td>
<td>10%</td>
</tr>
<tr>
<td>E</td>
<td>42%</td>
<td>12%</td>
</tr>
<tr>
<td>T</td>
<td>54%</td>
<td>15%</td>
</tr>
<tr>
<td>N</td>
<td>60%</td>
<td>17%</td>
</tr>
<tr>
<td>Y</td>
<td>60%</td>
<td>17%</td>
</tr>
</tbody>
</table>

Rate verified during TCP pilot
Rate reflected in most recent grant from nominating TCP foundation
NFF’S 2018 STATE OF THE NONPROFIT SECTOR

HEADLINE CHALLENGES

- Achieving Long-Term Financial Sustainability
- Raising Funds That Cover Full Costs
- Raising Unrestricted Revenue
- Offering Competitive Pay
- Employing Enough Staff
- Identifying and Cultivating Leaders

Challenges classified as either Operational/Financial or Staffing.
True cost project: next steps

- **Implement change internally** at each foundation
- **Disseminate knowledge** across the sector
- **Communicate with other funders and grantees**, via informal conversations, peer groups, conferences, etc.
- **Develop standards** in collaboration with third-party verification partners (BDO, FMA, Humentum)
- **Continue to deepen engagement of key stakeholders**, including TCP pilot grantees
Exploring Solutions:
Aligning on “guiding principles” to inform policy decisions

- Stimulate honest conversations between funders and grantees
- Promote efficient and effective allocation of resources
- Do what is right, and do no harm
- Act with consistency and fairness
- Pay fair share of indirect costs
SUPPORTING TRUE COSTS

Key benefits:

- Avoids undermining grantees’ overall financial health or sustainability
- Enables grantees to allocate grant dollars to direct and indirect costs within project as needed
- Takes burden off staff to negotiate rates
- Promotes a more fair and equitable approach
- Creates opportunity to adjust scope and/or expectations of the grant if HF grant amount cannot cover true cost
## Menu of funding options

<table>
<thead>
<tr>
<th>Enterprise</th>
<th>Program</th>
<th>Project Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Flexible enterprise-level support</td>
<td>Flexible programmatic support</td>
<td>Outcomes funding</td>
</tr>
<tr>
<td>Funds to be used entirely at grantee's discretion (incl. general operating support)</td>
<td>Flexible funding within a specific program</td>
<td>Payment per outcome achieved</td>
</tr>
<tr>
<td>Targeted growth support</td>
<td>All-in project pricing</td>
<td>Single price set by grantee; no distinction between direct &amp; indirect costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Funding amount determined based on direct &amp; indirect costs</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Flexible</th>
<th>Non-IDC Rate</th>
<th>IDC Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Indirect cost rate-based project funding</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
SPOTLIGHT: Hewlett Foundation

• GOALS & STRATEGY

Capitalization is not “a program.” It’s woven into grantmaking as usual.

- **Financial Due diligence**
  - “Fiscal Responsibility” is one of 5 selection criteria
  - SMU DataArts Funder Report informs decisions: metrics and trends reveal operating and balance sheet health
  - Conversations with grantees explore key questions raised by data in the report

- **Flexible, full cost funding**
  - General operating support grants are the norm (85%)
  - Program and project grants are funded at grantees’ self reported True Cost – or the program scope gets adjusted

- **Capital investment**
  - Capital selectively awarded to grantees with historically and currently little access to communities of wealth
  - Options include recovery, change, and facilities
  - Loans (up to $50K) available through the Arts Loan Fund, a pooled low interest fund at Northern CA Grantmakers
Resources and Contacts

Additional Reading:
Pay What It Takes Philanthropy
https://ssir.org/articles/entry/pay_what_it_takes_philanthropy
Time To Reboot Grantmaking
https://ssir.org/articles/entry/time_to_reboot_grantmaking
It’s Time For The Public To Understand Nonprofit Business Models
https://nonprofitquarterly.org/2018/03/13/nonprofit-business-models/

Questions about this presentation?

Adam Fong: afong@hewlett.org