

Investing for Impact

Indirect Costs Are Essential for Success



Fourth in a series of Streamlining Reports on solutions to improve government-nonprofit contracting issues



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ABOUT THIS REPORT

This report addresses how governments that hire charitable nonprofits to deliver services and then reimburse them for less than reasonable indirect costs undermine the ability of nonprofits to deliver high quality services. It reviews research documenting that such an approach erodes communities and offers practical solutions that governments at all levels can adopt to strengthen the government-nonprofit contracting relationship while ensuring higher-performing partners and cost savings for taxpayers.

ABOUT THE PROJECT

Since at least the 1960s, all levels of government have been entering written agreements with charitable nonprofits to deliver a broad array of services to the public. Governments have largely found nonprofits to be good partners: mission-driven rather than profit-focused and more efficient and effective than unwieldy government bureaucracies. In return, governments have paid late, paid less than the costs incurred to deliver the services, and imposed excessive paperwork burdens that raise costs. Once accepted by nonprofits as the cost of doing business with government, these and other government contract and grant problems were both exacerbated and exposed by the Great Recession. But there was little empirical research documenting the extent and severity of the harmful practices that weaken the ability of nonprofits to serve the public.

In 2009, the National Council of Nonprofits and the Urban Institute's Center on Nonprofits and Philanthropy began a multi-year collaborative project to identify the scope and depth of the problems that charitable nonprofits face when contracting with governments. In 2010, the Urban Institute published an in-depth study, *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants*.¹ That study provided the results of the first national survey documenting the serious and widespread problems experienced by nonprofit human service providers under contract with governments throughout the country. Specifically, the research found that governments are not always good partners with nonprofits, with many governments routinely failing to pay the full costs of the contracted services, imposing unnecessary and wasteful burdens, and not honoring their legal obligations of the written contracts they signed — all of which add unnecessary costs to governments and nonprofits alike. A companion report by the National Council of Nonprofits, *Costs, Complexification and Crisis: Government's Human Services Contracting "System" Hurts Everyone*,² provided additional context to the Urban Institute's findings by identifying specific practices that contribute to the problems and proposing solutions that government officials and nonprofit leaders can adopt to improve services, restore value for taxpayers, and strengthen communities.

Government officials and nonprofit leaders — who serve the same individuals and the same communities — know they cannot afford to do business as usual. Using the independent data from the Urban Institute, the National Council of Nonprofits and its network of state associations have been working with governments and nonprofits to reform the broken contracting “system.”

For additional information on government-nonprofit contracting issues and solutions, please visit our dedicated website at www.govtcontracting.org.



INVESTING FOR IMPACT: INDIRECT COSTS ARE ESSENTIAL FOR SUCCESS

September 2013

Conventional wisdom had it wrong.

Until recent breakthroughs, the conventional view held that the best charitable nonprofits were those that spent the least on indirect costs – that is, costs for such things as accounting, information technology, human resources, training, governance, and management. The same thinking has rarely been applied to for-profit businesses, where such expenses are accepted as essential for creating more efficient and more effective organizations that produce better outcomes. Yet public policies and community attitudes have historically believed that if nonprofit organizations incurred any similar costs, then they were somehow inappropriately diverting resources from direct service delivery.

In June 2013, various charity watchdog groups surprised the world of philanthropy by officially reversing their thinking and publicly repudiating conventional views about indirect costs. Specifically, Charity Navigator and the Better Business Bureau's Wise Giving Alliance, joined by GuideStar, launched an effort to "correct a misconception" about what matters most in deciding to support a charity.⁴ The three groups published an open letter to donors declaring: "the percent of charity expenses that go to administrative and fundraising costs commonly referred to as 'overhead' – is a poor measure of a charity's performance." Their analysis concluded that "many charities should spend more on overhead" and that funders failing to pay indirect costs "starve charities of the freedom they need to best serve the people and communities they are trying to serve."⁵

Policymakers who wish to get more bang for the taxpayer buck may wish to reconsider agency policies that limit overhead or indirect costs to artificially low levels.³

This public rejection of past thinking provides important momentum to mounting research documenting that indirect costs are not organizational "fat" that should be reduced dramatically, but are core investments needed for the successful operation of organizations. Landmark studies over the past ten years prove that the most efficient and effective charitable nonprofits spend more on indirect costs than their less effective peers.⁶ In fact, the studies show that the old way of thinking about indirect costs has led to diminished capacity by nonprofits to perform vital services to the public.

What are "Indirect Costs"?

With some exceptions, a nonprofit's indirect costs are equivalent to what for-profit businesses refer to as "overhead." They include 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.

In 2010, the federal Government Accountability Office (GAO) concluded that actions to underfund nonprofit indirect costs “potentially limit the sector’s ability to effectively partner with the federal government, can lead to nonprofits providing fewer or lower-quality federal services, and, over the long term, could risk the viability of the sector.”⁷ This underfunding gap creates an ongoing danger to the long-term economic viability of the nonprofit sector, threatening the government’s main partner in delivering services to people in local communities. Indeed, the replacement costs to governments – that is, how much it would cost taxpayers for governments to try to replicate the work of nonprofits – would likely be exorbitant.

To its credit, the federal Office of Management and Budget (OMB) has recognized governments’ great interest in sustainable nonprofit contractors and grantees that can provide cost-effective services in their communities. OMB is currently evaluating proposed guidelines on how best to ensure that state and local governments pay adequate and legitimate indirect costs as a core cost of operations.⁸

For government-nonprofit contracts and grants, this shift in thinking on indirect costs is long overdue and worthy of immediate attention by policymakers whose job is to ensure that taxpayer dollars are invested to deliver the greatest impact. Governments at all levels have the opportunity now to reverse outdated policies and practices regarding indirect costs and strengthen the service delivery system within their jurisdictions.

THE PROBLEMS: INCONSISTENCIES, ARBITRARINESS, AND UNREALISTIC EXPECTATIONS

Governments depend heavily on charitable nonprofits to meet the needs of citizens by providing services that support and protect the most vulnerable people in communities across the country. Yet for as long as most nonprofits can remember, governments that contract with nonprofits to provide these services have routinely failed to pay the full costs of delivering the services.⁹ The lack of full reimbursement includes both direct and indirect costs. The almost systematic failure of governments to fully reimburse for costs incurred has generated extensive research.¹⁰ Despite that research, people still regarded indirect costs differently than direct costs, due to what is now recognized as outdated thinking: that anything beyond the most minimal indirect costs is somehow wasteful and indicative of a nonprofit’s inefficiency.

That old thinking contrasts sharply with accepted practices for for-profit businesses. In those settings, people have long recognized that investing in items like office space and equipment, accountability and governance, research, training, and the like are expected as reasonable and necessary costs of doing business.

The same has not been true for nonprofits. The old thinking that results in the underfunding of nonprofits’ indirect costs has persisted for multiple reasons. They include inconsistencies in the use of similar-sounding accounting terms, arbitrariness in the rationale for and application of the limits preventing legitimate costs, and unrealistic expectations imposed via external pressures from private and government funders and watchdog groups. Compounding these problems is the reality that nonprofits themselves have added to what has come to be known as the “starvation cycle” by keeping these costs artificially low in order to meet these unrealistic expectations.

[T]hese challenges potentially limit the sector’s ability to effectively partner with the federal government, can lead to nonprofits providing fewer or lower-quality federal services, and, over the long term, could risk the viability of the sector.⁷

Inconsistent Terminology. People often presume that accounting is black and white and that accounting terms are defined distinctly and applied consistently. When it comes to the topic of indirect costs, however, that presumption is wrong.

Several similar yet distinctly different terms – indirect costs, administrative costs, and overhead costs – are often unknowingly used interchangeably, causing great confusion. For instance, the federal government, through OMB Circular A-122, instructs federal agencies contracting with or issuing grants to nonprofits to categorize the costs that nonprofits incur in delivering the services into two general buckets: either **direct** or **indirect**. The A-122 then further separates indirect costs into two subcategories: either administrative costs or facilities costs. **Administrative costs** include management and general expenses such as the salaries of executives and accounting personnel and library expenses. **Facilities costs** are items such as depreciation and capital improvement, interest on debt associated with certain buildings, and operations and maintenance expenses.¹¹

Yet the federal government, through the IRS Form 990 that applies Generally Accepted Accounting Principles (GAAP), tells nonprofits to categorize and annually report their costs in three separate buckets, with completely different labels: Management & General, Program Services, or Fundraising. **Management & General costs** are typically activities that are required by organizations to operate, but may support multiple programs and the organization as a whole, such as accounting, human resources, staff development, rent, and utilities. **Program costs** are those that are easily attributable to a specific program or project. **Fundraising costs** are self-explanatory.

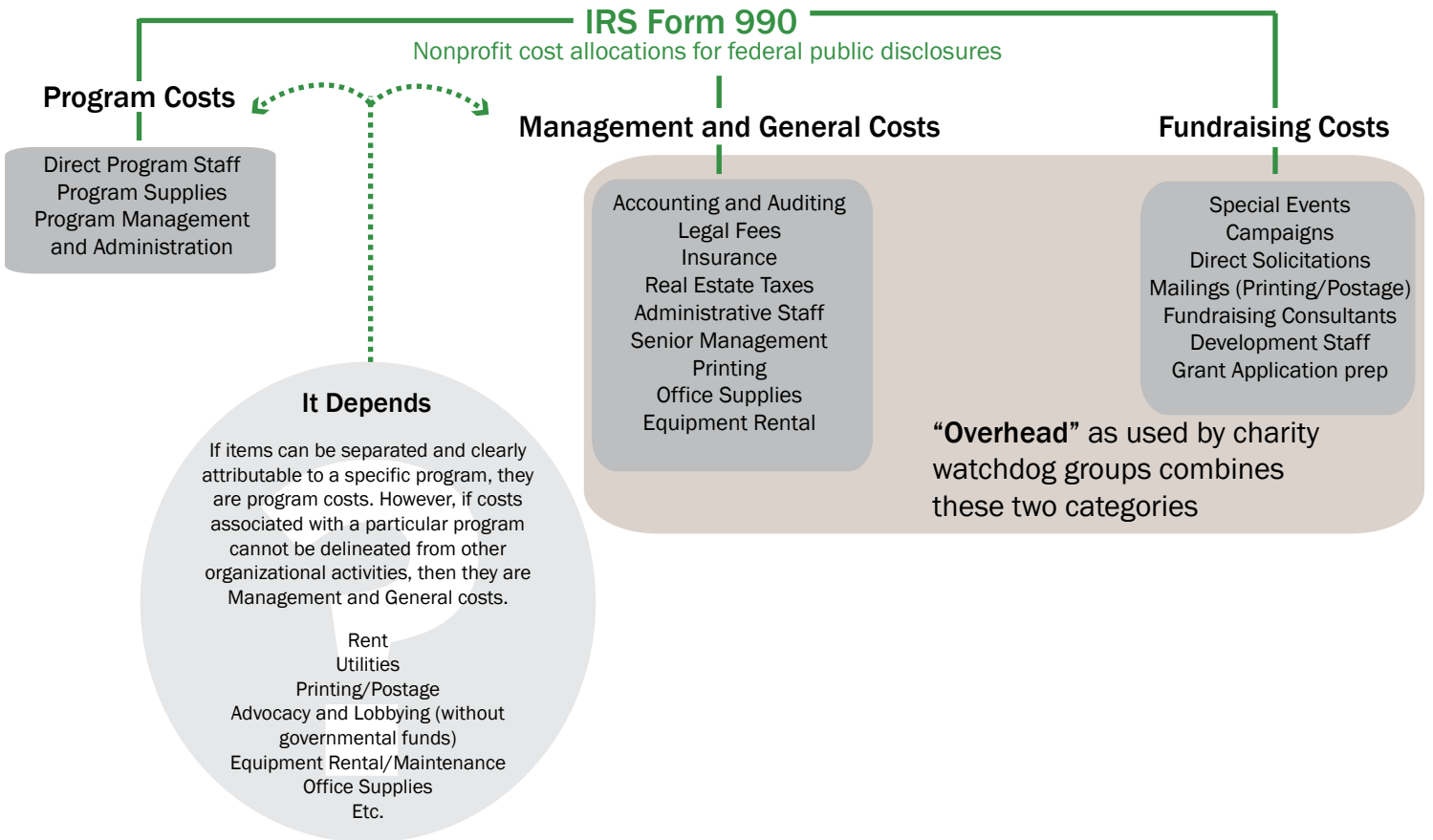
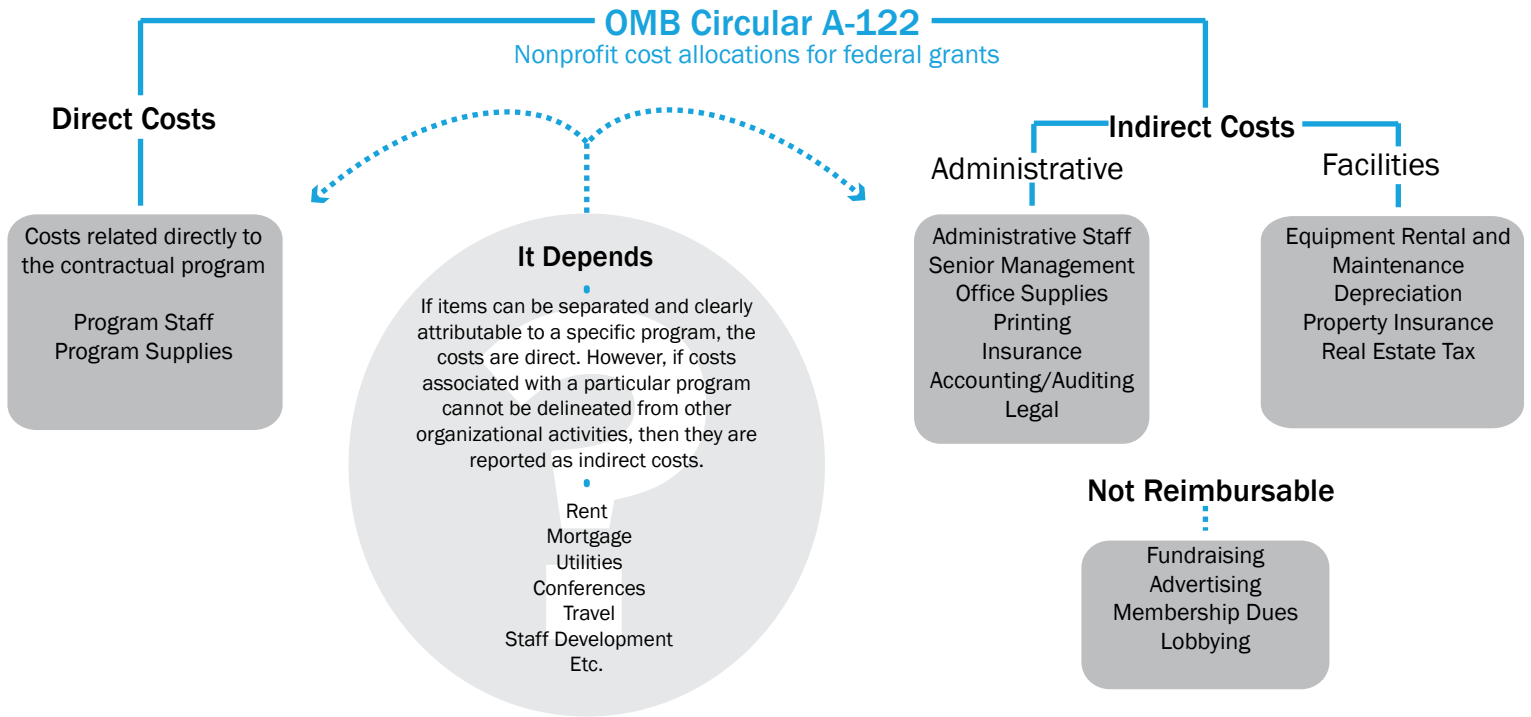
The objectives of the A-122 rules and the Form 990 are very different. The terminology for both seems similar, yet they cannot be directly compared. For instance, it might appear that the A-122's "direct costs" line up with the Form 990's "program costs" and that the A-122's "indirect costs" line up with the Form 990's "management & general costs." But it doesn't always work that way. For example, costs associated with the management and administration of a specific program are generally treated as direct costs on the Form 990, but may be indirect costs for A-122 purposes.¹² Further complicating the situation is that individual federal or state grants may modify normal payment terms regarding whether costs will be considered direct or indirect, as well as change which costs are allowable in the calculation of an indirect cost rate. To illustrate, a software upgrade necessary for efficient delivery of a contracted service may be considered a direct program cost to one federal agency, but identified as an indirect cost under a separate grant at a different government agency. This example shows the absurdity of the old way of thinking that "indirect costs" should be avoided, because the nonprofit had to incur the expenses of the software upgrade – the question is only whether the costs gets treated as a direct or indirect cost for A-122 purposes.

Superimposed on top of competing federal categorization systems is the confusion caused when laypeople use the similar-sounding term of "**overhead**." When charity watchdog groups refer to "overhead," they generally define this as **administrative (including facilities)** and **fundraising** costs combined.¹³ Yet when governments use the terms indirect or administrative costs, they do not include any fundraising costs. Governments consider the costs associated with fundraising as being separate and distinct costs unrelated to programs and unallowable for reimbursement purposes. Therefore, based on these definitions an organization may have a government-defined indirect cost rate of 25 percent, but a perceived overhead rate of 40 percent.

The point about governments not allowing fundraising costs as indirect administrative costs merits special attention. The research findings are consistent and undeniable: governments routinely fail to fully reimburse charitable nonprofits for the actual cost of the services they provide.¹⁴ That failure by governments forces nonprofits to engage in fundraising to make up the difference. The need to do fundraising thus becomes a real and necessary cost of providing services under the program.

What kind of cost is it?

It's Complicated*

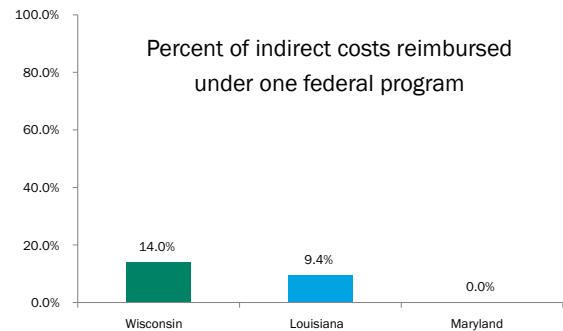


* Details in this graphic are provided for illustrative purposes only. Allocation of actual costs will vary.

Arbitrary Applications. A second major problem is the arbitrary ways in which governments apply indirect cost principles. The actual amount that a governmental entity reimburses a nonprofit for indirect costs can vary considerably, and it rarely equals the actual costs to perform the services. Federal grants typically allow nonprofits to receive reimbursement for at least a portion of the nonprofit’s indirect costs. When individual nonprofits are the direct recipient of federal funds, they negotiate an indirect rate with the federal government to be used when applying for federal grants. It is not uncommon, however, that a federal agency imposes an arbitrarily determined cap on indirect cost reimbursement (whether dictated by a statute or determined through executive action) that is well below the nonprofit’s negotiated rate.

But state and local governments do not typically have *any* requirement to reimburse nonprofits for indirect costs, even when the funds flow from a federal funding stream. In its research to determine state policies

with regard to reimbursing nonprofits for indirect costs, the GAO reviewed six federal grant programs and how indirect cost reimbursements to nonprofits were handled in three states and found substantial inconsistencies. For example, under one federal program advancing the same federal public policy and the same federal funding source, GAO discovered that a nonprofit providing services in Wisconsin was reimbursed for up to 14 percent of its actual indirect costs, a nonprofit providing the same services in Louisiana was reimbursed only 9.4 percent, and a nonprofit providing the same services in Maryland received zero for the indirect costs it incurred.



“These differences, *including whether nonprofits are reimbursed at all*, largely depend on the policies and practices of the state and local governments that award federal funds to nonprofits.”¹⁵ Further complicating the matter, nonprofits find that different government grants – often within even the same governmental office – may differ in what costs may be included or excluded from the calculation of indirect rates.

Unrealistic Expectations. Beyond these problems of inconsistencies and arbitrariness, external expectations of what are considered acceptable indirect costs have plagued nonprofits for decades. Major influencers of low indirect costs have been private giving federations, which for many years expected nonprofits receiving their funds to limit Management & General costs to no more than 20 percent of budget. Watchdog groups have similarly exerted pressure to keep costs low, citing overhead cost ratios as an indication of an organization’s efficiency and effectiveness with “lower is better.”¹⁶ In Louisiana, the expectation is that indirect costs should not exceed 15 percent.¹⁷ Likewise, in New York, Executive Order 38 mandates that by April 1, 2015 no more than 15 percent of the state funds used to reimburse for services may be used for administration.¹⁸ There are different rates utilized – rates established in rule or statute, per grant, or even based simply on “normal” practice – all of which have been set arbitrarily.

In response, nonprofits themselves have for many years added to the unrealistic expectations by citing artificially low overhead costs as if they were a badge of honor. An analytical report, *Anatomy of the Nonprofit Starvation Cycle*, provides a longitudinal study of nonprofit overhead (defined as management and fundraising expenses) from 1985 through 2007. That report “show[s] a definite downward trend in overhead costs,” likely reflecting both declining investment in key areas and increased pressure to underreport actual costs in order to conform to unrealistic standards.¹⁹

THE RESULT: REDUCED EFFICIENCY AND EFFECTIVENESS

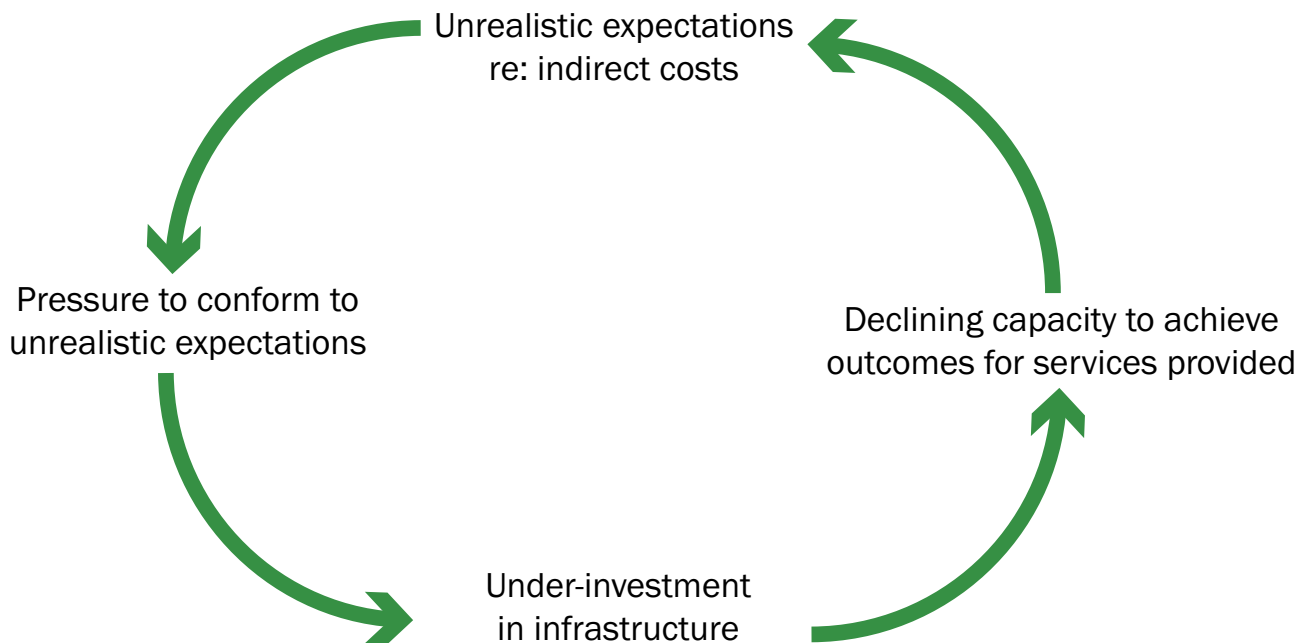
Arbitrary limitations on indirect costs have reduced the ability of nonprofits to successfully accomplish their purpose. Several studies have established that a strong organizational infrastructure is necessary to ensure efficient and effective services. In 2004, a joint project by the Urban Institute's Center on Nonprofits and Philanthropy and Indiana University's Center on Philanthropy found that "nonprofits with the weakest organizational infrastructures relied on the public sector for half or more of their revenue, and the public sector practice of providing little support for overhead costs was directly related to the existence of those weaknesses."²⁰

In a separate study, The Bridgespan Group examined the problems that nonprofits face regarding externally-imposed, artificially-low overhead costs and identified the importance of breaking what it termed the "vicious cycle of misleading reporting, unrealistic expectations of funders, and pressure to conform."²¹ Its analysis determined the following:

The cycle has grave consequences for an organization's ability to have impact. As unrealistic overhead expectations place increasing pressure on organizations to conform, executive directors and their boards can find themselves under-investing in infrastructure necessary to improve or even maintain service-delivery standards, particularly in the face of growth. In the short term, staff members struggle to "do more with less." Ultimately, it's the beneficiaries who suffer.

New research from Giving Evidence indicates that, in fact, "the highest performing nonprofits spend more on administrative overhead than their less effective peers."²²

A Vicious Cycle



The Government Accountability Office investigated concerns about the fiscal strain on nonprofits in its 2010 study on indirect costs.²³ GAO found that nonprofits typically bridged the gap between the costs incurred and the level of reimbursement by making what are difficult choices to favor program services over the well-being of the organization. The reason goes to the mission-oriented culture of the nonprofit community, which GAO summarized as follows: “because many nonprofits view cuts in clients served or services offered as unpalatable, they reported that they often compromise vital ‘back-office’ functions, which over time can affect their ability to meet their missions.”²⁴ The study concluded:

As the federal government increasingly relies on the nonprofit sector to provide services, it is important to better understand the implications of reported funding gaps, such as compromised quality of important administrative functions, including information technology, human resources, legal, and accounting operations [i.e., indirect costs].... [T]hese challenges potentially limit the sector’s ability to effectively partner with the federal government, can lead to nonprofits providing fewer or lower-quality federal services, and, over the long term, could risk the viability of the sector.²⁵

The GAO’s observations were supported by the Urban Institute’s landmark study on government-nonprofit contracting which, among other things, documented the effect that underpayment of actual costs has on the nonprofit human services sector. Sixty-eight percent of nonprofits (77 percent for larger nonprofits) in the study reported that the failure of governments to pay the full cost of a service was a problem, with the majority indicating that indirect cost reimbursement from government was limited to 10 percent or less. Additionally, 82 percent of nonprofits reported scaling back their operations, with most organizations resorting to two or more cutbacks. Half of organizations froze or reduced salaries, and 38 percent laid off employees.²⁶ In 2009, 42 percent of nonprofits reported ending the year with a deficit.²⁷

[T]he highest performing nonprofits spend more on administrative overhead than their less effective peers.²²

With governments scaling back through austerity measures and sequestration, the situation is getting worse, not better. In a 2013 Nonprofit Finance Fund (NFF) survey, only 17 percent of respondents reported that the federal government covers the full cost of the services they purchase.²⁸ Moreover, even fewer respondents (14 percent) reported that state and local government pay the full costs incurred by nonprofits. These data show that five out of six charitable nonprofits are being forced essentially to subsidize governments when they provide services to the public but are not reimbursed for their full actual costs.

A nonprofit leader summarized the challenge quite clearly:

The irony for the field as a whole is that a technique meant to control costs actually undermines efficiency and program quality. The inability of nonprofits to invest in more efficient management systems, higher skilled managers, training, and program development over time means that as promising programs grow, they are hollowed out, resulting in burned out staff, under-maintained buildings, out of date services, and many other symptoms of inadequately funded “overhead.”²⁹

Americans need a healthy nonprofit sector to provide a reliable social safety net and deliver a wide range of other services that are vital to the cultural, economic, spiritual, and environmental well-being of our citizenry and communities. Government also needs a healthy nonprofit sector. What the foregoing studies show is that governments continue to undermine their nonprofit partners by failing to adequately reimburse for legitimate indirect costs – thus putting the people served and governments at peril. Past efforts to keep indirect costs as low as possible are in reality reducing the effectiveness of the vital services on which so many Americans rely. Limiting a nonprofit’s effectiveness translates to an inability to achieve outcomes. With the growing emphasis on performance measurement and the shift by governments from purchasing services to investing in outcomes, it is important to recognize that nonprofits simply cannot produce desired outcomes without the basic resources needed to do so.

A WARNING: ONE SIZE DOES NOT FIT ALL

One single indirect rate will not apply in all circumstances. OMB found this to be true in 2012 when it received overwhelming opposition to a proposed flat rate for reimbursing indirect costs without the option to negotiate an individual rate. The complexities in setting indirect rates go well beyond organizational size, structure, and type of service. There are myriad other legitimate variables that must be considered which may differ from one organization to the next that can have a considerable influence on a nonprofit's indirect costs.

Studies that attempted to determine an “appropriate” or average indirect cost rate for charitable nonprofits found that nonprofits traditionally under-report indirect costs due to a lack of understanding about what is allowed to be included in their calculations, pressures from funders and charity watchdog groups, and postponing infrastructure improvements in an attempt to keep indirect costs artificially low. Attempts in the various studies to determine an average rate for indirect costs concluded that it cannot be done accurately because of the absence and availability of reliable data. Despite the many limitations in determining how much should be spent on indirect costs, multiple sources indicate a range of between 20 percent and 40 percent is appropriate, with a range of 25 percent to 35 percent as being most realistic.³⁰

This range is consistent with similar experiences in the for-profit sector. For its study, The Bridgespan Group reviewed the overhead costs of 24 for-profit industries to develop a comparable analysis. It found that for-profit overhead cost percentages averaged in the mid-twenties. Of critical importance to this discussion, Bridgespan determined that “for service industries, perhaps the best analog to the social sector, it'd be 34%.” Likewise, some governments recognize that they themselves have indirect cost rates that far exceed the artificial limits imposed on nonprofits. For instance, the California Department of Finance, when filing comments to the OMB guidance on indirect costs for nonprofits, stated that “California has no departments with an indirect cost rate of 10 percent or lower, with 81 percent of our departments having rates higher than 20 percent and 76 percent of those having rates higher than 30 percent.”³¹

The experience of federally-funded research is also informative. In 2010, a GAO study found that the 26 percent indirect cost rate established in 1991 for universities conducting research for government was not adequate in 83 percent of the institutions studied.³² After 1993, the 26 percent limitation was no longer imposed and could be negotiated higher to cover indirect costs. GAO determined that the average proposed rate was between 51.7 percent and 53.6 percent, with average negotiated rates between 49.1 percent and 51.6 percent – although rates as high as 75 percent are currently being paid. Nonprofit university indirect rates for instruction and other sponsored activities that were available for review could be considered fairly commensurate with the work of many community nonprofits. These approved negotiated rates tend to be in the 30 percent to 45 percent range.

From the foregoing, it is clear that there is not one indirect cost rate that applies to nonprofits generally; nor should there be one. The prevalent practice by governments of limiting reimbursement for indirect costs for human services nonprofits to between 0 and 10 percent is far below the well-recognized and documented actual costs incurred to provide services on behalf of government. Each charitable nonprofit is different, as is the nature of the work being performed on behalf of governments in unique communities across America. Policymakers should see paying the actual costs rather than an artificially low amount as being not only fair, but also an opportunity to enhance nonprofit efficiency and effectiveness through sound investment in the infrastructure and proper functioning of a valued partner.

SOLUTIONS

The shift in thinking about the important value of paying the actual costs of operations is beginning to occur not only with watchdog groups; it is happening within the federal government as well. The Proposed Guidance for Grant Reform³³ released for comment earlier this year by OMB includes significant changes that, if implemented, would start to address some of the systematic underfunding of nonprofits providing services on behalf of government. In the Proposed Guidance, OMB included a new requirement that pass-through entities receiving federal funds (most often state and local governments) pay indirect costs to their charitable nonprofit subawardees. The proposal, if adopted, offers three options. If a nonprofit already has an approved negotiated indirect cost rate with the federal government, pass-throughs would be required to use that rate. If a nonprofit does not yet have a negotiated rate with the federal government, then the pass-through entity is to negotiate a rate based on federal guidelines. In the interim, pass-throughs would be required to pay a minimum indirect cost rate to cover some of the nonprofit's costs, which can be done for up to four years. The National Council of Nonprofits submitted comments in support of the OMB proposal with proposed modifications, and the charitable nonprofit community is eagerly awaiting changes in federal reimbursement policy that will bring it more in line with the new informed thinking on indirect costs.³⁴

OMB guidance, while crucial, is only the first step toward ending the practice of nonprofits subsidizing the cost of services purchased by government. In the tradition of public and private parties coming together to solve problems in their communities, policymakers, government officials, and nonprofit contractors and grantees can work together on several other solutions to improve services and promote efficiency and effectiveness.³⁵ Here are only a few:

- **Provide and apply clear and consistent definitions of administrative costs, indirect costs, and overhead.** The terms administrative costs, indirect costs, and overhead are often used interchangeably and thus inconsistently. The inconsistent understanding and usage of these and other terms in OMB Circular A-122 and IRS Form 990 have contributed to the systematic underfunding of the work of charitable nonprofits, eroding their sustainability – which, as noted by the GAO, threatens government and the public.³⁶ Policymakers can significantly improve compliance and performance by clearly defining each term and codifying these definitions so they are consistent at the federal level and across states and localities.
- **Require federal, state, and local governments to reimburse nonprofits for indirect costs, regardless of whether the nonprofit is a prime or subrecipient, or from where funds originally emanate.** This solution may be in the beginning stages of being addressed with regard to federal funding streams through Proposed Guidance from OMB. However, if this Guidance is established, it will apply only to funds that originated with the federal government. States should adopt the same policy of officially recognizing the importance of paying indirect costs with regard to nonfederal funding sources.³⁷
- **Allow nonprofits the option of utilizing a reasonable standardized rate, a cost pooling system,³⁸ or a negotiated rate based on actual costs.** Government and nonprofits alike can benefit from eliminating the need for separate rate negotiations for each side that can be a very time consuming, cumbersome, and costly process. As demonstrated previously, a single rate cannot apply to every government-nonprofit contract; that is the reason that commenters roundly rejected an early proposal by OMB to set one flat fixed rate for all nonprofits. Yet governments and nonprofits are in the business of providing services to the public in cost-effective ways – not spending limited resources engaged in extensive and endless negotiations on each individual contract and grant. Negotiating separate indirect cost rates would divert limited resources of governments and nonprofits from program to process. Instead, a better approach is needed to replace the prevalent arbitrarily low rate that has proven to erode sustainability with a rate that keeps organizations sustainable while protecting

taxpayers from having to incur negotiation expenses every time that a contract or grant is issued. The cost-effective middle alternative is for governments to set a reasonable minimum flat rate that is high enough to cover actual costs in most instances, while permitting nonprofits the option of negotiating a different rate when the nonprofit recognizes that the proposed flat rate will be inadequate.

- **Standardize grant and contract language so that all are consistent with A-110, A-122 (or unified OMB Circulars), and GAAP.** In addition to creating consistency in the definitions used in grants and contracts, attention must also be devoted to standardizing what can and cannot be included within allowable costs across all agreements, rather than being established separately through each funding opportunity or agency. These actions will eliminate costs associated with preparing separate reports according to multiple sets of guidelines, enhance transparency, and promote greater compliance.
- **Stop legislatively mandating artificially low limitations on indirect costs per funding stream.** Some reimbursement rates are the result of statutory dictates by legislatures inserting arbitrary caps or other restrictions when creating a new program or designating a funding stream. The establishment of consistent and standardized contract and grant language and policies should include full reimbursement of indirect costs. Legislatures should resist the urge to impose arbitrary caps on indirect cost reimbursements for short-term savings that override policies designed to promote long-term sustainability of nonprofit partners that can achieve better outcomes for the public.

CONCLUSION

Conventional wisdom on nonprofit indirect costs is beginning to reach alignment with what governments and for-profit businesses have known all along, that continually spending **less** on indirect costs erodes efficiency and effectiveness, preventing organizations from producing better and lasting outcomes. Charitable watchdog groups are only the most recent parties to recognize what researchers have been documenting for years: that contracts and grants that fail to cover indirect costs actually reduce a charitable nonprofit's effectiveness and efficiency. Applied to government contracts and grants, this fresh wisdom of paying actual costs – both direct and indirect – can ensure stronger, more sustainable nonprofit service providers that reduce the cost of government while promoting better outcomes and greater return on taxpayer investment. It is crucial for governments to recognize the strain that the past practice of under-funding indirect costs has imposed on the nonprofit community and the related negative impact it is having on the ability of nonprofits to achieve outcomes. The federal government is taking the lead in promoting adequate funding of legitimate costs of performing under grants and contracts; states and municipalities have the opportunity to upgrade their contracting policies and procedures to capitalize on the new conventional wisdom.

END NOTES

¹ Elizabeth T. Boris, Erwin de Leon, Katie Roeger, Milena Nikolova, *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants* (Urban Institute Center on Nonprofits and Philanthropy) (2010).

<http://www.govtcontracting.org/sites/default/files/State%20Profiles.pdf>

² National Council of Nonprofits, *Costs, Complexification and Crisis: Government's Human Services Contracting "System" Hurts Everyone* (2010).

<http://www.govtcontracting.org/sites/default/files/Costs%20Complexification%20and%20Crisis.pdf>

³ The Center on Nonprofits and Philanthropy, Urban Institute and the Center on Philanthropy, Indiana University, "Getting What We Pay For: Low Overhead Limits Nonprofit Effectiveness" (August 2004) (herein "Nonprofit Overhead Cost Project Report"), p.4.

http://www.philanthropy.iupui.edu/files/research/nonprofit_overhead_brief_3.pdf

⁴ Overhead Myth Website by Better Business Bureau Wise Giving Alliance, Charity Navigator, and Guidestar (2013).

<http://overheadmyth.com/>

⁵ See also the groundbreaking work in Illinois by Donors Forum, which in 2012 established the Real Talk about Real Costs campaign to create a community of practice through which nonprofits and funders could learn, discuss, and identify solutions to the long-standing problem of underfunding indirect costs. While the group has focused on Illinois, its work is expected to have a ripple effect so that these conversations are held in communities throughout the country.

<http://donorsforum.typepad.com/realcosts/>

⁶ See, e.g., Giving Evidence, "Good charities spend more on administration than less good charities: Ground-breaking analysis by Giving Evidence disproves the popular idea that charities should spend less on administration" (May 2013).

<http://giving-evidence.com/2013/05/02/admin-data/>

⁷ GAO, "Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices" (May 2010).

<http://www.gao.gov/new.items/d10477.pdf>

⁸ Proposed OMB Uniform Guidance: Cost Principles, Audit, and Administrative Requirements for Federal Awards (February 2, 2013) ("The principles are designed to provide that Federal awards bear their fair share of cost recognized under these principles except where restricted or prohibited by law").

<http://www.regulations.gov/#!documentDetail;D=OMB-2013-0001-0002>

⁹ The focus of this report is on the specific services required under contracts and grants and does not presume that governments should be paying the costs for additional services – not specified in the contract or grant – that nonprofits provide to enhance the health, education, and wellbeing of the people they serve.

¹⁰ See, e.g., Urban Institute Center on Nonprofits and Philanthropy, "National Study of Nonprofit-Government Contracting State Profiles" (October 2010; <http://www.govtcontracting.org/sites/default/files/Full%20Report.pdf>). Results of a second national study scheduled for publication in December 2013.

¹¹ OMB Circular A-122, at General Principles C.2, expressly acknowledges the difficulty in applying these definitions relating to indirect costs: "Because of the diverse characteristics and accounting practices of non-profit organizations, it is not possible to specify the types of cost which may be classified as indirect cost in all situations."

¹² The IRS Form 990 allows management and administration for a specific program to be included within the Program Services category as a direct cost. Currently, OMB treats these items as indirect costs. The federal government's different treatment of fundraising costs is another telling example. The time and expenses associated with completing federal grant application and reporting requirements are typically treated as indirect costs under Circular A-122 as performing the services required by the grant. For purposes of the Form 990, however, grant and contract application costs are treated as fundraising costs, while the expense of reporting on grants and contracts are Program Service costs. This matters to charitable nonprofits because watchdog groups and donors may incorrectly presume that an organization is spending "too much" on fundraising costs when the nonprofit is actually complying with conflicting federal policies.

¹³ See, e.g., Letter to the Donors of America.

<http://overheadmyth.com/letter-to-the-donors-of-america/>

¹⁴ See, e.g., Nonprofit Finance Fund, 2013 State of the Sector Survey.

<http://survey.nonprofitfinancefund.org/2013/#respondents,demand,actions,engagement,finhealth/>

¹⁵ GAO, “Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices” (May 2010) page 11 (emphasis added).

<http://www.gao.gov/new.items/d10477.pdf>

¹⁶ See, e.g., Charity Navigator Financial Range Tables, which define “administrative expenses” this way: “Percent of total functional expenses spent on management/general (lower is better).”

http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48#.UjyAui3D_5p

¹⁷ Ann Silverberg Williamson, Louisiana Association of Nonprofit Organizations, “Fifteen Percent Overhead: Nonprofit Transparency or Snare?” (December 2011).

<http://www.lano.org/blogpost/755806/135414/Fifteen-Percent-Overhead-Nonprofit-Transparency-or-Snare>

¹⁸ New York Executive Order 38 (2012).

<http://www.governor.ny.gov/executiveorder/38>

¹⁹ Jesse D. Lecy and Elizabeth A. M. Searing, “Anatomy of the Nonprofit Starvation Cycle” (ARNOVA Conference November 2012).

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2170740

²⁰ *Id.* 3

²¹ William Bedsworth, Ann Goggins Gregory, Don Howard, “Nonprofit Overhead Costs: Breaking the Vicious Cycle of Misleading Reporting, Unrealistic Expectations, and Pressure to Conform” (The Bridgespan Group, April 2008 (herein “Bridgespan Report”).

<http://www.bridgespan.org/getattachment/93a03c17-154b-4cea-b7e7-5020f1c1ffec/Nonprofit-Overhead-Costs-Break-the-Vicious-Cycle.aspx>

²² Giving Evidence, “Good charities spend more on administration than less good charities: Ground-breaking analysis by Giving Evidence disproves the popular idea that charities should spend less on administration” (May 2013).

<http://giving-evidence.com/2013/05/02/admin-data/>

²³ GAO, “Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices” (May 2010).

<http://www.gao.gov/new.items/d10477.pdf>

²⁴ *Id.*, at “What GAO Found.”

²⁵ *Id.*, at p. 22.

²⁶ Urban Institute Center on Nonprofits and Philanthropy, “Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracts and Grants” (October 2010).

<http://www.govtcontracting.org/sites/default/files/Full%20Report.pdf>

²⁷ Urban Institute Center on Nonprofits and Philanthropy, “National Study of Nonprofit-Government Contracting State Profiles” (October 2010).

<http://www.govtcontracting.org/sites/default/files/State%20Profiles.pdf>

²⁸ Nonprofit Finance Fund, 2013 State of the Sector Survey.

²⁹ Clara Miller, “The Looking-Glass World of Nonprofit Money: Managing in For-Profits’ Shadow Universe,” *Nonprofit Quarterly* (Spring 2005).

<http://nonprofitfinancefund.org/files/docs/2010/NPQSpring05.pdf>

³⁰ In 2001, an analysis of 160,000 nonprofit tax filings (IRS Form 990s) conducted by the Urban Institute and Indiana University's Center on Philanthropy identified a combined overhead cost of 33 percent, based on average administrative costs of 17 percent and general expenses of 16 percent. (T. Pollack, P. Rooney, and M. Hager, "Understanding Management and General Expenses in Nonprofits," Urban Institute Center on Nonprofits and Philanthropy and Indiana University Center on Philanthropy, 2001), pp. 24-29.) In 2008 The Bridgespan Group studied four nonprofits intensely and found that while the nonprofits initially reported indirect costs of between 13 and 22 percent, Bridgespan determined that their actual indirect costs were between 17 and 35 percent (and that the nonprofit with the lowest revised indirect rate of 17 percent indicated that it was still under-spending on needed administration and infrastructure). (Bridgespan Group Report, "Nonprofit Overhead Costs: Breaking the Vicious Cycle of Misleading Reporting, Unrealistic Expectations, and Pressure to Conform," (April 2008) at p. 9. <http://www.bridgespan.org/getattachment/93a03c17-154b-4cea-b7e7-5020f1c1ffec/Nonprofit-Overhead-Costs-Break-the-Vicious-Cycle.aspx>). Further, Charity Navigator (a charity watchdog group) determined that "7 out of 10 charities we've evaluated spend at least 75% of their budget on the programs and services they exist to provide. And 9 out of 10 spend at least 65%." (Charity Navigator <http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48>). This suggests a rate of 25 percent to 35 percent is relatively common and appropriate. Likewise, Serious Givers.Org, an organization that provides donors with independent information about nonprofits, advises that a closer look should be given to organizations spending less than 20 percent on overhead because this may reflect limited capacity and the ability to operate efficiently. (SeriousGivers.Org Website, <http://seriousgivers.org/find-a-charity/charity-data-faqs/#spendingprograms>.) Finally, The U.S. Department of Agriculture publishes a chart identifying indirect cost rates for NIFA grants which on average identified rates not to exceed 30 percent. (USDA Website, http://www.csrees.usda.gov/business/awards/indirect_cost.html.)

³¹ Larry Satter, Chief Fiscal Systems and Consulting Unit, State of California, Reform of Federal Policies Relating to Grants and Cooperative Agreements: Cost Principles and Administrative Requirements Comments (May 2013). <http://www.regulations.gov/#!documentDetail;D=OMB-2013-0001-0104>

³² GAO, "Indirect Cost Rate Reimbursements Treat Schools Unequally" (September 2010). <http://www.gao.gov/assets/310/309236.pdf>

³³ Proposed OMB Uniform Guidance: Cost Principles, Audit, and Administrative Requirements for Federal Awards, February 2, 2013. <http://www.regulations.gov/#!documentDetail;D=OMB-2013-0001-0002>

³⁴ National Council of Nonprofits, Comments on OMB's Proposed Guidance (June 2013). <http://www.councilofnonprofits.org/files/National-Council-of-Nonprofits-Comments-on-OMB-Proposed-Guidance-6-2-2013.pdf>

³⁵ "Partnering for Impact: Government-Nonprofit Contracting Reform Task Forces Produce Results for Taxpayers," National Council of Nonprofits, April 2013. <http://www.councilofnonprofits.org/files/streamlining-report-partnering-for-impact.pdf>

³⁶ GAO Indirect Costs Report at "What GAO Found": "inconsistencies in the use and meaning of the terms indirect and administrative, and their relationship to each other, has made it difficult for state and local governments and nonprofits to classify costs consistently. ... This increases the challenges of administering federal grants and, in some cases, makes it difficult for recipients to determine those activities eligible for indirect cost reimbursement under a particular federal grant and those that are not."

³⁷ When governments fail to pay for the full cost of services, nonprofits must solicit donations from private funders to make up the difference – or in other words, to subsidize government. This obvious need to raise gap funding for what government fails to pay becomes a real cost of performing services under the contract with government. In all fairness, these fundraising costs should be treated as an allowable indirect cost.

³⁸ Some governmental entities currently reimburse nonprofits for their indirect costs on a monthly basis following a process known as "cost pooling." Under this approach, an indirect cost rate (as a percentage) is determined for each separate indirect cost pool developed. The various indirect cost pools are then classified within two broad categories: "Facilities" and "Administration."

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