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NONPROFITS: FINANCE

Progress on Raising "Indirect Costs" Reimbursement

11.18.22 | Linda J. Rosenthal, JD

Earlier this month, while the collective attention of most of us was laser-focused on the improbable match up in the World Series and the nail-biting midterm elections, the Ford Foundation made a low-key announcement of a policy change for its grants in 2023.

The philanthropy giant is raising "its minimum cost rate."

This is an incremental move from 20% to 25% "or to an even higher rate, under certain circumstances." Not exactly an "oh wow" moment for the nonprofit sector; nevertheless, it's newsworthy.

It's about the chronic struggle of nonprofit organizations to survive financially.

It's the latest step on the road to destroying the "Nonprofit Starvation Cycle"; another silver dagger plunged deep in the heart of the "Overhead Myth."

And "[w]hen Ford does things, people pay attention."

Setting the Stage

In *Increasing our indirect cost commitment* (November 2, 2022), Ford's Executive Vice President of Programs, Hilary Pennington, lays out the problem: "[F]or too many grantees," she explains, "indirect costs like utilities and legal assistance are barriers to ensuring the longevity of their work. For many years, funders have largely overlooked indirect costs, perpetuating what's been dubbed the nonprofit starvation cycle."

She adds: "This cycle centers grantmaking around the allure of new projects without allocating support for basic necessities—in other words, not allowing for vital funds our grantees need to ensure their long-term financial security."

This destructive mindset arises also from a related and widely held misconception called "the Overhead Myth: namely, "that low overheads in non-profits is a sign of efficiency." So funders adopt project-restricted funding policies. Grantees don't ask for unrestricted funds or specifically for indirect costs "in fear of being seen as inefficient. In the end, funders do not understand the needs of grantees and grantees do not have funding to support their infrastructure."

"The term 'nonprofit starvation cycle' describes the experience of many nonprofit organizations that struggle financially because most of their funding comes from project grants with strict limits on paying for indirect costs (or overhead). The cycle has plagued the sector for decades."

Catching Up

In *Smashing the Overhead Myth: A Step Forward* (October 24, 2019), we reviewed to that date the surprisingly brief history of this bold move away from archaic and unproductive grantmaking practices.

It began in 2009 with the groundbreaking article, *The Nonprofit Starvation Cycle,* published by three Bridgespan scholars in the *Stanford Social Innovation Review*. Their premise: It takes money to achieve charitable purposes; nonprofits must spend enough in overhead to avert being in constant financial straits.

In 2013, activist Dan Pallotta picked up this theme, railing against the demonization of overhead in a famous TED talk. Then came the posting by the editors of *The Nonprofit Quarterly* of a landmark letter from GuideStar, Charity Navigator, and the Wise Giving Alliance. In *The Overhead Myth* (June 17, 2013), they called for an end to the obsession many have had with nonprofit overhead costs as a proxy for measuring effectiveness…." These ratings organizations explained that "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" and that more attention should be paid "to other factors of nonprofit performance: transparency, governance, leadership, and results."

It was in September of 2019 when the heads of five of major U.S. foundations – Ford, Hewlett, MacArthur, Open Society, and Packard – revealed publicly for the first time that they had been meeting secretly since about 2016 to brainstorm ways to change the status quo. See *Five CEOs of Wealthy Foundations Pledge to Do More to Help Charities Pay Overhead* (September 4, 2019) Maria Di Mento, *The Chronicle of Philanthropy.*

That's where we concluded our October 2019 discussion about smashing the overhead myth, intending to pick up the thread as warranted. Of course, the pandemic swept the world just a few months later.

Notably, the global emergency created an independently compelling impetus for foundations to voluntarily modify their grantmaking policies and practices – at least temporarily. These accommodations included a variety of innovations long-sought by nonprofit organizations, including but not limited to providing more general operating funds.

The jury is still out on the extent to which the nation's funders intend to continue these policy changes.

Consortium Continues Progress

Largely behind the scenes, and concurrent with the nation's funders making significant COVID-19 (at least short-term) modifications to the pre-pandemic grantmaking norms, there has been considerable progress building on the groundwork laid by those five major foundations.

They "commissioned research from The Bridgespan Group which led them to conclude in 2018 that 'the starvation cycle' is real and that their foundations were contributing actors."

When they made the public announcement in September 2019 of their previously secret deliberations, they had already invited other major foundation leaders to join in this critical conversation. The core group expanded: From 2019-2021, a new "collaborative of 40+ staff from 12 private philanthropic institutions" with a new name, Funders for Real Cost, Real Change (FRC) "explored ways to improve indirect cost recovery in project grants." The seven new members are: Arnold Ventures, Conrad N. Hilton Foundation, James Irvine Foundation, Oak Foundation, Robert Wood Johnson Foundation, Rockefeller Foundation, and W.K. Kellogg Foundation.

FRC "was facilitated" by consulting firm BDO FMA. See website.

The collaborative focused on "several key tasks:

- Developing a straightforward set of guidelines and a tool to help nonprofits calculate an organization-level indirect cost rate that can be discussed with funders.
- Commissioning research to understand the effects of the starvation cycle on NGOs outside the U.S.
- Considering a range of options for structuring project grants to support organizational health, beyond the typical approach which requires nonprofits to create line-item project budgets and limits amounts allowed for 'overhead'."

Research Published

"After two and a half COVID-interrupted years," there is now an impressive body of research and reports, including:

- *Project Grants Need Not Be the Enemy—A Three-Part Series: A Funder Collaborative Tackles the Nonprofit Starvation Cycle* (February 15, 2022) Rodney Christopher, John Summers & Katrina Bandong, *The Chronicle of Philanthropy*
    - *Part One* (February 2022): A synopsis of "… the group's work and lessons about the importance of equity"; see also February 2021 post by the first author on the *Center for Effective Philanthropy Blog*
    - *Part Two* (March 2022): An introduction to "…results of a new research report from Humentum commissioned by FRC. It focuses on the impact of funders' indirect cost recovery practices on international NGOs in ten countries across five regions of the globe. Humentum Report Link (February 2022)

- *Part Three* (April 2022) A description of "… four grantmaking approaches explored by FRC for project grants that cover true costs and support healthy, resilient and innovative organizations"

Key Finding

"One of the most compelling research findings of this consortium was that they had underestimated the amounts that nonprofits generally pay for so-called overhead."

"It is common for private and government funders to limit overhead spending to 10-15 percent. But in 2019, when" research was conducted for the MacArthur Foundation, "we found that the average indirect cost rate (as reported on IRS Form 990s) of the financially healthiest quartile of more than 130,000 nonprofits is 29 percent."

That finding spurred action. For a start, MacArthur raised its "allowable indirect cost rate on project grants from 15 percent to 29 percent" as of January 1, 2020. Then, on July 1, 2020, the Robert Wood Johnson Foundation similarly increased its "indirect cost rate"; in this case from 12 percent to 20 percent.

According to Ford's Hilary Pennington, the Ford Foundation's recent move upping the rate from "20% to 25% – or sometimes higher" should permit Ford to "fully cover indirect costs on the vast majority" of its project grants. That will ensure their "grantees have the flexibility and support to cover the true cost of their work."

Conclusion

"The consortium," says Ms. Pennington, is "committed to ending the nonprofit starvation cycle" and has "worked collaboratively to unlock general support resources and move the sector toward a pay-what-it-takes model that reflects the true expenses needed to advance nonprofit organizations' work."

They "urge other leaders to join" them "in the years ahead."

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