Two-Legged Stool: New Findings from California on Nonprofits and Overhead

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Nonprofit overhead is a prevalent and controversial topic in the nonprofit and philanthropic sector. Online raters (such as Charity Navigator) point to the overhead rate as a key indicator of nonprofit worthiness. Different government entities use wildly different indirect cost rates when contracting with nonprofits, which translate into billions of dollars of funding being gained or lost. Foundations rarely have explicit guidelines, but most have informal rules of thumb that affect how a nonprofit can use grant funds. Meanwhile, nonprofit executives struggle to make sense of it all as they manage their operations amidst the conflicting requirements of their funding sources.

To gain insights into how overhead costs are handled in nonprofits, the California Association of Nonprofits (CalNonprofits) conducted a survey of 451 California nonprofit executives, as well as interviews with elected members of county boards of supervisors and their staff throughout California in the spring of 2016.[1] This paper reports on both of these, yet notes that they were part of a larger initiative of CalNonprofits called *The Nonprofit Overhead Project,* which also included:

- Interviews with Los Angeles County contract managers and finance managers of nonprofits who had contracts with the County of Los Angeles
- Survey of 800 randomly selected individual donors who made mid-level donations (between $200 and $1,000)
- Focus groups with mid-level donors in Los Angeles and San Francisco

The survey of California nonprofit executives explored:

- Experiences with government indirect cost rates and the new Office of Management and Budget (OMB) Uniform Guidance[2]
- Experiences with overhead in foundation grants
- How overhead and indirect costs are discussed with funders
- How indirect cost rates or overhead rates influence management decisions

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[1] Lake Research Partners conducted interviews with nine members of six county boards of supervisors (California counties are governed by elected boards of supervisors) in the counties of Alameda, Contra Costa, Fresno, Los Angeles, Riverside, and San Francisco.

[2] Office of Management and Budget, a federal agency, issued the Uniform Guidance, which became effective December 26, 2015.

Overall findings

Nonprofits are managing, but with difficulty. With inadequate funding of core operating costs, nonprofits are sitting on a two-legged stool, having to work with diminished capacity in staffing, financial management, insurance, facilities, technology, and other necessities that are needed by the entire organization and its beneficiaries.

This research confirmed that nonprofit executives implement strategies for managing the pressure to keep overhead low, and some of these strategies negatively affect their organizations and work. The most common ways that funding constraints on overhead negatively influenced decisions were in staffing, program quality and expansion, and use of reserves. Ironically, the drive to keep overhead low -- presumably to keep money in programs -- results in diminishment of both quantity and quality of programs and services.

A tangled knot of definitions and understandings

One objective of this survey was to better understand what overhead or indirect cost rates are acceptable by government, foundations, and private funders.

What clearly emerged was that nonprofit executives reported such dramatically different definitions and calculation methodologies that "rates" became problematic to analyze. In fact, the degree of confusion was itself a major finding.

For example, Foundation A may view all personnel costs as overhead, while Foundation B identifies some staff as direct program costs and other staff as overhead, while Foundation C funds direct wages but views all fringe benefits as overhead. In this example, all three foundations might say they are funding a 10% overhead rate, but actually they are funding very different percentages of the program's costs.

> *"Some foundations think we have a low overhead rate because we direct cost everything for them."* [3]

At first it might appear that government funding criteria are more clear because there are specific definitions and allowable methodologies for calculating indirect costs in contracts and grants.[4] With a look at the details, one can see that indirect costs in one contract were calculated as a percentage of direct allowable salaries, while another as a percentage of direct allowable personnel costs and a third as a percentage of total direct costs. However, the experienced reality is that these rules are interpreted differently by different government agencies. In addition, formal and informal policies frequently override rules, and different government agencies simply allow for different indirect cost rates.

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[3] Verbatim quotations from survey respondents are presented in italics throughout this paper.
[4] Despite significant technical and regulatory differences between federal contracts and federal grants, nonprofits experience them similarly and typically do not distinguish between them in discussions.

"We charge all govt contracts 8% indirect, but we charge rent, insurance, accounting "above the line" as direct costs."

"I am the rope in the tug-of-war [between] what grantors want to see on financials and how our accountant sees classing of expenses."

The complexity created by multiple definitions and allocation methods can result in funders not understanding what they are paying for, and/or the consequences of their funding restrictions.

"If there is a line item for overhead, then monies are taken away from project/program delivery because there is usually a ceiling on monies awarded. Unfortunately, it's just a "shell-game."

Trying to get all types of funders, regulators, nonprofits and individual donors to agree on definitions is probably an unattainable goal. But in the meantime, all findings about nonprofit overhead -- including those from this survey -- need to be strongly qualified with the understanding that people are using the same words to describe very different things.

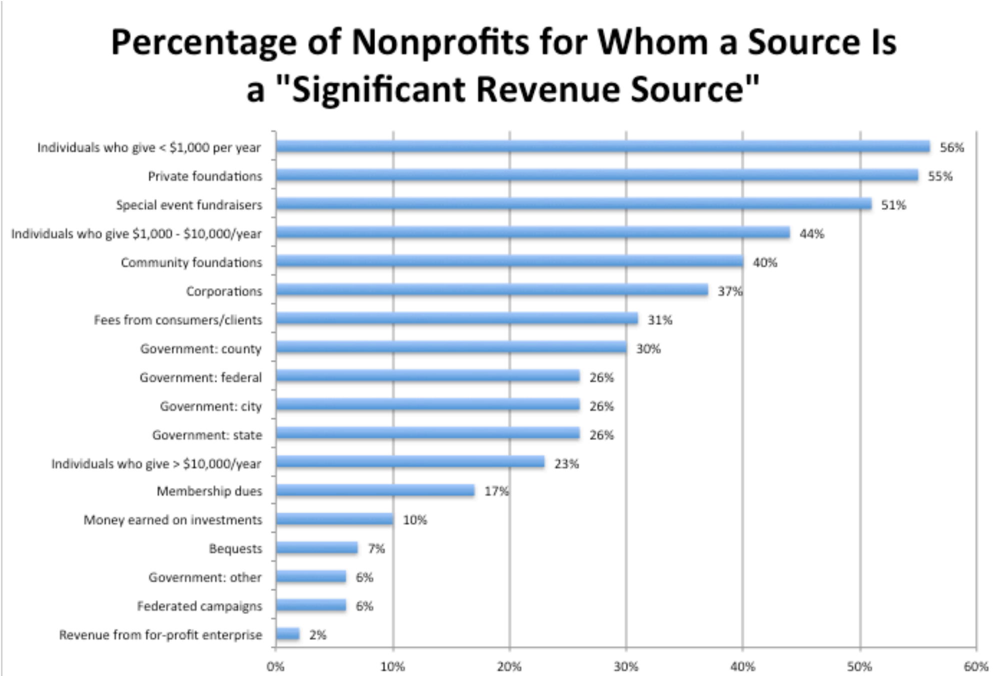
Multiple funders, multiple cost systems

A high percentage of nonprofits obtain funding from multiple types of sources, requiring them to track and report costs very differently to different types of funders. Figure 1 shows what types of funding nonprofits report as a "significant revenue source" for them. Of particular note for this paper:

- 55% of respondents receive significant funding from private foundations
- 40% receive significant funding from community foundations
- 30% receive significant funding from county government
- 26% receive significant funding from the following: city government, state government, and federal government

In short, most nonprofits are highly affected by indirect cost rate parameters from multiple institutional funders.

Figure 1. Nonprofit Revenue Sources



Many government contracts also take the form of fee-for-service contracts. Typically a per-unit cost is calculated based on direct costs and some amount of indirect costs resulting, for example, in a rate such as $3.40 per meal delivered to a senior. Fee-for-service contracts were not explored in depth in this study, although many respondents commented that fee-for-service rates may at one time have included some funding for overhead, but with rates often staying in place for five or ten years, they quickly fall well below the actual costs.

Government funding and indirect cost rates

Government funding continues to be important to nonprofits in California. More than one-half (55%) reported receiving funding from at least one level of government, and 15% of those received funding from two or more levels of government. The median number of government contracts was three.

Respondents were asked to report on their last two contracts in each category, and a total of 670 contracts were reported as below in Figure 2.

Federal contracts were most likely to be below $300,000 in size, with 45% of federal contracts that size having indirect rates most frequently in the 10% - 15.9% range, although another 42% had indirect rates of below 10%.

State contracts followed a similar pattern, with 92 of 149 state contracts at below $300,000, and of those 42% had indirect rates between 10% and 15.9%, with 46% having indirect rates below 10%.

County contracts were the most frequently reported, again mostly below $300,000. Of these, 45% of contracts had indirect rates below 10%, with 40% of contracts having rates between 10% and 15.9%.

City contracts were mostly below $300,000, with 50% of contracts having rates below 10%, and 39% of contracts with rates between 10% and 15.9%.

Figure 2. Size and Indirect Rates of Government Contracts

Federal contracts	<3%	3.0% - 9.9%	10.0% - 15.9%	16.0% - 29.9%	30.0% +	
< $300K	24	23	50	13	2	112
$300K - 999K	7	7	15	4	0	33
$1 mil - 4.9 mi	4	6	8	5	0	23
$5 mil +	0	2	0	2	0	4
						172

State contracts	<3%	3.0% - 9.9%	10.0% - 15.9%	16.0% - 29.9%	30.0% +	
< $300K	25	17	39	8	3	92
$300K - 999K	8	9	10	4	0	31
$1 mil - 4.9 mi	3	6	10	1	0	20
$5 mil +	2	0	1	0	0	3
						146

County contracts	<3%	3.0% - 9.9%	10.0% - 15.9%	16.0% - 29.9%	30.0% +	
< $300K	37	26	56	15	6	140
$300K - 999K	7	11	18	4	0	40
$1 mil - 4.9 mi	1	6	10	5	0	22
$5 mil +	0	0	2	2	0	4
						206

City contracts	<3%	3.0% - 9.9%	10.0% - 15.9%	12	30.0% +	
< $300K	45	18	50	12	2	127
$300K - 999K	2	2	10	0	0	14
$1 mil - 4.9 mi	0	2	2	0	0	4
$5 mil +	0	0	1	0	0	1
						146
						670

It was clear from many respondents' comments that working with multiple government contracts is itself a significant challenge.

Moreover, roughly three-quarters (78%) of respondents conveyed that government contracts typically do not cover the full costs of their programs.

"The issue that impacts us most is they fail to keep up with rising expenses."

"Because of the 2.5% limit on overhead costs by [federal funder], we're forced to operate under two fiscal systems."

The new OMB Uniform Guidance mandates that all contracts with nonprofits that contain federal funding -- including contracts that state and local governments make with nonprofits using federal pass-through funds -- honor the nonprofit's Negotiated Indirect Cost Rate (NICR) if the nonprofit has one. An NICR allows a nonprofit to charge indirect costs at the rate agreed upon in a negotiation with a federal agency.

Because NICRs are typically substantially higher than rates determined at state and county levels, having an NICR has become increasingly beneficial to nonprofits under the new Uniform Guidance.

However, as can be seen in Figure 3, only a small percentage of nonprofits have a federal NICR (8%) or are in the process of obtaining one (2%), and almost two-third (63%) do not plan on obtaining one. Such nonprofits typically cannot obtain a NICR because they receive federal funds through pass-through governments, not directly from the federal government. Of those with a NICR, the rates ranged from a low of 2.5% to a high of 75%, with a mean of 13%.

Figure 3. Prevalence of Federal Negotiated Indirect Cost Rate

If you have government grants or contracts, do you have a federal Negotiated Indirect Cost Rate (NICR)?
N=381 (84% responded)

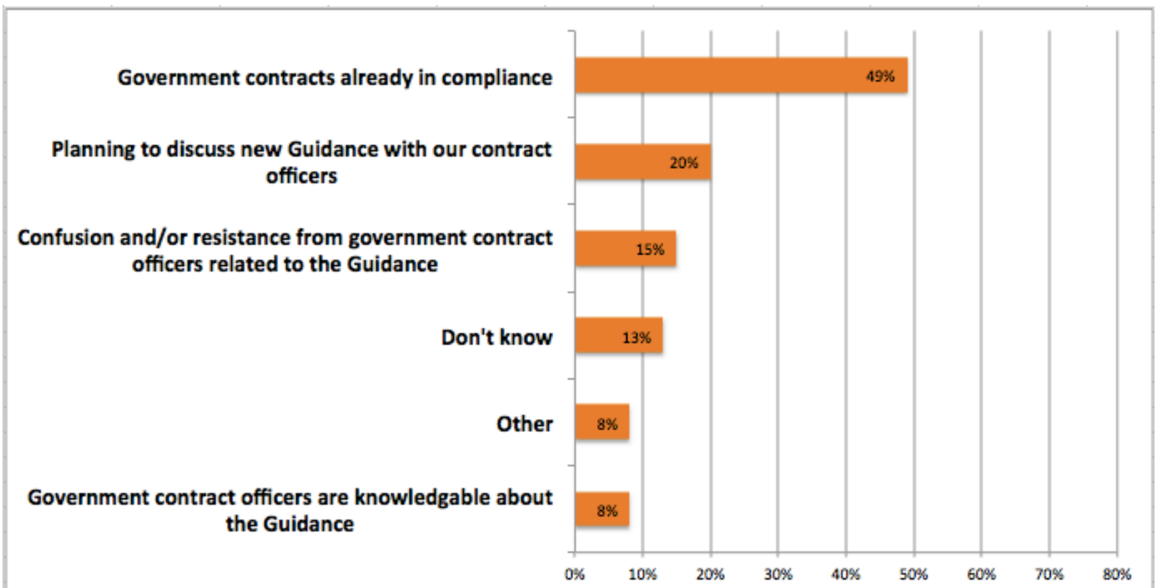
	N	%
We do not have a NICR and are not planning to obtain one	239	63%
I don't know	59	15%
We are thinking about obtaining a NICR	45	15%
We have a federal Negotiated Indirect Cost Rate	31	8%
We are in the process of obtaining a NICR	7	2%

The Uniform Guidance recognized the inability of many nonprofits to obtain NICRs, and allows for other rates, also mandating that all agreements utilizing federal funds permit nonprofits to be reimbursed for indirect costs as a minimum of 10% of Modified Total Direct Costs. As a result, contracts in compliance with the Uniform Guidance generally have no less than 10% indirect cost rates.

When asked how they are experiencing the impact of the new OMB Uniform Guidance related to indirect cost recovery in contracts with governments, nearly one-half (49%) of respondents reported their contracts were already in compliance, and another 20% said they were planning to discuss the Guidance with their contract officers. However, another 15% reported there is confusion and/or resistance from government contract officers and only 8% said that their contract officers are knowledgeable about the Guidance (see Figure 4).

> *"Local government says they never heard of such a thing."*
>
> *"Stipends paid to volunteers are excluded [from indirect cost rates]; 75% of the expenses in the contract are required to be spent on stipends."*

Figure 4. Compliance with OMB Uniform Guidance



Pressure to keep reported overhead rates low

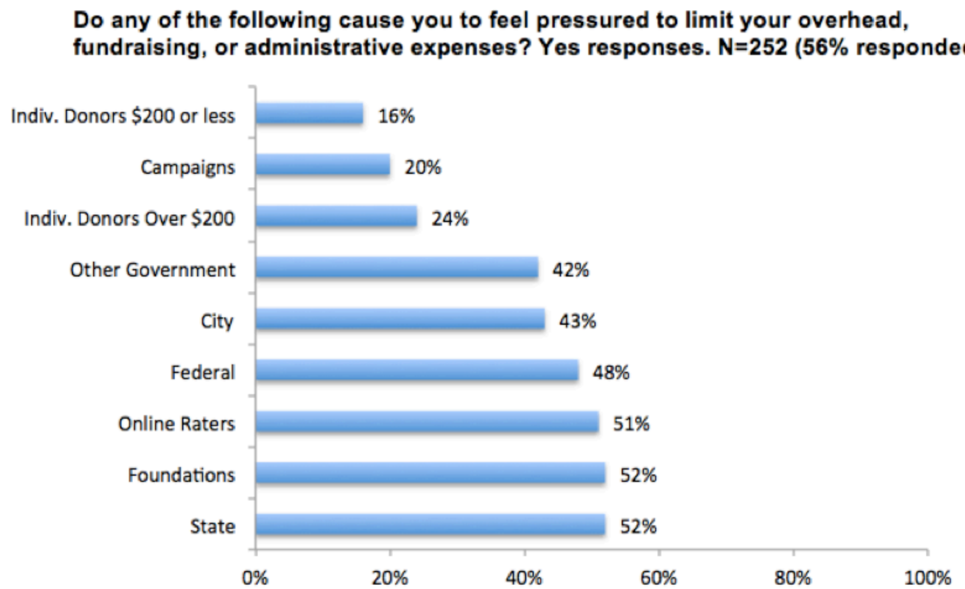
Figure 5 shows that at least one-half of respondents -- for whom a source was relevant -- indicated they feel pressure from their funding sources to keep their reported overhead rates low. These findings correspond with what the Bridgespan Group[5] described as a "vicious cycle" where funders reward low overhead rates, which pressures nonprofits to spend less on necessary overhead *and* report low (and sometimes misleading) overhead rates. In turn, such artificially low overhead rates result in funders expecting and demanding even lower rates.

Without knowing whether funders and raters intentionally exert pressure on nonprofits in terms of overhead rates, the point is that nonprofit managers clearly *feel* pressured.

> *"Donors think they will force efficiency by limiting overhead, but ultimately it is ultimately less efficient for the organization to implement/track/monitor that kind of grant. Foundations efforts to 'limit overhead' actually end up increasing overhead."*

5 Bedsworth, William, Gregory, Ann Goggins, and Howard, Don, "Nonprofit Overhead Costs: Breaking the Vicious Cycle of Misleading Reporting, Unrealistic Expectations, and Pressure to Conform." The Bridgespan Group: https://www.bridgespan.org/insights/library/pay-what-it-takes/nonprofit-overhead-costs-break-the-vicious-cycle

Figure 5. Sources of Pressure to Keep Overhead Low



Making ends meet: compensating strategies

More than three-quarters (78%) of respondents said that government funding doesn't pay for the full costs of programs:

> *"The contracts all require matching funding and none covers all administrative costs"*

> *"Some do [pay the full costs]. Some don't. It depends on the agency within the government."*

When asked how they compensate for the gap between the actual costs of a program and the allocated funding, nonprofits manage by using multiple simultaneous strategies. In some cases (and in varying degrees) these strategies include leveraging resources from outside the organization. But perhaps more telling are the strategies they use that are likely to be unsustainable over a longer period, such as under-staffing, under-investing in technology, and using monies from prior years. The main ways nonprofits compensate are summarized in the section below.

- <u>Raising funds</u>
  - From individuals 76%
  - From foundations 61%

> *"It's always a struggle to fund our overhead. We have attempted online fundraising campaigns this year with limited success."*

- Under-staffing

Keeping salaries and benefits low	54%
Adding responsibilities to existing staff	50%

"More reporting and compliance requires more management salaries and expense, which reduces the amount of money that actually touches the client."

"We have had to keep wages down in order to pay for accounting and payroll cost, as well as rent."

- Internal resources

Using monies from prior years	31%
Using profits from earned-income programs	28%

"Most recently we decided to go into reserves to cover overhead - and have had to remain understaffed administratively."

- Under-investment

Under-investing in technology	31%
Under-investing in physical infrastructure	27%

"We need new kitchen and office equipment, improvements needed in facilities etc.. [but] we don't have enough undesignated funding to pay for them."

In addition, many respondents commented that while low overhead rates may not result in cutting services, such rates prevent them from expanding services. For example, a nonprofit may be able to raise $100,000 to cover the gap in a government-funded program, but they may have to turn down the government's request to double the program because they don't think they can raise $200,000.

"We were about to turn down a corporate contract -- which is for a great program that will benefit the community immensely! -- because they offer only a 5% indirect rate. However, we will probably take the contract and then be forced to collect proportionately more overhead from funders with less robust reporting requirements."

"We are currently deciding whether or not we can afford another city contract without increasing admin/overhead. We might end up needing to turn it down, which is very sad for our homeless neighbors."

Messaging to government

Given the inconsistent implementation of the OMB Uniform Guidance, and the knowledge that most government-nonprofit contracting occurs through county government, the interviews with county supervisors sought to provide suggestions to nonprofits on how to discuss indirect cost rates with their government partners.

Some key findings:

- County supervisors are often unaware of how the overhead issue plays out in government-nonprofit contracting, and they rely heavily on departmental staff to develop and execute contracting policies.
- Supervisors view nonprofit contracting as a transactional, business relationship, and see themselves as purchasing services and outcomes.
- Supervisors are not opposed to paying for "reasonable" overhead, which is seen as a legitimate cost of business.
- Across the ideological spectrum, supervisors generally trust nonprofits to be honest, and are more concerned with ineffective management than with dishonesty or malfeasance.
- Wary of spin, supervisors reacted negatively to suggested alternative words such as "full costs," "real costs," or "foundational costs."

Four types of arguments (i.e., messages) were developed and tested: performance, fairness, basic costs, and flexibility. A brief statement was read to each county supervisor, with a request for reactions and feedback.

- Performance-based messages -- the idea that "performance and outcomes are what counts, and overhead is necessary to achieve them" -- were perceived the most favorably. One supervisor suggested that nonprofits say: "Hold us accountable to results, not overhead percentages."

- Fairness messages -- the idea that government should pay fairly for services – was the second most favorable type of message. The notion that government should pay overhead in nonprofit contracts as they do in contracts with for-profits particularly resonated for supervisors more familiar with nonprofits. Yet for supervisors less familiar with nonprofits, this type of message was perceived as misleading and not as effective.

- Basic cost messages -- using any term other than "overhead" or "indirect costs" made supervisors leery, although the idea of such costs made sense to them. When supervisors were asked to articulate a "best" argument for nonprofit overhead, they suggested ideas such as: "to keep nonprofits viable" and "to have the vital funding they need to keep alive."

- Flexibility messages -- the idea that nonprofits need overhead to remain innovative and flexible -- tested poorly with supervisors.

- Supervisors also emphasized the importance of messengers, as "validators" who can attest to a nonprofit's performance as an alternative to overhead rates as a proxy for performance. They suggested that recipients of services, unaffiliated community leaders, and other funders as effective messengers.

Concluding thoughts

This survey quantified and reinforced a growing consensus in the field that nonprofit overhead rates are problematic for nonprofit organizations. Nonprofits are frequently unable to cover the full costs of funded programs and to bridge the gap, they have to accelerate their fundraising from private sources, reduce salaries and benefits, under-invest in facilities and technology, and spend down reserves.

The new Uniform Guidance from the OMB is moving in the right direction towards more realistic, appropriate overhead rates for nonprofits. However, this study revealed the uneven progress towards full implementation.

The wide variety of practices revealed in this study suggest that different approaches -- both in messaging and strategy -- are needed for different audiences if more nonprofit contracts and grants are to cover the full costs of the programs funded. The *Nonprofit Overhead Project* will build on these findings to develop such approaches.

Attention to overhead has seen an important shift from one where "the overhead problem" is an issue of insufficient accounting expertise at nonprofits to a recognition that overhead is a larger systems concern and a public policy challenge. At stake are billions of dollars in nonprofit funding, and quality programs and services that affect millions of lives.

Further research and inquiry

Although policy development is frequently studied and analyzed by researchers, the possible gaps between policy and implementation are less frequently examined. This research revealed that while federal policies are highly developed and explicit, the fragmented and misunderstood way they are implemented across thousands of governmental bodies results in confusion and inconsistent policies that often prove detrimental to nonprofits.

This study, along with other work from the *Nonprofit Overhead Project* reveals that more research is clearly needed. Some specific questions that deserve attention and further inquiry for research and policy-making include the following:

- Are these findings from California similar or different from other states across the country? What are the implications of different city, county, state, and federal policies and practices across the United States on the nonprofit and philanthropic sector?

- How are changes in federal (and or state, county, city) regulations on government-nonprofit relations communicated and monitored by federal (and other) regulators?

- What are identifiable stages of implementation and typical timelines for implementation of federal regulations?
- How can gaps between regulation and implementation be researched effectively?

- What are established best practices for disseminating information, and training and monitoring policy implementation in this decentralized environment with multiple decision points and decision-makers?

About the participating nonprofits

Invitations to the survey were sent to CalNonprofits' electronic mailing list, with a request to forward the survey to other California nonprofits.

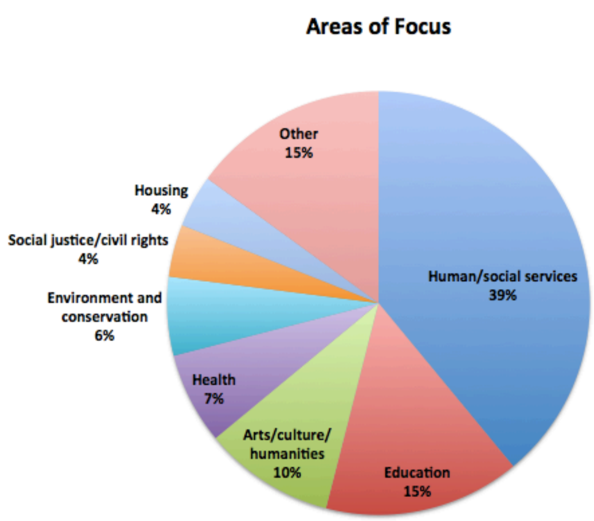
Geographic distribution: Although there was at least one respondent from 42 of California's 58 counties, most respondents were from urban areas. Fifty-eight percent of responses came from five counties, including Los Angeles (24%), San Francisco (9%), Alameda (9%), Orange (6%) and Santa Clara (5%).

Positions in nonprofits: The majority of respondents were executive directors (52%) or senior finance staff: (21%)

Areas of focus: Figure 6 shows the different areas of focus (i.e., subsectors) of participating nonprofits.

Budget size: Organization budgets ranged from a low of $0 to a high of $166 million, with a median of $888,000.

Figure 6. Participating Organizations' Areas of Focus



About the Nonprofit Overhead Project

The Nonprofit Overhead Project is an initiative of the California Association of Nonprofits (CalNonprofits) with multiple components including other quantitative and qualitative research, work with the foundation community, development and delivery of finance skills workshops for nonprofits, an online Toolkit, and public policy work in the California state legislature and in select California counties.

See more at http://www.calnonprofits.org/programs/overhead

Funders of the *Nonprofit Overhead Project* are the California Community Foundation, the California Wellness Foundation, First Five LA, and the James Irvine Foundation.

Unrestricted funders whose funding makes all of CalNonprofits' work possible include the California Wellness Foundation, the David & Lucile Packard Foundation, the Weingart Foundation, and the nearly 10,000 nonprofit members of CalNonprofits.

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