# REAL COST PROJECT: BARRIERS TO CHANGE

## REAL COST PROJECT: PHASE ONE REPORT

A summary of the findings from the field for the Real Cost Project, a joint statewide initiative of Northern California Grantmakers, San Diego Grantmakers, and Southern California Grantmakers.

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The Real Cost Project is a joint statewide initiative of Northern California Grantmakers, Southern California Grantmakers and San Diego Grantmakers. The goal of the Real Cost Project is to increase the number of funders that provide real-cost funding and to build the skills and capacity of all those engaged in grantmaking, including foundations, corporations, individuals, and government.

In June 2015, the Real Cost Project held Regional Forums across the state of California to understand the barriers that were stopping grantmakers from adopting new practices that reflect the current needs of the social sector.

Regional Forums:
- San Francisco – June 9, 2015
- Los Angeles – June 15, 2015
- Orange County –June 19, 2015
- San Diego –June 23, 2015

Simultaneously, partners at California Association of Nonprofits (CalNonprofits) held similar forums with nonprofit audiences around the state and a summary of these findings are included in the appendix.

Representatives from more than 150 different foundations as well as government agencies and individual philanthropists participated in the Regional Forums. The following report reveals common themes that surfaced from these forums and reflects the issues that participants viewed as the most relevant and urgent.

## FUNDERS

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## THE WORLD HAS CHANGED: SO MUST WE

The social sector is in the midst of a radical transformation. In the past ten years, many of the fundamental underpinnings of the sector have shifted:

- Governments at the Federal, state and local levels are changing how they fund and approach social problems – often resulting in less money for many nonprofits.
- Government funders are trying to be "smarter" about allocating limited dollars; and trends such as "pay for success" are shifting the risk from government onto philanthropy.
- Increased focus on collaboration and collective action presents incredible possibilities and significant challenges for the sector.
- A blending of the social and capital markets driven by a new wave of donors is looking for innovative means to invest in social outcomes.
- Technology and 'big data' are changing how organizations work, presenting a new set of opportunities and potential barriers.
- The increase of big money in political campaigns is threatening to drown out the voices of those who lack the resources to compete.

However, grantmaking practices – especially around funding indirect and overhead costs – have failed to keep pace. And the consequences are being felt across the nonprofit sector as organizations report feeling the effects and are challenged to meet ever-growing demand for services. Roughly seven in 10 nonprofits in California say the government funding they receive fails to cover the full cost of their services, according to *Nonprofit-Government Contracts and Grants: California Findings* a new report from the Urban Institute. A majority (64%) of California nonprofits reported that government contracts and grants pay only 10% or less for overhead costs. (Urban Institute, 2015).

Additionally, Nonprofit Finance Fund's *2015 State of the Nonprofit Sector* – a survey of more than 1,100 nonprofit organizations across the state of California – revealed that the top challenges faced by nonprofits include achieving long-term financial sustainability, attracting and retaining staff and raising funding that covers the full cost (Nonprofit Finance Fund, 2015 State of the Nonprofit Sector Survey). When organizations were asked if funding covered the full cost of achieving outcomes, the overwhelming answer was "No."

Most nonprofits in the state are operating with little or no safety net, with 53% of nonprofits report having three months or less of cash of hand (Nonprofit Finance Fund, 2015). And for nonprofit organizations serving low-income communities, 60% of organizations reported having less than three months of cash readily available (Nonprofit Finance Fund, 2015). Lack of liquidity means scrambling to manage payroll, cutting or reducing programs, and reducing staff hours or eliminating staff positions. These organizations do not have the financial capital to withstand risk and adapt to changes in the communities they serve.

While nearly 80% of nonprofit organizations have reported an increase in demand, only 44% said they could meet that demand. Among organizations serving low-income communities, only 35% of nonprofits could meet the demand for often critical safety net services (Nonprofit Finance Fund, 2015). The result is that everyday people in our communities are being denied access to critical services from healthcare to workforce development to childcare.

Grantmakers participating in the Real Cost Forums recognized that funding indirect and overhead costs is important for supporting nonprofit health, but highlighted that there are no universal standards for calculating these costs or even common definitions of what they may include. A series of interviews among the funding community executed by the Real Cost Project also revealed additional challenges, including a lack of well-defined policies to guide real cost evaluation and reimbursements, a reliance on individual staff members to make decisions around real cost funding, and funder practices driven and reinforced by cultural norms in the field (Research report link here: http://realcostproject.org/wp-content/uploads/2015/08/OVERHEAD-MADNESS.pdf).

Both funders and nonprofits agree that there needs to be a better understanding of the real cost of doing business as well as more open and transparent conversations between funders and grantees on what outcomes really cost. Heather Peeler, the Vice President of Member and Partner Engagement at Grantmakers for Effective Organizations, asserts that although challenges exist, the potential for real cost funding is greater alignment of a foundation's values and practices. She describes real cost funders as partners in the grantmaking process, that initiate and encourage grantee discussion, understand grantee theories of change, strive for the maximum appropriate flexibility of funding and build internal capacity to understand the real costs of their nonprofits.

## CURRENT GRANTMAKING PRACTICES

Prior to the Regional Forums, research was conducted to collect information and baseline data on the spectrum of current funder and sector practices that relate to real cost funding. The research included an environmental scan of research and studies related to funding of overhead and one-on-one interviews with practitioners in the field statewide. Interviews were conducted with Board Members, Executive Directors, and Program Officers, representing a variety of funder types, including corporate foundations, family foundations, community foundations, giving networks, public endowments and individual donors. The research yielded several major findings, revealed common practices in the field and pinpointed areas for skill building and training among the grantmaking community. Key takeaways include:

- **There is a lack of well-defined policies to guide real cost evaluation and reimbursements**
  According to a study by Grantmakers for Effective Organizations, 59% of foundations did not have formal policies around overhead rates (Peeler, 2015). Likewise, interviews showed a similar pattern with a significant lack of formal policies[1] around overhead and indirect costs. Funders often operated with an unwritten "commonly accepted rate of about 10-15%," which was highly negotiable depending on several conditions such as a grantee's current needs, a grantee's existing or past relationship with a funder and a funder's giving priorities (Interview Series, 2015). Additionally, funders often unintentionally signaled a limitation or overhead funding cap within their grantmaking process. For example, funders that provided a budget template for grantee applications often automatically calculated a fixed overhead percentage in the budget template. Finally, while some formal policies existed around funding university grants, they did not commonly exist in 501(c)3 settings.

[1] Policies refer to formally recognized amounts in percentage, dollars, etc. that grantmakers fund

- **There are no standard definitions of terms related to overhead and real cost funding**
  Terms such as overhead, indirect, administrative and operational costs are loosely defined or used interchangeably with inferential meaning. As a result, there is a lack of shared or common language across the field. In the 2010 Report to the Chairman, Committee on the Budget, House of Representatives produced by the US Government Accountability Office, a similar situation is described in governmental reimbursement processes, where "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" (US Government Accountability Office, 2010). Also, there was little if any training provided to program or grants management staff on how to calculate or determine actual overhead or indirect costs.

- **Funders rely on individual staff members to make decisions around real cost funding**
  Due to the absence of formal policies for funding overhead combined with the lack of a standard definition of overhead, decision-making is delegated to program, grants management and/or financial staff who have little or no formal training on determining full cost. These staff members are often tasked with making crucial recommendations on what is considered overhead and program allocations with no formal guidance.

- **Funder practices driven and reinforced by cultural norms and perceived "best practices" in the field.**
  An adherence to these accepted cultural norms in the sector at large, as well as within institutional cultures at individual grantmaking entities, resulted in radical differences in practices. Approaches were often adopted based on past practice and reinforced by unchanging processes and a reliance on individual approaches by program officers. In interviews, these methods were often referred to as "rules of thumb," "what's reasonable or acceptable," and "the way we've always done it" (Interview Series, 2015).

## FINDINGS FROM THE FIELD

During the Regional Forums, participants discussed the challenges and potential solutions to having grantmakers change their grantmaking practices in relation to real cost funding. There were several major themes that appeared including:

### Culture of Philanthropy

The uneven power dynamic between grantmaker and grantee creates a culture where nonprofits feel they cannot be transparent on issues around financial challenges and the true cost of delivering services. As one nonprofit leader revealed, "Due to the nature of the clients we serve, it costs approximately $15,000 to provide services to just one client. But I can't tell my funders that." Consequently, grantmakers are making funding decisions based on limited or inaccurate data and the result is often a misalignment between the funding and the business needs of the nonprofit. While both funders and grantees acknowledge that the system is not working effectively as it should, many continue to rely on existing practice. One forum attendee said, "There are no systemic incentives for funders to change current operating practices," while another simply said "we've always done it that way."

### Restrictions and Program-based Funding

Many grantmakers indicated that most institutional foundations are organized and staffed around specific program areas. This system institutionalizes practices that 1) reinforce the idea that programs – not overall organizational capabilities – are what matters most; 2) restrictions are necessary to link funding to specific program results; and 3) accountability is necessary for the program officer to justify the grant. These practices often result in nonprofit organizations trying to classify as much indirect costs as program costs as possible as well as trying to fit their grant requests into the funder's program areas. One forum participant described this by saying: "So much time is spent on repackaging. It's an operational opportunity cost that could be spent elsewhere."

**Engaging Leadership**

Leadership within foundations must be engaged and informed in order for policies and culture to change. While the role of Program Officers and their exchange with nonprofits is important to the grantmaking process, buy in at the executive and board level is needed to create institutional changes. One participant shared that the greatest impact on changing their funding practices was made by "bringing respected nonprofit leaders into the foundation's board meetings to let trustees hear the story directly, face-to-face."

**Shift to Outcomes**

There was a great deal of agreement among participants that focusing on inputs such as cost is not providing the opportunity for nonprofits to effectively deliver on mission. Rather, foundations should ground their grantmaking by focusing on what are they trying to achieve. Generally, participants encouraged outcomes-focused funding, however there is an acknowledgement that there is a lack of clarity and methods in measuring outcomes. But starting the engagement with grantees by focusing on the end goal allows funders and grantees to have a conversation around what investment is needed in order to achieve that goal. The was also recognition among participants that "outcomes were more expensive than inputs" and that funders would need to either provide larger (but perhaps fewer) grants or adjust their expectations – as one forum participant said, "Funders should use grantee engagement in order to be realistic about what dollars can do."

**Organizational Innovation and Growth**

Supporting indirect and overhead costs can have lasting impacts on organizations by allowing leadership the ability to remain flexible in changing times. Participants discussed the tension between wanting nonprofit organizations to innovate, to invest in systems such outcomes-measurement, and to scale and restricted programmatic funding being driven by longstanding risk aversion and the feeling that less stringent funding guidelines meant lower accountability. One participant shared, "Governance has developed with little tolerance for risk."

## BARRIERS TO CHANGE

As part of the Regional Forums and in post-event surveys, participants were asked three key questions:

- What are the organizational or institutional barriers to changing grantmaking practices?
- What are the sector-wide barriers to changing grantmaking practices?
- What types of support or capacity building is needed to help grantmakers adapt their grantmaking practices?

## ORGANIZATIONAL/INSTITUTIONAL BARRIERS

Participants acknowledged that there are often institutional processes in place that affect many departments so "buy in" is needed across the organization, which takes time, a precious commodity, amid busy grants cycles. In addition, organizational constraints both in terms of resources and staffing further limit maneuverability within philanthropic organizations. Grantmakers also pointed to a number of areas, such as:

- Lack of understanding of nonprofit financial management;
- Lack of established best-practices models around funding the full cost of programs; and
- Lack of trust and a belief that many nonprofits don't understand how to run "like a business" – especially among trustees and foundation board members.

### Program-Focused Practices/Structure

Participants discussed a mindset within many organizations that a nonprofit's program is what matters for impact. This mindset was further reinforced as organizations were funding by issue areas rather than an integrated multi-issue approach. This narrow focus on programs meant that many program officers were not examining the broader context especially around financial issues. A number of funders also raised the issue that there is a belief that they would have to give fewer grants if they increase the amount of the grants to cover real program/organizational costs. Alternatively, some suggested that instead funders should lower their expectations of what they can get for the same grant amount.

### Boards of Directors/Trustees

A major issue that was raised in all of the Real Cost Regional Forums was around the role of the Board of Directors/Trustees. There was general agreement that most foundation boards focus mainly on "administrative" costs and the bottom line; and that boards lack a deep understanding of the nonprofit business realities. Also, there was much discussion about how boards are unwilling to take the risk of making a change, that they lack a results-orientation to funding; and that there was a fear of transparency. To move to a real cost funding approach, there would need to be a cultural change for board members and that would require board and staff education around the issue in an on-going and concerted effort.

## SECTOR-WIDE BARRIERS

Participants also discussed what they saw as some of the broader sector-wide barriers that were preventing grantmakers from adopting new funding practices. Many have been referenced above but here are some of the key sector level challenges that participants identified:

- A pervasive culture and mindset that "Overhead is Bad"
- Lack of a shared language and common definitions around overhead and full costs
- Lack of open and transparent conversations between funders and nonprofits
- Deeply ingrained practices, beliefs and perceptions
- Lack of established best-practices models around real cost funding
- Lack of understanding of nonprofit financial management
- Lack of skills and training around measuring and evaluating outcomes
- Funders working in silos makes funding landscape complicated for nonprofits

There was good agreement among participants that the debate surrounding overhead needs to be repositioned as essential to strengthening the nonprofit sector and the as part of the sustainability conversation. Without a real cost funding approach, nonprofit sustainability will be unattainable.

# CONCLUSIONS: OVERCOMING THE BARRIERS

The research conducted prior to the Regional Forums clearly highlighted that the issue of adapting grantmaking practices was more of a cultural issue than an institutional policy issue. And that there was a need to **change the cultural norms and practices in the field**. In listening to the field and engaging grantmakers through the Regional Forums, there was a strong belief that to change the culture of philanthropy, the sector would need to achieve two objectives:

1. **Executive Buy in**

   Simply, change happens at the top. In order for lasting and impactful change to occur in funding methods, executives and boards of trustees must fully understand the issues and be prepared to implement changes. There was strong agreement that this change could not be driven from the program officer level and that before program staff were trained or engaged with their grantees around real cost, it was essential that their organizational leadership were prepared to support change. To that end, the Real Cost Project will be organizing a series of Leadership Briefings focused on Presidents and CEOs, senior foundation leaders, and Trustees with the goal to educate senior leadership on:

   - The changes in the socials sector that are driving changes to grantmaking practices;
   - How a real cost funding approach helps to increase impact and outcomes; and
   - Why funders need to engage their grantees in open and transparent conversations about what does it really cost to achieve outcomes.

2. **Engaging Grantees in a Real Cost Conversation**

   Before changing grantmaking practices, grantmakers need to examine their current practices – both formal and informal – and to engage in conversations with their grantees as to what does it really take for them to achieve their outcomes and how the funder's grantmaking practices are helping or hindering the achievement of outcomes. Then once funders have an understanding of how their current practices are impacting their grantees, they can make the appropriate changes to their practices. That may mean increasing the percentage of indirect costs their grants cover, or moving to providing general operating support, or it may mean changes to the grant application or reporting requirements.

To support both of these objectives, there is a need for training for staff and leadership at grantmaking organizations as well as for their grantees. This can encourage greater understanding of real cost and overhead as terms and better development and sharing of true "best practices" in the field. In addition, tools and processes are needed in order to help nonprofits correctly calculate fully-loaded costs of programs as well as to help funders better participate in supporting these costs.

Whether grantmakers provide general operating support, programmatic support, funding for capital projects or investments for social impact, understanding the real cost for delivering outcomes is critical to achieving their goals. With the commitment of philanthropic leaders, open and transparent conversations between grantmakers and grantees, and the rights tools and training, it will be possible to increase the impact of philanthropy in California, improve the lives of the people and communities served and to support a sustainable and vibrant social sector.

# APPENDIX

Voices from the Field: Nonprofits

About the Real Cost Project

## VOICES FROM THE FIELD: NONPROFITS

California Association of Nonprofits (CalNonprofits), the statewide association of nonprofit organizations, held a series of forums with nonprofit leaders around the state to gather their thoughts and experiences around overhead costs. Below is a summary of the major themes and issues that are most relevant for grantmakers and funders as part of the Real Cost Project. Forums were held in four major regions:

- Los Angeles – May 19, 2015
- San Francisco – May 20, 2015
- San Diego – June 3, 2015
- Orange County – June 5, 2015

56 nonprofit organizations were represented, with budgets ranging from $200,000 to $110 million. Participants included a mix of executive staff, development directors and administrative staff. Groups were convened to discuss their experiences working with foundations and indirect costs, in particular the types of indirect costs foundations allow, reporting of indirect costs and how they approach foundation partners when discussing overhead funding. Questions were openended to encourage dialogue. Sample questions include: “How do the foundations you work with handle indirect costs? What has been your experience in talking with foundations about your indirect costs?” Overall, nonprofits participating in these sessions felt that the vast majority of foundation grants did not cover the full cost of delivering outcomes and do not fully allow for indirect costs. Some the key findings and take aways which are highlighted below.

**Deeper investments are needed in the nonprofit sector**
Overwhelmingly, participants agreed that increasing demands for greater impact and growth of nonprofit services could only be met through investments in organizational health. In addition, participants shared that a push for innovation and collaboration are making these investments even more necessary. Overall, there was a general sense that organizations are very focused on organizational sustainability, but feel underfunded in their overhead costs to achieve it. One participant said: “There’s almost always a question on a grant application about organizational sustainability, and we’re made to feel bad if we don’t answer this well. But they won’t fund the infrastructure we need to be sustainable.”

**A wide spectrum of funding practices exists in grantmaking**
Participants described grantmakers as having a wide range of practices and processes when it comes to indirect costs. Nonprofits saw variance in several aspects of grantmaking, including how indirect cost is evaluated, as well as the level of institutional adoption of capacity building support. For example, while core support is trending among some foundations, others only include a budget line item for indirect costs or list percentage maximums in RFPs. Participants felt that this continuum of practice requires nonprofits to make educated assumptions around individual grantmakers and the indirect costs they will or will not cover.

**Definitions of overhead and indirect cost vary greatly**
Related to the wide variety of funding practices, nonprofit participants repeatedly brought up the lack of common definitions of indirect cost. Several participants reported that the lack of definition creates inconsistency and confusion around allowable expenses for indirect costs, and described a variety of complicated situations requiring them to "move numbers around" to meet the definitions used by each

foundation. Meeting these demands create feelings of frustration and operational challenges for nonprofits. One participant said, “We're all getting to the breaking point of all our linked spreadsheets." Another said: “You do what the funder wants.”

**Existing power dynamics require open conversation**

Many participants acknowledged the power dynamic that exists within funder and grantee dyanmic. One participant said: “Foundations tell us they want to be seen as working collaboratively with us, they say, ‘talk to us about what you need,’ but there’s a power dynamic that makes this difficult.” As a result, participants described how they rely on certain cues or behaviors to open the conversation. These included tactics such as presenting proposals with a safe percentage of overhead costs (usually 15-20%) in order to start a discussion. One participant said: “We just include 20% and see how the foundation reacts.” Another tactic was based on the level of rapport or relationship with program officers. One participant said: “We only talk about it if we feel we have a good relationship with the program officer.” Overall, conversation was seen as key to getting foundation partners to understand organizational challenges and ultimately the real cost of doing business.

As a whole, the groups convened were enthusiastic to share their insights on the issue of overhead and indirect cost. Participants saw the issue as incredibly impactful to their work and were encouraged that their insights would be shared with foundation partners.

# ABOUT THE REAL COST PROJECT

All of us involved in philanthropy today – foundations, individual donors, corporations, government, nonprofits, and community leaders – recognize that the social sector is in the midst of a radical transformation.

Accordingly, grantmakers across California are examining their practices and looking to develop new approaches in order to increase impact in the communities they serve. Recently, many grantmakers have begun exploring an approach based on real cost funding – that is all of the necessary investments for a nonprofit organization to deliver on mission and to be sustainable over the long term.

**The Real Cost Project**

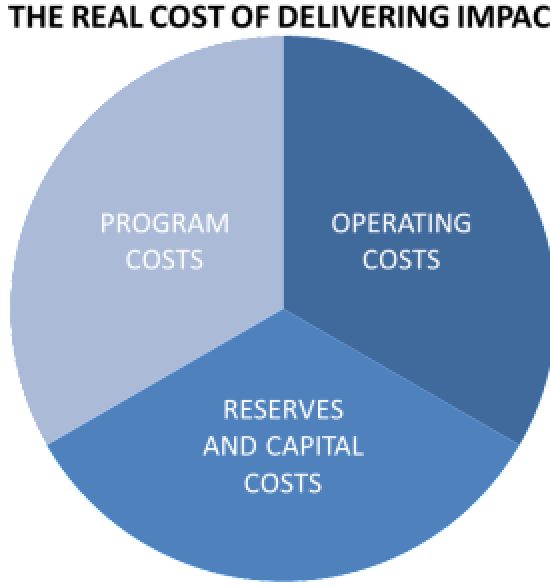
In response to these efforts, Northern California Grantmakers, San Diego Grantmakers and Southern California Grantmakers are proud to announce the launch of a joint statewide initiative – the Real Cost Project – to increase the impact of philanthropy across California. Created by funders for funders, the Real Cost Project will explore what it takes for funders to develop new grantmaking practices based on what it really costs to deliver outcomes.

We invite you to get engaged in this growing national conversation. Whether you provide general operating support, programmatic support, funding for capital projects or investments for social impact, understanding what is the real cost for delivering outcomes is critical to achieving your goals.

**Real Cost Funding**

Real Cost funding is a holistic approach to grantmaking that starts with the end in mind – what are the outcomes we are looking to achieve and what does it *really* cost to deliver those outcomes? By understanding what is the real cost for delivering those outcomes, funders can then determine what role they want their grant dollars to play in supporting their grantees.

THE REAL COST OF DELIVERING IMPACT




Simply put, the real cost of outcomes includes all of the necessary costs for a nonprofit organization to deliver on mission and to be sustainable over the long term. Like any enterprise – including for-profit corporations – nonprofits must be able to cover the real cost of their programs and operations if they are to deliver excellent outcomes. Whether an organization is serving the needs of returning veterans, providing health and human services to the neediest, or building vibrant communities, the cost of delivering results includes not only direct programmatic expenses but also the capacity and capital needs of the organization.

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The Real Cost Project is made possible with generous funding from the California Community Foundation, The William and Flora Hewlett Foundation, The David and Lucile Packard Foundation, The Parker Foundation, The Ralph M. Parsons Foundation and the Weingart Foundation.

## ADVISORY COUNCIL

The Real Cost Project Advisory Council works in partnership with the California regional associations of grantmakers to identify and develop best practices, policies, and guidance on what it takes for funders to effectively change their grantmaking.

- Aden Bliss, CFO, The Ford Family Foundation
- Vera de Vera, Director, Community Building Initiative, California Community Foundation
- Sylia Obagi, Executive Director, Roy and Patricia Disney Family Foundation
- Lindsay Louie, Program Officer, Effective Philanthropy Group, The William and Flora Hewlett Foundation
- Linda Baker, Program Officer, Organizational Effectiveness, David and Lucile Packard Foundation
- Judy McDonald, President, The Parker Foundation
- Jennifer Price-Letscher, Senior Program Officer, The Ralph M. Parsons Foundation
- Elizabeth Dodson, Director of Grantmaking and Grantee Impact, Silicon Valley Venture Fund
- Vy Nguyen, Program Director, Weingart Foundation