

THE REAL COST PROJECT

INCREASING THE IMPACT OF
PHILANTHROPY IN CALIFORNIA



NORTHERN CALIFORNIA GRANTMAKERS
SAN DIEGO GRANTMAKERS
SOUTHERN CALIFORNIA GRANTMAKERS

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— ABOUT THE REAL COST PROJECT —

The Real Cost Project is a joint statewide initiative by Northern California Grantmakers, San Diego Grantmakers and Southern California Grantmakers to increase philanthropy's impact across California. Funders have a timely opportunity to adopt new funding strategies centered on the needs of today's social sector organizations.

FUNDERS

The Real Cost Project is funded by 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 California's three regional associations of grantmakers to support funders in effectively changing their grantmaking.

- Aden Bliss, CFO, The Ford Family Foundation
- Vera de Vera, Director, Community Building Initiative, California Community Foundation
- Syla 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, Director of Special Programs, Weingart Foundation

PROJECT TEAM

Social Sector Partners managed the project working with the regional associations:

- Ann Burroughs, Senior Consultant, Social Sector Partners
- Christine Essel, President & CEO, Southern California Grantmakers
- David Greco, Managing Partner, Social Sector Partners
- Nancy Jamison, Executive Director, San Diego Grantmakers
- Beeta Jahedi, Senior Director of Learning and Programs, San Diego Grantmakers
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- Phuong Quach, Director, Member Engagement, Northern California Grantmakers
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— EXECUTIVE SUMMARY —

Around the country, as well as across the State of California, grantmakers are examining their funding practices and looking to develop new approaches to better support the communities they serve. Recently, numerous grantmakers have begun exploring what it would take to fund the real costs of the organizations they support – that is all of the necessary investments for a nonprofit organization to deliver on mission and to be sustainable over the long term. Building off of this interest, Northern California Grantmakers, San Diego Grantmakers and Southern California Grantmakers launched 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 explored how best to support grantmakers in developing new grantmaking practices based on what it really costs nonprofit organizations to deliver outcomes. Through research, regional convenings, and senior level executive briefings, the project identified what it would take for funders to overcome institutional and sector-wide barriers and to be able to move from awareness to action.

Designed as a multi-phase learning project, the Real Cost Project sought to answer the question “What do grantmakers need to drive change within their organizations and within the sector in favor of a real cost funding approach?” By identifying barriers that were preventing grantmakers from changing, the Project could determine what support grantmakers and their grantees needed to implement changes in practice. The work of previous projects including “Real Talk About Real Costs,” “The Overhead Myth,” and “The Starvation Cycle” had raised awareness for the need for new approaches to grantmaking and achieving real outcomes. The purpose of the Real Cost Project was to move from awareness to action and to actually change behavior – an ambitious goal.

KEY LEARNINGS

MOVING BEYOND “OVERHEAD”:

The Real Cost Project was intentionally designed to help move funders beyond existing thinking about overhead.

Funders across California very clearly indicated that they did not want a debate about overhead rates or what is or is not overhead. The debate on overhead was all focused on inputs and costs.

Instead, funders wanted to discuss outcomes and how grantmakers, with finite resources, can better support grantees to achieve the outcomes and impact we wanted to see in our communities.

PEOPLE NOT POLICIES:

Our work, as well as the work of others such as Grantmakers for Effective Organizations, showed that the vast majority of funders did not have formal policies on funding indirect costs and the policies that did exist often lacked formal definitions or specific guidance.

Instead, practices were a **cultural issue**, based on beliefs that were not grounded in any formal policies, tax laws, or governance requirements but that had become ingrained in the sector – for funders, nonprofit leaders, board members and trustees. Consequently, current funder practices regarding real cost funding varied radically across the sector.

The result is confusion for both funders and nonprofit organizations, systematic underfunding of nonprofit programs, and lack of investment in capacity and infrastructure to allow nonprofit organizations to meet demand for services and programs. Ironically, practices that were initially intended to help promote efficiency and effectiveness of nonprofit organizations are in fact undermining nonprofit’s abilities to achieve their mission and resulting in less impact and fewer or worse outcomes.

ENGAGING SENIOR LEADERSHIP:

We heard that “change happens at the top” and in order to change the culture of grantmaking institutions, the presidents and CEOs as well as trustees needed to buy-in and support a new approach – this was not a change that could be driven from the program director level.

Through a series of executive level peer conversations, president and CEOs agreed that this was indeed a strategic issue that needed to be led by the board of trustees and senior leaders across organizations. They were eager to engage in this conversation internally within their organization and with their grantees. But they felt that in order to have an effective dialogue, they needed a common language and set of definitions around real cost as well as training, tools and resources for grantmaking staff and trustees.

NEED FOR SUPPORT:

In order to move this issue forward there was a clear need for training with trustees and boards of directors, training for program staff and nonprofit leaders, and development of a common language, definitions and best practices around real cost funding.

Fundamentally, a sector wide acceptance of past practice and adherence to cultural norms undergirds the issue of real cost funding. These findings point to the need for human-centered approaches and a shift in behavior, rather than institution of policies alone. Therefore, to change behavior there are a series of next steps and recommendations for grantmakers, donors, government agencies as well as the field of philanthropy:

- We must develop a common language and set of definitions around real cost as well as training, tools and resources for grantmaking staff and trustees;
- We must support trustees in understanding what it really costs grantees to deliver excellent outcomes;
- We must engage in open and thoughtful conversations with grantees on the issue of real cost; and
- We must invest in building the capacity of grantees to be able to determine their outcomes and what those outcomes really cost.

NONPROFIT OVERHEAD PROJECT

While the Real Cost Project was focused on changing funder behavior, the California Association of Nonprofits (CalNonprofits) simultaneously launched the Nonprofit Overhead Project to educate policymakers and nonprofit leaders on the recent Office of Management and Budget Uniform Guidance on overhead rates related to federal funding streams.



— WHY THIS MATTERS TO GRANTMAKERS: — — PROJECT BACKGROUND —

In addition to the increased awareness around the negative impact of funding that doesn't cover the full cost of programs, the world in which social sector organizations operate and the way in which they work is shifting rapidly and drastically. Over the past ten years we have seen:

- *Governments changing how they fund and approach social problems* at the federal, state and local levels – often resulting in less money for many nonprofits.
- *Government funders trying to be “smarter” about allocating limited dollars*; and trends such as “pay for success” 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 looking for innovative means to invest in social outcomes.
- *Technology and ‘big data’ changing how organizations work*, presenting a new set of opportunities and potential barriers.
- *The increase of big money in political campaigns* threatening to drown out the voices of those who lack the resources to compete.

In 2005, there were no such things as B Corps, there was no ‘impact investing’ as a recognized approach to funding, there were no ‘Social Capital Markets’, and social impact bonds were still five years away. And there was no “Citizens United” that opened the flood gates of “big money” into political campaigns. Ten years ago, the social sector was a vastly different place.

Forget fundraising ratios and overhead rates. The debate over ‘overhead’ is a bit like arguing the virtues of Beta vs VHS in the age of online streaming videos. It is not about good or bad, it just isn't applicable anymore. Focusing on overhead means you are focusing on inputs in an outcomes-based world. The Real Cost Project aims to change that.

PHILANTHROPY'S OVERHEAD MOMENT

BY FOCUSING ON THE OUTCOMES THEY WANT TO ACHIEVE, BY UNDERSTANDING WHAT IT REALLY COSTS TO ACHIEVE THOSE OUTCOMES; AND BY FOCUSING ON THE STRATEGIC QUESTIONS TO BUILD A SUSTAINABLE ORGANIZATION, FUNDERS CAN NOT ONLY BRING THEIR GRANTMAKING INTO THE NEW REALITY BUT CAN PREPARE THEIR GRANTEEES FOR THE CHANGES THAT LAY AHEAD.

Numerous issues and events are converging to create an increased focus on funding the full cost of program delivery. Over the past few years, a series of publications and projects have raised awareness about the issue of nonprofit overhead and the link to effectiveness and impact including the *Starvation Cycle* by Ann Goggins Gregory & Don Howard of the Bridgespan Group; the “Real Talk About Real Costs”

project from Forefront (formerly the Donors Forum); the *Overhead Myth* campaign from Guidestar, the Wise Giving Alliance and Charity Navigator; as well as the work of national organizations such as Nonprofit Finance Fund and Grantmakers for Effective Organizations.

As this conversation takes place nationally, we hoped to engage California funders in a dialogue that can shape better outcomes for the sector. More specifically, key drivers for this conversation included:

- **OMB Guidance**

Recently, the White House Office of Management and Budget (OMB) issued an overhaul of federal grants policies and procedures. Most notably, OMB's Final Guidance makes clear that a nonprofit's indirect costs (sometimes called overhead or administrative costs) are legitimate expenses that need to be reimbursed for the organization to be sustainable and effective. The OMB Guidance explicitly requires pass-through entities (typically states and local governments receiving federal funding) and all federal agencies to reimburse a nonprofit's indirect costs by applying the nonprofit's federally negotiated indirect cost rate, if one already exists, or the default rate of 10% of their modified total direct costs (MTDC).

This federal change has led to a deep conversation about overhead among nonprofits and funders. Nationally, the National Council of Nonprofits is leading an effort to educate nonprofit organizations, state governments, and grantmakers about this new guidance. Here in California, CalNonprofits is leading an effort to work with the state to ensure compliance with the new federal guidelines.

- **Increased focus on outcomes**

Increasingly funders are shifting their focus – and their funding – from outputs to outcomes. However, there has been little discussion around the real cost of delivering outcomes. Heretofore, funders have focused on the cost of 'direct' programs and either inputs (staff salaries, travel costs, etc.) or outputs (number of people receiving services). As we shift to an outcomes based world, funders need to see how the costs to deliver outcomes differ and understand what real outcomes really cost.

- **Improving Economy**

Since the great recession, many nonprofits have remained in survival mode –trying to keep the doors open and the lights on. As the economy improves—albeit slowly and unevenly—we now have the opportunity to step back and be more strategic. How can we better support the long-term financial sustainability of our grantees?

- **Philanthropy California**

The issues facing nonprofits and funders across the state must effectively be addressed statewide. The three regional associations of grantmakers here in California—Northern California Grantmakers, San Diego Grantmakers and Southern California Grantmakers—have recently formed a strategic partnership. This statewide partnership will provide joint programming, communications and public policy efforts. This has greatly increased the ability to impact philanthropy statewide and provides a platform from which to tackle the issue of overhead funding and improved outcomes. Together we will be able to do the project far more efficiently, at less cost and with greater impact.

— THE REAL COST PROJECT OVERVIEW —

In designing the Real Cost Project, funders and the regional associations were very aware of the previous work around the Overhead Myth, the Starvation Cycle, and the Real Talk About Real Cost project as well as other work from Grantmakers for Effective Organizations (GEO), Center for Effective Philanthropy, Nonprofit Finance Fund, and the National Council of Nonprofits around funding overhead or providing general operating support. We understood that overhead was an ineffective indicator of performance and recognized that funding for far too many nonprofits failed to cover the cost of programs. But the critical question was, “How to move from awareness to action?”

MOVING BEYOND OVERHEAD: REAL COST FUNDING

Real Cost funding is not about overhead rates. Rather, it 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.

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 corporation – including for-profit corporations – nonprofits must be able to cover their real cost if they are to deliver excellent outcomes. Overhead simply is how we divide program and operating expenses but it does not include capital needs such as liquidity needs, investments in capacity and infrastructure, facilities expenses, and reserves and capital needs.

Whether it is general operating support, programmatic support, funding for capital projects or investments for social impact, it is critical for all funders need to understand what is the real cost for delivering outcomes in order to achieving their goals.



REGIONAL FORUMS

In trying to answer the question of how to move from awareness to action, the Real Cost Project developed a two-phase approach. The initial phase focused on identifying the barriers that were stopping grantmakers from adopting new grantmaking practices and what would it take for funders to implement a real cost funding model. We held a series of events, convenings and conversations across the state from March – October 2015, and we used three key questions to frame our work:

- 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?

We heard from representatives of more than 100 organizations including government agencies, family foundations, private foundations, community foundations, corporate foundations, individual donors, and nonprofit leaders. And almost without exception, we heard that the debate surrounding overhead needs to be repositioned as part of the sustainability conversation and that without a real cost funding approach, nonprofit financial sustainability will be unattainable. There was also clear recognition that 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.



In listening to the field and engaging grantmakers through the Regional Forums, 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. Consequently, the second phase of the project was focused on senior level, peer-to-peer conversations hosted locally by a recognized philanthropic leader committed to the goals of the Real Cost Project.

EXECUTIVE BRIEFINGS

Across the state, we convened executive invitation-only sessions to bring CEO's and Trustees together to discuss the issues of real cost. By having peer-to-peer executive level events, we were able to have open and honest dialogue between funders as to the challenges of adopting a real cost funding model and what was needed to move the field forward. Between January and April 2016, more than 100 senior leaders gathered at a series of events around the state hosted by Presidents and CEOs of local grantmaking institutions.



Much like in the initial phase, the CEOs and Trustees agreed that there was a need to fundamentally change how grantmakers work. And in order to achieve that change, the senior leaders identified the need to establish a common language, a common set of definitions, best practices, training, tools and resources as their top priority. It simply is not possible to have a real and honest conversation if the two parties are not using the same language or they don't have a shared understanding of what the issue even is. While not a solution in and of itself, training and tools for program staff, grants management teams, trustees, and grantees is a critical first step to having a real cost conversation.



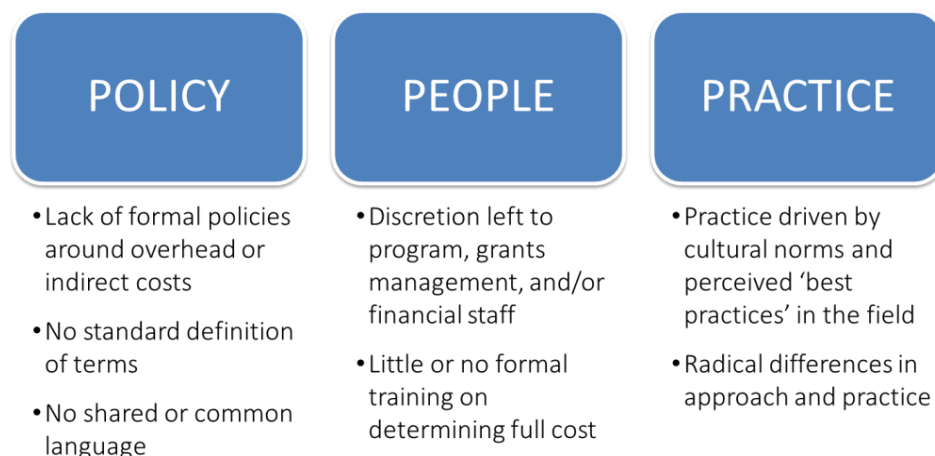
— KEY FINDINGS AND LEARNINGS —

Common themes emerged from the research, the Regional Forums, the Executive Briefings and related events and conversations, clearly showing a deep recognition that as a sector, as grantmakers, as leaders in the field, we must change the way we work. There was a strong appetite for change and for engaging in real and meaningful work to understand what it really costs to deliver great outcomes. Below is a summary of some of the key findings and learnings that came out of this interactive process.

WHAT THE RESEARCH TOLD US: PEOPLE NOT POLICIES

During the launch, we collected information and baseline data on the spectrum of current funder real cost funding practices. The research included an environmental scan of research and studies and interviews with board members, executive directors, and program officers, in corporate foundations, family foundations, community foundations, giving networks, public endowments and individual donors.

The research indicated that the barrier to adopting new grantmaking strategies was not a policy issue but a people issue – it was about changing culture. Most funders had no formal policies around funding full costs or had only loosely defined policies. Consequently, the decision to fund indirect costs and to what extent to fund them was often left to program officers, grants management staff or even finance and operations. But these staff members had little or no formal training on determining full costs and relied on what they perceived as best practices based on what other funders were doing. This led to radical differences in not only between funders but often between different program areas within grantmaking institutions.



- **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, Real Cost Project interviews showed a similar pattern with a significant lack of formal policies¹ 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.

- **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.

**59% OF FOUNDATIONS DID
NOT HAVE FORMAL POLICIES
AROUND OVERHEAD RATES**

- **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.

- **Cultural norms and perceived “best practices” in the field drive funder practices**

An adherence to 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).

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

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

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 flexible funding and build internal capacity to understand the real costs of their nonprofits.

WHAT WE HEARD FROM THE FIELD:

ORGANIZATIONAL AND SECTOR BARRIERS

With the understanding that the issue was a cultural and behavioral issue, not a policy issue, the Real Cost Project launched a series of convenings and meetings around the state (Regional Forums) to identify barriers to change and what would be needed to overcome those barriers. The following are common themes that surfaced from these forums and reflects the issues that participants viewed as the most relevant and urgent. Simultaneously, our partners at the California Association of Nonprofits (CalNonprofits) held similar forums with nonprofit leaders around the state and a summary of these findings are included in the appendix.

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:

1. **Negative Associations with Overhead**

There was widespread recognition that funders often don't recognize indirect costs as legitimate and many nonprofits often don't understand how to calculate or articulate their full costs. This issue was particularly problematic with the boards 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. One participant shared, "Governance has developed with little tolerance for risk." 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.

The bad associations with overhead resulted in underinvesting in one of the most critical areas for

"IT IS PEOPLE, AT THE END OF THE DAY, WHO MAKE CHANGE. YES, IT TAKES MONEY AND STRATEGY, BUILDINGS, INFRASTRUCTURE, AND POLITICAL WILL. BUT IT IS LEADERS WHO TAKE UP A CAUSE AND STOKES AN EMBER INTO A BLAZE. IT IS IN OUR COLLECTIVE BEST INTEREST THAT THEY BE NURTURED AND SUSTAINED."

—CARRIE AVERY AND CLAIRE PEEPS, THE DURFEE FOUNDATION

achieving social change: people. As Rusty Stahl at Talent Philanthropy has articulated, “Grantmakers only perform as well as their grantees. Grantees only perform as well as their people.”

We are seeing burnout, exhaustion of human capital, staff of grantees living on public assistance, and increased reliance on sweat equity. To attract the best talent, to encourage the next generation of social sector leaders, to develop a culturally and socially diverse workforce, grantees need to be able to pay a living wage and to make a career in the social sector economically feasible.

2. Program-based Thinking

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.

There is an erroneous belief (especially among some trustees) that spending percentages of each dollar on overhead is an effective indicator of impact and that less stringent funding guidelines means lower accountability.

These practices often result in nonprofit organizations classifying indirect costs as program costs wherever possible, and configuring their grant requests into the funder’s program areas. And there is an incremental cost to both funders and nonprofits in managing and reporting on project based grants. 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.”

3. Opening Real Dialogue

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.”

Lack of authenticity and transparency in conversations between funders and grantees is a major barrier to real cost funding. Participants agreed that having conversations both internally within their organization and with grantees was an important first step, however, they felt that it would be difficult to move forward without common definitions and understanding of real cost language and principles.

WHAT WE HEARD FROM SENIOR LEADERS: THE NEED FOR TOOLS, TRAINING AND RESOURCES

Much like their program colleagues, presidents and ceo's expressed a real commitment to change and a strong desire to be better partners with nonprofits and to better support sustainability and outcomes. As one CEO stated, "The under-funding of nonprofits is damaging to the sector. But the conversation with grantees is not simply about a "rate" – it is about how to evolve the relationship, how to support the overall organization and its business plan."

In discussing how to "evolve the relationship", leaders focused on a number of common themes including a culture that views overhead as a bad thing; a grantee-funder relationship that is broken; and a set of funder behaviors that are counter-productive. But far and away, the top priority was for training and resources. And here are the top training or resource needs:

1. Financial Literacy

As was uncovered in the research, the onus of determining how much overhead to support, as well as what counts as direct costs, falls to program officers, grants management staff or others who are not necessarily trained in assessing nonprofit financial health. Compounding the issue, nonprofit leaders who are program experts, are not always able to understand or articulate their fully loaded cost of doing business.

Part of the challenge is that much of the financial data grantmakers and nonprofits use are tax and compliance tools that don't necessarily provide the management of programmatic financial data to assess real costs and determine how best to structure grants and financial support.

"THE UNDER-FUNDING OF NONPROFITS IS DAMAGING TO THE SECTOR. BUT THE CONVERSATION WITH GRANTEES IS NOT SIMPLY ABOUT A "RATE" – IT IS ABOUT HOW TO EVOLVE THE RELATIONSHIP, HOW TO SUPPORT THE OVERALL ORGANIZATION AND ITS BUSINESS PLAN." DON HOWARD, PRESIDENT AND CEO, THE JAMES IRVINE FOUNDATION

2. Shared Language/Common Definitions

Senior leaders, much like their program counterparts, expressed frustration over the lack of a shared language and common definitions. The term 'overhead' is not an official accounting term and to make it more confusing, you may also hear terms such as 'indirect costs', 'administrative costs', or 'shared costs' being used as the equivalent of 'overhead'. In addition, the plethora of differing ratios, measurements, and "rules of thumb" are often contradictory and confusing.

3. Best Practices

The presidents and CEOs also wanted to learn from other funders who were already adapting their grantmaking. What lessons learned, best practices, policies and toolkits could be shared? In California, a number of foundations were exploring pilot projects to engage with their grantees around real costs conversations. Leaders were anxious to learn what worked and what didn't.

4. Funder Collaboration

There was strong recognition among participants that to really move forward on a better funding practices, funders will need to collaborate in ways they haven't yet. As stated by one participant, "There is a fundamental dysfunction in how philanthropy works – or more accurately how it does not – work together. Funders need to sit down not only with their grantees but with other funders and have a real conversation."

[Pamela David, Executive Director, Walter and Elise Haas Fund]

COLLABORATION

"FUNDERS NEED TO SIT DOWN NOT ONLY WITH THEIR GRANTEEES BUT WITH OTHER FUNDERS AND HAVE A REAL CONVERSATION." PAMELA DAVID, EXECUTIVE DIRECTOR, WALTER & ELISE HAAS FUND

— RECOMMENDATIONS AND NEXT STEPS —

From San Diego to Silicon Valley and from Los Angeles to San Francisco, grantmakers are engaged in a meaningful dialogue about how create new ways of working, new approaches and new practices that drive outcomes and create a more sustainable, healthy and resilient social sector. We recognize that changing funding practices requires a shift in how funders think about impact, and a willingness to re-examine cultural norms and current approaches to funding.

A range of learnings and recommends emerged from the research, conversations in the field, and senior leaders pointing toward four next steps for funders who want to take the next step toward adopting a real cost funding approach: Engage Trustees, Engage Grantees, Establish a Shared Understanding, and Invest in Training and Capacity Building.



1. Engage Trustees on the Need for Real Cost Funding

For almost all institutional grantmakers, the board is the final and ultimate authority. If the trustees remain focused on program or project support, if they don't view indirect costs as legitimate and if they do not trust their nonprofit partners to effectively manage their finances, then grantmakers will continue to shape policies and practices to reflect this culture.

Senior leaders within grantmaking institutions need to have focused conversations with trustees about the importance of covering what it really costs to achieve outcomes. There needs to be increased opportunities for Trustees to meet with or hear from nonprofits directly and to have real conversations about the grantee's programmatic, operating, infrastructure and long-term reserve needs.

As generally there is minimal contact between trustees and grantees – several foundations have addressed this in creative ways and the benefits have been culture shifting including initiating conversations between trustees and nonprofit leaders; setting aside 45 minutes of each board meeting for a conversation between their trustees and nonprofits; or taking trustees on an annual site visit.

2. Engage Grantees in a Real Conversation

There was widespread agreement that conversations between grantmakers and nonprofits generally do not provide the necessary information to make informed grant decisions about real cost. Often this is a reflection of the inherent power imbalance between applicant and funder, as nonprofits are afraid of sharing their real cost in fear of losing a potential grant. Also, the nonprofit leader may not have a full understanding of their business and reserve needs.

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 it really takes for them to achieve their outcomes and how the funder’s grantmaking practices are helping or hindering the achievement of outcomes. Once funders have an understanding of how their current practices are impacting their grantees, they can increase the percentage of indirect costs their grants cover, or move to provide general operating support, or change the grant application or reporting requirements.

ENGAGE GRANTEES

GRANTMAKERS NEED TO EXAMINE THEIR CURRENT PRACTICES... TO ENGAGE IN CONVERSATIONS WITH THEIR GRANTEES AS TO WHAT IT REALLY TAKES FOR THEM TO ACHIEVE THEIR OUTCOMES

3. Create Shared Language and Understanding of Real Costs

To support both of the above objectives, staff and leadership at grantmaking organizations need training and so do their grantees. From nonprofit leaders to program officers to CEOs, there was a strong consensus on the need for training and support on nonprofit finance, determining the fully-loaded cost of doing business, and establishing a common language and shared understanding on this issue.

To engage in a meaningful conversation with grantees, both the program officer and the grantee need to be able to have a conversation about what the organization is trying to achieve, what it really costs to achieve those outcomes and how the funder can best support those outcomes. Right now, neither is equipped with the skills or tools to create a shared understanding of a nonprofit’s programmatic, capacity, reserves and investment needs.

For training and education to be most effective, as a field, we need to develop common definitions and a shared language, to create templates and toolkits, and to identify best practices for open and transparent conversations. Then we will also need to ensure both program officer and nonprofits are trained on the same framework with the same definition of terms and same cost elements. Ideally, funders and nonprofits should be trained together whenever possible.

4. Invest in Financial Literacy and Outcomes Measurement for Grantees

In order to move to a new funding approach based on real cost, funders acknowledge that it will be critical to invest in building the capacity of their grantees to measure and evaluate outcomes, increase financial literacy, and better analyze their financial health to determine their programmatic and business needs. Far too many nonprofits struggle to keep their doors open and to meet the demand for existing programs; it is difficult for them to make the investments in outcome measurement and evaluation systems. Once they determine their outcomes and impact, they still need to be able to determine the cost of those outcomes which is a time consuming and resource intensive process.

In addition, funders can help reduce the burden of applying for and reporting on grants by:

- better sharing data across funders or developing shared data platforms,
- developing shared or common applications or reporting requirements, and
- eliminating application or reporting requirements that are not essential to the grantmaking decision or due diligence process.

ACTION ITEMS

- Initiate a conversation with staff within your organization about what is and is not working with your current funding practices, what are some of the barriers to change, and what support your team needs to adapt.
- Bring nonprofit leaders and grantees into the boardroom to share their experiences and their challenges with your trustees.
- Talk with the other funders who fund the issues and organizations that you care about and figure out how to work better together to achieve your shared goals.
- Train your program staff (and your operations staff) to understand the real cost of funding.
- Provide training opportunities for your nonprofit partners on financial literacy and understanding what it really costs to deliver outcomes.
- Create workshops and/or trainings with boards/trustees to increase buy-in to full cost funding.
- Provide support for your program staff (and your operations staff) to have authentic conversations with nonprofit partners about the real cost of funding.
- Start a flexible funding program within the foundation that allows program staff to fund needs that might not be included in traditional grant programs.
- Be a part of the evolving conversation. Stay connected.

— CONCLUSION: — — REAL COST FUNDING IN PRACTICE —

Across California, there is a general recognition that current funding approaches are not achieving the outcomes we would like to see in our communities as the sector we operate in is undergoing rapid and fundamental changes. To achieve real outcomes and real impact, funders recognize that they need to lead the ‘real cost’ conversation and that the conversation needs to include foundations (both large and small) as well as government agencies, corporate philanthropy, and individual donors. Working together, working collaboratively, funders can advance this vital issue.

Across the nation, a movement is underway to move from an overly simplistic, transactional approach to funding to a more holistic, outcomes focused relationship with nonprofit partners.

There is no one-size-fits-all solution. Rather it is about having real conversations between funders and grantees, about creating a shared set of goals, and a shared understanding of what it takes to get the job done. A real cost funding approach does not mean that an individual funder is expected to fully fund all of a nonprofit’s programmatic, operating, liquidity and reserve needs. Rather, it means that funders need to understand what their desired outcomes really cost and then decide how to align their funding with what the nonprofit really needs to achieve those outcomes. That could mean a range of possible funding options including programmatic support with increased amounts for overhead, general operating support, program related or mission related investments, funding reserves, pay for success, or maybe even debt repayment.

Building trust is critical and changing the nature of the conversations between funders and grantees is the first place to start. Funders need to have open, honest, transparent conversation within their organizations, with their boards of trustees and with their grantees about what it really costs to achieve the outcomes we want to see in the world. Then working together, working across silos, we can jointly develop solutions that drive both nonprofit financial sustainability and successful outcomes.

To get there, we need help. We need training, tool kits, templates, best practices and a common language. And the regional associations here in California in partnership with the Real Cost Project Funders and our partners at the California Association of Nonprofits are working to determine next steps. Given the significant interest in this issue and consistent feedback that our colleagues want to be diving more deeply into it within their institutions, with their grantees, and as a sector, we anticipate additional collaborative in this space.

Today, funders have the ability to adopt new funding strategies to meet the needs of today’s social sector organizations. 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.

CALIFORNIA PHILANTHROPY

Here in California, the three regional association of grantmakers are committed to working with funders and partners across the state to change the culture of grantmaking and ultimately increase the impact of philanthropy.

— APPENDIX —

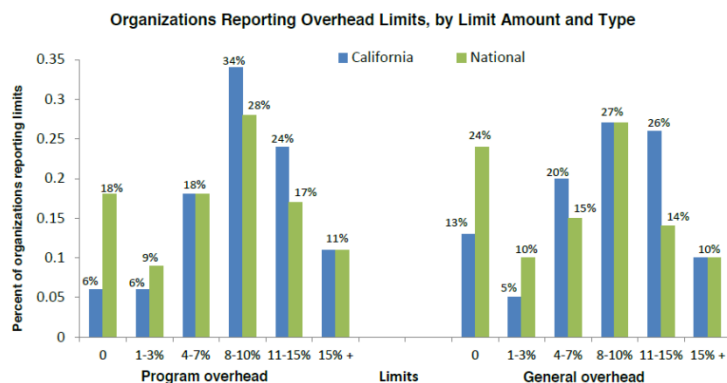
THE STATE OF THE NONPROFIT SECTOR

While the world in which nonprofits and funders operate has changed drastically over the past ten years, funding practices have not yet adapted to the new reality of the social sector. Consequently, funding approaches are misaligned to the programmatic and business needs of nonprofit corporations. The result is a social sector that has weak infrastructure, limited capacity, and an inability to scale.

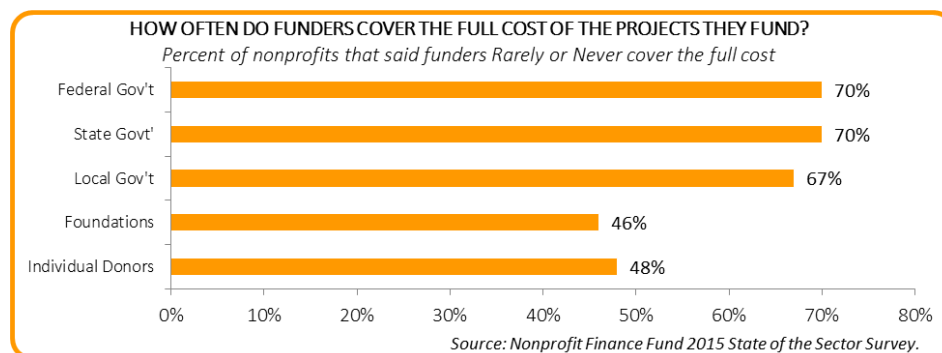
Nationally, and within California, research shows that funding for nonprofit organizations generally fails to cover the full cost of programs and services. Roughly seven in 10 nonprofits in California say the government funding they receive fails to cover the full cost of their services, according to *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).

Nonprofits Reporting Limitations on Full Cost Recovery from Government Contracts and Grants



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 nonprofits are facing are 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.”



These limitations on full cost recovery lead to several problematic consequences in the nonprofit sector. In an article titled *Paying for Not Paying for Overhead*, authors Hager, Rooney, Pollack and Wing claim that overhead limitations impact critical capacity and infrastructure needs of nonprofits, including staffing and technology. They say, “Limits on administrative costs are a cause for concern because nonprofits must find ways to cover those costs. Trying to minimize overhead costs might lead nonprofits to offer low pay for administrative positions, making it difficult to recruit and retain skilled and experienced staff. Or they may forgo investments in technology, reducing productivity and effectiveness” (Hager et al., 2005).

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.

MONTHS OF CASH	CALIFORNIA NONPROFITS OVERALL	CALIFORNIA NONPROFITS SERVING LOW-INCOME COMMUNITIES
<1 Month	13%	14%
1 -3 Months	40%	46%
TOTAL (LESS THAN 3 MONTHS)	53%	60%
3 Months +	47%	40%

Source: Survey data from Nonprofit Finance Fund’s 2015 State of the Nonprofit Sector Survey

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 critical safety net services. The result is that everyday people in our communities are being denied access to critical services from healthcare to workforce development to childcare.

ABILITY TO MEET DEMAND	CALIFORNIA NONPROFITS OVERALL	CALIFORNIA NONPROFITS SERVING LOW-INCOME COMMUNITIES
YES	44%	35%
NO	56%	65%

Source: Survey data from Nonprofit Finance Fund’s 2015 State of the Nonprofit Sector Survey

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 open-ended 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.”


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 creates feelings of frustration and operational challenges for



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.

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 dynamic. 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.