Paying what it takes

Funding indirect costs to create long-term impact

Social Ventures Australia and the Centre for Social Impact acknowledge Traditional Owners of Country throughout Australia. We pay our respects to Aboriginal and Torres Strait Islander Elders past, present, and emerging. We also accept the invitation in the Uluru Statement from the Heart to walk together with Aboriginal and Torres Strait Islander peoples in a movement of the Australian people for a better future.

Acknowledgements

This report was prepared by Social Ventures Australia (SVA) and the Centre for Social Impact (CSI). Contributors from SVA included Sam Thorp, Caleb Heard, Malcolm Garrow and Suzie Riddell. Contributors from CSI included Dr Jeremiah Brown and Professor Kristy Muir. Our thanks to Philanthropy Australia for their support with the research.

The Steering Committee for the Pay-What-It-Takes project has also contributed invaluably to the creation of this report. They include:

- Jo Taylor, Chair, former CCO, Paul Ramsay Foundation
- Jack Heath, CEO, Philanthropy Australia
- Suzie Riddell, CEO, Social Ventures Australia
- Professor Kristy Muir, former CEO, Centre for Social Impact
- Genevieve Timmons, Paul Ramsay Foundation
- Sean Barrett, Origin Energy Foundation.

We thank the many other people across the sector who have provided valuable feedback and advice on the work.

Suggestion citation for this report

Social Ventures Australia and the Centre for Social Impact (2022) *Paying what it takes: funding indirect cost to create long-term impact.* Social Ventures Australia.

Supported by:

paulramsay FOUNDATION PARTNERSHIPS FOR POTENTIAL

origin energy foundation

March 2022

www.socialventures.com.au | www.csi.edu.au

Executive summary

Charities, not-for-profit organisations and the wider social purpose sector are critical to Australia's society and economy.[1] Charities alone have annual revenue of $155 billion and employ over 1.3 million people in Australia. This means they are over 8% of Australia's GDP and account for one in ten of Australia's employees.[2] They provide services that people, communities and government rely on. They also deliver vital services – from disability services to early learning – on behalf of taxpayers, the Commonwealth and state governments.

The impact generated by not-for-profit organisations is fuelled by those who support them. Those who benefit most from the work of not-for-profits are often not the ones who are paying for it. Instead, philanthropy and government funders provide billions of dollars every year, much of it unheralded, to support the varied roles that the sector plays in society.

Thriving not-for-profit organisations are critical to the future productivity and wellbeing of Australia. But right now, when they are needed most, many not-for-profits are struggling. Over the past year we have explored financial vulnerability of charities in our *Partners in Recovery* series of reports, which included an analysis of the financial health of over 16,000 charities using Australian Charities and Not-for-Profits Commission (ACNC) data.[3] The reports have shown that:

- Many charities operate with thin or no margin and did so even before the COVID crisis.
- Many charities operate with limited reserves.
- A majority of charities reported that recent events had put strain on their financial operations, and more than half of the organisations were worried they would not be able to provide their services in the current economic climate.

US research has shown that one of the key drivers of this vulnerability is insufficient funding of not-for-profit 'indirect costs' – for example, HR, IT and finance.[4] This is called the 'non-profit starvation cycle', in which funders having inaccurate expectations of how much overhead is needed to run a not-for-profit means these organisations underrepresent their costs. This leads to a sector starved of the necessary core funding required to create resilient not-for-profits delivering long-term impact on complex social issues. As a result of this research, there has been a long-running campaign in the US to change perceptions of overhead by philanthropists and the government. This campaign has been taken up by a number of influential funders, and contemporary practice in US philanthropy is moving towards a more full-cost approach to funding.

Consequently, we launched this project to look at the issue of indirect cost funding in Australia and to investigate if there was an evidence base for action to be taken to promote and support changing the practice of funders and not-for-profit organisations, with a specific focus on philanthropic funders. This report summarises the key findings from the first stage of evidence collection across the larger project.

[1] We use 'charities' for organisations registered with the ACNC, and 'not-for-profit' for organisations that do not operate to return profits to shareholders or members. Charities are a subset of not-for-profits: all charities are not-for-profit, but not all not-for-profits are charities (see definitions on page 2).
[2] Australian Charities and Not-for-profits Commission (ACNC), *Australian Charities Report 2018*, Australian Bureau of Statistics (ABS), 2019, accessed 28 February 2022.
[3] Social Ventures Australia (SVA) and the Centre for Social Impact (CSI), *Partners in Recovery Series*, n.d., accessed 28 February 2022.
[4] AG Gregory, D Howard, 'The nonprofit starvation cycle', *Stanford Social Innovation Review*, 2009, accessed 28 February 2022.

The evidence we collected in this stage included:

- a literature review of Australian and international research
- nine financial analysis case studies of small and large not-for-profits
- fifteen interviews with small and large not-for-profit leaders
- ten interviews with philanthropic funders
- fifteen interviews with other sector participants.

Definitions

Indirect costs

There are many varied definitions of ‘overheads’ and ‘indirect costs’. We define indirect costs as costs incurred by an organisation that cannot be directly and easily attributed to a specific project. This means if the project did not exist, the organisation would likely still need to incur this cost. Indirect costs include IT, finance, human resources, learning and development, measurement and evaluation.

Charities, not-for-profit and social purpose organisations

While these terms are often taken to be synonymous, we have used them with specific meaning in this report.

- ‘Charities’ are organisations registered with the ACNC and have a specific charitable purpose.
- ‘Not-for-profits’ are a broader group, encompassing any organisation that has declared itself a not-for-profit entity in its constitution. All charities are not-for-profits, but not all not-for-profits are charities.
- ‘For purpose’ is broader again, encompassing organisations like some social enterprises that exist to fulfill a social purpose, regardless of whether they are not-for-profits.
- ‘Non-government organisations’ (NGOs) are a subgroup of not-for-profits, often broadly defined as working on social objectives or internationally.

Key findings

The evidence collected to date suggests that funding indirect costs is a problem for not-for-profits in Australia. Our work has also pointed to a number of potential actions to address the problem.[5]

1. Indirect costs do not indicate the efficiency or effectiveness of a not-for-profit

Research has shown that not-for-profits that spend less on indirect costs are not necessarily more efficient nor more effective than those who do not. Indeed, there is clear evidence that spending insufficient resources on indirect costs can potentially reduce overall effectiveness. However, a significant proportion of Australian funders, both philanthropic and government, only fund a specific percentage of indirect costs or still use indirect costs as a way to differentiate not-for-profits.

Suggested actions: Sector leaders are encouraged to support a range of activities and initiatives that educate not-for-profits, funders, government, the media and the general public that:

1. Funders, both philanthropic and government, should focus on impact when assessing not-for-profits.
2. Low indirect costs do not mean that a not-for-profit is being impactful, and high indirect costs do not imply that it is not impactful
3. Effective not-for-profits incur indirect costs that need to be funded to enable them to achieve their impact. Funders can increase their impact by offering full-cost funding.
4. Understanding impact requires investment in measurement systems.

2. Not-for-profits 'true' indirect costs often far exceed the amount they are funded

The average indirect costs of the not-for-profits analysed was 33% of the total costs, with significant variation between 26% and 47%. This is comparable to the minimum of 29% indirect cost funding found in a US study of 130,000 charities.

By contrast, funding agreements often only included indirect costs of between 10% and 20% of overall costs. A significant proportion of not-for-profits stated that they underreported their indirect costs to funders due to a pervasive belief that funders are unwilling to fund more than 20% of indirect costs.

Suggested action: A credible, independent set of definitions and data on indirect costs that funders and not-for-profits can use should be created. This will foster safe and honest conversations about the actual costs and help quantify how indirect costs deliver impact in not-for-profits. However, given indirect costs can vary significantly between organisations due to different models and investments, caution is needed when using them in benchmarking.

3. Caps on indirect costs leads to lower capability and effectiveness

Case study not-for-profits universally underinvested into their core capability. In comparison, a corporate sector benchmark study suggested they spent twice as much per employee on key capabilities such as IT, quality, training and marketing. We found that not-for-profits underinvest for a number of reasons:

[5] Evidence to support the key findings is detailed in later sections of the report

- Their indirect costs are not fully funded.
- They have reputational concerns around indirect costs.
- There are expectations around funder willingness to pay.

Increased demand for outcomes measurement, which is typically an indirect cost for not-for-profits, and trends towards greater regulation means pressure on indirect costs is rising. Currently, not-for-profits spend significant time searching for untied funding to shore up existing programs and introduce work-arounds to mask indirect costs. This underinvestment increases risk for beneficiaries as well as risk of non-compliance with regulations or funder requirements.

Suggested actions: Both funders and not-for-profits should be encouraged to have an open, productive dialogue around the true costs of any proposed programs or initiatives.

Some philanthropic organisations have begun to adopt a more contemporary approach to funding indirect costs but they are operating independently of each other. Building off this base of good practice, funders can support each other to move towards more evidence-based methods of not-for-profit organisation assessment and funding.

4. The drivers of indirect cost underfunding are complex and interrelated

The relative complexity of measuring not-for-profit organisation effectiveness when compared to for-profit sector pushes funders towards using indirect costs as a metric. Power dynamics between funders and fundees, and the competitive environment between not-for-profits further serve to reinforce this problem and prevent open conversations about funding.

Suggested actions: Understanding the drivers of underfunding allows for the creation of better potential solutions. In particular, we suggest the following:

- Funders, both philanthropic and government, need to actively have conversations with their fundees about how their true costs can be supported. Due to power dynamics, funders will likely need to be the first mover in many conversations.
- Increased collaboration across the philanthropic sector to share learnings on how full-cost funding will help accelerate change – and potentially provide evidence to then influence government funding.
- Funders and their charity partners will be well-served by building trusting relationships built on mutual understanding, which support open and transparent conversations.
- Promote consistent approaches to measurement of outcomes by funders to support their use as an impact metric.

There remain significant unanswered questions about the nature of indirect cost funding in Australia, particularly in relation to government, and we intend to explore this issue in future research. We hope this report forms part of an ongoing body of work that will continue to explore these issues and we welcome feedback and active participation in shaping that ongoing body of work.

In addition to this report, details of the evidence base arising from this work are now available by contacting the authors. This includes:

- detailed definition and taxonomy of indirect costs

- description of the methodology to calculate indirect costs
- the full literature review
- details of the indirect cost case studies for each charity organisation
- summary of the philanthropic interviews.

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Context

The vulnerability of not-for-profit organisations in Australia

Charities and not-for-profits represent an essential part of Australia's community. Charities' total economic contribution alone is equivalent to 8.5% of Australia's GDP; they employ more than one in ten employees or 1.3 million people. That's around the same number of people as retail trade (10.0%). That's more people than the construction (9.2%), manufacturing (7.2%), and professional, scientific and technical services (8.6%) industries. Charities is the second largest employing industry after health care and social assistance; they also engage over three million volunteers and provide over $12.7 billion of unpaid labour.[6]

Not-for-profits provide services that people, communities and government rely on. They deliver vital services – from disability services to early learning – on behalf of the taxpayers, the Commonwealth and state governments. We all benefit from their contributions to education, health care, aged care, sports and recreation, religion, arts and culture, animal protection and environmental protection.

While all not-for-profits are driven by purpose, there is considerable variation in their operating and financial models: some are highly asset-driven, like community housing, whereas others are far more dependent on human engagement. They vary dramatically in scale, diversity of programs and geography.

Not-for-profits are also unlike for-profit entities. With businesses, the 'customer' and the 'funder' are rarely different: the person who pays for a product is the person who wants it. This makes success relatively clear to measure, as the demand increases, the business income also increases. In many not-for-profits, however, this link is severed. The beneficiaries of a not-for-profit are often not the ones funding it, and the gap is filled by funders.[7] In a sense, not-for-profits are ruled by two masters: their funders and their beneficiaries. They also lack access to equity or other forms of capital, and the nature of their funding rarely allows surplus to reinvest.

Across government, the general public and philanthropy, funders provide nearly $90 billion to charities in Australia each year.[8] Ensuring that this money is spent wisely and distributed to organisations that will use it to create impact is an important concern for all funders. Ensuring we have thriving not-for-profits is critical to the future productivity and wellbeing of Australia. But right now, when they are needed most, many not-for-profits are struggling. Over the past year, we have explored financial vulnerability of registered charities in our *Partners in Recovery* series of reports, which included an analysis of the financial health of over 16,000 charities using Australian Charities and Not-for-Profits Commission (ACNC) data.[9] These reports have shown that:

[6] Data is from 2014-5. Deloitte Access Economics, *Economic contribution of the Australian charity sector*, Australian Charities and Not-for-profits Commissions (ACNC) website, 2017, accessed 10 March 2022.
[7] The emergence of consumer directed care in the Disability and Aged Care sector is changing this, though government remains the final funder in this case.
[8] Australian Charities and Not-for-profits Commission (ACNC), Australian charities report – 7th edition, ACNC, n.d., accessed 28 February 2022.
[9] Social Ventures Australia (SVA) and the Centre for Social Impact (CSI), *Partners in Recovery Series*, n.d., accessed 28 February 2022.

- **Many charities operate with a thin or no margin**: in the last financial year before the COVID crisis, 25% of charities operated in deficit and an additional 35% operated with a profit margin of less than 5%.
- **Many charities operate with limited reserves**: modelling found that a 20% decline in revenue due to the COVID crisis would result in 17% of charities being at high-risk of closing their doors in six months due to depleting their reserves.
- **Many charities feel vulnerable**: our late 2020 survey of over 200 charities found that 77% reported that recent events had put strain on their financial operations and 52% were worried they would not be able to provide their services in the current economic climate.

Understanding the drivers behind this vulnerability and how they can be addressed by both not-for-profits and funders is key to the ongoing sustainability of the sector. These organisations are not in this position because they have been mismanaged. In fact, they have been pushed into 'running lean' by various forces for many years.[10] This leanness has risks. This leanness means not-for-profits have a reduced ability to adjust to economic shocks.[11]

[10] N Cortis, I Lee, A Powell, R Simnett and R Reeve, *Australian charities report 2014*, Centre for Social Impact and Social Policy Research Centre, UNSW, 2015.
[11] GE Mitchell, 'Fiscal leanness and fiscal responsiveness: Exploring the normative limits of strategic non-profit financial management', *Administration & Society*, 2017, 49 (9):1272–1296.

The 'starvation cycle' in US not-for-profits

The issue of indirect cost underpayment has been a cause for debate in the US for over three decades. There is significant evidence of the negative impacts of using indirect costs as a yardstick for not-for-profit effectiveness in the US system and a growing movement to push back against it.

The 'non-profit starvation cycle', which was articulated by Bridgespan in 2009, is a key example of these negative impacts.[12] The researchers found that funder expectations led to not-for-profits feeling pressure to both underinvest in their indirect costs and underreport their true costs to funders, thus perpetuating the cycle:

> *"The first step in the cycle is funders' unrealistic expectations about how much it costs to run a non-profit. At the second step, non-profits feel pressure to conform to funders' unrealistic expectations. At the third step, non-profits respond to this pressure in two ways: They spend too little on overhead, and they underreport their expenditures on tax forms and in fundraising materials. This underspending and underreporting in turn perpetuates funders' unrealistic expectations. Over time, funders expect grantees to do more and more with less and less—a cycle that slowly starves non-profits."*

The unrealistic expectations are around the level of indirect costs needed to run a not-for-profit. When Bridgespan surveyed 20 high-performing not-for-profits, they uncovered that indirect costs could vary substantially by type and sector of not-for-profit and made up between 21% and 89% of direct costs.[13] They further found that the median indirect cost rate was 40% while US foundations and government allocated, on average, 10–15%.[14]

Another study commissioned by the MacArthur Foundation of the finances of 130,000 US not-for-profits found that "the minimum indirect cost rate associated with financially healthy organizations in the dataset is 29 percent". As a direct result this research, the MacArthur Foundation now gives organisations a flat 29% for overheads in addition to their project costs.[15]

[12] AG Gregory, D Howard, 'The nonprofit starvation cycle', *Stanford Social Innovation Review*, 2009, accessed 28 February 2022.
[13] Gregory and Howard, 'The nonprofit starvation cycle'.
[14] J Eckhart-Queenan, M Etzel and S Prasad, 'Pay-what-it-takes philanthropy', *Stanford Social Innovation Review*, 2016, accessed 28 February 2022.
[15] It should be noted that this flat approach does not take into account the variability in indirect costs by sector and activity found by Bridgespan.

An Australian perspective on pay-what-it-takes

The 'pay-what-it-takes' approach to philanthropy was first proposed in an article from Bridgespan that articulated the dire situation of not-for-profit funding in the US and how a new way of thinking about organisational funding was needed.[16] It proposes a different grantmaking approach:

> *"One that provides enough money for non-profits to pay for all their operations, not just programs and services."*

In Australia, conversations around indirect cost funding for not-for-profits have been gathering pace. Philanthropy Australia has hosted significant keynotes by Kathy Reich of the Ford Foundation and Valerie Chang of the MacArthur Foundation to raise the prominence of this issue.

The pandemic, and the resulting financial uncertainty among not-for-profits it created, catalysed a number of key organisations and funders to want to understand and address this issue in an Australian context. The Centre for Social Impact (CSI), Social Ventures Australia (SVA) and Philanthropy Australia (PA) came together to form a collaboration, supported by Paul Ramsay Foundation and the Origin Energy Foundation.

The 'Pay-What-It-Takes' collaboration

- Jo Taylor, Chair, former CCO, Paul Ramsay Foundation
- Jack Heath, CEO, Philanthropy Australia
- Suzie Riddell, CEO, Social Ventures Australia
- Professor Kristy Muir, former CEO, Centre for Social Impact
- Genevieve Timmons, Paul Ramsay Foundation
- Sean Barrett, Origin Energy Foundation

At this initial stage the collaboration has three main aims:

- Understand to what extent pay-what-it-takes is an issue in Australia by beginning to create an evidence base and case for change.
- Start bringing together a community of practice of funders to build collective understanding and progress best practice.
- Create strategies and structures to support an ongoing campaign to change philanthropic funding in Australia.

CSI and SVA were engaged to help with the initial phase of this work to create an evidence base to better understand the current state of indirect cost funding in Australia. The evidence base arising from this work is summarised in this report. Additional information is available from the authors and includes the following:

[16] Eckhart-Queenan et. al., 'Pay-what-it-takes philanthropy'.

- detailed definition and taxonomy of indirect costs
- description of the methodology to calculate indirect costs
- details of the indirect cost case studies for each charity organisation
- the full literature review
- write-up of the philanthropic interviews.

Methodology

Defining indirect costs

One of the key roadblocks for effectively solving this issue in Australia is a lack of a shared definition of what constitutes an indirect cost. This is partly due to the fact that it is a surprisingly complex concept: the classification of 'direct' and 'indirect' costs can vary between organisations. The allocation of a cost to a project is determined partially by whether there is an accurate and cost-effective way of attributing it. One organisation's indirect cost might be a direct cost at another, depending on size, scale, model and other factors.

The lack of a shared definition of indirect costs has a serious impact on not-for-profits. Organisations with multiple funders noted that a lack of consistent standards, expectations or benchmarks led to significant challenges in reporting.

For the purposes of this work, we have lightly adapted the MacArthur Foundation definitions and those used by the Cass Centre for Charity Effectiveness in the UK.[17] Not-for-profit costs can be classified into three categories: direct, shared and indirect costs.

Direct costs

Direct costs are those costs that are specific to a project, such as, salaries for project staff and materials required for the project. The key test is that these costs would not be incurred if the project being funded did not exist. For example, staff time that can be unambiguously identified as having been spent on the project or travel costs for project travel.

Shared costs

Shared costs are those costs that benefit multiple programs or projects and can be allocated across programs or projects in a reasonably consistent and accurate way. These costs are just as integral to the delivery of the project as the direct costs. Generally non-personnel costs, these costs can include office costs and facilities, utilities, telephone and internet access that can be clearly attributed to a person working on a specific direct cost project. Depending on how an organisation is structured, some quality, training, and measurement and evaluation costs may also be classed as shared costs. Note also that shared costs in some organisations and studies are described as an indirect cost.

Indirect costs

Indirect costs are costs for activities or services that support the organisation as a whole rather than any particular program or project. These are not costs associated with the delivery of program services. Nonetheless, they are essential costs of maintaining and managing the organisation through which program services are delivered. Examples of such costs include IT, marketing, fundraising, human resources, strategy development, learning and development, measurement and evaluation, finance and accounting support, and bank fees and board meetings.

[17] Cass Centre for Charity Effectiveness (CASS CE), *Cost recovery tools for success: doing the right things and doing them right*, Cass Centre for Charity Effectiveness (CASS CE), n.d., accessed 28 February 2022.

Funders will often not distinguish between shared and indirect costs. Therefore, many of the findings of this report apply equally to shared costs as they do to indirect costs (for more detail on definitions and cost allocations, see the appendix).

Figure 1 shows that the full cost to deliver a program includes not only the direct costs, but a proportion of the shared and indirect costs of the organisation. These definitions apply equally to for-profits as they do to not-for-profits. The key difference is that in for-profits they are almost never used in isolation and are instead analysed in relation to the sales and profit it generates. As this report will speak to, creating comparable efficiency metrics are less straightforward in the not-for-profit sector.

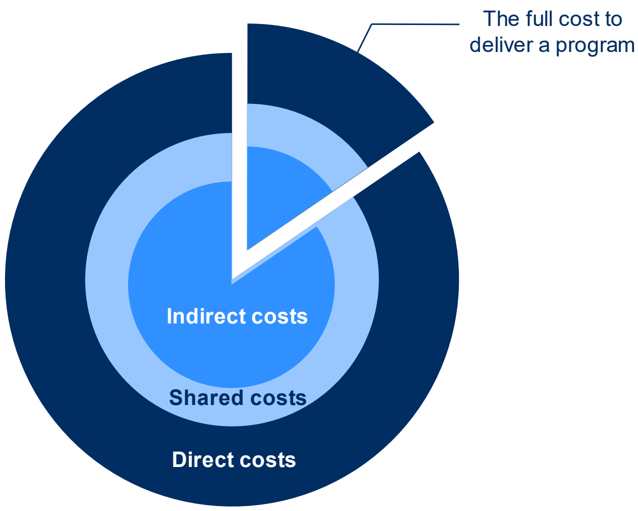


Figure 1: Full costs to fund a program

Data collection

Given the complexity of the issue, multiple methods of data collection and analysis were employed to compile an evidence base on indirect costs in Australia. This included:

- a literature review of Australian and international research on indirect costs
- analysis of not-for-profit survey data
- interviews with people from the Australian philanthropic sector
- in-depth financial case studies of a selection of not-for-profits in Australia
- interviews with not-for-profit staff and stakeholders.

Both the Centre for Social Impact (CSI) and Social Ventures Australia (SVA) conducted the research. CSI contributed three separate components to the research: a literature review, an analysis of survey data and semi-structured interviews with experts on not-for-profit funding from the Australian philanthropic sector. SVA conducted two interconnected pieces of research: semi-structured interviews with not-for-profit staff and detailed financial case studies of nine organisations.

Literature review and survey data analysis

The literature review examined 72 sources from the existing academic and grey literature on 'the non-profit starvation cycle', with an emphasis on sources that covered the Australian context. This was conducted to determine the key themes in the existing literature and to evaluate the state of the literature on the non-profit starvation cycle in Australia.

The literature review was complemented by the CSI 'Pulse of the For Purpose Sector' survey data analysis.[18] This examined trends around financial vulnerability of charities driven by the pandemic and the recent bushfires.

Interviews with philanthropic sector

Semi-structured interviews with 10 experienced practitioners working on funding from the philanthropic sector were also conducted. These interviews identified how people across the sector view the issue and the solutions that funders employed to address funding problems in the Australian context. A purposive sampling strategy was used.[19] The people interviewed came from a range of different philanthropic funding organisations: they varied in terms of geographical location, the sectors they funded, the size of their organisations and the level of financial support that their organisation provided to not-for-profits.

Interviews with not-for-profit staff and stakeholders

Interviews were conducted with 15 not-for-profit executive staff regarding the issue of pay-what-it-takes. In addition, two existing cross-sector collaboration groups of not-for-profits were consulted. Participants were asked to describe their organisation's approach to indirect costs, their funders and their funders' attitudes to indirect costs, and the extent of any underinvestment due to a lack of indirect cost funding.

[18] See https://www.csi.edu.au/research/project/pulse-of-the-for-purpose-sector/.
[19] Purposive sampling is widely used in qualitative research for the identification and selection of information-rich cases related to the phenomenon of interest.

Financial case studies

In-depth financial case studies of nine varied not-for-profits were also conducted. Figure 2 and 3 show the case study organisations in terms of size, sector focus and number of programs. These organisations provided a recent budget, which was then analysed by segmenting costs into direct, indirect and shared costs (see the appendix). Most case studies provided a 2019 budget or actuals to ensure the revenues and costs represented the normal operations and were not influenced by the disruption of COVID-19.

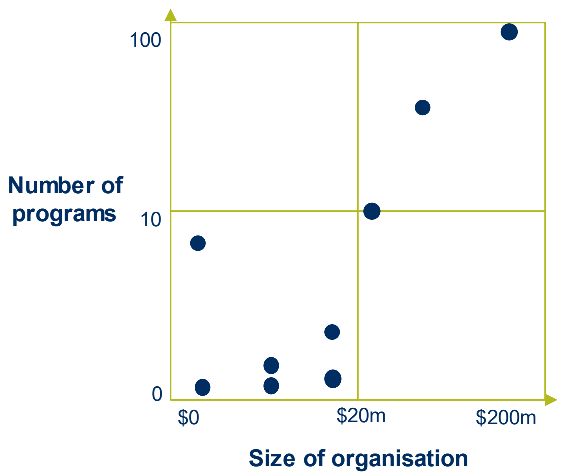


Figure 2: Case study organisations by size and number of programs

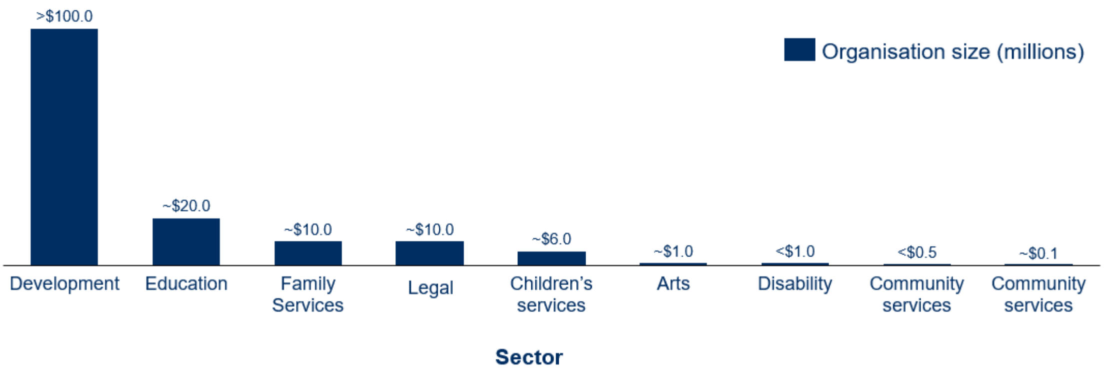


Figure 3: Case study organisations by size of organisation and sector focus

Sampling of not-for-profits was purposive. Due to the difficult nature of the public discourse around indirect costs, a strong trust-based relationship was required with each organisation prior to it taking part in the study. Equally important, no case study participants were selected because they had previously indicated a strong interest in the 'pay-what-it-takes' issue, and case study participants indirect costs were not known prior to their selection. Each not-for-profit agreed to take part under condition of strict anonymity.

While the focus of this research has initially been on the philanthropic sector, many of the findings bear relevance to government funding as well. Additional work will need to be undertaken to better understand indirect cost issues from a government funding perspective in detail.

Key findings

Section 1: Indirect costs and their effects

Indirect costs do not indicate the efficiency or effectiveness of a not-for-profit

At the core of 'pay-what-it-takes' is an examination of the use of indirect costs as a tool to estimate the effectiveness or efficiency of not-for-profits. *Research finds that low indirect costs do not mean a not-for-profit is more efficient or effective***.** In most cases, not-for-profits that spend less on indirect costs are no more efficient or effective than those who spend more.[20] Furthermore, there is some evidence that higher-impact not-for-profits may actually invest more in indirect costs.[21]

Funders have a duty to ensure that their funds are used in the most effective way. For many years, they have used the proportion of funds an organisation spends on indirect costs as a way of assessing not-for-profit efficiency or effectiveness. Indirect costs are examined closely by funders, donors and the media to determine which organisation to support, usually with the lens of lower indirect costs being preferred.

The problem is that the amount of money a not-for-profit spends on indirect costs has, often, no bearing on efficiency and effectiveness. The evidence suggests that there is no correlation between how much a not-for-profit spends on indirect costs and the outcomes it creates:

> *"Studies have failed to find any correlation between overhead ratio and cost-effectiveness: organizations with a low overhead ratio can still achieve very little and organizations with a high overhead ratio can be very effective."*[22]

There is some evidence that higher impact not-for-profits spend more on indirect costs.[23] This makes sense, as there is clear evidence that spending insufficient resources on overheads can negatively impact overall not-for-profit effectiveness.[24] The ACNC agrees that indirect costs are a poor measure of not-for-profit effectiveness and is publicly opposed to using indirect costs as a method to compare not-for-profits:

> *"All charities spend money on administration – without it, they wouldn't be able to operate and pursue their charitable purposes. It can be misleading to consider administration costs as separate from a charity's cause, because this fails to recognise parts of a charity's operations that enable it to deliver services."*[25]

[20] L Caviola, N Faulmüller, JAC Everett, J Savulescu and G Kahane, 'The evaluability bias in charitable giving: saving administration costs or saving lives?', *Judgment and Decision Making*, 2014, 9(4): 303–316.
[21] C Fiennes, *Good charities spend more on administration than less good charities spend*, Giving Evidence website, 2013, accessed 28 February 2022.
[22] Caviola et. al., 'The evaluability bias in charitable giving: saving administration costs or saving lives?'.
[23] Fiennes, *Good charities spend more on administration than less good charities spend.*
[24] P Rooney and HK Frederick, *Paying for overhead: a study of the impact of foundations' overhead payment policies on educational and human service organizations* [working paper], 2007, p 36.
[25] Australian Charities and Not-for-profits Commission (ACNC), *Charities and administration cost*, ACNC website, n.d., accessed 28 February 2022.

Australian not-for-profits reluctantly underinvest in indirect costs

Financial analysis of nine not-for-profits revealed that their average indirect costs were 33%, similar to findings from US research of 29%. Every organisation spoken to said that they had difficulty funding the true costs of what it takes to deliver impact. Most believed they were underinvesting in indirect costs, and several acknowledged that they underreported their direct costs to funders in order to win funding. Therefore, while the analysis represents each organisation's current expenditure, the optimal indirect cost expenditure could be higher.

The average not-for-profit indirect costs are also significantly lower than what businesses spend on indirect costs. For-profit organisations are able to spend as much or as little on indirect costs as is deemed appropriate for their organisation. Companies under $1 million in revenue, for example, spend on average 48% indirect costs, not including research and development.[26,27]

What do corporates spend on indirect costs?

According to Biery and Sageworks, companies with more than $10 million and less than $1 million in annual revenue on average spend between 25% and 48% of revenue respectively on selling, general and administrative expenses. The numbers are roughly equivalent to not-for-profit indirect costs, though not including research and development.[28]

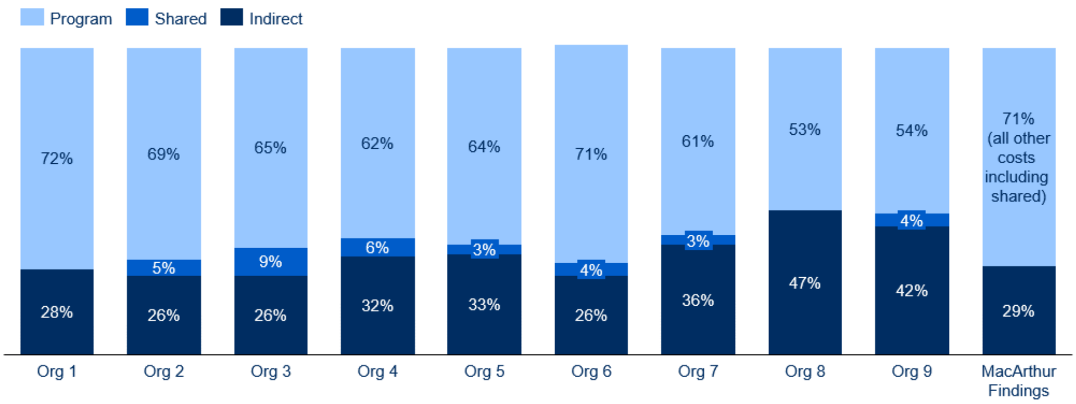
As we found in the social purpose sector, overhead ratios can vary dramatically by industry. This is in-line with outside-in analysis conducted by the authors on the ten largest listed organisations in the US. It found indirect expenditures to be, on average, 27% of total expenses in 2020. If research and development expenses (14.6% of total expenses) were also considered an indirect expense, then the average indirect expenditure would rise from 27% to 41%.

These findings suggest that larger organisations require less indirect expenditure as a proportion of total costs than smaller organisations, which sits in line with the initial case study findings. This also implies that in this regard, the social purpose and for-profit sectors are held to different standards.

More work would be needed to complete a thorough benchmarking of for-profit indirect costs versus not-for-profit.

[26] This analysis leverages income statement data on macrotrends for Apple, Microsoft, Amazon, Facebook, Google, Berkshire Hathaway, Tesla, NVIDIA, JP Morgan and Johnson & Johnson. This analysis made two broad but conservative assumptions. First, 'total expenses' to be the difference between revenue and net profit, with the aim of not missing any potentially relevant expenses. Second, 'indirect expenditure' to consist solely of selling, general and administrative (SGA) expenses, with the aim of not capturing any 'program expenses' within this category. Removing the outliers from the sample (JP Morgan (82%) and Apple (9%)) reduces the findings to 22% (ex-R&D) and 39% (in-R&D) respectively.
[27] It should be noted that indirect costs as a percentage of revenue is a different metric to case study analysis detailed in Figure 3, which measures indirect costs as a percentage of total costs. Therefore, it is not a perfect comparison but likely understates the business indirect costs. For companies making a profit, their indirect costs as a percentage of total costs will be higher than their indirect costs as a percentage of revenue. The opposite holds for companies making a loss.
[28] M Biery and Sageworks, 'A Sure-fire way to boost the bottom line', *Forbes*, 12 January 2014, accessed 26 February 2021.

In our research, we also found significant variation in not-for-profit indirect costs, ranging from 26% to 47% (Figure 4). The literature suggests that the necessary indirect costs for a not-for-profit varies substantially based on the sector and activities.[29] Therefore, this variation is likely to be attributable to the specific sector an organisation works within. For example, an organisation in the disability sector is likely to have additional costs for quality controls and regulatory compliance to ensure safe, high-quality care compared to an organisation in the arts sector.



Expenditure	>$100m	~$20m	~$10m	~$10m	~$6m	~$1m	<$1m	<$500k	~$100k	
Sector	Development	Education	Family services	Legal	Children's services	Arts	Disability	Community Services	Community Services	~130,000 US non-profits

Figure 4: Indirect costs by size across nine Australia not-for-profit organisations[30]

While we note the small sample size, the case study data also suggests that smaller not-for-profits may have a higher indirect cost base. This size effect is also seen in for-profit organisations; it could be attributed to funding, economies of scale or staff specialisation. However, more research would need to be conducted to confirm it.

One large not-for-profit noted that the way funders approach indirect cost funding can actually serve to erode the gains from economies of scale. While some costs are centralised, large not-for-profits will often use local suppliers and project teams for work that could be done centrally, purely to ensure that those costs are considered direct costs rather than indirect costs. The organisation we interviewed said:

> *"[Our organisation] can be viewed as the aggregation of a large collection of local services rather than a true national group benefiting from economies of scale and lower total delivery costs."*

Our findings align with the study commissioned by the MacArthur Foundation of the finances of 130,000 US not-for-profits. It found that 29% was the minimum indirect costs needed by financially healthy organisations. While a direct comparison to US data with different reporting requirements is

[29] Eckhart-Queenan, 'Pay-what-it-takes philanthropy'.
[30] This analysis is based on the cost allocation methodology developed by the MacArthur Foundation in the US (see the appendix for more information). The shared costs of organisation 1 and organisation 8 are incorporated within indirect costs due to the high-level accounting of administrative costs that was provided. Some analysis is limited to sub-organisations and programs within organisations.

imperfect, the large sample size and extensive research in the US provides a reference point to start understanding the Australian context.

In addition to the evidence compiled through the case studies, analysis of the CSI 'Pulse of the For-Purpose Sector' data demonstrates that there is currently no clear agreement on how to fund indirect costs in Australia. Figure 5 shows the responses to the first wave of the Pulse of the For-Purpose Sector survey relating to the level of costs covered by different types of funding source. There is a clear disparity with the full-funding of organisations from the responses given, especially in relation to funding from government, philanthropy and corporate funding. As can be seen in Figure 5, over 60% of respondents said that the funding they received from those three types of funders did not cover direct and indirect costs, or only covered direct costs. This highlights the widespread nature of indirect costs being underfunded in the Australian context.

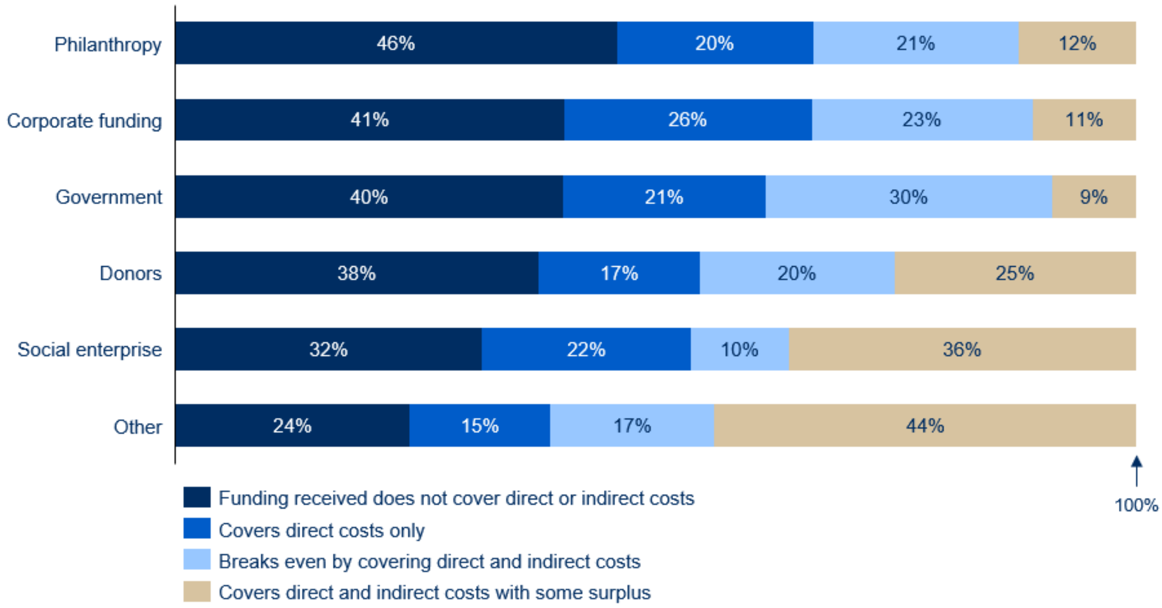


Figure 5: Funding source and level of costs covered (Pulse survey data)

Every organisation interviewed was emphatic that their grant funding did not cover the full costs of running their programs. They also believed that they were underinvesting in key core costs of the organisation due to these funding circumstances. As a small not-for-profit said:

> *"Funders want good financial systems and governance but aren't willing to pay for it."*

Figure 6 shows how much each organisation spends on key capabilities per employee, such as training and IT. Based on benchmark from Mercer, Australian businesses are spending on average 1.8–3.6 times more per employee than case study organisations across a range of important costs. This is particularly prevalent across the quality and marketing functions, where some organisations do not have the capacity to invest.

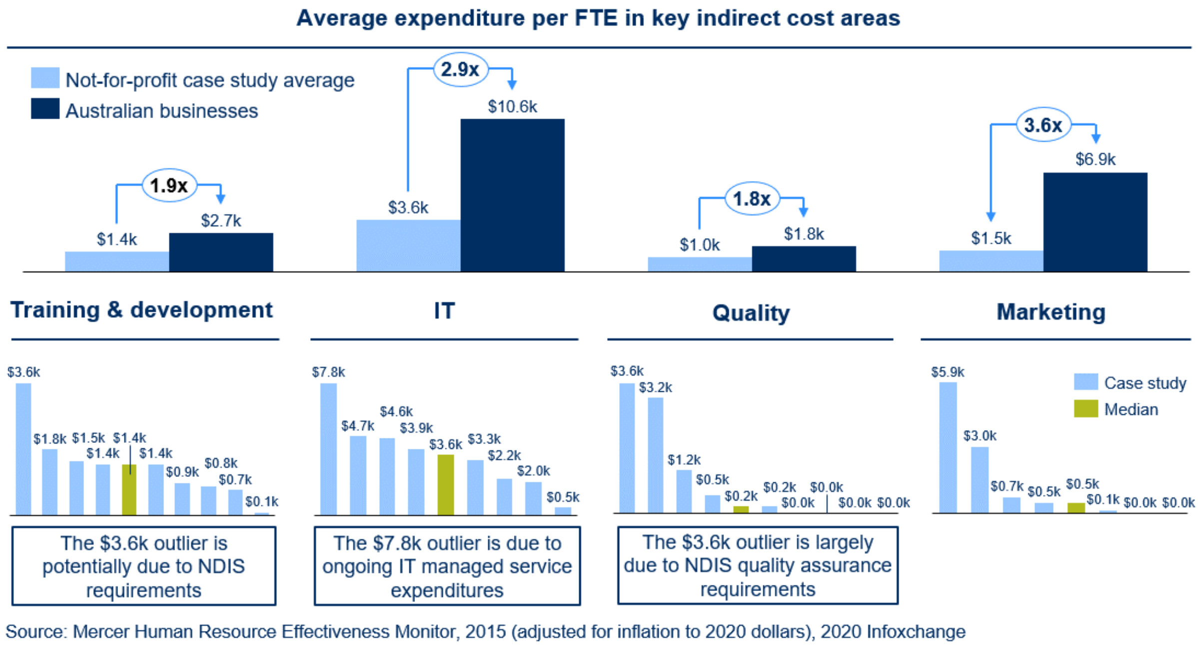


Figure 6: Comparing function spend per FTE of case study not-for-profit organisations with the Australian for-profit average.[31]

While this is a small sample, the $3,600 average for IT spend in the case study analysis is close to the average not-for-profit spending calculated by Infoxchange at $3,800.[32] This is a good indication that the sample is relatively representative. Even though we acknowledge that this is not a robust 'apples-to-apples' benchmarking exercise, we believe the initial results imply not-for-profits are underinvesting in these functions. Moreover, interviews also revealed that not-for-profits would universally choose to invest more money in indirect costs if resources were available.

A number of organisations further admitted to underreporting their indirect costs to funders in order to obtain funding, both intentionally and unintentionally. There was general agreement that more than 20% indirect costs on a grant application started looking 'high', and organisations would generally self-censor to stay at or under that level. In addition, many organisations lacked the resources to properly articulate indirect costs in complex models, and non-finance teams often have a limited understanding of the 'true' indirect costs of their programs. This means they default to the accepted wisdom of asking for lower indirect costs, without fully understanding the consequences for their organisation.

[31] Mercer Human Resource Effectiveness Monitor, 2015 (adjusted for inflation to 2020 dollars)
[32] Infoxchange, *Digital technology in the not-for-profit sector 2020*, Infoxchange website, 2020, accessed 28 February 2022.

Indirect and shared costs commonly excluded by funders

- Business development
- Services establishment
- Research, service design, and policy and advocacy
- Governance and risk management
- Media and communications
- Decommissioning or exit costs

Figure 7 further illustrates the financial structure of one organisation, which has true indirect costs of approximately 33% of total costs. The case study allows us to draw out the following points of note:

- The majority of this organisation's income is from government grants (81%), with a small amount of philanthropic income (15%).
- Income is mostly 'tied' to particular projects. Ninety-seven per cent of funding is only available to be spent on the specified activities. Only 3% of funding is 'untied', mostly due to being fee-for-service revenue.
- Fifteen per cent of this organisation's funding is formally restricted in terms of how much can be spent on indirect costs. Eighty-two per cent is tied to a project but is not restricted in how it can be spent.
- This restricted funding (15% of the total) is all from government grants. These grants have specific restrictions in their funding agreements, which means they can only spend 15% of the funds on indirect costs, forcing the rest of the organisations finances to make up the deficit.
- While that is the only formal restriction, this organisation has underreported its true indirect costs in order to win other historic grants. This means that, while they are not formally restricted, the grant funding does not fully cover the costs to run the program, leading to a substantial shortfall. Recognising the situation, the organisation has recently begun to include between 27–30% indirect costs on all new tenders, which has not received any pushback from funders.

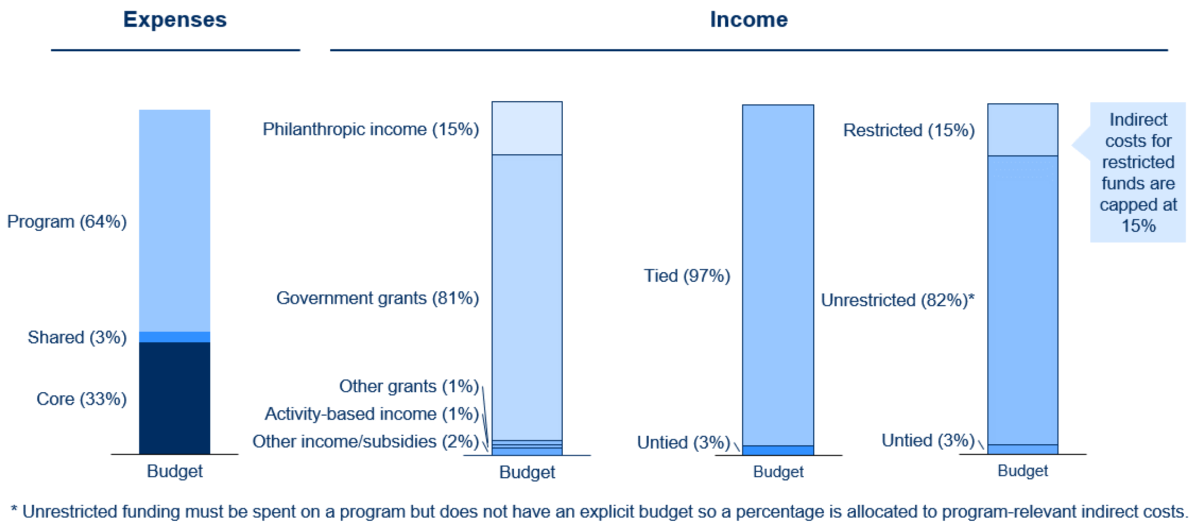


Figure 7: Expenses and income at case study organisation[33]

The organisation feels that it is underinvesting in core areas of its business, specifically in IT, innovation, marketing, and staff learning and development. Figure 8 shows the organisation's spending, which is substantially lower than the for-profit average across all four functions.

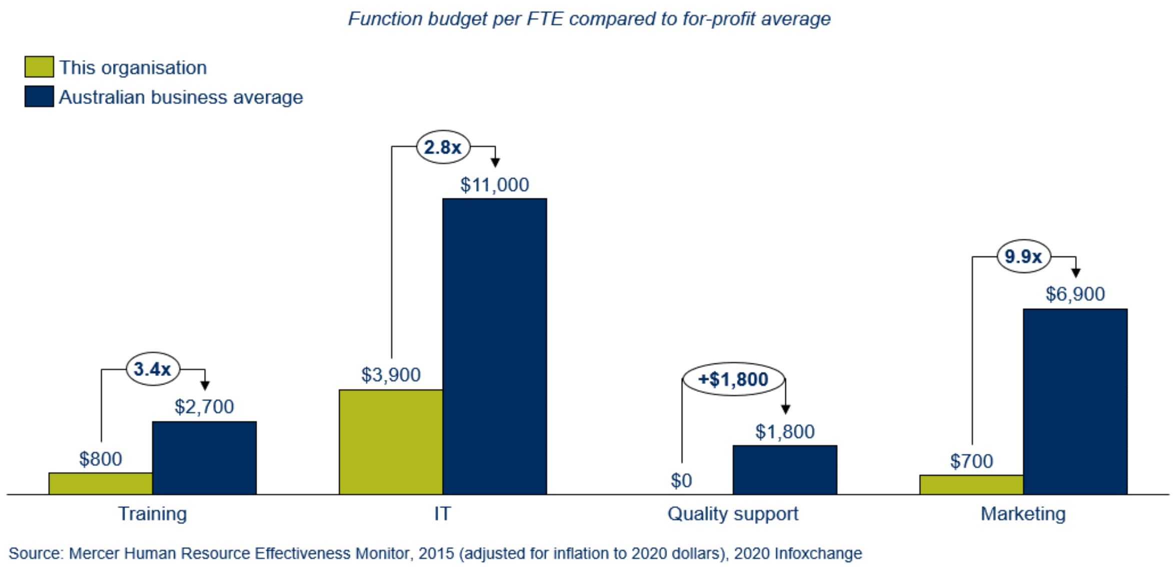


Figure 8: Spend per FTE compared to for-profit average

[33] We note that this organisation incurred a budgeted loss, but this is broadly indicative of the financial mix at this organisation.

Not-for-profit funding sources

Not-for-profits often have a variety of funding sources, including philanthropic, government and fee-for-service income. Our findings are most relevant to organisations with income from government or philanthropy, as the nature of the power dynamics mean that funders can place restrictions on both who can be funded and how funding can be spent. In general, fee for service funding is based on a market price and the onus is on organisations to ensure it covers their costs.

Placing caps on indirect costs leads to lower impact, increased risk and financial vulnerability

There is clear evidence that spending insufficient resources on overheads or indirect costs can impact overall not-for-profit effectiveness, equating to lower quality program outcomes.[34] In Australia, the most recent results from the PricewaterhouseCoopers (PwC) not-for-profit CEO survey highlight this issue, with the summary of the findings noting that:

> *"Not-for-profits are under intense pressure to keep administrative costs low even though healthy operating costs allow organisations to execute their mission more effectively."*[35]

Many not-for-profits reported that cost restraints resulted in challenging working conditions for staff. These conditions can include being overworked, underpaid and having low job security due to short-term funding arrangements. These organisations also reported facing high levels of attrition. A not-for-profit shared service noted:

> *"[Cost constraints] tend to create high staff turnover due to stress and juggling a lot of balls – retention is an issue."*

Not-for-profits also note that insufficient spending on indirect costs leads to increased risk to clients, as well as increased risk of non-compliance with funders' own requirements and regulatory requirements. Not-for-profits who provide services face similar risks to for-profits in Occupational Health and Safety (OHS), protection of information and fraud. Investment in IT systems and risk management is fundamental to the delivery of good services and important to the overall health of the organisation. Strategy development and strategic capability are another key area where not-for-profits may underinvest, leading to long-term impacts on effectiveness.

Within the academic literature there is evidence that financially vulnerable not-for-profits are less inclined to initiate and participate in internal and cross-sector collaborations.[36] This was supported in our interviews, with multiple organisations citing a lack of resources as something that constrained their capacity to collaborate with others, which in turn inhibits their potential to achieve impact.

[34] Rooney and Frederick, *Paying for overhead: a study of the impact of foundations' overhead payment policies on educational and human service organizations*.
[35] R Wilkie, J Edwards and L Goldstone, 'Future proofing: automation and outsourcing opportunities', Pricewaterhouse Cooper (PwC) website, n.d., accessed 28 February 2022.
[36] H MacIndoe and FM Sullivan, 'Nonprofit Responses to financial uncertainty: how does financial vulnerability shape nonprofit collaboration?', *Journal of Sustainability Science and Management*, 2014, 4 (3):1, doi:10.5539/jms.v4n3p1.

Not-for-profits use a variety of strategies to cope with the persistent underfunding of their core costs, many of which are either actively harmful or simply inefficient. Other than cutting back indirect costs as previously discussed, the most common is searching for 'untied' philanthropic funding in order to backfill the gap left by insufficient program funding. Organisations devote significant time and resources to finding additional funders that are willing to provide core funding or convert existing funders to providing untied funding. This was noted as a significant drain on resources. As a small not-for-profit noted:

> *"The nature of short-term funding means you spend most of your life looking for money."*

One not-for-profit that saw success from the strategy of pursuing untied funding was a small National Disability Insurance Scheme (NDIS) provider. The organisation managed to find a significant group of philanthropists willing to fund the overheads that the NDIS was not. The freedom that came with this trust-based funding meant the organisation felt they could invest the money as needed to best support themselves and felt that they invest well across the different areas of their organisation.

Another strategy, fee-for-service revenue, was mentioned by multiple not-for-profits as a potential funding source that came without restrictions. One not-for-profit mentioned that they had created a fee-for-service program purely to help the organisation be more financially sustainable. This strategy has risks: first, revenue diversification as a strategy was both supported and contested in the literature.[37] [38] Second, not all organisations have the capabilities to run a successful fee-for-service business. Finally, while revenue diversification might be an effective strategy for protecting against financial vulnerability, there are tensions related to financial decision-making across different revenue sources.

One not-for-profit mentioned that there was a tendency to not hire administrative staff as needed and push the burden onto program staff as a way to reduce indirect costs. It said:

> *"You're incentivised to burden front-line staff with admin because donors will pay for that."*

This makes programs less efficient and reduces the ability of staff to specialise.

One less common but often effective technique was being upfront with funders about the true indirect costs of the organisation. The not-for-profit that employed this technique found it to be effective. This technique does often require a strong relationship with the funder. Where a relationship of trust does not exist between not-for-profits and funders, the power dynamics and entrenched beliefs about indirect costs result in many not-for-profits being hesitant to employ this technique.

[37] M Kim, 'The relationship of nonprofits' financial health to program outcomes: empirical evidence from nonprofit arts organizations', *Nonprofit and Voluntary Sector Quarterly*, 2017, 46 (3): 525–548, doi:10.1177/0899764016662914.
[38] GE Mitchell and TD Calabrese, 'Proverbs of nonprofit financial management', *The American Review of Public Administration*, 2019, 49 (6):649–661, doi:10.1177/0275074018770458.

Section 2: Drivers of indirect cost misalignment

The observed underinvestment and underreporting of indirect costs has root causes in the fundamental structures of the funding environment and ecosystem not-for-profits find themselves in. Power dynamics between funders and not-for-profits, competitiveness of funding, trust-based relationships and the difficulty of measuring outcomes all play important roles in creating and reinforcing the observed behaviours by not-for-profits and funders (see Figure 9). Challenges with measurement of indirect costs, and the range of different definitions used across organisations were also recognised by those interviewed as contributing to indirect cost issues. The strength of the relationships between these causes, and the extent of their impact remains to be tested. It is also important to highlight that the extent of these influences will vary according to individual circumstances. Consequently, these drivers should be considered high-level tools for funders and not-for-profits to diagnose structural issues.

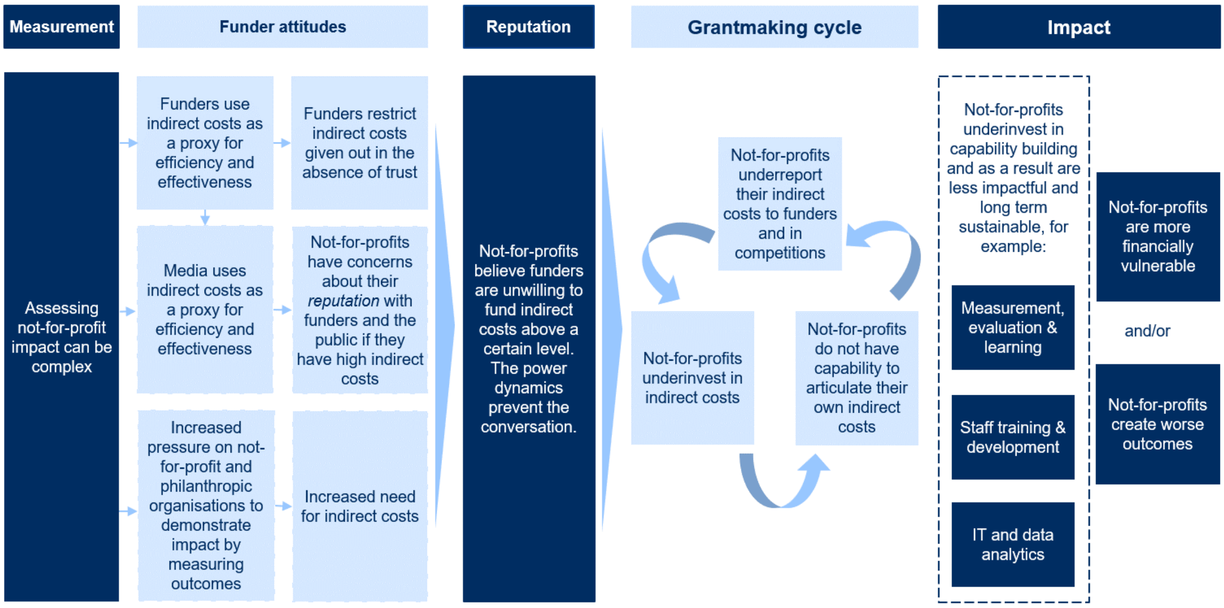


Figure 9: Hypothesised causes of indirect cost misalignment

Power dynamics with funders strongly influence not-for-profit behaviour

Power dynamics are a key factor in understanding the not-for-profit starvation cycle. In particular, the power asymmetry that exists between funders and not-for-profits is a significant contributor to the not-for-profit starvation cycle and it can be understood as a central feature of many of the problems discussed below. In simple terms, those with control over funding decisions drive the conversation. They determine which conversations can occur, where the conversations can start (and finish), and they also shape the public discussion of these issues. Consequently, not-for-profits feel pressure to construct their strategy based upon what they perceive funder expectations to be on certain issues.

The control around which conversations can occur starts with the fact that it is often funders who determine which issues they want to fund. While this is relatively straightforward at a high level, it can translate into more subtle issues around how not-for-profits go about attracting funding, and in particular, it can impact how they are able to construct a particular issue or program when seeking funding. For example, one of the philanthropic interviewees noted how in some cases funders can shape the issue through their view that:

> *"We have a great idea about what you, not-for-profits, should be doing, and we'll fund that."*

At times this can lead organisations to feel like they are being made to work to a mission that is not their own, with one not-for-profit in the case studies noting that:

> *"Often as an organisation you're trying to fit what you're doing into somebody's funding."*

Beyond determining the starting point of conversations about what work should be undertaken, funders also set the limits of the conversation, through their expectations around what levels of overhead should look like, and what levels of overhead are tolerable. While in some contexts there is scope for negotiation about what levels of overhead might be included in funding, these conversations are coloured by the power asymmetry between funders and funding recipients. In particular, even when pressing for higher levels of overhead funding, many funding recipients will feel constrained about what levels to ask for, based upon their perceptions about what funders might be willing to fund. As one philanthropic sector interviewee noted:

> *"I come back to the power imbalance here, nimble sophisticated grant seekers and grant recipients read the room, and they know intuitively how far to push things."*

In addition to the dynamics between funders and funding recipients, there is a second relationship where power dynamics operate and contribute to the non-profit starvation cycle. This is the relationship between philanthropic sector professionals and those in the funding authorising environment (for example, the board or trustees). This relationship is important, because it can result in a filtering of conversations and it can also shape the type of funding structure that is offered. Multiple interviewees highlighted this dynamic, with one stating that:

> *"The professionals who work in philanthropy that report back to boards are feeding their boards what they want – which is outcome related, they want to feed them projects that have exciting pictures attached to them."*

Another interviewee also stated*:*

> *"There's a lot of pressure on foundation managers to report back on impact. [This is tied to] pressure on outcome and output reporting."*

This is reflective of the wider issue whereby change across the funding landscape will need to occur through change at the authorising level. For change to happen in the funding of indirect costs, trustees, boards, and philanthropic professionals will all need to adopt more contemporary practices.

Both forms of power asymmetry feed into the other issues discussed below. For example, if a philanthropic funding organisation's board continues to set expectations around funding projects with outcomes attached to them, then it can drive up the importance of the measurement of those outcomes as a feature of the funding landscape. It also means that some elements of the competitive environment are perpetuated, with efforts to obtain funding from that funder ultimately tied to how well prospective fundees can present their outcomes in comparison to others.

Not-for-profits exist in a highly competitive funding environment

The combination of widespread financial vulnerability and a highly competitive funding environment is a critical driver of the non-profit starvation cycle. Because there is widespread financial vulnerability across the not-for-profit sector, it means that anything that can impact funding represents an existential threat to not-for-profits. While funding has always been a factor for not-for-profits' financial sustainability, over time the competition for funds has become "a core issue impacting on long-term sustainability".[39] In turn, this limits the capacity of not-for-profits to push back against unrealistic funder expectations around levels of indirect costs that are included in grants. As one interviewee described:

> *"[A not-for-profit] does what it needs to do to get hold of the money needed to deliver to its mission, notwithstanding the suboptimality of that funding."*

Another noted that in many cases:

> *"It's about getting the money, and not rocking the boat – because you actually get less and less opportunities to even have a conversation about funding … it seems to be more of a pay for service model."*

This feeds into a climate where not-for-profits feel pressure to act in a way that anticipates what funder expectations are. Yet, not every not-for-profit is able to conform to the various real and perceived expectations from funders about how to structure costs and pressures to keep overheads down, and in some cases this can negatively impact not-for-profit viability. These expectations and pressures can be harder on those with less resources to draw on in particular with one interviewee discussing the situation for one of the organisations that they funded:

> *"They don't have the resources to play the games around their budgets … but that means that they're never going to get funding from anyone else."*

Similarly, not-for-profits in the case studies noted the way that financial vulnerability and their potential to lose funding shaped their actions. A small not-for-profit said:

> *"You can't criticise them, they'll pull your funding."*

Together with the points raised by the interviewees, this highlights the significant financial vulnerability across the not-for-profit sector and the consequences of it. The first two quotes highlight the ways that vulnerability can drive not-for-profits to act in ways that can be suboptimal in order to secure funding. The third quote highlights the implications that can arise for those who are unable to conform to expectations – that they can be dependent on one particular funding source, and that they are vulnerable if they lose that source of funding. The fourth quote, from the case studies, demonstrates how some not-for-profits feel constrained in the current climate of financial vulnerability. Overall it

[39] MS Booth, *An accountability framework for the financial sustainability of Australian international development organisations*, [doctoral dissertation], Queensland University of Technology, 2017, accessed 28 February 2022.

creates an environment for not-for-profits where they are often fighting for survival and unable to challenge the norms that are negatively impacting the sector.

The greater the trust in the relationship, the more likely the organisation will be fully funded

Across the different pieces of work, trust between the funder and the fundee was identified as critical to discussions about funding overheads and also the willingness of funders to fund overheads. There was consistency across the philanthropic sector interviewees in the recognition that trust was central to their decisions around funding overheads and also consistency in the view that trust was built through sustained relationships. One interviewee expressed that idea through the phrase:

> *"Change comes at the speed of trust."*[40]

Interviewees stressed that funding approaches only change when there is a strong level of trust in the fundee. In particular, funding of core or indirect costs was more likely to happen as trust in a fundee had been developed over time. It reflected trust both in the fundee in general, but also trust in their ability to best allocate their resources. One interviewee explained that for them:

> *"Funding operations is more a matter of trust. I trust you to know what you need and to make sensible decisions about that."*

As another interviewee explained, it was long-term relationships that built up the trust between funders and fundees, which enabled a healthier dialogue about indirect costs. The interviewee said:

> *"A conversation between a grant recipient and a funder to push the envelope a bit [on indirect funding] would probably only take place on the basis of quite a long engagement* – a number of years of trust being built up *[emphasis added]."*

Trust is important in the other direction of the conversation about indirect costs as well. For fundees, being candid about their actual needs for core funding is tied to the level of trust that they have in the funder, because revealing higher levels of indirect costs can potentially expose them to losing funding. One example from the interviews highlights how these dynamics play out. In the example provided, there was a real risk that the fundee would have to close because of a lack of core funds. This organisation had strong ties to the community, the work they undertook was well regarded, and it would have been hard to replace the impact that they were having in the community:

> *"We had been doing a program that was quite successful … because we had funded them for quite a while,* they trusted us, they came to me *[emphasis added] and told us that they weren't going to be able to keep the lights on. My board knew the founder, knew the staff… it is a massive risk for an organisation to come to you and say we don't even know if we're viable…* that's not going to happen [without trust] *[emphasis added]… so we need to really*

[40] Often attributed to Stephen Covey

> *build the trust so that organisations can come to funders and say 'we're going to lose our CEO because we're just not competitive in this space'."*

In this case it can be seen how a fundee opening up to talk about financial vulnerability is itself an act that exposes them to risk. The funder may have decided to redirect funds to a different organisation rather than risk putting it into one that was at risk of no longer being viable. As the emphasis above also highlights, it was the trust in the relationship that the fundee had with the funder that enabled the conversation to take place.

Due to the power dynamics outlined above, it falls primarily on funders to lead on creating trust and having transparent conversations with fundees. Funders have the ability to be proactive and explicit about their objectives in order to create safety and have fewer barriers to starting the conversation.

The impact of not-for-profits is fundamentally hard to measure

Funding in the not-for-profit sector is competitive. This means, not-for-profits are not just required to justify their own work on its own merits, but are also expected to do so in relation to what other organisations are doing. In turn, the measures and data that are used to form these comparisons is of deep significance to the funding that not-for-profits can obtain. Yet there are a variety of issues tied to the measurement of not-for-profit outcomes and the wider comparison of not-for-profits, and these contribute to the not-for-profit starvation cycle.

One core issue related to measurement is that many not-for-profits undertake work that can be difficult to measure and evaluate. In part, this is because not-for-profits can undertake a wide range of activities that are tied to achieving their purpose. Some of these activities can be difficult to measure in a meaningful way, and it can also be challenging to isolate the effect that a particular not-for-profit has had from their work. In turn, this means that there can be challenges related to measuring the contribution an organisation makes and the attribution of impact that an organisation can demonstrate in a measurable way.

For example, it can be hard for a not-for-profit engaged in advocacy work to isolate their own contribution to a policy change. In addition to the challenges in demonstrating the impact of a specific contribution, there are also challenges with attributing impact. Where multiple organisations have engaged in advocacy on an issue and there is change, it can be difficult to determine which groups should have that change attributed to their advocacy in particular.

Similarly, tracking and isolating long-term impact can be difficult in dynamic environments where an organisation might be providing a range of support services. Even where these things are measured, it can be hard to be confident about how accurate these measures are. In some cases, it can be even harder to calculate the wider impact of a piece of work (see Figure 10). One interviewee highlighted this as an issue through the example of trying to evaluate the wider benefit to a community of educating a young child from that community: there is obviously some benefit, but it is very hard to say exactly how much benefit there is, and that makes it harder to convince funders of the value that their contribution might make.

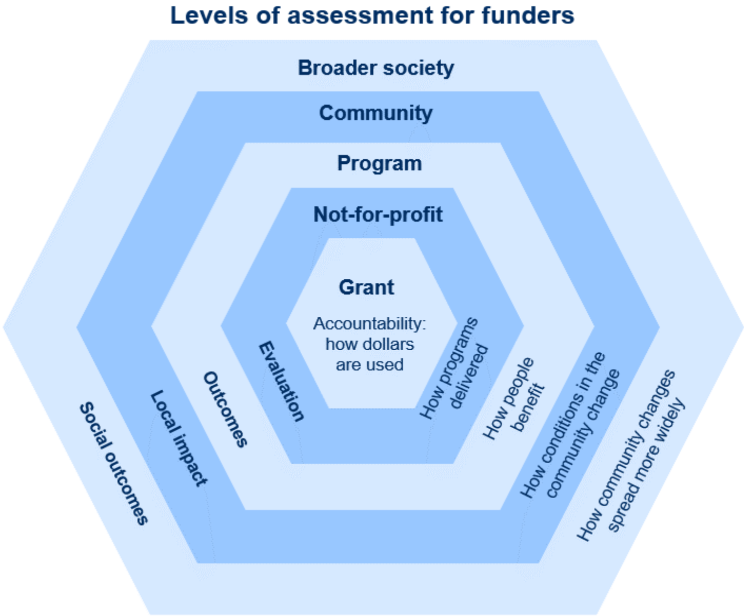


Figure 10: The Rockefeller Philanthropy Advisors articulate five levels of assessment, illustrating the difficulty of measuring the full impact of a grant[41]

All of these difficulties in measurement can make it hard to compare the outcomes and even outputs of different organisations to each other, especially across different sectors. For example, the output of a health service might be measured in the number of patients that visit a health clinic, whereas an advocacy organisation might make a contribution to a shift in policy that makes it easier to access free health services. While the specific services provided and the number of people who access them can be readily measured for the health clinic, it is much harder to measure the impact of the group that contributed to the policy shift, especially when they are one among many. Yet, comparison is a central feature of decisions about funding, with cost-benefit comparisons being an important component in deciding between which organisations to fund. Because comparisons like this can be very difficult to make, it means other characteristics and attributes can be used instead of comparing outcomes – with overheads being used at times in this way.

Funders have a not-unreasonable expectation that not-for-profits should be as efficient as possible. Yet the difficulty of measuring and comparing not-for-profits means that the usual avenues for measuring efficiency (industry benchmarks, financial reporting) are not available. Without standardised and publicly available outcome or impact measurement, funders fall back on what is available. Increased transparency on outcomes and the costs to sustainably achieve those outcomes will help to collectively learn what works.

A useful way to understand the prevalence of overheads in evaluation is through the idea of evaluability bias.[42] The evaluability bias is "*the tendency to weight the importance of an attribute in proportion to its ease of evaluation*"– this is regardless of whether the attribute is actually the best information to use as the basis of a comparison.[43] As mentioned above, there are significant challenges with providing measures of not-for-profit outcomes or outputs that are readily comparable.

[41] Rockefeller Philanthropy Advisors, *Assessing impact*, Rockefeller Philanthropy Advisors website, n.d., accessed 28 February 2022.
[42] L Caviola, N Faulmüller, JA Everett, J Savulescu and G Kahane, 'The evaluability bias in charitable giving: saving administration costs or saving lives?' *Judgement and Decision Making*, 9 (4):303–316, doi:10.13140/2.1.1028.9287.
[43] Caviola et. al., 'The evaluability bias in charitable giving: saving administration costs or saving lives?', p 303.

In contrast, differences in financial information – like the level of overhead costs not-for-profits have in comparison to each other – are relatively easy to grasp as a baseline for comparison, *regardless of how far removed they are from not-for-profits' outcomes.* In addition to being easy to grasp (at least at the surface level), every organisation has an overhead ratio. This is regardless of the sector that they work in. This means that they are a readily available measure, one that people feel that they understand, despite not being a good measure of not-for-profit effectiveness. Some of our interviewees were deeply critical of using low overheads as a measure of effectiveness, noting the role that this could play in undermining organisations achieving their purpose:

> *"Philanthropy thinks it is getting sophisticated, but if you can't understand how to link organisational outcomes back to overhead costs, then you are kind of missing the point of why that organisation even exists – if you can only link outcomes back to projects and programs, then we are on really, really, shaky foundations in terms of the sustainability of the sector."*

This fed into a wider belief among those interviewed that there needs to be nuance to how the impact of not-for-profits are understood. While it is important to ensure that not-for-profits are working effectively towards their purpose, there needs to be some sensitivity to the challenges that measuring impact can present – especially when making comparisons across organisations. Expectations around measurement should be realistic and acknowledge that some forms of work in particular face significant challenges related to measuring their contribution. At the same time, the challenges related to measurement and comparison should not be used as a justification to use alternative measures like cost ratio as the foundation of comparison – since these are not connected to the impact that organisations have. There is also the nuance that even once measured, comparing impact between organisations is not straightforward.

In addition to the measurement challenges associated with tracking impact and outcomes, there are challenges around defining and measuring indirect costs that contribute to the starvation cycle. Multiple interviewees from the philanthropic sector highlighted the ways that the lack of shared definitions contributed to different indirect cost levels across organisations and variations in accounting decisions about how costs should be allocated. The complexity of measuring and allocating indirect costs also means that smaller not-for-profits often found it hard to reliably identify them.[44]

The impacts of a lack of shared definitions across organisations was noted clearly by one interviewee, who explained:

> *"I guess the hard thing is that there is no legislation across the sector of what is classified in each category. So one not-for-profit tells me what their indirect costs are, but if I compare that to another organisation, what they've told me, they're not comparing apples with apples. So it's hard to say that this organisation is doing it way better than this other organisation. There's no standardized reporting on what is included."*

Other interviewees noted similar issues related to the nature of defining indirect costs and the type of accounting decisions that needed to be made by not-for-profits meant that the figures were unlikely to reflect the true indirect costs encountered:

[44] J Eckhart-Queenan, M Etzel, J Lanney and J Silverman, 'Momentum for change: ending the nonprofit starvation cycle', Bridgespan website, 2019, accessed 28 February 2022.

"My level of confidence in the figures provided is low, but it's not because organisations are being deceitful, in those instances those figures are being cut in certain ways. People think accounting in particular is black and white, but accounting is full of grey areas in how you count things. I just think that they're being cut in a certain way that they need to be cut in order to meet a requirement."

The lack of consistent definitions was framed in very similar terms by a third interviewee, who explained that:

"Well often anyone who has done basic accounting knows that characterisation is everything, and the question of how costs are allocated can be fluid on occasion, and it's another reason that we aren't really interested, or as focused on the characterisation as we are on the work."

In a similar vein, there are issues linked to the identification and measurement of indirect cost levels stemming from not-for-profits being under resourced. As discussed later in the report, there is a cruel irony where the lack of indirect cost funding inhibits the capacity of organisations to track their true levels of indirect costs.

Section 3: Indirect costs in practice

The drivers of indirect cost issues identified above play out in the sector through the actions that funders and not-for-profits take. Some funders, explicitly or implicitly, still use indirect costs as a filter for charity effectiveness, due in part to different expectations around not-for-profit costs. The public view of indirect costs is negative, perpetuated by media reporting. Thanks to these factors, not-for-profits have a strong belief that their indirect costs should be minimised and hidden from funders. not-for-profits believe that these issues are getting worse over time.

Indirect costs should only be used in ways that are supported by the evidence

Overhead aversion was identified in the literature review as a widely recognised key driver of the starvation cycle. Overhead aversion is the aversion that various funders, donors and the general public have to paying for costs that are not directly program related.[45] It feeds into issues with the way that indirect costs are included in the evaluation of not-for-profits and in the funding of projects. Rather than taking an open approach to determining what appropriate levels of indirect funding support should be, overhead aversion can lead to capped indirect cost levels and stifle conversations around the real level of support that is needed. As noted above, interviewees from the philanthropic sector were conscious of board and authorising environment level overhead aversion and described how that could prevent adequate indirect cost support being provided.

Indirect costs caps are still used by some funders to assess not-for-profits, primarily due to a belief that lower indirect costs are beneficial. Interviews suggest that funders in Australia across both government and philanthropy currently cap indirect costs in grant applications, use indirect costs to assess eligibility for grants, and determine winners of competitive bids.

Interviews with not-for-profits suggested that relatively few Australian philanthropic funders explicitly state that they 'cap' indirect costs in applications. One organisation states on their website that:

> *"Some overhead and administrative costs may be directly attributable to the projects … the Foundation will consider funding these expenses to a reasonable level, usually not more than 10% of the total amount requested."*[46]

However, while few funders have a public policy, it is reportedly common that indirect costs are raised as part of the budget or application process.

Government funding similarly has caps that are not always made explicit. Both the Department of Foreign Affairs and Trade Australian NGO Cooperation Program (ANCP) and the National Disability Insurance Agency cap indirect costs at 10%.[47] [48] However, other funding programs reportedly also have restrictions on the overhead costs allowed. Not-for-profits noted that 15% was a common upper limit for indirect costs in government commissioned services in the community services sector.

This was also true in open calls for proposals, where not-for-profits believed that indirect costs were used as a filter. Even in a competitive bid environment, not-for-profits believed that the proportion of their costs that were labelled as 'indirect' had an effect on their likelihood to win the work. Not-for-profits noted that funders of competitive bids commonly required detailed financial reporting similar to

[45] U Gneezy, EA Keenan and A Gneezy, 'Avoiding overhead aversion in charity', *Science*, 2014, 346 (6209):632–635, doi:10.1126/science.1253932.
[46] The Ian Potter Foundation, *FAQs*, The Ian Potter Foundation website, n.d., accessed 28 February 2022.
[47] Department of Foreign Affairs and Trade (DFAT), *ANCP manual*, Department of Foreign Affairs and Trade, 2020, accessed 28 February 2022.
[48] McKinsey & Company, *NDIS independent pricing review*, National Disability Insurance Scheme, 2018, accessed 28 February 2022.

grant based acquittal statements that itemise costs of services, despite the payments being based on outcomes or other output metrics. A large not-for-profit noted:

> *"Quality of service delivery [should win a bid] rather than back-office cost."*

While not-for-profits only see a small proportion of funders explicitly cap their indirect costs, this is enough to perpetuate the belief that many funders use indirect costs as an assessment tool.

Funders have different expectations of how not-for-profits operate and their costs

There are mixed expectations around how not-for-profits should operate in relation to norms relating to business. At times funders can expect not-for-profits to behave in ways that are explicitly different to how business operates. This is especially true in relation to costs: interviewees noted that there was at times a view that things should be cheaper than business might pay – that charity should come at a discount. Multiple interviewees noted that the ways that the poor financial health of the sector fed into things like payment for staff. As one stated:

> *"We all know that if you want to work in the social sector, you know, you don't get paid properly."*

Yet at the same time, there were expectations for not-for-profits to operate with the same approach that business and the corporate sector use. This is despite a lack of similar resources and access to staff with those capacities to support those kinds of behaviours. As one interviewee explained:

> *"A lot of people just don't understand what it's like to work for an NGO, to struggle month by month to raise enough funds to get your operations going and then to be able to expand into being more effective requires a deeper level of operational support and there's a real lack of understanding of how difficult that is for charities on one side. On the other side, NGOs don't have a lot of experience in business development … thinking about the business side of their work … if they're a smaller organisations they don't have the capacity to employ financial managers and business development managers – usually they've got people with a content background."*

Several not-for-profits and funders had a negative view of funders' ability to understand how not-for-profits operate. Not funding overhead costs was taken as a symptom of a wider lack of understanding of the true costs of running a charitable organisation. As one small not-for-profit explained:

> *"While the funding is based on this form of charitable model, it's always going to be like that. There's a core assumption that 'We don't have to pay for that, churches will pay for that because that's their role.'"*

One not-for-profit expressed that for some funders, there was a seeming expectation that the organisation receiving the funding should give something up as well by donating time or effort. They described:

"The attitude is 'We're giving something for free, you should provide something for free.'"

Another expressed that some staff in funding organisations did not have a strong grasp of the necessary financial knowledge to understand the funding of the organisations they support. The interviewee noted:

"I think there is a lack of understanding from staff of funders on how to understand some of these reports. I have had some difficult conversations with funders not understanding what the financial report is saying, which is quite remarkable."

A misalignment of expectations between not-for-profits and funders around operations and costs can lead to funders inadvertently acting in ways that prevent them from achieving their goal – to support organisations to grow and be successful.

Indirect cost reporting creates reputational concerns for not-for-profits

How indirect costs might be covered in the media is an issue of concern for many not-for-profits. There is evidence to support this concern, with media reporting around indirect costs almost universally unfavourable in Australia:

- 'Charities' fund-raising costs swallow millions in donations', *The Sydney Morning Herald*, 2013
- 'Charities lose millions to admin costs', *The Daily Telegraph*, 2017
- 'Australian Red Cross defends spending 10% of bushfire donations on office costs', *The Guardian*, 2020.

This reporting is likely to pressure charities to behave in line with public expectations, as it is directly linked to their reputation. A positive reputation is a valuable asset for a not-for-profit, with potential benefits including obvious things like increased public support, as well as other more subtle benefits like increased opportunities for collaboration.[49] Similarly, having a negative reputation related to overhead spending can be harmful and lead to a loss of public donations. In the literature not-for-profits showed concern about having negative press stories associated high overhead ratios and worried that it might negatively impact their reputation as an efficient charity.[50]

It should be noted that these fears are not unfounded, at least based on US evidence. Overhead ratios have been found to have a relationship with amount of government contracts and it has also been identified that higher overhead costs decrease the likelihood of funding for projects from the public through crowdfunding.[51] [52]

[49] S Peng, M Kim, and F Deat, 'The effects of nonprofit reputation on charitable giving: a survey experiment', VOLUNTAS: International Journey of Voluntary Nonprofit Organization, 2019, 30 (4):811–827, doi:10.1007/s11266-019-00130-7.
[50] T Boyd-Caine, Lead or be left behind: sustaining trust and confidence in Australia's charities, Origin Energy Foundation Knowledge Hub, n.d., p 28, accessed 28 February 2022.
[51] J Zhao and J Lu, 'Does government punish nonprofits for high administrative costs in contracting decisions?', The American Review of Public Administration, 2020, 50 (3):286–296, doi: 10.1177/0275074019893807.
[52] J Meer, 'Effects of the price of charitable giving: evidence from an online crowdfunding platform', *Journal of Economic Behavior & Organization*, 103: 113–124, Jul. 2014, doi:10.1016/j.jebo.2014.04.010.

Not-for-profits have strong beliefs about funder willingness to support indirect costs

The behaviour surrounding indirect costs from funders, the media and the public presents a strong signal to not-for-profits that indirect costs should be minimised. There was a common mindset among interviewed not-for-profits that 20% was the 'industry standard' level of indirect costs that could be safely asked for from funders.

This belief has two main effects: not-for-profits underreport their indirect costs to funders and they underinvest in their indirect costs. Multiple not-for-profits admitted to underreporting their indirect costs in funding applications to keep them under the 20% level, even when they knew this was inaccurate. This was often left undiscussed by not-for-profits if funders did not question it, with one not-for-profit describing how you 'don't rock the boat'. Power dynamics, outlined earlier, prevented not-for-profits from having hard conversations with their funders about their true levels of indirect costs. One not-for-profit stated that even though they had a strong understanding of their indirect costs, their fundraising team argued against including more than 20% indirect costs as it would be considered 'too high'. And as another noted, the consequences of these power asymmetries are that:

> *"We've created a really guarded non-profit sector that doesn't want to be honest about what it costs or what it takes to run their organisations."*

These messages have been internalised by not-for-profit staff as well. One not-for-profit said that there was a sense of guilt shared by staff – a mindset that it was more important to spend money on 'the mission' than on investing in the organisation. This leads to staff at all levels of the organisation underinvesting in indirect costs, as they are undervalued both internally and externally. This is supported by US evidence, where the prevalence of overhead aversion among the funding and donor landscape can drive not-for-profits towards minimising their overheads as a way to stay competitive for funding.[53]

The interviews with the philanthropic sector highlighted the other side of this dynamic, with funders discussing the pressures that drove the beliefs held by not-for-profits. Returning to the issue of trust and the importance of relationships, interviewees highlighted the role that relationships played in willingness to disclose the full indirect costs that a potential fundee might have. One interviewee noted:

> *"Whether or not they are willing to include the appropriate percentage of those indirect costs in the program costings boils down to the relationship that they have with the potential funder."*

Without high levels of trust and a strong relationship, conversations about indirect costs can be stifled. Given that the conversation starting point is tied to the power asymmetries outlined above and occurs in a competitive funding environment where not-for-profits have concerned about how they will be perceived, it starts to become clear why not-for-profits find it hard to push back.

[53] JE Portillo and J Stinn, 'Overhead aversion: do some types of overhead matter more than others?', *Journal of Behavioral and Experimental Economics*, 2018, 72:40–50, doi:10.1016/j.socec.2017.11.003.

Asking for what it takes

One organisation, a research institute, recently changed their ask for philanthropic funding to better reflect their true costs. While previously they had had a very limited ask for indirect costs and only in certain circumstances, they began to ask for more than 25% indirect costs as a minimum from all philanthropic funders.

They found that an estimated 90% of philanthropic funders were willing to pay for this quantity of indirect costs without comment. They guessed that around 20% of their funders were strong advocates for full-cost funding, 70% were happy to trust the organisation, and only 10% were unwilling to fund full indirect costs.

Many of these funders were long-term and had a high degree of trust. In addition, it appears that funders of research are more used to paying significant levels of indirect costs, given that some interviewees noted the university sector's strong stance on this issue.

This also required a number of internal conversations at the institute to convince staff to 'ask-for-what-it-takes' – thinking beyond the bare minimum project funding needed.

Not-for-profits often lack the resources to track their full costs

Multiple not-for-profits mentioned that they found it difficult or time consuming to measure their indirect costs. Several also mentioned that they did not have the time or resources to effectively understand and allocate the indirect costs across the organisation. Even the largest organisation in our sample had only recently done a cost-allocation exercise to understand the true indirect costs of its programs, prior to that:

> *"It was clear that our funded programs were running at a significant loss… though we didn't have the numbers to prove it."*

The level of sophistication of cost allocation varied significantly as well. One organisation had full time-cost allocations for each member of the core staff, while several others allocated costs broadly by revenue or full-time equivalent (FTE). The remainder did not have a clear existing method of cost allocation.

There is a cruel irony in the fact that a lack of investment in indirect costs was identified as a key reason why organisations were unable to calculate their indirect costs reliably, as the lack of indirect cost support often resulted in understaffed finance teams and limited systems. This is compounded by the fact that many funders have different reporting requirements, which means that finance teams must maintain multiple definitions of their 'indirect costs' for different budgets. One large not-for-profit noted:

> *"Mixing and matching what is presented to a donor based on what and where they feel a cost should sit is a constantly moving beast and makes reporting more of a burden when we are trying to be consistent with allocation of actuals."*

A related factor that led to underreporting was that even when the finance team had a good understanding of the true core costs of the organisation, that knowledge was not always clearly communicated throughout the rest of the staff. This meant that indirect costs were often underestimated in grant proposals.

Increased demand for outcomes measurement means indirect cost needs are rising, not falling

There was a sense that there are multiple headwinds to not-for-profits having their costs fully funded, including hardening donor attitudes, the increasing cost of servicing funder relationships and a reduction in the availability of untied funds. Pressure on indirect costs is also rising significantly due to broad external trends (such as, increased cybersecurity risks and modern slavery regulations) as well as sector-specific trends (such as, heightened compliance obligations due to the aged care, child safety and the disability royal commissions).

The difficulty of measuring outcomes for not-for-profits, outlined earlier, means that not-for-profits invest significant time and effort into measuring the impact of their work for funders. Multiple not-for-profits mentioned that the cost of servicing funders was going up over time. More data-driven, outcomes-focused granting has placed increasing strain on their measurement and evaluation. Importantly, this additional reporting burden was often not covered by the grant funding. Indeed, one interviewee noted that she had seen multiple not-for-profits “knocking back projects because the audit just isn’t worth it”.

One not-for-profit noted that they had seen a significant drop in the willingness of funders to provide untied funding over time. They estimated that previously they would have expected 30% of their funding to be untied, and this had now decreased to only 10%. This is a significant issue given that untied funding is often used to offset the underfunding of indirect costs elsewhere.

While one not-for-profit was confident that funder attitudes towards indirect costs were improving, many others said the inverse. A different large not-for-profit said:

> *“There is however growing commentary from donors who are demanding lower ‘overheads’ at a maximum of 20%.”*

Government attitudes to funding social purpose organisations

While this research has primarily focussed on philanthropic funding, we still heard a number of insights about government funding and how government engages with the not-for-profit sector. The initial insights are listed below but more work and evidence is required to validate them.

The move from government provision of services to those services being provided by the for-purpose sector has been swift. Only a few decades ago it was rare for government to provide funding to charities at all, whereas now they are the majority funder of the sector. This change has been accompanied by government seeing service delivery by charities as an exercise in procurement with a strong focus on 'value for money' or in other words: cost.

The outcomes of this shift of provision from government to not-for-profits, as perceived by interviewees, is a perception that government sees not-for-profits as purely service delivery vehicles without a full understanding of the potential to engage not-for-profits as an important part of Australian society who not only deliver needed services but also seek to drive improved outcomes for their clients and benefit all Australians. Additionally, government does not understand that its procurement processes push risk onto not-for-profits without commensurate reward and are impacting their long-term viability.

Reportedly, government funding of the social purpose sector is highly variable regarding indirect costs. While it is unremarkable for a government grant to pay 30% indirect costs in medical research, the National Disability Insurance Scheme (NDIS) pays 15% and Department of Foreign Affairs and Trade (DFAT) reportedly 7–8%. Multiple organisations noted that some of their government grants did not cover the full 'direct' costs of delivering a program, with no provision for indirect costs at all. The approach was also inconsistent with one not-for-profit noting that there were different approaches used by federal and state governments, departments within same government and, sometimes, different services commissioned by the same department.

An interviewee speculated that government would say funding is based on outcomes, but in practice, it has great difficulty in defining outcomes and demonstrating how funding impacts the quality of that outcome. This is important because, as this report has outlined, underfunding of the sector is likely to be reducing the quality of the outcomes created even if it does not result in not-for-profits leaving the sector.

Overall, there was a consistent theme that, for the social purpose sector to be sustainable and create impact, it is not simply about indirect costs. Governments will need to be convinced of the true value of the sector and its own role as a partner in impact. Driving that change in behaviour will require a considered campaign and will likely take considerable time.

There remain significant unanswered questions about the nature of indirect cost funding in Australia, particularly in relation to government, and we intend to explore this issue in future research.

Section 4: Paths forward for philanthropy and not-for-profits

So far we have covered what the evidence says about the problems that underpin the non-profit starvation cycle. Part of our evidence collection also included insights into what not-for-profits and funders were doing to address these problems and what they thought might work in the future. This section details some of the approaches that were used by philanthropic organisations to try and better support not-for-profits in achieving their purpose. These are strategies that other organisations can start using today to help improve the funding of indirect costs in Australia.

Current philanthropic strategies

Contemporary philanthropic practice is changing in Australia, with a number of funders already aware of this issue and taking action to support impact.There are a number of funding approaches that allow a not-for-profit to fully cover its costs. These include providing project grants that include the full costs, providing untied funding, and providing specific capability or operating cost funding.

Interviewees from the philanthropic sector were asked about current strategies that they used, as well as potential measures that could be used to address funding related issues. Below we outline some of the strategies they used and suggested for the sector. The insights that they have provided reflect early conversations with a small number of individuals, so the solutions offered are far from exhaustive. What was notable in the solutions that were raised is that some of the strategies only required subtle changes, not a radical reconstruction of the funding landscape.

Insights on next steps from Philanthropy Australia members

A presentation of early findings to a closed session of Philanthropy Australia members revealed the extent to which this issue is already top-of-mind for many funders.

Multiple philanthropic organisations talked about the need to fund organisations to be successful, rather than just funding programs. This involves actively facing into the existing power dynamics.

Implementation, however, was considered challenging. Philanthropic leaders needed to not only change their processes, but also convince board members of the value of a different funding approach.

One interviewee explained that because they used closed tenders it gave them a stronger level of confidence in conversations around overheads. They put a high degree of effort into their screening process to ensure that the organisations they worked with were of a high standard. By finding organisations based upon a belief that they undertook good work, it meant that the cost structure of the organisation was less important in their decisions about whether to fund them.[54] It also gave them a high degree of confidence in the figures provided. The interviewee explained:

> *"We don't take unsolicited requests for funding so when we deal with someone we've approached them, and so probably that biases it a bit, and from the*

[54] It should be noted that closed tenders require substantial investment on the part of the funder to do a comprehensive sweep of relevant potential grantees, as there are risks that high-impact not-for-profits 'outside the circle' may not be funded.

> *outset we have a certain level of confidence that this a good organisation or we never would have approached them in the first place, we would have heard things from other people, read about them, and so from the outset we know that we're dealing with people that are probably pretty reasonable, and that makes us fairly comfortable with the numbers we're being presented with."*

Interviewees also raised the importance of trying to reduce reporting pressure on not-for-profits and stressed that it was about trusting organisations to undertake the work to the best of their ability. For these funders, overly restrictive approaches made it harder for fundees to undertake their work, and the way that COVID-19 impacted how some organisations could use project funding was given as an example of the increased challenges it could raise. One explained their approach:

> *"Once we fund them, the funds are untagged. And we do want reporting for transparency, learning, relationship building, but we don't get into the details of the budget – we trust non-profits to get on with their business. I think one of the things that could be improved is that funds are more outcome or objective related rather than funders sitting around the table getting caught up on the line items in the budget… even if it was towards a project, it's towards that project's objectives, not kinda getting caught up with how much are you spending on the newsletter, and how much… I say to organisations that obviously for transparency purposes and assessment purposes we want to see a very high level budget, but once they get their funds they don't have to come back to me to say they spent five thousand dollars on this instead of that."*

Others noted that multi-year funding was an important mechanism to reduce financial vulnerability for not-for-profits. Longer-term funding offered some degree of financial certainty and helped to reduce the challenges that came with having to seek funding every year, including reducing the burden of having to write new funding applications. The approach also makes it much easier for organisations to plan for the future. In turn, this can also help with staff retention: an issue flagged in the literature review, the case studies, and in the interviews. When providing multi-year funding it is even more important to have an open, productive dialogue about the true costs of the program or initiative, as otherwise it simply means that the not-for-profit has to cover the budget gap for longer.

Where to next?

This report, and the work that underpins it, is a collection of preliminary evidence demonstrating that the starvation cycle exists in Australia. We have engaged with a range of stakeholders to begin to understand the issue, but there is more to be done. The existing evidence, albeit limited, strongly suggests that the problem is real – Australian not-for-profits are being underfunded, and Australian funders are not universally funding indirect costs, which together hampers the sector's ability to maximise impact. There remain significant unanswered questions about the nature of indirect cost funding in Australia, particularly in relation to government and we intend to explore this issue in future research.

There are real opportunities for funders to change their practice to enable not-for-profits to more effectively achieve societal outcomes. The process of materialising these opportunities is less straightforward and requires leadership from and collaboration between funders and not-for-profits.

The literature widely calls for a move away from using overhead ratios as the basis for evaluating not-for-profits. Many encourage a transition towards using measures that more accurately capture the outcomes and outputs of not-for-profits, rather than focussing on the precise structure of the financials for an organisation.

Not-for-profits and funders must create a common language and understanding around indirect costs. This understanding will facilitate transparency of what the average indirect cost scale is, which this report hypothesises to be greater than 30% for the average not-for-profit. Whilst a not-for-profit explaining overheads and their purpose can influence funder choices and decrease overhead aversion the power asymmetry puts the onus on funders to take the first steps to change. [55]

[55] H Qu and JL Daniel, 'Is "overhead" a tainted word? A survey experiment exploring framing effects of nonprofit overhead on donor decision', *Nonprofit and Voluntary Sector Quarterly*, 2020, doi: 10.1177/0899764020959475.

Calls to action

1. Sector leaders are encouraged to support a range of activities and initiatives that educate not-for-profits, funders, government, the media and the general public that:
    a. Not-for-profit funders should focus on impact
    b. Low indirect costs do not imply that a not-for-profit is being impactful, and high indirect costs do not imply that it is not impactful
    c. Effective not-for-profits incur shared and indirect costs that need to be funded to enable them to achieve their impact
    d. Understanding impact requires investing in measurement systems
2. Both funders and not-for-profits should be encouraged to have an open, productive dialogue around the true costs of any proposed programs or initiatives
3. There is a need to create a credible, independent source of data on the typical quantum or range of indirect costs. This will support a safer environment for charities to speak with funders about actual costs – rather than underreport. However, given indirect costs can vary significantly between organisations (for legitimate reasons related to business models and choices as to where to invest) be cautious about using them in benchmarking
4. Sector education initiatives can create a common language and foster understanding of what constitutes indirect costs
5. Funders and their charity partners will be well served by building trusting relationships which support open and transparent conversations. Due to power dynamics, funders will likely need to be the first mover in many conversations
6. Increased collaboration across the philanthropic sector to share learnings on how to fund indirect costs will help accelerate change across the sector – and potentially provide evidence to then influence government

Appendix: Indirect cost measurement

The following is guidance to help not-for-profits and funders have a common language. It does not aim to provide a comprehensive guide to indirect costs and cost allocation methodologies or attempt to substitute for an accounting standard.

Aims of indirect cost measurement

As a not-for-profit, understanding indirect costs is important to ensure that project funding pays for the full costs of that program. The direct costs of a program are generally easy to articulate. The indirect costs are harder but no less important to ensuring long-term financial sustainability of the organisation.

As a funder, the aim of measuring indirect costs should be to confirm that project funding is paying for the full costs of running the program.

Defining indirect costs

One of the key difficulties in paying-what-it-takes is a lack of a shared definition and understanding of indirect costs. This is partly due to the fact that they are a surprisingly complex concept:

> *"There are also no clear definitions as to what should be considered administration costs for accounting purposes."* – Susan Pascoe, ACNC[56]

The Australian Government notes the complexity of determining indirect costs in its definition:

> *"... indirect costs are those costs that cannot be easily linked to a cost object* or for which the costs of tracking this outweigh the benefits *[emphasis added]."*[57]

Almost any cost can be partly attributed directly to a project if enough effort is put into measurement. As a spurious example, an organisation which measures the exact amount of electricity every employee uses could legitimately claim the electricity that its program officers use is a direct cost, rather than an indirect cost. The cost of measurement would vastly outweigh the benefits of doing so, however.

For the purposes of this work, we have lightly adapted the MacArthur Foundation definitions and those used by the Cass Centre for Charity Effectiveness in the UK.[58]

We can think of costs in three categories:

- **Direct costs**

  Direct costs are those costs that are specific to a project, such as salaries for project staff and materials required for the project. The key test is that these costs would not be incurred if the project being funded did not exist. For example, staff time that can be unambiguously identified as having been spent on the project, or travel costs for project travel.

- **Shared costs**

  Shared costs are those costs that benefit multiple programs or projects and can be assigned or allocated across programs or projects in a reasonably consistent and accurate way. These costs are just as integral to the delivery of the project as the direct costs. Examples of such costs include occupancy and facilities, utilities, telephone and internet access (note that these costs are generally non-personnel costs).

- **Indirect costs**

  Indirect costs are costs for activities or services that support the organization as a whole rather than any particular program or project, including administrative and fundraising costs. These are not costs associated with the delivery of program services; nonetheless, they are essential costs of maintaining and managing the organisation through which program services are delivered. Examples of such costs include bank fees, fundraising, human resources, board meetings, finance and accounting support.

[56] L Caneva, 'ACNC myth-busts charity admin costs', *Pro Bono News*, 2016, accessed 28 February 2022.
[57] Commonwealth Department of Finance, *Australian Government cost recovery guidelines*, Department of Finance, n.d., accessed 28 February 2022.
[58] Cass Centre for Charity Effectiveness, *Cost recovery tools for success: doing the right things and doing them right*.

Categorisation of typical costs

Derived heavily from the MacArthur Foundation Indirect Cost Policy[59]

Example of cost	Generally				Notes
	Direct	Shared	Indirect	Could be direct or indirect	
Salary of program staff, including super	X				It should be noted that for staff working across areas, allocation of time spent working on the project is needed.
Salary of management, core staff (HR, IT and finance) and fundraising			X		
Professional fees for services working on the project	X				Professional fees are classified based on the function for which the professional services are being engaged for example, consultants working directly on the project.
Professional fees for services working in finance, IT, etc.			X		This includes professional fees for core support for example, audit, legal or HR.
Sub-grants and awards	X				
Project rent, occupancy and maintenance costs	X	X			Occupancy is normally reflected as a shared cost and is allocated based on the amount of space used by a project. If a space is rented specifically for the project, it may be a direct (rather than shared) cost. Note that occupancy costs are often shared across core and fundraising functions as well as programs and projects – this proportion would be in indirect costs.
Project utilities, telephone, internet	X	X			Normally reflected as shared costs and usually allocated to a project based on the number of staff associated with a project. If a project incurs utilities, telephone and/or internet costs specifically for that project, these would be direct (rather than shared) costs. As

[59] MacArthur Foundation, *Indirect cost policy*, MacArthur Foundation, n.d., accessed 28 February 2022.

Example of cost	Generally				Notes
	Direct	Shared	Indirect	Could be direct or indirect	
					with occupancy costs, these costs are often shared across core and fundraising functions – this proportion would be in indirect costs.
Project supplies and materials	X	X			Supplies and materials specifically used for a project are a direct cost. If all organisational supplies and materials are used in common, charge an appropriately allocated portion of costs to the project.
Insurance, bank fees, credit card fees, interest			X		This group is generally indirect, unless a project requires its own insurance.
Staff training and professional development costs			X		This group is generally indirect, unless the training is project-specific.
Advertising and marketing				X	Advertising and marketing costs normally benefit all areas and are usually considered indirect. Advertising related to outreach or marketing of a specific project may be direct.
Travel, meetings and conferences				X	Travel or meetings for the project is a direct cost, otherwise it is indirect.
Equipment purchases				X	Purchase of equipment necessary to the delivery of a project is direct, otherwise indirect. Note that this could include accounting for depreciation of existing equipment.

Allocating costs to programs

Understanding the costs of an organisation is only part of the challenge. It is important to understand, for each project, what its true costs are including a proportion of the overheads (in the UK this is known as 'Full Cost Recovery'). Figure 11 illustrates the concept of full-cost allocation. Every program budget should include a commensurate amount of the shared and indirect costs required for the project and organisation to run effectively.

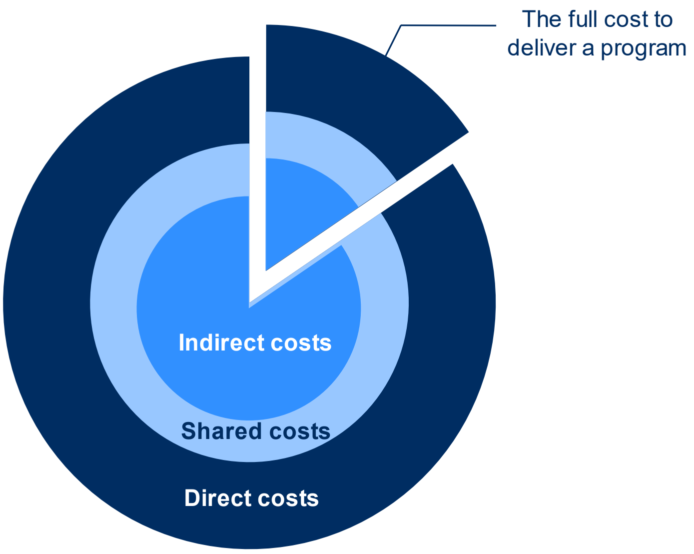


Figure 11: The full cost to deliver a program must include a proportion of shared and indirect costs

It is perhaps telling that, across the not-for-profits interviewed as part of this project, each one allocated their costs in a different way. There appears to be no single ideal cost allocation method – the industry, the size, and the complexity of an organisation all determine what makes most sense for a not-for-profit.

The other complexity is that the proportion of indirect costs at an entire organisation isn't necessarily the indirect costs used by each program. Different programs can call upon the central resources of an organisation in different ways. For example, one program might use a large number of volunteers, meaning it might require significantly more HR time than a program run by a small number of staff with the same budget.

Is fundraising/business development an indirect cost?

Under the above definition, fundraising is a clear-cut example of an indirect cost. It contributes to the organisation as a whole, and cannot be attributed directly to a program. However, multiple analyses (including the original *Stanford Social Innovation Review* article on pay-what-it-takes philanthropy) exclude fundraising costs from their analysis. While the reasons why are never explicitly addressed beyond a remark about 'different funding models', one hypothesis is that it is an extension of the issues raised above – funders are even less willing to pay for fundraising than for other forms of indirect costs.

One approach for distributing costs is built from the 'Full Cost Recovery' methodology from New Philanthropy Capital (NPC), outlined in Figure 12. Using this methodology, shared costs are allocated first across the different programs, followed by core costs and finally fundraising costs.

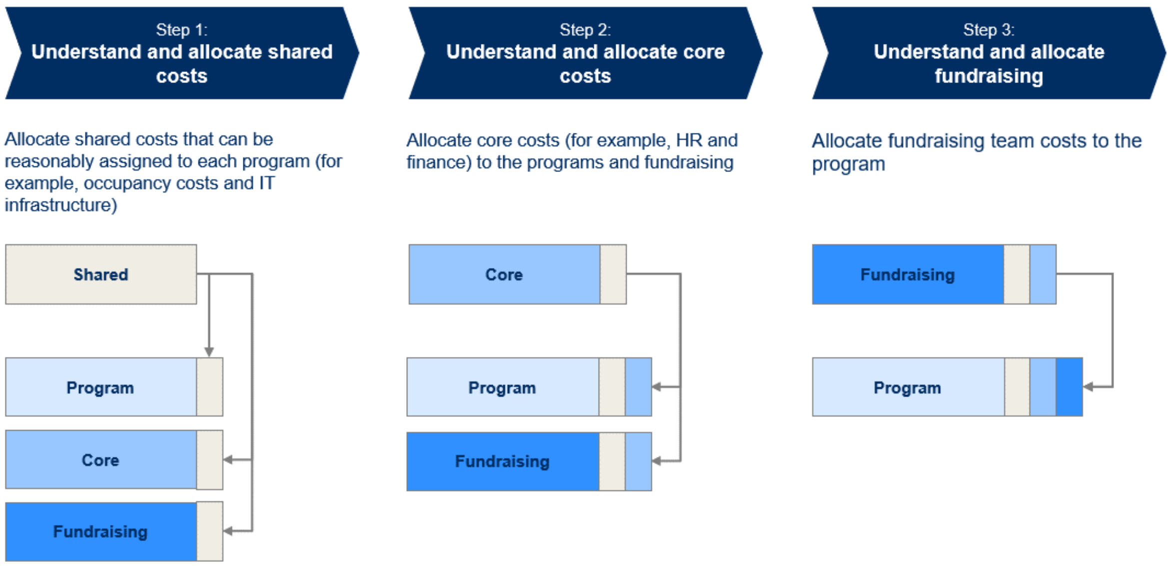


Figure 12: Full Cost Recovery methodology from NPC[60]

[60] New Philanthropy Capital (NPC), *Full cost recovery: can your organisation survive without it?*, n.d., accessed 28 February 2022.

Recommended resources

There is limited literature in Australia on the allocation of indirect costs. There has been significant work in the UK, however, which applies relatively well in an Australian context. For further detail on cost allocation methodologies, we would recommend referring to the following:

Cass Centre for Charity Effectiveness, *Cost recovery tools for success: doing the right things and doing them right*, <https://www.cass.city.ac.uk/__data/assets/pdf_file/0008/422828/CCE-Cost-Recovery-Guide-Final-Version.pdf>.

New Philanthropy Capital, *Full cost recovery: can your organisation survive without it?*, <https://www.thinknpc.org/resource-hub/full-cost-recovery/>.

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