

Council of the District of Columbia Committee on Facilities and Procurement

Public Hearing on B23-0107, the "Non-Profit Reimbursement Fairness Act of 2019" January 28, 2020

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Thank you, Chair White and members of the Facilities and Procurement Committee. I appreciate this opportunity to share information from nonprofits and governments across the country that have worked together to develop a practical solution to a longstanding contracting challenge common to every jurisdiction across the country. I am David L. Thompson, Vice President of Public Policy for the National Council of Nonprofits, the nation's leading resource and advocate for America's charitable nonprofits. Through our network of state associations of nonprofits and 25,000-plus organizational members – the nation's largest network of nonprofits – we serve as a central coordinator and mobilizer to help nonprofits achieve greater collective impact in local communities across the country. We identify emerging trends, share proven practices, and promote solutions that benefit charitable nonprofits and the communities they serve.

For more than 10 years, the Council of Nonprofits has worked in collaboration with state associations of nonprofits, national human service providers, research institutions, and governments at the local, state, and federal levels to identify and document grantmaking and contracting challenges, develop reasonable solutions, and work together to implement those solutions. At each step, we've sought to strengthen the government-nonprofit contracting relationship, while ensuring higher-performing nonprofit partners and securing cost savings for taxpayers.

I appear before you today with that background to share some of the experiences of nonprofits and governments in seeking the common goals of efficiency, effectiveness, and impact. I do not seek to lobby the Council for the specific piece of legislation – B23-0107 – but to provide context from across the country and answer your questions.

Summary

At the outset, permit me to summarize the key points in this written testimony.

- **The Problem: Unreimbursed Indirect Costs Lead to Organizational and Program Failures**

The federal Government Accountability Office conducted a study about indirect costs, finding that "Federal, state and local governments rely on nonprofit organizations as key partners in implementing programs and providing services to the public, such as health care, human services and housing-related services," and warning that not paying indirect costs threatened the

viability of nonprofits and their ability to deliver services to the public.¹ Policies that dictate reimbursement of nonprofit indirect costs at inconsistent and insufficient rates undermine nonprofit effectiveness, resulting in increased governmental costs and unmet program goals.

- **How the Problem Come About**

The practice or culture of underfunding nonprofits' indirect costs has persisted for multiple reasons, namely inconsistencies in the use of similar-sounding accounting terms, arbitrariness in the rationale for and application of the limits preventing legitimate costs, and unrealistic expectations imposed via external pressures from private and government funders.

- **Solution: Apply the OMB Uniform Guidance Treatment of Indirect Costs to All Grants**

In our view – and in the view of a growing number of jurisdictions – the Uniform Guidance of the federal Office of Management and Budget provides the best framework for all governments, including the Government of the District of Columbia, to achieve the efficiencies that result from streamlined and unified grants procedures and practices. Application of the Uniform Guidance's common set of rules for nonprofit indirect cost reimbursement would save tremendous time and effort by the District of Columbia Government and its nonprofit partners alike.

The Problem: Unreimbursed Indirect Costs Lead to Organizational and Program Failures

Governments at all levels depend heavily on charitable nonprofits to meet the needs of communities across the country by hiring them to build and maintain the well-being that allows residents to reach their full potential. Yet for as long as most nonprofits can remember, governments that contract with nonprofits to provide these services have not always been good partners. Governments have routinely failed to pay the full costs of delivering the services. As will be discussed, underfunding of indirect costs undermines nonprofit performance and sustainability, while also damaging the ability of governments to achieve program success.

The almost systematic failure of governments to fully reimburse nonprofits for costs incurred while delivering government services to the public has generated

extensive research.² Indeed, the mounting research proves that indirect costs are not the “fat” of an organization that should be dramatically reduced, but are core to the successful operation of

What are “Indirect Costs”?

With some exceptions, a nonprofit's indirect costs are equivalent to what for-profit businesses refer to as “overhead.” They include rent, utilities, technology, administration, professional fees, and other expenses that are not tied to any one program but are vital to sustaining a healthy organization.

¹ Government Accountability Office, “Nonprofit Sector: Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices,” Report GAO-10-477 (May 2010). <https://www.gao.gov/new.items/d10477.pdf>.

² See, e.g., Urban Institute Center on Nonprofits and Philanthropy, “National Study of Nonprofit-Government Contracting State Profiles” (October 2010); <http://www.govtcontracting.org/sites/default/files/Full%20Report.pdf>. Results of follow up study scheduled for publication in December 2013.

organizations. Landmark studies over the past ten years prove that the most efficient and effective charitable nonprofits spend more on indirect costs than their less effective peers.³

The outdated thinking on nonprofit indirect costs contrasts sharply with accepted practices for for-profit businesses. In those settings, people have long recognized that investing in items like office space and equipment, accountability and governance, research, training, and the like are expected as reasonable and necessary costs of doing business.

Why It Matters: Negative Impact on Nonprofit Organizations

The arbitrary limitations on indirect cost reimbursement have reduced the ability of nonprofits to successfully accomplish their missions, and, in some cases, their obligations under government grants and contracts. Several studies have established that a strong organizational infrastructure is necessary to ensure efficient and effective services. For instance, a joint project by the DC-based Urban Institute's Center on Nonprofits and Philanthropy and Indiana University's Center on Philanthropy found that "nonprofits with the weakest organizational infrastructures relied on the public sector for half or more of their revenue, and the public sector practice of providing little support for overhead costs was directly related to the existence of those weaknesses."⁴

In a separate study, The Bridgespan Group examined the problems that nonprofits face regarding externally-imposed, artificially-low overhead costs and identified the importance of breaking what it termed the "vicious cycle of misleading reporting, unrealistic expectations of funders, and pressure to conform."⁵ Its analysis determined the following:

The cycle has grave consequences for an organization's ability to have impact. As unrealistic overhead expectations place increasing pressure on organizations to conform, executive directors and their boards can find themselves under-investing in infrastructure necessary to improve or even maintain service-delivery standards, particularly in the face of growth. In the short term, staff members struggle to "do more with less." Ultimately, it's the beneficiaries who suffer.

Research from Giving Evidence indicates that, in fact, "the highest performing nonprofits spend more on administrative overhead than their less effective peers."⁶

³ See, e.g., Giving Evidence, "Good charities spend more on administration than less good charities: Ground-breaking analysis by Giving Evidence disproves the popular idea that charities should spend less on administration" (May 2013) <http://giving-evidence.com/2013/05/02/admin-data/>.

⁴ The Center on Nonprofits and Philanthropy, Urban Institute and the Center on Philanthropy, Indiana University, "Getting What We Pay For: Low Overhead Limits Nonprofit Effectiveness" (August 2004).

⁵ William Bedsworth, Ann Goggins Gregory, Don Howard, "Nonprofit Overhead Costs: Breaking the Vicious Cycle of Misleading Reporting, Unrealistic Expectations, and Pressure to Conform" (The Bridgespan Group, April 2008 (herein "Bridgespan Report") <http://www.bridgespan.org/getattachment/93a03c17-154b-4cea-b7e7-5020f1c1ffec/Nonprofit-Overhead-Costs-Break-the-Vicious-Cycle.aspx>.

⁶ Giving Evidence, "Good charities spend more on administration than less good charities: Ground-breaking analysis by Giving Evidence disproves the popular idea that charities should spend less on administration" (May 2013) <http://giving-evidence.com/2013/05/02/admin-data/>.

Combined, these analyses demonstrate that investing in the components of indirect costs is essential to success. The absence of these investments may not dictate failure in the immediacy. But the lack of investment is not sustainable, and performance consistently suffers.

Why It Matters: Negative Impact on Governments

The Government Accountability Office investigated concerns about the fiscal strain on nonprofits in its well-known 2010 study on indirect costs.⁷ GAO found that nonprofits typically bridged the gap between the costs incurred and the level of reimbursement by making what are difficult choices to favor program services over the well-being of the organization. The reason goes to the mission-oriented culture of the nonprofit community, which GAO summarized as follows: “because many nonprofits view cuts in clients served or services offered as unpalatable, they reported that they often compromise vital ‘back-office’ functions, which over time can affect their ability to meet their missions.”⁸ The study concluded:

As the federal government increasingly relies on the nonprofit sector to provide services, it is important to better understand the implications of reported funding gaps, such as compromised quality of important administrative functions, including information technology, human resources, legal, and accounting operations [i.e., indirect costs] [T]hese challenges potentially limit the sector’s ability to effectively partner with the federal government, can lead to nonprofits providing fewer or lower-quality federal services, and, over the long term, could risk the viability of the sector.⁹

The GAO’s observations were supported by the Urban Institute’s landmark study on government-nonprofit contracting which, among other things, documented the effect that underpayment of actual costs has on the nonprofit human services sector. Sixty-eight percent of nonprofits (77 percent for larger nonprofits) in the study reported that the failure of governments to pay the full cost of a service was a problem, with the majority indicating that indirect cost reimbursement from governments was limited to 10 percent or less. Additionally, 82 percent of nonprofits reported scaling back their operations, with most organizations resorting to two or more cutbacks. Half of organizations froze or reduced salaries, and 38 percent laid off employees.¹⁰

A nonprofit leader summarized the challenge to both nonprofits and governments quite clearly:

The irony for the field as a whole is that a technique meant to control costs actually undermines efficiency *and* program quality. The inability of nonprofits to invest in more efficient management systems, higher skilled managers, training, and program development over time means that as promising programs grow, they are hollowed out, resulting in burned

⁷ GAO, “Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices” (May 2010) <http://www.gao.gov/new.items/d10477.pdf>.

⁸ Ibid, at “What GAO Found.”

⁹ Ibid, at p. 22.

¹⁰ Urban Institute Center on Nonprofits and Philanthropy, “Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracts and Grants” (October 2010) <http://www.govtcontracting.org/sites/default/files/Full%20Report.pdf>.

out staff, under-maintained buildings, out of date services, and many other symptoms of inadequately funded 'overhead.'¹¹

How the Problem Came About

The old thinking that results in the underfunding of nonprofits' indirect costs has persisted for multiple reasons. We've identified at least three reasons that contributed to the problem of underfunding of indirect costs, each of which is relevant to the Committee's consideration of B23-0107, the "Non-Profit Reimbursement Fairness Act of 2019": **1)** inconsistencies in the use of similar-sounding accounting terms, **2)** arbitrariness in the rationale for and application of the limits preventing legitimate costs, and **3)** unrealistic expectations imposed via external pressures from private and government funders.

1. Inconsistent Terminology. People often presume that accounting is black and white and that accounting terms are defined distinctly and applied consistently. When it comes to the topic of nonprofit indirect costs, however, that presumption is wrong.

Several similar yet distinctly different terms – indirect costs, administrative costs, and overhead costs – are often unknowingly used interchangeably, causing great confusion. For instance, the federal government, through the OMB Uniform Guidance, instructs federal agencies contracting with or issuing grants to nonprofits to categorize the costs that nonprofits incur in delivering the services into two general buckets: either direct or indirect. The Uniform Guidance then further separates indirect costs into two subcategories: either administrative costs or facilities costs.¹² Administrative costs include management and general expenses such as the salaries of executives and accounting personnel and library expenses. Facilities costs are items such as depreciation and capital improvement, interest on debt associated with certain buildings, and operations and maintenance expenses.

Yet another part of the federal government, through the IRS Form 990 that applies Generally Accepting Accounting Principles (GAAP), tells nonprofits to categorize and annually report their costs in three separate categories, with completely different labels: Management & General, Program Services, or Fundraising. Management & General costs are typically activities that are required by organizations to operate, but may support multiple programs and the organization as a whole, such as accounting, human resources, staff development, rent, and utilities. Program costs are those that are easily attributable to a specific program or project. Fundraising costs are self-explanatory.

Superimposed on top of the competing federal categorization systems is the confusion caused when laypeople use the similar-sounding term of "overhead." When charity watchdog groups refer to "overhead," they generally define this as administrative (including facilities) and fundraising costs combined.¹³ Yet when governments use the terms indirect or administrative costs, they do not

¹¹ Clara Miller, "The Looking-Glass World of Nonprofit Money: Managing in For-Profits' Shadow Universe" *Nonprofit Quarterly* (Spring 2005). <http://nonprofitfinancefund.org/files/docs/2010/NPQSpring05.pdf>.

¹² [OMB Uniform Guidance](#), Section 200.56 Indirect (facilities & administrative (F&A)) costs.

¹³ See, e.g., Letter to the Donors of America, <http://overheadmyth.com/letter-to-the-donors-of-america/>.

include any fundraising costs. Governments consider the costs associated with fundraising as being separate and distinct costs unrelated to programs. Therefore, based on these definitions an organization may have a government-defined indirect cost rate of 25 percent, but a perceived overhead rate of 40 percent.

2. Arbitrary Application. A second major problem is the arbitrary ways in which governments apply indirect cost principles. Even assuming a clear definition existed, the actual amount that a governmental entity reimburses a nonprofit for indirect costs can vary considerably, and it rarely equals the actual costs of performing services. Federal grants typically allow nonprofits to receive reimbursement for the nonprofit's indirect costs. It is not uncommon, however, that a federal agency imposes an arbitrarily determined cap on indirect cost reimbursement (whether dictated by a statute or determined through executive or bureaucratic action) that is well below the nonprofit's actual costs or negotiated rates. The OMB Uniform Guidance is designed to reduce this inequity. But most state and local governments do not typically have any requirement to reimburse nonprofits for indirect costs, even when the funds flow from a federal funding stream. As will be discussed by other witnesses, nonprofits with several government grants may be struggling to manage a dozen or more indirect cost rates for the same expenses. Ironically, the multiplicity of reimbursement rates actually drives up the indirect costs that nonprofits and governments seek to control.

3. Unrealistic Expectations. Beyond these problems of inconsistencies and arbitrariness, external expectations of what are considered acceptable indirect costs have plagued nonprofits for decades.

People tend to bring up overhead only when talking about nonprofits. Yet a study of the indirect cost rates of S&P 500 companies revealed that consumer staple companies (e.g., food and household items) had a median overhead rate of 34 percent, and the rate for information technology companies reached 78 percent.¹⁴ Expecting nonprofits to have overhead as close to zero as possible – which would mean operating without some of the basics, such as rent, utilities, management, accounting, or technology – is simply illogical.

Major influencers of low indirect costs have been private giving federations, which for many years have expected nonprofits receiving funds to limit Management & General Expenses to no more than 20 percent of budget.¹⁵ So-called watchdog groups have similarly exerted pressure to keep costs low, citing overhead cost ratios as a flawed proxy for an organization's efficiency and effectiveness.¹⁶ In New York, Executive Order 38 mandates that no more than 15 percent of the state funds used to reimburse for services may be applied to administration.¹⁷ There are different rates utilized – rates established in rule or statute, per grant, or even are simply based on “normal” practice – all of which have been set arbitrarily.

¹⁴ Research by The Bridgespan Group, reported in *Stanford Social Innovation Review* (Summer 2016). <https://www.bridgespan.org/insights/library/pay-what-it-takes/pay-what-it-takes-philanthropy>.

¹⁵ Ibid.

¹⁶ See, e.g., Charity Navigator Financial Range Tables, which define “administrative expenses” this way: “Percent of total functional expenses spent on management/general (lower is better),” http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48#.UjyAui3D_5p.

¹⁷ New York Executive Order 38 (2012) <http://www.governor.ny.gov/executiveorder/38>.

Solution: Apply the OMB Uniform Guidance Treatment of Indirect Costs to All Grants

For many years, the networks of the National Council of Nonprofits have worked to document the problem of underfunded indirect costs and promote a very simple solution. We believe all parties – nonprofits providing the services, governments and taxpayers paying for the services, and the beneficiaries of those services – benefit by the application of a single set of rules for cost allocation and reimbursement.¹⁸ In our view, the Uniform Guidance of the federal Office of Management and Budget provides the best framework for all governments, including the Government of the District of Columbia, to achieve the efficiencies that result from streamlined and unified grants procedures and practices. The Uniform Guidance provides the clarity and consistency that, if adopted government-wide, would reduce costs and improve performance measures.

Implemented in 2014, the OMB Uniform Guidance consolidated eight OMB Circulars into a streamlined package of grants rules codified at 2 C.F.R. Section 200. For the discussions most relevant to this hearing, the Uniform Guidance establishes important rights for nonprofits that apply to many of the grants administered by the District. Specifically, the Uniform Guidance expressly requires pass-through entities using federal funds (such as the District Government, as well as some larger nonprofits) and all federal departments/agencies to reimburse a nonprofit for the indirect costs it incurs in performing services on behalf of governments. Nonprofits that already have a negotiated federal indirect cost rate must be paid that amount. Nonprofits that do not have a federally approved indirect cost rate can elect either to negotiate an indirect cost rate in accordance with the federal cost principles or opt to accept the *de minimis* rate of 10 percent of their modified total direct costs (MTDC).¹⁹ Importantly, when federal dollars are in the funding stream, the mandate to pay indirect costs applies to the pass-through entity.

Where there is confusion and complication, however, is whether the requirements of the Uniform Guidance apply to local dollars, such as match requirements or added services that the District chooses to purchase beyond what is in the federal program. We have found throughout the country that a decision not to apply the Uniform Guidance across all governmental agencies generally

¹⁸ The National Council of Nonprofits' [2020 Public Policy Agenda](#), at Section IV. **Public-Private Collaborations for the Public Good**, expresses unqualified support for "Collaboration between state and local governments and nonprofit contractors and grantees to:

- a. Ensure full and fair implementation at the state and local levels of the cost principles and other federal grants reforms contained in the Office of Management and Budget Uniform Guidance;
- b. Promote greater efficiency and cost savings by replacing existing state and local laws, regulations, and procedures with one uniform system based on the federal cost principles and reforms in the Uniform Guidance and applying them to all of their contracts and grants with charitable nonprofits, regardless of public funding source; and
- c. Identify and eliminate from state statutes and local ordinances arbitrary caps on reimbursement of nonprofit indirect, administrative, or overhead costs, or other unreasonable and burdensome statutory or procedural requirements for nonprofits that provide public services through government grants and contracts.

¹⁹ On January 22, 2020, OMB published in the Federal Register proposed updates to the Uniform Guidance that, if implemented, would clarify and strengthen the requirements for reimbursement of nonprofit indirect costs. See, [Guidance for Grants and Agreements](#), Office of Management and Budget Proposed Rulemaking, (Fed. Reg. #2019-28524).

increases costs for all parties to the grants or contracts – including higher costs for governments and taxpayers.

The reasons are easy to understand. Multiple indirect cost reimbursement rates on a single grant – as when the District reimburses for indirect costs at a different rate than the federal government for the DC’s portion of the grant – forces additional bookkeeping and administrative work for the District to administer the grant. Further, governments often issue multiple grants to individual nonprofit organization. Survey data from the Urban Institute found that 41 percent of responding nonprofits in the District reported working under grants with between two and four government agencies, and seven percent performed services pursuant to grants with five or more agencies.²⁰ When each separate District agency imposes its own indirect cost reimbursement rate, it must also employ additional staff to manage the grant, negotiate indirect cost rates, compute and rationalize audit results, and analyze and report on performance. Nonprofits must likewise employ additional staff and technology to attempt to keep straight which grants receive reimbursement under which rate, generate billing information that comports to conflicting demands, all while seeking to provide the needed services in the community.

In short, application of a common set of rules for nonprofit indirect cost reimbursement would save tremendous time and effort by the District Government and its taxpayers, as well as for its nonprofit partners.

Conclusion

Americans need a healthy nonprofit sector to play its vital role in ensuring that everyone has the opportunity to reach their full potential and contribute to their communities. Governments at all levels rely on charitable nonprofits to deliver a wide range of services that are critical to the cultural, economic, spiritual, and environmental well-being of our residents and communities. Yet, efforts to limit indirect cost reimbursements are in reality reducing the effectiveness of the vital services that form the foundation on which well-being is built for so many Americans. Curbing a nonprofit’s effectiveness translates to an inability to achieve outcomes. With the growing emphasis on performance measurement and the shift by governments from purchasing services to investing in outcomes, it is important to recognize that nonprofits simply cannot produce desired outcomes without the basic resources needed to do so. Application of the cost principles and indirect cost requirements of the OMB Uniform Guidance is a critical means of overcoming these challenges and building well-being not just for the District’s nonprofit partners, but for all of its residents.

²⁰ Urban Institute Center on Nonprofits and Philanthropy, National Study of Nonprofit-Government Contracting, [District of Columbia Snapshot](#), 2012 data.