Preventing death by starvation

Mark Salway and Eric Walker analyse the inevitable consequences for charities arising from a failure to adequately fund their overheads.

HERE'S A TOTALLY unsurprising statement from the commercial world – "Companies cover their overheads effectively and make a profit on their services."

Here's the same headline from the non-profit space – "We don't fully cover our overheads and regularly cover funding gaps from unrestricted donations which we work hard to get from the general public. There is mostly nothing added to our reserves from grants or contracts to guarantee our future sustainability."

Sounds wrong doesn't it? But this is reality for many charities.

Experience from the US is showing that this attitude is now becoming a major issue and threatening the future financial sustainability of many non-profits there. So how can the finance community do something about this here in the UK?

The history of core costs

Back in 1999, Acevo published a report by Julia Unwin called *Who pays for core costs?* It put forward the idea that charities and non-profits have overheads and should be paid appropriately when costing their work. It also highlighted that overhead levels are not the same in each organisation and depend on such things as quality, and the phase of growth the body is going through.

While it has always seemed obvious to commercial organisations that they need to recover their costs – plus make a profit to pay back to shareholders – many charities balked at the idea of recovering overheads, in many cases preferring to use their own unrestricted reserves to balance the loss on a grant or contract.

The situation was further compounded by some funders defending their position not to pay overhead costs by stating that they would prefer to spread their funding across a wider range of grantees, or by merely offering a notional overhead rate, such as 7 per cent.

At that time, many charities didn't know their overhead levels and some smaller organisations didn't have the skills to calculate it. Acevo provided a model for this by publishing *Funding our future: core costs revisited*, in 2004.

> "Some charities have grown rapidly by underpricing their services"

In the subsequent decade, some organisations have grown rapidly by underpricing their services and underpinning any deficit with donations. Many have done this unaware of the sizeable subsidy they were providing and some, unfortunately, suffered financial difficulties from this practice.

Meanwhile, the sector had negotiated with government to introduce the concept of a "fair proportion of overheads attaching to services", which was enshrined in the Compact – first made in 1998, and renewed in 2010.

Contracting for services and payment-by-results contracts became more usual. But still many non-profits did not know, or did not calculate effectively, the overheads for their services.

It took the recession, starting in 2009, to bring this into sharp focus – as grants and government money became more precious and competition for donations became intense, it became harder to subsidise services using donations.

Finance directors started to see full cost recovery as a way out of a funding squeeze.

Knowing your overheads

From multiple conversations we have conducted, only around one-third of all charities truly understand their overheads and can confidently negotiate with donors about them.

There is also an inherent optimism bias in everything with which we as a sector engage. That might be demonstrated by overpromising the impact of what we do, or underpricing our services because we believe we can do more in less time than we actually can.

With more effective funding of overheads we could guarantee more funding for capacity-building; give charities time to think; take some unrestricted donations to reserves, or help more beneficiaries. Surely this is worthwhile working towards.

Experience in the US

In the US, the world is changing. Organisations such as InsideNGO and Bridgespan are realising the impact of this underfunding of overheads and are talking about a 'starvation cycle' regarding overhead costs in non-profits.

Dan Pallotta's much-quoted Ted talk provocatively considered this. He asked: "Do we want to be remembered as NGOs for the low overheads we have, or by the impact we have on the world?" We recommend you watch this if you haven't seen it already:

www.ted.com/talks/dan_pallotta_the_way_we_think_about_charity_is_dead_wrong.

In the US they have identified a dysfunctional situation arising as two agendas collide – charities have a mission to help those in need, but equally 'value for money' is expected too. Rather than focusing on value for money by justifying the reasons why it costs more to help those hardest to reach, or demonstrating the quality of their output, this dynamic is leading non-profits to cut overheads instead.

InsideNGO, the US membership organisation focusing on operational excellence, has summarised the problem as follows: "In their enthusiasm to accept funding for the work they are passionate about, charities often let funders decide what value for money means and too often accept grants and donations that come with insufficient provision for overheads.

"The funding is too often inadequate to achieve the best programme results, and almost always insufficient to support the internal operations of accounting, human resources, information technology and other support functions.

"It is this short funding of support functions that puts at risk charities' financial health, staff retention, operational efficiency and, at the end of the day, their longer-term existence."

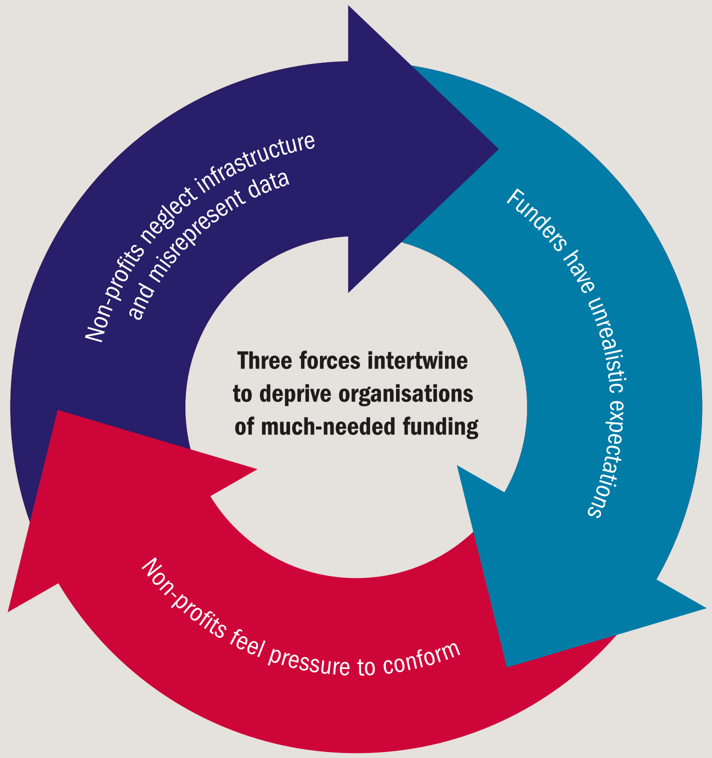
InsideNGO believes that "charities are in effect hollowing out their organisations and mortgaging their future."

The starvation cycle

In the US, the underfunding of governance, support and back-office functions has been dubbed the starvation cycle, based on a study by the Bridgespan Group published in the *Stanford Social Innovation Review*. The article, *The non-profit starvation cycle* suggests that many charities find themselves in a downward spiral driven by the three related events listed in figure 1.

Bridgespan also argues that this chronic underfunding of support functions means that many non-profits lack the infrastructure to grow effectively and take their work to scale.

figure 1: The cycle that starves non-profits



Source: The Bridgespan Group

> Charities are in effect hollowing themselves out and mortgaging their future

What can be done?

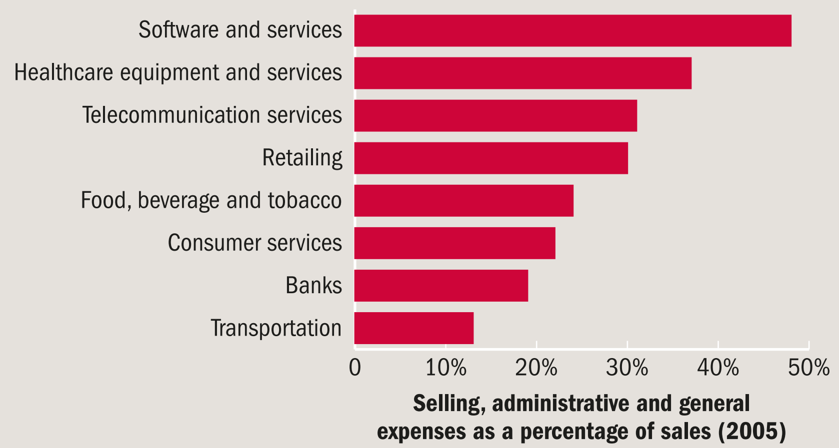
Bridgespan offers several ideas to help charities break the cycle:

- First, charity leaders must understand their back-office costs in detail (also known as overhead costs) and their real infrastructure needs. They must be transparent about this in both internal budget processes and external funding applications for programme work.
- Second, these NGO leaders must start speaking openly about these costs to break the downwards spiral. They must be willing to explain the real numbers to their governing bodies and enlist trustees in speaking to funders.
- Third, charities must attempt to educate their funders, and this may be better done with a combined voice.

Comparing across sectors

So what level of overheads should be included in funding applications? It helps to look at the private sector

figure 2: The real cost of doing business in different industries



Source: The Bridgespan Group, and Compustat; Standard & Poor's Global Industry Classification Standard Structure

for comparison, and again we can turn to US data. In Bridgespan's starvation-cycle article, they cite the Standard & Poor's data reproduced in figure 2. This shows that most industries spend well over 20 per cent – some considerably more – on overheads.

In a recent survey of its members, InsideNGO identified a minimum level of 22 per cent needed for basic support functions like finance, HR and IT – much more than the 10-20 per cent usually quoted in the non-profit sector.

In the UK, Mango is in the process of conducting a similar sector survey on cost recovery, see www.mango.org.uk/campaigns/costrecoverycampaign. Mango's survey will provide some indicative figures for overhead levels in NGOs and some welcome learning about what level would help achieve sustainability.

Tim Boyes-Watson, the director of Mango, says: "What concerns us about the current practices of both NGOs and donors is not just that we are perpetuating a cycle that starves organisations of the funds they need to make a sustainable impact. If NGOs use their precious unrestricted funding to subsidise donor-funded projects, we also compromise our ability to innovate and risk focusing the majority of our programme work on whatever the large donors choose to prioritise, rather than doing what our beneficiaries need most."

> "After 15 years of advocacy, we need a step-change in understanding"

The end game

In the US, the starvation-cycle conversation is shifting into a broader discourse often labelled 'full funding for results' – effectively our UK 'full cost recovery'. The conversation is moving away from debating the right overhead percentage to talking about the level and type of funding needed to accomplish sustainable, effective programmes.

The Donors Forum, a Chicago-based membership group of funders and grantees, has recently published its collective response to the starvation cycle in the *Donors Forum commitment to full cost funding*, making three promises to grantees: to engage in honest conversation, to provide grantees with the support they need, and to change practices and policies that hinder effectiveness.

Charity finance leaders can help change more lives by ensuring sustainable and properly costed funding of our organisations. We are reaching out through *Charity Finance* magazine to encourage FDs and their colleagues to consider the following critical questions:

- Do we truly know our overheads and how any shortfall in funding is being met?
- Are we being transparent about the size of any funding gaps?
- How can we close the funding gaps we have?

It's important that we all consider ways to address this issue, and ensure sustainability of funding for our charities in the future. After 15 years of advocacy and urging charities to improve their analysis of overheads, we need a step-change in understanding.

Let's learn from our US colleagues and avoid the starvation cycle that leads inevitably to a downward spiral of overhead funding. ■

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