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Linking Indirect Costs and Financial Health:

The MacArthur Foundation's Approach to Revising its Indirect Cost Policy to Better Support Grantees

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Background

Like many of its peers in the philanthropic community, the John D. and Catherine T. MacArthur Foundation has in recent years been engaged in an intentional effort to address the chronic underfunding of “indirect” or “overhead” costs that its grantees incur in grant funded projects.¹ This is in response to research and advocacy efforts—as well as MacArthur’s experience with its own grantees—showing that nonprofit organizations and their funders are engaged in a “starvation cycle.” As outlined in an influential 2009 article, the starvation cycle exists when funders’ skepticism of indirect costs creates an environment in which nonprofit organizations—through underinvestment or skewed reporting—seek to minimize those costs, which further reinforces funders’ reluctance to cover those costs at the level necessary to support effective operations.² [In an effort to break this cycle, MacArthur and several like-minded foundations](#) are signaling an increased openness to grantmaking that covers the actual costs—including indirect costs—of work that their grants support.

One significant challenge in this effort, however, comes in determining what adequate coverage of indirect costs actually means. Definitions and methodologies for calculating indirect costs are notoriously inconsistent across nonprofit organizations and funders, and solid information on nonprofit indirect costs is not easy to come by.³ Moreover, given that nonprofits have been incentivized to underinvest in administrative costs, it is possible that even with a clear and consistent method of calculating indirect costs many organizations’ **actual** investment in infrastructure is inadequate to what those organizations need for efficient and effective operations.

The MacArthur Foundation realized that its longstanding policy mandating a 15% cap on indirect costs in project grants was contributing to the starvation cycle for its own grantees. Analysis of grantee data showed that 70% of grantees had reported indirect cost rates above the 15% cap. Based on this, MacArthur resolved to revisit its indirect cost policy with respect to project-based grants.

1 See Jeri Eckhart-Queenan, Michael Etzel, and Julia Silverman, “Five Foundations Address the ‘Starvation Cycle.’” www.philanthropy.com/paid-article/five-foundations-address-the/293

2 See Ann Goggins Gregory and Don Howard, “The Nonprofit Starvation Cycle.” ssir.org/articles/entry/the_nonprofit_starvation_cycle

3 United States Government Accountability Office, “Nonprofit Sector: Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices.” www.gao.gov/assets/310/304470.pdf



Choosing a New Approach

The next challenge was to determine a method of funding indirect costs that would, at least, “do no harm” to the organizations receiving MacArthur grants. Having participated in a pilot study with four large private foundation peers to understand the true indirect cost rates of a select group of grantees, MacArthur considered an approach involving having a third-party “verify” an indirect cost rate for individual grantees that could then be applied to project grants.⁴ MacArthur determined that, for its purposes, this approach suffered from a number of potential flaws, including the time and expense associated with calculating and verifying a rate for every project grantee, as well as the fact that even a verified rate based on an organization’s actual cost structure may represent an underinvestment in critical operations or functions necessary for financial health and sustainability.

As an alternative, MacArthur explored establishing indirect cost rates for grants based on characteristics or profiles of organizations. This approach would have the advantage of simplifying the calculation of an indirect cost rate by not requiring extensive financial analysis for each grantee. Moreover, it could be considered a more evidence-based means of setting indirect cost rates on grants, one not tied to the potentially idiosyncratic cost structures of individual grantees.

A further advantage of this approach was the potential to relate indirect cost rates to evidence-based variables that are meaningfully associated with organizational outcomes. The theory behind the “starvation cycle” is that organizations forced to underspend on indirect costs (such as finance, HR administration, and fundraising)—due in part to inadequate indirect cost recovery on foundation grants—are likely to be more financially vulnerable than if they were able to invest adequately in those functions. By extension then, if the data showed that a certain level of indirect cost is related to better financial outcomes for organizations, MacArthur could set its indirect cost rate policy at a level likelier to support the financial health of its grantees.

⁴ Queenan et al.

www.philanthropy.com/paid-article/five-foundations-address-the/293



Analyzing Data to Establish an Appropriate Rate

MacArthur hired two finance and data consulting firms with extensive nonprofit expertise—Fiscal Management Associates, LLC,⁵ and BCT Partners—to analyze publicly available nonprofit financial data from the IRS Form 990 to research potential indirect cost rate standards for project grants. The goal of this analysis was to determine indirect rates better aligned with the costs for nonprofits to achieve and/or maintain a state of financial health, as measured by liquid unrestricted net assets (LUNA), a common measure of financial reserves.⁶

Fiscal Management Associates, LLC, and BCT Partners conducted a statistical analysis of all 501(c)(3) public charities filing electronic Forms 990 for 2015 to 2017, representing approximately 137,000 nonprofit organizations. The study design was a quasi-experimental observational data study that sought to determine an indirect cost rate⁷ (the independent variable) that predicted financial health (the dependent variable), controlling for certain contextual factors, including organizations' mission focus area, local levels of charitable contributions, and community socioeconomic context. The study used machine learning algorithms to match organizations – i.e., to find groups of organizations that were most similar to one another – based on their program model, county level of giving, and community socioeconomic context. This matching process ensured that organizations were being evaluated alongside ones similar to themselves to arrive at better aligned indirect cost rates regardless of what an organization does or where it does it. Algorithms identified 31 uniquely matched comparison groups based on these program model and community context factors.

Once organizations were placed into their matched comparison groups, the study identified and flagged the top quartile (25%) of each group's nonprofits with respect to their number of months of LUNA. Then, the researchers calculated the average minimum and maximum indirect rates for these top financially healthy organizations. This created an "ideal" indirect range for each of the 31 matched comparison groups. As is probably not surprising, the resulting indirect rate range was not the same across all groups. For most of the matched comparison groups (16/31), an organization's current indirect rate was a statistically significant predictor of financial health.

To calculate a better aligned indirect cost rate that could be applied across nonprofit organizations from all groups, the analysis identified the minimum indirect rate associated with financial health (i.e., the lower bound of the "ideal" range) across the 31 matched comparison groups. The resulting indirect rate for all types of nonprofits, across program model, community giving and community socioeconomic status, is 29%. This indirect rate is the **minimum** indirect rate for the top quartile of financially healthy organizations (based on months of LUNA), and falls within the "ideal" indirect range across all 31 groups of nonprofits. This rate was therefore determined to be an effective standard to guide grantmaking that is supportive of the ongoing financial health needs of grantees⁸.

⁵ Personnel of Fiscal Management Associates, LLC, that performed this work have joined BDO-FMA, LLC.

⁶ Calculated as unrestricted net assets minus the equity (non-debt) value of any fixed assets.

⁷ For purposes of the study, indirect cost rate was calculated as the ratio of management and general plus fundraising expenses to program service expenses as reported on the Form 990 statement of functional expenses.

⁸ For more detail on the study scope and methods see "Appendix: Methodology"

Translating Data into Policy

Armed with this analysis, MacArthur considered a range of options for translating the results of the study to its own indirect cost policy.

Among those options was a consideration to cover grantees' actual indirect cost up to the minimum of the "ideal" rate range—in other words, asking grantees to calculate and present their actual indirect cost rates and covering that rate in project grants up to the 29% rate associated in the study with financially healthier organizations. The primary disadvantage of this approach was that it relied on grantees' actual indirect costs rather than an "ideal" level of indirect cost (i.e., a level associated with financial health)—for example, a grantee with an actual indirect cost rate of 18% may still be underinvesting in the administrative and fundraising capacities that would put that grantee in best position to be financially healthy. MacArthur saw this as still potentially perpetuating the starvation cycle by covering only what organizations were able to invest in indirect costs rather than what they should invest.

Consequently, MacArthur settled on a policy approach that would cover grantees' indirect costs on project grants at a flat 29% of direct costs—the minimum rate that the analysis found was associated with financially healthier organizations.

For organizations whose actual indirect cost rate was below this level, the 29% would therefore help to "level up" their potential investment in the administrative and fundraising functions needed to enhance their financial health. For those organizations whose actual indirect cost rate was above the 29%, MacArthur recognized that future shifts or improvements may be required to address these organizations' needs.

This approach also helped to meet the Foundation's goal of simplicity in its indirect cost policy by not requiring grantees to make complex calculations and justifications of an indirect cost rate (a particular burden for smaller organizations with less capacity in the area of financial management). MacArthur also developed policy language that defined direct and indirect costs in clear and consistent ways, enabling more transparency in grant budgeting. Importantly, these definitions allow certain "shared costs" (such as rent/occupancy expenses) that support grant-funded activities to be partially allocated into project budgets rather than falling fully within the indirect category.⁹

9 The full revised indirect cost policy is available on the MacArthur Foundation website at www.macfound.org/about/our-policies/indirect-cost-policy/

Implementation and Evaluation

After a substantial amount of preparation including several internal and grantee focus groups, MacArthur launched the new policy to apply to project grants made beginning January 1, 2020.¹⁰ Grantees now receive an indirect cost rate of 29% of direct costs on all new project grants and grant renewals. Further, MacArthur does not mandate—or require reporting on—how these monies are spent. Grantees have full discretion on how and where to spend the funds.

The policy rollout included quarterly webinars for grantees and grant applicants describing the policy and walking through grant budgeting under the new framework. Implementation of the policy is ongoing, with MacArthur committed to understanding the impacts of the change to grantees as well as to the foundation's own grantmaking practices. In addition to the quarterly webinars, MacArthur maintains a dedicated email address to receive questions and feedback from grantees and encourages open communications between grantees and program officers on the implementation and impact of the policy. To date, most grantee feedback has been positive, with grantees expressing appreciation for the financial flexibility that increased indirect cost rates allow and a desire for other grantmakers to adopt policies covering the true indirect costs of nonprofit organizations.

One important constraint in the implementation of the policy was that the foundation's overall grantmaking budget did not change (i.e., increase) as part of the decision to increase indirect rates on project grants. As a result, other adjustments had to be made in order to accommodate the higher rate. For the most part, these adjustments centered around scoping grant-funded projects to allow for coverage of the project costs as well as the 29% indirect rate—by necessity, this results in a more limited project scope than would be possible with a lower (e.g., 15%) indirect rate. Therefore, adjusting expectations about the scale and scope of grant-funded projects—by grantmakers as well as funded organizations—has been an important component of implementing the policy in a realistic and meaningful way.

As the second year of grantmaking under the new policy is wrapping up, MacArthur intends to engage in intentional data collection about the results of the change and to continue to reflect on and revise its policies and practices as needed going forward. The foundation understands this change as a necessary first step though not necessarily the last word, and will continue to share lessons with the field in hopes of modeling possibilities for other grantmakers to better support the organizations who are essential to carrying out their philanthropic missions.

¹⁰ The policy applies to 501(c)(3) nonprofit organizations and equivalents. Exceptions to the policy include general operating support grants (which do not distinguish between direct and indirect costs) and certain other specific types of grants.

Appendix: Methodology

By Peter York, [BCT Partners](#)

The purpose of the study was to predictively determine an ideal indirect rate for nonprofits as correlated with evidence of nonprofits assessed to have achieved a relative state of financial health. The metric of success used for this study was months of available financial reserves, defined here as liquid unrestricted net assets (LUNA).¹¹ The research study used longitudinal publicly available IRS 990 data from all public charities filing electronic full form tax filings for 2015 to 2017, combined with the IRS Statistics of Income (SOI) data for the same years. Financial data from 136,929 organizations and community-level socioeconomic data from over 3,000 counties were included in the study. The study design was a quasi-experimental observational data study that sought to determine the ideal indirect rate (the independent variable) that predicted financial health (the dependent variable) controlling for the following contextual factors, which this study found do in fact confound the relationship between an organization's ideal indirect rate and its achievement of financial health:

1. Organizational program model, or what a nonprofit does (e.g., advocacy work, mental health service provision, arts and culture, food, etc.). The hypothesis of this study was that ideal indirect rates were necessarily different and not dependent upon or correlated with a nonprofit's field, core program model, size, etc.

2. Local levels of giving. The study found that the relationship between indirect rate and financial health was confounded by the amount of community foundation, private foundation and total public contributions given to all nonprofits in the County. Each of these factors were calculated using IRS 990 data from community and private foundations, as well as public contributions amounts submitted by nonprofits, whereby totals were calculated and rolled up for each county in the U.S. The analysis created five equally balanced categorical levels of giving (very high, high, medium, low, very low) for each of these measures (community foundation giving, private foundation giving and total public contributions), rather than using total actual dollars, to minimize the weight of the larger outlier philanthropies that mostly fund organizations outside of the County in which they reside.

3. Community socioeconomic status. The study showed a county's number of itemizers – a proxy for wealth – and unemployment rates affect an organization's ability to achieve financial health. From a financial health perspective, nonprofits are either positively or negatively affected by the socioeconomics of their county.

¹¹ Liquid unrestricted net assets, or LUNA, is a measure of an organization's financial reserves that are available in unrestricted, liquid (or near-liquid) form, expressed in terms of months of expenses. From the Form 990, it is calculated as [Part X, Balance Sheet, Line 27 (Unrestricted net assets) – Line 14 (Intangible assets) – (Line 10c (Land, buildings, and equipment) – Line 23 (Secured mortgages) – Line 20 (Tax-exempt bonds))] / [(Part IX, Statement of Functional Expenses, Line 25A (Total functional expenses) – Line 22A (Depreciation)) / 12 (months)]

The way that the study controlled for these confounding factors was to match organizations based on program model, community giving and socioeconomic status. Specifically, there are 26 major categories, or sectors, of nonprofit organizations using the IRS 990 National Taxonomy of Exempt Entities (NTEE), representing what the study calls “program models.” Examples of major categories/sectors are human service providers, arts, culture and humanities, environment, medical research, education, etc. This study trained machine learning algorithms to match organizations – i.e., find groups of organizations that were most similar to one another – based on their program model, county's level of giving and community socioeconomic status. Algorithms identified 31 uniquely matched comparison groups based on these program model and community context factors. This matching process allows study conclusions to determine the ideal indirect rate for achieving financial health, controlling for these program and community contexts. Put another way, this matching process ensured that conclusions could identify an ideal indirect rate, regardless of what an organization does or where it does it. Human service providers in Mobile, Alabama weren't being evaluated alongside human service providers in San Francisco, California, which would be an unfair comparison.

Once organizations were placed into their matched comparison groups, researchers identified and flagged the top quartile of each group's nonprofits with respect to their number of months of LUNA. Then, researchers calculated the average minimum and maximum indirect rates only for these top financially healthy organizations.

This created an ideal indirect range for each of the 31 matched comparison groups. As is probably not surprising, the resulting ideal indirect rate range for each matched comparison group was not the same across all groups. For most of the matched comparison groups (16/31), an organization's current indirect rate was a statistically significant predictor of financial health (LUNA), three years later ($p < .1$, and for 13/16 groups, $p < .05$).

To calculate one ideal rate for this project, researchers identified the minimum indirect rate that fell within the ideal minimum to maximum indirect rate for every one of the 31 matched comparison groups. The resulting ideal indirect rate across all types of nonprofits, regardless of their program model, community giving or community socioeconomic status, is 29%. This indirect rate is the minimum indirect rate for the top quartile of financially healthy organizations (based on months of LUNA), and falls within the ideal indirect range across all 31 groups of nonprofits. This rate is therefore an effective standard that philanthropy and government can use to guide grantmaking that is supportive of the ongoing financial health needs of grantees.

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