Do you know your full costs and recover them?

By Jim Simpson, CPA and director, Financial Technologies & Management

Last year, the Nonprofit Finance Fund in its State of the Nonprofit Sector reported that only seven percent of nonprofits received full project costs from foundations.

Let's make sure we have the same definition for defining full costs because it is not just expenses. Using the following formula helps to define what denotes full costs: day-to-day operating expenses + reserves + fixed asset additions + debt reduction.

Nonprofits that recover full costs prevent financial crises and interrupted services and enable leaders to stay focused on mission and related outcomes.

Many nonprofit organizations don't know their full costs and settle for less recovery than full costs.

This practice has resulted in too few nonprofits generating financial surpluses and reserves to ensure they remain financially viable. As a result, many nonprofits are just getting by without making important investments in their organizations' futures.

So how does your organization start to recover its full costs?

A start is for financial leaders to review and update the current financial reporting systems and then do the following:

1. Know your organization's full costs, which include working capital needed to pay bills on time and reduce debt, fixed-asset investments to maintain and improve facilities, equipment, technologies and systems and cash reserves to protect against risks and invest in new opportunities and capacity.
2. Have conversations with government, foundations, intermediaries, and donors to move towards an understanding of full cost recovery. Organizations' leaders must ensure that they have sufficient funding sources before they accept grants and contracts to recover full costs. For example, a program may only recover $50,000 from a program that truly cost the organization $75,000. So that leader needs to identify other revenue sources or find a way to reduce full costs to fill this financial gap or not accept the $50,000.
3. Banish the overhead ratio as a measurement of organizational efficiency or effectiveness. Each organization is unique and a lower overhead ratio or high overhead ratio does not indicate if an organization is more or less efficient or effective.

4. Have conversations with government, foundations, intermediaries and donors to explain that full costs include overhead costs. Explain that overhead dollars help the organization to run smoother and allows more clients to be served.

While funding sources have limited resources, it is important that they understand that their nonprofit clients have these same financial challenges. Grantors need to encourage and allow nonprofit grantees to report full costs, including all overhead costs. Most nonprofits underprice programs so it's important that grantors encourage full cost reporting.

Funders should focus on what the organization achieved with the grant dollars and allow nonprofits to keep unspent funds as a contribution towards full cost recovery.

Nonprofit financial leaders and funders need to work together to embrace the concept of full costs, which is much greater than just direct-program expenses and overhead recovery.

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Sources:

Why funding overhead is not the real issue: the case to cover Full Costs by Claire Knowlton of the Nonprofit Finance Fund, The Nonprofit Quarterly, Winter 2015

California Association of Nonprofits Overhead Project at
www.calnonprofits.org/overhead