

Stanford SOCIAL INNOVATION^{Review}

Viewpoint
The Hidden Costs of Public Contracting
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VIEWPOINT

The Hidden Costs of Public Contracting

Nonprofits need a strategy to ensure that public dollars don't put them in the red.

BY MARY KATE BACALAO

All grant dollars are equal, but some are more equal than others. Public contracts provide a stable revenue stream for nonprofit human-services providers, but they come with a hidden price tag—contract management costs that make public dollars much more expensive to administer than other types of dollars. Nonprofits often cope with the problem in isolation, using private, unrestricted dollars to offset the expenses of managing public contracts—but this creates opportunity costs for a nonprofit's least restrictive type of funding.

Indirect costs consist of all expenses that support a program but also serve a broader organizational purpose, such as agency-level accounting and operational expenses. Typically, nonprofits recover these and other overhead expenses by pooling and then allocating them to program contracts. Public funders usually assume that a default rate of 10 percent—assessed against the contract's subtotal of direct program costs—is sufficient for nonprofit human-services providers to recover their indirect expenditures.

But funders' assumptions about indirect costs are unrealistic. Understandably wary of disappointing their funders, nonprofits perpetuate the problem by underreporting their needs and then underresourcing vital agency systems. Research shows that this drives a "nonprofit starvation cycle" of "underfunded overhead"—a race to the bottom for nonprofits trying to attract and retain stable revenue streams. Ironically, funders' efforts to support nonprofit systems have produced an atmosphere of chronic underinvestment.

Public contracts not only fall short of covering indirect costs but also create them.

Contract management costs hide across a range of functions, from monitoring and reporting to budgeting and spending. When they add up in proportion to the value of a contract, they serve important purposes, such as ensuring robust stewardship of taxpayer dollars. But when they add up disproportionately, they unfairly burden the already underfunded systems that manage them.

INDIRECT COSTS

As a nonprofit senior manager, I oversee a diverse portfolio of contracts and subcontracts with federal, state, and city government agencies. My team performs all the functions of contract management and handles the attendant expenses. We know that indirect cost rates are poorly structured to absorb these expenses. The pressure that exists in these situations—to prove administrative

capacity by dealing seamlessly with duplicative obligations and delays—diverts resources from vital agency functions that help programs deliver outcomes. Contract management expenses fall into five general categories: program monitoring visits, fiscal monitoring visits, contract reporting requirements, delayed invoice payments, and budget modification delays.

Program monitoring visits offer nonprofit staff an opportunity to strengthen programs in collaboration with experienced public partners. However, when government monitors arrive on-site, these visits often feel like an exam in a course without a textbook. Monitors with heavy contract loads can't provide hands-on guidance, and grantee handbooks can muddy the waters. Such monitoring visits test how well nonprofit staff can guess the individual monitors' priorities, rather than how well the program works. The staff time devoted to this guesswork comes at the expense of real problem solving and performance management.

Fiscal monitoring visits are supposed to do what an independent audit does—so why do both? Nonprofit staff responding to fiscal monitors produce most, if not all, of the same types of documentation required for an independent audit—especially an A-133,

or Single Audit, which tracks compliance with federal circulars and other regulations. When government funders perform an additional audit, it doubles the demand on staff time, creating costs far outside the scope of the contract. Individual monitors lack the training and expertise of professional auditors, and nonprofit staff lose hours, if not days, completing administrative tasks.

A reporting calendar for a public-contracts portfolio can be a full-time job for a nonprofit administrator. Costs include the time required to pull data and



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plug them into each funder's template—a form of double data entry—as well as to produce detailed narratives and even participate in monthly phone calls with public agency representatives. The public contracts reporting function is extremely important: It can provide the evidence, from municipal legislatures to the US Congress, to justify appropriations for public programs serving the most vulnerable. But reporting must be cost-effective, whether that means streamlining protocols, increasing indirect rates, or both.

Budgeting and spending functions also incur outsize expenses. Nonprofit invoicing follows strict monthly deadlines, but no deadline exists on the government side for paying nonprofit invoices. Delayed payments translate into a pileup of receivables, straining short-term cash flow. As a result, payables can also accumulate, and nonprofit staff must do cash management gymnastics until payments arrive. If the agency can afford it, a line of credit does the heavy lifting to absorb the disruption to cash flow. However, this work-around shifts the burden to the nonprofit and its bank. It also shifts the focus from new dollars, which the nonprofit should be pursuing, to dollars already invoiced, which the nonprofit must continue to pursue instead.

Finally, the budget-modification process can drag for weeks or months, constricting short-term cash flow when spending needs diverge from the prenegotiated budget. To manage this problem, some public funders impose early deadlines for budget-modification requests—the idea being that advance notice of requests guarantees time to process them. But early deadlines don't prevent delays; instead, they shift the risk to nonprofits to identify spending patterns before true patterns have emerged. Funders will recapture any unspent funds—including those that can't be spent without a formal budget modification request—so nonprofits forfeit their funding if they don't expend the resources to monitor it closely.

If public funders don't cover the indirect costs that their own contracts create, then who does? Private foundations may be more willing to pay the real costs of delivering

results, and in doing so bust the myth that low overhead spending is a proxy for strong performance. But, by and large, private, unrestricted funds absorb the burden of full cost recovery, limiting the agency's use of its least restrictive dollars, which should ideally be discretionary surplus that the agency can reinvest in strategic needs. A board could spend these dollars on the agency's asset base, acquiring land, buildings, or equipment. Alternatively, the board could build a cash operating reserve to hedge against emergencies, funding cuts, or recessions. Instead, unrestricted dollars, with all their untapped potential, get sidelined to plug holes in program budgets or prop up underfunded administrative departments, depriving the board and senior staff of key investment and risk-management opportunities.

WHAT NONPROFITS CAN DO

The nonprofit starvation cycle has kept indirect cost rates artificially low for too long. If we want public funders to pay full costs—the daily operating expenses plus balance sheet costs for strategic needs—we must show them how this agency-level spending is beneficial at the program level. We must also make room in the budget by cutting the contract management expenses that divert nonprofit resources away from delivering results.

First, nonprofits must understand their total contract management costs and be prepared to communicate them to public funders. Managers should review the staff hours spent administering public contracts and produce a time study that tracks these costs. They should look for patterns: Are the most valuable contracts getting the most time, or is a smaller contract generating excessive costs? A time study—even an informal one—will help nonprofits clarify how they can afford to allocate their staff time to the delays and duplicative obligations involved in nonprofit contracting.

Nonprofits should also look for hidden costs in accounts receivable. Who owes the agency what, and how much? Managers must decide what's material: If a single public funder accounts for more than 10 percent

of the agency's receivables, then staff should work with that funder to reduce the agency's receivable days. The time spent analyzing receivables should then be added to the time study: How many hours do staff spend tracking submitted invoices and making ends meet until payments come through?

Second, nonprofits must propose cost-cutting solutions from the funders' point of view in order to show funders what it would look like to reduce unreasonable expenses. What is the agency's actual indirect spending, over and above its indirect rate? What percentage of this spending pays for unnecessary work, and how can those resources be reallocated?

It's critical that nonprofits create space in these conversations for full costs. If funders could cut contract management costs down to size, as well as raise indirect rates, how would the agency invest in its strategic needs? How would freed-up or additional resources help programs deliver outcomes? Managers must spell out the upside for their public funders and their publicly funded programs.

Third, nonprofits must manage their costs down, using red tape to create teachable moments. Doing so requires being proactive—and repetitive—about the key takeaways from the time study and the proposed cost-cutting solutions. It also means using contract reporting to document what is and isn't working to cut down on expenses.

One way to manage costs down is to resist being double monitored. If a nonprofit pays for an independent audit, managers should ask their fiscal monitors to rely on it. If the auditors have provided an unqualified opinion for several years running, what else do the monitors need to see? A public funder may refuse a nonprofit's request to forgo a second fiscal audit, but smart advocacy can substantially reduce its scope, saving hours of staff time.

Nonprofits must be prepared to encounter resistance from public funders, who stand to incur substantial expenditures if they change how they structure indirect rates. But that's precisely why the work must start with cutting the contract management costs that don't help nonprofits deliver results. ■