

Supporting Organizational Infrastructure In the Voluntary Sector

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Background on the Issue

There is emerging, both in anecdotal evidence and in the research literature, a growing recognition that a significant number of voluntary sector organizations in Canada are experiencing problems funding their operations and programs. A previous paper by this author, “An Overview of the Funding of Canada’s Voluntary Sector”, *Voluntary Sector Initiative*, September 2001¹ reviews the history and circumstances contributing to the current trend in voluntary sector financing. The paper identifies the cumulative effect of shifts in funding patterns and identifies some of the implications for voluntary organizations. The following stressors were identified as contributing to the current malaise in the voluntary sector:

- ?? Service contracts typically do not cover the actual costs of program delivery.
- ?? Voluntary sector organizations report increasing difficulty meeting legal and legislative obligations to staff, such as pay equity obligations and obligations to employees on contract over successive years.
- ?? Voluntary sector organizations are having increasing difficulty covering growing shortfalls in government funding with other stable sources of funds.
- ?? Voluntary sector organizations have increased difficulty providing the infrastructure needed for effective program delivery.
- ?? Securing funding to mount innovative and creative programs is becoming increasingly difficult.

The funding of the voluntary sector to deliver programs or services has typically followed a common formula and practice that evolves over time. Funding formula and funding practice have not been well supported by research or best practice literature and some funding practices have subsequently proven to be counterproductive. The ability of existing funding practice to support organizational infrastructure is one of the areas emerging as problematic.

¹Lynn Eakin, “An overview of the Funding of Canada’s Voluntary Sector”, *Voluntary Sector Initiative*, September 2001. Executive Summary page i

Coming to a Common Understanding of What Infrastructure Includes

Before a problem can be solved it is necessary to be able to agree on just what the nature of the problem is. This has proven complicated in discussions about the need for, and scope of, infrastructure funding.

When funding officers think of infrastructure they typically think of the hard costs of an organization's operation such as office rent or perhaps computers - costs that can be quantified and broken up into the "share" that belongs to the specific program they fund. Funding officers use an operational definition of allowable spending for "non-direct service costs"(defined as any cost other than frontline salaries) that typically requires a direct link to the program. For example, the contribution to financial services would be an estimate of the number of hours required to complete payroll for the specific program staff and comply with financial reporting requirements for the particular program.

When voluntary sector managers speak of the need for infrastructure funding they want to be able to build and sustain their organization so they can effectively manage and deliver quality programs. They need funding to cover the organizational management costs since every program delivered by their organization benefits from their organization's capacity. It takes money to maintain effective financial and data systems that support the different programs and services. Similarly, volunteer boards, service volunteers and community networks must be actively fostered and supported by senior management staff. Human resource practices that retain skilled and experienced staff are also needed for quality program delivery. These activities cannot always be easily itemized, individually costed or attributed directly to specific programs.

The current method of contract funding typically covers only the incremental costs directly related to the program -direct service staff, a supervisory staff (if necessary), and program related expenses such as office/program space, telephones, administrative supplies and a contribution to financial services. There is usually little or no contribution to organizational operations and management including human resource management, board governance, systems development and maintenance, external relationship building and other functions required for healthy organizations.

The first hurdle to overcome when addressing the problem of infrastructure and organizational capacity funding is the need to have a common understanding of the problem and a common language with which to seek resolution. Currently the definition of infrastructure differs between and among funders and voluntary sector organizations.

Examples Of The Shift In Thinking About Infrastructure

As concerns about decreasing organizational capacity among many voluntary sector organizations has grown, a few funders and voluntary sector organizations have taken the lead to incorporate the funding of infrastructure within the framework of program

funding. They took this initiative in response to the growing gap between the level of program funding and the actual costs of operation.

CIDA, Canada

CIDA is at the leading edge of this initiative. CIDA recognizes that infrastructure (they refer to it as overhead) is an essential cost of program delivery if voluntary organizations are to deliver quality programs over the longer term. They have developed a method for calculating the overhead percentage for each organization (recognizing that each organization is unique). The organization can then use the established overhead rate on subsequent CIDA contracts without recalculating. The rate is applied to CIDA contribution agreements and non-competitive services. It is based on the following principles:

“E) Principles for Establishing the Overhead Rate Policy

The following outlines the key principles used to establish this overhead rate policy:

- 1) It is recognized that overhead costs (i.e. indirect costs) are a necessary part of an organization's operations or business and that the organization has a right to be compensated for some of this overhead as part of a CIDA service contract or contribution agreement.
- 2) The calculation of the overhead rate should be profit neutral, or surplus neutral, to the organization (i.e. it should not contribute additional profit or surplus to the organization).
- 3) It is recognized that organizations have different or unique overhead rates depending on their operating environment, sector of expertise, organizational structure, etc.
- 4) The acceptable overhead rate should not reward an organization for inefficient operations, and conversely it should not penalize an organization for efficient operations.”²

The Nature Conservancy, USA

Another organization working on this issue is The Nature Conservancy, Arlington, Virginia, USA. They have produced a manual, *Core Costs and NGO Sustainability*. This booklet is the result of a project they undertook with some of their international projects to develop a method for identifying and calculating infrastructure costs. Their funding model is based on the premise that organizations delivering a program are entitled to full cost recovery and that an organization's unrestricted reserves should be dedicated to achieving the organization's mission and not to

² Overhead Rate Policy for CIDA's Contribution Agreements and non-competitive Service, 5/7/2002, page 1

cover off deficits in program funding.³ The manual is very detailed in its schedules of what costs are included and what costs are inadmissible. They have addressed what they view as legitimate donor concerns, and proposed formal rules of what's in and what's not. They have also identified that donors need to be satisfied that the NGO's systems can handle the rigors of recognizing and allocating the different costs correctly.⁴

Association of Chief Executives of Voluntary Organizations, Britain

ACEVO, a British voluntary sector membership organization has also tackled the infrastructure problem. They argue for:

- ?? A more transparent approach to core costs (their term for infrastructure costs).
- ?? Clear recognition that core costs are unavoidable
- ?? Recognition that pressure needs to be exerted to keep costs low.
- ?? A recognition that there is a line below which core costs cannot reasonably fall without the funded and the funding organizations incurring unacceptable risk.⁵

Developing a Format for Calculating Infrastructure Costs Across Programs

Four common themes run through the three initiatives:

- 1. An acceptance that infrastructure (overhead, core costs) is an essential component of program delivery costs.***
- 2. The recognition that any system developed to identify and allocate those costs across programs must be simple, transparent, and fair to donors.***
- 3. An understanding that the cost allocation system must be able to adjust to organizations changing circumstances and must be responsive to the organization's unique needs.***
- 4. Acknowledgement that the system must encourage efficient and effective use of funds.***

Proposing The Elements That Comprise Organizational Infrastructure

Since all programs of an organization benefit from the organizational capacity of the organization, it follows that all program funders should equally share in those infrastructure costs that create that capacity. The elements identified below for inclusion as fundable organizational infrastructure covers activity that contributes to organizational

³Core Costs and NGO sustainability, The Nature Conservancy, Pact Inc Publications 2001, page 15

⁴ Ibid., page 18

⁵ Julia Unwin, *Who will Pay for Core Costs?*, ACEVO, 1999 pg. 3

capacity. It includes those costs not included in direct service and program related expenses. Infrastructure costs do not include organizational activity which is not part of organizational capacity. Examples of unallowable costs are things like unrelated fundraising costs, or costs incurred such as penalties or fines.

Proposed Elements For Inclusion As Infrastructure

Infrastructure

Those physical assets, personnel, and financial practices that contribute to organizational functioning and management capacity.

Physical assets - office and program space, office contents including computers and software, telephones, servers and other equipment required for the operation of the organization. This would include service contracts, insurance and other costs associated with maintaining the physical assets of the organization.

Personnel - Personnel not allocated to a direct service program whose job function contributes to the organization and operation of the organization. This could include paid staff such as senior managers including CEO, Director of Finance, Director of Program, maintenance and service staff such as reception, information technology, record and information management, consultants in areas such as of finance, technology, management, legal, human resources, and evaluation.

Financial Practices - including maintenance of reserves for salaries and wage liabilities, capital replacement and contingencies, research and evaluation

The Effectiveness of the Voluntary Sector is Linked to its Organizational Capacity

The ACEVO work in Britain identified that if organizational infrastructure funding is too low both the organization and funder incur unacceptable levels of risk. CIDA and The Nature Conservancy also identified organization organizational capacity as essential for program quality. McKinsey and Company, working with Venture Philanthropy Partners undertook to identify of the elements of capacity in not-for-profit organizations and they have developed a framework to assist organizations evaluate their organizational capacity and set goals for improvement in this area. ⁶

The McKinsey framework is instructive because it demonstrates the difficulty funders and the voluntary sector will have resolving infrastructure funding if the funders continue to focus only on the “hard” quantifiable infrastructure costs. Few if any of the

⁶ Mckinsey Capacity Assessment Grid, Venture Philanthropy Partners, Web site. www.venturepp.org

components identified by McKinsey for organizational capacity are currently part of contract funding agreements.

Looking at the McKinsey Framework it becomes apparent that, for example, the cost of the audit will never ensure sound resource management nor will purchase of a computer provide the organization with the ability to develop and manage its database. It becomes clear that a different method of calculating the costs of organizational operation is required, one that does not force the organization to itemize the inputs but instead focuses more on demonstrated evidence of organizational capacity.

Table 1 McKinsey Capacity Assessment Framework

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|--|---|
| McKinsey developed for Venture Philanthropy Partners a capacity assessment framework for not-for-profit organizations. This is a summary of that work. | |
| Aspirations | Clarity of mission, vision and overarching goals |
| Strategy | Overall strategy including goals and performance targets, program relevance and integration, new program development Funding model |
| Organizational Skills | Performance management, planning, fundraising and revenue generation, external relationship building, public relations, influencing policy-making, management of legal and liability matters, organizational processes |
| Human Resources | Board, CEO, Management team, staff, volunteers – composition and commitment, involvement and support, experience, effectiveness |
| Systems and infrastructure | Systems-planning, decision making, -Financial operations, -Human resource management – recruiting, development, retention, incentives, -Knowledge management -Physical infrastructure – buildings office space, -Technological infrastructure – computers, applications, network, e-mail, web site, databases and management reporting systems |
| Organizational structure | Board governance, organizational design, interfunctional coordination, individual job design |
| Culture | Shared beliefs and values, shared references and practices |

Where Charity and Business Meet

For at least a decade voluntary sector organizations have been pushed to adopt more “business” practices. In some sectors this has led to the opening up of what were traditionally voluntary sector fields to for-profit organizations. In these sectors, not-for-profit organizations bid for service contracts along with for-profit organizations. In open competitions such as home care contracts in Ontario both not-for-profit and for-profit compete under the same rules. In other areas the field has not been opened to competitive bidding but funders have tried to implement “business” practices in their funding agreements, including increased accountability, measurable outcomes and fixed price contracts.

The introduction of business practices into voluntary sector funding was undertaken at a time when government funders were seeking to reduce and contain their spending. As a result, cost containment, cost reduction and efficiency strategies were given priority focus to the neglect of other business practices that might benefit and build the contractor organization. The process has been a “cherry picking” of business and charitable practices and the resulting funding formula has proved challenging for voluntary sector organizations. Many now find themselves with little or no reserves, thereby reducing their capacity to manage cost changes while operating programs year after year that are routinely funded below cost recovery.⁷ Table 2 (p.10) compares and contrasts a business approach and the hybrid business/charity funding model currently applied to voluntary sector organizations.

The hybrid business/charity model is not working well for many voluntary organizations and their clients. A new voluntary sector funding model is required that will provide for organizational excellence and sustainability over the long term.

Getting Started - Making a Strategic Investment in Infrastructure

In response to the growing recognition of the difficulties faced by many voluntary sector organizations, several foundations and governments⁸ have responded with initiatives directed at making strategic investments in organizational infrastructure. In addition, local branches of *Social Venture Partners* has responded by having its members provide “in-kind” organizational support to the organizations it selects for program funding.⁹ Strategic funding for capacity building is goal-oriented and time-limited.

While strategic investment funding is a useful approach for organizations needing to develop their organizational capacity, the gains may not be successfully maintained

⁷ Government Funding Cutbacks and their Effects on Nonprofits, Summary of Abstracts prepared by the Manitoba Intersectoral Secretariat on Voluntary Sector Sustainability, October 2000. pp. 27-29

⁸ McConnell Foundation, the joint Maytree/United Way of Toronto/Trillium initiative, Muttart Foundations, and the Federal Government in their *Guide to improving Funding Practices*, have initiatives aimed at building organizational capacity.

⁹ Social Venture Partners Model for Supporting Non-Profits, www.svpseattle.org

unless strategic investment is accompanied by structural and permanent changes to current contract funding. Only with ongoing organizational capacity funding can organizational effectiveness be sustained and improved over time.

Challenges to Developing Infrastructure Funding

The following are some of the challenges and barriers to achieving the goal of including infrastructure funding in program/service contracts:

✎✎ It will be important to have common elements in the definition of infrastructure costs accepted across funders. Key funder groups and voluntary sector organizations will need to be involved in the development of a framework for calculating infrastructure costs.

Since many organizations are supported by multiple funders, voluntary organizations will need to cover infrastructure costs by spreading the costs fairly over their funded programs. For this to happen, funders will need to recognize a common framework for calculating infrastructure costs. All groups of funders and organizations should be involved in the development of the framework.

✎✎ Keeping the calculation of infrastructure as simple and as transparent as possible will be a challenge.

Funders and organizations need to balance “total accuracy” with efficiency and practicality. The accounting definition of “material” could possibly be used to guide the development of the framework. Unless the variance was “material”, a formula could be used. An example would be the dividing of the telephone bill by formula instead of by actuals.

✎✎ Funders will need to increase funding to existing programs to cover the funding of infrastructure.

A phase-in of infrastructure funding may be necessary. Firm data is not yet known but estimates are that current funding for programs is from 7%-15% short of actual costs.

✎✎ Building in infrastructure to current contract funding will not solve some of the other underlying funding issues such as unstable short-term funding.

Other initiatives will be needed to address other underlying funding issues which impact on organizational capacity and program quality.

Moving Forward

The challenge is to bring funders from the three levels of government, the private sector, foundations and united ways together to build and sustain, through supportive and fair funding practices, a vibrant voluntary sector capable of addressing the social and cultural needs of Canadian communities. To accomplish this objective the following steps are needed.

?? **Increase understanding of funding issues and challenges among :**

- **Funders-** by preparing, and widely distributing, briefing materials that clearly make the business case for infrastructure funding to foster organizational capacity in the voluntary sector; by actively seeking opportunities to speak with, and recruit, concerned leaders from within the different funding sectors to champion the need for resolution of this issue across funders; by reaching out to funders not yet informed of, or committed to, supporting voluntary sector organizational capacity and sustainability.
- **Voluntary Sector Organizations** - by preparing and broadly distributing briefing materials that build understanding of the issues and the business case for sustainable funding; by actively seeking and/or creating opportunities to speak directly with Boards of Directors and senior managers; by supporting the voluntary sector in bringing their funding issues to the attention of their funders.

?? **Develop a common language and approach to calculating and funding infrastructure costs within program funding by:**

- **Developing a common language/definition of terms** - a common language, cross referenced with different sector definitions, is needed for a common definition and framework for infrastructure calculations to be understood and applied across sectors and services.
- **Developing a simple and responsive framework for calculating infrastructure and allocating it equitably across programs.** – The common framework must be sensitive to organizational workload while meeting funders' need for accountable reporting.

?? **Develop an implementation strategy to promote the use of the common infrastructure cost sharing model by:**

- **Making available the materials and providing training to organizations and funders.** Both organizations and funders will need to provide direction and training to staff upon implementation.

- **Providing support and problem-solving to both funders and organizations during implementation.** Coordinated problem-solving and support will help with preventing fragmentation and facilitate the sharing of experiences.

- **Undertaking evaluation and best practice analysis to increase understanding of infrastructure costs, organizational capacity measurement and effective methods of cost sharing.** Information on infrastructure costs relative to, organizational size and organizational capacity is not available currently. An effective and efficient evaluation tool measuring organizational capacity and health needs to be developed.

Table 2: Comparison of Voluntary and Private Sector Contractual Arrangements

| Not-for-Profit - Voluntary Sector Practice | For-Profit - Business Practice |
|---|--|
| <p>Fixed price contract (no profit allowance) -cost overruns are the organization’s responsibility -under spending is recovered by the funder</p> <p>Implications -The organization cannot build up reserves to cover program deficits. Every dollar overspent on a program puts an organization in debt. The organization has decreased resiliency, and organizational capacity.</p> | <p>Fixed price contract includes profit (ranging from 7-20%) -cost overruns are the organization’s responsibility. -under spending is retained by the organization (profit)</p> <p>Implications – For-profits can build up retained earnings out of surplus or profit. They can use these funds to cover program overruns in other areas. Organizational resiliency and capacity is built into funding structure.</p> |
| <p>Non-direct program costs (all costs except frontline staff salaries) are limited to 10% or similar figure depending on the program, regardless of actual cost. Funders expect the organization to cover the shortfall with a “contribution”. Most overhead costs are not considered for funding.</p> | <p>Non-direct program costs and overhead are negotiated into the pricing structure of the program with a profit margin. Funders expect and allow the business to cover its costs in the pricing structure.</p> |
| <p>Contract renewals do not necessarily include a review of the costs of a program. Contracts are often renewed for a pre-determined fixed amount. Actual increases in operating costs and staff compensation are often not considered when determining the renewal budget.</p> <p>Implications - Organizations may have difficulty meeting legislative obligations such as pay equity. Staff are hired on short term contracts to keep compensation low, increasing staff turnover. The organization must spend time searching for donors to support under funded contracts. The organization may have limited ability to absorb additional costs internally.</p> | <p>Contract renewals must keep pace with expenses or the business will withdraw from the program. The profit allowance gives the business more capacity to cover funding shortfalls until contracts can be adjusted.</p> <p>Implications – For-profit businesses have more capacity to absorb losses in the short term. Indeed, when competing against the voluntary sector, operating at a loss in the near term is one way of gaining market share.</p> |
| <p>Commitment to Mission Voluntary sector organizations are committed to their mission and tend to be reluctant to abandon a service notwithstanding inadequate funding. Funders have benefited from this commitment.</p> | <p>Commitment to Profit Funders understand and accept that for-profit businesses need to make a reasonable profit or they will stop providing the service. Funders respect this approach.</p> |