

**EXECUTIVE SUMMARY**

# Breaking the Starvation Cycle

How international funders can stop trapping their grantees in the starvation cycle and start building their resilience

Research into the coverage of administration costs being provided by funders to national NGOs in ten countries



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# Executive Summary

## Brief background to the research and methodologies used

Humentum is the leading global nonprofit working with humanitarian and development organisations to improve how they operate and to make the sector more equitable, accountable, and resilient. Funders for Real Cost, Real Change (FRC), a collaborative of private foundations,<sup>1</sup> commissioned this research and report to gather evidence on the extent to which international donor funding covers the real administration costs of national NGOs. The report will also offer recommendations on how funders could provide adequate cost coverage and strengthen their grantees' financial health and resilience.

Humentum's research team worked with national NGOs in ten countries in Africa, Asia, Latin America and Europe, which were grantees of at least one of the private foundations involved in the collaborative. During this, 81 NGOs completed an extensive survey on financial health and cost coverage, and 75 of these NGOs also submitted a self assessment questionnaire on their cost recovery practice. Humentum adapted an internationally recognised cost classification methodology that was used to analyse up to three years of financial data and details of grantee's largest restricted funding agreements. This financial data was then verified against supporting documentation for a subset of 38 of these NGOs. These 38 NGOs, along with a further 12 from the original cohort of 81, took part in 50 detailed assessment interviews that enabled the research team to make informed judgements on their financial situation and cost recovery practices.

# Three Key Findings

## KEY FINDING 1

**Most funders provide inadequate coverage of their grantees' administration costs, contributing to a starvation cycle<sup>2</sup> with significant negative organisational impacts.**

The financial data collected from the 38 NGOs included details of their largest restricted or project-based funding agreements for each year. Humentum's analysis of these 286 restricted funding agreements that came from 92 different funders showed that:



**of both the restricted funding agreements (63%) and of the restricted funders (68%), provided less than their fair share of administration costs.**

While the extent of coverage of administration costs provided through these restricted funding agreements varied over a wide range, no group of funders was consistently providing a full and fair share<sup>3</sup> of administration costs related to the project activities that they were funding.

The wider qualitative survey of 81 NGOs, (of which the 38 NGOs above were a sub-set), revealed which five organisational functions were being most significantly under-resourced as follows:

1. Safeguarding function<sup>4</sup> (54% of respondents)
2. Fundraising/business development function (53% of respondents)
3. Premises (43% of respondents)
4. Human resources function (38% of respondents)
5. Management information/technology systems and functions (36% of respondents)

When asked about the main impacts of inadequate cost coverage:



**said they were unable to attract or retain staff with adequate knowledge and experience.**



The research team heard about other negative impacts in the detailed assessment interviews with 50 of these 81 NGOs. We heard several stories of staff agreeing to work for reduced pay to try and sustain programmes or functions that were under-funded. The research team found that even those NGOs that were able to secure recovery of 100% of the actual administration costs on average from across their portfolio of funders still experienced what could be described as 'missing costs', which represent the costs of what it would take to fund core functions adequately.

<sup>1</sup>Funders for Real Cost, Real Change (FRC) was a collaborative of 12 private philanthropic institutions facilitated by BDOFMA that explored ways to improve indirect cost recovery in project grants from 2019 - 2021. Further details about the collaborative are provided in the Background and Purpose of the Research section of the report that follows the Executive Summary or can be found at [realcostfunders.org](http://realcostfunders.org)

<sup>2</sup>The term 'starvation cycle' was developed by the Bridgespan group over a number of years of work on cost coverage described here. ([philanthropy.com](http://philanthropy.com)) The nonprofit starvation cycle has been defined as "a debilitating trend of under-investment in organisational infrastructure that is fed by potentially misleading financial reporting and donor expectations of increasingly low overhead expenses." ([researchgate.net](http://researchgate.net))

<sup>3</sup>A full and fair share is defined as the portion of administration costs associated with the activities funded by a restricted funding agreement or agreements, calculated in accordance with the organisation's overall administration cost rate for the relevant year.

<sup>4</sup>Safeguarding refers to the responsibility of organisations to make sure that their staff, operations, and programmes do no harm to children and vulnerable adults, and that they do not expose them to the risk of harm and abuse. It covers both prevention of sexual exploitation and abuse and other forms of potential harm.

## KEY FINDING 2

**Inadequate cost coverage and limited access to unrestricted income is making it extremely challenging for most NGOs to achieve stable financial health.**

Analysis of reserve levels for the 38 NGOs with verified financial data found that:



**of the NGOs had unrestricted reserves equivalent to 21 days or less of annual expenditure.**

The average level of unrestricted income was 17%, with a median of 9%. The research developed an objective set of criteria to assess financial health and found that 66% of these 38 NGOs have low or medium-low financial health. The income for most of the NGOs was concentrated on a few funding agreements, with the single largest funding agreement making up an average of 40% of total income.

## KEY FINDING 3

**To stop trapping grantees in the starvation cycle and start building resilience, funders will need to provide: a) full cost coverage b) means by which grantees can contribute to unrestricted reserves and c) support to strengthen grantees' cost recovery capabilities.**

While the evidence of systemic underfunding of administration costs by most funders from this research is clear, we found reasons to believe that funders need to do more than close this funding gap to enable their grantees to become financially resilient. Our research suggests that national NGOs in the ten countries included in this study had limited options to develop unrestricted income sources. Assuming these research findings are generalisable, unless funders start providing a portion of their grants as unrestricted, most national NGOs will remain unable to generate the unrestricted reserves necessary to mitigate the financial risks they face.

This research developed systematic assessment frameworks to analyse two key drivers of financial health: the income quality available to NGOs and their relative capability in cost recovery practice<sup>5</sup>. The research found that mostly grantees with access to good income quality AND relatively developed cost recovery practice achieved sound financial health. This implies that funders need to adopt a 'both/and' approach, which involves improving income quality by providing better cost coverage and at least some unrestricted income, as well as supporting grantees to strengthen their cost recovery practice.

The research found that 61% of the 38 NGOs we collected financial data from have a relatively undeveloped cost recovery practice. Most of the 81 NGOs that responded to the initial research survey, said that improving their cost recovery practice was a high or very high priority over the next 12 months. Participating NGOs noted that their involvement in this research process provided a learning opportunity:



**There are lots of things that emerge from this research that have made us reflect more deeply on our practices which has been really beneficial for us... [we] realised that developing cost recovery capacity is really important and is now part of the new strategy.**

<sup>5</sup>Income quality refers to the flexibility that the NGO must apply its income to mitigate financial risks and achieve its strategic objectives and the relative diversity of its funding sources. Cost recovery practice relates to the NGOs technical proficiency in recovering administration cost from funders, as well as the relative extent of recovery it achieves in practice. The full assessment frameworks are detailed in Appendix 4 and 5.

# Implications: Funders Need to Shift Towards Equitable and Accountable Funding Relationships

## Hopes for the future from the participating NGOs

The NGOs that participated in this research told us about their hopes for the future in an open question, which formed part of the survey completed by 81 NGOs. Their responses can generally be categorised across three common themes: The need for:

- **a stronger long-term partnership approach** that directly addresses the challenge of the unequal power dynamic inherent in the funding relationship.
- **longer-term funding agreements** with a significant component of general operating support to enable NGOs to become more sustainable, including building up unrestricted reserves.
- **better cost coverage of all the administration costs** associated with projects, including items such as start-up and closure costs, with less reluctance to fund salary costs.

## Given the unequal power dynamic, it is funders that most need to change their practices

The NGOs that participated were not surprised by the key findings when the results were shared in two webinars held in November 2021. The research showed that they have low expectations of the extent of the cost coverage they are likely to receive from funders, and the level of financial health it is possible to achieve in their current funding context. These low expectations are an integral feature of the starvation cycle and how it operates.

The inequality of the power dynamic is likely to be increased by the reliance that most participating NGOs have on relatively few funders for a large proportion of their income. This places a greater responsibility on funders to use their relative power to shift towards more equitable funding practices.

## To shift towards more equitable funding practices will require greater accountability

In the learning discussions held within the philanthropy community to discuss the findings emerging from the research, a key theme that emerged was a need for greater funder accountability. Forms of greater accountability mentioned by funders staff in that learning session included:

- greater **internal accountability** of funder staff with responsibility for reviewing grantee budgets,
- greater **external accountability** of funders to show the extent of administration cost coverage they provide to prevent what one foundation president described as “free-riders”.

Such accountability will require more transparent reporting of indirect and administration costs and how they have been calculated. Efforts to increase transparency will need to mitigate the risk that publishing such financial data leads to simplistic, misleading judgements on low indirect rates as an indicator of relative efficiency. This has been previously noted as a key driver of the race-to-the-bottom of the low expectations fueling the starvation cycle.

# Three Key Recommendations for Funders

The three key recommendations arising from this research provide funders with a step-by-step approach they can take to change their own funding practices, invest in their grantees' capabilities to secure better cost coverage from all their funders, and lead a process of transformation in the funding eco-system.

**1 Funders should commit to consistently covering a full and fair share of all associated administration costs.**

**1.1. Provide accessible policies, guidance, templates, and training** for both their staff and their grantees to ensure full and fair cost coverage.

**1.2 Clearly communicate policies and provide guidance** to inform grantees of what they are entitled to ask for, as otherwise, the power dynamic will lead them to under-ask.

**2 Funders should directly fund grantees to strengthen their financial management, cost recovery and fundraising capabilities, and provide unrestricted funding to build reserves.**

**2.1 Provide training and coaching on the** cost recovery practices needed to secure adequate cost coverage from funders, including developing administration cost budgets and rates, justifying these to funders, and mechanisms to recharge costs incurred.

**2.2 Train grantees in negotiation skills with funders** and training for funder staff to redress the inevitable power dynamic in negotiation.

**2.3 Earmark at least a portion of restricted funding agreements for unrestricted use.**

**3 Funders should systematically collect data on the extent of adequate cost coverage. This data should be used to drive internal accountability and motivate funders to provide their full and fair share of administration costs in restricted funding agreements.**

**3.1 Individual funders should regularly collect anonymised data** from their grantees on the adequacy of cost coverage provided by their restricted funding agreements to **measure progress towards full and fair cost recovery.** This also serves to inform training and ongoing management of their programme staff on how to provide full cost recovery when agreeing on grant budgets.

**3.2 Funders and funder networks should share data** on the adequacy of cost coverage provided to their grantees to encourage and advocate for responsible funding practices.

**3.3 Funders should support initiatives, such as IFR4NPO and Money Where it Counts,** which seek to strengthen accountability through relevant international financial reporting standards and voluntary protocols.

The recommendations from this research align with the series of options identified by the twelve members of the wider FRC collaborative that funders can take to ensure project grants better support the financial health of their grantees:

- Funding the actual indirect cost rates of grantees as calculated according to an agreed-upon methodology
- Establishing a fixed or sliding scale indirect cost rate on project grants that is sufficient to cover most grantees' indirect costs
- Issuing flexible project grants for set amounts that allow for surpluses and do not require budgets that delineate direct and indirect costs
- Supplementing project grants with general operating support<sup>8</sup>

<sup>8</sup>To learn more about these options see Project Grants Need Not Be The Enemy: A Three-Part Series, published by FRC (philanthropy.com)

To read the full report and learn more about this research project, visit <https://humentum.org/policy/administration-costs-research-project/>

