United States Government Accountability Office

GAO

Report to the Chairman, Committee on the Budget, House of Representatives

May 2010

NONPROFIT SECTOR

Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices

GAO-10-477

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Highlights

Highlights of GAO-10-477, a report to the Chairman, Committee on the Budget, House of Representatives

Why GAO Did This Study

Nonprofits are key partners in delivering federal services yet reportedly often struggle to cover their indirect costs (costs not readily identifiable with particular programs or projects). This raises concerns about fiscal strain on the sector. To provide information on nonprofits' indirect cost reimbursement, especially when funding flows through entities such as state and local governments, GAO was asked to review, for selected grants and nonprofits, (1) how indirect cost terminology and classification vary, (2) how indirect costs are reimbursed, and (3) if gaps occur between indirect costs incurred and reimbursed, steps taken to bridge gaps. GAO selected six Departments of Health and Human Services and Housing and Urban Development grants and 17 nonprofits in Louisiana, Maryland, and Wisconsin. GAO selected these agencies for their historical relationship with nonprofits. GAO reviewed policies and documents governing indirect costs and interviewed relevant officials. GAO also reviewed research on nonprofits' indirect costs.

What GAO Recommends

GAO recommends that the Director of the Office of Management and Budget (OMB) bring together federal, state, local, and nonprofit representatives to help clarify and improve understanding of how nonprofits' indirect costs should be treated, particularly for grants passed through state and local governments to nonprofits. OMB agreed with GAO's recommendation.

View GAO-10-477 or key components. For more information, contact Stanley J. Czerwinski at (202) 512-6806 or czerwinskis@gao.gov.

What GAO Found

Depending on the grant program, nonprofits may be reimbursed for indirect costs (generally costs such as rent or utilities), administrative costs (generally cost activities such as accounting or personnel), both, or neither. OMB officials said costs can be classified as either indirect or direct, and administrative cost activities are usually, but not always, classified as indirect costs. However, inconsistencies in the use and meaning of the terms indirect and administrative, and their relationship to each other, has made it difficult for state and local governments and nonprofits to classify costs consistently. This has resulted in varying interpretations of what activity costs are indirect versus administrative. As OMB guidance on cost principles for nonprofits recognizes (2 CFR Part 230), because nonprofit organizations have diverse characteristics and accounting practices, it is not possible to specify the types of costs that may be classified as indirect in all situations. This increases the challenges of administering federal grants and, in some cases, makes it difficult for recipients to determine those activities eligible for indirect cost reimbursement under a particular federal grant and those that are not.

GAO found differences in the rate in which state and local governments reimburse nonprofits for indirect costs. These differences, including whether nonprofits are reimbursed at all, largely depend on the policies and practices of the state and local governments that award federal funds to nonprofits. Federal grants often provide wide latitude in setting cost reimbursement policies and practices, and some state and local governments do not reimburse these costs at all. Those that do can often choose the reimbursement rate. As a result, GAO found that variations in indirect cost reimbursement exist not only among different grants, but also within the same grant across different states.

GAO found that nonprofits fund indirect costs with a variety of federal and nonfederal funding sources, and that when indirect cost reimbursement is less than the amount of indirect costs nonprofits determine they have incurred, most nonprofits GAO interviewed take steps to bridge the gap. They may reduce the population served or the scope of services offered, and may forgo or delay physical infrastructure and technology improvements and staffing needs. Because many nonprofits view cuts in clients served or services offered as unpalatable, they reported that they often compromise vital "back-office" functions, which over time can affect their ability to meet their missions. Further, nonprofits' strained resources limit their ability to build a financial safety net, which can create a precarious financial situation for them. Absent a sufficient safety net, nonprofits that experience delays in receiving their federal funding may be inhibited in their ability to bridge funding gaps. When funding is delayed, some nonprofits said they either borrow funds on a line of credit or use cash reserves to provide services and pay bills until their grant awards are received. Collectively, these issues place stress on the nonprofit sector, diminishing its ability to continue to effectively partner with the federal government to provide services to vulnerable populations.

Contents

Abbreviations

ACF	Administration for Children and Families
CPD	Office of Community Planning and Development
CRS	Congressional Research Service
ESG	Emergency Shelter Grants
HHS	Department of Health and Human Services
HOPWA	Housing Opportunities for Persons with AIDS
IRS	Internal Revenue Service
HUD	Department of Housing and Urban Development
NCCS	National Center for Charitable Statistics
NTEE	National Taxonomy of Exempt Entities
OMB	Office of Management and Budget
PSSF	Promoting Safe and Stable Families
Recovery Act	American Recovery and Reinvestment Act of 2009
SAMHSA	Substance Abuse and Mental Health Services Administration

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United States Government Accountability Office
Washington, DC 20548

May 18, 2010

The Honorable John M. Spratt, Jr.
Chairman
Committee on the Budget
House of Representatives

Dear Mr. Chairman:

Nonprofit organizations have increasingly become key partners with the federal government in delivering important federal services throughout the nation, including health care, education, housing, and human services. One study estimates that nonprofits received approximately $317 billion from the federal government in fiscal year 2004 for service delivery.[1] The Congressional Research Service (CRS) estimates that government grants and payments to the nonprofit sector increased almost 53 percent from 1995 to 2005,[2] demonstrating governments' increased reliance on this sector to deliver public services. The breadth and diversity of nonprofits allow them to tailor services to the specific needs of communities and individuals. However, funding is often limited for the indirect costs associated with providing these services (indirect costs are generally costs such as rent or utilities that cannot be readily identified with a particular service or product). Sometimes costs that would normally be classified as indirect costs are covered in other ways; other times they are not covered at all. As such, we have reported that nonprofits often struggle to cover the costs of doing business, which raises concerns about the long-term financial health and durability of the sector and its ability to effectively deliver federal services and programs.[3]

Congress recently took steps toward addressing these challenges. For example, the Serve America Act[4] increases the limit on nonprofits' use of

[1] A. Abramson, L. Salamon, and C. E. Steurle, "Federal Spending and Tax Policies: Their Implications for the Nonprofit Sector," *Nonprofits and Government*, 2nd Edition, eds. E. Boris and C. E. Steurle (Washington, D.C.: The Urban Institute Press, 2006), p. 118.

[2] Congressional Research Service, *An Overview of the Nonprofit Charitable Sector*, R40919 (Washington, D.C.: Nov. 17, 2009).

[3] GAO, *Nonprofit Sector: Increasing Numbers and Key Role in Delivering Federal Services*, GAO-07-1084T (Washington, D.C.: July 24, 2007).

[4] Pub. L. No. 111-13 (2009).

program funds for administrative costs from 5 to 6 percent for some federal education grant programs, and the American Recovery and Reinvestment Act of 2009 (Recovery Act)[5] makes $50 million available through the Department of Health and Human Services' Strengthening Communities Fund to help build the capacity of nonprofit organizations. Further, if enacted, the Nonprofit Capacity Building Act of 2009[6] would establish a nonprofit capacity-building program to award grants for organizational development assistance to small and midsize nonprofit organizations facing resource hardship challenges.

Our prior work identified the need for more information on various aspects of the federal-nonprofit relationship, particularly funding received from federal sources.[7] Responding to your request for more information on indirect cost reimbursement, especially when federal funding is passed through to nonprofits from other entities such as state and local governments, we reviewed, for selected federal grant programs and nonprofits, (1) how indirect cost terminology and classification vary, (2) how indirect costs are reimbursed, and (3) if gaps occur between indirect costs incurred and reimbursed, steps nonprofits take to bridge the gaps.

To achieve our objectives, we selected six federal social services and housing grants from two federal agencies: the Department of Health and Human Services (HHS) and the Department of Housing and Urban Development (HUD). We selected HHS and HUD as our two primary agencies of focus because of their familiarity and historical relationship with nonprofit organizations. Within these agencies, we selected grants based on their design to fulfill a range of housing and social service needs. The selected grants are

- Promoting Safe and Stable Families (PSSF) grant and Family Violence Prevention and Services/Grants for Battered Women's Shelters administered by HHS's Administration for Children and Families (ACF),
- Block Grants for Community Mental Health Services and Block Grants for Prevention and Treatment of Substance Abuse administered by HHS's

[5] Pub. L. No. 111-5 (2009).

[6] S. 609, 111th Cong. (1st Sess. 2009).

[7] GAO-07-1084T, and GAO, *Nonprofit Sector: Significant Federal Funds Reach the Sector through Various Mechanisms, but More Complete and Reliable Funding Data Are Needed*, GAO-09-193 (Washington, D.C.: Feb. 26, 2009).

Substance Abuse and Mental Health Services Administration (SAMHSA), and

- Emergency Shelter Grants[8] (ESG) and Housing Opportunities for Persons with AIDS Grant (HOPWA) administered by HUD's Office of Community Planning and Development (CPD).

We reviewed federal statutes for the six grants we studied, as well as Office of Management and Budget (OMB), HHS, and HUD documents, guidance, and policies governing the treatment of indirect costs. We also interviewed budget and program officials at these agencies. We selected three states—Louisiana, Maryland, and Wisconsin—and more than 20 local government and nonprofit organizations to which these states award federal funding under some or all of the six grants. These states and nonprofits were selected based on criteria such as amount of HHS and HUD funding received, population, and geographic dispersion. We reviewed documents, guidance, and policies governing the treatment of indirect costs from these states, local governments, and nonprofits, and interviewed budget and program officials in these organizations. Further, we interviewed officials from nonprofit associations, such as the National Council of Nonprofits and the Nonprofit Finance Fund. We also conducted a literature review of research on nonprofits' indirect costs, and determined that the studies we included in our work are methodologically sound. This research is referenced throughout our report, where applicable.

We conducted this performance audit from October 2008 to May 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Although the illustrative examples in this review cannot be generalized to all federal grant programs, state and local governments, or nonprofit organizations, we believe they provide valuable insight into the challenges of indirect cost classification and the funding

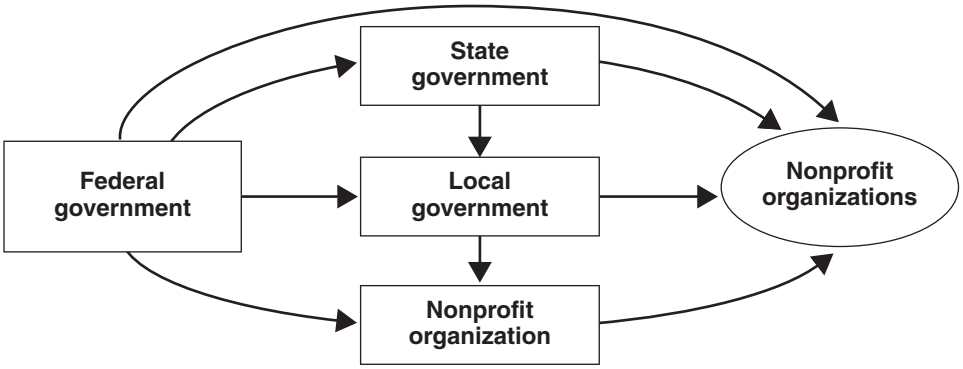
[8] The Homeless Emergency Assistance and Rapid Transition to Housing Act of 2009 changed the name of this program from the Emergency Shelter Grants to the Emergency Solution Grants effective November 20, 2010, or 3 months after the Secretary of Housing and Urban Development issues final regulations implementing the act. Pub. L. No. 111-22 (2009).

relationship between the federal government and the nonprofit sector. Appendix I contains more details on our scope and methodology.

Background

Federal grants are forms of financial assistance from the government to a recipient for a particular public purpose that is authorized by law. Federal grant funds flow to the nonprofit sector in various ways, as shown in figure 1. Some grant funds are awarded directly to nonprofits, while others are first awarded to states, local governments, or other entities and then awarded to nonprofit service providers.[9] Federal laws, policies, regulations, and guidance associated with federal grants apply regardless of how federal grant funding reaches the final recipients.

Figure 1: Examples of How Federal Funds Flow to Nonprofit Organizations



Source: GAO.

Some federal grant programs contain statutory limits on administrative cost reimbursement for state and local government grantees. Additionally, some federal grant programs predetermine a limit for subgrantees (see table 1 for the statutory limits on the six grants we reviewed).

[9] Federal grant funding may also be awarded to nonprofit subgrantees through contracts.

Table 1: Statutory Limits on Administrative Costs for Selected HHS and HUD Grants

Federal agency	Operational division/ subcomponent	Grant	Percentage limit	Federal statute - authorization
HHS	SAMHSA	Block Grants for Substance Abuse Prevention and Treatment	Five percent limitation on reimbursement for administrative expenses for states	Part B of Title XIX of the Public Health Service Act, 42 U.S.C. § 300x-31
HHS	SAMHSA	Block Grants for Community Mental Health Services	Five percent limitation on reimbursement for administrative expenses for states	Part B of Title XIX of the Public Health Service Act, 42 U.S.C. § 300x-5
HHS	ACF	Promoting Safe & Stable Families Grant	Ten percent limitation on reimbursement for administrative costs for states	Promoting Safe and Stable Families Act, 42 U.S.C. § 629-629e
HHS	ACF	Family Violence Prevention Services/Battered Women's Shelters Grant	Five percent limitation on reimbursement for administrative costs for states	Family Violence Prevention and Services Act 42 U.S.C. § 10401
HUD	CPD	Emergency Shelter Grants (ESG)	A recipient may use up to 5 percent[a] for administrative purposes; a recipient state shall share this amount with local governments funded by the state	McKinney-Vento Homeless Assistance Act, Title IV, Subtitle B, 42 U.S.C. § 11378
HUD	CPD	Housing Opportunities for Persons with AIDS Grant (HOPWA)	Grantees can receive up to 3 percent for administrative costs; Project sponsors[b] can receive up to 7 percent for administrative costs	AIDS Housing Opportunity Act, 42 U.S.C. § 12901

Source: GAO analysis of applicable program statutes and regulations.

[a]The Homeless Emergency Assistance and Rapid Transition to Housing Act of 2009 increased the percentage limit for administrative purposes from 5 percent to 7.5 percent effective November 20, 2010, or 3 months after the Secretary of HUD issues final regulations implementing the act. Pub. L. No. 111-22 (2009).

[b]Project sponsors are nonprofit organizations or state or local government housing agencies that contract with a grantee to provide HOPWA assistance.

OMB circulars A-87 and A-122[10] provide guidance to state and local governments and nonprofits on classifying costs as direct or indirect and direct state and local governments to employ the necessary management techniques in order to efficiently and effectively administer federal

[10] OMB Circular A-87, *Cost Principles for State, Local, and Indian Tribal Governments* (2 CFR Part 225), and OMB Circular A-122, *Cost Principles for Non-Profit Organizations* (2 CFR Part 230).

awards. OMB circulars A-87 and A-122 generally define direct and indirect costs as follows:

- Direct costs are those that can be identified specifically with a particular final cost objective, that is, a particular award, project, service, or other direct activity of an organization.

- Indirect costs are those that have been incurred for common or joint objectives and are not readily assignable to the cost objectives specifically benefited, without effort disproportionate to the results received. A cost may not be allocated to an award as an indirect cost if any other cost incurred for the same purpose, in like circumstances, has been assigned to an award as a direct cost. Direct costs of minor amounts may be treated as indirect costs under certain conditions. Recognizing that nonprofit organizations have diverse characteristics and accounting practices, the guidance states that it is not possible to specify the types of cost that may be classified as indirect costs in all situations. Whether a nonprofit classifies costs as direct or indirect is often a result of the organization's ability to link costs to a particular program.

OMB Circular A-122 guidance to nonprofits further divides indirect costs into two broad categories: facilities and administration.

- Facilities costs generally include costs related to the "depreciation and use allowances on buildings and equipment, as well as operations and maintenance expenses."

- Administration costs generally include "general administration and expenses such as the director's office, accounting, personnel, library services and all other expenses not listed under facilities."

OMB Circular A-133 provides general guidance on the roles and responsibilities of the federal awarding agencies and primary recipients of government funds regarding audit requirements of grantees.[11] It sets forth standards for obtaining consistency and uniformity among federal agencies for the audit of states, local governments, and nonprofit organizations expending federal awards totaling $500,000 or more annually. Among other responsibilities, it gives

[11] OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.*

- federal awarding agencies the responsibility to advise recipients of requirements imposed on them by federal laws, regulations, and the provisions of contracts or grants and

- primary recipients the responsibility to identify grant awards; advise subrecipients of requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements; and monitor the implementation of the grants.

Awarding agencies and all recipients and subrecipients of federal grant funds must comply with certain data collection, record-keeping, and reporting requirements to help monitor grant implementation. These requirements differ across grants and are determined by the federal awarding agency, federal law, or both. State and local governments sometimes impose additional requirements on their subgrantees.

Inconsistencies in Terminology Lead to Challenges in Cost Classification, Which Can Result in Uneven Treatment of Costs

Understanding OMB guidance regarding the relationship between indirect and administrative costs is particularly challenging for state and local governments and nonprofits. According to OMB officials, the terms "direct" and "indirect" can be thought of as ways to classify costs; that is, they are "cost buckets." In contrast, the term "administrative" refers to a cost function or activity—such as accounting, procurement, personnel, or budgeting. On the one hand, OMB Circular A-122 cost guidance to nonprofits indicates that administrative costs are usually but not always indirect costs; on the other hand, that same guidance lists "administration" costs as one of two categories of indirect costs. Further, OMB Circular A-87 cost guidance to state and local governments uses the terms indirect and administrative interchangeably in certain places. Taken together, the OMB guidance can be viewed as ambiguous. Guidance is most useful when it is clear and well understood. OMB officials told us that given the uncertainty and confusion with respect to these definitions and their application, it may be helpful to bring federal, state, and local officials together with representatives from nonprofit organizations to discuss these issues. Doing so, they acknowledge, could help clarify and improve understanding of how indirect costs should be treated.

Classifying similar costs differently can make it difficult to determine how much money grantees receive for cost activities typically thought of as indirect, and at what rate. For example, the ESG program provides states or local government grantees up to 5 percent for administrative costs. As the primary recipients of ESG funds, states are required to share at least a portion of this funding with local government subgrantees; however, there

is no such requirement for cost sharing with nonprofits. Thus, on its face it may appear as if ESG provides no administrative cost reimbursement for nonprofits. However, the ESG statute allows some emergency shelter costs, such as rent and utilities, which are typically thought of as indirect costs, to be claimed as a direct cost under ESG's "operating costs" activity—one of five direct program activities for which subgrantees may be reimbursed.[12] In another example, the statute for the HOPWA grant program limits administrative cost reimbursement for project sponsors to 7 percent. Because administrative costs can either be charged as direct or indirect costs depending on the circumstance, and because HOPWA has no explicit limit on indirect costs, it is difficult to accurately characterize cost reimbursement for activities commonly thought of as indirect.

When grants and grantees classify similar costs differently it can also result in the same cost activity being covered for some nonprofits but not others, and can increase the complexity of administering the grants. Nonprofit association officials told us that because grant award packages and federal guidance contain unclear or conflicting information on how to allocate costs, nonprofits sometimes unknowingly exclude eligible expenses in their calculation of administrative costs and, as a result, limit their own reimbursement potential.[13] Further, some of the nonprofit and association officials we spoke with said that because grant programs have different definitions of indirect costs, they must take care to reconcile their own accounting systems with the requirements of each grant they receive to ensure that they properly account for the funds. They also said that this is time consuming and resource intensive, and that more consistent classifications and treatment across federal grants would simplify grant administration and may reduce costs.

We and others have previously reported that federal grant programs sometimes classify similar or identical costs differently. In 2006, we reviewed seven programs from HHS, and the Departments of Agriculture and Labor, and found that the legal definitions of and the federal funding rules for administrative costs varied even though many of the same

[12] The other four eligible activities are renovation/rehabilitation or conversion, social services, homeless prevention, and grant administration.

[13] Nonprofit association officials also told us that some nonprofits intentionally request no or low reimbursement for indirect costs to show that they are operating efficiently and on a lean budget. Further, they said that some nonprofits do not include their accounting department, human resources department, or building furnishings in their operating costs.

activities were performed to administer the programs.[14] The report noted that the statutes and regulations that define administrative costs for these programs differ in part because the programs evolved separately over time and have different missions, priorities, services, and clients. Further, the report noted that a number of state budget officials said that varying definitions of administrative costs create challenges for them. For example, one said that it can be difficult to develop coding for accounting and budgeting that can be used across programs and, as a result, it can be difficult to monitor costs accurately; another shared this concern and said that consistent definitions of and caps for administrative costs would make it easier to allocate costs across programs and, therefore, might reduce costs. This concern is not new; in a 2002 report on tax-exempt organizations, we reported that different approaches for charging expenses, as well as different allocation methods, can result in charities with similar types of expenses allocating them differently.[15]

Even though the terms indirect costs and administrative costs are not synonymous, we found that some nonprofit, state, and local government officials we spoke with use them interchangeably. A national nonprofit association official made a similar observation, noting that terminology varies throughout the nonprofit sector. State and local government and nonprofit officials we spoke with also reported using other terms, such as overhead, general operating expenses, or management and general expenses, synonymously with indirect and administrative costs.

A 2007 report on nonprofits' overhead costs also discussed widespread confusion about indirect costs throughout the sector, and identified "variations in definitions of overhead and the overhead cost rate" as areas of concern among nonprofit researchers and practitioners.[16] The report also concluded that there is a substantial difference between indirect costs and administrative costs, noting that not all indirect costs are administrative, such as the costs of a telemarketing campaign, which is a

[14] GAO, *Human Service Programs: Demonstration Projects Could Identify Ways to Simplify Policies and Facilitate Technology Enhancements to Reduce Administrative Costs*, GAO-06-942 (Washington, D.C.: Sept. 19, 2006).

[15] GAO, *Tax-Exempt Organizations: Improvement Possible in Public, IRS, and State Oversight of Charities*, GAO-02-526 (Washington, D.C.: Apr. 30, 2002).

[16] E. Keating, *Reshaping the Overhead Debate: Getting to Mu* (Hauser Center on Nonprofit Organizations, Harvard University: 2007): p. 6. Analysis for this report included synthesizing prior research, convening nonprofit and foundation roundtables, and conducting additional interviews with nonprofit executives.

programmatic or fundraising function. The report also said that there are administrative costs that are direct costs, such as those for the computers and office supplies used by the finance department.[17]

Inconsistencies in guidance in grant award packages and across federal programs add to the challenge of administering federal grants. For example, officials from a Louisiana nonprofit said that one federal contract may allow them to charge rent as a direct cost, while another federal contract states that it is to be charged as an indirect cost. These officials told us that they should be able to "call an apple, an apple….every time." In another example, HUD's supplemental guidance for HOPWA recipients advises that in reviewing administrative and indirect costs, recipients should keep in mind that "all administrative costs are indirect costs, but not all indirect costs are administrative costs." Conversely, in describing HHS's PSSF grant and the Family Violence Prevention Services/Battered Women's Shelter grant, ACF officials explained that administrative costs can be either direct or indirect costs.

Nonprofits' Reimbursement for Indirect Costs Largely Depends on Federal, State, and Local Government Practices

For the majority of grants in our review, we found that state and local government grantees are allowed to decide whether or not and how much they reimburse nonprofit subgrantees for their administrative or indirect costs. In all three states we reviewed, we found differences in the rates at which state and local governments reimburse nonprofits for indirect costs. These differences, including whether nonprofits are reimbursed at all, largely depend on the policies and practices of the state and local governments that award federal funds to nonprofits. State and local governments may apply the same indirect cost limit to all subgrantees or may choose to apply different indirect cost limits to different subgrantees. For example, for all subgrantees who receive funds under the Block Grants for Community Mental Health Services and the Prevention and Treatment of Substance Abuse, the Louisiana Department of Health and Hospitals limits indirect cost reimbursement to 12 percent. Other state and local government agencies, such as the Wisconsin Department of Health Services, work with individual subgrantees to determine an indirect cost reimbursement rate. Officials from the department told us that they often

[17] The report also noted that the confusion is not limited to nonprofits' relationships with government entities. Some foundations develop their own definitions of overhead for grant applications that often mixes the concepts of indirect costs and administrative costs, while others leave the definition unclear. A frustration voiced by many was that fully funding efficient operations is made difficult by the inconsistent definitions of overhead costs.

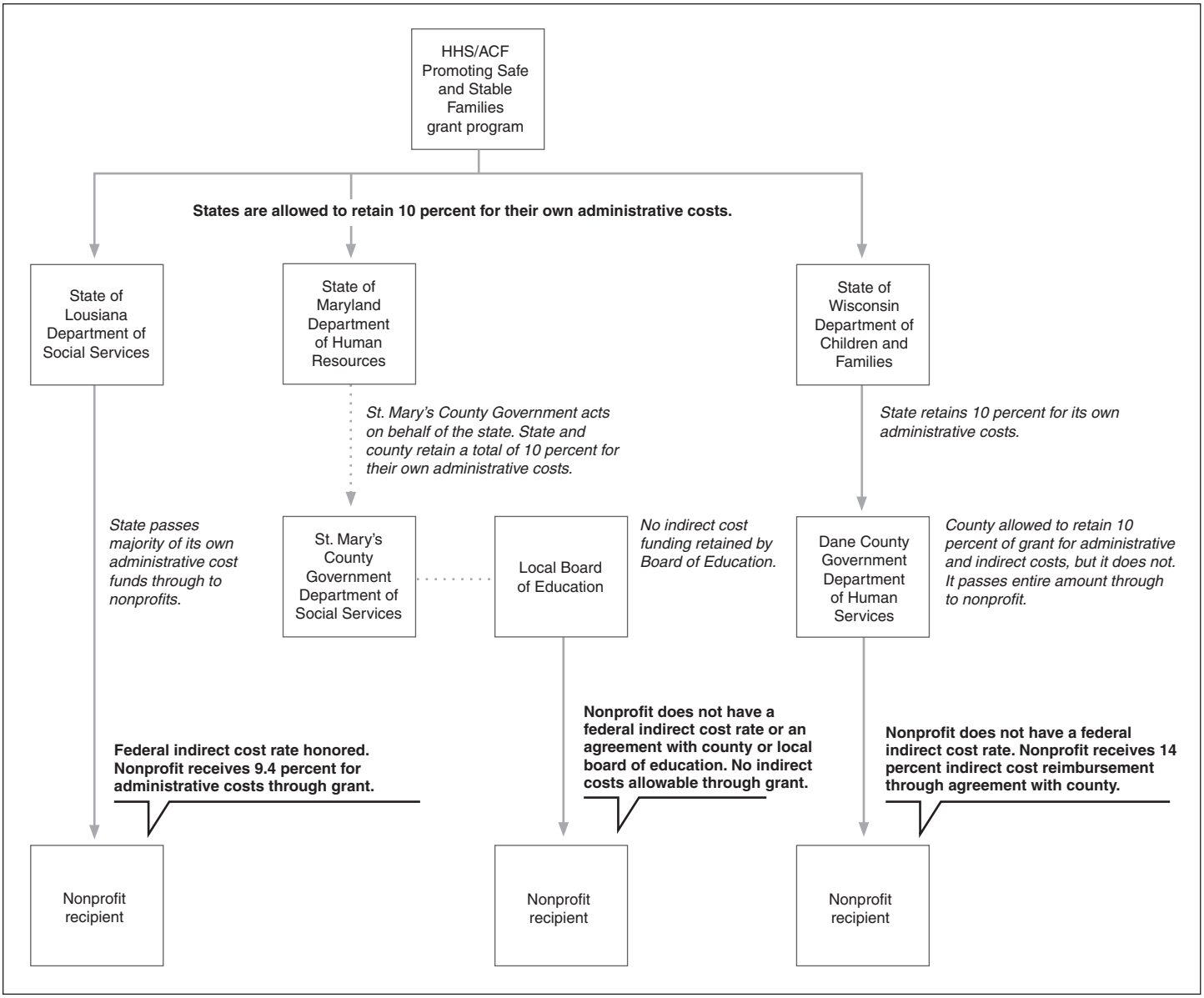
assist subgrantees in determining how to classify costs; this helps to determine what costs to reimburse as indirect, and at what rate.

The amount of funding passed through to nonprofits can also be affected by the amount of funding a state or local government uses for its own administrative costs. For example, according to a Dane County, Wisconsin official, Dane County receives 10 percent for administrative and indirect costs for the PSSF grant from the state of Wisconsin and passes the entire amount on to its nonprofit service providers; this increases the amount of funds available to nonprofits. However, some state and local governments we spoke with interpret statutory limitations on their own administrative costs as necessarily limiting the administrative and indirect costs allowable by the grant for all subgrantees. Although states often enjoy wide latitude in determining the administrative and indirect reimbursement rates of their subgrantees, applying a more specific interpretation of federal statute potentially limits the amount of funds available to nonprofits.

Variations in cost coverage exist not only among different grants across different states, but also within the same grant across different states. For example, for the PSSF grant, states may retain up to 10 percent of the grant award to pay for their own costs to administer this grant, or they may pass this amount through to the nonprofit service providers to which they award PSSF grants. In addition, states may determine the allowable level of indirect cost reimbursement for the nonprofit service providers to whom they award PSSF grants. As shown in figure 2, three nonprofits that receive funding under the PSSF grant in Louisiana, Maryland, and Wisconsin are reimbursed for their indirect costs, administrative costs, or both at different rates (9.4 percent, 0 percent, and 14 percent, respectively).

The differences among reimbursement rates for these nonprofits may in part be due to the presence or absence of an indirect cost rate agreement. Primary recipients of federal funds are required to have a federal indirect cost rate agreement in order to be reimbursed for indirect costs. There is no such requirement for recipients that receive federal funds that first flow through entities such as state and local governments. Five of the 17 nonprofits in our sample have federal agreements. However, state and local governments are not required to consider or honor federal indirect cost rate agreements when awarding federal funds. Some state and local governments negotiate a similar indirect cost rate agreement directly with subrecipients; others do not.

Figure 2: Examples of How Reimbursement for Nonprofits' Indirect and Administrative Costs for the Promoting Safe and Stable Families Grant (PSSF) Varies across States



Source: GAO analysis of HHS, state and local government, and nonprofit information.

Note: These examples depict how funds flow to the specific nonprofit subrecipients included in our sample; other pass-through relationships also exist in these states for this particular grant.

When Nonprofits Report Differences between Indirect Costs Incurred and Reimbursed, They Take a Variety of Steps to Bridge Gaps

Nonprofits Fund Indirect Costs from a Variety of Sources

To help cover their indirect costs, nonprofits reported using funding from a variety of sources in addition to federal funds, such as capacity-building grants, private donations, fundraising, endowment funds, and business income generated from services provided.[18] For example, some of the nonprofits we spoke with operate fee-for-service furniture restoration, repair shop, and batterers' treatment programs. A Wisconsin nonprofit official said that the United Way recognizes the challenges nonprofits face in receiving reimbursement for indirect costs and provides unrestricted funding to help cover them. Other nonprofit officials we spoke with, however, reported that these grants can be difficult to secure. A November 2009 CRS report noted, perhaps not surprisingly, that charitable giving declined during the recent recession.[19] For some nonprofits the decline comes at a time when their services may be in greater demand, which can further strain resources.

Nonprofits also rely on in-kind donations and volunteer labor to help cover costs. For example, nonprofits reported receiving food donations from local restaurants, furniture donations, and facilities repairs by nonprofit board members. One Louisiana nonprofit official said that in-kind and volunteer labor is essential for her organization's ability to provide services, and it received $160,000 in volunteer labor in 2008. However, nonprofit officials also noted that while the use of volunteer labor is valued, it is not "free," as volunteers may require additional supervision and training.

[18] Capacity-building grants are designed to supplement program funding and support efforts to expand an organization's ability to provide services.

[19] CRS, *An Overview of the Nonprofit Charitable Sector*.

Nonprofits Take Steps to Bridge Reported Funding Gaps

Fifteen of the 17 nonprofits in our sample reported that funding received for indirect costs does not cover their actual indirect costs.[20] A nonprofit official whose organization receives a HUD grant from the state of Wisconsin said that his organization is authorized to claim 5 percent for administrative costs associated with delivering supportive housing program services, but that amount does not cover the costs of administering the program. In another example, recipients of the Family Violence Prevention Services/Grants for Battered Women's Shelters grants in all three states reported receiving no indirect cost reimbursement, but their overall organizational indirect costs ranged from about 8 to 11 percent.[21] Similarly, nonprofit subrecipients of ESG funding across all three states reported no indirect cost reimbursement from state and local governments. The overall organizational indirect costs for these nonprofits ranged from 1.8 to 20 percent. These self-reported levels are generally in line with an Urban Institute study that analyzed the 1999 tax returns of approximately 160,000 health-related and human services nonprofits,[22] and reported average management and general expenses of 17 and 16 percent, respectively.

Although nonprofits' fiscal challenges are not limited to indirect cost funding, as noted above, funding sources that can be used to cover indirect costs can be difficult to come by. As such, it is particularly important to understand steps nonprofits take to bridge gaps when they report gaps between indirect costs incurred and reimbursed. We found that nonprofits often respond by reducing service levels, compromising

[20] As previously discussed, nonprofits classify costs differently; therefore, we lacked reliable data with which to confirm this gap.

[21] Management and general expenses as reported on the recipient organizations' 2007 Internal Revenue Service (IRS) forms. IRS Form 990 is an annual reporting return that certain federally tax-exempt organizations must file with IRS. It provides information on the filing organization's mission, programs, and finances. IRS defines management and general expenses as expenses that relate to the organization's overall operations and management rather than to fundraising activities or program services. Indirect costs are generally equivalent to management and general expenses. Some researchers have questioned the quality of IRS Form 990 data, as they are self-reported.

[22] T. Pollack, P. Rooney, and M. Hager, *Understanding Management and General Expenses in Nonprofits* (Urban Institute Center on Nonprofits and Philanthropy and Indiana University Center on Philanthropy: 2001): pp. 24-29. Researchers reported in a working paper that of the 19,786 health-related organizations in their study, the average management and general expenses level was approximately 17 percent. Of the 43,988 human services organizations whose IRS Forms 990 were reviewed in that study, the average management and general expenses level was approximately 16 percent.

infrastructure and staff investments, or both, and that these cost-cutting measures can limit nonprofits' ability to build a financial safety net.

Reduced Service Levels

Several nonprofits we spoke with said at the time of our interviews they had reduced the size of their programs and populations served as a result of gaps in funding for direct and indirect costs. For example, a Louisiana nonprofit official said that his organization scaled back its housing and shelter services 10 to 15 percent even though its mission is to serve all at-risk youth in need of these services. As a result, he said, the nonprofit now has a waiting list for its residential services. A Maryland nonprofit official told us that the organization's psychiatric rehabilitation program was one of the largest in the state. However, according to this official, the level of reimbursement his organization received from government sources led to the nonprofit reducing the program's size in order to remain viable. A 2008 study that examined several nonprofits also discussed negative effects on nonprofits' capacity to provide services due to funding gaps, noting that as a result of funding gaps in the short term, staff members struggle to provide more services but with fewer resources.[23]

Nonprofits we spoke with also reported reducing the range of services they offered. An official from a Maryland nonprofit whose mission includes providing housing, employment services, and job referrals, said that the organization once provided a computer lab with a part-time computer instructor for its clients as part of its General Education Development services. The official said that in an effort to more closely align costs incurred with costs reimbursed, the nonprofit eliminated the instructor position because it was not directly related to the organization's primary mission of providing supportive housing and housing placement. Officials from a Maryland drug and alcohol rehabilitation nonprofit told us that they discontinued a vocational education program for similar reasons.

Compromised Infrastructure Investments

Many nonprofits compromise vital facilities maintenance and "back-office" support functions, such as information technology systems, to avoid reducing their services. Almost half of the nonprofits we spoke with reported making such trade-offs. For example, a Louisiana nonprofit said that it does not have an updated security system that adequately protects the victims of domestic violence that it serves, which directly affects the

[23] W. Bedsworth, A. G. Gregory, and D. Howard, *Nonprofits Overhead Costs: Breaking the Vicious Cycle of Misleading Reporting, Unrealistic Expectations, and Pressure to Conform* (The Bridgespan Group, April 2008), pp. 4-7.

nonprofit's ability to fulfill its mission—providing a safe space for victims of domestic violence. We also observed ceilings that were in disrepair when we toured this nonprofit's facility. An official from a Maryland nonprofit said that her staff makes personal sacrifices to sustain services, such as working in dark offices to conserve electricity costs or bringing supplies from home. Wisconsin nonprofit officials reported that their medical and dental appointment systems are not integrated, inhibiting their ability to better serve their patients.

The experiences of these nonprofits are consistent with other studies' findings that trade-offs in facility maintenance can hinder nonprofits' ability to effectively carry out their mission in the long term. A 2007 study on the financial health of the human service providers in Massachusetts said that providers may defer routine costs, such as facility maintenance and other critical infrastructure investments, when they lack indirect cost funding.[24] A 2008 study suggested that funders have unrealistic expectations for nonprofits' indirect costs, which can lead nonprofits to underinvest in infrastructure that is needed to maintain or improve standards for service delivery.[25] A 2008 study on the administrative management capacity of 16 select nonprofit programs noted that many organizations cite a lack of resources for information technology infrastructure needs and that some organizations in the study reported that they cannot meet technology needs beyond a basic level of functionality.[26] The study also reported that these organizations lack sufficient strategic and long-term planning for future information technology needs and equipment and software updates.

Compromised Staff Investments

Nonprofits often report that they forgo staff investments or reduce or freeze salaries to avoid reducing services. Officials from 10 of 17 nonprofits we spoke with said that at the time of our interviews they had delayed filling vacant positions or have eliminated positions to cover costs. For example, officials from a Maryland nonprofit eliminated a

[24] DMA Health Strategies, *Financial Health of Providers in the Massachusetts Human Service System* (Massachusetts: Commonwealth of Massachusetts Executive Office of Health and Human Services, October 2007), pp. 1-2. This study consisted of providers who were recipients of federal funds.

[25] W. Bedsworth, A.G. Gregory, and D. Howard, pp. 4-7.

[26] Fiscal Management Associates, *Administrative Management Capacity in Out-of-School Time Organizations: An Exploratory Study* (New York: The Wallace Foundation, December 2008), pp. 51-55.

development position and trained a receptionist to assume other responsibilities. As a result, the organization lacked a dedicated receptionist during business hours, which makes it more challenging to respond to clients' needs. A Wisconsin nonprofit said that it has not hired a medical coder—a position that would allow the doctors in the organization to devote more time to seeing patients instead of on administrative paperwork. Another Wisconsin nonprofit official reported instituting a voluntary leave without pay program during the summer months to reduce salary costs. Another Maryland nonprofit official explained that because she cannot attract qualified staff at the salary she is able to offer, she usually hires people with very little experience who require a significant amount of training and supervision. Similarly, officials from a third Maryland nonprofit said that they are unable to provide salary increases or cost-of-living adjustments for their staff and have had to cut benefits.

Other studies have shown that nonprofits may also leave positions vacant to realize savings, which can have adverse quality implications. A 2008 study found that program staff at the 16 nonprofits in the study often take on administrative tasks, such as recruitment processes and site maintenance, to bridge gaps in administrative infrastructure and support; as a result, program staff devote less time to activities more directly tied to service delivery and quality programming.[27] A 2004 study on nonprofit overhead costs reported that limited or no staff for administrative functions limited nonprofits' ability to manage and monitor finance, development, and other important functions.[28] A 2007 study noted that staff salaries and benefits of the human service providers in Massachusetts do not appear to keep pace with increases in the overall cost of living. It further noted that the relatively low wages can limit the qualifications and level of experience of many direct care workers and can lead to rapid staff turnover. [29] A 2004 study on nonprofit overhead costs discussed how

[27] Fiscal Management Associates, pp. 1-6.

[28] Urban Institute Center on Nonprofits and Philanthropy and Indiana University Center on Philanthropy, "Getting What We Pay For: Low Overhead Limits Nonprofit Effectiveness" *Nonprofit Overhead Cost Project Brief No. 3* (2004), pp. 1-4. The Nonprofit Overhead Cost Project is a study that had three phases: analysis of over 250,000 IRS Forms 990, in-depth case studies of nine organizations, and 1,500 responses to a survey of U.S. nonprofits. The project defines overhead costs as an organization's infrastructure, including accounting, fundraising, information technology, human resources, physical plant, and other common organizational elements that stand behind and support a nonprofit's mission and program. The definition of overhead costs is consistent with our definition of indirect costs.

[29] DMA Health Strategies, p. 2.

challenges in recruiting and retaining qualified staff compromised nonprofits' effectiveness, noting that key positions are filled by individuals with little relevant experience and training, and once staff gain relevant experience, they seek employment at organizations with higher salaries, leading to high turnover for nonprofits.[30]

Limited Ability to Build a Financial Safety Net

Nonprofits' strained resources also limit their ability to build financial reserves for unanticipated expenses. Officials at a Louisiana nonprofit said that their ability to build a financial safety net is limited because they struggle to cover their costs and do not have money left over to save. A nonprofit association official said that nonprofits sometimes cannot set aside sufficient cash reserves to cover unforeseen costs, such as a broken boiler. To address unexpected costs, nonprofits often draw from their program costs where possible, which can lead to a decline in program quality. Other studies also reported on financial sustainability challenges for nonprofits. Nonprofit financial management experts have recommended that nonprofits maintain cash reserves sufficient to fund 3 months of operating expenses. A 2009 study on the operating reserves of over 2,000 Washington, D.C. area nonprofits reported that in 2006, 57 percent of the operating public charities in the Greater Washington area had operating reserves of less than 3 months; 28 percent of these organizations reported no operating reserves.[31] A 2008 study on the administrative management capacity of select nonprofit programs reported that half of the nonprofits in the study do not maintain the recommended level of reserves.[32] Finally, a 2007 study reported that one-third of the more than 600 Massachusetts providers in its sample had less than 15 days' cash at the ends of their fiscal years; another quarter have only 3 to 4 weeks of cash at the ends of their fiscal years.[33] Given recent economic conditions, the need for sufficient cash reserves may be particularly important.

[30] Urban Institute Center on Nonprofits and Philanthropy and Indiana University Center on Philanthropy, pp. 1-4.

[31] A. Blackwood and T.H. Pollak, "Washington-Area Nonprofit Operating Reserves," *The Urban Institute: Charting Civil Society No. 20* (July 2009): pp. 1-12.

[32] Fiscal Management Associates, pp. 18-20.

[33] DMA Health Strategies, pp. 14-15. Although the conclusions from these studies are nongeneralizable and often include a small number of cases, these reports illustrate how organizations can have trouble covering near-term operating expenses, as well as replacing aging infrastructure.

Untimely Reimbursements and High Grant Administration Costs Exacerbate Nonprofits' Reported Funding Gaps

A November 2009 CRS report noted that (1) in addition to funding cuts, states apparently have been delaying payments for services they have contracted with nonprofits to provide; and that (2) it appears that governments, particularly state governments, may be contributing to the financial difficulties of nonprofit organizations.[34] During the course of our work, we spoke with nonprofits that made similar observations. Factors such as untimely reimbursements and high grant administration costs can place stress on the nonprofit sector, diminishing its ability to continue to provide services to vulnerable populations. OMB officials acknowledged that building nonprofits' capacity to manage may help nonprofits better contend with these issues and continue to meet their missions.

Untimely Reimbursements

Untimely receipt of government grant and contract payments contributes to financial strain on nonprofits. Six of the 17 nonprofits in our study reported that their reimbursements from federal, state, and local governments are delayed at times, which can cause cash flow problems and undermine their sustainability. For example, an official from a Maryland nonprofit said that her organization was awarded an HHS grant from the state of Maryland in October 2008 but did not actually receive the funding until May 2009. Maryland nonprofit officials said they sometimes experience 15- to 30-day delays in reimbursement from the state of Maryland. One Maryland nonprofit official said delays such as these create a "cash-flow nightmare" for her organization. The nonprofit has a line of credit it can draw on to tide it over until it receives grant payments, but this increases costs because it incurs interest and fees on the line of credit, which are not reimbursed. Three of the nonprofits in our study said that smaller nonprofits without cash reserves or lines of credit rely on timely payments to sustain their operations. They said that even small delays put these nonprofits at risk of failure. Some state and nonprofit association officials we spoke with, however, said that reimbursement delays also occur when nonprofit staff are so busy operating programs that they do not keep up with filing invoices in a timely manner; as a result, when nonprofits most need the money, it is not available.

We and others have also cited challenges nonprofits face as a result of delayed reimbursements from federal, state, or local governments. In 2006 we reported that recipients of selected federal grants reported that delayed awards create significant burden on them and limit their ability to

[34] CRS, *An Overview of the Nonprofit Charitable Sector*.

plan for and efficiently execute grant programs.[35] Grant recipients noted that they often received award notifications significantly later than they had anticipated, sometimes months after the expected award date provided in the opportunity announcement. These uncertainties and delays caused significant problems in planning for and executing grant projects. Grant recipients in this study suggested that agencies should award grants in a more timely way or provide more precise information on when an award could be expected. A 2007 study on the financial health of the human service providers in Massachusetts noted that when an organization with limited cash experiences unexpected delays in the receipt of income, a crisis situation can occur.[36] A 2002 study that reviewed prior research on this topic noted that when government agencies are delayed in approving contracts or grant payments, recipient organizations often experience cash flow problems.[37] Consistent with comments from the nonprofits we interviewed, this report suggested that payment delays are especially difficult for smaller and new organizations because they do not have established mechanisms to withstand delayed or unpredictable funding.

Costs of Administering Grants

The high costs of grant administration sometimes discourage nonprofits from applying for grant funds. Three nonprofits we interviewed reported that they do not seek additional government grants or may not reapply for grants they currently receive for this reason. For example, a Maryland nonprofit official stated that her organization is eligible for a Recovery Act grant program that provides services to youth, but she is hesitant to take on the project because the grant's administrative reimbursement rate is 3 percent, which would not cover the cost of administering the grant.[38] Over half of the nonprofits in our study said that administrative reporting requirements make it challenging to administer grants they receive.

[35] GAO, *Grants Management: Grantees' Concerns with Efforts to Streamline and Simplify Processes*, GAO-06-566 (Washington, D.C.: July 28, 2006).

[36] DMA Health Strategies, p. 21.

[37] P. Frumkin and M.T. Kim, *The Effect of Government Funding on Nonprofit Administrative Efficiency: An Empirical Test* (Harvard University: 2002), p. 6; S.R. Bernstein, *Managing Contracted Services in the Nonprofit Agency*, 1st ed. (Philadelphia, PA: Temple University Press, 1991), pp. 30-31; and K. Grønbjerg, *Understanding Nonprofit Funding*, 1st ed. (San Francisco, CA: Jossey-Bass Publishers, 1993), pp. 219-240.

[38] For more information on Recovery Act funds and related administration challenges, see GAO, *Recovery Act: One Year Later, States' and Localities' Uses of Funds and Opportunities to Strengthen Accountability*, GAO-10-437 (Washington, D.C.: Mar. 3, 2010).

Officials from a Louisiana nonprofit told us that complying with reporting requirements for the more than 20 federal grants they manage requires a significant amount of staff resources. A Maryland nonprofit official explained that some of the nonprofits' federal grants are "big, complex, and complicated" to acquire and manage because it does not have a dedicated grants management team and establishing one would redirect resources away from other areas. Likewise, officials from a Wisconsin nonprofit said that complying with the county's challenging bureaucratic process requires a significant amount of time that could otherwise be spent on mission-related activities, and that the organization regularly loses money as a result of these requirements.

We and others have previously reported on the challenges facing nonprofits in administering grants. In July 2007, we testified that practitioners and researchers alike acknowledged the difficulty that nonprofit organizations, particularly smaller entities, have in responding to the administrative and reporting requirements of their diverse funders.[39] We said that although funders need accountability, the diverse requirements of different funders make reporting a time-consuming and resource-intensive task. For example, meeting the increasing expectations that nonprofits measure performance, given the size of grants and the evaluation capabilities of the staff, can be difficult. One researcher said that performance evaluation is one of the biggest challenges they face. A 2002 study, which included an analysis of Internal Revenue Service (IRS) Forms 990 from 1,172 nonprofit organizations from 1985 to 1995, found that for some nonprofits, an increase in government funding is positively correlated with an increase in the share of administrative expenses the following year, which could be the result of the costs associated with obtaining contracts and the challenges of meeting accountability and reporting requirements.[40] Similarly, a 2004 study on nonprofit overhead costs of 9 nonprofit organizations reported that the nonprofits with the weakest organizational infrastructures received half or more of their revenue from public sector sources, and that the public sector practice of

[39] GAO-07-1084T.

[40] P. Frumkin and M.T. Kim, pp. 11-15. This study presented the analysis of IRS Forms 990 from 1,172 nonprofit organizations from 1985 to 1995.

providing little support for overhead costs was directly associated with the organizational weaknesses at these nonprofits.[41]

Conclusions

Federal, state, and local governments rely on nonprofit organizations as key partners in implementing programs and providing services to the public, such as health care, human services, and housing-related services. Nonprofits' ability to determine and manage their indirect costs is affected by inconsistencies in terminology and guidance across federal programs on how to classify costs. Further, varying reimbursement practices by state and local governments that award federal funds affect the rate at which indirect costs are covered. Absent a clear understanding among federal, state, local, and nonprofit officials about how to interpret OMB's indirect cost guidance and consistently classify activities typically thought of as indirect costs, nonprofits will likely continue to struggle with accurately and consistently reporting on their indirect and administrative costs of doing business, and a clear picture of the true gap between actual and reimbursed indirect costs will remain elusive.

As the federal government increasingly relies on the nonprofit sector to provide services, it is important to better understand the implications of reported funding gaps, such as compromised quality of important administrative functions, including information technology, human resources, legal, and accounting operations. Such gaps further limit nonprofits' capacity to correctly determine how indirect costs should be treated. Collectively, these challenges potentially limit the sector's ability to effectively partner with the federal government, can lead to nonprofits providing fewer or lower-quality federal services, and, over the long term, could risk the viability of the sector. Given OMB's role in federal grants management, OMB is in a unique position to convene stakeholders to review these issues.

Recommendation for Executive Action

GAO recommends that the Director of OMB bring together federal, state, and local governments, and nonprofit representatives to propose ways to clarify and improve understanding of how indirect costs should be treated, particularly for grants passed through state and local governments to nonprofits by

[41] Urban Institute Center on Nonprofits and Philanthropy and Indiana University Center on Philanthropy, pp. 1-4.

- clarifying the definitions of indirect costs and administrative costs and their relationship to each other and
- considering ways to help nonprofits improve their understanding and ability to better capture, categorize, report, and recover indirect and administrative costs.

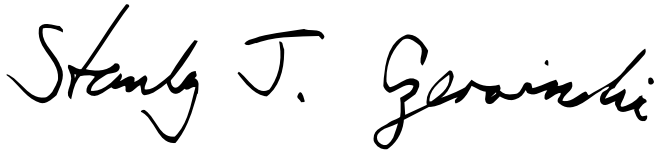
Agency Comments and Our Evaluation

We provided a draft of this report to OMB and the Departments of Health and Human Services (HHS) and Housing and Urban Development (HUD). OMB generally agreed with our findings, conclusions, and recommendations. OMB also provided technical comments, which we incorporated, and suggested clarifying language for the recommendation, which we agreed with and incorporated. HHS and HUD did not provide formal comments, but made technical comments by e-mail, which we incorporated.

We will send copies of this report to the Director of OMB and the Secretaries of Health and Human Services and Housing and Urban Development. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions about this report, please contact me at (202) 512-6806 or czerwinskis@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Key contributors to this report are listed in appendix II.

Sincerely yours,



Stanley J. Czerwinski
Director, Strategic Issues

Appendix I: Objectives, Scope, and Methodology

Our objectives were to provide information for selected federal grant programs and nonprofits on (1) how indirect cost terminology and classification vary, (2) how indirect costs are reimbursed, and (3) if gaps occur between indirect costs incurred and reimbursed, steps nonprofits take to bridge the gaps.

To address our objectives and obtain information on federal grants initially awarded to state and local governments and passed through to nonprofit service providers and the impact of indirect cost funding on nonprofits, we used several approaches. These included selecting a nonprobability sample[1] of federal grants, states, and nonprofits to serve as case studies and conducting a literature review to analyze published work related to this topic. The scope of the third objective was broader to include the perspectives of nonprofits that receive any federal funding, direct or pass-through. We also interviewed nonprofit association officials.

First, we selected six federal grant programs—four from the Department of Health and Human Services (HHS) and two from the Department of Housing and Urban Development (HUD)—of 26 grant-making federal agencies that offer over 1,000 grant programs annually. We selected HHS and HUD as our two primary agencies of focus because of their familiarity and historical relationship with nonprofit organizations. HHS and HUD grants address many of the National Taxonomy of Exempt Entities (NTEE) classifications related to social and housing services. The NTEE classification system for nonprofits was devised by the Urban Institute's National Center for Charitable Statistics (NCCS), which is a national clearinghouse of data on the nonprofit sector in the United States. NTEE classifications are widely referenced by the Internal Revenue Service and nonprofit researchers and practitioners. HUD and HHS grants address NTEE categories such as:

- Human Services
- Housing and Shelter
- Agriculture, Food, Nutrition
- Community Improvement, Capacity Building
- Youth Development
- Health Care
- Mental Health/Crisis Intervention

[1] Results from nonprobability samples cannot be used to make inferences about a population because in a nonprobability sample, some elements of the population being studied have no chance or an unknown chance of being selected as part of the sample.

- Civil Rights, Social Action, Advocacy

As shown in table 2, the six grants selected are designed to fulfill missions consistent with most of the NTEE categories listed above.

Table 2: Description of Selected Grants for Our Study

Grant name	Agency	Division	Purpose
Promoting Safe and Stable Families	HHS	Administration for Children and Families	To prevent the unnecessary separation of children from their families; improve the quality of care and services to children and their families; and ensure permanence for children by reuniting them with their parents, by adoption or by another permanent living arrangement
Family Violence Prevention and Services/Grants for Battered Women's Shelters	HHS	Administration for Children and Families	To support intervention and prevention of domestic violence
Block Grants for Community Mental Health Services	HHS	Substance Abuse and Mental Health Services Administration	To enable states to provide comprehensive community mental health services
Block Grants for Prevention and Treatment of Substance Abuse	HHS	Substance Abuse and Mental Health Services Administration	To support the development and implementation of prevention, treatment, and rehabilitation activities related to alcohol and drug abuse
Emergency Shelter Grants	HUD	Office of Community Planning and Development	To provide homeless persons with basic shelter and essential supportive services
Housing Opportunities for Persons with AIDS	HUD	Office of Community Planning and Development	To provide housing assistance and supportive services to persons with AIDS

Source: GAO analysis of HHS and HUD information.

Second, we selected three states for our case study—Louisiana, Maryland, and Wisconsin—as well as local governments within those three states, as appropriate. As part of our criteria for selecting states, we considered the following:

- **Levels of HHS and HUD funding**: We included states that receive varying levels of HHS and HUD funding to observe how indirect cost funding needs may be related to the amount of grant funding received by a state.

- **Population**: We included states with different population sizes to allow us to examine potential implications for states that need to provide services to larger numbers of persons.

- **Geographic dispersion**: We included states that were geographically dispersed to allow for regional representation across the country and diversity with respect to the population receiving services; the economic

climate of the area; and other regional, cultural, and demographic characteristics.

Third, we selected 17 501(c)(3) nonprofit organizations from Louisiana, Maryland, and Wisconsin that receive at least one of the six grants we selected. 501(c)(3) organizations are public charities that are eligible to receive federal funding to support their missions of providing for the public benefit. The nonprofits we selected had varying missions and represented a wide range of operating budgets, from less than $1 million to more than $25 million.

Once we selected our case study grants, states, and nonprofits, we reviewed Office of Management and Budget (OMB), HHS, and HUD documents, guidance, and policies governing the treatment of indirect costs, and interviewed budget and program officials at the three agencies. Further, we reviewed documents, guidance, and policies governing the treatment of indirect costs from the selected states, local governments, and nonprofits. We also interviewed budget and program officials from state and local government entities as well as from nonprofit organizations.

To further corroborate the information obtained from our case studies, we reviewed existing research related to nonprofits' indirect costs and overall financial health. We used several search strategies to identify existing studies. Through snowball sampling techniques, we identified research and received study referrals from numerous nonprofit researchers and other nonprofit groups. We conducted searches of several automated databases, including Checkpoint, the Government Printing Office's Catalog, ProQuest, Lexis Nexis, Academic OneFile, and FirstSearch. We also searched the OMB website, Congressional Research Service website, and the Federal Audit Clearinghouse. We searched on various combinations of the following terms: nonprofit, indirect cost, administrative cost, cost, overhead funding, nonprofit funding, overhead, administrative, pass through, grant, grantee, federal, fund, gap, and trade-offs. Finally, search results were limited to studies published after 1995. Through our referrals and literature searches, we identified eight studies and reports that were relevant to our work. We reviewed the studies we included in our work to ensure that they were methodologically sound.

Appendix II: GAO Contact and Staff Acknowledgments

GAO Contact

Stanley J. Czerwinski, (202) 512-6806 or czerwinskis@gao.gov

Acknowledgments

Jacqueline M. Nowicki (Assistant Director) and Sonya Phillips (Senior Analyst-in-Charge) managed this assignment. Carol Patey, Christine Hanson, Mary Koenen, and Barbara Lancaster made key contributions to various aspects of the work. Cindy Gilbert provided methodological assistance; Donna Miller developed the report's graphics; Sabrina Streagle provided legal support; and Jessica Thomsen provided key assistance with message development and writing.

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