Don’t Compromise Good Overhead (Even in Tough Times)

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The Bridgespan Group

In tough times like today's, funders are likely to scrutinize organizational overhead more than ever. But in conducting due diligence on a nonprofit, a would-be donor should never assume that low overhead is a sign of efficiency. Often it means the organization is stretched too thin to be healthy. What's more, by focusing too closely on overhead, a donor could be contributing to the nonprofit's illness.

In the for-profit world, overhead averages about 25 percent of sales. But large nonprofits report an average rate of only 18 percent. Nonprofits often under-invest in critical functions such as IT, accounting and marketing, and shape their financial reports and literature so as to appear as lean as possible. That's because they know that many donors take a dim view of supporting what are considered back-office operations. Indeed, a recent survey shows that 43 percent of Americans believe it's reasonable for nonprofits to spend less than 20 cents of each donated dollar on overhead.

The Bridgespan Group, building on existing research in this area, recently examined four nationally recognized youth-serving nonprofits with budgets ranging from $2 million to $10 million. All four are trying to become more transparent about overhead as a first step in remedying what they acknowledge internally as an ingrained tendency to underspend on support functions. Feeling relentless pressure to appear leaner than other nonprofits in order to attract more dollars, the organizations have been cutting corners for years, doing such things as leaving senior leadership positions vacant and utilizing outdated donor-tracking systems.

We concluded that everyone—donors, nonprofits and beneficiaries—loses when there's an overemphasis on lean overhead. "Operating with subpar [IT] systems meant that we simply couldn't support a bigger network," said an executive director who requested anonymity. "A smaller network, of course, means serving fewer kids." Another top executive says his leadership team believes creating the position of COO is vital to growing the organization, but pressure to limit overhead prevents budgeting for it.

To determine whether a nonprofit is underfunding administrative functions, donors—especially those considering major grants—should add a few steps to their due diligence:

- Ask about priorities the organization has been unable to fund. For example, has it been unable to afford a director of technology who would free the staff to spend more time serving beneficiaries?

- Look carefully at the organization's reports to see whether the leadership team seems big enough and experienced enough to manage its operations.

- Volunteer regularly with the organization—it's a great way to learn how well it operates and where it might be underinvesting.

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- Visit Guidestar.org, Philanthropic Research's Web site, where you can find detailed IRS information for nearly all nonprofits. Although vague IRS standards allow nonprofits to understate their overhead, use the data to start a conversation, asking, for example, what difficulties the nonprofit faces in operating within the budget it reports, how work is divided among the senior managers, and where the stress points are.

We believe donors should challenge nonprofits to explicitly recognize infrastructure needs and communicate to the board and the public the logic for increased investment. Contributors should urge organizations to present data showing how greater funding for overhead would do such things as improve outcomes and, in the long run, reduce the cost of serving beneficiaries. Donors also should consider making their gifts unrestricted or provide a grant explicitly for general operating support.

By providing the board with data on where resources are lacking and by seeking and partnering with funders who understand the value of overhead investments, the organizations we studied have boosted their transparency efforts. For example, they have developed business plans showing clearly what actions would be needed for healthy growth. "It's taken a tremendous amount of board and donor education, and not all donors understand these changes," said one COO, but for the most part, funders are responding positively to the increased transparency, providing resources to bolster management teams and make other operational improvements. These results show it's possible for nonprofits and donors to work together to break the destructive cycle of lean-overhead expectations.