NONPROFIT OVERHEAD COST PROJECT

FACTS AND PERSPECTIVES BRIEF NO. 3

CENTER ON NONPROFITS AND PHILANTHROPY, URBAN INSTITUTE
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Getting What We Pay For: Low Overhead Limits Nonprofit Effectiveness

Nonprofit organizations feel pressures to conform to expectations to keep overhead expenses down, and thus maximize the proportion of resources that can be devoted to programs. Yet recent years have witnessed a countervailing trend: significant investment in organizational capacity building, including areas properly considered overhead.

These different approaches raise important questions. How adequate are the administrative and fundraising capabilities of nonprofit organizations? How does strength or weakness in these areas relate to the overall effectiveness and efficiency of the organization? And to the extent that weaknesses exist, what appears to be their cause?

To study these issues in depth, we conducted detailed discussions with nine organizations. The organizations ranged in size from under $1 million to over $40 million in annual expenditures. They represented various fields of work, such as health, education, and the arts. This brief highlights three groups of findings relating to organizational effectiveness that emerged from these case studies.

Nonprofits vary widely in the strength of their organizational infrastructure

While some organizations have strong infrastructure, others clearly do not. By *organizational infrastructure* we mean accounting, fundraising, information technology, human resources, physical plant and other common organizational elements that undergird a nonprofit's mission and programs. Some of our sites had very nice facilities, the latest computers and software, and highly experienced and sufficient staffing in supporting functions. At other sites, rain came through the roof during our visit, computers were mismatched hand-me-downs, software was make-do, and key support staff had limited training or experience for their respective roles, or were part-time because this was all the organization could afford.

"Administration and fundraising are important parts of a nonprofit organization's infrastructure. How does strength or weakness in these areas relate to the overall effectiveness and efficiency of the organization? And to the extent that weaknesses exist, what appear to be their cause?"

Inadequate infrastructure compromises organizational effectiveness

The limitations in organizational infrastructure at these latter sites had real consequences for organizational effectiveness. Nonprofits in the arts, community development, and human services described how their development efforts were hindered by inappropriate donor database software. One site described the unproductive downtime and frequent maintenance associated with "free" but mismatched, outdated computers. In agencies where key positions such as development director either did not exist or were filled with inexperienced staff, the CEO had to fill that role, thereby neglecting parts of the leadership role. Sites without experienced finance staff had only rudimentary financial reporting and had limited ability to involve program managers in financial management, perform more sophisticated analysis,

About the Project

The goal of the Nonprofit Fundraising and Administrative Cost Project is to understand how nonprofits raise, spend, measure, and report funds for fundraising and administration, and to work with practitioners, policymakers, and the accounting profession to improve standards and practice in these areas. The overall study has 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.

Exhibit 1: Strong Infrastructure Cases

Organization	Infrastructure investments	Annual cash expenses	Percent restricted funding
Advocacy organization	• Two person finance staff • Blackbaud accounting software • Detailed budgeting and cost tracking • Raiser's Edge fundraising software • Latest computer hardware and software • Comfortable, professional workspace • Cash reserve of one year's expenses	$2.2 million	0%
Health foundation	• Three person finance staff • MIP accounting software • Two person development staff • Raiser's Edge fundraising software • Recently renovated facilities • Latest computer hardware • Routine software upgrades	$5 million	0%
Christian school	• COO plus seven accounting staff, including a CPA • Blackbaud accounting software • Computerized time-tracking for payroll • Detailed budgeting and cost tracking • Two person development staff • Raiser's Edge fundraising software	$9 million	0%

or identify financial issues for board and senior management. Backup for key roles was nonexistent, leaving basic functions like payroll, benefits, and network support dependent on a single person in even the largest nonprofit with which we spoke.

Low, noncompetitive salaries for administrative positions had consequences for effectiveness as well. While sites are sometimes able to find highly qualified people willing and able to work for below-market wages, this is not always possible. Key positions are often filled with junior people with little relevant training or prior experience, or long-term employees that grew up with the organization but lack relevant professional training and credentials. When junior staff gain the requisite experience, they often move on to better paying jobs. In a few cases where sites have found good long-term employees, executives worry they could never replace these staffers at anything like their current salaries.

End-of-useful-life facilities also have consequences. The CEO who grabbed a push broom to sweep out the rain that was coming through the roof during our interview was unable to use that time to think strategically or foster new relationships. Ditto for the CEO who had to scramble to get "new" cast-off furniture when forced to move because the mover refused to accept the liability of moving the old, broken-down furniture they had been using for years.

"Sites without experienced finance staff had only rudimentary financial reporting and had limited ability to involve program managers in financial management, perform more sophisticated analysis, or identify financial issues for board and senior management."

Restricted funding and small size lead to inadequate infrastructure

When we look across our cases, small size combined with restricted funding is a double whammy that appears to almost guarantee inadequate organizational infrastructure. When funders provide restricted funding, they tell the recipient organization what the money can be spent on, and often severely limit the portion that can be spent on overhead. The three cases with the weakest infrastructures all had under $1.2 million in annual expenditures and received approximately half their funding from restricted public sector

Exhibit 2: Weak Infrastructure Cases

Organization	Infrastructure limitations	Annual cash expenses	Percent restricted funding
Food bank	• Administrative director and grantwriter only three days a week • All three non-program staff share single office • Rain came through roof • Low pay; no retirement benefits	$500,000	60%
Literacy agency	• Inexperienced administrative and development directors • Only one copy of Quickbooks • Poor Access-based system for donor tracking • Poor Access-based system for student tracking • Furniture so beat up that mover refused to move it	$400,000	50%
Domestic abuse agency	• "I'm not an accountant, but I play one at work." • No donor analysis • Low salaries • No client tracking	$1 million	50%

sources with limited coverage for overhead costs. The three organizations with the strongest infrastructures were all over $2 million in size and received little or no restricted contributions from any source. One $40 million organization, 80 percent funded by restricted public sector sources, struggled with an infrastructure inadequate for its size; in this case, size alone could not overcome problems inherent in restricted funding.

To deal with the inadequate funding for administration, organizations resort to the strategies of *low pay, make do,* and *do without* that diminish organizational effectiveness.

Implications

These findings have important implications for a variety of stakeholders concerned about the nonprofit sector. Below, we briefly sketch these for donors, charity watchdogs, boards, senior management, funders, finance professionals and policymakers.

For donors and charity watchdogs

Absent good, comparative information about program or mission effectiveness, donors and charity watchdogs often place excessive reliance on financial indicators. Of particular concern to us is the use of overhead cost and fundraising cost ratios as stand-ins for measures of program effectiveness. No organization in our study was an extravagant spender on fundraising or administration. Yet contrary to the popular idea that spending less in these areas is a virtue, our cases suggest that nonprofits that spend too little on infrastructure have more limited effectiveness than those that spend more reasonably. Thus, in addition to the ceilings on these cost ratios that many watchdogs set, floors should perhaps be introduced as well. Although our study does not specify where those floors should be set, it is an issue the sector needs to reflect on and address.

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For boards and senior management

People do not typically seek careers in the nonprofit sector, or take positions on nonprofit boards, primarily because they want to build organizations with strong infrastructures. Rather, people get involved because they are passionate about the mission. However, organizational infrastructure is important for organizational and mission effectiveness. Thus, boards and senior management may wish to institute a review of current organizational infrastructure and explore its consequences for organizational effectiveness. Our case studies suggest that nonprofits with less than $1 million in annual expenditures face infrastructure challenges. Leadership of these organizations may wish to consider alternatives such as growing or merging to a scale where adequate

Exhibit 3: Consequences of Inadequate Organizational Infrastructure

Infrastructure weakness	Consequence
Prior administrative director had no financial training	"This is the first year we've known what the numbers are."
No finance person on staff	Missing invoices and cancelled checks; bookkeeping errors
Inexperienced administrative and development directors	Executive director overly involved in preparing financial reports and grant proposals
Poor Access-based system for donor tracking	No donor analysis; limited ability to target fundraising
Poor Access-based system for student tracking; No client tracking	Inability to provide funders with basic outcome information

infrastructure is affordable, outsourcing infrastructure services, or perhaps even restructuring to a smaller, more volunteer-centered organization where infrastructure issues tend to be less critical.

For finance professionals

As one administrative director told us, "I'm not an accountant, but I play one at work." Non-financial managers and board members may not know what they don't know. Whether the nonprofit is their employer or client, finance professionals are in a unique position to advise boards and senior management regarding the adequacy of the organization's financial management. They can raise awareness of controls, tools, concepts, and methods appropriate to the organization. Public accounting firms may be in a position to provide outsourced accounting services or make a referral. Auditors can use the management letter as a way to bring issues and suggestions to the attention of boards and senior management.

For funders

Among our cases, large grants for program services, whether from the public sector or foundations, tended not to include their fair share of the organization's administrative costs. Organizations that relied on this source of income, particularly small organizations, were less effective as a result. Funders who appreciate the link between the impact they seek and the organizational effectiveness of grantees may wish to reconsider their policies and practices with respect to funding overhead costs on project grants or providing operating support. Private sector funders may wish to consider funding advocacy efforts aimed at changing public sector practices for funding overhead.

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For policymakers

Among our cases, the nonprofits with the weakest organizational infrastructures relied on the public sector for half or more of their revenue, and the public sector practice of providing little support for overhead costs was directly related to the existence of those weaknesses. Policymakers who wish to get more bang for the taxpayer buck may wish to reconsider agency policies that limit overhead or indirect costs to artificially low levels. One option is to pay a share of the organization's overhead costs equal to the grant's percentage of the organization's total expenses.

Further Details

The project's lead researchers are Mark A. Hager, Thomas Pollak, and Kennard Wing (Center on Nonprofits and Philanthropy, Urban Institute) and Patrick M. Rooney (Center on Philanthropy, Indiana University). For more on these and other issues, visit **http://www.coststudy.org** or call (202) 261-5709 (Urban Institute) or (317) 236-4912 (Indiana University).

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