The Nonprofit Overhead Myth — Devil in the Details? A frank discussion of the overhead myth may impact the very survival of nonprofits.

By Eugene Fram

Is it absolutely vital for nonprofits to report low overhead percentages for administration and marketing? Is that the only way to satisfy donors? Or do low percentages do more harm than good? Do they make it difficult for the nonprofit to fulfill its mission? And if businesses can increase their overhead percentages in order to grow and prosper, why isn't this approach appropriate for nonprofits?

These are major questions being discussed in the nonprofit community. However, none of these discussions address several devils in the details:

- **Calculating overhead percentages is partly an accounting art.** While there are accepted accounting guidelines for developing yearly overhead expenditures, the judgment of the accounting firm may come into play. For example, the accountants may recommend either accelerating or decelerating the value of the nonprofit's real estate, which can impact the comparisons of overhead percentage with previous years.

- **Some donors require a single percentage** in order to make a decision about how and where to contribute their money. Large donors, with professional advice, can arrive at complex decisions relating to overhead percentages. But a vast number of small donors want a single guideline before making a donation. An unusually high or low overhead percentage can be a red flag for many small donors, but some nonprofits may need to justify a 30% overhead as being reasonable for what is being accomplished. However, dropping low single standards that have been culturally developed over decades will be difficult. Many small donors have been well educated to using a single guideline. How many donors will give to a charity if they know only 10% of their gift directly benefits the charity's clients and 90% is devoted to administration and marketing?

- **Nonprofits are looking to evaluate qualitative impacts** that are important to their success but aren't directly reflected in accounting statements. It's a significant challenge to measure such items as "community impact." This issue hasn't been part of the discussion of the overhead myth. But it appears nonprofits are ahead of for-profits in assessing qualitative impacts, partly because they're accustomed to using imperfect metrics well (http://bit.ly/OvF4ri).

- **The nonprofit sector has found that using imperfect qualitative data can be useful** in driving progress and tracking change. For business organizations, an article in the *Wall Street Journal* reports, "Companies are increasingly augmenting their financial reports with nontraditional performance benchmarks that aren't defined by U.S. accounting standards, forcing securities regulators to set up efforts to ensure that investors don't get suspect or misleading information" (http://www.financialnewsfocus.com/new-benchmarks-crop-up-in-companies-financial-reports-wall-street-journal/).

- **It may be less quantifiable to measure an organization's outcomes rather than its overhead percentages, but it may also be more relevant.** Brian Mittendorf, an accountant, argues that nonprofits may sacrifice reliability if they measure their impact rather than their overhead, but even he concedes that "accounting-based measures are [only] relatively reliable" (http://nonprofitnewswire.wordpress.com/2013/06/06/want-charities-to-be-evaluated-based-on-impact-be-careful-what-you-wish-for/).

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Having a low overhead percentage has been the key to nonprofit development success for decades. But the idea that low overhead equals high performance is a myth. A low overhead percentage can lead to long-term constraints.

In a "Letter to the Donors of America," three charity regulating agencies — GuideStar, Charity Navigator, and the BBB Wise Giving Alliance — weighed in on the overhead myth, urging donors to pay attention to *all* factors of a nonprofit's performance, not just the overhead percentage. But at the same time, they argue that, at the extremes, the overhead ratio can offer insight and be "a valid data point for rooting out fraud and poor financial management" (http://overheadmyth.com/letter-to-the-donors-of-america/).

That argument, based on the belief that extremely high overhead percentages always indicate mismanagement, is leading to new laws penalizing nonprofits for having high overhead percentages. A stark example is the new Oregon law that takes away tax deductions for nonprofits that devote less than 70% of their funds to programs. Donors to these nonprofits won't be able to take deductions for their gifts (http://www.fark.com/comments/7821500/Oregon-passes-law-to-take-away-charitable-tax-deductions-for-charities-that-devote-less-that-70-of-funds-towards-actual-charity-work).

The nonprofit overhead myth has opened a path for creative discussions. Some of the devils are in the details, like those cited above, and they need to be addressed. Others will surface as some nonprofits move away from the low overhead myth and become high performing nonprofits.

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