

# The Overhead Baby and the Bathwater: A Nonprofit Trustees' Need-to-Know

by John MacIntosh and George Morris

As this article points out, it may not make sense for external parties to use overhead as a primary measure of nonprofit effectiveness, but it's important for nonprofit boards to keep an eye on the ratio. Let's not throw the baby out with the bathwater.

A SUCCESSFUL NONPROFIT MUST BE financially viable, deliver an effective program, and be mission-driven. When thinking of financial viability, trustees should have a clear understanding of the nonprofit's business model, full costs, and overhead structure. Unfortunately, the last of these—overhead—is all too often seen as little more than a necessary evil, to be minimized as much as possible.

We disagree. While critics of the overhead myth rightly point out that an organization's level of overhead doesn't say much about whether its programs are effective, a thorough understanding of overhead *can* suggest whether the programs, effective or not, could be delivered in a more efficient and/or stable way.<sup>1</sup> So trustees should not hesitate to give overhead careful consideration and scrutiny alongside the other important indicators

of efficiency and effectiveness.<sup>2</sup> Trustees serious about overhead should keep in mind some important patterns highlighted by our recent analysis of the overhead of several thousand nonprofits:<sup>3</sup>

- In every sector—from arts and culture to health and human services—nonprofits report a wide range of administrative expenses. *But every sector also shows clear economies of scale*, with larger organizations showing administrative costs that are significantly less (15 to 50 percent lower) than smaller organizations as a percentage of total expenses. (Three-quarters of organizations have administrative expense ratios between 8 and 19 percent.)
- Despite all the attention they get, fundraising expenses represent less than 10 percent of total overhead (the rest are administrative expenses) and

are highly concentrated in a small fraction of organizations. In fact, almost half of the organizations—mostly very small groups or those working in health/human services with approximately 100 percent government funding—report no fundraising expenses at all. (Three-quarters of organizations have fundraising expenses between 2 and 9 percent.)

- While fundraising *ratios* differ considerably by sector and size, fundraising *efficiency*—the amount spent versus the amount raised—varies far less by sector and not at all by size. (Three-quarters of organizations have fundraising efficiency between \$0.09 and \$0.29.)

Does our analysis provide sufficient information for trustees to assess their organization's overhead? Of course not.

In fact, trustees should be very wary of making peer comparisons based only on publicly available information. However, organizations that appear to be well outside the “normal” range (i.e., outside the range of 75 percent of nonprofits of the same size and sector)—should try to understand why. If costs appear low, is this a sign of efficiency, underinvestment, or poor reporting? If costs appear high, is this an inherent feature of the program, a function of organizational structure, or something else? Even if overhead appears to be in the normal range, nonprofits need to make a persuasive argument that the level of expenses is appropriate and should be funded.

In a world where overhead was viewed in the proper context, organizations wouldn’t need an overhead strategy—but in the world we live in, they do. Though nonprofit leaders are working hard to educate donors to place less emphasis on overhead, to mandate that government contracts fully fund the associated indirect expenses, and to encourage foundations to be more generous with overhead-friendly general operating support, these efforts will take time. So, for the foreseeable future, organizations must continue to cobble together a varied portfolio of funding—high indirect-rate contracts, low indirect-rate contracts, restricted grants, and unrestricted general operating funds—to make ends meet.

Strategically, trustees should address two distinct questions regarding overhead:

### 1. Given our organizational boundaries, how can we fund our overhead?

- *Raise more unrestricted funding:* Dollar for dollar, unrestricted funding is by far the most valuable type of funding. It’s also the hardest to raise. To maximize unrestricted support, trustees must give meaningfully to

organizations they govern and encourage others to do the same. Despite this, only 60 percent of nonprofits report 100 percent giving by trustees, and only 26 percent of trustees are directly involved in fundraising from others. Trustees must also recognize that while the supply of total philanthropy is largely fixed, many organizations may be underinvesting in development. At the same time, they must be realistic about what is possible given the nature of the organization (issue area, size, etc.) and accept that any increased investment in development is truly “risk money” that may not pay dividends immediately, if at all. Finally, they should monitor the ratio of private general support relative to government and other restricted funding. A reduction in this ratio over time can lead to much greater risk.

- *Optimize restricted funding:* Funding streams differ in the amount of overhead that can be recovered. Some organizations are better than others at maxing out the recovery. And different organizations can incur very different marginal overhead costs for an identical program, depending on how it fits with the rest of their activities. So, in theory, it should be possible to optimize restricted funding based on a thorough understanding of each contract (or potential contract) and how it fits together with the rest. But, in practice, things are more complicated. Organizations must resist the temptation to chase fat contracts outside their area of expertise. Becoming overreliant on contracts that have been taken on because of the margin may erode the nonprofit’s ability to stay on mission and can become a Gordian knot (i.e., difficult to untangle) if circumstances change.

- *Achieve efficiency through organic growth:* Scale is associated with greater efficiency on average. But many nonprofits (and their trustees) underestimate the risks associated with trying to grow their way out of a funding problem. Increased scale is often accompanied by more managerial complexity. And contracts that don’t cover their fully loaded costs individually are unlikely to do so in aggregate. Furthermore, organizations generally require more private philanthropy (in absolute terms) as they grow, even if they become more efficient and, therefore, require less as a percentage of revenue. Growth may also require increased space to conduct programs. The financial commitments required to rent or own this space will generally be much longer in duration than the guaranteed program income, creating a significant mismatch risk.
- *Achieve efficiency through process redesign:* While scale effects are real, they appear modest compared with the range of performance exhibited by organizations of the same size. So nonprofits concerned about overhead costs but reluctant—or unable—to grow may still be able to increase efficiency by redesigning processes and using technology better. Nonprofits interested in exploring these strategies should work to recruit trustees with significant operating, technology, or business process experience.

### 2. Given our overhead, do we have the right organizational boundaries?

A second approach to more sustainably funding overhead is to explore moving the organization’s boundaries. Sometimes an effective program is embedded within an organization that, for whatever set of reasons, is not structured to deliver it efficiently and/or sustainably.

In this case, the situation might be improved by moving the organizational boundaries through outsourcing, joining a management service organization, sharing space, divesting/spinning off programs, or even merging with another organization. And this type of organizational redesign can sometimes offer the benefits that might come from greater scale, redesigned processes, or optimized funding at a lower risk than trying to achieve these things alone.

In our experience, organizations—particularly those that are “doing just fine”—often take their boundaries for granted and thereby fail to explore these opportunities. Of course, any suggestion that an organization’s boundaries might be moved can raise sensitive issues of mission, culture, board member ego, job security, funder reaction, and so forth. But with thoughtful planning, these issues can usually be worked through. And even if the organization determines not to move its boundaries, the exploration will leave it better aware of its strengths and weaknesses and the environment in which it operates.

• • •

So far, so good. But let’s be honest: few people join nonprofit boards to read spreadsheets or study expense allocations. Compensation and staffing levels are sensitive topics. *Merger* or even *outsourcing* can be dirty words. Analysis can suppress the warm glow that drives giving and service. There are no outside financial analysts, activist shareholders, or markets for corporate control to impose organizational effectiveness and efficiency from the outside. So the commitment to make overhead analysis part of everyday leadership and governance has to come from within. And in a tough environment, organizations unable to do this are likely to find themselves in an increasingly precarious position.

## NOTES

1. Art Taylor, Jacob Harold, and Ken Berger, “The Overhead Myth: Moving Toward an Overhead Solution,” open letter to the Nonprofits of America (GuideStar, BBB Wise Giving Alliance, and Charity Navigator, 2013).
2. For our discussion of related issues, see Dylan Roberts et al., *Risk Management for Nonprofits* (Oliver Wyman/SeaChange Capital Partners, March 2016), [www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/mar/SeaChange-Oliver-Wyman-Risk-Report.pdf](http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2016/mar/SeaChange-Oliver-Wyman-Risk-Report.pdf). See also Ruth McCambridge, “Nonprofit Risk Management Report a Must-Read for Nonprofit Boards and Execs,” *Nonprofit Quarterly*, March 16, 2016, [nonprofitquarterly.org/2016/03/16/nonprofit-risk-management-report-a-must-read-for-nonprofit-boards-and-execs](http://nonprofitquarterly.org/2016/03/16/nonprofit-risk-management-report-a-must-read-for-nonprofit-boards-and-execs).
3. Included in this analysis were 10,754 organizations in the New York Metropolitan Statistical Area—excluding all organizations reporting no administrative expenses (representing 10 percent by count, 1 percent by functional expense). The financial information used was from the 2014 filing year. Source: Amazon Web Services, IRS 990 Public Dataset, [aws.amazon.com/public-data-sets/irs-990/](http://aws.amazon.com/public-data-sets/irs-990/). For the full report, see John MacIntosh, George Morris, and Dylan Roberts, *Understanding Overhead: A Governance Challenge For Nonprofit Trustees* (Oliver Wyman/SeaChange Capital Partners, December 2016), [seachangeap.org/wp-content/uploads/2016/12/Overhead-for-Trustees.pdf](http://seachangeap.org/wp-content/uploads/2016/12/Overhead-for-Trustees.pdf).

**JOHN MACINTOSH** is a partner and board member at SeaChange Capital Partners, a nonprofit merchant bank in New York City. **GEORGE MORRIS** is a New York-based partner with Oliver Wyman, a global leader in management consulting

To comment on this article, write to us at [feedback@npqmag.org](mailto:feedback@npqmag.org). Order reprints from <http://store.nonprofitquarterly.org>, using code 230407.

# NPQ

“NPQ is a  
courageous journal  
in a field  
that will need  
courage.”

—**Jack Shakely**, NPQ reader

Thank you for subscribing  
to NPQ!

We see ourselves as being in deep partnership with you, our readers.

We rely on your feedback, your survey responses, your stories for our editorial content. Subscribers are the lifeblood of our organization *but we also rely on your donations for our financial health*. We keep the cost of our subscriptions low—

we don’t want cost to be a barrier for anyone! But if you can give more—and if you value what NPQ has provided for more than fifteen years—consider joining a growing group of your fellow readers, and go to [www.nonprofitquarterly.org](http://www.nonprofitquarterly.org) to make a donation today.

—**Ruth McCambridge**,  
Editor in Chief