

The Nonprofit Starvation Cycle

A vicious cycle is leaving nonprofits so hungry for decent infrastructure that they can barely function as organizations—let alone serve their beneficiaries. The cycle starts with funders' unrealistic expectations about how much running a nonprofit costs, and results in nonprofits' misrepresenting their costs while skimping on vital systems—acts that feed funders' skewed beliefs. To break the nonprofit starvation cycle, funders must take the lead.

By Ann Goggins Gregory & Don Howard Fall 2009

Organizations that build robust infrastructure—which includes sturdy information technology systems, financial systems, skills training, fundraising processes, and other essential overhead—are more likely to succeed than those that do not. This is not news, and nonprofits are no exception to the rule.

Yet it is also not news that most nonprofits do not spend enough money on overhead. In our consulting work at the Bridgespan Group, we frequently find that our clients agree with the idea of improving infrastructure and augmenting their management capacity, yet they are loath to actually make these changes because they do not want to increase their overhead spending. But underfunding overhead can have disastrous effects, finds the Nonprofit Overhead Cost Study, a five year research project conducted by the Urban Institute's National Center for Charitable Statistics and the Center on Philanthropy at Indiana University. The researchers examined more than 220,000 IRS Form 990s and conducted 1,500 in-depth surveys of organizations with revenues of more than \$100,000. Among their many dismaying findings: nonfunctioning computers, staff members who lacked the training needed for their positions, and, in one instance, furniture so old and beaten down that the movers refused to move it. The effects of such limited overhead investment are felt far beyond the office: nonfunctioning computers cannot track program outcomes and show what is working and what is not; poorly trained staff cannot deliver quality services to beneficiaries.

Despite findings such as these, many nonprofits continue to skimp on overhead. And they plan to cut even more overhead spending to weather the current recession, finds a recent Bridgespan study. Surveying more than 100 executive directors of organizations across the country, we found that 56 percent of respondents planned to reduce overhead spending. Yet decreasing already austere overhead spending (also called *indirect expenses*) may jeopardize organizations' very existence—not to mention their ability to fulfill their missions. And although the Obama administration's stimulus package may

fuel rapid growth among some nonprofits, many will lack the infrastructure to manage the windfall and may well be crushed under the weight of all those well-intended funds.

Why do nonprofits and funders alike continue to shortchange overhead? To answer this question, we studied four national nonprofits that serve youth. Each organization has a mix of funding, including monies from government, foundation, and individual sources. We also interviewed the leaders and managers of a range of nonprofit organizations and funders, as well as synthesized existing research on overhead costs in the nonprofit sector.

Our research reveals that a vicious cycle fuels the persistent underfunding of overhead.¹ The first step in the cycle is **funders' unrealistic expectations about how much it costs to run a nonprofit. At the second step, nonprofits feel pressure to conform to funders' unrealistic expectations. At the third step, nonprofits respond to this pressure in two ways: They spend too little on overhead, and they underreport their expenditures on tax forms and in fundraising materials.** This underspending and underreporting in turn perpetuates funders' unrealistic expectations. Over time, funders expect grantees to do more and more with less and less—a cycle that slowly starves nonprofits.

Although several factors drive the cycle of nonprofit starvation, our research suggests that taking action at the first stage—funders' unrealistic expectations—could be the best way to slow or even stop the cycle. Changing funders' expectations, however, will require a coordinated, sector-wide effort. At a time when people need nonprofit services more than ever and when government is increasingly turning to nonprofits to solve social problems, this effort is necessary to keep nonprofits healthy and functioning.

Funders' Unrealistic Expectations

The nonprofit starvation cycle is the result of deeply ingrained behaviors, with a chicken-and-egg-like quality that makes it hard to determine where the dysfunction really begins. Our sense, however, is that the most useful place to start analyzing this cycle is with funders' unrealistic expectations. **The power dynamics between funders and their grantees make it difficult, if not impossible, for nonprofits to stand up and address the cycle head-on;** the downside to doing so could be catastrophic for the organization, especially if other organizations do not follow suit. Particularly in these tough economic times, an organization that decides—on its own—to buck the trend and report its true overhead costs could risk losing major funding. The organization's reputation could also suffer. Resetting funder expectations would help pave the way for honest discussions with grantees.

Many funders know that nonprofit organizations report artificially low overhead figures, and that the donor literature often reflects grossly inaccurate program ratios (the proportion of program-related expenses to indirect expenses). Without accurate data, funders do not know what overhead rates *should be*. Although for-profit analogies are not perfect for nonprofits, they do provide some context for thinking about how realistic—or

not—average overhead rates in the nonprofit sector are. **Overhead rates across for-profit industries vary, with the average rate falling around 25 percent of total expenses. And among service industries— a closer analog to nonprofits—none report average overhead rates below 20 percent.**

In the absence of clear, accurate data, funders must rely on the numbers their grantees report. But as we will later discuss, these data are riddled with errors. As a result, **funders routinely require nonprofits to spend unhealthily small amounts on overhead.** For instance, all four of the youth service organizations that we studied were managing government contracts from local, state, and federal sources, and none of the contracts allowed grantees to use more than 15 percent of the grant for indirect expenses (which include operations, finances, human resources, and fundraising).

Some foundations allot more money for indirect costs than do government agencies. Yet foundations are quite variable in their indirect cost allowances, with the average ranging from 10 percent to 15 percent of each grant. These rates hold true even for some of the largest, most influential U.S. foundations. And foundations can be just as rigid with their indirect cost policies as government funders.

Many times, the indirect allowances that grants do fund don't even cover the costs of administering the grants themselves. For example, when one Bridgespan client added up the hours that staff members spent on reporting requirements for a particular government grant, the organization found that it was spending about 31 percent of the value of the grant on its administration. Yet the funder had specified that the nonprofit spend only 13 percent of the grant on indirect costs.

Most funders are aware that their indirect cost rates are indeed too low, finds a recent Grantmakers for Effective Organizations (GEO) study. In this national survey of 820 grantmaking foundations, only 20 percent of the respondents said that their grants include enough overhead allocation to cover the time that grantees spend on reporting.²

Individual donors' expectations are also skewed. A 2001 survey conducted by the Better Business Bureau's Wise Giving Alliance found that more than half of American adults felt that nonprofit organizations should have overhead rates of 20 percent or less, and nearly four out of five felt that overhead spending should be held at less than 30 percent. In fact, those surveyed ranked overhead ratio and financial transparency to be more important attributes in determining their willingness to give to an organization than the success of the organization's programs.

Not only do funders and donors have unrealistic expectations, but the nonprofit sector itself also promotes unhealthy overhead levels. "The 20 percent norm is perpetuated by funders, individuals, and nonprofits themselves," says the CFO of one of the organizations we studied. "When we benchmarked our reported financials, we looked at others, [and] we realized that others misreport as well. One of our peer organizations allocates 70 percent of its finance director's time to programs. That's preposterous!"

In this context, nonprofits are reluctant to break ranks and be honest in their fundraising literature, even if they know that they are fueling unrealistic expectations. They find it difficult to justify spending on infrastructure when nonprofits commonly tout their low overhead costs. For example, Smile Train, an organization that treats children born with cleft lip and palate conditions, has claimed that “100 percent of your donation will go toward programs . . . zero percent goes to overhead.” Nevertheless, the fine print goes on to say that this is not because the organization has no overhead; rather, it is because Smile Train uses contributions from “founding supporters” to cover its nonprogram costs.

This constellation of causes feeds the second stage in the nonprofit starvation cycle: pressure on nonprofits to conform to unrealistic expectations. This pressure comes from a variety of sources, finds the Nonprofit Overhead Cost Study. The survey found that 36 percent of respondents felt pressure from government agencies, 30 percent felt pressure from donors, and 24 percent felt pressure from foundations.³

Underfed Overhead

In response to pressure from funders, nonprofits settle into a “low pay, make do, and do without” culture, as the Nonprofit Overhead Cost Study calls it. Every aspect of an organization feels the pinch of this culture. In our consulting work with nonprofits, for example, we often see clients who are unable to pay competitive salaries for qualified specialists, and so instead make do with hires who lack the necessary experience or expertise. Similarly, many organizations that limit their investment in staff training find it difficult to develop a strong pipeline of senior leaders.

These deficits can be especially damaging to youth-serving organizations, notes Ben Paul, president and CEO of After-School All-Stars, a Los Angeles-based nonprofit organization that provides after-school and summer camp programs for at-risk youth nationwide. “It is clear to anyone who has led an organization that the most important capital in a company is the human capital,” says Paul. “In after-school we have a saying: Kids come for the program, but stay for the staff. If we don’t hire the right people, we might as well not run after-school programs.”

Meanwhile, without strong tracking systems, nonprofits have a hard time diagnosing which actions truly drive their desired outcomes. “The catch-22 is that, while organizations need capacity-building funding in order to invest in solid performance tracking, many funders want to see strong program outcome data *before* they will provide such general operating support,” says Jamie McAuliffe, a portfolio manager at the New York-based Edna McConnell Clark Foundation.

Take the case of a well-respected network of youth development programs. To protect the identity of this organization, we will call it the Learning Goes On Network (LGON). Poised for a huge growth spurt, LGON realized that its data systems would be hopelessly inadequate to accommodate more clients. An analysis showed that program staff spent 25 percent of their time collecting data manually. One staff member spent 50 percent of her time typing results into an antiquated Microsoft Access database.

Staff members can become so accustomed to their strained circumstances that they have trouble justifying even much-needed investments in overhead, our interviews revealed. “We [had] known for a long time that a COO was vital to our growth but [hadn’t] been able to fund one,” relates the CEO of one of the four youth development organizations that we studied. But when his organization’s board finally created the COO position, the rest of the staff resisted. “They had lived so long in a starved organization that the idea of hiring a COO was shocking to them.”

Misleading Reporting

The final driver of the cycle that starves nonprofit infrastructure is **nonprofits’ routine misrepresentation of how much they actually spend on overhead**. The numbers that nonprofits report on their financial statements “[defy] plausibility,” finds the Nonprofit Overhead Cost Study. Upon examination of more than 220,000 nonprofit organizations, researchers found that more than a third of the organizations reported no fundraising costs whatsoever, while one in eight reported no management and general expenses. Further scrutiny found that 75 percent to 85 percent of these organizations were incorrectly reporting the costs associated with grants.

Our study of the four youth-serving nonprofits likewise reported discrepancies between what nonprofits spent on overhead and what they reported spending. Although they reported overhead rates ranging from 13 percent to 22 percent, their actual overhead rates ranged from 17 percent to 35 percent.

Many factors support this underreporting of nonprofit costs. According to a survey conducted by *The Chronicle of Philanthropy* in 2000, a majority of nonprofits say that their accountants advised them to report zero in the fundraising section of Form 990.⁴ Limited surveillance of nonprofits’ Form 990 tax reports only exacerbates the problem: The IRS rarely levies the \$50,000 penalty for an incomplete or inaccurate return, and generally applies it only when an organization deliberately fails to file the form altogether. According to the *Chronicle* study, “Improperly reporting these expenses is likely to have few, if any, consequences.”

The IRS’ ambiguous instructions likewise lead to error, report several sources. For example, nowhere does the IRS explicitly address how to account for nonprofit marketing and communications. As a result, many organizations allocate all marketing and communications expenses to programs when, in most cases, these expenses should be reported as administrative or fundraising overhead.

Government agencies likewise have varying and ambiguous definitions of indirect costs. The White House Office of Management and Budget, for example, defines indirect costs as “those that have been incurred for common or joint objectives and cannot be readily identified with a particular final cost objective.” It then goes on to say that “because of the diverse characteristics and accounting practices of nonprofit organizations, it is not possible to specify the types of cost that may be classified as indirect cost in all situations.”⁵

There is some good news. Currently, the U.S. Government Accountability Office (GAO) is conducting a study of various federal grantors' definitions of indirect costs. As Stan Czerwinski, the director of strategic issues for GAO, explains, "The goal is to achieve consistency, so that when nonprofits go in for funding, they have clarity (as do funders) about what they're actually going to get reimbursed for." The study is in the early stages, but as Czerwinski notes, the need is clear: "We don't find anybody telling us that we're barking up the wrong tree."

Proper Care and Feeding

Although the vicious cycle of nonprofit starvation has many entry points and drivers, we believe that **the best place to end it is where it starts: Funders' unrealistic expectations.** Foundations and government funders must take the lead because they have an enormous power advantage over their grantees. When funders change their expectations, nonprofits will feel less need to underreport their overhead. They will also feel empowered to invest in infrastructure.

The first step that funders should take is to shift their focus from costs to outcomes. In the nonprofit world, organizations are so diverse that they do not share a common indicator of program effectiveness. In the absence of this indicator, many funders try to understand an organization's efficiency by monitoring overhead and other easily obtained yet faulty indicators. Funders need to refocus their attention on impact by asking "What are we trying to achieve?" and "What would define success?" In so doing, they will signal to their grantees that impact matters more than anything else. Even focusing on approximate or crude indicators (for example, "Are we getting an A or a C on our impact goals?") is better than looking at cost efficiencies, as focusing on the latter may lead to narrow decisions that undermine program results.

Funders must also clearly communicate their program goals to their grantees. Having established that funder and grantee share the same goals, funders should then insist on honest answers to the question "What will it take to deliver these outcomes consistently, or to deliver these outcomes at an even higher level of quality or quantity?"

One of our study participants, for instance, worked closely with its major funder to think through this question, and ultimately determined it needed a sizable investment in technology to support its projected growth. The funder agreed that only by making such an investment would the organization be able to track outcomes uniformly and to make program improvements quickly.

When feasible, funders should help meet grantees' identified infrastructure needs by making general operating support grants. Grantmakers and nonprofits agree that more operating support is very likely to improve an organization's ability to achieve results, finds the 2008 Grantmakers for Effective Organizations study. And a 2006 CompassPoint Nonprofit Services study of nearly 2,000 nonprofit executives in eight metropolitan areas reveals that receiving general operating support played a major role in reducing burnout and stress among executive directors.⁶ Yet although 80 percent of the foundations in this

study made some general operating grants, they dedicated a median of only 20 percent of their grant dollars to this kind of support.

Regardless of the type of support they provide, funders should encourage open, candid discussions with their grantees about what the latter need to be effective. Many funders' grantmaking processes are not set up to consider the full scope of what grantees do, and why. As a result, their grants are not as flexible as they need to be. Yet when funders fully understand their grantees' operations, they are more likely to meet their grantees' needs.

Although changing their expectations will have the greatest impact on the nonprofit starvation cycle, funders can also intervene in other useful ways. When making use-restricted grants, funders should commit to paying a greater share of administrative and fundraising costs. Indeed, in 2004, the board of the Independent Sector encouraged funders to pay "the fair proportion of administrative and fundraising costs necessary to manage and sustain whatever is required by the organization to run that particular project."

Likewise, **rather than prescribing an indirect expense rate for all grants, government funders should allow nonprofits to define their true overhead needs in grant applications and, so long as these needs are justifiable, pay for them.** For example, some federal funding contracts allow a nonprofit to justify an indirect cost rate (within guidelines), which the organization can then use for all its federal grant applications. Extending such a policy to all federal, state, and local government contracts would go a long way toward helping nonprofits deliver better programs while being able to pay for their grants' management.

Finally, to foster transparent and accurate reporting, funders should encourage the development of a standard definition of the term *overhead*. Currently, organizations have to report their overhead differently for nearly every grant that they receive. Standardization would allow funders to compare apples with apples, as well as allow grantees to understand better their own overhead investments—or lack thereof. Having a dialogue about real overhead rates could also help shift the focus to the real target: outcomes.

What Grantees Can Do

The burden of breaking the cycle of nonprofit starvation does not rest solely with funders. Nonprofit leaders also play a role. As a baseline task, they should commit to understanding their real overhead costs and their real infrastructure needs. At LGON, for instance, senior managers spent several months digging into their costs, analyzing their current systems—including the organization's subpar tracking process—and identifying gaps in capacity. After this strategic planning process, the organization could articulate a clear plan for a new tracking system and a 150 percent increase in nonprogram staff over three years.

Nonprofits must then speak truth to power, sharing their real numbers with their boards and then engaging their boards' support in communicating with funders. Case studies of organizations that have successfully invested in their own infrastructure have repeatedly noted the need for a shared agenda between the leadership team and the board. The executive director of LGON, for example, communicated early and often with her board members throughout the strategic planning process. She also facilitated several meetings to address infrastructure needs.

For their part, board members should ask the tough questions before funders do, namely: "What does this organization really need to succeed?" "Where are we underinvesting?" and "What are the risks we're taking by underinvesting in these areas?" Board members should encourage nonprofit leaders to develop strategies that explicitly recognize infrastructure needs. In developing plans for infrastructure, board members can help, notes Chris Brahm, chairman of the board of directors at Larkin Street Youth Services, a San Francisco nonprofit that serves homeless and runaway youth: "The people running agencies are often consumed with programs and raising money. Board members, whether businesspeople or otherwise, can bring external perspective on overhead services."

At LGON, for example, the executive director identified a handful of board members who were fervent supporters of the emerging strategic vision. These board members then communicated to their colleagues how much overhead this vision would require.

During these discussions, both board members and managers should focus on how investments in infrastructure will benefit the organization's beneficiaries, rather than reduce costs. Even within the confines of a "cost conversation," they should emphasize how infrastructure investments may actually reduce the costs of serving beneficiaries over time. One organization in our study, for instance, determined that an investment in technological infrastructure yielded \$350,000 per year by freeing up staff time and consolidating "scrappy" systems.

Finally, **organizations must attempt to educate their donors.** "Donors don't want to pay for an organization's rent, or phone bill, or stamps," notes Paul, "but those are essential components of everyday work. You can't run a high-performing organization from your car. And there are many ways to explain these types of expenses to donors."

Both funders and grantees are feeling the sting of the current recession. But this economic downturn is no excuse to cut overhead funding. "If a nonprofit's leaders are feeling as if they cannot raise money to support overhead, I think they're confusing the issue," says Brahm. "The real issue is that they can't raise enough money, period. Either they do not have, or they have not been able to communicate, a results story that is compelling to funders."

Rather than being the reason to reduce overhead spending, the recession is an excellent opportunity to redress decades-long underinvestment in nonprofit infrastructure. "There is real potential for change if all of the major stakeholders—government, private funders, and the nonprofits themselves—take steps to acknowledge that capacity building is

critical to the health of an organization,” says McAuliffe. And although the forces that fuel the nonprofit starvation cycle are strong, the opportunity to achieve more for beneficiaries in the long term should compel funders and grantees alike to stop the cycle.

Former Bridgespan Group manager William Bedsworth contributed to this article.