NONPROFITS: FUNDRAISING & DEVELOPMENT

Year-End Donor Queries and the Overhead Myth

12.08.16 | Linda J. Rosenthal, JD

In December 2014, we posted "Uh Oh. It's the End of the Year and We Have Money Left Over!" The point, of course, was that many nonprofits mistakenly believe they have to spend down every last penny by year's end in order to maintain their status.

We clarified that the term "nonprofit … usually means the type of organization that has successfully jumped through the proper state and federal hoops to receive the most favored, section 501(c)(3), tax-exempt status: the one that lets you off the hook for regular income taxes and makes you eligible for grants and tax-deductible contributions." But having that coveted classification doesn't mean that — by one minute before New Year's Eve — you have to spend every last cent that you've taken in.

Even though it's not created for a profit-making purpose, "[a] nonprofit *can* make a profit" along the way to fund its good works. Having the good fortune to collect more in donations than is needed in a particular year to cover expenses is ok."

The next December (2015), we reminded you that, in the rush to snag donations before the December 31st deadline, you are likely to be asked some pointed questions by your prospective donors. "Don't be surprised if some of them ask you for … details, numbers, program specifics, who is on your board, what's in your 5-year strategic plan, how much your CEO is paid, and – well, you get the idea."

Among the questions you will likely field are ones about how the proposed donation will be spent, including: (1) What are the specific purposes or programs for which your gift will be used, and (2) how much of the donation will be spent on these programs."

We cautioned that "many donors believe, incorrectly, that a high percentage of solicited funds must

be paid out directly for program activities and not for overhead." That's called the "Overhead Myth," – which takes us to this year's end-of-year topic.

What is the Overhead Myth?

Back in 2009, authors Ann Goggins Gregory and Don Howard published a landmark article in the Stanford Social Innovation Review. The title says it all: The Nonprofit Starvation Cycle. The premise was a forceful articulation of the reality that it takes money to achieve charitable purposes, and that nonprofits are correct to spend enough in overhead, including salaries, so they are not constantly in dire financial straits.

In March 2013, activist and fundraiser Dan Pallotta railed against the demonization of overhead in a " lively and irreverent" TED talk he called "The way we think about charity is dead wrong." Millions of people have listened to that address in which Pallotta –

> *calls out the double standard that drives our broken relationship to charities. Too many nonprofits, he says, are rewarded for how little they spend — not for what they get done. Instead of equating frugality with morality, he asks us to start rewarding charities for their big goals and big accomplishments (even if that comes with big expenses). In this bold talk, he says: Let's change the way we think about changing the world.*

In the June 27, 2013, edition of The Nonprofit Quarterly, the editors published a seminal letter, The Overhead Myth (June 17, 2013) from GuideStar, Charity Navigator and the Wise Giving Alliance "calling for an end to the obsession many have had with nonprofit overhead costs as a proxy for measuring effectiveness…" It was addressed to the "Donors of America," and began: "We write to correct a misconception about what matters when deciding which charity to support."

> *The percent of charity expenses that go to administrative and fundraising costs—commonly referred to as "overhead"—is a poor measure of a charity's performance.*
> *We ask you to pay attention to other factors of nonprofit performance: transparency, governance, leadership, and results….*
> ***
> *That is not to say that overhead has no role in ensuring charity accountability. At the extremes the overhead ratio can offer insight: it can be a valid data point for rooting out fraud and poor financial management. In most cases, however, focusing on overhead without considering other critical dimensions of a charity's financial and organizational performance does more damage than good.*
> *In fact, many charities should spend more on overhead. Overhead costs include important investments charities make to improve their work: investments in training, planning, evaluation, and internal systems—as well as their efforts to raise money so they can operate their programs. These expenses allow a charity to sustain itself (the way a family has to pay the electric bill) or to improve itself (the way a family might invest in college tuition).*
> *When we focus solely or predominantly on overhead, we can create what the Stanford Social Innovation Review has called "The Nonprofit Starvation Cycle." We starve charities of the freedom they need to best serve the people and communities they are trying to serve.*
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> *So when you are making your charitable giving decisions, please consider the whole picture. The people and communities served by charities don't need low overhead, they need high performance.*

The Nonprofit Quarterly editors added their own thoughts:

> *In an historic letter released today, GuideStar, Charity Navigator, and the BBB Wise Giving Alliance have joined forces to caution against overemphasis of the overhead ratio when judging a nonprofit's quality or worthiness as a grantee. The use of overhead ratios to judge nonprofits has probably intensified in recent years as information on nonprofit budgets has become increasingly accessible through organizations like these. One or two of them may even have encouraged that emphasis. But the use of overhead as a primary proxy has always been intensely flawed and has brought unfortunate consequences ….*

The Nonprofit Quarterly editorial staff concluded: "It is critically important that this letter is seen and interpreted as a clarion call to donors to look for more robust, more revealing measures of nonprofit quality. The next step would be for their overhead myths letter to be incorporated into the grantmaking behavior of institutional grantmakers, whose decisions shape aspects of public policy toward nonprofits."

Conclusion

Since then, a great deal has been written on, and discussed about, this provocative topic. It remains an important and sometimes controversial topic within the philanthropy community.

For some additional reading, especially if you're new to this topic, try Guidestar's The Overhead Myth: FAQs and the recent blog post from the always irreverent Nonprofit with Balls: "How to deal with uninformed nonprofit-watchdogs around the holidays."