The Overhead Myth: What Impact Really Costs

by Amie Miller, Greater Public foundation support advisor

Nonprofits – and funders – want their work to have impact. We talk a lot about how to measure impact, but a related question is equally important: What does impact cost?

It’s an essential question. What are the real costs involved in building, implementing and sustaining effective organizations and programs?

One method that has been used to assess nonprofit effectiveness is the “overhead ratio” – the percentage of an organization’s total expenses that is devoted to administrative and fundraising costs as opposed to program costs. Unfortunately, this proxy for effectiveness has led to what has been called the “nonprofit starvation cycle,” where nonprofits attempt to operate with ever-lower overhead costs – often grossly under-investing in their own infrastructure and significantly underreporting their true overhead costs.

Increasingly, both funders and nonprofits are recognizing that the idea that low overhead equals high effectiveness is a myth. And the truth is, there’s not just one overhead myth; there are several.

**Overhead Myth #1: There’s a definition of “overhead.”**

Weirdly, there really isn’t. Different organizations (both nonprofits and funders) include various kinds of costs under the heading of “overhead.” The IRS Form 990 asks nonprofits to divide all of their costs into three expense categories:

1. Program Service expenses
2. Management & General expenses
3. Fundraising expenses.

But exactly what these categories should include is not clear. “I think part of the problem is that everyone has a different understanding of overhead,” says Heather Peeler, vice president of member and partner engagement at Grantmakers for Effective Organizations. “Even grantmakers don’t really understand it.”

As a result, many nonprofits do not invest in – or even include in their budgets – the full costs of implementing their work or of building their capacity, and many funders do not push the issue. As Peeler adds, “One grantmaker’s definition of capacity-building is another’s definition of overhead. Grantmakers for Effective Organizations thinks that you can’t have effective programs in weak organizations. If you want strong results, you have to invest in the whole organization.”

**Overhead Myth #2: Overhead costs are not program costs.**
The lack of clarity around overhead costs is mirrored in a lack of clarity around program costs. “There is no definition for what is allowed in a program budget or not. So each organization does it differently,” says Unmi Song, president of the Lloyd A. Fry Foundation. Song argues that costs like rent, utilities, and technology are essential to running programs and should, therefore, be allocated across program budgets. Unfortunately, she notes, “Staff training, administrative support, a strong accounting office, a strong budgeting process, and up-to-date technology sometimes fall out of the program budgets. Training is generally specifically for a program. Evaluation, I believe, should be allocated toward program. A lot of nonprofits would really benefit from understanding that those are costs that definitely belong in project budgets.”

**Overhead Myth #3: You can’t talk to foundations about overhead.**

Many nonprofits are reluctant to talk directly with foundations about overhead, perhaps out of concern that overhead expenses make them look like ineffective stewards of resources. While it is true that some foundations put a cap on the amount of overhead they will fund, there is evidence that many grantmakers are willing to discuss overhead costs. A 2014 survey by Grantmakers for Effective Organizations found that:

- 77% of foundation respondents actively support capacity-building activities.
- 53% said they would be open to allowing a “significant proportion” of project grants to cover indirect costs “if it was justified.”
- 62% said they make decisions about how much overhead to allow on a case-by-case basis.
- Only one-quarter had a written policy about support for indirect costs.

“I think that for nonprofits, the door is open in terms of negotiating and putting [overhead] on the table,” says Peeler. “Ultimately it’s a matter of sitting down with the funder and talking about your vision for your organization, what you want to achieve, and what it will take to get there. Make that part of the case and believe that you’re worthy of investment. The worst a funder will say is no. Why say it for them?”

**Overhead Myth #4: Overhead takes away from impact.**

Bottom line, donors want to fund impact. And if they’re honest, both nonprofits and funders know that organizations that operate on duct tape and shoestrings are generally not effective at achieving their goals.

As Unmi Song points out, the Fry Foundation has found that the grantees with the best outcomes – the strongest impact – are the very ones that:

- Provide quality training to their staff.
- Actively research evidence-based practice.
- Have the most rigorous monitoring and assessment programs.
The Fry Foundation views these activities as essential to strong and effective programming and wants to see them included in program budgets. Other funders see them as overhead. But the bottom line is that they are central to driving impact.

So, why not just cover all overhead costs with general support? In fact, Grantmakers for Effective Organizations encourages foundations to give more general operating grants – and their research indicates that foundations are increasing this giving, if relatively slowly. But general support has a couple of potential problems:

1. Many funders want more accountability around outcomes than general support grants typically offer; and
2. Many nonprofits themselves recognize that they would have difficulty investing general support in infrastructure and capacity-building instead of expanded programming.

To meet the needs of both funders and grantees, some foundations have sought out a kind of middle ground. The John R. Oishei Foundation, for example, developed a category of grantmaking that it calls Core Operations Improvement Grants. Executive vice president Paul Hogan acknowledges that donors have a “wholly understandable” desire to see a direct line between the money they give and the services delivered. But as a former nonprofit executive himself, he also acknowledges that this desire for impact often pressures nonprofits to expand their programming, whether or not they are really equipped to do so. The Oishei Foundation’s Core Operations Improvement grants are specifically aimed at “strengthening the internal operations of organizations that help to better fulfill their missions.” The goal is to build grantees’ competence as a precursor to expanding their program capacity. Importantly, these grants are explicitly “time-limited, outcome-oriented and evaluable,” giving the foundation the level of accountability it needs.

The Bottom Line

It’s critical for nonprofits and foundations to find ways to speak as honestly as possible with each other about what it really costs to for the organization to do its work. Hogan says, “This is about going to a funder and saying, ‘I know you want to serve 10,000 more people. If I try to do that, the programming I do will not be nearly as good as if I professionalize my staff, bring our IT up to date, and so on -- first. Then I will be able to go and serve more people – and maybe at that point I might even be able to do it without your money.’ Most funders will hear that.”

Hogan adds, “The idea of overhead is still a raging debate, but it should not be. . . Nonprofit organizations need that money to operate. That’s the end of the conversation. The better that nonprofits get at telling what they do with that money, the more philanthropy will come along.”

Read more: The CFO’s Overhead Dilemma

Originally published in Greater Public’s February Edge Newsletter. Reprinted with permission.