The Great Debate
For years, nonprofit professionals have complained about having their hands tied by funders and donors who believe that low overhead is the primary measure of organizational effectiveness. The notion that organizations should accomplish great things with little investment in administration and fundraising has been pervasive in the sector, causing what has been called a “nonprofit starvation cycle.” Fortunately, this may be changing as “the overhead conversation” gains traction and public awareness. Although charity monitoring and rating services, the so-called “watchdogs,” and nonprofit pundits agree that overhead should not be the only arbiter of an organization’s financial health, they disagree on how much, or even whether, it should be used. And they have different views on exactly what should replace it. The discussion is definitely still a work in progress, but it is a step in the right direction for the sector.

When the presidents of GuideStar (www.guidestar.org), BBB Wise Giving Alliance (www.bbb.org/us/charity) and Charity Navigator (www.charitynavigator.org) wrote The Overhead Myth, an open letter to the donors of America, they wanted to encourage donors to look at the big picture of organizational performance. They wanted to help charitable organizations educate their supporters about the importance of investing in overhead while also considering such criteria as transparency, governance, results and impact.

“I was new at GuideStar, and this was something I had been thinking would be a good idea,” says President and CEO Jacob Harold. “We decided we needed something more formal for nonprofits to use with their donors, and we were all deeply involved in the wording of the letter. A single letter won’t transform the conversation, and change won’t be instantaneous, but you can retrain people to think differently.”

A good place to start is the Form 990.

The Ratio and the 990
Anyone can look at an organization’s IRS Form 990 and determine how much is spent on overhead by adding the administrative costs and fundraising costs and then dividing that number by total expenses. The overhead ratio has long been the standard by which people judge a charity’s effectiveness. However, relying solely on that or any other ratio does not paint the complete picture.

“Overhead shouldn’t be the primary metric. It’s a poor measure of a charity’s performance if it’s the only thing you look at,” says Ken Berger, president and CEO of Charity Navigator in Glen Rock, N.J. “You have to look at finance, governance and results. And if you don’t manage finances and governance, you won’t have results.”

While the overhead ratio may be helpful in identifying cases of fraud, it is also open to interpretation and misunderstanding. “I don’t think overhead ratios have anything to do with effectiveness, except at the margins,” says Art Taylor, president and CEO of BBB Wise Giving Alliance in Arlington, Va. “If someone’s spending only 9 cents on the dollar on programming, that’s an indication that something probably isn’t going well at the organization,” he says. “But, spending 65 percent on programming doesn’t necessarily mean you’re being efficient. Being within that guideline isn’t an indicator of efficiency, but being way outside that guideline is a red flag that probably means there’s room for improvement. The ratio is a tool for identifying where there may be problems.”

The flip side of the overhead ratio debate is embraced by individuals including Dan Pallotta, author, activist and president of the Charity Defense Council (http://charitydefensecouncil.org) in Cambridge, Mass. “I don’t see any value in the overhead ratio as a measure,” he emphasizes. “You’re not taking into account the urgency of the issue. All important subtlety gets pushed aside.”

In his March 2013 TED talk, Pallotta captured the sector’s attention when he recommended that donors focus on a charity’s dreams and progress rather than getting stuck on overhead numbers. “We’ve all been taught that charities should spend as little as possible on overhead things like fundraising, under the theory that the less money you spend on fundraising, the more
money there’s available for the cause,” he explains. “Well, that’s true if it’s a depressing world in which the pie cannot be made any bigger. But if it’s a logical world, in which investment in fundraising actually raises more funds and makes the pie bigger, then we have it precisely backwards. We should be investing more money, not less, in fundraising because fundraising is the one thing that has the potential to multiply the amount of money available for the cause.”

Although a complete meeting of the minds does not appear to be in the offing, there is one point of agreement: Looking only at the overhead ratio is not a reliable way to determine charity effectiveness. And that means the sector has to get donors to embrace an alternative. “At least a billion pieces of mail go out displaying that ratio, and we have trained donors to think it matters,” Harold says. “We can’t direct donors toward other information unless the nonprofits provide it.”

Rather than preaching about how little money an organization invests in its own infrastructure, there is general agreement that nonprofits need to help their donors make the shift from focusing on a ratio to the information they can glean from assessments of goals, effectiveness and impact. That is more easily said than done, however. Charities do not have a great track record of assessing their performance and communicating the results, and donors do not change their minds overnight.

So what should charity executives and development officers consider when trying to redirect the conversation with their stakeholders? There are several factors.

**Education**

It all starts with basic education. No bells, no whistles, just a concerted effort to communicate a clear and consistent explanation. Pallotta urges nonprofit professionals to adopt a strategic and proactive approach to educating all potential supporters about the importance of funding administrative and fundraising costs.

“There is no silver bullet. You have to get ahead of the curve,” he says. “Sometimes, you have to listen to a song 15 or 16 times before you know what it’s about. Hearing the TED talk once isn’t going to do it. It takes time. Nonprofits have to educate their boards and donors methodically, strategically and ongoingly.”

Pallotta also urges nonprofits to adopt a strength-in-numbers approach to educating the funders in their own communities. “Organizations need to band together,” he says. “If you’re in Madison, Wis., convene all the nonprofits in Madison, and go en masse to visit all the local funders and tell them!”

**Metrics**

The watchdog CEOs intended the June 2013 *Overhead Myth* letter to be something charities could use to educate their donors about the dangers of underinvesting in overhead. However, along with that message, charities must measure and report on their achievements in order to demonstrate that they are worthy of support. According to Charity Navigator’s Berger, this measurement is not happening on a regular basis in much of the sector. At the same time, most donors have not yet gotten the message about overhead.

“Most nonprofits aren’t doing this because they’re strapped for cash,” Berger says. “To build performance management and measurement systems costs money, and funders won’t pay for it. It’s a very significant challenge, but it’s not a valid excuse. Be creative with your budgeting. You’ve got to advocate for this. Funders are asking for outcomes, and we’re drowning in largely meaningless data.”

Robert Egger, founder and president of L.A. Kitchen ([http://lakitchen.org](http://lakitchen.org)), says he, like many nonprofit executives, did not know how to measure impact earlier in his career. He references his experience running the DC Central Kitchen ([www.dccentralkitchen.org](http://www.dccentralkitchen.org)) in Washington, D.C., which included a culinary training program.

“Most people would say, ‘We graduated this number of people, and their scores on the culinary exam were this, and their starting wages were this,’” Egger explains. “That’s fine, but those are low barrier metrics. It wasn’t until I was years into the DC Central Kitchen that I was able to say, ‘We’re following our graduates, and we know how much they earn annually, and we know how much they’re paying in payroll taxes.’ That was gold for us. You have to find the nuggets of gold.”

Egger emphasizes the importance of economic impact, such as measuring the success of a water program by citing the decrease in deaths due to cholera, rather than simply talking about the number of wells dug and gallons produced. He also recommends that charity executives ask young staff members for their ideas. “They have fresh
eyes. Ask them if there are new ways you can measure what you do,” he advises. “Listen to them, and don’t be afraid to use Facebook and Twitter to get ideas. We used to use a pity-based image and low administrative costs to make our case. We have to reframe the things we do.”

Story
That reframing involves being able to marry a compelling story with compelling quantitative analysis about impact and effectiveness. Harold compares it to buying a book on Amazon.com, where customers have access to price information, publisher rankings and reader reviews. “Consumers are getting used to multidimensional information when making a purchase, so there’s no reason to think they won’t want multidimensional information when making a gift,” he points out. “For a homeless shelter, donors might be interested in what the homeless have to say. For an environmental cause, they might care about what the environmental experts say. For an art museum, they might want to know what curators say. It’s the responsibility of fundraisers to tell the story about social good. My call to action is for nonprofits to be systematic about including all different kinds of information when they tell their story.”

Rikki Abzug, professor of management at the Anisfield School of Business at Ramapo College of New Jersey in Mahway, N.J., is concerned with the ranks, scores and grades that are applied to nonprofits across the board, regardless of a charity’s age and subsector. Although she and her colleague, Natalie J. Webb, associate professor of economics at the Defense Resources Management Institute at the Naval Postgraduate School in Monterey, Calif., are not focusing their research on overhead specifically, they are studying what it means for a nonprofit to be financially viable. “There shouldn’t be one set of metrics for all subsectors,” she says.

Abzug and Webb found, by comparing five nonprofit subsectors to the total sector, that “there were statistically significant variations in measures of average financial health across three indicators: fundraising efficiency ratios, working capital and years of assets. Studies using nonprofit financial data that do not make distinctions by subsector run the risk of overgeneralizing and missing important subsector distinctions.”

Abzug says that because different types of nonprofits have different ways of measuring effectiveness, they should be compared with other organizations in their subsector, i.e., museums with museums, food programs with food programs, etc. She feels that a multipronged approach to successfully address this issue should include updating the textbooks that are being used to teach the next generation of nonprofit managers and encouraging charity rating services, foundations and government officials to take a more nuanced approach.

“If the watchdogs have to give out scorecards, do it by subsector. It would be helpful if they were saying, ‘Here’s the health profile for food pantries, and here’s what we like to see in arts organizations.’ In government, anyone who calls a hearing needs to be aware that different subsectors require different standards. And foundations could do two things: avoid evaluating their own grantees based on simple sector-wide ratios and perhaps provide grant money to help educate grantees, the sector and the public about the dangers of reducing nonprofit effectiveness to ratio analyses. You can’t just say a nonprofit is healthy financially. It’s too wide a swath.”

Donors’ affinity for social good and human impact is born out by GreatNonprofits (www.greatnonprofits.org), a website where people review charities based on their personal experience. Donors who review human services nonprofits, in particular, frequently talk about how impressed or inspired they have been when talking to the individuals served by those organizations, according to GreatNonprofits CEO Perla Ni. People also give high marks to arts nonprofits that offer educational opportunities, especially for children in need.

Values
Taylor believes many donors are swayed by the values that an organization holds. Consequently, pushing a metrics-based assessment of success may not be the best way to win over those donors. “Certain organizations have never been effective, but that doesn’t mean we shouldn’t support them,” he says. “An organization may have raised untold sums to eliminate a disease, but the disease is still with us. The problem hasn’t been solved. I think what really matters to people is whether an organization gives them hope that the problem will be solved. We’re in the hope business, and the only way we can sustain that is by demonstrating trustworthiness. I see what some organizations are struggling with. Monitoring impact isn’t going to win with donors because they’re going to say, ‘The problem is not solved. I respect what you’ve done, but stop trying to sell me on how effective you are. Help me trust you so I can be hopeful that you’re going to solve the problem.’”

Again, this interest in human values, such as trust, is supported by the GreatNonprofits reviews. “What is interesting is that what donors talk about is almost the same as what everyone talks about as being important—the human capital, the people at the nonprofits,” Ni says. “They talk about whether they see the staff motivated, dedicated and responsive.”

Donors’ Resources
Nonprofits should not carry the full burden of educating their donors about how well they are meeting their goals and fulfilling their mission, according to Taylor. “It requires a certain amount of work and due diligence from the charities to produce information for donors to use,” he says, “and from donors to invest the time in looking at that information. No watchdog can produce a single metric to tell you that an organization is effective.”

The various sites can, however, offer a range of helpful information that will assist donors in going beyond calculating a ratio based on figures from a Form 990.

1. **Charity Navigator.** This group has a star rating system in which a charity can receive 0–4 stars, with a 4 being “Exceptional—exceeds industry standards and outperformed most charities in the cause.” Current ratings are based on two factors: financial health and accountability/transparency. Berger explains that they also have embarked on The Road to CN3.0, an effort to collect additional data that will enable them to rate charities on a third criterion: results reporting, or “how a charity comes to know, use and share its results.” This new information will include results logic and measures, feedback from beneficiaries and peer organizations, as well as published evaluation reports. They hope to have finished gathering information on all of the 10,000 charities in their database by 2016, at which time those organizations will be rated based on the three sets of data.

2. **GuideStar.** GuideStar is not, in fact, a charity “watchdog.” It is a collector and curator of nonprofit information. It also encourages nonprofits to share information about their organizations through the GuideStar Exchange. That GuideStar Exchange Program, in which 90,000 nonprofits have already participated, is a way for organizations to supplement IRS information with additional facts that encourage transparency. Depending on the amount of information the organization provides, charities earn bronze, silver or gold GuideStar Exchange Participant Status, which is noted on the site. This also entitles charities to use one of the GuideStar Exchange logos on their website.

**Charting Impact.** Charting Impact, a project developed by GuideStar, BBB Wise Giving Alliance and Independent Sector (www.independentsector.org), is now incorporated into the GuideStar Exchange. It provides five universal questions that organizations of all types, sizes and missions can use to describe their goals and accomplishments:

- What are your strategies for making this happen?
- What is your organization aiming to accomplish?
- What are your organization’s capabilities for doing this?
- How will your organization know if it is making progress?
- What have and haven’t you accomplished so far?
Charting Impact reports produced by participating organizations are available at [www.guidestar.org/chartingimpact](http://www.guidestar.org/chartingimpact) and on the Charity Navigator website. Soon, the reports also will be available on the BBB Wise Giving Alliance site.

### 3. BBB Wise Giving Alliance

In line with Taylor’s views on the importance of trust, BBB Wise Giving Alliance has developed 20 standards that they believe compose trustworthiness. Those standards fall into four categories: governance, measuring effectiveness, finances and fundraising, and information. They rate charities on the 20 standards using the following indicators: standards met, standards not met, did not disclose, review in progress and could not verify. Charities that meet all 20 standards receive the BBB Accredited Charity Seal rather than a grade or numerical rating.

### The Personal Touch

Pallotta points out that donors can make more educated decisions by taking the initiative and simply posing their questions directly to nonprofit representatives. “Have fun with it. Decide what issue you want to have an impact on, and over the course of a year, interview the organizations that deal with that issue,” he advises. “Call the charity, and meet with the director of development. Ask, ‘What are your goals? What progress are you making toward those goals? How do you know what progress you’re making? What data do you gather? How often? Do you analyze it? Who analyzes it?’ Even if you’re just a $500 donor, you should be as strategic about your philanthropy as Bill Gates is.”

Although rating services, executives and development professionals may look at the overhead issue through different lenses, they agree that it is a complex topic that deserves attention. Harold says that he, Berger and Taylor are considering writing a second letter, this time for foundations, a group of funders that can tie the hands of their grantees by putting caps on administrative costs.

Hopefully, more voices will join the discussion, and conflicting viewpoints will not stand in the way of the ultimate goal: creating an educated donor base that understands the importance of investing in overhead and makes informed giving decisions based on a range of legitimate factors.

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## Resources and Additional Reading

- Charity Navigator’s Results Reporting Project, [www.charitynavigator.org/index.cfm?bay=content.view&cpid=1526#.UukF1fIG61w](http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=1526#.UukF1fIG61w)
- “If We Want Our Funding to Change the World” video, [www.youtube.com/watch?v=z_w3v6TxJZQ](http://www.youtube.com/watch?v=z_w3v6TxJZQ)
- “It’s Time for Real Talk About Real Nonprofit Overhead Costs” by Valerie S. Lies, president and CEO, Donors Forum, [www.huffingtonpost.com/valerie-s-lies/its-time-for-real-talk-ab_b_3465036.html](http://www.huffingtonpost.com/valerie-s-lies/its-time-for-real-talk-ab_b_3465036.html)
- The Overhead Myth, [http://overheadmyth.com](http://overheadmyth.com)

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