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Nonprofits: Big Problems, Small Budgets

By Anna Gazdik
In the fast-paced, demanding, and money-centric business world, nonprofit organizations may seem like the youngest child: always there, but sometimes forgotten. The dichotomy between the for-profit and nonprofit siblings are extreme. Nonprofits are expected to solve huge societal problems and help alleviate suffering through service, yet they are oftentimes handicapped in the resources they are allotted, and discriminated against when they invest in self-sustaining expenses.

The growing need for charitable goodwill amidst increasing worldwide catastrophes, wars, and disasters has catapulted such charitable organizations into the limelight, and increased attention has also led to scrutiny on how nonprofits spend their money.

Most recently, the 2017 hurricanes in Texas and Florida brought a storm of criticism to nonprofits and ignited a debate over how charitable organizations should use the donations they are given. The dispute about overhead spending is not new—nonprofits have historically been forced to fire employees and descale after sponsors back out at the sight of increased spending on areas such as recruitment, advertising, and customer service. Critics called the Red Cross inefficient and dishonest for using 25% of Haiti earthquake donations on overhead expenses in 2010.1 After raising $108 million for HIV/AIDS, Pallotta Teamworks was forced to shut down and fire hundreds of employees after receiving backlash on their spending.2

Under the watchful eye of donors, government leaders, and members of the public, nonprofit organizations are receiving increased pressure to achieve high financial efficiency and decrease overhead expenses. But how can an organization achieve massive results without being allowed to use resources to scale, innovate, and problem solve? While for-profit organizations go years without showing return to their publics, nonprofits are expected to save lives through budgets that sometimes don’t allow for more than a meager community event.

To change the culture in which nonprofits are are evaluated and allow them the necessary room and resources to grow, one must understand (1) the role of nonprofits organizations, (2) the inefficiency of evaluating overhead ratio, and (3) the most effective measures of evaluation.

Role of Nonprofit Organizations

Nonprofit organizations help to sustain society. They provide relief in times of disaster, sustain arts and culture programs in local communities, aid refugees, and speak for millions more who do not have a voice but deserve to be heard.

The National Center for Charitable Statistics reports that there are more than 1.5 million registered nonprofit organizations in the United States, ranging from small private entities to large public organizations.3 Contrary to popular belief, nonprofits do earn a profit. Instead of distributing profit amongst shareholders as for-profit organizations do, nonprofits reinvest into the organization.4

According to The CPA Journal, nonprofit organizations are high economic contributors. Organizations across the United States contributed 5.4% of the GDP to the United States with just over $887 billion in 2012. Nonprofit organizations made more than $2 trillion in revenue that same year and held almost $5 trillion in assets. Not only economically robust, nonprofit organizations are socially powerful: more than one-quarter of U.S. adults volunteered through a nonprofit organization in 2013, and a total of $335 billion was donated by individuals, businesses, and organizations.5

The public disclosure of nonprofit financial records has increased both transparency and criticism for many nonprofit organizations, shaping a culture of competitiveness and pressure to perform.
Inefficiency of Evaluating Overhead Ratio

Reputation is the lifeblood of nonprofit organizations. If a reputation of high financial effectiveness is not upheld, then nonprofits will experience a decrease in public perception, and the flow of donations will begin to wither. Ultimately, the organization will be lost.

Determinants of Reputation

Patterns of reputation among nonprofits were found in a study of 152 U.S.-based charities. Organizational effectiveness was directly related to a nonprofit’s visibility, favorability, and attributes. Nonprofits who hold the highest reputation for effectiveness are more likely to be established, vastly large, and well known. Most significant was the finding that a nonprofit’s reputation is based off of the public’s perceived characteristics of the organization, and not its actual measures of effectiveness.

The Stanford Social Innovation Review found that overhead ratio is one of the biggest factors used in determining the effectiveness of a nonprofit organization.

Overhead Ratio

Overhead expenses include all operating costs such as fundraising, salaries, maintenance, and legal or financial fees. Nonprofits use a portion of donated funds to cover overhead costs, uphold internal infrastructure, and reach goals. Without overhead costs, an organization would be unable to function.

According to CharityWatch, a nonprofit organization is efficient when using 25% of its donations for overhead.⁹

Although measuring overhead rate is a valuable tool in comparing organizations and keeping them in check, it can quickly turn into a crippling standard of measurement. An overemphasis on the importance of overhead in evaluating an organization can blind donors to the good that an organization is doing, as well as pressure organizations to undercut proper funding.

Starvation Cycle

Although organizations have a duty to use donations for mission-related activities, they must also take care of themselves. If overhead costs are underestimated or undervalued, then a nonprofit organization will ultimately fail. After examining 25 years of nonprofit data and reports, Professor Jesse D. Lecy and Elizabeth Searing termed this phenomenon as the nonprofit starvation cycle.¹⁰

As seen in Figure 1, nonprofit organizations have three primary pressures that lead to a decrease in overhead: unrealistic donor expectations, misleading reporting, and competitive pressure. All three factors create reasons for organizations to lower their overhead expenses.¹¹

"Nonprofit leaders must make decisions with an outcomes-driven mindset instead of a compliance-driven mindset. In essence, they must temporarily forget about overhead and think big."
In essence, the pressure to lower overhead costs begins with the need to stay at the top of a competitive donor market. Intensified, such pressure results in compromised reports and skewed numbers, and donors cultivate unrealistic expectations of how much is actually needed to sustain overhead costs. Nonprofit organizations feel demanding expectations, and the cycle restarts.  

The starvation cycle is obviously prevalent in the nonprofit sector today. Levy and Searing found a severe drop in the average reported overhead costs for nonprofits in the last decade, and several organizations have even reported to spending no funds on overhead.  

Effects of the Starvation Cycle

The starvation cycle is having detrimental effects on nonprofit organizations. The Nonprofit Overhead Cost Study reports that underfunding overhead expenses has resulted in nonprofits filled with “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.” Skimping on overhead to please donors and inflate reputation means that quality service will not be delivered, services will not be tracked, and everyone will suffer.

The public’s method of using overhead costs to evaluate the effectiveness of a nonprofit company is dangerous, both to the organization and to its donors.

Effective Measures of Evaluation

If the starvation cycle is not soon resolved, then nonprofits will run themselves to the ground in order to try and satisfy unrealistic industry and donor standards for overhead costs. Even if proper resources are given towards overhead, the problem will not change unless methods of evaluating nonprofit effectiveness and determining reputation are changed.
In his TED Talk, entrepreneur and activist Dan Pallotta condemned society’s current view of charities, claiming that a double standard is applied when evaluating nonprofit organizations, as compared to their for-profit counterparts.

“We tell the for-profit sector spend, spend, spend on advertising until the last dollar no longer produces a penny of value. But we don’t like to see our donations spent on advertising in charity, as if the money invested in advertising could not bring in dramatically greater sums of money to serve the needy,” Pallotta said. “[Social problems] are massive in scale, and our organizations are tiny up against them, and we have a belief system that keeps them tiny. We have two rulebooks, one for the nonprofit sector and one for the rest of the economic world.”

Pallotta’s response to finding a better way of evaluating nonprofits? Treat them as if they are a for-profit.

The activist took out full-page ads in the Washington Post and New York Times to promote a charity event. The price tag on such a venture is cringeworthy, but the risk provided a huge return- the ads helped to bring in two and a half million dollars in revenue.

Pallotta’s not alone in his thinking. Nonprofit Finance Fund associate director Claire Knowlton presents the idea of outcomes-based measurement in evaluating nonprofit effectiveness.

Figure 2 presents two primary ways to measure the effectiveness of nonprofit organizations: outcomes-based measurement and compliance-based measurement. Compliance-based measurement encompasses the traditional method of looking at overhead ratio, restricted budgeting, and rigid criteria in evaluating a nonprofit organization. On the other hand, outcomes-based measurement is more flexible, and invites the analysis of impact over time and across different situations.

This new way of regarding and evaluating nonprofits is starting to catch on- 2013 saw GuideStar, Charity Navigator, and Better Business Bureau announce a change in their evaluation of charitable organizations. They pledged to “[denounce] the ‘overhead ratio’ as a valid indicator of nonprofit performance.”
The change must begin internally, and organizations must first free themselves from the overhead-focused, compliance-based cycle that leads to added pressure and inadequate internal funding. Nonprofit leaders must make decisions with an outcomes-driven mindset instead of a compliance-driven mindset. In essence, they must temporarily forget about overhead and think big. A change in the mindset of nonprofits themselves will terminate the nonprofit starvation cycle and help correct the culture in which nonprofits are evaluated. An increase of outcomes-based measurement will lead to more transparency and breathing room for nonprofit organizations, greater trust from key publics, and overall increased effectiveness and reputation.

Conclusion

Nonprofits are critical, and so are their reputations. The valued effectiveness of nonprofit organizations determines their funding and ability to do good in the world.

Using compliance-based, overhead-focused measurement to evaluate nonprofits will leave both donors and organizations at a disadvantage. Intense pressure caused by the starvation cycle promotes inadequate internal infrastructure and resources, thus disabling nonprofits in their efforts to fulfill their mission.

The reputation of nonprofits must be built on outcomes-driven measurement. Rather than looking at overhead ratios, donors must examine the outcomes that nonprofit organizations achieve. In doing so, pressure on organizations will be relieved and they will be better able to serve others.

Notes

16. NPR, “Do We Have The Wrong Idea About Charity?”
18. Knowlton, “Funding Overhead.”