Marriott Student Review

Volume 3
Issue 4 *Blog*

Article 32

May 2020

The Slow Death of the Nonprofit Sector and How to Stop It in Three Steps

Taylor S. McPheeters
Brigham Young University, taylo259@byu.edu

The Slow Death of the Nonprofit Sector and How to Stop It in Three Steps

By Taylor McPheeters

As a nonprofit professional, you're well aware of the financial pressure your sector faces on a daily basis. When you arrive at work, the rented office's lights flicker overhead, and you hope the Wi-Fi will work. When you sit at your desk chair you almost fall onto the floor because—you forgot—the fourth wheel is missing. Once you log into your hand-me-down, 20-year-old computer, the first email you've received from the CEO is entitled "CUTS TO FUNDRAISING EXPENSES."

If such budget costs seem like a never-ending cycle, that's because they are. In fact, it's so common in the nonprofit sector that it's been named: the Starvation Cycle. Organizations and donors have "unrealistic expectations around indirect costs, [which] create pressure on nonprofits to conform to low overhead rates."[i]

No matter how righteous the cause or how passionate the staff, the Starvation Cycle will prove the eventual death of the nonprofit sector.

However, a solution exists. Leaders of individual organizations, and the nonprofit sector as a whole, can end the Starvation Cycle by creating sector-wide definitions of indirect costs, setting realistic expectations of overhead within organizations and with donors, and committing to continual, positive change with a business mindset.

Creating Sector-wide Definitions

Loose definitions of direct and indirect costs (e.g. labeling fundraising expenses as program expenses, because the money was raised for the program) have created room for manipulation in cost reporting.[ii] For example, 25% of organizations with over $1 million in contributions reported zero fundraising costs, which is almost impossible. To get such funding, someone—be it the CEO or a fulltime fundraiser—is putting time and effort into fundraising.[iii]

This is a band-aid solution to the root issue, as well as a dangerous venture that could end in tax fraud. As a start, sector leaders can clarify that fundraising expenses include any salaries, or portions of salaries, that are related to fundraising, and any expenses acquired in fundraising. By doing so, organization will be less capable of manipulating financial statements.

In order to repair the damage done by misreporting overhead costs, leaders in the nonprofit sector must agree on specific definitions, not just for fundraising expenses, but also for administrative and program expenses. As the nonprofit sector accurately defines their expenses, donors will have a more realistic view of the money required to run an effective and long-lasting program.

Setting Realistic Expectations

After solidifying definitions, leaders must set realistic expectations within their own organizations and with donors. Leaders can begin this process by instilling the belief that overhead is a necessary part of running an organization. While being frugal is advised, it’s essential that each department receives the funding it needs to survive. Departments should accurately report expenditure needs in order to ensure that enough funds are raised to cover the *full* needs of the organization.

Popular guidelines suggest that nonprofits should spend no more than 25% of expenses on overhead.[iv] This expectation is unrealistic and leads to organizations making critical cuts to costs. Figure 1 displays the bleak reality of nonprofit funding. With government grants providing 0-10% and private grants providing 10-15% of funding for indirect costs, this money doesn’t even cover the suggested 25% of overhead expenses.[v]

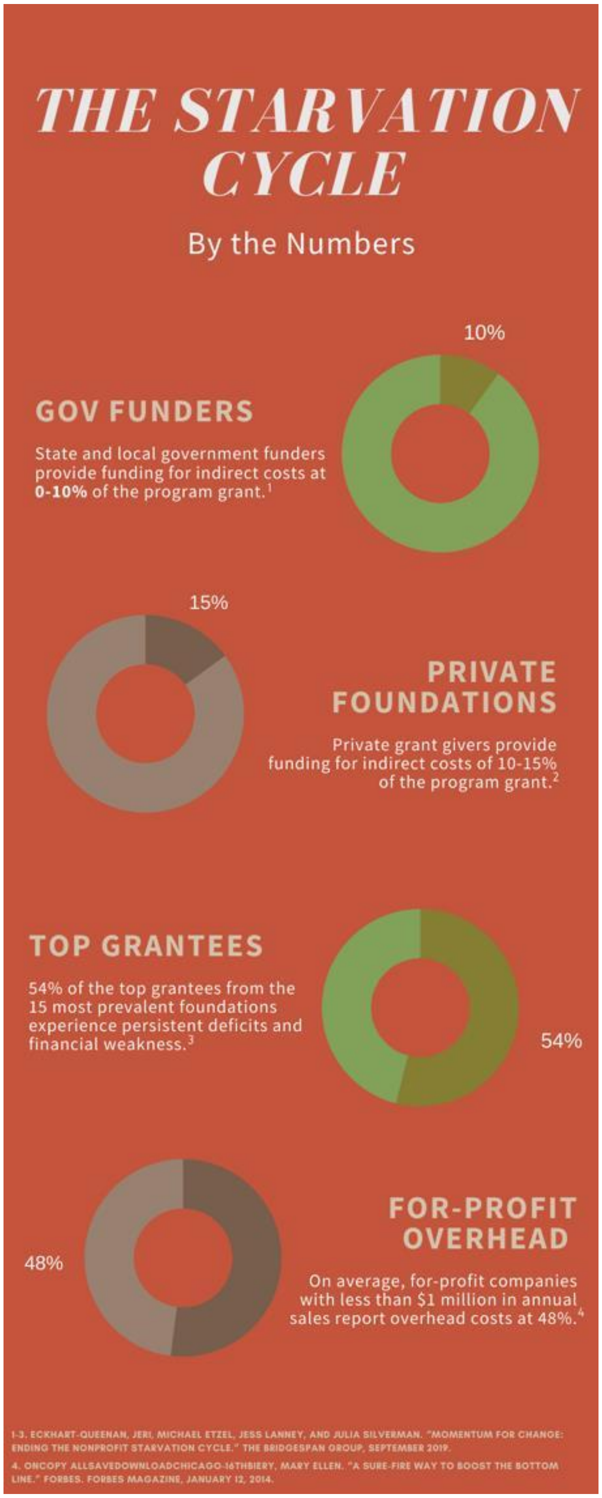

Figure 1.[vi]

Researchers at Georgia State University found that nonprofits who reported higher overhead costs—up to 31%-- had higher program outcomes.[vii] With such increased productivity in mind, organization management should refrain from cutting salaries and fundraising, and instead inform donors of the impact their donations make through the efforts of employees and volunteers.

In a similar strain, watchdog groups, such as Charity Navigator, who advise nonprofits on funding, should avoid such an emphasis on low overhead costs. Their current emphasis negatively impacts the public's expectations, discouraging them from donating to impactful organizations with higher overhead.

Indeed, boasting about excessively low overhead costs damages the public's understanding of the money needed to make a nonprofit's mission feasible. Despite popular belief, a nonprofit is still a business, and needs money to run.

Committing to a Business Mindset

A business mindset begins in each individual nonprofit. Successful businesses thrive because they recruit talented employees, focus on cost efficiency, and profit off of innovation. None of these can be achieved, however, if the employees are underpaid, mistreated, and quick to leave the nonprofit sector for a competitive wage.

Nonprofit professionals are notoriously underpaid. In fact, a significant proportion of cuts in overhead expenses come from staff wages.[viii] This leads to inexperienced executives, which points to further future financial problems. Competitive salaries only benefit the organization's mission, as they encourage the retaining of qualified, driven staff members.

Successful businesses still focus on keeping costs low, but it comes from a sense of efficiency, and certainly not the extent of the nonprofit-common Starvation cycle. As seen above in Figure 1, the average small business (with an income less than $1 million) reports overhead at 48% of costs.[ix] If small businesses find that such overhead costs provide employees with the resources needed to do their jobs, nonprofits would find the same.

Appropriate overhead costs create room for innovation. Having a business mindset ensures that employees have the resources they need to focus on the issues at hand and create the solutions necessary to excel in the organization's mission.

End the Cycle Now

As you commit to ending the Starvation Cycle, you are doing your part to reverse the slow death that the nonprofit sector has faced for decades. By focusing on sector-wide definitions, realistic expectations, and a business mindset, the nonprofit sector will reach new heights in fulfilling the needs of the constituencies it serves. However, it takes commitment from organization leaders to make these changes happen. Implement these steps into your own nonprofit organization so that your nonprofit can stop surviving and start thriving. Perhaps you'll even be able to afford a desk chair with four functioning wheels.

---

[i] Jeri Eckhart-Queenan, Michael Etzel, Jess Lanney, and Julia Silverman, "Momentum for Change: Ending the Nonprofit Starvation Cycle," *The Bridgespan Group*, September 2019, 21,

https://www.bridgespan.org/bridgespan/Images/articles/ending-the-nonprofit-starvation-cycle/momentum-for- change-ending-the-nonprofit-starvation-cycle.pdf.
[ii] Eckhart-Queenan, "Momentum for Change," 8-9.
[iii] Kennard Wing, Teresa Gordon, Thomas Pollack, and Patrick Rooney, "Functional Expense Reporting for Nonprofits: The Accounting Profession's Next Scandal*?" The CPA Journal*, August 2006, 14–18, http://archives.cpajournal.com/2006/806/infocus/p14.htm.
[iv] "Financial Score Conversions and Tables," *Charity Navigator*, February 6, 2020, https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48.
[v] Eckhart-Queenan, "Momentum for Change," 7.
[vi] Mary Ellen Biery, "A Sure-Fire Way To Boost The Bottom Line," Forbes, *Forbes Magazine*, January 12, 2014, https://www.forbes.com/sites/sageworks/2014/01/12/control-overhead-compare-industry-data/#2d0e2a9fd068.
[vii] Hala Altmimi and Qiaozhen Liu, "The Nonprofit Starvation Cycle: Impact of Underfed Overhead on Program Outcomes," Academy of Management Annual Meeting Proceedings, August 1, 2019, https://doi.org/10.5465/AMBPP.2019.217.
[viii] Jesse D Lecy and Elizabeth A. M. Searing, "Anatomy of the Nonprofit Starvation Cycle," *Nonprofit and Voluntary Sector Quarterly,* 44, no. 3 (2014): 539–63, https://doi.org/10.1177/0899764014527175.
[ix] Biery, "Boost The Bottom Line"