BOARDSOURCE®

201 KEY ISSUES

DISCUSSING OVERHEAD EXPENSES IN THE BOARDROOM

All funders want their money to make a difference. When they perceive waste or lack of impact from their funding, they will be less likely to continue supporting the grantee. Because overhead expenses drain resources, grantees may underplay certain indirect expenses to please funders, creating a funding culture that idealizes low administrative costs. These expenses, however, are often crucial to supporting an organization and its mission — a program cannot function without its infrastructure, adequate space, staff, and supplies. The board must take time to assess the organization's needs and ensure appropriate overhead makes the best use of its financial resources.

What is overhead?

Overhead refers to the ongoing cost of running a business; it exists even if no revenue is created. Every organization has some or all of the following overhead expenses: rent or mortgage, utilities, technology expenditures, office supplies, accounting fees, insurance, depreciation, advertising, taxes, and staff salaries for general administrative activities.

Efficiency and effectiveness

Efficiency and effectiveness usually come up in overhead discussions. Though they are often confused, they refer to different practices. Efficiency refers to being able to accomplish a task or a project quickly, with little cost and effort. Effectiveness refers to achieving desired goals — the work gets done and furthers the mission. In short, effectiveness refers to results and efficiency to process. Nonprofits should embrace both concepts.

What affects your overhead costs?

There is no one standard for overhead; many complex issues influence the amount of money an organization spends on overhead costs.

Mission — Some mission areas are simply more expensive to address. If you need special facilities to serve your customers and clients, your expenses will quickly surpass those of an online organization that only communicates with customers via e-mail. The delivery method for services influences expenses and effectiveness. If your programs rely on sophisticated machinery, its upkeep and depreciation are added costs. Liability insurance needs are different in a health care organization than they would be in a library. These are issues that the board must consider when monitoring overhead.

Location — An organization's location also affects overhead. New York City is more expensive than Little Rock, Arkansas, for example. An organization in a rural location may incur transportation or shipping expenses that an urban organization wouldn't. In addition, location may affect accessibility to client services and, thus, reduce revenue from those services. Owning your facilities lowers rental expenses but increases maintenance costs. A facility located in an area with high crime rates will likely have higher insurance and security expenses. The board has to calculate the pros and cons when deciding the best location for the organization.

Lifecycle — A new organization may find its administrative costs overwhelming. Starting up programs and opening an office and facilities can quickly deplete initial resources. The board needs to consider these factors when discussing overhead costs and plan accordingly.

Fundraising — An organization should determine what fundraising tactics make most sense for its needs and not necessarily follow the usual fundraising pattern. Expensive capital campaigns or fancy galas, for example, are not appropriate for every nonprofit. Soliciting individuals via mail and approaching major funders in person have very different costs. An organization with a strong development staff will have higher fundraising costs than an organization that relies on volunteers, but the amount of funds raised may also differ considerably. The board should make sure that Form 990 does not report zero fundraising expenses if the organization is actively soliciting funds.

Staffing — In principle, a volunteer-driven staff structure costs less than a paid staff. The board needs to assess when it is time to invest in hiring additional professional staff rather than simply relying on volunteers or "cheap labor." In addition, the board needs to ensure the staff has the proper tools (technology and training) to work efficiently and effectively.

Suggested practices

Various watchdog organizations have included overhead calculations in their standards. The Better Business Bureau Wise Giving Alliance recommends that a nonprofit spend at least 65 percent of its total expenses on programs. The Maryland Nonprofits' Standards for Excellence does not address program expenses, but sets a standard for fundraising, stating that, on average, over a five-year period, a nonprofit should generate revenue from fundraising and other development activities that is at least three times the amount spent on conducting them.

The dilemmas

Every organization has overhead expenses. If an organization raises funds, there are expenses related to solicitation. To prevent misunderstandings, it is crucial to keep accurate records and reports of these expenses.

Keeping track of expenses — The only way a nonprofit can accurately report its expenses is by using a comprehensive tracking system that allocates relevant expenses to each activity or program. Timesheets that track the employees' hours by program are essential. The chief executive's time should usually be distributed among administration, fundraising, and programs. Shared mailing expenses should be divided between appropriate programs, and these programs should be charged accordingly. Grant-funded programs must track their costs separately. Expenses that belong under the heading of "administrative expenses" include legal fees, investment fees, accounting/financial services fees, committee expenses, and staff meeting expenses.

Reporting to funders — Unfortunately, many grant proposals do not reflect accurate expenses for implementing a project. Nonprofits are sometimes hesitant to include all overhead costs, which results in a grant that only partially covers the cost of running the program. Some foundations also prefer seeing a lean budget in proposals that focuses on pure program expenses and excludes the share of overhead that every activity should have allocated to it. Both sides need better communication and understanding of the true expenses in the organization. Even high-quality, seemingly self-sustaining programs do not exist in a vacuum but need a solid infrastructure and adequate support to succeed.

Universal standards — Due to the diversity of nonprofit organizations, it is difficult to expect each one to fit within a single framework for determining overhead. Universal standards serve a purpose, but they must stress the need for accurate internal recordkeeping. In addition, organizations should be prepared to adjust their overhead based on their unique organizational needs at any given moment.

Ignoring the future — No organization can expect to remain solvent without preparing for the future. It is imperative to secure funds for rainy days, budget for system and equipment updates, and build capacity for future growth. It is the board's responsibility to lead the planning process and ensure that adequate funding is available at each phase of organizational evolution.