Investing for effective impact: Changing donor perceptions about not-for-profit efficiency in Canada

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o-ver-head: Typically defined as the percentage of a not-for-profit's operational expenses allocated to fundraising and administration.

For many donors, making a contribution to a not-for-profit can feel confusing. Many people and organizations find themselves looking for information about how an organization will use a donation in alignment with its social mission. Both the media and the public are asking not-for-profits for additional accountability by posing difficult questions about how funds are allocated within organizations to achieve an intended impact. They want to know which organizations best use donations and which organizations can be trusted.

It can be difficult to find clear answers to these questions, especially when faced with a slate of over 170,000 not-for-profits (over 85,000 of which are registered charities) in Canada.

Donors are concerned with the fundamental questions of issue and impact: *what* good will a not-for-profit achieve through financial support and *how* much good will the organization achieve in doing so, including the measures and benchmarks associated with its work.

The question of *how* much good can be achieved is receiving increased attention, arguably because it has been a difficult value to standardize given the many measurement frameworks available across the public, private and community sectors. Fundamentally, donors want to know how much good will come from each dollar donated and, perhaps trickier still, *how much additional good* will come from spillover socio-economic impacts associated with a not-for-profit's unique mission.

In an effort to help empower donors with tools and resources to make these choices, people and organizations have looked at methodologies to help clarify their choices including charity rankings, standardized ratios and overhead costs — or the combined cost of administrative and fundraising expenditures as a percentage of total expenditures related to a not-for-profit's social mission.

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Why do we look at overhead ratios?

Donors may be tempted to use overhead ratios in their decision-making processes to help answer the question of how effective an organization is in terms of its overarching financial performance. In part, this is because overhead ratios clearly show how funding is allocated towards a social mission—for example, monies used to support financial literacy training at an after school program vs. keeping the lights on in the building that houses management team running the programs. Using quantifiable financial data to understand performance parallels the way investors use a return on investment methodology to assess corporate performance.

But this approach runs the risk of simplifying organizational complexities and may leave out critical narratives related to why and how a not-for-profit best achieves its results. In most cases, donors are looking for data that reflects four key characteristics, as outlined in the figure below.

figure1: **Four key data characteristics**

1.) Reliable?
Overhead costs are often calculated using financial information found within an organization's financial statements. It's possible to verify or audit the information but data can vary depending on an organizations size or scope.

2.) Comparable?
For the most part, overhead costs can be calculated using the same financial information and can be compared. Some organizations use overhead costs as a basis for not-for-profit ranking methodologies.

3.) Consistent?
By clearly defining what is meant by 'overhead' and the boundaries associated with what it is (and what it isn't), a not-for-profit can produce consistent information internally and externally. Standardized definitions continue to be debated.

4.) Relevant?
There are different views on the role that overhead ratios play in helping to inform a donor's decision making processes. We will explore below.

Key takeaway: Data can be impacted by personal perception

There is continued debate over[1] whether overhead measures can provide 1.) reliability, 2.) comparability and 3.) consistency, however, there are key questions related to their 4.) relevancy that donors should explore in greater depth as part of their analysis. Given the complexities associated with social impact work, are we being short-sighted and asking the wrong questions?

Is overhead relevant? Well, it depends...

We can explore the question of how relevant overhead ratios are by comparing running a not-for-profit to maintaining an automotive vehicle. Let's look at the operational costs of an automotive vehicle and how they relate to its longer term intended impacts:

- initial investment via purchase or lease and ongoing cost of fuel to get us from A to B (direct costs)
- ongoing maintenance like oil changes, replacing mechanical parts or ad hoc repairs (overhead)
- our perception of impact, measured in terms of performance comparability, convenience, safety rating and/or reliability (impact)

We know that the initial investment required to purchase a vehicle might vary depending on factors including its size, brand, fuel efficiency and perceived value. Ongoing maintenance to the vehicle is necessary and can involve considerations ranging from general upkeep to changing tires or repairs based on roads more (or less) travelled.

An individual might also make conscious choices about the value they place on a mechanic's expertise to help with ongoing repairs, cost or reputation. In many cases, they may balance their investments of time and money to ensure the longer term use of the vehicle for its intended impact: better performance, safety, reliability or even values-based choices around fuel efficiency or environmental impact.

In the figure 2, we compare four vehicles, each with a different mix of investments. What's clear is that there is no right choice, but that each is based on a unique set of variables that relate to a direct cost + ongoing overhead = driving towards an intended impact. In scenario 'D' we see a smaller initial investment and greater attention to ongoing overhead, which lead to a greater long-term impact.

1 Charity Navigator, Guidestar, Better Business Bureau USA Wise Living Alliance, http://www.overheadmyth.com. Retrieved January 25, 2015

We can easily compare investing in maintaining an automotive vehicle to effectively running a not-for-profit—from the resources required for skilled expertise, office facilities, investments required for better internal controls and reporting or even keeping the lights on to support day-to-day work. In both scenarios, it's important to move away from thinking solely in terms of overhead ratios towards thinking about the component parts required to keep the not-for-profit engine in top condition.

What role should overhead ratios play? A question of trust…

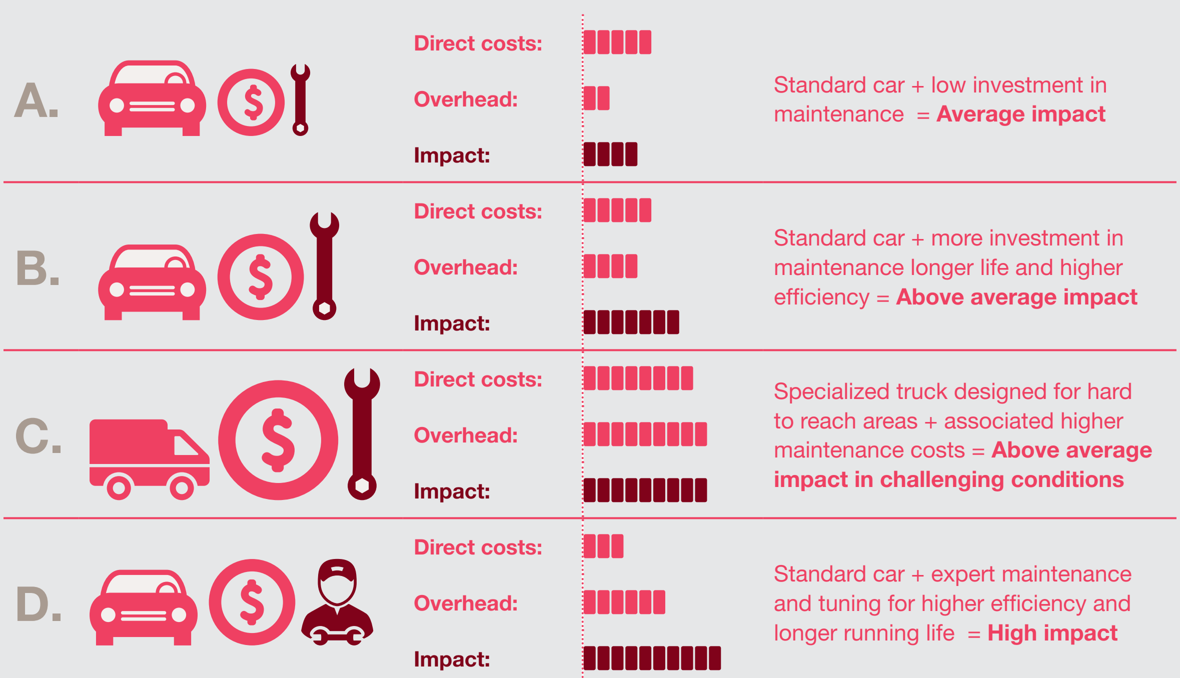
Let's also consider how investing for longer term impacts might lead to the development of trust between a donor and a not-for-profit. Overhead ratios are relevant only in so far as they speak to donors' questions about if they can trust an organization with their money.

Donors should remember that, just like in the automotive vehicle example above, a high overhead ratio doesn't necessarily mean that the not-for-profit isn't using the money in the best way possible. If a not-for-profit has a high overhead ratio, donors might need to ask questions about why resources are allocated the way they are and if the data is reliable, comparable, consistent and relevant in the context of the everyday work of the not-for-profit.

Donors should use overhead ratios alongside other markers of trust related to a not-for-profit's work. Some questions donors could ask include:

- Does the not-for-profit publish an annual report which speaks to the narrative about its work alongside financial information? How is funding allocated to help fulfill its social mission and what's the rationale?
- Does the not-for-profit prescribe to industry standards, for example, the Association of Fundraising Professionals' Donor Bill of Rights or the Imagine Canada Standards Accreditation Program?
- Does the not-for-profit have audited financial statements? Have you called a member of the not-for-profit's team to help you digest the information and answer any questions you might have?
- Does the not-for-profit have an experienced and trusted management team and board of directors?
- Do you have personal experience working with or volunteering for the not-for-profit?
- How does the organization make investments to fulfill its social mission? Does it require greater investments in people or facilities, programs or services, or skilled expertise based on its ongoing strategy?

figure 2: **Comparing investment scenarios to longer term impact**



We shouldn't use overhead ratios to tell us how much impact an organization is having. Instead, we should use overhead ratios to help us understand the bigger picture, that is, to help us ask questions about why and how an organization is making a difference and what resources it needs to be successful.

Risks of using overhead

Using broad not-for-profit ranking systems or methodologies to help compare overhead ratios might not help donors make better investment decisions. Not-for-profits may be discouraged from spending money on important infrastructure and capacity-building needs, and this can impact their long-term sustainability and, therefore, reduce the overall impact from any donation. The impacts of using broad not-for-profit ranking systems can be far-reaching:

- **Reduced accountability:** Producing clear and transparent reporting systems, including those that have been audited to help report on social or financial outcomes, require an investment of time and money. These overhead costs can be a double-edged sword, as they help improve transparency but worsen the overhead ratio.
- **Shifting the donor mindset about the costs required for doing good:** There's a donor perception that if a not-for-profit chooses to invest its funds in overhead costs (rather than direct costs associated with its good work), this results in a reduced impact and limited accountability. But in fact, many overhead costs are needed to operate the programs donors choose to support. To meet unrealistic expectations of donors, not-for-profits might participate in a 'race to the bottom' to promote lower overhead expenses to help build a case for programmatic support, without investing in the infrastructure to operationalize it. This issue, referred to as the 'not-for-profit starvation cycle,' has been explored in depth by various academics.[2]

2 Goggins-Gregory, Ann & Howard, Don. The Nonprofit Starvation Cycle. Stanford Social Innovation Review, Fall 2009.

What's next?

The overhead debate should be focused on asking the right questions and understanding the context for how a donor and a not-for-profit see the movement towards achieving social impacts. There are no perfect answers. Over the past decade there has been a re-emergence of not-for-profit enterprises attempting to measure their impact in financial terms—for example, "for every dollar spent on our not-for-profit, we can do $X good for society."

The advantage of framing the conversation in this way is that it attempts to speak directly to the impact an organization is making rather than the dollars it takes to get there. New models[3] are being developed to help organizations structure responses to these questions in a credible and meaningful way, for example, our Total Impact Measurement and Management[4] framework.

Key takeaways

With the many tools and resources available to donors today, we suggest focusing on the insights included within this paper and to keep the following points top of mind during your decision making processes:

- Don't assume that a high overhead ratio means money isn't going towards impact. Do your homework first.
- Think of your donation as a long-term investment in a not-for-profit's ability to grow its capacity to achieve its social mission.
- Consider donating unrestricted funds to allow the not-for-profit's management team to allocate resources where they're needed most. They're the experts.
- Ask questions about how a not-for-profit is collecting data (both qualitative and quantitative) that is reliable, relevant, consistent and comparable.
- Make sure to consider an organization's narrative alongside its financial information. What is the organization trying to do and how are they measuring it?

3 Good, Aaron & Broadbent, Doug (2014) Innoweave and Collective Impact Collaboration is just the beginning. The Philanthropist, Volume (26), pp. 83-90.

4 PwC. Total Impact Measurement and Management. http://www.pwc.com/totalimpact. Retrieved January 25, 2016.

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