Viewpoint
Moving Beyond Overhead
By Brian Mittendorf
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Charities can find better ways to communicate their spending priorities than a myopic focus on administrative costs displayed in simplistic pie charts.

BY BRIAN MITTENDORF

The American Society for the Prevention of Cruelty to Animals (ASPCA) is among a small group of charities that are household names across the United States. The ASPCA vaulted up lists of large nonprofits thanks in part to its well-known commercials that project images of suffering animals overlaid with the maudlin music of Canadian singer Sarah McLachlan.

The ubiquity of ASPCA ads has also led to scrutiny of its practices, including its spending priorities. The group has typically been able to alleviate any concerns about spending thanks to its reported high rates of programming expenses. Rating agencies like Charity Navigator consistently confirm that the nonprofit has “low overhead” and give high marks to the organization’s spending.

Yet, in 2021, a CBS News investigation revealed that only 7 percent of the money raised by the ASPCA had been spent on local animal shelters and welfare groups. The contrast between high program spending rates and low spending on these areas elicited strong—but varied—reactions. Some animal shelters expressed frustration about their donations drying up as donor funds accumulated at the ASPCA, while other observers saw it as unfair media targeting of a successful charity.

The ASPCA is just one of many popular charities over the years for whom program spending rates failed to tell the full story. Prominent organizations like the American Red Cross and Wounded Warrior Project have also faced public backlash for their spending, despite each reporting low overhead. Though these large organizations made the grade on paper, they spent in ways that deviated from public expectations, which prompted media investigations. Each case stemmed from a misconception about spending priorities. Nonprofits can communicate far more to donors and the public by breaking down not just the general purpose for which money is spent but also how it is spent to achieve that purpose.

When nonprofits address donors about their finances, most begin and end with a simple pie chart showing the percentage of spending focused on programs. Such fixation on the basic spending pie chart is often counterproductive, but it has been a hard habit to break.

THE WHY AND HOW OF SPENDING

To understand the issue, consider first what people are referring to when they tout “low overhead” or that a high percentage of donations “goes to the cause.” Statements like these are typically based on the accounting requirement that nonprofit organizations split their expenses by functional classification, meaning the purpose of each expense. Generally, the three functions are programs (spending related to a mission objective), fundraising (spending aimed at eliciting contributions), and administrative (spending on the general maintenance of the organization). Divvying expenses into these categories is a challenging accounting exercise that is subject to substantial discretion. Despite such discretion, too many readers take the functional classification as a clear-cut representation of where funds go, with program expenses reflecting “spending on the mission” and other expenses being “wasteful overhead.”

The fixation on the functional classification has proven problematic due to overestimation of what it can tell us. Even at its best, the functional classification only reflects the intention for spending, not the methods. Without additional information, people make assumptions about what program spending entails and are often disappointed if they learn that the methods used by an organization differ from their personal expectations of program expenses.

One feature that has underpinned support for the ASPCA over the years is its consistent level of program spending. Over the most recently reported 10-year period (2012-21), program spending represented about 75 percent of all ASPCA expenses. Annual percentages barely fluctuated, varying only between 73 and 77 percent during this time. Defenders of ASPCA can—and did—view this data and wonder why a sudden concern arose, given the organization’s consistent focus on programs.

The real disconnect, however, arose not about why money was spent but how.

The program spending rate is not a one-size-fits-all measure of effectiveness. Despite a popular perception that there are no alternatives, nonprofits have a straightforward way available to them to communicate more about spending priorities. The Statement of Functional Expenses—residing on page 10 of every Form 990—splits all spending across two different dimensions, with one dimension being the functional classification (the why) and the other being the natural classification (the how). The natural classification splits spending amounts among categories such as grants, salaries, advertising, facilities, travel, and so on.
The details this offers can be quite illuminating. An organization can use the two-way expense classification to communicate not just the amount spent on programs but also what tactics the organization used in that program spending. Did the resources go to support hands-on work by in-house staff, work by outside experts, use of media or postage, maintenance of facilities, provision of grants to others, or some combination of these?

Though the ASPCA demonstrated a remarkably consistent focus on program spending across the last decade, their spending priorities also exhibited a shift. In 2012, grants represented 12 percent of program expenses, while advertising and professional services combined to represent 15 percent of program spending. Over the decade, these two once-similar amounts moved in different directions. The gradual shift culminated in grants representing just 5 percent of program expenses in 2021, while advertising and professional services reached 26 percent.

Other organizations can readily follow suit and provide more information about the how of spending. Financial statements tell a story, and that story needs to be told richly if organizations want to build donor trust and ensure that their spending priorities match what donors think they are.

Given the shift in the how of spending that was lurking just below the surface at the ASPCA, it should not come as a surprise that concerns of local shelters not receiving sufficient support came to light in recent years. As with many others, the organization's program spending rate does not tell donors about a notable shift in spending priorities that slowly developed over a decade. Clear communication about not only how much was spent on programs but also how those amounts were spent could have provided this necessary context.

TELLING A RICHER STORY

To see how the Statement of Functional Expenses can add important detail in communicating an organization's spending approach, consider the case of four nonprofits labeled Charities A, B, C, and D, whose missions each center around breast cancer. The charities' respective program spending rates are 76 percent (Charity A), 82 percent (Charity B), 79 percent (Charity C), and 77 percent (Charity D).

When presented with this information and asked which charity is best suited to support breast-cancer patients, people invariably endorse Charity B. This has been my experience interacting with accounting, business, and nonprofit-management students over the years. Most will also admit that fixating on these metrics is myopic. Is Charity B's spending really “better” than Charity C's, based on its slightly different functional expense percentages? If the perfunctory pie chart is all that donors are given, they have no choice but to reach that conclusion.

If organizations communicate not just the why but also the how of spending, donors are better equipped to find a good fit. In this case, donors will find the ways in which money is to be used to support breast-cancer patients more relevant than just the why but also the how: Rather than just being provided the program spending rate, donors are consistently informed of precisely how those programming dollars are used.

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