

## **Our Little Secret -- Why Nonprofits Will Never have \$80 Screwdrivers**

By Thomas McLaughlin

Source: *The Nonprofit Times*, April 2000. Reprinted with permission.

Recently, we had conversations with two different nonprofit managers, each of whom was quite pleased that their organizations routinely post administrative costs of close to 8 percent. “We try to put the money into direct care,” said one.

This is a laudable though completely predictable sentiment. Is there any nonprofit manager out there whose agency tries to spend money on overhead expenses instead of direct service?

Like most such assertions, this one was as much an expression of philosophy as a statement of fact. From what we knew of both agencies, they certainly did not overspend on administrative costs. On the other hand, they were not cold-water bathrooms, 60-watt bulbs, and reuse-the-teabag types either.

Ironically, just a few miles away from where one of the executive directors sat was a major research-intensive university that we happen to know carries a routine overhead rate of over 100 percent. While we have never asked, we suspect that the organization would also say it likes to keep its overhead low and put most of its funds directly into education.

How can one explain this seeming paradox? Is it really true that two nonprofits can have such dramatically different overhead rates? Who’s mistaken here?

### **Defining and Calculating Indirect Costs**

The puzzling answer is that there is no mistake. They’re both right, each in their own way. For its part, the vast majority of the university’s buildings are relatively no more opulent than those of the smaller nonprofit. And although the university does generally have a much larger overhead structure, it’s certainly not 12.5 times larger, as its 100 percent overhead rate would suggest. So why are both right?

The answer begins with the definition of the term *indirect cost* (note: we’ll use the term indirect cost, although it can be called other things, such as administrative cost, management expense, general and administrative expense, overhead, etc.). Costs clearly associated with the mission of a nonprofit such as full-time staff and the cost of supplies that the programs use, are fairly easily attributed to programs in most accounting systems. This means that they are direct costs.

The next challenge is to calculate it. Table 1 (See tables below) shows a highly simplified nonprofit agency budget based on a two-program agency and various related expenses. What is the agency’s indirect cost rate? If you said 10 percent, you’d be right. If you said 71 percent, you’d also be right. In addition, if you gave a variety of other percentages you’d probably be right as well, because it all depends on how you define indirect costs.

Here’s how to get those two very different results. Table 2 makes every conceivable expense a direct charge. So it can be argued that the executive director, normally an indirect cost, spends fully half of her time supervising the two program directors. The administrative assistant is said to spend a third of her time dealing with indirect matters, and accepts the full charge for rental of the administrative space.

Formula: Indirect costs are drawn from the shaded areas. Based on this example, that means:

- 50 percent of the Executive Director's time plus 22 percent for taxes and benefits for a total of \$36,600;
- 33 percent of the Administrative Assistant's time plus 22 percent for taxes and benefits for a total of \$10,065
- \$5,000 for administrative rent. This produces a total indirect cost of \$51,665. This indirect costs as a percentage of total cost creates an indirect rate of 10 percent.

In table 3, indirect expenses is defined extremely broadly. This is what happens in federal funding (like what a university gets), where recipient organizations must charge a federal overhead rate based on a specific formula. It's also related to why the Pentagon is often accused of buying \$80 screwdrivers (\$4 for the screwdriver and \$76 automatic overhead charge on every order). In this computation the rate is a percentage of direct costs, not on the total budget as in the first example, which drives the rate even higher.

Formula: indirect costs are again drawn from the shaded areas. Indirect costs are: 100 percent of the time of all staff other than direct service staff plus 22 percent for taxes and benefits for a total of \$201,300; 100 percent of administrative rent and vehicle costs \$10,000.

This totals \$211,300, making the indirect rate 71 percent. Remember, unlike in the previous example, indirect cost is defined as a percentage of direct cost, not total budget. Direct cost is \$296,000 (\$507,300 total– \$211,300), so  $\$211,300/\$296,000$  is 71 percent.

### **Why it matters**

All of this seemingly obscure technical calculation is important for two reasons. First, the general public believes that indirect costs in a nonprofit are inherently bad and should be minimized or eliminated altogether. Although we in the nonprofit management sector may know better, we have to go along or risk losing funding or credibility. So, managers attempt to creatively define indirect costs out of existence.

But the real problem is that, by claiming indirect rates are rock-bottom-low, managers are subtly devaluing the work of management. That will be an even bigger problem in the future because the demands of the external environment are forcing the cost of management up, not down. Greater use of technology, the need to do more fundraising, and the overall cost of doing business all drive indirect costs up. Those who believe they can get away with less and less spending in this area are simply being short sighted.

Yet, the tension will continue. The average donor, empowered with more and more freely available information about nonprofit recipients, will demand low indirect costs as a condition of philanthropy. Media outlets are becoming savvier about the implied cost-benefit ratio of indirect costs to direct costs.

The pressure to report low indirect costs will not go away. Considering the relative lack of other structural pressures on nonprofits, this may very well be healthy for the sector overall. But that doesn't mean individual nonprofit managers should take their own press releases too literally. They must find a way to honestly report competitively low indirect costs even as they pay more and more attention to management matters. That can be the sector's little secret.

**Table 1. Agency Budget  
Computation of Indirect Costs**

Item	Dollars
Executive Director	\$60,000
Program Mangers (2)	80,000
Administrative Assistant (1)	25,000
Direct Service Staff	200,000
Payroll Taxes & Benefits (22% of salaries)	80,300
Direct Supplies	40,000
Program Rent	10,000
Administrative Rent	5,000
Vehicle Costs	5,000
Miscellaneous	2,000
<b>Total</b>	<b>\$507,300</b>

**Table 2. 10 Percent – Aggressive  
Computation of Indirect Costs**

Item	Dollars
Executive Director	\$60,000
Program Mangers (2)	80,000
Administrative Assistant (1)	25,000
Direct Service Staff	200,000
Payroll Taxes & Benefits (22% of salaries)	80,300
Direct Supplies	40,000
Program Rent	10,000
Administrative Rent	5,000
Vehicle Costs	5,000
Miscellaneous	2,000
<b>Total</b>	<b>\$507,300</b>

**Table 3. 71 Percent – Broad  
Computation of Indirect Cost**

Item	Dollars
Executive Director	\$60,000
Program Mangers (2)	80,000
Administrative Assistant (1)	25,000
Direct Service Staff	200,000
Payroll Taxes & Benefits (22% of salaries)	80,300
Direct Supplies	40,000
Program Rent	10,000
Administrative Rent	5,000
Vehicle Costs	5,000
Miscellaneous	2,000
<b>Total</b>	<b>\$507,300</b>