

# The Nonprofit Difference

by Woods Bowman

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**W**HAT ARE WE TO MAKE OF FOR-profit charities like Google.org and nonprofit corporations like the furniture purveyor IKEA and the New York Stock Exchange (before 2006)? These peculiar examples suggest that nonprofits and for-profits may have more in common than is commonly assumed, but their rarity also suggests fundamental differences.

The first part of this article explores the structural differences between nonprofits and for-profits, where the question is: What can one do that the other cannot? The second part explores operational differences, especially as they relate to financial decisions. The question then becomes: How should nonprofit finance differ from for-profit finance?

## Structure

There is just one structural difference between nonprofits and for-profits: nonprofits do not have investor-owners. But the implications of this single difference are far-reaching.

The most direct and important consequence is on fiduciary responsibilities. Every organization is a fiduciary for some group. A *fiduciary* is an entity “who obligates himself or herself to act on behalf of another . . . and assumes a duty to act in good faith and with care, candor, and loyalty in fulfilling the obligation.”<sup>1</sup> Fiduciary duties can be legal or moral.

For-profits have a *legal* fiduciary duty to their stockholders. The fiduciary duties of nonprofits tend to have more of a *moral* basis. A membership association has a clear duty to its members. Other types of nonprofits have a duty to groups whose members are identified only by common characteristics, such as age, poverty, or sickness.

Some nonprofits even owe duties to future generations. Examples are nonprofits that finance medical research, preserve historic sites, or preserve our cultural heritage (art museums, symphonies, etc.). These nonprofits tend to own portfolios of investments and manage them so as to produce a perpetual source

of income for current operations—that is, endowments.

There are several advantages to being a nonprofit: attractiveness to donors and members, protected management, and endowment ownership.

**Attractiveness to Donors and Members.** Individuals are more likely to donate to a nonprofit organization than a for-profit one *regardless* of tax-exempt status and deductibility of donations. Owners can be expected to take a portion of the organization's profits for themselves, but nonprofits keep it all to advance their mission. In addition, most membership associations are organized as nonprofits rather than as for-profits because nonprofits allow members more control.

**Protected Management.** If a for-profit publicly traded corporation performs poorly, a group of investors may buy it. Then, using their newly acquired power to influence policy, the investors can replace the management team. But there is no way for disaffected individuals to “fire” the board of a nonprofit and take control, except in the case of

membership associations with elected leaders. Only state attorneys general may sue to remove the management of a nonprofit, something which rarely occurs. This advantage has an important implication—it permits endowment ownership.

**Endowment Ownership.** The purpose of an endowment is to subsidize goods and services below their cost of production indefinitely. A for-profit firm faced with a product that costs more to produce than it earns would drop the product, not endow it. If it attempted to endow the product, a group of investors would surely emerge to take control of the organization and its endowment. Nonprofits, on the other hand, have protected management, enabling them to own their endowments.

Besides the intrinsic advantages arising from the absence of investor-owners within the nonprofit model, public policy also favors nonprofits in the following ways:

**Tax advantages.** Nonprofits are exempt from federal and state income taxes, and charitable organizations are eligible to receive donations that are tax deductible to the donors.

**Bankruptcy.** A nonprofit's creditors cannot force it to involuntarily liquidate, and, when nonprofits choose to reorganize under Chapter 11, they remain debtors in possession.

**Financial Transparency.** The U.S. Supreme Court has made it clear in a series of decisions that state and local laws cannot compel nonprofits to disclose their fundraising or administrative costs to prospective donors.

Federal law requires publicly traded for-profit companies to have annual meetings that are open to their stockholders, as well as to have annual audits, but it makes no comparable demands on even the largest nonprofits. The most recent federal law on corporate accountability (the Sarbanes-Oxley Act)

exempts nonprofits from all but two provisions: whistleblower protection and documents retention.<sup>2</sup>

An informational return filed annually with the IRS (Form 990) is the only information that federal law requires tax-exempt nonprofits to make available to the public, but no one verifies the self-reported information. According to research and news accounts, a significant number of Form 990 returns contain material omissions and misrepresentations.<sup>3</sup>

These policies notwithstanding, there are some disadvantages to being a nonprofit, the biggest being a shortage of cheap capital for expansion. Although nonprofits receive gifts of capital, these are not free. Fundraising costs may be substantial. In addition, the pool of major donors is limited for nonprofits, whereas the pool of capital available to for-profits is virtually unlimited and truly global. When a for-profit has an IPO (Initial Public Offering), its stock sells out in a day. And while the investment banker is well compensated, the amount of money raised relative to issuance expenses is enough to make any nonprofit envious.

A second disadvantage is more ambiguous. Because management is protected, as explained above, nonprofits provide space for amateurs to learn on the job and make mistakes. One of my favorite quotes, by Amanda Parry, is, “[Nonprofits are] like weeds, they often can grow under conditions others can’t.”<sup>4</sup> However, this charming advantage has a dark side: if a board is completely derelict in its duties, there is no way for outsiders to stop it from being run into the ground, short of intervention by a state attorney general.

## Operation

Although nonprofits are not in business to make money, they are, nevertheless, in business: they hire people, they produce

goods and services, and they have bills to pay. This means that nonprofits should function mostly in the same manner as for-profit businesses, but with some key differences.

Nonprofits should be businesslike, but not necessarily run “like a business.” This is not a contradiction. To run an organization “like a business” is to mimic for-profit businesses, including their goals. An online search of definitions for “businesslike” turns up the following qualities: *methodical, systematic, purposeful, earnest, practical, unemotional, careful, diligent, enterprising, industrious, hard-working, thorough*, among others. For-profit businesses do not have a monopoly on these admirable characteristics.

The call for nonprofits to be more businesslike is hardly new. During the eighteenth century, so-called “joint stock philanthropies” spearheaded a reform movement. They did not have stockholders in a legal sense; they earned the name by being managed like commercial enterprises, with a chief executive and a board of directors.

Like businesses that sold stock to the public instead of relying on a few partners to bankroll a project, joint stock philanthropies solicited the general public rather than relying on the generosity of a single individual or family. Almost three hundred years later, modern charities still follow this model.

Without investor-owners, nonprofits may generate income from sources other than the selling of goods and services from which for-profits benefit, such as gifts, grants, dues, and endowments. If a nonprofit has no such sources of *alternative income*, it may develop them, giving it strategic options unavailable to a for-profit firm.

Financial models used by for-profit managers must be modified before applying them to nonprofits, because

alternative income reverses financial logic. In for-profit firms, production creates revenue through sales of goods and services, but in nonprofits the amount of alternative income determines the amount of goods and services that an organization is capable of producing.

Nonprofit financial management has six chief concerns—*procedures, liquidity, resilience, sustainability, growth, and values-centered strategy*.

There are certain business tools and concepts applicable to these concerns, but they must be redefined before they are useful to nonprofits. For the following discussion, I used a large national database of ordinary nonprofits spanning five years to determine the fraction of nonprofits adhering to various standard management practices.<sup>5</sup> “Ordinary,” in this context, refers to nonprofits that are neither membership associations nor grant makers, and which are not endowed.

### 1. Procedures

The most important aspect of any organization’s finances is the control environment. Nonprofits need to pay attention to ethics and proper procedures for handling money in order to prevent theft (internal controls). The procedures are very similar for both for-profits and nonprofits, but there are two differences worth noting: the incidence of financial crime, and the presence of CEOs on boards.

Financial crimes are more common in the nonprofit sector than in business or government.<sup>6</sup> This is probably true because many nonprofits have untrained persons responsible for handling money. Anecdotal evidence suggests that the nonprofit work environment places a high value on the virtue of trust, and perpetrators are typically persons far above suspicion: they seem dedicated,

loyal, and they never take a day off. Nonprofits need to start taking special care in handling money, whereas careful money handling is built into the DNA of for-profits.

As for CEOs on boards, it is common for the CEO of a for-profit corporation to sit on his or her own board, but in the business world a board represents the interests of stockholders—and CEOs are usually stockholders. It is far less common for nonprofit CEOs to sit on their boards, because nonprofit boards represent the interests of the people they have a duty to serve. The interests of nonprofit CEOs are often ambiguous, and must be intuited. In the nonprofit setting, dialogue between manager and board is a useful discovery tool that is enhanced by maintaining separate and distinct roles.

A board’s chief responsibility is to hire a CEO, set goals, evaluate the CEO’s performance, and fire him or her if necessary. The board is also responsible for verifying the enforcement of applicable laws, like the whistleblower protections and document retention requirements of the Sarbanes-Oxley Act.<sup>7</sup> Boards tend to be clubby, so these oversight functions may be compromised when the CEO sits on his or her own board, even where the CEO is not on an oversight committee and abstains from voting on oversight matters.

BoardSource and the Independent Sector provide this good general advice: “Nonprofits must start by protecting themselves. They must eliminate careless and irresponsible accounting practices and benefit from an internal audit that brings to light weak spots and installs processes that are not vulnerable to fraud and abuse. Written policies that are vigorously enforced by executive staff and the board send a message that misconduct is not tolerated. These policies should cover any unethical behavior

within the organization—including sexual harassment.”<sup>8</sup>

### 2. Liquidity

The first operating imperative is to pay bills as they come due. A financial manager’s biggest nightmare is running out of cash. Nearly all ordinary nonprofits understand this intuitively. Almost 90 percent have positive liquidity and a majority has a comfortable amount, defined as the equivalent of one month of nonprofit working capital or more.

According to an Urban Institute study undertaken by Elizabeth Boris and colleagues, over half of human service nonprofits reported that late payments by governments were a problem, making it necessary to adjust conventional definitions of liquidity so as to take into account reliance on government contracts and local conditions.<sup>9</sup>

Nonprofits and for-profits measure liquidity by the extent to which cash and near-cash assets (current assets) exceed liabilities coming due within one year (current liabilities)—an amount generally known as working capital. Business finance texts include marketable securities in their definition of near-cash assets, whereas nonprofits have reasons for holding marketable securities that do not apply to for-profits (see discussion on operating reserve, under *Resilience*, below).

As a result, nonprofits should exclude marketable securities from working capital. Furthermore, for-profits do not have assets with donor restrictions or pledges, all of which get reported as restrictive on financial statements. Nonprofits should exclude these from their calculations of working capital.

### 3. Resilience

When maintaining annual surpluses and adequate liquidity becomes routine, the next task is to build an adequate

operating reserve to provide a margin for error and a cushion in case of sudden economic adversity.

For-profits generally do not have operating reserves. When economic adversity strikes, they cut costs by laying off workers and/or cutting services. Nonprofits experiencing economic adversity, on the other hand, try to avoid laying off workers and cutting services. Nonprofits need an operating reserve.

To build a reserve, a series of extraordinary annual surpluses is necessary. However, once an organization obtains an adequate reserve, its surpluses can return to normal, except when it has to replenish the reserve following a deficit year.

The question is, how large should a reserve be? The Nonprofit Operating Reserves Initiative Workgroup (NORI), an ad hoc group sponsored by the National Center for Charitable Statistics, the Center on Nonprofits and Philanthropy at the Urban Institute, and United Way Worldwide, has endorsed maintaining an operating reserve equivalent to three months of spending on operations.<sup>10</sup>

Ordinary nonprofits intuitively understand the utility of having a reserve. The proportion having positive reserves is nearly as large as the proportion with positive liquidity, and approximately half maintain their reserve at the NORI-recommended level.

But every organization should evaluate the NORI recommendation in light of its own particular circumstances. It should evaluate the likelihood that it will need sudden access to cash on a short-term basis, and calculate how much it is likely to need. An arts organization may need more (if it has an off-season, say), while a research organization may need less (if, for instance, its sole source of funds is an endowment).

The assets identified as being available in an emergency do not need to be as liquid

as cash or cash equivalents, but they do need to be convertible into cash within the span of a few months at the latest.

#### 4. Sustainability

A nonprofit's annual surpluses must be large enough to sustain financial capacity indefinitely, and to make additional investments for growth. I call this the sustainability principle. The nonprofit rule for long-run sustainability is that return on assets (ROA) must be at least as large as the long-run rate of inflation. This is a critical difference between nonprofit and for-profit businesses.

For-profit businesses tend to focus on return on investment (ROI) instead of ROA. However, ROI favors riskier, debt-financed financial activity, thereby increasing bankruptcy risk.<sup>11</sup>

Shareholders of a for-profit business that increases its borrowing can manage the additional risk individually by buying or selling its stock—depending on the shareholders' appetite for risk. Nonprofits have no stockholders, so the people they serve bear all of the increased risk from borrowing, and they have neither a voice in selecting managers nor the tools to manage unwanted risks.

When a for-profit firm considers undertaking a new project, it can focus on return and ignore risk without violating its fiduciary responsibility. By contrast, nonprofits have to be especially careful to evaluate the organization's risk-exposure in any new venture. Its fiduciary responsibility requires no less.

The single most important formula that is not commonly found in nonprofit finance texts is one that emphasizes perpetual stewardship. Given that the long-term rate of inflation is 3.4 percent, the minimum annual budget surplus needed to maintain assets at their replacement cost is:  $\text{Annual Surplus} = 3.4 \text{ percent} \times$

$\text{Total Assets} \div \text{Annual Spending}$ . This is a necessary condition for delivering service at the same volume and quality indefinitely.

Applying this formula to a large national database shows that ordinary nonprofits tend to focus on the short-term at the expense of the long-term. Although half or more have adequate liquidity and operating reserves, less than 40 percent are able to preserve their assets over the long run.

This finding is consistent with anecdotal observations of nonprofits struggling to serve their clientele and being loath to turn anyone away. However, this short-term compassion has a long-term downside for the health of the organization. Failure to maintain assets at their replacement cost necessitates periodic capital campaigns to renew the existing capital stock.

#### 5. Growth

Once an organization is sustainable, it has a base on which to grow. Managing growth is harder for nonprofits than for for-profits, because nonprofits have access to many types of revenue whereas for-profits just have "earned income," meaning income from selling goods and services.

Having more revenue options is both good and bad. More options means access to more dollars, but having more options also multiplies the number of strategic decisions to make regarding which sources of revenue to pursue. A diversified revenue portfolio provides some protection from the downside risk of any one of them drying up, but each source of revenue presents different management issues, which expands the skill set that nonprofit managers need.

Alternative income (gifts, grants, dues, and investment income from endowments) allows nonprofit clients to receive more service at lower prices than



the market would charge. Unfortunately, it also renders management more difficult and nonprofit finance less intuitive.

Nonprofits cannot sell stock to raise capital, so they must maintain large operating surpluses or stage capital campaigns, which have long lead times and are expensive. For many nonprofits, this restricts their growth prospects.

Each type of income is appropriate to a different provider/recipient combination. The key is having sources of income consistent with the nature of benefits conferred on, or of interest to, the providers of resources. In some cases, this may lead to reliance on a single source; in other cases, it may require a multiplicity of revenue sources.

Approximately 18 percent of ordinary service providers use a funding model almost entirely dependent on philanthropy, while 30 percent virtually ignore it, relying primarily on earned income. One-half uses a model that mixes both philanthropy and earned income. Only about 3 percent have neither kind of income, relying almost entirely on government support.

## 6. Values

Nonprofits *are* different. Their “business” is promoting values, and there is evidence that they do in fact act differently from profit-seeking firms. This is the case even with those nonprofit industries that depend greatly on commercial income.

To some observers, nonprofit hospitals are “large and highly commercial” enterprises that “do not look, feel, or act very much like the mental images that most of us have of nonprofit organizations.”<sup>12</sup> However, in 114 comparative hospital studies, nonprofits performed better in terms of economic performance (21 studies), quality of care (14 studies), and accessibility for unprofitable patients (28 studies).<sup>13</sup> Only 11 of these studies found that proprietary hospitals performed

better under the same criteria. The rest were inconclusive.

Furthermore, in 68 empirical studies of nursing homes, nonprofit nursing homes unambiguously performed better in terms of quality and accessibility—26 studies compared with 6 studies; the rest were inconclusive. For-profit homes had better economic performance—19 studies compared with 5 studies; the rest were inconclusive.<sup>14</sup>

Nonprofit organizations must become more sophisticated about “defining, producing, and documenting the unique and value-oriented outcomes that only mission-driven work can deliver.”<sup>15</sup> The fiduciary responsibility of nonprofits is to serve people in the best possible way—and this gives nonprofits a competitive edge over for-profit rivals.

An organization’s values are integral to its long-range strategy for delivering service, which in turn determines the amount of long-term financial capacity needed. Values must not change, but the environment does, which may in turn change how values are expressed. Updating the kinds of services provided by an organization, as well as the service delivery model it uses, should be done periodically by the board, in conjunction with the management team.

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Returning to the questions that introduced this article, what *are* we to make of the New York Stock Exchange operating as a nonprofit for nearly 200 years, for-profit charities like Google.org, and for-profit companies operating as nonprofits, like IKEA?

The New York Stock Exchange was formed to trade stocks, but it also served a regulatory function, sanctioning members who did not follow the rules. Until recently, it was competitive with other exchanges around the world. Initially, the advantages of being an

exclusive, member-controlled nonprofit outweighed the disadvantages of limited capital, but when major changes in its environment required vast new sums of capital in order to adapt, the advantage shifted toward being for-profit.

Google attempted to overcome the nonprofit capital constraint by using its ability to raise capital to finance an ancillary, but distinct, social mission. Its goal was nothing less than “re-inventing” philanthropy, but it has yet to find a new workable model.<sup>16</sup> To the outside observer, Dot Org (as company insiders call the philanthropic division) appears to operate more like a venture capital firm with a social agenda. This is a novel and useful paradigm, even if it has not inspired other corporations to follow suit.

IKEA has enjoyed a near-monopoly on the do-it-yourself furniture market, so it has not needed external sources of capital to grow. The nonprofit arrangement has served its founder well by allowing him to remain firmly in control for decades. The definitive study of IKEA has yet to be written, but a probable consequence of self-financing is slower growth, which IKEA has accepted as the trade-off for tight control over all aspects of its operations.

These stories illustrate the trade-off between control and capital that all organizations must confront, causing us to wonder which financing rules and techniques are transferable from for-profits to nonprofits. The answer is complicated. Most business rules and techniques work well for all nonprofit organizations. Others need considerable modification, because nonprofits are different from for-profits in structure and operation. Nonprofit managers should examine the rules they follow and the techniques they use, and then—as traffic signs say at dangerous intersections—proceed with caution.

## ENDNOTES

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