Can Nonprofits have too much money?

The financial question for those organisations

Topic of the month February/March 2014

Introduction

At the end of every year after the holiday season, nonprofit organizations check their bank accounts. For many nonprofits, the time before Christmas is their harvest time in terms of fundraising. People are in the mood of love, joy, and solidarity and thus, willing to give for people in need. And in a rich country such as Switzerland, enormous sums are donated to charitable purposes. In 2012, private donations exceeded 1.6 billion CHF, accompanied by 1.5 billion CHF by foundations and another 1 billion CHF by companies. In international comparison, Switzerland regularly hits the top three ranks in terms of private giving.

As a consequence, especially the large charities in Switzerland are financially well situated. The implementation of specific accounting standards in 2003 (Swiss GAAP FER 21) lead to a higher transparency and, in consequence, to some inconvenient questions by journalists and the public. Until now, apart from sporadic articles about well-financed nonprofits or scandals of mismanaged assets, a general discussion about the financial needs of nonprofits has not emerged. Nevertheless, the academic discourse on financial health of nonprofits is accelerating. Whereas in other countries questions on rationing are dominant, large Swiss nonprofits have to face the question of how to deal with high amounts of reserves and donor-advised funds in the context of impact measurement and accountability.

In this article we take up recent developments in research and practice and oppose the pros and cons of financial slack in nonprofits. First, we discuss the prevalent unconcern of nonprofits in financial issues. Second, we emphasize the increasing importance of accountability and its consequences for nonprofit financial management. Then, we consider the actual all-dominant argument of investment and growth that puts nonprofits closer to business companies. Finally, we will present some decisive aspects on financial health.

The financial ignorance of nonprofits

Nonprofit organizations are usually defined by naming several core criteria such as volunteering, purpose driven or independence from state. Above all, the most important criterion is the non-distribution constraint. Nonprofits are not restricted from making profits, but if they do so, they cannot distribute their surplus but have to reinvest it in the line of the organization's purpose. It is the focal distinction to market or state entities and involves fundamental consequences in the general perception of nonprofits.

From a theoretical point of view, the non-distribution constraint is the decisive factor for the existence of nonprofits. Where market-driven companies fleece clients because of information asymmetries or state agencies ignore minorities because of democratic procedures, nonprofit organizations reduce such failures and by this contribute to a well-functioning society. Nonprofits are said to obtain higher confidence from constituents, to act long-term oriented, and to reduce information asymmetries. Additionally, the non-distribution constraint implicates the absence of owner-

ship and individual profit seeking. Members of a nonprofit association or funders of charities do not search for individual profit when supporting their organization. As a consequence of all this, nonprofits tend to develop a persistent ignorance in financial issues.

In contrast to business companies, earnings are a precondition of corporate action, not the aim. Even in academic literature it is surprising how few pieces can be found that deal with nonprofit finances (excluding fundraising literature, which is to a large extent driven by marketing aspects). In practice, this financial ignorance is often the origin of wrong management decisions and organizational inefficiency in both ways – financial insufficiency and overfunding.

The accountability paradigm

The current answer to these developments is the accountability paradigm. The improvement of reporting and performance measurement is seen as the best way to improve the allocation of resources in nonprofits. One can differentiate between two basic forms of accountability: legal and moral.

Legal accountability is based on formally and officially defined contracts that both parties accept. Moral accountability exists when reporting is legally not required but parties believe there is an obligation for one to be accountable to the other. Following the assumptions of the underlying agency theory – self-interest and information asymmetry – accountability is mostly about organizing oversight and measuring past activities. Hence, the final aim of strengthening accountability is to enable nonprofits to provide more effective services in more efficient ways.

The investment and growth argument

Notwithstanding the importance of accountability and performance measurement, a new movement of rethinking the functioning of nonprofits is growing. Adapting strategies and techniques from venture capital to the financing of social purpose organizations, the notion of investing and re-investing was introduced in philanthropy. As a consequence, the understanding of giving transformed from alms to investment.

Nonprofits turn into hybrid organizations combining social and economic goals in favor of a better goal attainment. The basic idea of hybrid organizations is to use economic value creation strategies to solve social problems and by this, increase the utility of the donated money. At the forefront of this movement people like Dan Palotta call for a new framework of nonprofit actions, pushing them to be even more business-like. They criticize that nonprofits are too much measured by their inputs (especially cost efficiency) instead of their social impact. They blemish the uneven assessment of nonprofits and businesses.

For example, business start-ups can stay unsuccessful for several years and invest all their capital in business development, whereas nonprofits have to proof effectiveness and low administrative costs from their first day on. Consequently, they claim that nonprofit should focus just as business firms on investment and growth in order to increase their social impact in the long-run.

‘In general, nonprofits have to develop a new understanding of financial health.‘

Rethinking financial health of nonprofits

Although the growth argument is fascinating and compelling, it undervalues the fiscal and legal advantages that nonprofit have over profit companies. Hence, making nonprofits even more business-like endangers the loss of privileges such as tax exemptions or tax deductions for donors.

Nevertheless, nonprofits have to develop a new understanding of financial health. As much as austerity decreases goal attainment and capability, abundance puts nonprofits at risk to loose mission focus and, consequently, donor support and reputation. Nowadays, most nonprofits are insufficiently prepared to value their financial risks, introduce a fair asset pricing model, and combine their financial potentials with their given purpose. Especially for nonprofits with large fortunes the last aspect is of high importance.

Otherwise they risk their good reputation if clients, donors and the greater public once catch the idea, that nonprofits actually can have too much money.

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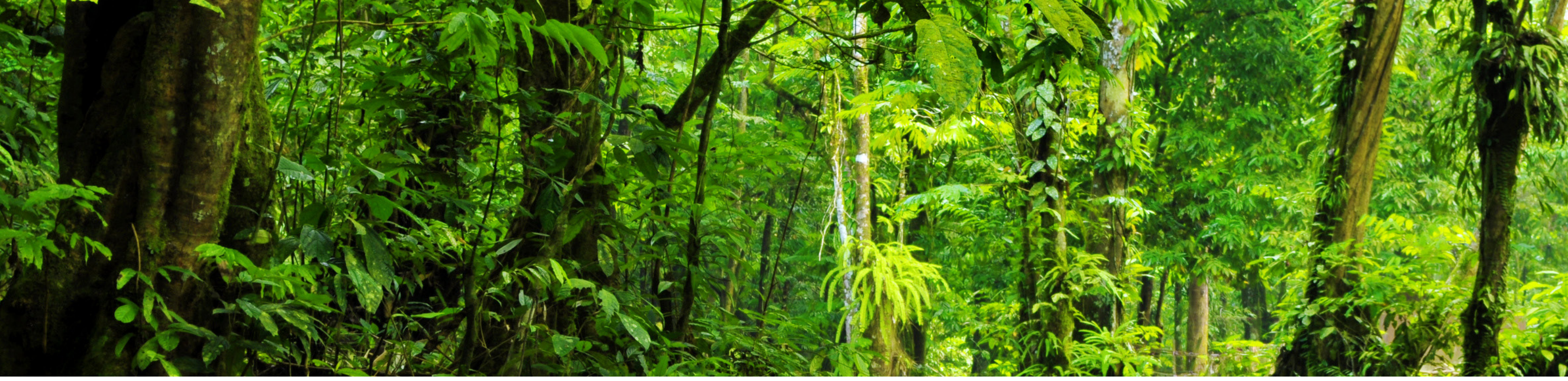
The Center for Philantropy Studies (CEPS) at the University of Basel is an interdisciplinary research and further education centre of the Swiss Foundation System. The CEPS was established in 2008 by an initiative of SwissFoundations, the Association of Swiss Grantmaking Foundations. The CEPS is a research think tank which deals with the multifaceted topic of philanthropy. - ceps.unibas.ch/en



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