Competition in the Non-Profit Sector Part IV

From Management in the Not for Profit Organization

The amount and manner of competition among not-for-profits have been changing, and the stakes are getting higher (please see previous installments of this series in the archives section).

Financial, political, and bureaucratic factors have coalesced into a morass that is threatening large and small organizations alike. In short, many nonprofits are finding themselves in a position where they are expected to do more and more, with less and less. Many organizations have cut back their services. Some have ceased to exist.

Solid numbers regarding the dissolution of nonprofits are difficult to come by. The primary source of financial data in the nonprofit sector in the United States has been Form 990. However, if an organization stops filing a Form 990, one cannot assume that it was because it ceased to exist due to the aforementioned pressures. Indeed, some not-for-profits voluntarily close their doors because they have successfully achieved their missions and the need for their services no longer exists. Also, one agency might have merged under the banner of another and disappeared in name only. Furthermore, organizations might dip beneath the dollar threshold at which a Form 990 is required. These continue to function, but are beneath the radar of the federal government.

Still, the anecdotal evidence is clear. Virtually everyone in the field with whom this writer has spoken, regardless of the US State in which they operate, is employed by or knows first hand of an agency that is on the brink of extinction. These observations cross many lines of funding and mission. Even those with strong endowments have suffered (due to the “dot com bust” and a stagnant economy).

As organizations compete for the limited resources, some will survive and some will not. Which will be winners and which will lose? This paper examines some of the existing thinking on this subject, and offers some thoughts that might help develop models that will serve as predictors and warnings.

Efforts to determine which organizations are at risk for failure have been underway in the for-profit sector for many years. This type of research was essential to those who considered whether or not to invest money in a particular business. Attempts to adapt those methods to the non-profit arena lagged far behind the initiation of their use in for-profits. This is, perhaps, because the concept of "investment" in a not-for-profit is in some ways an oxymoron. That is, by definition a 501c(3) entity cannot distribute "profits" to its "investors" in the traditional sense.

This does not mean that it is unimportant to have such models for nonprofits. It just means that the recognition of the need came late, so there is much catching up to do.

Donors want to know that their contributions are not being thrown into a bottomless pit.

Those who purchase bonds issued by nonprofits need to be assured that their investment will pay off.

Government agencies and others who contract with not-for-profits need to know that the organizations can fulfill the terms of the agreements.

Prospective and current employees need to evaluate their degree of job security.

Those who make decisions within nonprofits would benefit from the guidance of accurate models as they engage in risk management. Indeed, as argued by Reiser[1], it is this writer's position that it is important for each and every member of a nonprofit to participate in the oversight role. In doing so they require an understanding of what constitutes undue risk. A sound model of the behaviors and circumstances that create threats to a nonprofit's survival can be a key component of such a comprehensive system of oversight.

So, which analytical models are reliable and useful?

An excellent paper on the matter was done by Keating, Fischer, Gordon and Greenlee[2]. They examined the methods of Altman, Ohlson, and Tuckman & Chang in depth. Of these, "…the Ohlson model performs substantially better than the other models individually or combined…". However, "Despite its superior explanatory power, the Ohlson model actually classifies more firms incorrectly than the naïve model" which is simply a prediction that none of the organizations in the study will become distressed. In its summary, the paper reports:

“While the existing prediction models provide insight into some indicators of future financial vulnerability, they are not very effective in distinguishing the particular firms that will experience distress. Therefore, researchers and practitioners are not encouraged to use any of these models for purposes of default or bankruptcy prediction.”

The Ohlson model measured such things as working capital-to-total assets, liabilities-to-current assets, net income-to-total assets, total liabilities-to-total assets, a scaled change in net income, and it also included size and cash flow variables. Ohlson designed his model for use in a for-profit setting. Therefore, Keating, et al modified some variables to make the model more relevant to the not-for-profit environment.

Next, they supplemented the variables from the models they studied with two large categories that might be related to a non-profit’s viability: systematic and firm specific. Systematic refers to macroeconomic factors such as regional and industry factors. Firm-specific factors include such things as fundamental accounting based signals, earnings on investments, etc.

Keating et al then attempted to improve upon the above by adding two additional variables: reliance on commercial revenues and endowment sufficiency. They hypothesized that there was a direct relationship between these and the viability of an organization. With these additions, their measurements showed some improvement in the predictive ability of the model. But accuracy and reliability were still insufficient for use in decision-making.

In a paper prepared for a presentation at the 1998 Annual Meetings of the Association for Research on Nonprofit Organizations and Voluntary Actions, Mark A. Hager encouraged the exploration of a different approach[3]

He found methods such as those described above to be insufficient and encouraged investigation of idiographic approaches to causation   He asserted that “Change in organizations is a dynamic process that is not typically captured well by models that investigate the patterns of covariation of organizational characteristics in a population of organizations. Rather, methods that consider the roles that discrete events play in the unfolding of organizational life histories may be more useful in describing and understanding organizational change”.

The method he describes involves the study of a “strategic narrative” using Heise’s (1989) event structure analysis (ESA). This entails the development of a narrative using the skill of an interviewer and the judgment of the interviewee. ESA is then utilized to delineate the sequence of events that led to the outcome, and the causal relationships among those events.

Theoretically, this method might be honed to a point where it can help to identify organizations early in the process of their demise. However, it depends upon accurate memories, sound judgment, and forthrightness in those being interviewed. Similarly, the interviewing and documentation techniques would require a significant degree of consistency. While all of these things can be difficult to measure, and impossible to completely assure, this method appears to be a valuable adjunct to more traditional measurements of the correlation among variables. As such, this historical information could be valuable to decision makers for whom it is important to know when a nonprofit is in distress, and how to best intervene.

This writer considers three other factors, which were not specifically mentioned in the aforementioned studies, to be critical in the assessment of whether or not an organization will become distressed. These are:

1. The amount, quality, stability and political connectedness of competitors

2. The morale, ability, and stability of the organization’s human resources.

3. Legal/Regulatory status

Competition has become very fierce (please see previous articles in this series). This results in a thinning of the herd. However, even if an organization is in financial distress, they might still survive if they are the only game in town. On the other hand, even a small amount of financial difficulty might cause political enemies and competitors to smell blood and go in for the kill if the organization has made significant enemies.

Human resource issues must be a consideration, but models reviewed during the research for this article have, at most, given this only passing mention. In fact, these can make or break an organization.

This writer has witnessed examples of organizations whose staff essentially enabled them to continue to function effectively when, by any other measure, they should have ceased to exist. In one instance, an organization's primary customer became unable to pay its bills. The nonprofit had virtually no liquid assets, and almost immediately became unable to meet its payroll expenses. Nonetheless, all of the staff members were fully dedicated to the organization, its leadership, its mission, and its clientele. The employees continued to work without pay for several weeks until the money owed to their organization was forthcoming.

Of course, the opposite has been true as well. When a significant number of staff members arrive at the conclusion that the leaders of the organization are not operating in the employees' or the client's best interests, services can deteriorate quickly. This has led to a landslide of other problems for some organizations. In some cases, it has been a key factor in the destruction of organizations.

Finally, poor legal or regulatory status can quickly cause the demise of any business. Many nonprofits operate in environments that are regulated very heavily. The loss of a license to do business will immediately interrupt services, severely impact financial health, and cause a loss of confidence in management. Legal issues can be just as damaging. An organization facing a major lawsuit might lose large sums of money in the verdict, or via a settlement. Even if the organization wins a lawsuit it can face daunting legal fees.

In assessing which organizations will continue to exist, and which will fold, the above-described methods should be applied to assess not only one's own organization but its competitors as well. This information together with indices geared to measure and predict the size of the market can provide sound bases for decision-making.

There is nothing that can completely substitute for doing research yourself of the sort described above. However, if one wishes to use a fairly quick and easy indicator as a warning bell, one is often available for larger organizations: bond ratings.

For instance, Standard & Poor's has its own formula for gauging the health of human service providers. According to a paper done by John Fargnoli and Martin D. Arrick the "Major factors in Standard & Poor's Rating Services review include:

Service essentiality;

Provider assessment;

Management quality;

Financial analysis;

Funding agency relationship; and

Pledged security and legal structure."[4]

Fargnoli, of course, does not give specific details of techniques utilized to judge each of these items. The weighting assigned to each item is absent as well. In addition, the frequency with which an organization is rated is not clear. However, he provides sufficient description to conclude that the basic logic behind the ratings is sound. If S&P drops the bond rating on your organization, it is not something to merely be explained away at a board meeting. It is useful information in forming an assessment of your organization.

SUMMARY

So who will be the winners and who will be the losers in this rough and tumble competition for shrinking resources? In general if all else is equal, large companies will do better than small ones. They have the ability to spread shockwaves that hit a particular sector of their market over a larger area, thus diminishing the intensity of the impact on any single point. They also can have the benefits of economy of scale. However, there are two main exceptions. Small operations will often beat larger organizations if the larger ones are new to the geographic area, and more importantly, to the people who are the decision makers in that area. Hager, Galaskiewicz, and Larsen addressed this matter in detail in *Structural Embeddedness and the Liability of Newness Among Nonprofit Organizations*; Public Management Review, © 2004 Taylor and Francis, Ltd; http://www.tandf.co.uk/journals. One should never underestimate the impact of personal relationships. The other exception is diseconomies of scale. In this situation, put simply, the organization is so large and inefficient that it cannot get out of its own way.

Finally, if this writer were to compare two competitors and attempt to choose which was more likely to fail, he would look for the following:

A high debt load with poor liquidity

A small or nonexistent endowment

Routinely drawing clientele from the margin, rather than the core of the market

A culture of fear among employees

Alienated funding agencies

Poor communication among decision makers

Serious legal or regulatory issues

"Ponzi scheme" long-term finance planning (in which it will only remain solvent with growth – please see previous article here)

Upper level management with an "us vs. them" approach to managing their own personnel.

High staff turnover rates

Complete knowledge of what causes organizations to fail is impossible due to the myriad forms and settings in which they exist. Even if a perfect model was available, it would not prevent the loss of many nonprofits in the current environment.

However, it is the hope of this writer that a better understanding of the processes that lead to organizational distress will help to reduce unnecessary loss of valuable nonprofit entities. Therefore, much additional research is encouraged and managers are urged to acquaint themselves with the body of knowledge that is currently available.

[1]Dana Brakman Reiser, *Enron.org - Why Sarbanes-Oxley Will Not Ensure Comprehensive Nonprofit Accountability*, Brooklyn Law School Public Law and Legal Theory Research Paper Series, Research Paper No. 6; March, 2004

[2]Keating, Fischer, Gordon, **and** Greenlee, *Assessing Financial Vulnerability in the Nonprofit Sector*, July 2004

[3]Mark A. Hager, *Event Structure Analysis as a Tool for understanding Organizational Life Histories,* completed under sponsorship of the Nonprofit Sector Research Fund, November 1998

4 Primary credit: John Fargnoli; Secondary credit: Martin D. Arrick; *Public Finance Criteria: Human Service Providers*, Ratings Direct, Standard & Poor's, October 15, 2004