

Running Head: Funding Source Diversity

The Relevance of Non-Profit Funding Source Diversity

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Executive Summary

The following study is intended to address the issue of funding source diversity as a best practice for nonprofit organizations in pursuit of financial stability. Does revenue source diversity matter? Do organizations with diverse revenue sources demonstrate better financial performance exemplified by larger operating surplus? Or, does the type and size of the organization influence the answer to the aforementioned questions? Such questions are explored in this analysis. As new nonprofit organizations are founded by the thousands providing vital services to citizens nationwide these questions are very important to consider.

This study will use data from the National Center for Charitable Statistics (NCCS) provided by the Urban Institute and will analyze Bay Area organizations including San Jose, Oakland and San Francisco, with operating revenues totaling less than \$1 million (since the majority of Bay Area organizations are relatively small) in order to test relationships among a variety of financial variables. It is hopeful that the results of the data analysis will reveal new insights that will encourage responsible financial stewardship within nonprofits of the Bay Area.

Introduction

There were 845,233 501(c)(3) public charities registered with the IRS in the United States in 2004 with an increase of 64.7% from 1994-2004 (Pollack and Blackwood, p. 3, 2006). Of the major nonprofit sub-sectors, over 50% of reporting nonprofits perform very important educational and human services to citizens nationwide. In addition, “the nonprofit sector accounts for 5.2% of the gross domestic product (GDP) and 8.3% of wages and salaries paid in the United States” (Pollack and Blackwood p.1, 2006). It is clear that nonprofits represent a powerful force in the public sector yet surprisingly, very little research exists that delves into the capital structure of nonprofits providing best practice principles for maintaining an infrastructure able stand the test of time and weather financial storms.

It is often suggested that nonprofit institutions should “diversify,” collecting revenues from a variety of funding sources in order to prevent reliance upon a single source subject to change, and to increase self-sufficiency. Although an attractive notion on its face, very little empirical evidence exists to affirm or reject this principle as applicable to all organizations. In addition, of the research that exists, larger and wealthier organizations are at the forefront of analysis. It is very important therefore to ask the question: does diversity really matter? Are diverse funding sources important for all organizations?

The purpose of this paper is to test the following hypotheses: 1) non-profits with diverse revenue sources are wealthier, (exemplified by operating revenues in excess of expenditures), than nonprofits with less diverse or concentrated revenue sources and 2) there exists a relationship between the type of services an organization offers and the nature of that organization’s funding base (either diverse or concentrated). It is hopeful, that by comparing revenues, expenses, and funding sources across a variety of

organizations it will be clearer as to whether a diverse funding base should be the goal of most if not all organizations, and if not, why.

Review of Literature

Funding source diversity within non-profit organizations is often posited as a necessity to the wealth and stability of an organization. It is often difficult, however, beyond the process of trial and error for an organization to determine whether or not funding source diversity is necessary and beneficial. In the present paper, the role non-profit fund diversity plays in development of an organizations wealth is investigated. The following literature reviews support or refute the aforementioned hypothesis as well as expose the necessity for further study in this subject area.

Empirical research generally approaches the study of non-profit finance from two distinct angles: 1) comparing funding sources across organizations of varying types and sizes and 2) measuring financial vulnerability through detailed budgetary analysis. Research using the former methodology compares relationships between the amount of funding sources, size and type of organization and growth exemplified through annual revenue. The latter measures determine the likelihood for organizational insolvency (bankruptcy and/or inability to pay debt), including shifts in program expenditures and equity balances while observing revenue diversity or concentration. Both methods ultimately demonstrate the impact of concentrated and diversified revenue sources and financial performance.

Revenue Concentration and Diversity

Chang and Tuckman (1994) concluded that organizations with diversified revenue sources maintained a stronger financial position than organizations with concentrated revenue sources. This finding was exemplified through lower administrative costs associated with fewer funding sources. Researchers built upon the work of Hansmann (1987) and Weisbrod (1998) by splitting organizations into two

categories; *donative* and *program service*. Organizations whose program activities were supported 60% or greater by public donations were considered *donative* and organizations that earned 60% or more of annual revenue from program service fees were considered *program service* or *commercial* organizations. *Commercial* nonprofits were more likely to have a higher revenue concentration than *donative* non-profits indicating that an organizations type impacted the nature of its revenue source.

Foster, Dixon and Hochstetler, (2003) conducted a study investigating the relationship between an organizations revenue source and the size of the organization. Surveying 30 organizations specializing in youth service and environmental advocacy, the study concluded that larger wealthier organizations relied on a single funding source for more than 50% of its revenue; 78% on average for environmental organizations above \$10 million in revenues and above \$3 million for youth organizations. In addition, the study did not find a significant relationship between an organizations type and whether it had diverse or concentrated funding sources, but rather size was a significant factor.

Frumkin and Keating (2002) found that organizations with concentrated revenue sources were more efficient due to reduced fundraising expenditures and lower administrative costs. Growth, exemplified by a change in assets compared to annual revenues and expenses however, occurred both in organizations with diverse and concentrated revenue sources. There was no significant relationship between the diversity of revenue sources and growth.

Foster and Meinhard (2005) in a review of non-profit organizations in Canada, found that the age of an organization was not significantly related to revenue diversification and smaller organizations were slightly more likely to have more diverse revenue sources than large organizations. Foster and Fine (2007) found that the largest 144 non-profits in the United States had more concentrated revenue sources (on

average 90% total revenue from a single source) and were founded in the early 1900's. This study indicated that organizational age does play a factor in the size of the organization and the nature of its revenue sources.

Financial Vulnerability

Financial vulnerability measures are another tool that researchers use to determine trends and patterns in organizational wealth and sources of revenue. Tuckman and Chang (1991) developed commonly used measures to indicate financial vulnerability within non-profit organizations. Following their preliminary research, Greenlee and Trussel (2000), developed a study evaluating equity balances and administrative costs. Organizations with high equity balances were more stable as well as organizations with high administrative costs; with high operating margins an organization could potentially scale back on expenditures to prevent insolvency. They also created a revenue concentration index. Organizations that were considered financially vulnerable exhibited slightly lower equity means, higher revenue concentration and lower administrative costs or operating margins. Organizations falling in the lowest quintile in all of these areas were considered "at risk".

Greenlee and Trussel (2002) performed a follow-up study which observed administrative costs and surplus costs (revenues over expenses as a function of revenues). The follow-up study used a larger sample and additional categories of organizations. The second study found that vulnerable organizations had greater debt, higher concentration of revenues, lower surplus margins and were smaller in size.

Fischer, et al. (2005) concluded that there was a relationship between financial vulnerability (based on a 25% or greater reduction in program expenses over a 12 month period) and the size of an organization using the Ohlson measure of financial

vulnerability. Smaller organizations were more likely to be financially vulnerable if there was a drop in net income in the preceding year. However, Keating et. al., (2005) performed a detailed meta-analysis comparing the measures of Tuckman and Chang, Greenlee and Trussel, Ohlson and Altman, and found often weak and/or conflicting relationships between each financial vulnerability measure and hypothesized organizational outcomes.

Finally, Hodge and Piccolo (2005) compared organizations with varying revenues and measured financial vulnerability against funding types noting that organizations receiving the majority of funding from private sources were less vulnerable than organizations receiving funding from commercial or government sources.

Avenues for Further Research

Although each study utilized a separate methodology, there were consistent trends across the board. The size of a nonprofit influences the variation of funding sources, as well as the type of organization (as defined by the National Center for Charitable Statistics) and the level of operating surplus. However the majority of the aforementioned analyses were inattentive to organizations with revenues totaling less than \$1 million annually. Chang & Tuckman (1994), Greenlee & Trussel (2000) Trussel (2002) and Foster and Fine (2007) focused their analyses on organizations with revenues exceeding \$10 million annually.

It is very likely however, that smaller organizations illustrate different financial characteristics than larger organizations. This paper will attempt to take this work further by focusing on comparatively smaller nonprofits. Although smaller nonprofits comprise a negligent percentage of the total assets of the nonprofit sector, more than 61% operate with revenues less than or equal to \$250,000 annually (Pollack and Blackwood, 2006).

Method

Hypothesis

Since much of the literature in this subject area focuses on larger organizations with revenues exceeding \$10 million, this study analyzes organizations with annual revenues less than or equal to \$1 million. Using a cross-sectional model comparing organizations within the Bay Area (San Jose, Oakland and San Francisco), this study will test the following three hypotheses:

- Hypothesis 1 Larger organizations will utilize fewer revenue sources than smaller organizations
- Hypothesis 2 The amount of funding sources an organization utilizes varies distinctly across service sectors
- Hypothesis 3 Organizations running operating deficits will have fewer revenue sources than organizations with operating surplus

Quantitative

Data Source and Sample

Data will be collected from the National Center for Charitable Statistics (NCCS) using Core IRS descriptive financial data on 501(c)(3) tax exempt charitable organizations from the 2005 data collection year as the unit of analysis. Organizations in the dataset are required to file the IRS form 990 and have revenues exceeding \$25,000 annually. The sample is limited to organizations with annual revenues totaling less than \$1 million and should exceed 1,000 organizations total although the final sample is yet to be drawn.

Variables

This study analyzes data on Bay Area organizations (as mentioned previously) defined by NCCS Metropolitan Statistical Area “Bay Area” (San Francisco, Oakland and San Jose) and broken down into ten major sector classifications as defined by NCCS comparing the utilization of 6 major sources of revenue as compared to total expenses (see Appendix A). In order to test the aforementioned hypothesis’, revenue sources will

be analyzed as both the independent and dependant variable. It is hypothesized that organizations running operating deficits (in the “red”) will have fewer revenue sources than organizations running surplus (in the “black”). To test this hypothesis, the revenue source will serve as the independent variable with surplus and/or deficits as the dependent variables.

It is also hypothesized that the size and type of the organization impacts the amount of revenue sources. Therefore the size and type of the organization will serve as independent variables with revenue sources, dependent.

Qualitative

A minimum of 10 and maximum of 15 organizations will be selected for interviews. Executive staff of organizations will be contacted via phone for potential interviews. The sample is restricted to organizations with annual revenues less than or equal to \$1 million. Staff will authorize consent to be interviewed and will be asked basic questions about sources of revenue past and present as well as their insights and opinions on the ideal mix of funding (see Appendix B and C). Conversations will be transcribed and coded to highlight trends across organizations and or differences.

Issues and Limitations

Obvious limitations are that the sample will include only organizations reporting IRS Form 990 data. Organizations with annual revenues less than 25,000 will not be included in the sample. In addition, the Core dataset, using combines individual, foundation and government grants in one category. It is difficult therefore to analyze the utilization of revenue sources without comparing each specific funding source to the size and type of the organization separately. However, it is hopeful that through qualitative interviews, more detailed information will be gathered adding to research as a whole.

Also, only Bay Area organizations are analyzed for the purpose of this study. It is very likely that the financial behavior of nonprofits varies across geographical locations. However, these additional organizations are not analyzed in this report.

Finally, the ratio of revenues and expenses compared to revenue sources is limited as a justification for revenue diversification and/or concentration in that organizations may incur deficits due to reasons outside of the amount of funding sources. It is possible that mismanagement of funds, in addition to the acquisition of new property in the given year etc., are causes.

Conclusion

It is hopeful that this study will add to previous research by including smaller organizations and limiting the scope to the Bay Area. By including a diverse sector of nonprofits and a variety of financial variables this research should provide further insight into best practice principles for the acquisition of revenue sources and maintenance of financial stability.

Timeline

Month	Task
May	<ul style="list-style-type: none">• Download Data from NCCS Core Data Files
June	<ul style="list-style-type: none">• Selection of 20 prospective nonprofits for interview• Call nonprofits for availability and interest• Schedule 10-15 interviews
July	<ul style="list-style-type: none">• Perform Interviews
August	<ul style="list-style-type: none">• Perform Remaining Interviews• Transcribe Interviews

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Appendix A

NCCS Variables

Variable	Definition
EIN	Employer Identification Number
10 NTE Major Groups	Organization types: <ol style="list-style-type: none"> 1. Arts, Culture and Humanities 2. Education 3. Environment 4. Health 5. Human Services 6. International 7. Mutual Benefit 8. Public and Societal Benefit 9. Religion 10. Unknown
Metropolitan Statistical Area	Bay Area 501(c)(3) Organizations
Average Total Revenue	Line 12 Form 990
Net Income from Special Events	
Dues	
Program Revenue	
Total Public Support	All individual contributions
Expenses	

Appendix B

Methodology and Sample:

Select 10 Non-Profit Organizations of varying size (not exceeding \$1 million annually) and ask the following questions regarding financial performance. Profile each organization using Guidestar, Charity Navigator and the organizations website, before each interview to learn each organizations history, service area, size, etc.

Questions:

Non profits get revenues from various sources including foundation grants, government grants and contracts, corporate grants and donations from individuals, etc., which do you use?

What estimated percentage of each source do you use?

Do you feel that this is the right mix of sources for your organization?

Would you like more or fewer funding sources?

Why is that?

What trends have you observed in your revenues?

Have any actions propelled a recent or past growth in funding?

What are your funding challenges, if any?

Appendix C

RESEARCH SUBJECT INFORMED CONSENT FORM

Prospective Research Subject: Read this consent form carefully and ask as many questions as you like before you decide whether you want to participate in this research study. You are free to ask questions at any time before, during, or after your participation in this research.

Project Information	
Project Title: Funding Source Diversity	Project Number: N/A
Site IRB Number: N/A	Sponsor: N/A
Principal Investigator: Tiffany Green	Organization: San Francisco State University
Location: TBA	Phone: (415) XXX-XXXX

- 1. PURPOSE OF THIS RESEARCH STUDY**
 - You are being asked to participate in a research study designed to gather information on the financial behavior of your nonprofit organization
- 2. PROCEDURES**
 - You will be asked to answer a selection of 10-12 questions which will be recorded and transcribed for the purposes of this study
 - The interview will take approximately 30 minutes to complete
- 3. POSSIBLE RISKS OR DISCOMFORT**
 - There will be no risks and/discomfort associated with this interview
- 4. OWNERSHIP AND DOCUMENTATION OF INFORMATION**
 - The interview will be recorded and analyzed by Tiffany Green – Principle investigator and included in the body of a report. Results will be reviewed by San Francisco State University Professors and will be made available to you should you wish it.
- 5. POSSIBLE BENEFITS**
 - There are no direct benefits associated with this interview other than the addition of valuable information to the study of nonprofit finance.
- 6. FINANCIAL CONSIDERATIONS**
 - There is no financial compensation for your participation in this research.
- 7. CONFIDENTIALITY**

- Your identity should you authorize it, will be revealed included in the interview transcription. The results of the study may be published for research purposes.

8. TERMINATION OF RESEARCH STUDY

You are free to choose whether or not to participate in this study.

9. AVAILABLE SOURCES OF INFORMATION

- *Any further questions you have about this study will be answered by the Principal Investigator:*

Name: Tiffany Green

Phone Number: (415) XXX-XXXX.

10. AUTHORIZATION

I have read and understand this consent form, and I volunteer to participate in this research study. I understand that I will receive a copy of this form. I voluntarily choose to participate, but I understand that my consent does not take away any legal rights in the case of negligence or other legal fault of anyone who is involved in this study. I further understand that nothing in this consent form is intended to replace any applicable Federal, state, or local laws.

Participant Name (Printed or Typed):

Date:

Participant Signature:

Date:

Principal Investigator Signature:

Date:

Signature of Person Obtaining Consent:

Date: