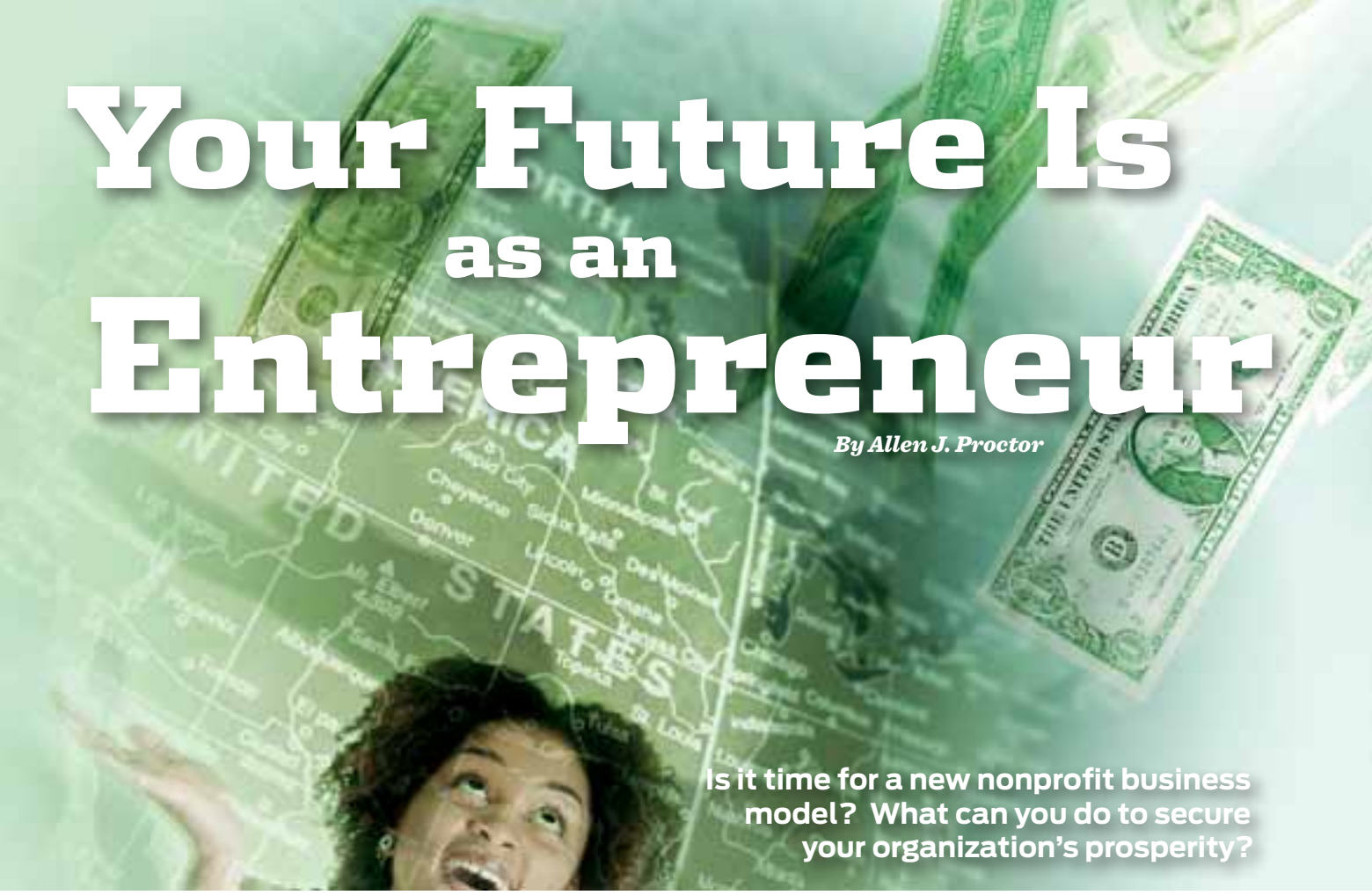
Your Future Is as an Entrepreneur

By Allen J. Proctor



Is it time for a new nonprofit business model? What can you do to secure your organization's prosperity?

The nonprofit business model has gone through many changes over the past century. Initially nonprofits created direct ties between donors and clients. This approach evolved to having employees do most of a nonprofit's work, with donors only connected emotionally by hearing how their money was used.

Over the past 25 years the number of nonprofits grew threefold in the United States, and the business model shifted once again, toward being a contract provider of government services. Philanthropy cushioned the space between what the government would pay and what it cost to provide the services.

This worked fine in the 1980s and '90s. In the last decade, however, government payments fell below nonprofits' costs, and contributions couldn't keep pace

And yet most nonprofits continue to follow this outdated paradigm. A recent Urban Institute survey found that about 75% of its nonprofit respondents had contracts with at least one level of government.

Moreover, the survey found that, when government cutbacks began over the last decade, nonprofits couldn't fill the gap through increased fundraising. Instead they cut wages and benefits, borrowed if they could, and ran down their reserves and even their endowments in an effort to avoid reducing services.

The theory has been that a nonprofit could offer all its services at less than cost and raise funds to make up the difference. You frequently hear people say, "Nonprofits aren't supposed to make money." And many nonprofits still plan to solve their financial problems through increased fundraising.

The Wrong Assumption

The assumption that philanthropy can cover the losses from government contracts has never been a reality. Philanthropy expanded in dollar terms as the number of nonprofits surged, but philanthropy in its best years only managed to rise to 23% of nonprofit revenues. Any notion that philanthropy will surge to close the widening divide in government payments has always been a pipe dream.

> "Philanthropy in its best years only managed to rise to 23% of nonprofit revenues."

Selling goods and services has always been the primary source of nonprofit revenues nationally. The most recent IRS data show that earned income constitutes 77% of nonprofit proceeds.

This share varies by the type of nonprofit, but it falls below a majority only in two sectors:

- P-12 education, which earns 43% of its revenues
- the arts, culture, and humanities sector, which earns 29% of its money through earned income.

Do-It-Now Action Recommendations

To be successful, nonprofits must link money to mission, mission to action, and action to accomplishment. They must see money management as more than numbers. Finance can serve as the primary tool to carry out the most important obligation: to know what's going on. Here are some concrete ways to get started.

- **Identify** the three to five primary activities of your organization. Estimate the revenues, contributions, and expenses for each activity. Be certain that the activities with lower mission priority also have smaller financial losses or larger net revenues.
- **Make sure** you have at least one goal each year that enhances the future sustainability of your services. Do you have a plan to reduce debt, accumulate unrestricted cash, or fund reserves that will help sustain services in lean times?
- **Include** in each annual budget at least three special initiatives that will advance, strengthen, or sustain your mission.
- **Put in place** a process to review at least every two years how the community's needs have changed and how your programs and mission should adapt in response to the changes.
- **Understand** how business cycles can impact your revenues and expenses.
- **Educate** your donors and grantors on recession planning and their roles in helping you build reserves so you can be a reliable service provider in any economy.
- **Ask** as many questions about good budget results as you ask about unfavorable budget results. Underspending can reflect underperformance, which isn't an appropriate way to save money.

These steps to success come from Allen J. Proctor's books *Linking Mission to Money* and *More than Just Money* (linkingmissiontomoney.com).

Even the human services sector raises more revenue through fees and contracts than through contributions.

Nonprofits must find a new business model. They must increasingly turn to earned revenues from non-government customers. Too many government contracts now lose money, and nonprofits need to accept only those with terms that come closer to covering the true cost of services.

And we can't assume that philanthropy will rise to a more significant role. It has always remained in the narrow range of 18 to 24% of nonprofit revenues. If its share couldn't break out of that range in the go-go years of the mid-1980s and late-1990s, there's no basis to assume it will happen in the future.

It's imperative that our society support a business model that enables the nonprofit sector to thrive — because our society can't thrive unless the nonprofit sector does. We mustn't forget that nonprofits fulfill community needs that for-profit companies can't.

The market system fails when businesses can't make a profit while meeting the community's need for quality, volume, or breadth of service. Economists refer to these shortcomings as public goods, externalities, and market failure. Nonprofits step in to make sure the community gets what it needs.

Therefore, every responsible nonprofit has a key mission that loses money if done well: emergency rooms, public access to education, food for homeless people, and so on. If we didn't have nonprofits, we wouldn't have these services.

We also want these services to be available regardless of the strength of the economy. In particular we don't want our nonprofits to use the option of service cutbacks and layoffs that helps for-profits survive recessions. We want reliability and sustainability of these key services.

What Makes a Sustainable Nonprofit?

For nonprofits to sustain their key services, they need to be financially viable. Here's what we should look for in sustainable nonprofits:

- **A clear identification** of their key mission activities and of the upper bound of financial losses they will tolerate for these activities.
- **Reluctance to accept grants and contracts** that don't cover at least the fully-loaded costs of the activities they fund.
- **Maintenance of their share of charitable contributions** in their revenue mix. This share peaked nationally at 24% in 2001 and recovered to near that level in the latest data. Maintaining current shares by all nonprofits will require continued effort, as corporate gifts of cash have remained flat.
- **Development of profitable activities** that are lower in mission but based on the expertise and business infrastructure of the nonprofits' core activities.
- **Paring of unprofitable and marginally profitable activities** that aren't central to the key mission.

Many of these actions are similar to what a for-profit business would do to remain viable. The key distinction, however, is that the nonprofit does all this to cover the financial losses necessary to preserve the quality of its most mission critical activities.

While a for-profit would drop the money-losing activities, the nonprofit exists to sustain those activities. That role highlights the need for nonprofit entrepreneurs to do three crucial things:

- **Develop enough profitable activities** to take care of the losses fundraising can't cover.
- **Acquire the cashflow necessary** to reinvest in their businesses.
- **Build balance sheets strong enough** to get them through a recession.

How to Support Entrepreneurship

Here are four ways we can support nonprofit entrepreneurship.

1. **Start looking at nonprofits as two businesses** operating under one roof:
   - ***The first business provides high quality services which can't be operated profitably.*** We evaluate its success by how well it fulfills community needs.
   - ***The second business runs profitable activities whose profits are reinvested into both businesses.*** We evaluate this second business by its profitability.

> "Nonprofits must find a new business model."

> Educate your donors on recession planning.

2. **Be aware of the implications** of how we support nonprofits. Unrestricted giving is the closest to how for-profits get capital. If we restrict our gifts to certain uses, we need to cover the fully-loaded cost of the activity we're funding and consider adding a profit margin. And we need to support strong balance sheets by rewarding nonprofits who are building reserves to sustain their operations and growth.
3. **Assure that nonprofit executives** receive training and support to give them the skills necessary to develop and evaluate business plans for new activities.
4. **Create new ways to provide investment capital** to nonprofits. This capital can expand the mix of financial structures to include equity and low-interest loans as well as grants, capital campaigns, and retained earnings.

As Peter Drucker once noted, all theories eventually become obsolete. When a theory shows signs of obsolescence, we must rethink it. It's high time we think carefully about the nonprofit business model and embrace a new one.

Allen J. Proctor, founder and principal of Proctor's Linking Mission to Money (linkingmissiontomoney.com) has 30 years' experience evaluating the financial health of organizations, developing effective business strategies, and enhancing organizational effectiveness. He is the author of numerous journal articles and publications and two books, Linking Mission to Money: Finance for Nonprofit Leaders *and* More Than Just Money: Practical and Provocative Steps to Nonprofit Success. *A frequent expert source, Proctor has been interviewed on National Public Radio and on Columbus and New York City broadcast and cable stations and newspapers, including the* New York Times.

Have You Got the Spirit in Ya?

For ways to ignite entrepreneurial spirit in your organization, see these articles, available at NonprofitWorld.org/members:

Can Your Organization Become More Entrepreneurial? (Vol. 20, No. 3)

Seven Pillars of Social-Enterprise Success (Vol. 22, No. 1)

How Much of Your Revenue Should Come from Earned Income? (Vol. 23, No. 3)

Nine Entrepreneurial Mistakes that Can Kill Your Organization (Vol. 20, No. 3)

How to Keep the Money You Earn (Vol. 17, No. 4)

Eight Principles of Nonprofit Entrepreneurs (Vol. 19, No. 4)

How to Write Your Business Plan (Vol. 17, No. 2)

Why You Need to Be More Entrepreneurial and How to Get Started (Vol. 19, No. 6)

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(free Yahoo login required)
or send a blank e-mail to:
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If you have any questions, contact Jason Chmura at jchmura@NonprofitWorld.org.