PART ONE

Why ROI?

CHAPTER 1

Demystifying the Status Quo

JOHN MAYNARD KEYNES *The difficulty lies, not in the new ideas, but in escaping the old ones, which ramify, for those brought up as most of us have been, into every corner of our minds.*

Nonprofits are not that different from for-profits. This statement alone causes heated discussion and may lead many to dismiss the concepts in this book. The management skills needed may be different. The "mission" is different. The single concept that is not different is that both nonprofits and for-profits must *provide value to investors*. If a for-profit organization does not do this, the market puts it out of business. If a nonprofit does not do this, the market does not fund it.

They're Big and in Business

Nonprofits are big business, with special emphasis on the words *big* and *business*. Americans gave over $260 *billion* to nonprofits in 2005, according to *Giving USA*, the annual yearbook on philanthropy. Who gave what?

Who	*How Much*	*Percent*
Individuals	$199 billion	76.5
Foundations	$30 billion	11.5
Bequests	$17 billion	6.7
Corporations	$13 billion	5.3

What does this say? Americans are generous? Yes. Individuals give far more than anyone else? Yes. Corporations, by comparison, are rather stingy? Yes. But these numbers alone do not tell the whole story.

Giving USA is also astute enough to track where the money goes, by type of organization. The religion category, comprised of churches and other religious organizations, happens to attract the largest share at over $93 billion, almost 36 percent of all contributions. Subtracting the $93 billion from the $260 billion leaves $167 billion for the rest of the nonprofits in this country.

According to the National Center for Charitable Statistics, in 2004 there were approximately 1.8 million nonprofit organizations registered with the Internal Revenue Service (IRS) in this country:

850,000 public charities

104,000 private foundations

464,000 miscellaneous types

377,000 churches/congregations

Now bring in some facts from different sources. The January 2006 Harris Interactive DonorPulse survey reported that about half of those who gave to charitable organizations in 2005 gave less than $500. Only 6 percent said they gave $5,000 or more. They also report that in 2005, the largest percentage of donors, approximately 50 percent, gave to churches and religious organizations. In 2004, the National Center for Charitable Statistics also reports that public charities reported nearly $1.1 trillion in total revenues, with 23 percent coming from contributions, gifts, and grants; 71 percent coming from program revenues (which include government contracts and fees); and 6 percent from other sources (including dues, special events income, rents, and products sold).

Simple arithmetic lets us paint a picture of an "average" public charity. If one divides the 850,000 public charities into the $1.1 trillion in total revenues, it yields an average annual budget of $1.29 million. Looking at it another way, dividing the sum of 850,000 public charities, 104,000 private foundations, and 464,000 miscellaneous organizations into the $167 billion given to nonreligious organizations yields about $118,000 per year from private sources for each organization.

Here is the picture that emerges of the nonreligious nonprofit landscape:

- Many organizations are competing for dollars.
- Relatively small amounts of total funding come from private sources.
- Private contributions are usually in small amounts.
- There is a heavy dependence on government funding.

We go from hundreds of billions of dollars in aggregate to an average of $118,000 per organization from private sources. Many nonprofits have come to rely on getting the majority of their funding from the government. What does come from the private sector is reminiscent of a tin cup and begging, rather than being funded because of the good work being done. This vision seems to reinforce the negative connotations of *charity*, in every sense of the word. One has to wonder if this is the way in which America wants its nonprofits to operate.

Not only are nonprofits big business, but the thousands of companies that make their collective living by selling them things are big business, too, especially those involved in helping them raise money. Let's just look at some of the household names everyone knows, the brand-name nonprofits: the American Cancer Society, the Red Cross, and the Salvation Army.

According to the *Chronicle of Philanthropy*, which annually publishes *The Philanthropy 400*, a listing of the largest charities based on their "ability to attract private support," all of these nonprofits are in the top five in terms of amounts raised in the United States in 2005. The American Cancer Society raised over $929 million, the Red Cross over $1.27 billion, and the Salvation Army over $3.59 billion. The amounts spent on fundraising, rounded down to the nearest million, were $188 million, $118 million, and $137 million, respectively. Just these three nonprofits alone spent over $443 million on fundraising in just one year.

Just how this money was spent reads just like a for-profit business. Marketing certainly makes up a large part of it. So does technology, salaries, and outside consulting services.

The fact that three nonprofits spent $443 million to raise approximately $5.8 billion raises several questions. Is this good? From whose perspective? More importantly, did it provide an acceptable return on investment (ROI)?

To answer the first and second questions simultaneously, yes, it is good from society's perspective. These three nonprofits appear to be very good at what they do in terms of the societal good they provide. From a nonprofit's cost point of view, the answer is also yes. The ratio of fundraising expenses to private support dollars was 20.3 percent for the American Cancer Society, 9.3 percent for the Red Cross, and 3.8 percent for the Salvation Army. Collectively, the cost of raising funds was around 8.3 percent.

Can most nonprofits compare themselves to these three examples, or even the Philanthropy 400? Certainly not, since a given nonprofit had to raise over $37.7 million in 2005 just to break into the Philanthropy 400. Since the average annual budget for a public charity is somewhere in the neighborhood of $1.3 million, most have a long way to go.

The question of providing an acceptable level of ROI is more difficult to answer. Anecdotally, it must have provided an acceptable level of ROI to the organizations, since they continue to spend large amounts of money on fundraising year after year. Theoretically, a numerator of funds received divided by a denominator of the cost to raise the funds produces an ROI of $5.8 billion divided by $443 million, or 13 times. Most of us would be hard pressed to come up with a return that paid 13 times our investment in one year. But again, most nonprofits do not have the luxury of spending relatively large amounts of money on fundraising, even if it does generate 13 dollars for every one spent.

The preceding paragraph surfaces a central issue when discussing ROI and nonprofits: Most of the time, the discussion revolves around the issue of *fundraising effectiveness*, and that is not the point. It is not about how much was spent to raise how much more, at least from an outside investor's perspective. Prospective investors in a nonprofit want to know "What was accomplished with my money?" not "How much was spent on getting my money?" (within certain limits, of course). They want to know that the cause they believe in is being addressed: whether a positive effort is being enhanced, or a negative circumstance is being eliminated.

Facts Are Facts

This book is based on both qualitative and quantitative foundations. It is said that morality describes how things should work, and economics describes how things actually work. The strong economic flavor will become apparent very quickly.

Formal logic is a good place to introduce the premise of what follows. *Modus ponens* is a basic form of logic, which states that

If P, then Q.
P.
Therefore, Q.

Applying this logic to the current situation of funding for nonprofits, we get the following argument:

1. If a nonprofit demonstrates results, then Individuals, Corporations, and Foundations will fund it.
2. A nonprofit has demonstrated results.
3. Therefore, Individuals, Corporations, and Foundations will fund it.

Obviously, funding a nonprofit is not this easy, but the logic still holds. Consider these facts:

Fact 1. Individuals, Corporations, and Foundations will fund nonprofits.

Fact 2. Individuals, Corporations, and Foundations invest in results.

Fact 3. There is increasing competition for dollars.

Conclusion: The nonprofit that demonstrates results is more likely to be funded.

In other words, the charity model that many nonprofits have adopted will become less and less effective in the future as competition for dollars becomes more intense. Most nonprofits intuitively understand this, but many are still reluctant to embrace the concept of nonprofit investment. Hopefully, this book will help eliminate that reluctance.

They're Everywhere

Chances are you have been directly touched by a nonprofit. You also might not have realized it. Perhaps you have been a member, worked directly for the organization, served on a committee or board, attended an event, or bought what they are selling.

If any of these apply, you are living proof of my assertion:

You have gone to church.

You have attended college.

You volunteer your time.

You donate used clothes.

You bought popcorn from the little league.

You got your car washed in the fast-food parking lot.

You sent in your alumni dues.

You renewed your membership to Ducks Unlimited, the Sierra Club, or the local Corvette Club.

You bought something at a bake sale.

You attended the symphony.

You went to the museum.

You served food at the soup kitchen.

You ate food at the soup kitchen.

You ran in a 5k race.

You wear a yellow latex band on your wrist.

You have paid admission to a college basketball game.

You bought a beer at the local arts festival.

The list goes on and on.

Why does this matter? People often have the misconception that a nonprofit is a completely different species of animal than the usual for-profit business, and not something familiar to them. Although some differences certainly do exist, this book demonstrates that while nonprofits may be a different animal, they are in the same species, and are more like first cousins. This is especially true when examining the aspect of sustainable funding; both for-profits and nonprofits must address it to effectively carry out their missions.

This book focuses on the one aspect of nonprofits that has not changed in decades: Nonprofits need to raise money. The fact that nonprofits need to raise money is not in question; however, the best way to do it is. The foundation for this book, and the key point borrowed from the for-profit world that is not different, is that both nonprofits and for-profits must do one thing to be successful:

Provide value to investors.

Investors and Value

The two pivotal words in the statement "provide value to investors" are *investors* and *value*. Let's first talk about nonprofit investors. Yes, nonprofits have investors. People, foundations, and corporations give nonprofits money in return for something. That is what an investor does. Not an investor as in an equity position, complete with shares of stock and legal claims on assets, but an investor in that they expect something in return for their money. The challenge is in identifying what the investors expect and then giving it to them.

All of the following are examples of nonprofit investors, and they come in many shapes and sizes:

- The wealthy widow who makes a large gift to the hospital where her husband died to help fund the new cancer wing
- The couple who retires to a new community and gives to the community college where they take that long-awaited scuba diving class
- The local small-business person who helps build the new soccer field
- The foundation that helps fund the startup of a community center for teenage mothers so they can continue their education
- The large corporation that invests in regional economic development efforts to make the area more economically attractive
- The entrepreneur who endows a chair at his alma mater
- The homeowner in the neighborhood who buys door-to-door popcorn
- The average person shopping at Christmas time who drops some change in the red bucket outside the department store

Now for that other interesting word in the statement "provide value to investors": *value*. Many books have been written on values (plural) and their relationships to nonprofits. One of the very best is Kay Sprinkel Grace's *Beyond Fundraising*. It contains a great discussion on values-based mission statements, and differentiates between philanthropy, development, and fundraising. The very first sentence of the very first chapter says it all, "Philanthropic behavior is motivated by values."

Her point cannot be debated; people will not fund (or donate time, energy, or knowledge to) those organizations whose values they do not share. When the values of the investor (or donor if you must) align with the nonprofit organization, both parties benefit. As she states:

> At the most altruistic, this motivation draws people into selfless involvement with organizations that are advancing and strengthening basic community and individual values. At the other end of the continuum, there will be those whose initial motivation is the WIIFM (What's in it for me?).

This book deals with those precisely at that other end of the continuum, the "What's in it for me?" camp, and here's why. Many of the nonprofits we have dealt with over the last dozen or so years do not have the luxury of an internal development office. They cannot dedicate staff to development, or fundraising (if that word must be used). They typically have short timelines for funding (read *need money sooner rather than later*), and do not have the budget to devote to ad campaigns or lots of glossy collateral material. In other words, the distance between Point A (a potential funder) and Point B (a check arriving in the mail) has to be short. We have found, over and over again, that the shortest distance between these two points, in the fastest time possible, is the credible demonstration that the outcomes effectuated by the nonprofit are valuable. If the right value, in the true economic sense, is conveyed to potential funders, they become investors.

Value and Values

Part of the confusion may have to do with the difference between the words *value* and *values*. In the *Beyond Fundraising* context, values are the principles, ideals, ethics, and morals of a given society. Value, in the "What's in it for me" camp, is the getting of something in return proximate to what is given. When one spends $20 on a hamburger, it had better be a good hamburger. When one gives $100,000 to a nonprofit, it had better deliver value *and* be consistent with one's values.

These two points are pivotal for the investment-driven model, discussed in detail later, to work for nonprofits:

1. The nonprofit must provide outcomes that have *value*, that is, outcomes that are desired.
2. The outcomes must be consistent with the *values* of the investor.

In defense of the WIIFM folks, they have their altruistic facets also. They are not looking for personal gain per se, but for community or societal gain. By virtue of being members of that community or society, however, they are gaining personally as well.

They Are Different

There are, of course, differences between nonprofits and for-profits. While the philosophical differences could be, and probably will be, argued for years, these three are facts:

1. Their Economic Impact (Officially) Is Lower

All economic activity has an impact, and there is quite an industry dependent on demonstrating that impact. One of the common ways to determine that impact is with the use of input-output multipliers. Multipliers measure the so-called ripple effect, which is an analogy to the concentric ripples that form in the water when a stone is tossed into it. The tossed stone produces successive ripples that get larger and larger until they dissipate into the original surface of the water. An initial economic action causes another economic action to occur, with each action cumulatively adding to the impact of those that come before it.

To illustrate this difference in impact, let's compare several sets of multipliers across industries in a given geographic area. Using the Seattle area RIMS multipliers as an example, Exhibit 1.1 provides the direct earnings and

EXHIBIT 1.1 **DIRECT EFFECT INDUSTRY MULTIPLIERS: GENERAL INDUSTRY**

	Earnings Multiplier	Employment Multiplier
Water transportation	4.3945	6.2978
Retail trade	1.9609	1.6900
Telecommunications	2.2479	3.0535
Construction	1.9943	2.2754
Aircraft manufacturing	2.4886	4.4270
Paper and paperboard mills	2.6748	4.1881
Average	2.6268	3.6553

EXHIBIT 1.2 **DIRECT EFFECT INDUSTRY MULTIPLIERS: SOCIAL SERVICE SECTORS**

	Earnings Multiplier	Employment Multiplier
Social assistance	1.7875	1.4326
Performing arts companies	1.8049	1.2161
Museums, historical sites, zoos, and parks	2.0254	2.0708
Religious organizations	1.5540	1.4598
Grantmaking, giving, and social advocacy	2.1683	2.2119
Civic, social, and professional organizations	1.9520	1.6470
Average	1.8820	1.6730

employment effect multipliers for six basic industry sectors that are a good representation of the Seattle economy.

Exhibit 1.2 provides the same multipliers for six sectors that are traditionally populated with nonprofits.

For every job in the private sector, using the average of the six industries, an additional 2.66 jobs are created within the geographic area. Each dollar paid in earnings by this same group begets an additional $1.63 in earnings in the area. Contrasting these results with the average of the nonprofit sample yields only .68 additional jobs and $.88 in additional earnings.

Why is this? The manufacturing sector, for example, typically takes a raw material, performs a process that adds value, and sells the product at a higher price. The retail sector buys products, inventories them, and resells them at a higher price. The nonprofit sector, however, does not purchase raw material, or resell a product after it is processed. It doesn't require a lot of expensive equipment or large blocks of real estate. Their value is typically more intangible and labor intensive, and fewer economic events occur from the input to the output stage; therefore, their multiplier is smaller and their impact is lower.

Not only does classical economic impact analysis of nonprofits (using techniques such as input-output tables) produce a lower value, but what these methods fail to measure is the very core of what nonprofits often address, such as the value of disease prevention, reducing negative social consequences, and lowering opportunity costs. In other words, while classical input-output analysis is valuable, it is based on a more industrial economy, not a service economy, which is where nonprofits generally find themselves.

2. They Pay Less

Salaries are generally lower in nonprofit organizations than in the for-profit world, but how much they vary depends on the source. Rather than use data supplied by the various philanthropic and nonprofit trade groups, which could be viewed as biased, or combing through IRS Form 990s, which have their own limitations for analysis purposes, this analysis will use government-supplied information. This comparison uses May 2005 National Industry-Specific Occupational Employment and Wage Estimates information from the Bureau of Labor Statistics (BLS), the most recent information available across all categories as of this publication.

The BLS created the North American Industry Classification System (NAICS) system to replace the outdated Standard Industrial Code (SIC) to more accurately reflect the changing economy, and provides information collected from employers who, by law, must report accurate information. This system is more useful than information collected, for instance, from the surveys of individuals about their employment status, the results of which are subject to the understanding or honesty of the person who answers the survey.

The major sectors presented in Exhibit 1.3 list the average annual wage of all occupations within the sector, and the average annual wage of only those considered to be in a management position.

The difficulty in determining how nonprofit compensation differs from for-profit compensation stems from the classification system itself; there is no nonprofit category. Since the information is not sorted by nonprofit versus for-profit, but rather by industry classification, one cannot reach a conclusion about nonprofit compensation. Digging deeper, though, and examining those specific six-digit industry classifications in which most

EXHIBIT 1.3 AVERAGE ANNUAL WAGE BY MAJOR INDUSTRY SECTOR

Major Category	All Occupations	Management Positions
Professional, scientific, and technical services	$58,560	$113,090
Retail	$26,360	$ 81,200
Manufacturing	$39,240	$ 99,900
Health care and social assistance	$39,400	$ 71,410

EXHIBIT 1.4 **AVERAGE ANNUAL WAGE BY SIX-DIGIT CLASSIFICATION**

Major Category	All Occupations	Management Positions
Civic and social organizations (NAICS 813400)	$24,490	$61,950
Social assistance (NAICS 624000)	$25,760	$53,970
Individual and family services (NAICS 624100)	$28,170	$59,010
Services for the elderly and persons with disabilities (NAICS 624120)	$23,860	$58,510
Community food and housing, and emergency and other relief services (NAICS 624200)	$30,670	$57,270
Performing arts companies (NAICS 711100)	$41,440	$77,400
Museums, historical sites, and similar institutions (NAICS 712000)	$31,360	$82,150
Social advocacy organizations (NAICS 813300)	$35,330	$69,300

nonprofits find themselves, reveals a more accurate picture as presented in Exhibit 1.4.

While it is true that nonprofits generally pay less than for-profit enterprises or government positions, new information from the *BLS Quarterly Census of Employment and Wages* reveals some interesting new insights. As reported in the September 2005 *BLS Monthly Labor Review,* for-profit firms paid wages that averaged 11 percent higher than nonprofits in 2002. However, in industries where both nonprofits and for-profits are involved, nonprofit wages actually equal or exceed those of for-profits in some areas.

This somewhat surprising picture emerges when industry aggregations are replaced with specific IRS designations regarding nonprofit or for-profit, and combined with detailed industry information. When this is done, hospitals and nursing homes are at approximately the same wage levels, their IRS designation notwithstanding. In the areas of education, social services, residential care, and day care, "nonprofit wages actually exceed the for-profit wages of their counterparts, often by a substantial margin."

The gist of this article, and its relevance to our discussion here, is nicely summarized by one sentence:

> What this suggests is that the apparent disadvantage of nonprofit wages is more an industry phenomenon, reflecting the fields in which nonprofits are active, than it is a sector phenomenon, reflecting the human resource policies of nonprofit agencies.

And that is precisely the point. Where nonprofits must compete with for-profits, they must pay industry-standard wages to stay competitive in the marketplace. It is in those areas where for-profits fear to tread, where there is a need but nobody willing to fill it because they cannot make a profit, that nonprofits step in to help. It is these nonprofits, when aggregated with the few that pay industry-standard wages, that lower the average nonprofit sector wage level.

3. They Play by a Different Set of Rules

Nonprofits, as most would describe them, are usually considered 501 (c) (3) organizations, the largest category of tax-exempt organizations classified by the IRS. Of the 20+ possible categories, only 7 qualify to receive tax-deductible contributions. Nonprofits need a ruling from the IRS in order to operate as a nonprofit that is exempt from income tax and for donors to be able to deduct contributions. This ruling is the one additional hoop they must jump through. That is it. They do not need a certain level of capitalization. They do not need to identify their strategic strengths. They just need to apply and meet three generalized tests.

The textbook *Financial and Strategic Management for Nonprofit Organizations* does a good job of describing these three tests.

The Organizational Test This test states that the nonprofit must be organized for a lawful purpose in the one of following eight areas:

1. Educational
2. Religious
3. Charitable
4. Scientific
5. Literary
6. Testing for public safety
7. Fostering certain national or international amateur sports competitions
8. Preventing cruelty to children or animals

Since it would be relatively easy to conduct the preceding with a motive for making money, the IRS also requires that the motive not be one of advancing the private welfare of individuals, or what is known as the profit motive to most people. The motive must be one of charity; that is, the beneficiaries must be the community or the public in general. Specifically, the IRS states the following:

> (ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the founder or his or her family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.
>
> —[Treasury Regulations, Section 1.50 (c) (3) – 1, (d) (1) (ii), 1980]

The IRS further requires that specific purposes be identified, describing in more detail what the nonprofit does and in what general areas it operates.

The Political Test Organizations desiring 501 (c) (3) status must also state in their organizing document that they will not participate in any political campaign on behalf of a candidate or make expenditures for political purposes. Other 501 designations may do this, but not 501 (c) (3) organizations.

The Asset Test The nonprofit must also state in its charter that it prohibits the distribution of assets or income to individuals except as fair compensation for services rendered. It must also state that it will not be used for the personal gain or benefit of the founders, employees, supporters, relatives, or associates.

If these three tests are met, and all the accompanying paperwork is in good order, the nonprofit will likely become a tax-exempt, 501 (c) (3) organization. Then the challenges really begin.

Final Thoughts

Nonprofits are different from for-profits, and can be very different from each other. Their varying characteristics, from budgets ranging in the billions to the thousands, and programs ranging from arts and culture to human services, do not make for a one-size-fits-all process of demonstrating return on investment. Add to this the changing philanthropic environment discussed in the next chapter, and one can see that motivations, outcomes, and methodologies all merit further exploration.

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