CEPS Working Paper Series
No. 12, October 2017

Nonprofit Financial Growth and Path Dependency

Georg von Schnurbein

Citation:

ISSN: 2296-7516 (Print)
2296-7524 (Online)
Executive Summary
Financing non-profit organizations (NPOs) differs from financing business companies. Based on a literature review this article highlights that many aspects of nonprofit development are defined at the stage of the organizations’ foundation. Thus, we apply the path dependence theory as a basis for an analysis of nonprofit finance and the questions, if a static organizational behavior influences nonprofit finance, and which factors influence financial growth in nonprofits. The results highlight that organizations in a lock in status built less organizational capital and have lower revenues. For practical application, nonprofits face the challenge to develop a stable – i.e. projectable – mix of financial resources. This means to build up a holistic financial management that matches donations, government spending, own revenues, and financial revenues under consideration of the NPO’s purpose and eliminating the threat of becoming inflexible.
## Contents

Nonprofit Financial Growth and Path Dependency ................................................................. 1

Executive Summary ............................................................................................................... 2

Contents .................................................................................................................................... 3

1. Introduction ..................................................................................................................... 4

2. Financial Management of Nonprofit Organizations ......................................................... 4

3. Path dependence in nonprofit finance ............................................................................. 7

4. Methods .......................................................................................................................... 9

5. Results ............................................................................................................................ 10

6. Discussion ....................................................................................................................... 11
1. Introduction

Profit making is central to for-profit companies and, implicitly, it contains a growth paradigm. Investments in technological progress, better production methods, or cost reductions are taken to increase income and profit. In nonprofit organizations, the basic assumptions are different: the major aim is its mission. To complete your mission, you do not necessarily need growth. Much more important are value congruence and the orientation along the needs of your clients (Calabrese 2011). Nevertheless, growth can be a legitimate management aim for nonprofits, if it helps to increase mission completion (Chikoto and Neely 2014).

In the history of nonprofits, one can find many examples of organizations that succeeded in their mission only because of a growth paradigm. For instance, the International Committee of the Red Cross only became the threshold of humanitarian international law through an international expansion. Otherwise, it would have remained a club of Geneva citizens. Among others, WWF, Amnesty International, or World Vision, where only able to reach their global reputation through constant growth.

The reasons for missing growth are manifold (Foster and Fine 2007). The purpose might imply some limitations of growth; the geographical radius, the field of activity, or the financial assets available may restrict the development of the organization. However, the people involved, the given structures, or common attitudes are the more severe limitations. For fear of lacking the necessary competencies, nonprofit leaders are satisfied with what they have achieved. Additionally, the structural changes need for growth (for instance, transformation of legal type or (de-)centralization) are often not realized or strand at the resistance of members or other constituents.

All these factors, single or in combination, lead to a situation in which nonprofits reach a glass ceiling that prohibits further growth of the organization. However, the circumstances in which nonprofits act are changing rapidly (Salamon and Sokolowski 2016; von Schnurbein 2013): rationing of state funding, decrease in private donations, or the rise of the efficiency-movement question the survivability of many nonprofits.

This piece of work deals with financing nonprofits. It analyzes the consequences of a static organizational behavior on the financial development of the nonprofit and searches for factors influencing financial growth. Based on a profound literature review on financial management in nonprofits and applying path dependency theory, the study emphasizes how financing nonprofits is shaped by organization-specific factors in a long-term perspective. For the empirical analysis, a sample of Swiss charities is applied. Finally, recommendations for both, research and practice are presented.

2. Financial Management of Nonprofit Organizations

James (1983) was one of the first to categorize the three major financial sources of nonprofits: state funding, private donations, and earned income. In the following, very different streams of research developed on the three categories. State funding is part of public administration and public management, looking at nonprofits as subsidiary organizations to execute public tasks and steered via contracts (Thom/Ritz 2008). Private donations and giving are researched through original fundraising research (Sargeant 2009). This stream of research is highly influenced by marketing and communication and there are only few scientific papers on the financial aspects of fundraising (Calabrese 2011). Earned income covers (membership) fees and pricing (Littich 2007). As a consequence of increasing accountability, financial returns of investment are of specific interest today. Hence, in current studies financial returns are investigated separately of other earned income (Chikoto and Neely 2014; Yan et al. 2009). This separation of revenue streams is a major reason, why research on a coherent management of finance in nonprofit is scarce and developed in recent years, only.
In the following paragraphs, I outline some core aspects of financial management in nonprofits based on existing literature.

2.1 Financial aims

The aims of financial management have to strengthen the overall achievement of the organization’s mission. Thus, one of the classical financial management aims – profitability – has to be replaced by efficiency (Littich 2007). Hence, resource allocation has to lead to an optimal ratio of allocation and result. The second important financial aim is liquidity. As nonprofits have highly reduced options for issuing debt, securing liquidity is even more important than in market corporations. However, there is a trade-off between efficiency and liquidity. On the one hand, nonprofits need enough liquidity to secure maneuverability. On the other hand, holding high cash assets reduce the means for mission tasks and impede a high efficiency of resource allocation (Littich 2007). Additionally, holding unrestricted net assets is limited for nonprofits in most countries (Blümle and Schauer 2003).

There are two consequences of these aims that distinct financial management in nonprofits from for-profits. First, being charitable brings tax benefits to the organization and the donors. These privileges are valuable for fundraising and the operations of the organization as they increase margins and simplify calculations. However, being charitable limits the opportunities in financial management. Nonprofits have limited access to debt as they can offer only few securities. The mean debt ratio among Swiss charities, for example, is 9 per cent, of which two thirds are mortgages (n= 186 NPO; Neubert 2007). Additionally, charitable organizations cannot offer all their services at market prices. Thus, they lose one possibility to use earned income to increase unrestricted net assets. Another yet, unintended effect of the charitable orientation is that competencies in financial issues are often missing on nonprofit boards. The focus in composition lies on the nonprofit's mission and less on other competencies.

The second major difference between nonprofits and for-profits in financial management is the possibility of capital gain. Companies can generate capital gain through issuing shares or warrants without influencing the running revenues. In nonprofits, all gains flow through the annual revenues. A major donation in one year swells the annual account and leads to high cutbacks in the following year. Consequently, academic literature on nonprofit financing is predominantly focusing on the revenue mix not on capital structure, as I will prove in the following section.

2.2 Nonprofit revenue mix

Generally, financial management differentiates between external and internal financing. External financing consist predominantly of equity financing and debt, while internal financing covers cash flow and sales revenues (Littich 2007). Following the arguments made before, this distinction is not helpful for nonprofits as external financing is nearly irrelevant to most nonprofits. More important is the distinction between the revenue categories. In recent literature (Chikoto and Neely 2014; Tevel et al. 2015; von Schnurbein and Fritz 2017; Yan et al. 2009) a distinction in the following four categories has been used widely: government grants, donations, program revenue, and investment income.

In search for an optimal nonprofit revenue mix, different theories are used. Most common is portfolio theory, which emphasizes financial stability through diversification over several revenue sources. In order to
balance shortfalls, the portfolio has to consist of revenue sources that are independent from each other (Carroll/Stater 2009). Kingma (1993) highlights the importance of interdependencies of revenue sources that reduce the advantages of diversification. However, diversification increases financial management costs (Frumkin/Keating 2011). Bowman (2002) uses financial management theories to investigate effects on the nonprofit capital structure. In static trade-off theory, managers balance the benefit of borrowing against their costs. With pecking order theory, nonprofits favor internal revenue over external alternatives. According to Bowman (2002) and Calabrese (2011), nonprofits rather follow a pecking order logic when structuring their financial capital. Wilsker and Young (2010) present a rare example of a specific nonprofit theory on financing. Their benefits theory of nonprofit finance states that financial revenue sources of nonprofits are dependent on the kind of goods that nonprofits offer. Nonprofits with public good are more likely to receive public funding or donations, whereas nonprofits with private goods receive more earned income. This theory emphasizes that there is a link between financing and service provision in nonprofits (see also Aschari-Lincoln and Jäger 2015; Clifford and Mohan 2016). Although these theories help to explain how nonprofits get to a certain mix of revenue sources, they fail to explain how nonprofits can generate growth. Yet, existing literature favors stability over growth, as will be discussed in the next paragraph.

2.3 Financial health

As presented before, the analysis of financial health in nonprofits is based on different aims than in forprofits. The dominant logic is grounded in the missing profitability of service provision and resource dependency theory. Hence, nonprofits have to secure access to relevant resources. In terms of financing, financial health predominantly means financial stability. Tuckman and Chang (1991) define a nonprofit as financial vulnerable if it is endangered to reduce service provision after a financial shock. Greenlee and Trussel (2000) define financial vulnerability, when a nonprofit has to reduce mission spending in three consecutive years. Instead, financial stability is best achieved through the diversification of revenue sources. Several studies (Carroll and Stater 2009; Froelich 1999; Tevel et al. 2014) prove a direct link between diversification and financial stability or reduced volatility respectively. Additionally, diversification increases survival of the organization (Jegers 1997; Kingma 1993) and serves for a better connection into society (Galaskiewicz and Bielefeld 1998).

However, recent literature critically reviews the concept of financial health. Prentice (2016) criticizes that accounting measures frequently used are not clearly linked to financial health. Chikoto and Neely (2014) emphasize that financial health consists of both, stability and capacity. Bowman (2011) defines financial capacity as “the wherewithal to seize opportunities and react to unexpected threats” (p.38). Potluka et al. (2017) present findings from Czech nonprofits, that there are different influences on long-term capacity in assets and short-term capacity in revenues. An important precondition of financial capacity is the concentration of revenue sources. Foster and Fine (2007) prove by using longitudinal data that concentration on one revenue source increases financial capacity. Additionally, Gmür (2013) shows for Swiss fundraising charities that concentration on donations and major donors has a positive impact on fundraising efficiency. Another criticism concerns the empiric measurement of financial health (Prentice 2016). Kingma (1993) criticizes the use of a Hirschman-Herfindahl Index (HHI) and recommends the use of variance-covariance measures. Chikoto et al. (2016) highlight that the level of aggregation has an influence on the results. Additionally, organizational and environmental factors influence the grade of diversification (von Schnurbein and Fritz 2017).
Especially the latest findings on external influences on financial stability (Prentice 2016), benefit dependence (Bowman 2017), or financial efficiency open a new perspective on nonprofit finance that pays attention to further influencing factors. In the following part, I apply path dependency theory to test, to what extent the past development of an organization has an influence on the ability of growth.

3. Path dependence in nonprofit finance

Path dependency theory deflects explanations for change and development of organizations or technologies not in their context or in exogenous conditions, but in the decisions and influences in the past (North 1990). As consequences of these earlier incidences, the present situation or solution might not be the most efficient given existing framing conditions. Instead, several parallel solutions might exist. Hence, path dependency theory disagrees with theories on short-term adaptions to changing environment and the expectation of self-regulating market forces (Wolf 2013). According to Sydow et al. (2009), path dependency “stresses the importance of past events for future action or, in a more focused way, of foregoing decisions for current and future decision making.” (p 690). Schreyögg et al. (2003) name existing mindsets and routines as determining factors of existing situations. The core of path dependency theory consists of three areas: positive feedback, non-ergodicity, and irreversibility. Positive feedback contains self-reinforcing influences in a way that the increase (decrease) of a variable leads to further increase (decrease). Non-ergodicity means that there is not only one stable mode (equilibrium) at one time, but there are multiple equilibriums because of distinct path dependencies (David 2001). Finally, irreversibility describes the dependence on the point in time of the process. Once a decision has been taken, the costs of reorientation are higher than just proceeding in the chosen path (Ackermann 2001). In the following, I will discuss these three phenomena based on nonprofit literature.

3.1 Positive Feedback

The self-reinforcing tendency of “more of the same” can be found in nonprofit financing in several ways. Foster and Fine (2007) analyzed 144 US-based nonprofits that were established after 1970 and generated more than 50 million USD in 2003. They emphasize that these organizations predominantly relied on one funding source and that they had adjusted their funding strategy and structure according to that one source. For Lu (2015), existing state funding is one of the most important predictors of further successful state funding. Similar relations exist for foundation fundraising or capital campaigns. This Matthew effect type of pulls reassures nonprofits to proceed and invest in the existing funding sources. At the same time, they spare no effort on investments in new funding sources. The finding by Calabrese (2011) that nonprofits include future financial needs in the existing structure of assets may also be interpreted as an extrapolation of the current financing structure. In another analysis on 193 Swiss nonprofits, only 18.3 per cent changed their major income source over a period of seven years (von Schnurbein and Fritz 2016).

3.2 Non-ergodicity

Non-ergodicity, hence, the coexistence of several equilibria can be observed in nonprofits from the first moment on. With the establishment of a nonprofit important decisions are made that cannot be changed later or only at high costs. The choice of the legal type does not only define the governance system but also
options for financing. In civil code law, foundation and association can be chosen for the same tasks. The major difference is that a foundation needs an endowment. Instead, associations have difficulties in building up funds later in existence, because the members expect their fees to be used for the mission (Blümle/Schauer 2003).

Additionally, the kind of financing leads to path dependencies through different equilibria. Galaskiewicz et al. (2006) differentiate nonprofits that are funded through donations or earned income. In the first group, organizations grow faster that are well connected to urban elites and other nonprofits. In the second group, nonprofits grow faster that are at the outer limits of interorganizational networks and that have fewer connections. Thus, donor-based nonprofits can build their reputation through connections with other nonprofits, whereas revenue-based nonprofits act more out of a competition mindset.

### 3.3. Irreversibility

There seems to be no higher path dependence than the mission purpose of a nonprofit. Associations may change their purpose based on member vote, but for a foundation there are nearly no options (and if, only by the decision of the supervisory advisory) to change its purpose (Schönenberg 2009). The high dependence on the giving purpose has an influence on the composition of the board or access to financial resources.

Gregory and Howard (2009) present another form of irreversibility. They describe a starvation cycle of too low reported administration costs to please donors. The decision to report low administration costs raises the expectation of the donors that the administration costs will decrease in the next year, because an increase could lead to lower donations. Once in this starvation cycle, the nonprofit can hardly get out again.

### 3.4 Consequences of path dependencies

Following the theoretical outline, path dependency leads to several consequences that may have a negative influence on the future development or the growth of an organization. Literature names unpredictability, inflexibility, and potential inefficiency as examples (Wolf 2013). Unpredictability means that despite positive feedback the development of a path dependent process is not clearly identifiable. Influenced through conscious decisions or external circumstances, the orientation of a path can change at so-called critical junctures. Additionally, path dependent processes are inflexible as changes are difficult to be realized. Finally, path dependency might lead to inefficiency if the chosen equilibrium does not lead to a positive output under the given circumstances. If path dependency lead to a situation of total inflexibility and a change of paths is not possible any more, then literature describes this situation as “lock-in” (Ruttan1997).

The following study applies path dependency theory focusing on financial health. I analyze the differences in organizational structure and financial growth for organizations according to their financial health. Following the theoretical assumption, nonprofits with lower financial health are more likely to find themselves in a lock-in status. I expect that less financial healthy nonprofits report lower unrestricted assets, as they have no means to build it up (Chikoto and Neely 2014). As path dependencies develop in a process over time, older nonprofits should be more likely touched by consequences of positive feedback and irreversibility leading to a lock-in status. Especially, positive feedback will lead to a higher concentration in revenue sources, e.g. nonprofits with lower financial health are more dependent on one revenue source. Following the definition of Bowman (2011) nonprofits with less financial capacity have reduced options to react on
environmental changes that has a negative influence on financial growth and overall revenues. Carroll and Stater (2009) show that nonprofits with higher revenues have a reduced volatility in annual revenues and, thus, a better financial stability. Hence, financial growth is not only a means to an end, but it allows better planning and strategy realization. Thus, I formulate the following four hypotheses:

H1: Older nonprofits are more likely to find themselves in a lock-in status

H2: Nonprofits with high financial health have more unrestricted funds.

H3: Nonprofits with high financial health have more diversified revenue sources.

H4: Financial health has a positive influence on the size and development of revenues.

4. Methods

In the following section, I analyze the consequences of financial health using a data set of 193 Swiss fundraising charities. All nonprofits in the sample are certified by ZEWO, a Swiss label for good standards in dealing with donated funds. According to Bies (2010), ZEWO is one of the most elaborated certificates in Europe. I choose this sample, because all ZEWO certified organizations have to apply an accounting standard, Swiss GAAP FER 21, especially developed for nonprofits. As Swiss nonprofits are not obliged to disclose any financial data by the law, the ZEWO regulations allows to access financial data and to have higher levels of comparison. The data taken from annual reports and web pages shows two points of time, 2005 and 2012.

Especially for the analysis of path dependencies, a larger period offers better opportunities for analysis than two consecutive years. A full longitudinal analysis of seven years went beyond the resources for this study, as all data had to be initially collected. The values of 2005 were corrected for consequences of high donations to international organizations in the realm of the tsunami in South-East Asia end of 2004 (von Schnurbein and Fritz 2017). For the analysis, I executed t-tests and OLS regression models.

For the t-tests, the sample was separated in organizations with or without lock-in status. A lock in status means that an organization loses the possibility to react to changes and to compete in the market (Wolf 2013). The lock-in status was operationalized as binary variable using two indicators. The first indicator is measured as low changes in the expense ratio (±10%), meaning that an organization has not grown or decreased overall in seven years. The second indicator is measured as low changes in project payout ratio (±10%), meaning that an organization invests in 2012 the same amount of money in their project as in 2005. If a nonprofit fulfills both indicators, it has not developed in terms of overall size and in terms of project funding. I choose expenses as a measure of size instead of assets or revenues because of two reasons. First, expenses are directly linked to the reported year and, second, expenses consist of values directly linked to the organizations activities. Assets are not a good measure of the actual size of a nonprofit, as two organizations with the same annual budget can have very different size of assets (e.g. if one owns real estate and the other does not). In addition, revenues are more volatile from one year to another, e.g. when a large donation comes in one year, but pays for operations over several years. For this study, I assume that an organization in a lock-in status has low financial health. The two indicators showed a weak positive non-significant correlation (0.143; p=0.077).
I conducted two OLS regression models with the dependent variables log. revenues for 2012, and revenue growth from 2005 to 2012. As independent variables I used a Hirschman-Herfindahl-Index (HHI) as diversification measure as proposed by Yan et al. (2009), the project payout ratio counted as:

\[
\text{project payout ratio } = \frac{\text{revenues} - (\text{administrative costs} + \text{fundraising costs})}{\text{revenues}},
\]

the log. unrestricted net assets, and the dummy variable of the lock-in status. Control variables were year of establishment, and the legal type (foundation or association).

5. Results

In table 1, the descriptive statistics for the total sample and for the relevant variables of the regression analysis are presented. Table 2 follows with descriptive data for the t-tests, differentiated in nonprofits with high/low financial health. Due to missing values in year 2005, the sample size is reduced to 153 nonprofits.

In the following, I discuss the results of the t-tests (see table 3). Except for the diversification index, all variable have homogeneous variances, because of the Levene-test with non-significant results. However, only two variables, Year of establishment and unrestricted net assets, have a significant difference between the two groups or organizations. Nonprofits with good financial health have more unrestricted net assets, and older organizations are more likely to be stuck in a lock-in status. Thus, hypotheses 1 and 2 are supported. As mentioned before, the Levene-test for the diversification index is significant and, thus, heterogeneous variances have to be assumed. Under this assumption, the t-test is significant and there is a negative relationship, e.g. nonprofits with low financial health have a higher concentration in financial sources. However, this result is not univocal and has to be tested with a larger sample. Thus, I reject hypothesis 3.

Table 1: descriptive statistics on the total sample

<table>
<thead>
<tr>
<th>Variable</th>
<th>mean</th>
<th>std. d.</th>
<th>min</th>
<th>max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of foundation</td>
<td>1958</td>
<td>31.8</td>
<td>1848</td>
<td>2005</td>
</tr>
<tr>
<td>Legal type (association=0; foundation=1)</td>
<td>.30</td>
<td>.46</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Unrestricted net assets 2012 (log.)</td>
<td>14.31</td>
<td>1.73</td>
<td>10.05</td>
<td>19.11</td>
</tr>
<tr>
<td>Expenses 2012</td>
<td>11,356,240</td>
<td>24237063.91</td>
<td>34'235</td>
<td>231'639'000</td>
</tr>
<tr>
<td>Revenues 2012 (log.)</td>
<td>15.11</td>
<td>1.51</td>
<td>10.53</td>
<td>19.34</td>
</tr>
<tr>
<td>Revenue growth 2005-2012</td>
<td>.2191</td>
<td>.35</td>
<td>-1.35</td>
<td>.95</td>
</tr>
<tr>
<td>Diversification index 2012</td>
<td>.5509</td>
<td>.24</td>
<td>.00</td>
<td>.93</td>
</tr>
<tr>
<td>Program payout ratio 2012</td>
<td>.7881</td>
<td>.15</td>
<td>.16</td>
<td>.99</td>
</tr>
<tr>
<td>Lock-in-Status</td>
<td>.18</td>
<td></td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Table 2: descriptive statistics for nonprofits grouped by high/low financial health

<table>
<thead>
<tr>
<th>Lock-in-Status (n=28)</th>
<th>Variable</th>
<th>mean</th>
<th>median</th>
<th>std. d.</th>
<th>min</th>
<th>max</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year of foundation</td>
<td>1948</td>
<td>1949</td>
<td>.33</td>
<td>1887</td>
<td>2004</td>
<td></td>
</tr>
<tr>
<td>Unrestricted net assets 2012 (log.)</td>
<td>14.72</td>
<td>14.75</td>
<td>1.70</td>
<td>12.33</td>
<td>18.69</td>
<td></td>
</tr>
<tr>
<td>Diversification index 2012</td>
<td>.5985</td>
<td>.5985</td>
<td>.18</td>
<td>.19</td>
<td>.87</td>
<td></td>
</tr>
<tr>
<td>Another NPO (n=125)</td>
<td>Year of foundation</td>
<td>1960</td>
<td>1967</td>
<td>.30</td>
<td>1888</td>
<td>2005</td>
</tr>
<tr>
<td>Unrestricted net assets 2012 (log.)</td>
<td>14.05</td>
<td>13.95</td>
<td>1.66</td>
<td>11.39</td>
<td>18.35</td>
<td></td>
</tr>
<tr>
<td>Diversification index 2012</td>
<td>.52</td>
<td>.60</td>
<td>.26</td>
<td>.00</td>
<td>.93</td>
<td></td>
</tr>
</tbody>
</table>
In Table 4, the results of the OLS regression models are presented. Model 1 has the dependent variable «log. revenues 2012» and explains 51.8 per cent of the variance. Unrestricted net assets and the control variable legal type show a positive and significant effect. The legal type presents different governance structures. According to the results, foundations have significantly higher revenues than associations. Even more influence have the unrestricted net assets. Organizations with a good financial health have higher revenues. The second model with revenue growth as dependent variable explains only 16.3 per cent of the variance. Here, the HHI, project payout ratio, lock-in status, and legal type show significant results. The HHI, the lock-in status, and the legal type have a strong negative influence, whereas the project payout ratio has a positive influence. Thus, nonprofits with high revenue growth (independent from the actual size of the revenues) have concentrated revenue sources, are less likely in a lock-in status, report higher project payout ratio, and are more often organized as association. Thus, hypothesis 4 is not rejected.

<table>
<thead>
<tr>
<th>Table 3: t-Tests for nonprofits with high/low financial health</th>
</tr>
</thead>
<tbody>
<tr>
<td>Variable</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Year of foundation</td>
</tr>
<tr>
<td>Unrestricted net assets 2012</td>
</tr>
<tr>
<td>Diversification index 2012</td>
</tr>
</tbody>
</table>

*p < 0,1; **p < 0.05; ***p < 0.00

<table>
<thead>
<tr>
<th>Table 4: Regression analyses with dependent variables revenues 2012 and revenue growth 2005-2012</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dependent variable</td>
</tr>
<tr>
<td>(constant)</td>
</tr>
<tr>
<td>revenues 2012</td>
</tr>
<tr>
<td>Program payout ratio 2012</td>
</tr>
<tr>
<td>Unrestricted net assets (log.)</td>
</tr>
<tr>
<td>Lock-in status</td>
</tr>
<tr>
<td>Year of foundation</td>
</tr>
<tr>
<td>Legal type</td>
</tr>
</tbody>
</table>

*p < 0,1; **p < 0.05; ***p < 0.00

6. Discussion
From the findings of this study, I can draw important insights for the further development of financial management in nonprofits. In existing literature, a coherent understanding of financial management in nonprofits is scarce. Instead, the focus on the specifics of the single revenue sources such as state subsidies, private donations, or earned income prevents a more comprehensive understanding of financial management. This impedes a more systematic alignment of nonprofit financing along with the financial aims of
liquidity and efficiency. Based on the basic assumptions of path dependency theory, one can say that nonprofit financing is less dependent on current environmental influences and more on positive feedback, non-ergodicity, and irreversibility. A worst case is that path dependency finalizes in a lock-in status that is affected by inflexibility and quasi irreversibility. In my study, I defined a lock-in status, if a nonprofit organization over a period of seven years reports only small changes in its total expenses and in its project payout ratio. The results support differences based on age and unrestricted net assets. It seems logic that the danger of a lock-in status increases for older organizations. Same, an inflexible nonprofit organization is more likely to lack revenues in order to build up unrestricted net assets. Hypothesis 3 has been rejected due to missing significant results. Finally, good financial health has a positive influence on revenue size and revenue growth, supporting hypothesis 4. The analysis of path dependencies relies on longitudinal data. Thus, I used an operationalization of the lock-in status as a result of path dependency. Nevertheless, the results show that static organizational behavior has a negative influence on the development of the nonprofit and, thus, nonprofit should manage their finances actively and more strategically.

However, some limitation have to be discussed. First of all, the sample consists of certified fundraising charities, thus, a special type of nonprofits, and the results cannot be generalized on all nonprofit types. Despite the fact that all organizations included have to report according to a given standard, differences in the annual reports cannot be excluded. Finally, financial health was operationalized by a distinction of a lock-in status, which is probably a too narrow concept of bad financial shape. However, the narrow focus allowed for clear interpretations of the reported relationships.

6.1 Implications for further research

Considering the basic assumptions of path dependency theory, it is surprising that the theory found little resonance in nonprofit literature, so far. Many factors that influence nonprofit financing are defined at the establishment of the organization and are difficult to change at later stage. Further analysis based on case studies of single nonprofits may help to understand better the influences of founding decisions on the finance management of nonprofits. Another reason to promote further path dependency theory in nonprofit literature is the conceptual closeness to resource dependency theory, one of the major theories in nonprofit financing. Access to relevant resources is the success of a long process that has to be managed by each organization specifically (Teece et al. 1997). Especially in times of changing environments, the path dependency theory helps to understand better financing processes that have to be created out of the proper organization and less through external willingness to give.

The results of this study call for further research on two topics: the importance of unrestricted net assets and the securing of degrees of independence in nonprofit finance management. Both, t-tests and regression analysis give insights on the importance of unrestricted net assets: nonprofits with little changes in expenses and project payout ratio have significantly less unrestricted net assets. Additionally, the unrestricted net assets have a positive influence on the revenues. Especially, as nonprofits have limited access to issuing debt, unrestricted net assets are essential to plan investments and to build up new activities. Based on path dependency theory, the high dependence on past decisions defines the present value of unrestricted net assets. As building up unrestricted net assets may be, create problems both, from legal perspective and public opinion, future research should offer answers to the optimal amount of unrestricted net assets and how to deal with this kind of bunkered money.
Furthermore, the results show that a strategy build on stability and continuity only is disadvantageous compared to the overall development of the sector at large. If the budget is always based on the precedent year and planning is bound to annual periods, the danger of a lock-in status is raising. There is a need for extended research on modern budgeting methods and long-term financial planning in nonprofits. Additionally, we have to understand better, how diversification of financial sources influences the management of nonprofits. Research should not treat diversification or concentration as given fact, but as creative leeway that can be changed by management decisions (von Schnurbein and Fritz 2016). Based on my results, further influencing factors on financial growth are the project payout ratio and the legal type. Investments in projects increase revenues, which can be explained as positive feedback according to path dependency theory. If a nonprofit finds and develops good projects, it can generate more revenue for these projects.

6.2 Implications for practice

Nonprofits are mission-driven, which means that their establishment is fueled largely by intrinsic motivation. The founders envision a socially relevant aim and all other aspects of the establishment are subordinate to this aim. However, founders of nonprofits should be aware that their decisions have a long-term influence on the development of the organization. The formulation of the purpose, the legal type or the structure of financing sources at the beginning give directions for all later management decisions and are difficult to change. But path dependencies not only develop at the establishment of a new nonprofit. At later stages, the development of a nonprofit is less dependent on the current circumstances than of self-created structures and procedures. Thus, nonprofits should regularly check their own constitution. Decision-making processes, governance structures, or opportunities to participate for constituents are path-creating factors, as well as attitudes towards funding sources, a focus on input instead outcome, or the missing storage of existing history. With regards to the financing of nonprofits, the major challenge is to develop a stable – future-oriented – funding mix for the own organization. Therefore, nonprofits have to develop a comprehensive financial management that jointly deals with donation, subsidies, earned revenues or financial revenues under consideration of the organization’s mission and purpose.

The theory of path dependency spotlights negative outcomes, but it has to be clear that path dependent processes are not always inefficient or undesirable. Hence, they facilitate the organizations planning as they reduce options of action. This may lead to economies of scale, network advantages, or learning effects (Sydow et al. 2009). Thus, in the analysis of path dependent processes the pros and cons of each equilibrium have to be respected.

References


