Almost two decades ago, Chang and Tuckman (1990) provided empirical evidence that a high proportion of nonprofits report end of year surpluses. These authors offered several reasons for nonprofits to actively accumulate surpluses, including the financing of future service provision, as a source of funds for expansion and/or new program development, as a hedge against uncertainty and risk, as a means to increase nonprofit financial independence, and as a measure of financial success. Their analysis found that most nonprofits run a surplus, these surpluses can be substantial, and surplus accumulation behavior is pervasive but varies among different mission-related groups such as churches, educational institutions, and health care nonprofits.

Over the years, researchers in a variety of fields have commented on the existence of surpluses, explored how best to measure them and in some cases challenged both the value of and the legitimacy of accumulating surplus funds. Surpluses are sometimes likened to profits in the sense that they represent funds leftover for future use. The analogy is weak, however, because by law they cannot be distributed to owners or managers of a nonprofit, as is the case of a for-profit enterprise. Thus far, however, researchers have not succeeded in producing a clear cut definition of nonprofit surplus or how consistently surpluses are run by nonprofits.

To shed greater light on these issues, we created a unique data panel to explore transitions from one period to another. We combine 1999, 2001, and 2003 IRS 990 data from the National Center for Charitable Statistics and use this panel with two definitions of surplus—“total” and “operating”—to measure median surpluses. Our analysis introduces a Markov chain model as a framework for characterizing and measuring transition probabilities between the surplus and deficit states that a nonprofit may occupy in any given year. This allows us to trace the movement of organizations between surplus and deficit states over time, a phenomenon that has been overlooked in the nonprofit literature. We find that a high percentage of nonprofits run surpluses in any given year, but there is considerable movement from a surplus to deficit state and vice versa. These findings have implications for nonprofit financial policies. For example, the analysis is consistent with the view that surpluses may be used as rainy day funds and also with the idea that funds may be accumulated for the purpose of using them for programmatic applications. We also find that a nonprofit in a deficit state has a higher probability of staying in that state than does a nonprofit in a surplus state remaining in surplus. Overall, we also find that only 26% of the nonprofits consistently earned surpluses over the five year period studied.

Finally, we divide our panel into nonprofits that are endowed and those that are not, in order to increase understanding of the role of endowments in the surplus accumulation process. We explore whether endowments tend to increase or decrease the probability that a nonprofit will continue to accumulate profits over time, and we consider whether nonprofits use surpluses to build endowments.

Our findings offer fresh insights into the dynamics of movements into and out of a surplus or deficit state and they suggest that a nonprofit that runs a surplus in one year faces a good chance that it will face a deficit in the next one. We conclude that while much is written about surplus accumulations among large nonprofits (e.g., the endowments at Harvard and Princeton), most of the sector must work hard to ensure that it maintains surpluses over time. Overall, our findings indicate that serious attention should be given to creating policies to ensure that nonprofits are able to accumulate the resources they need to address their long term needs.

References


