Research Notes

Growing Up Nonprofit: Predictors of Early-Stage Nonprofit Formalization

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Abstract

The nonprofit organizational life cycle literature has traditionally focused on the entry and exit processes; the intermediate organizational life stages between these bookends have received less attention. Almost half of all nonprofits at any given time operate in an early life stage with less than US$100,000 in revenue, minimal overhead spending, and no paid managers. This study examines the process by which nonprofits leave the small, informal, startup phase and begin the next life stage characterized by growth and formalization. We identify financial and organizational characteristics that predict whether the nonprofit will successfully transition out of the early and informal life stage. We find that investments in professional fundraising and access to government funds are predictive of the transition out of the start-up phase, while traditional financial predictors such as revenue concentration, equity ratio, fixed cost ratios, and the accumulation of unrestricted assets have modest to no effects.

Introduction

The nonprofit management literature contains an interesting paradox. Although the group of nonprofits with more than US$1 million in annual revenues accounts for only 18% of all nonprofits, they garner 97% of all sector revenues, according to 2010 tax filings (calculated from National Center for Charitable Statistics (NCCS) Core files).

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As this segment includes large, professional, and influential nonprofits, much of the nonprofit management literature focuses on these entities, especially as they are the group that can afford to hire management consultants and pay for training. Less attention is paid to the other 82% of nonprofits, including the 43% with revenues less than US$100,000. Although it is economical to focus attention on the set of actors that generate most of the resources for the sector, the paradox is that small nonprofits typically need more help with building capacity and sustainability. This study aims to fill this gap by examining characteristics of nonprofits as they transition out of the initial stage in the organizational life cycle and begin the process of formalization and growth.

Literature on nonprofit life stages tend to focus on either end of the spectrum. Many studies focus on the nascent stages of formation (Andersson, 2016) or process of nonprofit entrepreneurship (Andersson, 2016; James, 2003; Rose-Ackerman, 1996, 1997; Young, 1980). On the opposite end of the life cycle, a great deal of work focuses on nonprofit closure (Cordery et al., 2013; Hager et al., 1996; Searing, 2018; Tevel et al., 2015). The intermediate life stages between these bookends of organizational birth and organizational demise have received comparatively less attention. Although there is a healthy academic literature on small nonprofits that intend to remain informal grassroots organizations (D. H. Smith, 1997; Toepler, 2003), there is limited work on small nonprofits that aspire toward sustainability or growth (Badelt, 2003; Carman & Nesbit, 2013; Searing, 2015).

We shine light on the transition process through a financial management lens by examining two questions: what do the internal fiscal dynamics of a nonprofit look like as they cross the threshold into the early phase of formalization, and do they differ significantly from organizations that remain small? We use the NCCS Digitized Data to create a panel of nonprofits that were granted tax-exempt status in 1998. We follow these organizations more than 6 years and observe whether they successfully transition into the early stages of formalization and growth or remain small and informal. We measure the transition by observing which organizations cross a revenue benchmark of US$100,000, which serves as a proxy for the threshold between life stages. This benchmark is a good proxy for several reasons: previous studies show that investment in paid management begins here (Lecy & Searing, 2015), plus was the threshold used by the Internal Revenue Service (IRS) as one of the criteria mandating the filing of the Form 990. Organizational practices that predict a successful transition are identified using discrete time hazard analysis. As findings offer insight into the precursors of nonprofit growth, they are valuable to practitioners and to scholars who seek to develop management theory for small nonprofits and donor agencies and management consultants working with organizations at early stage of life.

Moving Beyond the Liability of Smallness

Scholars have long held an interest in the initial stages of firm development as they are common to all organizations and can be a difficult to escape. Aldrich and Auster (1986) describe the liability of smallness, which posits that conditions inherent in being small
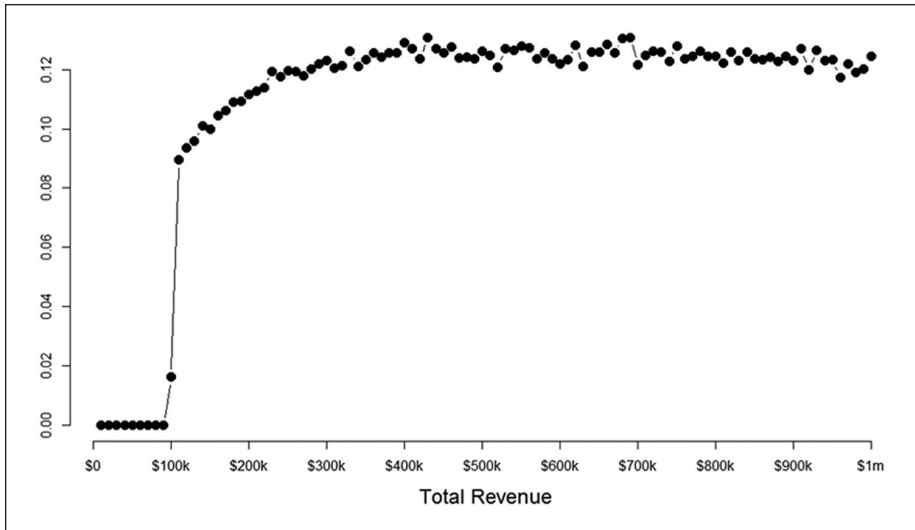
Figure 1. Median overhead ratio as a function of total revenues.
Source. NCCS Digitized Data.

cause an increased likelihood of organizational demise. These conditions are common to most organizational start-ups, including nonprofits. For example, small nonprofits are often run on a volunteer basis with both donated time and capital from their founders, with both resources likely to be scarce (Singh et al., 1986). The lack of a successful record or external reputation means that allies and funders are more likely to be personal contacts of the founders. Early on revenues are mostly allocated to programs, leaving little to pay management or build capacity.

Escape from the liability of smallness requires the stabilization of finances, formalization of managerial control structures, and predictable organizational processes. The exact transition point can be challenging to triangulate, but previous nonprofit scholarship shows that there is a clear punctuation that occurs as revenues approach the US$100,000 mark and an organization ceases directing all expenditures to programs and begins allocating resources to paid administration (Lecy & Searing, 2015, 2016). Shortly after passing this revenue threshold most nonprofits will hire their first employee or paid director, begin fundraising professionally, and engage in other behaviors indicative of professionalization (Hwang & Powell, 2009). This phenomenon is illustrated in Figure 1.

All nonprofits that eventually scale their missions will pass out of the start-up phase and into subsequent stages in the organizational life cycle characterized by capacity-building and growth. The second phase is the one in which precarious pilot programs evolve into revenue-generating services; experimental artistic performances turn into more permanent theaters and galleries; spontaneous social movements develop stable leadership structures that can sustain campaigns and recruit new members; and

informal voluntary associations develop governance structures to apply for grants. Founders are no longer asking: Can this idea work and does it provide value? They are now asking, "How can we formalize our operations to sustain these activities?"

The second phase of the life cycle is a meaningful distinction from the start-up phase because activities such as tutoring clubs, cultural festivals, and environmental campaigns can emerge organically from social capital in communities and operate with informal leadership structures. Bylaws, accounting protocols, contracts, HR handbooks, member databases, and donor reports do not emerge organically. They are created intentionally as scaffolding for organizational maintenance and growth, and they require skills that are distinct from those needed to invent new programs or services.

Organizational life cycle theory lacks a standard term applied to the second phase of organizational development. Although the term "formalization" has a slightly different and more precise meaning in other parts of the management literature (see Pugh et al., 1969), it is used here as a generic label for this second stage in the nonprofit context and as an umbrella term that encapsulates many managerial subprocesses. For example, nonprofits will begin "professionalization" during this stage, shifting administrative responsibilities and from volunteers to paid experts (Salamon, 1999). They might also initiate managerialization, rationalization, schoolification, marketization, and commercialization of revenues (Eikenberry, 2009; Hvenmark, 2013; Hwang & Powell, 2009; Kreutzer & Jäger, 2011; Maier et al., 2016). Many can occur simultaneously, and few are discrete tasks. Formalization thus describes the transition from the phase of creating programs to the efforts aimed at sustaining programs. Some organizations undertake these activities proactively in anticipation of subsequent stages of growth, whereas others might be forced into them when early success attracts donors or creditors that require certain governance and accountability practices before receiving grants, contracts, or loans.

This study does not attempt to observe or measure the constellation of formalization processes directly, but rather relies on myriad financial indicators that show they start when nonprofit revenues reach US$100,000. The revenue threshold thus serves as a useful mechanism to model the distinct behaviors of early-stage nonprofits associated with a successful transition into the second stage of life. As a large proportion of nonprofits will never escape the first stage, practices that differentiate those that do from those that do not are useful to managers and policymakers. More generally, the duration analysis framework presented below offers scholars a tool for analyzing transitions through various stages of the nonprofit life cycle.

Hypotheses: Crossing the Threshold

Drawing on existing literature, we have identified observable nonprofit financial management practices that correspond with formalization and growth. We have operationalized the study hypotheses as management practices or resource strategies that, when implemented, should support a successful transition out of the startup status and commencement of formalization processes. Our empirical model allows us to determine

which of these prescribed practices predicts a successful transition in reality. We focus on five main practices:

Hypothesis 1 (H1): Early investment in managerial infrastructure leads to formalization.

Investments in professional administrative services such as accounting and fundraising require resources that are scarce in initial life stages and, therefore, signal a commitment to growth intention. The introduction of professional accounting and fundraising practices can increase resources and the capacity to manage them. Furthermore, successful investment in managerial capacity impacts overall operations and morale of the organization (Carvalho et al., 2016).

Hypothesis 2 (H2): Investment in organizational financial slack provides protection from shocks and grants managerial flexibility that encourages growth.

Bowman (2011a, 2011b) emphasizes that the key to short-term financial health and sustained growth is the ability to withstand sudden revenue shock. The nonprofit financial vulnerability literature has long equated the reduction of slack with increased likelihood of financial distress (Chang & Tuckman, 1991; Keating et al., 2005). A respectable "rainy day" fund will provide security important during periods of organizational change. In addition, slack provides management with room for programmatic experimentation and the ability to pursue unexpected opportunities.

Hypothesis 3 (H3): Government funding favors the achievement of formalization.

The comfort of revenue stability is coveted especially during the young and small years of a nonprofit's life, so specializing in stable sources will assumedly support a successful transition out of the informal phase. Kim and Bradach (2012) find that government funding increases revenue stability; this is especially true when compared with donative nonprofits (Froelich, 1999). Furthermore, it may signal legitimacy that small and young nonprofits traditionally lack (Jung & Moon, 2007; T. M. Smith, 2007). Government funding additionally promotes formalization through stringent accounting and reporting capacities that are a requirement of the grant or contract (Lu, 2015; Suárez, 2011).

Hypothesis 4 (H4): Concentrated revenue sources (specialization) facilitate the achievement of formalization.

In their study of fast-growing nonprofits, Foster and Fine (2007) find that the organizations achieve vast growth primarily through revenue concentration, not diversification. Chikoto and Neely (2013) affirm this finding through a large-N panel study using IRS financial data. The argument is both ecological and economic: by specializing in the acquisition of a particular type of resource, an organization can gain a competitive advantage in acquiring that resource compared with other organizations.

So long as the resource remains plentiful, the nonprofit with a competitive advantage (in the form of specialized staff, connections, etc.) will be able to utilize that resource more efficiently and effectively. This assertion is in conflict with the prevailing wisdom in the literature which suggests that nonprofits should diversify revenues to grow (James, 1983), and that diversification has broad organizational benefits (Chang & Tuckman, 1991; Greenlee & Trussel, 2000). We predict that revenue concentration, not diversification, will boost the likelihood of formalization.

> **Hypothesis 5 (H5)**: Organizations with more financial flexibility are more likely to formalize.

Carroll and Stater (2009) describe financial flexibility as a function of the relationship between debt, equity, and fixed costs in the nonprofit budget. Too much debt or too many financial commitments can render an organization structurally incapable of growth because new revenues cannot be directed toward productive purposes that support formalization and expansion. For example, debt service competes with other investments like hiring employees. The long-term commitment of resources also limits the flexibility of an organization to respond to a changing environment (Mitchell, 2017). Unlike Hypothesis 2, which focuses on cash reserves that can be deployed quickly, fiscal flexibility is a long-term structural consideration that might not limit liquid cash reserves but does constrain managerial discretion. We expect that organizations that are free of excessive liabilities and long-term financial commitments will have the ability to adapt to their funding environment and respond to opportunities, thus increasing their likelihood of growth and formalization.

Method

Data

This study requires detailed archival information that allows us to observe the formalization process and operationalize hypotheses through detailed financial data. The NCCS-GuideStar National Nonprofit Research Database (the "Digitized Data") from the National Center of Charitable Statistics provides this level of granularity through detailed records of the Form 990 financial filings.[1] Although a short panel of 6 years (1998–2003), the Digitized Data includes substantially more information than other publicly available datasets in addition to checks for accuracy.[2] Furthermore, despite documented limitations of Form 990 data, it is the appropriate source and specificity for this type of analysis (Froelich et al., 2000). To hold age and environment constant and to maximize the length of the study period, we limit the sample to organizations granted tax-exempt status in 1998.

Dependent Variable

As mentioned previously, we consider the nonprofit to be entering the formalization phase the first year the US$100,000 threshold is crossed.[3] This threshold has been

shown in the literature to be of particular significance in the life cycle of a nonprofit (Lecy & Searing, 2015, 2016).

To observe changes that occur during the transition out of the small start-up phase and into the early periods of the formalization stage, we further limit the sample to all new nonprofits that report total revenues of less than US$100,000 in their first year of operation. We believe those nonprofits that begin with more than US$100,000 in revenues in their first year are likely organizations with the backing of philanthropists or other institutions or spin-offs from existing nonprofits. There are 7,744 organizations in the Digitized Data that begin their lives as preformalized nonprofits in 1998, of which 32% cross the US$100,000 threshold during the study period. They each appear an average of 2.8 years in the panel, resulting in 22,026 total observations. The sample framework details are available in Table A1 of Supplemental Appendix.

Independent Variables

We are interested in the managerial decisions that allocate scarce resources to achieve growth. Reported spending allows us this insight: We see the prioritization of different objectives and resources via numbers. We operationalize our hypotheses through a set of independent variables derived from measures available in the Digitized Data; see Table A2 in the Supplemental Appendix for the specific data fields utilized.

For Hypothesis 1, the investment in professional practices is measured by two variables: the use of accrual accounting and investment in professional fundraising. Cash accounting is a simple and more intuitive approach for start-up nonprofits, but offers limited insight into financial structure and long-term fiscal health. It is appropriate for small organizations with few assets and no growth aspirations. Accrual accounting is required by Generally Accepted Accounting Principles (GAAP) for nonprofit reporting and indicative of an investment in financial sophistication. Therefore, the presence of an accrual system indicates investment in managerial capacity (Hwang & Powell, 2009). Similarly, the employment of a professional fundraiser also signals investment in the expansion of resources and formalization of marketing and planning processes. Although it is not the same as developing staff knowledge, the employment of a specialist indicates the recognition of a need to expand beyond the current managerial limitations.

We measure organizational slack using both a financial stock variable and a financial flow variable. Unrestricted net assets (UNA) measures the quantity of assets in excess of liabilities that are not constrained by donor designations. Also known as retained earnings, they are the accumulated savings or "rainy day" fund that a nonprofit can access to address a resource shock or pursue an opportunity. The stock of retained earnings grows or is depleted through annual surpluses or deficits known as net income, which represents the difference between annual revenues and expenses. To account for organizational slack, this study uses the surplus ratio measure calculated as net income divided by total revenues. This measure describes the nonprofit's current operational slack (revenues growing faster than expenses), whereas the UNA represents a reservoir of resources that can be deployed as necessary.

Table 1. Summary Statistics.

Statistic	Minimum	Median	M	Maximum	SD
Revenue >US$100,000	0	0	0.11	1	0.31
Pro fundraiser	0	0	0.03	1	0.16
Accrual acct	0	0	0.22	1	0.41
Surplus ratio	−6.77	−0.25	−2.13	0.38	2.98
UNA (1,000s)	−4,630	0.00	18	21,027	200
% rev. from govt	0.00	0.00	0.04	1.00	0.17
Revenue HHI	0.00	0.85	0.68	1.00	0.38
Equity ratio	0.00	4.17	29.61	2,605.17	91.12
Fixed cost %	0.00	0.00	0.04	1.00	0.11

Note. N = 7,744 small nonprofits granted tax-exempt status 1998; 22,026 observations more than 6 years. Our dependent variable, the transition out of the start-up phase and into the beginning of the formalization life stage, is proxied by revenues growing to exceed US$100,000. Nonprofits with revenues above US$100,000 exhibit behaviors commensurate with early stages of formalization, such as nontrivial overhead investments and hiring the first full-time employee or manager. UNA = Unrestricted net assets; HHI = Herfindahl–Hirschman Index.

The degree of government funding in Hypothesis 3 is operationalized as the percentage of total revenues originating from government sources. Unlike many other studies, the Digitized Data allows us to isolate grants, contracts, and fees from government sources, giving a clearer picture of the landscape of government funding. We measure revenue concentration for Hypothesis 4 though a Herfindahl–Hirschman Index (HHI) of revenue concentration across grants, donations, and earned income sources, a traditional metric utilized in the nonprofit financial literature. The ratio has an upper bound of one, representing a single revenue source. Lower measures represent more diverse revenue structures.

Fiscal flexibility in Hypothesis 5 is measured using two variables. First, the equity ratio of total assets to total liabilities indicates the amount of debt a nonprofit has leveraged. Second, we include fixed costs as a percentage of total expenses to indicate managerial discretion in the budget. Although there may have been necessary large capital acquisitions required for start-up depending on the sector, it also signals ongoing mandatory expenses that limit managerial flexibility.

Because each subsector has different revenue compositions and capital requirements that impact fiscal structure, we include estimates disaggregated by subsector based on major National Taxonomy of Exempt Entity (NTEE) codes.[4] Summary statistics for all variables are included in Table 1.

Model Estimation

The purpose of this Note is to estimate the impact of managerial behavior on the probability of a small nonprofit start-up beginning the formalization stage. Our dependent variable is a binary outcome representing the commencement of that stage. As our
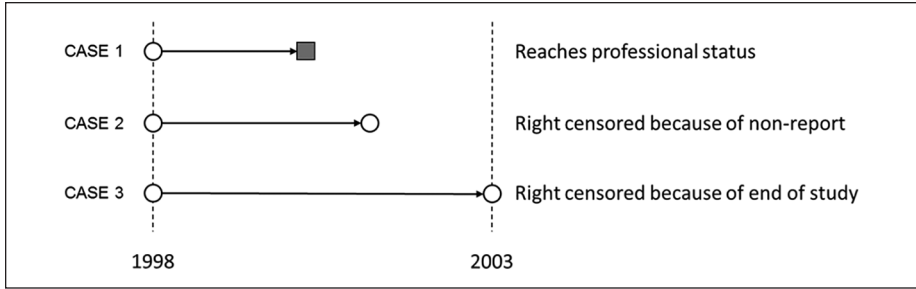
Figure 2. Examples of the types of "spells" used in the study.

variables are all time-variant and formalization can be observed at a specific point in time as a binary outcome (revenues crossing US$100,000 used as a proxy for formalization), a duration model is the most appropriate way to structure the analysis (Figure 2). As variables are observed in 1-year increments, a discrete–time hazard model is the preferable approach (Singer & Willett, 1993).[5]

In hazard models, each set of observations associated with an individual organization represents a "spell." As we cannot observe nonprofits prior to 1998 in the Digitized Data, we restrict the sample to those with a 1998 ruling date to create a meaningful cohort of new organizations with a long period of observation. As we are interested in the process of moving from an informal to a more formal status, the organizations need to begin in a start-up phase proxied by low revenue. This study also includes two types of right-censored data: nonprofits that remain small throughout the study period and nonprofits that cease filing 990 reports, usually because they have either stopped operating or because they have become dormant.

The hazard rate h_j in this context is a conditional probability that an organization will formalize at age j, given that it has not formalized in prior periods.

$$h_j = \Pr[T = j | T \geq j]$$

The hazard rate at time j is conditioned on prior events, meaning the probability of formalization within a given time period takes into account the proportion of the sample that has already formalized in previous periods. The hazard rate at each time period represents the probability that a remaining small start-up nonprofit formalizes. As such, it is an instantaneous rate.

The probabilities are represented as log-odds, which allows the duration process to be estimated as a linear model.

$$\log\left(\frac{h_{ji}}{1 - h_{ji}}\right) = \left(a_1 D_{1i} + \cdots + a_j D_{ji}\right) + \left(\beta_1 Z_{1i} + \cdots + \beta_p Z_{ki}\right)$$

In this format, h_j represents the probability of formalization in period j, D_j represents a dummy variable that is coded one if organization i is age $= j$ in a given period,

and zero if it is another age in that period. The Ds collectively comprise the baseline hazard rate in the model, *ceteris paribus*. The vector Z_k represents binary or continuous covariates used as independent variables in the study. The duration panels are constructed in such a way that each organization occurs one time in the data set for each period it is operating as a small start-up nonprofit, and one period total as a professional nonprofit if it reaches that stage by the end of its spell. The parameters are estimated by running the model as a logistic regression.

To recover the baseline hazard rates from the log-odds representation, we must manipulate our regression function until we arrive at the following baseline hazard model for each period j:

$$h_j = \frac{1}{e^{-a_j D_j}}$$

If we include independent variables in the model, the hazard function is constructed as follows:

$$h_j = \frac{1}{e^{-\left(a_j D_j + \beta_1 Z_1 + \cdots + \beta_p Z_p\right)}}$$

The survival curve S represents the proportion of the population at period $= j$ that has not yet formalized, or stated differently in this context the proportion of nonprofits that have not yet formalized by age $= j$.

$$s_j = \prod_{k=1}^{j} \left(1 - h_k\right)$$

Log-odds from a logistic regression are difficult to interpret in the duration framework as interpretation requires the link functions above, so we instead report results as effect sizes calculated from hazard rates and survival curves estimated from the model. We examine marginal effects by centering the covariates at their median values and then manipulating one independent variable at a time, examined changes relative to the baseline hazard rate and the survival curve. The full table of regression coefficients can be found in the Supplemental Appendix Table A3.

Findings

In a duration model the hazard rate represents the probability of an organization formalizing in a given time period. In the example in Figure 3, the base rate for nonprofits entering the formalization phase in the third time period is approximately 0.11, meaning that 11% of nonprofits that are still at the start-up stage in the third time period are expected to cross the US$100,000 threshold in their third year. The hazard rate increases to 0.18 if we consider the contribution of one independent variable (a generic independent variable is included here for illustration only). The effect of the independent variable is a 7-point increase in the probability of entering the formalization stage in the third year.
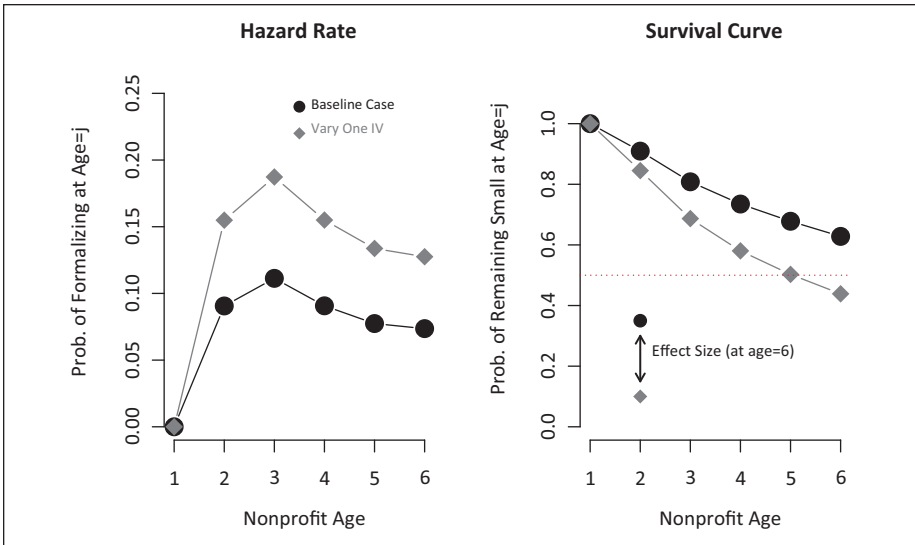
Figure 3. Hazard and survival rates related to formalization.

The survival curve represents the proportion of organizations that have not yet entered the formalization stage at each point in time. Whereas it is common in duration models to report an effect as the change in median survival time (the point at which at least half of the sample has formalized), most of our baseline models do not reach the median survival time within the 6-year panel available to us. We instead calculate effects as the contribution each covariate makes to the increased probability of formalization relative to the baseline model in the sixth time period. As the Digitized Data covers years 1998 to 2003, 6 years is the longest observation period.

The effect size represents the additional proportion of nonprofits in the sample we would expect to enter the formalization phase by Year 6 when the nonprofit has higher levels of the specific covariate throughout the study period.[6] These effects are summarized across the seven models in Table 2. The effect gives a sense of the relative contribution of each covariate when the nonprofit embraces a discrete practice like professional fundraising or possesses an above-average amount of measures like organizational slack (Figure 4).

Many of the results are in the expected direction. Broadly, investment in managerial infrastructure is a strong indicator of commitment to growth. We observe that nonprofits which invest in fundraising and accounting capacity are more likely to successfully transition to the stage of formalization and expansion. Accrual accounting, on the contrary, is required to comply with requirements of several public and foundation revenue sources, but it is not as strong of a predictor as professional fundraising.

Financial slack is also a strong predictor of the transition to the formalization phase, but most prominently through the surplus ratio and much more modest for the equity

Table 2. Effect Size Calculations by Subsector.

	All	Arts	Health	Human services	Public	Education	Other
H1: Professional Practices							
Pro fundraiser	0.340	0.426	0.215	0.338	0.353	0.452	0.015
Accrual acct	0.190	0.276	0.066	0.189	0.204	0.312	0.000
H2: Financial Slack							
Surplus ratio	0.381	0.520	0.239	0.359	0.372	0.399	0.750
UNA (1,000s)	0.098	0.143	−0.016	0.149	0.204	0.182	−0.010
H3: Government Revenue							
% rev. from govt	0.392	0.365	0.270	0.397	0.411	0.429	0.014
H4: Revenue Concentration							
HHI	−0.022	0.072	−0.142	−0.030	−0.002	0.100	−0.015
H5: Financial Flexibility							
Equity ratio	0.114	0.193	−0.035	0.096	0.206	0.253	−0.008
Fixed cost %	0.042	0.125	−0.081	0.048	0.049	0.139	−0.010

Note. The "effect size" represents the change in proportion of nonprofits that exit the start-up phase by Year 6 if the level of the independent variable is increased from the 50th to the 99th percentile for continuous variables, or from zero to one for binary variables. It is the gain in the likelihood of the transition that results from an increase in the independent variable. UNA = Unrestricted net assets; HHI = Herfindahl–Hirschman Index.
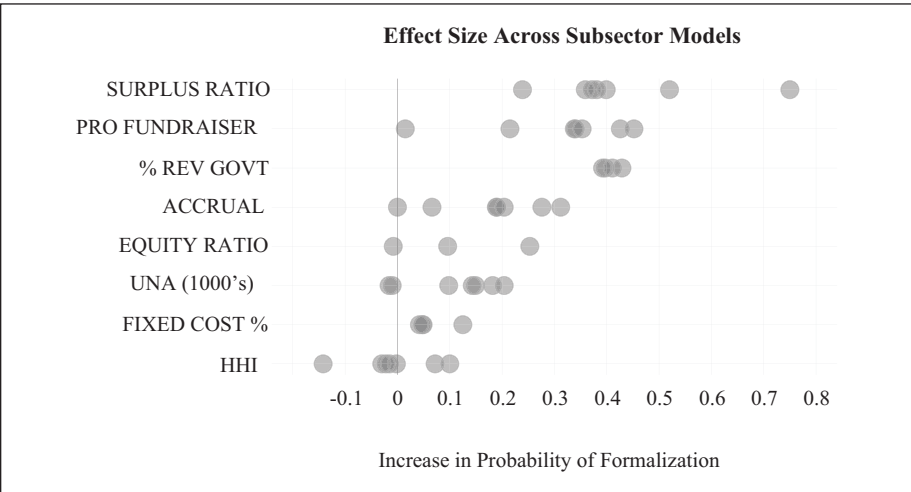

Figure 4. Summarizing effects across all sector models.
Note. Graphical representation of the effect size calculations in Table 2. If the coefficient was not significant in the subsector model, the effect is not included in the graph. UNA = Unrestricted net assets; HHI = Herfindahl–Hirschman Index.

ratio, fixed cost ratio, and UNAs. All have positive impacts on the likelihood of escaping the earlier life phase, but surplus ratio (UNAs) has one of the largest effects on the probability of entering the formalization stage in the full model (0.381), whereas the impact of the equity ratio (0.114), the fixed cost ratio (0.042), and UNAs (0.098) are approximately one quarter to one tenth as strong. Despite their importance in the literature, neither the equity ratio nor the percentage of fixed costs have a significant impact on more than half of the subsectors. This may be because these are typically measures of investment in things such as facilities and equipment, which might not be important or acquirable at this life stage for nonprofits. Similarly, an above-average endowment (UNAs) is consistently significant in the models across subsectors, but the impact is also consistently small (0.098).

On the revenue side, government grants also have a large and positive impact on formalization, a finding that is surprisingly uniform across sectors. This supports the findings of Kim and Bradach (2012) regarding the stabilizing effect of government funds, in addition to government's general preference for formalization (Stewart & Faulk, 2014). The necessary development of institutional capacity and resources to manage government funding directly supports the logic of the formalization model. The primary caveat with this finding is the reliability of the reported government income on tax forms. Although we include three types of government funding sources, it is difficult to parse out government programs from other fee-for-service activities. Finally, despite the predictions of Foster and Fine (2007) and Chikoto and Neely (2013), we fail to find support for the hypothesis that revenue specialization supports formalization. Although significant in some of the models, the effects on growth were sometimes positive, sometimes negative, and always modest (approximately −0.1 to +0.1).

Discussion

This study highlights the lack of guidance in the academic literature for managers in young and small nonprofits, with the aim of being able to help fill that gap. Several useful insights can guide current practice and future research.

First, not all methods of improving financial well-being are equally as important. The financial slack variables suggest that structural constraints on the budget are meaningful and savings is good (UNAs). However, a robust revenue model that generates net income (the surplus ratio) is a much stronger predictor of growth for small nonprofits than accumulated assets. A healthy equity ratio signals stable financial management practices, so saving up for a rainy day is a good idea in terms of protecting against revenue shocks. However, neither an absence of debt nor a stockpile of assets are as strongly predictive of entering the professionalization stage as net income.

Second, the type of income forming the basis for that revenue model matters. Government funding is universally predictive of formalization, though it is difficult to determine whether it is due to the salubrious effect of multiyear awards that stabilize finances, or whether it is the legitimacy and access gained from government relationships. Similarly, investments in human resource capacity through

professional fundraisers and accrual accounting practices are highly predictive of a successful transition. There are two possible mechanisms, though. Fundraising efforts and government grants provide access to new revenue streams, but compliance with government regulation and adopting rigorous accounting standards both indicate a commitment to professionalization, future research is needed to disentangle the true mechanism.

Third, our findings on revenue concentration suggest a small, but statistically significant link between diversification and the success of small nonprofits that has heretofore been absent in the literature. Although Foster and Fine (2007) demonstrate the important of revenue specializing for very large nonprofits, this study is more similar to Searing (2015) and finds that the risk mitigation of revenue diversification (rather than concentration) for smaller nonprofits may help stabilize income. This is also consistent with the financial vulnerability literature, which claims revenue diversity is protective from shocks. It is entirely possible that specialization may be more beneficial when nonprofits reach a later developmental stage, and we encourage researchers who continue to explore the impact of revenue concentration to incorporate life stage into their models.

Finally, qualitative and cross-sector work on the challenges of formalization would be welcome, especially regarding the intent to formalize. Although the empirical results here are agnostic to intent, additional studies on the motivation and commitment of leadership teams as they push toward growth are needed. The board, especially, is very important in the management and governance of start-up nonprofits. Qualitative research on the discretionary components of management strategies would significantly enhance this type of revealed preference model by unpacking information and team dynamics that shape the decisions to employ the management processes we observe in the data. We anticipate that discovering how nonprofits determine the right time to push for a transition out of the start-up phase will generate deeper insights into early life stage dynamics than modeling the financial management outcomes that emerge from the discourse.

Conclusion

This study expands the understanding of how an organization achieves the transition from founding to formalization, which expands the knowledge base for practitioners and scholars focusing on the managerial needs of small nonprofits. In this study, we find that investments in fixed assets, the accrual of savings, and the specialization of revenue sources are not good predictors of a successful transition out of the start-up phase. Rather, net income, access to government grants, and investments in a professionalization are more predictive of a successful transition to the early stages of formalization. These findings lend additional credence to the value of life-cycle studies and other approaches that extend beyond typical financial growth modeling. Furthermore, we can offer practical takeaways to managers of small nonprofits, such as diversifying your revenue streams, prioritizing the use of a fundraiser, and watching for appropriate government funding opportunities.

The academic literature on nonprofit management continues to flourish, but relatively few studies focus on the needs of small nonprofits, even though the data serving as the basis for this Note show that more than half of organizations in the sector have revenues below US$200,000 a year. We should not assume that management lessons derived from studies of large nonprofits are suitable for small ones. It is difficult to know how to allocate scarce time and resources in organizations at a stage where the organization is almost certainly run by volunteer managers or unpaid staff and cash is scarce. We hope that this study inspires future research specifically dedicated to the challenges of small nonprofits.

ORCID iDs

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Supplemental Material

Supplemental material for this article is available online.

Notes

1. The Form 990 and Form 990 EZ are financial information forms submitted by the nonprofit; this filing is required by the IRS for all tax-exempt nonprofit organizations which make more than US$25,000 in gross revenues (for the EZ) or more than US$100,000 in gross revenues (for the full Form 990) at the time of the study. Nonprofits with gross revenues between US$25,000 and US$100,000 that have more than US$250,000 in assets must file the Form 990 (IRS, 1998). Many smaller organizations also file voluntarily for reasons of transparency, legitimacy, or to comply with contractual or regulatory stipulations.
2. In the revenues section of the Form 990, some expenses are included with their corresponding revenue (such as cost of goods sold), whereas others are not (such as professional fundraising fees). Therefore, gross revenue figures are used rather than net values; expense figures were likewise adjusted to include the expenses previously netted out. This brings the Form 990 values closer to the reporting used on the financial statements of most nonprofits.

3. Formalization status is imputed as achieved if the threshold is crossed in the current year, the previous year is missing, and the status 2 years prior is beneath the threshold. Formalization status is imputed as not achieved if the threshold is not crossed in the current year, the previous year is missing, and the status 2 years prior is beneath the threshold.
4. We use the NTEE major 12 categorization. Arts, Health, Human Services, Public, and Education (excluding Higher Education) are included as unique subsectors. Higher Education and Hospitals are removed from the analysis due to very low numbers of organizations starting up with revenues beneath the threshold. All remaining subsectors are combined into a single "Other" category.
5. The discrete time hazard model has the advantage over other parametric models such as Cox regressions, which impose strong assumptions on the shape of the hazard curve. As the discrete time model uses dummy variables to represent each duration, it allows the hazard rates to be nonmonotonic, which is important in this case as they appear to have a parabolic form, first rising until Year 3 of operations and then falling steadily thereafter.
6. Effects are calculated by centering the hazard estimates at the median level of all continuous independent variables, or at level zero for each binary covariate, which is also the mode of each binary variable in our data. This serves as the baseline model. The effect is then calculated by changing one independent variable to its 99th percentile value, or changing a binary variable from zero to one, and reporting the corresponding changes to the survival curves in the sixth year relative to the baseline model. We selected a large change in the continuous variables so that the effects of continuous and binary variables are comparable, and we omit the last percentile to control for outliers.

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