Intersections and Innovations

Change for Canada's Voluntary and Nonprofit Sector

The Muttart Foundation

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Acknowledgements

For far too long, Canada has lacked a comprehensive resource examining Canada's charitable sector. That has now ended.

The Muttart Foundation has spent many years focusing on building the capacity of charities in this country. The publication of this collection is another contribution to that effort. By understanding more about itself, the sector can continue to develop and find new ways to serve Canadians and those in need outside our nation.

The authors of these essays bring different perspectives on the role and inner workings of Canada's charities. Collectively, they bring an unprecedented insight into the work of organizations whose diversity is exceeded only by their desire to serve.

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The work of all of these individuals has come together in this resource which we dedicate to all of those in, or interested in, Canada's charitable sector.

Malcolm Burrows, President

Bob Wyatt, Executive Director

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Part II Navigating a Changing Environment

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The Funding Environment

The People Environment: Leaders, Employees, and Volunteers

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The Funding Environment

Chapter 9

Financing Canadian Charities: The Conditional Benefits of Revenue Diversification

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Introduction

The long-term viability of Canada's nonprofit sector is deeply connected to the social, economic, and cultural well-being of Canadian communities, just as the well-being of Canadian communities depends on the health of the nonprofits that serve them. An important measure of a nonprofit's long-term viability is its financing structure or revenue "portfolio" (Kearns, 2008; Young, 2007). In general, Canadian charities are financed through a variety of revenue streams that include individual and corporate donations, government contracts, foundation grants, memberships, and a growing array of commercial activities. This funding is increasingly volatile, and many charities feel financially vulnerable in both the short- and long-term for good reason.

Many feel the pressures of stagnating levels of giving and volunteering, with philanthropy that may be increasingly concentrated in a smaller cadre of wealthy individuals (Lasby & Barr, 2018; Wallace, 2018; Rooney, 2019). Competition for fundraising has intensified, including the emergence of personal GoFundMe campaigns. Austerity measures taken by governments often result in a sudden loss of contracts, or at least increased rivalry for shrinking pies, while commercialization through social enterprise and new forms of social finance have not yet delivered the anticipated injection of large amounts of private capital.

The advice that is overwhelmingly given to nonprofits on how to survive and thrive in such an unstable financing environment is to diversify their sources of revenue. This strategy of diversifying funding makes intuitive sense and has become accepted wisdom among the multitude of consultants and financial advisors to nonprofits. It seems logical that overreliance on any one revenue stream is to be avoided because it can potentially expose nonprofits to financial instability if the funding source is reduced or eliminated. The academic research, however, does not unequivocally support diversification as *the* best strategy. A number of studies (Carroll & Stater, 2009; Hager, 2001; Keating, Fischer, Gordon, & Greenlee, 2005; Tuckman & Chang, 1991, 1994; Thomas & Trafford, 2013) have found positive relationships between funding diversity and financial stability. Yet recent studies point to evidence against revenue diversification and in support of revenue concentration, demonstrating that organizations with concentrated revenue portfolios have increased capacity (Faulk, 2010; Foster & Fine, 2007). Collectively, research suggests that the associations between revenue diversity and financial health may be more complex and uncertain than typically conceived. One reason is that many of the models used in existing research may be improperly specified, resulting in inconsistent findings about associations between revenue diversification and financial health. In addition, most of this work has been conducted in the US or Europe, and its relevance to Canada has not been tested.

This chapter takes a closer look at the revenue streams of Canada's charitable sector, with a view to better understanding the pros and cons of financial diversification. Do increasing degrees of diversification produce increasingly better financial health? For which kinds of charities does diversification seem to produce greater long-term viability? We first provide an overview of the mix of revenue sources for Canada's charitable sector and review the theories that aim to explain the benefits of diversified revenue portfolios. These theories and the ways in which they have been applied have significant limitations, however. In general, existing research has been limited to *linear* associations between revenue diversity and organizations' financial conditions; that is, they assume that as revenue diversity increases, there will be a proportionate effect on financial stability and health. In practice, however, this relationship may be nonlinear, and, in fact, diversity may exhibit diminishing returns on financial health at a certain point. In this chapter, we argue for a more sophisticated approach to understanding the effects of funding diversification and test the potential for Canadian charities of a nonlinear relationship of diversity and financial health.

Charity Financing in Canada: Mixed Portfolios

An examination of the revenue structure of the Canadian charitable and nonprofit sector illustrates the multiple revenue streams on which organizations may rely, while comparing subsectors reveals the heterogeneity of revenue portfolios in the sector. As noted in other chapters, a clarification is required on this "sector"; specifically, while we refer to nonprofits and charities in the literature review, the analysis below is limited to registered charities (please see the "Data" section below for a description of the data sources and organizations used for this analysis).

By all measures, the charitable sector is growing – at times faster than Canada's overall economy (Emmett, 2018). Between 1997 and 2007, for instance, the sector grew by nearly 100%, driven largely by demand for services due to an aging population, concern for specific issues such as environmental protection, and changing social and cultural norms (Emmett, 2018).

Social services such as temporary shelters, youth services and welfare, family services, support for disabled persons, and material assistance (food banks, clothing) make up nearly a quarter of the total share of the charitable and nonprofit sector GDP at 21.4% (Emmett, 2016). Development and housing organizations make up the next largest share at 17.3%. This is followed by "culture and recreation organizations" (10%) and "education and research," also at 10%. Religion-focused organizations make up about 8%, and "business, professional associations and unions; philanthropic intermediaries and volunteerism promotion; health; law, advocacy and politics; environment; international; and others" make up the rest (Emmett, 2016). The fastest-growing subsector of organizations between 2000 and 2008 was those classified as "other," at 10% growth, followed by "philanthropic intermediaries" at 9%. Finally, law, advocacy and politics, and international organizations also showed a growth rate of slightly over 8% (Emmett, 2016).

Overall, Canadian nonprofits generate 51% of revenue from government sources, followed by 39% from fees for service, and 9% from philanthropic sources (Hall et al., 2005). When excluding hospitals, universities, and colleges, these revenue percentages shift slightly: 39% from government sources, 48% from fees, and 12% from philanthropy. The revenue composition of nonprofits and charities in Canada is, on average, similar to other "welfare partnership" countries such as France, the Netherlands, and Belgium, whose nonprofit sector revenue is, on average, dominated by government sources: 68% government, 22% fees, and 13% philanthropy (Salamon, Wojciech Sokolowski, Haddock, & Tice, 2013). In contrast, Australia's nonprofit sector, an "Anglo-Saxon" regime model, has revenue portfolios that are, on average, less reliant on government sources: 33% government, 51% from fees, and 11% philanthropy (Salamon et al., 2013).

When we examine a subset of Canadian nonprofits and charities (Figure 1), "receipted gifts" (donations) make up about 45% of average revenue structure. Revenue from provincial governments is the next largest at about 10%. When examining specific subsectors, the revenue portfolio changes dramatically. Social welfare organizations, for example, generate about 40% of their revenue from provincial government, followed by funding from the sale of goods and services (Figure 2). Revenue for education organizations is less concentrated, with funds from provincial government making up about 30%, municipal government making up about 25%, and receipted gifts making up nearly 20% (Figure 3). Finally, benefits to community organizations such as libraries and museums are also more diverse revenue portfolios compared to welfare organizations. These charities generate 25% of revenue from receipted gifts, followed by 15% from municipal government, 15% from federal government, and about 10% from provincial government (Figure 4).

Figure 1. Canadian Charities

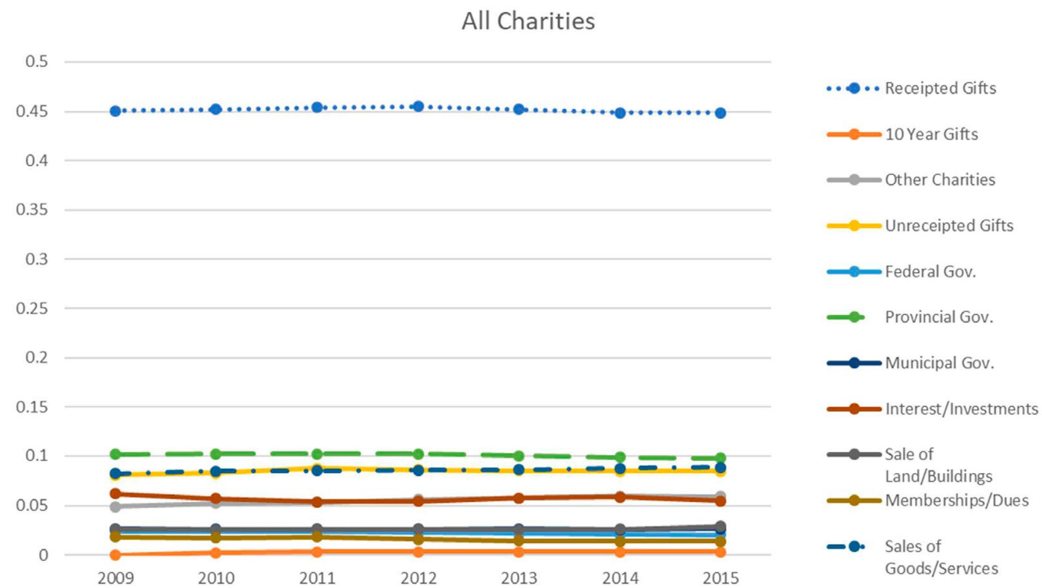


Figure 2. Welfare Organizations

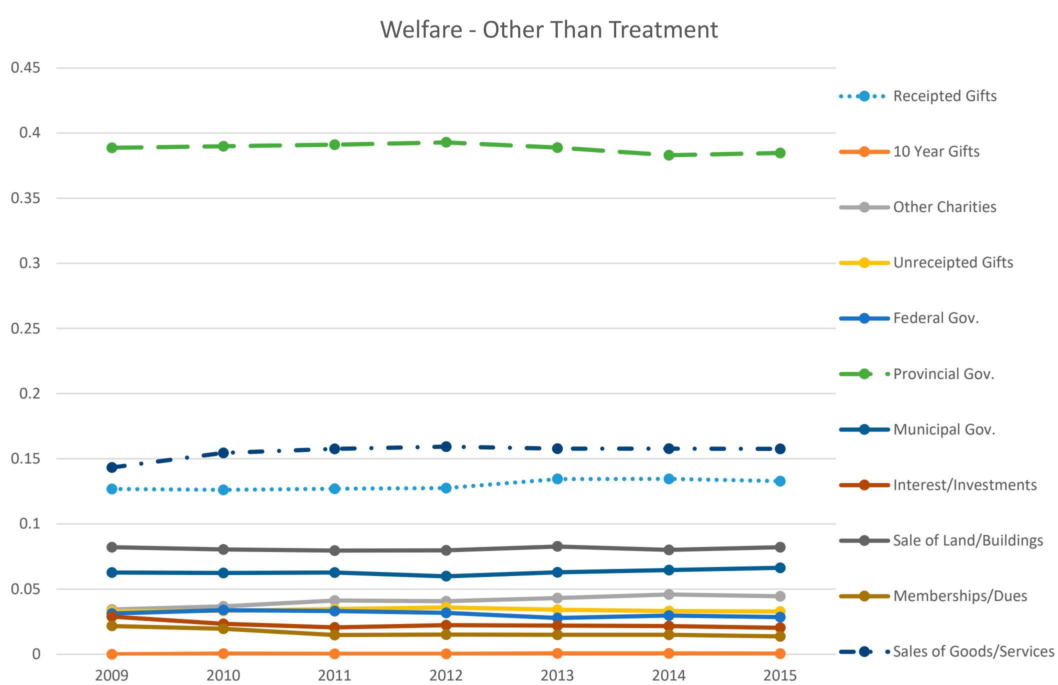


Figure 3. Education

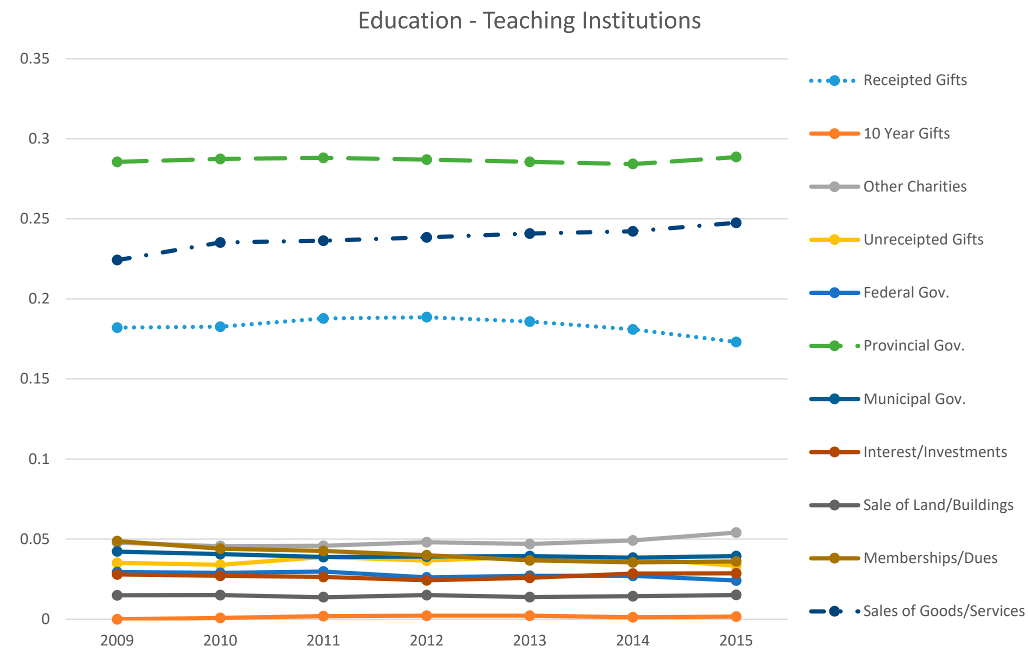
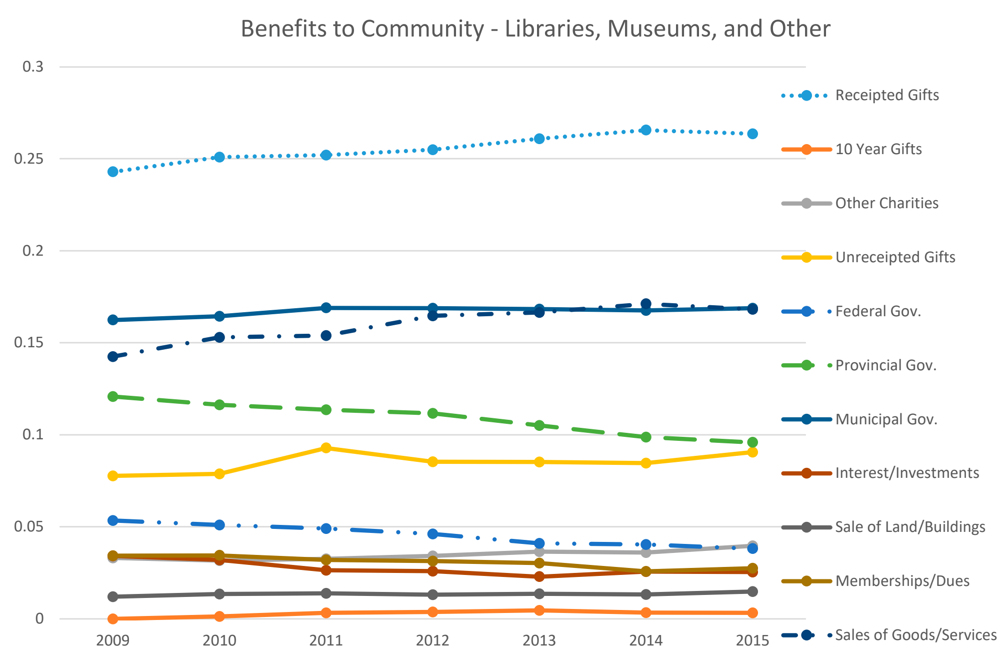


Figure 4. Libraries and Museums



The financing environment has changed significantly in recent years, becoming more competitive in a variety of ways (Scott & Pike, 2005). Arguably the most pressing and universal challenge is determining the appropriate number of revenue streams, and their amounts, to fund programs, operations, and long-term sustainability. This task is complicated by the management issues associated with being a nonprofit or charitable organization. First, charities must earn revenue before they can provide services, and often provide services to clients regardless of clients' ability to pay. This is the opposite of the traditional business model, in which revenue is earned through service provision and services are denied to clients who cannot pay. As such, traditional business models often build in a profit on top of production costs that is paid by the customer. Charities, on the other hand, and in particular those that serve vulnerable communities, provide services below production cost and thus require fundraising to cover the gap in costs. As such, charities are usually financed with a variety of revenue streams, which makes their financial management particularly challenging. In addition, charities serve multiple stakeholders, and it is unclear who their clients are – whether they are the direct recipients of the service and their families or the funders who require outcome measures that may not measure anything meaningful. With this distinctive set of circumstances and challenges, how do we determine the most successful strategies for achieving financial health and long-term viability? The next section provides an overview of some of these theories and their limitations.

Theories of Charity Financing: Explaining How to Achieve Financial Health

A number of theories seek to explain the implications of charitable revenue structures, which differ based on assumptions about the motivations that drive charities' behaviours. We divide these into three groups: 1) theories drawn from economics, which assume that charities are either risk-averse or utility maximizers (Kingma, 1993; Kearns, 2008); 2) an institutional approach, which assumes that charities pursue specific income streams that confer legitimacy in their communities or allow them to leverage a relationship with a funder (Kearns, 2008); and 3) Young's (2007) "benefits theory," which focuses on the various benefits provided by the organization and is more interdisciplinary in its assumptions.

Theories that assume behaviour based on risk aversion argue that highly concentrated revenue portfolios are vulnerable to disruptions to revenue acquisition caused by exogenous shocks. That is, an organization reliant on a single or small number of revenue sources is placed at higher risk because it will suffer if these sources withdraw their funding. The rationale for this argument is that organizations should have more than one revenue source and that, ideally, all income sources should be independent of one another. Diversifying the overall portfolio among various income sources will reduce risk proportional to the number of sources (Markowitz, 1952; Kingma, 1993). Other economic theories of charitable behaviour view charities as akin to rational, utility-maximizing firms. Decisions about revenue portfolios are based on how each revenue stream will maximize total output or maximize expected return with the minimal amount of volatility or risk (Kearns, 2008).

Alternatively, theories based on institutional approaches argue that charities choose revenue streams "in order to maximize their perceived importance, centrality, and legitimacy in the community" (Kearns, 2008: 298). This legitimacy argument implies that charities are highly sensitive to the demands of various stakeholders, particularly funders, and thus base revenue decisions on how they may strengthen relationships with funders (Kearns, 2008).

A third, more interdisciplinary approach is the benefits theory formulated by Dennis Young (2007), which focuses on the nonprofit's mission and its intended beneficiaries. The benefits implied by the organization's mission should drive the types of revenues pursued and received (Young, 2007; Fischer, Wilsker, & Young, 2011). The four main types of possible benefits and beneficiaries are:

1. private benefits conferred to individuals (i.e., students, patients, etc.);
2. group benefits conferred to a specific group of individuals (i.e., refugees, senior citizens, etc.);
3. public benefits to society at large (i.e., environmental advocacy, national security, etc.); and
4. trade benefits conferred to specific individuals or companies collaborating with the charity on a quid pro quo basis.

In short, each program offered by a charity has a primary, secondary, and tertiary set of beneficiaries, each of which implies a specific sort of revenue stream. Private benefits are ideally funded by earned income or fees; group benefits are funded by donations and philanthropic foundations; public benefits are funded by the government; and trade benefits can exchange relationships between individuals as volunteers or other organizations. For example, educational institutions confer primarily private benefits to individual students but also offer secondary group benefits to alumni and families and tertiary public benefits to the community at large. They can also offer trade benefits to companies through exposure and marketing in exchange for free supplies (i.e., athletic gear, scientific equipment, etc.). Thus, an educational institution's revenue portfolio will consist primarily of student tuition (fees); followed by donations from alumni, families, or other groups who benefit from maintaining the school's reputation; next are government grants for programs that benefit the community or public at large; and finally, a smaller portion of its revenue portfolio may consist of in-kind donations from other organizations or volunteers. Once this composite revenue portfolio is determined, charities must then consider the feasibility of each revenue source, their interaction with each other, trade-offs between mission accomplishment and financial sustainability, and risk. Charities may go through a decision-making process with each of their programs or services and come up with a weighted revenue portfolio (Young, 2007).

Among these differing theories, only Young's benefits theory offers guidance as to the relative proportion of revenue sources, but it remains to be tested, and uncertainty remains as to the most efficient revenue composition for long-term financial health.[1] There are disadvantages to a highly diversified revenue portfolio, one of which is the high fundraising and administrative costs associated with it, or what Young refers to as the "feasibility issue."

While both theory and practice suggest that greater revenue diversification may be beneficial to organizational financial health and sustainability, the body of evidence for this positive relationship is mixed. A number of studies support a positive relationship between revenue diversity and financial health (Chabotar, 1989; Tuckman & Chang, 1991, 1994; Carroll & Stater, 2009; Tevel, Katz, & Brock, 2015), while others find that a concentration of revenues is associated with other benefits (Foster & Fine, 2007; Chikoto & Neely, 2014; Faulk, 2010).

One explanation for conflicting findings among numerous studies is that scholars use different measures of nonprofit financial health. A number of studies, for example, focus on the ability to grow revenues as a measure of financial health (Foster & Fine, 2007; Chikoto & Neely, 2014; Faulk, 2010). Other studies operationalize organizations' financial condition with a measure of the stability of their funding sources (e.g., Carroll & Stater, 2009; Hager, 2001; Keating, Fischer, Gordon, & Greenlee, 2005; Thomas & Trafford, 2013). Prentice, however, using a single financial health construct, finds no relation between this construct and revenue diversity (2016). Thus, the varied findings, as well as the differing financial health measures, suggest that optimal benefits cannot be achieved with either high concentration or high diversification. Furthermore, Shea and Wang find that revenue concentration may be difficult for certain charities (2015), raising questions about the practicality of diversification efforts for these organizations.

In summary, the current body of evidence indicates that the relationship between revenue diversification and financial health is nuanced and unlikely to have uniformly positive or negative associations with financial health. In this chapter, we argue that the relationship between revenue diversification and long-term financial health is likely to be nonlinear. Specifically, we contend that, at some point, revenue diversification may have diminishing returns because of administrative costs associated with a greater and more diverse set of revenue streams; mission drift, due to "chasing the money" or funding that is only tangentially related to the organization's core mission; or "crowd-out" effects due to revenue stream interactions. The models presented in this chapter offer a preliminary test of these ideas and will make a valuable contribution to the revenue-diversification debate by using Canadian data to test for curvilinear associations between revenue diversity and multiple indicators of financial health.

Testing Revenue Diversification and Financial Health

Measuring Diversification

In order to test associations between diversification and financial health, we rely on a common measure of revenue diversification known as the Herfindahl-Hirschman Index (HHI). The HHI has frequently been used as a measure of revenue diversity (Yan, Denison, & Butler, 2009; Carroll & Stater, 2009), while its inverse has been used as a measure of revenue concentration (Chikoto & Neely, 2014). In this study, we use 12 revenue categories from the T3010 form (the mandatory annual charitable tax return filed by all charities) to calculate the diversity index.[2]

Measuring Financial Health

We test the association of revenue diversification with three variables representing charities' financial health. The first is a savings indicator, which identifies whether the organization can add to its net assets, calculated as total revenue less expenses divided by total expenses. Positive values indicate additions to the fund balance, while negative values reflect a shrinking fund balance. We do not suggest that charities do or should attempt to maximize this fund balance, as eventually excess revenues should flow into operations; however, we believe this measure can measure short-term financial health.

Two long-term measures of financial health focus on revenue growth and volatility. The first, the five-year growth rate, examines the rate of change in total revenue over a five-year period. The second, the standard deviation of expenses, measures the variability of the organization's prior five years of total expenses (excluding depreciation) and reflects the volatility (risk) of the organization.

Independent Variables

A number of independent variables identify the associations between revenue diversification and other essential elements of charitable organizations, on the one hand, and our measures of financial health, on the other. Specifically, we could expect that diversification might be influenced by organizational size (i.e. total expenses, revenue growth, or total revenues, depending on the specific model) and organizational capacity (i.e. administrative and fundraising expenses). The administration expense ratio is included to account for human capital, which might influence financial health, while fundraising expenses control for organizations' capacity to raise revenues by expanding their fundraising.

The Data

This study relies on data from the charitable tax return (T3010) filed by all registered charities with the Charities Directorate of the Canadian Revenue Agency – and thus the analysis, discussion, and implications are for the population of charities rather than the broader nonprofit sector. Specifically, data is drawn from about 84,000 of Canada's approximately 86,000 charities, as we include only charities with more than $100,000 in total revenue to ensure that financial data is comparable.[3] The analysis uses financial data from 2009 to 2015 for the panel models used for our short-term dependent variable and data from 2015 for our cross-sectional long-term models. Our analyses are reported in a simplified format, with more specific detail about the measures and statistics available upon request.

Findings

We first model the association between revenue diversification and a short-term measure of financial health.[4] Second, we model long-term effects using robust regressions, which reduces the influence of extreme observations and ensures more conservative estimates of the effects of the independent variable (diversification measures) on the dependent variable of financial health (Li, 1985).

When we examine the results of the models for all Canadian charities (Table 1), we find evidence for a nonlinear effect in our short-term model and in one of our long-term indicators – the standard deviation of expenses. The model for the savings indicator demonstrates that short-term growth diminishes and is dramatically reduced for organizations with high levels of diversification. While this function is nonlinear, the effect is consistent for most of the range of revenue diversification (Panel 2).[5] When examining risk, we see that diversification is associated with reduced volatility at the outset but that the effect is quickly overwhelmed, indicating that only that initial movement away from absolute concentration could be likely to reduce variation in revenues. Additional diversity is associated with greatly increased volatility.

Table 1. Revenue Diversification and Financial Health – All Charities (over $100K in revenues)

	Short-term Models			Long-term Models			
	Savings Indicator (log)			Five Year Growth		Standard Deviation of Expenses (Minus Depreciation)	
	Coefficient P>|t|			Coefficient P>|t|		Coefficient P>|t|	
RevDiv	-0.22	***		0.00		-33926.00	***
	0.000			0.903		0.000	
RevDiv^2	0.07	**		0.00		54961.52	***
	0.005			0.953		0.000	
TotalExp/TotRev	0.00	***		0.00		0.08	***
	0.000			0.264		0.000	
AdminExp	0.01	***		0.00		0.00	***
	0.000			0.654		0.000	
FRExp	0.00	***		0.00		0.00	***
	0.000			0.196		0.000	
n	**277,419**			**38,029**		**38,620**	
groups	**51,557**						
Prob > F	0.000			0.000		0.000	

Panel 2. Revenue Diversification and Financial Indicators – All Charities

Figure 5. The Savings Indicator

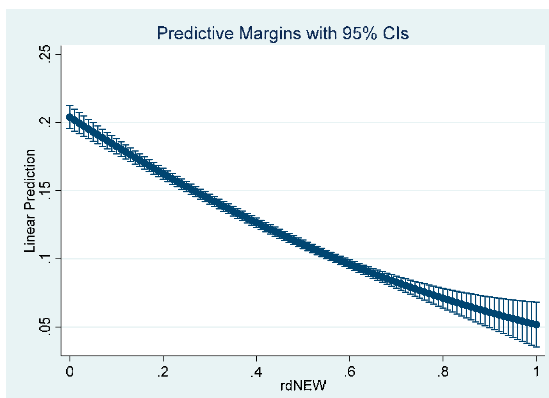
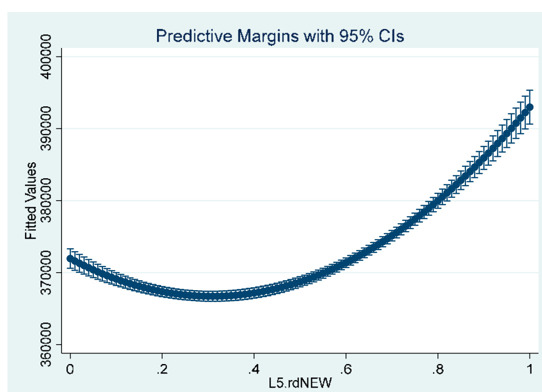


Figure 6. Standard Deviation of Expenses



In combination, these results suggest that a relatively concentrated portfolio could lead to both short-term and long-term stability. Altogether, considering the insignificance of revenue diversification in our model of long-term growth, we find little evidence that maximizing diversification is optimal for Canadian charities. In fact, organizations with relatively concentrated revenue portfolios (HHI, near .4) experience both short-term growth and low expense volatility. While this result is far from definitive, it provides some support for the notion that charities should diversify with caution, avoiding the risk of absolute concentration and pursuing additional revenue sources strategically. To take a deeper dive, we examine three subsectors in more detail: welfare organizations providing care other than treatment, education institutions, and libraries and museums.

When we consider only welfare organizations (Table 2), there is a consistent pattern of results: a high degree of revenue diversification is associated with reduced short-term net asset growth and increased expense volatility. In fact, the least desirable financial conditions are associated with very high degrees of revenue diversification (Panel 3).

Table 2. Revenue Diversification and Financial Health – Welfare Organizations

	Short-term Models	Long-term Models	
	Savings Indicator	Five Year Growth	Standard Deviation of Expenses (Minus Depreciation)
	Coefficient P>|t|	Coefficient P>|t|	Coefficient P>|t|
RevDiv	-0.42 ***	0.05	-138752.40 **
	0.000	0.000	0.006
$RevDiv^2$	0.42 ***	-0.10	140621.80 **
	0.000	0.512	0.011
TotalExp	0.00 **	0.00	0.07 ***
	0.001	0.127	0.000
AdminExp	0.01 ***	0.00	0.00 ***
	0.000	0.850	0.000
FRExp	0.00 *	0.00	0.00 ***
	0.038	0.910	0.000
n	**15,593**	**2,137**	**2,164**
groups	**2,584**		
Prob > F	0.000	0.000	0.000

Figure 7. The Savings Indicator

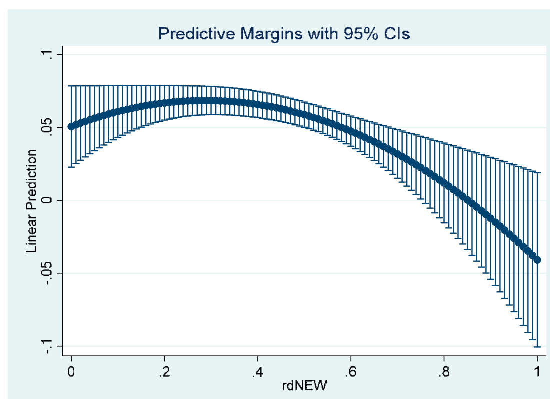
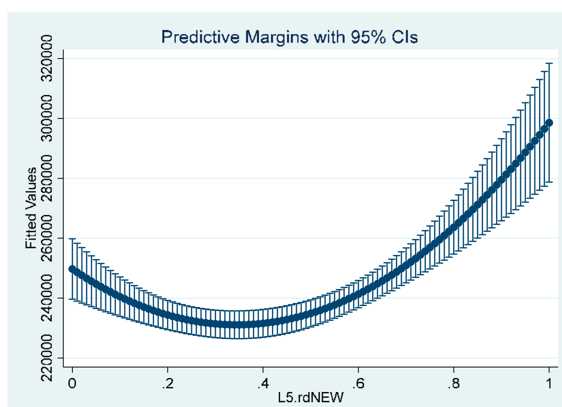


Figure 8. Standard Deviation of Expenses



Panel 3. Revenue Diversification and Financial Indicators – Welfare Organizations

Charities in the education subsector demonstrate a slightly different relationship between revenue diversification and revenue growth but have consistent results for expense volatility (Table 3 and Panel 4). Net growth of assets is associated with both highly diversified and concentrated revenue structures relative to more balanced revenue structures. Revenue diversification, as compared to concentration, slightly increases expense volatility when moving away from the midpoint of our measure of diversification.

Libraries and museums provide no evidence that diversification can be expected to lead to wide-ranging improvements to an organization's financial condition (Table 4 and Panel 5). In the case of short-term growth, diversified portfolios are associated with lower values of the savings indicator than are highly concentrated portfolios. Long-term growth is positively associated with initial diversification but is diminished at higher levels of diversification. Expense volatility also increases with extreme diversification, suggesting that the degree of diversification should be considered when attempting to reduce risk.

Table 3. Revenue Diversification and Financial Health – Educational Organizations

	Short-term Models	Long-term Models	
	Savings Indicator	Five Year Growth	Standard Deviation of Expenses (Minus Depreciation)
	Coefficient P>|t|	Coefficient P>|t|	Coefficient P>|t|
RevDiv	-0.42 ***	0.05	-138752.40 **
	0.000	0.729	0.006
$RevDiv^2$	0.42 ***	-0.10	140621.80 **
	0.000	0.512	0.011
TotalExp	0.00 **	0.00	0.07 ***
	0.001	0.127	0.000
AdminExp	0.01 ***	0.00	0.00 ***
	0.000	0.850	0.000
FRExp	0.00 *	0.00	0.00 ***
	0.038	0.910	0.000
n	**15,593**	**2,137**	**2,164**
groups	**2,584**		
Prob > F	0.000	0.000	0.000

Panel 4. Revenue Diversification and Financial Indicators – Educational Organizations

Figure 8. The Savings Indicator

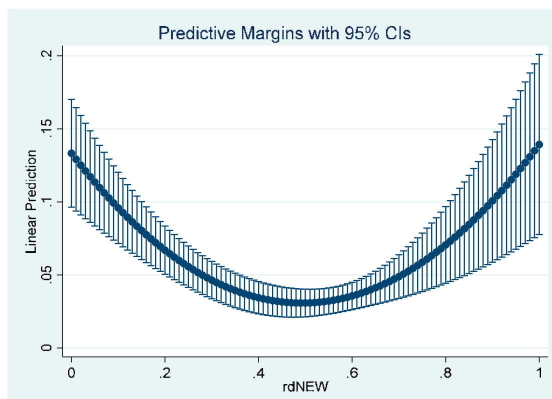


Figure 9. Standard Deviation of Expenses

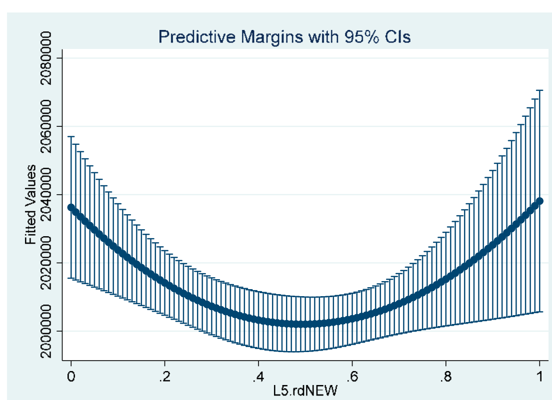


Table 4. Revenue Diversification and Financial Health – Libraries and Museums

	Short-term Models		Long-term Models			
	Savings Indicator		Five Year Growth		Standard Deviation of Expenses (Minus Depreciation)	
	Coefficient P>|t|		Coefficient P>|t|		Coefficient P>|t|	
RevDiv	-0.53	***	0.55	**	-58956.53	
	0.000		0.025		0.059	
$RevDiv^2$	0.15		-0.55	**	57181.43	
	0.285		0.020		0.058	
TotalExp	0.00	***	0.00		0.08	***
	0.000		0.625		0.000	
AdminExp	0.19	***	0.00		0.00	***
	0.000		0.261		0.000	
FRExp	0.54	***	0.00		0.01	*
	0.000		0.302		0.043	
n	**6,012**		**815**		**826**	
groups	**1,140**					
Prob > F	0.000		0.000		0.000	

Panel 5. Revenue Diversification and Financial Indicators – Libraries and Museums

Figure 11. The Savings Indicator

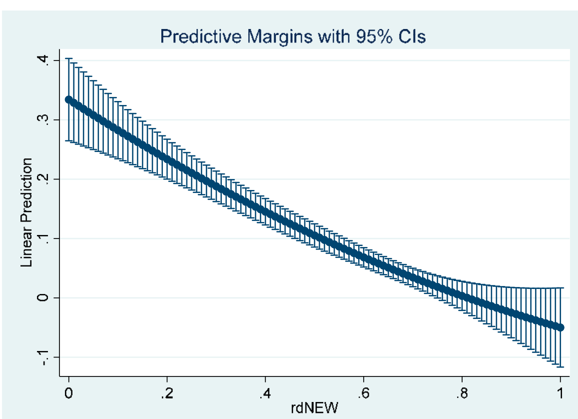
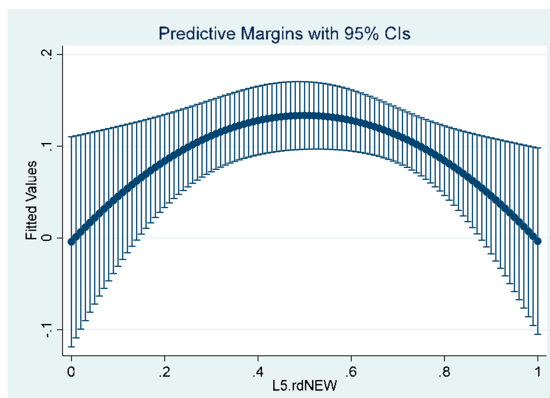


Figure 12. Standard Deviation of Expenses



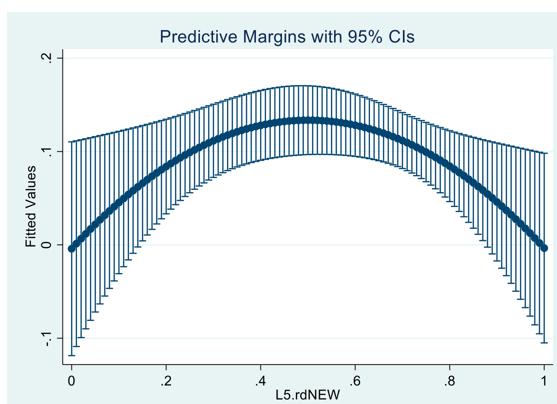


Figure 13. Standard Deviation of Expenses

Discussion: Diversification Reconsidered

While this analysis can only provide associations, not determine causation, the models provide important evidence regarding revenue diversification of Canadian charities. Organizations hoping to maximize short- and long-term growth while minimizing expense volatility should not expect revenue diversification to provide these benefits. While we cannot speak to causal relationships, we can speak to the absence of evidence of consistently linear and positive associations between funding diversification and these select measures of financial health. Our evidence shows that financial health is not consistently highest at high levels of diversification; on the contrary, the greatest expense volatility and less-than-optimal short-term growth is associated with extreme diversification. When considering these widely accepted measures of financial health, we find no evidence that extreme diversification is associated with an improved financial condition. Initial movement away from absolute concentration, however, is likely to be associated with reduced risk. As is suggested by theory, relying almost exclusively on one revenue source is consistently associated with our measure of risk.

Conclusion

This study has examined the associations between revenue diversification and three measures of financial health of Canadian charities with more than $100,000 in total revenue, taking a deeper look at charities working in the areas of welfare, education, and community services to assess any differences by subsector.

Ultimately, we believe the models suggest that absolute expectations about the potential impacts of revenue diversification should be tempered. Most critically, in the Canadian context, we find little evidence that maximizing diversification will benefit the short- or long-term financial health of organizations. This suggests that educators, consultants, managers, and board members should moderate any language and thinking on the potential effects of diversification. While it seems likely that charities should avoid absolute concentration, the benefits of diversifying are also likely to be conditional. This may be due to the trade-offs between short-term return and risk, the potential for diminishing returns, and tipping points at which diversification becomes inefficient. Although our analyses do not attempt to explain the reasons for our findings, certainly the inherent complexity of charitable revenue management may make diversification costly, or the competition for these revenues may make their pursuit inefficient.

From a scholarly perspective, Canadian data suggests that modelling revenue diversification without accounting for nonlinearity may be problematic. At the minimum, any linear model that identifies a positive or negative association with financial indicators should test for a nonlinear association with a squared term. While alternative approaches to modelling exist, this change may reveal misspecification.

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Notes

[1] Fischer, Wilsker, and Young (2011) offers a preliminary test of Young's benefits model.

[2] We calculate diversity using the formula: RD = $(1- \sum_{i=1}^{n} Ri^2)/ [(n-1)/n)]$

[3] This includes more than 50,000 organizations required to complete Schedule 6, with more detailed financial information. The data set was cleaned by removing observations that include any of the following: revenue categories that exceed the variable for total revenues; expense categories that exceed total expenses, either negative revenues or expenses; or negative or zero end-of-year assets (Bowman, Tuckman, & Young, 2012).

[4] These fixed-effects models are based on a Hausman test, assessing whether random effects are orthogonal to the regressors. The results suggest that the fixed-effects models are more appropriate due to the potential correlation between observed predictors and time-invariant unobserved predictors (Allison, 2009; Hsaio, 2014; Rothman, et al., 2008). In these models, the coefficient represents the effect of the unit of analysis within the panel, accounting for unobserved heterogeneity that is correlated with our independent variables and allowing us to assess within-unit associations.

[5] This can be demonstrated by calculating and graphing the marginal effects (see Figures 5 and 6), which highlight very different patterns of association between these two indicators.

Biography

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Nathan J. Grasse focuses on the governance and financial management of public-serving organizations. This includes the study of revenue structures, the potential conditioning effects of organizational and environmental factors, and the implications of strategic choices on financial health and other organizational outcomes.

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