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TACTICAL PHILANTHROPY

Charities Should Be Held to 'Philanthropic Equity' Standards

By Sean Stannard-Stockton

It is time for nonprofit accounting standards to recognize the concept of "philanthropic equity."

For too long, donors have looked at nonprofit financial statements and believed that as much money as possible should be spent on programs and as little as possible should be spent on the organization itself. This logic is fundamentally flawed because, no matter how great a program is, only a high-performance organization can deliver, expand, and improve effective programs.

The fact is nonprofit groups need two kinds of cash flow: revenue and equity. Recognizing the distinction between revenue and equity is critical to building great organizations. Revenue is cash flow delivered to an organization in exchange for execution: delivering goods and services.

Equity is cash flow delivered to an organization for the purpose of building the organization. Without the ability to account for philanthropic equity, it is simply not possible to distinguish between donations that keep a nonprofit running and those that are intended to build the organization.

Like a for-profit company that offers a great product but doesn't have the resources to invest in great management, technology, and infrastructure, a nonprofit organization without equity is doomed never to fully realize its potential. Just as some people are customers of a company and others are investors in it, donors can play the role of providing nonprofit organizations either revenue or equity, or both. But for donors to evaluate a nonprofit group's need for equity and the effectiveness with which it uses that equity, the two forms of cash flow must be recognized separately. The current nonprofit accounting standards ignore the existence of equity and treat all cash flow as revenue.

High-performing nonprofit groups need equity to grow and improve. Unfortunately, nonprofit groups are systematically starved for equity capital. Since we tend to get those things we measure, it is critical that we begin to explicitly measure equity on nonprofit financial statements.

A new equity-like methodology, called the "sustainable enhancement grant," has already been deployed successfully among several high-performing nonprofit groups to help shed light on their finances in a way that allows them to attract equity-like philanthropic donations. The system was developed by the Nonprofit Finance Fund and it has been well vetted by leading law firms and accounting firms. Now it is time to build those concepts into standard nonprofit accounting guidelines.

Warren Buffett is known to believe that evaluating the amount of profit a company makes (what we in the nonprofit world might refer to as results) is not enough. To truly understand how well a company is performing, Mr. Buffett looks at the return on equity. This measure reveals the performance of a company in relation to the amount of capital invested in building the organization. The nonprofit world needs a similar measure. If we hope

to encourage donors to truly invest in nonprofit groups, they must be able to understand how their “equity investments” are performing.

The need for this change is urgent. The newly created government Social Innovation Fund is designed specifically to increase the flow of equity-like capital to nonprofit groups. The bill authorizing the fund requires that the money be used to build the capacity of nonprofit groups to copy and expand proven programs. But without official accounting recognition of philanthropic equity, it will be impossible to evaluate whether those capital flows actually are used to effectively build the grantee organization or simply to finance operations.

According to the White House, the Social Innovation Fund is all about “finding and scaling the best social innovations.” This is an important and achievable goal. But “scaling” a nonprofit group requires more than just making big grants. It means offering capital that is explicitly earmarked for building the organization itself, not for spending to deliver programs. But without philanthropic-equity accounting, only the handful of organizations voluntarily using the sustainable enhancement grant accounting system have the ability to actually account for how effectively they are using grants intended to help them expand.

There is too much at stake for donors to continue giving more than \$300-billion a year without a better understanding of which nonprofit groups are using their money to build sustainable organizations and which are not. It is time for the Financial Accounting Standards Board to recognize philanthropic-equity accounting.

Sean Stannard-Stockton, a regular columnist for The Chronicle of Philanthropy, is a principal and director of tactical philanthropy at Ensemble Capital Management and author of the blog [Tactical Philanthropy](#).