COVER STORY

Nonprofit vs. For-Profit Boards

Critical Differences

By Marc J. Epstein and F. Warren McFarlan

A nonprofit organization has asked you to serve on its board of directors. You should accept because nonprofits need business leaders, but expect to be surprised. Though some of the principles are the same, many are quite different.

Covering a wide array of organizations, nonprofits span hospitals (half of which are nonprofits), schools, colleges, museums, professional service organizations, social service organizations, and so on. They improve the lives of individuals, members, organizations, communities, and society as a whole. Not only are business leaders on nonprofit boards, but increasingly they are leading the organizations more than are those from traditional social service backgrounds. Recent surveys of Harvard Business School alumni, for example, show 80% or more being involved with nonprofits during their careers and more than 50% serving or having served on one or more nonprofit boards. These organizations vary in size from small community music schools to multibillion-dollar health organizations.

Our new book, *Joining a Nonprofit Board: What You Need to Know*, discusses the differences between nonprofit and corporate boards as well as leadership activities. Here we provide a brief overview of the two types of boards.

Similarities and Differences

There are a number of similarities between for-profits and nonprofits that make leaders with for-profit experience particularly helpful as board members.

1. Both types of organizations can grow, transform, merge, or die. Success isn't guaranteed for either, and it requires sustained work.
2. Cash is king.
3. Good management and leadership really matter. Delivery of service, motivating and inspiring staff, and conceiving new directions for growth are vitally important.
4. Planning, budgeting, and performance measurement systems are vital.
5. Both face the challenges of integrating subject matter specialists into a generalist framework.
6. Both add value to society but in different ways.

In short, there's a great deal of overlap between the skills needed and perspectives provided by leaders in the

Table 1: Key Differences of For-Profit vs. Nonprofit Governance

FOR-PROFITS	NONPROFITS
MISSION	
Mission important	Mission very important
Financial results	Cash-loss generator may be the key service
Nonfinancial metrics important	Nonfinancial metrics of mission performance very important
FINANCE	
Financial metrics of performance P&L, stock price, and cash flow very important	Financial metrics of meeting budget and cash flow projections also important
Funds come from operations and financial capital markets	Funds come from operations, debt, grants, and philanthropy
Short-term goals very important	Deep focus on long-term goals (as long as cash is there)
EXECUTIVE	
Small board—paid governance	Often large board—volunteer governance
Few board committees	Often many board committees
Combined chair/CEO plus lead director	Nonexecutive volunteer chair, plus CEO

two types of organizations. This is a key reason why social-enterprise courses have taken root in business schools and why, appropriately socialized (understand the different context, people, goals, etc.), those with for-profit backgrounds can contribute so much to the nonprofit world.

But new board members must understand deep differences to avoid irretrievable damage to their credibility and effectiveness in a nonprofit organization. Five major differences are:

- Mission,
- Nonfinancial performance metrics against mission,
- Financial metrics,
- Governance, and
- The chair and CEO relationship.

The nonprofit differs fundamentally from the for-profit because of its societal mission. Understanding the mission, helping the organization to fulfill it, and adapting it to a changing world is the very core of nonprofit governance and management. Without the mission, there's no purpose. Right behind this are the two major intertwined strategic themes that the nonprofit board member must deal with.

The first theme is fulfilling the mission in a fiscally responsible fashion. A nonprofit board must clearly define the mission and measure performance against mission. For a new board member, understanding these issues is a critical place to begin. The second theme is financial solvency. Our life experience drives us to put this behind "performance measurement against mission." Repeatedly we've seen new board members and ineffective boards try to wag the mission dog with the financial tail, but it just doesn't work that way. Without mission and its accountability, we have nothing.

Achieving financial sustainability is very different for the nonprofit because it can't easily access the public equity markets. Instead, it has philanthropy as a potential additional source of funds. A board member's role in philanthropy is to give often and generously and, when not giving, help others give—hence the phrase "give, get, or get off."

Finally, the nonprofit board differs from for-profit ones because of mission performance measurement and different capital markets. Nonprofit boards are often larger, have more committees, and have a very different board member lifecycle. Further, the heart of the governance process is a volunteer nonexecutive chairman and volunteer board leading a staff of paid professionals. The dynamics of this are complex and profoundly different from the process in the for-profit world. Table 1 shows these differences.

Mission

Too often, we've seen nonprofit organizations spend so much time on the day-to-day operational issues, including fundraising and achieving budgets, that they lose sight of their mission. They forget that the nonprofit exists to accomplish social or service goals, and they need to stay focused on those goals. In the absence of the discipline of a profit and loss (P&L) statement, developing a mission and measuring progress against it is a critical and different nonprofit task. Neither developing the mission nor tracking progress against it is easy.

In the for-profit world, an economist would argue that the organization's main objective and mission is to earn an appropriate return on invested capital for its shareholders, but the organization, of course, also provides ancillary services such as employment, tax support for the community and state, and special contributions to local communities.

The nonprofit operates in the space between government-provided services and for-profit ones. Absent the discipline of the financial market on the one hand and government mandate on the other, special clarity is needed to effectively allocate financial resources and monitor how they are spent. These tasks bring us to the mission and mission accountability.

In its basic form, mission is the reason the organization exists. It defines social services the organization provides, guides investment decisions, and provides a basis for its performance to be evaluated. A case in point is the mission statement of the Dana Hall School, a 129-year-old girls' school, which evolved through 26 drafts in a time of financial stress. In part, it reads: "committed to fostering excellence in academics, the arts and athletics within a vibrant caring community…[It] provides its students with a unique opportunity to prepare themselves for challenges and choices as women."

These ideas are powerful. First, it will remain an all-girls' school because of the unique contribution it can make to *women*. Although this idea was supported by a lot of research, it was nonetheless an out-of-favor concept at the time the mission statement was developed in the mid-1980s. Yet leadership, math, and science capabilities are examples of skills that research shows an all-girls' education can increase. Second, it will strive to be excellent in academics ("We are not a remedial school and academics are our first priority"). Right behind (but behind) are arts and athletics, both of which can be quite capital intensive.

In 1995, after a decade of heavy operating losses, confidence in this mission meant taking on $8 million in debt to build a new, world-class science center. Several years later it took on more debt and built a world-class athletic center. Science, women, and excellence combined made this the obvious first investment and worth undertaking the financial risk in a stretched organization. In 2011, the school is thriving academically as it still deals with its debt load.

The process of developing and disseminating the mission is as important as the mission itself. The power of the Dana Hall mission stemmed from a six-month series of meetings that included spirited discussions among the board, parents, alumni, student body, and faculty. Out of them came a shared sense of strategic alignment and deep personal commitment "to take the path less travelled," which was crucial for an organization facing a time of financial stress. Finally, because board membership changes over time, the mission needs to be periodically revisited to educate new members.

When nonprofits lose sight of their focus, mission drift or diffusion often occurs. Donors and employees are spending their time on daily operational issues and often ignore the bigger picture of whether they are accomplishing the social or service goals. These goals need to stay front and center, and the performance metrics must focus on the right goals.

Nonfinancial Performance Metrics and the Mission

During the past 15 years, corporations have increasingly recognized the importance of appropriate nonfinancial performance metrics, in addition to the more traditional financial metrics (as in a balanced scorecard or dashboard), in evaluating organizational success. Most nonprofit organizations desperately need performance measures to achieve their overall long-term goals and mission rather than only the short-term goals of fundraising and budget achievement.

Today, many nonprofit organizations have developed new performance measures to track their nonfinancial performance. One example of a social-impact-focused organization that has made progress here is KaBOOM!, a nonprofit whose mission is to build playgrounds and create safe places for children all over America to play. A related goal is to inspire local residents to work together and become more proactive in revitalizing and maintaining their communities. The organization has created an overall performance measurement system that includes these financial performance measures:

- Build efficiency in cost per build (actual vs. planned),
- Program efficiency (program expenses as percentage of total expenses),
- Fundraising efficiency (dollars spent to generate one dollar in revenue),
- Total cash available at the end of the period, and
- Annual revenue growth.

Along with these efficiency performance measures, the KaBOOM! board uses other performance indicators to assess past impacts and steer the organization toward success. Some of these performance measures include:

- Total number of volunteers per year,
- Number of media mentions per year,
- Number of children served within walking distance (actual vs. planned),
- Number of playgrounds started and completed, and
- Number of individuals who have taken a step beyond volunteering on a build.

Few nonprofits have developed nonfinancial performance metrics and used them regularly to monitor achievement of their mission. Yet the process of identifying and using these performance measures typically provides an opportunity to discuss goals and the actions to achieve them.

Financial Metrics

The financial metrics and incentives are dramatically different between for-profit and nonprofit organizations. The income statement, earnings per share (EPS), and growth in market capitalization are all widely focused performance metrics and important components of long- and short-term executive performance assessment and compensation in the for-profit world. There are literally no analogies for these items in the nonprofit world. There's no ritual of tracking stock price on a continuous basis on PC screens in the nonprofit world.

There *is* a need for for-profit financial skills on the nonprofit board, but the individuals have to be sensitive to the different nuances in financial reporting and to the role of finance in the nonprofit. For example, two financial metrics—free cash flow and revenue growth—are also very relevant to the nonprofit world. An important additional source of funds for the nonprofit world is philanthropy in its various forms of annual giving, capital campaigns, and planned giving. Cash flow is king, and annual giving and capital gifts are often critical to financial viability.

Also, the accounting framework of nonprofits differs from that of for-profits. For example, nonprofits don't typically apply normal accrual accounting concepts. Instead, they use "fund accounting." For those organizations that have an endowment, significant pressures exist on the board to manage it effectively and have an appropriate rate of withdrawal. Finally, debt and its servicing status are important issues for those nonprofits that have access to the public debt market.

Because of financial reporting metrics, the for-profit world tends to have a strong short-term performance focus. Meeting the quarterly earnings targets, the annual earnings goal, and the steady drumbeat of the stock price all drive a short-term orientation.

In addition, the pace of the nonprofit couldn't be more different. The heart of its financial activities is the annual budget, its forecast of revenues, and the hard choices it has to make about various costs. Monthly reviews focus on success in meeting cost and revenue targets where variances against budget are analyzed repeatedly. The reality, however, is that negative variances just don't have the same impact on internal and external perceptions of performance as a missed EPS number does for the for-profit. Beyond all of this, of course, is the need to peer around the corner and look toward the organization's long-term future challenges, which can be five to 10 years in the future.

Governance

As a result of the excesses WorldCom, Tyco, and Enron triggered, best practices in governance have changed for for-profit as well as nonprofit organizations over the past decade.

Similar governance issues in for-profits and nonprofits are:

◆ The new position of lead director oversees board processes for for-profits and is responsible for the board process and direct continuous communication with the CEO. In nonprofits, the unpaid nonexecutive chair has always been the dominant organizational form.

◆ Regularly scheduled executive sessions of external directors only candidly discuss board concerns, review CEO performance, and so on. This regular schedule is critical in blurring the organizational anxiety that tends to arise whenever a special executive meeting of external directors is called.

◆ An expanded role of the audit committee as a result of the Sarbanes-Oxley Act (SOX) and the requirement that at least one member must be a "financial expert" (a former CFO, CEO, or accounting firm partner). Dealing with material compliance issues has become an increasing concern to the nonprofit because of new accounting standards for nonprofits.

◆ As a result of the heightened public and regulatory concern about executive compensation, the compensation committee's role has become much more burdensome in for-profits. Excesses in compensation in nonprofits have resulted in celebrated cases like Eliot Spitzer's pursuit of Dick Grasso in the New York Stock Exchange and the attorney general of New Hampshire against the rector of St. Paul's School.

◆ The governance committee's role has become more significant in both for-profits and nonprofits since it has taken the initiative of screening and nominating new directors and managing committee assignments (as opposed to an earlier time when the CEO played a much more important role in the process). It also manages the annual CEO evaluation and counseling process.

But governance processes differ and include board size, committees, and volunteer vs. paid governance.

Size

The nonprofit board is larger, sometimes much larger, and its membership is much more heterogeneous. Two factors drive the size. One is the board development role since an important part of some members' cultivation is placement on the board of trustees. This can lead to very large boards of 25 to 30, or even as many as 130 as is the case with the Dana-Farber Cancer Institute board (who, with their friends, raise 75% of the funds of this very successful fundraising organization). The second reason for larger size is to have appropriate community representatives who can be the nonprofit's eyes and ears in the community. A nonprofit hospital board recruited one-third of its members this way, and they serve as invaluable ambassadors, indirectly helping to fill beds.

Realistically, these risks of board size are worth bearing because of the benefit of binding certain potential donors closer to the organization. But one caveat is that these board members must behave in a discreet way—or at least not disrupt the board processes. For example, one museum board chair couldn't convince the governance committee to appoint someone who had given another organization a major gift because the governance committee chair saw the individual as potentially disruptive to board processes. To facilitate this increased influence, an effective board leadership and committee structure typically is necessary.

Committees

The nonprofit board often has many committees, but the typical for-profit board includes audit, compensation, and governance committees, and maybe one other such as public relations or technology. The typical medium-sized or larger nonprofit has a variety of standing committees beyond these, including the development committee, investment committee, and facilities committee. Individuals with extraordinary talents whom the nonprofit couldn't possibly attract as full-time employees often staff these committees. The large nonprofit is also much more likely to form a series of ad hoc committees to deal with special issues, such as a CEO search committee or a special program review committee.

Volunteer vs. Paid Governance

The responsibilities and motivations of nonprofit board members couldn't be more different from those of their for-profit brethren. For-profit board members are financially well compensated for their service with not only attractive retainers and board meeting attendance fees, but company stock as well. As a result, they are keenly interested in stock price and the company's economic performance. When they finish their term or the company is sold, however, the relationship between the director and the company often abruptly and completely ends. Their participation in a social system disappears.

Now consider the nonprofit board members. Not only is there no compensation, but, because of the philanthropic aspect, their financial compensation is often deeply negative. In some cases, such as museum boards, expectations for capital gifts, annual giving, and participation in galas and the like are so high that many people can't afford to consider being a board member.

Unlike the for-profit board, where time demands are somewhat predictable, the longer a board member remains on a nonprofit board, the more time is demanded until burnout becomes a real problem. Board chairs and chairs of capital campaigns and CEO search committees, for example, are high-burnout positions that sometimes require more time than a member's regular paid business position.

Yet emotional engagement is one real benefit of nonprofit board membership. Though meetings can be long and sometimes meandering, believing you are positively changing society is a very powerful tonic that helps overcome a lot of frustration. Most importantly, appropriate engagement with a nonprofit is often a lifelong arrangement. When you leave the board, the alert nonprofit organization makes sure you're involved for the rest of your life. Former-board-member meetings and honorary board membership are tools the nonprofit uses to keep the link for philanthropic and ambassadorial purposes.

The Chair and CEO Relationship

First and foremost, the nonprofit board chair is almost always a volunteer. The relationship between the board chair and the organization CEO is a very important and sensitive one. Usually the board chair turns over more rapidly than the CEO position. This means that the CEO not only has a much deeper grasp of the operational nuances, but also a much longer insight into how issues are playing out and their context. Sometimes, however, the governance committee picks an incoming chair who may have a different set of organizational priorities than a predecessor, so significant disagreements between a chair and CEO can occur and must be managed effectively.

Although a nonexecutive chair of for-profits is common in the United Kingdom and Australia, the position is still emerging in the United States. Yet the unpaid nonexecutive chair has always been around in nonprofits. In a nonprofit, the relationship between the chair and the CEO is probably the most important two-person relationship in the organization. It plays out very differently from one organization to another and evolves over time. But some points remain constant throughout:

◆ The governance committee is ultimately responsible for executing board governance processes. Its members evaluate and select the CEO, which sounds easier than it is because the CEO often has much longer tenure than the chair and has a much deeper grasp of organizational mission and operational details.

◆ Great care must be taken in selecting the board chair. In times of organizational crisis, the chair will be the person who makes things happen. For example, in 1992 at Trinity College in Hartford, Conn., when both the president and dean resigned, the de facto operational control of the college was left to the chairman until an interim president was chosen, which took one month. The chair needs to have the board's confidence, a good working relationship with the president, and a broad understanding of the organization's mission and operational challenges.

◆ The CEO is the organization's operational leader and primary external face, whereas the nonexecutive chair is relatively invisible. Major prospective donors expect to spend time with the CEO, and, in times of capital campaigns, 50% or more of the CEO's time is devoted to development.

Shaping and managing the board chair and CEO relationship takes time and effort on both sides. Consider the case of the University of Hawaii board with only a three-year term for members—a recipe for disaster. This three-year term contrasts with most boards, where stability and continuity are ensured since members often serve for a decade or more. Going through four chairs in an 18-month period several years ago, the lack of experience and organization instability resulted in the board firing the university president in a way that unnecessarily cost the university millions of dollars.

Lifelong Rewards

Serving as a nonprofit organization board member can be a very fulfilling experience and the start of a lifelong relationship. Although business leaders have developed skills that nonprofit organizations desperately need, they need to recognize that nonprofit boards are different. Understanding these differences substantially improves the quality of service for the organization and the experience for the board member. **SF**

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Note: This article draws heavily on the 2011 book, Joining a Nonprofit Board: What You Need to Know, *by Marc J. Epstein and F. Warren McFarlan, and published by Jossey-Bass.*