

## Chapter 2

# How Nonprofit Organizations Manage Risk

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**Abstract** The purpose of this essay is to identify the kinds of decisions where nonprofit organizations need to manage their risks in a strategic fashion, to review what is known about how they approach these decisions, and to offer a conceptual framework that nonprofits can use to develop a more sophisticated and effective approach to their risk-management decisions. For various reasons, nonprofits have not taken a sufficiently robust view of risk management. A simple framework is presented to address the risk-related decisions of nonprofits in a strategic fashion, with a view to inspire fuller attention to risk management in the nonprofit academic literature and in professional forums.

### 2.1 Introduction

Effective management of risk is fundamental to the proper functioning of any organization. Organizations that operate in a changing or otherwise uncertain environment in which the outcomes of their decisions, or their failure to make decisions, cannot be perfectly predicted, face risk. For nonprofit organizations, risk is encountered in many different ways. Financial, personnel, program and capital expenditure decisions all entail risk because they involve interactions with changing, complex, volatile or intrinsically stochastic economic, political and social environments. Hence their outcomes cannot be precisely determined in advance.

Risk management is important to nonprofit organizations for two closely connected reasons: First, nonprofits may wish to protect themselves as well as they can against disastrous outcomes that could threaten their survival and their capacities to address their missions. Second, as nonprofits consider alternative ways to address their missions they may often find that those options which promise greatest impact also entail greater risk. Hence, nonprofits must find combinations of risk and “return” with which they are most comfortable.

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The literature on nonprofit risk management falls mostly in the first category. In particular, nonprofits do pay substantial attention to how they can insure themselves against lawsuits against directors and officers, against potential liabilities from operating risky programs such as children's summer camps, or ordinary hazards such as crime, fire and flood. Less attention, however, has been paid to the second category of risk management – the strategic weighing of risks and benefits that allows organizations to have the greatest impact on their missions. Relatively recently, nonprofits have adopted principles of strategic finance, which allow them to follow a “prudent man” approach to investing financial resources in appropriately diversified portfolios that embody sensible levels of risk in order to achieve strong financial returns (Fremont-Smith 2004). While such financial decision-making is a bit more complicated for nonprofits than it is for private firms or individual investors – since nonfinancial impacts of financial decisions often matter to nonprofits – it is also clear why nonprofits have been able to approach risk strategically in the financial area. In particular, the primary metric for success in this area – financial return in dollar terms – is usually clear. In other areas of nonprofit decision making, the “return” may be less clear or tangible – measured in terms of social or mission impact, for example. Hence, the notion of thinking in terms of risk vs. return is not as natural. Nonetheless, a strategic approach to risk management is just as important – otherwise, nonprofits may find themselves making unduly conservative decisions that fail to achieve as much impact as they might, or in some cases taking unreasonable amounts of risk for a low return.

The purpose of this paper is to identify the kinds of decisions where nonprofits need to manage their risks in a strategic fashion, to review what we know about how they approach these decisions, and to offer a conceptual framework that nonprofits can use to develop a more sophisticated and effective approach to their risk management decisions in the future. The hope is that this will inspire fuller attention to risk management in the nonprofit management literature and in professional forums devoted to nonprofit management and leadership.

## 2.2 Special Issues of Risk for Nonprofits

There are a number of reasons why the issues of risk management are particularly complex for nonprofit organizations. It is important to highlight these issues before trying to assess current practices and research on this subject. One set of issues has to do with measurability. Others have to do with who bears the risk and how much risk it is appropriate to bear.

*Measurement.* As suggested above, nonprofits operate in areas where the results are not necessarily measurable in dollar terms, or even quantitatively. Nonprofit organizations address the health, education and well-being of people, look to improve the quality of the environment, produce and preserve great art, or seek social justice and change. While it is increasingly important, if only to satisfy the ever more demanding accountability requirements of funders and government overseers,

for nonprofits to develop quantitative measures of their mission-related impacts, nonprofits often have their hands full trying to do so. Strategic risk management demands even more of them – not only measuring mission-related impact but also considering how that impact might vary under various contingencies. As we indicate below, measures of impact or “return” need not be terribly sophisticated in order for nonprofits to be able to consider risk in strategic terms, but a capacity for nonprofit executives to rate the value of alternative outcomes at least in relative terms is required. Moreover, nonprofit executives must be able to assess the likelihoods that different outcomes will occur – a crystal ball exercise with which nonprofit executives unschooled in contingency planning may not be comfortable.

*How much risk and who should determine it?* Nonprofit decisions are made by paid executives or by volunteer trustees, but the impacts of those decisions are felt by the clientele or societal groups served by nonprofits and by the volunteers and benefactors who supply the resources. In essence, nonprofit executives and trustees are agents for others, and in the largest sense, agents for a society that has commissioned nonprofits to carry out their socially worthy missions. All this complicates the accounting for risk in strategic nonprofit decision making. In a business setting, shareholders ultimately hold executives responsible for managing their assets to achieve maximum financial returns within the bounds of specified tolerance of risk. In a nonprofit, executive staff and the trustees to whom they report, are left to interpret – from the viewpoint of society or their particular constituencies – what is appropriate in terms of the risks they should assume and the levels of social return they should seek. While boards of trustees can, should and do, deliberate on these matters, and often consult with their constituents, no stock market exists for such issues to be sorted out. Within broad bounds, nonprofit trustees have discretion, and indeed many executives whose boards do not exert tight oversight, also have wide discretion. It is often only when results turn disastrous that public scrutiny comes into play.

The ambiguity of who bears the risk, and what levels of risk taking are appropriate, impacts directly on nonprofit decision making. What standard should an executive or a trustee use in determining if a particular alternative is too risky or too conservative? There are three possible levels on which this question can be approached. The first is the personal level. Some decision makers are more inclined to take risks than others. Is it therefore appropriate for a more dynamic executive to take greater risks on behalf of the organization? In one sense the answer is yes: a nonprofit board that hires an executive director implicitly takes attitude towards risk taking into account in making the hiring decision. Engaging an “entrepreneurial” chief executive can be a signal that the board, interpreting what is best for the organization, endorses a new level of risk taking in order to achieve greater impact. More generally, however, individual risk preference is not the appropriate standard for a nonprofit organization. Individuals, either executive directors or trustees, do not own the nonprofit organization nor are they engaged by shareholders who do so. Rather, they are entrusted with the organization’s resources in order to achieve public purposes. Thus they are obligated to interpret what is best from the organization’s or society’s point of view.

However, the appropriate risk preference standard for the organization as a whole is not obvious either, for several reasons. First, resource providers may exert special influence. For example, even though major donors provide “gifts” they may expect those resources to be utilized with a particular level of prudence, such as they would apply to themselves. Government or other contractors will often impose their own standards or required practices as well, as a *quid pro quo* for their support. And professional codes of practice will also guide the decisions of particular nonprofit officials, such as chief financial officers and investment counselors. While each of these sources influences the risk-related behavior of nonprofit organizations, none represent the nonprofit organization as a whole or define its appropriate risk preference profile.

A nonprofit’s risk preference may also be influenced by its age and life cycle stage as well as its size and asset base. A small, fledgling nonprofit may have little to risk and little choice but to take risks in order to get itself established. A more mature organization with substantial resources has more to protect and hence may approach risk in a more conservative fashion, even though it may be in a stronger position to gamble if it has accumulated reserves. Similarly, an organization that is part of a supportive network may feel more secure in taking risks than one on its own without such a safety net (Derryck and Abzug 2002).

Clearly a nonprofit’s risk preference should be influenced by its mission. For example, if the organization operates in a dangerous setting, such as a war zone, it probably needs to recognize that high risk tolerance is necessary for effectiveness. Or, if it is established with the intention to achieve a certain goal, say eradication of a disease within a limited period of time as specified by a founding donor, then it may have to take more chances. By contrast a nonprofit, such as a school or a museum or community foundation, intended to provide benefits to a community into the indefinite future, must be sufficiently conservative to ensure its continued viability. Thus, it is up to the nonprofits’ trustees to interpret the implications of mission for risk-related behavior and decision making.

From the viewpoint of society as a whole, one could argue that nonprofits collectively should be risk neutral – neither too conservative in their deployment of resources nor too risk-taking. The logic here is that some nonprofits may fail and others may succeed as they pursue their individual missions and approaches, but a stable society can accommodate both as long as the end result is the best possible return. Such logic, though not appropriate for individual nonprofits, allows policy makers to view the country as a large insurance pool for nonprofits experimenting with different approaches. Moreover, it raises consciousness about the societal risk tolerance for nonprofits: some should be allowed to experiment and take chances in responsible fashion while others are appropriately conservative. They cannot all be held to the same standards of risk taking.

Nonprofits can run into trouble when their individual decision-makers assume an inappropriate level of risk preference. They cannot simply impose their personal preferences approaches to risk taking onto their organizational decision-making responsibilities. Nor can they blithely assume that their organizations have an obligation to minimize risk in order to assure their survival for society’s welfare.

There is no getting away from the requirement that nonprofit executives and trustees need to develop an organizational attitude towards risk taking that reflects the particular societal missions with which they are entrusted.

In actual practice, at least two broad factors influence nonprofits' attitudes towards risk. The first is a conservative tendency stemming in part from the fact that people are reluctant to take chances with resources that are entrusted to them, but which do not belong to them (Scanlan and Dillon-Merrill 2006). The second is an entrepreneurial tradition based on the understanding that nonprofits are often in the business of achieving social change, led by people inclined to take substantial risks in order to achieve the organization's goals (Young 1986). Either of these influences, if left unchecked, can lead to inappropriate approaches to risk management in the context of nonprofit strategic decision making.

## 2.3 Views from the Literature

It is difficult to pin down the literature on nonprofits' management of risk since risk is necessarily connected to virtually all facets of nonprofit organizational decision making. This section takes a broad view, inquiring into literature on various areas of nonprofit decision making as well as writings explicitly focused on nonprofit risk management. Even with this broad sweep, however, an interesting dichotomy emerges: most contributions focus on how nonprofits can minimize the risks that they face, rather than on the strategic trade-offs they may have to make between achieving impact or return and tolerating risk.

A good place to start is the literature on nonprofit governance, since it is at the board level that responsibility resides for decisions involving the prudent deployment of resources to achieve the organization's purposes. A recent review of research on nonprofit governance (Ostrower and Stone 2006), for example, identifies two normative models of corporate governance in the health care field – the corporate model and the philanthropic or stewardship model, the former being more sympathetic to strategic risk taking and the latter more inclined towards “asset preservation.” Several other articles suggest the pervasiveness of the “asset preservation” view, with its concomitant emphasis on reducing risk rather than trading it against potential gains. For example, Gibelman and Gelman (1999) highlight the idea of “safeguarding” as a guiding principle for management of risk by nonprofit boards. Middleton (1988) describes “planning” as a way for nonprofit boards to reduce their uncertainty about actions to be taken in the future. Brown and Iverson (2004) describe four different strategic orientations of nonprofit boards, two of which (“defenders” and “reactors”) are distinctly conservative in their approaches to products and services. Finally, Henson and Larson (1990) promote a comprehensive risk management approach that entails risk avoidance, risk transfer, better understanding of necessary risks, and risk reduction.

Some scholars attribute risk aversion to the economic incentives intrinsic to the nonprofit structure. For example, Wedig (1994) argues that nonprofit hospitals are

risk averse in connection with cash flows and fund balances because they are constrained from paying cash dividends. Similarly, Preyra and Pink (2001) demonstrate that CEOs of for-profit hospitals are greater risk takers than their counterparts in nonprofit hospitals, receiving substantially greater compensation but with much wider variances, because the compensation structures of the two types of hospitals differ in accommodating such differentials.

Other scholars identify specific risk management strategies designed to reduce a nonprofit's exposure to risk. For example Bennett et al. (2006) argue that nonprofit commercial ventures can serve as a hedge against the uncertainty of donations. Along similar lines, Chang and Tuckman (1990) cite the accumulation of financial surpluses as a hedge against financial risk and uncertainty for nonprofit organizations. Bielefeld (1992) also argues that nonprofits tend to pursue a number of uncertainty reducing strategies such as finding new revenue sources, retrenching operations or finding ways to gain legitimacy in the eyes of funders. Similarly, Gronbjerg (1990) argues that nonprofits tend to seek less volatile funding sources, e.g., from government, despite the often substantial costs associated with complying with those sources.

In the area of institutional grant making, examples of both strategic and preservation philosophies are found. Higuera (1992) reports that most surveyed corporate giving managers are willing to assume risks by funding unproven and innovative programs, while Olenick (1988) reports that grantors tend to avoid risk by funding well-managed and reliable nonprofits even where other riskier nonprofits might ultimately yield a greater impact. Interestingly, Olenick also finds that some nonprofits make the opposite mistake, leaping into risky commercial ventures when safer and more effective options are available.

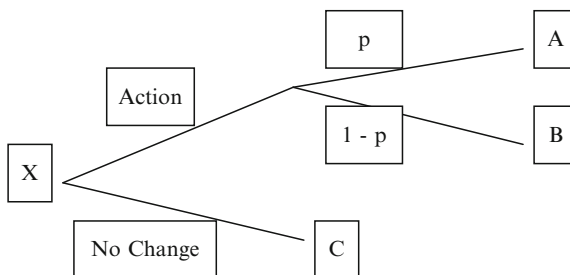
Of course there is nothing inherently unwise about seeking ways to reduce risk, especially in instances where that can be done without loss in performance, impact or contribution to mission. In fact, some classic risk management strategies such as insurance-type arrangements for risk sharing, and diversification of assets, income sources or programmatic alternatives for risk reduction, make eminent sense and are not sufficiently exploited by nonprofit organizations. However, the tenor of much of the literature suggests that mission impact or other measures of performance often get lost in the discussion about managing risk. Indeed, a key review article Tremper (1994) and a recent comprehensive text on managing risk in nonprofit organizations Herman et al. (2004) are generally focused on identifying the spectrum of possible risks a nonprofit may face (all the things that could go wrong with property, programs, people and finances, etc.) and how to minimize or protect against potential losses. To a certain extent, these references consider the probabilities and consequences of such losses, but they do not focus on decisions that may require accepting certain levels of risk in order to achieve desired goals or gains. This preventative approach to risk management is useful because many risk reduction policies may be effective and cheap, and do not preclude strategic management of risk. However, reliance on risk reduction alone may have the consequence of incurring large opportunity costs – missed chances for substantial gain caused by a failure to recognize and assume prudent risks.

## 2.4 Causes of Inefficient Nonprofit Decision Making Under Risk

In order to consider how nonprofits should manage risk, and how efficient they are in making decisions in the face of risk, one needs a normative framework that describes desired or “optimal” behavior. A classic model from decision theory contains the basics for identifying how rational decisions under risk should be made and what errors may preclude reaching the best decisions under risk. Figure 2.1 illustrates a simple two option choice where the consequence of one option (for example maintaining the status quo) is certain and known while the consequence of the second choice is uncertain, but could potentially lead to either a better or worse outcome than the first choice (see Behn and Vaupel 1982 for a more extensive analysis of this model).

Figure 2.1 captures most of the considerations of more complex decisions under uncertainty. The action alternative involves risk represented by probabilities  $p$  and  $(1 - p)$  that a better (A) or worse (B) outcome will result than if we followed a riskless middle path with outcome C. Clearly this is the interesting case. If A and B were both better than C, the action alternative would always be preferred; similarly if both A and B were worse than C, the no change alternative should clearly be chosen. In order to make this choice, the decision maker needs a number of important pieces of information. What are the magnitudes of the possible outcomes (gains or losses) A, B and C? What is the probability  $p$  that A will occur if the action option is chosen or  $1 - p$  that B will occur instead? And what is the decision maker’s tolerance of risk?

Characterizing risk preference in the context of this diagram requires a little more subtlety. Analysts use the concept of “expected value” to characterize the apparent worth of the action alternative. In this case, “expected value” EV can be calculated from the formula  $pA + (1 - p)B$ . For example if  $p$  is 0.5, A is 100 and B is zero, then EV is equal to 50. This is the value one can expect to receive on average from the action choice if one were to make this choice over and over



**Fig. 2.1** A simple decision tree: action with uncertain outcome vs. known status quo

again (the problem, however, is that this is a single decision at one point in time). So, a decision maker who was “indifferent to risk” would choose the action alternative if the certain choice yielded a value of  $C$  less than 50. Otherwise, she would choose the certain (no change) alternative. But if the decision maker were “risk averse,” she would choose the certain alternative even if  $C$  were somewhat less than 50. The more the EV would have to be in order for the decision maker to take the action choice, the more risk averse he or she is. For example, if the decision maker required EV to be 90 (a 90% chance of outcome A) before she would prefer that alternative to a certain outcome of 50, she would indeed be very conservative. In contrast, a decision maker that required EV to be only 40 for the action alternative when the certain outcome was 50 would be considered a risk-preferring gambler.

We can look at this in a slightly different way in order to get an index of a decision maker’s risk preference. Let’s ask the decision-maker the following question: what value of  $C$  would make you indifferent between taking the action alternative and taking the certain path? Let’s call the answer to this question the “certainty equivalent,” CE. If CE is less than EV then the decision maker is risk averse. If CE is equal to EV then the decision maker is risk neutral. And if the answer is  $CE > EV$  then the decision maker is risk-preferring.

With this model as background, we can now identify the various different ways in which decisions under risk can be poorly made. In particular:

- The decision maker may have a poor estimate of the consequences of different choices (A, B and C)
- The decision maker may have a poor estimate of the probabilities of good and bad outcomes ( $p$ ,  $1 - p$ ) for the action choice
- The decision maker may have an inappropriate risk preference profile; e.g., relative to the mission and situational characteristics of the organization, she may be too risk averse or too risk preferring
- The decision-maker uses poor logic, failing to compare EV with her CE in order to make the best choice

In addition to these basic sources of error, there are two others implied by this model as well:

- The decision-maker fails to take advantage of sufficiently low cost information that would either give her a better estimate of  $p$  or might even yield advanced knowledge of the action outcome and whether A or B is the result
- The decision maker fails to take advantage of risk sharing arrangements such as insurance or risk pooling which might reduce the cost of a poor outcome (B)
- The decision-maker fails to exploit possible diversification or other design strategies that could increase the attractiveness of the action alternative by reducing the probability of a poor outcome

The power of this general model lies in its applicability to a wide spectrum of nonprofit strategic decisions. Some of these applications are considered in the next section.



## 2.5 Nonprofit Strategic Decisions Under Risk

Consider four different kinds of strategic decisions a nonprofit organization (board of trustees) may face:

1. *A New Venture*: From time to time nonprofit organizations consider doing something new – opening a new branch office, adding a new service, undertaking a commercial venture, and so on. The (more predictable) alternative is to keep going with the existing array of services and facilities.
2. *Expanding or Reducing Capacity*: Changes in demands and costs over time, or technical obsolescence may require a nonprofit to consider expanding, contracting or renovating a facility or other aspects of its infrastructure, such as its equipment, staffing or location. The (more predictable) alternative is to maintain the current capacity.
3. *Engaging New Leadership*: Boards and executives are often faced with decisions to renew the contracts of incumbents or to seek alternative candidates for executive or managerial positions. The (more predictable) alternative is to continue with the incumbent.
4. *Entering a Collaboration*: Nonprofits face multiple decisions to join associations or engage with other organizations in collaborative efforts, partnerships, or even mergers. The (more predictable) alternative is to continue going it alone.

In each of these cases, the status quo is more predictable or certain in its outcome (C) because it is a direct extrapolation of the current experience. The action decision, however, could improve matters (A) or make them worse (B). Hence, each of these kinds of decisions fits the framework of Fig. 2.1. So too, nonprofit decision making in each of these cases can be faulty in its approach to risk in the various ways considered above.

Table 2.1 elaborates on various ways in which these different types of decisions can go wrong in each of these situations. Read differently, the table points out the alternative ways in which decision making under risk can be improved for nonprofit organizations. The logic for each type of decision is very similar. One big difference in applying the decision tree logic in practice, however, is that some types of decisions are easier to quantify than others. For example, choosing a new leader is inherently more subjective than making a financial investment or undertaking a new programmatic venture. However, both cases can be accommodated. We illustrate this for two cases, as follows:

### Case 1:

*A profit-making venture or fund raising initiative.* In this instance it is clear that the outcomes A, B and C may be quantified in dollar terms, while the probabilities must be assessed subjectively using the best available information and judgment. Suppose the status quo option was to continue the nonprofit's traditional fund raising program, yielding say \$500,000 just like last year. Suppose the new program could potentially net \$1 million (A) if successful, but might lose \$0.5 million (B) if it failed. Further suppose that a fund raising consultant firm estimated an 80% chance

**Table 2.1** What can go wrong with nonprofit decisions under risk

	New venture	Change capacity	New leadership	Collaboration
Consequences	Net benefits of venture success or costs of failure are poorly assessed	Costs and/or benefits of the expansion or contraction are miscalculated	Failure to anticipate what could go wrong, or what special benefits might result, with new leadership or with continuing the incumbent	Failure to anticipate what could go wrong once a collaboration is engaged or what unanticipated benefits might result from collaboration
Probabilities	Chances of success poorly estimated	Probabilities of expanded or reduced demand for service are poorly estimated	Poor assessment of the likelihood of finding a superior candidate	Chances of a successful collaboration poorly estimated
Risk preferences	Venture rejected when EV is much greater than C; or chosen when EV is much less than C	Action rejected when EV is much greater than C; or chosen when EV is much less than C	Search for new leadership rejected when EV is much greater than C; or chosen when EV is much less than C	Collaboration rejected when EV is much greater than C; or chosen when EV is much less than C
Logic	Decision is made without comparing status quo with CE of undertaking the venture	Decision is made without comparing status quo with CE of undertaking the change	Decision is made without comparing status quo with CE of undertaking a search for new leadership	Decision is made without comparing status quo with CE of entering the collaboration
Risk reduction	Failure to follow good financial or other practices that reduce probability of failure; failure to diversify venture initiatives	Failure to utilize the most effective practices, materials or technologies	Failure to follow proven policies and strategies for assessing candidates, including examining a sufficient number of candidates	Failure to provide an adequate period for mutual negotiation and consultation before a decision is reached. Failure to diversify the number of partners
Risk sharing	Failure to enter an agreement with partners or insurers that would reduce potential losses without sacrificing too much potential gain	Failure to investigate possibilities for sharing new capacity with another organization	Failure to participate in mutually-beneficial information sharing arrangements with other units or organizations in the market for leaders	Failure to negotiate a fair division of costs in the case of dissolution of the collaboration or benefits in the case of success
Information	Failure to invest in due diligence or research that could cheaply reveal a much more precise estimate of failure or success	Failure to invest in market research that could cheaply reveal a much more precise estimate of need for future capacity	Failure to invest in market research or internal programs that could cheaply reveal a much more precise estimate of available talent	Failure to invest in cost-effective research on similar collaborations elsewhere which could reveal a more precise estimate of the likelihood of success

of success and 20% chance of failure for the new program. Then the expected value is \$700,000 compared to \$500,000 dollars under the status quo. Thus, the trustees' CE for the action alternative would have to be less than \$500,000 for them to reject the new initiative in favor of the status quo.

Clearly, the trustees can potentially make a number of mistakes in this decision. The information they have from the consulting firm could be wrong – either the probabilities or the potential gains or losses from the new venture. Or, they could be too risk averse or too risk prone. The latter is a subjective judgment they must make by discussing the mission and context of the organization and the importance of taking chances to increase their impact versus preserving the organization's capital. Certainly they could fail to follow an appropriate logic, for example determining that the action alternative had a CE more than \$500,000 but then deciding against it.

As Table 2.1 suggests, other shortcomings might have to do with failure to put the decision on a firmer footing by improving its overall risk-related and pay-off parameters. Are there ways to improve the design of the initiative, for example by diversifying the donor base, in order to improve the probability of success or reduce the chance of a large loss? Are there other nonprofit organizations that could be engaged as partners to share the risk?

One can also ask – is there additional cost-effective information that can be secured to improve the choice? For example, could an independent consulting firm carry out some market research to determine with more confidence whether success or failure will occur? Indeed, the trustees can calculate an upper limit to what such information might be worth. A perfect source of information would tell them with certainty whether the venture will or will not succeed. The chances that such a source would signal success would, as far as the trustees can determine a priori, is 80%. The option of obtaining such “perfect information” changes the “lottery” they face because if they learned that the venture was sure to fail they would take the certain alternative. Thus they would face the following new set of possibilities: an 80% chance of learning that the action alternative will succeed and hence receiving \$1 million by taking the action alternative, and a 20% chance of learning that the action alternative will fail, hence going with the status quo for \$500,000. Calculating the expected value of this situation yields \$900,000. So indeed the trustees could be prudent in spending up to \$200,000 (the difference in EV with and without perfect information) for additional market research information, depending of course on the anticipated quality of that research. In any case, the trustees would be making a mistake to spend more than that on new information (since any such information is likely to be less than perfect), but they might also err by failing to spend enough to improve their information.

## Case 2

*Selecting a new leader.* In this instance, the foregoing logic can be applied in essentially the same way but quantification is more difficult. Suppose the choice is between undertaking a search for a new executive director and renewing the contract of the current director. If the action alternative is taken, the current director will certainly leave and a new one will be selected. A search firm has suggested that the probability of finding a more effective leader is 70% and the chance of hiring

someone that turns out poorly is 30%. The trustees have a firm idea of what they can expect in the way of performance if they retain the incumbent. They might even give him a rating of say 7 on a 10 point scale. After considering the information they have about the quality of potential candidates in the market, from the search firm and colleagues in the field, they determine that a more effective leader would probably rate a 9 while a poorly chosen candidate would likely be a 5. Hence, the expected value yielded by search would be 7.8, not much above the incumbent's 7. They might be sufficiently risk averse, therefore, to reject the search and retain the incumbent. Note that, the quantitative (utility) index helps with this decision, but it is not necessary. All that is required is for the trustees to mentally consider the gamble they are facing with the search and compare in their minds the expected outcome to the incumbent in hand, given what they know about the estimated probabilities and the quality of potential candidates.

The sources of errant decision making here are the same as well. The probabilities could be badly estimated. The quality of potential candidates and their potential performance levels could also be poorly specified. Or the trustees could be inordinately conservative in rejecting an alternative that seems likely to yield a better result. Here too, risk reduction strategies might not have been sufficiently pursued, such as efforts to widen the pool of potential candidates by extending the fields or locations for search. Risk sharing strategies might also be possible, such as insurance against the loss of a new hire for just cause. Finally, information seeking through engagement of private investigators who, for a price, could uncover heretofore unknown risks associated with likely candidates, might also be possible. Trustees could determine for themselves what such information might be worth and use it to investigate likely candidates before they decide to formally undertake the search, thus reducing the risk associated with the action alternative.

## 2.6 Concluding Remarks

We argue here that, for various reasons, nonprofits have not taken a sufficiently robust view of risk management. While they seem to engage in a variety of sensible practices designed to reduce or minimize risk, they less commonly approach consequential decisions that involve risk in a strategic fashion. We have presented a simple framework for nonprofits to approach their risk-related decisions in strategic fashion, taking into account the probabilities of success and failure, an appropriate attitude towards risk that properly reflects the mission and circumstances of the organization, and engagement in efforts to share risks and obtain critical information to improve the likelihood of successful choices.

The paper suggests risk management as a frontier for research on effective decision making in nonprofit organizations. Areas where research can contribute include a more complete classification of nonprofit strategic decisions involving risk, methodologies to assess the nature (probabilities) and consequences of those risks, norms of risk aversion for different risk-related contexts in which nonprofits find

themselves, and developing methodologies such as utility indices in nonprofit situations where the consequences of decisions and the probabilities of alternative contingencies are difficult to quantify. It would also be useful to study empirically what factors, such as organizational size, economic capacity, field of service, type of mission, organizational age or stage of development, connectedness to other organizations or networks, organizational philosophies and leadership personalities, influence nonprofits' risk-related behavior. Finally, it would be helpful to examine the legal, ethical, institutional and economic underpinnings for risk taking in a nonprofit context, what normative principles can be recommended to leaders in this decision-making milieu, and what kinds of institutional structures may bias decision-making to be inordinately conservative or risky.

The uncertainties and instabilities associated with nonprofit decision-making are not likely to diminish in the near future. All indicators point to continued change and limited options for preserving the status quo. An expanded capacity for strategic risk management will serve nonprofits well in this environment.

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