

# Non-profit organization's endowment as a source of financing to improve its sustainability

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**Abstract.** Non-profit organizations are an important part of the economy and are needed to fulfill many beneficiary roles that neither market, nor state would fill. Non-profit organizations in Slovakia became important after the 1989 Velvet revolution, the dissolution of the Czechoslovakia and creation of the free and democratic Slovak Republic. Ever since them, non-profit played a role in everyday life of people in Slovakia. Non-profit organizations exist with the aim of providing generally beneficiary services without the aim of making profit for their founders – which is what makes them distinct from for profit businesses. However, non-profit organizations need funding for their operations in the same way as any other organizations. They need to pay their bills, salaries, purchase materials, services, etc. Because of their non-profit nature, the sources of financing for these costs are different. The aim of this paper was to look at the endowment of non-profit organizations and its investment as a source of non-profit financing and the current situation in Slovakia regarding it use. We analysed financial statements of foundations available through Finstat.sk database. We found that the use of investing the endowment for self-financing of non-profit organizations is almost non-existent in conditions of Slovak non-profit sector, with only 13,7% of organizations having any long-term financial assets and only 3,9% having any substantial gains from them. Further, we proposed a framework for possible use of the endowment as a source of funding for more non-profit organizations in order to improve the financial situation and sustainability of the non-profit sector.

**Keywords:** non-profit organization, non-profit endowment, foundations, investment, non-profit self-financing

## 1 Introduction

Non-profit organizations are an important part of the economy and are needed to fulfill many beneficiary roles that neither market, nor state would fill in areas like healthcare, social care, education, culture, sports and culture, community development, etc. The importance of non-profit organizations is rising in the economic activity of contemporary societies. [1] Non-

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profit organizations in Slovakia became important after the 1989 Velvet revolution, the dissolution of the Czechoslovakia and creation of the free and democratic Slovak Republic. Ever since them, non-profit played a role in everyday life of people in Slovakia. They have been only getting more and more important since. Currently, there are 51 784 non-profit organizations as per the latest data available for 2018 by the Statistical Bureau of the Slovak Republic. Out of which, 45 938 are associations, 4874 non-profit organizations, 468 foundations and 504 non-investment funds. [2]

Non-profit organizations exist with the aim of providing generally beneficiary services without the aim of making profit for their founders – which is what makes them distinct from for profit businesses. However, they need funds for their functioning the same way as for-profit businesses do. There are many ways they can get the funds they need. Some of them have already been studied by Slovak authors. [3, 4] Authors usually focus on fundraising from external sources, either public or private, or self-financing through business activities. Non-profit organizations may carry out income-generating activities, if their statutes so provide, only insofar as this serves the purposes for which they were established, and if it meets those objectives [5] and some authors think of it as an insurance [6] However, we identified one source that has been neglected and underdeveloped in the body of literature on non-profit organizations financing and funding. It is the creation and use of endowments to self-fund the non-profit organizations. In this article, we understand an endowment as money given to the organization to provide it with an income. It is a source of financing for non-profit organizations that is rarely mentioned in studies or articles, however, we find in an interesting option to be explored. Endowments, if properly invested and generating return, can help provide stable source of income for non-profit organizations independent on outside fundraising, current profitability of their business activities or grant applications.

The aim of this paper is to explore the endowment and its investment as a source of non-profit financing and the current situation in Slovakia regarding it use. Furthermore, we intend to offer a framework for possible use of the endowment as a source of funding for more non-profit organizations.

This paper is divided into 3 parts. The first part is a literature review of both domestic and foreign authors. The second part describes the methodology used in this paper. The third part represents the results of the analysis and discussion of possible solutions.

## **1.1 Literature review**

Non-profit organizations in general have been and still are an object of study by many authors, both internationally and domestically. Sources of non-profit financing are also among the topics studied although are only marginal. Nationally, we can mention Hraskova [3] who wrote about dimensions of financing non-profit organizations in Slovakia, their different sources of financing which she identified as follows:

- state funding;
- partnership with other sectors;
- obtaining finance from own activities,
- use of EU funds and others.

Valaskova [4] focused on principles of non-profit financing and assess the system and structure of financing of a non-profit organization taking into account conditions of Slovak Republic. They both agree on vulnerability of non-profit organizations to the dependence on a single funding sources and that multiple sources of financing help achieve their long-term sustainability and existence. Valaskova [4] goes even further and mentions that historically, non-profit organizations in Slovakia have been dependent on a main source of financing from large, mainly foreign foundations and their existence is threatened by depletion of this source of financing.

As for the use of endowment for investing and generation of income, it has been mentioned by Marcek [7] who mentioned it as a form of self-financing among others, Svidronova and Vacekova [8] included it in their study on the sources of financing in 2011. They found it being used by 7,69 % of respondents, however she had only 136 of them. They didn't go further and focused only on the use of the sources, not on their principles.

As for internationally, this topic has been much more studied, since it is more common in other countries for non-profit organizations to have endowments. Main body is consisting of the articles from the US. There, the topic research was mainly the endowments of universities, who are non-profit and invest their endowment in search of a revenue stream. Merton [9] studied optimal investment strategies for university endowment funds back in 1993. Davidson [10] researched the same topic even before in 1971 while focusing on the differences in using internal and external management for the funds. Dahiya and Yermack [11] made an exhaustive study of non-profit endowment funds in the US on a sample of 29 762 organization in years 2009-2017. Endowment funds in the US is \$0.7 trillion asset class, with majority of them (54%) being the higher education endowments while constituting only 6% of observations in the study. Best known example of a higher education endowment might be the one of Yale University, which is reported to be \$29.4 billion in 2018. However, they found that typical endowment underperforms a 60-40 portfolio of equity and bond market indexes by about 4,46 percentage points. Liaw [12] also analysed investment strategies and return of university endowments and found their investment performances underperformed passive benchmarks for the studied years. In general, he found that stellar returns achieved by high profile endowments could not be duplicated by endowments of all sizes. He also underscored the importance of choosing and having access to top performing managers. There are also articles from other countries on the topic of university endowments – some analysed the methods of managing endowments and their applicability in Russian universities [13] others studied university endowments in Pakistan [14]. They both stressed importance of the endowments for the stability of the organizations.

Other type of research focused mainly on the technical aspects of non-profit endowments studying the efficiency of institutional spending and investment rules [15] or asset allocations [16]. Big data is also a new emerging trend. [17, 18] Others focus on strategic orientation [19] and employees [20].

As with all investing, there are financial risks involved for the organization and it is important to know how to assess them. [21, 22]

## 2 Methodology

The aim of this paper is to explore the endowment and its investment as a source of non-profit financing and the current situation in Slovakia regarding it use. Furthermore, we intend to offer a framework for possible use of the endowment as a source of funding for more non-profit organizations.

We use the data from publicly available sources such as the Statistical Bureau of the Slovak Republic, Database of non-profit organizations of Finstat (available at <https://finstat.sk/databaza-neziskoviek>), the Registry of financial statements and so on. Accounting legislation in the Slovak Republic gives entities the space to choose, within the regulated financial accounting, some alternative accounting procedures. [23]

This paper is aimed at Slovak non-profit organizations. In Slovak law, there is a broad definition of what a non-profit organization is - a taxable person not founded or incorporated for doing business. This would include churches, universities or state television and radio corporation. A stricter definition would include only organizations that are a part of what is more generally perceived as a non-profit, third, sector in Slovakia. That would be civic associations, foundations, non-investment funds and non-profit organisations providing

generally beneficial services. However, due to the lack of availability and accessibility of information, we will focus on the assessment of foundations. It is also the best type legal entity to create an endowment and invest it.

The study focuses on the use of basic scientific methods of analysis, synthesis, induction, deduction and abstraction to accomplish the determined aim.

### **3 Results and Discussion**

To analyze the current state of the use of endowments as a source of financing for non-profit organizations in Slovakia, we chose to analyze 51 foundations in Slovakia. The criterion for their choice was the availability of data from their financial statements available through Finstat for the year 2019. We found data for 51 foundations and analysed all of the available data. This constitutes approximately 10% of all foundations in Slovakia. We analyzed their balance sheets and income statements to look for evidence of any long-term capital and gains from it. We conducted this research on foundations, as they are the best vehicle to create an endowment and invest it and also, they are the most likely to publish their financial statements online. However, we accept this as a limitation for our research.

Only 13,7% of foundations had any kind of long-term financial assets on its book. Moreover, we found that only 3,9% (2 out of the 51 studied) had any substantial gains from their capital. It was invested in bonds held till maturity. Coincidentally, both of these organizations were corporate foundations of banks operating in Slovak republic. Corporate foundation can be defined as founded by a corporation and having the corporation's name in its name. That might point to a better understanding of the use of the foundation's capital in foundations tied to banks. However, not every foundation founded by a bank was using its capital this way.

Most of foundations had their assets in form of cash in the bank, some of them even to the tune of millions of euros (7,8%), but usually in hundreds of thousands (58%). That is a lot of capital sitting in the accounts that could maybe be used for more productively – to gain some income that would further help finance organization's mission. Most of these were sitting idle gaining no income in interest, or only a modest interest in tens of euros.

A few of the analyzed foundations had other some other type of assets (buildings, land), but only one had earnings from lease.

What we thus see is that non-profit organizations in Slovakia in general don't use their capital endowment to generate income but usually only redistribute this capital or spend it on their mission.

What we want to propose for them is to create an endowment with principal that would not be touched and will be invested for gains. The central idea is to set aside a certain sum of money which can be invested to earn a sustainable form of income for the non-profit organization. Which would make it less dependent on outside financing.

We see this as a possibility mainly for the bigger foundation with already a large amount of money and an established donor base, that can redirect a part of their cash into investments and progressively create a nest egg that would be sufficient. Exact rates of investments are dependent on the ability to explain this plan to their stakeholders or find a replacement source of income in order not to decrease their current funding for their missions. Some of the biggest foundations in Slovakia are corporate foundations which usually serve as a sort of philanthropic arm of their parent corporations. They usually also depend on their parent company for most of their funding, either through direct donations or through tax assignment, which is a special form of support for non-profit sector whereby companies can direct a percentage of their income tax paid to a non-profit organization or organizations. Creation of an endowment might allow them to flatten the fluctuations in donations and assignments

from the parent company stemming from the different stages of the economic cycle and help them create more stable income flows. For smaller non-profit organizations, we see this as an opportunity for creating a community behind a shared goal of creating an endowment that would finance the concrete missions – small local community projects, specific research, etc. for future generations. For example, with a creation of endowments for specific causes, they might persuade a big donor or a group of donors to put the principal in exchange for naming rights and then just support the mission from the realised income from the investments.

As for potential ways to invest the endowment, there are many possibilities. The choice depends on the amount of money invested, the timeframe for the endowment or choice of endowment spending policy. The bigger the amount of the endowment, the more possibilities it opens, since big sums open access to investment previously unavailable. Also diversification can better be attained while keeping in mind the costs of investing. The timeframe of endowment and choice of spending policy are tied together. The timeframe of the endowment depends on how much of income do we drain each year and whether we use its “body”. The wisest spending policy would be to use only a part of the gains and reinvest in order to grow. This should however be decided in accordance with the means and goals of an organization.

As for investment vehicles, options are limitless, however many would be available only at higher sums and not for retail. Safest bets would be bonds. That’s what some foundations already own. Bonds are generally considered less risky form of investment and pay yearly coupon payments, which can be translated into the spendable income. The safest would be government bonds, however with interest rates as low as 1%, they would not provide enough of an income. Corporate bonds are a riskier possibility; however, they can provide a more attractive interest rate. Stocks are another option with a possibility of more upside but also downside. Stock picking and trading stocks might not be what a typical non-profit organization might have the necessary know-how to do. For example, they might use technical analysis for their trading activities or P/E models. [24, 25] Slovak stock market is underdeveloped and thus they would be trading probably bigger European markets or the US market. [26] However, it is more probable they will use mutual funds managed by some domestic or international manager. Their disadvantage is the management fees they charge. In fact, there was even a mutual fund dedicated to non-profit organizations created in 2003 called CharityFund managed by Tatra Asset management, however, it’s not available anymore. [7] A creation of a new such fund might be also a possibility to support creation of endowments in non-profit organizations in Slovakia, as it might provide easy way to invest, if it also kept fees low. However, as already mentioned, Dahiya and Yermack found that typical endowment in the US underperforms a 60-40 portfolio of equity and bond market indexes by about 4,46 percentage points. [11] Therefore, it might be wiser to shun stock picking and passively invest in market indexes, maybe even the 60-40 split suggested in their study. Pursuing this idea, a creation of an index fund aimed at Slovak non-profit organizations with the support of one of the big foundations supporting the non-profit sector giving it the proof of trustworthiness might be a right push to encourage Slovak non-profit organizations to invest. Another asset class non-profit organization might invest in is real estate. Whether commercial or residential, it might provide income through from renting it out and also might appreciate in value. Non-profit organizations functioning locally might have an added insight while investing in this type of assets and can also use these to fulfil their missions by being a sort of social entrepreneurs. Social entrepreneurship, socially responsible investing and impact investing might also be choices for an investment although we don’t see many non-profit organizations going that way because of the complexity.

There are also some disadvantages. First and foremost, with almost any investment, there is a risk of a loss – loss of the income generated but also of a part or the whole of principal invested. For non-profit organizations, such a loss might threaten its financial stability and

sustainability and also bring about an important reputational damage. Secondly, there are costs involved. Most of the investments mentioned have some costs either for the transaction or there are costs for the management of investments. These have to be taken into account too. They might be restrictive for non-profit organizations with smaller endowments, that's also why we proposed an establishment of a low-cost index fund for non-profit organizations.

Creation of such a fund might help keep costs low while letting the largest number of organizations to invest their capital in order to help sustainable fund their missions.

## 4 Conclusion

Non-profit organizations need funding for their operations in the same way as any other organizations. They need to pay their bills, salaries, purchase materials, services, etc. Because of their non-profit nature, the sources of financing for these costs are different. The aim of this paper was to look at the endowment of non-profit organizations and its investment as a source of non-profit financing and the current situation in Slovakia regarding it use. We found that the use of investing the endowment for self-financing of non-profit organizations is almost non-existent in conditions of Slovak non-profit sector. Further, we proposed a framework for possible use of the endowment as a source of funding for more non-profit organizations in order to improve the financial situation and sustainability of the non-profit sector. Limitation of our research might be its reliance on data only from foundations and not other types of non-profit organizations. However, we chose foundations due to the availability of data.

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