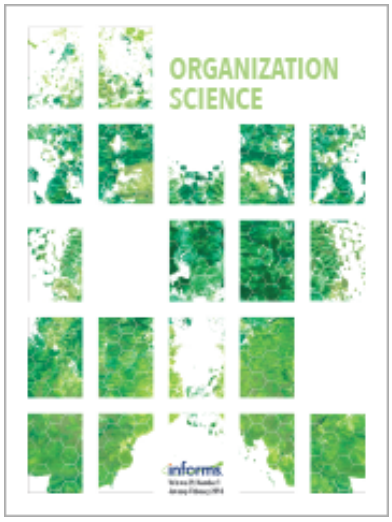

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When Funders Aren't Customers: Reputation Management and Capability Underinvestment in Multiaudience Organizations

David Keith,[a,*] Lauren Taylor,[b] James Paine,[a] Richard Weisbach,[a] Anthony Dowidowicz[a]

[a] Massachusetts Institute of Technology, Sloan School of Management, Cambridge, Massachusetts 02142; [b] Harvard University, Harvard Business School, Boston, Massachusetts 02163
*Corresponding author

Contact: dkeith@mit.edu, https://orcid.org/0000-0003-4938-0617 (DK); ltaylor@hbs.edu, https://orcid.org/0000-0002-9608-6878 (LT); jpaine@mit.edu, https://orcid.org/0000-0002-1945-8359 (JP); rweisbac@mit.edu (RW); dowidowi@mit.edu (AD)

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Abstract. In contrast with for-profit companies, many "multiaudience" organizations, such as universities, hospitals, and nonprofits, receive revenues not just from customers but from third-party funders. This distinction is most stark in donative nonprofits that receive all of their funding from noncustomers and have long been perceived to underperform because of persistent underinvestment in organizational capabilities. In this paper, we explore how the need to manage funder perceptions influences how managers allocate resources to investment in organizational capabilities versus programmatic spending. We develop a model of capability dynamics based on fieldwork with six nonprofit organizations that incorporates the mechanism of reputation management. We argue that difficulties communicating the impact of nonprofits to donors often leads managers to instead focus on the amount of work being done, creating a bias toward programmatic spending. Analyzing our model, we show that a capability tipping threshold exists: for nonprofits with low capabilities, it is boundedly rational for managers to underinvest in organizational capabilities in order to manage donor perceptions even when this practice is known to limit performance. Our findings suggest that building high-performance nonprofits requires coordinated action between managers and donors to allow capability investments to accumulate. Counterintuitively, deliberately restraining programmatic expenditure (i.e., serving fewer recipients) while the organization builds its capabilities may be the best strategy for nonprofits to achieve sustained high performance and impact in the long run.

Supplemental Material: The online appendix is available at https://doi.org/10.1287/orsc.2022.1579.

Keywords: field study • research design and methods • organizational capabilities • strategy and policy • computer simulations • decision making • organizational behavior • public management • multiaudience organizations

1. Introduction

Organizations research frequently features for-profit companies that generate revenues directly from the sale of goods and services to a customer, providing the channel through which market forces come to bear on organizational management. However, for many organizations, the source of revenues (or capital) is not customers, but third-party funders. Examples of such "multiaudience" organizations include startups seeking investment from venture capitalists, universities receiving donations from alumni, and nonprofit organizations reliant on philanthropic donors. In such organizations, managers must be responsive to two distinct audiences: customers (or recipients), who receive products and services and who are able to assess performance, and funders, who are able to provide resources. The result is that managerial attention is split between funders and customers with managers needing to communicate performance to funders who are unable to observe organizational performance directly.

Multiaudience organizations can be situated along a continuum. On one end are organizations that receive only ancillary funding from noncustomers, such as universities. On the other end, are organizations that receive all their funding from noncustomers, such as donative nonprofits, which is when the organizational consequences of managing for multiple audiences is most pronounced. Nonprofit organizations play a critical role in society, providing community services across a range of domains, such as healthcare, education, homelessness, and the arts and contributing more than 5% of GDP in the United States

(National Council of Nonprofits 2019a). And yet the management of nonprofits receives limited attention in the management literature, which is particularly curious considering the widespread perception that nonprofits systematically underperform relative to for-profit firms. The general public has a negative perception of nonprofits' basic managerial ability, viewing nonprofits as warm but not competent, whereas viewing for-profits as competent but not warm (Aaker et al. 2010). Recent survey data on the financial performance of nonprofits supports the stereotypes of nonprofits as managerially challenged, finding that approximately half of nonprofit organizations run chronic operating deficits, and more than 40% of human services nonprofits lack sufficient liquidity to meet their short-term financial obligations (Morris et al. 2018). Does the need to manage for multiple audiences explain this performance gap?

The organizations literature has long recognized that the build-up of organizational capabilities has a positive effect on organizational performance (e.g., Repenning and Sterman 2002b, Gibbons and Henderson 2011, Rahmandad et al. 2018). This insight is also well-understood in the nonprofit context. The nonprofit practitioner literature addresses the topic of "capacity building" at length, which the National Council of Nonprofits (2019b) defines as "…whatever is needed to bring a nonprofit to the next level of operational, programmatic, financial, or organizational maturity, so it may more effectively and efficiently advance its mission into the future. Capacity building is not a one-time effort to improve short-term effectiveness, but a continuous improvement strategy toward the creation of a sustainable and effective organization." The term "capacity" is, thus, synonymous with the use of the term "capabilities" in the organizations literature, so we use the term "capabilities" henceforth for parsimony except when referring specifically to literature that makes use of the term "capacity." Both the scholarly and practitioner nonprofit literatures emphasize that nonprofits need to make greater investments in capability building, even though it requires diverting funds away from serving clients, to building strong and sustainable organizations (Light 2004, Jared et al. 2014, Raynor et al. 2018). Despite this, many nonprofits continue to underinvest in capabilities; in Oliver Wyman's recent (nonrandom) survey of more than 150 U.S. nonprofits, "capacity-building and innovation costs" were identified as the number one challenge facing the human services sector (Morris et al. 2018).

In this paper, we seek to understand how the need to manage multiple audiences influences the ability of managers to make these capability investments and the subsequent performance of the organization. We develop a model of capability dynamics in the nonprofit context that builds on extant literatures in organizational studies and nonprofit management as well as observations from fieldwork with six donative nonprofits in the northeastern United States. We emphasize the role of reputation management in the patterns of behavior observed, closing the feedback that describes how organizational performance shapes funder perceptions, which determines resource availability and the performance of the organization subsequently. Using simulation, we show how this focus on reputation management leads managers to prioritize programmatic spending to demonstrate scale and keep the nonprofit's overhead ratio low, diverting resources away from capability building for which the benefits take time to accumulate. These dynamics create two stable equilibria representing sustained low and high performance, respectively, with a tipping boundary in between, which explains why nascent nonprofits with low capabilities frequently struggle to reach the high-performance equilibrium. Counterintuitively, we show that high performance is best achieved by providing fewer programs, at least temporarily, so that the organization can build up its stock of capabilities sufficiently to deliver high performance subsequently. Enabling this temporary reduction in programs implies the need for coordinated action between funders and organizations but ultimately results in higher capabilities and performance over the longer run. Our research extends the existing literature on organizational capabilities to the neglected problem of nonprofit underperformance, shedding light on the critical role of reputation management in donative nonprofits. In multiaudience organizations of various kinds, our analysis suggests a need for managers and funders to coordinate expectations and actions closely to build financially sustainable and high-performing nonprofit organizations.

2. Audience Management in Donative Nonprofits

In what has now become a seminal reference on nonprofit theory, Henry Hansmann's (2006) *The Role of Nonprofit Enterprise* defines a nonprofit organization as one that is barred from distributing its net earnings (pure profits) to individuals who exercise control over it. Most notably for the work presented here, he distinguishes between "donative" nonprofits, which receive most or all of their income in the form of grants or donations, and "commercial" nonprofits, which receive the bulk of their income from prices charged for services (e.g., hospitals and universities). Whereas commercial nonprofits are usually multiaudience organizations, donative nonprofits are the clearest example of the multiaudience form. Third parties are frequently individual donors, philanthropic and corporate foundations, and governments, who may provide resources

through donations or grants. Opportunities to raise funds from third-party funders can be rare, often limited to only a handful of significant fundraising events or grant windows, which makes the pressure on this type of multiaudience organization particularly acute.

2.1. Measuring and Communicating Performance

Whereas for-profit organizations have long operated with a straightforward profit-maximization objective, the objective of nonprofit organizations is contested, simultaneously seeking to serve those in need of services and satisfy donors. Nonprofit managers, therefore, face an ongoing challenge in measuring and communicating their own performance. Whereas the extent to which nonprofit funders reward achievement is the topic of prior study, a consensus on how to operationalize nonprofit performance remains elusive. Scholars highlight difficulty in assessing achievement with any certainty and objectivity in the nonprofit environment (Herman and Renz 1999) and researchers examining nonprofits from a resource-dependence view suggest that these challenges contribute to the gradual commercialization of the nonprofit sector (Froelich 1999, Malatesta and Smith 2014), defined as the selling of goods and services.

Conceptually, many academics and practitioners agree that nonprofit performance should be judged by assessing the total impact of the nonprofit's work, and impact would be measured by a multiple of the number of units of service provided (e.g., warm meals served) and the outcome achieved per unit of service (e.g., the health benefits of a nutritious diet) (Ebrahim 2010). However, operationally, nonprofits struggle to assess their work in this way because, whereas the number of units provided is highly observable, the outcome achieved per unit is difficult, if not impossible, to observe consistently (Lewin and Minton 1986, Saul 2004, Epstein and Buhovac 2009, Ebrahim 2010). Measurement challenges abound. First, many nonprofit investments carry potentially large spillover effects that are difficult to capture precisely. The impact of an additional year of schooling to the young girl's likelihood of going to college may be measurable in time, but the impact of that investment on lifetime wages, family planning, and self-confidence may be less so. Second, nonprofit organizations often pursue long-term change in individuals and communities, meaning that lengthy time delays can exist (in the order of years or even decades) between when effort is applied and when impacts are realized. Furthermore, it is difficult to imagine that a standardized metric for impact could work across the varied settings in which nonprofits operate from social and health services to education and development. Considering these challenges, nonprofit managers rely heavily on what they can observe—the number of units delivered—as a proxy for impact (Mitchell 2013). Visit the websites of most nonprofit organizations and you are greeted with a series of statistics about how many people have been served in the past year. This metric allows for clear, if incomplete, communication of performance to stakeholders and most notably donors.

The challenges nonprofits face in measuring impact render measurements of organizational efficiency especially thorny. Nonprofit managers would ideally capture and report "impact per dollar invested" in their organization. Lacking a clear impact measure, many nonprofits rely on what's called an "overhead ratio," calculated as the proportion of all revenue expended by the organization that is *not* spent on charitable goods, services, or programs (and it is trivial to calculate from every nonprofit's IRS form 990 "Return of Organization Exempt from Income Tax" across all sectors). Just as number of units delivered is an imperfect proxy for impact, the overhead ratio is widely acknowledged to be an imperfect proxy for organizational efficiency. Nevertheless, it has become a near-universal indicator in nonprofit evaluation reports and a key construct in third-party rating systems of the "best" nonprofits to which to donate (Bowman 2006, Krause et al. 2019). Rough guidelines often set a desirable overhead ratio as under 10%.

Widespread reliance on such an imperfect performance metric is consistent with a long line of institutional theory research within and beyond the nonprofit sector. This research indicates that resource providers financially reward organizations for symbolic behavior, such as adherence to imperfect performance measures that conform to prevailing managerial rules and norms (DiMaggio and Powell 1983, Liebschutz 1992, Alexander 2000). In other words, nonprofit firms may be motivated to attend to what donors expect because donors are the providers of resources to ensure continued viability (Moore 2000).

Nonprofit managers often lament that their work is undervalued because of these measurement challenges and that their real impacts are more extensive than can be calculated (Torjman 1999, Glasrud 2001, Gugerty and Karlan 2018). In the eyes of funders, claims such as these can be motivated more out of a desire for funding than genuine concern over underestimation of impact. Yet funders are in no better position to ascertain the actual impact per unit of the nonprofit's work because they are not the recipient of a nonprofit's products or services. Moreover, the ability to accurately measure performance according to any metrics requires investment in capabilities, including not only staff time but often information technology.

2.2. Capability Building

The repeated findings in the management literature that capability investment improves organizational performance has penetrated the nonprofit sector and

manifests in frequent practitioner conversations about the need to invest in capacity. We adopt the definition of capacity introduced by Eisinger (2002) as "a set of attributes that help or enable an organization to fulfill its mission." In a national study of community development corporations, Glickman and Servon (1998) outline five major components of nonprofit capacity: resources; organizational factors, such as effective leadership; an external helping network; specialized skills; and political resources. Whereas an awareness of organizational capabilities penetrates discussions of nonprofit management (Silverman and Taliento 2006, Jared et al. 2014, Le 2019), many nonprofits continue to find it difficult to act on the clear evidence that capability building could yield performance gains for their organization.

Several models are proposed in the practitioner literature to account for this inability to invest in capacity. One prominent nonprofit advocate described what he calls the "capacity paradox," in which nonprofit managers need capacity-building funding in order to invest in capacity, but many funders want to see strong program outcome data *before* they provide such general operating support (Le 2014). Such a catch-22 ultimately makes capacity building seem impossible. Attempts to invest in human resources can lead to a similarly frustrating and self-perpetuating cycle. A consultant report describes how nonprofits struggle to attract new staff because of under-compensation and overstretching; the inability to attract new staff further stresses existing staff and results in higher turnover; higher turnover erodes "institutional memory" and adversely impacts organizations' long-term financial stability, and the cycle repeats (Morris and Roberts 2018). Other consultants describe a "nonprofit starvation cycle" wherein nonprofits underreport their true expenses in an effort to appear efficient in the eyes of funders, funds underpay in an effort to extract additional efficiencies, and the nonprofit finds itself trapped in a cycle of unrealistic expectations (Goggins Gregory and Howard 2009). Each of these accounts contains insight but fails to systematically account for the full breadth and depth of the capability-investment challenges faced by nonprofits. In most cases, these authors suggest that nonprofit managers, donors, or some combination thereof misperceive the true amount of capacity investment required for success.

3. Methods

We used simulation modeling informed by qualitative field research to develop theory about nonprofit capability dynamics, capturing the endogeneity that exists between organizational performance, resource availability from funders, and managerial decision making. We began by consulting the extant academic literature on nonprofit organizations, including reviews of available papers in management and nonprofit journals (e.g., *Voluntas*, *Nonprofit and Voluntary Sector Quarterly*), gray literature from think tanks (e.g., Center for Effective Philanthropy, Urban Institute), and relevant periodicals (e.g., *Stanford Social Innovation Review*) for insights on the challenges of nonprofit management. Having observed clear guidance regarding the need for investment in nonprofit capabilities, but no analysis of why many organizations have not acted on this advice, we sought to clarify our understanding of these issues through empirical observation and qualitative analysis of donative nonprofits in action.

3.1. Field Site Selection

We designed a plan for qualitative field research in a set of six donative nonprofit organizations, believing that the study of these types of organizations would present the clearest examples of how the pressures that multiaudience organizations face manifest. Whereas commercial nonprofits (e.g., universities, hospitals) are also on the continuum of multiaudience organizations and subject to some of the same organizational challenges, their reliance on what are ostensibly business transactions to generate funding leave them more closely resembling for-profit businesses when it comes to capability investments.

The six nonprofit organizations we studied were selected to be deliberately diverse in terms of size and sector. They ranged from $2M to more than $50M annual budget and 10 to 500 employees. Three of the six were focused on poverty alleviation, offering a suite of government and organization-specific programs for children, individuals, and families facing social challenges related to housing, food access, and work. These organizations represented the "core" of the nonprofit sector, insomuch as they provide charitable goods and services for which there is no viable market. The balance are two organizations focused on improving education and one in media broadcasting.

3.2. Data Collection

Table 1 summarizes the details on each of the nonprofit organizations selected for our qualitative field study. The identity of each organization is concealed as per our institutional human subjects' approval.

For each nonprofit site, our fieldwork included a combination of semistructured interviews involving two to four members of our research team and a review of relevant documents. Interviews were conducted predominantly in person at a time and place convenient to the interviewee and lasted between 30 and 60 minutes. Following a discussion and confirmation of informed consent, the research team relied on a six-question, open-ended interview guide, augmented with more specific questions to guide the

Table 1. Summary of Field Sites

	Description	2017 annual budget[a]	Full-time employees[a]	Document review	Senior staff interviews conducted	Site visit
Site 1	Education	$5M–$10M	10–50	Tax filings, Charity Navigator, fundraising materials	2	Yes
Site 2	Multiservice poverty organization (housing, education, job training)	$1M–$5M	100–500	Tax filings, Charity Navigator, strategic plan, annual report, communications with community, job postings	3	Yes
Site 3	Media	$25M–$50M	100–500	Tax filings, Charity Navigator, annual reports	2	Yes
Site 4	Multiservice poverty organization	$1M–$5M	10–50	Tax filings, Charity Navigator	4	Yes
Site 5	Early childhood education	$1M–$5M	10–50	Tax filings, Charity Navigator	*N/A*	No
Site 6	Multiservice poverty organization (food pantry, housing assistance)	$1M–$5M	10–50	Tax filings, Charity Navigator, strategic plan	3	No

[a]Collected from public document IRS form 990.

discussion (see Section S1 of the Online Appendix that accompanies this article for a sample interview guide and details on the interview protocol). Researchers requested permission to audio-record conversations to enable verbatim transcription. In all but one case, interviewees agreed. Documents reviewed included publicly available 990 IRS tax filings and Charity Navigator ratings as well as site-supplied organizational charts, strategic plans, and fundraising materials. When possible, members of the research team also visited the organization and observed how staff and clients interacted with one another and their physical space. In some instances, standard data collection was augmented with discussions with board members and attendance of community meetings.

We relied on an inductive analytic process of data gathered through fieldwork (Miles and Huberman 1984). All coauthors read all interview transcripts, which were professionally transcribed, and reviewed all notes and documents collected. In so doing, each researcher independently developed a set of annotations and reflections that formed the basis for group discussion. We did so using a grounded theory approach without any particular guiding frameworks or taxonomies in mind. The research team then met to combine these annotations and reflections into an initial set of open codes that captured key ideas. The codes included the following: (1) capability building; (2) endowment or reserve; (3) flexible, general operating dollars; (4) fundraising; (5) scope of organization; (6) metrics and measurement; (7) moral imperative to do more; (8) observability of results; (9) nonprofit mission; (10) overhead; and (11) scaling and growth. These code as well as the illustrative quotes that gave rise to them form the basis of the model we develop, which we describe in the following section.

4. Model

We build our model in a manner consistent with previous treatments of organizational capability building and managerial decision making in a for-profit context. Specifically, we build on top of the capability dynamics models developed by Rahmandad et al. (2018) and Repenning and Sterman (2002b). However, these existing models assume resource availability to be exogenous, which is a critical limitation for the multiaudience context in which the availability of resources is a critical influence on managerial decision making. Here, we introduce our core model of capability dynamics consistent with prior work and then extend it to endogenize resource availability through the mechanism of reputation management.

4.1. Investment in Organizational Capabilities

Managing the trade-offs between achieving programmatic goals in the short term and maintaining organizational capabilities in the long term was a key consideration for management at all the nonprofits we visited. We model organization capability, C, as a stock variable that cannot be directly influenced by managerial action (Dierickx et al. 1989, Rahmandad et al. 2018). Instead, managers in this space can only affect the rate of change of this stock via the decisions they make vis-à-vis spending organizational effort and resources on either direct performance outcomes or investing in organizational capability. The rate of change is influenced by two flows, growth resulting from investment and decline resulting from natural erosion over time:

$$\frac{dC}{dt} = e_c\rho - C\tau. \quad (1)$$

In the equation, the first term is the product of the resources the organization invests in building capability,

e_C, and the efficiency of converting those resources into stock of capability, ρ. The second term is the erosion of the capability stock over a given time constant τ.

We model that the management of the firm has the choice of allocating available firm resources either directly toward serving the mission of the organization, which we describe as programs, or toward building the stock of capability. We define the level of resources available to the firm at a given time as h and the fraction of those resources dedicated toward programs as u:

$$e_P = uh,\ e_c = (1-u)h. \tag{2}$$

Performance is calculated as a constant returns to scale Cobb–Douglas expression of the stock of capability, C, and the resources currently being dedicated to generating performance, e_P:

$$P = C^{\beta} e_P^{(1-\beta)}. \tag{3}$$

For any constant values of resource efficiency ρ and capability erosion time constant τ, the allocation value u must be equal to $(1-\beta)$ under steady-state conditions. We define this specific allocation as u^*:

$$u^* = (1-\beta). \tag{4}$$

From this, we can also determine the steady-state value of the stock of capability, which is equal to the expected capability given the values of ρ, τ, h, and β:

$$C^* = (1-u^*)h\rho\tau. \tag{5}$$

Furthermore, given the steady-state value of the stock of capability C^* and steady-state allocation u^*, the steady-state performance of the firm is known:

$$P^* = P(u^*, C^*) = C^{*\beta} e_P^{*(1-\beta)},$$
$$\text{where } e_P^* = u^* h_0. \tag{6}$$

We further assume that the environment in which the firm operates has an expectation of performance based on knowledge of the steady-state allocation of resources u^* and expected firm capability C^*. This expected or target performance, under steady-state conditions, is defined as

$$P_0^T = P^*. \tag{7}$$

We define the firm's *performance ratio* as the ratio of the firm's expected actual performance of the firm relative to the target or expected value under no shocks and expected allocation u^*. Values of this ratio below one imply the firm is performing at a level below the expectations of its environment and will, in turn, pressure managers to allocate more resources toward performance-related activities:

$$PR = \frac{P^*}{P^T}. \tag{13}$$

Critical to the behavior of this model is how managers allocate resources between programs and building capability. We conceptualize that managers operate along a spectrum of short- and long-term-focused behavior and define a variable γ to control this focus between the two extremes. We combine both the long- and short-term managerial perspectives given into a single decision expression, which uses γ to vary from purely long-term decision making (at $\gamma = 0$) and purely short-term (at $\gamma = 1/(1-\beta)$). Under this decision rule, managers adjust their performance to match both needed long-term capacity building and short-term performance relative to the factors that are externally observable:

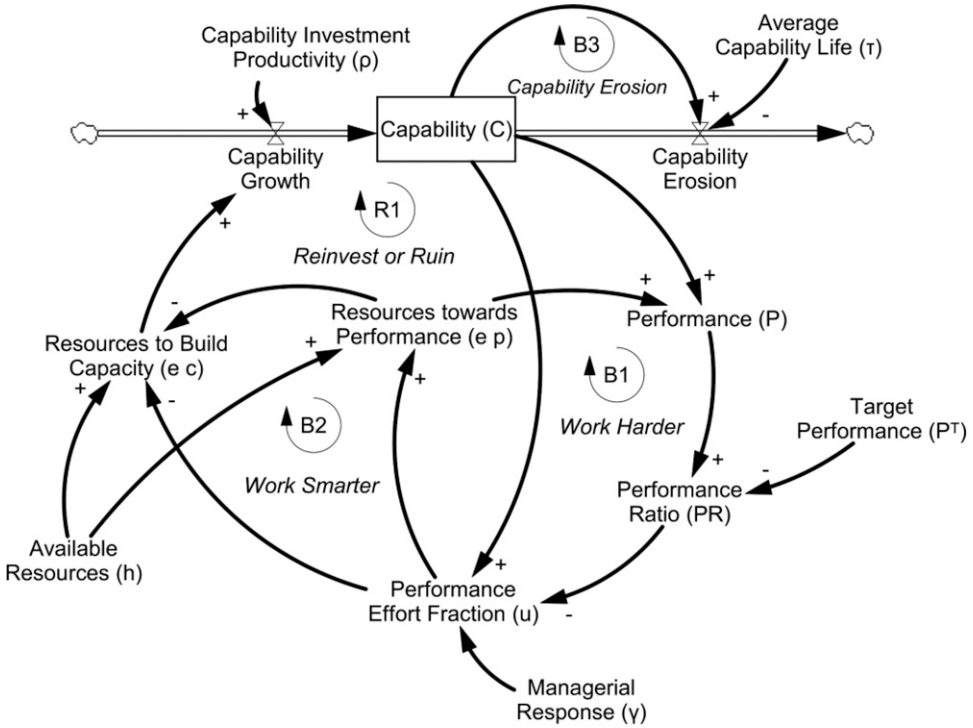
$$u = Min\left(1, u^*\left(\frac{P^T}{P^*}\right)^{\gamma}\left(\frac{C}{C^*}\right)^{1+\gamma(\beta-1)}\right). \tag{7}$$

Combining this series of expressions gives a general model of firm performance consistent with previous models of decision making under performance shortfalls, summarized in the causal loop diagram (Sterman 2000) shown in Figure 1.

Figure 1 captures the decision that managers face regarding how to allocate resources when faced with a gap between actual performance and their target performance. When facing a shortfall in performance, the organization can allocate more resources to programs (e.g., increasing the scale or scope of existing programs) or to develop capability (e.g., improving processes to increase the effectiveness of existing programs) with the managerial response parameter (γ) determining the sensitivity of the manager toward either action. Both these actions serve to close the gap between performance and target performance. However, whereas committing more resources toward performance has an immediate impact (balancing loop B1 *work harder* in Figure 1), time delays exist between committing more resources to building capability (e.g., investing in the development of new IT systems) and the realization of improved performance (balancing loop B2 *work smarter* in Figure 1). It is for this reason that managers tend to favor working harder over smarter when facing performance pressure with critical implications for the long-term performance of the firm. Previous research illuminates a tipping-point dynamic in which insufficient investment in organizational capability causes the efforts of the firm to become successively less effective at delivering performance as its capability erodes. Once the firm falls below a critical level of capability, it gets caught in a "capability trap" in which it is unable to prevent a collapse in performance even as the organization works harder and harder (Repenning and Sterman 2002a).

As ubiquitous as these pressures are across all organizational forms, our fieldwork suggests that various reasons exist to suggest that these dynamics may be further exacerbated in the nonprofit context. The existence of unlimited demand for services ensures

Figure 1. Base Model of Organization Capability Building



that target performance is always higher than current performance, keeping the performance ratio below one. And multiple mechanisms push nonprofits to prioritize programmatic spending, including earmarked funds that explicitly prevent investing in capabilities, overreliance on overhead as a performance metric, discouraging nonprogrammatic spending, and a moral imperative to deliver assistance to vulnerable populations as quickly as possible.

4.2. Measuring Performance

Whereas the reliance of donors on overhead ratios has been criticized as short sighted, we observed nonprofit managers to have largely internalized this logic: "I think when you're donating to an organization and you look online and what are good organizations to donate to and you get the information. Well, you want to look for an organization that's been 80% of what you're giving to the programs and people that they're serving. And less on themselves" (site 4).

Other nonprofit managers maligned funders' reliance on overhead, arguing that overhead gives little indication of quality and forces nonprofits to make investment choices that would be absurd in other sectors. Underscoring how efforts to keep overhead low can become absurd, a nonprofit senior team member asked, "Would they expect a pizza place to make their pizza without electricity?" (site 4). Empirical analyses support this manager's intuition, finding overhead ratios to be poor proxies of performance and unreliably correlated to fundraising success (Frumkin and Kim 2001).

Nevertheless, overhead persists as an almost universally reported metric in the nonprofit sector with most organizations feeling the need to report overhead on websites and annual reports, and nonprofit watchdog organizations using it as a critical input to summary ratings. In the words of one donor relations manager, "It's hard to run things on such a lean budget and then be so effective. The whole argument of, should you really be donating to the charity that has the least overhead cost, because are they really being effective for that? But it is still something that's very much out there for people to pay attention to" (site 4).

A "standard" overhead rate in the nonprofit sector is benchmarked between 3% and 15% of all spending (Saber 2015), and recent analyses find that organizations that appear inefficient in overhead ratios receive less donor support (Greenlee and Brown 1999, Jacobs and Marudas 2009). The focus on overhead persists in spite of recent work showing overhead to be negatively correlated with other measures of organizational efficiency (Coupet and Berrett 2019). The persistence of overhead ratios in spite of this evidence illustrates DiMaggio and Powell's (1983) insight that institutions within a field use rationalized myths to convey legitimacy even when the myth is inaccurate and some nonprofit leaders view overhead minimization directly as a management outcome (Mitchell 2013).

As overhead rate is a proxy for resource efficiency, we introduce it in our model as the ratio of resource expenditure on capability building (or really any expenditure on non–performance-related activities) to total resource expenditure:

$$OHR = \frac{e_C}{e_C + e_P}. \tag{8}$$

However, whereas performance ratio is measured relative to an external expectation (and, thus, is easily comparable across firms by funders), the overhead ratio is relative to the firm itself. Therefore, we consider the relative overhead ratio as the overhead ratio relative to some expectation of resource allocation. From our research and case studies, this is a reasonable assumption as different types of nonprofit work have different expected overhead rates from funders.

We define a *relative overhead rate* OHR_R that scales in the same manner and direction as the performance ratio. It has a value of one when overhead spending matches the expected overhead rate OHR_E. It has a value greater than one when overhead spending is *less* than expected and a value less than one when overhead spending is *greater* than expected:

$$OHR_R = 1 - OHR + OHR_E. \tag{9}$$

The expressions for performance ratio and relative overhead rate can now be combined to create the indicated reputation R_I. We further assume that not all funders update their perception of a firm's reputation equally based on performance or overhead. We introduce a variable λ, varying between zero and one, to control the relative importance of overhead versus performance for funders. Higher values of λ indicate that funders place more emphasis on the performance outcomes of the firms they are funding (as opposed to its overhead ratio):

$$R_I = (PR^{\lambda})\left(OHR_R^{(1-\lambda)}\right). \tag{10}$$

4.3. Endogenizing Resource Availability: Reputation's Impact on Available Resources

Throughout our conversations with organizations, it was consistently apparent that the managers we spoke to made decisions not only based on the internal needs of the firm, but also based on how those decision would *appear* to external funders. This is a necessary consideration because external third parties ultimately determine the resources available to the firm and who are usually making investment decisions in the absence of objective performance measures. We label this as "reputation management" and view the role of the manager in a donative nonprofit as managing the overall performance of the organization and the reputation of the organization simultaneously.

These managers described their organization's reputation as a function of both their observable effort toward performance and maintaining low overhead ratios. This reputation management is seen to be a fact of life for nonprofit managers who perceive pressure from donors to see "scale" in nonprofit operations and because of how ubiquitously reported and relied upon overhead measures are. This focus on reputation management can lead some nonprofits to prospectively consider how funders will perceive their financial statements when making decisions about when monies can be spent: "These are the crazy things you have to think of. You have too much cash on your books. If you look too rich when you go to apply for a grant, you [look like] don't need a grant. I've had people say that" (site 4).

The director of finance echoed this concern: "When we show financials to donors, they don't want to see that we have money sitting over here [in reserve]. So it's kind of a double-edged sword there. We need [the money], but it's hard to show that to donors. Because then they think … 'Oh, they're rich, they're wealthy, they're organized, they don't need us.' And so they'll go somewhere else" (site 4).

Several other managers agreed with this senior leader's sense that the way an organization "looked" in the eyes of funders was of paramount importance. One executive director highlighted how this focus on funders was inconsistent with the organization's stated mission: "Nonprofits in general … if you think about who are we accountable to, we are consistently I think getting it wrong because our accountability should be to the people we're trying to work with. And yet we demonstrate our impact to our funders" (site 2).

Some high-performing nonprofits aggressively manage their reputation in such a way that donors were sufficiently impressed with the organization's performance that they were able to overcome biases about higher-than-standard overhead numbers. We observed nonprofits that had constructed dashboards and indices of firm-specific metrics in order to court individual donors who were more flexible in how they judged performance and less interested in making systematic comparisons of impact across a portfolio of donations. This finding is keeping with the Urban Institute's five-year nonprofit overhead cost study (The Urban Institute et al. 2004), which demonstrates that nonprofit organizations are gaming overhead numbers in deleterious ways in order to meet donor expectations.

What is clear from this is that the resources a donative nonprofit has available are not exogenous but rather endogenously influenced by the decisions of the nonprofit manager. We, therefore, extend our base formulation to recognize that the concept of available

resources, represented by parameter h in Expression (2), is endogenous, influenced by the reputation of the organization as perceived by donors:

$$h = h_0 R. \tag{11}$$

Reputation is not directly controlled by the firm itself but rather by the perceptions of the funders. As such, reputation builds and depletes over time as a function of the actions of the firm, delayed by the typical time for the funding community to internalize new information about firm performance and allocation decisions. As such, we model reputation as an information state variable whose value changes to match the actual value expected by the actions of the firm over some delay.

We name the state variable (the instantaneous value of the reputation as viewed by the funders) as the *recent reputation* R and the value indicated by the actual performance of the firm as the *indicated reputation* R_I. The gap between the recent reputation and the indicated reputation updates over some average time constant κ:

$$\frac{dR}{dt} = \frac{R_I - R}{\kappa}. \tag{12}$$

From our conversations, we identified two major contributions to the availability of resources for firms operating in this environment: performance and resource efficiency. Performance itself can be a function of the quality of services provided and the scale of operations. We abstract away from the specifics of modeling quality of services (which is hard to observe by both the environment and funders) and assume scale of operations proportional to resources expended.

Under steady state, both the indicated and recent reputations have values of one. By combining the expression for indicated reputation with those for this steady state, we can show that the expected overhead ratio is exactly equal to the Cobb–Douglas coefficient in the expression for performance P from earlier:

$$OHE_E = \beta. \tag{14}$$

By inspection of the definition of performance given, we see that β is the relative weight of the stock of capability in determining performance given a specific resource expenditure. Therefore, this result that the expected overhead ratio from funders is β is expected.

Adding these formulations for performance measurement and reputation management to our base model, we get the full model of nonprofit capability dynamics shown in Figure 2.

5. Analysis

We begin by considering the growth trajectories of new organizations that begin life with minimal reputation and organizational capabilities, recognizing that, for the case of nonprofits, these organizations may struggle to ever grow meaningfully. Unless otherwise stated, the simulations shown use the reference parameter values shown in Table 2 with h_0 chosen so that the firm is in a stable and high-performing equilibrium when both reputation and capability have values of one.

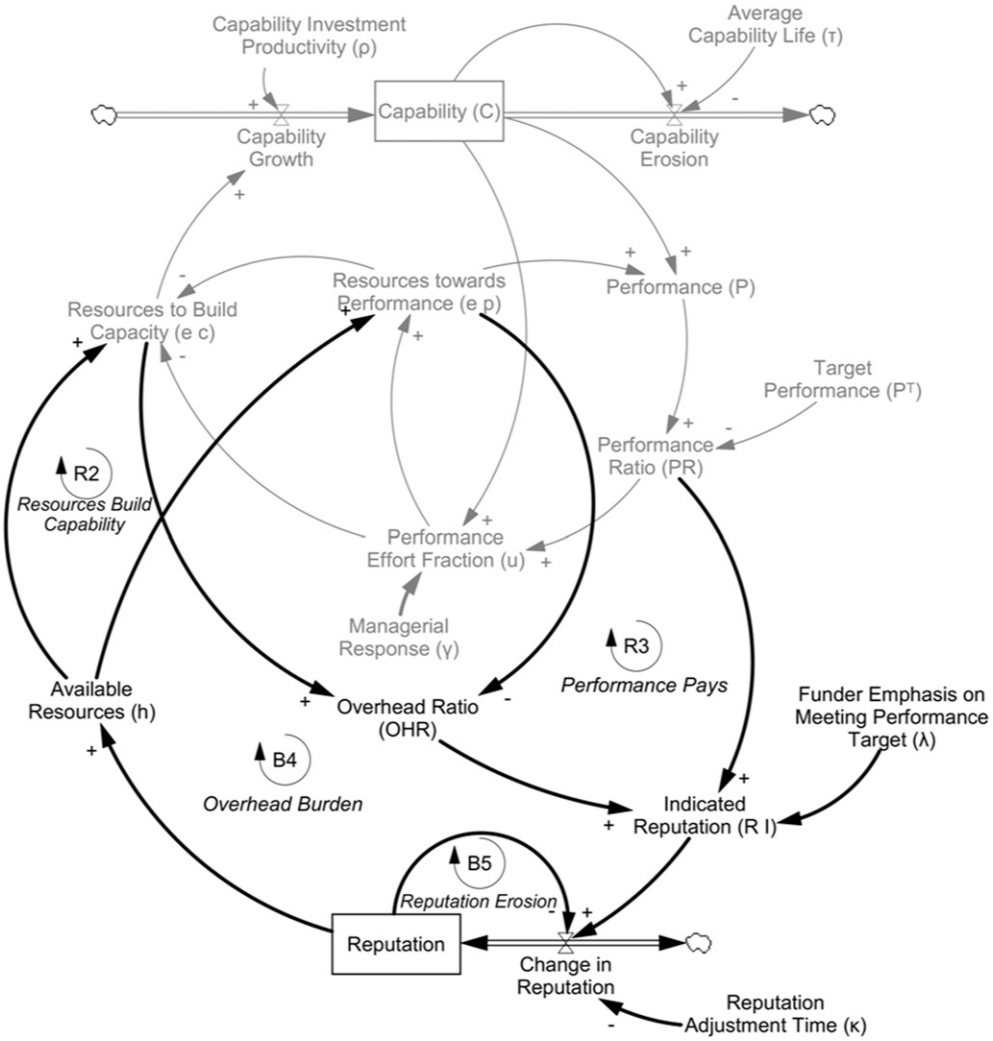
In addition to the analyses presented, we provide details on running the full model in the online appendix along with details on how to reproduce all analyses and figures.

5.1. The Challenge of Building Capabilities for New Organizations

We begin by considering the growth of a newly formed multiaudience organization that begins life with low reputation and organizational capabilities and receives an initial investment of resources to build the organization. Because the firm is unable to directly control reputation as perceived by funders, we assume that this initial investment can only be applied to influence the capability of the organization, represented as an exogenous investment into the stock of capability for a limited period. We simulate how the organization's capability, reputation, and performance evolve over time following the introduction of three alternative capability investments: a *low* investment by which start-up capability investment is provided for six months, a *medium* investment by which start-up investment is provided for 12 months, and a *high* investment by which start-up investment is provided for 18 months (Table 3).

Figure 3 illustrates how these different levels of initial investment generate distinct patterns of behavior over time. With the low capability investment, capability falls as soon as the initial investment ends (Figure 3(a)), and reputation continues to rise temporarily before falling toward zero (Figure 3(b)) as the organization fails. We use the term "failing" to mean persistently low-performing organizations following Meyer and Zucker (1989), who use the term to describe organizations struggling in the face of conflicting expectations and demands from stakeholders in spite of managerial efforts. Because the organization only reaches a modest level of performance when the initial investment ends (Figure 3(c)), the pressure to perform leads managers to commit more resources to programs (balancing loop B1 *work harder* in Figure 1). This allocation of resources has the effect of both increasing performance and reducing overhead ratio, leading to continued growth in the organization's reputation and eliciting more resources. However, the failure to adequately allocate resources to capability building leads to the rapid erosion of the capability stock, resulting in the terminal decline of the organization's performance (reinforcing loop R1 *reinvest or ruin*

Figure 2. Full Model of Nonprofit Capability Building with Reputation Management



in Figure 1). Whereas the medium investment ultimately yields the same as with the low investment—the failure of the organization—we see that the organization remains in operation and maintains a relatively high reputation for an intermediate amount of time in this case. This is because, having accumulated a higher level of capability initially, the organization is able to sustain its performance for some period of time by committing relatively more resources to programs to compensate for steadily declining capability. It is only in the case of the high initial capability investment that we see the organization able to build its stock of capability over time and achieve sustained high performance. This is because the high initial investment allows the organization to build its stock of capability sufficiently that it closes the performance gap and is able to commit significant further resources to develop capability (balancing loop B2 *work smarter* in Figure 1), leading to a virtuous cycle of high performance and reputation, plentiful resources, and continued capability reinvestment (reinforcing loop R1 *reinvest or ruin* in Figure 1).

5.2. Tipping Points in the Operating Environment

The simulations we show highlight the challenges that new multiaudience organizations face in growing from a place of low reputation and capabilities. However, we can readily extend this analysis to a firm regardless of current levels of reputation and capability. Because the model has only two state variables, or stocks, we can construct a two-dimensional phase plot that summarizes the rate of change of the organization's reputation and capability for every value of those stocks (Figure 4(a)) along the level of performance achieved given those values (Figure 4(b)).

Figure 4 illustrates two stable equilibria represented with black dots at (0, 0) and (1, 1), separated by a ridge (dashed line). Flow lines indicate how the system behaves from each point. The ridge simply represents the boundary that separates values of reputation and

Table 2. Summary of Model Parameters

Parameter	Name	Description	Base value
ρ	Capability investment productivity	Productivity of resources allocated to capability growth. Its value only scales the results.	0.05
τ	Average capability life	Time for capability to erode. Depending on the type of capability and firm, this can be from a few months to a few years.	12 months
β	Firm's typical overhead ratio	The constant return to scale capability building Cobb–Douglas coefficient. This ultimately is equal to the expected overhead ratio for the firm in its industry.	0.5
γ	Managerial response	Value determines how short-term focused the manager of the firm is. Given the value of β and Expression (7), the value can vary between zero (totally long-term focused) and two (totally short-term focused).	1.5
κ	Reputation adjustment time	Time for funders to update their view of the reputation of the firm. Depending on the firm and nonprofit industry, this can vary from a few months to a year or more.	6 months
λ	Funder emphasis on meeting performance target	The constant return to scale reputation building Cobb–Douglas coefficient. Value determines degree to which the funders emphasize meeting performance targets versus overhead targets in determining the firm's reputation. Varies between zero (totally overhead focused) and one (totally performance focused).	0.5
h_0	Exogenous or baseline firm resources	The amount of resources available to a firm with reputation of one per time period. The value chosen only scales the output. The base value was chosen here to ensure that meeting the performance target corresponds to a capability of one and a reputation of one.	3.33 resources

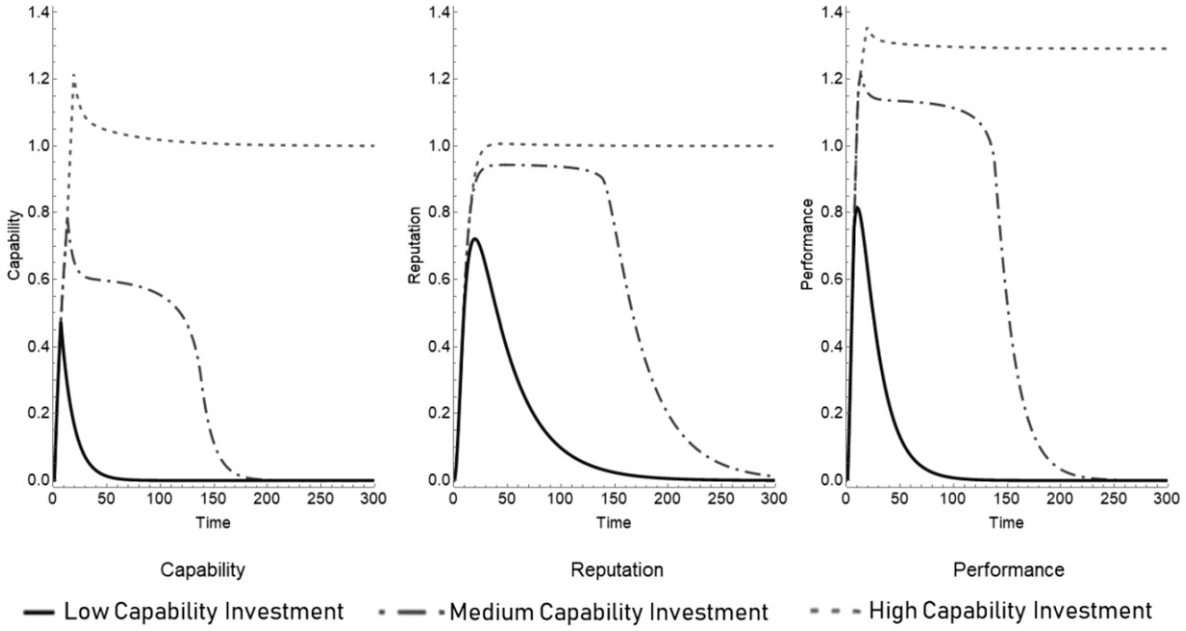
capability that evolve to either stable equilibrium. For low levels of reputation and/or capability (below the ridge), the system always reverts to (0, 0), representing organizational failure. This is because managers' perception of a performance gap encourages them to commit more resources to programs, "spending" their capability to temporarily sustain their reputation. If, however, the nonprofit is able to find its way to the upper side of the ridge, these same mechanisms drive the organization to the stable high-performance equilibrium at (1, 1). Above this threshold, and for reputation levels less than one, the performance is still below target performance, so managers commit more resources to programs, leading to a modest reduction in capability and an increase in performance and reputation. Above the threshold and for reputation levels greater than one, the organization's strong reputation generates ample resources from donors, allowing for high performance and investment in capability, increasing the organization's performance but perversely decreasing its reputation at the margin (because of an increased overhead ratio).

In Figure 5(a), we show how the policies we simulate in Section 5.1 map onto this phase plot. Here, we see that the low and medium investments are insufficient to lift over the threshold with the firm's state tending back to (0, 0) once the initial investment ends and the organization diverts resources away from investing in capability. The high investment, in contrast, builds a highly capable organization that is able to close a modest performance gap by diverting more resources to programs once the initial capability investment ends. The importance of managerial willingness to invest in capability for the long-run performance of the organization is further emphasized in Figure 5(b), in which we simulate a scenario in which managers are relatively more willing to commit resources to build capability when faced with a performance gap (achieved in the model by reducing the value of γ from 1.5 to 1.2). Here, we see that, whereas the two stable

Table 3. Scenario Parameters: Exogenous Capability Investment

	Low capability investment	Medium capability investment	High capability investment
Initial capability (C0)	0.001	0.001	0.001
Initial reputation (R0)	0.001	0.001	0.001
Size of investment	0.1/month	0.1/month	0.1/month
Start of investment	Month 1	Month 1	Month 1
Length of investment	6 months	12 months	18 months

Figure 3. Evolution of Capability and Reputation with Different Capability Investments



equilibria remain in the same locations, the ridge that separates success and failure moves downward significantly with lower levels of capability needed to cross the ridge and achieve long-term organizational stability. This is because, with greater willingness to work smarter, the nonprofit is willing to commit resources to capability building at lower levels of performance. For the same initial capability investments, we now see that the medium initial capability investment is sufficient to help the organization achieve the high stable equilibrium and target level of performance. This shifting in the ridge separating the stable equilibria, while leaving the equilibria themselves unchanged, is consistent for all feasible values of γ (here, $0 \le \gamma \le 2$ given the value of β). The online appendix illustrates this in more detail.

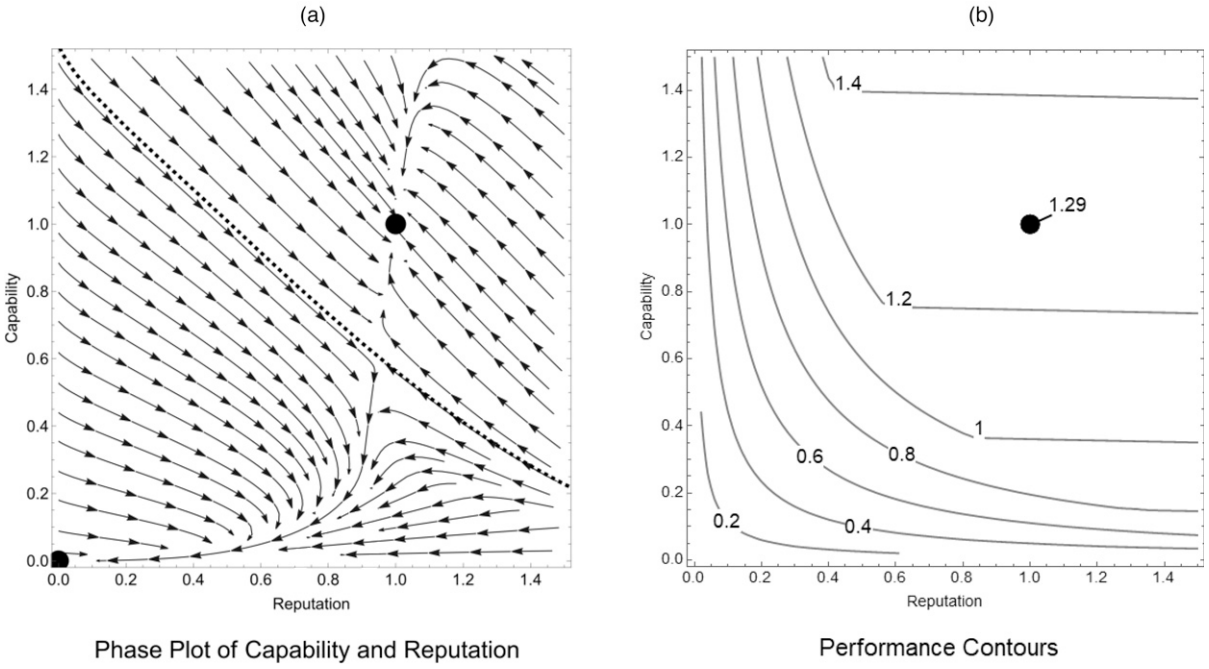
When applied to nonprofit organizations, this analysis reinforces that, although substantial barriers remain to the growth of sustaining nonprofit organizations, greater managerial willingness to invest in capabilities substantially helps the growth of nonprofit organizations even when funders have a preference for low overhead ratios that discourage capability investments.

5.3. The Paradox of Funders' Prioritization of Performance over Overhead

In response to the pressures that nonprofit managers face in building and sustaining high-performance organizations, it is increasingly suggested that donors should worry less about overhead ratios and focus more on the organization's ability to deliver against its aims (Goggins Gregory 2013, Lecy and Searing 2015, Taylor et al. 2015). This argument seems appealing given the capability dynamics we observe if a decreased emphasis on overhead empowers managers to make greater investments in capability.

Simulation of this scenario in our model, however, points to an unintended consequence of prioritizing performance that has not been appreciated by academics or practitioners previously. In Figure 6, we show the system phase plot when model parameter $\lambda = 0.7$ so that funders place more emphasis on performance than overhead ratio in the way that they perceive the firm's reputation. Here, we see in Figure 6(b) that the high stable equilibrium has moved upward (relative to the reference parameterization shown again for comparison in Figure 6(a)) as expected. This is because with decreased emphasis on overhead ratio, the organization's reputation suffers less when it commits resources to build capability, leading to an increase in available resources and, ultimately, higher performance. However, paradoxically, we see that the ridge between success and failure is now substantially higher, meaning that higher levels of capability and/or reputation are needed to cross this threshold and achieve sustained high performance. This raising of the threshold comes about because the prioritization of performance over overhead ratio hurts rather than helps emerging nonprofits who have only been able to grow to a low or moderate level of performance. This stretching of the space separating the stable equilibria, which affects the ridge separating these points and the position of the upper equilibrium point itself, is consistent for all feasible values of λ as we show in the online appendix.

Figure 4. System Phase Plot (Reference Parameters)



5.4. When Less Is More: Building Capability Before Increasing Expectations

Our analysis highlights just how difficult it is for these organizations to build sustaining levels of organizational capabilities from an initially low level given their boundedly rational (i.e., rational from a short-term perspective) decision making in the donative fundraising environment. However, these pressures persist even for nonprofits operating at a high and stable level of performance. How, then, can such organizations continue to grow their performance over time?

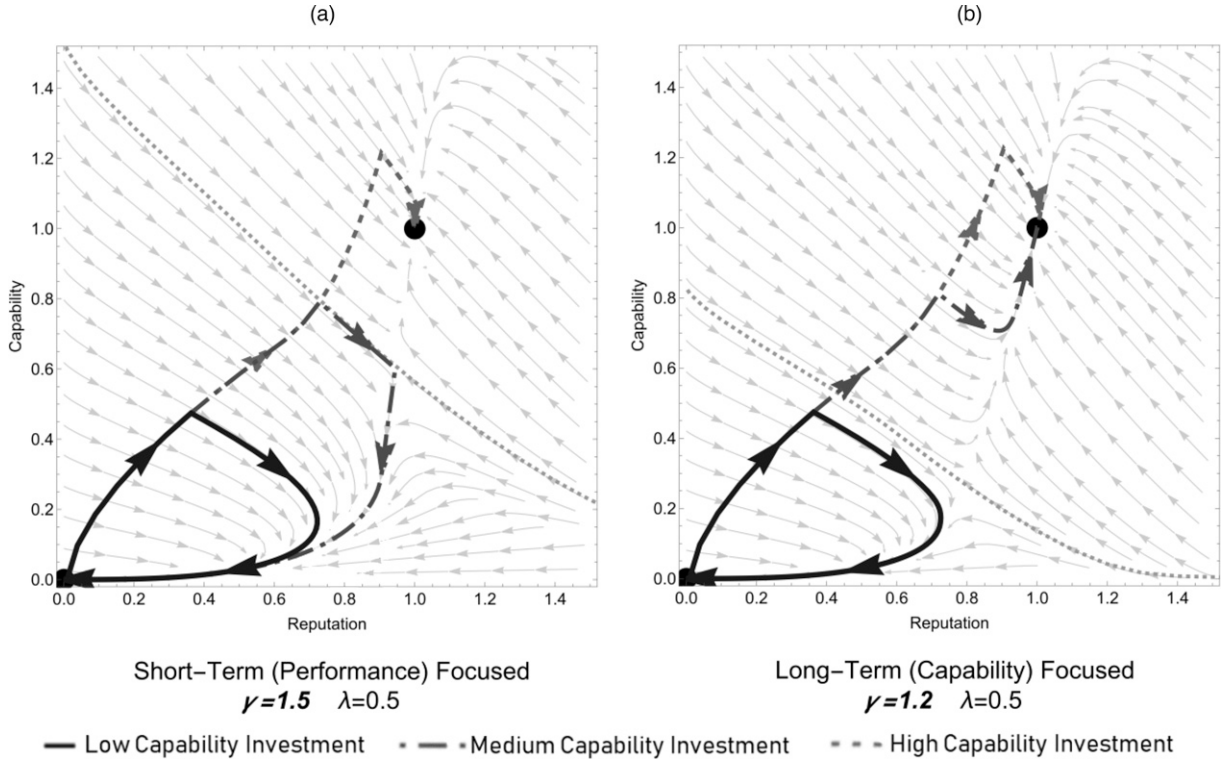
Simply raising the target performance is ineffective because the system prevents the firm from sustaining the levels of capability and reputation needed to generate that higher level of performance as we have demonstrated. Moreover, funders having a greater emphasis on performance shifts the high stable equilibrium to a higher level of performance but also raises the ridge that makes it harder for many nonprofits to reach that higher level of performance (Figure 6). These observations suggest that the path to high performance nonprofits ultimately lies in doing *less* rather than *more*, at least temporarily. If the firm has the opportunity to "stockpile" capability for a period of time, for example because it actively runs fewer programs and instead focuses on improving the nonprofit's internal processes, it should be able to reach a higher level of target performance subsequently when it returns to regular operations with a more capable organization.

To test this intuition, we simulate a scenario in which funders place greater emphasis on performance versus overhead ratio (as is Section 5.3) and the firm temporarily reduces its target performance with the support of donors so that the performance gap is more easily closed and the organization can commit more resources to building capability before raising target performance to a new and higher level. The details of these scenarios are summarized in Table 4.

Figure 7 shows simulations for the two scenarios defined in Table 4. This illustrates that maintaining a higher emphasis on performance is only sustainable in the long-term by first *reducing* the target, allowing the firm to focus more on investing in organizational capability. Thereafter, the target can be increased, and the new stronger emphasis on meeting that higher target further reinforces and maintains this higher performance level. Indeed, as seen in Figure 6, the higher emphasis on meeting performance targets (higher λ) is part of what shifts the stable equilibrium up and to the right, resulting in higher organizational reputation, capacity, and stable performance. Figure 7(c) further reinforces that this first reduction in performance target allows the firm to *first* build organizational capability, while in tandem, the increase in emphasis on hitting this reduced target facilitates this build.

We recognize, however, that managers of multiaudience organizations such as those we spoke to in our fieldwork may face significant challenges in implementing this strategy of deliberately lowering their

Figure 5. Paths of Capability Investment for $\gamma = 1.5$ and $\gamma = 1.2$



target performance for many of the same reasons that they couldn't invest in capability in the first place. For nonprofits, such a strategy could feel foreign or even immoral relative to standard practice, requiring that the organization restrain itself from responding to all identified demand for the nonprofit's services for some period of time. Funders may similarly struggle to commit to this strategy, which would manifest in an unwillingness to donate to an organization that is spending money on itself instead of its constituents.

Figure 6. Shift in Phase Plot with Greater Donor Emphasis on Performance

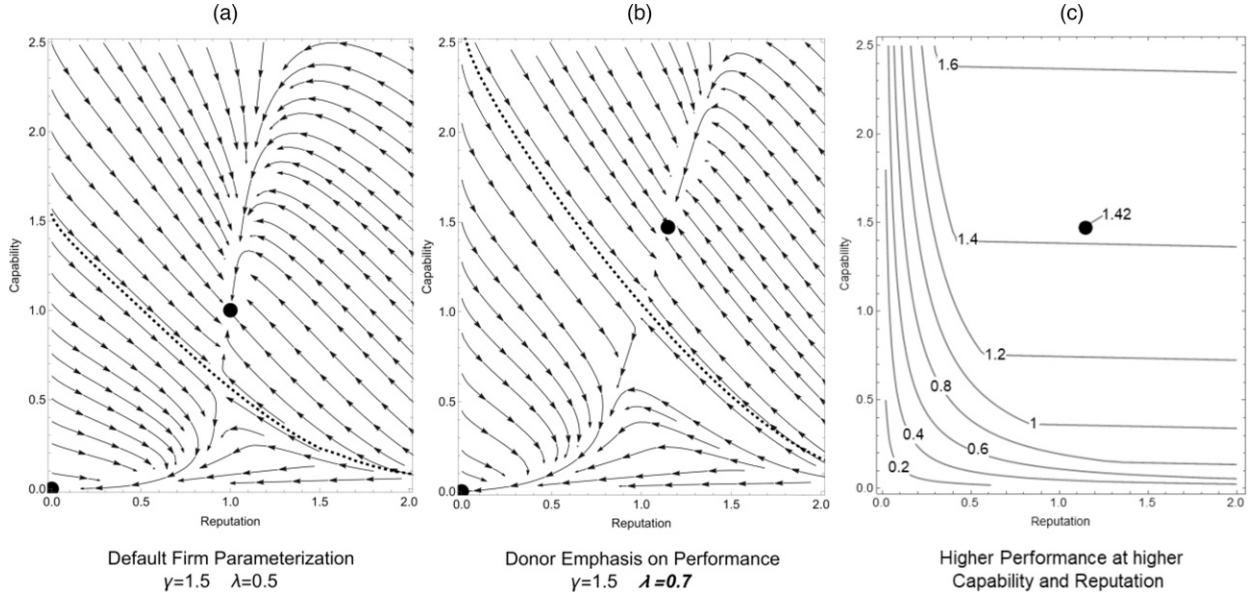


Table 4. Scenario Parameters: Temporary Reduction in Target Performance

	Target increased after firm is allowed to build capability	Target increased without capability building
Original target performance	1.3	1.3
Reduced target performance	1.2	*unchanged*
Target step down time	Month 12	*N/A*
Increased target after step up	1.32	1.32
Target step back up time	Month 24	Month 24
Original λ	0.5	0.5
New λ	0.7	0.5
λ step time change	Month 12	Month 12

Despite this, we believe this strategy is worth pursuing because temporarily lowering target performance makes it easier for nascent multiaudience organizations to cross the tipping threshold and reach the state of sustained high performance. We hope that the analysis we have undertaken here will help managers and funders develop improved mental models of nonprofit capability dynamics, building the shared understanding needed to make implementation possible.

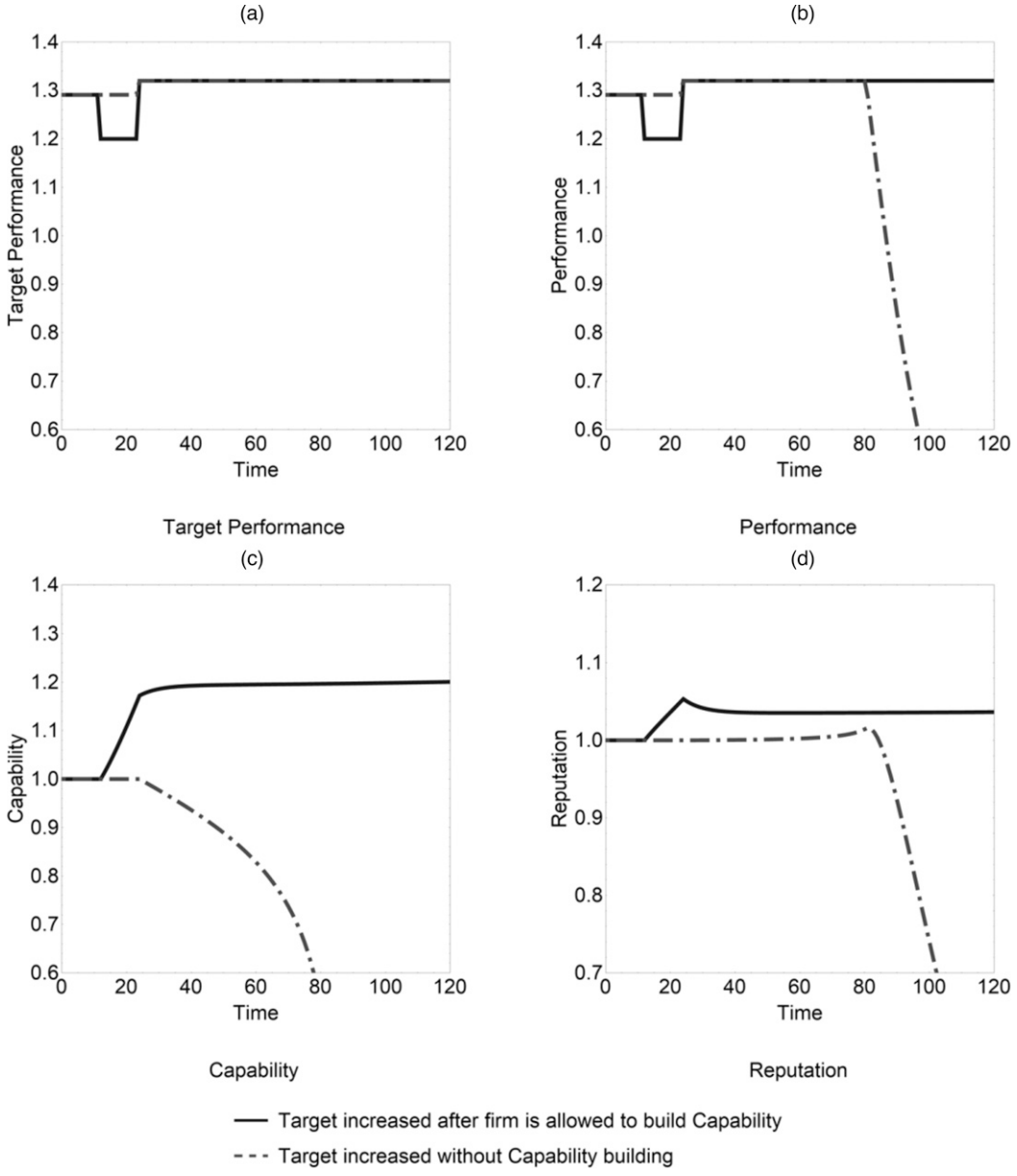
6. Discussion

Our research highlights that nonprofits and other multiaudience organizations face a structural challenge to investing the kinds of capabilities that are widely acknowledged to be essential to organizational success. The structural challenge is born of these organizations' reliance on external parties to supply funding and the pressures this reliance puts on managers to demonstrate high-throughput, low-overhead programs. In these circumstances, it is boundedly rational for managers to manage their short-term reputation to secure resources from funders even when doing so comes at the expense of investing in organizational capability. These dynamics are observed in a variety of multiaudience contexts, such as venture-backed entrepreneurs who feel pressure to appear managerially lean and operationally efficient to secure future funding. And these dynamics are only exacerbated by the moral imperative of nonprofit managers to serve the essentially unlimited demand that exists for social services, such as housing, nutrition, and healthcare.

Our model of multiaudience organization capability investment makes an important contribution to the literature on organizational performance and capability dynamics (e.g., Repenning and Sterman 2002a, Gibbons and Henderson 2011, Rahmandad et al. 2018), providing novel insight into how to build and sustain high performance in these organizations. We highlight the critical role of reputation management, stemming from the need to satisfy funders who are separate from service recipients in multiaudience organizations. We show that coordinated action by both managers and funders is needed if multiaudience organizations are to invest sufficiently in organizational capabilities and, counterintuitively, both parties may need to pursue a strategy of restraint, at least temporarily. Our simulations suggest that the most likely path to sustained high performance requires funders to pull back on their short-term performance expectations and managers must allow overhead ratios to rise higher than current industry standards in the same time window because capability investments are problematically classified as "nonprogrammatic spending" that increase overhead spending. Even then, achieving these capability gains is likely to require enduring "worse before better" dynamics in which the organization is spending more (on itself) and getting less (delivery of programs) to build the capabilities needed to increase performance subsequently. Strong leadership is required throughout because the desired capability gains are squandered if either managers or donors waiver, serving only to reinforce existing perceptions about low nonprofit performance and capability underinvestment. This finding positions our analysis in a broader literature on the game theory of interfirm coordination, which previously focuses most squarely on strategic alliances among for-profit firms (Grandori 1997, Park and Ungson 2001).

For nonprofit managers, our analysis provides guidance on how managers may seek to avoid falling into the capability trap of high programmatic spending and persistent low performance. First, avoiding the drive to constantly do more, such as offering additional services and reaching more people, is critical if managers are to avoid spreading resources too thin. In our fieldwork, the strongest nonprofits we observed were those with a clear understanding of which programs were most critical toward achieving the organizational mission and, crucially, which programs were not. Being clear about limits, although challenging, allowed nonprofit managers to build the capabilities necessary for a robust organization. This point was reiterated by our simulations. Second, our work underscores the value of making the impacts that nonprofits create as observable as possible to build the organization's reputation in the eyes of funders. We find that funders rely on overhead ratios as a

Figure 7. Response to an Increase in Target Performance



proxy for actual performance because it is difficult to observe directly whether their investments are making the desired impact, consistent with a long-standing literature about managers' reliance on heuristics for decision making under uncertainty (Fischer et al. 1987, Artinger et al. 2015). The clearer nonprofit organizations can be about the impact that they are making in their communities, the less dependent the organization's reputation should be on its overhead ratio.

Our modeling also makes three assumptions that could be relaxed in future work. First, we assume that the endogenous effect of reputation on resource availability is either fully present or fully absent. We realize that there may be degrees of effects of reputation on resource availability in the full continuum of multiaudience organizations with some portion of resources being derived directly from the performance of the firm rather than reputation effects. Examples would include large nonprofit hospitals (with some fee-for-service revenue structure) or religious organizations that derive most of their donations from first (congregants) versus third parties (outside donors). Modeling this degree of decoupling between the performance of the firm and how resources are obtained helps to understand the management of organizations that lie on the continuum between for-

profit and nonprofit. Second, we assume that funders prefer low overhead ratios primarily because they cannot perceive actual performance and generally refer to measurable or observable performance measures other than overhead ratios when available. Although this is reflected in our observations in the field, our analysis assumes that overhead ratios are only useful as a proxy for unobservable information, which may not be sufficient for funders who genuinely want to see low overhead ratios for efficiency's sake. Finally, although the concept of adjusting the scale of programs to address funding concerns was discussed in our qualitative fieldwork, the model assumes constant returns to program scale. Nonlinearities in how program effort delivers impact, for example, because working with fewer program participants for a sustained period delivers greater results than working with more participants for a shorter period, could create additional dynamics that materially affect the strategies needed for effective management of multiaudience organizations.

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David Keith is the Mitsui Career Development Professor of System Dynamics at the Massachusetts Institute of Technology (MIT) Sloan School of Management. David's research examines issues including spatial patterns of technology adoption, supply constraints in production, platform competition, and the impact of new technologies on energy consumption and the environment. He completed his PhD in the MIT Engineering Systems Division researching the adoption of emerging automotive technologies.

Lauren Taylor is an assistant professor in the department of population health at the New York Univrsity Grossman School of Medicine. Lauren studies governance and management of health improvement efforts within the United States and abroad. She undertook her PhD at Harvard Business School focusing on organizational theory and business ethics.

James Paine is a doctoral candidate in the system dynamics group at the Massachusetts Institute of Technology Sloan School of Management. His research focuses on behavioral operations management questions, including human–algorithm interactions, supply chain research and analytics, and dynamic modeling of product and service delivery systems.

Richard Weisbach is a management consultant in the deal strategy group at Strategy&, where he provides advice on mergers and acquisitions and other growth strategies. He completed his MBA at the Massachusetts Institute of Technology Sloan School of Management.

Anthony Dowidowicz is both a clinical physician and management consultant who provides strategic advice to healthcare organizations. He undertook his doctor of medicine at Dartmouth College and his MBA at the Massachusetts Institute of Technology Sloan School of Management.