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Incorporating Profit

profit:

noun

1 [C or U] money which is earned in trade or business, especially after paying the costs of producing and selling goods and services:

2 [U] the benefit or advantage that can be achieved by a particular action or activity:

http://dictionary.cambridge.org/define.asp?key=63222&dict=CALD

What is the difference between a for-profit and nonprofit organization?

To answer that we first need to ask what is profit?

Well profit is usually money. But not just any money, it's a particular subset of money. And defining just what money becomes profit and what does not is a dicey proposition. A proposition that keeps countless accountants, lawyers and bureaucrats employed and busy the world over.

So what is profit again?

Profit is a social fact, a social convention that distinguishes one set of money from another. Its a social convention that has been codified into law, but it remains a surprisingly fluid and flexible convention as any small business owner or accountant could tell you. The Wikipedia (on Wednesday, December 14th 2005 9:34AM EST) gives a hint of this fluidity: "It (profit) is a relatively ill-defined concept - methods of calculation differ between accountants and economists."

Where profit really becomes truly strange is when we look at corporations. In particular there is a class of corporations known as nonprofits or not-for-profit organizations. The very fact that these entities are corporations at all is generally obscured, few advertise that fact at least in America, where incidentally most of this inquiry will be focused. Nor is it very well known that no nonprofit is tax exempt by default, tax exempt status must be applied for with the federal government in a separate process than the state run incorporation procedure.

Stripped of the legalese and cultural cladding though, a for-profit and nonprofit corporation are remarkably similar. Both are organizations that limit the liabilities of the people that start and run them. Both are chartered by states. Both pay taxes on any positive returns not based on donations. Even nonprofits with tax exempt status need to pay taxes on the surplus of certain returns, say on the sale of t-shirts and buttons. What separates nonprofits and for-profits is a social fact, the concept of profit. In a for-profit corporation positive surplus funds are transformed into profit. In a nonprofit, that very same surplus is just regular money, it can not by definition be profit. From this social difference has emerged a widely divergent set of corporate cultures. The goal of this paper is to explore these differences and then find a point of convergence (or perhaps reconvergence) between the two.

The modern corporation first began to take its shape in 1830s America as states began to develop more and more general laws for incorporation. Corporations had been around for centuries before, but were essentially handcrafted one at a time by the joint efforts of governmental officials and the corporate founders. The government vested each corporation with a very specific set of goals and a specific set of rights. Goals of say trading in the East Indies, or building a bridge across the Charles River. Rights to perhaps sell stocks, or the rights for the directors to be limited in legal liabilities, the rights to charge tolls, or even mount standing armies in foreign territories. Every single set of circumstances lead to an new charter, a new incorporation of purposes and goals.

At its best this form of chartering allowed for the creation of institutions uniquely tailored to the needs of the local community or to specific tasks on the national level. At its worst it leads to the sort of corruption and influence peddling that all so often emerges at the juxtaposition of government and commerce. It also leads to a particular sort of corporate culture that is quite at odds with the viewpoints of both the economists and industrialists of the past. Adam Smith might be a hero to the contemporary CEO but in his opinion companies "have in the long run proved, universally, either burdensome or useless, and have either mismanaged or confined the trade." (http://www.adamsmith.org/smith/won/won-b5-c1-article-1-ss2.html)

Smith instead favored individual businessmen and small economic partnerships, the economic form also favored by the early industrialists. According to John Micklethwait and Adrian Wooldridge, "limited liability, that was viewed, to the extent it was considered at all, as a weakness rather than a strength, because it would lower the commitment of the partner-owners". The risky propositions of an economic partnership, where each partner assumes the potential liabilities for each others debts, were considered an advantage for the precisely how tightly they bound the partners together socially. In a partnership trust is at the core of the relationship, the partners have literally everything to lose if something goes sour. The limited liability of a corporation in a large part protects the owners from each other, and reduces the amount of trust required to enter into a collective enterprise.

The creation of the abstract corporation played a large role in dampening the intensity of trust at the core of a business relationship. Starting in the 1830's and drawn out in a nearly century long race to the bottom, state governments in America began to create more and more abstract legal conceptions of corporations. As the popularity of limited liability corporations increased in America, the state's power to shape each and every corporate charter began to seem less like a power and more like a legislative burden. The response was to create generic, modular means of incorporation. Fill out some forms, pay a few fees and a businessperson could obtain there own vessel of limited liability. In order to create this abstract corporation though, the states need to simplify the process, the old complexity need to be transformed.

The key to this operation was the bifurcation of the corporation into two entities. One being corporations chartered with specific reasons in mind, the other being corporations chartered mainly to produce surplus cash for their owners. In other words nonprofit and for-profit corporations. The bulk of this operation centered around the later, by stripping out *the need for a corporation to be vested with a purpose or goal*, the states created a vastly simpler and easier to replicate form of incorporation. By simplifying the process the states amplified the already growing demand, and the corporate form began to evolve rapidly and with it a new business culture.

Today there are very few nonprofits out there that will stress the fact that they are incorporated (with the RAND Corporation being the prominent exception). The very word has become associated with the for-profit world. Over the past century and a half a large philosophical and cultural gap has opened up between the two corporate forms. The for-profit corporation has become the default business organizational form, an abstract catch all vehicle that can be filled with a large array of purposes. The nonprofit has become a purpose driven organizational form, each individual one is vested with a particular purpose or set of purposes at birth, purposes that seemingly then protect the organizations from both the positive and negative advances of their for-profit corporate cousins.

It is quite clear that for-profit enterprises have been evolving at a rapid rate over the past century. Part of this comes from the very abstractness of the laws that govern their incorporation. Once incorporated the organization can decide to do just about anything. A select few grow into multinational behemoths, the Exxons and General Electrics with their own distinct and doubtlessly bizarre corporate cultures. Others stay small and privately held, local grocery stores, graphic design firms and family holding companies. Others take more unique and twisted paths, Enron's corporate structure became so complex and incestuous that it practically existed solely to perpetuate the company itself, but instead led to its collapse. Technology companies in Silicon Valley mesh together in a complex network of shared experiences and supply chains as their engineers hop from firm to firm, while those around Boston opt for more vertically integrated and paranoid forms similar to the New England mills of centuries before.

Some corporations like Gore are almost completely flat and non-hierarchical, while others like Apple can sometimes resemble their CEO's private kingdoms. Some like Newman's Own are highly charitable, others like Wall Street hedge funds exist only to skim cash off the top of other people's money. With all this range, is there anything cohesive to the for-profit corporate form? Art Kleiner has proposed a theory of core groups, that all organizations have group of individuals at their center that generate the goals and directions of the entire organization. This is probably true on many levels, but it tells us very little about what separates a nonprofit from a for-profit, as nonprofits have core groups too.

No what separates nonprofits from for-profits is self evident in their names. A for-profit corporation possess a certain social gravity that subtly pushes the organization to transform money into profit, to create a set of money that can be extracted from the system and placed into private hands. This social gravity can sometimes be put in check for quite some time. Privately held companies can be lead in strange directions by their founders, Benetton for example funds a design school, magazine and ad campaigns that sometimes act more like activist broadsides than calls to consumption. But the social gravity towards profit never disappears, and is often amplified by the common act of taking a company public.

When an company sells a bit of itself on the stock markets it loses a degree of autonomy. The shareholders not only have a small degree of control over the company, they also generally have very little interest in the day to day operations of the company. They tend to buy stock to make money, not because they are interested in seeing the company improve its products, or even maintain quality in any way. Nor are they particularly interested in the research and development of the companies engineers or the marketing teams efforts to communicate well with customers, except in the ways that these activities might help generate profit. What they are interested in is what has come be known as a company's fiduciary duty, the legal need for the company to act in the best interests of its shareholders, interests that tend to be defined in financial terms.

One of the clearer and more dramatic examples of this process in action is the Body Shop, a cosmetics retailer founded in the 1970's by Anita Roddick. As the founder Roddick vested the company with an extensive set of social and environmental goals. The products made extensive use of sustainable natural ingredients, playing a large role in generating a market for goods that had previously had none. The company developed close relationships with various growers of the raw goods they used, push recyclable and low impact packaging, and refused to advertise. Instead their stores used their display space to propagate a particular brand of social awareness, pushing a message where most operations would be pushing products.

The Body Shop was wildly successful and expanded rapidly. As part of the process the companies stock was floated on the open market, raising funds for growth, but diluting Roddick's financial position as controller of the company. At first this was a somewhat irrelevant financial fact, as long as the company continued to grow and generate profit, the shareholders and the board that represented them were happy to allow Roddick to continue to lead the company as she had. But if economic history has just one lesson to teach it's that the good times can not continue on forever, and the Body Shop stumbled badly in it's rapid expansion across the US market. Suddenly the company's philosophy and fiduciary duty came into conflict, the board pushed for changes, they wanted the company to start advertising and stop scaring off consumers with political messages. Roddick struggled to maintain the stances she imbued the company with from the get go, but could only stand her ground so long and eventually resigned. While the Body Shop still stands significantly to the left of most corporations today, it is no longer the activist vehicle it once was, and instead just another shop in the mall.

At the peak of activism the Body Shop reached the sort of effectiveness that very few nonprofits ever achieve. Even without using advertising they had the ability to spread their message widely and strongly and then back up the message with real economic actions. Technically there is very little reason why a nonprofit couldn't step up and do exactly what the Body Shop did, and like wise there is little reason Roddick couldn't have organized the Body Shop as a nonprofit is she had so chose. Financially the vehicles for expansion would need to be different and perhaps more difficult to obtain, but by no means impossible, nonprofits for instance are capable of issuing bonds and in some cases even certain classes of stock.

What really separates nonprofits from for-profits are the modes of thinking involved. Nonprofits have an embedded fear of selling, that only a few organizations have overcome. Most prefer methods of fundraising that date back to sovereign eras in their thinking, either they inherit their money from some wealthy founder or they go out and beg for it as either donations or grants. There is perhaps some confusion between the effects of profit and the effects of increasing the velocity of cash flows, that prevents many nonprofits from learning from the for profit world. This spreads to the area of hiring, where nonprofits actually have a tactic that gives them a huge leverage over for-profits, the fact that they have a purpose, and the purpose is defined and guaranteed by the act of incorporation. This advantage is often tempered by the lower levels of cash flow most nonprofits suffer. Given equal or similar salaries, job descriptions and benefits how many people do you think would chose a nonprofit over for-profit as an employer?

There is a similar, although in ways quite different effect at work in the opposite direction. It's entirely possible for an entrepreneur to start the exact same company, which at the present is almost always incorporated for-profit, as a nonprofit, but it is an extremely rare occurrence. For one its not common knowledge that it's even an option. Beyond that though is a particular entrepreneur's dream, that the company will reach a point where it can be sold off or cashed out, that the founder can step away and never work again.

The heads of successful nonprofits are rather well compensated, well entrenched socially and economically in the upper classes with healthy six figure salaries. But they need to work day to day, year to year to maintain this status, and while rich they are not filthy rich. Few entrepreneurs are ever filthy rich either, most aren't even rich, and many take great enjoyment and personal interest in their work, but somehow the cash out dream remains compelling, despite it's rarity. For an entrepreneur to decide to incorporate as a nonprofit means giving up this particular dream, for in a nonprofit there is no exit strategy, but instead a purpose.

What would happen if nonprofits started to learn more from business, or if business decided they where actually going to hard code themselves a purpose, rather than just talk about it? Its a difficult question to answer, but what is clear is that there is a space that exists in between the traditional for-profit and nonprofit corporation. What lies in this space is not exactly answers to myriad of problems facing both the nonprofit and for-profit corporation as organizational forms, but merely the potential for answers, and that to me is a start.