THE ARCHITECTURE OF ARTS ENTERPRISE

E. ANDREW TAYLOR
Assistant Professor of Arts Management
American University
Washington, DC

Andrew Taylor joined the Arts Management faculty at American University in 2012 after directing the Arts Administration MBA at the Wisconsin School of Business for over a decade. He is a past president of the Association of Arts Administration Educators, and a consulting editor for *The Journal of Arts Management, Law, and Society*, and for *Artivate*.

ABSTRACT

This paper is part of an on-going research agenda to contribute toward a more focused and cohesive framework for structure, strategy, and performance in the nonprofit arts. Through a series of papers and research projects, the author seeks to connect scholarship on *physical structure*, *capital structure*, and *organizational structure*, into a shared framework for cultural organizations and their leadership. As a first step, this paper's primary focus is *capital structure* in nonprofit enterprise – how such structures are constructed or evolve, how they are defined, and how they influence organizational performance. A survey of existing scholarship in for-profit and nonprofit capital structure will frame the topic. Connections to applied research by service organizations and foundations will enhance this investigation and ground it in existing practice.

[capital structure, nonprofit finance, organizational design]

INTRODUCTION

This paper is part of an on-going research agenda to contribute toward a more focused and cohesive framework for structure, strategy, and performance in the nonprofit arts. Through a series of papers and research projects, the author seeks to connect scholarship on *physical structure*, *capital structure*, and *organizational structure*, into a shared framework for cultural organizations and their leadership. As a first step, this paper's primary focus is *capital structure* in nonprofit enterprise – how such structures are constructed or evolve, how they are defined, and how they influence organizational performance. A survey of existing scholarship in for-profit and nonprofit capital structure will frame the topic. Connections to applied research by service organizations and foundations will enhance this investigation and ground it in existing practice.

Winston Churchill famously declared to the House of Commons that "we shape our buildings, and afterwards our buildings shape us" (Churchill 1943). Similarly, the systems we form in arts organizations also have a formative influence on the performance of the firm. This interplay between structure, strategy, and performance has drawn scholarly focus in a range of disciplines, from physical to financial to organizational systems. Scholarship in Spatial Organization, Architecture, Industrial Design, Urban Planning, and related disciplines emphasizes *physical structure* and the built environment – factories, offices, production spaces, public spaces – and their impact on motivation, communication, culture, and performance. Finance and Economics scholars often explore structure

and performance through the lens of capital – or the *capital structure* described by a firm's financing through net assets, equity, or debt. Finally, *organizational structure* in Organizational Studies and Organizational Psychology

emphasizes the formal and informal relationships between people, tasks, and resources within a firm, and how those configurations impact performance over time.

This research series will suggest that the ways we describe, design, and engage these structures has material impact on mission attainment and alignment in the nonprofit arts. Further, it will suggest a productive frame for that effort, defined not by the structures, themselves, but from the qualities and configurations of the *spaces* those structures define.

DEFINING CAPITAL STRUCTURE

Oxford English Dictionary offers seven definitions for the noun form of "structure," the most relevant to *capital structure* being "The mutual relation of the constituent parts or elements of a whole as determining its peculiar nature or character" (*OED Online* 2013). Structure, therefore, is defined by the relationships between parts in a whole, specifically those relationships that determine fundamental or defining qualities. In *architecture*, structure is defined by the relationship and configuration of physical elements, including space (Hillier 1996). In *organizational analysis*, structure is defined by the relationship and configuration of people, tasks, and resources (Kottke and Agars 2007). In finance and economics, *capital structure* is traditionally defined by the relationship and configuration of financing methods, primarily debt and equity (Bowman 2002).

The modern theory of capital structure began with Modigliani and Miller, who also described the three classes of professionals most concerned with the subject: "(1) the corporation finance specialist concerned with the techniques of financing firms so as to ensure their survival and growth; (2) the managerial economist concerned with capital budgeting; and (3) the economic theorist concerned with explaining investment behavior at both the micro and macro levels" (Modigliani and Miller 1958). Their paper argued that the choice between financing with debt or equity (the decision that defines capital structure) was *irrelevant* to the market value of the firm under perfect market conditions. That conclusion provoked a generation of scholars, both to challenge its basis and its validity, and to describe the circumstances under which capital structure decisions *were* relevant to market value (Sheikh and Wang 2011). The relevance of the decision between financing with debt and equity was connected to market imperfections such as tax policies, variable financing costs, subsidized debt, or potential costs of financial distress (Wheeler et al. 2000).

Managers, therefore, design or redesign the capital structures of their firms in response to a complex web of financing costs, agency issues, industry risk, and competitive market forces. Or, equally plausible, the capital structures of their firms emerge from the aggregate choices managers make, rather than by comprehensive design. In either case, their assumed goal is to ensure positive return on capital, and to maximize the market value of the firm.

Beyond the goal and the context, capital structure research also explores the means by which managers make these complex choices. In one theory, firms determine an optimal amount of debt by balancing its costs and benefits (*static trade-off theory*). In another, firms have a preferred sequence of financing options due to market factors, and follow that sequence in their decision-making (*pecking-order theory*), generally from internal equity, to debt, to new equity (Calabrese 2011). In both approaches, the consequences of sub-optimal decisions are economic and market-driven, as the firm either grows or falls in market value, has greater or lesser access to additional financing, or gains or loses positive return on capital.

There is little research on the *internal* and *behavioral* implications of various capital structures (Yetman 2007), except for related research in behavioral economics and individual investment (Hayes 2010, as an example) or more broadly focused behavioral research related to decision-making within firms (Cyert and Simon 1983).

CAPITAL STRUCTURE IN NONPROFITS

The majority of scholarly research on capital structure has focused on commercial enterprise, and specifically on public, nonfinancial corporations with access to global capital markets. These firms draw the most scholarly attention likely because they represent the largest volume of corporate financial activity, have access to the broadest menu of financing choices, and can adjust their capital structures at relatively low cost (Myers 2001). A related cluster of research has explored finance decision-making and patterns in the public sector.[1] And an even smaller subset has focused specifically on capital structure among nonprofits, much of it focusing on hospitals.[2]

Since most nonprofit capital structure research draws upon the findings of commercial-sector research, a first step is to define the differences between the sectors. Bowman suggests that financing behavior among nonprofits is distinct because of four driving factors: "Nonprofit firms (1) do not have owners, but (2) their donors have the power to restrict what nonprofit firms can do with donated assets. In addition, nonprofit firms (3) are not subject to involuntary bankruptcy and (4) can sell bonds at tax-exempt rates" (Bowman 2002).
These distinctions, of course, are not flaws of the nonprofit corporate form, but rather elements of its design. The sector exists to deliver goods and services at a level, quality, or location that the commercial sector cannot, and the public sector chooses not to. The absence of owners and the corresponding non-distribution constraints on net assets create the opportunity for contributed subsidy and donated capital as an intended alternative to market equity (Hansmann 1979).[3]

In lieu of owners, nonprofits are directed by "an other-regarding corporate body that seeks to maximize a social benefit" instead of "a collection of autonomous, self-regarding, private individuals who seek to maximize profit" (Bowman 2002). This separation of ownership and control creates both unique tensions and solutions for addressing social-sector needs, including decisions and behaviors surrounding capital structure (Fama and Jensen 1983).

As in the scholarship on commercial firms, research into nonprofit capital structure is dominated by discussion of the right side of the balance sheet (or, more accurately for the sector, the statement of financial position). In the absence of market equity, threads of research track whether and why nonprofits borrow (Denison 2009; Bowman 2002; Yan, Denison, and Butler 2009), and whether and why they finance their efforts with net assets, whether from earned or contributed funds (Calabrese 2012; Chang and Tuckman 1990; Fama and Jensen 1983).

Nonprofit managers, therefore, design or redesign the capital structures of their firms in response to a complex web of financing costs, agency issues, and industry risk, as do their commercial counterparts. But nonprofit managers do so without access to equity markets, and with additional constraints of donor restrictions and the complexity of managing in a market failure.

Do nonprofit managers and their boards design their capital structures with intent? Or do they merely accept the capital structure as a byproduct of other decisions? There is insufficient sector-wide research to know, or even to guess. Wheeler et al. found evidence of strategic intent among nonprofit hospitals (2000), but the diversity of the nonprofit sector makes those findings impossible to generalize.

1 For a summary of public finance theory and its relation to nonprofit finance, see Yan, Denison, and Butler 2009.
2 Yetman offers this assessment of the existing body of research on nonprofit capital formation and use: "we know slightly more than very little" (2010).
3 Hansmann describes the nonprofit enterprise as "a reasonable response to a particular kind of 'market failure,' specifically the inability to policy producers by ordinary contractual devices," which he called "contract failure."

A BALANCED VIEW OF THE BALANCE SHEET

Outside traditional academic research and publishing, there is a significant body of writing on nonprofit finance and capital structure, some of it specific to the arts. Foundations, service organizations, consultants, and practitioners have all explored the challenge of acquiring, applying, and sustaining capital assets and capital financing toward mission fulfillment. However, the literature is strangely detached from the academic, and vice versa.[4]

Part of this disconnect may be definitional. While the academic literature defines capital structure almost exclusively on the *right* side of the balance sheet, through the proportions of debt, equity, and net assets used to finance real investment (Myers 2001), the professional literature explores *both* sides of the balance sheet, inclusive of real investments. The Nonprofit Finance Fund, for example, defines capital structure as "the pattern of distribution of an organization's financial assets and liabilities," including cash, investments, buildings and equipment, receivables, inventory, and prepaid expenses (Miller 2001).

Another disconnect may be the unique qualities of assets in the nonprofit firm, particularly in cultural organizations. Bowman suggests that in the for-profit sector, "which assets are used and in what proportions are determined by the producer's choice of (1) product, defined to include its level of quality, and (2) the technology used to produce it" (2010). The same could be said for a nonprofit cultural organization. But because the services are produced at a chosen quantity and quality, using a chosen technology, *despite* the market return rather than *because* of it, the relationships between asset and financing is different, and an effective capital structure needs to describe them both.

Further, assets among nonprofits, and perhaps particularly among cultural nonprofits, exhibit many qualities of liabilities. Guthrie describes many assets of the New-York Historical Society as costing more than they contribute, labeling the effect the "liability of assets" (Guthrie 2008). Bowman describes the "monumental churches, ornate halls, cavernous museums, and historic university structures" as symbolic and perhaps useful to mission, but also expensive to maintain and operate. Despite their drain on resources, these assets cannot be sold for a range of reasons, and must be maintained and retained. He calls these "privileged assets" (Bowman 2007).
Finally, different accounting rules between for-profit and nonprofit firms treat similar financing differently. For-profit firms record equity investments directly to the balance sheet. Nonprofits must claim similar contributions, donations to support a new facility for example, as revenue.
Regardless of the disconnect between academic and professional, the professional literature spends significant time explaining and exploring assets as part of capital structure. The Nonprofit Finance Fund, particularly, defines the entire pattern and allocation of assets, debt, and net assets as an essential corner in their "iron triangle" of Capital, Capacity, and Mission that defines the enterprise platform, and demands continuous and conscious balance (Miller 2001).

Ellis suggests that the particular challenges of nonprofit finance appear most vividly during periods of growth:

All dynamic, mission-driven nonprofits live in the force field created by the tension between money and mission. The force field grows more powerful the greater the urge to expand programming.... However, growth usually cannot be funded by retained surpluses — simply because generally there aren't any! Growth therefore needs to be funded externally. But debt- funded growth requires repayment of both interest and eventually principal and therefore assumes either that the investment will generate a positive rate of return or, more usually, that it will attract philanthropic funding to meet these repayment costs. Equity investment, per se, is not an option for nonprofits....The primary source of funding for growth is therefore either contributed income or income from reserves and endowments that have themselves been created through contributed income. However, unless nonprofit arts organizations can articulate — and funders embrace — the idea that growth requires investment, and that the full rather than marginal costs of growth need to be covered by these sources of contributed income, the impact of growth is generally to stretch organizational and financial capacity more and more thinly... leading to systemic under-funding of such areas as facilities maintenance, funded depreciation, working capital, staff development, competitive salaries, or training — all of which are required to support programs (Ellis 2001).

4 Only one academic source reviewed for this paper mentioned any findings from the gray literature, which had also been published in a journal (Bowman 2010). None of the gray literature referenced the academic studies.

The professional literature suggests that capital structures among nonprofits are generally *not* the focus of strategic planning nor comprehensive design. Rather, capital structures emerge from a range of other choices – about growth or expansion or new programming or opportunistic funding. And because nonprofits lack an equity market to reward or punish those choices, they are slow to adjust their capital structure, their organizational capacity, and their missions in response (Ellis 2004).

More recent research on the cultural building boom from 1994-2008 suggests dramatic misalignment between capital structure and operating health, between increasing supply of cultural production and cultural demand (Woronkowicz et al. 2012).

Miller further suggests that stable and sustainable capital structure is derived from the underlying business rather than the particular mission, or even the industry (Miller 2002). Organizations that fill slots or seats (private elementary schools, performing arts centers, airlines) will share a similar capital structure, as will organizations that mobilize people (dance companies, workforce development providers, counseling agencies).
The gap between academic and professional literature on the subject of capital structure is both deep and wide. There is great potential in applying empirical rigor to the frameworks and theories of professional studies. Just as there is potential in bridging scholarly literature into professional practice. The following section begins to suggest a framework within which to make those connections.

CONCLUSION AND NEXT STEPS

Modigliani and Miller suggested the three professional most concerned with capital structure, and the cost of capital, were the corporation finance specialist, the managerial economist, and the economic theorist (1958). Yet in the nonprofit arts, many other professionals have immediate and essential connections to the subject, as well. Boards and executives, funders and policy makers, financial managers and civic leaders, artists and arts support workers are all affected by decisions on capital structure.

Capital structure, including *both* sides of the balance sheet, not only defines the capacity of an organization to do its work, but also the *quality* of the space within which it works. Ellis suggests that due to their expressive endeavor, arts organizations have a necessary, rather than contingent, relationship to risk by virtue of their core purpose (2002). Bowman describes how fixed-cost investment today can restrict managerial discretion to respond to change tomorrow (Bowman 2007). Both risk and managerial flexibility are essential to expressive enterprise.

And while research tends to focus on the proportions, the relationships, and the structure of assets and financing, a more productive frame might be to focus on the spaces these structures define for people to work within. Here, the structural considerations of architecture might provide productive steps forward.
In Hillier's architectural theory, he builds the argument that "a pattern of space in a complex can affect the pattern of co-presence and co-awareness of collections of people who inhabit and visit that complex" (Hillier 1996). He suggests that it's not the walls and structural elements of the built environment that inform this effect. Rather, it is the shape, nature, and configuration of the *spaces* defined by the structures that affect the social relationships within them. He believes that architecture begins when "the configurational aspects of form and space...are treated not as unconscious rules to be followed, but are raised to the level of conscious, comparative thought, and in this way made part of the object of creative attention.... We build, that is, aware of intellectual choice, and we therefore build with reason, giving reasons for these choices" (Hillier 1996).
The research exploring the *many* structures that define and sustain cultural organizations – physical structures, capital structures, organizational structures – demands the same level of conscious, comparative thought, to become part of the object of creative attention for cultural leaders, funders, and policy makers.

REFERENCES

Bowman, Woods. 2002. "The Uniqueness of Nonprofit Finance and the Decision to Borrow." *Nonprofit Management & Leadership* 12 (3): 293.
———. 2007. "Managing Endowment and Other Assets." In *Financing Nonprofits: Putting Theory into Practice*, edited by Dennis R. Young, 271–289. Lanham, MD: National Center on Nonprofit Enterprise and AltaMira Press.
———. 2010. "Asset Composition." In *Handbook of Research on Nonprofit Economics and Management*, edited by Bruce A. Seaman and Dennis R. Young, 69–82. Edward Elgar Publishing. http://lib.myilibrary.com/Open.aspx?id=253386.
Calabrese, Thad D. 2011. "Testing Competing Capital Structure Theories of Nonprofit Organizations." *Public Budgeting & Finance* 31 (3): 119–143. doi:10.1111/j.1540-5850.2011.00989.x.
———. 2012. "The Accumulation of Nonprofit Profits A Dynamic Analysis." *Nonprofit and Voluntary Sector Quarterly* 41 (2) (April 1): 300–324. doi:10.1177/0899764011404080. Chang, Cyril F., and Howard P. Tuckman. 1990. "Why Do Nonprofit Managers Accumulate Surpluses, and How Much to Do They Accumulate?" *Nonprofit Management and Leadership* 1 (2): 117–135.
Churchill, Sir Winston S. 1943. "A Sense of Crowd and Urgency" presented at the House of Commons, October 28, London.
Cyert, Richard M., and Herbert A. Simon. 1983. "The Behavioral Approach: With Emphasis on Economics." *Behavioral Science* 28 (2) (April): 95–108.
Denison, Dwight V. 2009. "Which Nonprofit Organizations Borrow?" *Public Budgeting & Finance* 29 (3): 110–123. doi:10.1111/j.1540-5850.2009.00939.x.
Ellis, Adrian. 2001. "Loss Leaders | Grantmakers in the Arts." *Grantmakers in the Arts Reader* 12 (3). http://www.giarts.org/article/loss-leaders.
———. 2002. "Taking Risks in Times of Adversity". Ford Foundation.
———. 2004. "Mission, Money and Models: New Approaches to Sustaining the Arts in the United Kingdom". AEA Consulting.
Fama, Eugene F., and Michael C. Jensen. 1983. "Separation of Ownership and Control." *Journal of Law and Economics* 26 (2) (June): 301.
Guthrie, Kevin M. 2008. "The New-York Historical Society: Lessons from One Nonprofit's Long Struggle for Survival." In , [2nd ed.]. Houston, TX: Long Tail Press/ Rice University Press. Hansmann, Henry B. 1979. "Role of Nonprofit Enterprise, The." *Yale Law Journal* 89: 835.
Hayes, Suzanne K. 2010. "Exploring Investor Decisions in a Behavioral Finance Framework." *Journal of Family and Consumer Sciences* 102 (2): 56–60.
Hillier, Bill. 1996. *Space Is the Machine: a Configurational Theory of Architecture*. Cambridge ; New York, NY, USA: Cambridge University Press.
Kottke, Janet L., and Mark D. Agars. 2007. "Organizational Structure." In *Encyclopedia of Industrial and Organizational Psychology*, edited by Steven G. Rogelberg, 2:585–589. Thousand Oaks, CA: Sage Reference.
Miller, Clara. 2001. "Linking Mission and Money: An Introduction to Nonprofit Capitalization". Nonprofit Finance Fund.
———. 2002. "Capital Structure Counts: The Business Roots of Capacity and Mission at Nonprofits". Nonprofit Finance Fund.
Modigliani, Franco, and Merton H. Miller. 1958. "The Cost of Capital, Corporation Finance and the Theory of Investment." *The American Economic Review* 48 (3) (June 1): 261–297. doi:10.2307/1809766.
Myers, Stewart C. 2001. "Capital Structure." *The Journal of Economic Perspectives* 15 (2) (April 1): 81–102. doi:10.2307/2696593.
OED Online. 2013. Oxford University Press. http://www.oed.com.proxyau.wrlc.org/view/Entry/191895?isAdvanced=false&result=1&rske y=EKudJ6&.

Sheikh, Nadeem Ahmed, and Zongjun Wang. 2011. "Determinants of Capital Structure: An Empirical Study of Firms in Manufacturing Industry of Pakistan." *Managerial Finance* 37 (2): 117–133. doi:http://dx.doi.org.proxyau.wrlc.org/10.1108/03074351111103668.
Wheeler, John R. C., Dean G. Smith, Howard L. Rivenson, and Kristin L. Reiter. 2000. "Capital Structure Strategy in Health Care Systems." *Journal of Health Care Finance* 26 (4): 42–52. Woronkowicz, Joanna, D. Carroll Joynes, Peter Frumkin, Anastasia Kolendo, Bruce Seaman, Robert Gertner, and Norman Bradburn. 2012. "Set in Stone: Building America's New Generation of Arts Facilities, 1994-2008". Cultural Policy Center, University of Chicago. http://culturalpolicy.uchicago.edu/setinstone/.
Yan, Wenli, Dwight V. Denison, and J. S. Butler. 2009. "Revenue Structure and Nonprofit Borrowing." *Public Finance Review* 37 (1) (January). http://search.proquest.com.proxyau.wrlc.org/abicomplete/docview/207647347/13D54C2271 A4D45FB67/2?accountid=8285.
Yetman, Robert J. 2007. "Borrowing and Debt." In *Financing Nonprofits: Putting Theory into Practice*, edited by Dennis R. Young, 243–268. Lanham, MD: National Center on Nonprofit Enterprise and AltaMira Press.
———. 2010. "Capital Formation." In *Handbook of Research on Nonprofit Economics and Management*, edited by Bruce A. Seaman and Dennis R. Young, 59–68. Edward Elgar Publishing. http://lib.myilibrary.com/Open.aspx?id=253386.