

UNDERSTANDING NONPROFIT ORGANIZATION FINANCES

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Nonprofits include a wide variety of organizations. They are ubiquitous and are part of the fabric of most communities in the United States with a wide array of missions, such as local neighborhood associations, social service agencies, churches, hospitals, and private colleges and universities. These organizations differ from companies in the private sector and government agencies in the public sector in that many of them exist to provide services that cannot or will not be provided solely by the other sectors. Nonprofits also play a unique role in our economy.

Their missions are diverse and offer complexity beyond the scope of this book. While diverse, they have common characteristics such as the fact that they are voluntary and cannot distribute surplus. They also present challenges in terms of financial management and literacy. The intent of this book is to provide insights into the financial management of these organizations, how they differ from the other sectors, and how their finances are governed and managed. It is, in essence, about financial leadership in nonprofit organizations. Proficient financial management enables and enhances mission achievement.

The National Center for Charitable Statistics (NCCS) publishes *Facts about Nonprofits*:

- There are 1.57 million tax-exempt organizations of which over 1.1 million are public charities (2017).
- In 2013, public charities reported \$1.73 trillion in total revenue and \$1.63 trillion in total expenses.
- In 2013, public charities reported over \$3 trillion in total assets.

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- Charitable contributions from individuals, corporations, foundations, and bequests in 2014 were \$358.4 billion (an increase of 7.1 percent over 2013).¹

In a report issued by The Moody's Foundation in 2012, financial literacy in nonprofit managers is increasing, but there is still much room for improvement.

As organizations deal with the fluctuations in their sources of funding, having an understanding of the need for financial flexibility has taken on increased significance, and financially literate managers can help their organizations craft sound strategies and objectives that will keep their organizations not only afloat, but thriving during temporary economic declines (Moody's 2012, 38).²

The number of registered charitable organizations has exploded from roughly 300,000 in 1970 to 1,599,471 in 2016. There are many more small organizations and churches that are not registered. One-half of the nonprofit sector's revenue goes to the largest 15 percent of these organizations, some of which are large hospitals and universities. Faced with growing missions and shrinking resources, many organizations have relied more on for-profit activities, such as issuing credit cards with their logos and selling their mailing lists to advertising firms in order to augment their revenues. Most of these same organizations have overlooked the potential of better financial management to enhance revenues from better investment management and faster cash collections or reduce costs from better negotiations with banks and other vendors and process reengineering.

1.1 THE IMPACT OF THE GREAT RECESSION

The Urban Institute and NCCS published a research paper in 2014 on how the "Great Recession" (2008–2012) impacted the nonprofit sector. The study examined the closure rates of nonprofit agencies for two time frames. The baseline timeframe was from 2004 to 2008 and the recession time frame from 2008 to 2012. They looked at closure rates across several subsectors: arts and culture; education; environment; health; human services; international affairs; public and societal benefit; and others. Some conclusions of this study:

- In all subsectors, organizational closure was more prevalent during the recession period than during the baseline period.
- In both time periods and across all subsectors, smaller organizations (revenues of between \$50,000 and \$99,999) were most vulnerable to closure.
- The largest increase in closure rates was in international organizations, while human services experienced the least increase.
- In addition to higher closure rates, the recession is also associated with loss of revenue among smaller nonprofits. Eight percent of all organizations with \$50,000 to \$99,999 in revenue in 2004 had revenue fall below \$50,000 in 2008. That share jumped to 11 percent for the 2008 12-month period.³
- While this study did not directly state that organizations without sufficient liquidity did not do well, it could be considered a safe assumption that in an era when revenues and liquidity were constrained, many did not survive.

In 2012, Baruch College (CUNY) conducted research in six cities to determine how the economic challenges of the great recession affected nonprofit organization. Researchers found that corporate donations, government grants, and investment income decreased while

individual contributions and demand for services increased. Organizations needed to reduce their service delivery and cut expenses in order to survive.⁴

In a challenging environment, proficient financial management is a must. The framework of this book is intended to be of immediate value to nonprofit financial professionals and board members. This handbook caters to the chief financial officer, budget director, or treasurer with little or no formal training, business-only training, or too little time (perhaps due to a multitude of responsibilities) or support staff to do the job the way he or she knows it can be done. Our other target audiences are the chief executive officer (or executive director) and board members. This handbook specifically includes material for small and resource-constrained organizations, as well as large ones. Material is presented in an easy-to-use format, including forms or checklists where helpful. The discussion goes beyond the buzzwords to provide reasonable steps toward more proficient treasury management. We incorporate a number of concepts:

- Primary financial objective
- Donor accountability and stewardship
- Learning organization, reengineering, and benchmarking
- Balanced scorecard
- Program selection and cost-benefit evaluation
- Social entrepreneurship
- Strategic alliances and collaborations
- Accounting and financial reporting basics
- Financial statements and ratio analysis
- Budgeting techniques, including cash budgeting
- Financial forecasting and planning in the long term
- Liquidity measurement and analysis
- Fundraising evaluation
- Fraud prevention and detection
- Advanced cash flow management
- Investment and other financial policies
- E-business, cyber risk, and fraud detection and prevention
- Financial aspects of human resource management
- Cross-sector initiatives
- Sustainability practices

1.2 DEFINITION OF NONPROFIT ORGANIZATIONS

In the broadest terms, *nonprofit* is a designation given by the IRS to describe organizations that are allowed to make a profit but that are prohibited from distributing their profits or earnings to those in control of the organizations. If these organizations apply for and receive tax-exempt status from the IRS, they are not required to pay federal income taxes or state business income taxes except in specific cases, which are discussed later in this book. This classification makes them distinctly different from for-profit corporations, which distribute profits to their owners or shareholders and must pay corporate income taxes on their earnings. As a Section 501(c)(3) organization, the entity does not have to pay

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federal unemployment taxes. Furthermore, tax-exempt organizations *may* also be exempt from paying property tax, sales tax, and use tax – not all states exempt nonprofits from all of these taxes and challenges are mounting in some locales to take back these exemptions to meet governmental budget shortfalls.

In addition, contributions to some nonprofit organizations are tax deductible for donors. After receiving federal tax exemption, refer to the National Association of State Charity Officials website (www.nasconet.org) to see whether your organization is required to register with a state to solicit for contributions or be exempt from state taxes in that state. Further details regarding nonprofit organizations can be found in Sections 501 through 521 of the IRS code (www.irs.gov).

The approximately 1.9 million nonprofit organizations in the United States include about 1.6 million tax-exempt organizations registered with the IRS as 501(c) organizations as well as the 312,000 churches that are not registered with the IRS. It is worth noting that over 275,000 charities lost their tax-exempt status in 2011 because of their failure to comply with new IRS regulations that required nonprofits with less than \$25,000 in annual gross income to file a new form (Independent Sector, 2016).⁵ The number of nonprofit organizations in the United States must be estimated because many churches and very small nonprofits are not included in the IRS statistics. Churches, integrated auxiliaries of churches, and associations or conventions of churches, as well as any organization normally having gross receipts each year that are \$5,000 or less may be considered tax exempt under Section 501(c)(3) even without filing the IRS Form 1023. Some of these may file this form to obtain recognition from exemption from federal income tax anyway, simply to receive a determination letter from the IRS that both recognizes their 501(c)(3) status and indicates whether contributions to them are tax deductible for federal income tax purposes.⁶

The Independent Sector report that in 2013, nonprofit organizations provided 5.3 percent of the United States' Gross Domestic Product⁷ is further underscored by these estimates compiled by the Independent Sector and the Urban Institute.

- Over 10 percent of all paid employees in the United States are employed in the nonprofit sector. Between 2000 and 2010, employment in the nonprofit sector grew an estimated 18 percent, a rate faster than the US economy (Independent Sector, 2016)
- Total public charity revenues in 2013 were estimated to be \$1.73 million, with 48 percent coming from private dues and services, 24 percent flowing from government grants and contracts, 13 percent arising from private contributions, and the remaining 15 percent from other sources, such as investments, interest, and dividends
- Healthcare and education garnered about 59 percent of total nonprofit sector revenues in 2013.
- Private contributions go largely to religious organizations: In 2014, 32 percent of private contributions were received by congregations and other religious entities, according to the Indiana University Center on Philanthropy's Giving USA report. Education ranked a distant second, gathering 15 percent.⁸

(a) 501(C)(3) CORPORATIONS. Most organizations are qualified for tax-exempt status under Section 501(c)(3) of the IRS code. These organizations are usually termed “charitable” nonprofits. Included here are religious, educational, scientific, literary, social welfare, private foundations, and other charities. Their 501(c)(3) status gives them tax-exempt status *and* enables donors to give tax-deductible donations to them. Other 501(c) organizations are tax-exempt, but donors may not deduct donations to these organizations from their federal income taxes.

The management implications of tax-exempt status are fourfold:

1. Organizations are responsible for putting the mission first. Programs and activities must support that mission, which is to be of benefit to society and serves as the foundation for the organization's founding and ongoing existence. This stipulation implies that income-earning activities may be taxed if not closely linked to the organization's primary programs and services.
2. The organization does not issue stock and may not pay out excess revenues (those over and above expenses) to employees, board members, clients, or donors. This stipulation *does not* imply that the organization may not make a "profit," surplus, or net revenue, however. It does imply that the capital structure of the nonprofit is limited to debt financing, which many nonprofits limit or shun entirely, and the change in net assets, which may be obtained only by taking in revenues over and above period expenses. In the for-profit world, those accumulated profits are labeled "retained earnings." One advantage for nonprofit financial managers is that they need not concern themselves with issues of when and how much in cash dividends and share repurchases to initiate.
3. Nonprofits are not owned by their permanent capital providers, unlike the shareholder-owned for-profit organization. This stipulation implies that outside parties such as donors may not exercise direct control over the organization's affairs, particularly its financial policies.
4. Without shareholders as the stewardship focus of the nonprofit, the primary financial objective is not maximizing profits or shareholder wealth. This stipulation implies that the organization must determine and implement in its operations a different primary financial objective. We believe that objective to be achieving and maintaining a target level of liquidity.

We shall see the significance for managers and board members of items 2 and 4 later in this chapter and then more fully in Chapter 2.

The 501(c)(3) category includes about 76 percent of all tax-exempt organizations registered with the IRS in 2015. Exhibit 1.1 profiles the various categories of tax-exempt

| 501(c)(3) | Religious, educational, charitable, and similar |
|--------------------------|--|
| 501(c)(4) | Civic leagues, social welfare organizations, and local associations of employees |
| 501(c)(5) | Labor, agriculture, and horticultural organizations |
| 501(c)(6) | Business leagues, chambers of commerce, and real estate boards |
| 501(c)(7) | Social and recreational clubs |
| 501(c)(8) | Fraternal beneficiary societies and associations |
| 501(c)(9) | Voluntary employee beneficiary associations |
| 501(c)(10) | Domestic fraternal beneficiary societies |
| 501(c)(12) | Benevolent life insurance companies |
| 501(c)(13) | Cemetery companies |
| 501(c)(14) | State chartered credit unions |
| 501(c)(15) | Mutual insurance companies |
| 501(c)(17) | Supplemental unemployment benefit trusts |
| 501(c)(19) | War veteran's organizations |
| 501(c)(25) | Holding companies for pensions and other entities |
| Other 501(c) subsections | |

Source: US Internal Revenue Service.

| Type of Organization, IRS Code Section | 2012 | 2013 | 2014 | 2015 | 2016 |
|---|------------------|------------------|------------------|------------------|------------------|
| Tax-exempt organizations and other entities, total | 1,616,053 | 1,599,013 | 1,723,315 | 1,702,267 | 1,751,993 |
| Sections 501(c) by subsection | 1,484,818 | 1,442,197 | 1,568,454 | 1,548,948 | 1,599,471 |
| (1) Corporations organized by act of Congress | 449 | 615 | 708 | 638 | 643 |
| (2) Title holding corporations | 4,933 | 4,730 | 4,752 | 4,499 | 4,501 |
| (3) Religious, charitable, and similar* | 1,081,891 | 1,052,495 | 1,117,941 | 1,184,547 | 1,237,094 |
| (4) Social Welfare organizations | 93,142 | 91,056 | 148,585 | 84,155 | 83,392 |
| (5) Labor and agriculture | 50,046 | 48,545 | 48,711 | 46,576 | 46,591 |
| (6) Business leagues | 69,198 | 66,985 | 68,208 | 63,919 | 63,866 |
| (7) Social and recreation clubs | 56,880 | 54,962 | 56,139 | 47,956 | 48,482 |
| (8) Fraternal beneficiary societies | 50,763 | 48,578 | 47,773 | 46,264 | 44,610 |
| (9) Voluntary employees' beneficiary associations | 7,240 | 6,884 | 6,909 | 6,559 | 6,446 |
| (10) Domestic fraternal beneficiary societies | 16,432 | 16,049 | 16,998 | 16,226 | 16,469 |
| (12) Benevolent life insurance associations | 5,575 | 5,486 | 5,601 | 5,304 | 5,320 |
| (13) Cemetery companies | 9,636 | 9,482 | 9,858 | 8,977 | 9,125 |
| (14) State chartered credit unions | 2,797 | 2,711 | 2,326 | 1,887 | 1,812 |
| (15) Mutual insurance companies | 999 | 905 | 871 | 723 | 698 |
| (17) Supplemental unemployment benefit trusts | 130 | 112 | 110 | 103 | 98 |
| (19) War veterans' organizations | 33,737 | 31,674 | 32,039 | 29,749 | 29,493 |
| (25) Holding companies for pensions and other entities | 865 | 813 | 815 | 790 | 756 |
| Other 501(c) subsections | 105 | 115 | 110 | 76 | 75 |

*Includes private foundations. There are organizations in Section 501(c)(3) that do not need to apply for recognition of tax-exempt status. Included in this group are churches, other interchurch, integrated auxiliary, and conventions or associations of churches. Furthermore, with the exception of private foundations, if organizations have normal gross receipts in each taxable year of \$5,000 or less they do not need to apply for recognition. Finally, some organizations are covered by a group exemption letter given to their parent affiliate. If a Section 501(c)(3) organization did not apply for recognition of tax-exempt status, it is not included in this number.

Source: Tax Exempt and Government Entities, Exempt Organizations (IRS). Table 25 of IRS Data Books 2013–2016.

EXHIBIT 1.2 BREAKDOWN OF TAX-EXEMPT ORGANIZATIONS IN THE UNITED STATES

organizations in the United States and Exhibit 1.2 provides a numerical breakdown of 501(c)(3) and other categories of 501(c) organizations. Faith-based organizations are the largest single category within the 501(c)(3) world, and they will receive correspondingly greater attention in this volume. We also highlight managerial applications for healthcare and education in most chapters due to the disproportionate size of many of these entities. Many of these are also faith-based organizations as they are affiliated with religious organizations.

(b) BYLAWS AND ARTICLES OF INCORPORATION. The articles of incorporation (or charter) and bylaws are the initial documents that spell out the rules, regulations, and procedures for nonprofit corporations and form the basis for subsequent policy setting.

Nonprofit charitable organizations are exempt under Section 501(c)(3) of the Internal Revenue Code. Other tax-exempt organizations covered in this section include those exempt under Sections 501(c)(4) through 501(c)(25). Descriptions of these organizations are in Exhibit 1.1. The number of organizations for each type is shown in Exhibit 1.2. Note the increase in the total number of tax-exempt organizations, despite the fact that the IRS has worked to weed out closed or merged organizations from its data file.

The trustees are responsible for preparing, periodically reviewing, and amending these documents to keep pace with the mission and support structure of the organization.

The articles of incorporation are prepared and submitted when the organization first applies for state corporate status, and they are maintained in the state office responsible for corporate records (i.e., secretary of state's office).

The board of trustees (or board of directors) is also responsible for drafting the bylaws, which serve as the organization's operating rules. Bylaws are more detailed than the charter and include information such as the number and tenure of trustees, how and when meetings are to be called, when reports are to be presented, how board vacancies are to be filled, and other details needed to ensure the consistent and efficient operation of the organization.

The trustees are legally responsible for periodically reviewing the nonprofit organization's bylaws and articles of incorporation to ensure that they accurately reflect what is happening in the organization. It is also the trustees' responsibility to ensure that those provisions of the governing documents are followed.

Once these two documents are in place, the trustees should develop policy manuals covering their own service, personnel, finances, equipment, and other areas. These policies should address issues related to the operational and financial means of implementing the organizational mission, such as conflict of interest, human resource management, cash controls, cash management, investment guidelines, debt and liability guidelines, risk management (including financial statement compilation/review/audit and cyber risk), property, and facility use.

1.3 CHARACTERISTICS OF NONPROFIT ORGANIZATIONS

A nonprofit organization has most or all of these characteristics:

- Public service mission
- Organizational structure of a not-for-profit or charitable corporation
- Governance structures that preclude self-interest and personal financial gain
- Exemption from paying federal taxes
- Special legal status stipulating that gifts made to the organization are tax-deductible

We shall introduce the mission and the organizational structure in this chapter. We detail these items as well as governance structures and tax and legal provisions in subsequent chapters.

(a) ORGANIZATIONAL MISSION. One essential difference between a nonprofit and for-profit corporation centers on its mission. The ultimate mission of for-profit organizations is to generate wealth for the owners/shareholders, ranging from an individual, as sole proprietor, to corporate ownership through the purchase of shares.

A nonprofit organization does not include the concept of ownership and, therefore, has a completely different thrust. Its mission is to serve a broad public purpose, which is clearly

incompatible with ownership and personal gain. This prohibition of “private inurement” does not prevent nonprofit organizations from paying salaries to their employees, including the chief executive officer or chief financial officer. The board members typically donate their time as a public service and receive no compensation, with the exception of a few private foundations which compensate directors a nominal amount for necessary services the directors perform for the organizations.

These requirements also *do not* prevent nonprofit organizations from making money. Nonprofit organizations can and do make money in the same way as for-profit organizations. The difference is that the surpluses earned must be directed to the public purpose for which the nonprofit organization was established, held in reserve, or turned over to another organization with a public purpose. Thus, a key element of all nonprofit organizations is the use of earnings from the endeavor to promote the organizational goals, not to enrich the owners or stockholders.

The customers of nonprofit organizations are as diverse as their missions. Constituencies may include not only people, but also historic buildings, forests, endangered animals, and sports teams, individually or collectively. In addition, the people who have given their time, money, and other types of assets to further the cause are as much customers of the nonprofit as the actual recipients of the service being provided. They ask the most difficult questions of the nonprofit, have the greatest knowledge of the asset base, and are able to measure it against the activity performed on behalf of the organization. The organization acts as a steward both for its clients and its donors.

A for-profit organization has a clear mission (to make a profit) and a clear decision-making path for achieving it. However, the public service nature of a nonprofit poses a major challenge in terms of identifying and articulating its mission and developing criteria for measuring its success. The mission statement must not only define what the organization is and does; it must also state these concepts in a way that enables its achievements to be measured and evaluated. As we shall see a bit later in this chapter, many nonprofits are unclear even as to the primary financial objective(s) that they are or should be pursuing.

After developing its mission statement, a nonprofit organization faces two additional major challenges: identifying its client population and sources of funding, and within funders, identifying its donor constituency and level of involvement. After clearly identifying the group it intends to serve, a nonprofit must design an organizational structure that reinforces its commitment to the target group. It must then establish an image in the community, provide direction to potential funding sources, and either attract or repel the people to be served by the nonprofit organization.

(b) ORGANIZATIONAL STRUCTURE. The structure of an organization defines the roles and responsibilities of those charged with pursuing its mission – the board of directors/trustees, committees, staff, officers, outside contractors, and volunteers. A nonprofit organization must be structured to meet its goals. Water reclamation projects will require a structure involving engineers and construction experts, while feeding the homeless requires a completely different set of skills and financial resources to meet that goal. Although both operate as nonprofits, one may need to retain a huge amount of capital-intensive equipment, while the other may require only a portable cooking facility.

The type of nonprofit determines the organizational structure and complexity of its membership. Medical research, conducted in conjunction with commercial medical development, requires a strict accounting for the input of each member or contributor and an equally strict accounting for any profit or gain realized from the joint venture. The organizational structure for financial management, including treasury and controller

duties, will be addressed in greater detail in Chapter 4. We shall document how control and reporting duties, springing from chief financial officer (CFO) education and training as well as time and staffing concerns, have unfortunately taken precedence over treasury duties.

1.4 UNDERSTANDING THE LANGUAGE OF THE NONPROFIT ORGANIZATION

Some of the terms most commonly used by nonprofits with working definitions follow:

Articles of incorporation Legal document used to create a nonprofit organization; sometimes termed a “charter.”

Board of directors Two or more individuals who serve as the governing body of an organization.

Board of trustees Governing board of the nonprofit corporation (trust or charity); see *board of directors*.

Bylaws Set of rules that govern a nonprofit organization’s internal affairs.

Chair of board Person selected by board to be its leader.

Chief financial officer/controller Staff member most responsible for financial analysis and decision-making; in smaller organizations without finance staff this role may be jointly assumed by the CEO and the bookkeeper or board treasurer.

Conflict of interest State of affairs that looks suspicious and raises questions of appearances.

Deferred giving A charitable gift made before one’s death.

Endowment An accumulation of contributions that is held for investment; earnings, if any, can be distributed to programs.

Fiduciary One who is legally bound to oversee the affairs of another using the same standards as one would employ to look after his or her own assets.

501(c)(3) Section of the IRS Internal Revenue Code that defines charities as a special type of tax-exempt, nonprofit corporation; other than testing for public safety organizations, all 501(c)(3) organizations are eligible to receive tax-deductible donations.

Fund Separate accounting records for a part of the organization, such as permanent endowment, board-designated investment amounts, or restricted for a specific purpose by donors. Grant tracking falls under this.

Fund accounting Technical accounting term that refers to a system of accounting for funds by project, so that assets and liabilities are grouped by the purpose for which they will be used; use of fund accounting is inconsistent with newer accounting standards’ emphasis on showing the financial position of the organization as a whole, but many organizations continue to use fund accounting for internal book-keeping and stewardship purposes.

Nonprofit Corporation that is not allowed to distribute profits or surpluses to its board or those in control of the organization.

Officer of corporation Legal representative of the board of nonprofit corporation: president, vice president, secretary.

Permanent fund A fund in which the principal is never spent.

Philanthropy Goodwill; active effort to promote human welfare.

Restricted fund A fund that has been contributed to a nonprofit organization for a specific, designated purpose and cannot be used for general operations.

Secretary Officer of nonprofit board responsible for preparing board agendas, minutes, and other documentation of business of the nonprofit board.

- Stewardship* Holding something in trust for another.
- Tax-exempt* Not subject to income taxes.
- Treasurer* Traditionally, the chief financial officer of nonprofit organization; now used in more restricted sense as board member having the primary responsibility for the board's oversight of financial policy and financial issues such as budget approval.
- Unrestricted fund* A fund contributed to a nonprofit organization whose use is determined by the board of directors.
- Volunteer* One who does meaningful, but unpaid, work for the nonprofit organization.

1.5 FINANCIAL POLICIES

We cannot emphasize this strongly enough: The most important aspects of proficient financial management in the nonprofit sector are the primary financial objective and the financial policies the organization uses. Second in importance are the tools and practices used, but these are primarily means of implementing the objective and policies. Throughout this book, we emphasize how the various financial management areas link up to the primary financial objective, and we provide guidance on appropriate financial policies in those areas. While we view this as critically important, many clients and students report that their organization does not have financial policies or that if there are policies, they are not aware of them. We postulate that sustainable financial practices in nonprofit organizations rely on this foundational concept.

Policy is the rule of law for an organization in a particular decision area. Examples include an organization's investment policy or internal cash control policy. Policies should be viewed as a set of guidelines (laws, rules) or principles for how day-to-day business should be performed. Some policies are determined internally; others are prescribed for the organization by outside organizations and are necessary in order to accept funds from those organizations or to work within applicable laws and regulations. Even if policies are not written down, all organizations have some financial policies that comprise the guiding principles regarding how they do certain things. Were it not for policies, a method or plan would have to be established each time someone needed to do something. Think of procedures as the specific steps that will be followed in order to implement a particular policy.

To help us distinguish between policy and procedure, let's consider two general definitions for policy and procedure, one authoritative and the other practical:

| | Authoritative | Practical |
|-----------|---|--|
| Policy | A definite course of action adopted as expedient or from another managerial consideration | A set of guidelines or principles defining an organization's philosophy about how business should be conducted |
| Procedure | The act or manner of proceeding in any action or process; conduct | Steps and/or actions to be taken to comply with a specific policy |

Throughout this book, we illustrate financial policies and some financial procedures. In addition, for those wishing to further investigate policies and procedures, Chapter 5 provides guidance on how to go about setting policies in many areas, for organizations that have never before formalized their policies and for those organizations that wish to revisit

their policies periodically to modify and update them. Chapter 15 builds on that discussion and introduces additional ways to review policies. In today's donor, grantor, and regulatory environments, it is extremely important to be able to document and communicate policy.

1.6 FINANCIAL PRACTICES

A special focus in this book that sets it apart from other books in the field is the our presentation of the “state of the art” regarding practices in nonprofit financial management. We develop this profile in three ways:

1. We provide survey evidence from studies we have done as well as others on the degree to which organizations use tools and techniques in carrying out the finance function. Critical evaluation is offered on current practices.
2. We profile business-sector practices that nonprofit sectors may adapt for their charitable missions and for earned income ventures.
3. We present brief case studies or single-organization illustrations of “best practice” implementation, including anecdotal observations we have made and illustrations gathered from consulting firms and financial service providers.

Practices covered include the following:

- Primary financial objectives
- Organizing the finance function
- Accountability structure
- Use of technology in treasury
- Conforming to external watchdog standards
- Cash and liquidity management
- Banking selection and relationship management
- Budgeting
- Cash forecasting
- Financial ratio analysis
- Reporting
- Long-range financial planning
- Capital project evaluation
- Investment policies and management, short-term and long-term
- Relative use of different forms of debt
- Bank borrowing and how banks view nonprofit organizations
- Tax-exempt bond issuance
- How bond raters view nonprofit organizations
- Earned income ventures/social entrepreneurship
- Evaluating mergers and acquisitions
- Risk management
- Foreign exchange and interest rate risk exposure

- Board duties and how they are viewed
- Internal controls
- Financial accountability

In the companion book, *Cash & Investment Management for Nonprofit Organizations* (published in 2007), we provide more in-depth guidance on:

- How and why cash management and investments provide financial strength for the nonprofit
- Cash and liquidity management
- Appropriate size for cash and operating reserves
- Using reserves to self-fund new program and program expansion capital expenditures and maintenance
- Short-term investment policies and practices
- Long-term investment policies and practices
- Endowment
- Pensions

All of these decision areas steer the organization toward accomplishment of its primary financial objective.

1.7 PRIMARY FINANCIAL OBJECTIVE

Board members and financial executives who come to nonprofit organizations from the business sector are often confused and frustrated by the different environment. Consider the two polar extremes in Exhibit 1.3. At one extreme are organizations that are able to gain all of their revenue from product or service sales. These “commercial” organizations look much like businesses and are sometimes labeled “businesses in disguise.” But most nonprofits are religious organizations or charities, which find themselves at or near the opposite pole, with their revenues coming from grants and gifts. These are termed “donative” or donation-dependent nonprofits. They provide “public goods” free of charge or at subsidized rates to their clients. Before directly addressing the most appropriate financial objective for a nonprofit, let us discuss why this is important.

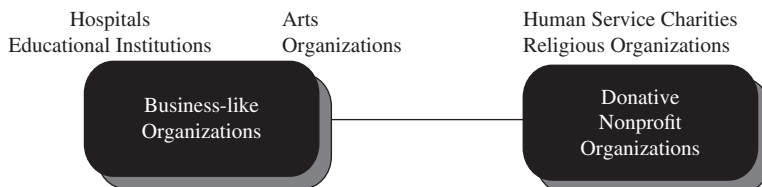


EXHIBIT 1.3 SPECTRUM OF NONPROFIT ORGANIZATIONS

(a) DIFFERENCES BETWEEN BUSINESSES AND DONATIVE NONPROFITS.

(i) *Businesses Have a Numerical, Specific Objective: Maximize Stock Price.* This specific objective typically translates into maximizing long-run risk-adjusted profits. Intermediate targets that foster increased profits and stock price are also pursued. These targets include increasing market share (a company's percentage of total industry sales), increasing quality, increasing share of mind (identified by company's target audience), and increasing short-run revenues or reducing short-run costs (or both). Nonprofits that are business-like in nature, such as hospitals and private schools or colleges, can adopt many of these same intermediate targets. However, donative nonprofits generally do not see their revenues automatically increase when they provide more services. This fact is significant for three reasons.

1. The donative organization is forced to do additional fundraising just to cover the added costs of providing more of the same or new services, instead of simply collecting higher revenues from additional sales, as a business would.
2. The nonprofit that does not understand this linkage will find itself in an ever-worsening financial shortfall each period that transpires without new donations.
3. A large percentage of nonprofit funding (grants and contributions) is restricted for time or purpose. In addition, nonprofits often receive multiyear grants, and GAAP accounting standards require that the total amount be recorded when the grant agreement is received. This requirement creates a situation where nonprofit accounting practices differ significantly from businesses (often creating a lot of confusion in the boardroom).

For these reasons, financial management is more challenging for the donative nonprofit. Soon we shall point to a more appropriate primary financial objective.

(ii) *Businesses Can Price Their Services and Then Use Revenues to Gauge Their Marketing Success.* "Business-like" nonprofit entities, such as hospitals and educational organizations, can and do gauge marketing success from revenues for some of their programs and services, insofar as they do not violate their exempt status and societal role. Donatives and dues-based nonprofits may also apply this standard to certain of their earned income ventures. Revenues do not clearly reflect the quality and quantity of all services provided, however.

(iii) *Businesses Typically Know Who Their Customers and Owners Are.* Knowing who customers and owners are may be difficult for nonprofit organizations, particularly donative ones. Are the donors the customers, the owners, both, or neither? Or is the organization tied permanently to the activities specified in the charter and/or articles of incorporation, in a sense owned by its founders or society? Determining this is important because in order to assess trade-offs correctly when making major programmatic decisions, especially when finances are tight, managers must make the assessment based on the proper criteria. Some organizations have gone overboard with this, defunding, mothballing, or radically changing key programs due to declining financial support, even though those programs were central to their missions.

(iv) The Typical Pattern of Cash Flows Often Differs, Particularly for the Donative Nonprofit. In donative nonprofits, the fiscal year often begins with a stockpile of financial resources that must cover the shortfall of donations experienced prior to the major inflow around Thanksgiving and Christmas. The stockpile may include one or more of: cash on hand, short-term securities, bank loans, soon-due pledges receivable, or salable merchandise. The service effort is typically constant or almost so during the year, and the payroll and supplies expenditures continue on a fairly steady basis. Donations tend to cluster around Easter and the period from Thanksgiving to Christmas. The organization lives off its stockpile, to a large degree, until the heavy inflows materialize, at which time it replenishes its stockpile. When face-to-face fundraising is done, and wills and bequests are received periodically as a matter of course – as with Father Flanagan’s Boys Town – the organization may use an income stream generated by endowments to partly offset the dry periods. The restricted nature of many of the large gifts, wills, and bequests may preclude interest or principal from being used for operational needs. Consequently, many nonprofits may experience a short-term need for funds during their operating cycles. The need for funds may have resulted from a downward trend in donations, a predictable seasonality in the receipt and disbursement of cash, or an unexpected event affecting costs, such as a strike. The worst case may occur when demand suddenly accelerates: When a business experiences higher sales, the sales revenues typically offset the higher costs, but a nonprofit has no assurance that donations will increase quickly when more services are provided. During the height of the Great Recession (2008–2009), many nonprofits were faced with the perfect storm of financial management. Their donations went down, the value of their investments decreased, and the need for services rose.⁹

Taken together, these operating characteristics of organizations that depend on donations for a significant percentage of their annual revenues drive their financial focus to a different objective. We now turn to some survey evidence to find out what that objective is.

(b) SURVEY EVIDENCE ON THE PRIMARY FINANCIAL OBJECTIVE. In our early 1990s Lilly Endowment–sponsored study of 288 chief financial officers of faith-based organizations, “financial break-even” (revenue equals expenses) was the dominant financial objective (111 respondents), followed by “maximize net revenue” (59 respondents).¹⁰ As secondary objective, respondents indicated a concern for cost minimization (34 respondents), avoiding financial risk (25 respondents), and maximizing net donations (20 respondents). One observation we make here is that financial risk avoidance is justifiably gaining attention from nonprofit organizations. *Yet we believe that break-even and cost minimization are inadequate as primary financial objectives.* It would be much better to focus on net revenue, financial risk, net donations, or cash flow – all of which represent more focused attention to the positive contribution the finance function can make to mission achievement. Maximizing cash flow or net revenue, or attempting to break even, will force attention on cost control. Accordingly, cash flow or net revenue may retain the best of each of the other two related objectives while adding to them. This in no way negates the importance of program outreach and quality attainment, but indicates ways in which resources will be allocated to carry out the mission. Yet, we argue that the primary financial objective is to set and strive to achieve a targeted liquidity level. (See Exhibit 1A.1 for more on this study and its results.)

Subsequent to that study, the Lilly survey instrument was revised to include more objectives from which to choose as the organization’s primary financial objective. A fax-back survey was administered in 2002 to member organizations of a group of faith-based international outreach organizations, now part of a larger group called Missio Nexus.

The results are fascinating. Respondents were asked first to select their organization's primary financial objective. The results are shown here:

| Percentage of Respondents | Primary Financial Objective |
|---------------------------|--|
| 35.7% | Break even financially |
| 21.4% | Maintain a targeted level of cash reserves and financial flexibility |
| 14.3% | Maximize cash flow |
| 7.1% | Minimize costs |
| 7.1% | Maximize net revenue |
| 7.1% | Maximize net donations |
| 7.1% | Make a small surplus |
| 0.0% | Avoid financial risk |

The key point to note is that ten years after the original survey 35.7 percent (21.4% + 14.3%) of a similar group of nonprofit organizations were focusing much more on cash flow and cash position – or “liquidity management” (just as many as were following the “received wisdom” that has been recommended by various sources to nonprofits: of not making a profit but covering costs).

More recent evidence we have comes from a 2011 survey of 514 mid-sized nonprofits conducted by Indiana University and conference surveys from a Rice University development-finance annual symposium. The Indiana University survey finds that “striving to meet an appropriate liquidity target over time – that is, “maintaining a targeted level of cash reserves and financial flexibility” (37.6 percent) and “assuring an annual surplus so the mission can be achieved in down years” (26.6 percent) – are the top two primary financial objectives for organizations. An additional 23.7 percent reported that breaking even financially was a primary financial objective for organizations.”¹¹

Three preconference surveys administered to attendees of the Rice Development & Finance Symposium in 2014–2016 found that between 33 percent and 45 percent of the respondents selected “achieving and maintaining a targeted level of cash reserves and back-up liquidity” as their organization's primary financial objective.¹² Clearly, targeting liquidity and achieving financial flexibility while doing so constitute the financial objective that is primary in the minds of nonprofit financial managers. Simply “balancing the budget” no longer suffices, as surpluses are necessary to build and sustain the cash flow needed for a thriving organization.

Cash flow refers to the difference between cash inflows and cash outflows in a given period. **Cash position** is the amount of cash and near-cash investments held by the organization. **Liquidity management** includes forecasting, and managing cash flow and the cash position, and ideally should include setting and managing toward a preferred cash position, or liquidity target. A **liquidity target** includes the elements of the cash position, along with unused short-term borrowing capacity. Your organization may have a pre-approved line of credit with a bank, some of which has not been borrowed or “taken down” at present.

Also important to note here is that the majority of respondents in each of the surveys chose an objective *other than financial break-even* as best describing their organization's primary financial objective. Apparently an increasing number of CFOs have concluded that striving for financial break-even cannot suffice as a nonprofit's primary financial objective. We elaborate on liquidity targeting in the next sections.

(c) **FINANCIAL OBJECTIVE FOR PURELY FINANCIAL DECISIONS.** Richard Wacht, an academic who has written on nonprofits, proposes that a nonprofit's financial objective be limited to "purely financial decisions" and is best stated as "cost minimization, subject to the absolute constraint of maintaining organizational liquidity and solvency over time."¹³ He arrives at this objective by assuming that the financial objective must be largely divorced from the programmatic, mission-related objectives. While we see this as true up to a point, we believe that the program and financial objectives are more closely and holistically linked in most organizations' decision-making and in most major spending and service-level decisions.

(d) **RECOMMENDED PRIMARY FINANCIAL OBJECTIVE: APPROPRIATE LIQUIDITY TARGET.** Our view, based on field evidence we have gathered, survey evidence, and the environmental and management constraints nonprofits face, is that the primary financial objective of organizations is to *strive to meet an "appropriate liquidity target" over time*. Managing cash flow, the cash position, and back-up sources of cash are the keys to accomplishing this. Implementation of this objective requires marshaling (a) enough cash, (b) at the right time, and (c) not overpaying to have that cash available, while (d) protecting that cash from impairment, and then (e) spending that cash in support of the mission while adhering to donor stipulations. We develop the basis for this conclusion in Appendix 1A and in Chapter 2.

When this primary objective is described to clients and our college-level financial management students, the response is often that this seems obvious when stated. It seems to make sense to them because of its intuition but is not generally thought of as being normative.

For those uncomfortable with a single objective, consider the financial objectives articulated by William Hopkins, former treasurer of ChildFund:¹⁴

- Cost effectiveness
- Financial accountability
- Maximization and protection of cash flows
- Maintaining liquidity that ensures the future of the organization

Were we to implement these objectives in our organizations, we would order them in terms of importance:

- Maintaining liquidity that ensures the future of the organization
- Maximization and protection of cash flows
- Cost effectiveness
- Financial accountability

No doubt some readers will express surprise that we placed financial accountability last. An important first step toward financial health and sustainability is maintaining the necessary amount of liquidity. At a minimum, this entails setting up an **operating reserve**.¹⁵ Formally, an operating reserve is:

... an unrestricted fund balance set aside to stability a nonprofit's finances by providing a "rainy day savings account" for unexpected cash flow shortages, expenses or losses. These might be caused by delayed income payments, unexpected building repairs, or economic conditions.

While championing accountability, we prioritize liquidity for two pragmatic reasons:

1. Managers tend to focus on one or at most two primary objectives, and we believe the first two in our ordering of Hopkins's list are the most important objectives.
2. Environmental factors and the accounting training of the CFO of many organizations ensure that much attention will be paid to financial accountability.¹⁶

We have seen a small number of organizations that are not as careful in being accountable as we would hope.

1.8 CONCLUSION

The nonprofit environment is a challenging one for financial managers. Multiple stakeholders, confusion about what financial objective to pursue, limited staff, funding, and technology resources, and inattention to cash and treasury management are all factors contributing to the difficulty of the nonprofit financial management.

We have presented the main structural components, the key policy areas, and the primary financial objective in this chapter. We profiled the survey evidence regarding the objective that the chief financial officers of charities say that they pursue, and found that cash position and cash flow management are becoming more prominent. We then recommended as a primary financial objective striving to meet an “appropriate liquidity target” over time. This entails running surpluses in some years, possibly deficits in a few years. We develop the idea of liquidity management, including monitoring the cash position and managing cash flow, in greater detail in Appendix 1A and in Chapter 2.

In the remainder of this book, we provide guidance on how this cash position and cash flow management focus translates into financial policy and practices. In our next chapter we turn to a fuller investigation of why these concerns should be at the top of a nonprofit organization's financial concern list.

Notes

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THE LILLY STUDY FINDINGS

THE LILLY STUDY

We have seen much hyperbole about the true state of financial management in nonprofit organizations. This is especially the case regarding perceptions of social services charities, religious, and art organizations – really all nonprofits outside the health and education sectors. A large group of these donative organizations, which depend on gifts for 60 to 100 percent of their annual operating revenues, was the focus of a two-phase study completed in the early 1990s. This study was funded by the Lilly Endowment, Inc. as part of a project entitled “Organizational Goals and Financial Management in Donative Nonprofit Organizations” conducted by John Zietlow.

More than 1,000 religious or religiously based organizations in four categories were selected for study: denominational headquarters, denominational foreign missions (where the headquarters was separate), independent foreign mission agencies, and localized rescue missions. The latter are often called homeless shelters, but their work goes beyond sheltering.

Treasury management topics were studied in detail in Phase 1 of the project. Questions were asked on a 12-page mail survey about organizational and financial goals and all “short-term financial management” (STFM) or treasury management areas: cash management, cash forecasting, inventory management, accounts receivable and accounts payable management, bank selection and relations, fundraising evaluation, short-term investing, short-term borrowing, risk management, and organizational attributes. Logical organizational characteristics were studied to better understand why certain organizations functioned more effectively or efficiently than others: size, age of the organization, role and interest of the board of directors, and formal training and experience of the chief financial officer.

Completed surveys were received from 288 (29 percent) of the surveyed organizations, a good response rate for a survey that is lengthy and difficult to complete. Based on the survey responses, and with the help of an expert advisory panel, each organization’s survey responses were scored based on the financial management sophistication portrayed in the answers provided. For each of the four categories listed, the “best in class” organization was visited in person, as was an “average-rated” organization. How and why CFOs followed specific approaches and used various financial management techniques was the focus of in-depth interviews along with additional decision making and board evaluation questionnaires. Interviews were conducted with the CFO, CEO, and the outside (nonemployee) board member most familiar with that organization’s financial management.

The typical organization was small, having an annual revenue of only \$800,000, on average. One-half of the CFOs had related business experience, typically eight years or more.

The “best of the best,” those organizations having the highest overall STFM score in their respective categories, were:

- Independent Foreign Mission: Campus Crusade for Christ (Orlando, FL – John Webb, Director of Finance)
- Denominational Mission: (1) Church of God Missionary Board (Anderson, IN – Darryl Smith, CFO); and (2) Southern Baptist Board of Missions (Richmond, VA – Carl Johnson, CFO)
- Rescue Mission: Peoria Rescue Ministries (Peoria, IL – Reverend Jerry Trecek, CEO and CFO)
- Denominational Headquarters: Church of the Brethren (Elgin, IL – Darryl Deardorff, CFO)

The findings provided in the next section are mostly linked to survey results, although our understanding of these findings was enriched by what was learned in the onsite visits. We now turn to what the survey results revealed.

KEEP THE MISSION FIRST! The first principle that the survey results revealed cannot be emphasized strongly enough: Mission first! Nonprofit organizations do not answer to stockholder owners but instead must adhere to the charter and mission of the organization. Finance sustains mission. Regrettably, some organizations permit a proposed new program to take precedence over existing programs, simply because corporate or foundation or government grant money is easier to get for the proposed program (which often is not closely linked to the charter or mission of the organization).

MANAGEMENT AND FINANCIAL OBJECTIVES

Management Objectives Maximizing the quality and quantity of service was selected by most respondents as the primary management objective, followed by maximize quality. Mission-minded organizations are service-minded, as one would expect.

Financial Objectives Break-even (total revenues equal to total expenses) was the dominant choice selected as descriptive of the organization (111 of the 288 respondents), followed by maximize net revenue (59 respondents). As a secondary objective, respondents indicated a concern for cost minimization (34 respondents), avoiding financial risk (25 respondents), and maximizing net donations (20 respondents).

We note that, on the positive side, financial risk avoidance is justifiably gaining attention by religious nonprofit organizations. However, break-even and cost minimization are inadequate as primary financial objectives, in our view. It would be much better to focus on net revenue, financial risk, and net donations – all of which represent more focused attention to the positive contribution the finance function can make to mission achievement. Even the latter objectives are secondary in our opinion. In chapter 1 we proposed and in Chapter 2 we defend an objective that supersedes these objectives—that of achieving an appropriate liquidity target. One must recognize the overlap between the break-even and cost minimization and maximizing net revenue objectives, as shown in Exhibit 1A.1. Maximizing net revenue or attempting to break even will force attention on cost control. Accordingly, net revenue may retain the best of the other two objectives while adding to them. This in no way negates the importance of program outreach and quality attainment, but it indicates ways in which resources will be allocated to carry out the mission. We also note that

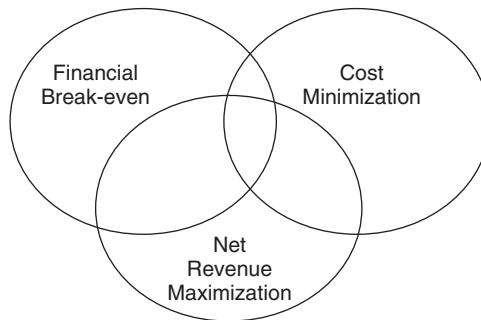


EXHIBIT 1A.1 OVERLAP OF SEVERAL POPULAR FINANCIAL OBJECTIVES

some organizations budget for a “contingency” or add a “savings account (or operating reserve) contribution” in their expense listing, implying that “break-even” objective is in fact a “small surplus” objective. Using a very conservative revenue and support forecast along with a realistic expense forecast has the same result as adding a contingency or reserve set-aside.

We consider “net revenue” as a second-best primary financial objective for most non-profits. We imagine the following conversation between two chief financial officers (CFOs), CFO #1 who believes net revenue is the best objective and CFO #2 who believes a liquidity target is the best objective:

Topic of Discussion: “What is the best primary financial objective – to maximize funding? If no, what should be the primary financial objective?”

CFO #1: “No. Net revenue should be the primary financial objective.”

CFO #2: “No, setting and reaching a target amount of liquidity should be the primary financial objective.”

CFO #2 then cross-examines CFO #1.

CFO #2: “Then you want to maximize net revenue?”

CFO #1: “No.”

CFO #2: “So, do you want to strive for a target amount of net revenue?”

CFO #1: “Maybe, yes.”

CFO #2: “What would you set your target based on?”

CFO #1: “A funding target, maybe.”

CFO #2: “Could an organization still fail financially, or fail to meet its other financial goals when doing this?”

CFO #1: “Yes, I guess so.”

CFO #2: “Why?”

CFO #1: “Well, I guess it might have inadequate cash or other forms of liquidity, and either go out of business or not be able to make investments in growth or new programs.”

CFO #2: “OK, could we derive a target net revenue and have that serve as a means to the end of reaching a liquidity objective?”

CFO #1: “Yes, I suppose we might.”

CFO #2: “How?”

CFO #1: “By having a liquidity target and then backing into the required net revenue to bring in that year to reach or maintain that target amount.”

CFO #2: “And what would that required net revenue be based on?”

CFO #1: “Financial projections for the organization. I would project operational and capital (property, plant, equipment) needs, which combined would be my funding need. From that I would then know what my financial cash flow would need to be for that period. We would then determine how much outside financing through loans or bonds we might go after, and the gap that remains would have to be funded through internal funding in the form of net revenues.”

CFO #2: “Exactly! I believe we are making an assumption here about the mission, mission funding, and reaching the primary financial objective.”

CFO #1: “I am not sure I understand; could you explain?”

CFO #2: There must be a direct tie between the mission (and its programs), the funding of that mission through revenues and support, and meeting the primary financial objective. We have to ensure consistency between this year’s programmatic outreach, funding mix and amount, and reaching the target liquidity amount.

An example will help us see how these items tie together. Our organization has a debt policy that is “maxxed out” at this point in regards to outstanding borrowings. It does not anticipate any investment gains or losses during the year, and all revenues and support will be received in cash during the year. It has a target liquidity (Appropriate Liquidity Target) of \$475,000 for the year just ended. The organization’s ALT, or target liquidity, has been set at \$500,000 for next year. Let’s say that in the coming year the planned mission level and its programs will require the following expenses and expenditures:

Expenses:

| | |
|--|------------------|
| Program Expenses | \$750,000 |
| Management Expenses | \$125,000 |
| Fundraising Expenses | \$45,000 |
| Depreciation Expense (not allocated to above categories yet) | \$30,000 |
| Total Expenses | \$950,000 |

Other Expenditures:

| | |
|---|------------------|
| Working Capital (Inventories, Receivables, Short-Term Growth Capital) | \$50,000 |
| Addition to Storage Space | \$100,000 |
| Repayment of Previous Borrowings | \$20,000 |
| Total – Other Expenditures | \$170,000 |

The most accurate and realistic forecast of revenues and support for the upcoming year is:

Revenues & Support:

| | |
|---------------------------------------|--------------------|
| Revenues | \$875,000 |
| Support | \$125,000 |
| Total – Revenues & Support | \$1,000,000 |

Note that this organization plans to “run a surplus,” or positive net revenue, of \$50,000 (\$1,000,000 – \$950,000). Recall that the organization’s ALT, or target liquidity, has been set at \$500,000 for next year. Note that this is \$25,000 higher than this past year’s target liquidity of \$475,000, due perhaps to organizational growth.

Is the projected net revenue, based on the mission’s plan and related expenses and expenditures, sufficient to maintain the organization’s target liquidity of \$500,000? If not, what action(s) might we recommend?

First, let's adjust the expenses for the fact that depreciation is a noncash expense. It is a bookkeeping entry (see chapter 6), and does not represent a cash outflow. Cash expenses then equal \$920,000 (= \$950,000 – \$30,000).

Second, we add other expenditures to the adjusted expense amount to get funding need.

$$\begin{aligned}\text{Total Funding Need} &= \text{Adjusted Expenses} + \text{Other Expenditures} \\ &= \$920,000 + \$170,000 \\ &= \$1,090,000\end{aligned}$$

Third, we find the difference between Total Revenues & Support and Total Funding Need:

$$\begin{aligned}\text{Excess (Shortfall) in Funding} &= \text{Total Revenues \& Support} - \text{Total Funding Need} \\ &= \$1,000,000 - \$1,090,000 \\ &= (\$90,000), \text{ or a } \$90,000 \text{ Shortfall}\end{aligned}$$

Finally, we check to see if our projected Excess (Shortfall) in Funding will suffice given the existing target liquidity level of \$475,000 and the required target liquidity level of \$500,000:

$$\begin{aligned}\text{Required Target Liquidity} &= \text{Existing Target Liquidity} + \text{Excess (Shortfall) in Funding?} \\ \$500,000 &= \$475,000 + (\$90,000)? \\ \$500,000 &> \$385,000\end{aligned}$$

Or, in words:

$$\text{Required Target Liquidity} > \text{Existing Target Liquidity} + \text{Excess (Shortfall) in Funding}$$

Now, how might we address this \$115,000 projected deficiency? The temptation is to task the development office with bringing in an additional \$115,000. The problem here is that that would take more resources to invest, and many nonprofits are unwilling or unable (do not have the extra funds) to make that investment. Additionally, we are uncertain regarding the ability of more development effort to bring in an additional \$115,000 when it is presently expected to raise \$170,000. Another option is to establish or increase the size of a credit line with a financial institution. We turn down this option because borrowing is not a means of bringing in reliable, yearly revenues and support to fund ongoing annual expenses. The painful option, but most likely one in the short-run, is to reduce our planned expenses and other expenditures to be able to meet our primary financial objective of \$500,000 (and, we might add, that may only need to be \$475,000 with a lower level of expenses and expenditures). After studying the make-up of the planned expenses and expenditures, management and the board finance committee jointly determine that (1) \$475,000 will suffice as a revised target liquidity with a somewhat smaller programmatic expenditure next year, leaving us with a \$90,000 gap (= \$115,000 previous gap – \$25,000 reduction in liquidity target) and (2) outflows may be pared by reducing program expenses by \$70,000, management expenses by \$10,000, and working capital expenditures by \$10,000. Our financial

plan now generates enough of a net surplus to deliver a slightly smaller-than-planned level of programmatic services and achieve the primary financial objective of maintaining a target liquidity level of \$475,000. We now insert our modified numbers to recheck whether our projected Excess (Shortfall) in Funding will suffice given the revised required target liquidity level of \$475,000:

$$\begin{aligned}\text{Excess (Shortfall) in Funding} &= \text{Total Revenues \& Support} - \text{Total Funding Need} \\ &= \$1,000,000 - \$1,000,000 \\ &= \$0 \\ \text{No excess or shortfall.}\end{aligned}$$

$$\begin{aligned}\text{Required Target Liquidity} &= \text{Existing Target Liquidity} + \text{Excess (Shortfall) in Funding?} \\ \$475,000 &= \$475,000 + \$0? \\ \$475,000 &= \$475,000.\end{aligned}$$

Let's circle back to see what this implies about net revenue (or surplus, as it is commonly called). Were you able to detect the planned net revenue to bring this about? The \$80,000 reduction in planned expenses implies the net revenue for the year will now be \$130,000 ($=\$1,000,000 - \$870,000$). Had the organization not made these calculations and been accepting of running a slight surplus of \$50,000, by the end of the upcoming year it would have seen its liquidity drop by \$115,000 from \$475,000 to \$360,000. It is easy to see how and why so many nonprofits experience cash shortages as they plan only small surpluses, or worse, break-even operating results.

Achievement of Financial Objective: How Well Are You Doing, Regardless of Objectives Pursued? Self-ratings on the achievement of the stated financial objective were: excellent (14 percent of respondents), very good (43 percent), good (30 percent), fair (10 percent), and poor (4 percent). This self-rating was one of the best predictors of the organization's overall Short-Term Financial Management (STFM) Score. The overall score was determined based on a careful evaluation of each question in terms of its ability to indicate proficient financial management. An expert advisory panel, assembled under guidance of the Lilly Endowment, assisted in this process. Our rationale for doing this scoring is that primitive financial management process and techniques are unlikely to achieve effectiveness in an organization's financial management outcomes. Individual questions within the survey were differentially rated, based on appropriateness for the size and type of organizations studied. We were impressed by the fact that most respondents had a fairly accurate idea of how effective their financial management process was, and the tabulated results indicate that sophistication (what the questionnaire was really measuring) had a strong correlation with perceived effectiveness (as measured by the respondent's self-assessment).

Is the Indicated Financial Objective Really Operational? This finding is fascinating. A hypothetical decision was posed to the respondent to find out whether the financial objective was actually being pursued or was merely a stated objective. A new or expanded program recommended by the CEO or board clearly conflicts with the financial objective: What would most likely be done? In 46 organizations (17 percent), the program would be fully implemented anyway; in 68 organizations (24 percent), it would be scaled down somewhat, but the financial objective would still be set aside; and in 166 organizations

(59 percent), the objective would be met by scaling down the program adequately or not implementing it at all. In other words, the finance function imposes essentially no discipline on 46 of the organizations that responded, and in an additional 68 organizations, that discipline is weak. Possibly this is due to ignorance among the officers regarding either the proper role of finance or the importance of sound financial management. The good news is, that in roughly three in five organizations, the financial objective held sway over programmatic expansion that would be financially jeopardizing.

Some nonprofit executives would object to our conclusion that forging ahead with a new program despite the fact that it causes the organization to fall short of meeting its primary financial objective implies poor management “because we are called to do this and faith must be exercised.” For organizations with a religious orientation, this response may be legitimate. Finance staff would carefully monitor such program initiatives to ensure that additional funds are ultimately raised to vindicate that faith. Where sufficient funds do not materialize during program implementation, this fact should be made apparent to the CEO and board in order to (1) ensure that the organization does not unduly expand those programs (draining resources from other important program areas) or add new ones until cost coverage is attained, and (2) inform decision makers of the types of situations about which to be more cautious in the future. As Ron Mattocks, author of *The Zone of Insolvency*, likes to say, “faith and prudence are not mutually exclusive.”

ON-SITE INTERVIEWS, QUESTIONNAIRES, AND ARCHIVAL STUDIES

The second phase in the Lilly study involved field studies of eight selected organizations. In-depth interviews, study of archived documents such as board meeting minutes and financial reports, and a statistical study of cash flows were executed for each of the eight organizations. A pattern of financial decision making appeared from these studies, particularly for those organizations that were scored highly on the financial management proficiency rating that we applied to the survey results. Bear in mind that the organizations studied are non-commercial, donative nonprofits. These results and the conclusions we garner from them are still applicable to commercial nonprofits such as hospitals or colleges, but healthcare and educational foundations as well as private foundations may see the liquidity target as a secondary objective.

THE APPROPRIATE LIQUIDITY TARGET MODEL

We call the model the “Appropriate Liquidity Target” model of financial decision making. Exhibit 1A.2 provides a graphical presentation of the hierarchy of factors influencing decision making in this model. Notice that the central concentric circle depicts the primacy of the organization’s mission – its charitable purpose.

Note the financial objective nearest to the center – “liquidity target.” It appears that organizations strive to maintain, within some range they are comfortable with, a certain amount of liquidity – an Appropriate Liquidity Target (ALT). This target may also be called an “Approximate Liquidity Target,” in that it is managed intertemporally. This is just a fancy way of saying that the organization’s liquidity may dip below or shoot above the targeted range in any given year, but the organization will attempt to return its level of liquidity to the prescribed range in the following year(s). What might be an acceptable amount of liquidity for one organization could well be too high or low for another, very similar organization.

Donative Nonprofit Decision-Making Influence Spheres

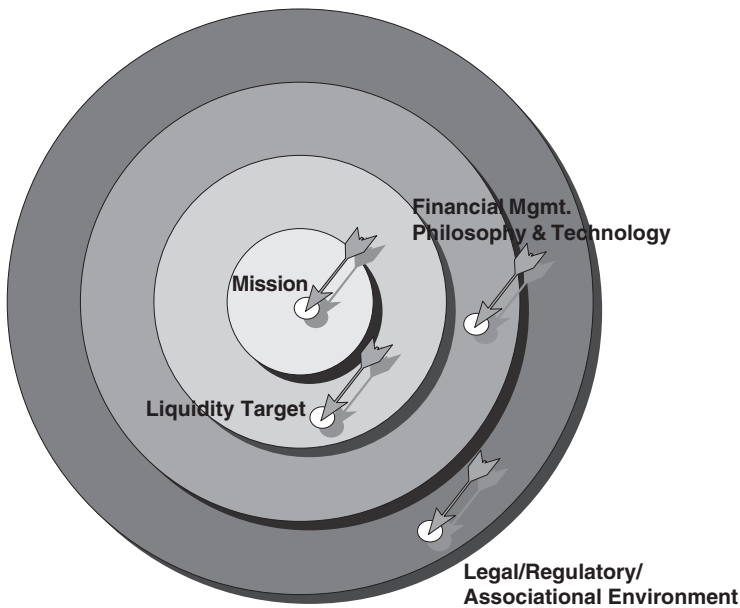


EXHIBIT 1A.2 OVERLAP OF SEVERAL POPULAR FINANCIAL OBJECTIVES

Why is this important for us as financial decision-makers or board members? The ALT model suggests that (1) the liquidity target range is actually the chief financial objective of the donative nonprofit organization, and (2) mission-related program initiatives may actually be managed in such a way to assist the organization in meeting its target. That items 1 and 2 hold may be masked by two factors: (1) it does not necessarily happen each year, but over time, and (2) the level of mission-related program initiative may be managed more with new program development and expansion/reduction of existing programs than with a given year's "output" level of program services. This fact seems to imply that the cart (financial resources) is driving the horse (mission-related program delivery). However, it may simply be that the managers of these organizations are well aware of the inability to tap external equity and the limited ability to utilize long-term debt (and, in many cases, a disinclination to use short-term debt) and are thus assigning more importance to liquidity and its linkage to survival. Without financial health, and with a threat to survival, the organization's ability to deliver its mission today and into the future is jeopardized. Funders are becoming aware of the tie between an organization's cash flow and its capacity to deliver on its mission: "Understanding the cash flow of the organizations you are granting to will tell you a lot about the degree of capacity they have to deliver on the results they are promising."¹

The Appropriate Liquidity Target model can be expanded to show behavioral aspects of managerial decision making. The joint effect of three categories of variables drives the programmatic and resource allocation decisions as the donative nonprofit organization strives to reach its ALT. We can see the environmental, mission, and financial management categories in Exhibit 1A.3.

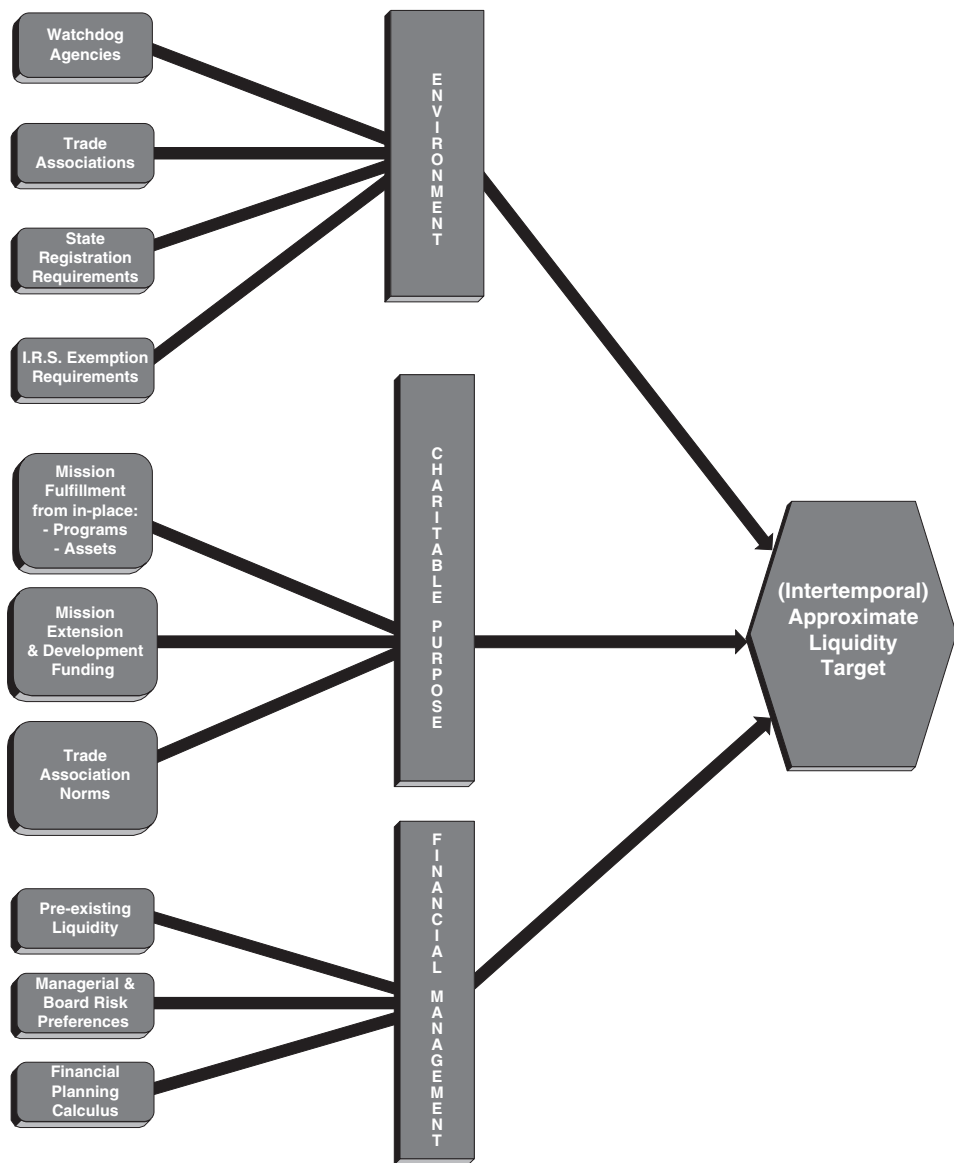


EXHIBIT 1A.3 INTERTEMPORAL APPROPRIATE LIQUIDITY TARGET MODEL

Although not shown in the exhibit, the model allows for feedback effects from the realized liquidity position in any given year to the mission delivery (for assets and programs in place), mission expansion or growth path, and preexisting liquidity for following periods.

The box labeled "financial planning calculus" needs further explanation. This "calculus" involves the philosophy as well as technology employed for cash budgets, operational budgets, and pro forma financial statements. So it encompasses both short-run and long-run financial planning methodologies, including (for faith-based organizations) the decision

maker's view of the relevance of faith in developing the coming years' output levels. For example, your organization might use incremental budgeting, in which next year's figures are simply small adjustments made to this year's budget or in light of this year's actual revenues, support, and expenses. We shall have more to say about this in Chapters 8 and 9.

Throughout the remainder of this book, we provide practical and policy guidelines regarding how to set the liquidity target and how to forecast and manage cash flows to best ensure the maintenance of that target and the continued financial vitality of the organization. Our next step is a deep dive on nonprofit liquidity in chapter 2.

Note

1. Miles Wilson, director of The Grantmaking School, part of the Dorothy A. Johnson Center for Philanthropy and Nonprofit Leadership at Grand Valley State University, as quoted by Nancy Burd, "On the Money: The Key Financial Challenges Facing Nonprofits Today—and How Grantmakers Can Help," *Grantmakers for Effective Organizations*, 2009, pg. 11. Available at: www.geofunders.org.