

Assessing the Financial Health of Nonprofit Organizations and Implications for Grantmaking

Presented for
Orange County Funders Roundtable

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Nonprofit Finance Fund (NFF)

NFF works to create a strong, well-capitalized and durable nonprofit sector that connects money to mission effectively, supporting the highest aspirations and most generous impulses of people and communities.

Serving thousands of nonprofit and funder clients nationwide since 1980

- \$290 million in loans in support of over \$1 billion in projects
- Customized financial consultations with the Nonprofit Business Analysis and Tough Times engagements
- Strategic partnerships to advance the nonprofit sector
- Thought-leadership to advance friendlier funding practices

Experts in nonprofit finance

- Nearly 30 years of experience as a 501(c)(3) Community Development Financial Institution (CDFI)

Serving nonprofits nationwide from seven local offices

- Northeast: Boston, New York
- Mid-Atlantic: Philadelphia, Washington, DC, Newark, NJ
- Midwest: Detroit, Chicago
- **West Coast: San Francisco, Los Angeles**

"We're in the business of helping nonprofits run better."

*-Clara Miller
NFF President & CEO*

TODAY'S GOALS



- Review how NFF analyzes financial information to assess the health of nonprofit organizations.
- Look at strategic grantee engagement: Build vs. Buy
- Discuss a framework for structuring grants to be most effective in supporting the organizations long term sustainability and impact.
- **Bonus:** Provide the key financial assessment and due diligence questions to engage potential and current grantees about financial management challenges.

OVERVIEW: RULES OF THE ROOM



Speak freely

No judgments

Ask questions

Please turn off all cell phones and other devices

Feel free to get coffee or get up and stretch

Agenda



Overview: Challenges in Nonprofit Finance

Assessing Financial Health

Build vs. Buy

Wrap-up and Questions

OPERATING WITHIN A FLAWED SYSTEM



The Realities and Challenges of Nonprofit Finance

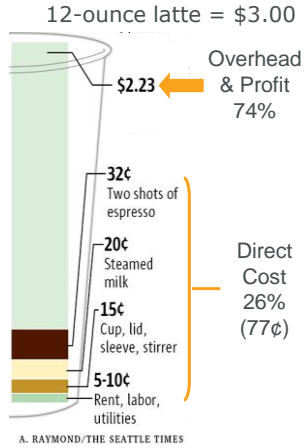
- 1. Covering the Full Cost**
- 2. The Subsidy Business**
- 3. Fundraising Hierarchy**
- 4. Inflexible, programmatic funding**
- 5. Reliable Revenue**

COVERING THE FULL COSTS



In the for-profit world, overhead and profits are seen as **necessary and regular** part of the business

In the nonprofit world, overhead and profits are often seen as **unnecessary and unrelated** to achieving the mission.



"[Charities] fulfill the expectations of givers when they allocate most of their budgets to providing programs. Charities fail givers expectations when their spending on programs is insufficient."

When charities spend more on administrative cost "that means most of your money goes toward such expenses as overhead, administrative staff and associated costs, and organizational meetings, not the programs you aim to support."

-Charity Navigator Website

Surplus Size Matters: Understanding "Full Costs"



It's easy to forget that organizations must absorb the 'full cost' of delivering programs

- Tax Status vs Business Model
- Full costs > Operating Expenses

Full costs include:

- Total operating expenses
- Depreciation allocation
- New capital investments
- Debt
- Savings for the future

MISSION SUPPORT (SUBSIDY) BUSINESS



Since nonprofits can rarely charge prices sufficient to cover the full cost of their core mission programs, they require support businesses (a.k.a the "subsidy" business)

Nonprofits use subsidy to make up the money lost on every "widget" → required "dependency"

When program growth or change occur, one of two things happens:

- more subsidy
- financial chaos

Common subsidy businesses include:

- Sweat equity (underpaying, overworking, using volunteers)
- Fundraising
- Investment income
- Real estate (rental income)
- Earned income ventures

FUNDRAISING HIERARCHY: REVENUE AND RISK



It's easier and cheaper to raise money for...

Capital and/or Program Expansion
(build a building, start a new program, expand services)

than for...

Program Continuation
(business as usual without growth)

than for...

Overhead
(administrative expenses: systems, staffing, etc.)

than for...

Capital Maintenance: Physical and Organizational
(depreciation, R&D, retraining of staff)

Highest Risk



Lowest Risk

RESTRICTED FUNDING



In the for-profit world, we place no restrictions on the money we give to corporations either as buyers or investors.

However, in the nonprofit sector, restrictions are the norm:

- Restricted contributions implicitly...and often times explicitly... forbid organizations from using funds to pay for "indirect" costs
- Nonprofit leaders have become desensitized and trained to 'accept what they can get' rather than to ask for what they need.

THE "RIGHT" REVENUE



The "right" money is recurring, reliable, and flexible

It covers full costs and meets full enterprise needs

Nonprofit leaders have a responsibility to:

- Accept that not all revenue opportunities are worthy of pursuit
- Manage costs in the context of revenue reality
- Articulate cases for revenue and capital based on the full range of business needs

Funders have a responsibility to understand these needs and define what role their money will play

Agenda



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UNCOVERING THE FINANCIAL STORY



Understand Operating **Performance**



Determine **Strength** of Balance Sheet



Assess Ability to Handle **Risk** and Pursue **Opportunity**



Comprehensive Financial Analysis

UNDERSTANDING OPERATING PERFORMANCE: STATEMENT OF ACTIVITIES



1. Revenue Dynamics

- Where does the organization's money come from?
- Is it reasonably diversified or at risk?
- Do revenue streams appear reliable / consistent?

2. Cost Dynamics

- What does the organization spend on operating activities?
- Are expenses adjusted in line with revenue changes?
- Note: Statement of Activities will not present expenditures on capital items or debt principal repayments.

3. Profitability and Savings

- Does the organization cover its costs?
- Are surpluses sufficient to meet balance sheet obligations?
- Is the agency saving? If so, is it enough?

NOTE: Conversations with leadership will offer greater clarity than financials alone.

ABC CENTER STATEMENT OF ACTIVITIES



ABC Center Statement of Activities

Years ended June 30, 2005 (\$ in thousands)

	Operating Activity			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
Revenues, Gains and Other Support				
Support				
Foundations	113	58	-	171
Government	57	-	-	57
Corporations	49	-	-	49
Individuals	248	-	-	248
Total Support	467	58	-	525
Investment Income	7	-	-	7
Tickets, Dues, Other	484	-	-	484
Net Assets Released from Restriction	749	-749	-	-
Total Revenue, Gains and Other Support	1,707	-691	-	1,016
Operating Expenses				
Program Services	1,004	-	-	1,004
Supporting Services				
Administrative	209	-	-	209
Development	49	-	-	49
Total Supporting Services	258	-	-	258
Total Expenses	1,262	-	-	1,262
Change in Net Assets	445	-691	-	-246

ABC CENTER STATEMENT OF ACTIVITIES



ABC Center Statement of Activities (Revised)

Years ended June 30, 2005 (\$ in thousands)

Breakdown of Revenue:
Earned vs. Contributed

Temp. restricted
revenue has met donor-
imposed restrictions

Natural classification
of expenses

Determine true
Operating Surplus /
Deficit

Non-operating revenue
segregated and placed
"below the operating
line"

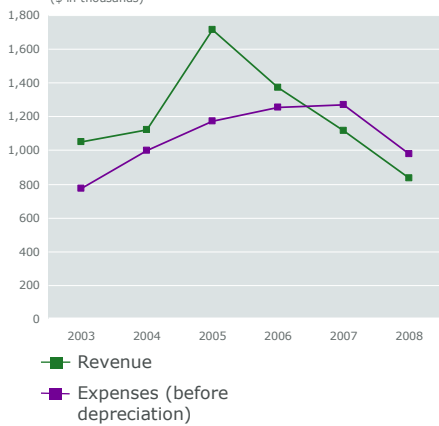
	Operating Activity			Total
	Unrestricted	Temporarily Restricted	Permanently Restricted	
Operating Revenue				
Earned				
Investment Income	7	-	-	7
Program Fees & Tickets	410	-	-	410
Rental Income	30	-	-	30
Government Earned	10	-	-	10
Earned Operating Revenue	457	-	-	457
Contributed				
Individual	248	-	-	248
Foundations & Corporations	162	58	-	220
Government	47	-	-	47
Special Events, net	44	-	-	44
Net Assets Released from Restrictions	152	-152	-	-
Contributed Operating Revenue	653	-94	-	559
Total Revenue	1,110	-94	-	1,016
Operating Expenses				
Personnel	550	-	-	550
Professional Fees	39	-	-	39
Occupancy	90	-	-	90
Interest	-	-	-	-
Support	490	-	-	490
Total Expenses	1,169	-	-	1,169
Surplus/Deficit Before Depreciation	-59	-	-	-59
Depreciation Expense	93	-	-	93
Surplus/Deficit After Depreciation	-152	-	-	-152
	Non-Operating Activities			
Unrestricted Non-Op. Revenue/Expenses (e.g. capital campaign receipts/releases)	597	-597	-	-
Net gain (loss) on sale of assets	-	-	-	-
Change in Net Assets	445	-691	-	-246

NON-OPERATING DOLLARS HIDE TRUE OPERATING PERFORMANCE



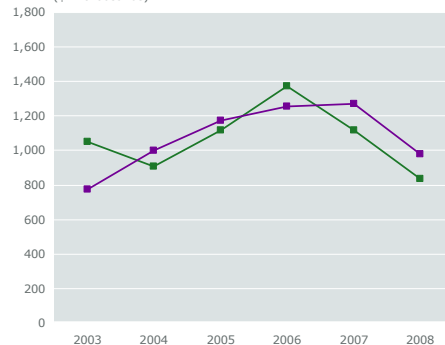
**Unrestricted Revenue & Expenses
(including non-operating)**

(\$ in thousands)



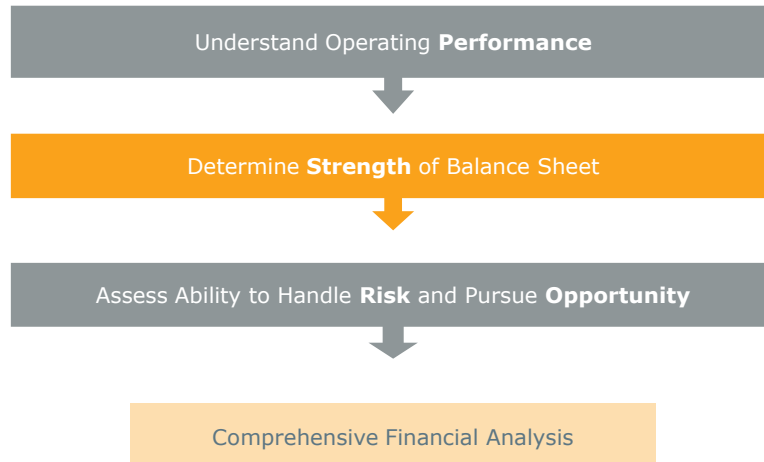
Operating Revenue & Expenses

(\$ in thousands)



With revenue for capital projects
"below the line," this organization
is not breaking even!

UNCOVERING THE FINANCIAL STORY



GROUP EXERCISE



- Identify what changed. Which numbers went up? Which ones went down? How are they related?
- What investment did the organization make?
- How did the organization 'finance' the change?
- What was the impact on total net assets?
- How was liquidity affected?

FINANCIAL POSITION TELLS A STORY



Evolution of your Financial Position

Statement of Financial Position
 FYE 06/30/04 (\$ in thousands)

Assets		Liabilities	
Cash	296	Payables	131
Receivables	612	Debt	0
Prepaid Exp.	22		
Other	29		
P&E (Net)	256		
Long-term receivables	39	Total Liabilities	131
		Net Assets	
		Total Unres.	325
		Temp. Rest	797
		Perm. Rest	0
		Total Net Assets	1,122
Total Assets	\$1,253	Total Liab./Net Assets	\$1,253

From 7/1/04 to 6/29/05.

You engage in operations

Statement of Activities and Statement of Cash Flows

Statement of Financial Position
 FYE 06/30/05 (\$ in thousands)

Assets		Liabilities	
Cash	191	Payables	57
Receivables	55	Debt	114
Prepaid Exp.	41		
Other	0		
P&E (Net)	760		
Long-Term receivables	0	Total Liabilities	171
		Net Assets	
		Total Unres.	771
		Temp. Rest	105
		Perm. Rest	0
		Total Net Assets	876
Total Assets	\$1,047	Total Liab./Net Assets	\$1,047



THE STATEMENT OF POSITION CAN HELP REVEAL:



4. Health of Balance Sheet

- Is the distribution of assets appropriate, given the core business?
- Is the organization investing in its fixed assets?
- How "leveraged" are they?
- What is the composition of net assets?
- How much is unrestricted and liquid?

5. Liquidity

- Does the agency have enough cash to cover current obligations?
- How well are they managing receivables?
- Are they delaying payment to others?

*Conversation with leadership will offer greater clarity than financials alone

WHERE ARE LIQUID NET ASSETS?



ABC Center Statement of Financial Position

(\$ in thousands)

	Audit			Audit	
	June 30, 2004	June 30, 2005		June 30, 2004	June 30, 2005
Assets			Liabilities		
Current			Current		
Cash and Equivalents	296	191	Accounts Payable	127	57
Grants & Pledges Receivable	612	55	Accrued Salaries & Benefits	-	-
Accounts Receivable	-	-	Other Current Liabilities	5	-
Inventory	-	-	Total Deferred Revenue	-	-
Prepaid Expenses	22	41	Short-Term Debt (incl. current portion of LT debt)	-	-
Other Current Assets	29	-	Total Current Liabilities	131	57
Total Current Assets	959	287	Long-Term		
Long-Term			Long-term Liabilities	-	-
Long-Term Investments	-	-	Long-Term Debt	-	114
Deposits and Prepaid Rent	-	-	Other Long-Term Liabilities	-	-
Grants & Pledges Receivable	39	-	Total Long-Term Liabilities	-	114
Net Fixed Assets (plant, property & equipment)	256	760	Total Liabilities	131	171
Other Long-Term Assets	-	-	Net Assets		
Total Long-Term Assets	295	760	Unrestricted		
Total Assets	1,253	1,047	Unrestricted	70	11
			Unrestr. - Board Designated	-	-
			Unrestr. - Property Plant & Equipment	256	760
			Total Unrestr. Net Assets	325	771
			Temp. Restricted Net Assets	797	150
			Perm. Restricted Net Assets	-	-
			Total Net Assets	1,122	876
			Total Liab. & Net Assets	1,253	1,047

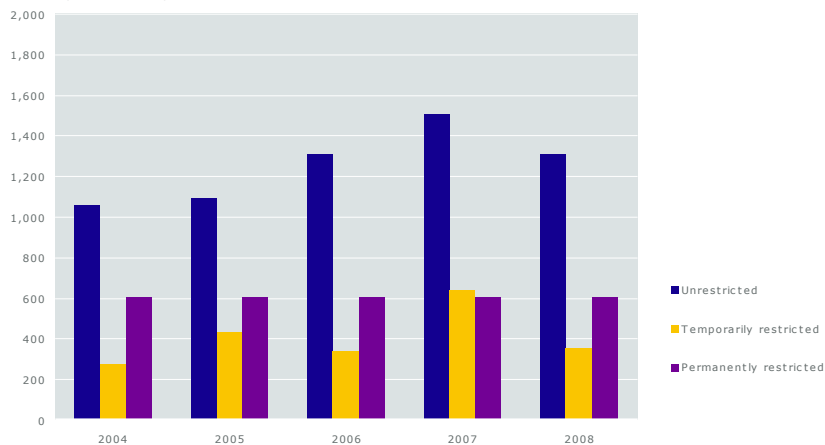
UNDERSTANDING NET ASSETS



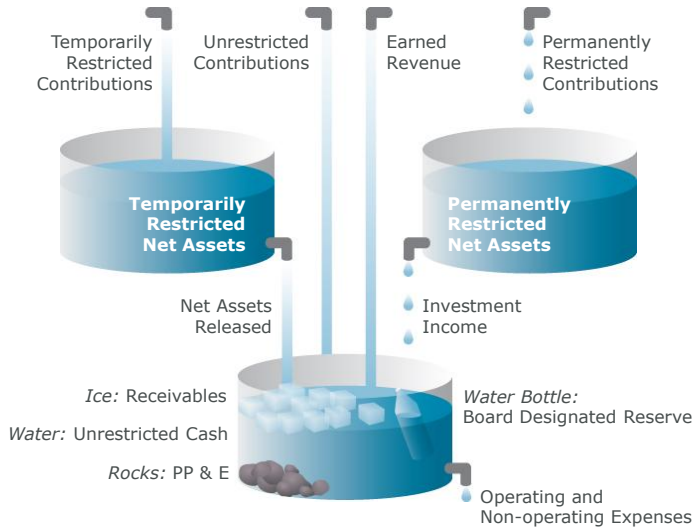
Is this a healthy organization?

Total Net Assets

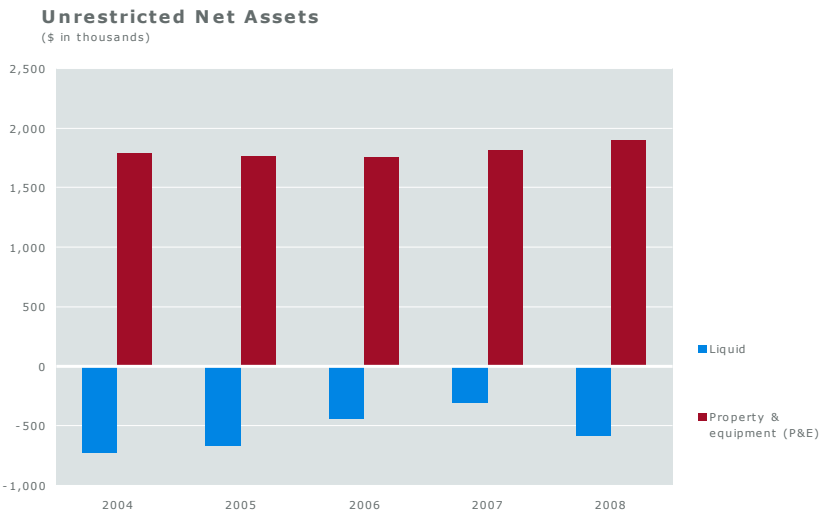
(\$ in thousands)



EXAMINE NET ASSET COMPOSITION



UNRESTRICTED LIQUID NET ASSETS ARE ESSENTIAL



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Nonprofit Commerce Is Different



In the for-profit sector, investors and buyers have explicit, well understood roles:

- Buyers pay full cost for value
- Investors provide capital for financial return
- Equity investors serve to protect the organization from being exploited or overextended

In the nonprofit sector, these roles are murkier:

- Support does not cover the fully loaded cost
- Thus, there is always a 'subsidy' business
- Revenue is inflexible
- Easy money is for the most risky undertakings

Nonprofits lack an “Equity Ethic”



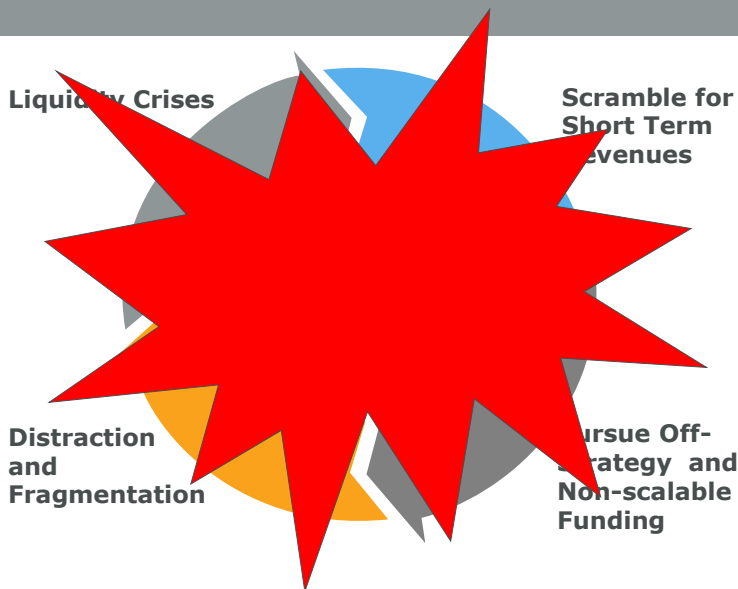
Equity ethic challenge:

- Often nonprofit managers, board members, funders and clients want organizations to do more or to do differently—always at less expense
- There are limited incentives to ensure that the “enterprise” is properly capitalized to deliver on mission

No equity ethic → fragile “enterprise”:

- Nonprofits scramble to raise the difference between the cost of service and the market price
- Nonprofits can’t invest in long-term horizon projects
- Nonprofits lack “no” and “uh-oh” money: \$ to say no to sub-optimal funder requests and \$ to make mistakes
- A multitude of small funder relationships can dilute focus
- Funders write small checks, fearing dependency
- Funders have difficulty accepting that exit strategies may not exist

Reality: The “Doom Loop”



Making the Distinction



What distinguishes capital from revenue is NOT what you are getting in return for your grant, but what your money is designed to accomplish.

Expect something to **change**?

A Build (capital) proposition

- Growth
- Buying/renovating space
- Significant investment in IT, HR, fiscal, etc.
- Improving the subsidy business
- Retrenchment/downsizing/merger

Looking to maintain the **status quo**?

A Buy (revenue) proposition

- Funds to do what you already do
- Pays for full costs of business through a combination of:
 - Earned income
 - Project support
 - General Operating Support

Builders and Buyers are Different



	Buyer	Builder
Role	I'm buying tutoring sessions for kids in Roxbury.	I'm providing the capital you need to generate more consistent revenue.
Exchange	Here's \$5,000. How many tutoring sessions does that buy?	Here's \$5 million. How long until your revenue is more sustainable?
Success	That was a good deal. I'd like to buy more now.	Congratulations. You don't need my money again for a while.

Achieving Nonprofit Equity



All nonprofits require revenue and capital to survive and thrive

Nonprofits have a responsibility to understand, plan for and obtain the kinds of money that they need to accomplish their goals

Funders have a responsibility to understand these needs and define what role their money will play

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SOUND FINANCIAL MANAGEMENT: WHAT DOES IT LOOK LIKE?



- Operating results are consistently **positive**
- Balance sheet is **strong** and right for your business
- You can **anticipate and prepare** for cash flow shortfalls
- You can **predict** year-end results accurately
- Internal systems allow you to **adjust quickly** to unexpected financial developments
- Your board **understands** the organization's financial condition and how it relates to program decisions
- You can **evaluate** the reliability and longevity of your most important sources of revenue
- You **calculate** and raise revenue to cover the full, all-inclusive costs of your services

A Rational Approach to Financing Mission Success



Your grantee would fully articulate its capital and revenue needs

You would be clear about what you are willing to provide

Your grantee would decide how to move forward with its plan, in the context of your investment and the investment of others

Buyers would understand that they have fewer information rights than builders

Individual investors would not decide how a nonprofit spends its money

RECOMMENDATIONS FOR FUNDERS



- **Fund at the organization rather than the programmatic level, even when the primary interest is in one program**
- **Fund to meet the organization's business needs and operating realities**
- **Avoid frequent changes in funding priorities; signal exit or changes well ahead of time**
- **Understand when you are "building" or "buying" and fund accordingly**
- **Be thoughtful about whether and when to encourage growth**
- **Incorporate organizational health metrics to measure and report effectiveness**

NONPROFIT FINANCE FUND



Thank you

**To learn more about NFF,
visit us at nonprofitfinancefund.org**

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SAMPLE ASSESSMENT AND DUE DILIGENCE QUESTIONS

How do this year's numbers compare with last year's? What trends do you see? What are the amazement numbers?

- 1. Profitability & Savings:** *Does the agency cover its costs? How large are surpluses/deficits relative to revenue? Is the agency saving? If so, is it enough?*
- 2. Revenue Dynamics:** *Where does the organization's money come from? Are they well diversified or at risk? Do the revenue streams appear reliable/consistent?*
- 3. Cost Dynamics:** *What levers does the agency have in its control to manage expenses? How hard is it to tighten the belt? Is management responsive to operating changes and prepared to make difficult decisions?*
- 4. Liquidity:** *Does the agency have enough cash to cover current obligations? How well are they managing receivables? Are they asking others to "pay the bills"?*
- 5. Health of Balance Sheet:** *Is the distribution of assets appropriate, given the core business? Is the organization investing in its fixed assets? How "leveraged" are they? What is the composition of net assets? How much are unrestricted and liquid?*

FINANCIAL PLANNING CONSIDERATIONS



How might we work with the agency to address its financial challenges? What strategies might we employ? Who should we involve?

- 1. The Importance of Surpluses:** *Is there a culture of budgeting and managing to a surplus? If not, how can this culture be created? Does the balance sheet require immediate stabilization? How can these needs be addressed through operations?*
- 2. Strengthening Operating Model:** *What does the organization do well (is it attempting to do too much)? What are the economics of its programs? Is there a methodology for allocating overhead? Does the organization have a framework for "linking money to mission" i.e., tying impact and financial data together?*
- 3. Fundraising:** *Who loves the organization? How does it cultivate and maintain funder relationships? What are its fundraising strengths? What is the role of the Board?*
- 4. Cash Management:** *How is the organization monitoring cash? Is it jeopardizing relationships by asking others to "pay the bills"?*
- 5. Reserve Options:** *How can the organization protect its assets and strengthen its balance sheet? Does it have reserve goals (e.g. internal line of credit, rainy day fund, building reserve)? Can it create board policies to guide the use of these funds?*

SAMPLE ASSESSMENT QUESTIONS



Is the organization generating annual operating surpluses consistently? Is operating performance improving?

Has the organization been able to cover the "full cost of business" (depreciation, debt, savings) each year?

Do revenue streams appear consistent and reliable over time? Which are at risk and what are the plans to replace them or explore offsetting cost savings?

Has revenue composition changed over time and if so, why?

Is in-kind revenue a large source of income? If in-kind revenue were to go away, how would the corresponding expenses be covered?

If growth or capital projects are near-term priorities, does the campaign plan consider one-time vs. ongoing expenses –as well as contingencies?

SAMPLE ASSESSMENT QUESTIONS



What has the impact of any facility been on the organization's capital structure and profitability? How has the organization financed the facility and its improvements?

Does the organization have a manageable amount of debt? Are surpluses sufficient to cover annual principal payments?

How many months of cash and short-term investments are on hand? Does the amount seem appropriate given internal dynamics and external risk factors?

Are net assets largely unrestricted? How much are liquid?

Is the organization able to set aside savings each year (or according to a pre-defined plan)?

Does the organization have one or more board-designated reserves? What is the purpose of any reserves? How are they accessed? Do any specific policies govern their usage and replenishment?

Does the organization have a restricted endowment? What is its purpose and does it contribute to the organization's financial health?

WRAP UP: ADDITIONAL DUE DILIGENCE QUESTIONS



Is the organization's self-assessment of its financial health aligned with your assessment of the data?

Does leadership set strategic direction with financial considerations, including capitalization needs, in mind?

Where is the organization in its lifecycle and what are the capital implications?

Is the mission long-term and institutional or more immediate and project-based?

What is the potential impact of the economic environment on operations and financial structure? What kind of plans and reserves does the organization have in place to adapt to these changes?

ABOUT NONPROFIT FINANCE FUND

Products and Services Offered by NFF's Western Region

Nonprofit Finance Fund services are designed to optimize financial expertise and the flow of funds within the nonprofit sector:

Financing

- Loans and Lines of Credit
- New Markets Tax Credits
- Program Investment structuring and decision support

Facility Management

- Systems Replacement Plans
- Building For the FutureSM
- Facilities Planning Workshop

Financial Consulting

- Nonprofit Business Analysis (NBA)
- Tough Times Consulting Services
- Advisory Clinics and Workshops
- NFF Capital Partners: growth capital planning services

Thought Leadership & Partnership

- Articles, presentations and conferences on nonprofit finance
- Work toward improved practices
- Studies of the nonprofit economy

FUNDER SERVICES



Funder Workshops and Training

- NFF offers workshops and technical support to help funders use financial information to improve grantmaking decisions. Workshops discuss approaches that can contribute to building and sustaining financially healthy nonprofits. They include customized review, analysis and consultation around a Foundation's grant making process, current grantee portfolio, and staff understanding of nonprofit finance.

Syndication & Participation

- For jointly-funded lending opportunities, we help enlist funders and manage transactions (structuring, documentation, closing, administration, reporting).

Program-Related Investment (PRI) Services

- NFF offers funders a package of consulting services for the creation and maintenance of PRI portfolios. Through PRIs, funders provide nonprofits with a variety of strategic loans at lower interest rates. NFF provides services for underwriting, loan closing, documentation and post closing, including loan monitoring, billing and collection.

Re-granting Services

- On behalf of funders, NFF administers grants to nonprofits as a component of initiatives. We provide assistance including due diligence on applicants and one-on-one consultations to help grantees through the application and implementation process.

NFF HELPS CONNECT NONPROFITS WITH CAPITAL



Nonprofit Financing

- **Facilities Loans** – acquisition, new construction, renovation, leasehold improvements and related costs
- **Working Capital Loans** – bridge loans, lines of credit and program expansion
- **Equipment Loans** – office equipment and furniture, computer hardware and software

"[NFF is]... arguably the most influential voice in the ongoing effort to reshape thinking and practice about nonprofit capitalization."

—The NonProfit Times

NFF Capital Partners

- Planning and analysis support to prepare nonprofits to solicit and manage growth funding

FINANCIAL EXPERTISE: NONPROFIT FINANCE TRAINING



Nonprofit Finance Workshops

- Linking Money to Mission: A Balancing Act
- Managing in Tough Times
- Facilities Projects: Funding and Financing Strategies
- Growth and Nonprofit Organizations: Achieving Impact and Stability

Financial Leadership Clinic

- What every nonprofit leader needs to know about the role finance plays in supporting nonprofit mission and program
- An opportunity to bring key staff and board members together to examine the crucial financial underpinnings of an organization
- A chance to gain in just two days:
 - – A greater understanding of nonprofit finance
 - – Customized financial analysis of the organization
 - – An insider look at the financials of similar nonprofit organizations

FINANCIAL EXPERTISE: NONPROFIT BUSINESS ANALYSIS (NBA)



The NBA is a one-on-one consultation using proprietary financial analysis. It provides:

- An in-depth examination of a nonprofit's financial strengths and weaknesses
- A fresh, independent perspective to help organizations balance financial considerations with program goals
- Clear visuals and helpful tips to help an organization better communicate its financial situation to stakeholders

Clients benefit from:

- One-on-one collaborative engagement with nonprofit financial experts
- Clear and easy-to-use reports, illuminating a five-year financial picture
- Trend analyses, charts and recommendations to communicate financial needs to stakeholders
- Technical assistance to reinforce lessons from the NBA

FINANCIAL EXPERTISE: TOUGH TIMES CONSULTING SERVICES



Our **Tough Times** engagements are a comprehensive package of rapid-response services that focus on strengthening decision-making by uncovering the key financial drivers and essential program economics to enable organizations not only to weather the current economic uncertainty, but to emerge healthier, stronger and more sustainable.

These services can be customized to meet the needs of a wide range of organizations as determined by factors such as size, mission-focus, financial condition and goals for the future.

Clients benefit from:

- Financial Diagnostic
- Cash Flow Forecasting
- Program Profitability Analysis
- Scenario Planning
- Tools to communicate financial needs to stakeholders

Tough Times Continuum of Services

