

# STRANGE ACCOUNTS

## Understanding Nonprofit Finance



# Welcome

**T**HE *NONPROFIT QUARTERLY* LIKES TO DIG DOWN DEEP INTO ISSUES THAT, AT TIMES, have befuddled the best of us. So of course we were attracted to the topic of nonprofit finances—it contains so many trapdoors that are very hard to struggle back out of after you’ve fallen in. Every game has different rules. How well you play the game depends upon your knowing those rules and understanding what strategies produce what result under what conditions. For instance, if you were playing on a chessboard with checker rules you’d be a sure loser. In fact you wouldn’t even really be considered a player. So it is with nonprofit finance. You are just not on the same board as you would be in a for profit environment. The rules are different. If you don’t know how different they are and why that is so, you can’t be as skillful a strategist—as a manager or board member—as you might like.

This collection of articles includes some which we believe should be standard reading for every board member and manager. In particular we think that Clara Miller and Jon Pratt’s articles provide extraordinarily useful frames for constructing your financial model. This construction can and should be a far more conscious process than it is in many nonprofits. Jennifer Lammers addresses the financial ratios outside stakeholders may be using when judging your effectiveness; increasingly important as foundations and individual contributors use online resources to guide their giving. Elizabeth Keating and Thomas Raffa talk practicalities of deciding grant overhead and perception problems caused by the recording of multi-year grants. Finally, for the financial management 101 crowd, we include a chapter from the *Executive Director’s Guide*, a layperson’s primer on nonprofit financial management. This piece is wonderful in its simplicity and thoroughness.

Enjoy this collection and please let us know what you think! You may reach the editors at [feedback@nonprofitquarterly.org](mailto:feedback@nonprofitquarterly.org). And if you like these articles, you won’t want to miss receiving the *Nonprofit Quarterly* as a whole. You can subscribe at on our Web site at [www.nonprofitquarterly.org/subscribe](http://www.nonprofitquarterly.org/subscribe).

**Ruth McCambridge**  
Editor in Chief

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# The Looking-Glass World of Nonprofit Money: Managing in For-Profits' Shadow Universe

by Clara Miller

**I**F BUSINESS IS PART MYSTERY AND PART ART, A BIG PART OF IT IS ALSO BASIC SCIENCE and arithmetic. Some fairly ordinary rules predict typical financial results. Moreover, whether we flout them or honor them, they seem to be universal—almost like laws of nature—and difficult to ignore. But enter the nonprofit sector, and it's a new and irrational world, like stepping through a looking glass. The rules, when they apply at all, are reversed, and the science turns topsy-turvy. Not only are nonprofit rules that govern money—and therefore business dynamics—different from those in the for-profit sector, they are largely unknown, even among nonprofits and their funders. Or at the very least, they remain unacknowledged and unspoken. Some say they are a closely guarded secret. Even when revealed to for-profit cognoscenti, they are so at odds with the listeners' familiar world as to prompt confusion, disbelief, and related feelings of cognitive dissonance.

Some of this is also true for government. But there, at least, reporters are sometimes inclined to pass through the looking glass and send back the occasional cautionary dispatch. For example, soon after he was elected, New York Mayor Michael Bloomberg turned to fellow business tycoon Richard Riordan, the past mayor of Los Angeles, for advice on making the leap from private to public management. *The New York Times* picked up the story, reporting that the Californian advised the *New Yorker* “to brace himself for a journey to Mars. ‘Don’t do your own thinking. You are going into another world. It is like going to Mars and having a different logical and mathematical system.’”<sup>1</sup>

The logic and the math are at least as upended in nonprofit management as in government. However, fewer reporters are apt to cross that divide, and even if they did, they would be hard pressed to find a returning Mars explorer like Riordan willing or able to guide them along. Nonprofit managers sometimes find it difficult to explain their unique universe to board members and the public, partly because the rules sound so improbable. In the words of one for-profit businessman joining a nonprofit board, “It’s as if we’ve been transported back in time and we’re bartering chickens for tools!”

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The lion's share of nonprofit social service, healthcare, job training, housing, and similar businesses provide services to one consumer but are paid by another—or, frequently, by a dizzying array of others, including several levels and programs of government, various private philanthropies, and individual givers.

Yet at a time when both government and philanthropy are placing substantial bets on the virtues of business and free markets—swept up by venture philanthropy, market-based strategies, social enterprise, and earned-income models for the delivery of public services such as education and healthcare—it would seem more timely than ever for the looking-glass universe of nonprofit management to be revealed. To the extent that government, philanthropy, and the for-profit sector rely on nonprofits to tackle many of our society's greatest challenges, and are investing public and private funds to that end, a short tour across the Martian surface and into this “shadow economy” might prove helpful.

The following true/false quiz is based on seven core assumptions—rules, really—that are pretty dependable in the for-profit sector. In each case, the nonprofit answer is supplied, and the pattern that develops reveals a business and management environment that would give the best, most heroic for-profit managers challenges tantamount to the Seven Labors of Hercules.

**Rule #1: The consumer buys the product. True or false?** In much of the nonprofit sector, the answer is usually “false.” One of the primary jobs of many nonprofits is to provide vital services to people who can't pay for them, or at least can't pay the full freight. Especially in health and social services, a third party usually pays for the product on behalf of the consumer. Therefore, the lion's share of nonprofit social service, healthcare, job training, housing, and similar businesses provide services to one consumer but are paid by another—or, frequently, by a dizzying array of others, including several levels and programs of government, various private philanthropies, and individual givers. Each has varying ideas of what kinds of products, in the form of job training or social services, are needed. Each also has limitations on what kind of product it is willing to buy for the person who can't pay.

What is a rough for-profit equivalent? Let's imagine a hotel (on Mayor Riordan's Mars, perhaps) where the guests arrive needing a room for the night, but most lack the money to pay for it. Before you check them in (you're the desk clerk as well as the owner; it's a low-overhead hotel) you need to make sure there's someone else who is willing to pay for their rooms. For someone in the hospitality business, this is a challenge. Luckily, a variety of people and organizations are willing to pay for these guests. However, each has a different idea about what the guests really want, how much the room should cost, even whether some guests should be able to stay or not. You get on the phone for several hours, making deals and ensuring that there's someone to pay for the guest's room, that all the guests will be served, and, to the guests themselves, that the rooms will be OK.

Sound exhausting? That's one aspect of the job of managing a nonprofit organization that provides services to one group of constituents but receives funding from a range of other sources, including government, individuals, and private philanthropy. The sellers of the hotel's services (in this case, you) are much like a typical nonprofit director; the third parties who pay for the rooms (donors) are analogous to government and philanthropy; the rooms are the services that nonprofits are paid to render (social, educational, medical, cultural); and the ultimate consumers are the people your nonprofit serves (homeless adults, school children, young adults, the unemployed).

## Test Yourself First

### In Nonprofits...

THE CONSUMER BUYS THE PRODUCT.	TRUE	FALSE
PRICE COVERS COST AND EVENTUALLY PRODUCES PROFITS, OR ELSE THE BUSINESS FOLDS.	TRUE	FALSE
CASH IS LIQUID.	TRUE	FALSE
PRICE IS DETERMINED BY PRODUCERS' SUPPLY AND CONSUMERS' ABILITY AND WILLINGNESS TO PAY.	TRUE	FALSE
ANY PROFITS WILL DROP TO THE BOTTOM LINE AND ARE THEN AVAILABLE FOR ENLARGING OR IMPROVING THE BUSINESS.	TRUE	FALSE
INVESTMENT IN INFRASTRUCTURE DURING GROWTH IS NECESSARY FOR EFFICIENCY AND PROFITABILITY.	TRUE	FALSE
OVERHEAD IS A REGULAR COST OF DOING BUSINESS, AND VARIES WITH BUSINESS TYPE AND STAGE OF DEVELOPMENT.	TRUE	FALSE

In the for-profit universe, a manager operating an unprofitable business will eventually fold, but most nonprofits' missions dictate that they accept a "market defect" of some kind...

Many nonprofit organizations provide services to people who can't pay for them and therefore must "sell" their wares both to the users and to the people who do pay. The players in these two markets have diverse and sometimes contradictory goals, and nonprofit managers spend time and attention marketing to them all. This adds complexity and high transaction costs to the business—and a constant tension over mission.

**Rule #2: Price covers cost and eventually produces profits, or else the business folds. True or false?** This is false, and it is really very difficult to manage around. It is particularly awkward when growth or change occurs, and is one of the harshest business realities of the sector. In the nonprofit world, you do lose a buck on virtually every widget (or guest at the nonprofit hotel) and no, you don't make it up in volume in the nonprofit sector, either. The difference is, you keep doing it! In the for-profit universe, a manager operating an unprofitable business will eventually fold, but most nonprofits' missions dictate that they accept a "market defect" of some kind—lack of profit being the most common—as a standard operating condition. Why don't they exit an unprofitable business? Because their nonprofit missions dictate that they stay in it, providing shelter, medical care, disaster relief, and similar services to people with no means to pay and no other options.

There are other contributing factors to lack of profitability. First, most of the work is skilled and labor-intensive (human services, education, surgery, nursing care, theater). In institutional settings in particular, fixed costs of operation outside of labor are also high. As former Princeton President William G. Bowen and colleagues so masterfully

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demonstrated in their classic, *The Charitable Nonprofits*,<sup>2</sup> economies of scale are elusive for a variety of reasons, including, most important, qualitative ones (i.e., if we increase class sizes to 100, all kindergartens will be profitable; and if we simply use volunteers to do brain surgery and provide nursing care, all hospitals will be, too).

Second, prices to constituents are inelastic, whether they pay or third party payers do. It’s difficult if not impossible to raise prices for elderly, low-income, or uninsured patients, for example. Therefore, absent the option of full cost pricing to the many market constituents, growth inevitably deepens red ink for the preponderance of nonprofits. And if the payer won’t offer full cost pricing of services, it can be sure that a bullying posture to negotiate lower prices will work. There’s a reason nonprofits operate most of these services: staying in this unprofitable market—peopled by abused children, frail elderly people, terminally ill, and similarly needy citizens—is a moral imperative for the nonprofit manager and employees. They won’t walk away from the highly unprofitable business, even when it’s to the eventual detriment of their programs.

This creates a double whammy for management: lack of profit-generated working capital to fund growth (as noted previously), and a continuing need for larger subsidies as growth proceeds. To make up for a lack of profit in the core business, nonprofits, almost by definition, run two businesses—the core, mission-oriented business, and a second “subsidy” business or businesses.

The former is easily recognizable in the mainstream economy because it’s quite similar to a for-profit enterprise. The nonprofit is paid for its “core business”: delivering services such as drug treatment, home care, education, or innovative cultural programming. Many of these services receive market-derived revenue—via government contracts, ticket sales, tuition, and similar “fees for service,” even when they are paid indirectly (by third party payers). Almost always, however, the cost of these services is greater than the price the government, or foundations, or ticket buyers, or parents paying tuition are able or willing to pay. Even Phillips Academy charges a mere \$28,000 in tuition for an education that it notes costs it \$50,000 to supply (see, [www.andover.edu/alumni/strategicplan/strategicplan.htm](http://www.andover.edu/alumni/strategicplan/strategicplan.htm)).

This requires that most nonprofits operate what is, in essence, a “subsidy business,” to make up the difference between the price it can get for mission-related services and what the services really cost to deliver. Subsidy businesses include fundraising, dinner dances, special events, bingo, the capital campaign, for-profit related and unrelated businesses (book stores, gift shops, parking lots), donated services, wine and cheese parties, endowment management, and any number of creative fundraising ideas long a staple of the sector. The subsidy business needs staffing and investment all its own and is subject to its own laws of growth. Nonprofit Finance Fund’s experience has shown that the cost per dollar raised via the subsidy business varies a great deal, but that scale is key: a dollar raised from individuals at a small social service agency, for example, might cost 50 cents (or even \$1.53!). A major institution with highly efficient subsidy businesses (major universities or hospitals, for example) may spend only a fraction of a cent. However, the efficiency of use of that subsidy dollar is subject to another set of rules, making the monitoring of “fundraising expense” as an indicator of anything useful for most nonprof-



its subject to question. More important, how much does it then cost to deliver high quality services?

**Rule #3: Cash is liquid. True or false?** For the lion's share of many nonprofits' revenue, the answer is false. When is cash not liquid? When it's restricted cash! As a good manager in the nonprofit economy, you bring in revenue from direct customers, donors, foundations—a large group of interested “buyers.” These buyers often restrict their purchases and gifts to specific purposes—teacher's salaries, for example, or books. It's understandable: this gives your donors a direct, defined connection between their funds and the program. Nevertheless, by nonprofit accounting rules, the restricted cash must then sit in the bank until you go out and buy the item or perform the service its purchaser or donor prescribes. Let's say your donor restricts the cash donation to replacement mattresses for your homeless shelter. If there's a plumbing crisis, or you decide to add maintenance staff, you can't touch that cash. Even if you have cash in the bank, you're going to need another source of payment, fast. This creates the impression among some that a nonprofit is solvent—flush, even—when it's actually in a cash crisis.

And when you expand services, it can be just as dicey. With grants for growth, it's common for generous donors to give a large gift for a relatively narrow purpose—to expand the number of people served, for example—and to restrict the use of the funds to a just a few purposes related to that growth. What is less evident to the donor is that an unintended effect of paying only for new beds (for example) is that even more money will be needed for the things the restrictions don't cover—the other furnishings in the rooms, the heat, blankets, case workers, and similar parts of the operation that you will need to add if you accept the money for new beds. In other words, it actually costs you money—sometimes lots of it—when a donor shows up with a check that has restrictions on its use.

Most of us are prone to feelings of cognitive dissonance here. Does this mean that when an organization gets a huge government contract or a large foundation grant, even when it has received the cash and it's in the bank account, that it's possible to have no operating cash? How can a nonprofit have cash but not be able to spend it? It's common, and generally it's because the cash is restricted with respect to purpose and timing. Sometimes another donor has already given funds with the same restrictions. This often means that the manager needs to raise money to pay for costs the other funds don't cover in order to be able to fulfill the contract or grant terms. When government funds go unspent, and the announcement is made that there was (for example) “all this day care money, and nobody needed it...” it's often because, ironically, many nonprofit agencies can't afford to take the money, given the restrictions and the lack of funds to pay for all the necessities those restrictions rule out.

**Rule #4: Price is determined by producers' supply and consumers' ability and willingness to pay. True or false?** The triangular aspect of the nonprofit customer relationship makes this answer false as well. The elementary supply-and-demand relationship is usually plotted on a two-dimensional graph. But the nonprofit relationship is

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not two-dimensional. It's more than a battle for market share from consumers making relatively simple buy/no buy decisions about a commodity available from competing suppliers. It's a complex market in which the battle is for both subsidy and fees, depending on product and market. Moreover, those providing one or the other have different, often conflicting, goals and values. This is most evident in the negotiation around quality and price, where one set of customers is most concerned with quality (I want my child to have a first-class, public education), and the other with price (I want the greatest number of children to be served for our tax dollar).

One variation on Rule #3 above is the case of the payer (government, for example) who can't or won't cover the entire cost of the services. This creates a situation where the nonprofit provider is left with the difficult task of finding additional subsidy, turning proffered money away, or providing undercapitalized services to clients, with eventual decline in quality

**Rule # 5: Any profits will drop to the bottom line and are then available for enlarging or improving the business. True or false?** False: To most for-profit business people, Rule #5 might seem like the last straw. Even in the unlikely event that a nonprofit finds a way to become more profitable, save money, or build up cash for the next year's cash needs or multi-year investment, it is frequently unavailable for your use. Thus, the primary source of working capital is systematically eliminated from most nonprofits' managerial toolboxes, with predictable consequences.

Here's what it's like. As the executive director of a nonprofit residential social service business, you ordinarily receive a fixed amount to deliver services to, let's say, children in foster care. One year, you decide to weatherize your building, make the boiler more energy-efficient, and upgrade electrical appliance efficiency. Even though the government foster care agency won't pay for capital improvements, you and your board decide to go ahead anyway—the project will lower costs and make the children more comfortable. It turns out that the energy efficiency makes a big difference, and you end the year with a surplus in your foster care program. Because of reductions in energy use and operating costs, you don't use the line item for "energy" completely. Can you use it for other approved purposes in the agency—maybe for training or to fund some of the capital improvements, or for extra tutoring? In this case, absolutely not! Under your standard contract, even line item savings within a budget cannot be shifted to another purpose within the budget, and profits (surplus or revenue over expenses) must be refunded, usually by lowering cost reimbursement levels for the next year (or contracting period). At the other end of the spectrum, if you exceed your budget, you must absorb the excess of cost over payment from the contracting agency. And to top it all, the capital expenditures are non-reimbursable. Even though not every case or contract is as draconian as this one, the mentality pervades the sector: surpluses are bad! They signify that you don't really need the money, and that we're giving you too much.

**Rule #6: Investment in infrastructure during growth is necessary for efficiency and profitability. True or false?** It stands to reason that this rule is false, just because

the other rules are! And while this rule is true in both the for-profit and nonprofit sectors, the nonprofit rules of business largely prohibit investment needed to increase efficiency as growth occurs. Third parties paying for a service prohibit or put limits on spending for anything but “direct program,” not realizing that there are costs of growth in this highly regulated business. Some donors imagine that by limiting the use of their funds to certain direct services only—teachers’ salaries, food to be transfused, youth workers, food for the soup kitchen, new productions—all other costs (which take on the appearance of wasteful luxuries anyway) will disappear. Moreover, many donors (including those with economics degrees or MBAs) don’t recognize the concept of marginal cost in nonprofit work. They forget, or in some cases deny outright, that growth carries costs of its own separate from direct cost increases (although given the other irrational aspects of the nonprofit economy, who can blame them?). Training of staff for a new facility; people with more sophisticated management skills for key management functions; marketing to a larger audience; managing a larger, more complex organization; additional supervision to help teachers and administrators get used to a larger group of classes; improvement of computer or phone capacity, and the attendant training needs—all these things improve efficiency but are neither regular overhead nor direct costs of program or program expansion.

Thus, funds to defray costs that all of us—nonprofit or for-profit—consider a regular, sensible cost of business and a desirable investment in greater efficiency are frequently unavailable, ill-timed, and considered a cost “above and beyond” the real cost of providing services.

Again, the desperation of the people being served, and the dedication of those who serve them, make nonprofit managers only too eager to take this untenable deal. Givers, almost invariably well-meaning, generous individuals or foundations, often imagine that this practice improves the likelihood that more money will be spent on services, and increases the number served. Actually, this practice only accomplishes two things: it increases the likelihood that the dedicated manager will lie to protect the people served, or it encourages the manager to seriously underinvest in support and systems, thereby undermining the entire operation, and eventually the quality of services. The irony is that these money rules end up undermining program quality most consistently among the best and the brightest: the innovative community-based programs with important successes, which are going to scale.

**Rule #7: Overhead is a regular cost of doing business, and varies with business type and stage of development. True or false?** It’s unanimous! They all are false! The nonprofit manager operates in another business universe from the earth of Riordan and Bloomberg: no profits; no path to folding the unprofitable business or weed out the walking wounded; restricted revenue; and to top it off, a general allergy to the dread “overhead.” For some reason, overhead is seen as a distraction—an indication that an organization is not putting enough of its attention and resources into program. But wait a minute, say the for-profit managers. Purchasers tell you how to use your revenue? And it can only go to certain kinds of expenses and not others? And on top of this, the amount

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that can go to overhead is pretty much set at around 10 to 15 percent, unless you have the brand and clout of a major institution (or defense contractor!), no matter whether you run a school, a fundraising organization, a growing research and advocacy group, or a 300-year old major university? Now you’re getting the idea. Because resources (capital) are scarce, the nonprofit capital market, such as it is, assigns to this capital a manufactured high cost of funds via conflicting rules, high transaction costs, and similar complexities.

It’s a little like this. You’re now back in the for-profit universe (having landed from Mars) and you’re the owner of a restaurant. Your paying guest comes to pay the bill, offers a credit card, and prepares to sign the charge slip. But before signing, the guest says, “I’m going to restrict my payment to the chef’s salary. He’s great, and I just want to make sure I’m paying for the one thing that makes the real difference here. I don’t want any of this payment to go for light, or heat, or your accounting department, or other overhead. They’re just not that important. The chef is where you should be spending your money!”

The irony for the field as a whole is that a technique meant to control costs actually undermines efficiency and program quality. The inability of nonprofits to invest in more efficient management systems, higher skilled managers, training, and program development over time means that as promising programs grow, they are going to be hollowed out, resulting in burned out staff, under-maintained buildings, out of date services, and many other symptoms of inadequately funded “overhead.” A colleague who heads the nonprofit side of a hybrid nonprofit/for-profit computer consulting firm explained, “The difference between me and my for-profit counterpart is that he instinctively overstaffs operations for growth, and I instinctively understaff in the same management situation.”

Why are these “facts of nonprofit business life” important, or even relevant? For one thing, in light of these rules, it’s fairly easy to see why executive leadership in the nonprofit sector is difficult to find and retain (and keep from burning out); why nonprofit self-sufficiency is in reality an ephemeral state in the tradition of Brigadoon and Camelot; why sustainability is so difficult for managers to attain without reaching substantial scale over many years; why keeping the promise of social enterprise is a complex problem for managers from Edison Schools to the pta; and why economies of scale are so difficult for the sector to attain while maintaining program quality. All the good will, brain power, capacity-building, finger-wagging, standard-setting evaluation and impact measures will eventually be undermined by the way we finance these enterprises. The financial system we have put in place and support is the worst enemy, not only of the improvements everyone is trying to make, but of the socially critical programs and services this system is meant to sustain. All efforts to improve the sector will be merely palliative without essential, systemic reform of the way the rules of finance work.

To complicate things, in the nonprofit sector the big spender is most often the government and the real guest is a homeless person who desperately needs a bed, or a child in need of an after school program so she won’t be home alone. Turning them away goes against the grain for all of us, but most viscerally, for the social worker or teacher who is called to take care of them.

Society pays dearly for having to do business on Mars. Here are some thoughts on how the system can be improved, and how some well-meaning improvements will simply backfire:

Nonprofits need to make profits, just like their for-profit counterparts, or their enterprises falter. This alone would improve things. Behind nonprofits' difficulty pricing their services to cover their costs is a wider struggle for resources. In government contracting, for example, for-profits now price to cost plus profit, and generally enjoy better business terms. The for-profit and nonprofit government contracting rules should align with respect to pricing, profit margins, growth capital, overhead, and other well-known and accepted aspects of business operations.

The focus on overhead or fundraising cost rules of thumb for nonprofits is generally misplaced. It doesn't get at the productivity of the organization with respect to mission, and ignores the nuances of a variety of business types and stages of development. Delta Airlines has a different cost structure from e-Bay's; and the Boys & Girls Clubs' is different from Compumotor's. Let's be intelligent about their financial needs.

More and more diverse scrutiny from government and other funders will create more transaction costs in an industry already carrying an overly high level. This will burden large and small alike, making small, innovative, and efficient organizations experience an infusion of cost just as growth is proceeding, and increasing the length of the already long climb to scale. Funders can go a long way toward lowering transaction costs for themselves and their grantees via small modifications to the way they do business, and by taking on the formidable task of tracking program and mission productivity—rather than questionable financial indicators—field-wide.

Funders of all types and at all levels—individuals and government alike—need to be aware of the toll the financing system takes on “human capital.” Our capital “supply side” is fragmented and expensive to access, which is burdensome and discouraging for far too many valuable people—from young, innovative teachers to heads of established social service agencies.

For all donors, unrestricted grants are the most positive financially and should be the rule and not the exception. This is because anything else, generally speaking, creates cost for the recipient. There may be exceptions, and giving unrestricted funding does not mean that funders cannot or should not be actively involved in communicating with the recipient about plans for the funds, budget, and program strategy. However, anything but unrestricted grants generally creates cost within the grantee's operation.

With self-discipline and a little creativity, we can improve the business environment for our sector, creating a more intelligent, nuanced system of finance for “social enterprises,” and nonprofit services. This will work better than the current approach, which substitutes well-meaning but counterproductive rules of thumb for sensible, informed financial practices. And it will allow us to power sustainability, management improvement, and innovation in the sector by leveraging appropriately some effective and time-tested rules of business.

**Endnote.** 1. Dean E. Murphy, “Two Cents from a Rich Ex-Mayor: Los Angeles's Riordan Gives Bloomberg a Few Tips,” *The New York Times*, December 17, 2001, p. 2-B.  
2. William G. Bowen, Thomas I. Nygren, Sarah E. Turner, and Elizabeth A. Duffy, *The Charitable Nonprofits: An Analysis of Institutional Dynamics and Characteristics*, Indianapolis: Jossey-Bass, October, 1994.

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# An Executive Director's Primer on Financial Management

by Deborah Linnell, Zora Radosevich, and Jonathan Spack

**N**OT EVERY EXECUTIVE DIRECTOR WILL COME TO THE JOB WELL EQUIPPED TO manage finances. If you happen to fall into the financially challenged category, don't despair. Help is available from peers, board members, service providers, and consultants. As executive director, however, you must have a sufficient knowledge base in financial management to enable you to make the best use of this outside help.

Financial management is the foundation of planning and managing every other aspect of the organization, including buildings, equipment, people, programs, fundraising, technology, printing, and insurance. Thinking strategically when managing money is essential because it is so interlinked with every other function.

A thorough understanding of your agency's finances will allow you to know if programs are cost-effective, if staffing patterns make sense, if the organization has a balanced budget, and if fund development can keep pace with the growth of the agency. Common questions that require a full understanding of agency finances include:

- Do our financial decisions reflect our organization's core values?
- How much will it cost us to raise money this year? Over the next three years?
- What are our staffing constraints, given our current and projected revenues?
- What are the costs associated with operating core programs?
- What are the costs associated with developing a new initiative?
- How much will employee benefits cost? Do we need to change our benefit mix to adjust for anticipated rate increases?

Money isn't just money. It is another lens through which we can view our organization's current reality and future potential. Money, along with mission and values, should be one of the primary screens for all organizational decisions. Executive directors and boards of directors who do not understand this—who see financial management as a necessary evil or enemy of mission and program—run the risk of jeopardizing the organization's future. Mission, money, and values are integrally connected as the core indicators

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Confidence in the financial stability of an organization will increase the confidence of the staff to take on new challenges and make the organization a more valuable asset to the community.

for how, and at what level, programmatic actions can be taken.

Upholding fiduciary responsibility does not mean that an agency will remain forever solvent. Too many factors influence the financial health of a nonprofit organization for any guarantees. Careful financial stewardship, however, will increase the likelihood of stability and will enhance your organization's credibility with all its constituents, both internal (board, staff, and volunteers) and external (funders, vendors, colleagues, and regulatory agencies). Confidence in the financial stability of an organization will increase the confidence of the staff to take on new challenges and make the organization a more valuable asset to the community.

## Roles and Responsibilities

Financial accountability is a shared responsibility of the board of directors and the executive director. In small organizations, the board or the board and executive director may do all of the financial management. As organizations grow, their roles and responsibilities become more defined, as outlined below.

**Board of Directors.** The primary role of the board is oversight. As the legally accountable entity for the entire organization, the board has overall responsibility for its financial health.

The treasurer's job is to review the organization's finances at least monthly. Some treasurers rely on monthly statements and analysis provided by the executive director, bookkeeper, or controller. Others will 'open the books' once a month and do their own analysis.

Other key financial responsibilities of the board (which each individual director takes on when he or she agrees to be a member of the board) include:

- *Approving the annual budget* (and helping to design it in small organizations). The annual budget should use realistic (conservative) projections for revenue to help ensure that the organization does not end up with an unexpected deficit.

The budget should include expense line items that set the parameters within which the executive director can operate. We recommend a board-established policy that allows for a modest variance (generally five to ten percent) for each line item, so that the executive director does not have to alert the board to minor variances—as long as the bottom line does not change. If the organization is being managed within these parameters, the board's financial oversight responsibility should be limited to monitoring. Unless there are serious problems or the executive director or treasurer requests help, board micro-management of finances is usually counterproductive and not in the best interests of the organization.

- *Ensuring that the agency has adequate funds* to operate on an annual basis.
- *Ensuring that all financial reports, taxes, and other government requirements are met* by the agency.
- *Establishing policies and procedures to ensure overall accountability* for programs and finances and to ensure that adequate systems are in place to implement them.
- *Choosing and contracting with a CPA to conduct an audit* on an annual basis.
- *Ensuring ongoing fiscal monitoring.* This role is extremely important because of the liability associated with a failure to exercise appropriate financial oversight. As stated above, the treasurer should carefully review the books monthly and report to the board



at its regular meetings. A regular treasurer's report to the board of directors is the foundation of the checks and balances system that ensures full disclosure and accountability within the financial function of the nonprofit organization. In the event of a financial crisis or serious irregularity, the treasurer should inform the president and, if necessary, request a special board meeting.

**Executive Director.** The primary responsibilities of the executive director are to understand the organization's finances, interpret them for other stakeholders, and, together with the board, ensure the agency's financial accountability to its community.

Typically, the board delegates responsibility for managing the functions that fulfill its role in meeting legal requirements to the executive director, who handles the actual contracting with auditors and filing of legal forms, such as annual reports and tax returns. The executive director, in turn, often delegates these functions to staff and consultants, depending on the size of the organization. The executive director must have a basic understanding of bookkeeping and nonprofit financial management. She or he should be able to read a budget, monthly financial statements, and audit reports and be able to understand, and sometimes develop, internal financial management systems and controls. In addition, the executive director should know how to project the agency's financial needs against its fundraising capacity.

In smaller organizations where the budget does not support a separate financial management staff, the executive director typically takes on all the work of the financial manager as well.

*Be honest with yourself.* If you are not skilled at financial projections, monitoring, building meaningful budgets (operating, capital, and fundraising), and creating sound financial management systems, and you don't have other staff who can do these things, get support from the board or community and meet monthly with people who can help you with your overall financial management responsibilities. No executive director will have every skill required for the range of nonprofit management functions. If your strengths lie elsewhere, find partners to help with financial management. Take a course from a nonprofit training center or local college.

In very small nonprofits the executive director or a board member is often also the bookkeeper. Note, however, that this is not a good situation—primarily for ethical reasons. If you find yourself in this situation, ask a local auditor (even if your organization is too small to require an audit) to give some pro bono time to analyze your financial management system and recommend appropriate checks and balances.

**Financial Manager.** Some organizations have a large enough or flexible enough budget to employ a financial manager or controller. A financial manager can take care of many tasks that would otherwise fall to the executive director, treasurer, and finance committee. A financial manager maintains the general ledger and can prepare budget drafts, develop financial management and monitoring systems, and assist with the financial details of human resource issues, such as retirement funds, health benefits, Section 125 plans, and projecting cost of living and other salary increases. The financial manager can shop for better buys, research accounting software, monitor monthly expenses by line item, generate financial reports at the level required by the board of directors, monitor cash flow, assist with the budgets of funding contracts, and prepare reports to funders

Be honest with  
yourself. If you are  
not skilled  
at financial  
projections,  
monitoring,  
building meaningful  
budgets and  
creating sound  
financial  
management  
systems, and you  
don't have other  
staff who can do  
these things, get  
support from the  
board or  
community.

An executive director who is a generalist and doing many other things should dedicate on average one to one-and-a-half days every two weeks to all the tasks related to financial management.

as required. In some cases, the financial manager will also do all the basic bookkeeping.

**Bookkeeper.** Many organizations have dedicated and highly skilled bookkeepers who do many of the tasks described above for the financial manager. The basic responsibilities of the bookkeeper, however, are to record income and expenses according to generally accepted accounting methods, create and maintain simple financial systems that enable the accurate recording of income and expenses on a monthly basis, prepare billings to funders and other customers, produce clear reports to the executive director and board of directors—typically on a monthly basis—and produce needed documents for the auditor on an annual basis.

### Staffing Considerations

The way financial management tasks are handled within an organization often depends on the size of the budget and, especially in smaller organizations, on the competencies of the staff. An executive director who is a generalist and doing many other things should dedicate on average one to one-and-a-half days every two weeks to all the tasks related to financial management. Keep in mind, however, that this will only cover the basics.

With the widespread use of computers, the time needed for bookkeeping for nonprofits has been slashed dramatically. An experienced bookkeeper working with an organization that has sound financial systems, a modest number of government contracts, and a budget under \$1 million should be able to fulfill basic bookkeeping responsibilities in eight to 10 hours per week. However, even a \$1 million organization might need considerably more bookkeeping time, up to a full-time position, if it has multiple funding streams or government contracts that include strict budget and reporting requirements.

A growing, mid-sized nonprofit should consider hiring a full-time financial manager or experienced bookkeeper who can handle all the details. Such an action can free the executive director's time to provide general management of this function and to position the organization for a more mature pattern of growth through sound financial practice. By the time an organization has reached the \$2 million-plus level, a full-time accounting position is usually justified, especially if the organization's finances are fairly complex (multiple state and federal contracts, ongoing fundraising campaigns that entail pledging, multiple sites or management of multiple facilities). Organizations of this size often need a half-time bookkeeping position as well. Larger nonprofits (over \$5 million) will typically require a finance department that will include a controller, staff accountant, and bookkeeper.

**Endnote.** This article is excerpted from *The Executive Director's Guide*, to be published in May 2001 by United Way of Massachusetts Bay. Copyright 2001, United Way of Massachusetts Bay. Reprinted with permission.

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# Analyzing the Dynamics of Funding: Reliability and Autonomy

by Jon Pratt

**E**VERY NONPROFIT ORGANIZATION BEGINS WITH HIGH HOPES AND ASPIRATIONS FOR public benefit, with a mission to make the world a better place. An immediate challenge is how to put these goals into action, and how to finance the organization. Or, as one cartoon caption under a drawing of Moses holding two large stone tablets put it, “What about funding?”

Money is a limited and competitive resource; organizations without a permanent source of funds must do their best to accommodate the preferences and conditions of funding sources. Striking necessary bargains with devils and angels constitutes the defining struggle for nonprofit boards and managers. This existential dilemma is played out in every nonprofit budget and strategic plan: how does the organization raise funds to realize its long-range purpose while also scrambling for its existence?

The way an organization handles decisions about funding sources sets in motion an ongoing chain of consequences, further decisions and compromises about what the organization will and will not agree to do. Throughout the history of nonprofits, major changes in size, direction, and strategy (and even new names and purposes) are more commonly due to shifts in revenue than to changed intent.

Among the funders of nonprofit activity, attaching conditions and targeted funding are considered valid methods for increasing the accountability and effectiveness of grantees. Whether it is a government agency or a private foundation, the allocators of funds have authority over a finite resource with many requests from the outside. They conclude from previous experience which types of activities are most likely to succeed, and seek the “biggest bang for the buck” by focusing and restricting their money to this narrower range of activities.

For nonprofit organizations, not all funding has an equal effect on the bottom line. Complying with the conditions attached to funding—and coping with fluctuations in revenue—imposes direct and indirect costs, and occupies the attention of managers and boards. The drawbacks of this situation are self-evident to anyone who has managed a

The way an organization handles decisions about funding sources sets in motion an ongoing chain of consequences, further decisions and compromises about what the organization will and will not agree to do.

From government  
contracts to  
foundation grants,  
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they are signing  
onto a variety of  
conditions that are  
attached to funding,  
comparable to “if  
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shilling you do the  
King’s bidding.”

nonprofit organization, but board meetings and financial reports can have the effect of simplifying the problem down to “will we take in enough money to cover expenses?”

Board members, nonprofit employees, and clients (and even other funders) frequently believe that an organization has more latitude over how and when it spends its funds than is actually the case. This limited autonomy squeezes nonprofit managers by putting them in the onerous position of enforcing and defending compliance with funding conditions, sometimes in the face of solid arguments for an alternative course—all the while being criticized that “if they wanted to do it, they could.” Or worse still, different parts of the organization disagree about the conditions that exist, the wisdom of compliance, or the likelihood and severity of sanctions, causing internal conflict or even misappropriation.

An organization-wide appreciation of these revenue-source issues is in the interest of the board and staff, informed by an examination of the two major variables: reliability and autonomy. This does not lessen the constraints—but can clear the air so that decision making is based on a common understanding of an organization’s available degrees of freedom and the future implications for revenue changes.

### Reliability of Funding

To what extent can an organization predict its revenues year-to-year for budgeting, staffing, and program planning? Is it reasonable to expect a particular funding source will be renewed? This information—projecting and tracking revenue and expenses—is key to managing any enterprise. Boards and nonprofit managers are under a legal mandate to exercise their best judgment concerning what revenue will be available, with serious consequences if they are wrong. The decisions they make will be based on their confidence level regarding the relative stability or volatility of each element of the organization’s financial support.

The Reliability-Autonomy Matrix divides twelve common types of nonprofit funding into three levels of reliability: high, medium, and low. This necessarily gross categorization is useful to identify funding sources on a continuum from dependable to speculative, although an individual organization’s experiences will vary. (The placement of any specific funding source on the reliability axis can vary considerably based on the organization’s relationships, existing commitments, and other constraints influencing the funding source.) The three levels of reliability include:

**High reliability:** small to medium-sized individual contributions, endowments, memberships, United Way support, rental income, advertising.

**Medium reliability:** fees for services, ongoing government contracts, third-party reimbursements, major individual contributions, corporate charitable contributions.

**Low reliability:** government project grants, foundation grants, corporate sponsorships.

### Organizational Autonomy

Dependency theory indicates that the autonomy of nonprofit organizations is directly related to the extent of their reliance on suppliers of funds.

From government contracts to foundation grants, organizations know they are signing onto a variety of conditions that are attached to funding, comparable to “if you take the King’s shilling you do the King’s bidding.” These conditions can range from the general targeting of an activity to extremely detailed specifications dictating the ingredients, personnel, time, place, and manner of activity. For the donor, these conditions represent due-diligence assurances that funds will be effectively and responsibly expended, while for the recipient organization, a number of these conditions are unwelcome, burdensome, and counterproductive.

As with the reliability index, the matrix divides eight common types of nonprofit funding into three levels of autonomy: high, medium, and low. This similarly gross categorization distinguishes between conditional and unconditional sources, and an individual organization’s situation will vary. (The location of any specific funding source on the autonomy axis can be adjusted based on the organization’s relationships, existing commitments, and other constraints influencing the funding source.) The three levels of autonomy include:

**High autonomy:** small to medium-sized individual contributions, fees for services, foundation operating grants, endowments, memberships.

**Medium autonomy:** major individual contributions, corporate charitable contributions.

**Low autonomy:** third-party reimbursements, government project grants, ongoing government contracts, foundation project grants, United Way support.

The revenue situation for any particular organization will have special characteristics, and could change over time. To understand an organization’s “center of gravity,” it is possible to calculate an overall reliability/autonomy score using a spreadsheet and formula on the *Nonprofit Quarterly* Web site ([www.nonprofitquarterly.org](http://www.nonprofitquarterly.org)). The eight revenue archetypes set out some typical situations and management responses. A closer analysis of a single organization can reveal a greater level of detail and more options. Organizations are free to change the rating for funding types based on a frank assessment of their own situation and relationships.

## Management and Governance Implications

The Reliability/Autonomy Matrix is designed to reveal priority issues for board and management attention and indicate strategies needed to handle the relative reliability and independence of its revenues. The profiles and archetypes, themselves, are difficult to shift (e.g. dramatically increasing autonomy) since most mature organizations have an established mix of funding. Wherever a funding source falls within the matrix, it carries with it a variety of management options, many of which, in turn, increase the complexity of the management task. Increasing the number of sources and transactions is generally a useful strategy to increase organizational autonomy and security—though it demands more administration.

The Reliability/Autonomy Matrix is designed to reveal priority issues for board and management attention and indicate strategies needed to handle the relative reliability and independence of its revenues. The profiles and archetypes, themselves, are difficult to shift (e.g. dramatically increasing autonomy) since most mature organizations have an established mix of funding.

Many organizations are so steeped in their existing funding patterns and relationships that they no longer recognize or think about the nature and limits of their situation.

One critical additional variable is the sheer number of funding sources. Most organizations work hard to diversify their sources of funding, both in type and number of sources, in order to reduce funding volatility and lower their risk of catastrophic loss (such as when a major funding source withdraws its support).

Boards of directors expect to be involved in budget planning and monitoring, but in many organizations they are often not aware of the degree of volatility of their funding, or what the organization should do about it.

Organizations with funding that is low in reliability have a variety of possible actions to reduce the uncertainty in their environment:

- Maintain higher cash reserves to fill in gaps and reduce the roller-coaster-budget effect.
- Give greater management and board attention to cash management and financial systems, thus predicting shortfalls and allowing quick decisions.
- Use volunteers, consultants, and temporary employees to increase flexibility of the workforce, and thus reduce dislocation.
- Develop close relationships with organizations in the same subject area to track industry changes, and share information on funding source preferences and behavior.
- Submit multiple applications to offset low-response rates.

Organizations *low in autonomy* have a special set of problems, because although their funding sources are definitely willing to transfer funds to them, they want to do this in a particular way. An African proverb says that “if you want to give a man a goat you have to let go of the rope,” but of course many funders have perfectly good reasons why they can’t completely “let go of the rope.”

Boards of directors are less aware of their role in monitoring the restrictions placed on the funds their organizations receive. Low-autonomy organizations must also develop a special set of skills to preserve sufficient maneuvering room:

- Emphasize negotiation skills and develop a persuasive case of what the organization brings to the table (local community knowledge, flexibility, reputation, track record, volunteers, leveraged money, etc.) to equalize exchange and offset unwanted conditions.
- Monitor (via the board) the consonance between the organization’s mission and the nature of the projects it is asked to undertake.
- Be prepared to resist and reject incompatible conditions by having a gift-and-grant-acceptance policy.
- Maintain a robust financial system to track and comply with conditions and restrictions on funding and effective segregation of funds. Monitor conditions on funding. Discuss as a board the purpose of funding and contract monitoring.
- Increase the total number of funding sources, even if they are low autonomy, to reduce the degree of control of any one source. An organization with a dozen or more low-autonomy funding sources can mitigate the lack of flexibility by diversifying.
- Take part in policy networks and coalitions to resist or reduce excessive conditions by government funding sources.



One of the easiest types of organizations to manage, and the most satisfying for a board experience, is a high-reliability/high-autonomy organization. These organizations are better able to chart their own course and stay flexible, and have the time and freedom to ask the big questions and make long-term plans. More complex are high-reliability/low-autonomy organizations, which are often large institutions enjoying tight relationships with government or the United Way; they are generally long-term relationships in which funding conditions are accommodated over a long period of time.

The most difficult organizations of all to manage are low-reliability/low-autonomy (a.k.a., Dante's Seventh Circle of Hell). These organizations are stuck in an ongoing loop of project creation, submission and approval, and have a high need for both negotiation and earnings management, which sometimes are in conflict.

Many organizations are so steeped in their existing funding patterns and relationships that they no longer recognize or think about the nature and limits of their situation. The Reliability-Autonomy Matrix enables boards and managers to take a systemic view of their revenues by providing a framework for examining them in a relevant, strategic context. The value of the Matrix is its ability to help nonprofits easily identify funding limitations and flexibility within their organizations, which is central to effective strategic and financial planning.

An Excel spreadsheet template for the Reliability-Autonomy Score, providing a quick method to analyze and score the organization's revenue reliability and autonomy, is available for downloading at the *Nonprofit Quarterly* Web site (<http://www.tsne.org/files/298-32.xls>).

**About the Author.** Jon Pratt is the executive director of the Minnesota Council of Nonprofits and a contributing editor to the *Nonprofit Quarterly*.

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The Reliability-Autonomy Matrix enables boards and managers to take a systemic view of their revenues by providing a framework for examining them in a relevant, strategic context.

# Eight Nonprofit Revenue Archetypes:

The ability to recognize patterns in any endeavor gives us a valuable leg up. Having those patterns explicitly laid out provides us with a greater capacity to make an informed decision about the course we wish to take in choosing the financing model for our work. Sometimes these models may appear to be predetermined by the field that we are in but there is often some room for choice about balance and proportion.

The following easy-to-use chart begins a process of clearly and simply laying out some common patterns and the association between them including:

- the predominance of a particular revenue source in a nonprofit;

COMMON REVENUE TYPES What is the dominant source of income?	EXAMPLES What kinds of organizations tend to rely on this revenue type as dominant?	REVENUE PROFILE Where does this leave you in terms of reliability and autonomy?
Individual contributions dominant	Small grassroots organizations working on local issues; Humane and animal-rights organizations; Faith-based programs; Environmental and other national advocacy organizations; Disease-specific organizations.	High reliability; High autonomy
Individual or organizational: membership dues dominant	Labor unions; Credit unions; Neighborhood associations.	Medium reliability; High autonomy
Government contract dominant	Charter schools; Workforce development groups; Human service agencies.	Medium reliability; Low autonomy
United Way dominant	YMCA/YWCA; Boys and Girls Clubs; Boy Scouts/Girl Scouts; Campfire Girls.	Medium reliability; Low autonomy
Earned income dominant, individual payors	Theaters; Private colleges or universities; Management support organizations.	Medium reliability; High autonomy
Third-party payor dominant	Community health centers; Hospitals; Nursing homes.	High reliability; Low autonomy
Foundation grant dominant	Advocacy groups; Public-policy centers; Start-up organizations; Arts organizations; Some organizing groups.	Low reliability; Low autonomy
Blended/ diversified revenues	Advocacy organizations; Community-based organizations.	Medium reliability; Medium autonomy



# A Guide for Managers and Boards

- the degree of autonomy the nonprofit has;
- the degree to which that source is reliable, and;
- the management challenges and tasks associated with that source.

We think that this is a great tool to promote conversation at the board level as is—but it is also a work in progress. We may have missed something and would love to hear back from our readers about what else might be added to ensure that this becomes a comprehensive tool for nonprofit managers and boards.

## MANAGEMENT CHALLENGES

**What are the special problems or demands associated with this revenue situation?**

## MANAGEMENT FOCUS

**What appropriate responses are available to management to cope with these specific management challenges?**

Need for high recognition, good reputation;  
Management of multiple-donor relationships;  
List management;  
Monitoring of continuous changes in market and market reactions to various solicitation techniques.

Systematic research and analysis;  
Intensive, frequent communications;  
Excellent information systems;  
Storytelling;  
Development of volunteer base;  
Perpetual scanning for new donors.

High expectations for transparency;  
Member engagement and interactive communications;  
Leadership development;  
Collection of dues;  
Member politics.

Large representative, democratically elected board;  
Member interest tracking;  
Visible commitment to procedural rights of members;  
Pricing;  
Well-designed member benefits;  
Effective conflict-resolution mechanisms and skills.

Cash flow issues;  
Limited capital;  
Maintenance of political relationships;  
Compliance with reporting regimen and external standards of demonstrating results;  
Contracts often lag behind innovation;  
Tight eligibility requirements;  
Dependence on categorical, inflexible funding leads to political skewing of mission or programs;  
Underpriced services produce need for other subsidies;  
Requires ability to predict, track and produce outcomes required by funders.

Closely monitor and educate authorizing environment;  
Negotiate optimal contract terms;  
Maintain cash reserves;  
Systems-focused to ensure compliance.

Often requires compliance with many conditions including those associated with measurement and reporting;  
May restrict own donor-development activities;  
May include fundraising blackout periods.

Close monitoring of changing United Way preferences and conditions;  
Support public relations of United Way;  
Responsiveness to information requests.

Need for visibility in primary and secondary markets;  
Maintenance of institutional reputation;  
Maintaining knowledge of market needs and preferences;  
Incentive to focus exclusively on "billable hours" or strictly marketable or self-paying activities.

Ethic of excellence;  
Innovation in products and services;  
Relentless marketing;  
Customer research;  
Competitor analysis;  
Seek charitable or government funds to subsidize and broaden user base.

Highly detailed transaction processing;  
Quality control;  
Certification, licensing and regulatory compliance;  
Employee motivation and retention.

Tight management systems and chains of command;  
Standardized treatment, automated transactions;  
Cross-function employee communications.

Sponsor relations and education;  
Visibility in field;  
Project development and sequencing;  
Institutional reputation.

Development of expertise;  
Innovation and anticipation of developments in field;  
Fundraising and negotiating skills to maximize revenue and minimize adverse grant conditions;  
Substantial cash reserves.

Complexity of revenue streams;  
Complexity of financial management and reporting;  
Cash flow;  
Variable combination of all of the above with specific sources driving management challenges.

Attentive board with understanding of budget;  
Financial protocols and tracking that makes sense of complexity;  
Strong strategic planning processes keyed to financial planning.

# Hidden in Plain Sight: Understanding Nonprofit Capital Structure

by Clara Miller

Capital structure is the distribution, nature and magnitude of an organization's assets, liabilities and net assets.

**A**S A PART OF THE JOB DESCRIPTION, ALL NONPROFIT EXECUTIVES MANAGE THE tension between the pursuit of mission and the preservation of organizational and financial viability. This tension exerts pressure on day-to-day operations, and while it sometimes seems that one role dominates the other, in a healthy organization they always must be balanced.

Actually, three key factors interact to sustain health over time. The first two points of this triad are mission and organizational capacity, which are familiar to all. The third is equally important but less well understood: capital structure. I will refer back to this triad later in the article.

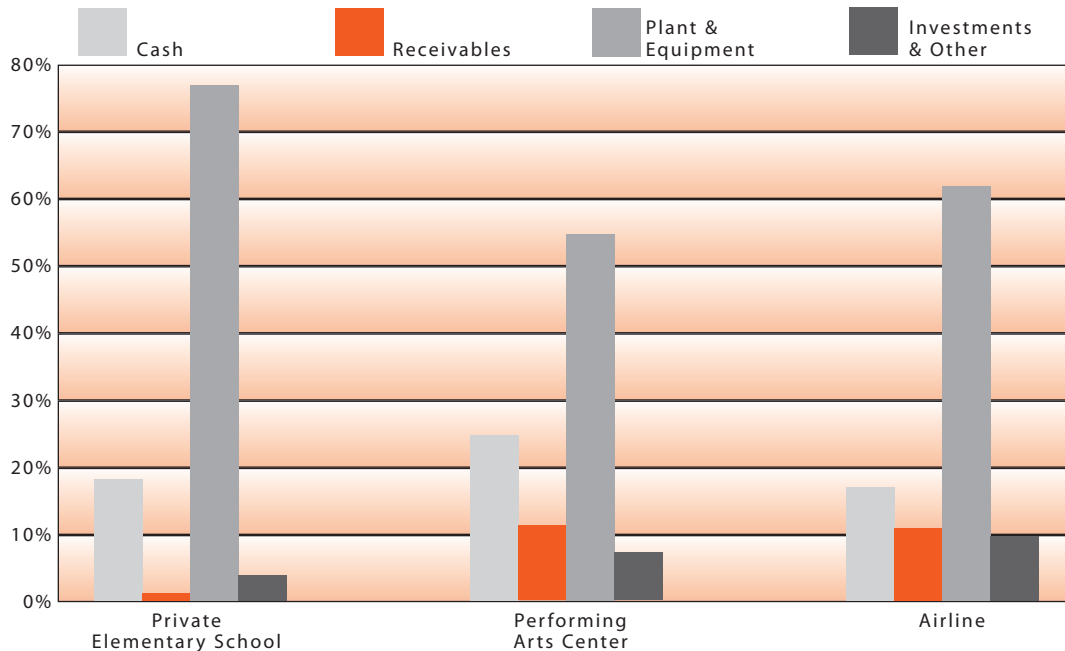
Capital structure is sometimes invisible but never absent. There are four principles to remember:

- First, and fundamentally, capital structure exists in even the smallest nonprofits; ignoring it puts an organization at risk.
- Second, capital structure always has an impact on mission and program, and on organizational capacity.
- Third, capital structure is linked directly to a nonprofit's underlying business, which is distinct from, though clearly related to, its program.
- Fourth, healthy capital structures are difficult to maintain in nonprofits because there often are restrictions on nonprofit assets; this creates a “super-illiquidity,” or lack of financial flexibility, that makes it difficult to keep the “business” aspects of nonprofits functioning well.

## What Is Capital Structure?

Capital structure, as described in the “Elements of Capital Structure” box on page 27, is the distribution, nature and magnitude of an organization's assets, liabilities, and net assets. Every nonprofit—no matter how small or young—has a capital structure. There are many kinds of capital structure, and there is no such thing as one “correct” kind. It can be

Comparison of Capital Structure



An inappropriate capital structure often elevates fixed costs, freezes resources and pushes program growth beyond what is healthy to maintain quality.

simple, with small amounts of cash supplemented by “sweat equity” and enthusiasm, or highly complex, with multiple reserves, investments and assets.

Let’s look at an example: a school. Typical schools have classrooms with desks and chairs, teachers and administrative staff who are paid on a regular basis, computers and other equipment, and varying amounts and kinds of receivables (a school’s receivables might include multi-year pledges in a capital campaign, tuition owed, government funds to reimburse per-pupil expenditures, and certain kinds of grants). Sometimes the school has been financed by a long-term loan (a mortgage or tax-exempt bonds). Sometimes it draws on a line of credit at a bank or a cash reserve to fund payroll before tuition has been received. Some schools have endowments that are invested and produce income to help subsidize operations. Some own vehicles, art, or substantial tracts of land.

The combination of these elements translates into the school’s capital structure. And decisions affecting it—how large a building, whether to finance it or not, how many computers, etc.—not only affect organizational capacity and program, but also affect the financial viability of the operation.

### Capital Structure Pushes Us Organizationally

Growth and change affect capital structure—more students means more desks, chairs, computers, and teachers, and therefore more space, cash, and receivables. Expansion of program requires expansion of capacity, which requires expansion of the balance sheet as a whole, not just one part.

Conversely, changes to capital structure often drive changes in organizations and programs. With large investments, small or young organizations can become larger overnight. This will bring increased levels of organizational complexity, often with greater

It may be less obvious that cash reserves need to be expanded or rebuilt as part of the new capital structure.

proportions of fixed assets, as well as implied longevity of the current institutional and programmatic identity. This has a profound effect on the long-term effectiveness and flexibility of the program itself, and it tends to fuel more growth and change (and the need for capacity building).

Let's build on the example above with an account of how a change in capital structure—in this case the drama of a new building—can affect program and organizational capacity.

Organizations whose leadership anticipates the need for an overall growth of assets to accompany the massive growth in “property, plant and equipment” typically have the greatest success in managing the construction of new buildings. Without such attention, these projects pose major hazards even when the bricks and mortar are all in place. The investment looks great on paper, expanding the organization's unrestricted net assets. But program success requires that cash be maintained in balance with the new building, or the program will be hurt.

This is intuitively obvious with respect to the need for cash and, generally, unrestricted revenue. It may be less obvious that cash reserves need to be expanded or rebuilt as part of the new capital structure. These expansions, which need to be relatively permanent, might take the form of expanded reserves or credit lines, which will be needed to finance the expanded business cycle (more students means higher receivables, a bigger payroll, more insurance to prepay, and therefore potential cash flow concerns). Or they may take the form of permanent working capital to finance programmatic and administrative needs generated by the growth: more marketing, program development, administration and development staff for the larger enterprise.

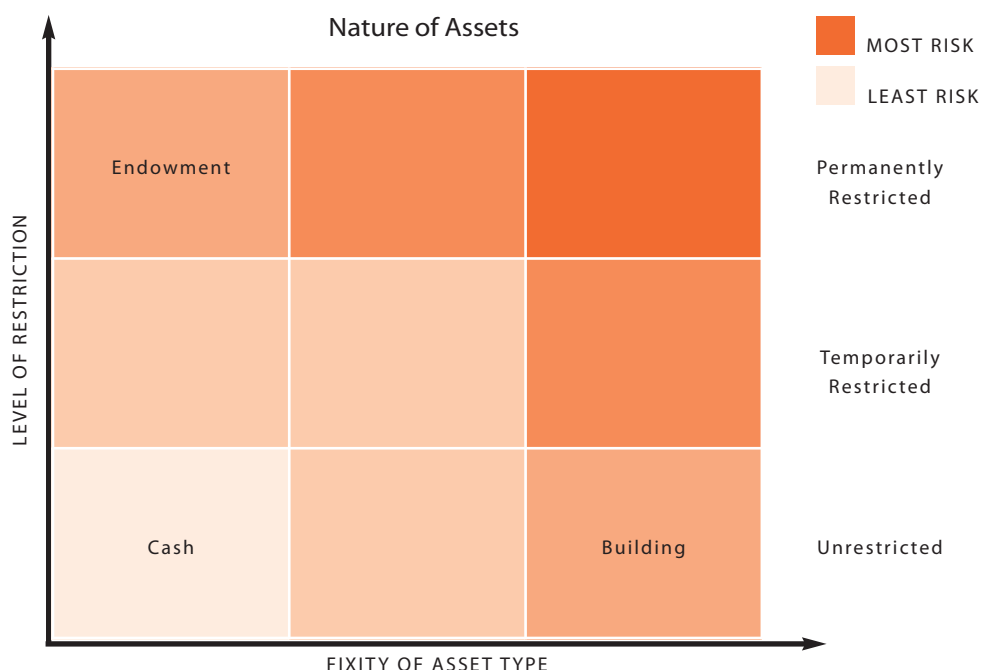
Intermittent cash flow problems, inadequate reserves and raided endowments often result from a lack of such planning. In turn, these cash flow problems lead to imbalances that starve discretionary areas of activity such as program innovations, staff benefits, or maintenance of buildings.

In fact, no matter how good a fortuitous chunk of capital may look, some projects are simply too big with respect to where the organization is in its development. A dance company's development director put it this way:

“We needed to expand to accommodate the new works the artistic director was planning. So we decided to create our own performing space. The board was enthused and raised \$2 million . . . but . . . now we need more operating money to fund production costs and operations. It looks as if the artistic director needs to do nothing but raise money full-time for the next eight months. That knocks out the first part of the season that he's supposed to choreograph. We realized this last week and we've already announced the season with his works.”

The image here is the well-known drawing from *The Little Prince* where a boa constrictor has swallowed an elephant and ends up looking like a man's hat.

An inappropriate capital structure often elevates fixed costs, freezes resources and pushes program growth beyond what is healthy to maintain quality. In the example above, the point is not that buildings are bad, but that planners of these projects must understand the bigger picture—and the need for growth of the whole balance sheet and opera-



In fact, no matter how good a fortuitous chunk of capital may look, some projects are simply too big with respect to where the organization is in its development.

tions, including, most importantly, the program—to fully realize the great potential of a good capital project.

While not all effects of an unplanned change in the balance sheet are as dramatic as these, the result of inadequate and unbalanced capitalization is a systematic under-investment in your enterprise as a whole, which over time will undermine organizational capacity and achievement of the mission.

## Core Business Differs from Program

The notion that “programs” differ from “businesses” is not widely understood in the sector. Nonprofits, reasonably enough, are typically grouped, evaluated and funded based on their programs—such as social services, arts, education, health, etc.—because program and mission are primary.

Funders, however, don’t give mission or program; they give money, which is converted into program accomplishments via operations. Their grants necessarily have business implications (sometimes unanticipated) that shape capital structure and, ultimately, programs.

Organizations that have common overall goals in one field of practice may choose diverse program tactics and therefore diverse business strategies. For example, several organizations may share the mission of “protecting the health of low-income children.” One program goes door to door to deliver immunizations; another establishes a walk-in family health clinic; a third creates preventive public health curricula and advertising to educate parents and children; and yet another advocates for expanded health care funding by government. While they claim the same ultimate goal—and might even be funded by the same foundations or government agencies—their underlying “core” businesses are quite diverse. Each implies a different capital structure.

In the nonprofit world, however, both assets and income can be restricted by donors. This creates a situation where their essential nature is altered or emphasized.

Conversely, organizations can have varying missions but very similar core businesses: an arts organization, a school and an airline, for example. Even though they have widely divergent missions, they have in common the business of filling seats. That fact drives their core business and is required to create the revenue that is earned by fulfilling their missions. Ticket sales or tuition essentially buy the right to sit in a seat.

While it is highly relevant to mission that the theater is presenting the finest repertory theater in the world or that the airline eventually will fly its seats to Paris (with you in them sipping champagne and nibbling pate), or that the school has the best chess team in town, these are all, from the core-business point of view, simply means to get people to sit in the seats and pay money.

What is relevant to capital structure, at the business operation level, is that these three organizations always need to figure out how to buy or rent those seats, to pay for them, keep them relatively comfortable, expand them, contract them, charge more for them, and sell more of them. In addition, they have to adequately pay and support great artists, pilots, teachers and other related program people to fulfill their missions.

Notice how similar the asset side of their balance sheets looks in the “Comparison of Capital Structure” graph. Their characteristic patterns of assets exist whether the pilot or artistic director is good or bad, whether the board consists of geniuses or ninnyes, whether the executive director has gone to nonprofit management training or not, and whether people show up to sit in the seats. And if this graph changes, they have probably changed their core business.

## Restricted Assets

In both the nonprofit and the for-profit worlds, assets consist of familiar balance sheet items: plant and equipment, receivables, cash, etc. In both worlds, assets have varying degrees of liquidity or illiquidity inherent to the nature of the asset. In the business world cash is highly liquid; receivables are less so, with their liquidity dependent on how quickly they are collected and become cash. Buildings, which require sale to realize cash, are even less liquid.

In the nonprofit world, however, both assets and income can be restricted by donors. This creates a situation where their essential nature is altered or emphasized. Cash can become non-fungible, or hard to move around and use—essentially illiquid. Substantial cash net assets, such as permanently restricted endowments, are in this category. This state of illiquidity also applies to increased receivables, yielding cash that can be used only for a certain purpose, and to a building, particularly one whose use or sale is restricted. This “super-illiquidity” is depicted on the “Nature of Assets” chart.

In “The Rime of the Ancient Mariner,” Coleridge wrote, “Water, water, everywhere, nor any drop to drink.” This states the problem of illiquidity well. We can restate it thus: “Assets, assets everywhere, and we can’t make our payroll this week.”

Donor restrictions on either assets or income, coupled with the nature of the asset, create risk and expense because they are more likely to create demands on capacity and program beyond what the donor originally envisioned and what may have been planned for by the nonprofit.

For instance, most nonprofits have some experience with restricted grants and con-

# Capital-Savvy Principles for Grantmakers

by Clara Miller

## Focus on the Core Business

- When you make a grant, know that you are really funding an underlying business, which supports but is separate from program. Identify the business, and design grants that honor its dynamics. Don't fool yourself that you can invest funds directly in program or discretely for program.

- Understand the capital needs this nonprofit business will have over time, and make sure the leaders of the nonprofit understand them too. Make this understanding explicit—for you and your grantee—with income statement and balance sheet projections.

- Design financial investments—grants, loans or capacity building help—to support that business over time.

## Be Sensitive to Transitional States (Growth, Start-up, Turnaround, Merger)

- When nonprofits grow they almost always require increasing fixed overhead costs in proportion to total budget, beyond what is typical in regular operations. Like when you buy a too-big dress for a quickly growing child because you know you won't be able to afford another for a while, growth happens on a steady curve, while organizational capacity is often built in leaps.

- Organizations in periods of growth (as well as start-up and turnaround) are made particularly vulnerable by grants that are not supportive of the core business. Again, capital needs can be extraordinary

in relationship to overall budget during these periods.

### Restrictions

- The stronger the restrictions on a grant, or the greater the fixity of assets acquired with that grant or loan, the higher the risk to the organization.

- Be aware that any restricted grant creates expense for your grantee. This increases the burden to raise unrestricted cash to cover this expense in direct proportion to the size, complexity and degree of restrictions on the granted funds.

## Consider the Whole Organization

- An organization is a system: endowment, cash, facilities, technology, human capital, capacity—all are interdependent. Changing one changes all the others. Funding only one creates a draw on all the others, and building capacity in one requires that capacity be built in all others.



Endowment ties up large blocks of funds that, all other things being equal, the organization might put to use in other ways as it grows and develops.

tracts creating expenses that they do not fully cover. Often such restricted grants may be for new or expanded programs, and they rarely provide for the totality of additional staffing and operational costs that accompany program growth. Equally rarely do they provide for the attendant expansion to the balance sheet in the form of cash reserve, additional plant and equipment, and the like. (See Elizabeth K. Keating's article for more on how to avoid this, page 24.)

Growth through temporarily and permanently restricted revenue and assets, as well as through the expansion of assets that are illiquid simply by their nature (buildings or computers, for instance), creates greater organizational risk because it drives increased demand for the unrestricted income that is needed to add to program and organizational capacity.

### **The Paradox of the Poor Little Rich Organization**

The notion that money and investment create expenses when donated is counterintuitive for most people, and the idea that an endowment challenge grant could be destabilizing is especially so. Let's look at how a \$1 million contribution to an endowment for a theater company does both.

Let's say a certain Mrs. Glitterbosom makes a \$1 million cash contribution to create a permanently restricted endowment for the HelioTroupe Theater Company with the stipulation that the recipient must raise a similar amount to match it. She restricts the gift to new program development in a particular area—say, for the production of “living theater”<sup>1</sup> (in which she is somewhat of an expert). The HelioTroupe Theater has excellent programs, is lean but well managed and pretty well capitalized. It has annual revenue of \$1 million—60 percent of which is earned, mainly between October and March—and a cash reserve of \$200,000, which is used to fund pre-production costs for shows. It employs 12 people, eight of whom work roughly full-time on program and production and the other four of whom raise money and run the support operation. This addition has the added value of extending their mission of presenting artistically path-breaking, socially relevant material.

Who would turn away \$1 million to support something their organization is committed to? No one in their right mind! But there are real potential threats to HelioTroupe's capital structure in this situation. An endowment, like a capital building project, imbalances the capital structure and puts pressure on the other two points of the nonprofit management triad—mission and capacity.

### **How does this happen?**

Matching the \$1 million endowment creates an immediate demand for fundraising efforts—and of course the match will also be restricted. This requires a draw on unrestricted cash (to pay for increased fundraising capacity) while diminishing its future availability, since fundraising will focus on restricted cash for endowment. The program restrictions will create other pressures. Artistic staff will be expected to develop new works and present them, which will require draws on the existing cash reserve (now used to front about \$600,000 in revenues from shows). If the calendar of shows is expanded, the cash reserve will need to be permanently expanded as well to cover cash flow, receiv-



ables and the like. This requires more fundraising and management capacity. Moreover, the new shows are more likely to be risky with respect to revenue, so the wise course would be to ensure that the cash reserve can be replenished if necessary.

But won't the Glitterbosom Endowment for Living Theater produce revenue in the form of interest income to defray some of these costs? The immediate projected income of about \$50,000 (an estimated 5 percent realized return, which is optimistic in these times and probably too much to ensure growth of the endowment itself) will allow the organization to expand by about one-half a fully supported person. This amount is arguably inadequate for the development of new programs and to also pay for the increased program and administrative toil that will accompany the creation and rollout of new works, and it definitely is inadequate to fund the ongoing cost of increasing and maintaining reserves, beefing up fundraising and adding supporting administration. Even the eventual \$100,000 in "new money" from interest on the matched endowment will be restricted to new works, requiring more unrestricted cash rather than filling the need for it.

The point is not that endowments are a bad idea, nor that the challenge grant described here is an opportunity to be avoided. The point is that this endowment created a significant change in capital structure that neither management nor the donor took into account. And any change to one point in the triad—even the addition of thrillingly large amounts of capital in the form of endowment—requires adjustments in the remaining two.

## The Quandary of Nonprofit Growth

In the business sector, profits are used to fund working capital and other growth needs. During growth or startup, businesses budget for unprofitable years, sometimes several of them, and have tools to plan for and fund these deficits. With these planned deficits, the business is investing to build the market and infrastructure it needs to succeed. Among nonprofits, profit margins are frequently thin, discouraged or simply prohibited. Both government contracting rules and nonprofit culture discourage the development of operating surpluses (If you have a surplus, why should we give you a grant?) or induce nonprofits to hide them.

The truth is, not only is it difficult to afford the management improvements that must accompany growth, it is difficult even to afford the ongoing improvements necessary to maintain effective and efficient operations without growth. As a result, management (as opposed to program) is frequently staffed too thinly and under-supported in relationship to program. Financial systems often are rudimentary, and while small and medium-sized agencies have staff with sophisticated, specialized program expertise, they frequently lack the increasingly specialized fundraising, planning and financial management skills that become crucial during growth. The irony is that a technique meant to control costs and focus efforts on mission actually undermines efficiency and harms program.

There are many such trap doors associated with the largely unrecognized issue of capital structure. For instance, programs meant to build capacity in nonprofits very often don't address the need for attention to capitalization, ultimately limiting what they can accomplish in terms of promoting sustainable organizational health. Organizational depth and sophistication require capital planning and organizational slack. This means we

The truth is, not only is it difficult to afford the management improvements that must accompany growth, it is difficult even to afford the ongoing improvements necessary to maintain effective and efficient operations without growth.

The reasons for the neglect of capitalization run deep in nonprofit culture.

should encourage in the organizations we care about occasional periods of time when capacity exceeds what is required simply to operate current programs. Without such foresight, even the most promising nonprofits are sentenced to the purgatory of marginal improvements, usually after a lag time during which inadequacies are glaringly apparent.

### Putting Capitalization on the Agenda

The reasons for the neglect of capitalization run deep in nonprofit culture. Managers, employees and funders share the belief that energy, willpower, stamina, and enthusiasm can overcome all obstacles, and that where it does not, some sort of personal failing is to blame. The idea that an inappropriate capital structure can subvert an organization's ability to meet its objectives can seem overly deterministic, even fatalistic. In the face of adversity, the temptation is to say, "We must work harder," rather than to look at the balance sheet—where money is or is not allocated—for systemic reasons for failure.

But what works for small organizations rarely works for larger, more complicated

## The Elements of Capital Structure

The elements of capital structure are represented on an organization's balance sheet as divided into assets, liabilities and net assets. Our discussion of capital structure focuses primarily on some observations about assets and the way they are allocated, although all are important.

Major assets are:

- cash
- investments
- buildings and equipment
- receivables, inventory, and prepaid expenses.

In the nonprofit world, funders routinely place restrictions on the use of funds. These include all assets and net assets, which are restricted in different ways. These restrictions can accentuate existing challenges to liquidity posed by increasing fixed assets or receivables, for example. Most puzzling to visitors from the for-profit economy, restrictions can even make cash and investments illiquid under certain circumstances. Let's look at the main components.

**Cash and investments** may be unrestricted—available for use for any purpose—or restricted, per-

manently or temporarily. Restrictions on use are typically placed by donors, government, or in some cases, internally. Most organizations have some cash that is unrestricted and used for ongoing operations. Sometimes this is referred to as working capital. Other cash (or frequently investments) is categorized as reserves (cash set aside for specific purposes such as building repairs or to fund cash needs for predictable business cycles), and temporarily restricted funds (cash meant for a specific purpose or time period as stipulated by the donor). A third category of cash and investments is permanently restricted—most often "endowment," a permanent source of subsidy for the organization. This means that cash and investments aren't always liquid—in fact, depending on a nonprofit's core business, they often are illiquid.

Endowment ties up large blocks of funds that, all other things being equal, the organization might put to use in other ways as it grows and develops. While endowment can support sustainability where mission-driven programming needs subsidy, the opportunity costs are high. And while the security of an endowment may be appealing and provide a

institutions, and vice versa. In other words, “sweat equity,” and an organizational culture (and capacity) driven mainly by stamina or enthusiasm, does not scale well. A major mental health organization doesn’t use amateurs to treat severe mental illness. Conversely, a small group of enthusiastic graduates who want to experiment with new approaches to teaching through theater may do best with the least “infrastructure.” Neither is better, but each model implies differing capital structures and capacity requirements, and each has a different array of programmatic choices. Capital structure, then, changes as organizations go through various stages of development and growth.

Capitalization as a concept is not typically a part of the current nonprofit lexicon—nor that of funders. Although, as was stated at the beginning of this article, all nonprofits have a capital structure, the lack of a rational approach to it is a largely unnamed and therefore quietly powerful problem. Because capital structure is not an explicit part of practice, people don’t even know it’s missing.

Capitalization as a concept is not typically a part of the current nonprofit lexicon—nor that of funders.

financial cushion, it can also enable organizations to become disconnected from market realities. One example is a secondary school that uses its substantial endowment to cover up cash shortfalls year after year, and—to the detriment of its long-term health—ignores steady downward trends in alumni giving, enrollment and tuition, and the quality of its student body.

**Receivables** represent money due to an organization. They reflect business cycles and are financed by cash. Typical receivables might be fees due from the government for services rendered, or capital campaign pledges, or credit card receivables for merchandise or subscriptions, or billings for services such as educational programs or classes. Inventory is similar, in that cash must be laid out with the expectation that revenue will come in as a result of sales. For both inventory and receivables, there is collection or sales risk. In some cases, receivables are use-restricted (such as in government programs or in the case of a pledge for a specific purpose).

**Liabilities** are the other side of the balance sheet equation. Liabilities include various accounts payable (your organization’s financial obligations to investors and vendors), short-term debt, long-term debt, etc. They also include promises to provide services, such as day care (deposits for slots), school (tuition paid in advance), contract advances (social services), or ticket sales for performances yet to occur.

In many cases, liabilities represent the source of cash for financing assets: the mortgage on the building; a line of credit to finance inventory; or a cash flow loan against a school district contract are all loans payable. They are broken down into current liabilities (those requiring payment within one year) and non-current liabilities (those requiring payment beyond one year). Liabilities are organized on the balance sheet by increasing maturity (short-term to long-term), much as assets are listed in order of decreasing liquidity—from cash to fixed assets and endowments. Matching the relative liquidity of assets and the longevity of liabilities is important to keeping the capital structure in balance.

The difference between assets and liabilities is the organization’s net worth, or net assets. The nature of the assets and liabilities indicates the varying degrees of flexibility in operations. For example, the lion’s share of the “unrestricted net assets” of many organizations consists of plant and equipment because the building may be free of funder restrictions. But this is hardly a source of ready cash. When cash net assets are restricted by the donor—to endowment for example—liquidity is also restricted. Therefore, a positive balance in net assets is not the same as liquidity. It is the liquidity of an organization’s net assets—i.e., unrestricted cash net assets—that has the greatest relevance to its cash flow and ability to respond to needs and manage its operations well.

By confining their funding to the marginal costs of programs that are relevant to the pursuit of their own missions, funders may unintentionally contribute to the systemic under-capitalization of the sector . . .

Reversing the nonprofit sector's neglect of capital structure requires both a broad-brush advocacy and education campaign and the changed habits of individual nonprofits and funders. The leadership of organizations must begin identifying their core businesses—how they get and spend money to accomplish their missions. From there they can make capital structure an explicit part of strategic planning. Boards, consultants and nonprofit managers can then turn their attention to questions such as: What does our capital structure look like, and what should it look like? What priorities does it imply or demand? Is it appropriate for our purpose and plans? How will growth affect it? Will it improve or go out of balance as a result?

Funders can be a powerful force in improving things, because their grants have such a major impact on capitalization. By confining their funding to the marginal costs of programs that are relevant to the pursuit of their own missions, funders may unintentionally contribute to the systemic under-capitalization of the sector—controlling rather than developing it, and encouraging the growth of programs without providing for the commensurate growth in capacity. The attached guide, “Capital Savvy Principles for Grantmakers,” may be instructive in reversing this trend.

**Endnote.** 1. For the uninitiated, living theater, as a genre, mixes art and politics in productions that are highly engaging and confrontational with audience members.

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# Know Your Ratios? Everyone Else Does

by Jennifer A. Lammers

**M**Y BROTHER-IN-LAW IS ADDICTED TO CONSUMER RESEARCH REPORTS. WHEN he and my sister were in the market for a car, he scoured the Internet for information on every make, model, and year. When determining which stroller, highchair and car seat to register for before my nephew was born, he could recite the price, durability, and safety ratings for almost every item.

But when it comes to supporting a charity, my brother-in-law's need for pertinent information is stymied. He knows where to find an organization's IRS Form 990 and is even familiar with the major national charity watchdog sites and reports. He knows the various ratios and the rankings they use, but still he isn't satisfied: "What do these numbers really tell me about this organization? Is a higher program ratio always better? Does anybody measure effectiveness?"

He has a point. Many of the charity reports produced today give only part of the picture, emphasizing spending practices over effectiveness or program quality. Choosing which charity to support based only on financial ratios is a little like choosing a restaurant based on how much it spends on advertising and marketing versus food. You really don't know what you'll get.

Yet, like it or not, charity watchdogs are becoming increasingly popular with the information-hungry public, and the financial ratios they employ are being accepted as proxies for performance, quality, and integrity. It is the wise nonprofit that knows the lay of the ratings agency land and is prepared to make sure its story is told as completely as possible.

## Pros and Cons of the Ratings Revolution

Charity rating agencies ideally help donors avoid fraudulent organizations or outright scams and make it easier for the public to identify and support legitimate charities. By increasing access to information, watchdogs have the potential to demystify the work-

Choosing which charity to support based only on financial ratios is a little like choosing a restaurant based on how much it spends on advertising and marketing versus food.

Increasingly, the information and reports provided by watchdogs are being used not to help donors weed out those groups that fail to meet minimum accepted levels of performance, but to “rank” well-performing charities against each other.

ings of the nonprofit sector and to provide managers with valuable tools for monitoring and evaluating their own performance. The emergence of multiple recognizable and reputable sources for information on charitable organizations (see “National Charity Review Organizations” box) marks the further evolution of the nonprofit sector and, if managed properly, has the potential to improve the performance of nonprofits, increase public trust, and encourage informed and generous philanthropy in America.

But the ultimate impact of what is being called the ratings revolution has yet to be determined, and a number of potential problems remain to be worked out. The public, often in the form of the media, wants black/white, good/bad explanations that force watchdogs to act as judge and jury, despite many of their efforts to simply “inform the donor’s decision.” Increasingly, the information and reports provided by watchdogs are being used not to help donors weed out those groups that fail to meet minimum accepted levels of performance, but to “rank” well-performing charities against each other. “Why donate to an organization that spends 78 percent on programs when I can give to one that spends 82 percent?”

An over-emphasis on financial ratios is demonizing necessary administrative and management expenses and elevating the value of efficiency over effectiveness. The resulting pressure on nonprofit managers leads to increasingly creative allocations of expenses, further muddying the true performance picture. Even worse, some nonprofits adhere to bare-bones administrative budgets that actually jeopardize the organization’s stability and hinder its ability to grow or respond to change.

## Getting Into the Game

So what’s a nonprofit executive to do? Even if your organization is small or local enough to avoid being covered by one of the bigger, national watchdogs, you aren’t out of the woods; the criteria they use will increasingly become the accepted industry standards. Donors and the media, which have easy access to your 990 through the online database GuideStar, can run the numbers on their own and make decisions about your performance.

Educating yourself, your staff, and your board about watchdog organizations and their standards is the place to start. Incorporating the primary watchdog requirements into your organization’s regular self-assessments will eliminate any surprises should you find yourself under one of their microscopes—and even if you never end up having a formal review, the internal monitoring of your compliance with these standards can yield valuable information.

Comparing your performance with that of other organizations in your community or field can open your eyes to possible inefficiencies or areas of unique success. Learning to “talk the talk” so you can explain your organization’s performance in relation to that of other organizations—both those with similar programs and missions and those that differ greatly but compete for the same donor dollars—will help you establish creditability with donors and the media.

## A Focus on Finances

While a number of the rating agencies report on a wide variety of operational practices,



including governance, public disclosure/accountability, and fundraising activities, the media and donors give greatest attention to those standards and criteria dealing with the use of funds.

A failure to understand the financial ratios that watchdogs employ or what circumstances may affect a charity's performance against them puts some organizations at a disadvantage when they are evaluated—whether formally or simply by a reporter or donor with a calculator. At best, an organization's numbers may not be as favorable as others'; at worst, a good organization may actually fail to meet the minimum requirements, receiving a negative ranking or report.

Internally, when used as baseline, minimum performance criteria, the financial ratios used by watchdogs have been proven to be generally valid guideposts. A failure to meet these benchmarks should set off warning bells for an executive director or board members and lead to an analysis of your organization's spending and financial presentation. There may be valid reasons why your organization is not generating the same numbers as other charities, but knowing how and why is key. By becoming familiar with the ratios, the rating agencies and their reports, managers can benchmark their organization's performance against that of other charities in their community, field or revenue bracket. Such information can be powerful when trying to attract donors or negotiate with outside service providers, like fundraisers.

## The Most Common Calculations

Almost every rating agency employs a "fundraising ratio" to calculate the amount of revenues or related contributions spent on fundraising. This calculation is designed to answer the perennial donor question: "How much of my donation actually goes to...feed the poor, teach adults to read, preserve American folk art traditions, etc.?"

In using this ratio, it is first important to note whether the fundraising percentage being used is calculated based on the percent of total revenues, percent of total expenses, or percent of related contributions. Related contributions can be defined as only those revenues derived directly from fundraising activities. They do not include interest or earned income. Some watchdogs actually calculate multiple forms of the fundraising percentage to determine a charity's ultimate ranking, so it is important when comparing the fundraising percentages among different organizations to make sure the same formula is used. In general, fundraising percentages based on total revenue will be smaller than those calculated using related contributions or expenses, because most organizations have revenue sources over and above contributions and, hopefully, spend less than they earn in a given year.

According to The Wise Giving Alliance's 2001 Donor Expectations Survey, 80 percent of adults think that no more than 30 percent of their donation should go toward fundraising.<sup>1</sup> The agencies that set acceptable fundraising percentage limits say that on average an organization's fundraising expenses throughout the year should not represent more than 35 percent of the donations raised, and most organizations come in significantly below that benchmark. It is important to understand that a particular fundraising activity, such as a gala or telemarketing campaign, may yield returns much lower than the 35 percent-on-a-dollar target. These expensive fundraising activities are not prohibited by the watch-

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Newer organizations may be expected to have higher fundraising costs, as donor acquisition is more expensive than donor renewal.

dogs, but they should be coupled with lower-cost fundraising activities such as grant writing or soliciting Internet contributions to keep an organization's fundraising ratio below an average of 35 percent for the year.

Newer organizations may be expected to have higher fundraising costs, as donor acquisition is more expensive than donor renewal. Additionally, some watchdogs believe charities that champion unpopular causes may understandably have higher fundraising ratios. The experience of early AIDS organizations is often cited as anecdotal proof to support this belief.

However, simple differences in financial presentation can affect an organization's fundraising percentage as well. For example, if an organization deducts the costs of any direct benefit to the donor (such as the greens fees at a golf outing) from special event revenues, as is allowed by generally accepted accounting principles, both total contribution revenue and total fundraising expenses will appear lower than those of an organization that simply presents the gross revenue and full expenses. In most cases, using net event revenue when calculating the fundraising ratio will result in a lower percentage.

Adding to the confusion, many organizations still erroneously deduct all related expenses from event proceeds, further reducing their fundraising expenses and corresponding fundraising percentage. If this error is not taken into account when calculating an organization's ratio—and to be honest, it can be hard to spot, even for the watchdogs—an organization can unfairly be elevated in comparison to other, more conservative charities.

## Measuring Program Expenses

Another popular ratio employed by the rating agencies involves a "program expense" calculation. In most cases, the total amount allocated and spent on programs—as opposed to administrative overhead or fundraising—is divided by the total amount spent by the organization during the fiscal year to give a "program percentage."<sup>2</sup> While different watchdogs require different minimum program allocations for compliance or a favorable rating, the range generally falls between 60 and 70 percent of total expenses.

It is widely accepted that new organizations (younger than three years) may spend less on their programs than older, more established charities because of the administrative and fundraising efforts involved in launching an organization.

Although most organizations, regardless of size or field, spend 70 percent or more of their total revenue on their programs and services, the program percentage may be affected by a variety of factors. For example, an environmental or community development organization that regularly buys land or buildings in pursuit of its mission—for redevelopment or to establish wildlife habitats—may not be getting credit for these capital expenditures because they don't show up on the 990 or in the Statement of Activities as program expenses. However, most donors would not be alarmed or disappointed to know that their donation was going toward these mission-driven purchases.

Additionally, the treatment of donated goods and services in calculating an organization's total expenses may affect its program percentage. Proper accounting requires an organization to count the value of certain donated goods and/services as donations. If a charity has these types of donations, there must be a corresponding expense when the



good or service is used. For example, a food reclamation program that receives \$100,000 in donated restaurant foods and packaging would indicate that it received \$100,000 in in-kind contributions and spent a corresponding \$100,000 on its programs feeding the poor.

In practice, not all organizations include in-kind donations of goods or services in their financial statements, and some rating agencies deduct them from their calculations, citing irregularities in the way these gifts are valued. This practice means some rating agencies are excluding the expenditure of in-kind gifts from program expenses, even though a lot of donors view the use of donated services and products as a creative way to maximize the impact of cash contributions. And because the 990 does not account for in-kind donations in the same way as financial statements, those watchdogs that use either the 990 or financial statement when reviewing an organization may not always be presenting “oranges-to-oranges” comparisons.

## Making Your Case

If your organization finds itself under review by a watchdog, challenged by a reporter or questioned by a donor, it's important that you understand both the numbers and your organization's circumstances. “I don't know” or “You must be mistaken” or “You'll have to speak with our auditors” are not the answers that will best serve your organization.

When dealing with the watchdogs, provide the most complete information possible. Failure to respond to requests for information automatically gives your organization a black mark with many rating agencies. Take advantage of the opportunity to submit supplementary information for publication online and for reporting services like GuideStar. In the eyes of the suspicious public, the more information available on your organization, the better.

If you believe your organization's numbers are legitimately different from other charities' or you know that a unique situation might unfairly skew your review, take the time to include an explanation of the facts before the watchdog issues its finding. If a rating agency issues a report you disagree with, ask for a meeting to discuss its findings or for an opportunity to submit an explanation and supplemental information in writing. Many of the watchdogs will amend their reports based on additional information, and some will even include an explanation from the charity in the report.

You may head off donor or reporter questions by including information on your spending practices in your annual report and on your Web site. Sharing your spending ratios shows that you have nothing to hide and that you believe the numbers are legitimate reflections of the work your organization does. If your numbers appear lower than those of similar organizations, you may wish to consider including a simple explanation of how the numbers are calculated and what factors may be influencing them. Providing this explanation to any staff or board member who might be questioned about it may prevent problems, since they will have a ready and well-reasoned explanation for your organization's performance.

## Inaccurate Reporting Hurts the Sector

The argument is often made that an organization's allocation of expenses between program, administration and fundraising is, ultimately, arbitrary, and that the emphasis

If your numbers appear lower than those of similar organizations, you may wish to consider including a simple explanation of how the numbers are calculated and what factors may be influencing them.

By giving in to the  
“no administrative  
costs” pressure,  
nonprofit managers  
legitimize  
unrealistic donor  
expectations and  
affirm the mistaken  
belief that  
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are frivolous.

on financial ratios rewards the aggressive or deceptive and punishes the conservative or modest.

By calling what is essentially a direct-mail fundraising campaign “public education,” an organization can shift expenses from fundraising to program, often with an air of legitimacy. The allocation of a percentage of the cost for professional fees or staff development activities among various programs hides these very necessary administrative costs. By getting one or more major funders to cover administrative costs, some charities claim to other funders that “100 percent of this donation will go to our programs” when soliciting donations. Accounting rules, by the way, no longer find this practice allowable.

While these allocation games can raise program percentages and lower the appearance of administrative costs, and result in better rankings with various watchdogs, there are consequences. By giving in to the “no administrative costs” pressure, nonprofit managers legitimize unrealistic donor expectations and affirm the mistaken belief that administrative costs are frivolous. This sector-based support for these harmful misconceptions makes it harder to make the case for reasonable administrative expenses like professional development, software upgrades or marketing consultants. Individual charities and the sector as a whole are better served when nonprofits make an effort to understand the ratios and how their organizations’ unique circumstances may affect them.

Real numbers and careful explanations are powerful tools when discussing your organization’s performance with donors, reporters or the watchdogs themselves.

**Endnotes.** 1. BBB Wise Giving Alliance Donor Expectations Survey, 2001.

2. It should be noted that both the United Way and the Combined Federal Campaign use revenue-based calculations in determining an organization’s eligibility. Both look to see that 25 percent or less of total revenue is spent on administration and fundraising activities. In addition, the standards employed by the BBB Wise Giving Alliance until March 9, 2003 actually calculated program spending as a percentage of total revenues and required charities to spend a minimum of 50 percent of total revenue on its programs annually. In the newly issued standards, an expense-based calculation is employed.

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# The Challenge with Fundraising Costs and Multi-Year Grants

by Thomas Raffa

ONE OF THE MORE COMMON MISREADINGS OF THE FUNDRAISING COST-TO-REVENUE ratio occurs when a multi-year grant is reported. While accounting procedures require that the entire grant (termed a temporarily restricted grant) be reported in the year it's received, obtaining large grants usually takes consistent and concerted effort over time—often several years. So, because the revenue from a large grant arrives in a lump sum, costs may appear much higher as a percentage of revenue in the non-receipt years (see below).

Because the revenue from a large grant arrives in a lump sum, costs may appear much higher as a percentage of revenue in the non-receipt years

	YEAR 1	YEAR 2	YEAR 3	YEAR 4
ANNUAL REVENUE	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
ONE-TIME THREE-YEAR GRANT	\$600,000	\$0	\$0	\$0
TOTAL REVENUE	\$1,600,000	\$1,000,000	\$1,000,000	\$1,000,000
MANAGEMENT & GENERAL EXPENSES	\$225,000	\$225,000	\$225,000	\$225,000
FUNDRAISING EXPENSES	\$100,000	\$100,000	\$100,000	\$100,000
TOTAL SUPPORTING SERVICES	\$325,000	\$325,000	\$325,000	\$325,000

Although there are few exceptions to the United Way and CFC application requirements, it is always worthwhile for nonprofits to take the time to explain the variation and to explain it in every document going to any funder that might misread the ratios.

The United Way and the Combined Federal Campaign (CFC) require recipient organizations to keep their total management and general (M&G) and fundraising expenses to 25 percent or less of total revenue. As a result, nonprofits receiving any large contribution in any one year could be hurt. Although there are few exceptions to the United Way and CFC application requirements, it is always worthwhile for nonprofits to take the time to explain the variation and to explain it in every document going to any funder that might misread the ratios.

	YEAR 1	YEAR 2	YEAR 3	YEAR 4
TOTAL REVENUE	\$1,600,000	\$1,000,000	\$1,000,000	\$1,000,000
TOTAL SUPPORTING EXPENSES	\$325,000	\$325,000	\$325,000	\$325,000
PERCENTAGE	20%	32.5%	32.5%	32.5%

M&G expenses more than likely will increase in years two through four as the nonprofit administers the grant, elevating these percentages even higher. But even if the nonprofit could stabilize these costs (in the example above), fundraising expenses would have to be reduced by 75 percent in order to pass the United Way and Combined Federal Campaign “tests.”

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# Is There Enough Overhead in this Grant?

by Elizabeth K. Keating

**I**MAGINE THAT YOU'RE THE DIRECTOR OF A COMMUNITY CENTER THAT HAS BEEN invited to submit a \$50,000 grant request to fund a summer sports program. This would be a new effort, although it's nicely linked to existing youth programs in the center. How can you determine whether the grant will be financially beneficial or detrimental to the whole organization? Many managers rely on intuition or incomplete information about overhead rates to answer this question. This article presents a structured method of conducting a financial cost-benefit analysis. The accompanying sidebar clarifies common misunderstandings related to the term "overhead rate."

The goal is to identify every financial cost and benefit of the grant to the organization.

## Step 1: Assessing a Grant's Full Costs and Benefits

The first step of the grant's cost/benefit analysis is to develop a schedule of expected costs and benefits associated with the grant.

The goal is to identify every financial cost and benefit of the grant to the organization. At this stage, avoid adjusting costs based on grant constraints or the organization's budget. On the revenue side, consider such questions as: Do the financial effects include only the grant funding or is there an opportunity for additional program service fees? On the cost side, it is relatively easy to identify readily apparent costs, such as program staff time, recreational equipment, program advertising/promotion, and grant administration.

However, the value of this step lies in identifying the unexpected costs and revenues. For example, you would find with a thorough brainstorming that the full cost of the summer grant includes not just what is immediately apparent but also such things as insurance, maintenance, and the costs of fundraising and administrative staff time. It is useful at this point to talk with others who have run a similar program to be sure you are anticipating costs properly.

At this point, it's helpful to assess not just the immediate effects of the grant but also longer-term consequences. In our example, the grant may cover the cost of new playground equipment. The equipment provides a long-term financial benefit to current and

Applying for a grant to finance any particular project can be costly to other parts of the organization, since it may reduce the donor's willingness to consider other projects in the near term and cause the organization to forgo other opportunities to accept this project.

future summer programs, but it also creates insurance and maintenance costs that will continue into the future. By quantifying the full range of financial costs and benefits before applying for a grant, management can make a better-informed decision about both the short- and long-term obligations the grant initiates.

When a grant funds only a portion of a larger program, it is generally preferable to conduct this analysis at the program level and include other program-related revenue.

At the most basic level, you should include in this step the following consideration: Applying for a grant to finance any particular project can be costly to other parts of the organization, since it may reduce the donor's willingness to consider other projects in the near term and cause the organization to forgo other opportunities to accept this project.

## Step 2: Distinguishing Between New and Existing Financial Effects

The second step in performing the cost/benefit assessment is to divide the financial costs and benefits between new and existing items. The objective here is to distinguish the costs and revenues that will occur only if the grant is obtained from those that are predetermined or fixed. It is the new or incremental costs and revenues that will be relevant in the later steps.

In our grant example, the committed costs include the existing mortgage, maintenance, insurance, and salaried staff time. The new or marginal items include the class registration fees collected on the new programs as well as the cost of an additional summer program staff member, new playground equipment, incremental printing and mailing costs, and repairs to a basketball court. It also is important to identify the future recurring costs and revenues, such as the increased insurance premiums, added maintenance costs, the summer program staff member, and registration fees.

The final list of new or incremental costs should include both the one-time costs and a portion of the new recurring costs. The recurring costs that are included depend on the grant's allowable scope and the nonprofit's plans for covering the ongoing costs in the future. In our example, the nonprofit may decide to include the increased insurance and maintenance for the full year as a new marginal cost. It may be able to limit the future recurring costs by deciding that future registration fees and a fundraiser will be required to cover the costs of running the program in future years.

## Step 3: Conducting a Break-Even Analysis

At this point, it's useful to compare the new or marginal costs to a realistic estimate of the eventual grant amount and new revenues. The goal is to determine if the grant will break even financially. Ideally the grant and new revenues should equal or exceed the new costs. Any excess of the grant over these costs contributes to the organization by covering existing costs or the excluded future recurring costs. While a nonprofit can pursue some grants that are close to or even below break-even, the organization needs enough funding with positive contribution margins to cover its committed costs. So some organizations determine a pre-set contribution margin, or hurdle rate, in order to approve a grant.

If the break-even analysis determines that the marginal costs are greater than the grant amount, then the plan should be revised. This phase of the analysis often results in reducing the scope and extent of new activities that will be funded by the grant. Alterna-

tively, the nonprofit can pursue supplemental sources of revenue, such as contributed goods and services, donations and fee-for-service arrangements, to cover the shortfall.

In our example, suppose the nonprofit estimates that the grant will be \$50,000 and the incremental registration fees will generate \$10,000. The repairs, playground equipment, summer staff member, and program promotion total \$52,000, and a year of increased insurance and maintenance equals \$3,000. So the marginal revenues of \$60,000 exceed the marginal costs of \$55,000. The difference of \$5,000 (or 10 percent of the grant) can be used to cover existing costs. The 10 percent often is referred to as the “contribution margin.”

#### Step 4: Deciding If the Grant Fits the Organization

Upon seeing the favorable contribution margin, many managers proceed immediately to preparing the grant budget. But it's important to examine the grant's role in the organization first. The attractiveness of applying for a grant with a particular contribution margin depends upon the fit with mission, other funding options, and the organization's financial condition and uncertainties.

An analysis of organizational fit helps ensure that managers put the grant in perspective. Grant proposal writers are eager to obtain a particular grant. As a result, the fundraising appeal often emphasizes that certain programmatic activities cannot occur without the funding. Grantors, too, want to hear that their funds are bringing about some new positive change. Hence, the organization feels pressure to request grants that primarily fund new costs.

In our example, a 10 percent contribution margin seems attractive. Suppose, however, that the funder would be equally willing to provide the \$50,000 without the expanded summer course offerings or the repairs to the basketball court. A financially struggling nonprofit might prefer this second option, since the contribution margin is higher, even if it does not expand the programmatic impact of the organization.

Some groups have a tendency to focus on obtaining the latest grant rather than ensuring complete funding for the program. Managers tend to include the most appealing costs in the immediate grant proposal and often underestimate them. This may leave a set of costs that no donor is willing to fund. Hence, it's important to determine if there will be stranded costs and how they will be financed. Without forethought, the community center could be financially burdened, for instance, with increased insurance premiums and maintenance costs.

Along with considering financial costs and benefits, the organization should consider the effect of the grant on the mission and on the organization as a whole. A funding opportunity may support a program that is central to the mission, or it may shift the mission, thereby alienating some constituents or diffusing the impact of the organization. The grant also may place demands on staff time, distracting them from other mission-critical activities. Finally, the enhanced program may create a set of expectations—rightly or wrongly—among the community, board members and employees that the program will be continued in the future. If the program is likely to be sustained, then the organization should include the costs of asset replacement and ongoing program fees in its list of financial effects.

Some groups have a tendency to focus on obtaining the latest grant rather than ensuring complete funding for the program. Managers tend to include the most appealing costs in the immediate grant proposal and often underestimate them. This may leave a set of costs that no donor is willing to fund.



Many donors do not require or expect that the direct costs be new. Others allow costs such as an external program evaluation to be classified as direct.

At the conclusion of this step, the nonprofit should have a good understanding of how the grant relates to particular programs and to the organization as a whole. Ideally, the grant will cover new costs, including some contingencies, while also contributing to both the mission and the financial health of the organization.

### Step 5: Preparing the Grant Budget

The final step is to produce the grant budget. This is essentially the pricing phase of the analysis. Since most donors expect costs to be divided between direct and indirect costs, the budget generally includes this breakdown. Some grant writers assume that the only costs that can be listed as direct are those that are both new and program-related. A careful review of the application instructions can determine whether this is true. Many donors do not require or expect that the direct costs be new. Others allow costs such as an external program evaluation to be classified as direct. In other instances, any identifiable costs, including grant administration, rent and supplies, can be listed as direct costs. Hence, the classification of costs between direct and indirect in the grant proposal may not correspond strictly to either a program-support services distinction or to a new-versus-committed cost breakdown. So the stated indirect costs for the summer sports grant could

## The Confusion Over Overhead Rates

Many executive directors, fundraisers and program staff want to know their agencies' overhead rate to help them determine the attractiveness of various funding opportunities and for internal management purposes. When questioned for this rate, the finance staff inevitably answers, "That depends who's asking." This response mystifies and often frustrates, for it would seem that the finance staff should know exactly what the overhead rate is.

However, there is no consistent definition of the overhead cost rate because there are differences in how funders and others expect it to be computed. The rate is composed of overhead costs (which may include more or fewer categories depending on the definition being used) in the numerator and a benchmark amount in the denominator—all costs of a

grant, of the associated program or of the agency as a whole.

While the appropriate benchmark or denominator may be easy to select given the reason for the analysis (Are we looking at the whole organization or just a part?), there is considerable variation in what constitutes the numerator, i.e. overhead costs. While the term "overhead" refers to the indirect cost of an organization's products and services, in a nonprofit setting, it can be used to mean administrative expenses, fixed costs (such as salaries and rent), or the amount stated in a grant application. Rather than labeling all three concepts as "overhead," some try to reduce misunderstandings by referring to them as support service expenses, committed or fixed costs, and indirect cost recovery, respectively.

be \$5,000, as in the break-even analysis, \$8,000 if the insurance and maintenance are included, or even higher if the repairs or promotional costs are classified as overhead.

Some donors have a preference for grant proposals that include little or no stated overhead. It's wise to be cautious and to examine and compare details. If you compare the stated overhead rate in a grant to the percentage of organizational expenses that are classified as general overhead and the grant rate is higher, it cannot be assumed that all the overhead costs are covered and that you can now proceed with the grant. Definitions differ broadly because many grant makers have their own guidelines that determine whether a cost is classified as direct or indirect. It's best if you keep in mind that the indirect costs stated in a grant represent the price you set (as allowed by the funder), not necessarily a true cost. It is simply an amount that the applicant hopes to receive from the donor.

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Definitions differ  
broadly because  
many grant makers  
have their own  
guidelines that  
determine whether a  
cost is classified as  
direct or indirect.