

Are You a Dipper?

Nonprofits, Sin, and Shadow Loans

by John MacIntosh

Dipping into your restricted funding isn't exactly illegal—and, as the author points out, it “represents an important, perhaps irreplaceable source of informal ‘shadow’ financing.” But dipping is dangerous, and this article advises nonprofits to focus on getting the majority of their working capital self-financed or through appropriately structured third-party debt.

IT SEEMS SELF-EVIDENTLY BAD TO BORROW money from someone without permission. Yet nonprofits do it all the time. Sometimes, though very rarely, it's fraud; far more often, the nonprofit doesn't *know* it's borrowing or doesn't think of it *like that*. Let me explain.

For-profit businesses require working capital, because they make things before they sell them or provide services in advance of getting paid. The amount of working capital depends on the length of time between the cash outlays and receipts. A successful business satisfies its working capital needs by borrowing or by self-financing through retained earnings.

It might seem that nonprofits don't require much working capital, since their cash revenues often arrive *before* the associated expenses. And this is certainly true for grants. In fact, restricted net assets reflect revenues that have already come in and where the associated expenses have yet to be incurred. But this is not the case for government

funding, which is generally provided on a cost-reimbursement basis, with an associated need for working capital to bridge the timing gap. How can a nonprofit finance this need?

One way is to borrow—but this is tricky, since most nonprofits have few unencumbered assets to offer a lender. In addition, the monies coming to them from the government are often too conditional to be considered good receivables by conventional banks, and the payments cannot usually be assigned to third parties (as required by many asset-based lenders). And even if the nonprofit *can* borrow, the interest payments must be funded through philanthropy, because few government contracts treat interest as a reimbursable expense. Debt also introduces a new risk that the organization may not have the people or processes to manage.

A second way is to self-finance through retained, uninvested surplus.¹ In theory, this is the best approach, but in practice it's very tough for many

organizations. Consider a typical human services nonprofit: 80 percent government funded, 20 percent privately funded (of which 75 percent is restricted), an average surplus of 1 percent. If the working capital need associated with the government funding is forty-five days, then it would take about six years of average surpluses—with no bumps in the road—to self-finance through internal reserves.

The third way is to dip into restricted private funding, which, unlike government money, is usually paid in advance. The “typical” human services nonprofit described above has more than enough restricted grants to fund the working capital associated with its government contracts. The problem is that if a portion of the restricted grant for program Y is tied up as working capital for program X, then how will program Y ever be fully funded? By using a portion of the restricted funding associated with (future) program Z!² In effect, the organization borrows from Y to support X

and then borrows from Z to support Y, and so on.

It's pretty easy to tell if you are a dipper (and we're not talking about tobacco-stained teeth!). If your operating reserves (unrestricted net assets less fixed assets and associated debt) are negative, then you have dipped into your restricted funding and probably can't make good on your current obligations to restricted funders without dipping into future restricted funding.³ If your operating reserves are positive but less than the difference between your maximum working capital need during the prior year and the working capital as of your current financial statements, then you probably dipped at some point during the year but are in the clear for now.

Dipping is dangerous because the organization can easily find itself on a debtor's treadmill, where the only way to pay off one unwitting lender is to borrow from another, with no end in sight. Dipping for working capital can also be the gateway for dipping to cover operating deficits: the nonprofit road to perdition. Dipping is also exhausting for all concerned, and hardly the recipe for running an effective organization. It only ends when the organization is finally able to earn its way to self-financing or reaches the breaking point when it cannot fulfill its obligations to funders and must fess up.

Is Dipping a Sin?

Dipping may be dangerous and exhausting, but is it a sin? It all depends on the nature of the understanding—written and tacit—between the nonprofit and the restricted funder(s) into whose cash it has dipped. These funders fall into five categories:

1. **Cost-reimbursement.** Cost-reimbursement funders make it impossible to dip into their cash by releasing it only after the allowable program costs

have been incurred. However, the transaction costs (reporting, compliance, wire transfers, and so forth) associated with this type of funding are high. Cost-reimbursement grants are also challenging for foundations to include in their cash-out-the-door-this-fiscal-year grant budgets, given the uncertain timing of the disbursements. Many funders also recognize that without the associated working capital, some nonprofits will not be able to incur the costs to be reimbursed in the first place, making the grant self-defeating. Very few foundations make cost-reimbursement grants.

2. **Cash-is-king.** Cash-is-king funders require that their cash be held in a separate bank account and disbursed only to cover the costs of the program that they have agreed to support. While this no-commingling requirement comes at the cost of maintaining a separate account, it works well when the funds are to be regranted or used to pay a small number of third-party costs. It's more of a hassle when the funds are intended to cover program costs—usually staff—that are incurred on a frequent basis, given the resulting bank transfer and bookkeeping needs.

3. **Control-by-accounting.** Control-by-accounting funders expect their funds to be treated *as if* they were separate, but do not require the money to be segregated in a separate account. They assume that the nonprofit has the accounting and control processes in place to treat the grant as separate, even though the cash is commingled.⁴

4. **Funds-are-fungible.** Funds-are-fungible funders believe that money is fungible. They expect cash *equal to the grant amount* to be spent on the supported program over the grant period.

While they don't explicitly allow their cash to be used for other programs, they are okay with it because they expect that someone else's cash will be used for *their* program.

5. **Best-efforts.** Best-efforts funders expect the nonprofit to use its best efforts to spend an amount equal to the grant on the supported program, but they recognize that their favored program won't be delivered if the organization falters. They are happy if their cash is commingled with cash from other funders. They believe that it makes no sense for their cash to be sitting around doing nothing if it could be used as a zero-interest loan to support the working capital needs of the nonprofit. They understand that there may be circumstances beyond the nonprofit's control that make fulfilling the grant terms impossible. They accept this risk as an unavoidable cost of doing philanthropic business.

In my experience, restricted grant agreements are pretty vague, though most are probably closest to the funds-are-fungible category. But the vagueness leads to misunderstandings, because many nonprofits think that they have received best-efforts funding while the funders believe they have made control-by-accounting grants. This results in many bad feelings if the nonprofit hits a bump and its best efforts turn out not to be enough. And while a nonprofit will always have to grapple with how to balance its conflicting obligations to clients, staff, and funders in times of duress, a lack of clarity around the deal with funders doesn't make things any easier.



Dipping represents an important, perhaps irreplaceable, source of

informal “shadow” financing for nonprofits, but the sector would be better off if more of its working capital were self-financed or provided through appropriately structured third-party debt. Not only is shadow financing inadequate or unpredictable for many organizations, the practice also erodes trust between funders and their grantees. Three things could help wean nonprofits off of shadow financing:

1. Every nonprofit should do the work to understand the extent of its dipping. It should also recognize that dipping—inadvertent or otherwise—is very tempting when the alternative is to cut programs or not make payroll. So, processes should be put in place to reduce the risk of its happening without the knowledge and concurrence of the board. Every nonprofit should also develop a plan to increase the extent to which it can

self-finance—either through retained surplus, special-purpose unrestricted gifts, or by appealing to funders to consider making socially motivated working capital loans in addition to grants.

2. Government should reduce the working capital needs associated with its contracts through faster, more predictable payment (better yet, more payment in advance) and by granting explicit permission for nonprofits to assign government payments to third-party lenders.
3. Private funders should be clearer about their expectations. They should tilt their restricted grantmaking to best efforts or, better yet, provide unrestricted support. They should consider making working-capital loans to grantees in addition to grants. They should recognize that working capital—while perhaps less “sexy”

than pay-for-success bonds, double-bottom line social enterprise investing, and so forth—is a large and important impact-investing opportunity that is available right now.

None of this will happen overnight, but we’ve all got work to do, so let’s get moving. The next few years are going to be tough, and nonprofits need all the help they can get.

NOTES

1. The nondistribution requirement means a nonprofit must retain any surplus. However, amounts retained but invested in assets—IT, real estate, etc.—will be unavailable for working capital needs. Fiscal Management Associates (FMA) calls these uninvested, “liquid unrestricted net assets” (LUNA).
2. Program Z might be the continuation of program Y, but the problem remains the same.
3. This is not technically true. You may be able to make good on your obligations to funders by stiffing vendors, though this is less common, since vendors (for example, the auditor, landlord, accountant, food provider) have high-powered ways to make life difficult, and your biggest vendor—your staff—is your most important asset. You might also be able to earn your way out of the problem, but this is unlikely within the period of your current grants.
4. A nonprofit with little margin for error needs very timely accrual accounting at the fund level to avoid inadvertent dipping. This is more challenging than many funders realize.

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