

# Organizational Slack (or Goldilocks and the Three Budgets)

by Woods Bowman

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**O**RGANIZATIONAL SLACK IS AN IMPORTANT concept in the management literature, but you won't find it mentioned in articles on nonprofits. It has several definitions, but all boil down to *extra* resources or resources held in *reserve*. The difference between a hand-to-mouth organization and a vibrant one is slack. Think of slack as the financial aspect of organizational *capacity*.

Nonprofit commentators write about capacity as if an organization can't get enough of it, but slack (financial capacity) has a dark side. Too much slack can distort priorities, erode managerial discipline, and encourage wastefulness, especially high salaries. I will emphasize the positive aspects because I believe that most nonprofits do not have enough slack, but I caution that it *is* possible to have too much of a good thing.

## A Primer on Slack

Nobel laureate Herbert Simon (1947) disparaged the economic assumption that decision makers seek to maximize utility, profit, or anything at all, arguing that maximization requires more information than ordinary mortals are likely to possess or could even process if they had it. Instead, he proposed that decision makers stop short of that elusive goal when they reach a sat-

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isfactory state of affairs—a situation he famously called “satisficing.”

The difference between satisficing and maximizing is slack. This seems to be an ideal starting point for nonprofit analysis, since profit maximizing is not the norm for nonprofits (Steinberg 1986; Brooks 2005). Nonprofits even shun the word “profit,” preferring to use “surplus” as the name for an excess of revenue over expenses.

I like a definition from the traditional (i.e., for-profit) management literature. Slack is “A cushion of potential resources which allow an organization to adapt to internal pressures for adjustment or to external pressures for change in policy, as well as to initiate changes in strategy with respect to the external environment” (Bourgeois 1981). This seems to me to perfectly capture the idea of nonprofit financial capacity, so from here on that is what I will call it.

Bourgeois and Singh (1983) identify three forms of slack, i.e., financial capacity. Several methods are available to measure each one (Bowman, Keating and Hager 2005). Here I have selected the simplest methods.

First, there is *available*, or *unabsorbed*, financial capacity. Think of this as ready cash, although a more accurate description would be liquid assets. One purpose of available financial capacity is to cope with occasional or periodic negative cash flows without having to borrow from outside the organization. Another purpose of available financial capacity is to cope with occasional budget shortfalls on an annual basis without having to borrow from outside the organization.

A standard metric of short-term available financial capacity is *working capital*, which is current assets minus current liabilities. Current assets are unrestricted cash and cash equivalents, inventory, and monies an organization expects to receive within one year. Current liabilities are obligations to creditors that an organization must discharge within one year. An alternative metric useful for comparing available slack in organizations of different sizes is the current ratio, which is current assets divided by current liabilities.

The second form of financial capacity is *recoverable*, or *absorbed*, financial capacity. Think of this as overhead spending. When times are tough, overhead can be cut and resources recovered for operations (Chang and Tuckman 1991). The metric for this form of financial capacity is administrative expenses divided by the sum of administrative expenses and program expenses.

Overhead should not include spending on fundraising because spending a few dollars more or less on overhead will not influence the organization’s revenue. Money spent on fundraising should pay for itself and then some. If fundraising spending is optimized, it would be foolish to cut it in a crisis because more revenue would be lost than the amount of money saved.

Third, there is *potential* financial capacity. Think of this as the capacity to borrow. There are multiple ways of measuring this concept. The simplest metric is the ratio of total liabilities to total assets—the value of everything owed divided by the value of everything owned—a quantity commonly called leverage. Simply put, the less an organization owes, the more it can borrow.

Long-term borrowing should be reserved for expanding the organization’s ability to increase its revenues. If this sounds crass, consider this: without more revenue, an indebted organization will have difficulty repaying principal with interest. Unless an organization is careful, additional long-term debt might leave it in worse shape for years to come and, in the worse case, may cause its extinction. Potential financial capacity indicates that an organization has not borrowed to the hilt.

### **Cold Organizations Need It**

A cold organization is frail, unable to adapt to

changing needs of its constituents, unable to invest in training and new technology, and unable to take advantage of opportunities. It is stale though not yet failing. It has ideas but does not have sufficient capacity to implement them.

At the most basic level financial capacity reduces risk. It cushions an organization from economic shocks. It permits a nonprofit to maintain service levels in the face of temporary reductions in income.

Many nonprofits are tyrannized by inflexible business models. Cold nonprofits easily become locked into program models not fully appropriate to their communities—but favored by their funders. In other words, financial capacity gives nonprofits the flexibility to navigate around restricted funds and to avoid mission distortions that can result from overdependence on grants.

It also allows the organization to equalize budgets among various parts of the whole. An example of this might be the community mental health organization that used cash earned from a thrift store to support a domestic violence program which it had adopted in an underfunded state.

Above all, financial capacity supports innovation. Vibrant organizations do research about the needs and interests of their communities and about promising program models, and experiment with new ways of doing things. Financial capacity facilitates strategic behavior, allowing a nonprofit “to experiment with new strategies such as introducing new products and entering new markets” (Tan and Peng 2003, paraphrasing Thompson).

### How They Can Get It

Where does financial capacity come from? There can be only one place: annual surpluses. Some nonprofits worry that it is bad to have annual surpluses. Others would like to have surpluses but believe they are unaffordable. Both views are wrong.

A budgeted surplus is an insurance policy against a deficit and allows the organization to remain nimble and responsive to constituents. Unexpected adverse circumstances will create a smaller surplus than anticipated, but this unhappy situation is better than having an actual deficit. Besides, nonprofits cannot sell stock. If a nonprofit wants to grow, it will need to invest in physical capital. An annual surplus

allows a nonprofit to accumulate the resources needed to pay cash or to service a debt.

Instead of explicitly budgeting a surplus, too many organizations take the easy, but sloppy, road by deliberately underestimating revenue and overestimating expenses. It is best to avoid this expedient. It will require some tough choices to adjust a tight budget to provide for a surplus, but once it is in a budget, it is easy to retain because it makes no demands on new dollars. Phase it in—first one percent of revenue, then two, then three, and maybe more depending on the long-term reliability of the organization’s funding. Higher risk requires higher surpluses.

A budgeted surplus is just the first step. Managers need to be able to spend extra resources to deal with unforeseen contingencies and opportunities. Top managers—CEOs, finance directors, chief program officers—need contingency accounts in their departmental budgets to be able to respond to business opportunities, to pay the bills if the electric company raises rates in the middle of the year, or to hire lawyers if the organization is hit with a lawsuit.

All contingency spending is not created equal. It is important to distinguish among three types of new spending:

- non-recurring (one-time);
- new spending that will recur in future budgets, but will generate more than enough new offsetting revenue; and,
- new spending that will recur in future budgets without new offsetting revenue.

Ideally, all “just right” contingency spending would be of the first type, establishing no new ongoing commitments. Contingency spending of the second type can be thought of as an investment but, as with all investments, there will be the problem of judging how long it will take to break even. If it will take more than a year, future financing must be secured before spending occurs. A financing plan is required for contingency spending of the third type.

### Hot Organizations Have Too Much

A hot organization is one that is extremely successful—at least financially. It has a big portfolio and yet money keeps rolling in. These fortunate nonprofits are an exclusive club, but as I have said, there is a dark side to their success.

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The idea that a point exists where financial capacity passes from being merely large to being excessive is based on the observation that people (and organizations) tend to lose their edge when they are sated.

Too much financial capacity can support waste, high executive salaries, lack of discipline, hoarding behavior, and lack of innovation—with no one taking notice. Paradoxically, some organizations that have the greatest capacity to do research, experiment, and innovate are restrained by their wealth. “Don’t mess with success,” could be their motto.

Frumkin and Keating (2001) analyzed CEO compensation in over 15,000 nonprofits in relation to organization size, managerial performance, and free cash flow. They define the latter concept in terms of liquidity, which is what I call available financial capacity. They use statistical techniques to hold two of these three variables as well as industry constant while measuring the effect of the third on CEO compensation.

They find that CEO compensation is positively related to organization size (measured by value of physical assets and total program services), but not related to managerial effectiveness (measured by overhead ratio and dollar growth in donations). CEO compensation is positively related to free cash flow (measured by liquid assets-to-expenses ratio) and the size of an organization’s investment portfolio in relation to its total assets. However, after controlling for organization size and managerial ability, the effect is not large. Human service organizations were the only ones where organization size and managerial performance significantly outweighed the effects of free cash flow and portfolio size on CEO compensation.

It is easier to say how much financial capacity is too little than to identify the threshold where it becomes too much. The idea that a point exists where financial capacity passes from being merely large to being excessive is based on the observation that people (and organizations) tend to lose their edge when they are sated. It need not happen to everybody; Warren Buffet is as sharp today as when he was a mere millionaire. For a nonprofit, the secret of continued success lies in its board. If its board is self-renewing and keeps the best interests of its clientele in mind, a huge financial capacity need not create problems.

### Goldilocks and the Three Budgets

Every nonprofit has a culture of budgeting. This is illustrated in an exchange between two board members of an organization in its early stages of

development. One board member was arguing for austerity based on the organization’s relative youth and her own natural fiscal conservatism. Another challenged her saying “that’s scarcity thinking. We need to have abundance thinking here!” In some cases these two orientations do not get resolved—one simply wins out over the other. This can result in an organization’s starving itself or, alternately, resolving to build its asset base almost as a mission goal in and of itself.

Without knowing it, the board members were arguing about the appropriate level of financial capacity. As we have seen, both too little and too much are bad—for different reasons. An optimal amount of financial capacity must lie somewhere between (Nohria and Gulati 1997). Organizations fortunate enough to operate in this financial environment are the “Just Right” nonprofits.

A careful analysis of an organization’s financial capacity should include a study of its financial statements (see A Primer on Slack on page 16), executive compensation, and administrative staffing. The sidebar to the right (What’s Your Financial Capacity Quotient?) provides a non-scientific, rough and ready scorecard of financial capacity quotient for readers to assess whether a detailed analysis would be worth the time and effort. Persons with a good working familiarity of an organization should be able to complete the scorecard without leaving their armchair to hunt for old financial statements.

The highest possible financial capacity quotient is 8; the lowest possible quotient is -8. A “Just Right” organization has a low positive score. The best way to understand how the scoring system works is to examine three alternative hypothetical scenarios. Obviously an organization with a +8 quotient on the first scorecard is hot and one with a quotient of -8 is not. The following examples are in the middle of the pack.

*Scenario A.* The revenue of a large human services organization consists of 30% restricted government contracts, 25% individual donations, 25% program service income, 15% restricted grants, and 5% investment income (-1). It ended three straight years with a surplus (+3), including one of 11% (+1). It has a line of credit but never needs to use it (+1). It recently filled a new administrative assistant position (+1). The

## What's Your Financial Capacity Quotient?

To find out whether your organization has too little or too much, fill in the scorecard. The number in parentheses after each statement is the score for a true statement. Write it on the line that introduces the statement. The score for a false statement is zero. A statement that bodes well for financial capacity earns a positive score; a statement that implies impaired financial capacity receives a negative score. The highest possible financial capacity quotient is 8; the lowest possible quotient is -8. "Just Right" organizations have low positive scores. Be careful answering questions about surpluses and deficits; they should be based only on unrestricted amounts, including resources released from restrictions.

Item 13 costs more than most people think, but an organization with financial capacity should be able to finance it easily. An organization with a performance budget based on measurable outcomes

is probably staying sharp, even if it has a very large financial capacity, but it will need an R&D program to keep its performance measures updated.

The figure 10% in the last two items represents the approximate rate of inflation over the past three years. It is not possible to say exactly how much R&D and training an organization should do without knowing something about its mission and its business model, but one can say that all organizations should be doing some of each and their spending on these activities should keep up with inflation.

The Adjusted Financial Capacity Quotient should be approximately zero. A negative sub-total on the first scorecard and a score of -2 or more negative on the second one indicate that good work is probably unsustainable at its current level.

1. \_\_\_ The CEO or CFO has a budgeted contingency account. (+1)
2. \_\_\_ Unrestricted income from investments is greater than 10% of annual budget. (+1)
3. \_\_\_ Restricted revenue is greater than 1/3 of budget. (-1)

*Within the last three years the organization:*

4. \_\_\_ had a unrestricted surplus every year. (+3)
5. \_\_\_ had a unrestricted deficit every year. (-3)
6. \_\_\_ had at least one unrestricted surplus greater than 10% of revenue. (+1)
7. \_\_\_ had at least one unrestricted deficit greater than 10% of revenue. (-1)
8. \_\_\_ was refused a line of credit, or was refused a higher borrowing limit. (-1)
9. \_\_\_ did not use its line of credit. (+1)
10. \_\_\_ borrowed to the maximum on a line of credit. (-1)
11. \_\_\_ cut general administrative positions. (-1)
12. \_\_\_ added general administrative positions. (+1)
- \_\_\_ Financial Capacity Quotient: items 1-12 (range +8 to -8)

*The critical issue is how an organization uses its financial capacity. If your organization has a quotient above zero, then fill in the short scorecard below. These are things that organizations should be doing because they reduce risk and improve service quality, but cold organizations can't. Hot ones have no excuse for not doing all of them. "Just Right" organizations should be doing at least some of them, so their score should be near zero. The item scores are negative because they use financial capacity, but that is the point of this scorecard.*

13. \_\_\_ The organization has a performance budget with measurable outcomes. (-1)
14. \_\_\_ The program service budget increased every year. (-1)
15. \_\_\_ The program service budget increased in years when total income decreased. (-1)

*Within the last three years the organization:*

16. \_\_\_ made a major investment in new technology. (-1)
17. \_\_\_ increased its research and development budget by more than 10%. (-1)
18. \_\_\_ increased its training budget by more than 10%. (-1)
- \_\_\_ Adjustment: items 13-18 (range 0 to -6)
- \_\_\_ Adjusted Financial Capacity Quotient: items 1-18 (range +8 to -14)



The Financial  
Capacity Quotient  
is designed to  
challenge  
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financial capacity quotient for this organization is +5. It is borderline hot.

*Scenario B.* The revenue of a small human services organization consists of 70% restricted government contracts, 10% individual donations, 10% program service income, and 10% restricted grants (-1). It had deficits two of the last three years (-1), and one was larger than 10% of its budget (-1). It maxed out its line of credit (-1) and had to cut one administrative position (-1). Its financial capacity quotient is -5. It is cold.

*Scenario C.* The revenue of a small arts organization consists of 80% ticket sales, 10% individual donations, and 10% grants (+1). It has no endowment, but it ended each of the last three years with a small surplus (+1). It uses its line of credit occasionally (-1). It added one administrative staff in group sales (+1). The financial capacity quotient for this organization is +2. It is neither cold nor hot. It is “just right.”

The second scorecard determines whether financial capacity is working or wasted. When this score is added to the first, the Adjusted Financial Capacity Quotient should be near zero. Look at the three budgets again.

*Scenario A:* The hot organization’s revenue increased three years in a row, and it increased its program service budget each year (-1). It invested in new technology (-1). Its Adjusted Financial Capacity Quotient is +3. It has capacity to do more.

*Scenario B:* The cold organization is not in a position to keep program spending constant when income goes south. It cannot do much R&D, training, or investing in new technology.

*Scenario C:* The small arts organization probably could afford to do one or two of the items 13 through 18, but not all. It chose to increase its production budget (+1) and to invest in technology (+1). It is neither hot nor cold. With an overall quotient near zero, it is a “Just Right” organization and would probably use additional capacity wisely.

The Financial Capacity Quotient is designed to challenge organizational denial and complacency and to give all organizations a “to do” list. If you are a cold organization in denial, the Financial Capacity Quotient will point out what you can improve. If you are a complacent hot organization, the Financial Capacity Quotient will show you how to put your financial capacity to work. Now, go to it!

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