

Managing *in the* New Economic Reality

by Jina Paik

Short-term “cash needs” measures like dipping into cash reserves or using lines of credit are not the answer to weathering the recession. Instead, such long-term internal tactics as cutting costs, generating new revenue, and managing financials strategically, and external strategies like engaging board members and funders and cultivating partnerships and collaborations, are key to improving your economic situation.

MOST NONPROFIT ORGANIZATIONS ARE nothing if not resourceful, and in an environment where your fortunes are largely determined by others, it takes a good deal of care and creativity to stay afloat. But the recession has stretched many nonprofits to their limits and forced them to learn new coping strategies. What follows is what we at Nonprofit Finance Fund (NFF) have heard about the problems nonprofits have been confronted with over the past few years, and the management strategies used to address them.

Economic Stresses Force Nonprofits to Take Action

Four years of difficult economic times have left many organizations in a weaker financial position, with less cash, neglected facilities, rising debt, and ever-more delayed payables. In the words of one Montana arts and culture organization leader, who responded to our 2012 national State of the Nonprofit Sector survey: “We just finished our most

recent audit. . . . It shows a substantial deficit for the third year in a row. While our organization is holding on . . . funding organizations look at the tax return, our lack of reserves, and our P&L, and it looks as if we are sinking. . . . Our staff is stretched to the limit, our board has no experience in running campaigns, and no major funder wants to give to an [NPO] without a solid financial future. It’s a horrible cycle and there is no way out.”

We saw many nonprofits experience a sudden drop in foundation giving in 2008 through 2009, forcing organizations to scramble to meet expenses. Many were unable to do so and had to dip into cash reserves, borrow from other internal funds (more on this later), or use lines of credit. Organizations that had to employ drastic short-term strategies at the beginning of the downturn are now left to repair balance sheets that were stripped of assets, overly leveraged, or neglected.

For many organizations, government funding has been declining overall since the beginning of the economic downturn. Some organizations have experienced cuts to core programs but were offered money for other initiatives less central to their mission. And many organizations have experienced delays in terms of contract payments and even contract signing. These issues are financially destabilizing, to say the least,

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especially for safety-net organizations that are heavily reliant on government support—recent funding cuts and payment delays mean they can't cover costs, have to turn away people in need, or dip into reserves. As one Delaware nonprofit leader explained in the survey: "We currently shelter thirty-six homeless men and operate two transitional houses while turning away over one hundred individuals monthly." It also means that core administrative and fixed facilities costs may be threatened when contracts that covered some portion of them are lost.

This does not mean that no nonprofits are experiencing growth. There are some fields that have experienced a significant increase in demand for services, requiring nonprofits to be resourceful in assembling the funds necessary to support the needs of the communities they serve. One of these fields is community health. With the downturn of the economy, communities have increasingly become unable to afford health insurance coverage or are not eligible for Medicaid coverage in their states. In response, many centers have developed plans to expand the infrastructure needed to support both existing demand and anticipated increases with the implementation of the Affordable Care Act. For example, one community health center in an underserved neighborhood embarked on a project to double its services. Despite the challenging economic conditions and highly competitive environment for capital, this nonprofit was able to put together a creative financing structure using New Markets Tax Credits and a combination of public and private investments to fund its expansion.

Nonprofits Often Start with Internal Actions

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If an organization is experiencing cuts, often the strategies employed first are internal to the organization, as these are the ones fully within the control of management. Internal actions often focus on *cutting costs, developing new revenue strategies, employing cash management tactics, and improving financial and cash management processes.*

1. Cost-cutting measures

When cutting costs, be careful not to cut essential programs or functions. Cost cutting is a tried-and-true tactic that almost every nonprofit has had to use in the last few years; the trick is to figure out which cost-cutting measures result in the biggest savings with the least disruption. For some organizations, cutting back surfaces efficiencies; for others, reductions are a financial necessity but less sustainable in the long term.

Staffing creativity may be necessary. The rightsizing of an organization may have to occur multiple times as an organization contracts and grows with the environment. As one arts and culture nonprofit from Georgia reported: "At the end of our last fiscal year, we had a deficit and [took] strong action to reduce the debt. For this season, we have reduced programming and staff in an effort to eliminate the debt. The debt will be eliminated at the end of the year, and we will begin to produce a more consistent season next year. Our biggest challenge will be strategically adding staff . . . back to accommodate the increased workload without causing the same strain on the budget as occurred in the past." Some organizations may end up using more contracted workers, whose hours can be adjusted, to avoid having to lay off and then rehire permanent staff. Others may investigate the more widespread use of volunteers, but this generally takes volunteer management capacity.

2. Revenue-generating strategies

When you invest in more fundraising, make sure you are not engaging in unrealistic thinking—give this strategy time to develop. "More money" is the response I usually hear when I ask nonprofit leaders what's most needed in their organizations. Indeed, in NFF's 2011 survey, 61 percent of respondents identified "fundraising assistance" as the single most desired type of technical assistance. The economic challenges have prompted many nonprofits to focus more resources on investments in fundraising—either in staff, consultants, and/or time spent fundraising by non-fundraising staff. The difficult lesson many are learning, however, is that it takes time for new fundraising activities to bear fruit—if it pays off at

all. Many organizations that have weathered the recession had their fundraising capacity and relationships firmly in place and ready to be deployed when people became ready to give.

New revenue strategies work best when they are closely associated with who you are. In addition to fundraising, nonprofits are looking to maximize income-generating revenue streams. One healthcare nonprofit facing shrinking government funding for HIV screening—a needed service within its poor and isolated community—sought out new funding opportunities to subsidize existing services. It added more well-funded screenings for hepatitis to its service offerings as a means of supporting healthcare workers' salaries. Likewise, other nonprofits able to generate income through service fees, sales, or other activity began looking at pricing—balancing what a client can/will pay versus an amount more meaningful to the nonprofit's financial sustainability.

3. Cash management

Using restricted money to cover other items is a dangerous practice. With funding cuts and delays, nonprofits have been using their own cash to close the gaps. In fact, NFF's 2012 survey showed the use of cash reserves as the number one way organizations are managing government funding delays. For organizations without reserves, cash has most often come from delaying payables or taking on debt. In some cases, managers used cash from up-front (sometimes restricted) payments, leaving them obligated to deliver on future programs, possibly without the funds to do it—not considered a best practice! One NPQ reader recently commented that everyone calls the financial staff at her organization the “reallocation team.” It is dangerous to reallocate funds, as many organizations discovered during this period: you risk being unexpectedly audited by a funding source.

When cash is tight, make active use of cash-flow projections. In an environment where many organizations have been experiencing payment delays for their services—particularly from government—having a good handle on cash flow has been critical to meeting payroll and keeping the doors open. Managers using cash-flow projection

tools have been able to predict cash shortfalls and address them by managing their own payables, or, in some cases, through a line of credit. While managers most often run monthly cash-flow projections, organizations in crisis may create weekly—or even daily—projections.

Do use your line of credit when timing is the issue. Since the economic downturn, we've seen increased interest in opening lines of credit. This may seem like an attractive option when faced with funding delays, but organizations may confuse *cash-flow* needs with *cash* needs—a problem we see often. *Cash-flow* problems are a timing issue—money is coming in but perhaps not in time to pay off vendors. In these instances, lines of credit can be an appropriate way for an otherwise financially healthy organization to manage cash-flow timing issues. *Cash* problems are very different—they are an issue of not having secured enough total revenue to cover expenses. Organizations facing overall cash shortages are often turned down by lenders because there is no concrete source of repayment, raising concerns that the line of credit would be used to plug operating deficits, thus destabilizing the organization in the long term. (Thinking you might get a grant is different from having an award letter.)

Use a line of credit thoughtfully. In an example of appropriate line-of-credit use, one California child care nonprofit took on a line of credit to manage extended delays in state funding while in the midst of shifting its business model. It used the credit to invest in the move away from its underutilized child care centers to preschool programs, which were in high demand and more lucrative. The organization was able to manage expenses while waiting for income from the preschool programs, and eventually repaid the loan.

4. Financial management processes

If you are not clear on why you are failing, get an expert analysis of your organization's financial dynamics. As the economy brought financial challenges into stark relief for many nonprofits, leaders began to expend more resources on increasing their own financial capacity. They wanted to understand the financial dynamics that drove their organizations, plan around

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uncertainties, and communicate financial needs more clearly to stakeholders. Recently, a New York nonprofit sought help because it was on a financial cliff. It had been incurring deficits for several years and was at a point where another year of deficits would have meant closing its doors. It operated many programs but didn't know which ran deficits and which produced surpluses. With a program profitability analysis, management was able to understand which activities drove revenue versus where the cost centers were, and could consider how best to balance programs that both achieved their mission and improved their financial position. In another example, an arts organization faced with an unsustainable business model had to undergo programmatic and financial soul-searching. It needed to rebuild support among funders, board members, and clients, but to do so it first had to understand its value in the marketplace and the internal financial dynamics that had driven past decisions regarding programmatic investment. Only then could the organization communicate a new plan for programs and finances more in line with core values.

External Responses Help Strengthen Relationships

As we saw in the last example, many nonprofits quickly need to look beyond their own walls when considering strategies for improving financial strength. Externally focused strategies, such as *engaging board members*, *engaging funders*, and/or *creating partnerships and collaborations*, are often helpful in strengthening the key relationships that directly or indirectly result in revenue or cost savings.

1. Engage board members

Get the board to step up as partners in developing financial strategy. In the past few years, nonprofit managers have increasingly reached out to their boards to enlist their know-how and networks. Board members, particularly for smaller organizations, have started to play a more active role in helping organizations manage through tough times. More than giving money, they have given time and expertise. For one organization facing a period of financial instability, the board was

critical in reaching out to funders to explain the situation and address any concerns they might have had about the organization's long-term game plan and stability. They also dug into the financials, making sure they understood the details in a deeper way and helping leadership think about how they could get on a path to better long-term health. This engagement of boards around the financial health of the organization often prompted requests for more useful, clear reports that could generate meaningful board discussion. Boards wanted more strategically presented material that allowed for well-informed decision making and governance. Conversely, we saw nonprofit managers eager to educate their boards on the organization's financial dynamics, trends, and needs as a way to begin a dialogue around the importance of more-concerted board efforts. Our 2012 survey showed that around two-thirds of nonprofit leaders wanted to see their boards more actively engaged—either directly or indirectly—in fundraising for the organization.

2. Engage funders and friends of the organization

Figure out how to talk with funders about what you really need. Engaging funders may seem obvious, but less obvious has been knowing how much to reveal to funders about financial challenges. Since the recession, we saw more nonprofits wanting to engage long-time funders regarding their continued commitment to their missions as well as how economic circumstances have affected their financial picture. Those able to have these conversations not only created trust through transparency but in many cases also strengthened their funder relationships. Yet NFF's 2012 survey reflected that many nonprofits didn't feel comfortable talking to their funders about deeper financial issues. Only one in five respondents felt they could raise the topics of cash flow, operating reserves, or working-capital needs with their funders; even fewer felt they could discuss debt or building reserves. While these conversations may be difficult to start, due to actual or perceived reluctance on both the funder and nonprofit sides, they are increasingly important in a world of diminished resources. As one California human services organization said,

“We will respond to the decrease in funding by continually transforming our programs so that they are as efficient and effective as possible. We will also be diligent and intentional in our messaging to our funders so that they see the benefit in contributing to us.”

3. Create collaborations and partnerships

Look for supply chains you can be a link in.

More and more, nonprofits are looking to partner with other organizations to find efficiencies and increase programmatic impact. In NFF’s survey, around half of nonprofits said they had collaborated to provide programs and would continue to do so. These partnerships range in depth from a coordinated but separate effort to a joint program to a full legal merger of two organizations. Collaboration can be a smart way to access necessary but non-core services that are ably provided by another organization. One of my favorite examples is Pine Street Inn, a homeless services nonprofit in Boston that decided to get out of the clothing business (“as nice as it was, it wasn’t essential for housing”) and instead partner with a neighboring Goodwill Industries to provide clothing to their homeless clientele. As the executive director tells it, “When I went to meet the head of Goodwill she showed me a huge barrel of socks. . . . She told me they threw them out because no one bought them. . . . I laughed, because one of my first jobs at Pine Street was . . . collect[ing] socks. We went through so many socks. Here was Goodwill five blocks away, and they could have supplied us with all the socks we needed for free. I think of this story often because I don’t think we collaborate or share information enough in this sector, even in simple ways.”

Cautionary Tales

While we’ve seen many strategies that have helped nonprofits maintain or even improve financial health in the last few years, we’ve also seen a few that should carry cautionary messages. These strategies were often examples of “silver bullet thinking”—our term for tactics that appear as a singular solution to transform a business model and are often taken without comprehensive planning and research. We’ve seen silver bullets not

only fail to produce the kind of financial stability nonprofit leaders hoped for but also actually leave organizations in worse shape. Silver bullets take many forms, but let’s look at a few common ones—*new earned income ventures*, *new fundraising strategies*, and *endowment building*—and their associated financial risks.

1. New earned income ventures

Be realistic about new business ventures—they all need time and capital, and most fail to generate expected net revenues. Many organizations have strong business models that include earned income activities from ticket sales, specialized services, and/or program fees. Appropriate earned income efforts become a silver bullet when organizations start new ventures to generate income *without proper planning or investment*. Just think of how many new small businesses fail, even without a nonprofit organization to support. New earned income ventures often require up-front capital in amounts difficult to attain for most organizations, and an appetite for risk—and stomach for failure—that many nonprofits can’t afford. A new venture may also mean adding a whole new line of business to the organization—one that requires its own staff, has its own priorities, and incurs its own set of fixed expenses. For example, one religious organization decided to take advantage of its prime location and ample space by renting rooms on its upper floors. The strategy could potentially have added thousands in revenue, but it required investment to bring the rooms to code and ongoing costs for facility maintenance, a building manager, and marketing efforts. Plus, the facility- and room-rental business often monopolized the attention of the board members, who were responsible for most of the organization’s regular operations. And, while the activity did generate some revenue, it proved difficult to analyze if it was generating sufficient *net* revenue to validate the tremendous effort.

2. New fundraising strategies: individual donors

Raising money from individuals takes an understanding of and investment in the process. With government and foundation funds in increasingly

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short supply, many nonprofits are pinning high expectations on a new source of funding: individual donations—either in large campaigns with many small donations or a few targeted high-net-worth donors. This strategy may prove to be a good solution for some organizations, particularly since comparable flexible operating money is often difficult to raise. But tactics for generating individual funds differ from strategies for raising foundation or government dollars. If this is a new effort for an organization, it may require hiring new staff with a whole new set of skills, relationships, and experience. It's a decision that may require immediate up-front investment in staff and systems, and the return will likely take time.

3. Endowments

If you need operating cash, do not place money in an endowment. The current economic climate has resulted in many struggling organizations, including ones with large endowments. As expected funding sources fell through and long-time revenue streams declined, it highlighted restricted endowments' inability to help an organization through a difficult time. The total assets may look wonderful on paper but are of little help if inaccessible during times of crisis. For example, one New York human services organization with a sizable endowment has been struggling as much as its non-endowed peers with the steady decline in government funding for core safety-net services. During the past few years, the endowment has not always been able to generate significant income as investments underperformed. Also, because this inaccessible/restricted endowment often created an appearance of financial health, the organization often needed to educate funders about its continued need for ongoing support.

Endowment-building activities can undermine fundraising for annual operations. Organizations looking to create an endowment should consider that while traditional endowments may provide steady resources to an already strong organization, starting or dramatically increasing one is not the answer for most nonprofits. And if you raise the dollars, the corpus is often tied up in restrictions disallowing usage during periods of

crisis, even in the face of bankruptcy. Also, most organizations must raise a relatively large endowment to ensure investment revenue that creates real impact on an annual basis. Board-designated reserves, which can be used at the discretion of the board, have much greater flexibility and are a better vehicle for most organizations.

Strategies for Financial Strength

So what are some actions that nonprofits can take to improve their financial situation? Three tactics that will improve your ability to make strategic and informed decisions are *understanding your income statement and balance sheet, your cash situation, and your data.*

1. Understand what your income statement and balance sheet are really telling you

You can't solve a problem without knowing it exists and from where it originates. Organizations that take the time to analyze both their true operating performance in a given year and their overall resilience as reflected in the balance sheet have the clearest understanding of their financial condition and are therefore best positioned to make smart decisions accordingly. I worked with one human services organization that seemed to be fairly financially stable, judging by their annual profitability—in most years, revenue kept up with expenses. But the balance sheet told a very different story. They had outstanding loans accrued from the last ten years that they had no ability to repay with existing or prospective money. Additionally, the balance sheet reflected ownership of an extensive amount of property, all of which was fully depreciated and in need of immediate maintenance. This understanding of the balance sheet was critical for the organization's fundraising and decision making—an examination of the income statement alone would have masked the nature and immediacy of its true needs and the fact that it had no cash or receivables to absorb deficits.

When looking at their income statements, smart leaders are making sure that they separate restricted from unrestricted funding—something that is not always made clear externally in audits or other nonprofit accounting treatments. These organizations then know whether they are

running an operating surplus or deficit. “Counting” restricted funding (such as foundation grants for future years) in the year it was awarded rather than in the year it can be spent can skew the view of an organization’s current financial situation. In addition to looking only at the amount that’s spendable in a given year, it’s also important to separate operating from non-operating money, such as from a capital campaign or endowment gift. Looking at finances like this year after year will help an organization understand its true ability to meet operating expenses.

While surplus and deficit are an important measure of one year’s performance, the balance sheet reflects an organization’s overall financial resilience. It shows all of an organization’s resources (assets), how much is owed to others in payables and debt (liabilities), and how much cash is accessible to cover expenses. By examining the ratio of assets to liabilities and the funder restrictions placed on them, nonprofit leaders can begin to understand how much financial breathing room an organization has for operations.

2. Understand your cash situation

Every nonprofit, whether in a cash crisis or not, should understand its cash-flow situation. Reviewing cash-flow projections regularly will help you predict your organization’s need for cash throughout the course of the year and allow you to plan for potential shortfall. By seeing a visual landscape of cash coming into and leaving the organization, managers can begin to distinguish between seasonal lags in cash versus what might be a lack of cash (liquidity) in general, each of which requires very different interventions. Cash-timing strategies might include extending payables (provided that you are staying within your vendor’s credit terms), accelerating the collection of receivables, or accessing an outside line of credit. On the other hand, overall cash shortages will require broader management tactics that result in increased revenue or reduced expenses. Finally, keep in mind that if the cash received is restricted for future periods, it should be tracked separately to ensure appropriate usage; otherwise, your organization may end up using dedicated funds in a way not intended by the donor.

3. Be willing to make data-driven decisions

Beyond having access to the right data (be it financial, programmatic, or management), management needs to understand the implications of the data and be willing to make difficult choices based on the information. The organizations we’ve seen most often on the right track were the ones with access to accurate, timely, and actionable management data, an understanding of what the data were saying, and a willingness to take decisive action based on the data. Management and planning tools most often used by organizations that were able to be nimble in their decision making included profit/loss statements, balance sheet reports, cash-flow projections, profitability analyses, and dashboards. But more important than the volume of data, effective leaders knew how to zero in on the key programmatic and financial metrics that should be used to drive their decisions. To be truly helpful, the data must be presented well, in clear and regular reports. Often, the ability to make “real-time” decisions from these management reports and analyses was the key to turning a deficit situation into a break-even or surplus year.

A Blend of the Old and the New

There are many exciting new ideas within the nonprofit sector right now—public/private partnerships, mergers and collaborations, pay-for-success/social impact bonds, and social investment instruments, to name a few. While organizations will certainly need to include new options in their tool kit of responses, the tried and true will continue to be important. Sustainability for most organizations will continue to include grant writing, cultivating donor relationships, and applying for government contracts—all while keeping costs as low as possible. Nonprofits need to understand this, and so do funders. As demand for nonprofit services continues to grow and resources become more limited, nonprofits that can proactively take stock, plan, and respond to the changing world will have the competitive advantage and, more important, best be able to deliver on mission.

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