

WASHINGTON STATE NONPROFIT CONFERENCE

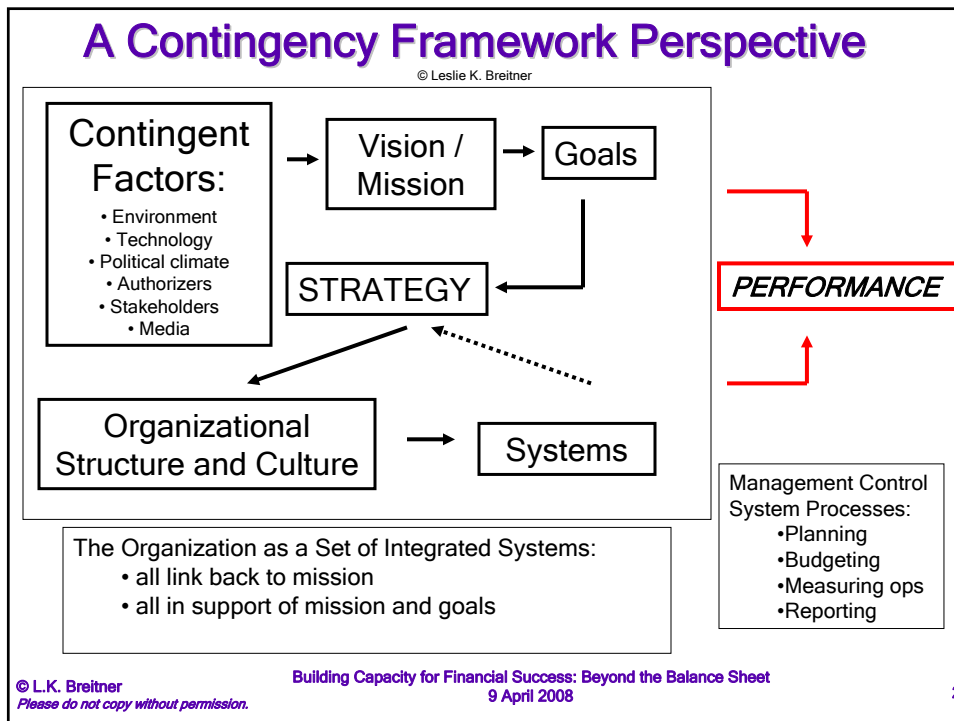
*Building Capacity for Financial Success:
Beyond the Balance Sheet*

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Financial Statements:

How do I tell the financial story of this organization from reading the financial statements?

- Interpret and use financial statements.
- Distinguish between accounting and financial management issues.
- Gain awareness of appropriate costs for financial decision-making.
- Develop ability to serve in positions of governance.
- Be able to communicate with funders or lenders, some of whom may be in the private sector.

What Do We Want to Know?

Is the organization:

- Earning a sufficient surplus? (**PROFITABILITY**)
 - What is a surplus anyway?
 - Why is this important?
- Generating enough cash? (**LIQUIDITY**)
 - What is the timing of cash flows?
- Managing its assets well? (**ASSET MANAGEMENT**)
- Financing itself appropriately? (**Long-Term SOLVENCY**)
 - What are the sources of revenue?
 - Are they sustainable?
 - Is there debt? Enough? Too much?

Concepts & Techniques

- Financial statements are accrual-based.
- Cash inflows and outflows are different from revenues and expenses.
- Five critical financial management issues:
 1. Profitability
 2. Liquidity
 3. Asset Management
 4. Solvency
 5. Critical Success Factors

What do the Funders Want to See?

What does this mean?

Net Assets (Balance Sheet):

- Unrestricted
- Temporarily restricted
- Permanently restricted

Cash (Balance Sheet):

- Unrestricted
- Temporarily restricted
- Permanently restricted

Surplus/Gains (Operating Statement):

- Operating gains/losses
- Non-operating gains/losses

The Rasmuson Foundation: A New Format

Balance Sheet:

- Separate unrestricted cash from restricted cash
- Use a classified statement: classify unrestricted net assets among:
 - Available for operations
 - Board designated for particular purposes
 - Invested in PP&E and unavailable for spending

Statement of Activities:

- Separate operating from non-operating activity
- Show breakdown among unrestricted, temporarily restricted and permanently restricted

Footnotes:

- Contributions by donor type and purpose
- Disclosures about endowment spending

Fundamental Questions for Financial Analysis of Nonprofits

1. Are the organization's goals consistent with the financial resources it needs to finance them?
2. Is the organization maintaining intergenerational equity?
3. Is there an appropriate match between sources and uses with respect to resources?
4. Are the current resources sustainable?

From Herzlinger and Nitterhouse, 1994

Q1: Are the organization's goals consistent with the financial resources it needs to finance them?

- What's the relationship between ambition and competency?
- How do we measure organizational wealth?
 - Liquidity: ability to meet short-term obligations
 - Long-term solvency: organization's reliance on debt in its capital structure and its ability to repay it (with interest)
- What's the relationship of operating activity with respect to assets?
- Do financial resources affect the organization's mission inappropriately? Is the mission consistent with financial ability?

Q2: Is the organization maintaining intergenerational equity?

- Is the organization maintaining purchasing power of its net assets?
- Do they use past savings to finance the present?
- Are they using the present to finance the future?
- Are net assets increasing more than the rate of inflation?
- Look at ratio of surplus to net assets. Is it different than the rate of inflation?

Q3: Is there an appropriate match between sources and uses with respect to financing?

- Match long-term with long-term and short-term with short-term.
- Long-term assets should be financed with long-term sources of capital - why?
- How stable and predictable are the sources of financing?

Q4: Are the current resources sustainable?

- Dispersion of sources and uses of capital: the fraction of the total category accounted for by one activity in that category.
- Diversified sources of revenue.
- Is "tipping" a concern for the organization?
 - Tipping occurs when an organization receives so much support from so few sources that it is no longer considered a charity, but rather a private foundation.
 - To retain public charity status, at least 1/3 support must come from the general public over a 4-year period.
 - Being "tipped" from a public charity to a private foundation can hinder the ability to carry out the mission.

Use the Three Financial Statements

- The Balance Sheet: A Status Report
- The Operating Statement (Statement of Activities): A Flow Report
- The Statement of Cash Flows: Where did it come from? Where did it go?

Analyze:
Trend Analysis
Ratio Analysis

Financial Statement **Red** Flags: *Quality of Earnings*

- Lack of diversity in revenue sources
- Relatively low current ratio (poor liquidity)
- Negative cash flow from operations (what does it mean?)
- Negative unrestricted net assets (what does it mean?)
- High administrative cost ratio
- Unexplained trends or budget variances
- Extraordinary events to achieve a surplus (unsustainable activities)

From E. Floyd (Moss-Adams LLP)

Key Concept:

Nonprofits Need Surplus Too

[From David W. Young]

- Assist the organization to obtain funds necessary to replace assets that wear out or become obsolete *
- Generate sufficient cash to support organizational growth
- Provide the organization with funds necessary to expand and diversify its fixed assets as it expands activities
- Protect from fluctuations in revenues from year to year, and from uncertainties surrounding ongoing operations

**Socking away amounts equal to depreciation will leave you shortchanged at time of asset replacement (due to inflation). How does this work?*

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Board Decision:

Buy a new truck?

How do we decide?

REVENUES	
Fees for Service	\$ 25,000
Campaigns	33,000
Foundations and Corporate Matching	40,000
Events	75,000
Government Grants	80,000
Individual Contributions	32,000
Miscellaneous	500
TOTAL REVENUES	
EXPENSES	
Administration	
Fundraising	
Operations	
Capital Improvements (New truck)	\$ 42,500
Operating Supplies	3,000
Rent	9,000
Repair & Maintenance	2,250
Transportation	600
Utilities	1,200
Vehicle	3,750
Operations Total	
Personnel	
Staff Salaries	\$ 150,000
Payroll Taxes	18,000
Medical & Dental	14,000
Other benefits	9,000
Parking	1,200
Personnel Total	
TOTAL EXPENSES	
SURPLUS (DEFICIT) Before Contribution from Reserves	
From Reserves	
SURPLUS (DEFICIT)	

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REVENUES	
Fees for Service	\$ 25,000
Campaigns	33,000
Foundations and Corporate Matching	40,000
Events	75,000
Government Grants	80,000
Individual Contributions	32,000
Miscellaneous	500
TOTAL REVENUES	\$ 285,500
EXPENSES	
Administration	30,000
Fundraising	35,000
Operations	
Depreciation	\$ 8,500
Operating Supplies	3,000
Rent	9,000
Repair & Maintenance	2,250
Transportation	600
Utilities	1,200
Vehicle	3,750
Operations Total	\$ 28,300
Personnel	
Staff Salaries	\$ 150,000
Payroll Taxes	18,000
Medical & Dental	14,000
Other benefits	9,000
Parking	1,200
Personnel Total	\$ 192,200
TOTAL EXPENSES	\$ 285,500
SURPLUS (DEFICIT)	\$ -

What's the value of accrual accounting?

Why depreciate your assets?

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THREE OPTIONS FOR EARNING A SURPLUS

1. Reduce Expenses
2. Increase Revenues
3. A Combination of the Two

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CASH NEEDS ASSOCIATED WITH GROWTH: Example

Assumptions:

1. Growth in revenue and expenses on a monthly basis.
2. Accounts receivable collection lag of two months.
3. Accounts payable paid immediately.
4. No surplus.

CASH NEEDS ASSOCIATED WITH GROWTH

	-----MONTH-----					
Operating statement:						
Revenue	100	102	104	106	108	110
Expenses	100	102	104	106	108	110
Surplus	0	0	0	0	0	0
Cash collections	96	98	100	102	104	106
Cash payments	100	102	104	106	108	110
Change in cash	(4)	(4)	(4)	(4)	(4)	(4)
Cumulative	(4)	(8)	(12)	(16)	(20)	(24)

FOUR OPTIONS TO FIX THE PROBLEM:

1. Speed up collection of receivables
2. Delay payment of expenses
3. Slow Growth
4. Earn a surplus (how much?)



Equal to the
negative change in cash

EXAMPLE: REDUCE EXPENSES BY 4 IN MONTH 3

Operating statement:

	-----MONTH-----					
Revenue	100	102	104	106	108	110
Expenses	100	102	100	102	104	106
Surplus	0	0	0	0	0	0
Cash collections	96	98	100	102	104	106
Cash payments	100	102	104	106	108	110
Change in cash	(4)	(4)	(4)	(4)	(4)	(4)
Cumulative	(4)	(8)	(12)	(16)	(20)	(24)

THE SOLUTION: A SURPLUS OF 4

Option 1: Reduce Expenses

-----MONTH-----

Operating statement:

	100	102	104	106	108	110
Revenue	100	102	104	106	108	110
Expenses	100	102	100	102	104	106
Surplus	0	0	4	4	4	4
Cash collections	96	98	100	102	104	106
Cash payments	100	102	100	102	104	106
Change in cash	(4)	(4)	(0)	(0)	(0)	(0)
Cumulative	(4)	(8)	(8)	(8)	(8)	(8)

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Fundamental Financing Issues

Leverage
 (Level of Debt)

And

The Role of Surplus
 (Revenues less Expenses or Expenditures)

Nonprofits Need Surplus Too

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Key Concept: Financing Growth with Leverage

Leverage - The use of debt to purchase more assets than you can with only generated surpluses.

Advantages: grow faster, serve more, increase revenues

Disadvantages: interest fees, cash flow challenges, meeting debt service obligations

LEVERAGE ALLOWS AN ORGANIZATION TO HAVE MORE ASSETS ON THE BALANCE SHEET THAN EQUITY ALONE WOULD PERMIT. THEREFORE . . .

WHY NOT FINANCE AS MANY ASSETS WITH DEBT AS YOU CAN?

From E. Floyd (Moss-Adams LLP)

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What's Wrong with Leverage?

Financial Risk	High	Possible	Danger Zone
	Low	Very Safe	Necessary
		Low	High
		Business Risk	

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How Much is Enough? *It Depends.*

- Operating reserves = unrestricted fund balances
 - Cushion for unexpected events, changes in revenue sources
 - Enhance flexibility to develop new programs
 - Expand opportunities for growth or expansion
- Operating revenues
 - Reliability of sources
 - Seasonality/timing of cash flows
- Financing
 - Availability of external financing
 - Stability of expenses
 - Nature of liabilities

Surplus and Growth - Summary

Nonprofits need surplus ("profit") to:

1. Replace assets
2. Finance growth and/or diversify assets
3. Protect against uncertainties, fluctuations
 - *Note that understanding cash flow is critical*

Use of Leverage: increasing debt is an alternative, but this strategy comes with its own risks, advantages and disadvantages

FOR YOUR ORGANIZATION

Is it:

- Earning a sufficient surplus?
- Generating enough cash?
- Managing its assets well?
- Financing itself appropriately?

How have things changed over the last three-years?

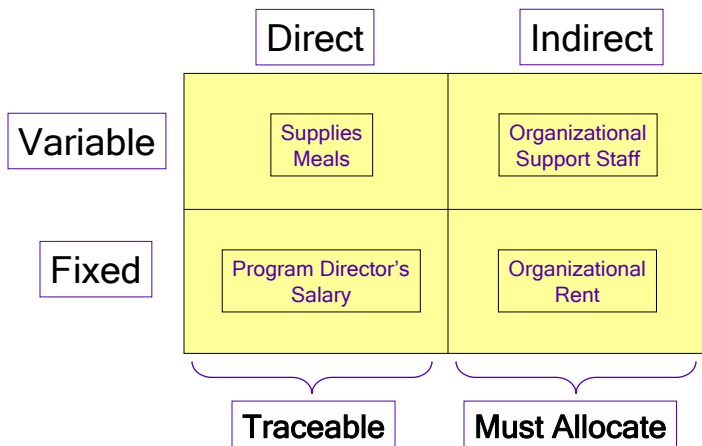
Financial Accounting Financial Management Management Accounting

- Financial statements portray financial performance and position.
- Analysis of financial management issues informs strategic planning and organizational analysis.
- Knowledge of cost structure and behavior is imperative for effective management and operational decision-making.

Managerial Decision Making: Decisions that Use Cost Data

- Pricing decisions require full cost information.
- Programming decisions require differential cost information.
- Revenue sources and resource allocation are critical to enhanced performance and organizational sustainability.
- Capital budgeting tools (discounted cash flow, payback) enhance analysis.
- Cost-benefit analysis can be simple.
- Use Social Return on Investment analysis (SROI) for evaluation purposes. This can be complicated!

Can you classify your organization's costs?



FULL COST

- Direct and Indirect Costs
- Indirect costs must be allocated
 - Cost drivers
 - ABC
- Direct costs are traceable and don't have to be allocated.
- Uses of full cost data:
 - Pricing decisions
 - Cost control/comparison
 - Knowledge of underlying cost structure

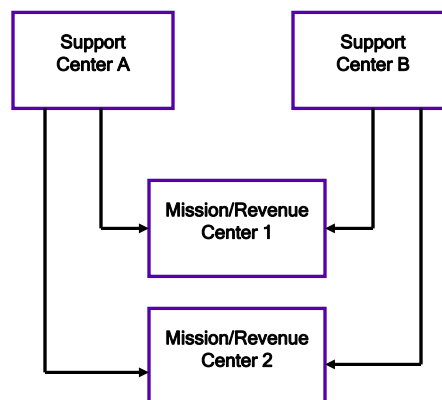
Cost Allocation

- Process to assign indirect costs (overhead or cost from support centers) to mission (or revenue) centers.
- Key decision is determining the cost base (aka basis of allocation).
- Examples of Cost Bases -
 - Payroll → number of people in each mission center
 - Purchasing → number of purchase orders completed for each mission center
 - Rent/utilities/etc → square feet of space
- Cost allocation is not the same as resource allocation.

Direct Distribution Method

- An approach to allocation that allocates indirect costs only to mission/revenue centers.
- Does not account for the fact that support centers may spend a time and resources supporting other support centers.
- Need a means to provide incentives for support center managers to control their costs!

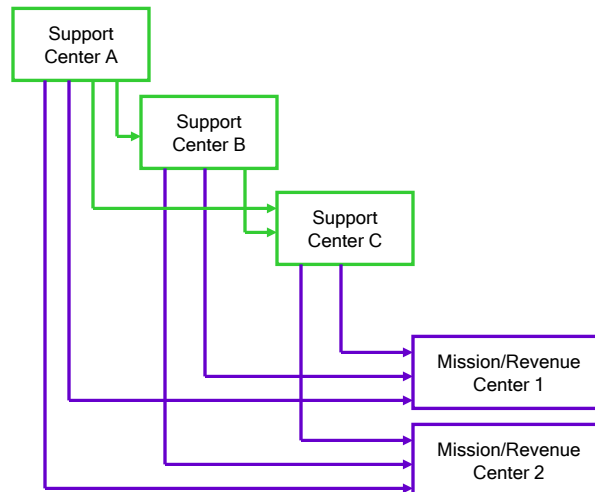
Direct Distribution Method Diagram



Step-down Distribution Method

- An approach for allocating service center costs where each center is allocated to every other center (service and mission/revenue) that has not allocated its costs yet
- Requires a decision about the *order* of allocations
 - To minimize distortion, start by allocating costs from the support centers that are most heavily utilized by other support centers
- A way to minimize cross-subsidization

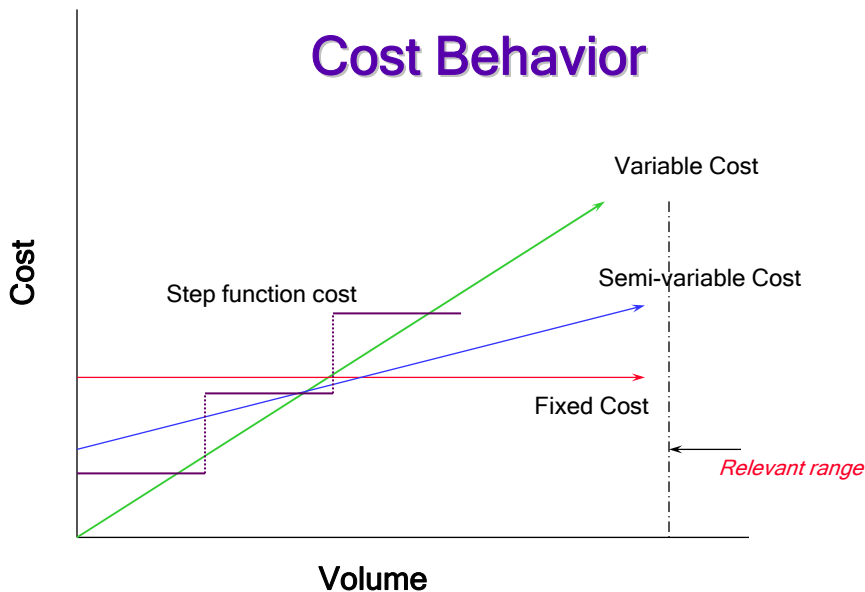
Step-down Distribution Method Diagram



DIFFERENTIAL COSTS

- Costs used for certain decisions.
 - "Make/buy" decisions
 - Eliminate/add a program
 - Marginal cost decisions
- Which costs will be different in the new scenario?
- Which costs are irrelevant for this type of decision making?

Cost Behavior



Budgeting for Managers:

How do I plan my programs with limited resources?

- Understand how programs compete with other programs for resources. Prioritize!
- Understand basics of state, local and federal budgeting (there are differences) if you're in the public sector.
- Understand the demands of the funders and the relationship to your cost structure!!
- Appreciate connections among the external environment, the organization, and performance results.
- Consider partnerships with organizations in other sectors.
- Understand the role and mechanics of *differential cost decisions!*

The Budget

- Role of the budget (budget becomes policy!).
- The power of understanding the financial picture.
- Budgets look forward; financial statements are historical.
- Is the budget the decision driver, or do strategic decisions drive the budget?
- Can you link the strategic plan with the budget?
- Can you link cost data for decision making with the budget?
- Do you analyze budget variances and compare with other budgets?
- Who are the key players in formulating the budget?
- Do you anticipate constraints posed by funders as you plan?

Logic Model Approach

\$\$\$\$

```

    graph LR
      A[Resource/Inputs] --> B[Activities]
      B --> C[Outputs]
      C --> D[Outcomes]
      D --> E[Impact]
      subgraph OP [Operational Planning]
        A
        B
      end
      subgraph SP [Strategic Planning and Intended Results]
        C
        D
        E
      end
    
```

Questions to ask:

1. Relationship to mission, goals?
2. Link planning to results?
3. Link delivery of services to financial measures, by program?
4. Link RESULTS to financial measures.
5. What is the roadmap of *related* events?

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Logic Model Approach

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```

    graph LR
      A[Resource/Inputs] --> B[Activities]
      B --> C[Outputs]
      C --> D[Outcomes]
      D --> E[Impact]
      subgraph OP [Operational Planning]
        A
        B
      end
      subgraph SP [Strategic Planning and Intended Results]
        C
        D
        E
      end
      OP --> SP
      SP --> OP
    
```

Map forward from inputs and activities to answer, "Why is this desirable?"

→

Map backwards from high-level outcomes to answer, "How to create this result?"

←

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The Balanced Scorecard in Nonprofit Organizations

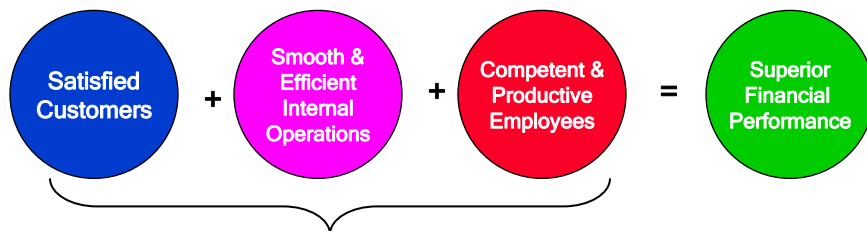
1. What non-financial results would you like?
2. What are your financial objectives and constraints, and how will you measure them?
3. Who are your clients and what must you do to satisfy them?
4. What internal processes are key to your success and how will you know if they are functioning properly?
5. What employees are key to your success and how will you know if they are satisfied with their jobs and doing a good job?

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Theory Behind the Balanced Scorecard



Leading Indicators of Financial Performance:
Manage them well and you will have superior financial performance.

From David W. Young

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