Financial Stability

The Impossible Dream?

Dream? Dream?

No, it's not a pipe dream. Nonprofits are using stabilization programs to dramatically improve their financial condition. And having more money on hand is only one of many benefits.

BY BRIDGET E. ROBINSON

A recent Gallup survey found that 31% of Americans (up from 20% in 1990) disagreed with the statement that "most charitable organizations are honest and ethical in their use of funds."[1] Such findings point to a growing *fiduciary expectation,* even as grantmakers and organizations try to operate within self–imposed *fiduciary responsibility.*

The problem for both grantmakers and organizations is that donor confidence drops when fiduciary expectation is not met. United Way provides a recent example; its donations have plummeted since the public uproar.

As public scrutiny of funds management increases, so does the media's pursuit of a good story. Thus, there's a greater chance than ever before that a nonprofit's poor financial management will make the papers.

Fortunately, as this article will discuss, the arts community began addressing these problems in the '80s. Arts organizations provide a model for all nonprofits in the way they have developed "stabilization programs" designed to get rid of deficits and bring operational stability.

How Does Stabilization Build Donor Confidence?

For the grantmaker, it has become increasingly shortsighted to make grants to just anyone who can write persuasively about a program, regardless of its merits. In this vein, some argue that programs are and always should be what drive funding. If nonprofits don't adequately serve a public good, they should fail in a Darwinian kind of way, through loss of funding and lack of public demand. Others contend that stabilization funds take away from programs. Thus, programs can't provide quality services, and donor confidence drops.

Those arguments hold true in some cases. Still, it's even harder to build donor confidence if nonprofits need constant funding infusions just to stay alive.

Research shows that unstable firms cannot consistently deliver quality service. Lack of quality service conflicts with consumer expectations and often results in loss of market share. The same is true for nonprofits that fail to meet their service commitments. When poor financial management leads to unmet objectives, the result is a slippery slope: Revenues may deteriorate via losses in contracts, donations, and grants.

But Why Grantmakers?

Why should grantmakers be the ones to help nonprofits achieve stabilization? There are a number of powerful reasons:

1. Enlightened Self–Interest. Research shows that a business can be affected even if it's only marginally affiliated with a poorly run firm. Both companies' stock prices may fall when the affiliate's bad news is released. Likewise, a grantmaker that associates with a deficit–ridden nonprofit may be giving the impression of irresponsible fund stewardship. Such an implication may affect donor confidence and subsequent donations to a re–grantor, community foundation, or other grantmaker.

In addition, a nonprofit's finances may affect the grantmaker directly. If poor financial management becomes public and causes contributions to fall, the nonprofit may actually become *more dependent* on the grantmaker. It is in the grantmaker's own interests, therefore, to increase nonprofits' financial stability.

2. A Powerful Position. Grantmakers are often a nonprofit's primary "customers," deciding whether or not to fund. Thus, they're in the best position to improve a nonprofit's finances. They're also in a strong position to help nonprofits find management support. The change needed in some nonprofits requires a good amount of investment. Requiring highly skilled technical management assistance, whether through internal hires or external consultants, is absolutely necessary to ensure meaningful and lasting improvement.

3. A History of Success. There is evidence that grantmakers are successful stabilization proponents.

"For–profits" would be ecstatic if they accomplished such change.

BOX 1

Keys to Running a Competitive Organization

1. Cash flow *under the discretion of management* is the driver that permits increases in quality of service, investment in new businesses, and so on. Cash management is a major key to an organization's stability and overall ability to grow.

2. The return on investment from every service line must exceed the cost of financing or no economic value is created for owners (shareholders).

3. Every functional area (such as finance, marketing, and accounting) should be a "strategic partner." Re–engineering how these areas work is the best way to reach that goal.

4. Everyone in the organization is *accountable* for managing costs incurred. Using continuous quality improvement, every effort should be made to reach the highest level of efficiency and quality possible.

Note: For further reading, see *The Quest for Value,* Stewart, Harper Business, 1991; *The Empowered Organization: Redefining the Roles and Practices of Finance,* FERF, 1994; and *Quality or Else,* Dobyns, Houghton Mifflin, 1991.

Cutting–edge foundations are pushing their grantseekers to improve their financial situation.[2] In particular, National Arts Stabilization requires grantseekers to reduce their deficits and define clear objectives. Others, including the Ford Foundation and the Pew Charitable Trusts, also fund stabilization. The question will soon become "when and how"—not "if"—stabilization will be widely funded.

Is the For–Profit Model Relevant?

These stabilization pressures originate in the for–profit sector. For–profit trends explain why the public is increasing its scrutiny of nonprofits. People approach problems with perceptual predispositions, and most Americans live with for–profit constructs all their working days. When they approach nonprofits, they often make their demands from this perspective. From total quality improvement and managed care to job redistribution through downsizing and now upsizing, corporations have developed influential theories about how business must be run to be competitive. Most businesses now accept certain "lessons" (see Box 1). Many of these ideas may be helpful in nonprofits' stabilization efforts as well.

In a nutshell, the goal of American business is to grow continually and efficiently, since doing so increases the firm's stock price or "creates shareholder value" (which in turn increases executive pay). The way to create shareholder value is to reach optimal production of goods or services. Doing so requires controlling cash flows, investing them in parts of the company that return more per dollar than they cost per dollar to run.

Reaching maximum return on the investment means using the best practices available by re–engineering the company from top to bottom. Re–engineering means comparing the company to best–run firms to see how it stacks up, redesigning processes to eliminate wasteful or redundant steps, using technology to reduce labor costs and improve information flow, and refocusing functional areas, such as marketing and finance, to provide strategic information.

BOX 2

Steps to Stabilization

National Arts Stabilization (NAS), a leader in stabilization programs for nonprofits, follows these steps with each nonprofit organization it funds:

Step 1. The nonprofit's key board, staff, and community members assess the following:

- the community and market environment
- marketing development of the organization
- the organization's facilities
- strengths, weaknesses, opportunities, and threats affecting the organization
- governance of the organization
- the organization's financial situation, with development of profit–and–loss and balance–sheet projections
- the organization's long–term capital needs, with development of a plan
- the organization's financial systems, bringing these systems "in house" as much as possible.

Step 2. Based on these assessments, the nonprofit and the stabilization group work together to develop a work plan that will lead to long–term organizational change.

Step 3. Using this plan, the nonprofit works to reduce its deficit and receives monetary rewards for doing so.

If the organization can cut its deficit in half, NAS will cut them a check for the rest.

For established firms, this has often meant revamping each functional area of corporate control while developing total quality programs for operations. The result is that all employees are made accountable (and are rewarded) for decisions and resource use in their areas of employ. While it's not a bad concept, it obviously can be used excessively or irresponsibly. However, it's one of the reasons for the economic recovery, which means more income and therefore increased charitable contributions for those so inclined.

It's easy to see why nonprofits are being pressured to find new ways to operate efficiently without diminishing the quality of services. Essentially, they are being asked to adopt the new for–profit perspective to reach long–term sustainability of the organization. The group of nonprofits feeling the greatest crunch from the for–profit sector are those affected by managed care systems. Such organizations will soon have to find ways to build and maintain about three months of liquid reserves to handle the advance payment schedules of care management—YIKES! However, they are not alone. The fiduciary–expectation evidence suggests that virtually all nonprofits will have to address this efficiency pressure.

OK, So How Does Stabilization Work?

What's a nonprofit organization getting into if it participates in a stabilization program? And what should a grantmaker consider in creating such a program? To answer these questions, it's worth looking at one trend setter in depth. National Arts Stabilization (NAS) has been a leader in developing stabilization programs around the country, involving 58 nonprofit organizations in six cities. In a recent interview with Nancy Sasser, president of NAS, we discussed NAS history and operating policies.

With roots in the '60s, but taking hold in the '80s, NAS was an outgrowth of a Ford Foundation program. NAS began by challenging cities to match NAS funds to create an asset pool. NAS has provided both loans and grants, focusing on grant approval after one to five years of required technical assistance (see Box 2).

As part of the technical assistance process, NAS interviews the organization's stakeholders (board, staff, and community members) and reviews the organization's materials. NAS then develops a strategic assessment of the organization. This assessment covers the interview information, the history of the organization, and critical success factors suggested by NAS staff. Next, NAS develops a joint work plan with the organization to implement change.

Once the organization has completed the technical assistance program, NAS uses a formula for grantmaking that creates strong incentives for deficit reduction. It works like this:

The asset pool is used to grant 25% of the nonprofit's operating budget up to a $1 million cap. The $1 million cap can be made up of 25% of the operating budget or a combination of 25% of operating and deficit reduction. If the organization can cut its deficit in half, NAS will *cut them a check* for the rest, up to a $1/2 million cap. What that means is that if a nonprofit has a deficit of $1 million and is able to cut it to $500,000 in the first year of the grant, the asset pool pays off the rest, just like that.

However, Sasser emphasizes that the goals should be more than monetary. What the nonprofit organization gets out of the process, including confidence in approaching funders, is what's important. One client says that the NAS grant is like a "Good Housekeeping Seal of Approval" for contributors and funders. It also provides a sense of "where I am, where I am going, and how to get there," he says.

The stabilization process does hold pitfalls, Sasser acknowledges. Stabilization takes more effort than nonprofits expect, she warns. It's important that programs maintain quality despite the increased demands throughout the stabilization process. Finally, it's an extraordinarily expensive process. The amount of technical assistance spent on a small nonprofit is about the same as for a large one, even if the stabilization grant ends up being much smaller.

So Why Do It?

If program clarity and the "Good Housekeeping Seal of Approval" are not enough incentive, the financial data speak strongly for stabilization. In reviewing data provided by NAS, it is clear that stabilization dramatically improves the financial condition of participating nonprofits. For 50 nonprofits with eight years of data in six cities, liquidity (all figures on an annual basis) has gone from $3.5 million to $9 million. That's a $12.5 million shift. It means that in an average year, these nonprofits saw an increase of $1.56 million.

THE ARTS WORLD IS 10 YEARS AHEAD OF MOST NONPROFITS IN ADDRESSING THESE ISSUES.

BOX 3

What Every Nonprofit Needs to Know about Stabilization

Why do nonprofits seek stabilization funds?

- The worst reason is that they are "crisis organizations," which are either in crisis now or which have historically seen a lot of crises.
- Another bad reason is that the organizations are seeking grants and feel this is an easy road to funding.
- The best reason is that there is a readiness on the part of management and leadership to change.

Why do stabilization efforts fail?

- *Most important:* If there is no staff "buy–in" for change, then stabilization is not going to happen.
- If organizations are in crisis, they can't handle overall change effectively.
- On a community level, there can be lack of leadership.

How does stabilization help meet nonprofit goals?

- Stabilization efforts permit clearer identification of goals.
- The stabilization process provides development of a roadmap to get where the nonprofit wants to go.
- Stabilization efforts lead to higher–quality services.

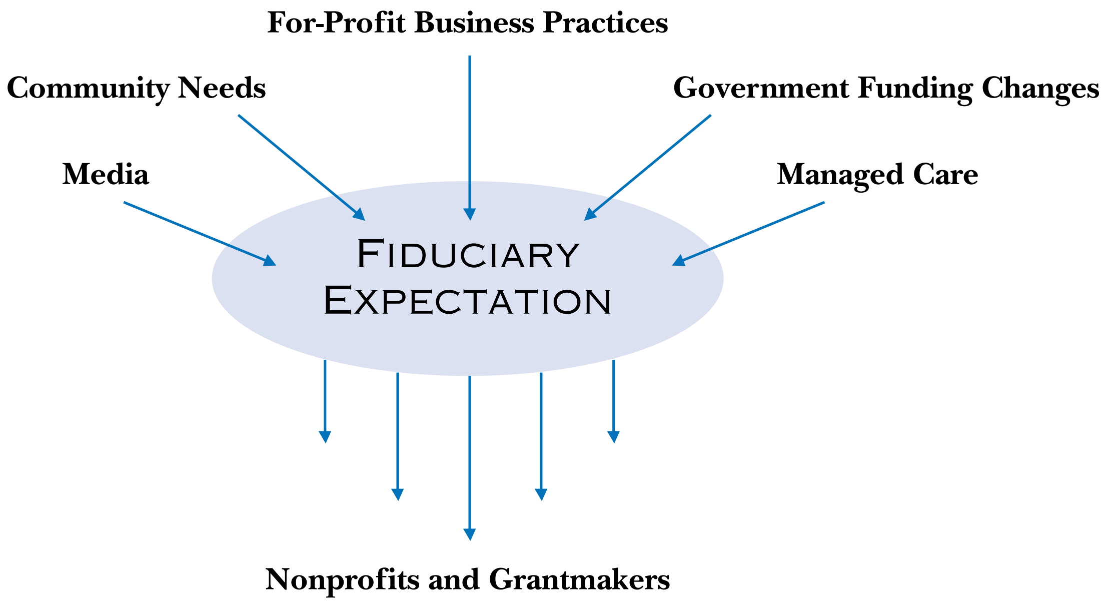
Although operating expenses to handle program innovations increased 59% (from $141 million to $225 million), the working capital of these nonprofits over the same length of time increased over *800%,* from $2.35 million to $21.6 million. These changes provide the kind of financial strength that empowers nonprofits to choose between real alternatives when making strategic and operational decisions.

The kicker, however, is in endowments and income. Endowments increased from $144 million to $251 million—a 74% increase or an average of about 9% per year. Total income increased from $141 million to $236 million—a 67% increase. And earned income increased from $84 million to $142 million—a 68% increase. "For–profits" would be ecstatic if they accomplished such change in an eight–year period.

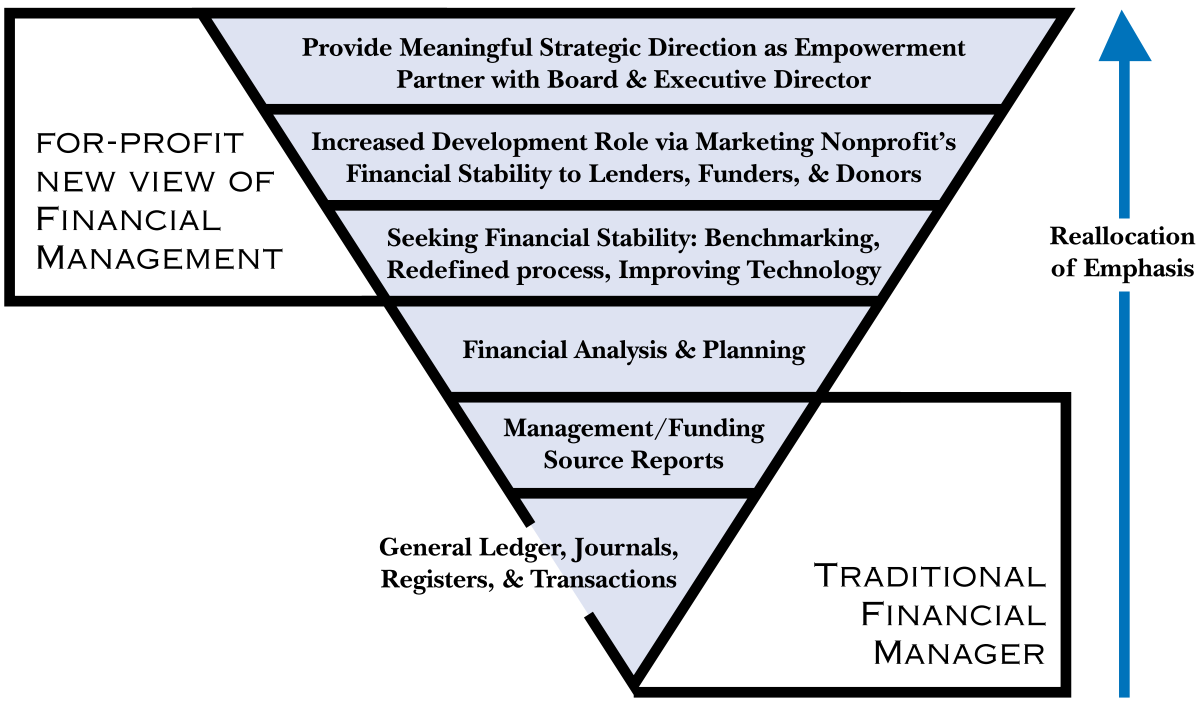
The endowment value is of special interest, because endowments act as an internal foundation for nonprof-

TURN FINANCIAL STABILITY FROM DREAM TO REALITY BY SPOTLIGHTING FINANCIAL EXPECTATIONS AND CARVING OUT A NEW FINANCIAL MANAGEMENT ROLE.

Spotlight on Finances



A New Role for the Nonprofit Financial Manager???



THE GRANT IS LIKE A "GOOD HOUSEKEEPING SEAL OF APPROVAL" FOR CONTRIBUTORS AND FUNDERS.

its, reducing their long–term reliance on grants for working capital. In the NAS situation, the increase in endowments was $107 million. Speaking in averages and assuming a 10% return on an invested endowment, with a 3% holdback for inflation, a net 7% return means that these nonprofits would have an extra $7.5 million, or about $150,000 per organization, available—funds they don't have to go out and actively raise. Though no one would argue that this is the only reason to embark on stabilization, it certainly provides compelling impetus on an understandable level.

Although NAS provides just one snapshot, albeit an experienced and successful one, the arts community is taking strides to clarify its stabilization processes. The result will be better information for nonprofits as they come to terms with fiduciary expectation.[3]

IDEAS FOR THE FUTURE

Organizations are not really, and can never truly be, stable, as Melanie Beene has noted.[4] Applying anthropology's principle of "dynamic adaptability," she points out that organizations are ever–variable. They require ongoing operating support so that they can respond to the changing environment. Building a more front–end, reward–granting model is the best way to sustain an organization, she contends. By denying renewal funds if certain operating conditions are unmet, such a model provides incentives for real long–term change.

Her perspective holds great promise, but it is questionable whether a nonprofit that hasn't yet reached stability can "drive forward" as a dynamically adaptable organism. Such a model is probably achievable in the arts sector, but the arts world is 10 years ahead of most nonprofits in addressing these issues. The rest of the sector faces a long learning curve. (See Box 3.) That curve may be reduced, however, because NAS is conducting a second research study on measurability of stabilization success. When finished, this study will provide useful guidelines for assessing improvement across the entire nonprofit sector.[5]

In the meantime, don't overlook the idea of a stabilization program for your organization. It provides a viable answer to the public's demand for accountability, while ensuring that your organization will survive for the long haul. ■

THE WORKING CAPITAL OF PARTICIPATING NONPROFITS HAS INCREASED OVER 800%.

Footnotes

[1]For more on this survey, "Giving and Volunteering in the United States," see *Nonprofit World*, January–February 1997, p. 56, or contact Independent Sector, 1828 L Street, N.W., Washington, D.C. 20036.

[2]See "Foundations Encourage Arts Groups to Develop Financial Discipline," *Philanthropy News Digest*, August 7, 1996.

[3]As a starting point, see "Using Evaluation to Restructure a Local Grantmaking Program" in which the Pew Charitable Trusts' Marian Godfrey describes how they evaluated existing grantmaking. This is Part 1 of a study on developing nonprofit health and leadership through stabilization. For more details on specific nonprofits that have embarked on stabilization, refer to the *New York Times* article, "Tough Line on Grants for Arts: Shape Up," 8/5/96, which discusses specific art organizations' achievements. Also, another article is currently being written by this author, providing case studies of nonprofits around the country that have embarked on stabilization.

[4]A nationally renowned arts consultant now at the Hewlitt Foundation in California, Melanie Beene explores the "dynamic adaptability" concept in the superb foundation–commissioned article "No Slow Fix, Either" (*Grantmakers In The Arts*, Spring 1996).

[5]For more information, contact National Arts Stabilization (NAS), 36 South Charles Street, Suite 1515, Baltimore, Maryland 21201, 410–332–1900.

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