Scaling What Works

A LEARNING INITIATIVE OF

GEO GRANTMAKERS FOR EFFECTIVE ORGANIZATIONS

BRIEFING PAPER

TOPIC 4

How Does Financial Sustainability Relate to Growth – and What Can Grantmakers Do to Support It?

REFRAMING THE CONVERSATION:
A GEO BRIEFING PAPER SERIES ON GROWING SOCIAL IMPACT

In the midst of a prolonged economic downturn and a mounting imperative to achieve better and more results, grantmakers of all kinds are seeking to better understand what works, why and how — and are shifting the way they think about scale, emphasizing not size or reach but impact.

Accompanying this shift is a renewed interest in financial sustainability, a necessary precursor to any conversation about growth. As Jon Pratt, executive director of the Minnesota Council of Nonprofits, has noted, "The landscape of social progress is complicated and can be fraught with conflict. Nonprofits need healthy organizations to persevere in their missions even in tough times."

These are certainly tough times. A recent survey of nonprofits by Nonprofit Finance Fund found that 85 percent of nonprofits surveyed anticipated an increase in demand for services in 2011, but only 46 percent expected to be able to fully meet this demand. Only 30 percent of these nonprofits expected to operate above break-even; 60 percent had three months or less of cash available and 10 percent had none.[1]

The potential for nonprofits to plan for, assess and have maximum impact is thwarted by one obvious yet persistent problem — grantmakers' reluctance to fully fund the organizations and the programs they support. Numerous studies have documented the fact that nonprofits are being "hollowed out" by grantmakers and public sector funders who show a preference for program-restricted support, yet rarely provide the funding needed to cover the true operating costs of those programs.[2] As many nonprofits struggle to provide an accurate picture of the true cost of their operations, "[a] vicious cycle is leaving nonprofits so hungry for decent infrastructure that they can barely function as organizations — let alone serve their beneficiaries. The cycle starts with funders' unrealistic expectations about how much running a nonprofit costs, and results in nonprofits' misrepresenting their costs while skimping on vital systems."[3]

With restricted funds, a lack of sufficient overhead, and an inability to adapt to new challenges or opportunities, some nonprofits end up chasing revenue-generating activities — whether through contributed, earned or endowment income — that don't align with their mission. Yet these activities can lead to mission creep, which, over time, can be as destabilizing to an organization as insufficient revenue.

[1] Nonprofit Finance Fund, *2010 State of the Sector Survey* (New York: Nonprofit Finance Fund, 2010), 3.
[2] For example, see Ann Goggins Gregory and Don Howard, "The Nonprofit Starvation Cycle," *Stanford Social Innovation Review* 7, no. 4 (Fall 2009): 49–53; Elizabeth T. Boris, Erwin de Leon, Katie L. Roeger and Milena Nikolova, *Human Service Nonprofits and Government Collaboration: Findings from the 2010 National Survey of Nonprofit Government Contracting and Grants* (Washington, DC: Urban Institute, 2010).
[3] Goggins Gregory and Howard, "The Nonprofit Starvation Cycle," 49.

NONPROFIT FINANCIAL SUSTAINABILITY: WHAT DOES IT LOOK LIKE?

Nonprofit organizations that are financially sustainable have enough revenue to meet the long-term operating needs of programs that deliver on their mission.

In practice, this means that an organization's core activities attract or generate sufficient, recurrent revenue to meet ongoing operating expenses, and they produce the desired result. It also means that the organization itself has adequate capital, beyond current revenue, that provides some flexibility to adapt over time — to meet unanticipated needs and plan for the future (including, in some cases, growth).

"It's not enough to have a high-impact program if there's no effective strategy for sustaining the organization financially," note Jeanne Bell, Jan Masaoka and Steve Zimmerman in *Nonprofit Sustainability: Making Strategic Decisions for Financial Viability.*[4]

There is no single, right way for organizations to approach financial sustainability. Each organization's business plan and funding model — its activities, sources of revenue and capital structure — are unique and responsive to a particular context and may change over time.

What is important, for grantmakers and grantees alike, is whether an organization's current business model is aligned with its mission and supports its efforts to achieve the desired result.

To fully grasp a nonprofit organization's financial picture and help determine the type of support to provide, NFF suggests that grantmakers conduct a financial analysis by reviewing available financial data, which might include audited financial statements, budgets and forecasts over a multiyear period. However, the financials often do not provide all the answers; they can also help put forward questions. To understand the full organizational and programmatic story driving the financial situation, grantmakers also need to engage in conversation with the organization's leadership and key staff.

This analysis and dialogue, carried out respectfully and in the spirit of true partnership, can show how a nonprofit is performing along the following dimensions:

- ***Operating performance.*** Does the organization have a track record of generating unrestricted surpluses? Are operating revenues sufficient to pay for operating costs and to maintain a healthy, appropriately liquid balance sheet?
- ***Balance sheet.*** Do the size, nature and distribution of assets, liabilities and net assets seem likely to support the organization's mission and programs long term? Does the organization maintain its fixed assets, collect its receivables in a timely fashion and pay its obligations as they come due? Does the organization maintain adequate working capital and set longer-term savings goals?

Glossary of Financial Terms

Capital – Available money designed to be used to change how a nonprofit organization currently operates or to explore new ways of operating and providing services.

Revenue – Money that funds regular operations and pays for the services delivered by a nonprofit. Sources of revenue include payments for services; donations from individuals, foundations and corporations; support and contract payments from government agencies; and income from fundraising activities and investments.

Sustainability – When a nonprofit organization can cover the full cost of doing business through a combination of contributed and earned revenue.

Sources: Nonprofit Finance Fund, "Glossary of Financial Terms," retrieved April 29, 2011, from http://nonprofitfinancefund.org/financial-terms.

Nonprofit Finance Fund, "Assessing and Supporting Nonprofit Financial Health" (presented at Grantmakers for Effective Organizations, Washington, DC, November 9, 2010).

[4] Jeanne Bell, Jan Masaoka and Steve Zimmerman, *Nonprofit Sustainability: Making Strategic Decisions for Financial Viability* (San Francisco: Jossey-Bass, 2010), 3.

- ***Ability to handle risk and pursue opportunity.*** How liquid are the nonprofit's net assets? Does the organization set aside surplus cash into one or more reserves and/or raise funds specifically for this purpose? Have management and the board clearly communicated the purpose for such reserves?[5]

An organization's capital structure is revealed through its balance sheet, which comprises assets (restricted and unrestricted cash, investments, buildings and equipment, receivables, inventory, prepaid expenses) and liabilities (accounts payable, short- and long-term debt, promises to provide services such as advance ticket sales). The difference between assets and liabilities is the organization's net worth, or net assets.

Net assets may be permanently restricted (often held in an endowment), temporarily restricted (usually for future years or programs) or unrestricted. The liquid portion of an organization's unrestricted net assets provides flexibility funds that can be used at the organization's discretion to manage the unexpected, take risk, innovate and course correct.

The Nonprofit Operating Reserves Initiative Workgroup (sponsored by the National Center for Charitable Statistics, the Center on Nonprofits and Philanthropy at the Urban Institute, and United Way Worldwide) points out that "[i]n its very simplest concept, an operating reserve is a rainy day fund, and people have such funds because they provide shelter from the storm. Operating reserves are essentially the accumulation of unrestricted surpluses that are available for use at the discretion of an organization's board." Operating reserves simply cannot be built from restricted revenue.

The workgroup, along with NFF and others, recommends an operating reserve ratio of 25 percent or three months of the organization's annual expense budget — noting that there is no one size that fits all, as organizations with more risk factors will need higher reserves than others.[6] NFF adds as a caveat: Organizations that are heavily government funded often find it difficult to achieve cash positions that approach the recommended level. Still, as NFF puts it, "Risk minus cash equals crisis."

About This Paper Series

This briefing paper is the fourth topic in a series from GEO's *Scaling What Works* initiative, which will be released throughout 2011. Authored by Dara Major, the collection pulls together the best thinking, research and actionable approaches to scaling impact, as well as provides additional resources for grantmakers that would like to dive deeper into paper concepts and questions. Individual papers delve into topics such as understanding approaches to scale, developing grantee evaluative capacity, structuring and financing scale, and more.

To access the latest topic and learn more about *Scaling What Works* and how you can get involved, please visit www.scalingwhatworks.org.

[5] Nonprofit Finance Fund, "Assessing and Supporting Nonprofit Financial Health" (presented at Grantmakers for Effective Organizations, Washington, DC, November 9, 2010).

[6] Nonprofit Operating Reserves Initiative Workgroup, *Operating Reserve Policy Toolkit for Nonprofit Organizations*, sponsored by the National Center for Charitable Statistics, the Center on Nonprofits and Philanthropy at the Urban Institute, and United Way Worldwide, September 15, 2010, 12.

In short, whatever an organization's size or life-cycle stage, revenue must be sufficient to enable the nonprofit not only to survive economic storms but to thrive and adapt to new opportunities. Although many nonprofits cannot accurately estimate the true cost of their operations (including both direct and indirect costs of service delivery, as well as annual expenditures required by their balance sheet), financial analysis and conversations with key staff can nonetheless lead to more informed grantmaking, as well as to better alignment between grantee needs and grantmaker support.

SETTING THE STAGE FOR GROWTH

Financial sustainability is related to but fundamentally different from growth; it sets the stage for growth by creating the stability and flexibility needed to build capacity for future stages of development.

Without financial sustainability, resource-strained nonprofits cannot develop the capacities they need to consistently produce results and grow over time. These capacities are both internally focused (such as leadership, a strong culture and sound evaluation practices) and externally focused (such as communications, fundraising and alliance building).

Researchers Paul Bloom and Aaron Chatterji suggest that externally focused capacities actually position organizations for scaling more effectively than others. They found that sustainable, scaled organizations had planned for and invested in ***s***taffing, ***c***ommunications, ***a***lliance building, ***l***obbying, ***e***arnings generation, ***r***eplication and ***s***timulating market forces — SCALERS.[7]

While organizations at different stages of growth meet their revenue needs in varying ways, this aligns with a growing body of evidence suggesting that organizations that reach financial sustainability at scale have done so by purposefully investing in their capacity to generate reliable revenue. According to William Foster, a partner at the Bridgespan Group, "In contrast to the mantra of diversification, the larger organizations get, the more likely they are to get the majority of their revenue from a single type of funding, such as government or corporations." In order to identify, develop and maintain that source, he notes, "[s]ignificant organizational capabilities are required." In a Bridgespan Group study of over 100 U.S. nonprofits that had grown to $50 million or more in annual revenues between 1970 and 2003, most organizations had concentrated on a single type of funding, and had grown organizational capacity to obtain and keep it.[8]

These findings upend fairly widespread thinking that internally-focused capacities are key to growing impact — both are important. Moving from sustainability to scale requires planned, targeted investment in internally- *and* externally-focused capacities.

THE GRANTMAKER'S ROLE IN SUPPORTING FINANCIAL SUSTAINABILITY

Grantmakers seek to deliver on their mission in a variety of ways — and scalability may not be what they are looking for in every case. While some grantmakers may provide support at multiple points along the continuum from growth to sustainability at scale, others may focus on helping to scale a proven program — or helping a scaled organization to increase the efficacy of its programs, which can be a highly leveraged way to generate large-scale growth in impact. Observes Kerry Herlihy Sullivan, president of The Bank of America Charitable Foundation, Inc., "Supporting a national or global organization that has already scaled and has their hands in many markets, such as Habitat for Humanity or the United Way, is also an effective way to grow impact."

[7] Paul Bloom and Aaron Chatterji, "Scaling Social Entrepreneurial Impact," *California Management Review* 51, no. 3 (Spring 2009): 14–33. This model is tested in Paul Bloom and Brett R. Smith "Identifying the Drivers of Social Entrepreneurial Impact: An Exploratory Empirical Study," in *Scaling Social Impact: New Thinking*, ed. Paul Bloom and Edward Skloot (New York: Palgrave MacMillan, 2010), 11–28.
[8] William Foster and Gail Fine, "How Nonprofits Get Really Big," *Stanford Social Innovation Review* 6, no. 2 (Spring 2007): 46–55.

Grantmakers that seek to grow impact need to clearly define an approach and align their activities to support it. Though they cannot address all of the challenges facing nonprofits, they can certainly change their own practices to more effectively support grantees — whether they are engaged in a growth process or not. These practices include the following:

Listening to what grantees say they need. Clara Miller, in reflecting on some lessons learned at NFF, noted, "[I]n hindsight, I think we imagined 'innovative' and 'adaptive' were always mutually inclusive when they frequently are not."[9] Grantmakers can help grantees to adapt as they grow by making sure their strategies are aligned with grantees' missions and reflect the perspective and support the needs of grantees according to where they are in a growth process. Take the time to listen to grantees by engaging in respectful relationships and obtaining regular feedback. Discuss the organization's current funding model and the risks and opportunities it presents. Understand how your grant fits into the nonprofit's financial picture to better determine and communicate its true operating costs and its periodic needs for capital.

"Right-sizing" application and reporting requirements to fit the size and type of grant awarded to reduce transaction costs that diminish the value of grants. At a minimum, grantmakers should vary their requirements, including during financial analysis, depending on the size and type of grant and nature of their relationships with grantseekers and grantees. In its survey of grantmakers, however, Project Streamline found that 66 percent do not vary their requirements depending on the *size* of the grant; 59 percent do not vary their requirements depending on the *type* of grant; and an overwhelming 72 percent do not streamline their process for previously funded grantees, which means that returning grantees must start from scratch when they reapply.[10]

Providing sizable, predictable and flexible funding. To enhance sustainability, the types of grants most useful to grantees are large, multiyear and unrestricted. These grants bypass questions about adequately funding the true cost of programs or overhead and enable organizations to build the reserves they need and to make strategic changes to their work as they go. The F.B. Heron Foundation is one of a handful of foundations that provides primarily general support. In its funding guidelines, the foundation notes that "[g]eneral support is highly valuable in helping an organization to conduct its business, set and modify objectives and strategies, and plan and innovate. If a strong core of an organization's work is consistent with the foundation's funding strategies, and if the organization assesses its impact, is well-managed, and meets the other criteria specified, the foundation prefers to make general support grants…" Despite their value, however, the Foundation Center has found that only 19.2 percent of grant dollars awarded by foundations are for general support.[11] Further, as Nancy Burd has noted, "The preference for one-year commitments to grantees ignores a basic fact about organizational sustainability. It is almost impossible for an organization to develop a long-term business plan or build financial stability without knowing the funds will be received on a year-after-year basis."[12]

If growing impact is a key objective, ***consider providing growth capital to financially sustainable nonprofits.*** "The issue of sustainability is separate from that of providing growth capital," William Foster has observed. "Growth capital is like the icing on the cake — you need the cake first before you can frost it. The cake is a sustainable funding model. If you want to put in good growth capital, you need to start with a clear line of sight to sustainability" — before, during and after a growth process.

[9] Clara Miller, November 8, 2010 (1:14 p.m.), comment on Rebecca Thomas, "How Money Can Influence Innovation," *Chronicle of Philanthropy Money and Mission Blog*, November 8, 2010, http://philanthropy.com/blogs/money-and-mission/how-money-can-influence-innovation/27624.
[10] Jessica Bearman, *Drowning in Paperwork, Distracted from Purpose: Challenges and Opportunities in Grant Application and Reporting* (Washington, DC: Project Streamline, 2010), 12.
[11] The Foundation Center, *Highlights of Foundation Giving Trends*, June 2010, 2, available at: http://foundationcenter.org/gainknowledge/research/pdf/fgt10highlights.pdf. This percentage has been fairly consistent over the last 10 years
[12] Nancy Burd, *On the Money: The Key Financial Challenges Facing Nonprofit Today – and How Grantmakers Can Help* (Washington, DC: Grantmakers for Effective Organizations, 2009), 7.

WANT TO BE A GRANTMAKER THAT SUPPORTS NONPROFIT SUSTAINABILITY AND HELPS SET THE STAGE FOR GROWTH?

Financially sustainable organizations are built for impact, not financial stability alone. In practice, this means that an organization's core activities attract or generate sufficient revenue to meet ongoing operating expenses, and they produce the desired result. It also means that the organization itself has adequate financial reserves, beyond current revenue, that provide some flexibility to adapt over time — to meet unanticipated needs and plan for the future (including, in some cases, growth).

Grantmakers that seek to support nonprofit financial sustainability should consider the following steps:

1. **Understand whether an organization's current funding model is aligned with its mission and works** — Financial analysis and conversations with key staff can uncover whether a nonprofit has positive operating results, a strong balance sheet and the financial flexibility to handle unanticipated risk and opportunity.
2. **Listen to what grantees say they need** — Make sure your grantmaking strategies are aligned with grantees' missions and reflect the perspective and support the needs of grantees by engaging in respectful relationships and obtaining regular feedback. Support their efforts to better determine and communicate their true operating costs.
3. **"Right-size" application and reporting requirements** — To reduce transaction costs that diminish the value of grants, vary your requirements to fit the size and type of grant awarded.
4. **Provide sizable, predictable and flexible funding** — Large, multiyear and unrestricted grants bypass questions about adequately funding the true cost of programs and enable organizations to build the reserves they need and to make strategic changes to their work as they go.
5. **Provide growth capital to financially sustainable nonprofits** — Financial sustainability is a necessary precursor to any conversation about growth — before, during and after a growth process.

About *Scaling What Works*

Launched in 2010, *Scaling What Works* is a multiyear learning initiative of Grantmakers for Effective Organizations, a thought leader for promoting grantee-centric philanthropic practices that lead to more effective results. With the support of a coalition of 22 funders, GEO aims to expand the number of grantmakers and public sector funders that are working together to broaden the impact of high-performing nonprofits. Through *Scaling What Works*, GEO will offer trainings, networking opportunities and a host of tools and resources, such as this paper series, to better equip grantmakers to help the nonprofit organizations they support to plan, adapt and grow their impact in creating sustainable benefits for people, their communities and our planet.

For more about GEO and *Scaling What Works*, please visit www.scalingwhatworks.org.

GEO THANKS THE FOLLOWING INDIVIDUALS FOR THEIR INPUT AND FEEDBACK ON THIS PAPER:

Fiona Aitken, The Bank of America Charitable Foundation, Inc.

. . .

William Foster, the Bridgespan Group

. . .

Carla Javits, REDF

. . .

George Overholser, Third Sector Capital Partners

. . .

Gail Perreault, the Bridgespan Group

. . .

Hilda Polanco, Fiscal Management Associates

. . .

Jon Pratt, Minnesota Council of Nonprofits

. . .

Craig Reigel, NFF Capital Partners

. . .

Kerry Herlihy Sullivan, The Bank of America Charitable Foundation, Inc.

. . .

Rebecca Thomas, Nonprofit Finance Fund

. . .

Susan G. Zepeda, Foundation for a Healthy Kentucky Inc.

. . .

ADDITIONAL RESOURCES:

For additional resources on supporting nonprofit financial sustainability, check out the "Useful Links" section of our website, www.scalingwhatworks.org/resources/useful-links.

. . .

1725 DeSales St., NW, Suite 404 / Washington, DC 20036
Tel: 202.898.1840 / Fax: 202.898.0318
Web: www.geofunders.org