# How to Research a Nonprofit's Financial Strength—Deep-Dive Approach

Is your potential grantee financially sustainable? In other words, can it reliably support its core programs and services? What is its financial track record? Where is it vulnerable?

Strong programs and demand for services do not automatically equate with adequate funding—to the contrary, "success" typically means more money is needed! Nonetheless, understanding an organization's financial situation is critically important because doing so will give you a clear line of sight into its long-term prospects, its ability to put additional funds (yours) to good use, and a sense of where it would (or should) use your support.

This tool runs you through some helpful indicators. Among other things, you'll be looking to see that your potential grantee isn't overly reliant on a small number of funders, that it has enough cash on hand to weather an unexpected storm, and that it has robust financial reporting systems that support sound financial management. If you find that the organization is less financially mature, you'll be considering whether its leaders have a solid plan to achieve a level of financial stability, and whether it has the capabilities it needs to put that financial plan to work. Finally, you'll ascertain how well prepared its leaders are to handle changes in expenses and revenues, which often crop up unexpectedly in the nonprofit world.

Your comfort with different levels of financial sustainability will depend in large part on the role you hope to play in the organization's trajectory. For example, you will likely find less financial sophistication and certainty from a small, entrepreneurial start-up than from a large, established nonprofit. But maybe you want to help that smaller organization get off the ground—or maybe you want to help the larger organization expand to new cities. What matters is that you learn enough about the organization's financials to determine whether your support will be put to good use.

## Initial assessment

As you begin your financial research, you'll first want to look out for signs of true financial peril. Is the organization in dire straits? Unless you really believe your support will help the organization make a dramatic turnaround, you will probably say no to supporting an organization in this situation.

Look for a few key warning signs before you spend significant time doing more intensive financial research. You will want to do this respectfully, understanding that financial troubles are a touchy issue. Instead of working directly with the organization's leader, for example, you might ask first to see the organization's financial statements. What can you infer by looking at those reports? You might also ask to be put in touch with a member of the nonprofit's financial management team or board audit committee.

If you uncover no suggestions of financial jeopardy, continue to gather a more nuanced picture of the organization's business model and how your support might be put to use.

## Full financial assessment

> For a fuller picture of the financial trials nonprofits face, see Clara Miller's excellent article, "The Looking Glass World of Nonprofit Money."

An in-depth financial assessment examines three components of an organization's financial health: **financial management, sources of revenue**, and **cash position**.

Think of this process as one more way of getting to know your potential grantee. If you discover vulnerability in its financials, seek the root causes. Look for ways that your support could fundamentally strengthen the nonprofit's financial position. For example, funding an investment in an IT system to provide better real-time financial information could open the door for better financial management; alternately, funding a development staff position might lead to a marked increase in the organization's revenue.

## Financial management

Nonprofit financial management principles turn for-profit principles on their heads. In the nonprofit world, for example, increased demand for services often means an increase in costs (to provide those services) with no associated change in revenue. Such a scenario leaves an organization scrambling for funding to keep up with demand. What's more, nonprofits don't have access to the same capital markets as for-profit enterprises. That means that they do not have the option of selling shares to fund growth or weather tough times, but must find funds elsewhere. Given this challenging context, the strength of a nonprofit's financial management team is one of the best indicators of its ability to survive and grow.

The size of the organization's financial management team will vary. A large organization may have a dedicated Chief Financial Officer (and maybe even staff), with support from selected board members and/or board audit committees and the executive director. In a small organization, the executive director might be flying solo. There is no "magic number" of people or positions to look for; instead, you will likely form an impression of the quality of the staff through your personal interactions. Consider other means of validation as well—such as the confidence of other funders who have vetted the organization. Keep in mind that in younger organizations, sophisticated processes and procedures are less likely to be established, but the basics should still be in place to assure sound management.

Regardless of size, at a fundamental level you want to hear that the organization has a strong grasp of how its costs reflect the strategy it is trying to achieve. First, how are the organization's priorities reflected in its budget? For example, if the organization emphasizes the importance of its advocacy work in its strategy, but you see only minimal expenditures on advocacy, that is a red flag.

Second, what does it actually cost the organization to achieve results? Understanding how the organization thinks about this is a great way to see how it translates its strategy into action. This line of inquiry doesn't necessarily require a complex calculation, but it is a good idea to gauge how management thinks about costs on a "per beneficiary" or "per outcome" basis. If the numbers they share seem wildly high or low, dig deeper to understand more about the feasibility of the organization's goals.

The organization's financial team should be able to answer a few additional questions (listed below), and provide you with the documents you request. They should also be comfortable seeking input from the board when appropriate. If team members have difficulty with your requests or seem uncomfortable communicating with directors, that's not necessarily a negative indicator; instead, it's an opportunity to ask yourself, "Could I structure a grant to help the organization hire or train to fill this need?"

Ask the following questions to inform your perspective on an organization's financial management:

**Financial leadership's strength and ability to support the nonprofit's strategy**

- Who, currently, is responsible for the organization's financial strategy? What type of formal education and work experience do they have?
- Can you share how your strategic priorities are reflected in your budget?
- Does the organization have detailed budget projections based on what is required by the strategy?
- Does the organization have a clear understanding of its operating costs (for example, has it conducted a "true cost" analysis, where it has estimated allocations of its central costs to its programs)?
- What resources or programs would you add or cut if your revenue grew or shrunk by 10 percent? How flexible are your expenses (for example, do you have significant capital expenses or debts that require servicing)?

**Strength of the nonprofit's financial processes**

- Do the organization's financial reporting systems provide the necessary information in a clear and timely way?
- Does the organization have systems in place to evaluate its financial progress and refine its budgets and plans? (These might include management reports, or other documents that provide an overview of current financials against plan, such as monthly dashboards.)
- How is the board involved in monitoring the organization's financial position?
- If the organization has over $500K in revenue, check to make sure it has a recent audit and that you understand the

comments.

## Revenue sources

Good programs alone are not enough for an organization to attract funding, given that resources do not automatically flow to the highest-performing nonprofits. Nonprofits need to have a strategy to raise revenue to fund their programs.

Reliable funding sources enable an organization to identify with a reasonable degree of predictability how much money it will raise in a given year. They also allow an organization's financial management team to think ahead. In other words, instead of being in constant "survival mode," the team can work with the organization's leadership to set longer-term goals and priorities with confidence in the resources it will be able to spend on core programs and services.

Three criteria contribute to the stability and flexibility of an organization's revenue sources, allowing it not only to raise dependable funds, but to put the money where it is most needed:

- **The percentage of ongoing costs that are covered by reliable funding sources.**
- **The number of decision makers in control of revenue sources.** Having a greater number of consistent funders increases the likelihood that revenue will continue even if one funder chooses to exit. This does not preclude an organization from earning the majority of its revenue from one type of source (for example, government contracts), but rather looks at how many separate payers (for example, how many government contracts) are involved within that one type of funding.
- **The restrictions donors have placed on their funding.** When donors restrict funding to certain programs, organizations are not free to allocate money where they need it most. If a large portion of a nonprofit's funding is restricted, its ability to sustain itself as a whole may be compromised, even if the amount of money in play appears to indicate financial health.

To identify what portion of ongoing costs is covered with reliable funding, you first need to assess which funding streams are reliable. Speak with members of the financial management team or the organization's leader and ask them to tell you about the organization's most dependable funding sources. For example, can the organization generally count on a certain, steadfast set of funders, year after year? Has the organization been able to add reliable funding sources to keep pace with growth? How confident are the organization's leaders that these trends will continue? If the grant you're offering is significant, you might also consider interviewing other major funders to gauge their level of commitment and long-term interest.

### A Note on Restricted Funding

Restricted funding is revenue that has been designated by a donor for a specific purpose, such as a particular program, a scholarship, or support for a new IT system. It is not the same as revenue that comes in from a particular fee-for-service program, as the organization can use its earned income in any way it chooses.

For a perspective on the importance of unrestricted funding, see: "Fund organizations, not projects."

Next, review past operating revenues and costs (looking back three to five years), excluding any "blips" such as one-time growth or capacity-building investments or major grants. Compare the total reliable revenue identified for each year you have analyzed with the operating costs for that year. There are no strict guidelines as to the percentage of funds that should be reliable, but it is an encouraging sign if these types of sources cover at least 70 percent of ongoing costs.

You'll also want to find out how many grants or contracts comprise the bulk of the funding. The organization's financial documents should reveal this information; you can also ask the nonprofit's financial management team.

You also want to understand how much discretion the organization has in how to spend its revenue – what proportion of the budget is restricted for particular programs, for instance? If you get the sense that the organization doesn't have the flexibility to allocate resources to its highest priority areas, this might be something you can help with.

## Funding models

As part of the conversation on revenue sources, it may be helpful to understand whether the leader has thought about a funding model. A funding model is a nonprofit's strategy for attracting a reliable mix of revenue sources to support programs and services. It has three defining elements:

- Funding source (the type of funding, such as a foundation, government, or individuals)
- Funding decision-maker (for example, a foundation program officer, a government purchaser, or an individual donor)
- Funder motivation (for example, issue falls under a foundation focus area, organization provides a low-cost and effective service, individual was personally touched by a disease)

For more detail, see Bridgespan article "Ten Nonprofit Funding Models."

Most organizations lend themselves to certain types of funding models. For mature organizations, evidence of a clear funding model should be emerging. Many young nonprofits will not have fully established funding models, but ideally they are working towards a coherent, strategic model. You may want to engage the leaders of younger organizations in a conversation to hear if and how they are thinking about which models might fit their organization best.

> "Our fundraising strategy used to be 'let's raise more money this year than last' and we always were unsure of where we'd be. Then we got serious in thinking about our model and identified an ongoing type of government funding that was a good match for our work. While it required some program changes to work, we now predictably cover 70 percent of our costs in any locality."
> *-Earl Martin Phalen, cofounder of BELL, an after-school and summer educational organization*

As you learn more about the organization's most reliable funders, keep its existing (or potential or emerging) funding model in mind. What is the organization's rationale for appealing to each of funder? Where does (or would) each funder fit into the model? (To learn more, read "Finding Your Funding Model.")

## Cash position

You will want to complete your research into the organization's financials by confirming it has sufficient cash on hand to pay the bills and weather unexpected challenges.

At a minimum, you will want to understand whether the organization:

- Has had difficulty making payroll, currently or in the recent past
- Is falling behind on its rent or debt payments
- Has no available lines of credit
- Is using funds restricted to a specific program to support core operations instead

After completing this initial assessment of the organization's current situation, it is a good idea to understand the organization's access to cash more generally and how it thinks about, from a time perspective, mapping its expenses to its revenues. Cash goes by many different names: working capital, operating reserves, and endowments are just a few of the ways accountants organize capital. What's really important is the **amount** of the organization's **liquid assets** that can be used for whatever purposes necessary.

### *How large a cash reserve does the organization need?*

#### Key Points to Remember

- A nonprofit needs access to sufficient cash to cover ongoing expenses should revenues not come in as planned.
- How much is sufficient? The answer depends on how smoothly revenues come in, but typically you will want to see at least three months' worth of expenses in ready cash.
- Reserve cash must not be restricted to particular program areas.

The amount of cash an organization needs to have on hand depends not only on how much it spends, but also on the timing of its revenues and expenses. Just as a drug company might see a cash influx when a drug reaches market, a nonprofit might raise the bulk of its donations at an annual dinner, or collect government grants just twice a year. Its expenses will continue regularly throughout the year, creating a few months when the organization appears to be flush with cash, and several months when cash seems about to run out. As long as this flow is regular year in and year out, a nonprofit should be able to plan ahead and keep the necessary amount of cash on hand to make the next payment.

For example, consider a nonprofit that depends upon funding from the state of California, which often can’t close its budget before October. The nonprofit must provide services regardless, and so will accrue expenses for months until it the state pays up. In this case, the nonprofit needs upwards of six months of cash on hand. In a reverse situation, another organization might have over a years’ worth of cash in the bank right after its annual conference (its big revenue generator), but would likely run very low on cash as it nears its next conference.

Consistent, reliable funding is key. For example, consider a nonprofit that is nearing the end of four major grants. While it may appear to have sufficient cash on hand to cover operating expenses for the next six months, it may not have a plan in place to cover expenses once those grants end.

Finally, consider alternatives to cash or cash-like assets. Many nonprofits have lines of credit to cover their short-term costs—especially nonprofits that rely on government contracts.

A word about relative financial health: Most nonprofits don’t come close to having the cash reserves you would ideally want to see, at least not all of the time. Keep in mind that your decision to fund any given organization should take many factors into consideration in addition to its cash reserves (and that your funding might serve to provide or bolster a reserve.)

Keeping these nuances in mind, there are some basic guidelines that most nonprofits ought to follow.

### *How much reserve cash is enough?*

**One month or less:** This organization faces a significant risk of a cash flow crisis, and will continue to do so until this number goes up. An organization in this position may not actually face a crunch yet, and it would be worth finding out when it expects its next revenue and what other sources of capital it can use to meet current needs—such as debt, a bank loan, or restricted funds intended for a different purpose. The only way to dig out of this hole is to earn a surplus or to secure an unrestricted contribution.

**Two months:** This organization should be able to weather cash-flow issues within reasonable bounds, such as a major funder delaying a payment by a limited period of time (a month or two). But two months of capital does not create a buffer against larger challenges, such as the loss of a government contract that supplies a major portion of its revenue.

**Three months or more:** This organization has a reasonably comfortable cushion. Consider it a starting point for looking into the timing of the organization’s revenues and expenses as well as the liquidity of its cash on hand.

### *How liquid is the organization’s cash reserve?*

Once you’ve figured out how much cash the organization has on hand, you’ll want to dig deeper into the nature of that cash and its sources. If the capital is entirely restricted to a particular program, the organization may not be able to use it to pay rent or cover payroll. In another scenario, the organization might have an endowment that is intended to fund growth, but its leaders may be able to tap into those funds to cover cash flow issues in the economic downturn. The bottom line question is this: Does the nonprofit have sufficient cash (or assets that can be easily converted to cash) to cover expenses should revenues not come in as planned?

#### A Note on Endowments

Endowments can have multiple purposes that can be restricted or unrestricted, as determined by the board or a separate endowment board. For example, consider an organization that received $1 million from the estate of a long-time volunteer. This endowment came with no requests or restrictions and the board passed no requirements, so the organization is free to use the principal of this endowment to cover operating expenses. However, a nonprofit that draws upon its endowment in this way will principal of this endowment to cover operating expenses. However, a nonprofit that draws upon its endowment in this way will ultimately spend down that pool of cash.

On the other hand, an organization with a restricted endowment may have the option to seek the board’s vote to remove restrictions. In this case, it is important to have significant financial oversight from the board.

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