Planning to Survive in Uncertain Times

Part II: Financial Management Strategies
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Workshop Description

This workshop will focus on current trends affecting non-profit organizations with an emphasis on short and long-term financial management strategies. Participants will be provided with examples of financial management tools to assist in strategic decision making that will financially position their organization for long-term sustainability.

Learning Objectives

At the conclusion of this workshop, participants should:

1. Understand the importance of financial management strategies and their direct link to an organization's overall strategic plan.
2. Understand the current environment that non-profits operate in and the critical importance of monitoring trends that will affect future operations.
3. Understand basic cost principles and terminology.
4. Be able to perform basic financial analysis and use that information to make informed decisions.

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Program Overview

- Current Environment for Non-Profit Organizations
- Financial Tools and Strategies for Survival and Sustainability
- Monitoring Financial Strength

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Current Trends Facing Non-Profit Organizations

- In many instances, *overwhelming* need and demand for services
- Increased competition for funding (from all sources: individuals, businesses, government agencies and foundations)
- Federal, state & local government deficits
- Increased competition from for-profits (food service companies)
- Increased accountability and scrutiny from funders and donors (more transparency)
- Increased IRS scrutiny (through the expanded form 990, donation reporting, etc.)
- Trends in volunteerism—overall; generational; and in how people volunteer

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Current Trends Facing Non-Profit Organizations

- Non-profits will need to embrace more partnerships and collaborative ventures; create additional revenue streams
- "Social entrepreneurship"—non-profits will be competing for donations from investors in socially responsible investments
- Aging population—obvious ramifications for MOWA and related organizations; also projected retirement of experienced nonprofit leaders
- Changing demographics of the U.S. population (expansion of Asian, Hispanic and other minority groups)
- Increased operating costs—health care/benefits, insurance, fuel costs, cyber-security, technology, etc.

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Responding to Current Trends Facing Non-Profit Organizations

Focus on utilizing best practices, including:

a. Risk management

b. Improve financial strength of the organization—through budgeting, reserves, utilizing financial analyses

c. Realize: it is OK for a non-profit organization to have a "surplus" at end of the year!

d. Know your organization's "cost of services"

e. Be able to provide specific information about outcomes and impact from your organization's programs

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Responding to Current Trends Facing Non-Profit Organizations

f. Make financial decisions that link to/support the organization's strategic plan!

g. Experiment with developing new revenue sources; consider partnerships with other organizations

h. Mergers!

i. Prepare an achievable strategic plan; monitor implementation and be accountable. Revise in response to changing conditions (annual review!).

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Financial Management Strategies and Tools for Sustainability

- Use budgets—both operating and capital
- Understand important financial terms and definitions
- Apply financial analysis to various decisions
- Utilize reserves to ensure long-term viability of the organization
- Will need "start-up" capital to begin new ventures and for initial operating period
- Use ratios to monitor financial strength

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Budget Development

- How should an operating budget be developed for an organization?
- Approaches to budgeting:
  - a. Last year's budget plus/minus a %
  - b. Current year results, extrapolated
  - c. Zero-based budgeting model

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Developing the Revenue Budget

- Where to start?
- Primary sources of revenue—revenue mix
- Any revenues "at risk"
- New sources of funding—likelihood of occurring (and being profitable!)
- Project/forecast revenue for the upcoming year based on best information available

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Developing the Expense Budget

- What are your major costs, and what are the primary determinants of those costs?
- If new programs or initiatives are planned for the next year, will need to incorporate into the budget
- Consider ways of reducing costs, such as:
  - a) Sharing employees with other organizations
  - b) Investments to automate operations or reduce energy consumption
  - c) Outsourcing certain functions
  - d) Purchasing groups

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Monitoring Budgets

Comparison of budgets to actual results

- An effective method for monitoring performance and protecting assets.
- Variances from budgeted amounts should be analyzed, focusing on the underlying causes.
- Explanations for variances should be specific and include anticipated effect on future periods if applicable.

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The Capital Budget

- Purchases of items such as machinery, equipment, vehicles, etc. are typically included in the annual capital budget.
- Separate from the operating budget; why?
- How to determine what to replace/add each year?
- How are these items paid for?

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Survey Questions

Please complete the online polling questions about budgeting

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Financial Management Tools

A few simple methods and techniques can be used to evaluate a potential investment or capital purchase:

- Payback analysis
- Return on investment (ROI)

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Capital Project Analysis

Payback analysis

Formula = $\frac{\text{Cost of the investment}}{\text{Savings or financial benefit}}$

- The resulting measure is a “time period” (i.e., the payback period) of how long it will take to recover the cost of the investment.

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Capital Project Analysis

Return on Investment

Calculation:

$$\frac{\text{Net savings, additional earnings, etc.}}{\text{Investment cost}}$$

Result is a return % (e.g.,10% ROI)

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Example—Payback and Return on Investment

Refer to the Analysis of Investment Opportunities Exercise in the handouts for this webinar

What are the current costs?

120 hrs/week x $10/hr x 22 week season

120 x $10 x 22 = $26,400 x 1.15 (benefits) = $30,360 Total current costs

Example—Payback and Return on Investment

What are the costs with the new machine?

45 hrs/week x $10/hr x 22 weeks

45 x $10 x 22 = $9,900 x 1.15 (benefits) = $11,385 plus $2,500 (operating costs) = $13,885 Total costs with new machine

$30,360 Total costs of current method

$16,475 Total projected annual savings

Example—Payback and Return on Investment

What is the payback period?

$55,000 / $16,475 = 3.33 Years

What is the ROI?

$16,475 / $55,000 = 29.95%

Appears to be a good investment!

Other factors to consider?

Building the Business Case

How do you justify:

- The purchase of new equipment?
- Adding additional personnel?
- Starting a new line of business?
- Need to “make the business case” to be successful (i.e., obtaining the approval of your board, specific funder or other authority) with such a request!

Building a Business Case

Elements the Business Case should include:

a. Executive summary of the proposal (1 – 2 pages)
b. Description of current state or situation
c. The Proposal—details
d. Financial evidence—the quantitative analysis that justifies and supports the proposed change (e.g., payback and ROI calculations)
e. Conclusion
f. Supporting materials

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Building a Business Case

- Make your Business Case as strong as possible with a *clear and understandable financial analysis based on sound assumptions*.
- A proposal with weak or limited financial benefits = guaranteed rejection (most of the time!)

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Survey Questions

Please complete the online polling questions about evaluating capital investments

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Important Terminology for Financial Analysis

Some frequently used terms:

- Fixed costs
- Variable costs
- Relevant costs
- Sunk costs
- Break-even point

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Break-even Analysis

- What is the "break-even" point?
- Essential for evaluating new ventures
- The point at which the total revenue generated is sufficient to cover all of the costs of production (variable costs), fixed costs, plus the target amount of profit. Can be used to illustrate the efforts of different selling prices on quantity (or vice versa)

Break-even formula:

Qty. x Price = (Qty. x Var. Costs/Unit) + Fixed Costs + Target Profit

Break-even Analysis Example

Assume that an organization wants to sell its product for $35/unit. Its variable costs per unit are $21, it incurs $7,000 of fixed costs, and it desires to generate a profit of $10,000. How many units must the organization sell in order to break-even (i.e., cover its costs)?

Computation:

$35 x (Qty.) = $21 x (Qty.) + $7,000

Solve for Qty.

Break-even Analysis Example

Break-even point is:

$35 (Qty) = $21 (Qty) + $7,000

Qty = 500 units

Break even *with* $10,000 Target Profit:

$35 (Qty) = $21(Qty) +$7,000 + $10,000

Qty = 1,214 units

Very useful tool for determining pricing! Can be used for evaluating special events and activities!

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Lease vs. Buy Decision

- A “classic” financial management decision
- Companies/organizations have wrestled with this concept for many years
- What are the relevant factors to be considered here, both quantitative and qualitative?
- Example exercise—refer to handouts

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Lease vs. Buy Example

Cost of the lease:

Years 1 – 3 = $344/mo. X 36 mos. = $12,384

Years 2 – 6 (have to lease again; assume at same rate) = $12,384

Excess mileage = 3,000 miles x 6 years x $0.12/mile = $2,160

Total lease cost = $26,928

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Lease vs. Buy Example

Total cost of purchasing:

Down payment = $5,000

Monthly payments 23,400 (5 yrs., $390/month)

Additional maintenance in years 4 to 6 =

$1,500 x 3 = $4,500

Total costs = $33,390

Less $11,000 value (end of year 6) =

$22,390 (total net cost of purchasing)

Net savings from purchasing = $4,538

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In-House vs. Outsourcing Decision

This topic has received significant coverage in the business press, seminars, etc. Many businesses "outsource" large portions of their work. Can affect both operating and capital budgets (less investment in equipment, etc.)

- Examples of outsourced work
- What factors should be considered in making this decision (quantitative and qualitative)?
- Example

In-House vs. Outsourcing Decision

Refer to the Outsourcing exercise in the handouts

Current production costs = $234,000 (in-house)

If purchased:

$29/unit x 6,000 units = $174,000

Fixed costs ($72k x 75%) = $54,000

Total if purchased = $228,000

Savings from purchasing = $6,000/year

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Analyzing Special Opportunities

- What is a special opportunity?
- Unique opportunity to provide a product or service, often at a lower than typical price, in exchange for a large volume single order (or recurring orders).
- How does the organization make a decision on this?

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The Importance of Reserves

- Reserves:
  - a) Operating
  - b) Capital
- What are operating reserves?
- How should reserve amounts be determined?

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Operating Reserves

Definition:

"That portion of available unrestricted net assets* that an organization's board maintains and/or has formally designated, or reserved for use in emergencies to sustain its financial operations in the unanticipated event of significant unbudgeted increases in operating expenses and/or losses in operating revenues."

*Unrestricted net assets less the equity in fixed assets (i.e., total fixed assets less any related long-term debt)

Source: The Nonprofit Operating Reserves Initiative Workgroup Whitepaper

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Why Do Non-Profit Organizations Need Reserves?

1. Become more self-sufficient!
2. Prepare for market-related risks (endowment funds decrease in value, resulting in reduced distributions)
3. Avoid unplanned cost-reduction measures
4. Lessen the impact of industry-specific risks
5. Ability to provide start-up funds for new ventures

Source: Reserves Planning: A step-by-step approach for non-profit organizations (Grant Thornton)

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Survey Questions

- Please answer the polling questions regarding your organizations and their use of reserves

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How Much Should be in an Organization's Operating Reserve?

- It depends!
- Organizations should develop an operating reserve policy
- The policy should specify a % of total operating expenses to be maintained, or a minimum number of months operating expenses

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Establishing the Operating Reserve Policy

- Establish a minimum amount
- Define how your reserve will be determined (% of, number of months of operating expenses, etc.)
- Include how the reserves will be invested (Note: need to be readily available)
- Address how will the reserves be measured and reported
- Discuss how reserves will be replenished if they are used

Source: The Nonprofit Operating Reserves Initiative Workgroup Whitepaper

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Financial Ratios for Non-Profit Organizations

Monitoring ratios vs. established goals and industry norms
Suggested Ratios for Non-Profits (see separate handout)

- Current ratio
- Defensive interval ratio (DIR)
- Debt ratio
- General & administrative expense % (efficiency measure)
- Fund-raising expense % (efficiency measure)
- Operating margin % (efficiency measure)
- Revenue mix
- Net asset mix

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Summary and Wrap-Up

- Non-profit organizations are unique but can benefit from using financial tools similar to for-profit entities
- Current trends will significantly impact non-profit organizations and must be closely monitored
- Budgeting, building reserves, and other financial tools should be applied to non-profit organizations to improve their performance and provide long-term financial sustainability

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References and Resources

- Center for Philanthropy at Indiana University (www.philanthropy.iupui.edu)
- Grant Thornton whitepaper: "Reserves planning: A step-by-step approach for non-profit organizations"
- The 2012 Bank of America Study of High Net Worth Philanthropy (in conjunction with Indiana University)
- With Charity for All: Why Charities are Failing and a Better Way to Give, by Ken Stern (2013).
- "Operating Reserve Policy Toolkit for Non-Profit Organizations" (sponsored by the National Center for Charitable Statistics, Center on Nonprofits and Philanthropy—Urban Institute, and United Way Worldwide); 1st Edition—September 15, 2010
- Maintaining Nonprofit Operating Reserves: The Nonprofit Operating Reserves Initiative Workgroup Whitepaper

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