5 Myths in Nonprofit Finance

Continuing my occasional series on de-mythification, I turn to a favorite topic: financial management and strategy for nonprofit orgs. We've got some big fish here.

Where to start? How about with the myth embedded in a three-syllable word?

1. Nonprofits can't make profits.

Contrary to popular misconception – and a literal reading of the name of our sector – there's no law or standard that bars a "nonprofit" from earning a fiscal surplus (also known as *profit*).

This label is unfortunate for many reasons. The term *nonprofit* came into being merely to distinguish these organizations from other businesses with regard to their overarching purpose and tax status. It has nothing to do with financing or budgeting constraints. Nonprofits have many financing options, including those available to for-profit businesses, and are similarly free to make or lose money.

Two caveats: Some profits may be taxable, which is permissible and perfectly acceptable. (Having profits that can be taxed is actually a nice problem to have, when you think about it). Also, to be clear, maintaining your tax-exempt status is not a given; if an organization strays too far from its mission or starts stockpiling cash that status could (and probably should) be in jeopardy. But a wide range of fiscal outcomes stay far from such a problem.

Bottom line: there's no rule that says a nonprofit can't make more money than it spends. Which takes us to a related topic…

2. A budget is supposed to have a bottom line of zero.

This is another widely-held misconception, and a harmful one at that. While a budget can have a zero, negative or positive bottom line, the common practice of matching expenses and revenues is not required, should not be a standard, and can have negative consequences.

A budget is simply a plan for the near future, and actual results may vary. One problem with a net-zero budget is that it allows no buffer for variable results, and may therefore make a deficit more likely. Your budget should be a reasonable forecast for the coming year. Even if net-zero budgets turn out to be accurate forecasts, the organization's financial position will slide backward over time for the simple reason that cash reserves will not, in many cases, keep pace with inflation.

For this reason, I have a special term for the practice of matching expenses and revenues evenly over time: a *structural operating deficit*. It's not a good thing.

3. The nonprofit business model is mainly about successful fundraising.

Fundraising itself is actually a small part of a nonprofit's business model, which starts with the logic behind its programs, and covers the framework of its operations as well as the revenue structure. The latter often includes other elements, not just fundraising. Another key component of the business model is the set of value propositions for those with a stake in the organization's work. Fundraising follows from the value propositions to those people and institutions that may (or may not) give you money, but the *act* of fundraising is more like dessert than the main course. (If this sounds mysterious, see our recent white paper on the nature of the nonprofit business model for more detail.)

Even where fundraising is important to financial success, it won't be effective over the long-term if the business model is flawed.

4. If an organization's grants (or contracts) cover its direct program costs, everything's hunky-dory.

Many organizations have died or had near-death experiences from this assumption. The Nonprofit Starvation Cycle is a name used to describe what happens when purpose-specific funding is based on direct costs and dominates an organization's revenue mix. This practice actually has a *negative* economy of scale, and you can literally grow yourself to extinction this way.

Why is that? Because core operating functions must thrive for any organization to be healthy. These fall under *indirect*costs, and it they aren't fully supported or don't keep pace with changing demands, the whole house can fall down.

One solution is *full-cost pricing*, which sounds suspiciously like business terminology. It's not yet fashionable in nonprofit circles, but I hope that's starting to change.

5. A nonprofit shouldn't hold more than a couple of months' cash reserves – doing so would mean limiting needed services and/or raising a flag with donors.

No, no and no!

Think of your household budget. How much would it cost to live for a month if you lost your source of income? How long would it take to find a new job if you needed one? Now imagine the economy is down – how much longer would it take? And what compromises would you be forced to make if your savings started to scrape bottom?

An organization isn't all that different from a household. No financial adviser would recommend that you keep just two months' expenses in your personal savings account, and they shouldn't for your organization either. Six months to a year is more like it. This prepares you for many unknowns, both bad and good. It's better for your clients and more appealing to most donors.

There are a variety of strategies for building healthy reserves while maintaining strong operations. But that's for another article…

Some myths are good stories with a little bit of truth and a valuable lesson. Those great tales from ancient Greece are worth remembering for those reasons. Other myths, like the five here, have neither virtue, and are better forgotten.