Community Action Partnership: Understanding & Planning for Full Cost

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Spectrum Exercise: Where do you fall?

How much do these statements describe you?

I love the balance sheet and couldn’t imagine running my organization without it.

I would rather sing opera in front of 500 people than build a budget.

I can think of no better way to spend a Wednesday afternoon than talking about nonprofit finance.
Nonprofit Finance Fund: Where money meets mission

NFF envisions a world where capital and expertise come together to create a more just and vibrant society

We unlock the potential of mission-driven organizations through

- **Tailored investments**
- **Strategic advice**
- **Accessible insights**

Guided by our Core Values ➔
Agenda

The Flawed System of Nonprofit Finance
- Structural and Behavioral Challenges that Inhibit Nonprofit Health

Understanding the Full Cost of Your Organization
- Defining Full Cost
- Determining Full Cost Priority
- Full Cost Planning & Budgeting

Wrap-Up & Key Takeaways
“Rules” of Nonprofit Finance

- Nonprofits exist to fill a social need for which there is rarely an obvious commercial return

- Client often does not pay or pays partially for the product (e.g., homeless do not pay per night for shelter)

- Nonprofits rely on third parties (donors and funders) to pay for the cost of program and services

- Donors and funders want most of their contribution to go directly to the people served → “restricted” funding

- Overhead and profits are often seen as unnecessary and unrelated to achieving the mission
Mission Support (Subsidy) Business

“Subsidy businesses” generate support to fill the gap between core funding and the cost of operations

- Since nonprofits can rarely charge prices sufficient to cover the full cost of their core mission programs, they require support businesses (a.k.a the “subsidy” business)

**Common subsidy businesses include:**

- Sweat equity (use of volunteers, underpaid staff, low benefits)
- Fundraising
- In-kind contributions
- Investment income
- Real estate (rental income)
- Earned income ventures

When program growth or changes occur, **subsidy must grow in proportion.**
Like any organization, nonprofits need to cover the full cost of delivering programs

- Tax Status vs. Business Model
- Full costs > Operating Expenses > Direct Expenses

**Ideal:** Surpluses Sufficient to Cover Full Costs Year Over Year
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About Total Expenses

Total Expenses

- Found on the income statement
- Include:
  - Operating and non-operating expenses
  - Depreciation
  - Ongoing cost of impact measurement and some upfront costs of impact measurement
  - ‘Direct’ program expenses
  - ‘Indirect’ / ‘overhead’ expenses
- Unfunded expenses

Total Expenses are NOT

- Any purchase that is capitalized
- Repaying debt
Defining ‘Unfunded Expenses’

Unfunded Expenses = Expenses that are not currently incurred, but, if covered, would allow the organization to work at their current level in a way that is reasonable and fair.

- ‘Sweat equity’ – overworking and underpaying staff – is the most common example, such as:
  - The gap between current wages and fair wages for the exact same amount of work.
  - The cost to hire a 20hr/week assistant that would allow the ED to reduce her time from 60hr/week to 40hr/week.

- Other examples: sub-par supplies, slow internet

Unfunded expenses are NOT

- Expenses to expand or do more.
About Working Capital

**Working Capital**

- Dollars to cover *predictable* timing of cash ebbs and flows
- Dollars to continue business operations if receivables are late or bills must be paid early
- Needed by all organizations
- Amount needed varies by organization
- Easily accessible to management (i.e. in the checking account, not restricted or strictly designated)
- Connected to cash flow planning/projections

**Working Capital is NOT**

- Dollars to cover lost revenue, unplanned expenses, or deficits
About Reserves

Reserves

- Dollars used and eventually replenished
- Often board designated
- Example of intended uses
  - **Operating reserve** to protect the organization from risk by covering short-term deficits
    - Lost funding, unexpected expense, leadership transition
  - **Facilities reserve** to maintain building and equipment, pay for repairs and/or replacement
  - **R&D reserve** to allow for trial and error
    - Take artistic risk, investigate new program approach
  - **Investment reserve** to generate revenue
About Reserves (continued)

Reserves

- Reserves are needed by all, but size and purpose vary by organization.
- Accessible to management under certain conditions:
  - May require board approval to spend.
  - May be held as cash in savings account, or as investments that can be liquidated in a reasonable timeframe.
About Debt Principal Repayment

**Debt Principal Repayment**

- Dollars to pay down debt
- Debt can be
  - Line of credit
  - Mortgage
  - Loans from board members
  - Other forms of borrowing
- Debt can be a valuable financing tool, but there must be a plan to repay it
- Repayment is commonly financed through year-to-year surpluses
Fixed Asset Additions

- Purchase of new equipment, buildings, furniture, land, leaseholder improvements, etc.

Fixed Asset Additions are NOT

- Replacement or simple maintenance of existing fixed assets
  - Save for replacement in reserves
- Small equipment purchases that won’t be depreciated
  - Small purchases are expensed
About Change Capital

Change Capital

- *Periodic* reinvestment in organization to change its business model (how it makes and spends money in service of mission)
- Covers up-front costs of change *and* deficits until new business model revenue exceeds new business model expenses
  - Includes launch/scale of subsidy businesses to sustain the organization
- Typically large, flexible, multi-year funding from an external source

Change Capital is NOT

- Self-funded, organic growth
How Change Capital Supports Business Repositioning

**Business Model Deficits:** Incurred en route to new business model, paid for with change capital

**Goal:** Generate surpluses for current capital needs, future change and resiliency
Defining Two Different Types of Money: Capital & Revenue

There are two flavors of funder money: Capital and Revenue.

They play different roles in an enterprise:
- Capital is for Change (adaptation, growth)
- Revenue funds Regular operations (routine)

Both Capital and Revenue are necessary for mission success.
Revenue and Capital Pay for Different Needs

Revenue (Buy Money)
- Funds to do what the organization already does
- Pays for day-to-day operating expenses and margin to contribute to other full costs (i.e. working capital, reserves, debt repayment)
- Recurring in nature

Capital (Build Money)
- Funds to change what the organization does
  - Growth (launch or scale a program, expand to new places)
  - Improving or launching a subsidy business
  - Buying/renovating space
  - Significant investment in IT, HR, fiscal, etc.
  - Retrenchment/downsizing/merger
- Episodic in nature
### Example: Revenue vs. Capital Transaction

<table>
<thead>
<tr>
<th>Role</th>
<th>Revenue</th>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>I’m supporting a program that seeks to improve high school graduation rates in the inner city.</strong></td>
<td><strong>I’m providing the funds you need to replicate your program in two more schools.</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Here’s $25,000. How many after-school sessions will that support next year?</strong></td>
<td><strong>Here’s $2 million. How long until your revenue is more sustainable?</strong></td>
<td></td>
</tr>
<tr>
<td><strong>Graduation rates were on target and I’d like to support the same program next year.</strong></td>
<td><strong>Congratulations! You don’t need my money again for a while.</strong></td>
<td></td>
</tr>
</tbody>
</table>
Change Capital is Temporary

Total Budget: Successful Launch

<table>
<thead>
<tr>
<th>Year</th>
<th>Ordinary Revenue</th>
<th>Change Capital</th>
<th>Regular Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
When Change Capital is Misused

Total Budget: Chronic Bailouts

2005 2006 2007 2008 2009

Ordinary Revenue
Build Capital

Change Capital
Regular Revenue
Calculating Full Cost Needs

Debt Principal Repayment: Loan agreement

Fixed Asset Additions: Vendor quotes

Working Capital: Cash flow projection

Reserves: System replacement plan Risk analysis Estimates Scenario planning

Change Capital: Multi-year projections of redesigned business model

Easiest to Calculate Most objective

Hardest to Calculate Least objective
Where We Go From Here: Adopting a Full Cost Mind-Set

Learning about full cost can be overwhelming or galvanizing

Be galvanized!

- Adopt a full cost mind-set by asking:
  - Which apply to my organization?
  - Which do I have covered?
  - Which are top priority?

- Full cost needs are:
  - Unique to each organization – context matters!
  - Change over time

While needs are specific, there are guiding principles for every full cost journey
### Principle #1: Three ‘Must Haves’ Apply to Every Organization

<table>
<thead>
<tr>
<th>Total Expenses</th>
<th>Working Capital</th>
<th>Reserves</th>
<th>Debt Principal Repayment</th>
<th>Fixed Asset Additions</th>
<th>Change Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating, non-operating, and unfunded expenses</td>
<td>Access to cash for day-to-day needs</td>
<td>Savings, a “rainy day” fund</td>
<td>Mortgage, line of credit, etc.</td>
<td>Money to purchase a new building, or computers</td>
<td>Resources to adapt, grow, and/or expand</td>
</tr>
</tbody>
</table>

‘Must haves’ for all organizations

Sometimes needed by some organizations
Principle #2: Balance Short-term Mission-Delivery & Long-term Needs

First Priority: Expenses

- Pays for year-to-year mission delivery
- Sector gets stuck discussing expenses:
  - Concerns about ‘overhead’ have limited ability to pay for necessary day-to-day expenses
  - Wages and benefits are unsustainably low
  - Unfunded and underfunded expenses undermine our effectiveness
Beyond expenses, full cost has a hierarchy of need:

- **Liquidity**
  - Does the organization have adequate cash to meet its month-to-month operating needs?

- **Adaptability**
  - Does the organization have flexible funds that allow for adjustments, growth, or change?

- **Durability**
  - Does the organization have access to funds to address a variety of future needs to deliver mission over the long-term?
How do Full Cost ‘Slices’ Meet Capitalization Needs?

- Change Capital
- Fixed Asset Additions
- Debt Principal Repayment
- Reserves
- Working Capital

Liquidity | Adaptability | Durability
---|---|---
Line of Credit, Board loan for cash flow | Software for impact measurement | Building
| | Facility Reserve, Investment Reserve

- Operating Reserve
- R&D Reserve
- Mortgage

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Solution: Show Balance Sheet Goals Below the Line to Communicate Plans

<table>
<thead>
<tr>
<th>Marine Center Budget (FYE 12/31, in 000s)</th>
<th>2017 Unrestricted</th>
<th>Temporarily Restricted</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Program Fees</td>
<td>$213</td>
<td></td>
</tr>
<tr>
<td>Foundation grants</td>
<td>175</td>
<td>450</td>
</tr>
<tr>
<td>Individual contributions</td>
<td>230</td>
<td></td>
</tr>
<tr>
<td>Released from restriction</td>
<td>150</td>
<td>(150)</td>
</tr>
<tr>
<td><strong>Total Revenue</strong></td>
<td>$768</td>
<td>$300</td>
</tr>
<tr>
<td><strong>Expenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Personnel</td>
<td>$504</td>
<td></td>
</tr>
<tr>
<td>Professional fees</td>
<td>91</td>
<td></td>
</tr>
<tr>
<td>Occupancy</td>
<td>74</td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>10</td>
<td></td>
</tr>
<tr>
<td>Supplies and other</td>
<td>40</td>
<td></td>
</tr>
<tr>
<td><strong>Total Expenses</strong></td>
<td>$719</td>
<td></td>
</tr>
<tr>
<td><strong>Operating Surplus/Deficit</strong></td>
<td>$49</td>
<td>$300</td>
</tr>
<tr>
<td><strong>Priority Balance Sheet Needs</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working Capital</td>
<td>$150</td>
<td></td>
</tr>
<tr>
<td>Fixed Asset Additions <em>(computers)</em></td>
<td>30</td>
<td></td>
</tr>
<tr>
<td><strong>Shortfall After Priority Balance Sheet Needs</strong></td>
<td>$(131)</td>
<td></td>
</tr>
</tbody>
</table>

Below the line: Communicate intentional use of surplus
Worksheet: Full Cost Planning

Annual surpluses will help you cover your organization’s full costs, but you may need one-time infusions of capital as well. Estimate each element of your organization’s full cost based on your current needs and plans for the future. Knowing it is unlikely that all full cost needs will be met with this year’s revenue and capital opportunities, think about how long you will need to finance your full costs.

<table>
<thead>
<tr>
<th>What are your full costs?</th>
<th>Total Balance Sheet Needs</th>
<th>Years to Accomplish</th>
<th>Amount Budgeted This Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Budgeted Expenses: What expenses are already reflected in your budget?</strong></td>
<td></td>
<td>Annually</td>
<td>$</td>
</tr>
<tr>
<td><strong>Unfunded Expenses: What additional day-to-day expenses do you need to operate in a fair and reasonable way?</strong></td>
<td></td>
<td>Annually</td>
<td>$</td>
</tr>
<tr>
<td><strong>Working Capital: Do you have the cash on hand needed to manage cash flow?</strong></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Reserves: What reserves do you need to build the organization’s adaptability or durability?</strong></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Debt Principal Repayment: If you have debt, how much needs to be repaid and when?</strong></td>
<td>$</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td><strong>Fixed Asset Additions: Are there fixed assets you plan to purchase? When?</strong></td>
<td>$</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Change Capital: Given the organization’s plans, do you need an infusion of capital?</strong></td>
<td>$</td>
<td></td>
<td>$</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>$</td>
<td></td>
<td>$</td>
</tr>
</tbody>
</table>

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Wrap-Up & Key Takeaways
Ways We Can Get It Right

Nonprofits
- Know and ask for full costs
- Ask for the right kind of money (build v. buy)
- Don’t try to make up in volume what you lose on each unit
- Use change capital wisely – not to keep unsustainable activity going
- Test plans through market experiments, not just analysis

Funders
- Create an environment for full cost conversations (even if you don’t fund full costs!)
- Fund full costs
- Remember we need both builders and buyers – know which one you are
- Don’t confuse general operating support for change capital
- Allow for flexibility
Thank you.

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