Top Indicators of Nonprofit Financial Health

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In a world where the last two years have produced 90% of all data ever created (so says IBM), there is something to be said for avoiding information overload. This is especially true for nonprofit organizations whose leaders must constantly balance money and mission, while marshaling ongoing evidence of social and financial performance. With limited finance staff and multiple sources of financial information, it's no wonder these leaders and their supporters often struggle to tell a clear, compelling financial story that makes sense of all the data.
How can nonprofit executives, funders, and advisors identify what matters most when examining finances? What are some trends and indicators that can guide us through an abundance of data and help assess true financial health?

Not all financial indicators are created equal. Below, I offer a short list based on NFF's years of experience lending to and advising nonprofits. You can find this data on historical-looking documents such as audited financial statements and Forms 990, as well as on forward-looking internal budgets and projections.

Strapped for time to do this number crunching yourself? (There are tools you can use, such as the Financial SCAN, a data platform developed by NFF and GuideStar, to help you do this analysis, and illustrate the trends in an organization's financial performance through user-friendly dashboards and graphs. It can also be used to see how one organization's financial metrics and ratios stack up against its peers.)

INCOME STATEMENT INDICATORS:

- **Revenue reliability.** Rather than overly focusing on the ratio of earned to contributed revenue, we suggest evaluating revenue reliability – an organization's track-record of bringing in recurring dollars, on an unrestricted operating basis, year after year. Reliable revenue doesn't always come from the same sources providing the same amounts of money. However, it suggests the ability to predict levels of income with a fair amount of certainty, based on historical performance and an understanding of market dynamics.

- **Consistent surpluses.** A healthy business model is one characterized by reliable revenue that covers operating expenses and contributes to surpluses – all in the service of mission. Nonprofit is a tax status, not a way of operating: Positive operating results (unrestricted revenue consistently exceeding expenses) are an indicator of strong financial management. Aiming for breakeven results doesn't allow for the breathing-room necessary for when things don't go according to plan. Nonetheless, since 2008 when NFF began measuring the percentage of nonprofits reporting a surplus for our annual State of the Sector Survey, this measure has never surpassed 40%.

- **Full cost coverage.** Nonprofit leaders are encouraged to set revenue targets high enough to cover not just their direct and indirect operating expenses but also the *full* costs of doing business. Though these additional costs aren't reflected in the income statement, surpluses can provide the additional dollars needed to address these demands over time. These "hidden costs" such as depreciation on fixed assets and reduction in debt principal reside on the balance sheet and must also be covered by surpluses. Ideally, surpluses should also contribute to savings, such as for a future rainy day or a strategic opportunity. Though covering the full costs of doing business every year is aspirational for most organizations, doing so ensures longer-term sustainability and vibrancy.

BALANCE SHEET INDICATORS:

- **Ability to manage debt**. Debt is a critical financial tool that can help organizations manage the ebbs and flows of cash for operations, facility purchases and upgrades, and more. But as liabilities bump up against an organization's ability to pay off those obligations, they can become a real problem. Measuring an organization's liabilities as a percent of total assets can show how much an organization owes relative to what it owns. As this percentage creeps up near the 50% mark, it can call into question the organization's ability to manage debt, which could jeopardize the delivery of programs and services.

- **Ability to steward facilities.** If an organization owns property and equipment, it has a responsibility to maintain and replace these assets over time. We look for reserves dedicated by the board of directors to facility improvements and replacements. Absent formal reserves, are there appropriate levels of liquidity to respond to issues such as replacing the hot water heater or complying with ADA regulations? Additionally, accumulated depreciation can be a helpful accounting proxy for evaluating the remaining "usable" life of these fixed assets, but keep in mind that the accounting value of an asset doesn't reflect its market value. An engineer can help identify the true future costs of fixed asset repairs and replacements.

- **Appropriate liquidity.** There are a number of ways to measure liquidity, the resources available to absorb risk and respond to new opportunities. NFF often measures liquidity in terms of the months of expenses that can be covered with available unrestricted cash (or access to it). This year's State of the Sector Survey results indicated that 56% of respondents expected to have three months of cash or fewer in 2013. As a general guideline, fewer than three months of cash is often perilously tight for nonprofits, though the "right" amount of liquidity depends on several elements, including an organization's strategic priorities, funding volatility, facility needs, and the general economic environment.

When conducting a financial analysis like this one, remember that numbers tell us a lot about an organization's finances, but they also have their limitations. At NFF we strongly believe that no analysis is complete without an understanding of the context behind the numbers. There is no "right" business model or balance sheet, other than the one that contributes to an organization's ability to manage the unexpected, adapt to changing circumstances, and pursue mission imperatives.

Still, these indicators are a useful starting point. If you work at a nonprofit, use them to focus your staff and board on the big picture story. If you are a nonprofit supporter, consider streamlining your financial due diligence using these themes as your guide. Examining these key indicators of financial health can help replace belief with fact – ensuring decisions are driven by data that will support mission execution today and for years to come.