



- Do we have these functions/elements in place?
- Where is the leverage? How do we leverage?
- How strong are they? How well do they function?
- Where is the challenge? How do we address it?

**The weakest link(s) is what we need to focus on.**

## Financial Warning Signs

Financial statements carry all kinds of warning signs if you know where to look and how to interpret them. Take the Audited Financial Statement, for example:

### The opinion letter:



The 1<sup>st</sup> sentence of the letter says anything other than “*We have audited...*”



If the auditor’s opinion (sentence in the 3<sup>rd</sup>, 4<sup>th</sup> paragraph) says something like “*except for...*” or “*it was not possible to...*”



If it says “*going concern*” toward the end of the letter



If the difference between the end of the FY and the date of the letter is more than 90 days



If the difference between the end of the FY and the date of the letter is more than 120 days

### The balance sheet:



Shows asset imbalance – e.g. if “cash” is more than 10% of the total annual revenue, it may not be the most efficient use of your excess cash; if 5% or less, it could mean the organization is cash-starved; if “account receivable” is the largest category, it means that the bills that were sent out haven’t yet been paid.

### The revenue and expense statement:



Shows deficits – if not much, don’t be alarmed, but find out the reason and act accordingly

### The footnotes of the financial statements:



Show related party transactions



Show high interest rates charged – banks do their own assessment and the high interest rate may mean they know something you need to know too



Lists lawsuits against the organization

### Other signs:



Insufficient cash reserves

Late or unfiled Form 990



## ***In the Zone***

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*If you aren't familiar with the term, the Zone of Insolvency, you should be. It could have an impact on your fiduciary responsibilities.*

Question 1: Do you serve on the board of a financially distressed nonprofit organization? One out of three nonprofits in the United States operates in perpetual financial distress. By some estimates, 7 percent is technically insolvent. If you are an active nonprofit board member, chances are you have served, or currently serve, a financially distressed organization.

Now, Question 2: Have you ever heard of the Zone of Insolvency? In 1991, a Delaware Chancery Court identified the zone and expanded the legal responsibilities of boards governing financially distressed organizations. Subsequently, numerous cases involving nonprofit corporations have charged boards with breaches of fiduciary responsibilities while governing organizations in the zone.

### **Defining the term**

The Zone of Insolvency is, most simply, a period of corporate financial distress during which reasonable people could at least foresee total insolvency as a possibility. Organizations in the zone typically experience symptoms that may include decreasing cash reserves, unfunded depreciation, deferred maintenance, increasing levels of debt, aging product lines, and general inability to invest in the future. When governing an organization in the zone, it is not enough for the board simply to protect the assets of the corporation. Its responsibility is legally expanded to protect all interests of all parties of the corporation and ensure that one party does not benefit while disadvantaging another party. Parties of the nonprofit corporation can include creditors, employees, retirees, customers served, donors, and other stakeholders. There are only three ways out of the zone: turnaround to financial strength, filing for dissolution, or arranging a merger. Each strategy has potential risks and rewards, and the board must proceed with caution and sound legal advice to avoid violating the rights of any party while in the zone.

There are several reasons why the nonprofit community has a disproportionately large percentage of organizations in the zone. Incredibly, during the past 20 years, the rate of incorporation for new nonprofit organizations has been double that of for-profit corporations. At the same time, disproportionately few nonprofit organizations file for dissolution, choosing instead to operate in financial distress. Some close the doors without ever formally filing for dissolution; others limp along in survival mode while putting the board, staff, and creditors at great risk. The reluctance to file may be the result of passion for mission, ability to raise funds to subsidize losses, or the legal complexities of filing for dissolution, which are more onerous for nonprofits than for-profits.

Unfortunately, there are no sirens alerting the board that its organization has crossed the line into the zone, and most board members never hear of the Zone of Insolvency until they are being sued for breach of fiduciary responsibility for decisions made during a period of financial distress. The closest thing to a siren may be a note in an audit, but audits are historical in nature and may be too little too late.

These examples shed light on how boards can stumble into the zone. In 2007, Women in Community Service filed for dissolution after wandering through the zone for several years as its government contracts waned, leaving the organization trapped with high fixed overhead and reduced revenue. In the mid-1990s, the Foundation for New Era Philanthropy went into bankruptcy after duping dozens of prominent organizations, including Harvard and Yale universities, the Philadelphia Orchestra, and Young Life out of hundreds of millions of dollars, having existed for fewer than 10 years as a corporate entity, all in the zone. And in 2002, the chief executive of the Allegheny Health, Education and Research Foundation went to jail after leading that organization through the zone into bankruptcy.

### **So what is the board of a financially distressed organization to do?**

First, articulate the problem. Move past wrestling with finances. With the help of your chief executive, chief financial officer, and financial experts, clearly define the scope and nature of the problem, and build board consensus around the definition. It might sound like this: "This organization crossed into the Zone of Insolvency this year. Our cash reserves are rapidly decreasing, and we are generating annual operating losses. We soon will not have the reserves to pay off our obligations if we file for dissolution. If we do not turn this around in six months, we will pass the point of no return."

Second, identify the root causes. The board must understand the true financial condition of the organization and should acquire any expertise necessary to ensure complete understanding. Be precise, and accept responsibility as appropriate: "Our market has changed, and government funding is no longer available. We are locked into high overhead expenses, but our revenue has dropped so far that we cannot afford the overhead. We should not have locked ourselves into long-term expense contracts when we had short-term revenue contracts."

Third, commit to moving out of financial distress. If you do not do so, your organization will likely continue to operate in perpetual financial distress. As a board, commit to a financial turnaround by a specific date, negotiate a merger, or file for dissolution. In this era of Sarbanes Oxley, the California Nonprofit Integrity Act of 2004, and the increased call for board accountability, there are no other options.

Building consensus of the board on these three steps – defining the problem, identifying the root cause, and committing to action – will help you avoid or escape from the Zone of Insolvency.

### **IS YOUR ORGANIZATION IN THE ZONE OF INSOLVENCY?**

Do any of the following statements apply to your organization? In general, the more "true" answers you select, the more likely it is that your organization is operating in the zone. This test may be helpful in confirming some of your concerns, but there is no simple test that can absolutely determine your status. An organization could be in the zone with just one of these statements selected or, due to unique factors, not even identified in this test.

- Our organization generated a net loss on operations last year.
- Our organization is likely to generate a net loss on operations this year.
- Our organization's cash reserve equals less than one-fourth of our annual operating expenses.
- Over the past three years, our annual gross revenue decreased.
- Over the past three years, our organization experienced a reduction in cash reserves.
- Our organization experienced cash flow problems in the past three years severe enough to disrupt timely payment of payables, taxes, payroll, or benefits contributions.
- Our organization has been forced to reduce staffing during the past three years due to finances.
- Our organization's facilities and/or equipment are in disrepair due to deferred maintenance.
- The level of aged receivables on our balance sheet increased over the past three years.
- Our debt load increased over the past three years.

### **References**

Source: [www.RonMattocks.com](http://www.RonMattocks.com)

Ron Mattocks, *Zone of Insolvency: What Nonprofits Need to Know to Avoid Hidden Liabilities and Build Financial Strength* (John Wiley & Sons April 2008).

BoardSource, "[The Nonprofit Survival Guide: Finding Your Way in the New Economy](#)" *Board Member Special Edition* (BoardSource 2003).

## ***Elevator Speech Development***

**What is an Elevator Speech?** - an overview of an idea for a product, service, project, or campaign. The name reflects the fact that an elevator pitch should be possible to deliver in the time span of an elevator ride, meaning in max 30 seconds and not more than 130 words. It intends to capture the interest of the listener to want to continue the conversation further. Developing an elevator pitch helps you polish on the key ideas and messages, paves the foundation for presenting a compelling case (in itself and/or as part of a face-to-face solicitation), and builds your readiness and confidence to do it.

### **Project and Target Audience**

ELEVATOR SPEECH SPECIFICS	YOUR ANSWERS
<b>Specify project:</b> (e.g.: service, organization, capital campaign, recruiting)	
<b>Specify your target audience:</b> (e.g.: parents, alumni, family, community leaders, personal/business contacts, and friends)	

**Speech** (tailor your speech based on the project and how well your target audience knows your organization)

QUESTIONS	YOUR ANSWERS
<b>Who are you? What needs do you serve?</b> (e.g., “We provide”, “We ensure” – think big)	
<b>How is your organization different? What is one thing you are best at?</b> (e.g. “the only organization to”; “We’re best at youth leadership development.”)	
<b>Who do you do it for and how do you do it?</b>	
<b>What is the challenge/opportunity the project addresses?</b>	
<b>What are the benefits to your clients/families/ community? What’s in it for the audience?</b> (e.g., include “so that the kids can,”)	
<b>Why is it important now?</b> (e.g., include “be able to use it this summer”)	

**Put it all together** (assemble the combined results here):

YOUR RESULTS

**You’re ready to test and tweak!**

## “X” Camp Retention/Revenue Projections

Age/Budget year	05-06	06-07	07-08	08-09	09-10	10-11
9	11	12	15	15	15	15
10	14	5	12	15	15	15
11	10	13	4	11	13	14
12	19	10	13	4	11	13
13	17	19	10	13	4	11
14	8	16	17	9	12	3
15	16	7	16	17	9	12
Total students	95	82	87	84	79	83

Apply financial information to these projections:

- full tuition
- scholarships
- incentives

	<b>06-07</b>	<b>2005-2006</b>	<b>New #</b>	<b>Leave #</b>	<b>Net/End of Year #</b>	
<b>age</b>		<b>Actual #</b>	12		12	<b>9</b>
<b>9</b>		11	1	-7	5	<b>10</b>
<b>10</b>		14		-1	13	<b>11</b>
<b>11</b>		10	1	-1	10	<b>12</b>
<b>12</b>		19	0		19	<b>13</b>
<b>13</b>		17	-1		16	<b>14</b>
<b>14</b>		8	-1		7	<b>15</b>
<b>15</b>		16				
		<b>95</b>	<b>12</b>	<b>-9</b>	<b>82</b>	
<b>07-08</b>		2006-2007	15		15	<b>9</b>
<b>9</b>		12	0	0	12	<b>10</b>
<b>10</b>		5	0	-1	4	<b>11</b>
<b>11</b>		13	0	0	13	<b>12</b>
<b>12</b>		10	0	0	10	<b>13</b>
<b>13</b>		19	0	-2	17	<b>14</b>
<b>14</b>		16	0	0	16	<b>15</b>
<b>15</b>		7				
		<b>82</b>	<b>15</b>	<b>-3</b>	<b>87</b>	
<b>08-09</b>		2007-2008	15		15	<b>9</b>
<b>9</b>		15	0	0	15	<b>10</b>
<b>10</b>		12	0	-1	11	<b>11</b>
<b>11</b>		4	0	0	4	<b>12</b>
<b>12</b>		13	0	0	13	<b>13</b>
<b>13</b>		10	0	-1	9	<b>14</b>
<b>14</b>		17	0	0	17	<b>15</b>
<b>15</b>		16				
		<b>87</b>	<b>15</b>	<b>-2</b>	<b>84</b>	
<b>09-10</b>		2008-2009	15		15	<b>9</b>
<b>9</b>		15	0	0	15	<b>10</b>
<b>10</b>		15	0	-2	13	<b>11</b>
<b>11</b>		11	0	0	11	<b>12</b>
<b>12</b>		4	0	0	4	<b>13</b>
<b>13</b>		13	0	-1	12	<b>14</b>
<b>14</b>		9	0	0	9	<b>15</b>
<b>15</b>		17				
		<b>84</b>	<b>15</b>	<b>-3</b>	<b>79</b>	
<b>10-11</b>		2009-2010	15		15	<b>9</b>
<b>9</b>		15	0	0	15	<b>10</b>
<b>10</b>		15	0	-1	14	<b>11</b>
<b>11</b>		13	0	0	13	<b>12</b>
<b>12</b>		11	0	0	11	<b>13</b>
<b>13</b>		4	0	-1	3	<b>14</b>
<b>14</b>		12	0	0	12	<b>15</b>
<b>15</b>		9				
		<b>79</b>	<b>15</b>	<b>-2</b>	<b>83</b>	

## Telling your Financial Story in a Recession: A Self-Assessment

Telling your financial story is critical to the success of any nonprofit. Today, more than ever, it's necessary to keep your stakeholders engaged and provide the strongest, most urgent case for your organization's impact and accomplishments. Review the following financial questions and use your answers to build the financial story you want to share with funders and supporters.

### Revenue

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#### **How might the reliability of your nonprofit's revenue streams be affected in an economic downturn?**

Will gov't contracts be affected by state /local budget cuts? How about foundation giving? What is your exposure to corporate philanthropy, particularly from the financial sector? Which major donors might be at risk? Can you rely on your Board to help with funding losses? Have you updated your fundraising message to include the strongest, most urgent case for your impact and success?

### Operating Results

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#### **How might changes in revenue streams affect operating results?**

Will the recession lead to increased demand for services and, if so, how will you respond? How will your organization deal with these potentially competing effects?

### Expenses

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#### **Will costs have to be cut? If so, which costs?**

Will staff, often the largest expense, need to be furloughed or let go? Have you considered collaboration as a cost-saving strategy? Will growth and capital campaign plans need to be phased or delayed?

### Health of a Balance Sheet

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#### **How might changes in operating results affect your organization's balance sheet?**

Will it be necessary to renegotiate terms of existing debt or take on debt to fund operations? Might you need to dip into board-designated reserves? If you have a facility, how will maintenance issues be addressed? What is your strategy for investments and how are they withstanding the current environment?

## Liquidity

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### **How will changes to the balance sheet affect your organization's liquidity?**

Will there be less cash on hand for operations? If so, what strategies might management implement to cope?

## Financial Planning

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### **Have you incorporated contingency plans into your budgets and/or reforecast?**

Does your organization consider best case, probable case and worst case scenarios? For example: If revenue declined by X%, what specific expenses would you cut or plans would you postpone? Do you project, track and monitor cash flow on a monthly basis? Can you articulate the economics of your programs? Is your Board regularly reviewing your financial condition and encouraging early action in response to the unfolding economic situation?

## Navigating the Financial Crisis

A broad economic crisis can magnify a nonprofit's pre-existing financial difficulties. The tips below are helpful for sound financial planning in all economic situations. However, in unstable times, they become even more vital. Getting through such crises requires communication, transparency, and planning rather than "fake it 'til we make it" behavior. In preparation for a possible recession, NFF recommends a two-part strategy: assess your nonprofits potential financial risks, then create a plan to respond to those risks.

### Assessing Risk

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#### How might the recession affect business?

Determine possible reductions, delays, or losses of particular revenue streams:

- Government contracts or grants.
- Foundation and corporate giving.
- Individual donations and special events.

Conduct program economics analysis:

- Know whether surpluses in some programs are subsidizing deficits in others.
- Assess which program affect overall financial health most and evaluate their mission impact.

- Consider whether demand for specific programs will increase or decrease in a recession.

Assess current levels of liquidity, using multiple measures:

- Months of expenses covered by cash.
- Working capital — current assets less current liabilities.
- Liquid net assets — not all unrestricted net assets are available for general operations.

Determine availability / use of any reserve funds for "rainy days."

Make sure cash deposits are insured or distributed among banks and investments are varied.

### Addressing Risk

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#### Plan a response to recession-related challenges.

Keep internal lines of communication open:

- Ensure that organizational decision-making processes are sufficiently agile.
- Clarify financial responsibilities of management and board.
- Assess board's ability and willingness to cover possible revenue shortfalls and/or tap into existing cash and investments.

Budget conservatively with best and worst case scenarios:

- Assume cash will arrive late and bills must be paid sooner than expected; plan accordingly.
- Plan your response to unanticipated or worse-than-expected revenue shortfalls.
- Ensure that cash flow projections are performed on a regular basis (monthly, weekly).

Stay in front of funders:

- Be candid about the impact of the economic climate and your specific strategy to adjust.
- Emphasize your commitment to mission and the urgency of need your programs address.

- Thank donors frequently, and make outreach personal.
- If your organization offers services that will lessen the negative impact of a recession, approach government funders more aggressively for support.

Diversify revenue with caution.

- Consider new revenue streams but be aware of risks related to new lines of business.

Reevaluate growth plans:

- Reconsider any plans for program expansion or development of new programs.
- Assess current programmatic priorities in light of program economics analysis.
- Communicate with board and staff about any possible cuts to program or personnel expenses.

Investigate options for renegotiating payables, debt, or leases.

Consider postponing large investments in infrastructure, including facility projects.

## Merger Myths

*6 reasons the package really is on the truck*

**A**s the interest in nonprofit mergers grows, so do the myths surrounding them. In the nonprofit sector, mergers carry the stigma of for-profit experiences. This is understandable, considering some of the legendary train wrecks of for-profit mergers.

Many people reject them on that basis alone. Decision-making gets skewed when myths dominate thinking instead of clear-eyed analysis. This is a good time to examine some of the more persistent ideas about mergers in the nonprofit sector.

The increase in mergers is a product of the economic downturn. Although it is logical to associate the increase in merger activity with the economic downturn, the fact is that many nonprofit resources are locked in outdated corporate structures and aging program models. While the downturn is making mergers seem like a logical choice, it is only a catalyzing agent for trends that were already under way.

**We'll save administrative costs.** The most persistent myth about nonprofit mergers is that they will save administrative costs. It is possible, but maybe not. Many well-meaning outsiders looking in on the nonprofit sector conclude that there are "too many nonprofits" and that there should be a lot of mergers to save money.

This myth mostly taps into everyone's shared distaste for spending more money on administrative costs than is absolutely necessary. There is no constituency for wasteful overhead spending, so it's a risk-free proposition.

Let's look at the economic realities of nonprofits and their mergers. The majority of nonprofit, public charities have revenue barely into six figures, and most rarely clear even \$2 million per year. Many pressures already keep administrative spending low, so trimming even a small slice of that amount is a nearly heroic accomplishment. Those entertaining a merger with the primary idea of achieving major administrative savings

will almost certainly be disappointed.

More important, any merger whose chief goal is to achieve, say, \$20,000 in administrative savings, is quickly going to seem like cruel and unusual punishment to those trying to make it happen. At some point they'll likely stop, look around, and ask each other "we're doing all this just to save \$20,000?" It's better to have a lofty strategic goal and be realistic about administrative savings.

It's more likely that any savings will show up as more bang for the same buck. Only when one of the entities is much larger than the other and has far more established and efficient administrative systems will there likely be significant administrative savings.

**There will be massive job cuts.** The second most pervasive myth about nonprofit mergers is that they lead to massive job losses. This one is largely a carryover from mergers in the for-profit sector and the simplistic media coverage they usually get. Investors generally like mergers but they dislike the dip in stock prices they can bring. CEOs need to produce a quick offset to the additional cost of the merger, and the fastest way to do that is to lay off staff.

The real heart of a merger is pretty unglamorous stuff, but the local television news reporter gets a ready-made, instantly understandable story, and that becomes the lead. Interestingly, it might be the announcement itself that they're counting on to reassure investors. One study tracked layoff announcements from *The Wall Street Journal* and calculated that if all of the announced job cuts had actually happened, the unemployment rate would have been 50 percent.

In the nonprofit sector, there is nothing comparable to investor pressure so there is no inherent pressure to cut jobs. There might be incidental job losses, but any major level of job loss that occurs during a nonprofit merger was probably going to happen anyway. In fact, a merger might actually reduce some of those losses if it promotes more efficient service delivery models.

**We'll lose our identity.** Of all the merger myths in this sector, this is one of the least well understood. For practical purposes, "identity" means "brand," and managing brands is one thing that the nonprofit sector is just beginning to master.

In the days when the prevailing nonprofit model was one-corporation-one-site-one-brand, this might have been a legitimate fear. But many nonprofits are learning that it is possible and sometimes even desirable to have multiple brands under the same roof. The decision to merge corporate structures is not the same thing as the decision to merge brands.

**Let's figure out the structure first.** Once the initial exploratory discussions are over, many board members and some CEOs want to jump right into a discussion about a desirable corporate structure. That's a big mistake.

Form should follow function. Decide what you want the merger to accomplish and be clear about your shared assessments and desires. Only then is it worth having a discussion about structure.

**Sbbbb. Don't tell anyone.** For-profit mergers are done in secrecy because they have to be. Large amounts of money are often made or lost on swings in stock prices, and there are laws and regulations governing what merger planners can say. Premature disclosures can sink a deal, and unauthorized outsiders (and insiders) are always willing to try to cash in on a tip.

Nonprofit mergers might well have to start out in secrecy for vaguely similar reasons. No nonprofit wants potentially damaging rumors to scare off donors or unnecessarily alarm government funders. And, the wrong kind of disclosure can create staff anxiety.

But if the best nonprofit mergers are decided from the top down, they must be implemented from the bottom up. Owning the company in a for-profit context confers "now-hear-this" authority. But in the non-

profit sector, authority is diffused and employee buy-in and good will are essential for implementation.

Nonprofits can often manage the message effectively to external stakeholders, such as donors and even the media. Without the lost-jobs theme, nonprofit mergers take on less urgency for most media outlets. Even today, when the mainstream media picks up on stories about nonprofit mergers, the treatment tends to paint nonprofits as a monolithic industry, with specific mergers used as illustrations of broad trends rather than as the story itself.

**Only failing organizations merge.** Ironically, this tends to be a self-fulfilling myth. If they do not clearly understand the implications of their financial condition, many struggling nonprofits tend to hold on longer than they should. By the time they are finally ready to consider the idea it could be too late to salvage the programs.

The result is that the first wave of mergers in a given area does tend to involve stronger organizations taking over weaker ones, so that becomes the prevailing imagery. But combining an organization with a lot of problems with another, healthier organization just produces a larger organization with a lot of problems to solve. The most constructive use of mergers is not to rescue organizations in trouble – which might be able to be done in other ways – but to strengthen community capacity by building nonprofit organizational strength.

Mergers are simply another leadership tool. Reflexive loyalty to unneeded corporate structures or to program models in need of innovation is not a virtue. It's time to lighten the baggage of mythology.

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