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When Best Practices Aren't Best

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Philip Rosenbloom

At NFF, one of the most difficult parts of monitoring and reporting on a nonprofit's finances can be the task of taking all the individual bits of information and gathering them into a coherent, transparent picture – a picture that gives leadership a clearer look at how their programmatic and administrative decisions will impact financial health.

Inevitably, the picture must incorporate two competing pressures nonprofit leaders face: an external pressure to comply with funding requirements and an internal need to pursue financial stability. For the former, external stakeholders insist on specific calculations and presentations of financial data. For example, a funder might require that expenses are allocated to conform to overhead allowances. Additionally, the IRS Form 990 requires revenue to be categorized in a particular way and charity ranking organizations generally evaluate nonprofit efficiency based on standardized sector ratios for program and administrative expenditures. We can describe this type of financial presentation as "**compliance-driven**" in that it focuses on an organization's ability to conform to externally-determined measures.

Being able to handle compliance reporting is essential because missing compliance targets puts the organization in danger of strained relationships with foundation funders, disallowances on government contracts, or the appearance of inefficiency.

However, we should also recognize an internally-motivated approach to an organization's finances, one we might call "**strategic**," as opposed to compliance-based. The primary difference here is that a strategic approach to finance is organized around internal goals developed in response to the organization's particular circumstances.For example, most nonprofit leaders know intuitively that developing annual fundraising targets must be accomplished in the context of other internal information, such as the size of the expense budget, the amount of earned revenue expected, and larger programmatic and financial priorities. A one-size-fits-all benchmark for the sector would clearly not work.

Compliance and strategy can coexist in a dynamic tension (in a recent Social Currency post, my colleague Craig Reigel, noted just such a case, when VolunteerMatch was pressured by an outside auditor to 'normalize' its fundraising efforts), but where we often run into trouble are the instances where nonprofit leaders attempt to impose a compliance framework on what should ideally be a strategic financial question. Oftentimes, managers look to external definitions of best practices for internal decision-making, using what I call a "compliance mind-set" to formulate their organization's benchmarks.

For example, NFF advocates that nonprofits monitor their balance sheets regularly in order to ensure that they have sufficient liquidity to weather the financial risks inherent in their business. In response, nonprofit leaders often ask us to provide a recommendation on how many months of cash to have on hand. While a common rule of thumb suggests that three months of cash represents adequate liquidity for a nonprofit, this guideline could fluctuate widely depending on the organizational context. Consider the following:

- If the majority of an organization's cash is program restricted, that cash may not provide the flexibility required for true operating liquidity.
- An organization will require a bigger cash cushion during a period of program growth.
- If the organization's annual business cycle includes several lean months in a row, three months of cash might not be sufficient.

A "sector standard" target for liquidity can leave nonprofit managers wondering why it's so hard to pay all the bills on time even though they're conforming to best practices. The reality is that nonprofit business models vary so substantially that financial benchmarks must be the result of internal analysis in order to be effective. The alternative is to spend valuable time and effort chasing often arbitrary metrics that may or may not promote financial sustainability for your organization. In extreme cases, adherence to inappropriate metrics can even prevent organizations from implementing appropriate changes to program structure or administrative capacity, effectively undermining their financial stability.

In short, the financial indicators should fit the organization, and nonprofit leaders must seek to develop the capacity not just for compliance-based monitoring and reporting, but for strategic financial analysis.

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Walrus • 3 years ago

Nicely said! Unfortunately, there seem to be very few people -- accountants included -- who really understand and appreciate the nuances of not-for-profit accounting. Even those of us who purport to be experts can get blind-sided when we rely on financial statements that have been prepared by auditors/accountants who clearly should not be in the not-for-profit sector. Thanks, Nonprofit Finance Fund -- And Mr. Rosenbloom -- for keeping a trained and professional focus on this critical area!

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Jennifer Dickinson • 3 years ago

Great post on an important distinction! One of the challenges I see in this area is that many small nonprofits lack a CFO or finance person who is able to interpret financial metrics and set strategic targets, hand in hand with the ED. There may be one (even part-time) bookkeeper, often focused on compliance. In those cases I would hope that the Board Treasurer becomes a partner on the strategic financial questions.

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