Building Stronger Nonprofits Through Better Financial Management

Lauren J. Kotloff with Nancy Burd

Early Efforts in 26 Youth-Serving Organizations

P/PV Public/Private Ventures
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P/PV is a national nonprofit whose mission is to improve the effectiveness of social programs, particularly those that aim to help young people from high-poverty communities successfully transition to adulthood. Working in close partnership with organizations and their leaders, P/PV aims to:

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The Wallace Foundation is a national philanthropy that supports and shares effective ideas and practices to expand learning and enrichment for disadvantaged children. The foundation maintains an online library of research reports and other publications at www.wallacefoundation.org. Included are lessons and information stemming from the foundation's current efforts in: strengthening school leadership to improve student achievement; creating more time for learning during the summer and school year; enhancing after-school opportunities; improving arts education; and developing audiences for the arts.

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Executive Summary

Nonprofit organizations are rarely judged solely by their financial bottom line; instead, their worth is gauged by the effectiveness of their services and how successfully they achieve their mission. Accordingly, recent efforts to improve the quality of out-of-school-time (OST) services have centered on various aspects of programming (e.g., applying "best practices," increasing professional development, tracking outcomes, etc.) and have largely ignored building the capacity of the organizations themselves. Yet, for most organizations, the ability to deliver effective services is dependent on sound management practices, of which financial management is an essential piece.[1]

Unfortunately, past research has shown that even high-performing nonprofit organizations have serious gaps and inefficiencies in their financial and other core management systems.[2] In an effort to maximize the resources that go to serving clients,[3] public and private funders have traditionally set very low limits on administrative, management and other "overhead" expenses not directly related to programming.[4] There is now widespread agreement among nonprofit leaders and those who study them that the percentage of funds from grants and contracts that can be used to cover overhead is, as a rule, unrealistically low.[5] In addition, nonprofits often find that managing their many grants and contracts and complying with the reporting requirements of various funders is enormously time consuming, especially for the sizable proportion of organizations that rely on government funds.[6]

This situation leaves nonprofit organizations vulnerable. Many lack cash reserves, making it difficult for them to build a safety net for periods of low revenues.[7] Organizations often struggle to manage their finances effectively—challenged by the basic, day-to-day demands of paying bills, submitting vouchers and responding to funder requests. In these situations, leadership is forced to focus on survival and crisis management, rather than long-term strategic planning and development or improving program quality.[8] Inadequate investment in core management systems, including financial management, has led to what one expert describes as a "continued and persistent hollowing out of organizational infrastructure" across the nonprofit sector.[9]

The Current Study

The Strengthening Financial Management in Out-of-School Time initiative (SFM) grew out of The Wallace Foundation's long-standing commitment to improving the quality of services for youth during nonschool hours and the realization that even successful nonprofits face financial management challenges that have an impact on their ability to achieve their missions. The four-year initiative seeks to improve the financial management systems of 26 well-respected OST-providing nonprofit organizations in Chicago. It is offering their key staff training and support, while also working to reform funder (both public and private) practices that strain OST organizations' financial management capacity. Participating organizations are receiving financial management training and peer-networking opportunities, using one of two models that vary in intensity and in the balance of individual vs. group-based training and support.

The following pages summarize a report by Public/Private Ventures (P/PV) that describes the financial management challenges of participating organizations at the start of SFM, as well as their progress to date. It also suggests early lessons for OST funders and nonprofit leaders that have emerged from SFM's first 12 to 18 months. A second report that focuses on the implementation, cost and effectiveness of the initiative will be published in 2014.

The current report is based on information from the following sources:

- ***Baseline and nine-month follow-up surveys*** of the CEO and lead financial officer (or equivalent) in each of the 26 participating organizations.
- ***Formal assessments*** of the financial management practices of each organization, conducted by Fiscal Management Associates (FMA), which provided financial management training and capacity building for the initiative.

- ***Interviews*** with the CEOs, lead financial officers and, in some cases, program managers of 12 SFM organizations.
- ***Interviews*** with FMA staff and reviews of FMA documents and annual reports.

Summary of Findings

From interviews with experts on nonprofit financial management, we identified three practices essential to a nonprofit organization's ability to be financially strong and effective:

1. Understanding the true costs of all programs to develop accurate, realistic budgets;
2. Monitoring the financial status of individual programs and the organization as a whole on an ongoing basis; and
3. Meeting expenses in a timely manner.

To implement these key practices, an organization needs:

1. Strong financial management resources, both human and material;
2. Procedures and methodologies to generate key indicators of its financial status, account for overhead costs and alert staff about available cash as well as shortfalls; and
3. Systems to effectively communicate financial information among financial and nonfinancial staff.

However, the SFM organizations faced significant challenges in each of these areas:

The organizations' finance offices were hindered by having too few staff to deal with too much work, staff with less-than-optimal analytical and strategic skills, and staff configurations that created inefficiencies and slowed work flow. The staffing of the SFM organizations' financial offices had not kept pace with their rapid growth and the increasing complexity of funding requirements. Generally, finance office staff were able to carry out tasks necessary for maintaining their organization's daily operations, but their strategic and oversight functions were performed in a very limited way. Lead financial officers had to devote too much of their time to basic operational tasks and contract/grants administration, leaving little opportunity for big-picture analysis and long-term planning. Many offices needed to broaden the expertise and skills of staff and reconfigure duties and lines of authority to perform the full spectrum of financial activities effectively.

The majority of the organizations either needed to update or better utilize their financial software so that they could reduce inefficiencies and generate more accurate and reliable financial information. While some organizations needed to upgrade to more sophisticated software because they had outgrown their existing program, the majority of the organizations had appropriate software but were not using it to its full capacity—most likely because staff lacked the training needed to do so. As a result, the organizations' ability to produce critical financial reports was limited.

The organizations needed better procedures to ensure that organization-wide and individual program budgets reflect true and full costs of operations. Budgets are critical for good fiscal management—but only to the extent that they are based on accurate information about the true cost of running an organization's programs and services. The budget for any single program must include a share of the overhead costs of the organization that runs and houses the program, as well as the "direct" costs associated with delivering the program's services. About a third of the SFM organizations (9 of the 26) needed to develop a more accurate and automated method for capturing and allocating overhead costs and incorporating them into program budgets.

Many of the organizations were struggling with financial monitoring and forecasting. Most SFM organizations (80 percent) were producing financial reports, referred to as "budget-to-actual" reports, that present the variance between the amount that has been budgeted and the amount actually spent at specific points in time. Reviewing these reports helps ensure that actual expenditures do not exceed what was planned. Unfortunately for the SFM organizations, these reports did not always help program staff make informed decisions about how to manage their budgets. One reason is that many organizations were not generating program-level budgets and thus could not create budget-to-actual reports for individual programs. In addition, program managers did not always have the skills needed to understand and act on the financial information they received.

Finally, cash flow projections were not being generated often enough or projected out far enough to help the organizations predict and plan for cash shortfalls. More frequent and extended projections are especially important in the current economic context, in which late state payments and low cash reserves often make it necessary for organizations to open lines of credit to meet their expenses.

Communicating financial information to program staff was a significant challenge. Budget development should be a team effort, based on input from staff from finance, programs, development and human resources.[10] Because they have direct knowledge of the resources needed to implement program activities, program managers are especially important members of the team. P/PV's data indicate that program staff were participating in developing annual budgets. However, program managers and finance staff were not routinely meeting to discuss any variances between a program's budgeted and actual costs, leaving program managers without the information they needed to carefully plan how to use discretionary funds to achieve the maximum impact for youth.

Responding to these challenges, the SFM organizations made encouraging progress during the first 12 to 18 months of training.

As a group, the 26 SFM organizations have responded enthusiastically to the SFM initiative and have made some promising early progress toward their goals. Lead financial officers' ratings of the skills of the financial office staff improved between the baseline and nine-month follow-up surveys. Data from these surveys also indicate that, on average, the organizations made modest gains in generating key financial reports more frequently, and were moving closer to the recommended benchmark of monthly reports. In particular, organizations' use of cash flow projection methods were on the rise. Finally, as a group, the program managers' ability to develop and/or understand budgets and financial reports improved over time.

Recommendations

Changes in the larger funding environment are needed to produce deep and sustained improvements in nonprofits' financial management capacity—and thus their ability to fulfill their organizational missions. Public and private funders should consider the following reforms:

Invest in nonprofits' core administrative infrastructure, especially financial management. Without sufficient funds to invest in software, training and technical assistance, and—perhaps most important—staff and managerial time, nonprofit organizations will not be able to improve their financial management practices at any kind of scale. In practical terms, this means funders should consider raising the level of overhead they allow in their grants and contracts, recognizing the importance of a strong organizational infrastructure for the delivery of quality services.

Reduce administrative and financial burdens that result from current funding practices. Meaningful change in this area cannot be accomplished by any single funder alone, but rather requires the collaboration of a significant proportion of public and private funders across a given sector.

Invest in financial-management capacity building. This study suggests that nonprofits are in need of and open to such assistance. Early SFM data indicate that peer learning opportunities (like its quarterly meetings for CEOs) may be particularly valuable. Funders should invest in these kinds of capacity-building efforts, including evaluations to document successful approaches.

Final Thoughts

The SFM organizations are some of the most well-established youth-serving organizations in Chicago, and yet they all are struggling to manage their finances effectively. If financial management problems are hampering their ability to achieve their missions, it is quite likely that weak financial management resources, communication systems and practices are hampering many other youth-serving organizations across the nation. And as a result, young people are not being served as well as they could be.

Improving the quality of OST programs—indeed of all social programs—can be achieved only if the leaders are not consumed with the very survival of their programs. Thus, efforts to improve program quality will need to be combined with efforts to strengthen organizations' financial management capacity.

In the current economic climate, it is more urgent than ever for organizations to adopt effective and strategic financial management practices. Findings from the start-up phase of the SFM initiative suggest that these organizations are very receptive to training designed to build their financial management capacity and are willing to devote staff time to carry out an ambitious change agenda. The ultimate success of these efforts, and what level of intervention will prove to be most cost effective, remains to be seen.

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Introduction

Chapter I

Like so many other not-for-profit organizations, for the first three decades of our existence, we operated more like a "mom and pop shop" than like a multimillion dollar business. Because of [our] (1) lack of sophistication with financial management, human resources management, facilities management and information technology, (2) historical unwillingness to "take money from programs to pay for administration," and (3) significant environmental changes in the accountability, sustainability and transparency for nonprofits, we face momentous financial management challenges. We are currently… putting systems in place that will help us more effectively and efficiently meet the needs of a 21st century medium-sized business. Contrary to past trends in nonprofit thinking, [we believe] improved financial practices will allow us to expand and improve our delivery system and…out-of-school-time (OST) programming.

—Excerpt from an application to the Strengthening Financial Management in Out-of-School Time initiative, submitted by a multiservice organization

Over the past two decades, the nonprofit sector has experienced unprecedented growth, particularly among organizations that deliver human services, including out-of-school-time (OST) programs.[1] These organizations are rarely judged solely by their financial bottom line; instead, their worth is gauged by the effectiveness of their services and how successfully they achieve their mission.

And yet finances do matter. For most organizations, the ability to deliver effective services is dependent not only on solid funding for those services, but also on sound management practices, of which financial management is an essential piece.[2] Indeed, as public demand for more effective, efficient and accountable services has increased, good financial management has become more important. Increasingly, nonprofit organizations are expected to make creative use of scarce resources and take fiscal realities into account as they make programmatic decisions.[3]

However, to date, most efforts to improve the finances of OST and other human services organizations have focused on helping them develop fundraising and sustainability strategies that can succeed in today's complex funding environment. Little attention has been paid to the equally important areas of financial accounting and management.

Similarly, recent efforts to improve the quality of OST services have centered on various aspects of programming—such as incorporating quality standards and "best practices," increasing professional development opportunities for staff, tracking and improving youth outcomes and establishing citywide systems to increase access—and have largely ignored building the capacity of the organizations themselves, including their financial management capacity. This was the conclusion, for example, of a recent study by Fiscal Management Associates (FMA) that found a number of gaps and inefficiencies in the financial and other core management systems of the 16 high-performing OST-providing organizations it assessed.

The Current Study

Believing that quality programs in the OST field are dependent on and can only be sustained by healthy OST-providing organizations, The Wallace Foundation launched the Strengthening Financial Management in Out-of-School Time initiative (SFM) in 2009. The four-year initiative seeks to improve the financial management systems of 26 OST-providing nonprofit organizations in Chicago. It is offering their key staff training and support, while also working to reform funder (both public and private) practices that strain OST organizations' financial management capacity.

This report is part of a larger study being conducted by Public/Private Ventures (P/PV) on the need for—and implementation, cost and effectiveness of—SFM.[5] Drawing from P/PV's interviews and surveys of participating organizations' staff, as well as early assessments conducted by the initiative's capacity-building provider, FMA, the report describes the financial management challenges of the organizations at the start of the initiative and suggests early lessons for OST funders and nonprofit leaders.

While the initiative and this report focus on OST-providing organizations, our findings will likely offer a window into the financial management strengths and challenges of others in the nonprofit sector. The issues we explore are in fact vitally important and worthy of additional research, as the sector increasingly recognizes that sound financial management provides the foundation for effective services.

Sources of Data

The report is based on information from the following sources:

- ***Surveys of all 26 organizations.*** P/PV surveyed the CEO and lead financial officer (or equivalent) in each of the 26 organizations participating in SFM. This report uses data from the ***baseline survey***, which was administered to each organization three months after it started the initiative, and a follow-up survey, which was administered six months later (that is, nine months after it started the initiative).
- ***FMA's formal assessments*** of the financial management practices of each organization, conducted during its first three months of participation in the initiative.
- ***Interviews*** with the CEOs, lead financial officers and, in some cases, program managers of 12 SFM organizations, conducted by P/PV over the phone or during site visits in November 2009 and November 2010.
- ***Interviews*** with FMA staff and ***reviews*** of FMA documents and annual reports.

Organization of the Report

Chapter II reviews existing research on the causes and consequences of weak core management, including financial management, within the nonprofit sector. Chapter III presents a brief overview of SFM and the participating organizations, including their financial status at the start of the initiative. Chapter IV explores the financial management challenges experienced by the SFM organizations. The report concludes with a chapter that draws on the findings about the organizations' financial management capacity at the start of the initiative and the early progress of SFM to generate recommendations for funders and nonprofit leaders about how they can best support this important core capacity.

Background: How Funding Practices Have Weakened Nonprofits' Administrative and Management Capacity

Chapter II

To understand the factors that contribute to weak financial management in the nonprofit sector, it is important to consider how nonprofit organizations are generally funded and the effects of funding practices on their organizational capacity. Most of the literature on this topic focuses on the effects of funding practices on organizations' internal management capacity as a whole, which includes financial management as well as other core functions, such as fundraising and facilities management. What is clear from the literature and the experience of many nonprofits is that certain common funding practices make it exceedingly difficult to invest in the type of organizational infrastructure needed to support and sustain quality programming.

Limited Funding for "Overhead" Expenses

The true costs to an organization for delivering programs and services are not limited to the costs of the materials, equipment and staff salaries directly associated with each particular program. There are also operating expenses associated with running the organization itself, frequently referred to as "overhead" costs. These include management and administrative expenses, costs associated with raising money for the organization (e.g., development staff salaries), human resources, information technology (computers, software and staff time), office furniture, heat, phones, rent and the maintenance of the facility. Typically, when funders award a grant or contract for a particular program, they specify the amount of the money that must go directly to the program and the amount that can be applied to the organization's overhead expenses.

Overhead costs have been chronically underfunded by the public and private funders of nonprofit organizations. There is widespread agreement among nonprofit leaders and those who study these funding practices that the percentage of funds from grants and contracts that can be used to cover overhead expenses is, as a rule, unrealistically low.[6] Recent studies have cited several interrelated reasons for this. For example, there is a long-standing conviction among funders, charity group watchdogs and nonprofit organizations themselves that overhead costs should be kept as low as possible so that more resources can go to providing services to clients.[7] In this view, funding is seen as a "zero-sum game" in which support for the organization's operating costs is provided at the expense of serving people.[8] As a result, funders have traditionally set very low limits on expenses not directly related to programming.[9]

The desire to keep overhead costs low can lead organizations to under-report these costs, to conform to the expectations of their funders. Bedsworth et al. describe a vicious cycle in which funders consistently underestimate the costs incurred in running a nonprofit organization, which in turn puts pressure on nonprofits to under-report their overhead costs or risk alienating their funders.[10] Of course, this only reinforces funders' inaccurate ideas about overhead costs, leading them to continue setting unrealistically low levels of allowable expenses.

There is also evidence that some nonprofit organizations do not ask for sufficient funds for overhead expenses because they lack the expertise and technical capacity to determine these costs. This was one finding of a recent P/PV study of the costs of OST programs: Many of the nonprofits being considered for participation in the study lacked the basic financial management systems, technology and knowledge to generate accurate information about the true costs of their programs.[11]

Most studies examining funding for nonprofit administration and management have focused primarily on government grants and contracts, which are a major source of income for human services–providing organizations. For example, in a survey of 33,000 nonprofits conducted by the Urban Institute, about 60 percent reported the limit for overhead costs set by their government contracts was 10 percent or less of overall operating expenses.[12] This is in stark contrast to the estimated 17 to 35 percent of overhead expenses that may be necessary to support a strong administrative and management infrastructure.[13] It goes without saying, therefore, that for organizations relying heavily on government contracts, the gap between reimbursement and the actual costs of operation is especially large. In keeping with this picture, another Urban Institute study found that the organizations with the weakest infrastructures were those receiving 50 percent or more of their funds from public sources.[14]

To compensate for the limits put on nonprogram costs from their grants and contracts, organizations have to try to raise additional funds to cover their overhead expenses. But, because of the priority that funders give to supporting programs and services, it is generally extremely difficult for nonprofits to find funders willing to provide this kind of core support.[15]

Burdensome Administrative and Reporting Requirements

In addition to the pressure created by tight limits on overhead, nonprofits often find that managing their many grants and contracts and complying with the reporting requirements of various funders present an enormous challenge. This is especially true for the sizable proportion of organizations that rely on government funds, which typically have rigorous and time-consuming documentation and reporting requirements.[16] As a group, human services–providing nonprofit organizations have an average of six government grants and contracts at any given time; large organizations (those with annual budgets of $1 million or more) have nine, on average.[17] Reporting requirements often differ from funder to funder and even contract to contract, and they are often inconsistent (e.g., different budget categories and definitions of allowable expenses) and/or redundant (requiring organizations to provide the same data for multiple reports).

Beyond the burden of regular reporting requirements, there are other funding demands that can require significant time of managers and organizational leadership, often straining already under-resourced financial systems.[18] Audits, for example, are required by some government grants, and organizations with multiple government grants may have to prepare more than one audit. This is particularly burdensome because an audit can involve months of staff time and managerial attention to prepare. And because of the audits' importance to the organization, preparation is often monitored by the organization's senior executives.[19] Furthermore, time spent on grant compliance necessarily takes away from time available to focus on other organizational priorities, such as quality improvement, program development and long-term planning.

The Consequences for Nonprofits

The limits that funders traditionally place on reimbursing programs for overhead expenses have had the following negative consequences for nonprofits' financial soundness and organizational effectiveness.

Financial vulnerability. Low levels of overhead funding leave nonprofits financially vulnerable. Many lack cash reserves, making it difficult for them to build a financial safety net for periods of low revenues, or to deal with unexpected expenses without having to rely on credit. While cash reserves covering at least three months of standard operating expenses are recommended,[20] studies have found that the majority of nonprofits do not meet this benchmark. For example, a study of 2,000 nonprofits in Washington, DC, found that 57 percent had reserves that would cover less than three months, and almost 30 percent of those organizations had no operating reserves at all.[21]

At the same time, many funders have moved to a fee-for-service structure, in which nonprofit organizations must submit invoices to be paid for services they have delivered. This means organizations must have reserves of cash already on hand to meet payroll and other expenses associated with these services. Given the low cash reserves typical in the field, this situation creates difficulty for many nonprofits, especially when reimbursements are late, which happens frequently with financially strapped state and city governments. If payments are late and cash reserves are low, organizations may experience serious cash shortages that make it difficult to meet basic financial obligations.[22]

Weakened capacity to support quality programming. Another consequence of low levels of overhead funding is that many nonprofits have little money to invest in core management and administration, compromising their ability to function effectively.[23] Inadequate investment in core management systems has led to what one expert describes as a "continued and persistent hollowing out of organizational infrastructure" across the nonprofit sector.[24]

What this means in practice is that activities that are crucial for effective programs—such as staff development and the assessment and improvement of program quality—often are not implemented or implemented well. Many organizations don't have the “luxury” to spend time collecting and analyzing outcomes data, gathering qualitative feedback from participants or thoughtfully discussing the needs of individual participants or the organization more broadly. Without a significant financial investment—in terms of technology as well as staff and managerial time—such activities are difficult or impossible to carry out.

P/PV’s study of the cost of OST programs provides some direct evidence of the link between organizational capacity and program quality. The study found that the highest-quality programs serving elementary and middle school students spent proportionally more on staffing than did lower-quality programs; notably, the difference was not the result of higher average staff salaries, but rather of more paid staff hours spent on non–direct service activities, such as meetings, training, administrative time and supervision, as well as more staff time spent with children.[25]

Weak administration and management typically extends to the financial management office. When that office is under-resourced, it severely limits an organization’s ability to have a clear picture of its finances or to identify which of its programs are financially sound and which are not. These organizations often struggle to manage their finances effectively—challenged by the basic, day-to-day demands of paying bills, submitting vouchers and responding to funder requests. In these situations, an organization’s leadership is forced to focus on survival and crisis management, rather than long-term strategic planning and development or improving program quality.[26] In this way, limited resources beget limited resources, with organizations struggling just to stay afloat. This is the situation that so many nonprofits find themselves caught in—and that SFM was designed to address.

SFM and Participating Organizations

Chapter III

The Strengthening Financial Management in Out-of-School Time initiative grew out of The Wallace Foundation's long-standing commitment to improving the quality of services for youth during nonschool hours and the realization that even successful nonprofits face financial management challenges that hinder their ability to achieve their missions. The initiative was founded on the belief that, if these OST-providing organizations adopt more effective financial management strategies, and if public and private funders improve their policies and practices, these organizations will be better able to deliver high-quality services to children.

The four-year initiative, which began in Summer 2009, seeks to strengthen OST-providing nonprofit organizations in Chicago through two strategies:

1. Building the financial management capacity of a select group of organizations by funding investments in their financial management infrastructure and providing them with two years of individual and group financial management training and consulting.
2. Funding the Donors Forum, a group of public and private funders, government leaders and nonprofit providers, to design and implement strategies to reform funding practices that create burdens for nonprofits (see box).

Twenty-six Chicago-area OST-providing organizations were selected to participate in the initiative. They represent a wide range in terms of size (i.e., budget size, staff size and number of youth served annually) and service structure (with organizations that offer multiple services to both youth and families, as well as organizations that serve only youth). Two are affiliates of national youth-serving organizations; the remainder are local to the Chicago area.

To learn about the effectiveness of different financial management capacity-building approaches, the initiative is testing two models that vary in intensity and in the balance of individual vs. group-based training and support.[27] (A graphic depicting the initiative's theory of change is presented in Appendix A.)

The Goals of the Donors Forum

With funds from The Wallace Foundation, the Donors Forum will convene funders, city and state leaders, and the CEOs and lead financial officers of OST organizations to identify and implement mutually beneficial changes and efficiencies in funding policies and practices. Specifically, the Forum will:

- Conduct an environmental scan to identify contracting/funding policies and practices of government agencies (City of Chicago and State of Illinois) that impede system effectiveness and explore reasons for these policies;
- Develop principles to guide decisions and solutions for system improvements;
- Recommend streamlining proposal, reporting and payment policies and practices to create more efficient contract management; and
- Identify and implement strategies to build momentum for reforms that support more efficient management of OST-providing nonprofit organizations (e.g., increased overhead funding, simplified reporting).

At the outset, SFM organizations were assigned to one of the two models:

The Intensive Model. Over the first two years, the 14 organizations participating in the Intensive Model receive individualized assistance and capacity-building support from FMA that includes:

- An initial in-depth assessment of the organization's financial management systems, including financial planning and monitoring, software utilization and staffing configuration, and the creation of a work plan for implementing needed changes;
- Intensive on-site management assistance, coaching and training provided to executive staff to support implementation of the work plan; and
- Quarterly peer learning and networking meetings for CEOs.

The organizations receive quarterly follow-up support for an additional two years and continued quarterly CEO peer learning and networking meetings.

The Institute Model. The 12 organizations participating in the Institute Model receive the following services from FMA over the initial two-year period:

- An individualized self-assessment of the extent to which the organization implements financial management best practices (in areas such as financial planning and monitoring, software utilization and staffing configuration), as well as suggestions for improvement;
- Eight daylong quarterly group training sessions (the "Institute") that focus on financial management training and professional development of executive staff; and
- Individual one-hour consultations with executive staff following each Institute session.

FMA provides four semiannual group sessions over an additional two-year period.

By measuring the changes in financial management practices within the organizations participating in each training model, the evaluation will generate valuable lessons about how to improve the financial management of nonprofits in a cost-effective manner and, more generally, how best to deliver effective long-lasting training and technical assistance (of any kind) to leaders of different types of OST organizations.

The Economic Context for SFM

When SFM started in the summer of 2009, the nation was in the first year of a deep and protracted economic recession—the worst since the Great Depression. The recession caused the steepest decline in state tax revenues on record, producing serious budget gaps in fiscal years 2009 and 2010 in all but a handful of states.[28]

The State of Illinois was especially hard hit, ranking among the states with the largest budget deficits.[29] In an attempt to reduce its budget shortfall, the state cut funding for human services, threatening the fiscal stability of the state's nonprofit community, including its OST organizations. Some 90 percent of the state's nonprofit human services organizations have state contracts or grants.[30] The state's financial woes and the resultant funding uncertainty organizations face are likely to continue for several more years, creating a tumultuous backdrop for SFM.

Funding cuts are not the only problem with which Illinois' nonprofit community has had to contend. The state has a long history of being late in paying its vendors,[31] and since 2009, it has fallen seriously behind in paying nonprofits for contracted services. That year, the rate of late payments to human services nonprofits in Illinois was the worst in the nation, with 72 percent of nonprofits reporting delays in state payments (compared with a national average of 41 percent). Payments to Illinois nonprofits are routinely more than 90 days overdue.[32]

Because, as noted in Chapter II, most nonprofit organizations operate with very little cash reserves, Illinois' late payments have created severe cash shortages for many. The organizations that rely on state funding have tried to deal with the crisis through severe cost-cutting measures, such as staff furloughs and discontinuing contributions to employee pension plans.[33]

The nonprofit sector, which was already struggling with financial management issues, has been rocked by the recession. The economic downturn was not anticipated by the developers of SFM, and the initiative was not specifically designed to help organizations weather such harsh economic times. The course of the initiative and the progress participating organizations make toward strengthening their financial management will undoubtedly be affected by these economic conditions. We will revisit this issue in our final report.

The SFM Organizations

The Wallace Foundation wanted to select organizations for SFM that are considered by Chicago's OST leaders and funders to be among the city's best OST providers, in terms of the quality of their services and their reach in the community. An earlier Wallace-funded study of the management practices of high-performing OST-providing organizations discovered that these organizations suffered as a result of many ineffectual financial management

Table 1.
Features of the 26 SFM Organizations

Organizational Feature	Number or Range
Multiservice organization[a]	13 organizations
Youth-only organization[a]	13 organizations
Annual budget (range)[b]	$822,300–$35,700,000
Size of full-time financial staff (range)[c]	1–11 full-time staff

Sources: [a]SFM organizations' initial proposals to The Wallace Foundation; [b]FMA document; [c]CEO baseline survey.

Table 2.
Organizational Transitions Experienced by 26 SFM Organizations in the 6 Months Prior to Starting SFM

Organizational Transition	Percentage of Organizations
Program expansion	38%
Organizational restructuring	25%
Leadership change	27%
Staff reductions	50%
Facilities expansion	27%

Source: CEO baseline survey.

practices that severely hampered their abilities to serve youth most effectively.[34] Given that this was the case for high-performing organizations, it is likely to be even more true for organizations with greater capacity-building needs. Learning how financial management practices can be improved will help not only other strong organizations but also less established ones, and ultimately the youth served by the organizations.

The foundation sent requests for proposals to approximately 55 OST-providing nonprofits in Chicago that met the following criteria:

- Funded by the Chicago Department of Children and Youth Services, which the foundation had a long history of partnering with;
- Recognized by the city and leaders in the field for the high quality of their OST programming; and
- Provided OST services to at least 100 youth per year.

The 41 organizations that ultimately responded underwent an extensive assessment by staff from the foundation and FMA, which included evaluations of the organizations' financial health, their leadership's commitment to participate in the initiative, their readiness to address gaps in financial management, staff qualifications, board engagement and program quality. The final group of 26 organizations represented the strongest applicants, with the highest scores in the areas assessed.

The foundation also chose organizations whose features—such as size, service structure (i.e., multiservice vs. youth only) and funding structure—are representative of the variation within the OST field.[35] The features of the 26 SFM organizations are summarized in Table 1.

Background information about the organizations from P/PV's baseline survey shows that many had undergone significant transitions in the six months prior to joining the initiative (see Table 2). Of particular importance is the finding that half of the organizations had experienced recent staff reductions, most likely the result of the cuts in state funding that began in 2008. In fact, of the programs reporting staff reductions, 38 percent reported program expansion as well—a particularly difficult situation to be in.

Table 3.
Baseline Views About the Administrative Burden of Public and Private Funding Practices

How strongly do you agree or disagree with each of the following statements?	Public Funding (mean)	Private Funding (mean)
Complying with the unique proposal formats for each RFP is labor intensive and costly.	7.90	5.94
Complying with the unique definitions of the same thing across funders and contracts (such as the definition of "overhead") is labor intensive and costly.	7.54	5.44
The unique reporting requirements, formats and schedules of various grants/contracts make reporting labor intensive and costly.	7.96	6.04
Lack of a unified reporting system across government agencies creates the need to report the same or similar data to multiple agencies in multiple formats and systems.	8.12	6.15

Scale: 1–9, where 1=Strongly Disagree and 9=Strongly Agree

Source: CEO and lead financial officer surveys. Each survey included identical questions about funding practices. A single score on each item for each of the 26 organizations was created by calculating the average of the CEO and lead financial officer ratings for that item.

Challenges Meeting Funding Requirements

The majority of the organizations in the study reported receiving more than half of their funds from government sources. The multiservice organizations in the sample tended to receive a larger proportion of their funding from government sources than youth-serving organizations received, which is true of the sector as a whole.[36] As discussed in the previous chapter, organizations that receive the bulk of their funding from government sources face numerous and complex management and administrative demands.

As Table 3 shows, baseline surveys completed by the SFM organizations' CEOs and lead financial officers revealed strong feelings about the cost and time required to comply with the unique definitions, formats, reporting requirements and schedules of their various grants and contracts.

Financial Status of the Organizations When They Began the Initiative

Although SFM is not designed to directly improve the finances of the participating organizations (that is, training and support are not focused on developing more successful revenue-generating strategies), the expectation is that if the organizations adopt better financial management practices, their financial health will ultimately improve. To get a picture of the financial soundness of the organizations when they entered the initiative, we examined four indicators of financial health, as generally accepted in the financial industry. The definition and significance of each indicator are presented in the box on the next page.[37]

Four Indicators of Financial Health

Indicator	Importance
Absence of recurring annual deficits	Ending a single year with a deficit may be insignificant. However, recurring annual deficits make it impossible for organizations to build cash reserves that allow them to weather economic downturns more easily, take advantage of opportunities and mitigate financial risks. Recurring deficits can eat into an organization's net worth and will have a significant impact on its ability to function.
Cash reserves	Having a sufficient number of months of operating expenses in cash reserves indicates that an organization can weather an unexpected interruption of business or a sudden change in funding streams and still cover its current obligations, such as salaries, rent, vendors, etc. Three months of cash reserves is considered the minimum that organizations should have.
Quick ratio of liquid assets (e.g., cash) to current liabilities	The quick ratio is the ratio of current assets to current liabilities and indicates whether an organization has sufficient liquid assets to meet its short-term operating needs. A quick ratio of 1.5:1 means that the organization has liquid assets at least 50 percent greater than its liabilities.
Concentration of government funds	Government grants and contracts often require extensive reporting obligations, requiring sophisticated mechanisms and staff time to link expenditures with the funding source. Thus, the greater the proportion of an organization's expenses that are supported by government funds, the greater the costs to the organization of providing these services. Yet these costs may not be fully covered through government funds. Further, these funds are often not paid until well after expenses are incurred and require reserves or lines of credit.

Table 4 on the next page presents information about where the organizations stood on each indicator.

Surplus/deficit trends. Twenty-eight percent of the organizations had no deficits in 2006, 2007 or 2008, and only 8 percent (two organizations) had deficits all three years. However, the economic crisis that began in 2008 had an impact on many of the SFM organizations, especially those that rely heavily on government grants: By the end of that year, more than half of the 26 organizations had experienced deficits.

Months of cash. All but one organization had only slightly more than one month in cash reserves, which made them vulnerable to cash shortages in the event of unexpected expenses. This was especially troubling for the organizations relying on state funds, because of the increasingly late payments they have been forced to contend with.

Quick ratio. Approximately 35 percent of the organizations had quick ratios that were *below* the preferred target range of 1.5:1, meaning they had less than the recommended amount of liquid assets available to pay off current liabilities and still have a cushion of liquid assets.

Concentration of government funds. As discussed previously, having a high concentration of government funding can create problems for an organization. In addition to extensive reporting obligations that require complex accounting mechanisms, there can be financial risks associated with government grants and contracts. These funds are often not paid until well after expenses are incurred, necessitating the organization to maintain additional cash reserves or secure lines of credit. In this context, the fact that more than half of the SFM organizations rely on government grants and contracts for the bulk of their revenues yet have very small cash reserves is particularly concerning.

Table 4.
Percentage of SFM Organizations With Financial Health Indicators, 2006–2008

Financial Benchmark	Percentage of Organizations
No deficits in any year	28%
Deficits in two of the three years	20%
Deficits in all years	8%
Deficits in 2008	56%
Three months or more of cash reserves	4% (one organization)
Quick ratio: liquid assets equal to or greater than 1.5:1	65%
50 percent or more of revenues from government grants	70%

Source: FMA documents.

Thus, to summarize, while the 26 organizations participating in SFM were considered strong, well-established nonprofits, they all were in somewhat vulnerable financial positions as the initiative began. This financial vulnerability meant that the high-quality services provided by these organizations were also vulnerable—for example, line staff could not be certain there would be funds for their positions, and program leaders could not know with certainty how much money they would have in the future to most efficiently plan for program improvements. As we discuss in the next chapter, to varying degrees, all the organizations had gaps in their financial management infrastructures, which drained organizational resources; made informed, strategic decision-making difficult; and weakened their capacity to deliver the highest-quality services.

Financial Management Challenges

Chapter IV

Strong financial management practices are rarely part of an organization's mission statement and yet they are integral to its ability to achieve that mission in a sustainable way. Thus, while investments in improving the financial management of a youth-serving organization may not evoke the same emotion as investing in services that touch the life of a child directly, they are just as deserving of support—because organizations with strong financial management capacity will be better able to carry out their missions.

This chapter first presents information about essential practices for strong financial management. Using these practices as a framework for organizing our findings, we then explore the financial challenges that the SFM organizations were experiencing at the time they began the initiative. We describe the state of their financial management resources and procedures, as well as communication systems that affect their ability to develop accurate budgets, monitor their financial status and manage their cash flow needs.

Essential Practices for Strong Financial Management

From interviews with experts on nonprofit financial management, we identified three practices essential to a nonprofit organization's ability to be financially strong and effective:

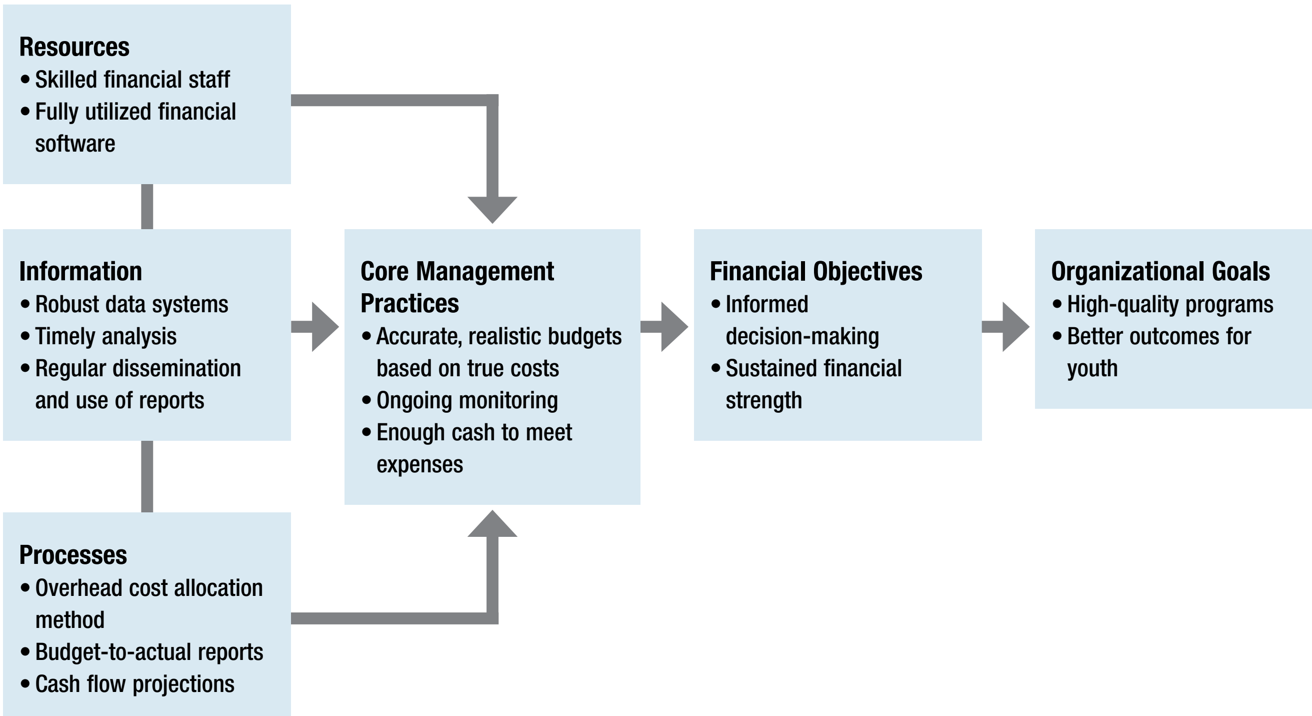
- First, the organization needs to **understand the true costs** of its programs to develop accurate, realistic budgets. This means that it must calculate both those costs directly linked to the delivery of program services (such as equipment and program staff salaries) *and* the overhead costs of running the organization itself.
- Second, an organization needs to **monitor the financial status** of individual programs and the organization as a whole on an ongoing basis. Because the world is not static, organizations need to compare actual expenses against original projections to identify problem areas (such as programs that are overspending or underspending), make decisions about how best to use existing resources and decide whether to raise additional money or make cuts in services to bring expenses in line with revenues.
- Finally, the organization needs to meet its expenses in a timely manner. While an organization may not have control over when money comes in, it can **project and manage its cash flow needs** to ensure that it has the liquid assets necessary to meet expenses such as payroll, facilities maintenance, debt payments, rent and emergencies.

All three practices are critical to the survival of the organization. Underestimating the true costs of programs erodes the organization's financial resources. If leaders know the true cost of operating but do not monitor the rate at which these costs are being incurred, the organization may end up underspending or overspending and having to make drastic changes once the discrepancy is realized. And finally, if the organization monitors expenses but does not manage cash flow, the organization may not be able to meet its financial obligations and could end up going out of business.

An organization's capacity to implement these key practices relies on three things:

- First, the organization needs strong financial management **resources**. These include human resources (an efficient finance department whose members possess the skills needed to conduct daily financial operations as well as long-term financial planning) and material resources (primarily financial software sophisticated enough to meet the organization's multiple budgeting, monitoring and reporting needs).
- Second, the organization needs to put into place (and, to the extent possible, automate) **procedures and methodologies** to generate summary indicators of the financial status of the organization and its component parts, account for overhead costs in a rational fashion and alert executives and staff about available cash and cash shortfalls.
- Third, systems must be in place to effectively **communicate financial information** among financial and nonfinancial staff. That is, there must be systems for gathering financial data in a timely manner and for disseminating accurate,

Figure 1.
Components of an Effective Financial Management Structure



Source: Public/Private Ventures, forthcoming 2012 interim evaluation of the Strengthening Financial Management initiative.

up-to-date financial reports and reviewing them with the individuals who are in the best positions to act on the information.

Figure 1 above presents a graphic representation of the components of an effective financial management structure.

Challenges With Financial Management Resources

The Finance Office. The tasks that finance offices in nonprofit organizations perform can be put into two main categories: operational and strategic (see box on the next page).

The operational functions of the finance office, such as paying bills, processing payroll and producing reports for funders, are essential for keeping the organization going on a day-to-day basis. The strategic functions include long-term planning; forecasting and analyses of the organization's operating, investing and financing needs; and oversight of the organization's key business activities.[38] To be successful in this role, the lead financial staff person must have time away from day-to-day financial operations so that he or she can see the larger picture of the organization's current financial status and develop strategies to ensure its future financial health.

FMA's assessments and P/PV's interviews and surveys both indicate that the organizations' finance offices were hindered by having too few staff to deal with too much work, staff with less-than-optimal analytical and strategic skills, and staff configurations that created inefficiencies and slowed work flow. The result was that the finance offices could carry out tasks necessary for maintaining the daily operations of their organization and complying with requests from their funders, but the strategic and oversight functions of the finance office were either not being carried out or were performed in a very limited way. This is reflected in the organizations' baseline surveys, in which lead financial officers were asked to rate their

What Does a Finance Office Do?

	Purpose	Examples of Tasks
Operational Function	Conduct day-to-day financial processes; manage grants and contracts; perform basic accounting tasks.	Invoice for contracts; pay bills; follow up on accounts receivable; prepare bank deposits; process payroll; prepare monthly reports to funders.
Strategic Function	Conduct financial planning and financial oversight for the organization; oversee and direct the finance department activities. Provide financial information to support organizational decision-making and long-term strategic planning.	Guide accounting activities; analyze and submit financial reports to the board and executive director; lead the annual budgeting process; monitor financial activities; and conduct a periodic analysis of actual expenditures to the budget.

Adapted from: Jeanne Bell Peters and Elizabeth Schaffer. 2005. *Financial Leadership for Nonprofit Executives: Guiding Your Organization to Long-Term Success.* Minneapolis: Fieldstone Alliance.

finance office staff on a range of skills encompassing the various responsibilities of the office. Table 5 on the next page shows that, in general, more analytic and forecasting skills (in blue) received lower ratings than skills connected with basic operational function tasks (in white).

For half of the organizations we visited, the staffing of the finance office had not kept pace with the organization's growth. During one site visit, for example, staff reported that their organization's overall budget had more than doubled over the two years prior to SFM (from $1 million to $2.5 million). Although these grants had resulted in the hiring of at least 13 new staff members, making payroll and other financial management functions more time-consuming and complex, the size of the organization's finance office had remained the same.

The finance offices in three other organizations we visited were led by individuals whose skills were limited to basic bookkeeping. The CEO in a fourth organization felt that her organization's infrastructure did not support recent growth. She needed a financial leader who was able to strategize, forecast, conduct long-term planning and "understand what the organization needed and how to use financial management systems…. Five to ten years ago, this structure was okay…, but now we need more highly skilled people."

FMA's assessments of the 14 organizations participating in the Intensive Model included a close look at the configuration of their finance offices. The assessments found that 12 of the 14 organizations needed to reconfigure their staffing to eliminate inefficiencies, improve work flow and free the lead financial officers from being too immersed in day-to-day operations. FMA found that roughly half of the organizations needed additional manager- or director-level positions in the finance office to, for example, oversee the grant and contracts monitoring activity.

Because of poorly configured finance offices, the lead financial officers were typically too busy to engage in long-term planning and oversight activities. The chain of command in one large financial office was such that everyone reported directly to the lead financial officer, leaving her little time for long-term planning and oversight activities, "because I'm always responding to calls from staff for assistance." The comments of another lead financial officer starkly illustrate how poorly configured finance offices can lead to a reactive, crisis-driven mode of operating and a frazzled lead financial officer: "We have gotten out of the planning mode and [the mind-set of] committing to have certain things done at certain times. I have been operating with a 'whatever is happening at the moment' mentality, so what needs to happen now is what gets done. The rest gets pushed off and put on a list of things to do later."

Table 5.
Lead Financial Officer Ratings of 26 SFM Organizations' Finance Office Staff

Finance Office Staff Skills	Mean	Minimum	Maximum
Managing accounts payable	7.2	3	9
Monitoring contracts	6.5	2	9
Managing accounts receivable	6.4	2	9
Developing budgets	6.3	2	9
Producing financial reports	6.1	2	9
Timely production of audit schedules and year-end reports	6.0	1	9
Understanding financial software	5.9	2	9
Forecasting cash needs	5.9	2	9
Conducting financial analysis	5.8	2	9
Strategic financial planning	4.9	1	8

Scale: 1–9, where 1=Not Strong at All and 9=Very Strong

Source: Lead financial officer baseline survey.

Financial Software. Having—and utilizing—the appropriate financial software is a crucial financial management resource. Once the correct data are entered, the software can generate budgets at the organization, contract, department and program level. It can generate reports that are essential for financial monitoring and forecasting. Lack of software capacity affects the efficiency of the finance office overall.

On P/PV's baseline survey, SFM CEOs rated their financial software fairly highly (6.7 on a 9-point scale). However, other data suggest that the CEOs may have overestimated their pre-intervention software capacity. In its initial assessments of the organizations, FMA found that all but 3 of the 26 organizations needed to make changes in their financial software to reduce inefficiencies and generate more accurate projections and reports. In a follow-up interview with P/PV to discuss this finding, FMA staff reported that, while some organizations needed to upgrade to more sophisticated software because they had outgrown their existing program, the majority of the organizations had appropriate software but were not using it to its full capacity, most likely because staff lacked the necessary training.

Inappropriate or underutilized software created serious inefficiencies. For one thing, it meant that finance staff were doing tasks manually that could have been done automatically through their software. This was the case in 6 of the 12 organizations we visited. For example, in one large multiservice organization that had 40 government contracts, the lead financial officer reported spending an inordinate amount of time filling out about 20 different vouchers each month.[39] Although his office had upgraded to a sophisticated financial software package, the software was not configured to generate the needed information, and he had to prepare the vouchers manually. He explained, "There is a huge amount of data entry that needs to be done on a monthly basis—it is a real time-consumer."

Such problems were not limited to the larger organizations that had many government contracts. FMA reported that the smallest organization—with virtually no public funding—was manually classifying expenses, which could have been done using software if it were configured properly.

Without the proper software, organizations' ability to produce critical financial reports is limited. Two organizations we visited reported not being able to generate budget-to-actual reports (defined later) from their software, which, as we discuss in the next section, is critical to ensuring that programs do not underspend or overspend.

Challenges With Financial Management Processes

Strong financial management resources alone will not ensure that an organization can know, monitor and meet its true costs. The organization must also have processes in place that allow it to develop accurate budgets at the program level and organization-wide, compare budgeted costs to actual expenses at regular intervals, and predict and plan for periods when money coming into the organization is expected to be low relative to its expenses.

Accounting for Overhead Costs. Broadly speaking, a budget is "an organization's operating plan stated in dollar terms." It is critical for good fiscal management, allowing an organization to effectively allocate resources and monitor their use, and to share its plans and expectations with staff as well as external partners and stakeholders.[40]

To be useful, however, budgets must be based on accurate information about the true cost of operating. The cost of any single program includes not only the "direct" costs associated with delivering the program's services, such as art materials, sports equipment and instructors' salaries, but also a share of the indirect—or overhead—costs of the organization that runs and houses the program. These include expenses incurred by the development, finance and central administrative offices, as well as rent, facilities maintenance, information technology, phone, heat, etc.

Calculating the direct costs of a program or service is fairly straightforward; however, it is much more complex to determine how to allocate to individual programs the overhead costs of the larger organization. For example, how should the cost of raising funds for the program, monitoring the grants and contracts that support it, and heating the space where it takes place be accounted for? The complexity of this task was captured in one organization's proposal to The Wallace Foundation for acceptance into SFM:

> *We need to be able to distinguish direct from [overhead] costs and program from administrative and fundraising costs. Further complicating this is the fact that some grants do not cover administrative costs, some cap the amount of administrative costs they will cover, and some cover all administrative costs.*

However complicated it is, accounting for overhead costs in the budgeting process is essential to the long-term financial health of an organization. Organizations that do not know the true costs of their programs can find themselves breaking even on direct costs, but still running organizational deficits each year, because they have not taken overhead costs into account in their budgets and thus do not raise the funds needed to cover these costs.

In its initial assessments, FMA found that about a third of the organizations (9 of the 26) needed to develop a more accurate and automated method for capturing and allocating overhead costs and incorporating them into program budgets. Ideally, the organization's financial software should be configured to generate these costs, but many of the SFM organizations were not optimizing their financial software and were doing cost allocations manually—which was both time consuming and prone to inaccuracies.

It is not surprising, then, that organizations seemed uncertain about how to determine the proportion of overhead costs that should be incorporated into program budgets, as was expressed by the lead financial officer of one of the SFM organizations: "When we apply for a grant, are we pricing [the program] correctly? How much does it really cost us to run a program? We have a pretty good idea, but I would like us to be more accurate."

Financial Monitoring at the Program Level. Once a budget has been developed and approved, it has to be carefully monitored to make sure that actual expenditures do not exceed what was planned. If this occurs, decisions need to be made as to whether to seek additional funds or cut back on services. Underspending can create as many problems for an organization as overspending, especially with government grants and contracts, where funds not spent by the end of the grant period may be lost and/or the grant may be renewed at a lower rate.

The financial report that is used for monitoring budgets is referred to as a "budget-to-actual" report. This report presents the variance between the amount that has been budgeted for the service or program and the amount actually spent at specific points in time. Data from P/PV's baseline survey indicate that most SFM organizations (80 percent) were producing budget-to-actual reports frequently enough (i.e., monthly, as recommended by experts) and distributing them at least quarterly to program managers. However, our interview data suggest that these financial reports did not always help program staff make informed decisions about how best to manage their budgets. One reason for this was that many organizations were not generating program-level budgets and thus could not create the budget-to-actual reports for individual programs that would be most useful to staff.

Projecting Cash Flow. To have enough available cash to pay their expenses, organizations need a way to predict and plan for temporary cash shortfalls. Using information about the schedule of cash inflow and cash outflow over the course of the year to make "cash flow projections" allows financial staff to predict and plan for times when they might need to tap into their cash reserves or access a line of credit to meet expenses.[41] Because organizations must be able to meet expenses, projecting, monitoring and managing cash flow are critical for sustainability.[42]

Unfortunately, data from P/PV's survey indicate that the majority of SFM organizations lacked a good method for projecting cash flow. Roughly two thirds of the organizations did not update cash flow projections frequently enough (i.e., monthly). Of the eight organizations that did, seven reported how far out they projected, and none projected further than 23 days, far short of the six-month recommended benchmark. According to one lead financial officer, the chronically late payments from the state for contracted services made cash flow projections difficult. Commenting on the feasibility of making six-month projections, she remarked, "It's probably a really good practice to have, and I plan to get to the six-month projections, but it feels like a lot of guessing [because] I don't know if the state will give me money in a particular month. So, I can do the projection, but I am not sure how helpful it will be going out this far [six months]. And when I project that we need to take money from our line of credit for a month, but then ultimately don't need to [because the state money came through], that scares the board unnecessarily."

Challenges Communicating Financial Information

To effectively pursue its financial management objectives, a finance office and the rest of the organization must be in constant communication. The finance office must obtain accurate and timely financial information from department managers. It must then relay useful summaries of this information back to the managers and the organization's leadership on a regular basis so they can responsibly manage their work with the funds available.

For example, development and finance offices have to communicate about whether outstanding proposals have been awarded and what funds still need to be raised to cover costs; program managers need to alert finance staff if the program assumptions on which their budgets were based are faulty. For their part, nonfinance staff must have enough knowledge to understand and make use of the reports that the finance office provides them.

Budget development should be guided by the overarching goals of the organization and its component services, and based on input from staff from programs, development and human resources.[43] This team-based approach to budgeting yields more accurate information about the funds that will be needed to implement engaging and effective programs. Because they have direct knowledge of the resources needed to implement program activities, program managers are especially important members of the team.

P/PV's baseline survey of SFM organizations indicates that program staff, as well as staff across key departments, were participating in developing annual budgets (see Table 6 on the next page). However, our data indicate that, at the start of the initiative, program managers were not playing a regular role in monitoring the budget they helped develop. One reason for this was that their lack of familiarity with budgets and financial reports made it difficult for them to interpret these reports. In response to P/PV's survey questions, CEOs and lead financial officers gave relatively low ratings of their program managers' financial skills (see Table 7 on the next page).

Finally, FMA found that meetings between finance staff and program managers to discuss any variances or make adjustments to the budget or the program were not routinely occurring.

Summary

At the start of SFM, participating organizations faced a number of serious financial management challenges. The staffing of their finance offices and software capacity had not kept pace with their growth and the increasing complexity of funding requirements. Hampered by too few staff overall, as well as staff who lacked necessary skills, and mired in day-to-day tasks, finance offices generally were not carrying out important strategic functions. Lead financial officers had to devote much of their time to basic operational tasks and contract/grants management, leaving little opportunity for big-picture analysis and long-term planning.

Many of the organizations were struggling to put in place data-gathering, cost allocation and reporting systems that would result in more accurate and timely budgets, monitoring and financial forecasting. Many were not using key financial reports (such as budget-to-actual reports at the program level or cash flow projections), an omission that could have serious implications for program quality. Close communication between program managers and finance staff about any variances between a program's budgeted and actual costs were not routinely occurring, leaving program managers without the information they needed to carefully plan how to use discretionary funds to achieve the maximum impact for youth. Without these reports, and the thoughtful analysis and decision-making they support, programs are not in a position to make informed decisions about how best to use scarce resources.

Perhaps because the organizations faced significant financial management challenges, they have responded enthusiastically to SFM. The next chapter details some promising early gains made by the organizations as they work to strengthen their financial management practices and capacity.

Table 6.
Staff Involved in Budget Development at Baseline

Who was involved in developing the last annual budget?	Percentage of Organizations
Executive director/CEO	92%
Lead financial officer	85%
Development director	81%
Program and operations directors	73%
Finance committee of the board	69%

Source: CEO baseline survey.

Table 7.
Mean Ratings of Financial Management Skills of Program Managers in the 26 SFM Organizations

Program Managers' Skills	Mean	Minimum	Maximum
Developing realistic budgets	4.46	2.5	7
Understanding financial reports	4.35	2	7
Understanding budgets	4.85	2	7

Scale: 1–9, where 1=Not Strong at All and 9=Very Strong

Source: CEO and lead financial officer baseline surveys. A single score on each item for each of the organizations was created by calculating the average of the CEO and lead financial officer ratings for that item.

Early Progress and Lessons

Chapter V

Our final evaluation of the training and support that organizations received as part of SFM will not be complete until 2014. However, preliminary findings of progress made during the first 12 to 18 months of training are encouraging. As a group, the CEOs' and lead financial officers' initial response to SFM has been very positive, as measured by their ratings of the initial assessment and work plan development phase, their participation in group meetings and their early progress toward their SFM goals.

Early Response to the Initiative

The CEOs and lead financial officers we interviewed enthusiastically embraced SFM and were glad that a major foundation was committing funds and resources to help them build their financial management capacity—an area that funders have historically neglected. Some CEOs we talked with, especially those who had recently navigated their organizations through financial difficulties, saw the initiative as an opportunity to acquire the skills and tools that would help them avoid financial crises in the future. Others saw the training as a chance to learn how to make changes that they had been wanting to make but had not had the funds or the know-how to accomplish on their own.

As mentioned earlier, one important component of SFM's Intensive Model is a quarterly peer-learning meeting for CEOs. Facilitated by FMA, the meetings are organized around specific financial management issues. They are intended to encourage CEOs to network with each other and discuss and seek solutions to common challenges. These sessions have been well received and attended and appear to be generating the anticipated benefits for participants. All or nearly all of the 13 CEOs who attended at least one peer meeting agreed or strongly agreed that the meetings addressed highly relevant issues, created an environment of mutual support and provided opportunities for them to network, get ideas and discuss the current funding environment with their peers. Because of the success of these sessions, FMA began holding similar meetings for the lead financial officers in all 26 organizations.[44]

Interviews and surveys of the CEOs and lead financial officers conducted 12 to 18 months into the initiative show that, in response to the SFM training, the organizations had made a number of important changes that strengthened their financial management resources, improved their systems for communicating financial information and implemented better core management processes.

Improvements in Financial Management Resources

One of the key steps to strengthening an organization's financial management infrastructure is ensuring that the individuals who work in the finance department are appropriately skilled. To track how staff members' skills will be changing over time, lead financial officers will be asked periodically throughout the evaluation to rate the skill levels of their staffs. Table 8 on the next page shows how these assessments changed over the first nine months of the initiative. Mean assessments on the follow-up survey were compared with mean scores on identical items from the baseline survey.

As seen in Table 8, the mean ratings of all but one financial management skill improved from baseline to nine-month follow-up. In all but one skill (managing accounts receivable), the improvements were statistically significant, meaning that they are quite unlikely to have occurred by chance. Interestingly, however, while the financial staffs' analytic and forecasting skills were seen to have improved, they were still rated lower, on average, than skills connected with basic operational functions. This suggests that additional experience and/or training may be needed before staff can be equally proficient in basic and higher-order financial management skills.

Improvements in Core Financial Management Processes

Data from the lead financial officer surveys indicate that, on average, the organizations made slight gains in generating key financial reports more frequently and were moving closer to the benchmark of monthly reports.

Table 8.
Changes in Mean Ratings of Financial Management Skills of Finance Staff in the 26 SFM Organizations

Finance Staff Skills	Baseline	Nine-Month Follow-Up	Change
Conducting strategic financial planning	4.83	5.83	1.00**
Developing budgets	6.26	7.13	.87*
Producing financial reports	5.96	7.12	1.16**
Conducting financial analysis	5.74	6.70	.96**
Managing accounts payable	7.13	7.57	.43+
Managing accounts receivable	6.25	6.50	.25
Working/communicating with nonfinance staff	6.08	6.75	.67*
Forecasting cash needs	5.83	6.43	.61*
Monitoring contracts	6.43	6.96	.52+
Timely production of audit schedules and year-end reports	5.96	6.91	.96*
Understanding financial software	5.84	6.44	.60*

Scale: 1–9, where 1=Not Strong at All and 9=Very Strong

Source: Baseline and nine-month follow-up surveys of lead financial officers in the 26 SFM organizations.

Note: The differences between baseline and follow-up scores were statistically significant on all measures except managing accounts receivable: + $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Of particular note is the change in the use of cash flow projections. Organizations made projections more frequently, and only 8 percent of organizations reported not doing cash flow projections at all (down from 20 percent at baseline). In one dramatic story, the CEO from an organization that was beset by late payments from the state used the cash flow projection tool that FMA had distributed in training to calculate how long her organization could meet expenses if the state continued to delay its payments. When she saw that her organization would run out of cash in a matter of months, she used this information to petition the state and was placed in a special program that was distributing emergency funding to organizations most in need.

Improvements in the Communication of Financial Information

There were indications from survey and interview data that program managers' understanding of and participation in budget development and monitoring had improved. For example, Table 9 on the next page shows that ratings of the ability of program managers in the 26 organizations to develop and/or understand budgets and financial reports improved over time, on average.

In addition, program managers interviewed in five of the Intensive Model organizations reported greater involvement in developing and monitoring their budgets, which was an explicit part of the training they had received.

Emerging Lessons

Providing high-quality services to youth over the long run can occur only if the youth-serving organization is on firm financial ground and covering all its costs. Programs can be dramatically improved only if the leadership has time to think strategically and make decisions based on accurate information on what these changes would cost. Thus, financial management was chosen as the focus of the Wallace capacity-building initiative, to strengthen the

Table 9.
Changes in Mean Ratings of Financial Management Skills of Program Managers in the 26 SFM Organizations

Program Manager Skills	Baseline	Nine-Month Follow-Up	Change
Developing realistic budgets	4.46	5.38	.92***
Understanding financial reports	4.35	5.15	.81**
Understanding budgets	4.85	5.73	.88 **

Scale: 1–9, where 1=Not Strong at All and 9=Very Strong

Source: Baseline and nine-month follow-up surveys of CEOs and lead financial officers. A single score on each item for each of the 26 organizations was created by calculating the average of the CEO and lead financial officer ratings for that item.

Note: ** $p < 0.01$, *** $p < 0.001$

organizations' long-term ability to support quality programs for youth.

The challenges the SFM organizations experienced in knowing, managing and forecasting their financial situations are likely representative of financial management challenges faced by other OST organizations—and may even yield insight about the nonprofit sector as a whole. Effectively overcoming these challenges is vital to improving the quality of services that OST and other nonprofits provide and will require the concerted effort of public and private funders, as well as program staff and leadership.

Overall, we found that the finance offices of the SFM organizations struggled to keep up with the increased demands that had resulted from their growth and, for those that relied on government funding, with increasingly complex grants management and reporting requirements. When they began participating in SFM, these organizations had a variety of financial management resources, systems and practices that were in need of improvement.

- ***Staffing the finance office.*** Many offices needed to improve and broaden their level of expertise and skills to perform the complete spectrum of financial activities fully and effectively. Financial analysis and forecasting were skill areas that needed particular attention. In addition, reconfiguring the division of duties and lines of authority within the finance offices was needed to improve work flow efficiency and enable the lead financial officers to spend more time on long-term planning.
- ***Using financial software.*** The majority of the organizations needed to update and more fully utilize their financial software so that they could automate many essential financial management functions and generate accurate and reliable financial information.
- ***Developing realistic budgets.*** As a group, the organizations needed to put systems and practices in place to ensure that organization-wide and, perhaps more important, individual program budgets reflect true and full costs of operations. This required developing a more inclusive budgeting process based on input from staff across the departments responsible for fundraising, staffing and managing programs. Equally critical was the need to improve the way overhead costs are captured and allocated into the budgets of individual programs.
- ***Communicating important financial information with key stakeholders.*** Many SFM organizations did not widely share financial information with program and other staff across the organization. For example, program-level budget-to-actual reports were often not being shared and discussed with program managers. When they were, program managers could not readily interpret them. Providing training to program managers on how to read financial information was needed to allow

them to better monitor their program budgets. Over time, such knowledge will also enable them to make more informed decisions about when and how to spend their discretionary funds (on such activities as field trips, speakers or cultural events—an example of financial management challenges directly affecting programming).

- ***Forecasting cash flow needs.*** At the start of the initiative, cash flow projections, which help ensure that organizations will have the cash to meet their expenses, were not being generated often enough or projected out far enough to help the organizations predict and plan for cash shortfalls. More frequent and extended projections are especially important in the current economic context, in which late state payments and low cash reserves often make it necessary for the organizations to plan ahead to open lines of credit to meet expenses.

While there are early indications of progress in many of these areas, a stark reality remains: However strong and efficient the financial management of these *individual organizations* becomes as a result of SFM, changes in the larger funding environment are needed to produce deep and sustained improvements in the capacity of nonprofits to fulfill their organizational missions. Public and private funders should consider the following reforms:

- ***Invest in nonprofits' core administrative infrastructure,*** especially financial management. The challenges experienced by SFM organizations at the start of the initiative were, in part, the result of changes in the nonprofit funding climate (i.e., increased expectations for accountability) simply outpacing the growth of organizations' financial management capacity. But they are also symptomatic of a larger "hollowing out" of administrative infrastructure that has occurred across the nonprofit sector. Without sufficient funds to invest in software, training and technical assistance, and—perhaps most important—staff and managerial time, nonprofit organizations will not be able to improve their financial management practices at any kind of scale. In practical terms, this means funders should consider raising the level of overhead they allow in their grants and contracts, recognizing the importance of a strong organizational infrastructure for the delivery of quality services.

- ***Reduce administrative and financial burdens*** that result from current funding practices. The organizations participating in SFM reported spending significant time complying with the requirements of their funders—including widely differing definitions, formats and reporting schedules. This work is particularly complicated and time consuming for organizations with multiple public contracts. Meaningful change in this area cannot be accomplished by any single funder alone, but rather requires the collaboration of a significant proportion of public and private funders across a given sector. Representing a major step forward, the Donors Forum (with a grant from The Wallace Foundation) is working to streamline granting, payment and reporting practices in Illinois to foster more efficient management of nonprofit organizations. P/PV's final report on SFM will document lessons learned from that effort.

- ***Invest in financial management capacity building.*** This study finds that nonprofits are in need of and open to such assistance. Early data from SFM indicate that peer learning opportunities (like its quarterly meetings for CEOs) may be particularly valuable. P/PV's final report will compare the cost effectiveness of the two SFM models in improving the financial planning, budgeting, monitoring and reporting systems of OST-providing nonprofits. This information will undoubtedly be useful in guiding future efforts, but much more research is needed to understand the capacity-building strategies that are most effective for different types of organizations. Funders should invest in these kinds of capacity-building efforts, including evaluations that can document successful approaches.

Final Thoughts

The nonprofit organizations participating in SFM are some of the most well-established youth-serving organizations in Chicago, and yet they all are struggling to manage their finances effectively. If financial management problems are hampering the ability of these high-performing organizations to meet their mission of improving the lives of youth, it is quite likely that weak financial management resources, communication systems and practices are hampering all youth-serving organizations in Chicago and indeed across the nation. And as a result, young people are not being served as well as they could be.

As OST programs have become a core experience in the lives of more and more youth, program leaders and public and private funders have engaged in intensive efforts to improve quality and impact. The push to improve the quality of OST programs—indeed of all social programs—can be achieved only if service providers are not consumed with the very survival of their programs. Thus, efforts to improve program quality will need to be combined with efforts to strengthen organizations' financial management capacity.

In the current economic climate, the very existence of many nonprofits is threatened by deep budget cuts and late payments from funders. Under such conditions, it is more urgent than ever for organizations to adopt effective and strategic financial management practices. Findings from the start-up phase of SFM suggest that these organizations are very receptive to training designed to build their financial management capacity and are willing to devote staff time (CEO, lead financial officer, program managers) to carry out an ambitious change agenda. In the first year of the initiative, the majority of the organizations have remained deeply committed to the work and have begun to improve their financial management systems. The ultimate success of these efforts, and what level of intervention will prove to be most cost effective, remains to be seen.

Endnotes

1. United States Government Accountability Office. 2007. "Nonprofit Sector: Increasing Numbers and Key Role in Delivering Federal Services." Washington, DC: United States Government Accountability Office.

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5. A final report will be published in early 2014.

6. Urban Institute Center on Nonprofits and Philanthropy. August 2004. "Getting What We Pay For: Low Overhead Limits Nonprofit Effectiveness." Nonprofit Overhead Cost Project: Facts and Perspectives, Brief No. 3. Washington, DC: Urban Institute Center on Nonprofits and Philanthropy; Gregory, Ann Goggins and Don Howard. Fall 2009. "The Nonprofit Starvation Cycle." *Stanford Social Innovation Review.* Stanford, CA: Stanford Graduate School of Business.

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11. Grossman, Jean Baldwin, Christianne Lind, Cheryl Hayes, Jennifer McMaken and Andrew Gersick. 2009. *The Cost of Quality Out-of-School-Time Programs.* Philadelphia: Public/Private Ventures.

12. Boris, Elizabeth T., Erwin de Leon, Katie L. Roeger and Milena Nikolova. 2010. *Human Service Nonprofits and Government Collaboration: Findings From the 2010 National Survey of Nonprofit Government Contracting and Grants.* Washington, DC: Urban Institute Center on Nonprofits and Philanthropy.

13. There is little published information about actual rates of overhead expenses in the nonprofit sector, in part because definitions of what constitutes "overhead" expenses vary and many organizations lack the accounting systems necessary to generate accurate rates. A study of four nonprofits conducted by Bedsworth and Howard found that while the organizations reported overhead rates of 13 to 22 percent, their actual overhead rates ranged from 17 to 35 percent. A study by the Urban Institute that reviewed the IRS Form 990 of 44,000 nonprofit human services organizations found average overhead expenses to be about 16 percent (Pollak, Thomas H., Patrick Rooney and Mark A. Hager. 2001. "Understanding Management and General Expenses in Nonprofits." Overhead Cost Study Working Paper presented at the 2001 Annual Meeting of the Association for Research on Nonprofit Organizations and Voluntary Action, New Orleans). Charity Navigator, a nonprofit watchdog group, sets 25 percent of an organization's total expenses as the benchmark for management, administration and fundraising expenses. www.charitynavigator.org/index.cfm?bay=content.view&cpid=419. The Better Business Bureau has a benchmark of no more than 35 percent of total expenses for nonprogram costs: www.bbb.org/us/Charity-Standards/.

14. Urban Institute Center on Nonprofits and Philanthropy, "Getting What We Pay For."

15. Burd; Huang, Judy, Phil Buchanan and Ellie Buteau. 2006. "In Search of Impact: Practices and Perceptions in Foundations' Provision of Program and Operating Grants to Nonprofits." Center for Effective Philanthropy.

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17. Boris, de Leon, Roeger and Nikolova.

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20. A generally accepted financial benchmark is for nonprofits to maintain a minimum of three months of cash reserves.

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22. Boris, de Leon, Roeger and Nikolova; Fiscal Management Associates, LLC.

23. Urban Institute Center on Nonprofits and Philanthropy, "Getting What We Pay For"; United States Government Accountability Office, "Nonprofit Sector: Treatment and Reimbursement of Indirect Costs Vary Among Grants, and Depend Significantly on Federal, State, and Local Government Practices."

24. Burd.

25. In the study, Grossman, Lind, Hayes, McMaken and Gersick use the following indicators to assess the cost of quality programs:
    - Staff members receive a formal performance review.
    - The organization has a formal mission statement.
    - The organization has a formal orientation process.
    - Staff meetings take place at least twice a month.
    - The organization collects formal feedback from youth participants.
    - The organization collects formal feedback from parents.
    - Facilities provide adequate space for socializing.
    - The programs operate with a low staff-to-youth ratio (less than or equal to 1:10).
    - The organization provides or refers staff members to required training sessions.

26. Urban Institute Center on Nonprofits and Philanthropy, "Getting What We Pay For"; Fiscal Management Associates, LLC.

27. P/PV's report that compares the financial management outcomes for the two groups and the progress of the Donors Forum in instigating reform will be published in early 2014.

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30. Urban Institute Center on Nonprofits and Philanthropy. National Study of Nonprofit-Government Contracting: State Profiles Survey Results (2009 Data). Retrieved 6/17/2011 from www.donorsforum.org/s_donorsforum/bin.asp?CID=17354&DID=43463&DOC=FILE PDF).

31. Jones, Tim. "Illinois Has Days to Plug $13 Billion Deficit That Took Years to Produce." January 3, 2011. Retrieved 6/17/2011 from Bloomberg at www.bloomberg.com/news/2011-01-03/illinois-must-plug-13-billion-deficit-in-days-that-took-years-to-produce.html.

32. Urban Institute Center on Nonprofits and Philanthropy, National Study of Nonprofit-Government Contracting: State Profiles Survey Results (2009 data).

33. In March 2011, the State of Illinois announced the initiation of the Vendor Payment Program to provide immediate assistance with cash flow to nonprofits that have experienced delays of at least 90 days on payments from the Illinois Department of Human Services. (Thomason, Andrew. "State Begins Vendor Payment Program to Help Pay Overdue Bills." December 12, 2011. www.wjbdradio.com/?f=news_single&id=30473; www2.illinois.gov/payments/Pages/default.aspx.) The program sells the state's debt to a qualified bank, which immediately pays 90 percent of the amount due to the vendor, with the remaining 10 percent withheld until the state pays the amount due to the bank holding the debt (www.donorsforum.org/s_donorsforum/doc_wide.asp?CID=11186&DID=47723). At the conclusion of this report, information was not available on the outcomes of the program.

34. See Fiscal Management Associates, LLC.

35. In the final report, we will explore whether and how these organizational features are associated with variations in the financial management outcomes of the initiative.

36. Boris, de Leon, Roeger and Nikolova.

37. This information was gathered by FMA in 2009 as part of its initial assessment of the financial status of each organization during the three years prior to the beginning of SFM—2006, 2007 and 2008.

38. McKinney.

39. Organizations submit vouchers to be paid for services provided to individuals or families. Vouchers for different contracts typically do not use a standard format.

40. Fiscal Management Associates, LLC.

41. "Cash inflow" refers to money coming into the organization from, for example, payments for services rendered, interest on investments, or money from sale of property or equity securities. "Cash outflow" refers to money the organization must pay to, for example, its employees, suppliers and lenders.

42. Fiscal Management Associates, LLC.

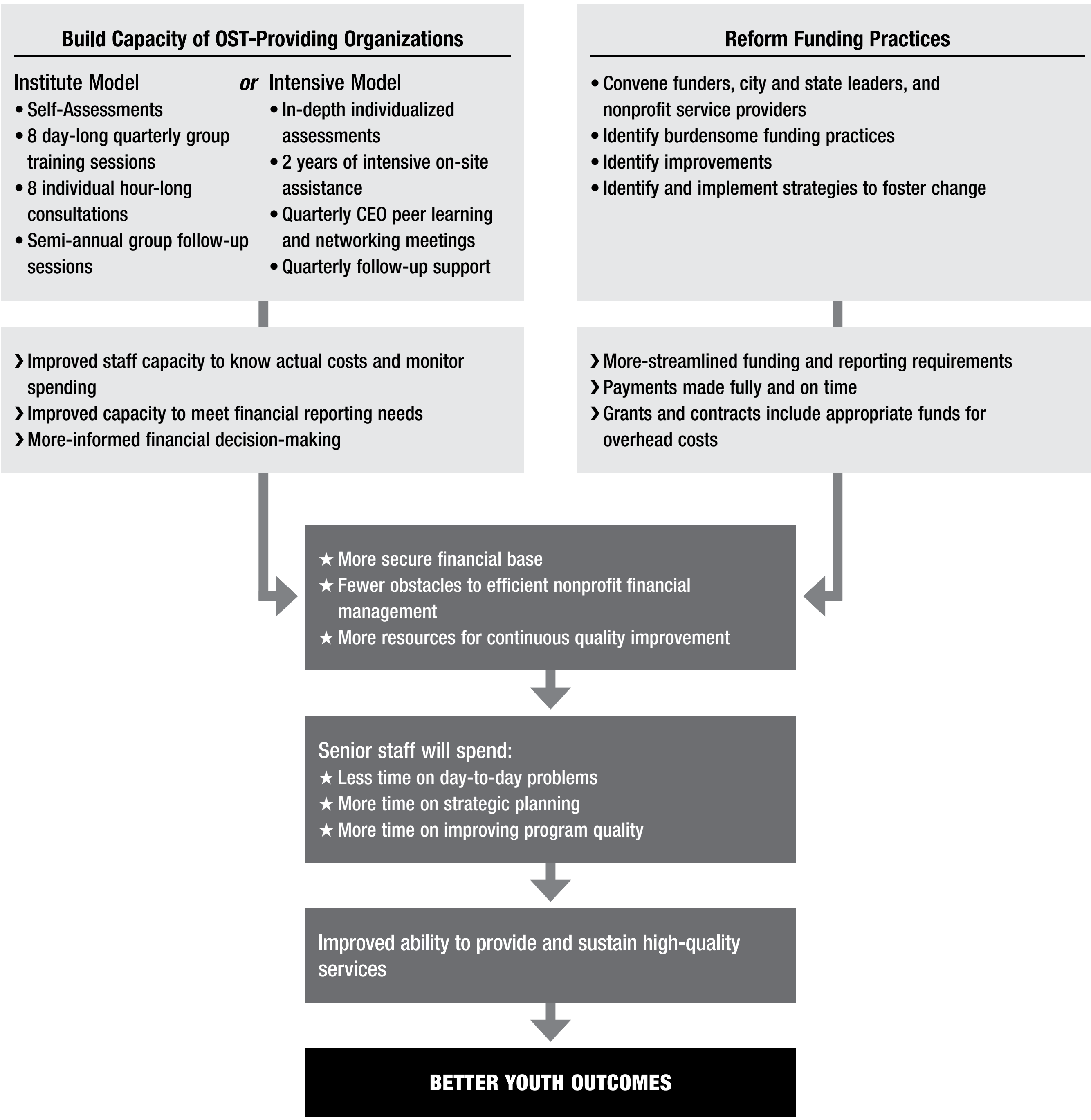
43. Ibid.

44. Sessions for the lead financial officers began after data collection for this report ended; therefore, we have no information about the response of the participants.

Appendix

Appendix A

SFM's Theory of Change



Source: Public/Private Ventures, forthcoming 2012 interim evaluation of the Strengthening Financial Management initiative.

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