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The Case for Cash Flow

Understanding how a nonprofit works today, and how it is likely to perform in the coming years, is fundamentally rooted in an understanding of its cash flow. Without an ongoing awareness of how funds enter and leave the institution's coffers, annual budgets or records of past experience, even ones that are laboriously composed, may offer little operational help to board members. It is time for the boards of nonprofit institutions, both large and small, to consider changing their approach to money matters. This means moving away from an almost singular preoccupation with assets and liabilities and toward a greater awareness of cash flow.

For change to take place, incentives or benefits must occur that prompt different actions. In this chapter the case for adding cash flow budgeting, forecasting, and monitoring to the board's arsenal of fiscal tools is bolstered by a set of powerful incentives and significant benefits.

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What are the incentives and the benefits of using cash flow?

The clarity of cash flow budgets is what makes them so valuable to board members. Since these documents combine actual income and expense within the fiscal cycle of the institution, they provide more operational information. Board members gain a better understand-

ing of the financial position of their organization and can thus participate more fully in problem solving and decision making. Greater participation is the key to ensuring that all board members can perform their fiduciary duties on behalf of the institution.

Cash flow forecasts provide a practical basis for projecting income and expense into the future. By capturing the dynamic quality of an institution's annual or multiple-year financial cycle, these forecasts provide the opportunity to anticipate and prepare for future events. Cash flow monitoring establishes an ongoing awareness of fiscal position.

Cash flow analysis leads to an understanding of three key factors in nonprofit financial management:

- Money, whether raised, earned, or borrowed, costs money to secure.
- Inflation is of profound significance in the nonprofit arena and must always be considered.
- Time and timing are critical elements in nonprofit financial management.

Cash flow thinking allows tools to be designed to address financial questions confronting any nonprofit institution. The Cash Flow Forecaster and the Real Estate Calculator are computer software that board and staff members can use to rapidly explore complex problems. The Cash Flow Forecaster provides graphic illustrations that allow board members "to see the money," a clear benefit for those who shy away from numbers in the boardroom. The Real Estate Calculator allows different real estate strategies to be instantly compared and contrasted. Both tools dramatically reduce the time necessary to perform these functions.

A major incentive for using cash flow concepts is that they provide the basis for dealing with financial shortfalls and windfalls. Shortfalls can be addressed through the use of fully secured credit.

Credit used to provide locally obtained working capital reduces or eliminates the need to create cash reserves or endowments. Windfalls should be spent for operations, to pay back debt, or to expand programs and services.

Cash flow principles can be applied to questions of ownership versus leasing of real estate and equipment. In addition, earned revenue strategies can be assessed in terms of their impact on cash flow.

Should we change our current system of accounting?

Most nonprofit institutions have their books set up on the accrual basis of accounting. Accrual-basis accounting recognizes expenses when they are incurred and revenues when they are earned, rather than when cash changes hands. This approach to accounting is standard, valuable, and a boon to the keeping of accounts in the commercial world. Yet, for many nonaccountants or people without financial training, the terminology and reports generated by this system can be quite daunting and in some cases opaque.[2]

The cash flow budgets and reports we describe in this book are simple and easy for everyone to understand. Cash-basis accounting records only those events that involve the exchange of cash and ignores transactions that do not involve cash. The financial picture presented by our approach to cash flow is not as finely detailed as the accrual-basis system, yet for board members the grasp of operations provided by focusing on cash flow more than compensates for its inherent simplicity.

Lest any certified public accountant (CPA) reading this book feel that we are making even the slightest criticism of that valuable profession, please allow us to note that the German poet Goethe is quoted as describing accounting this way: “Double entry bookkeeping is one of the most beautiful discoveries of the human spirit.” Our sentiments exactly![3]

Traditional accounting, with all the bells and whistles that pertain to nonprofit institutions, still has an important role to play in

generating periodic financial reports and the audits requested by funding agencies. So hang on to your current system—but supplement it with the approach that we propose and watch the improvement at your next board meeting.

If every board member can understand and apply cash flow concepts, then the burden that normally falls to the finance committee can be relieved. And it must be, since every board member bears financial responsibility for a nonprofit institution. Cash flow concepts allow everyone to participate in the problem solving and decision making that lie at the heart of good governance.

Cash flow budgets, reports, and forecasts using twelve-month recording of income and expense are dynamic in contrast to conventional balance sheets. A balance sheet is a snapshot of a fiscal moment in time. A cash flow budget, report, or forecast is like watching a movie in which income and expense costar with time to express the ebbs and flows of your organization's financial position.

Money and money matters generate a considerable amount of anxiety in most boardrooms. Cash flow budgets, forecasts, and reports provide a great deal of information that directly addresses the operational concerns of the organization. For example, in determining how to deal with shortfalls and with windfalls, cash flow analysis provides the basis for better decisions in the boardroom. Cash flow is reality based; it increases the range of options available to board and staff members confronted by questions such as whether to build a cash reserve or establish a fully secured line of credit with the bank.

Cash flow concepts open the door to a thoughtful assessment of financial policies and practices that may be popular but are also fiscally very inefficient. The creation of endowments, the ownership of buildings and equipment, and even the virtues of earned revenue strategies can all be viewed through a cash flow lens with surprising results.

Finally, because so many board members are successful businesspeople in their nine-to-five lives, the importance of cash flow needs

to be emphasized. These board members frequently see the nonprofit sector as just an underdeveloped version of the commercial world, and many translate their notion of good business practices directly into recommendations for financial policies for their nonprofit institution. The cash flow concepts that we use throughout this book place very little emphasis on the accumulation of assets by nonprofit institutions. This is baffling to some business-oriented board members. As we demonstrate, however, it makes perfect sense once you grasp the importance of cash flow to the nonprofit sector.

Why shouldn't a nonprofit be more like a business?

In both the commercial world and the nonprofit sector, cash flow is important, particularly as a tool for understanding operations. Yet, as any businessperson will tell you, the bottom line in the commercial sector is all about assets and liabilities. For nonprofit institutions, cash flow is uniquely important—and here are some of the reasons why.

First, businesses are creatures of the marketplace; nonprofits are creatures of the tax collector. After all, without a charter from the state and feds, tax-exempt organizations could not offer deductions for contributions and avoid most of the taxes businesses pay. Second, the ways in which the two types of organizations are allowed to raise money are not the same. As we shall see, the rules that apply to this money create some profound differences.

Businesses sell equity (ownership) to investors in the form of stocks, bonds, partnerships, and venture arrangements. Once the equity has been sold, businesses have a great deal of flexibility in how and for what they spend their money. The notion that in business "cash is king" is just another way of paraphrasing Yogi Berra's line: "Cash, why it's just as good as money."[4]

Yet in the remarkably regulated financial environment in which nonprofits operate, even cash is not always a liquid asset (*liquid assets* are funds in a form such as a mutual fund or savings account from which they can be easily withdrawn and spent). Restricted cash may

be in the bank account but not available for any purpose other than the specific one dictated by the funding authority. This factor alone can create a fiscal crisis for otherwise seemingly solvent nonprofit institutions.

Nonprofits are prohibited from selling equity to anyone. Instead, they are allowed to receive tax-deductible gifts and grants, which often come with strings attached.

Businesses can use their profits (what is left over when all the bills have been paid) to pay for their activities. Nonprofit institutions are often contractually bound to observe government or foundation requirements that any funds left over from grants be refunded rather than switched into different budgetary areas.

Both businesses and nonprofit institutions can borrow money. So the major difference is this: Businesses sell equity and distribute profits to investors and to the government in the form of taxes; nonprofits receive tax-deductible grants and gifts that are meant to be spent for the social purpose for which the organization was formed.

Businesses have a very different annual fiscal cycle from that of their nonprofit counterparts. Businesses mobilize money through the sale of equity, or they use their profits or borrowing to provide the funds they need to operate. At the end of the fiscal year they distribute earnings in the form of dividends and taxes.

The nonprofit organization is continually soliciting gifts and grants, attempting to earn revenue, and occasionally borrowing. But because they have no equity to sell, nonprofit organizations do not engage in distribution to investors and in many cases pay little, if anything, in federal, state, or local taxes. Therefore, the fiscal cycle for a nonprofit organization is only about cash flow: income in and expenses out.

It is the central importance of cash flow in the nonprofit world that prompts us to examine it much more carefully. In the next chapter, we offer you the opportunity to root out for yourself the differences between conventional budgets and cash flow budgets.