CHAPTER ONE

THE CASE FOR CASH FLOW THINKING

Cash flow thinking involves focusing on the arrival of revenues and the departure of expenditures that occur during an institution's fiscal year. It's simple to understand cash flow thinking, and it is easy to use it to address some of the toughest fiscal problems confronting decision makers in the nonprofit world.

First and foremost, cash flow thinking is a supplement—not a substitute—for the accrual basis accounting systems most nonprofit institutions employ. Cash flow thinking allows everyone at the board and staff levels to comprehend the financial position of their institution. By making the fiscal picture simple to grasp, the organization encourages greater participation. With cash flow thinking, more than just the members of the Finance Committee can be actively involved in decision making. This means that all board members are able to exercise their responsibility for due diligence, and it allows the staff an opportunity to understand and share the fiscal information that is vital to the well-being of the institution.

Nonprofit organizations are set up and run differently from commercial enterprises. As we show later in this chapter, the two types of organizations are just different enough to make cash flow thinking especially pertinent to nonprofit institutions. Which is not to say that cash flow is not a powerful driving force in business and in markets, but the special role that cash flow has in the nonprofit arena is what needs to be clearly understood.

Key Questions

Should we create a cash reserve or manage our risk with a fully secured line of credit with the bank? This is just one of a host of questions that cash flow thinking can answer definitively. We explore some of the other questions in this chapter and the answers later in the book.

Cash flow thinking creates a platform for the creation of budgets, forecasts, and reports that are easily generated and understood. It has also stimulated the development of tools such as the Cash Flow Forecaster and the Real Estate Calculator, and techniques such as the creditholder concept, which provides collateral for fully securing an institution's borrowing. Finally, cash flow thinking opens the door to the analysis of a variety of topics that have a direct bearing on the fiscal health of your organization:

- Should we establish an endowment?
- Are we better off owning or leasing our facilities?
- What impact will earned income have on our budget?

Why does the simplicity and ease of cash flow thinking matter to leaders in the nonprofit world?

Cash flow is the term used to describe the revenues that flow into an institution's coffers and the expenses that are paid out when bills are due. Cash flow implies a very literal approach to both money and time. This means that income has to be in hand before it is counted; promises that the check is in the mail don't count. And bills are considered paid only when the checks really are in the mail.

We are advocates of concentrating on cash flow as one of the financial tools available to nonprofit decision makers. Over the years, we have encountered many decision makers and nonprofit professionals who did not fully understand their own institution's financial statements. Adding to the problem, the same individuals who failed to grasp the meaning of their institution's fiscal affairs often counted on someone else to be responsible for understanding the budget and the financial reports. *Just talk to our accountant,* or *let the chief financial officer answer that question* have often been the responses to our financial interrogations. And the situation in the boardroom is rarely much better.

Members of the Finance Committee—an eager stockbroker, an overworked CPA, an amiable local banker—are typically drafted to take care of business and to be responsible, while the rest of the board members focus on other issues. The problem is that all members of the board are equally responsible for the financial well-being of their institution, and they endure considerable liability in their capacity as board members. It is vital for everyone on the board to understand the numbers.

Trustee ownership and understanding of financial matters has been a running debate in the field. This issue has evoked a variety of responses ranging from suggestions to mandate financial training for executives and nonprofit board members to notions of designating specialists to work alongside board and staff to supervise and coach them in money matters.

While we appreciate the benefits of training and the obvious profit potential for consultants working as capacity builders to nonprofit institutions, we instead advocate starting out by making things so simple and so easy that anyone who sits on the board or in a managerial capacity can quickly grasp the essential financial issues confronting the institution.

The clarity of cash flow thinking starts to deliver positive benefits the moment you adopt it. Everyone will be able to read and understand your budgets, forecasts, and reports. For the numerically challenged, cash flow is straightforward in much the same way that a checkbook is immediately accessible. For those who like pictures, cash flow lends itself to helpful graphic images. English majors, who may hate numbers, will appreciate the almost poetic footnotes that accompany your materials.

Why is cash flow thinking particularly relevant to nonprofit organizations?

How many times have you heard a colleague or a board member lament that your nonprofit organization should be more like a business? It's a refrain that we have heard from many people who are or have been successful in their nine-to-five business lives. For these people the importance of a cash flow approach to nonprofit institutions needs to be especially emphasized. These folks 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. While nonprofits can learn a lot from businesses, the differences between the financial practices of the two sectors need to be understood in the context of the very real differences between them.

For example, the cash flow concepts that we advocate place very little emphasis on the accumulation of assets by nonprofit institutions. This is often baffling to businesspeople. Yet it makes perfect sense once you grasp the importance of mission to the nonprofit sector, and the way restricted funds turn into smoke and mirrors for many institutions.

In both the commercial world and the nonprofit sector, cash flow is important, particularly as a tool for understanding operations. Yet, as anyone in business will tell you, the bottom line in the commercial sector is all about the assets and liabilities left at the end of the fiscal year. On the other hand, for nonprofit institutions, cash flow is uniquely important, because assets don't always have the same impact on the bottom line as they do in commercial settings. Here are three reasons why things are different:

First, businesses are creatures of the marketplace; nonprofits are creatures of the IRS. After all, without a charter from the feds, tax-exempt organizations could not offer deductions for contributions and avoid most of the taxes businesses pay. Another way of looking at this issue is to say that while businesses are created by markets, nonprofits are often the creatures of market failure. Market failure occurs when customers are unable or unwilling to pay the full price of the services or goods they receive. In the nonprofit field this means that a third party, such as a donor, foundation, or government agency, is needed to supplement the cost of the activity.

Second, the ways in which the two types of organizations are allowed to raise money are not the same. 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 when he says: "Cash, why it's just as good as money."[1]

Yet in the remarkably regulated financial environment in which nonprofits operate, even cash is not always a liquid asset. *Liquid assets* consist of unrestricted cash, and of money in a mutual fund or savings account that can easily be converted into unrestricted cash. Restricted cash may be in the bank account but not available for any purpose other than the specific one dictated by the funding source. This alone can create a fiscal crisis for 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 profits 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 returned to the source 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.

Third, 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 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.

Nonprofit organizations are 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 this characteristic of nonprofit institutions that makes cash flow thinking so relevant to understanding how they work.

Arthur Levitt, the former chairman of the Securities and Exchange Commission, states in *Take on the Street* that to understand the quality of the financial situation of an enterprise, you need to look at the cash flow report.[2] We agree, which is why we focus on cash flow budgeting, cash flow forecasting, and cash flow monitoring. The assets and liabilities are important too, but in nonprofit organizations cash flow thinking needs to be accorded a special place at the table when fiscal decisions are made.

Why add a cash flow–based approach to supplement our existing system?

Before you read on, you may want to buy your bookkeeper a bottle or two of over-the-counter heartburn medication. Then it will be ready when you announce that you are considering adding another level of financial record keeping to that already busy schedule. You can imagine the warm embrace we receive from our clients when we strongly urge them to do just that. What we often hear in response to our request is that they already have a perfectly fine system of accounting that has been mandated by the Federal Accounting Standards Board (FASB).

Our answer to this objection is that cash flow budgeting, forecasting, and monitoring make it possible for everyone, not just the accountants and members on the Finance Committee, to understand what is going on. Using cash flow budgets, forecasts, and reports to complement an existing system of financial management may at first seem like an added chore. After all, having an accrual basis accounting system in place generates lots of information in the form of balance sheets, income and expense statements, statements of changes in net assets, and statements of cash flows. The difficulty is that not everyone is comfortable with the information provided.

Accrual basis accounting is a system that recognizes income when it is earned and expenses when they are incurred, rather then when cash actually changes hands. To someone versed in finance and accounting the accrual basis system is finely detailed and comprehensible. To those without a financial management background, accrual basis accounting can be something of a challenge.

Accountants and lots of other people understand accrual accounting and consider it the appropriate standard for all financial environments. Accrual basis accounting uses a system that identifies payables and receivables in a virtual time frame. So, if you have been notified that a grant has been awarded, your bookkeeper "books" the amount at the moment of the award. But if, as sometimes happens, the grant is slow in arriving, and your fiscal year ends, you still have the receivable on your books. You account for it within the fiscal year time frame, but you still do not have the money that was meant to be spent on the program for which the funds were designated. For folks who understand this approach, it makes sense; they have a mental model that allows for everything to balance in the institution's accounts over time.

As that popular source "The Motley Fool" noted in November 2006: "Be Careful When It Comes to Accruals."[3] Unless you understand that the money in the last report may not be money in the bank, you can find yourself in financial trouble. The problem, as we see it, is that the way for-profit businesses almost universally use this system of accounting gives it a lot of authority, but people in business generally know that there can be a disconnect between receivables and sales. In the nonprofit setting the impact of booking third-party-payer revenues well in advance of receipt of funds can be much more problematical. The typical line we hear is, "Well, we got the grant, so what's the problem?" Well, the problem is that if the grant or contact check has not arrived, or the funds are restricted—something that does not happen in business—then other funds on hand may not be available for either operations or programs. The same thing happens with endowments or restricted cash reserves. The money is there on the balance sheet, but that does not mean that it can be spent to deal with today's expenses.

On the other hand, income and expense are empirical phenomena—that is, you can see them as they happen—in cash flow thinking. Everyone may be aware that money is coming, but until it lands in the bank, it is not booked. The same is true with expenses paid. This is familiar from daily life: the float attached to your credit card purchases means that you don't feel the actual impact on your wallet until you write the check to pay off your bill.

Cash flow thinking requires reporting only those events that involve the exchange of cash. It acknowledges but sets aside any transactions that do not involve cash, such as depreciation or amortization. Cash flow budgets, reports, and forecasts merge actual time with real money. They are dynamic—unlike conventional budgets and 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.

With accrual basis accounting, income and expenses are posted before they are received or paid. This creates a virtual world that can sometimes be confusing. For example, when multiple-year pledges that have been posted do not arrive on schedule, your organization can be much poorer than it looks on paper. Our cash flow approach focuses exclusively on the income that arrives at your door and the expenses that are recorded as checks as they sail off in the mail. A sense of practical reality accompanies cash flow thinking.

Because these two systems (accrual and cash basis accounting) treat money in relation to time differently, a cash flow approach must be kept separate from your accrual basis accounting system. To make the separation easy, simply use the Cash Flow Forecaster tool that comes with this book. That will be much better for the bookkeeper than all that heartburn medication.

Can thinking about cash flow answer our perennial fiscal questions?

In our approach to thinking about cash flow, this inherently simple system is also the key to an in-depth understanding of many of the most complex issues in nonprofit financial management. If this seems like a paradox, read on.

Here are some related questions many leaders ask:

- Should we stockpile cash in unrestricted reserves or a restricted endowment, or both?
- Should we own our facilities or should we lease them?
- Why should we establish a line of credit and pay the bank interest, when we could build a healthy cash reserve and collect interest ourselves?
- Should we be cautious before starting a money-making enterprise to supplement our other sources of revenue?

The list goes on and on, and in each case, thinking about cash flow can help to provide clear answers.

Most leaders in the nonprofit sector pay careful attention to the assets and the liabilities of their institutions. But in some cases that focus on the pluses and minuses can make it difficult to answer complex fiscal questions. For example, one of the difficulties some larger institutions face is that their balance sheets can look strong, particularly if they have endowments, while their access to spendable dollars is quite limited. Decision makers may be unclear about the financial position of their institution because the restricted assets provide a false sense of fiscal security. Decision makers ask us whether it is cheaper to have a cash reserve or a fully secured line of credit. We tell them that without doing a cash flow analysis and a direct comparison, you cannot establish the precise difference in benefits of one approach or the other.

The same concerns influence decisions about which dollar to use to cover which purpose in the budget. If all dollars cost the same, then it makes no difference. But dollars can have very different costs, and cash flow lets you focus on the differential cost of money. So if the bank account is low this month, it makes sense to use the cheapest dollar—namely the borrowed one—to fill up the tank, rather than those expensive dollars that have been earned at high cost to your institution.

The benefits of applying cash flow principles to financial problems are most clearly demonstrated in the area of real estate. Leaders in the nonprofit world spend countless hours each year trying to figure out whether it is better to own or lease space, or whether a capital campaign is the right approach to adopt, versus a host of alternative strategies for dealing with facility issues. The Real Estate Calculator that comes with this book will reduce these difficult questions into understandable alternatives that can be compared and contrasted quickly. The software does this by providing standardized terms to follow and by establishing a common cash flow basis so that comparison of different approaches is possible. Typically, real estate discussions swing between hard issues, such as costs and financial consequences, and soft issues, such as the desire to own rather than rent because the notion of ownership just feels better. Without a clear differentiation among the factors that drive the choice, real estate decisions are often more art than science.

Are there other incentives and benefits to thinking about cash flow?

Cash flow budgeting, forecasting, and monitoring set the stage for strategic thinking for leaders, particularly in the area of financial risk management. Understanding how a nonprofit organization works today, and how it is likely to perform in the coming years, is fundamentally rooted in an understanding of its cash flow. Ongoing awareness of when funds enter and leave the institution's coffers is necessary to ensure the health and stability of the organization. Thinking about cash flow can set the stage for the use of credit to address both financial shortfalls and windfalls. It also makes it possible to communicate clearly with the individuals and institutions that will make the credit you require available to you. And in the process our recommended procedures for budgeting will dynamically illuminate your financial game plan.

Using cash flow tools such as the Cash Flow Forecaster makes generating useful forecasts or quickly preparing financial reports, and many other financial tasks, turn out to be much easier and far less time-consuming to perform. Our cash flow–based electronic tools enable you to generate useful forecasts in much less time—forecasts that can be easily advanced as you move through the fiscal year. The same tools make financial monitoring a breeze. These savings in time and energy may bring you back into the good graces of your bookkeeper.

Cash flow thinking can also help leaders analyze their financial policies in new and different ways. By using cash as a common basis, fiscal data from different institutions can be used for comparing and contrasting patterns and trends that would otherwise be inaccessible. These benefits of cash flow presentations can be shared with donors, foundations, and government agencies. Cash flow budgets can provide them with real insight into your circumstance—bolstering your requests—and bring a much-needed financial reality to discussions about their policies for restricting grants and gifts.

For example, some foundations have a policy that prohibits them from funding organizations that have incurred a deficit, even if it is only on paper and actually a matter of timing, not money. Other funders refuse to pay for the operational expenses necessary to administer their funded programs. Using a cash flow–based approach, you can control your own destiny by understanding the impact of these issues on your bottom line. You may not be able to convince the funders that you need more operational dollars to sustain their grants, but you will be prepared to take constructive action to mend this situation on your own through the use of credit.

Cash flow financial management alerts you to potential shortfalls and windfalls. Knowing in advance how the budget will be affected by these changes can be a lifesaver for administrators focused on fulfilling their mission. Cash flow thinking also opens the door to a new resource for nonprofit organizations, the use of fully secured credit to fill in income gaps or to hedge against future risks.

Why should board members support the use of cash flow thinking?

People sign up to be board members and staff of nonprofit organizations for a variety of reasons, but struggling with fiscal systems is rarely one of them. Just saying the words *financial management* to many people in the nonprofit sector evokes a wince. Yet, like it or not, all nonprofit board members are responsible for the financial well-being of their organization. They are legally liable for the finances, just as administrators, acting as agents for the board, are obliged to ensure that budgets and reports are accurate. Because fulfilling the mission is inherently dependent on good fiscal practices, it is important that financial reporting and analysis be comprehensible to all.

The case for using a cash flow approach begins with the clarity that cash flow concepts bring to budgets, forecasts, and reports. Everyone associated with a nonprofit institution is more likely to grasp financial management issues when cash flow tools are used and shared.

The simplicity and clarity of cash flow has special applicability for the board members of nonprofit institutions. Cash flow budgeting and reporting means that board members are encouraged to participate more fully in problem solving and decision making.

Having clear, readable financial information means that board members, even those who are allergic to budgets and numbers, can assume their rightful responsibilities as trustees. These responsibilities include providing financial oversight and the problem solving and decision making necessary to sustain or attain financial health for their organization. Having the Finance Committee examine fiscal issues in great detail may be wonderful, but *due diligence* demands that all board members understand the implications and consequences of their votes on critical issues.

Here's a simple formulation for this concept: *Cash flow approach = better understanding of fiscal matters = greater comprehension by board and staff = wider participation in decision making = better decisions and due diligence.*

A solid grasp of the relationship between income and expense and the assets and liabilities of the institution is an important ingredient in nonprofit financial management. But for many board members, it is a challenge to understand the terminology and the relationships associated with nonprofit financial thinking. This is where cash flow tools and techniques, in the form we present them here, are so helpful. It is possible to use cash flow as a guide for performing the key fiscal functions asked of board and staff members.

And this is why cash flow budgeting, forecasting, and monitoring are so important in the nonprofit sector. Traditional accounting, with all the bells and whistles that pertain to nonprofit institutions, has an important role to play in generating periodic financial reports and the audits so often requested by funding agencies. But you still need to set up a cash flow budgeting, forecasting, and monitoring system to provide the supplemental information that leaders need to run things.

Why should nonprofit managers and administrators adopt the cash flow approach?

The case for cash flow is slightly different for administrators and staff than it is for board members. Cash flow concepts are inherently rooted in operational considerations. All nonprofit institutions, whether large or small, must integrate their money with time. This is most dramatically clear in situations that trigger shortfalls or windfalls. Interestingly, having too much money on hand is just as significant in terms of fiscal decision making as having too little. Of course, most of us would opt for the surpluses, the surprise gifts, or the mystery bequests, but the principle is the same. Having more or less money than your operation requires right now means that the issue of what to do with this money must be addressed. It is here that cash flow analysis really pays off. The decision of what to do with all that extra money—or the flip side, what to do when the cookie jar is empty—can be greatly enhanced if decisions are made using cash flow analysis.

Cash flow budgets, forecasts, and reports allow for nimble financial management. As we lay out in forthcoming chapters, strategy is an integral part of forecasting, balancing preparation with adaptability. Strategy involves making choices in a temporal context. So any decision—to advance, or to hold, or to retreat—has an awareness of time built into it. Since cash flow merges money with time, it sets the stage for strategic financial thinking. We have witnessed too many nonprofit planning sessions that simply did not take time into consideration, which is why we sometimes have heard the nonprofit sector called *the land that time forgot.* Cash flow thinking forces everyone to see things in relation to time because it is about actual cash that is only counted when it is in hand or out the door.

As time becomes increasingly precious, both in the office and in the boardroom, the essential requirements of accurate financial reporting by staff, along with comprehension and oversight by board members, remain the same. These functions will always demand attention, regardless of the size or complexity of the institution. Yet without an ongoing awareness of how funds enter and leave the institution's coffers, annual budgets or records of past years, no matter how laboriously composed, offer little help in understanding how a nonprofit organization works today and how it is likely to perform in the coming years. An annual cash flow budget, starting with the cash in the bank and then divided into monthly segments, is arguably one of the most valuable tools that the administrator of any nonprofit needs to maintain the health and stability of the organization. Our approach to cash flow and the tools that accompany it dramatically reduce the time needed to prepare and use financial forecasts and reports.

Income is on everyone's mind in the nonprofit world. One of the most compelling reasons that nonprofit institutions try to increase their earned revenue is that the surpluses thus obtained are *unrestricted:* they have no strings attached. There is a real need for unrestricted funds that can be plugged into operational categories, avoiding the restrictions that so often come with gifts and grants. Cash flow analysis and concepts can help you understand the impact of earned income. Knowing when to be entrepreneurial and when to stick to your knitting can be very valuable. Access to working capital is the single greatest challenge to nonprofit institutions. Moreover, the key to confronting this daunting issue is to be found by thinking about cash flow. More about this in Chapter Nineteen, where we present some ideas for legislation that will increase nonprofit institutions' access to working capital—those operational dollars that are now so scarce.

Looking Ahead

We are making some serious claims for thinking about cash flow as simple and easy. In the coming chapters we show you why cash flow thinking really is simple for everyone—and we substantiate these claims by making it easy for you to use these ideas. We provide case studies, sample forms, contractual agreements, and actual letters so that you don't have to reinvent the wheel to get on board with cash flow.

Speaking of hopping on board, in Chapter Two we share with you the terrible plight of one of our clients' chief financial officers. And we show you how a little cash flow thinking solved the problem for this gifted CFO by making it simple for her board to see their actual fiscal position.