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Financial sustainability and accountability: a model for nonprofit organisations

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Abstract

Financial sustainability and accountability are ever-present issues for nonprofit organisations (NPOs) as they seek to balance their mission with financial responsibility. Both issues arise as a result external demands and internal needs.

The mission of an NPO is usually expressed as the role it plays in the segment of society within which it serves. Once its mission is defined, an NPO often finds that it is unable to withdraw. This may be due to external exit barriers placed on the organisation by local community groups, ethnic or religious groups, or by other organisations which are convinced that the maintenance of some other activity is dependent on continuing the current activity. In addition, an NPO may find itself with internal exit barriers because of its societal interests and its humane commitment to its clients. Thus, the centrality of mission to the operation of an NPO may expose it to issues of financial sustainability that are not faced by organisations operating in other sectors.

With the increase in the scope and size of the nonprofit sector have come calls for the need for increased financial accountability. Yet, because NPOs are established to accomplish altruistic rather than financial goals, their accountability systems have often developed on an exigency basis. Nevertheless, the public, in the role of volunteers, donors and taxpayers, have made significant contributions to the development and resources of the third sector are thus entitled to effective systems of accountability. This call for accountability has arisen from two sources. One is an internal need for an NPO to be well managed, because the nature of its mission and the sources of its revenue demand a high degree of accountability which in turn demand a sound internal control system. Secondly, there is the external demand for accountability because resource providers expect an NPO to utilise resources in a manner that is consistent with its mission. Thus, there is a fiduciary duty between the resource provider and the managers of an NPO. In addition, there is demand for accountability from the public, from potential donors and from the media.

The increasing body of literature that addresses financial management of NPOs focuses on the "how to" of accounting, rather than providing measures of an organisation's financial sustainability or accountability. This study presents a model for determining the financial health of an NPO by investigating various operational criteria over time, and addressing these in relation to accountability issues such as intergenerational equity. It makes a significant contribution to nonprofit research by providing an analytical means of investigating a single organisation's financial sustainability and suggesting specific measures that can be undertaken to improve financial health.

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Financial Sustainability and Accountability: A Model for Nonprofit Organisations

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Keywords: Nonprofit organisations, financial sustainability, accountability

1. Introduction

With the increase in the scope and size of the nonprofit sector (Lyons and Hocking 1998) have come calls for the need for increased financial accountability (Blickendorfer and Janey 1988; Courtney 1994; Industry Commission 1995; Herzlinger 1996). Yet, because nonprofit organisations (NPOs) are established to accomplish altruistic rather than financial goals, their accountability systems have often developed on an exigency basis. The public, in the role of volunteers, donors and taxpayer, have made a significant contribution to the development and resources of the third sector and are thus entitled to effective systems of accountability. Since 'accountability relies upon the provision of up-to-date, accurate and relevant information relating to the operations and finances of organisations' (Industry Commission 1995: 201), it is appropriate to focus on effectiveness of accounting systems in order to gain this increased accountability.

This paper considers how financial accountability and sustainability in NPOs are closely intertwined with mission. It proposes a model for measuring the financial health of an NPO and then illustrates the application of this model to a particular organisation. The paper concludes with examples of the contribution that the utilisation of this model can make to an organisation.

2. Financial Accountability

If an organisation has a good system of financial accountability, its ability to sustain financial shocks will be readily foreseeable and measureable. From an internal perspective, accountability systems can be linked to appropriate internal monitoring of financial affairs which ensures the provision of reliable accounting information necessary for responsible financial management (Sopher, 1998). It is generally agreed that the requirements for good internal management control include competent personnel, assignment of responsibility, division of work, separation of accountability from custodianship, adequate records and equipment, rotation of personnel, internal auditing and physical protection of assets (Anthony and Young, 1994; Gaffikin, 1993; Herzlinger and Nitterhouse, 1994). However, accountability expectations extend management control into areas of planning and budgeting, raising funds, allocating resources, record keeping, monitoring and evaluating, reporting and auditing (Elkin, 1985).

Such controls are essential for NPOs because they "provide current data on where your organization is and projected data on where you want to be. These benchmarks are essential in evaluating results and mapping out plans (Sopher, 1998, p. 45). Furthermore, although "most nonprofit leaders trust that people will 'do the right thing' ... errors and fraud do occur if proper controls aren't in place" (Lambert, Main and Lambert, 1998, p. 46).

Many potential problems can be overcome if appropriate accountability procedures are adopted. Internal control systems provide measures which prevent and detect errors and frauds by implementing various checks and balances. Errors may arise as acts of both commission (such as handling cash incorrectly) or omission (such as failing to obtain funding by being late with grant applications), while fraud occurs because of misplaced trust. Table 6.1 provides recent examples of third sector fraud that specifically arose due to inadequate internal control procedures.

Table 1: Examples of Nonprofit Fraud *

The Individual	The Crime	The Problem
The treasurer of a local police association with 15 years service	Embezzling \$200,000 over 6 years	His duties included cheque authorisation, cheque signing and bank reconciliations.
The financial director of a state branch of the American Cancer Society	Embezzling \$85,000 over 13 months by writing 58 cheques to herself	Her background had not been properly investigated. It was subsequently discovered that she was on probation for embezzling \$800,000 while engaged as the accountant for a firm of real estate agents.
A treasurer of a nonprofit organisation	Depositing members cheques but pocketing their cash payments.	When members complained about large balances being over due, governing board accepted the assurance of the treasurer that everything was under control and failed to investigate any further.
A staff member of a national nonprofit organisation	Embezzling \$265,000 in cheque theft through forgery	Two key existing internal controls were disregarded and the accounting manager was allowed to handle accounts payable and daily deposits, as well as reconciling monthly bank statements.
An executive director of a nonprofit organisation	Misappropriating \$244,100 of funds	The director was able to override the internal control structure by a dominating management style.

* Sources: Barton et al (1996), Lambert et al (1998) and Smith (1997).

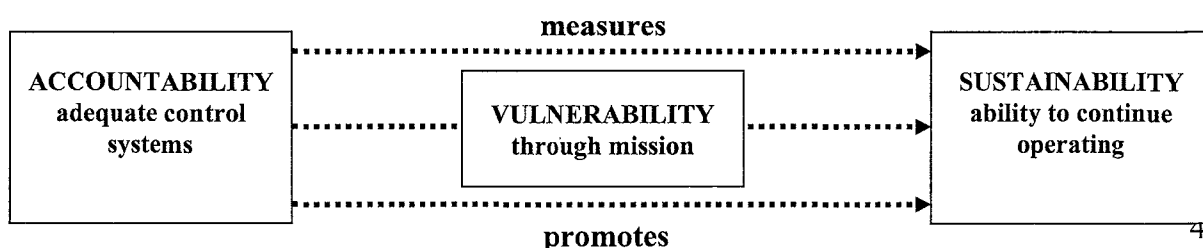
While many of the financial management practices of business “are useful and long overdue in the nonprofit world” (Langan, 1998, p. 75), the combination of unique forms of governance, heavy reliance on volunteers, varying tax and legal considerations, and the absence of a profit motive, mean that there are also important distinctions in financial practices between for-profit and nonprofit organisations. Frequent turnover of third sector leadership, due to the voluntary nature of the organisation, may lead to delays and confusion in implementing various financial strategies. The nature of the NPO's mission and the sources of its revenue demand a high degree of accountability, which in turn demands a sound internal control system.

However, as voluntary organisations, there is often a tendency for NPOs to emphasise participatory democracy, dispersions of power and consensus management (O’Connell, 1988). Because organisational goals may be altruistic, qualitative, intangible and non-monetary (Gerard, 1983; Kramer, 1981), an NPO may often tend to reject the more ‘objective’ accounting control measures mentioned above because they were seen as more appropriate to a “business” organisation. This resistance to the introduction or increase in management control strategies that appears not to further their service goals is common to NPOs (Stanton, 1989; Weiss, 1988).

3. Financial Sustainability

Thus, adequate financial accountability systems will enable nonprofit leaders to decide in a timely manner, whether their organisation is likely to be vulnerable to financial shocks, and thus to anticipate the extent of the organisation's financial sustainability (Ireland, 1999). This linkage of financial accountability and sustainability is depicted in Figure 2. Whereas adequate accountability controls both measure and promote financial sustainability, there is an intermediary variable of vulnerability that arises as a result of the commitment of the NPO to its mission.

Figure 2: Linkage of Accountability and Sustainability in NPOs



The financial sustainability of the third sector is of major concern because it is

1. very large and has been growing rapidly (Lyons and Hocking, 1998);¹
2. a substantial employer;
3. the provider of services which fill gaps in government services;
4. an alternative delivery mode for public services, a rich source of diverse ideas and an avenue through which minority demands for public goods can be channelled (Douglas, 1987; Weisbrod, 1988), and
5. an important expression of the pluralistic approach that underlies Western democracies.

An NPO may be regarded as having difficulty being financially sustainable if it prone to reduce its service offerings directly it experiences a financial shock (Greenlee and Trussel, 2000; Tuckman and Chang, 1991). However, due to its societal interests, the NPO faces distinct pressures, not experienced by organisations in other sectors, if it attempts to abandon a non-profitable market. These pressures may expose the organisation to problems with respect to the financial sustainability of its operations. Internal pressures may arise because of a humane commitment to its clients. External pressures may originate from local community groups, ethnic, religious groups or other organisations which are convinced that the maintenance of some activity is dependent on the NPO continuing the current activity. These nonfinancial pressures means that the NPO may find itself with an exit barrier (Harrigan, 1980; Porter, 1980) which in turn increases its financial vulnerability.

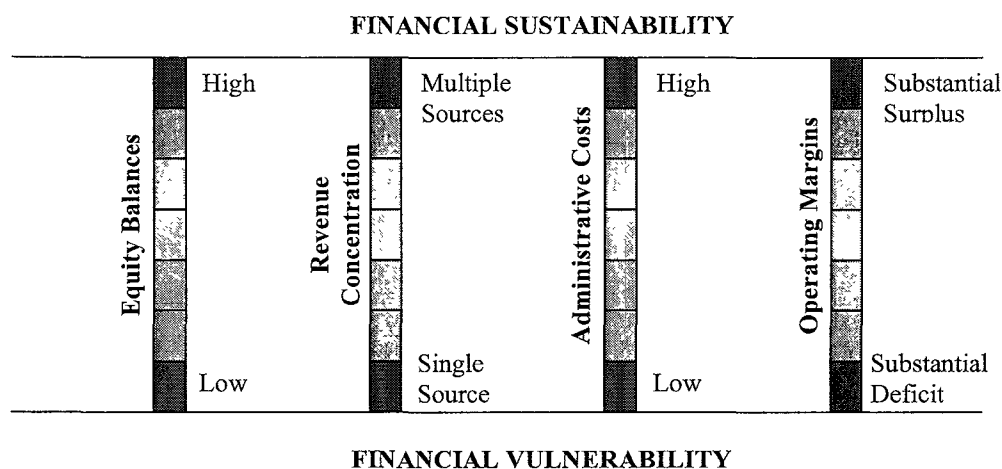
Thus, it is essential that a single NPO can judge its financial sustainability at any point in time. Tuckman and Chang (1991) suggested that there are four operational criteria which should be considered in relation to the financial vulnerability of nonprofit organisations: inadequate equity balances, revenue concentration, low administrative costs and low or

¹ It is claimed that

To varying degrees, nonprofit organisations are sustained by millions of ordinary people, through gifts of time and of money, or volunteering and giving. They are also generously supported by governments and business, though in both cases, there is often an element of reciprocity to this support: governments fund nonprofit organisations to provide services that might otherwise be provided by government directly; business looks to obtain favourable publicity and sales through an association with well known nonprofit. (Lyons and Hocking, 1998, p. 2)

negative operating margins. These four criteria have been combined to form the basis of the model of financial health shown in Figure 2. Each criterion operates along a continuum corresponding to the movement between financial sustainability and financial vulnerability. This is an important tool which allows an NPO to measure its current state of health by considering its position in relation to these criteria both now and over time.

Figure 2: A Model to Measure the Financial Health of an NPO



4. The Model Defined

4.1 Equity Balances

An organisation's equity is equivalent to its net assets, or the residual amount after its liabilities are subtracted from its assets. Since an NPO's operating equity is derived solely from its operating income, its equity is equal to its total net operating results (the balance of surpluses and deficits) since its foundation. However, this equity may be held in either liquid assets such as cash, or non-liquid assets such as property. If an NPO were to receive a contribution intended for capital purposes, this would be a source of equity capital rather than operating capital with equity capital being a restricted fund and operating capital being an unrestricted fund.²

Equity balances are important to the financial health of an NPO because

² However, all funds are in effect "restricted" in an organisational sense. They can only be used to meeting organisational goals. Therefore, the key question underlying the use of all funds is "How will this expenditure promote the achievement of our mission?"

- if they are held in non-liquid forms, they can be used to free up funds, by refinancing an existing property or obtaining a mortgage on a property that was previously debt free;
- if they are held in unrestricted liquid forms, they can be used to finance the working capital needs associated with a growth in services or to replace temporarily lost revenues during a deficit period;
- if the NPO experiences a series of deficit periods, unrestricted non-current assets can be sold off and used to offset these losses so that the organisation can continue to operate;
- if management needs flexibility to meet and respond to changing resourcing and financial requirements during the implementation of a program or project, nonrestricted equity balances can be used, and
- if the NPO has significant restricted equity balances in liquid form, it may alter its mix of services so as undertake activities which are permitted from the restricted funds, thus freeing unrestricted funds for other uses.

In addition, an organisation with a larger net asset base has two other advantages over one with a smaller asset base. It has a greater ability to replace revenue used in operations and external assistance may be more readily available because there is more expectation of a return on the investment, or at least a return *of* the investment. The financial health model uses a relative measure, the ratio of equity to revenue, to operationalise the potential that an NPO has to find replacement revenues. This measure is generally accepted as an indicator of long-term stability (Glynn et al, 2003; Turk et al, 1995).

4.2 Revenue Concentration

There are two components of revenue concentration: diversity and distribution. First, diversification of revenue sources increases financial sustainability because of the probability that all sources will not be affected by the same economic shock (Bryce, 1992). Conversely, the fewer an organisation's revenue funds, the more financially vulnerable it is to revenue downturns (Trussel et al, 2002; Tuckman and Chang, 1991). Secondly, an NPO with equal distributions of income from various revenue sources will be more financially sustainable, than one which receives most of its income from a single source. Therefore, the larger the number of revenue sources and the more equally these sources contribute to total revenue, the more financially sustainable the organisation.

The financial health model uses an operational measure that incorporates both the diversity of revenue sources and the distribution of these sources; that is, an index produced by summing the square of the percentage share that each revenue source represents of the total revenue (Greenlee, 2000; Trussel, 2002; Tuckman and Chang, 1991).

4.3 Administrative Costs

In simple terms, there are two ways of improving a financial position, or balancing a budget: either revenues must be increased or expenditure must be decreased. Therefore, if an organisation is unable to raise additional revenue, or if revenues decline, it must look to reducing its expenses. In order to continue to provide services, an NPO will not at first consider cutting the direct costs involved in the provision of these services, but will be more likely to reduce indirect expenditure, such as administrative costs.

All NPOs have administrative costs, but the size and composition of those costs vary depending on a number of factors including the nature of the organisation, its size, the length of time it has been established and its growth rate. Administrative costs often include expenditures for resources that do not produce immediate results, such as training, planning, consultation and fund-raising functions. There are various viewpoints in regard to differing interests and claims on budget allocations of direct (program) and indirect (administrative) costs (Haller, 1982) with the need for administrative support being viewed differently by

- *a donor* (who wants to see their contribution going towards direct service provision);
- *a member of the governing board* (who sees the need to be responsive to donor and the member and believes that too much money may be “wasted” on administrative salaries and other costs), and
- *a member of staff* (who wants an increase in salary – just to keep up with inflation - and who cannot carry out all the assigned roles because there are just not enough hours in the day).

If an NPO has relatively high administrative costs, then it is more likely to be able to reduce expenditures without seriously affecting service delivery. However, an organisation with low administrative costs would be expected to have few opportunities to reduce expenditure before it impacts on its provision of services. Consequently, an NPO with lower administrative costs has less room for cost reduction before service provision is affected, and

is more likely to be financially vulnerable to declines in revenue, than one with higher administrative costs. The financial health model operationalise administrative costs by considering a relative measure, administrative costs as a percentage of total costs.

4.4 Operating Margins

An NPO's financial sustainability is related to its operating results. Although a comparison over time may indicate a trend in deficits or surpluses, it is difficult to compare individual results because of the change in the value of money over time and change in activities. Therefore, the financial health model uses a relative gauge, the operating margin ratio, to measure and compare operating results over time. The operating margin ratio is expressed as the percentage that the organisation's net operating result (income less expenditure) represents of its total income.³ The operating margin is related to equity balances in that a large operating margin provides the organisation with funds that can be saved to build operational equity. If an organisation has a low or negative operating margin, then it will have little or no cash surplus upon which the organisation can draw before having to cut services. Consequently, an NPO with a high, or at least positive, operating margin will be financially sustainable.

5. The Model Applied

This model has been applied to an Australian NPO which has existed for over eighty years and has an annual income in the vicinity of \$AUS1.5 million. However, throughout the 1990s it struggled with declining membership and deficit operating results. The study investigated the annual reports from 1924 to 1997 to obtain data for each of the operational criteria. Other archival and contemporary material relevant to the organisation's history, culture and structure were also sourced. The data was analysed by financial ratio analysis, trend analysis and graphical means to determine the financial health of the organisation and make suggestions regarding helpful changes that could be implemented to increase financial sustainability.

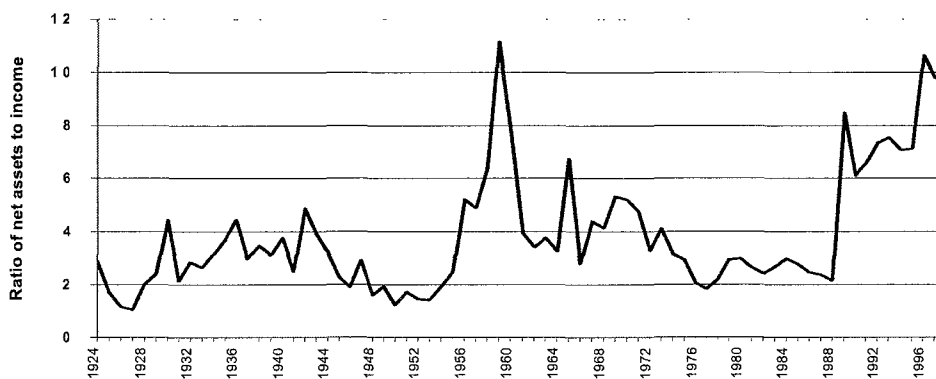
³ In for-profit organisations, this ratio is often called the profit margin and it measures the net profitability of each dollar of sales.

5.1 Equity Balances

The operational criteria used to investigate equity balances was the ratio of net assets to total annual income, representing the potential of the organisation, at various points in time, to find replacement income. The results demonstrate that this ratio was quite high, and increasing, which is probably due to its large non-current asset base of around \$AUS8.5 million.

Nevertheless, whether the organisation is prepared to sacrifice these assets in the future is doubtful. As in many NPOs, assets are regarded as a source of intergenerational equity, and thus it would be difficult to dispose of such assets which have assumed emotional symbolism at the heart of the organisation. To many people, the sale of these assets would represent the demise of the organisation.

Figure 2: Ratio of net assets to total income (1924 to 1998)



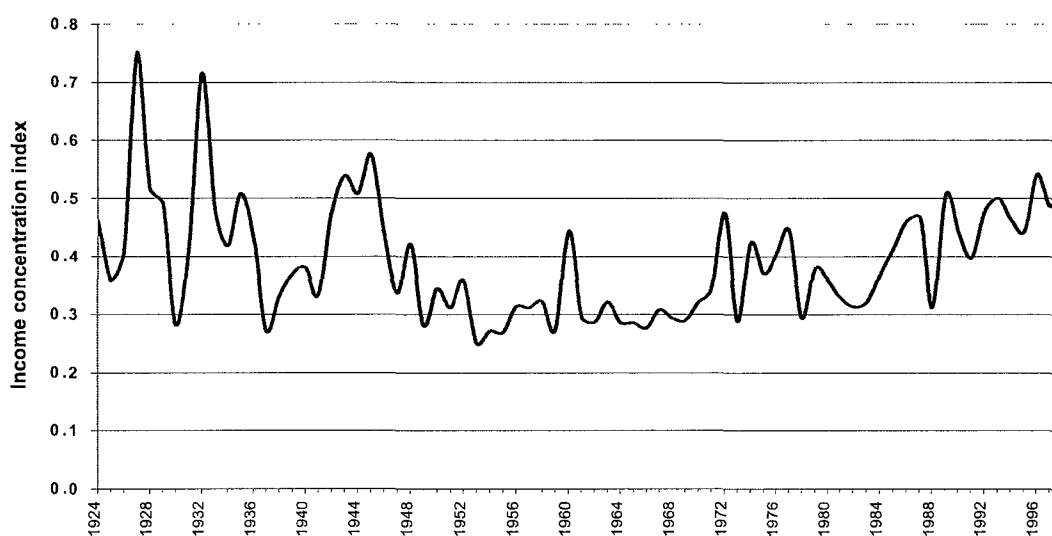
5.2 Revenue Concentration

The second operational criteria was an index measuring revenue diversification and distribution. If the organisation had equal revenues from many sources the value of its index would be close to zero. However, if its revenues were from a single source it would have an index of one. Consequently, the organisation is most likely to be financially sustainable at times when its concentration index is closest to zero. Figure 3 shows that the index has remained between 2.5 and 7.5, implying that in terms of its revenue concentration, the organisation has been neither severely at risk nor significantly healthy.

The index was highest in the earliest years of the organisation, when it relied almost exclusively on income from donations. The index fell in the years when there was also significant fundraising activity. At its lowest points, the organisation had reasonably balanced

income sources from membership subscriptions, investment income, trading, donations, fundraising, events and other sundry items. In the last two decades the index has tended to rise. As interest rates fell, donations became harder to obtain, and as more of the organisation's traditional fundraisers entered the workforce, income from these sources was significantly reduced. Thus, membership subscriptions are contributing an increasing proportion to total income.

Figure 3: Changes in Revenue Concentration Index (1924 to 1998)



Consequently, at a time when much is known about the need for income diversification, the organisation appears to be regressing. Its Management Committee, at which such decisions are made, is not composed of any professional managers. Consequently, there was a reluctance to interfere with the employees in the retail department, even though it had consistently returned a negative result over the last five years of the study. Similarly, the Management Committee refused to act to convert some non-liquid assets into liquid form to enable the development of a new source of revenue. Similar to many NPOs, there are a number of individual agendas that are imposed at the cost of the organisation as a whole.

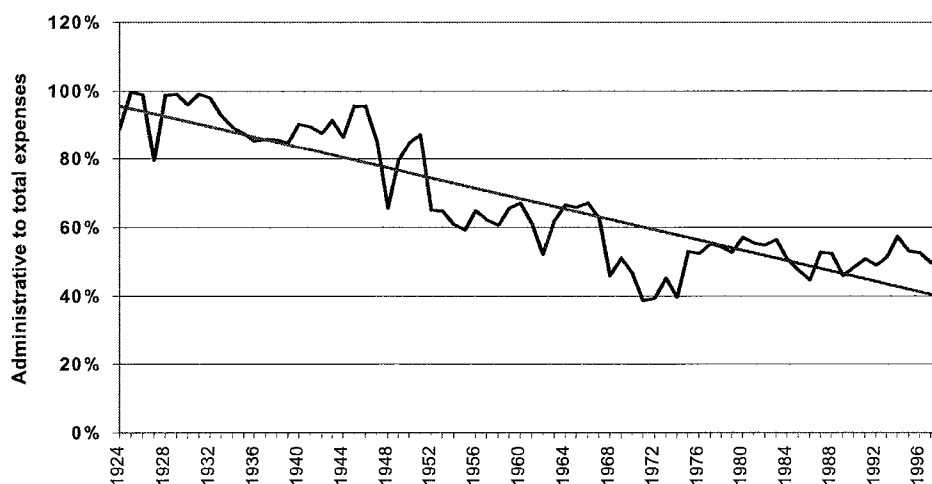
5.3 Administrative Costs

At times when the third operational criteria, the ratio of administrative costs to total costs, is low, an organisation has fewer opportunities to reduce expenditure without having an impact on the services provided.

In the early years of the organisation, this ratio was very high as would be expected from an organisation relying almost completely on voluntary labour and donations. As the organisation grew, expenditure increased in service-related areas with the payment of wages and salaries, expenditure on properties and activities, and payment of membership fees to affiliated bodies. Thus, the ratio of administrative expenses to total expenses decreased. The trend line, added to Figure 4, has a negative gradient, highlighting the continued decline in the ratio. It was lower directly following times of financial crisis, indicating that the organisation has reduced administrative costs at such times in order to attempt to balance the budget. Examples of this can be seen after the deficits of 1936, 1942, 1948-50, 1958-60 and 1968-71. An example of one case where this occurred was reported as follows:

Owing to the need for economy, the Management Committee was obliged to give up half its previous floor-space, and Headquarters departments successfully compressed themselves into the remaining half (Annual Report, 1937, p. 5).

Figure 4: Ratio of annual administration costs to total costs (1924 to 1998)



It appears that only after the deficits of the 1990s did the Management Committee not reduce administrative costs. However, by the end of 1998, the Management Committee recognised the need to reduce administrative costs and decided that the organisation would need to reduce space, by relocating all staff and volunteers on the second floor of its building to enable it to lease out the first floor. The decision had the dual effect of reducing

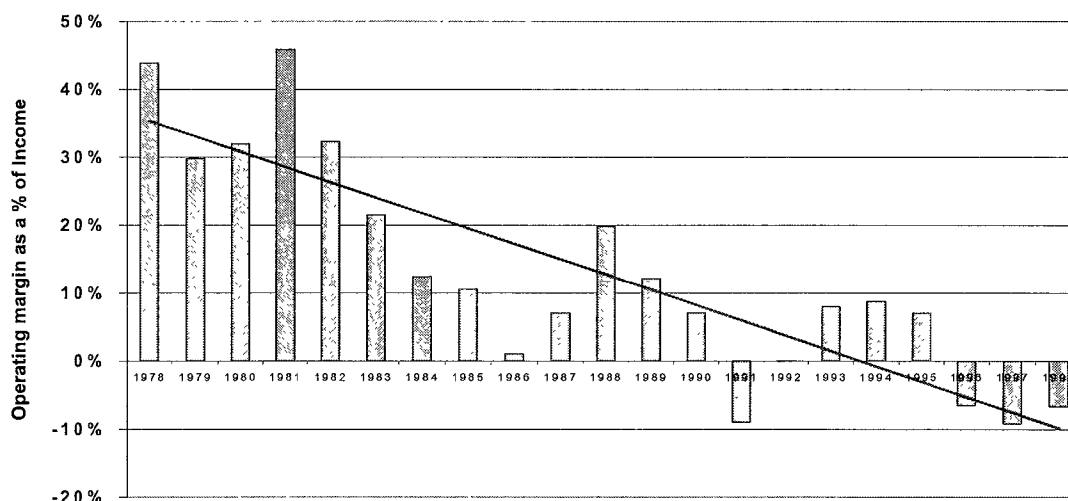
administrative costs and raising revenue. However, with the ratio sitting at around 50 percent, the organisation still has a significant buffer against reduction in service delivery.

5.4 Operating Margins

The fourth operating criteria was a measure of the operating margin, calculated by finding the ratio of annual net operating result to total income. As shown in Figure 6, the downward trend has been significant from 1978 to 1998 with the average operating margin decreasing from 35 percent to a negative margin of 10 percent in that period. As a result of this, the levels of operating margin were much lower than in earlier times, making it more difficult for the organisation to recover from deficit years. To meet these deficits, the organisation consumed past resources to provide current services, raising the issue of intergenerational equity, under which the present generation of an organisation should be “using no more and no less than its fair share of organizational resources (the amount it contributed)” (Herzlinger and Nitterhouse, 1994, p. 5).

Figure 6

Ratio of operating margin (net income) to total income (1978 to 1998)



It is interesting to note that when Frances Hesselbein became Chief Executive Officer of an affiliated organisation in the United States, she discovered that an analysis of ingenerational equity indicated that the organisation’s “losses” reflected a deeper concern with its ability to perpetuate itself. The issue is now similar with this organisation. An operating loss in a given year indicates that members have not provided enough revenues to meet the expenses

incurred that year. Future generations have to make up the losses or the organisation will not be viable. However, intergenerational equity means “that each generation, or more specifically each year, should pay its own way” (Anthony and Young, 1994, p. 105).

6. Conclusion

The application of the financial health model leads to various recommendations that can be made with respect to this NPO.

1. The organisation has a significant asset base, but these assets are largely in non-liquid forms. Whereas the asset base acts as a buffer against insolvency, it would require a significant difference of heart for the Management Committee to decide to part with any of these assets. Although they believe that the assets contribute to the mission of the organisation, it is essential that there be a cost-benefit analysis and a strategic plan created to verify this.
2. Although as yet to reach critical levels, the organisation does not have sufficient revenue diversity to provide a buffer if one source, particularly a major one, should fail. The paradox here is that the organisation is depending increasingly on membership fees as the major source of income, and yet membership is declining. Thus less members need to pay more. There is a need to investigate alternative feasible revenue sources so that the organisation is not so vulnerable to downturns in membership.
3. In the past, deficit years have been followed by a decline in the ratio of administrative costs to total costs, meaning that either administrative costs have decreased or total costs have increased. An analysis of the administrative figures, shows that the decline in the ratio has been due to decreased administrative costs. However, over the last two decades this has not been the case. Despite lower membership numbers, administrative costs have remained static or even climbed. Nevertheless, with administrative costs being around 50 percent of total costs, the organisation should seriously consider cutting back in this area, so that it is able to continue funding its services to members without operating at a deficit.

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4. Intergenerational equity is continuing to be eroded each year that the organisation's expenditure exceeds its revenue. The steady fall to a negative operating margin position over the last two decades is further indication that the organisation needs to consolidate its revenue position and re-address its expenses.

In summary, the organisation has some financial flexibility in that it has access to equity balances and relatively high administrative costs. However, it has few revenue sources and very low operating margins. Its flexibility is such that in the short term it can survive financial shocks, remain financially sustainable and continue to offer the same level of services to its members. If the situation continued, the organisation would need to consider the sale of non-current assets in order to have cash available to meet operating expenses. It would be better if, before this happened, the organisation consolidated its assets so that that it received more return on its investments.

Financial sustainability and accountability are ever-present issues for NPOs as they seek to balance their mission with financial responsibility. This financial health model provides the framework for investigating the financial sustainability of an NPO by considering changes in financial position over time. It illustrates the formulation of operational criteria, analysis and conclusions with respect to a particular organisation. This model can, in turn, be applied to other NPOs to diagnose their financial health.

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