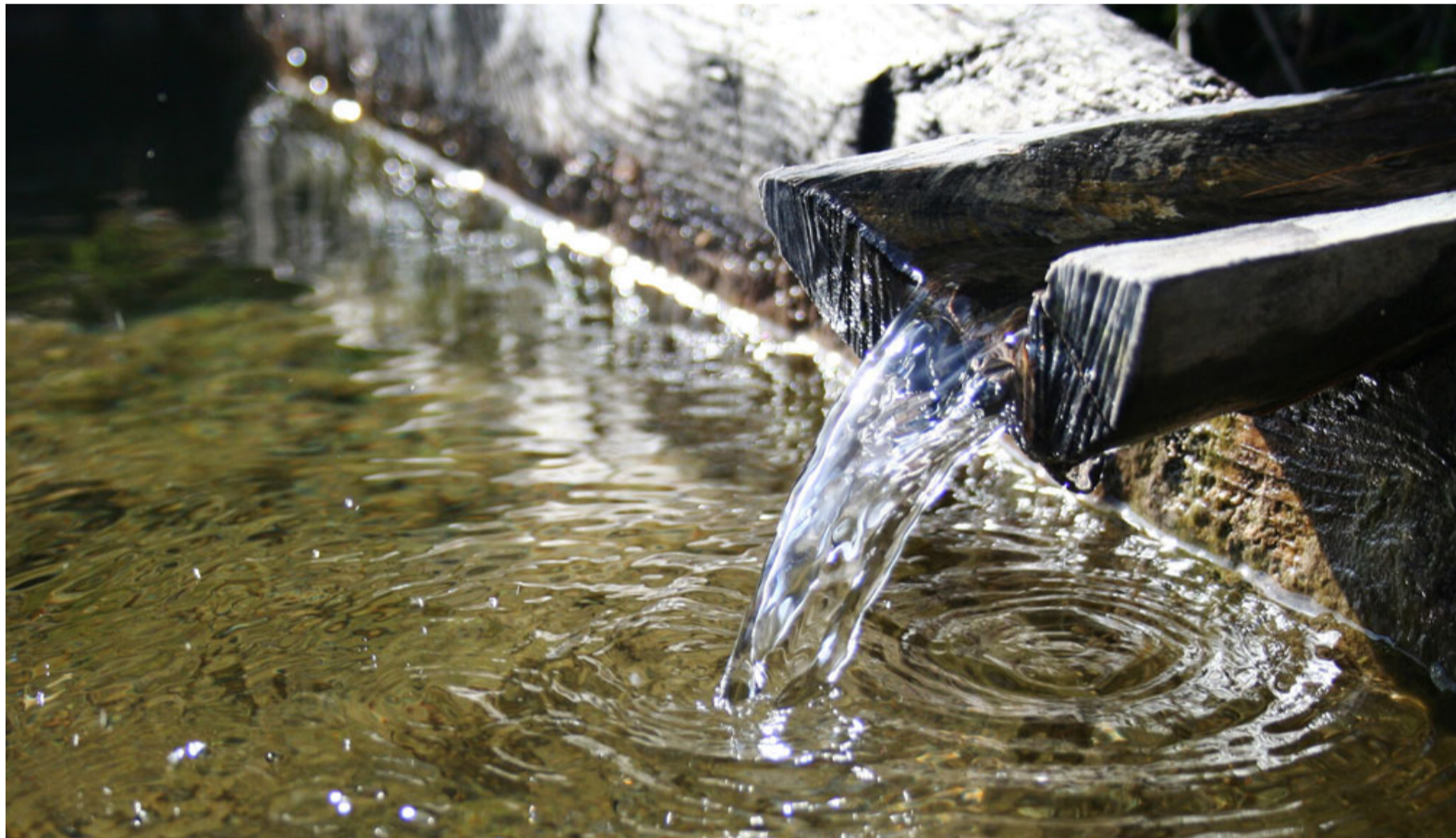


[CASH FLOW AND LIQUIDITY](#), [FINANCIAL MANAGEMENT](#), [FINANCIAL SUSTAINABILITY](#)

Cash Flow in the Nonprofit Business Model: A Question of *Whats* and *Whens*



["flowing" by Mathias Erhart](#)

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In recent years, the concept of the "business model" has gained a great deal of currency within the nonprofit sector, with nonprofit leaders as well as grantmakers and other stakeholders focused on understanding and improving the business and financial underpinnings of how organizations deliver on their missions. Discussions of the nonprofit business model often include considerations of things like cost to deliver services, mix of sources of funding, and key drivers of financial results.¹ Discussions of financial stability and sustainability often focus on the overall health of the balance sheet and (accrual-based) operating results. While these are all essential elements to understanding an organization's finances and business model, such conversations sometimes miss one critical component of any business—namely, day-to-day liquidity. This article will discuss ways in which cash flow impacts—and is impacted by—the way a nonprofit organization does its business.

Cash flow is simply the mix—and timing—of cash receipts into and cash payments out of an organization's accounts. It is where the numbers on budget spreadsheets and financial reports translate into the reality of money changing hands. And as such, it is a very specific lens on the reality of a business model—one that takes into account not just *what* an organization's revenues and expenses look like, but *when* they come and go. Managing cash flow, therefore, is primarily a question of when—when we pay our staff, when this bill is due, when the grant payment will come in. And as there are many varieties of nonprofit business models, each one has a particular bearing on many of those *whens*.

Nonprofit business models have two main components: what kinds of programs and services nonprofits deliver, and how they are funded.² For nonprofits, the latter component is a bit more complicated than for our colleagues in the for-profit world, for whom the answer is (nearly) always "by selling them to customers." Of course, this isn't

to say that cash flow is perfectly smooth or frictionless even in the for-profit sector, only that the range and variety of funding models for nonprofits (including not just “customers” but also third-party funders such as foundations, governments, and even individual donors) adds additional complexity.

Each component of the nonprofit business model—the delivery model and the funding model—has implications for organizational cash flow that should be understood for effective financial planning. We’ll look at each one in turn before discussing some strategies for addressing the almost inevitable occasions when the cash flowing in doesn’t match the cash flowing out.

What Do We Do?

“What do we do?”—what kinds of programs and services an organization delivers (and how it delivers them)—is really a more high-minded way of asking, “What do we spend our money on?” (Granted, some services may be delivered by volunteers or use donated goods, but money is still necessary to pay managers and fund operations.) Really understanding “what we spend money on” will also generally give us a good idea of “when we spend it.” For example, a performing arts company that does four productions a year will have a fairly steady base of ongoing expenses, with spikes during the periods when productions are being prepared and staged. An emergency relief organization may have its baseline of operating expenses, with sudden (and unpredictable) surges of cash needs in response to a local hardship or disaster. A public policy research organization may have very predictable and consistent monthly cash outlays: payroll every two weeks, rent on the first of the month, invoices on the fifteenth and thirtieth. In each case, the cash flow demands are inherent in the business model.

Job one for cash flow management, then, is to understand the timing of cash needs—the magnitude and due dates of an organization’s bills.³ Again, the “what do we do” side of the business model is the guide. If what you do is relatively stable, consistent, and predictable (as in the policy research organization example), your cash needs likely will be as well. If what you do is predictable but not consistent (as in the performing arts company with productions at various points throughout the year), you know to plan for the surge in cash needs when the programming picks up. If what you do is unpredictable (as in the disaster relief agency), you will need cash available to deploy at a moment’s notice.

The examples above only take into account normal operations—businesses also need cash at certain points for longer-term investments like moving to a new space or buying a building. And while a major investment like that wouldn’t happen without a solid plan, there are also the occasional random but significant expenses like repairing a broken elevator. Again, the business model tells the story of the cash needs: while the policy research organization may not be making capital purchases beyond a new set of computers, a housing development organization may need enough cash for major real estate purchases or construction of buildings. However large or small the investment, at the end of the day it means cash flowing out of your account.

How Are We Funded?

Wouldn’t it be nice if the biggest task were simply thinking through one’s program delivery model to identify when the cash will be needed, and then turning on the tap to make it flow? Unfortunately, cash doesn’t work like a tap (and in fact, we have to have cash to keep water flowing). While the ideal case scenario is that cash comes into an organization at a similar volume and velocity to how it goes out, in reality nonprofit funding streams very often don’t work like that. In fact, an organization with a balanced (or even surplus) budget can still end up running out of cash due to timing mismatches. Looking at the “how are we funded” side of the business model can give us a better sense of what to expect in terms of cash inflows and of what to do if they don’t line up with the “what do we do” side. Each type of income stream tends to have particular implications and challenges for cash flow, so a business model built primarily around one type of funding will need to understand and plan for those implications and challenges.⁴

In Fiscal Management Associates’ (FMA) consulting work, a revenue-side business model that we see posing one of the biggest challenges for cash flow management is funding from government (particularly state and local) sources. In general, contracts with government entities pay for services only after the services are delivered, forcing the service-providing nonprofit to cover the initial outlay of cash to deliver those services. This is actually fairly typical of any business (for example, a retailer has to front the cash for inventory before generating income from sales; a professional services firm delivers services to clients prior to invoicing and collecting cash), but it is often compounded in the case of government funding by bureaucratic delays in registering contracts or processing invoices and payments. In some extreme cases, we have seen gaps of six months or more between an organization’s disbursement of cash to deliver contract services and collection of cash under the terms of the contract. In the absence of other revenue streams or other ways of accessing cash (about which more later), nonprofits in situations like this can face true cash flow crises.⁵

Earned income from nongovernment sources—for instance, ticket sales for a performing arts organization—brings some of the same challenges, although (ideally) without the additional bureaucratic delays sometimes inherent in working with government. Even so, cash outlays typically happen in advance of cash collection—performances are rehearsed and sets are built before the audience buys tickets. This means that an organization needs cash to finance those costs that will later generate revenue back into the organization. (Any sort of prepayment on earned income—for example, advance ticket sales for performances or advance payments or retainers for service delivery—can help to fund the initial cash outlays.)

Cash from contributions and donations doesn't come with the bureaucratic delays of government funding or the up-front outlays required to generate earned income. But organizations whose revenue model is primarily driven by voluntary contributions often face another reality of managing cash, which is that cash inflow can be very concentrated at a particular point (or points) within the year. For example, an organization that generates a significant portion of its income from an annual gala-type fundraiser may have an event in spring whose receipts may have to carry it much of the way until the next spring. Another may see much of its cash come in from an annual campaign timed to take advantage of end-of-year holiday (and tax write-off) giving. Nonprofits with highly concentrated cash inflow can exist in something of a "feast or famine" mode—flush when the money is rolling in but concerned that it will have to carry all the way until next year, or at least the next campaign.

Support from foundations and institutional philanthropy has its own implications for cash flow. On the positive side, grants are generally paid at the start of a funding period rather than following the delivery (and costs) of programs and services. On the negative side, grantmaking calendars can vary considerably from a nonprofit's own programming calendar, so there can still be periods when ongoing program or operating costs have to be financed from other sources. Another relatively common characteristic of foundation support (and a cash flow consideration unique to the nonprofit sector) is its *restriction* to particular programs or activities, meaning that a condition of a grant is that its funds be used only for a specified purpose. So, what may look like readily available cash to meet current needs could technically be a set-aside for expenses weeks or months down the road.⁶

Each side of the nonprofit business model—what and how we deliver, and how we fund it—helps set expectations about the timing of cash into and out of the organization's accounts. But, particularly given the fact of nonprofit life that our "customers" and "payers" are often different entities, there's only so much we can do to line up that timing to smooth out cash flow. If it does happen to line up perfectly, it's probably due more to coincidence (or miracle) than conscious effort. So, once we establish solid expectations for what our business model means in terms of the timing of cash going out and coming in, the task is how to manage the many and inevitable instances when the timing doesn't line up.

Balancing Cash In and Out

Regardless of the nature of our business model, or of how well we plan, there will inevitably be periods in which more cash is going out of an organization than is coming into it. This is most obvious during a start-up phase, when the initial investments made in (or loans made to) a new organization are essential to meeting cash needs before income generation kicks in. But even for an established organization in a relatively steady state, "you have to spend money to make money" (and generally in that order) is a rule of business. So, how do we meet our cash needs in those times when there is not enough coming in from operations?

Before discussing that question, one critical point: It's true that in almost any business, there will be times when cash coming in doesn't cover the full need for cash going out. That may be because of certain timing issues inherent in the organization's business model—slow payments for services delivered under a government contract, say. But it may also be because there's simply not enough revenue in the business model to cover the expenses of operating the business. If the issue is a temporary cash shortage, then an organization's leaders will know (or have a reasonable sense of) when the situation will be back in balance, with sufficient cash coming in to cover expenses. If the issue is a more permanent imbalance, what may be presenting as a cash flow problem (i.e., a matter of timing) is in reality a broader business model problem—not just a disconnect between *when* money is coming in versus going out, but between *how much* money is coming in versus going out. If an organization's overall business model is in deficit and out of balance, cash flow problems will certainly exist, but not ones that can be resolved by the methods discussed further down. In those cases, cash flow problems are just a symptom of the bigger challenge of overall revenues not being enough to cover expenses; treating that situation as a matter of cash flow timing will only delay and intensify the necessity to address the deeper need to increase revenues and/or decrease expenses.

On the flip side, an apparently healthy cash balance doesn't necessarily translate to cash fluidity. For instance, particularly in organizations that have multiple streams of funding for individual programs (where, as alluded to earlier, some money is restricted to certain activities), it is easy to lose track of the purposes for which each stream may be used. You may have enough money to run the program, but the money may end up being spent in ways

other than what each funder requires. To make a bad situation worse, such mistakes can be punishable by a requirement to repay, making future cash even harder to come by. Thus, in nonprofit finance, cash is not fungible like it is in most for-profits: you cannot necessarily take it from one overfunded function and devote it to another that is underfunded. This can be confusing to boards—and also, too often, to unschooled executives. Such mistakes with government contracts and other forms of restricted funding can have serious high-profile repercussions for your long-term financial health and cash flow.

With that major caveat out of the way, let's turn back to the question of how to address timing issues when last month's collections are lower than this month's bills. The most basic (and important) solution is drawing on an organization's own cash reserves, which supply the working capital to keep current on payroll, rent, and other expenses. Having a cushion of a few months' worth of expenses built up in the bank account provides the liquidity necessary to avoid being at the mercy of each day's cash receipts to determine which bills to pay. Cash reserves are a good indicator of a nonprofit's overall financial health and sustainability, but from an even more practical perspective they are an essential resource for managing cash flow and payment schedules.

Unfortunately, development of a robust cash reserve can be a significant challenge for many organizations. While financial surpluses and accumulations of reserves should always be a goal of budgeting and financial management, some organizations' business models make this particularly challenging. For instance, heavily government-funded social service providers face a Catch-22, in that expense reimbursement contracts cannot by definition operate at a surplus, yet the typically slow pace of cash receipts makes it particularly important to maintain a significant cash reserve. What options exist in such cases?

For any business unable to meet cash needs with its own resources, it must meet them by borrowing from someone else's resources (that is, taking on debt). To meet operating cash needs in the absence of adequate cash reserves, a nonprofit can turn to a line of credit as a "floatation device" to meet the *temporary* imbalance between available cash and expenses due. We stress the word *temporary* here to echo the important point made a few paragraphs back: that lines of credit should be used *only* to address a timing discrepancy between payment of expenses and receipt of cash. Without a reasonable and relatively specific understanding of when the cash will be available to repay the line of credit, an organization is at risk of using credit to fund an operating deficit—and, of course, exacerbating the deficit with the interest expense associated with the debt!⁷

That said, credit lines used responsibly can be a useful and vital tool for cash flow management, particularly for those organizations whose business models entail slow collection of major receivables or long gaps between cash infusions. We typically recommend that organizations in those situations secure a credit line at least as a safety net, since using credit is generally a better course of action than delaying payment of expenses that are critical to the functioning of the organization. And, as a general rule, it's much easier to secure a line of credit *before* it's needed than it will be when and if the situation becomes urgent. Of course, credit doesn't come free, and organizations using lines of credit must also plan and budget for interest expenses and any other transaction costs associated with taking on debt.

If neither reserves nor credit are options in a cash crunch, nonprofits may be forced to resort to less appealing means of riding out the storm. These may include measures such as approaching funders for accelerated or advanced payments (here again, it would be critical to show that the problem is only one of timing mismatch in order to avoid raising a huge red flag to a funder) or delaying payment of certain noncritical vendors. An even less appealing option would be a loan from a staff or board member, which could raise conflict-of-interest concerns. Probably the worst-case scenario is delaying payroll for some or all staff, which could jeopardize the organization's programs as well as potentially raise legal issues. Far better to understand your business model and budget, and plan in such a way as to establish a solid cash cushion for the lean times.

Cash Management across an Organization

The challenges and consequences nonprofit organizations face with respect to cash flow are to a large extent inherent in the business models those organizations operate with—what kinds of programs and services they deliver and the way(s) they are funded. But this isn't to say that nonprofit leaders are purely at the mercy of the business model; understanding the way the model impacts cash flow is the first step toward planning for and managing it. While it may be impossible to ensure that cash is coming into the organization exactly on time and on target to keep things on automatic pilot, it is certainly possible to plan for those times when it isn't, and to take advance measures to be sure that bills (and staff) are paid on time.

In this effort, it helps to take a team approach. While one person or department (finance) will be in charge of the central cash flow projection tool, effectively planning and managing cash requires input from across an organization. Program and human resources staff have the most insight into the timing of expenses. The fundraising team knows the most about timing of grant payments and donor gifts. Contract managers can set

expectations about reimbursement schedules. Team members working on earned income projects can estimate billing and collections. Ultimately, all of this information should flow to the CFO to project and plan for any potential shortfalls (or, in the happy event of significantly more cash than necessary, to park it in safe short-term investments). Staff across the organization may also be asked to help manage challenges as well—perhaps by rethinking timing of certain expenses or working on accelerating collection of cash from donors or customers. Being informed, strategic, and collaborative in cash flow management can help to ensure that a nonprofit’s long-term strategy isn’t derailed by avoidable—if inevitable—short-term obstacles.

Notes

1. Of course, there isn’t one single version—“nonprofit,” as we often say, is a tax status, not a business model—and the variety of ways nonprofits create, deliver, and fund their impact is at least equal to the range of business models in the for-profit sector.
2. See the discussion of nonprofit business models and the “business model statement” in Jeanne Bell, Jan Masaoka, and Steve Zimmerman, *Nonprofit Sustainability: Making Strategic Decisions for Financial Viability* (San Francisco: Jossey-Bass, 2010).
3. A tool developed by FMA for projecting and monitoring cash flow needs is available for download at <http://www.wallacefoundation.org/knowledge-center/resources-for-financial-management/Pages/Cash-Flow-Projections-Template.aspx>.
4. Funding that is diversified across income types can mitigate some of the cash flow challenges particular to a single type of income, although that kind of diversification is itself challenging to achieve successfully.
5. Some government agencies do offer cash advances or no-interest loans to their nonprofit contractors, but these practices are far from universal.
6. That said, tapping into restricted funds to meet immediate cash needs is a potentially dangerous (but not uncommon) practice among nonprofits. Organizations doing this need to be very confident that they will be able to replace those funds when the time comes to deliver on the activities promised in the grant.
7. Again, FMA’s cash flow projections template, cited in note 3, can help nonprofit leaders map out projected inflows and outflows of cash, offering insight into both when the use of credit may be necessary and when it could be repaid.

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