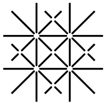

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ENTREPRENEURSHIP IN NONPROFITS

Managing your financial resources

[Georg von Schnurbein] In a recent study, we asked nonprofit managers, "what are your major challenges?". As you can see, two of the three major challenges concern financing the organization. A similar study in the UK showed the same result. Managing finances is crucial for the survival of your organization.

The core aspect of financial management is securing cash flow. More precisely, it is about managing financial health and choosing your revenue sources well. I will first talk about criteria and indicators of financial health, and then present criteria for evaluating different financial sources.

Financial health consists of two different constructs. One is financial stability, and the other is financial capacity. The problem is that they are sometimes contradictory. If you want to have stability, you need to reduce risks and look for continuity. If you want to increase your financial capacity, you have to invest, which means that you have to take risks.

One of the most common discussions in that sense is the question of concentration or diversification. Following portfolio theory, many textbooks recommend to diversify your financial revenue mix in order to spread the risk. Thus, most nonprofits diversify between donations, state funding, and own revenues.
The downside of diversification is increased costs of control because every revenue source has its own rules. What is more, portfolio theory only works if the sources show reverse developments.
You have to decide on your own how diversified you want to be, but you should analyze it. The typical indicator is the so-called Herfindahl Hirschman Index, HHI, and this is the formula. It is defined as the sum of the squares of the share of each revenue source within the total revenues of the organization, where the revenue shares are expressed as fractions. The result is proportional to the average revenue share weighted by revenue share. As such, it can range from 0 to 1, moving from a huge number of very small revenue sources to one single revenue source.

However, the more different sources you include, the more precise it gets. We have here an example with three different main sources, and then more disaggregated seven sources. As you can see the HHI three offers a totally different picture than the HHI seven, which is more precise.

There are two other important indicators that I want to present to you. One is called operating margin, and tells you something about the ability of your organization to go further. The second is called administrative cost rates one and two, and deals with the resources not directly used for projects.
These indicators help you to get a constant oversight of the financial situation in your organization. Additionally, you might find one or two other indicators that are of specific interest for your organization. After we have talked about financial health, I want to present you with five criteria to evaluate different revenue sources. As we have already discussed, each organization has to find its own mix of revenue sources. The following criteria help you to look beyond pure financial return and include other decisive factors in your decision making.

The five criteria are governance/ethics, competency, efficiency, volatility, and interdependencies. The reliance of nonprofits on private or public donors has an impact on the governance system. In connection

with financial sources, ethical norms apply to disclosure, conflict of interest, and the coherence of a revenue source with the organization's mission.

The effective use of every revenue source depends on a different set of competencies. Maintaining a revenue source requires internal expertise. Fundraising has become a profession of its own, and for state subsidies, nonprofits require considerable knowledge on submission requirements and processes. Each revenue source has different costs of control and transaction costs. The more revenue sources are included in the portfolio, the more different cost structures must be managed. Nonprofits are highly reliant on revenue stability to manage their liquidity.

The exposure to volatility varies between the revenue sources. While earned income might change quickly following market developments, state funding is rather stable. However, a change in legislation might cause a shock and lead to state income dissolving at once. You always have to keep in mind spillover or crowding-out effects between different revenue sources.

The literature is not univocal about effects between, let's say, government funding and private donations. But you should check for consequences on your existing funding sources before you add a new one. Managing financial sources is not only about numbers. Most importantly, it's about your mission. Your revenue sources have to fit your mission and supply you with the necessary means to fulfill this mission, all along respecting your structure, your capacity, and your constituents.