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What Financial Challenges Do Nonprofits Face?

Financial struggles are a reality for many nonprofits, even those with excellent programs. Primarily dependent on highly restricted grant support that does not cover general operations, today's nonprofits spend too much time trying to cobble together a patchwork of funding sources. They are subjected to complex and redundant paperwork in order to apply for and report on grants. And, last but not least, they plow most if not all of their grant monies into delivering services now, rather than investing in strengthening their organizations.

All of this contributes to hollowed-out nonprofit organizations with high rates of personnel turnover and executive burnout — not to mention an inability to grow stronger over time. This piece outlines the key challenges nonprofits face in achieving financial sustainability and the ways in which grantmakers can contribute to these stressors.

Top Financial Challenges for Nonprofits

Financial instability is a reality for many nonprofits. Recent findings from the Nonprofit Finance Fund's 2013 State of the Sector Survey found that 42 percent of nonprofit respondents did not have the right mix of financial resources to thrive and be effective in the next three years. Further, one in four nonprofits surveyed have 30 days or less of cash-on-hand.[1] These findings illustrate a sector in which nonprofit organizations are struggling to cover basic costs, plan for the future and starved for critical investments in key infrastructure — i.e., technology systems, leadership development, facilities upkeep, among other things.

For more on this topic, see *On the Money: The Key Financial Challenges Facing Nonprofits Today — and How Grantmakers Can Help*, by Nancy Burd (Washington, D.C.: GEO, 2009).

1 Nonprofit Finance Fund, "State of the Sector Survey," 2013. Available at http://nonprofitfinancefund.org/state-of-the-sector-surveys.

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Grantmakers can play a significant role in helping relieve the financial strain on nonprofits, but there are also a number of ways in which grantmakers can instigate some of the main financial challenges nonprofits face. GEO's research identified five of the primary problems:

1. Restrictions on Funding: Despite the obvious importance of infrastructure to the success of nonprofits, grantmakers overwhelmingly prefer to support direct delivery of services or programs, often leaving out or paying a small percentage of the costs to deliver those services or operate the enterprise. As a result, nonprofits are using funds that could otherwise go to investments in their infrastructure and operations to cover the costs of delivering programs that funders don't fully support. Because they are unable to make critical investments in their organizations or build a financial reserve, nonprofits become less resilient and more susceptible to losing ground during tough times.

2. Misperception Around Sustainability and Growth: To some grantmakers, sustainability means nonprofits will lessen their reliance on foundation funding and will learn how to pay their own operating costs. To many nonprofits, however, sustainability means having sufficient capital to operate effectively and grow year after year, no matter the sources. And, often the structure of nonprofit organizations means that most will be dependent on contributed dollars — so sustainability means finding contributed dollars to provide sufficient capital. Exacerbating this difference is a lack of understanding by grantmakers about the type of capital offered to grantees. In a recent white paper, The Nonprofit Finance Fund has outlined a distinction between "building versus buying" in which a grantmaker interested in offering capital for a nonprofit to grow is a "builder" and a grantmaker who is interested in supporting an organization to "keep doing what it already knows how to do" is considered a "buyer." In reality, most grants are too small and too short in duration to support nonprofit growth. As a result, the majority of grants go toward programs, despite the pressure on nonprofits to expand reach and results.

3. "Too Many Masters": Revenue diversification is the rule of thumb in resource development for nonprofits. But a greater variety of resources comes with a corresponding increase in resource dependencies, management challenges and mission creep. Although the benefits of diversification may mitigate the risk of losing one or more grantmakers, the consequences of "too many masters" may create problems for the typical nonprofit. As it plays out, most nonprofits raise money from one grantmaker at a time, developing a strategy that is customized for each funder's program and grantmaking strategy. Considering the small size of most foundation grants, this piecemeal

approach to raising money can lead to haphazard growth and can divert the organization from its core focus and mission as it tries to meet the varying demands and interests of an array of grantmakers.

In a study of nonprofit organizations whose budgets had grown to $50 million or more between 1970 and 2003,[2] the Bridgespan Group found that organizations that achieved significant growth had two main things in common:

- They raised most of their funds from one type of funding source (e.g., government, fees or corporate), debunking the belief that growth and sustainability could be achieved only through diversification.
- They built the infrastructure of their organizations to maximize their capacity to get and manage the funds.

While not every organization can or should aspire to extraordinary growth, the lessons learned from organizations that did are important. The study suggests that nonprofits should not necessarily seek diversity of funding for diversity's sake, but that they must become more intentional in determining their funding mix with an eye toward resources that are reliable. Grantmakers that want to help nonprofits improve their funding streams should consider providing flexible funding that allows nonprofits to develop other reliable sources of revenue. Because government grants are more likely to come with greater restrictions and only cover program delivery, grantmakers also should consider covering the operating costs of nonprofits that rely to a large degree on government grants for program funding.

4. Onerous Grantmaking Practices: Nonprofits — and many grantmakers themselves — often lament the varying and sometimes onerous requirements that organizations must follow in applying for and reporting on grants. From duplicative grant applications to demands for arbitrary impact indicators, many grantmakers place enormous burdens on grantees — even those that receive relatively small amounts of money or funding from the same grantmakers every year. In addition, grantmakers typically ask for the same data from repeat grantees year after year, which is time-consuming and expensive.

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2 William Foster and Gail Fine, "How Nonprofits Get Really Big," Stanford Social Innovation Review, Spring 2007. Available at http://www.ssireview.org/images/articles/2007SP_feature_fosterfine.pdf.

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A 2008 Project Streamline study concluded that many common grantmaking practices — such as "one-size-fits-all" application requirements — can actually interfere with the ultimate effectiveness of grants. The study also found that the cost of applying for many foundation grants often is too great in comparison to the award. While GEO's 2011 study of philanthropic practice reports an increasing number of grantmakers who are aware of this discrepancy, half of grantmakers still do not adjust grant requirements based on grant size. Grantmakers also do not have a good understanding of the resources expended by grantees to meet these grant requirements because the study found that only 12 percent of respondents collected information about how long it takes grantees to meet administrative requirements. Using data commissioned from Center for Effective Philanthropy, the Project Streamline study found that the average grant proposal creation and application/selection process takes 27.45 hours per grant.[3]

5. Knowledge Gaps: Both grantmakers and nonprofits have a fundamental lack of understanding of the nature of money in the sector. For their part, most foundation staff members are generally hired for their expertise in a given area as opposed to their understanding of nonprofit finance. And a major problem facing the sector is a lack of shared understanding and consensus about the types of capital that nonprofits need most. A 2001 paper for The Rockefeller Foundation and the Fannie Mae Foundation identified the three primary forms of capital that nonprofits need. These include:

- Facilities capital — funds for building or acquisition of real estate to house nonprofit offices and programs.
- Working capital — funds for routine expenses during times of low cash flow, or for more strategic investments in an organization's capacity to grow or improve its services. This is the most sought after form of capital.
- Permanent capital — funds granted for an organization's endowment, or to the capital reserves that community development organizations use to invest in housing and business development.[4]

A lack of understanding about what it actually costs nonprofits to deliver services or to achieve their goals for growth is another obstacle that can get in the way of a grantmaker's ability to provide nonprofits with the right kind of support at the right levels. This gap in understanding is further exacerbated by

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3 Jessica Bearman, "Drowning in Paperwork, Distracted from Purpose: Challenges and Opportunities in Grant Application and Reporting" Project Streamline, 2010.
4 William P. Ryan, "Nonprofit Capital: A Review of Problems and Strategies," Fannie Mae Foundation and The Rockefeller Foundation, 2001. Available at http://www.community-wealth.org/_pdfs/articles-publications/pris/paper-ryan.pdf.

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the common (and flawed) perception that nonprofit overhead costs should be low no matter what. This contributes to a lack of transparency among nonprofits about the true costs of running their programs and sustaining their organizations. However, efforts such as The Overhead Myth and Real Talk About Real Costs are working to counter the harmful assumption that the ratio a nonprofit directs to overhead is an appropriate way to measure any organization's effectiveness.

Conclusion

We know that nonprofits today spend a lot of time seeking and sustaining funding from multiple sources. These efforts, coupled with the pressure to direct all their resources to programs and services creates significant financial stress on nonprofit organizations. Grantmakers can help alleviate the stress by providing flexible dollars, reducing paperwork burdens and increasing dialogue and knowledge about what it takes to build the financial sustainability of grantees.