Grantmakers in the Arts
GIAreader
Vol. 22 No. 1, Spring 2011
Ideas and Information on Arts and Culture

Why Do Balance Sheets Matter?

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Reprinted from the Grantmakers in the Arts ***Reader,*** Vol. 22, No. 1 Spring 2011

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Supporting a Creative America

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Why Do Balance Sheets Matter?

Rodney Christopher

If I have learned anything in my thirteen-plus years of helping nonprofit leaders interpret their finances, it is that the numbers alone can never tell you the full story. Whenever possible, I encourage you to have a conversation with an organization's leadership if you find that their financials are not passing your litmus test. I also urge you to keep in mind that the knowledge base and comfort level with talking about balance sheets vary widely across the leadership of cultural organizations. The field will benefit to the extent it is possible for you to gently guide the groups you support toward clarity, ownership, and dialogue about capitalization. Finally, improving capitalization requires time, patience, and celebration of progress. It also requires funders to play a leadership role in using carrots and sticks to encourage and ensure that progress occurs.

One way to think of the balance sheet is that it can inform us about the kinds and degrees of financial risk an organization faces as it delivers on its artistic mission.

If we agree that the capitalization of arts organizations is important, and that evidence of capitalization can be found on the balance sheet, what should you, as grantmakers, be looking for?

One way to think of the balance sheet is that it can inform us about the kinds and degrees of financial risk an organization faces as it delivers on its artistic mission. In this context, risk — and its converse, opportunity — has three distinct levels:

- **Liquidity:** Does an organization have adequate access to cash to meet its operating needs?
- **Adaptability:** Does an organization have flexible funds that can allow it to make adjustments as its circumstances change?
- **Durability:** Does an organization have access to funds sufficient to address the range of needs that it may face in future years?

Addressing liquidity is necessary, although for many organizations it can be quite difficult. Healthy liquidity requires an accumulation of annual operating surpluses (occasional deficits may be planned or unavoidable) and, where appropriate, a line of credit.

Funding adaptability and durability are more complex, since surpluses, when they exist and can be set aside as reserves, are rarely sufficient to do the job. Periodic infusions of contributed capital and strategic use of long-term debt are typical strategies to fund long-term needs, which can range from investments in technology to making major repairs on a building to pursuing new or improved ways of generating revenue.

I will provide a case to introduce how to use the balance sheets of your applicants and grantees to make an initial assessment of their liquidity, adaptability, and durability needs. I will focus on making observations about the numbers you see and employing two key ratios. To reinforce your learning, I encourage you to use a balance sheet from one of your grantees as you read. I will assume that you understand terms such as assets, liabilities, and net assets (see the final section, "Additional Resources," for ways to obtain definitions of financial terms); I will provide definitions for less-common terms.

So, Let's Get Practical

Grab the balance sheet of one of your applicants/grantees. In general, it is best for you to review audited financial statements. Their numbers have been independently assessed and the notes to the audit, which you should always review, can provide helpful details you will not see on the balance sheet itself. When examining balance sheets, it is also important for you to have the statement of activities (income statement) nearby. Because the balance sheet is a snapshot in time, it is possible that the audit might present an artificially pessimistic (or optimistic) picture at the fiscal year end (FYE). Thus, it is useful to learn about the cyclical nature of a grantee's business; for example, do they get most of their cash during a specific three-month window?

The sample balance sheet on page 21 is based on that of an actual theater company — let's call them the Cider Hill Players (CHP). Below the balance sheet (a.k.a. the Statement of Financial Position), you will also see the operating expenses for each of the two years (found on the income statement); this will help with our calculations.

What can you see with a quick glance of the CHP balance sheet? Here are some important details you can identify:

1. They do not own a building (Property and Equipment, net of accumulated depreciation is $6,298 at FYE '09), and the bulk of their property is equipment, sets, and costumes that have all but fully depreciated from an accounting standpoint. It is likely that CHP can use some of their items for a few more years; it is also likely that some replacements are in order.
2. They have a board-designated reserve ($50,000 at FYE '08 and '09 — an audit note might tell us whether there are any parameters for use of the reserve).
3. They have a line of credit (we don't know how much is available — an audit note should tell us that; but we

do know the line is at least $25,000 as that was the amount outstanding at FYE ’09).

Together, these items give us a good entry point. The first involves durability, the second adaptability, while the third is linked to liquidity. It is possible to draw some conclusions about CHP from these three data points, but I generally prefer to look deeper. Now take a look at your grantee’s balance sheet. Jot down some initial observations or questions. Then put them aside. After you’ve worked through the balance sheet with this article, go back and see if you have greater insight into what you noted.

Analysis of balance sheets can be aided by the use of some ratios. There are limits to the usefulness of ratios when applying sectorwide standards, which I mention at the end of this article. However, within an organization and looking year over year, ratios are meaningful. To gain perspective on the significance of the dollar amounts of the items on the balance sheet, it is important to relate them to the statement of activities. At Nonprofit Finance Fund (NFF), we do so by creating ratios based on operating expenses.

Liquidity Measures

Two such ratios that assess liquidity and, to an extent, adaptability are Months of Cash and Months of Liquid Net Assets. Each gives you a distinct window. In both cases, we want to know how long an organization can operate with the funds it has in hand. Let’s look at Months of Cash first.

Months of Cash = the number of months of expenses that can be covered with available cash.

The formula is fairly straightforward: determine the amount of one month’s expenses by dividing total expenses by 12; then, divide total cash by one month’s expenses.

$$\frac{\textbf{Cash}}{\textbf{Annual Expenses / 12}}$$

On the sample balance sheet on page 21 we see that at FYE ’08, CHP had nearly seven months of cash, while at FYE ’09, the amount dipped to about five months. In general, NFF encourages organizations to aim for a minimum of three months of cash at all times (note that this is a guideline rather than a firm standard). For those producing and presenting riskier/less commercial fare, we suggest aiming for at least six months. Ideally, for all organizations at least three months would be set aside explicitly in a risk reserve, to be replenished as soon after use as possible.

As a nonprofit’s cash can often be restricted, we also want to measure liquidity against that portion of the organization’s net asset base that should be truly available to cover operations. Such net assets do not include property and equipment (which cannot easily be converted into cash for operations). We call this portion of unrestricted net assets “Liquid Net Assets.”

Months of Liquid Net Assets (LNA) = the number of months of expenses that can be covered with the liquid portion of unrestricted net assets.

The formula is more complex: take the total amount of unrestricted net assets and subtract from it property and equipment (PE, net of depreciation) minus facility-related debt. Divide the result by one month’s expenses. (Note: generally, board-designated funds would be subtracted from unrestricted net assets, too. CHP’s balance sheet format takes care of that for us.)

$$\frac{\textbf{Unrestricted Net Assets - (PE Net - PE Debt)}}{\textbf{Annual Expenses / 12}}$$

Cider Hill Players has little property and equipment and no facility-related debt, so the calculation is fairly basic. In the callout box, we see that at FYE ’08, CHP had nearly seven months of LNA, while at FYE ’09, the amount dipped to about six months. It is safe to say, then, that CHP has strong liquidity. When we add their $50,000 board-designated reserve, we could make a case that they have a reasonable amount of adaptability as well. How does your grantee’s balance sheet fare on the liquidity measures?

Adaptability and Durability

Beyond liquidity are longer-term risks that cultural organizations are challenged to address. Examples include:

- buffering against unexpected challenges (e.g., recessions)
- seeding support for pursuing new artistic opportunities
- investing in organizational change that can lead to improved net revenue
- funding new purchases, upgrades and replacements to property and equipment
- providing long-term stability

As stated previously, organizations address these capitalization needs with infusions of capital from strategic debt as well as grants and contributions. An additional approach that NFF urges organizations to take is establishing and building reserves. Reserves help lower the risk of whether funds will be available when they are needed. It is a very rare organization that has sufficient amounts set aside in reserves to meet all its future needs. And we would not encourage organizations to move in that relatively impractical direction. But, we have seen and do see the wisdom in putting a reasonable sum of funds into reserves that can be drawn down and replenished as possible.

There is a range of reserves that can provide arts groups with a first line of defense or source of opportunity; a

This sample balance sheet is based on that of an actual theater company — let's call them the Cider Hill Players (CHP).

What can you see with a quick glance of the CHP balance sheet? Here are some important details you can identify (FYE = fiscal year end):

They do not own a building and the bulk of their property is equipment, sets, and costumes that have all but fully depreciated. It is likely that CHP can use some of their items for a few more years; it is also likely that some replacements are in order.

They have a line of credit (we don't know how much is available — an audit note should tell us that; but we do know the line is at least $25,000 as that was the amount outstanding at FYE '09).

They have a board-designated reserve ($50,000 at FYE '08 and '09 — an audit note might tell us whether there are any parameters for use of the reserve).

CIDER HILL PLAYERS
STATEMENT OF FINANCIAL POSITION
DECEMBER 31, 2009 AND 2008

ASSETS	**2009**	**2008**
CURRENT ASSETS		
Cash	$ 453,728	$ 492,511
Investments	144,616	144,113
Accounts receivable	9,121	2,400
Grants receivable	41,759	54,167
Prepaid expenses	1,874	8,743
Total current assets	651,098	701,934
PROPERTY AND EQUIPMENT		
Equipment	33,794	38,363
Production sets, costumes	53,000	53,000
Leasehold improvements	15,082	15,082
Less: Accumulated depreciation	(95,578)	(100,120)
Property and equipment (PE), net	6,298	6,325
OTHER ASSETS		
Security deposit	23,020	22,260
Total other assets	23,020	22,260
TOTAL ASSETS	$ 680,416	$ 730,519
LIABILITIES AND NET ASSETS		
CURRENT LIABILITIES		
Accounts payable	662	5,012
Unearned revenue	5,222	31,600
Line of credit, payable	25,000	20,000
Total current liabilities	30,884	56,612
LONG-TERM LIABILITIES		
Total liabilities	30,884	56,612
NET ASSETS		
Unrestricted	548,667	491,840
Unrestricted, board designated	50,000	50,000
Temporarily restricted	50,865	132,067
Total net assets	649,532	673,907
TOTAL LIABILITIES and NET ASSETS	**$ 680,416**	**$ 730,519**

	2009	2008
TOTAL EXPENSES	**$ 1,074,344**	**$ 862,296**

Analysis of balance sheets can be aided by the use of some ratios. Within an organization and looking year over year, ratios are meaningful. To gain perspective on the significance of the dollar amounts of the items on the balance sheet, it is important to relate them to the statement of activities.

$$\textbf{Months of Cash} = \frac{\textbf{Cash}}{\textbf{Annual Expenses / 12}}$$

$$\textbf{2009} = \frac{453{,}728}{1{,}074{,}344 / 12} = 5.1 \text{ Months}$$

$$\textbf{2008} = \frac{492{,}511}{862{,}296 / 12} = 6.9 \text{ Months}$$

Above, we see that at FYE '08, CHP had nearly seven months of cash, while at FYE '09, the amount dipped to about five months. In general, NFF encourages organizations to aim for a minimum of three months of cash at all times (note that this is a guideline rather than a firm standard).

$$\textbf{Months of Liquid Net Assets} = \frac{\textbf{Unrestricted Net Assets - (PE Net - PE Debt)}}{\textbf{Annual Expenses / 12}}$$

$$\textbf{2009} = \frac{548{,}667 - (6{,}298 - 0)}{1{,}074{,}344 / 12} = 6.1 \text{ Months}$$

$$\textbf{2008} = \frac{491{,}840 - (6{,}325 - 0)}{862{,}296 / 12} = 6.8 \text{ Months}$$

CHP has little property and equipment and no facility-related debt, so the calculation is fairly basic. Above we see that at FYE '08, CHP had nearly seven months of LNA, while at FYE '09, the amount dipped to about six months. It is safe to say, then, that CHP has strong liquidity. Their $50,000 board-designated reserve provides a reasonable amount of adaptability as well.

few common ones and the balance sheet risks they address include:

- Operating cash flow — *liquidity and adaptability*
- Property and equipment — *durability*
- Risk (unexpected challenges and opportunities) — *adaptability*
- Investment (board-designated endowment) — *durability, with some adaptability*

Analyzing balance sheets for adaptability and durability is not as straightforward as it is for liquidity. The first step is to look for reserves. Few organizations have multiple reserves; many have none. CHP's $50,000 is enough to cover half of one month's expenses — not a lot, but far better than zero. Does your grantee's balance sheet show reserves? How sizable are they in relationship to expenses? If there is a property reserve, what is the difference between that amount and accumulated depreciation (on the balance sheet or in the notes)? It is ideal for the amounts to be somewhat similar, but it is often difficult to set aside large-enough sums. It is best if your grantee has a proper engineer's assessment of their building's needs to determine the size and timing of growth for their property reserve.

Analyzing balance sheets can be a more valuable exercise when looking at more than one or two years. Reviewing a minimum of three years, preferably five, allows one to understand an organization's financial structure and ongoing needs.

In addition to reserves, cultural nonprofits and their supporters seek to establish durable institutions. Typically this is accomplished through the purchase of property and the formation of endowments. CHP has neither. How about your grantee? Put simply, buildings and endowments can be wonderful for cultural organizations. But I have worked with many organizations that have struggled mightily on the heels of a major facility project. And I have seen quite a few that have endowments too small to generate enough money to make a difference — those funds could be put to much better use in a reserve (even an investment reserve, which the board has the power to use for other purposes in extraordinary circumstances).

Debt can also be a source of adaptability and durability. When used properly, loans can be an effective tool for capitalizing a healthy organization. Lines of credit offer great flexibility — borrow when the funds are needed, then repay them when the cash comes in. Longer-term debt can allow organizations to improve their durability by financing purchases of property and equipment and sometimes other items. Of course, debt only works when organizations are capable of repaying it.

I would encourage most organizations and funders to focus first on liquidity and adaptability. Where owning property is essential for any number of reasons, it is critical that organizations have an audience capable of generating sufficient revenue to support annual programs and operations as well as future building needs. If there are two things that cultural groups most need in the environment in which they now operate, and will operate for years to come, it is liquidity and adaptability.

Knowing the degree of an organization's stability can help assess the best ways to help them as grantmakers. For organizations that have remained roughly the same balance sheet size for several years, the first question remains whether they have sufficient liquidity. If not, a grant for a cash reserve might be one option. If their liquidity is reasonable, the next question is whether their fixed assets are substantially depreciated. If they are, then you might look at making a grant to replace or upgrade specific fixed assets (ideally prioritized by the grantee) or providing funds to start or grow a fixed-asset reserve. Alternatively, if the organization makes a strong case that an infusion of capital could help them invest in strategies to improve their earned or contributed revenue, you might provide them with "change" capital.

Importance of Multiyear Review

Analyzing balance sheets can be a more valuable exercise when looking at more than one or even two years. Nonprofit Finance Fund has found that reviewing a minimum of three years, preferably five, allows us to understand an organization's financial structure and ongoing needs. For some organizations, the shifts in their balance sheet composition are minimal over a several-year period; for others, there can be substantial growth or downsizing.

In the case of the Cider Hill Players, the fact that between 2008 and 2009 expenses rose nearly 25 percent ($212,000) while their balance sheet shrank by 7 percent ($45,000) leads to changes in their liquidity ratios and throughout the balance sheet's line items. Identifying and interpreting these changes could fill another article. Suffice it to say we would want to understand the line items that saw the biggest changes: temporarily restricted net assets, liquid net assets, cash and deferred revenue.

A high-level assessment would show that a sizable portion of CHP's expense growth was funded by multiyear grant dollars; 2009 resulted in a healthy unrestricted surplus (note: the statement of activities is needed here); and the spending of deferred revenue in 2009, without a similar occurrence of cash received in 2009 for 2010, accounts for the lion's share of the decline in cash.

On balance and based on two years of data, CHP has experienced significant change and is maintaining a pretty healthy balance sheet with strong liquidity and — with a $50,000 board reserve — a reasonable level of adaptability. The critical issue that you will want to know is whether and how much change your grantee is planning. If they expect substantial growth, or even downsizing, they may require significant capital to achieve this. If they are expecting incremental change, the question is: how well capitalized are they now?

To be clear, it is not plausible to be capitalized perfectly. It is, however, important for the leadership of cultural organizations and program officers at foundations to be conversant about capital needs, and how they will be prioritized so they can be addressed over time.

What Can You Do?

The ability of organizations to pursue capitalization strategies is compromised by long-held but ill-advised "best practices":

- Breaking even each year is enough.
- Growing unrestricted net assets is always hoarding.
- Endowments and property ownership provide stability.

While your foundation may not expect grantees to follow these practices, other funders, grantee board members, community members, local media, and so on, may make it very challenging for organizations to build a balance sheet that is able to support their artistic missions for years to come. Here are a few suggestions that I encourage you to consider:

- *Express concern and engage in a dialogue* when you see operating deficits for two or more consecutive years — especially important when an organization's liquid net assets are in negative territory.
- *Build funder partnerships.* Capitalizing an organization often requires sizable sums of money. When funders collaborate, you can choose, for example, to invest in a third-party analysis of an organization's financial health and capitalization strategy before making a sizable investment. You can similarly choose to obtain third-party expertise in structuring and monitoring such investments.
- *Support or expand existing working capital loan programs; in some cases, create them.* Offer credit enhancements such as loan guarantees to bank and Community Development Financial Institurion programs. One foundation worked with NFF to establish a new zero-interest loan program in response to the current recession. The funder provided the capital; NFF is underwriting and monitoring the loans.
- *Be careful not to apply one-size-fits-all criteria with respect to financial health.* The challenge with many financial ratios is that setting specific fieldwide targets (e.g., a minimum of three months of cash) may not work well for organizations in all artistic disciplines and geographic regions. The variability of organizations and the relative youth of the nonprofit field currently lend themselves to broad guidelines, rather than prescribed expectations. As we progress in efforts to educate ourselves about the financial underpinnings of nonprofit cultural organizations, it is likely that we will be able to move toward establishing meaningful benchmarks.

To be clear, it is not plausible to be capitalized perfectly. It is, however, important for the leadership of cultural organizations and program officers at foundations to be conversant about capital needs, and how they will be prioritized so they can be addressed over time. Otherwise, we all continue to gamble with the health and vitality of the nonprofit arts landscape.

Additional Resources

GIA's *National Capitalization Project 2010 Summary* provides helpful context and some definitions. It may be found at www.giarts.org/article/national-capitalization-project.

A comprehensive glossary of financial terms for nonprofits can be found at nonprofitfinancefund.org/financial-terms.

On the Boards: Sustaining a Vibrant Seattle Arts Institution is a short case study describing how an organization can improve its capitalization. It can be found at nonprofitfinancefund.org/files/ontheboardsdraft_111010sng.pdf.

Top Ten Finance Essentials for Nonprofits and Funders, a two-page tip sheet can be found at nonprofitfinancefund.org/files/Top_Tens.pdf.

Case for Change Capital in the Arts (based on NFF's experience to date with the Doris Duke Charitable Foundation-funded Leading for the Future initiative) to be released by NFF this summer.

Rodney Christopher is vice president, Consulting Services, Nonprofit Finance Fund (NFF).