Government-Funded Nonprofits Face Serious Obstacles to Building Financial Reserves and Working Capital

by John Summers

Executive Summary

Based on publicly available financial data, this research summarizes the financial impact on nonprofit organizations of working with government funders. The article discusses the role nonprofit leaders, governments and philanthropy can play in addressing the most acute challenges so nonprofits can achieve greater financial sustainability and maintain their ability to deliver critical services.

Those of us who work in or with nonprofit organizations are likely aware of the difficulties associated with government funding and the implications for running sustainable organizations and maintaining continuity of services. Government funders maintain tight controls over how funds can be used, require rigorous accounting and financial reporting, and often—particularly state and local governments—delay reimbursement, sometimes for months after services have been delivered. Thus, while government grants can be sources of substantial, recurring revenue, governments can be challenging business partners to nonprofit organizations, even as they rely on these organizations to deliver critical, mandated, social safety-net services to vulnerable populations.

Sector-wide financial data further reveals that a nonprofit business model that depends on receipt of government funding can be financially and administratively challenging. Analysis of IRS Form 990 data from almost 130,000 nonprofits clearly shows that **high concentrations of revenue from government grants are correlated with dangerously meager financial reserves, low levels of cash on hand, and scant profit margins**. [1]

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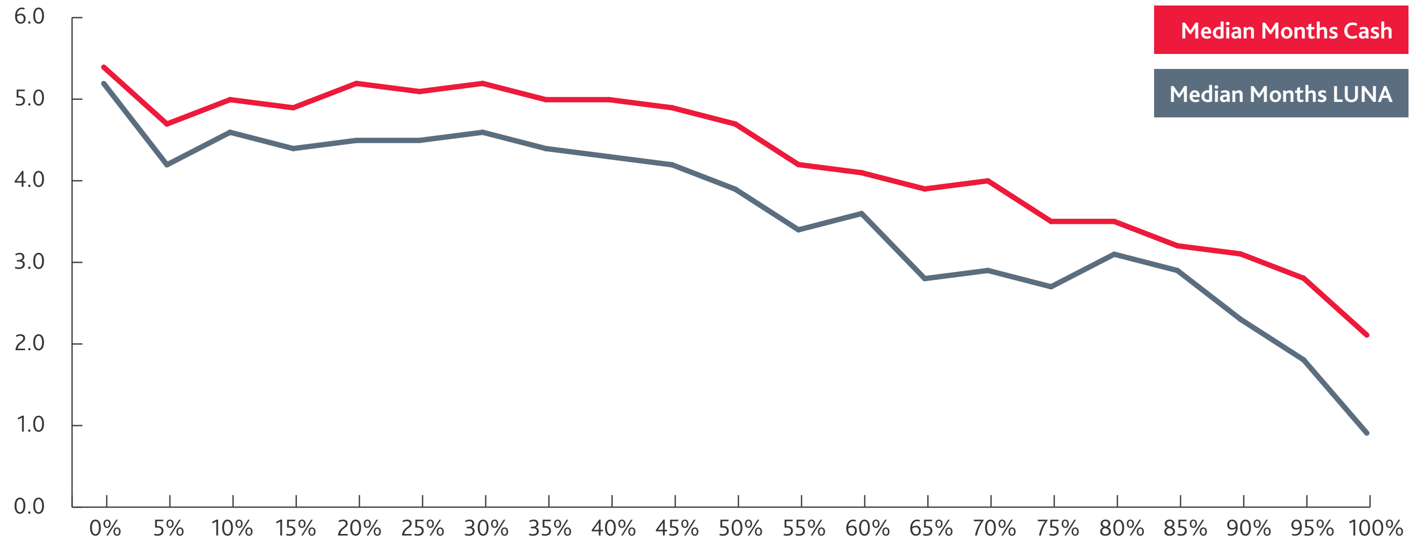
1 Please note that this study considers *only* funds categorized as Government Grants/Contributions (rather than as Program Service Revenue) in the calculation of revenue from government sources. These are grants, contracts, or other contributions from government whose “primary purpose is to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public rather than to serve the direct and immediate needs of the governmental unit.” Most significantly, this does *not* include Medicare and Medicaid payments to nonprofit organizations.

The graph below shows the relationship between the percentage of a nonprofit organization's total revenue deriving from government grants/contributions (x-axis) and the median number of months of expenses that nonprofit organizations with that concentration of government revenue held in operating reserves (liquid unrestricted net assets, or LUNA) and in cash on hand (y-axis).

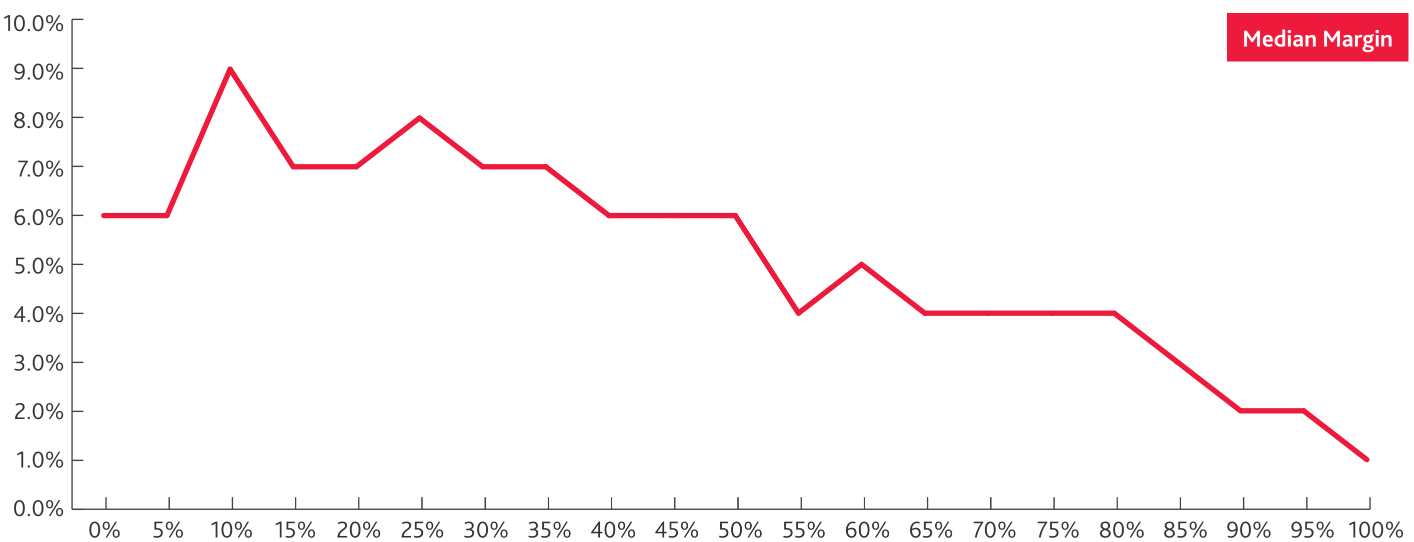
Median months of financial reserves (LUNA) and cash on hand by percentage of revenue from government grants



The trends in these metrics are obvious. Available reserves and cash are relatively flat for organizations up to about 40% of total revenue from government sources, with a gradual decline in these measures for organizations between 40% and 85% government funded, and a precipitous drop—to a median of less than a month of available reserves—for those organizations exclusively or almost exclusively funded by government.

Unsurprisingly, a similar trend holds when looking at operating results / profit margin[2] through the same lens.

Median operating/profit margin by percentage of revenue from government grants



2 Operating margin or profit margin is defined here as change in unrestricted net assets (surplus or deficit) as a percentage of total unrestricted revenue.

The relationship between government funding and operating results is mixed from 0% to around 40% concentration of government revenue, then a gradual decline to around 80%, followed by a sharp decline to a median of a less than 1% profit margin for exclusively government funded nonprofits. (This is understandable as very few government grants allow for any sort of surplus.) These low margins are the reason that it is so difficult for organizations with significant concentrations of government funding to accumulate financial reserves.

In sum, heavily government funded organizations are quite likely to face a situation of slim profit margins, low operating reserves, and insufficient working capital. This makes such organizations highly vulnerable to disruptions in their revenue and cash flow, such as loss or reduction of government grants (as may happen in the event of political transitions) and delays in payments from grantors. It also makes it quite challenging for organizations to invest in the kinds of support and infrastructure that may improve their financial situation, such as additional fundraising and strategic financial management capacity. And given their tight funding, these organizations are rarely able to offer competitive salaries and benefits to attract and retain staff, leading to high turnover and challenges in service delivery.

How Nonprofit Sector Stakeholders Can Help Address These Challenges

FOR LEADERS OF GOVERNMENT FUNDED NONPROFITS

Identify other sources of working capital. The realities of working with government funders—particularly at the state and local levels—include challenges with covering the full costs of services, tight or nonexistent operating margins, and long delays between delivery of services and receipt of reimbursement. Among the many ways that these realities can affect operations is by limiting the availability of working capital to cover everyday costs like staff salaries, rent and utilities. A lack of working capital can create a vicious cycle in which restricted cash flow makes it impossible to hire staff and cover other costs of delivering services, which reduces the amount available to be reimbursed by funders, which further impedes the ability to hire staff and cover other costs of delivering services. Leaders of nonprofits heavily funded by government therefore need access to other sources of working capital, be it reserves (again, difficult to achieve in this context), loans or lines of credit, advances, or some other source. Do note, however, that interest expense on loans is typically not reimbursable from government grants, which will further erode surplus for organizations that choose this route.

Optimize for rapid reimbursement requests. Some government funders require weeks, months, sometimes even years to remit payment to their nonprofit grantees. Given that, nonprofits need to do everything they can to submit reports, vouchers and invoices quickly and accurately, to avoid any delays on their end. Accounting, reporting and grants management systems and processes should be optimized and automated in any way possible to maximize the speed and accuracy of reimbursement requests.

Maximize indirect cost rates: One of the few sources of flexibility in government grants is indirect cost coverage, which funds the administrative and overhead costs of government grantees. While indirect cost coverage is often inadequate in comparison to the actual costs of doing business, it's critical that nonprofits learn how to maximize indirect cost rates and leverage that coverage to support the administrative infrastructure necessary to deliver programs and services. When possible, nonprofits should negotiate an adequate indirect cost rate with funders in order to more fully cover their operating costs.

Diversify revenue sources by seeking private donations. For heavily government-funded organizations, diversification of revenue to include private, unrestricted dollars can help create breathing room in cash flow and financial management. Individual donors, private philanthropy, and corporate giving can all ease the burdens created by reliance on government funds—even if it's only a small percentage of overall income it can make a big difference in terms of cash flow and flexibility. That said, the skills, systems and relationships required to raise funds from private donors are dramatically different from government contracting and will require significant investments of time and resources to develop.

FOR GOVERNMENT AGENCIES THAT FUND NONPROFITS

Pay quickly and, if possible, in advance. Perhaps the most important thing that government funders can do to ease the burdens of this business model on the nonprofits that deliver critical services is to *pay your grantees quickly, in full,* *and in advance if possible.* No individual, family, business, or government agency would expect to be able to endlessly delay payment to a vendor or contractor and expect to still receive uninterrupted provision of goods and services, yet that is just what many government funders force upon their nonprofit partners. It's exploitative and it's dangerous.

Pay what it actually costs. One of the few sources of flexibility in government funding is indirect cost rates, portions of grants/contracts that can be used to cover an organization's administrative and overhead expenses. Government funders should ensure that these rates are fair and adequate to the actual costs of their nonprofit partners, rather than capping indirect cost rates at an arbitrary (and typically inadequate) level. State and local funders should also be willing to negotiate an adequate indirect cost rate with their grantees rather than simply offering a standard or *de minimus* rate—this is even mandatory for grant funds that originate at the federal level.

FOR PRIVATE PHILANTHROPY AND DONORS

Make flexible and unrestricted grants. The biggest thing your government funded grantees/donees need is flexible, unrestricted funding to provide working capital and a financial cushion against the difficulties of working with government. General operating support can be like water in the desert for these organizations, many of whom are providing services to the most underserved segments of the population.

Keep administrative burdens to a minimum. In addition to all of its other challenges, government funding typically entails extensive budgeting and financial reporting requirements, including budget modifications and line-item reports on the disposition of every dollar. Private donors need not be so rigorous, so don't add lots of unnecessary administrative requirements to grant budgets or reports.

Grant as much as possible up front. Finally, given the substantial need for working capital among government funded nonprofits, be sure *to disburse as much of the grant as possible up-front*.

NOTES ON DATA AND METHODOLOGY

Data from this study were drawn from the IRS public database of Form 990 filings: https://www.irs.gov/charities-non-profits/form-990-series-downloads

The analysis was limited to 501(c)(3) nonprofit organizations filing the full Form 990 with at least $200,000 in total revenue in the most recent filing year available. The analysis was also limited to organizations whose most recent available filing covered fiscal years ending from January 2020 through December 2021. Data was analyzed for only the most recent available year of data for each organization (i.e., there were no duplicate organizations in the dataset). This yielded a total of 127,150 organizations for analysis. Due to the ways some organizations choose to report results in Form 990, not every organization is represented in each of the metrics analyzed in the study.

This study considers *only* funds categorized as Government Grants/Contributions (rather than as Program Service Revenue) in the calculation of percentage of revenue from government sources. These are grants, contracts, or other contributions from government whose "primary purpose is to enable the organization to provide a service to, or maintain a facility for, the direct benefit of the public rather than to serve the direct and immediate needs of the governmental unit."[3]

Thus, government funding percentage is calculated as the amount reported on an organization's Form 990 Part VIII ("Statement of Revenue"), Line 1e ("Government grants (contributions)"), as a percentage of total revenue (Form 990 Part VIII, Line 12, column A). Note again that this does *not* include any revenue reported as Program Service Revenue on lines 2a-2g of the Statement of Revenue (including Medicare or Medicaid reimbursements).

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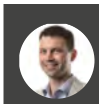

John Summers, Managing Director, BDO Nonprofit and Grantmaker Advisory Services, jsummers@bdo.com

3 See 2022 Instructions for Form 990 Return of Organization Exempt From Income Tax, p. 38. https://www.irs.gov/pub/irs-pdf/i990.pdf

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