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Nonprofit Budgets Have to Balance: False!

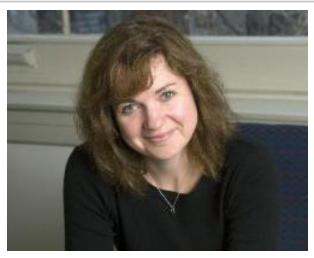
PRACTICAL, PROVEN SUBSCRIPTIONS FOR NONPROFITS
by Jeanne Bett (<https://blueavocado.org/?taxonomy=post-author&term=jeanne-bett>), on May 15,

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As nonprofits serving people and communities in these difficult financial times, we don't expect things to turn around for our communities in the near future. Many of us are wondering: how can we achieve a balanced budget in these times? When is it okay not to have a balanced budget?

A potentially harmful habit practiced in many community nonprofits is presuming that a break-even budget is mandatory. Board members and staff may be under the influence of the false but persistent 'nonprofits can't make money' myth as they develop the year's income and expense plan. Like other conventional wisdom, the balanced budget is based on sound concepts, but can become unnecessarily constricting. Instead of "How can we make the budget balance?" the annual budgeting cycle should begin with the question, "What financial outcome does our organization want or need this year?" Different scenarios lead to different decisions about what the budget's bottom line should look like:

1. We need to increase reserves or pay down debt: **adopting a surplus budget.** When the organization's leaders decide that its cash and other reserves are lower than ideal, the organization can plan to generate more income than expenses, creating surplus funds that can be used in future years. A surplus may also be needed to provide funds for paying down debt or

for easing cash flow. The board should direct staff to develop the draft budget by determining realistic income targets that nonetheless outpace expenses. If the organization can deliver on a surplus budget, it will have higher net assets (net worth) at the end of the year, and enjoy a stronger financial position.

2. We can't gain ground now, but we can't lose ground either: **the break-even budget**. Typically, organizations choose break-even budgets by default and the skin of their teeth. A first cut on the budget shows expenses much higher than revenue, so the staff then tries to figure out how to increase the revenue number (but still stay close to reality) and decrease the expenses (but not damage programs). The staff and the Finance Committee tack their way towards a break-even budget, and hope that their cautiously optimistic projections work out.

3. There are three typical reasons for adopting **deficit budgets**. First and rarest, the organization's leadership decides that its cash and other reserves are *more* than sufficient, and so spending some of those reserves in the coming 12 months is a good idea. They may choose to make one-time purchases or expenditures, or to give the staff one-year, non-permanent raises. At the end of the year they will have more expenses than income for the year, and thus a deficit for the year.

A second reason for a deficit budget is a decision to invest. For example, the organization may invest funds in strengthening its fundraising capacity, or in new programming. Leadership believes that resources from previous surplus years can be risked as investments in future programmatic or financial paybacks.



An all-too-common third reason for adopting a deficit budget is a decision that ending the year in a worse financial situation is the lesser evil. For some organizations, simply cutting costs may not be the right financial decision. For example, in an organization that relies on earned income, cutting staff will result in lowering income. The leadership will need to re-work the way its services are structured—perhaps too complicated to do in just a month or two. Or an organization may be in executive transition, and the board believes that the dip in revenue is due to the absence of an executive director, and expects that income will go up again. They decide simply to “bite the bullet” this year—and they believe they can afford it.

At the end of a deficit budget year—assuming that reality matches the budget—there will be a lower net worth and the organization will be in a financially weaker position. But “weaker” should be in quotes because a planned loss may, in fact, be a sound, strategic fiduciary decision by a board. For example, investing in a new website may mean a deficit this year, but could reap

substantial gains in fundraising in coming years.

The core issue is *intentionality*. An unplanned deficit reflects an error in planning and/or execution, while a *planned* deficit is an investment of accumulated reserves for the benefit of the organization and its constituents.

Consulting to nonprofits, I've come to see that one of the reasons executives struggle to break the break-even habit is that foundation grants and government contracts are typically break-even contracts. We must prove that we spent exactly what we raised. But while grants and contracts are designed to break even, organizations are not. Healthy organizations require cash reserves, which means they must generate excess cash in at least some of the years.

The majority of community nonprofits with whom I work need to build reserves. But especially as we head into recession—which classically means fewer resources and higher demand for nonprofit services—developing a credible surplus budget may prove impossible. We may have to settle for break-even because we don't see opportunities for income growth or expense cuts. But we'll be settling for break-even, not aspiring to it.

Jeanne Bell (/content/jeanne-bell-mna), MNA, is CEO of CompassPoint Nonprofit Services (<https://www.compasspoint.org/>), and consults to nonprofits in business planning, financial systems, and sustainability. She co-authored *Financial Leadership for Nonprofit Executives* (Fieldstone).

Comments

David M. Patt (<http://www.aem-patt.com>) says



September 28, 2018 at 9:04 pm (<https://blueavocado.org/finance/nonprofit-budgets-have-to-balance-false/#comment-6982>).

If you consistently spend more money than you raise, you will run out of money and not be