HANDOUT 1: EARLY WARNING TOOL

WARNING SIGNS: A TOOL FOR NONPROFIT LEADERSHIP

Introduction

The purpose of an early warning sign, symptom, or system is to alert decision makers of an impending negative circumstance. Early warnings are supposed to provide us with time to react, to change course, to intervene and thus avoid or ameliorate that negative consequence. From an environmental perspective, certainly the proposed radical shifts in policies of longstanding emanating from Washington should serve as a general warning to the sector that there could be significant change ahead. Similarly, the budget shortfalls in CT and other states and municipalities such as Hartford are loud alarm bells that the local environment for government contracting is in for major disruption.

Short of the imminent notification of the cancellation of a major contract, what are the early warning signs that a nonprofit should be considering significant options beyond incremental planning? These options might include major restructuring and/or consolidation with other entities. What we know is that major restructuring and consolidation take time. Too often nonprofit leadership maintains optimism that things will get better, or that some saving grace will emerge, for far too long. The failure to anticipate the need for major change has led in many instances to bankruptcy or precipitous closure with substantial injury to staff, clients, and donors as well as the loss of deep experience and tacit knowledge.

The purpose of this tool is to provide nonprofit leadership with some metrics and a methodology to provide an early warning that major change should be initiated. It has two parts: the first is a set of financial metrics that can easily be drawn from audits. The second is an exercise to consider the core of an entity. During a period of retrenchment, when it becomes necessary to shrink, a prime consideration is the determination of what should survive as resources disappear. Once the preferred core is identified, leadership must assess its viability and a set of metrics is used to help with that assessment.

Instructions and the tool's components follow.

Financial Metrics

Negative results for any one of these criteria should get leadership's attention. In the current environment, a set of three negative results, in any combination, should cause a "stop and think" occasion and initiate deeper conversations about the entity's future. In the current environment, indication of significant financial vulnerability could spell real trouble with a precipitously short time frame if an existing major revenue stream is disrupted. Score 1 point for each red flag based on your analysis of whether the warning sign is present.

Warning Sign	Key Ratio/trend	Calculation	Red Flags
1. Deficit pattern			
An operating deficit (excluding depreciation) of greater than 10% for two consecutive years or a majority of years in a longer period: (as in 3 of 5).	Revenue- Expense multi year		
Overall reduction of total revenue greater than 20% within a 12 month period.	Revenue – Expense; compared to previous year		
Net assets trend			
Reduction in net assets (ratio less than 1) from last year to this year	Net assets 2016/Net assets 2017		
Defensive interval			
Reflects how many months the organization could operate if no additional funds were received. • Red flag: Less than 4 months	Cash + Marketable Securities + Receivables / Average Monthly Expense		
Liquid Funds Indicator			
The liquid funds indicator is similar to the defensive interval in its use but is more conservative in removing assets with restrictions on them from the calculation. It also determines the number of months of expenses that can be covered by existing assets.	Total Net Assets – Restricted Net Assets – Fixed Assets/ Average Monthly Expenses		
Red flag: Less than 2 months			

Warning Sign	Key Ratio/trend	Calculation	Red Flags
Revenue Ratios			
To establish trends in the relative contribution of various revenue streams. While all revenue sources should be tracked, declining revenues in these sources are of particular concern:	Revenue Source/ Total Revenue; year over year		
• Public contributions			
• Government grants			
• Program service revenues			
• Individual giving			
Red flag: A pattern of decline in multiple revenue streams or a major unplanned decline (>25%) in a revenue stream that accounts for more than 30% of total revenue			
Assets to liabilities ratio			
Indicates credit worthiness or future liquidity problems	• Total assets/Total liabilities		
Red flag: Ratio is > 1			
Accounts Payable Aging Indicator			
The accounts payable aging indicator sheds light upon the credit-worthiness of the organization. The lower the indicator, the faster the organization pays its bills.	(Accounts Payable x 12) ÷ Total Expense		
Red flag: > 3 months coupled with deficit larger than 10% of total expenses			
Fundraising Ratio			
The fundraising ratio measures the relationship between fundraising expenses and fundraised revenue	Fundraising Expenses / Fundraised Revenue		
Red flag: Based on historical average of the entity, the ratio of fundraising expense to fundraising income rises above 30% (include staff time in ratio)			

Management Cost			
Trend as a percentage of all expenses	**Management salaries/Total expenses; Multi year trend**		
Red flag: percentage of management expenses to all other expenses increases over a period of two or more years			

Considering the Core of the Entity

As indicated above, three or more red flags should set off a deeper discussion of viability and scenario planning. An organization with no red flags may also want to consider their positioning as they may be able to use the downturn as an opportunity to grow. For those with red flags, leadership should recognize that the entity will be more vulnerable in the expected turbulent period. How should that discussion be framed?

The first scenario to consider is whether the entity can shrink and re-organize, and still remain viable. A bit of imagination is required as leadership may not know what the lost revenue will be or what parts of the entity are at risk. In general, there are four models for designing the part of an entity that remains after major loss. Leadership may or may not have the ability to choose freely among these options, depending upon the nature of funds lost. The options are:

Option 1	The entire organization but on a smaller scale
Option 2	Those elements of the organization that are most adaptable or innovative under conditions of uncertainty
Option 3	The one, two, or three programs most essential to consumers
Option 4	The one, two or three programs that survive the cuts

Based on scenarios appropriate to your organization, you may want to conduct the exercise below with more than one option and to hold this discussion with multiple stakeholders in the room to avoid optimistic bias. The scoring on this exercise is also subjective. Again, this is about critical thinking and preparedness, not necessarily an exercise to yield a definitive strategy but rather to guide the next set of questions.

Core Viability		**Your Score**
On a scale of 0-5, (5 is as strong as possible) score the core scenario chosen against these criteria:		
	• Current stable funding: Revenue has exceeded expense for each of the last three years	
	• High appeal to groups providing **future support** whether consumer fees, grant funds, state or federal contracts	
	• Market demand from a large consumer base that is not expected to shrink	
	• Measurable, reportable program outcomes	
	Maximum: 20 **Your Total**	
Competitive market strength		**Your score**
On a scale of 1-5, (5 is as strong as possible) score the core scenario chosen against these criteria:		
	• Good location and logistical delivery system	
	• Large reservoir of consumer loyalty and the assurance that consumer choice will continue to govern consumer decisions in the future	
	• Dominant and growing market share of the target consumers currently served	
	• Superior quality coupled with the ability to account for quality	
	• Stable staffing (Annual turnover rate less than10%)	
	• A refined understanding of what competencies will be required to provide these services in the future and identified sources and resources to acquire them	
	• Superior ability to communicate with consumers and other stakeholders	
	• Cost effective services and the ability to demonstrate this	

	• A solid track record for securing grants, contracts, and donations to support this programming	
	Maximum: 45 **Your Total**	
Coverage		**Your score**
	(Choose only one of the following based upon whether consumers have alternatives if your organization closes.)	
	There are 0 to 1 alternatives for consumers (add 10)	
	There are 2-4 alternatives for consumers (add 0)	
	There are 5+ alternatives for consumers (subtract 10)	
	Maximum: 10 **Your total**	
Cost of aggressive competition		**Your score**
If there are 2 or more alternatives, how much additional investment is required to aggressively compete? Choose one.		
$25,000 or less	Available? Add 10 Not available? Add 0	
$25,001 to $50,000	Available? Add 10 Not available? Add 0	
$50,001 to $100,000	Available? Add 10 Not available? Add 0	
$100,001 or more	Available? Add 10 Not available? Add 0	
	Maximum: 10 **Your Total**	

Scoring rubric

65 or more	**Smaller, core entity is likely to be viable**
50 to 64	**Smaller, core entity is likely to struggle, consider partnering?**
49 or fewer	**Smaller, core entity is likely to fail, consider consolidation?**
TOTAL SCORE	

HANDOUT 2: KEY PREPARATORY QUESTIONS FOR BOARD MEMBERS

How do we expect the environment to change around us?

How will those changes, change expectations of our organization?

Of the areas below, which will be most heavily affected?

- *Cost effectiveness*
- *Outcome accountability*
- *Quality assurance*
- *Collaboration*
- *Social impact or public policy*
- *Increasing dependence on fundraising*
- *Adaptation of program models…fundamental redesign*
- *Need to establish for profit enterprises*
- *Outreach*

Why are we considering an alliance or collaborative venture? Or consolidation?

Given the specific environment in which we operate and the challenges we face, can we more efficiently and effectively deliver on our mission statement by working together with one or more partner organizations, or by working alone?

HANDOUT 3: DEVELOPING A RESPONSE POLICY

Worksheet for Constructing a Board Policy for Responding to Potential Consolidation Options

1. All inquiries concerning our organization's interest in becoming involved in a new venture involving possible consolidation will be referred to:

____

2. If the initiative involves a potential merger, the Board President will be informed. Yes No

3. The initiative will be tested for early feasibility by:

____

4. The party named in (1) will have the authority to screen out the initiative Yes No

The party named in (1) may screen out the initiative with the agreement of

____

5. The party named in (1) may expend up to $______________________

to test the feasibility of an initiative. Resources beyond this amount

may be expended with the agreement of:

____

6. If the initiative is feasible, it will be discussed with

____

7. In case quick response is needed, ______________________________

has authority to give approval to the party named in (1) to pursue the opportunity.

8. In all other cases, the _____________________________Committee may screen out the opportunity or recommend it to the Board of Directors for pursuit.

9._____________________________________ will determine the negotiating team for each opportunity approved for pursuit.

SAMPLE FLOW CHART