

Your Net Assets

How to recover from a case of parentheses

By Thomas McLaughlin

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Take out your most recent audited balance sheet. Find the liabilities section and look for the term net assets – unrestricted. Look to the right of that term. Do you see parentheses? If you do, get a glass of water and sit down. Relax. Read this column thoroughly. It is a quick financial survival kit, and it could save your agency.

If you are like many nonprofit managers and board members you will not see parentheses, though you may see a number perilously close to zero. If the latter is true – or if the number next to that term has been declining steadily over the years – get that glass of water. If the number is big and healthy and has been that way for some time, read the column anyway. You could be in parentheses yourself someday.

What you have just done is one of the quickest possible tests for financial solvency, and it is one that an increasing number of nonprofits are having trouble passing.

Net assets is the term describing the cumulative financial value of the nonprofit corporation. The term used to be known as fund balance until fairly recently when the accounting professional decided to make it more precise. For-profit firms call it a number of things such as net worth, owner's equity, retained earning, share-holders equity, etc.

Whatever it is called, it grows the same way: by adding each year's profit. It also gets reduced by every deficit; special adjustments having nothing to do with yearly profits or losses can change it as well.

So, the number is a kind of running report card on both management's decisions and funding sources' policies.

If the net assets number is in parentheses the organization has no cumulative net worth. What that means is that all things being equal, if the agency were to close down as of that day and sell its assets to pay off its liabilities – assuming the assets fetched prices close the value the books showed they had – then the agency would be unable to make good on at least some of its liabilities. This state of affairs is better known as bankruptcy.

If you discover parentheses where you would rather see none – or if you discover a pattern of declining net assets linked to routine operating losses – there are a few things you should do:

1. Take it seriously. Hard as it is to believe, many nonprofit managers and their boards of directors do not take this situation seriously. Or, to be precise, they state that they take it seriously but do not follow up with any action. So, an executive director or board members worries about the negative net assets but discounts it with a comforting or dismissive explanation. Some examples:

- It was a smaller negative net assets figure than we thought it would be;
- It has only been three bad years out of 30
- Most of the loss was due to depreciation;
- Everyone is feeling the same pinch.

Most of these responses are irrelevant or misinformed and serve mainly to excuse inaction. Unfortunately, when a great many people in a nonprofit's leadership positions do not appreciate how desperate their financial picture truly is, these responses are likely to go unchallenged.

Note that there are a few unique situations, rooted in accounting policies, in which the reality of an agency's financial picture is much brighter than the records show. For example, a major asset carried by the corporation may be fully depreciated but have a high market value that does not show up on the balance sheet. These types of situations are rare, however, and for the most part one must assume that the financial reporting is faithful to reality.

2. Stop the hemorrhaging immediately. If the net assets are negative, they got that way via a steady stream of losses each year. Chances are, those losses are continuing. They must be stopped – now. In all probability this means that the agency must spend less money than it has been spending, since revenues are hard to boost on short notice and since prior managers have probably already explored these options. Consequently management must make cuts in current spending levels, and the sooner the better.

3. Do not just talk about it, make a plan. A small group of managers, including board members if appropriate, should devise a solution to the problem. The priorities here are to make the plan realistic and to put it together quickly – sizable negative net asset problems will usually get worse as time goes on. Timeliness is more important than elegance and articulate documentation. Nor does the plan have to be comprehensive, at least in the beginning. It can be buffed up later – the spirit should be ready, fire, aim.

4. Pull a financial fire alarm. The whole agency needs confirmation of the problem and some indication that you are attempting to make it right. Notice the phrase “confirmation of the problem” – it is very hard to hide financial difficulty. Staff members will suspect what is going on even if it is never confirmed.

Announcing the existence of the problem accomplishes two things. First, it gets the problem out into the open where it can be handled better. Second, if dealt with properly, it can be part of the solution. Finally, it buys a little time.

This is where your plan gets used. Announcing financial difficulty alone is a little like staff abuse. Staff may think that somehow or other, management must have created the problem so it should be up to management to stew about it. Just announcing fiscal trouble and then walking away can damage staff morale, public image, and even continued funding. Worse, it can be counterproductive, creating resentment and fear.

But, giving the bad news accompanied by a plausible recovery plan and a request for staff feedback and additional ideas can turn a negative story into a positive one of motivation and trust. By inviting staff participation in crafting an agency-wide response, management creates a single focus point for action.

Just as important, it communicates respect for others' ideas. And the feedback and ideas should be sought aggressively and in person, not just by saying “the door is always open.” Not coincidentally, this approach also lifts a bit of the onus for a solution from management.

5. Monitor the response. This is where most agencies fall down. The recovery plan may go through several different versions, but the final provisions need to be monitored for effectiveness. It is entirely possible that some of the initial financial problems were caused by inattentiveness, so this step may be particularly difficult to continue over time.

It is also likely that the shortcomings of the current financial reporting system will be highlighted during this period. Take notes: if the plan works, you will get a chance to fix the reporting system later.

If the plan does not work, it is time to consider alternatives. The obvious one is a merger with a financially stronger agency. The problem is that at this point there may not be much value left in the organization to attract a merger partner.

The best time to merge is when a nonprofit does not face a financial crisis. It is difficult to resolve a financial crisis solely through an attempted merger.

The best approach is always preventive. Protect your assets, minimize your liabilities, maintain program quality. And keep your eye out for parentheses.