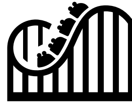

THE SECRET TO ACHIEVING FINANCIAL HEALTH

It's very simple. Make more money than you spend. Consistently. In all circumstances.

All the rest is detail.

But, if it were that easy, everyone would be doing it! So, read on…

HEALTHY OPERATIONS

Financial health tends to go hand in hand with healthy operations. A strong bottom line coupled with sufficient reserves reduces stress for leaders and allows them to focus on other concerns. Conversely, constant worry about spending tends to ripple through the entire organization, affecting every department and stealing focus from **mandate**. As well, toxic work relationships — although not financial in nature — can produce poor financial results to the extent that they demoralize staff or provoke high turnover.

Two paradigms for conceptualizing healthy operations:

- People, time and money
- Mission, capacity and capital structure

One paradigm for thinking about healthy operations is "people, time and money." If money is short, you can often compensate by spending more time on something. If you lack time, you can often buy what you need (which might include hiring more people). If you don't have enough people to get something done, the current team members can spend more time, or you can pay for more help. To accomplish a project or manage an organization in a healthy fashion, leaders must ensure that these three resources are adequately balanced. This capacity-focused model is useful for thinking about small operations, particularly volunteer-run, with fewer **assets** and limited infrastructure.

A more sophisticated triad — and one applicable to organizations of any size — is "mission, capacity and capital structure," described in a 2003 article by Clara Miller of the Nonprofit Finance Fund, "Hidden in Plain Sight: Understanding Nonprofit Capital Structure." **Mission** captures the organization's purpose and its approach for achieving its goals. Capacity describes the organization's ability to marshal its resources to deliver on its mission and accomplish its goals. Key elements of capacity for arts organizations include people, time and money, as we just discussed. At a more complex level, facility or venue must be added, and the "people" element broadened to include not just number of people, but also their skills and competencies. Not-for-profit capital structure refers to a much larger idea than simply the quantity of money available to get things done. It refers to the financial dimension of operating structure — and it merits a deeper discussion.

NOT-FOR-PROFIT CAPITAL STRUCTURE

> Capital structure… is the distribution, nature and magnitude of an organization's assets, liabilities and net assets. Every nonprofit — no matter how small or young — has a capital structure. There are many kinds of capital structure, and there is no such thing as one "correct" kind. It can be simple, with small amounts of cash supplemented by "sweat equity" and enthusiasm, or highly complex, with multiple reserves, investments and assets.[5]

The corporate world talks about capital structure in the sense of how a business is financed — that is, what use management makes of external funding via borrowing and shareholders' **equity**.[6] The debt-to-equity **ratio** is a key tool for evaluating the sturdiness of a business's capital structure. With respect to that ratio, I argue that its applicability to not-for-profits depends on the use that the not-for-profit makes of debt and that there is a distinction between debt arising from operations and debt undertaken to finance assets. We can extend that thinking to an understanding of not-for-profit capital structure. For smaller, "asset-light" not-for-profits, capital structure is tied to day-to-day operational concerns, while for larger more "asset-intensive" entities, capital structure may play out more on the balance sheet.

The capital structure (i.e., the "distribution, nature and magnitude of an organization's assets, **liabilities** and **net assets**") of a non-venue-owning mid-sized theatre company, for example, might consist mostly of

- office equipment, and perhaps some production equipment;
- various **receivables**, such as box office settlements (assuming that our mid-sized company rents theatres and uses their box office services), presenter fees from tours and **grant** installments from funders;
- short- and long-term investments, such as an operating reserve and an endowment fund;
- a constant stream of payables;
- short-term **financing** via a **line of credit** from the bank or a company credit card; and
- cash resources enabling the theatre to manage its operational commitments.

Decisions affecting any element of the capital structure may affect other elements. If equipment must be replaced, how will it be financed? Can we pay for it from this year's **budget** or from our reserves, or will we use the line of credit? If we've used the line of credit, what will we do in case of an unforeseen operational problem? Perhaps we should be approaching the bank for an increase to the line of credit… As you can see by that chain of questions, discussion of a new acquisition quickly looped through asset, liability, net asset and operational concerns.

---

[5] Clara Miller, "Hidden in Plain Sight: Understanding Nonprofit Capital Structure."

[6] Corporations might employ different forms of borrowing arrangements, as well as different classes of shares, each with distinct shareholder rights.

It's all interconnected.

Furthermore, the elements of capital structure shift with changes to operations (e.g., programming decisions, staff arriving and departing, equipment being added or replaced) and as external circumstances evolve. A capable financial manager knows how their balance sheet should look. If receivables or payables are unusually high, they will notice and investigate. Likewise, they will be alert to the annual ebb and flow of accruals (e.g., how **deferred revenue** should grow during next year's subscription campaign, or what the balance of prepaids ought to be in different phases of the annual cycle).

Despite the various expansions and contractions related to circumstance, companies tend to maintain a core operating model that retains a similar shape over the years, unless something causes it to change. Understanding how your company works and how its activities tend to shape its balance sheet are important aspects of managing its financial health. While developing operating budgets, you should be mindful of their eventual impact on net assets. Each year's operating decisions impact capital structure for better or worse — and significant changes of direction can change the capital structure altogether.

Suppose our non-venue-based mid-sized theatre company acquires a performance space. This creates a permanent home, opportunities for enhanced programming, convenient in-house access to rehearsal and workshop space, a better experience for the audience and unused capacity that can be rented out to other organizations in the community.

"A little bird hops happily

Along disaster's fences,

As it does, it can't foresee

Any consequences."

—Evgenij Vodolazkin, novelist and scholar

These changes can be described in terms of mission and outreach (e.g., as an evolution of the company's artistic significance). From a practical standpoint, the project will also change the theatre's core business. Its old **business model** was fundamentally to sell seats (or, more broadly, to sell shows).[7] Once it owns a building, it adds a secondary (and unfamiliar) core business: being a landlord. Typically for arts organizations acquiring a facility, renting out unused capacity becomes essential to making the building financially feasible. The new building has the potential to cause a "sea change"[8] to operations and to affect every element of the balance sheet.

Let's look at a real-life example. Founded in 1983, Crow's Theatre (legal name Crow's Theatre Circus) has long been known as a home for socially critical and innovative new works. The company is associated with many Canadian theatre luminaries, and its influential work has been acknowledged

---

[7] Clara Miller observes that airlines, universities and performing arts organizations share the same core business: selling seats, an ephemeral inventory. As soon as the gate closes, the semester begins or the curtain rises, the inventory loses its value. Inside the arts business, we need to take a broader view. For instance, when we're selling sponsorships or tours, the "commodity" is the show itself, or perhaps the organization's brand, rather than the seating capacity. And, when we're "selling" donors on the idea of supporting our organization, we're promoting the benefits and outcomes our organization as a whole creates.

[8] Reference to a well-known passage from William Shakespeare's *The Tempest*, Act I, scene ii.