LANCASTER POLLARD
INVESTMENT ADVISORY GROUP

Why Nonprofits Fail: A Case Study

Board members and officers must implement fiduciary policies and monitor an organization's operations and financial health.

Each day board members and executives of nonprofit organizations make decisions that have a fundamental impact on the organizations they serve. To effectively operate a nonprofit organization, it is essential board members and officers implement fiduciary policies and have access to information to monitor the organization's operations, as well as its financial health and performance. As this case study illustrates, improper financial governance can significantly alter an organization's future. The following information is based upon facts uncovered during an operational and financial review.

Background

The facility enjoyed low staff turnover, strong referrals and satisfied residents, as well as a large endowment and no debt.

The facility was founded after the Civil War by two nurses in an effort to help post-war orphans and widowed women. In the mid-1900s, the organization became a nursing facility. By the year 2000, the facility was a small, thriving retirement community that included a 33-bed licensed nursing facility with a 23-bed assisted living wing, with 89% occupancy and 57 full-time employee equivalents (FTEE).

The organization experienced low staffing turnover and was located in a supportive community. It had built strong community relationships that led to referrals from hospitals and doctors, and the city in which it was located had developed a good reputation for welcoming seniors. Residents reported being happy and satisfied, and the facility was awarded a "Friend of Family" Award in 2001.

The facility had been able to develop and grow its endowment to more than $16 million by 2000. The board began thinking about expansion and renovation plans for the outdated physical structure. It hired an architect and developed a master plan in 2001 and commissioned an operational and financial analysis of the facility's operations in 2002.

Surprising Discoveries

The organization's balance sheet had no debt. Cash reserves provided solid liquidity, and the overall size of the endowment provided good credit strength for an organization of its size. On the surface, the idea of little or no debt, combined with low employee turnover, satisfied residents and a strong endowment, appeared to be an ideal situation.

However, it was relying too heavily on endowment earnings to subsidize an operating deficit.

However, the facility had serious and irreversible financial problems. Occupancy rates were declining. From 1999 to 2000, the average annual occupancy rate fell from 98% to 89%, a 9% decline. From 2000 to 2002, the occupancy rate slid to 85%, a drop of almost 5%.

The organization also relied heavily on strong endowment earnings to subsidize operations and expenses. It had produced an average annual operating deficit of $1 million per year, or 38% of the annual operating budget. It covered these operating losses by spending 12.5% of its endowment annually. To further exacerbate the situation, the endowment fund lost $2 million in value when the stock market turned in 2001.

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The board and management did not implement recommended operational changes that could have reduced operating losses. By spring 2003, expansion and renovation were out of the question, and the board determined the facility could not be financially sustained. After nearly 140 years, the facility closed its doors.

How This Happened

The key issues that forced the facility to cease operations relate directly to board financial governance. While it is very clear the board had the best intentions of furthering the facility's mission, it is also apparent it did not adequately fulfill key financial governance responsibilities.

Specifically:

1. ***The board lacked key policies, especially a spending policy.*** Without a spending policy, the board did not understand there were limits to how much endowment should be used to fund the growing operating deficit. Additionally, the size of the endowment and the investment returns of the 1990's bull market helped mask the severity of the situation. When the stock market declined in 2001, the losses from operations and the investment portfolio pulled straight from the endowment and cash reserves, decreasing the credit strength and liquidity of the facility.

The organization exceeded almost all industry expense benchmarks.

2. ***The organization admitted a financially unattractive resident mix.*** Over time, the organization's mix of residents changed. The organization admitted a high percentage of Medicaid and a low percentage of Medicare and private pay residents. Because of the fiscal losses incurred for each Medicaid resident, the facility locked in a negative spread of revenue that could not keep pace with increasing expenses. While endowment revenues were able to subsidize the altered resident mix for a few years, this change in resident mix was not viable in the long term.

After nearly 140 years, the facility closed its doors.

3. ***No benchmarks were in place to measure wages, expenses and government subsidies.*** There was very little control over expenses. The facility was overstaffed and operated inefficiently. In addition, the organization exceeded almost all industry benchmarks for expenses, including exceptionally high wages and benefits.

To people inside and outside the organization, it appeared that the facility was doing an outstanding job of fulfilling its mission. The endowment was large, residents were happy, and the staff was well compensated and loyal. However, the fiduciary safeguards were simply not in place to prevent an unchecked desire to spend money on the mission. As a result, the facility is now deciding how to disperse its remaining endowment instead of planning how to best serve the community for another 140 years.

About the Firm

Lancaster Pollard Investment Advisory Group understands that nonprofit organizations and the missions they serve are intended to last forever. Nonprofit executives and board members need a different perspective than their for-profit colleagues, as well as access to a comprehensive financial toolset to link today's decisions to the future.

Lancaster Pollard's mission is to help nonprofit organizations' board members and executives fulfill their fiduciary duties and optimize investment plans and outcomes. Our Process for Perpetuity™ helps nonprofit organizations and their missions last forever by developing and implementing an ongoing financial governance plan integrated with the organization's capital structure.