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COMMUNITY ECONOMIC DEVELOPMENT ORGANIZATIONS AND THEIR FINANCIAL HEALTH

MONEY MEETS COMMUNITY

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This is part of the 2023 Money Meets Community Series — six briefs exploring the lines of business and financial resources of the field of community economic development organizations in the United States. Authored and commissioned by the National Alliance of Community Economic Development Associations (NACEDA) as part of its Grounding Values in Research program, the Money Meets Community Series arrives in 2024 at a critical juncture for our country's low- and moderate-income people and places and the local organizations dedicated to serving them.

SUMMARY

The financial health of the nonprofit community and economic development (CED) sector is of considerable importance to the nation's efforts to promote the economic and social wellbeing of poor communities. Nonprofits with strong cash flows and healthy balance sheets are better able to develop affordable housing and real estate, support small business, and provide services to families in need.

To help understand the financial health of the sector, we developed a methodology for scoring the financial condition of CED groups, adapting a set of validated key performance indicators developed by NeighborWorks America. NeighborWorks uses key performance indicators (KPIs) to monitor the financial health of its network members, to identify financial risks, and to determine where improvements are needed. Our analysis was based on the NeighborWorks financial analysis methodology, adapted to use the financial measures available from the Internal Revenue Service (IRS).

We applied the adapted financial analysis to a national database of IRS Form 990s from community-based development organizations, which were compiled by the Urban Institute and augmented by NACEDA researchers.[1] We found that:

- Nationwide, 17 percent of CED groups can be considered in excellent health, and 18 percent display health that we consider fragile by virtue of their cash position, net assets, and how these fluctuate over time. The remainder of CED nonprofits — 65 percent of the industry — are evenly divided among those that are in adequate or good health.
- Across financial health indicators, CED groups have the most difficulty with cash flow and related measures, including the number of days of expenses that are covered by cash on hand, revenue volatility, and annual net income. The growth and decline of net assets is another important indicator of financial health.
- While both small and large nonprofits display excellent financial health at similar rates, smaller organizations (as measured by amount of annual spending) are more often than larger ones to be scored as being fragile.

These findings reinforce CED advocates' longstanding calls for government and philanthropy to bolster CED groups' cash flow by providing core operating support. Further, resource providers can strengthen groups' balance sheets by investing in technical support and increasing the supply of flexible, low-cost capital. At a minimum, we hope that this methodology can be used to help groups themselves assess their own financial health relative to that of their peers.

BACKGROUND

Earlier briefs in this series have highlighted the scale and diversity of the nonprofit community and economic development (CED) sector, which consists of some 5,000 organizations devoted to improving the social and economic wellbeing of America's disinvested communities. This diverse complement of groups consists of real estate developers, social services agencies, community advocacy groups, and others. CED organizations are supported by a loose network of government agencies, financial institutions, corporate and private philanthropies, and thousands of community members who contribute time and money to help make their communities better places to live.

Why is the financial health of the community-based nonprofit CED sector important?

First, a financially strong CED sector means more *effective* use of the $22 billion in resources it mobilizes annually, not including the billions more the sector raises and invests in real estate and business development.[2] As shown below, financially healthy groups build assets rapidly, enabling them

[1] The IRS information dates from 2018 and earlier, the latest available information at the time of the Urban Institute's data compilation. See https://www.urban.org/projects/grounding-values-cbdos/phase-one to Urban's Technical Report and Summary Report.

[2] Walker and Woodruff, "Community Economic Development Organizations and Their Activities" 2023 https://naceda.memberclicks.net/ced-organizations-and-their-activities

to develop more affordable housing, expand economic and provide higher-quality services in their communities.

Second, because better health means more income and assets available for investments in systems and operational infrastructure, healthy CED groups have the wherewithal to make more *efficient* use of development, management, social services and community organizing resources, $9 billion of which is paid for by taxpayers at various levels.

Third, to the extent that communities experiencing persistent poverty find it difficult to support large and well-resourced organizations, targeted efforts to build smaller groups' financial health can help ensure an *equitable* distribution of CED efforts throughout the United States. Moreover, growth of smaller and emerging CEDs provides an opportunity to develop new leaders, both as staff and volunteers, in the communities they serve.

But like most nonprofit organizations, CED groups spend much of their time worried about money – how much they have and where they can get more of it. Few groups have secured sources of revenue that provide a reliable flow of funds year-in and year-out. Only the most financially well-capitalized groups can generate enough funding from their own resources to cover their expenses and capital needs. As we shall see, in any given year, only 58 percent of groups raise enough money to fully cover expenses.

CED groups and their supporters have long sought to amplify and streamline flows of operating support and capital. Success in doing so produces important organizational results:

- Predictable revenue flows that reliably cover expenses enable groups to achieve organizational stability, sustain project pipelines and programs, and recruit and retain high-quality board and staff.
- A meaningful surplus of revenues over expenses enables groups to invest in program improvement and expansion, develop staff technical and leadership skills, and better track and report on the quality of their community outcomes.
- Strong balance sheets with high net assets, especially unrestricted net assets available for any purpose, enable groups to self-finance early-stage program and project costs that are especially difficult to raise money for. This can help organizations attract capital for development on more favorable terms and reduce overall interest expenses, maximizing the *efficiency* of investments for community purposes.

This brief represents our first attempt to assess the financial health of all groups across the CED sector. It sets the stage for further study of financial vulnerabilities, the financial factors that drive fragile or excellent performance, and the organizational and environmental factors that contribute to financial health.

RESEARCH QUESTIONS

There is no generally accepted industry-wide test or scorecard of financial health of CED groups, but national intermediaries and larger CED groups routinely use financial performance indicators in their work. These indicators, along with the experience of community development experts, provided a foundation for development of the sector-wide measures of financial health presented here. Using this methodology, this issue brief answers three research questions:

- **How well does the CED sector as a whole fare in terms of financial health?**
- **How do financial indicators differ across increasing levels of health?**
- **How does group size affect health?**

Our research builds on the Key Performance Indicators (KPIs) developed by NeighborWorks which they use to evaluate the financial condition of their member groups. NeighborWorks reviews the financial health of its network of CED nonprofits annually. The financial indicators are broadly grouped into three categories: cash indicators, asset indicators, and financial ratios, which represent various asset-liability and income-expense dynamics.

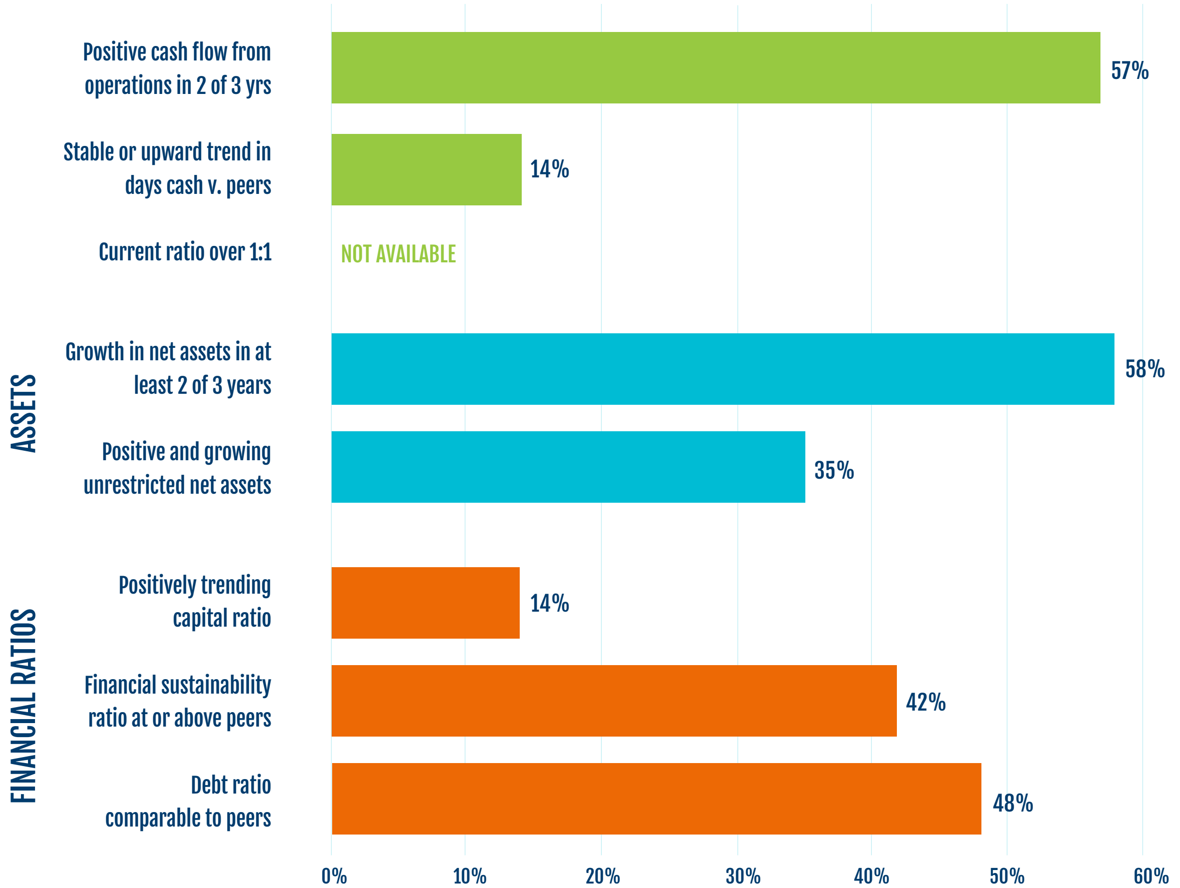
Exhibit 1 presents the indicators in each group, their definitions, and how they bear on financial health.

The NeighborWorks methodology uses two separate scales to determine excellent health and to determine fragile health. **FIGURE 1** presents the KPIs that determine whether an organization *exceeds* industry standards, as well as the percentage of groups that "meet" or "pass" each. These groups most often pass tests of annual positive cash flow, routine net asset growth, solid financial sustainability, and debt ratios. They less often can establish a stable upward trend in days-cash on hand and an upwardly trending capital ratio.

> Our research builds on the Key Performance Indicators (KPIs) developed by NeighborWorks which they use to evaluate the financial condition of their member groups.

FIGURE 1 Passing Rates for Elements of NeighborWorks America "Exceed" Measure

(Percent of Groups Exceeding Each Measure in 2018)



NOTE: To be considered "excellent" a group must pass 5 of the 7 measures.

Source: Urban Institute 2018 tax data as augmented and analyzed by NACEDA; Weighted N = 3,850

Exhibit 2 presents the KPIs that determine whether a CED group fails to meet minimum standards, and is therefore considered "fragile" in the combined health measure discussed below. Fragile groups struggle most to generate positive net income and establish an upward trajectory of net assets. Interestingly, fragile groups less often suffer sharp decreases in total revenues, expenses, and assets.

A noteworthy feature of the NeighborWorks methodology is that it benchmarks selected performance tests to groups of peer organizations. These peer groups are defined by similarity of business lines and asset sizes.

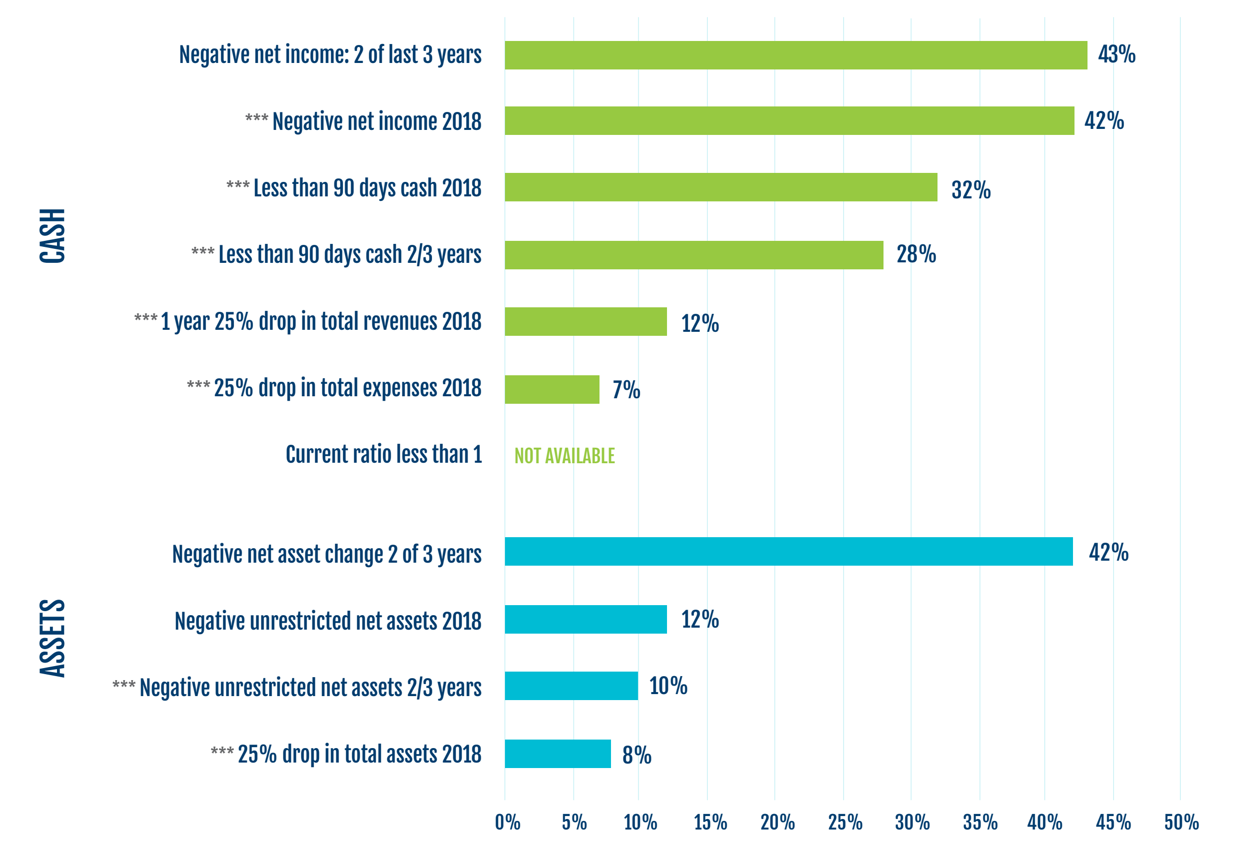
Considerable effort was required to adapt the NeighborWorks KPIs for use in the NACEDA financial health score because NeighborWorks uses audited financial statements from their members whereas NACEDA relied on IRS Form 990s. For example, six additional IRS-based indicators were needed to yield results that approximated those obtained by NeighborWorks with the four audit-based indicators.

Our method approximates, but cannot duplicate, the NeighborWorks original approach for measuring financial health. However, we produced test results that are broadly consistent with what could be obtained using audit data, with several caveats:

- IRS data do not usually include information on subsidiary partnerships, a commonly-used legal form for affordable housing and other real estate developments.
- Financial data reported on IRS forms are not usually verified by the IRS and thus the quality of this information may be uneven, especially for smaller groups;
- Data available to this analysis date only from 2018 and before, although we suspect that sector-wide financial health changes slowly.

FIGURE 2 Failure Rates for Elements of NeighborWorks America "Fragility" Measure

(Percent of Groups Exceeding Each Measure in 2018)

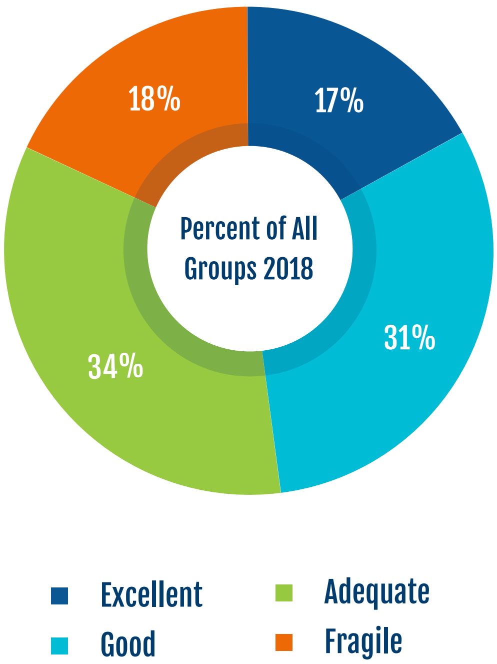


*NOTE: To be considered "fragile" a group must fail at least 5 of the 10 measures   *** indicates added NACEDA measures*
Source: Urban Institute 2018 tax data as augmented and analyzed by NACEDA; Weighted N = 3,850

RESULTS

To produce a summary measure of financial health that combines the separate scales for excellence and fragility, we devised a four-category measure. All of the groups that pass the excellence test (passing five of seven measures) or fail the fragility test (failing five of ten measures) are assigned to the corresponding categories on the combined measure. Groups that pass three or four of the excellence measures and do not fail more than one of the fragility measures are assigned to the "good" health category. The remainder are considered "adequate." Exhibit 2 provides an interpretation of what organizations in each of these financial health categories may look like.

FIGURE 3
Financial Health of Nonprofit Community Economic Development Groups



Source: Urban Institute 2018 tax data as augmented and analyzed by NACEDA; Weighted N = 3,248

FINDING 1:

CED nonprofits have excellent financial health and fragile financial health at about equal rate: *17 percent scored "excellent." 18 percent scored "fragile."*

FIGURE 3 shows the results of our combined measure, which can be thought of as a report card or scale of ascending health. Eighteen percent scored "fragile", 34 percent rated "adequate," 31 percent scored "good" and 17 percent rated "excellent." Put another way, roughly half of groups can be rated "good" or "excellent" — and the other half rated "adequate" or "fragile."

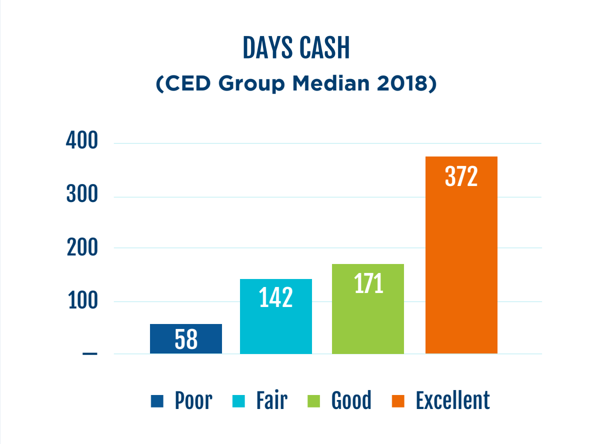
FINDING 2:

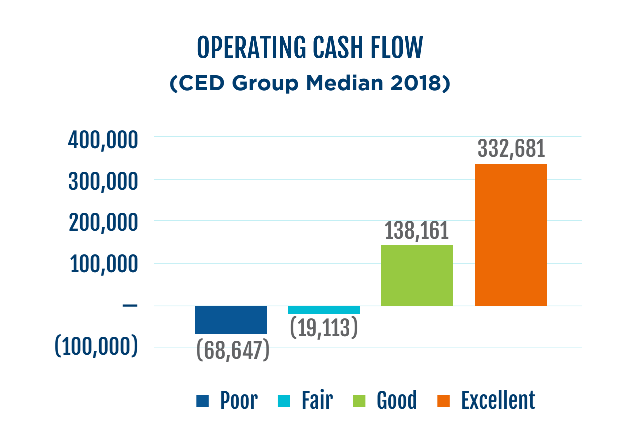
The combined health score measure enables us to establish financial benchmarks for groups in each category of financial health.

The next three groups of charts show how the values of the indicators used to construct the summary health score correspond to how well groups fare. **FIGURE 4** shows a clear increase from fragile to excellent in cash-flow based measures of days cash, operating cash flow, and net income as a share of total expenses. For example, the median value of groups' ratio of net income to total expenses ranges from a 10 percent shortfall for groups in the "fragile" category to a 14 percent surplus for groups in the "excellent" category. **FIGURE 5** portrays the same relationship for asset measures, and **FIGURE 6** for financial ratios.

Exhibit 2 then presents, for each category of financial health, a summary interpretation of what it means for a group to be in each category.

FIGURE 4 Group Cash Flow Indicators by Financial Health Category





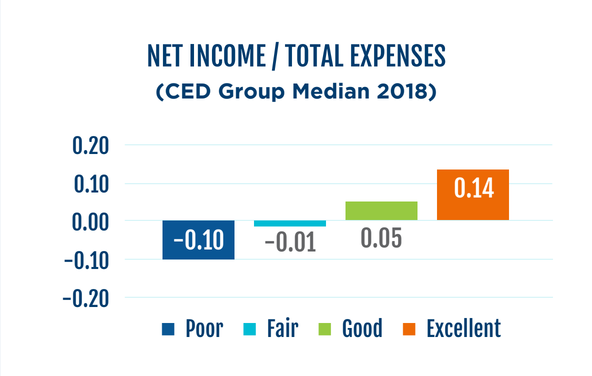
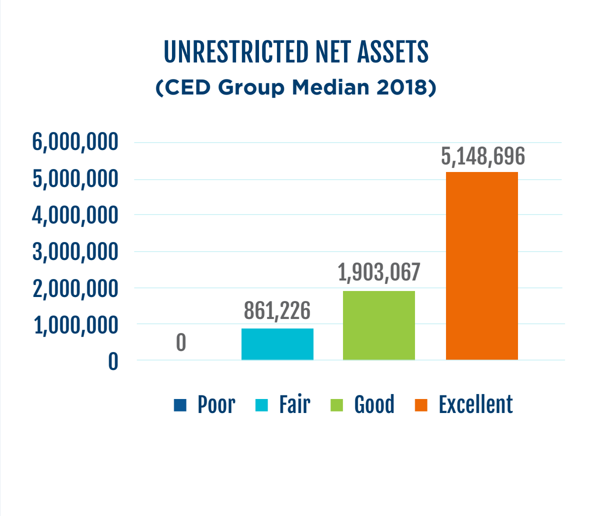
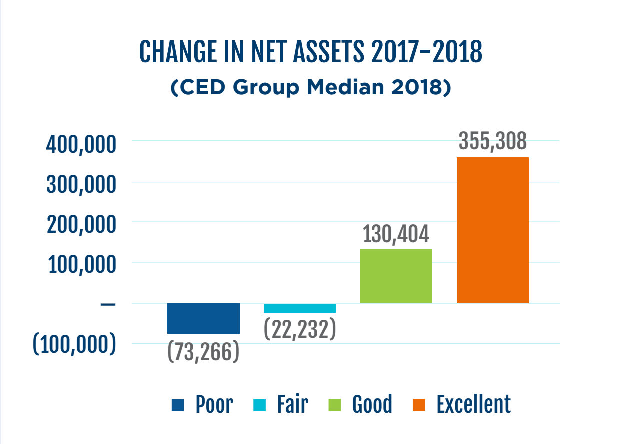


FIGURE 5 CED Group Asset Indicators by Financial Health Category





Source: Urban Institute 2018 tax data as augmented and analyzed by NACEDA; Weighted N = 3,248

FINDING 3:

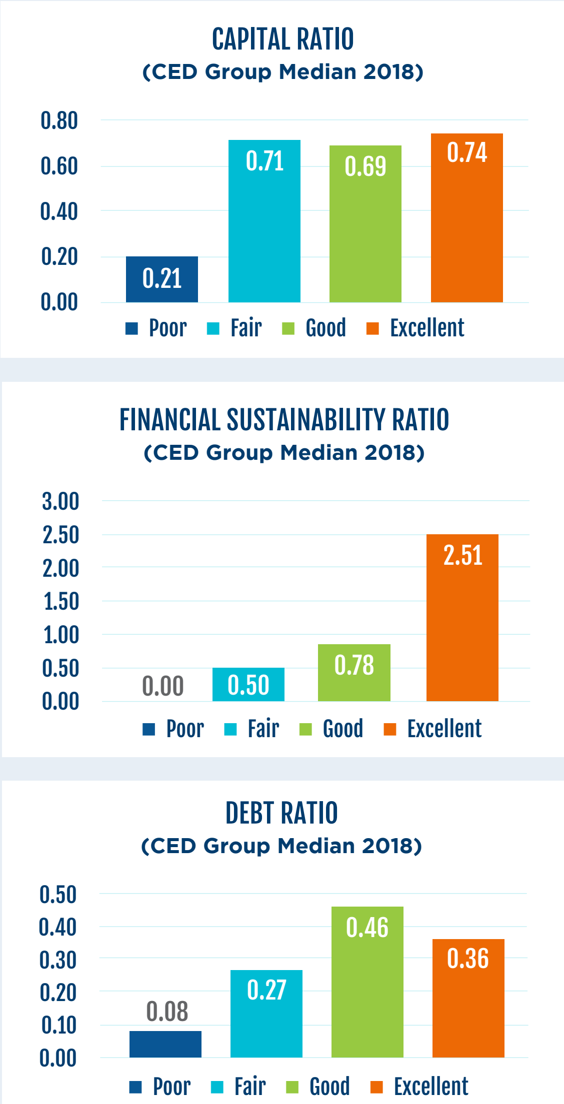
The smaller the CED group, the more likely they are to be in fragile financial health.

Note that several charts show the actual dollar value of financial indicators, including median operating cash flow, unrestricted net assets, and change in net assets. On all three measures, median dollar amounts in the "excellence" group are substantially higher than amounts in the other categories. This pattern suggests that larger groups (measured in terms of revenues, expenditures, or assets) are typically financially better off than smaller groups.

As shown in **FIGURE 7**, the smallest organizations (i.e. the three smallest deciles of annual expenses) have the highest rates of fragile financial health. Some 25-30 percent of the smallest organizations have fragile financial health, compared to only 10-17 percent of the largest organizations. This is not an unexpected pattern given what is known statistically about small businesses and anecdotally about other types of nonprofit groups.

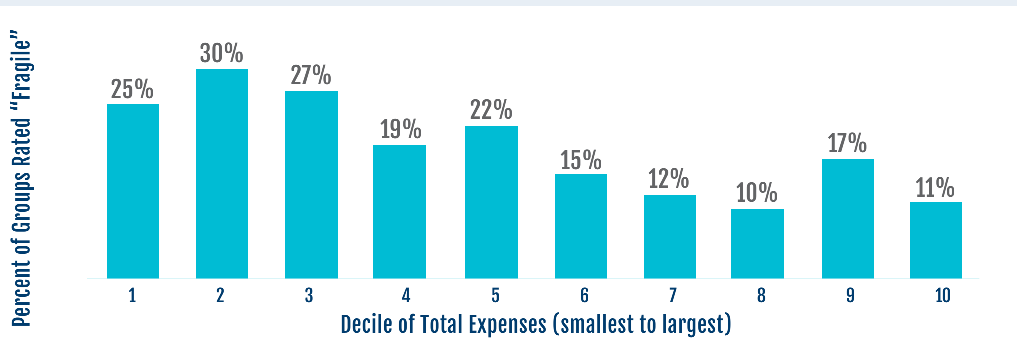
By contrast, "excellence" rates are broadly similar across size categories. Approximately the same percentage of groups were rated as excellent across each decile of expenses. This may happen in part because we set excellence benchmarks based in part on size of total assets for certain types of groups. In other words, fragile health is defined by a standard that is the same for all groups; excellence is graded on a curve that poses more stringent tests for larger groups.

FIGURE 6
CED Group Financial Ratios by Financial Health Category



Source: Urban Institute 2018 tax data as augmented and analyzed by NACEDA; Weighted N = 3,248

FIGURE 7
Percent of CED Groups in Fragile Financial Health
By Size of Group



Source: Urban Institute 2018 tax data as augmented and analyzed by NACEDA; Weighted N = 3,248

CONCLUSIONS

The financial health of the CED sector varies greatly depending on the size of the organization. Overall, 17 percent of the sector has excellent financial health. Conversely, about 18 percent of all CED nonprofits are in fragile financial condition. Smaller organizations can be almost twice as likely as the sector overall to have fragile financial health. We found that 25 to 30 percent of smaller organizations are at serious financial risk. While perhaps not surprising, these financial challenges pose a threat to the delivery of essential affordable housing and community economic development services in communities.

This highlights the opportunity for the philanthropic community to set strategies and goals that can improve the financial health of the sector with a specific focus on smaller organizations. The philanthropic community should consider strategies that reduce the likelihood of fragile performance or that increase the percentage of CED groups that score “good” or “excellent.” These goals require overlapping policy, technical supports, and financial supports. Preventing fragile performance among the greatest number of CED nonprofits would best be accomplished by directing resources to smaller organizations. Increasing unrestricted investment in CED nonprofits will also help build financial strength of the sector, but it requires assurance of proper internal controls as well as philanthropic and investor monitoring of impact and financial management.

To increase financial excellence, the philanthropic community should consider efforts to increase unrestricted net assets from year to year, increase capital ratios, and increase days of cash-on-hand. To reduce financial risk, the philanthropic community should consider efforts to increase operating cash, grow net assets from year to year, and ensure positive net income. This is a tall ask, but it begins with focused technical assistance and funding that improves the financial sustainability of CED nonprofit lines of business.

Generally speaking, cash flow issues are more troublesome than issues tied to assets or asset-liability ratios. Groups in fragile health fail most often on cash flow measures, whereas groups in excellent health most often pass them. This suggests that technical assistance to help CED leaders increase revenues or cut costs should continue to receive attention from technical and financial supporters. In particular, and in line with long-standing appeals from CED groups, the sector needs increased flows of core operating support.

In addition to bolstering organizations’ cash positions and liquidity, priority efforts could include asset-focused measures that increase unrestricted net assets. Sources of flexible, low-cost capital, of the kind extended through foundation program-related investments, is one important way to do this.

For the field as a whole, a patchwork national support system dedicated to increasing the financial strength and productivity of CED groups is already in place. However, this system’s reach is limited by shortages of grant funding and the right kinds of capital. Ultimately, one of the best ways to improve the sector’s financial health is to bring more groups into the orbit of regional and national CED intermediaries equipped to diagnose and treat cash flow and balance sheet problems.

Finally, it is our hope that CED groups in the field will take advantage of this new methodology to assess their own financial position relative to their peers, and to take the kinds of steps needed to increase net income and strengthen their balance sheets. CED nonprofits and funders can also use financial performance benchmarks to assess financial health and set goals for improvement. The benchmarks may need to refined based on business model, but a transparent approach for assessing and benchmarking financial health can help CED nonprofits and the philanthropic sector work together on improving financial health so that greater mission impact is possible.

For our part, future policy briefs on this topic will explore how different kinds of CED groups (e.g., developers or social services providers) fare in terms of financial health, whether where groups work matters, and other topics as they arise.[3]

[3] Note that NACEDA will post a public database to enable researchers to carry out their own investigations into CED group finances.

APPENDIX NOTE ON RESEARCH METHOD

Financial Health

This research has relied upon a methodology for rating the financial health of community and economic development (CED) organizations developed by NACEDA researchers with the help of staff from NeighborWorks America. In the absence of an established method for rating financial health, we constructed a method based on the rating criteria already tested in practical use by NeighborWorks staff to assess the financial capacity of their own CED group members.

Elements of the NeighborWorks methodology have been outlined in the text. There are several features worth calling attention to:

1 NeighborWorks relies on information contained in groups' annual audits, supplemented by staff knowledge of group financial practices and organizational activities. In the absence of a national repository of audit information for CED groups, we relied on data these groups reported on IRS form 990s.

2 NeighborWorks conducts separate tests for "excellence" and "fragility" reflecting its concern for promoting CED groups' financial self-sufficiency, on the one hand, and avoiding financial collapse, on the other. For its part, NACEDA's interest in a combined scoring across the full range of financial performance required a combined rating scale that incorporated results from these separate tests.

3 Certain performance benchmarks at the "excellence" end of the spectrum take account of different NeighborWorks group business lines and asset sizes – peer groups – which influence the validity of some tests. These business line classifications are based on NeighborWorks staff knowledge of group activities, which cannot be exactly replicated using the information available to NACEDA researchers.

In view of these differences, we were obliged to validate our results by trying to replicate NeighborWorks audit-based results for its 243 members using IRS data. We were able to approximate the NeighborWorks results to a degree, but the resulting estimates are, by design, conservative.

That is, we tested alternative IRS-based measures of excellence and fragility until we were able to best reduce the number of false-positives at each end of the spectrum. In other words, we wanted to reduce groups that scored as "fragile" by the IRS-based method but not by the original audit-based method, and the same for tests of excellence.

Therefore, as applied to the larger CED population, the resulting scores most likely understate somewhat the percentage of groups in the larger population that score as "excellent" at the high end and "fragile" at the low end of the health spectrum.

To construct a combined score, we assigned groups that rated "excellent" or "fragile" by the NeighborWorks method to corresponding categories on the NACEDA scorecard. We then assigned groups that scored just under the threshold for excellence (passing three or four of the seven measures instead of the required five) to the "good" category, and the remainder to the "fair" category. (Any groups initially in the "good" category by virtue of their score, but which also failed any of the fragility tests, were assigned to "fair.")

Finally, we approximated NeighborWorks peer group benchmarks using information recorded from organizational websites (see below) about CED groups' business lines and for certain group types (real estate developers, property managers and developers).

Core File Construction

To construct a roster of organizations for this research, NACEDA compiled lists of CED groups. The lists consist primarily of CED groups that are members of state associations that advocate for community and economic development. The lists also include CED groups that have received community development funding from prominent national community development intermediaries or the Federal government.[5] The Urban Institute, under

[4] A more detailed description of this methodology and our testing results is available at https://www.naceda.org/money-meets-community-series

[5] As noted above, the research team did not make special efforts to include lenders, such as certified Community Development Financial Institutions. If these types of groups were found on the lists we assembled, they were not excluded from analysis.

contract to NACEDA, combined these lists and removed duplicates.[6]

Some 80 percent of groups appeared on multiple sources, giving us a great deal of confidence that our method produced a combined list of groups that fairly represent the CED sector's most active members. The Urban Institute merged this list with financial information on each group, drawn from the IRS Form 990s, which are the tax returns filed by most nonprofit organizations. This information consists of detailed breakdowns of groups' revenues, expenditures, assets, and liabilities. This information is not as detailed as that contained on audited financial statements.

As we considered ways to further analyze the data, our advisory group of industry practitioners made clear that financial characteristics of groups – and therefore the indicators of their financial health – are influenced by the types of activities they undertake. But the lists used to construct the CED cohort contained very little information on the organizations themselves beyond name, location, and contact information. The IRS files contain detailed financial information, but not much information on groups' activities.

To find out more about these groups, NACEDA paid graduate students to review websites for a large sample of groups and record their activities.

EXHIBIT 1: Definitions and Interpretation of Financial Health Indicators

	Definition	Interpretation
Cash Indicators	**Cash flow from operations:** a measure of the cash generated by core business activities	Measures of the cash dynamics of a business – positive cash flow from operations is an indicator for business model health.
	Total days cash: the number of days that cash and liquid assets can cover expenses	Organizations with higher days cash are able to cover unexpected costs and invest in improvements and/or expansion of activities. These are not the only measures needed to determine if the organization has adequate liquidity and a sound business model.
	Current ratio: ratio of current assets to current liabilities	Ability to meet short-term debt obligations – the higher the ratio, the more liquid the organization.
Asset Indicators	**Net assets:** the value of total assets minus total liabilities	Measure of balance sheet health – higher levels enable groups to attract capital or reinvest it in new projects or programs.
	Unrestricted net assets: The value of total assets minus total liabilities which have no funder restrictions on further use	Measure of balance sheet health, with higher levels enabling groups maximum flexibility to invest in priority areas of improvement or expansion.
Financial Ratios	**Capital ratio:** Ratio of net assets to total assets	Percentage of total assets financed through equity – a high or upward trending percentage would indicate increasing or improving financial strength.
	Debt ratio: Ratio of total liabilities to net assets	Proportion of total net assets financed by debt – a high number or one trending upward may signal future liquidity problems or difficulty in acquiring additional debt.
	Financial sustainability ratio: Ratio of unrestricted revenue to total expenses	Percentage of expenses covered by unrestricted revenues – the higher the percentage, the more sustainable the organization is.

[6] A very detailed description of our list construction method appears in the Urban Institute's Technical Appendix to their study of financial characteristics of these groups. https://www.urban.org/research/publication/financial-health-community-based-development-organizations

Coders also recorded groups' primary activities, enabling us to segment our analysis of the CED sector according to agency types – developers, managers, lenders, planning and organizing agencies, and social services agencies.

The original cohort includes 5,702 groups. The new segmentation file contains data on 2,225 groups – roughly a 50 percent sample of the 4,206 groups with websites. (The figures in this brief, therefore, are weighted to represent all 4,206 groups, excepting those where information is missing or not applicable.) Our financial health scoring covers 3,248 groups, reflecting the loss of cases resulting from incomplete IRS information for all years. Because groups without websites tend to be very small, this analysis necessarily ignores the least active groups in the sector.

EXHIBIT 2: Interpretation of Financial Health Categories

Category	Interpretation	Percent of CED Groups
EXCELLENT Passed 5+ "excellence" measures	Regular achievement of positive net income and positive cash flow from operations; strong liquidity that enables investment in operational improvements; growing net assets and sufficient unrestricted net assets to enable early-stage project development without resorting to excessive new debt; high liquidity and strengthening balance sheet able to attract new long-term debt on favorable terms; business model often includes earned revenues that more than fully cover expenses.	17%
GOOD Passed 3-4 "excellence" measures	Typically have positive net income and operating cash flow; more than 90 days cash on hand, enabling coverage of gaps in revenue flows and modest new investments in operations; solid net asset position and usually positive change in net assets, usually able to partially fund early stage project development; strong capital and debt ratios, but typically less able to cover expenses with unrestricted cash. Able to attract new long-term debt on somewhat favorable terms.	31%
ADEQUATE Passed fewer than 3 "excellence" measures & failed fewer than 5 "fragility" measures	Typically have more than 90 days cash on hand but operating margins are thin and groups are vulnerable to interruptions in revenue making it difficult to plan for program improvement or expansion; some unrestricted net assets are available but net asset growth is uncertain. Capital and other ratios are generally similar to groups in the "good" category enabling them to at least some capital for investment.	34%
FRAGILE Failed 5+ "fragility" measures	Weak cash flow and very thin or non-existent cash cushion, making it difficult to attract or retain staff and invest in internal operations; negative net assets and lack of unrestricted net assets hamper ability to raise cash to cover gaps in cash flow or raise short-term capital for project development. Relatively high debt burden makes it very difficult to attract investment capital. Often reliant on few revenue sources.	18%

Note: See Appendix for scoring methodology.

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