The New Nature of Money:

Financial Flexibility and Sustainability in the Cultural Sector

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The world of nonprofit finance is changing fast. For today's cultural leaders, the challenge is to come up with a strategy that will allow these organizations to thrive both financially and artistically, a task that has only gotten more complex in recent years. Watching the financial crisis unfold, aware of the demographic shifts in the audience, and needing to confront deep-rooted financial challenges related to the financial model in the cultural sector, many organizations are in a state of turmoil and uncertainty. At the middle of this vortex is the question of how nonprofit cultural organizations can build enough flexibility into their finances to sustain themselves over the next decade and continue to create value for the public. The challenge of finding a path to financial and artistic health is complicated by the range of competing strategies and responses to change that are possible. Innovation and adaptation are prerequisites to building a new, more flexible and sustainable financial model, which in turn will allow these organizations to create value for their audiences and communities.

Elements of a Model

Four central concepts are critical to understanding the challenge that cultural organizations face. The most basic of these interlinked concepts is the question of the financial model that supports the organization, and the most critical is the issue of value creation for the public. Linking them are two central ideas of financial flexibility and sustainability. To organize the argument that follows about the centrality of flexibility and sustainability to the future of the cultural sector, it is useful to define all the elements of the model and then consider the factors that shape the ability of cultural organizations to actually improve their financial position and, in the process, improve the likelihood that they create meaningful and lasting social value.

Designing the enterprise

What are the dominant financial models in the cultural sector today? One recent study argued that there were ten different funding models in the nonprofit sector based on differences in the sources of funds, types of decision makers, and motivations of the decision makers. In the case of cultural organizations, range of models is far more constrained. In fact, there are really two main models based on the nature of the customer. It is important to note that nonprofit organization generally differ from for-profit companies because they do not always sell their services to the persons who will ultimately consume the service. In many cases, an individual or institutional donor pays for a service that is consumed by someone else. This is rarely the case in the business world where buyers and users are one and the same. One challenge for nonprofit organizations – and this is especially the case with cultural groups– is knowing how good their service is when the persons consuming it and relying on it are not the ones that have to pay the full cost of production. Without a clear market feedback mechanism, nonprofits often spend large amounts of time convincing donors that the work they do for others does in fact matter and deserve support.

The lack of a consistent, unitary buyer-consumer turns out to be a key starting point for understanding the different kinds of financing models that populate the cultural sector today. Some organizations have completely separated the buyers from consumers by having donors subsidize the production of cultural programming so that they can be enjoyed by others. The purely or largely donative organizations simply cannot get the consumers of the arts and culture to pay the costs of production, and as a result look to patronage from individual donors, foundations and corporations to cover the shortfall between the price the consumer will pay for the experience offered and the real costs of delivering programs. Organizations devoted heavily to arts education for disadvantaged populations are often closest to the pure form of donative financial models. At the other end of the spectrum are presenting organizations that are extremely disciplined about what they will and will not do based on audience demand. These more commercial organizations study carefully what their audience wants to see and then delivers this to them, while requiring them to pay for their experience. Many performing arts centers have taken this road and now book shows based on a tough calculation of which productions are likely to generate a profit or at least break even. The quest for cash flow positive productions has led some venues to even accept money – "enhancement funding" – from investors to present material that will later go on to larger venues, but that needs to be test marketed in "safe locations" away from the limelight. This funding guarantees a minimum sum of gate receipts and makes these productions attractive to the more commercially minded.

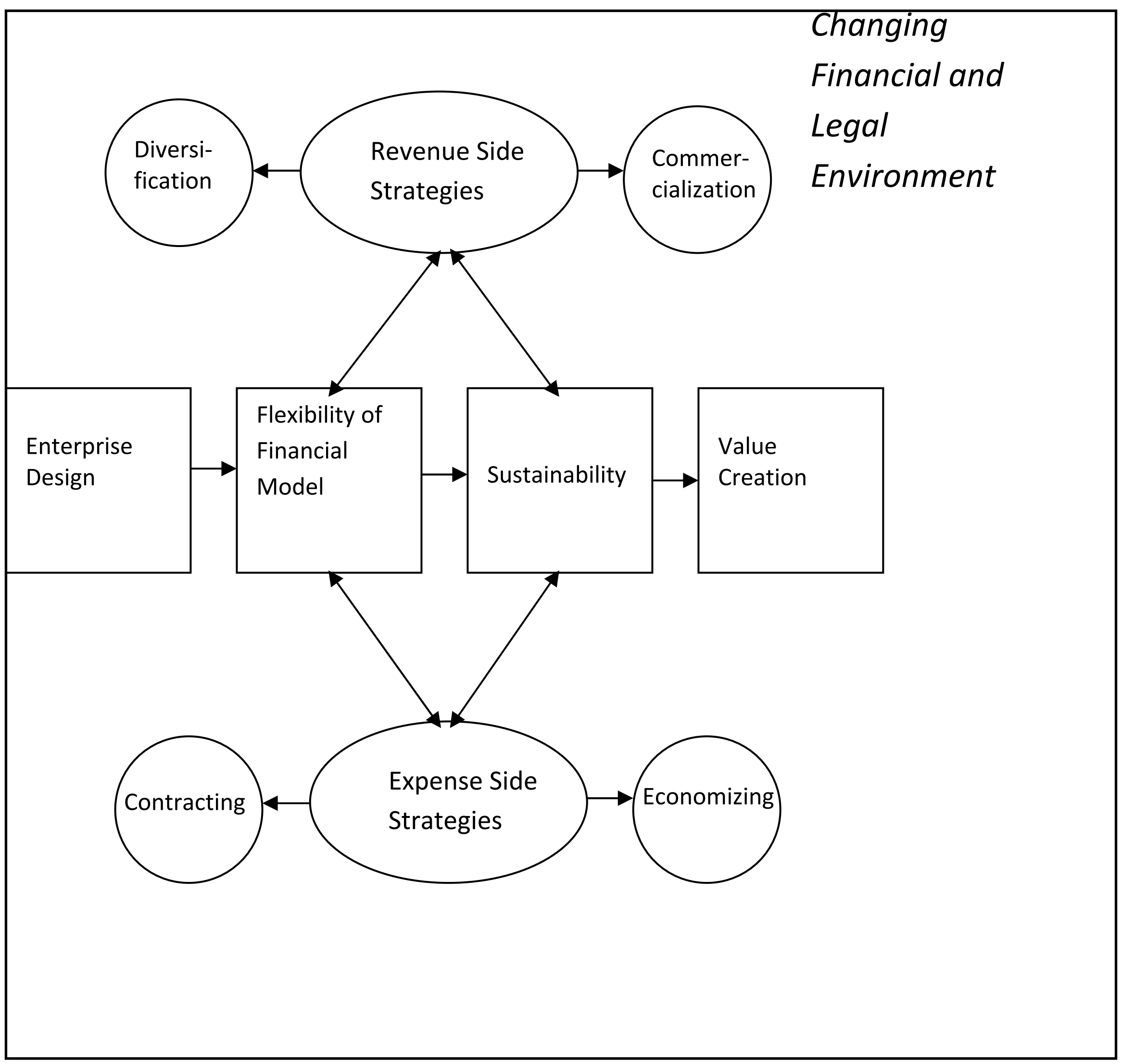
In between the purely donative and purely commercial financial models lie the vast majority of cultural organizations in America. They may generate some income from ticket sales and other commercial activities, but they still depend on donors to provide a supplement that allows them to do their work. This mixed financial model takes on many different shapes, depending on the type of cultural product being produced and the local conditions within which the organization operates. The main choice in funding models is rarely if ever at the extremes of the continuum stretching from donative to commercial, but rather in the complex choices and tradeoffs that are made in the middle. Compromises between programmatic and business decisions abound in this space. The relative power of market considerations and economic considerations changes over time as the underlying financial position of the organization worsens or improves. There are times when the production of niche programs is supported by understanding patrons. There are also times when hard-nosed decisions about programming must be made based on what will sell, especially if the organization is operating with little money in reserve.

The kind of financial model at play is just one driver of value creation in a cultural organization. The two other main elements of the model advanced here lie at the center of Figure 1 below. Of special interest are the concepts of financial flexibility and sustainability, which turn out to be closely related to one another. By financial flexibility we do not mean the ability of cultural leaders to perform gymnastic moves with financial statements in hand. Instead, the idea of flexibility comes down to the capacity of an organization to adapt and endure in light of changing organizational imperatives and environmental conditions. Few cultural organizations can afford to remain static over long periods of time as tastes change, as funders enter and leave the scene, and as community around the organization changes. Instead, cultural leaders are constantly challenged to adapt and evolve their organizations to the shifting reality that they confront each and every day they go to the office.

Flexing the enterprise

Financial flexibility is more than just adaptability. It also comes down to designing the financial model of an organization in a way that allows for enough slack to deal with the regular boom and bust cycles in the world of culture. When it is the best of times, financial flexibility allows an organization to accumulate surpluses and expand programs. In troubled times, an organization that has flexibility will be able to contract and streamline its operations to address the changing reality on the ground. Financial flexibility also gives an organization important freedom to respond to changes in the environment, especially when economic conditions worsen or when new opportunities for growth and expansion present themselves. Freedom from worrying about how to meet payroll and freedom to try new and risky projects are important drivers of value creation in the cultural sector. Just as importantly, flexibility is ultimately linked to the idea of sustainability.

Figure 1


Changing Financial and Legal Environment
Diversi- fication
Revenue Side Strategies
Commer- cialization
Enterprise Design
Flexibility of Financial Model
Sustainability
Value Creation
Contracting
Expense Side Strategies
Economizing

What does flexibility in the cultural sector actually look like and how would one recognize it if one saw it? On the revenue side, consider a theater that received most of its income from a couple of local foundations. These grants are targeted and cannot just be used for general operating expenses, but instead must be used to launch new program initiatives, develop arts education and outreach efforts, and offer free or subsidized programming for the community. To make matters worse, tickets sales are way down and the theater has no real plan for turning this situation around because they are busy executing on the terms of their foundation grants. On the expense side, the group is running a small deficit and has few expenses other than salaries and benefits for full-time staff. Finally, the group has only three months of operating expenses in the bank. This is an organization not just in severe financial jeopardy, but one that has very little flexibility to make adjustments. Its revenues are concentrated and targeted, and it cannot make major changes on the expense side without firing core staff. It is not hard to see that this organization’s long term sustainability is clearly at risk because it has so little cushion to draw upon and few opportunities to adjust should conditions worsen.

Now consider a museum that is in a very different position. It has robust ticket sale revenue because it brings blockbuster shows through each year, and the museum shop is doing very well with a new line of umbrellas and pillows featuring the most noteworthy painting in the collection. It has a solid endowment that covers the salaries of the director and senior curators. It receives an evolving mix of corporate and foundation grants and is aggressive in its management of these institutional relationships, constantly bringing in and cultivating new prospects. The museum has 18 months of operating expenses in cash and generates a small surplus each year that allows it to plow funds into an account in the endowment that remains accessible in times of need. It also employs a large number of independent contractors who work on publicity, bookkeeping, security and other functions. Of course, this museum is in a far better financial position than the theater above. But what is less obvious is the fact the strength of its financial position is not a function just of its resources. It is a good position because of the flexibility of its financial model. Not only does it have many sources of funding, it has reserves and a set of expenses that it can adjust and control easily should conditions in the community change.

In each of these two examples, financial inflexibility and flexibility is a marker of where the organization is likely headed, but it is also an indicator of what kind of culture and management approach is likely to dominate. When an organization is stressed due to little or no slack, it operates often in a state of fear, depression, or panic. New ideas are shelved, risks are avoided, and survival becomes the name of the game. In cases where there is flexibility, the organization’s leaders can afford to take some chances, try new things, and make decisions based on their merits. Under such conditions, the culture is more likely to be entrepreneurial and optimistic, with new ideas flowing freely at the water cooler and at staff meetings. This turns out to be a very important difference. Flexibility also pushes the decision making horizon out. Choices are not made simply in terms of their short run budgetary implications, but instead on the basis of likely social value creation over the medium and long term. Not only is financial flexibility connected to wise decision making and predictive of operational sustainability, but also a foundation for success in delivering on mission.

Sustaining the enterprise

Sustainability is linked to flexibility but is conceptually different. An organization is sustainable if it can endure over time. In a sector where over 200,000 of the roughly two million nonprofit organizations registered with the IRS are non-functioning and defunct, it is undeniable that failure in the nonprofit sector is widespread. Studies of the causes of unsustainability and failure have revealed that nonprofit organizations that go under do so because they do not adapt to shifting needs and evolving funding realities. Organizational missions become decoupled from their sources of support. This erodes internal operational capacity, which then makes execution harder. And a vicious cycle of poor performance, diminishing support, and irrelevance eventually drives the nonprofit into the ground. Not all nonprofits die slow deaths. Some are poorly positioned from the start and never really get off the ground. Others die sudden and violent deaths after founders walk away, administrators ruin the reputation of the agency by misappropriating charitable funds, or some programmatic failures hit the news.

For cultural organizations, sustainability is a real challenge because so many cultural enterprises – such as opera – can only survive with substantial subsidies from patrons and supporters who are willing to give in a sustained manner. While many cultural organizations have endured for centuries thanks to the gifts of patrons, this does not mean that there are not better strategies for sustaining an organization over time. And in fact many groups have spent considerable time and effort working to find a way to create greater financial sustainability, precisely because the patronage model runs the inherent risk of collapsing should support erode or loyalty shift.

Creating value

Understanding the kind of financial model in operation, the flexibility allowed by the model, and the long-term potential for sustainability are all important in determining the probability that a cultural organization will be able to produce value for the community. In the framework depicted in Figure 1, sustainability is not an end in itself, but only a way station on the path to social and artistic value creation. Of course, the question of what is of value is hotly contested in the cultural context, more than in many other areas of nonprofit activity. When an education program claims to create value, its assertion can be checked against the test scores of the young people it has served. When a clinic claims to create value, its work can be assessed based on the health outcomes of its clients and their pattern of recovery from illness. When a human service organization claims to prepare single mothers for work, the claim of value creation can be checked against the employment record of its clients after they complete the program. In a cultural organization, the claim to produce public value is much harder to measure and difficult to even define. Is the critical consideration artistic quality? Defined by whom? Or is the main determinant community acceptance and participation? Measured simply in terms of numbers? These are enduring questions for which there are no easy answers.

The complexity of the linkage between financial models and value creation is exacerbated by the fact that the model in many ways determines the kind of value that will be produced, and at the same time the value produced by an organization will dictate the financial model it follows. There is thus a troubling circularity to the relationship, with a feedback loop bringing funding and value creation into permanent and ever evolving contact. For example, when a group is producing programming that wins critical praise and recognition but fails to win a large audience, the support of donors will become essential. They will need to override the market response and pay for the production of art for which there is limited demand. On the other hand, when a group has a massive commercial success with tickets being sold at high prices and profits being booked, the case for subsidies will weaken. The cultural product meets the market, and the buyer and consumer become one. This kind of success feeds upon itself and future productions may be expected to support a pattern of commercial success.

Changing Environment: New forms, actors, and instruments

The financial model, the degree of financial flexibility in the enterprise, the probability of sustainability and the capacity for value creation constitute the core of the framework presented here. All around this value chain in Figure 1 is the changing legal and financial environment that both shapes what is possible and, increasingly, opens new options and opportunities. The broader policy context affects cultural organizations' ability to deliver on the central value chain leading from financial considerations to value creation.

Over time, the range of possible forms in the "social sector" has expanded, and the line between business and nonprofit has been blurred. A spectrum of forms ranging from purely charitable to entirely commercial has emerged, and its middle is filled with organizations that do not fit within the traditional nonprofit and for-profit molds. This middle is populated by nonprofits that have gravitated toward a financial model driven by earned income (related and unrelated to mission), hybrid forms like L3C and B Corps, and for-profit firms that have a social purpose.

Beyond the choice of form, cultural leaders must also confront changes in the nature of the actors that shape the revenue stream of the sector. The funding scene has shifted over time to the point where impact investors, not longstanding foundation donors or individual givers, are key trend setters. These new impact investors in the sector have made strong demands for results and proof of impact, which have challenged charities and cultural organizations in particular. Compared to some human service nonprofits that have a long tradition of tracking outputs and outcomes, many cultural organizations struggle to engage with the performance measurement challenge. Many of them are caught between two equally unappealing options for dealing with the demand for metrics from the donor community. The first is to simply get very good at counting outputs (number of tickets sold, number of free tickets given away, number of education programs carried out, number of schools reached through outreach efforts, etc.) and to simply avoid the more complex topics of outcomes (how did the programs actually change the people who took part) or the even thornier question of artistic and program quality. The second approach is to focus much more on financial performance and to use a range of metrics as proxy measures for social value creation. Of course, neither move is particularly satisfying, and neither truly responds head on to the challenge of measuring performance for the increasingly demanding donor community.

In the area of fundraising, there have been a series of major changes that have swept across the field in recent years. Cultural organizations have experimented with new ways to tap into growing possibilities of online, social media fundraising, using networks and new technology to attract new support from donors who would otherwise not be accessible. While it is easy to ask others to follow one's organization on Twitter, actively managing and maximizing these new modes of engagement require real effort and attention. One of the implications for social media fundraising is that the model of cultivating donors has changed from one in which a small number of high stakes contacts is replaced by an approach that instead emphasizes a much larger number of more informal contacts. By building a relationship built on regular contact around content that is of interest to subscribers and supporters, social media has changed the way cultural organizations and their stakeholders interact.

At the same time, giving circles and donor advised funds within mutual funds and community foundations have emerged as important but sometimes difficult to access sources of funding. These aggregations of individual donors pose a new challenge to fund raisers since neither philanthropic form is as easy to identify and access as traditional philanthropic foundations that are listed in directories, have staffs who respond to inquiries, and are generally oriented toward interacting with nonprofit organizations. Giving circles and donor advised funds are far more private, more introspective and less open to approaches from grantseekers. This all has implications for the way fundraising is now done and will need to be done in the future.

New instruments are being used to finance social impact across the nonprofit sector and in the process create new ways to finance organizational growth. Cultural organizations need to appreciate that there are signs of a shift away from grants to quasi-equity investments, which allow investors in nonprofits to participate in the financial upside-- and downside -- of programs financed with their funds. When the program proves successful at creating a return, part of this return is shared with the investor. There have also been efforts to launch social stock exchanges that permit investments in businesses that have a social purpose, and allow these firms to raise capital more efficiently than would otherwise be possible. And there are many new ideas about debt instruments for the nonprofit sector, some of which would be pertinent to larger cultural organizations seeking to mobilize funds for capital and other projects. And as a result of the cultural building boom of the past two decades, more and more organizations are willing to take on debt – and sometimes very substantial debt – to finance their projects. In this sense, the mainstream cultural sector has become far more "corporate" in the way they think about borrowing and finance.

This new financial landscape must be appreciated and understood, with new forms, actors, and instruments all considered together and placed in the broader context of change and increased competition in the sector. Cultural leaders must now be prepared to ask complex questions about when it may make sense to look beyond the nonprofit form, when to use new organization forms like B Corporations and L3Cs, how to interact with new funders and financiers, and how to think in a fresh way about all the new options that the changing environment presents. For some organizations, the for-profit form may be appealing for what it signals about market responsiveness. But the B Corp and L3C forms promise to preserve the trust element that creates confidence by opening these companies to external scrutiny of their environmental and human resource policies.

Taken as a whole, the world around cultural organizations looks different than it did 10 years ago. New forms have appeared, new actors have emerged and new tools have been introduced, as have new demands and new challenges. All of which requires that we take seriously the new nature of money.