Illinois
Facilities
Fund

Capacity-Building Digest

Costs of Late Government Payments

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Introduction

"Part of operating in a cash-constrained environment is making choices . . . choices of how to allocate limited resources," says Joe Neri, Director of the Loan Program for the IFF. "In a way, you could say that there are no good answers to the dilemma of having legal commitments to pay for things and not enough cash. But we know that some agencies are better than others at predicting and managing in this perpetually unstable operating environment."

In the State of Illinois, the provision of government-mandated human services is largely privatized, and nonprofit corporations are the service providers the government most frequently seeks. As Illinois, like nearly every other state in the U.S., grapples with a slumping economy, revenue short falls and enormous pressure on cash flow are requiring belt tightening and leading to program elimination and delayed payments to vendors, including nonprofit service providers. The result is further extending the payment cycle of many government programs that had not been paying according to their contractually prescribed schedule even during stronger economic times. Many nonprofits are also facing an increased demand for services and decreased revenues from donations and other private sector resources.

These cash flow challenges for government and nonprofits come after a decade of significant changes in the business relationship between government and nonprofit service providers, as government has increasingly moved away from contracts to fee-for-service reimbursement models. In the contract model, the provider agency receives an advance on the funds required to provide the services specified in the contract, and then typically receives a monthly installment on the remainder of the contract, with any advance being liquidated in the final months of a contract. This enables the agency to make an up-front investment in staff and to cover the costs of service delivery as these costs are incurred. In the fee-for-service model, in most cases, the agency must provide and document the service, bill the government, and wait for payment. While this change has certain benefits to ensure that the work is completed, the service provider incurs real costs before government funding is received. For organizations whose primary financial partner is government, this creates a need for cash on hand, sometimes significant amounts, or cash flow problems occur.

A Long-Time Problem—Practical Responses

This *Digest* will illustrate, through a small number of examples, the very real and high cost of government payment practices. It will also show that cash flow problems are greater for smaller agencies and for agencies with no cash reserves and without a long relationship with a bank familiar with government revenue timing. There is no easy answer to the problem of lack of cash.

The strategies highlighted in this *Digest* are useful cash management approaches for executives, administrators and financial managers in agencies of all sizes.

In 1998, the Illinois Facilities Fund and the Donors Forum of Chicago published *"Illinois Nonprofits: Building Capacity for the Next Century,"* a statewide study of the financial health of the nonprofit sector. Key findings of this report include:

- Government grants and contracts represent the single largest source of income for nonprofit organizations–accounting for 50.3% of all revenue.
- The larger the nonprofit organization, the more likely it is to have government revenues to perform services.
- 79% of human services agencies reported cash flow problems.
- 60% of organizations that experienced cash flow problems attributed them to delays in government payments.
- One third of all organizations surveyed had a cash reserve equal to only one month's operating expenses or less.
- There is a direct relationship between the level of government funding and the presence of cash flow problems.

The issue of government paying late on contracts for human services has been very real for more than ten years.

Quantifying the Cost of Late Payments

Fourteen chief executive officers, executive directors and chief financial officers from various segments of the human services sector were interviewed for this *Digest*, and they offered different reasons for the government–mostly the State of Illinois or City of Chicago–paying bills late. They also had varying views on the system failures that contributed to governments regularly missing payment deadlines for human services. All those interviewed agree that the practice of using borrowed funds or funds raised from charitable sources for other purposes to cover cash shortages due to late government payments is not a sound long-term financial practice, but is one that is often employed by nonprofits waiting for payments on government contracts in Illinois.

"Interest expenses, liability insurance and health insurance are in the category of business expenses that collectively are hammering agencies and pulling resources away from mission and programs," observes Martin Sinnott, President, Central Baptist Services.

To help understand the financial management challenges nonprofit corporations face in providing government-funded services, this *Digest* will identify direct and indirect costs associated with late government payments, and provide examples of strategies employed by managers to overcome the challenge of managing operations on consistently late revenue receipts.

When cash is not received on schedule, does an organization pay its employees or its other bills? Should an agency borrow to cover payroll costs, thereby increasing costs through interest expense? Can any bills be put off? What can the agency do to expedite payment from government agencies? How can the agency dedicate the time necessary to manage dozens of contracts on different payment cycles? These are the kinds of questions the IFF asked nonprofit corporate managers. This *Digest* examines the lessons learned from their answers.

Cash Flow Problems Create Real Costs: Costs You See and Costs You Don't See

Youth Services Bureau of Illinois Valley (YSBIV) in Ottawa, Illinois, helps young children and their families achieve success by providing counseling and child care services. YSBIV receives 80 to 85% of its funding from 24 different state departments through fee-for-service payments. The 24 different government reimbursement schedules vary from 30 to 90 days after the services have been concluded. This means the YSBIV funds these programs and services for up to three months before receiving any payment from the government. YSBIV covers these expenses, which can run as high as $80,000 per government department/program for a 90-day period, with cash reserves. In addition to the quantifiable interest expense associated with fee-for-service reimbursement schedules, YSBIV also incurs the cost of staff time managing the accounts receivable associated with government payments, and has to defer maintenance expenditures and other needed purchases. These decisions may also include limiting investment in new or expanded programs, which can result in a higher cost later. This could include higher utility bills, for example, when window replacements are deferred.

Michelle Rich, Fiscal Manager, and Dave McClure, Executive Director, are convinced that having good internal computer systems, well-trained staff and tight internal deadlines are the keys to staying on top of paperwork. "We didn't use our bank line of credit for almost two years because we worked so intensively on getting paid on time," says Dave McClure. "But we are using it again now and will probably do so through the end of 2002."

CASH FLOW

Strategy: Tight Controls and Good Internal Communications

The effect of late receivable payments is both direct and indirect. Quantifying direct costs is fairly simple: Direct costs are those expenses incurred as a result of not having cash on hand to meet current expenses. Quantifying indirect costs is a bit less straightforward: Indirect costs are expenses that are not directly attributable to a slow payment cycle but are a result of the lack of cash caused by high receivable balances.

Direct Costs	Indirect Cost
Line of credit interest expense and fees	Lost interest income on cash reserves
Fees charged on delayed bill payments	Opportunity cost on lost working capital
Staff costs spent on collections of receivables	Inability to increase services
	Delayed nonessential purchases
	Hiring freezes
	Delayed maintenance
	Poor liquidity/loss of flexibility
	Danger of poor credit rating
	Organizational stress

Direct Costs

Line of Credit Interest Expense

According to the *Illinois Nonprofits* study, 70% of nonprofits that borrow money do so to stabilize cash flow. One common way that both nonprofit and for-profit businesses supplement their cash flows is through a line of credit. A line of credit begins with a lender's approval of a specified amount of credit that will be available to the organization. There is a fee for establishing and maintaining the line, although interest is paid only on the amount drawn.

A line of credit may be viewed as a credit card. It is a good and quick way to pay bills when there is a lag between reimbursements and when expenses must be paid. When the nonprofit managers foresee that cash reserves will be exhausted, the lender advances funds sufficient for the manager to have enough cash to meet pending expenses. Once the organization receives payment from the government, it can repay all or part of the funds advanced by the lender.

The line of credit may be a flexible source of funds, depending on the agreement between the borrower and the bank. As opposed to a conventional loan where the entire amount of the loan is disbursed, an organization only draws on the amount needed of the total line of credit. Interest expense applies on funds drawn. Interest rates for agencies interviewed for this *Digest* ranged from just under the prime rate to three points over prime in 2001. For instance, an organization that has a $1,000,000 line of credit and needs only $200,000 to pay its expenses can borrow $200,000 from the line of credit and repay that amount when it has the funds to do so.

The Cost of Obtaining a Line of Credit

Most loan agreements on a line of credit mature one year after initiation. At the maturity date, all advances are due. If the lender and borrower are satisfied with the relationship, the line of credit can be renewed or extended. Securing a line of credit can be a challenge unless the agency already has a good relationship with its bank and is in good standing. Because lenders don't always consider the full value of a government contract for service to a secure line of credit, nonprofit corporations may need other collateral, such as property and equipment, to secure the credit line.

"More recently we have seen that larger banks won't establish lines of credit below $300,000. They want the fees on at least this much in order to make it worth their while to do the underwriting, "says Dottie Johnson of the Nonprofit Financial Center in Chicago.

Strategy: Establish Line of Credit

In the IFF's experience with hundreds of nonprofits, the bank line of credit is a standard financial operating practice. Ironically, in the current economic climate, banks are pulling back from establishing new lines of credit, and watching existing ones more closely. So nonprofits, which the government relies on to deliver services, are less likely to be able to use this practice to remain stable through this challenging period. This lack of access to cash affects employees, clients and participants in programs.

"We would be unable to operate without our line of credit," says Eileen Durkin, Executive Director of the Victor Neumann Association (VNA). VNA relies heavily on the State of Illinois offices of Mental Health and Developmental Disabilities in the Department of Human Services. Even these two offices within the same department have different funding processes and rules for reimbursement, according to Durkin. She estimates that VNA pays $40,000 per year in interest expense on their line of credit. This is clearly a direct cost.

Late Fees and Staff Time

When cash is limited, an organization must prioritize and choose between obligations that must be met *today* versus those that can be put off until later. This often means deferring payment to some vendors. Some vendors will charge a late fee or start accruing interest on payments not received within the billing cycle. Overtime, these late fees and interest expenses can be sizeable amounts, or trigger additional expenses in penalties.

Our World Child Care and Adult Services, a 24-year-old agency in O'Fallon, Illinois, provides child care as well as adult day services for seniors in St. Clair, Clinton and southern Madison counties. Our World incurred late fees repeatedly on invoices during 2001, and borrowed on its bank line of credit to make mortgage payments twice within the last year to avoid late fees and credit issues with the mortgage holder.

For Our World, 65% of the adult day services are funded by a fee-for-service contract with the Illinois Department on Aging. In 2001, Our World has seen its average government accounts receivable balance increase from $35,000 to $75,000. This increase is not due to increased revenues or additional contracts but is solely attributable to a delay in the payment cycle. According to Joy Paeth, Executive Director, currently the average collection period is 60 days from the time of billing, which is 90 days from the time of service provision.

Our World bills the State at the beginning of each month for the prior month's services. Therefore, services provided during the month of January are billed on the first of February and payment is received around the first of April. So expenses incurred on January 1st are not offset by revenue until the first of April. Our World relies on a line of credit, as well as revenues from private sources, to cover this collection period. They have, on occasion, incurred interest expense from the use of the line of credit.

Our World's line of credit is for 80% of the average government receivables amount, at a rate of prime plus 1%, and the line is secured by their building. Prior to owning the building, they were unable to obtain a line of credit as an emergency back-up. Paeth believes, "we would not have the line of credit if we didn't have a Board member who is employed by the bank."

Strategy: Maintain A Good Relationship with a Bank

At YSBIV, an average of 16 hours of staff time a month are spent just managing government account receivables. With 24 separate contracts, a spreadsheet (separate from their accounts receivable system) that tracks the billing and receipt of government contract receivables is the only way for fiscal officer Michelle Rich to see at a glance the status of their 24 contracts, essential for her to continually develop cash management strategies.

While Illinois' prompt payment laws entitle nonprofits with government contracts to interest on payments more than 60 days late, it does not allow for expenses for staff to manage or collect on government contracts paid late.

Norm Groetzinger has been the executive director of the Counseling Center of Lakeview in Chicago for 25 years. This agency provides community-based mental health services to underserved populations, and over the years Groetzinger has weathered many financial storms. He believes that fee-for-service arrangements have many hidden costs, including additional time for program staff meeting additional paperwork requirements and administrative staff meeting the billing requirements. The Counseling Center of Lakeview expends approximately $10,000 per year on interest expense on its line of credit.

To quantify staff costs spent on collections of receivables, consider the percentage of the total time that a staff person spends on following and tracking delayed government payment collections beyond normal bill processing. That corresponding percentage of wages or salary is a direct cost.

RELATIONSHIP

Strategy: Build Cash Reserves in Any Way Possible

Lost Interest Income

If an organization has sufficient reserves on hand, it may dip into this cash to help cover cash flow deficits. In these instances, there is a cost of lost interest income. While this situation does not involve incurring short-term debt, interest on cash reserves that are depleted to cover expenses while awaiting reimbursement is a very real cost of managing receivables.

As an example, the majority of YSBIV's Migrant Head Start program expenses are incurred during the six-month period from May through October 2002. For three months during that period, YSBIV had payroll and other expenses of $85,000 related to this program that it was carrying, waiting for payment. These expenses created a substantial drain on cash reserves. YSBIV's interest income on cash reserves has dropped from $10,000 to $4,000 per year.

Cash reserves can also be built through new revenue strategies and increases in earned income. A previous *Capacity-Building Digest* highlighted the Chicago Project for Social Entrepreneurs, and described eight approaches to increase bottom-line management or the establishment of mission-related business. In other cases a cash reserve can be raised from donors, as long as they have a clear understanding of the use of their funds.

Using existing assets to expand cash reserves is also possible for some nonprofits. Search Developmental Center in Chicago provides residential and day services to adults with developmental disabilities. Search's entire $10 million budget comes from government contracts. As the push toward fee-for-service gathered momentum five years ago, Search "saw the writing on the wall," according to executive director John Lipscomb, and began a plan to build cash reserves to accommodate what he knew would inevitably be long payment cycles. This involved investing considerable time meeting with large banks and other institutions presenting a plan to sell, mortgage and refinance its many residential properties to free up equity which then became a cash reserve of approximately $1.2 million. (Using long-term debt on property can be less expensive than interest costs on a line of credit–every fiscal officer should conduct this comparison as part of regular cash management planning.) Search sold under-used real estate to convert the assets to cash. Search also negotiated a $1 million line of credit to meet any cash needs over and above the reserves they could build by selling and refinancing property. As predicted, Search's government receivables have grown from an average of $750,000 to $1.6 million. Indirect costs have included interest lost on cash reserves and refinancing costs.

Lipscomb estimates that lost interest on cash reserves increased from $75,000 in 2001 to $100,000 in 2002. "About one third of our revenues are from the Department of Public Aid," Lipscomb says, "and they are paying about 75 days late. We learned our lesson in the late 80s, when we had no cash due to huge government receivables. Now my Board agrees that cash is king."

Opportunity Costs

Opportunity cost is a term that captures the earnings or other benefit that might have been obtained if the cash had been applied to an alternative use. In this *Digest,* the opportunity cost represents the lost productive use of the cash tied up in receivables. When the receivable balance is converted to cash, the organization can use the cash as planned: to meet its obligations, to maintain its programs, and to pay its staff.

Our World and YSBIV have both experienced opportunity costs due to late government payments. For example, Our World had to delay maintenance on building and equipment and could not recruit staff for open positions, lowering their staff-to-client ratio. Equally important, the inability to hire new staff plays out by denying the economic impact of employment of a local resident and the community. Similarly, the YSBIV faced needed maintenance expenditure delays and deferred computer purchases and equipment servicing. Every manager knows there is a very high cost to having poorly maintained technology systems. Deferred physical maintenance can lead to higher utility bills and a drop in the value of property over time.

Instability and Poor Liquidity: Dangers of Poor Credit Rating

As John Lipscomb says, "cash is king." Organizations that carry high receivables are probably not as liquid as they need to be to function as stable businesses. This often affects an organization's ability to secure other debt, such as a mortgage on a building, which in turn constrains its ability to continue to meet its mission. As mentioned earlier, some banks will value government reimbursement receivables at only 50% of their full cash value.

Funders and donors may also be alarmed by a balance sheet that consistently shows large accounts receivables, high interest expense, and low working capital.

If an organization's cash crunch is chronic and the result is late payments of bills, that organization could receive a poor credit rating that tarnishes its reputation in the community and, under extreme circumstances, reduces it ability to obtain credit in the future.

Organizational Stress

Perhaps most difficult to quantify, low morale is the long-term effect of repeated cash flow crises on staff, management and members of the Board of Directors. Volunteers give their time, leadership, and charitable contributions to causes in which they believe. Their support can easily be eroded by financial crises over which they have no control. If payroll is not always met, hiring decisions delayed and/or salary increases deferred, anxiety will permeate the organization. This decline in morale can be felt in staff productivity, retention and the delivery of quality client services.

Michelle Rich, Fiscal Officer at YSBIV, claims "the biggest impact on morale is staff not knowing if they are going to have a job tomorrow."

Summary

In addition to the costs identified in the examples thus far, there is a cost to the government agencies that are unable to meet their commitments on time. These include:

- Relationships with the community-based partners that carry out state funded and mandated programs and services; and
- A financially weaker nonprofit sector, unable to be flexible to expand or adapt services to the changing needs of its constituents.

While these kinds of costs are difficult to capture or would require complex economic tools to quantify, they are costs that are also felt by individuals and communities. The cost of poor partner and community relationships and poor responsiveness to community needs undermines the very essence of most human services agencies' missions. Easier to quantify, and therefore easier to use to assess the total cost of late government payments, are the direct and indirect costs illustrated in this *Digest*.

The cumulative effect of extended payment cycles from the various state agencies that contract for services with nonprofit corporations is also elusive because it is one factor in the multifaceted contract relationship between government and nonprofit corporations. This *Digest* has specifically identified direct and indirect costs incurred by nonprofit corporations. These costs also hint at but do not quantify real costs to society at large that are incurred as nonprofits slip further from their missions as poor cash flow becomes an increasing problem: Levels of service may shrink as staff is reduced (often 70% or more of total agency operating costs in the human services field); opportunities for innovation, program improvements and new programs are lost when cash flow is disrupted; and, finally, programs may go under if the amount and frequency of payment does not adequately cover the cost of services. Such gaps in service not only harm those unable to obtain service; they may shift societal costs to other, more costly alternatives.

Adding it Up

Using the interest rates and management strategies discussed in this *Digest*, estimates for late payments in one service sector will provide a context of the extent of the cost of government's payment failures. For example, the Illinois Department of Aging has contracts with 55 nonprofit corporations to provide adult day care services to low-income senior citizens in the state's fiscal year 2003. These contracts total about $6.3 million, or an average of a $114,000-contract to each agency. To calculate the cumulative cost of interest paid by the nonprofits to finance a line of credit, assume that the state: 1) owed an equal share of money to each agency and made equal installments over 12 months; 2) made their payments three months later than contracted for; and 3) as a result, that 41 of the 55 agencies had to use a line of credit to cover obligations for each of those three months. Also assume that each of the 41 agencies paid the prime interest rate on their line of credit (a conservative assumption since many of the examples in this *Digest* incurred higher interest rates). In this hypothetical, over three months each agency would accumulate approximately $1,342 in interest payment for a total of $55,046. That is $55,000 in three months that could have otherwise been used to provide day programs, activities or meals to needy senior citizens throughout Illinois. Similar examples could be developed for countless other human services programs. Cumulatively, the scale of lost cash from human services from late payments has a significant effect on the ability of nonprofits to meet our communities' needs.

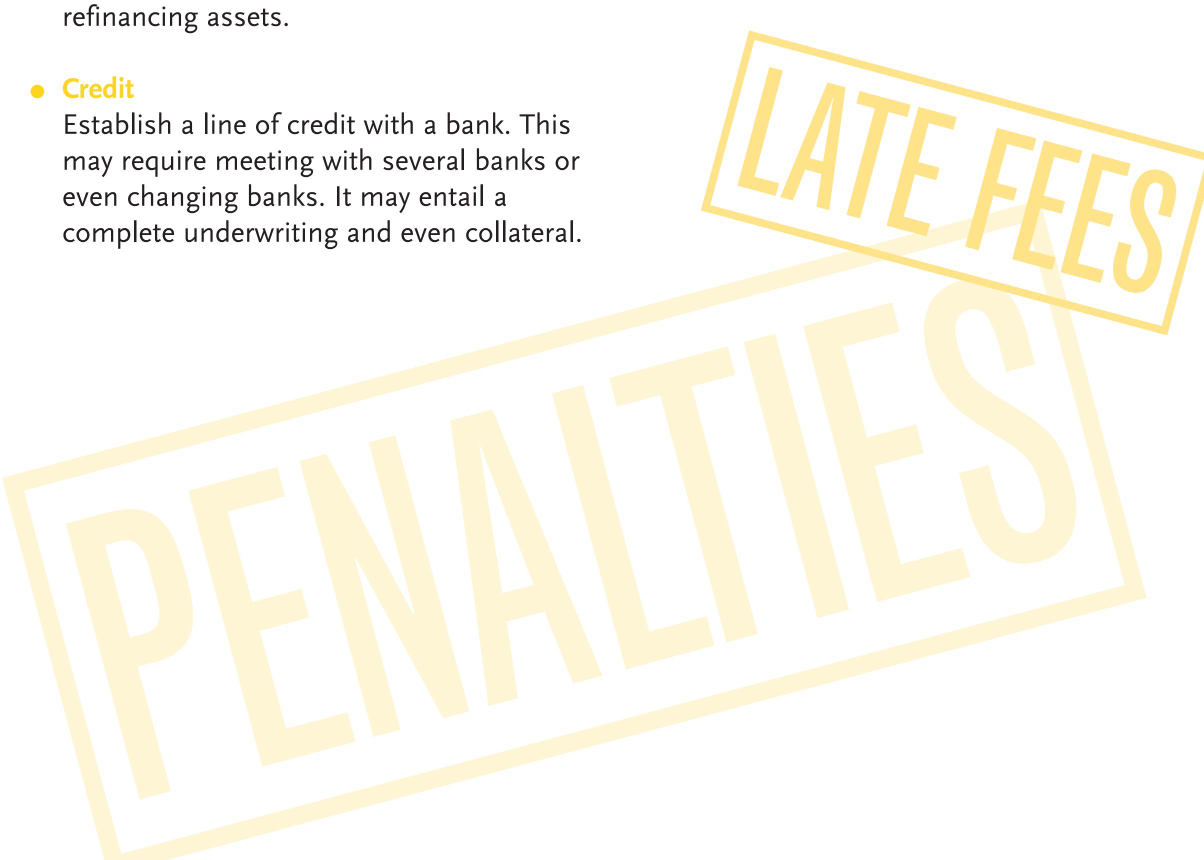
The tested strategies for coping with cash shortages due to late payments highlighted in this *Digest* illustrate a range of approaches to cash flow management. These strategies are also examples that can be adapted in nearly endless variety to the particular circumstances of a nonprofit corporation to create fiscal management tools to balance revenues and expenses with cash flow. These approaches focus on three main categories:

- **Systems**
  Good financial systems and control; timely communication between program administrators, program staff and fiscal staff; good working relationships with government contacts; continual review of the status of cash; good cash management practices

- **Cash**
  Build cash reserves through any measure possible and reasonable, including selling or refinancing assets.

- **Credit**
  Establish a line of credit with a bank. This may require meeting with several banks or even changing banks. It may entail a complete underwriting and even collateral.

While the problem of cash flow can have many roots, for thousands of nonprofit agencies that work to carry out government-funded programs the government is the largest source of revenue; therefore, changes in its payment cycle have the biggest impact on cash flow. Sound fiscal and service management is essential but cannot result in stability for the industry sector when a major revenue source does not meet is payment obligations. Estimates from the Illinois Association of Rehabilitation Facilities and the Jewish Federation of Metropolitan Chicago calculate the sum of late payments from state agencies alone at $400 million annually. The magnitude of this burden should persuade government to consider alternatives to solving its own cash management problems that would spread the cost more equitably and fulfill its goals to support all citizens at an agreed-upon level of service.



Policy Takeout

What can government do to improve its payment policies?

The examples discussed in this *Digest* show how a few nonprofits position themselves and manage their cash to respond to late payments on government contracts. These examples offer specific models to implement or adapt for your own agency management, and suggest certain changes that government can and should implement to improve its payment practices and better reflect the public interest value of government contracts for human services.

Certainly government revenue shortfalls and tight budgets require belt-tightening all around; but the state's fiscal challenges can not and should not be solved by delaying payments to community-based nonprofits that provide vital services to our neediest neighbors.

There are short-term and long-term solutions that must be implemented by government to address the cash flow problems created by late payments. For example, if a nonprofit corporation is facing a dire fiscal crisis, the Office of the Comptroller will take one-time steps to speed up a late payment that can forestall or solve the crisis. While not an adequate long-term solution, the partnership with contracted nonprofit corporations reflected in the Comptroller's responsiveness should be the model approach across state government. Current law allows for nonprofits to claim interest payments on late payments for all human services except Medicaid and education-funded programs. Such penalties may be useful tools of last resort, but likely will not foster positive, collaborative partnerships to support human services to low-income individuals, families and communities. Moreover, if payment of penalties comes from a state agency's program budget, excessive penalties may curtail service for lack of funds. Payment incentives could be implemented to reduce delayed payments: a higher reimbursement rate could be required of all fees-for-services that are paid more than 60 days after submission. Similarly, the clock should start ticking on a bill from a nonprofit human service provider upon receipt at a state agency, regardless of when the state begins its payment processing. These kinds of incentives are useful tools for government to meet payment deadlines and foster productive relationships with community-based nonprofit service providers.

Penalties for late payments should also be considered, particularly if incentives are not soon built into the system. A claims process that would use the Court of Claims as adjudicator of late payment penalties and fund such penalties would preserve full funding for programs and not threaten the service levels for already-stretched human services.

Implementation of these solutions will represent significant improvements in government contract payment administration, but will not address an equally or more important financial challenge for nonprofits that is not addressed in this *Digest*–the cost of service as related to the reimbursement rate in most government contracts in Illinois.

There are fundamental changes that government can and should be undertaking that would address not only cash flow problems related to late government payments, but those caused by reimbursement rates that are insufficient to cover the cost of service and other flaws in the government contracting cycle. The IFF is forming a work group to articulate and promote strategic solutions to the funding and operating problems faced by nonprofit corporations as a result of government contracting policies and practices. If you are interested in joining this work group, please contact us at ***www.iff.org*** *or 312 596 5116.*

Defining Financial Health

The IFF and the Donors Forum of Chicago define financial health as a nonprofit's ability to maintain programs without interruption, to meet all financial commitments, and to end each year with positive net assets. In addition, a financially healthy nonprofit has a board of directors that assumes responsibility for the financial stability of the organization and has management that integrates financial and program planning.

Successful nonprofits operate with proactive strategies to define appropriate and balanced relationships with clients and constituents, with the government, with funders and with the community, using dedication to mission as the driving force.

For a copy of *Illinois Nonprofits: Building Capacity for the Next Century*, or to add a colleague to the mailing list for the *Capacity-Building Digests,* visit our website at www.iff.org, e-mail: iffmail@iffund.org or call 312.629.0060.

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