

ASSESSING PROGRAM PROFITABILITY

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Whether tuition based or grant-funded, every program impacts your organization’s bottom line. Making informed decisions about critical organizational issues like hiring or fundraising requires a clear understanding of each program’s profit or loss. Is it inherently profitable? Does it require subsidy? How does it fit together financially with other programs? To answer these questions with confidence, Nonprofit Finance Fund (NFF) uses a special approach to program profitability assessment.

Most often, we look at program finances through a Quickbooks printout or a grant report, where salaries, occupancy, and other overhead costs are included. Allocating these expenses to programs is an important exercise and doing it well is an important part of securing and renewing grants. For external funders and stakeholders, you absolutely need an allocated budget to show the fully loaded costs of delivering a program.

Yet using an allocated budget to make internal management decisions can have disastrous consequences. The goal of a program profitability assessment is to look at the financial and mission impact of each one of your programs to ensure that all programs are in line with your organization’s mission and long-term financial targets. Often, this relationship is unclear. A program profitability assessment can provide much needed clarity, giving senior leadership and board members the data and perspective needed to make informed, financially sound decisions. Looking at the “marginal” or profitability impact of each program essentially just explains that program’s impact on the organization’s bottom line (i.e., the financial contribution it provides or the deficit it incurs). This information can then help managers balance financial factors against each program’s contribution to mission.

Some programs in the nonprofit sector will inevitably have a deficit. In fact, many nonprofits’ core programs will generate deficits. Indeed, one of the primary reasons that nonprofits exist is because the work they do cannot be provided by existing for-profit markets. So the organization must subsidize that deficit through fundraising or with earned revenue (e.g., scholarships for low-income students are often subsidized through revenues earned by tuition-based group classes). The key is to (1) be clear about how closely aligned a program is to your organization’s mission and (2) consider whether the profit it generates or the subsidy it requires is appropriate given this alignment.

The chart below (Figure 1) unpacks the relationship between the twin considerations of money and mission:

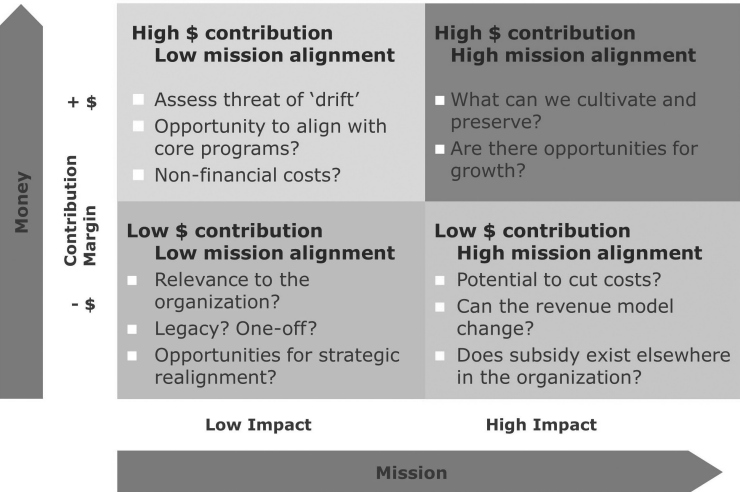


Figure 1

Along the bottom axis is mission. The programs on the right have high mission impact, while those on the left have lower mission impact. Along the vertical axis, the programs at the top generate a surplus and provide a large financial contribution, while the others break even or require subsidy. This simple two by two grid can enable a discussion about the relative trade-offs between financial contribution and mission alignment.

- **Upper right** programs are the clear winners, because they are aligned well with mission and generate surplus (meaning that revenue generated by the program exceeds its expenses). These types of programs are rare, however, with the exception of tuition-driven group instruction. Many “high mission” programs do not generate sufficient funds to cover their direct expenses. These programs may also compete with for-profit social enterprises.
- **Lower right** programs are closely linked to your mission but these programs need to be sustained by another area of the organization. This is typical of organizations serving low-income populations, as many Guild members do.
- **Upper left** programs have high margin contribution, but low mission alignment. Perhaps your organization provides arts education and also offers space rentals for events. While the space rental business is not closely related to the mission, it does generate a profit that the organization can use to subsidize other programs.
- **Lower left** programs on the grid provide little financial or mission contribution. These programs should prompt some soul searching. Most organizations do not intentionally choose to operate low mission programs; they are often legacy programs that have evolved over time.

TOOLKIT

The first step in a program profitability assessment is to take a hard look at all programs to determine which ones are mission critical and which ones were “good ideas at the time.” Once there is agreement on the relative mission merits of each program, assessing the underlying program economics can inform strategic decisions about:

- Whether and how to cut costs
- Where to focus fundraising efforts
- Whether to sustain, grow, cut or change programs
- How to respond to changes in the operating environment
- How to allocate resources among competing priorities

CASE IN POINT: ROCK CITY

A real life example from an NFF client can demonstrate the value of this type of assessment. NFF previously worked with an arts organization (we’ll call them “Rock City”) that makes musical theater and music classes available to low-income and homeless children. Rock City’s mission is to improve the lives of youth, teens, and families through music and musical theater. By using hip-hop and rock genres, they engage kids in a passion outside of school and have remarkable success in keeping young people out of detention centers.

The programs are very popular and have won several awards—so popular, in fact, that demand skyrocketed over the past 10 years. Funders were also excited to fund the increasing demand. During a 9-year period, the organization’s annual budget grew from \$200,000 to over \$2 million. But at the mid-point of this growth period, Rock City underwent two years of significant operating losses. After two very tough years, rebuilding their balance sheet was an immediate priority.

To do this, Rock City sought to improve their annual operating performance. The board and leadership recruited NFF to help them answer the following strategic questions.

Rock City Program Profitability Model



Rock City PPM FY2010				Capacity				
	Original Productions	Arts-in-Education	Community Events	Program Subtotal	Gen Ops	Development	Capacity Subtotal	Total Budget
	Revenue							
	(A) Earned							
	Admissions	\$14	\$73	\$10	\$97			\$97
	Fees	\$58	\$29	\$402	\$489			\$489
	Merchandise Revenue	\$4	\$3		\$7			\$7
	Subtotal	\$76	\$105	\$412	\$593			\$593
	(B) Contributed							
	Government				\$49		\$49	\$49
Individuals	\$75			\$75	\$88	\$138	\$225	\$300
Corporate	\$18			\$18				\$18
Foundations					\$44		\$44	\$44
Net Assets Released	\$312	\$682	\$205	\$1,199	\$340		\$340	\$1,539
Subtotal	\$405	\$682	\$205	\$1,292	\$520	\$138	\$658	\$1,950
Total Revenue	\$481	\$787	\$617	\$1,885	\$520	\$138	\$658	\$2,543
Expenses								
Personnel	\$152	\$401	\$157	\$710	\$181	\$137	\$318	\$1,028
Artist fees	\$128	\$132	\$306	\$565	\$148	\$4	\$152	\$717
Facilities	\$70	\$57	\$3	\$129	\$57	\$7	\$64	\$194
Office/ Misc.	\$36	\$8	\$6	\$50	\$46	\$7	\$53	\$103
Advertising/ Marketing	\$24	\$16	\$4	\$44	\$4	\$20	\$23	\$67
Productions/ Programs	\$24	\$46	\$9	\$79	\$3	\$11	\$14	\$93
Hospitality/ Travel	\$176	\$25	\$108	\$308	\$2	\$31	\$33	\$341
Total Expenses	\$609	\$684	\$592	\$1,885	\$440	\$217	\$657	\$2,543
Surplus/Deficit	(\$128)	\$103	\$24	(\$0)	\$80	(\$80)	\$1	\$0

Figure 2

- What are the available “levers” to reduce an organization-wide deficit?
- Which programs may be leaving untapped revenue on the table?
- What needs to change to ensure that both programs and capacity (overhead) are fully supported?
- How can we generate a surplus sufficient to cover our organization’s future needs?

NFF worked with Rock City to understand these dynamics using the aid of a program profitability model (Figure 2).

The right side of this model demonstrates all of the “capacity” (i.e., non-program or overhead) areas, such as operating support, leadership staff members, overhead, and development/fundraising. It can be tempting to allocate a percentage the overhead expenses in the capacity columns (for example, the executive director’s time) into the programmatic expenses on the left. While doing so is helpful when producing a budget for external purposes—you do not want to allocate overhead/capacity expenses to programs when assessing program profitability. When it comes to allocation, NFF uses the following litmus test: “If the arts education program went away, would 10% of my executive director’s time go away?” The answer is almost universally “no.” Since you will always have to pay the ED, 100% of the ED’s time is tied up in the capacity side of this model. The ED’s salary is just one of those expenses that will always be paid.

Due to their general operating support grants and unrestricted contributions from individuals, Rock City broke even on the capacity side. Breakeven results are not necessarily bad; an organization may choose to break even instead of generating a surplus so as to avoid making cuts to staff or programs. This is why it’s important that profitability be considered in the context of an organization’s financial situation and priorities. Rock City’s leadership prioritized surplus generation because surpluses were imperative to rebuild their balance sheet for the long term.

The left hand columns show Rock City’s three primary program areas, which effectively “break even” when they are combined:

1. Original productions, the core program, provide students with a chance to practice and perform the skills learned in Rock City’s classes. But as you can see on the bottom line, it is a deficit-producing program. (Note that these numbers are shown in thousands, so the program deficit is \$128,000.)

2. Arts in education has been a large growth area. The program, driven by contracts from the school system to teach classes, produces a profit.

3. Community events consist of shows that are more ad hoc in nature, often one-time events. This program also produces a small surplus.

To understand how the organization could start generating a surplus, each programmatic area was further scrutinized through consideration of their sub programs. After further breaking down “Original Productions” and “Arts in Education” into their subprograms (not shown in chart), some key observations surfaced:

- The July 4th show is an annual event within the “Original Productions” program. While its mission alignment was relatively low, it provided Rock City with great marketing and visibility. Rock City’s leaders were surprised to learn that the show produced a deficit. After further analysis, staff determined that the show could serve as a fundraising platform because its visibility made it attractive to corporate sponsors.
- Rock City’s music education and mentor programs—the most important parts of their education work—did not have significant revenue streams. Although staff had advocated in the past to charge a nominal fee for these programs, the issue was a non-starter with the board, as some trustees were strongly against the idea of charging fees.

Looking at programs in this way enabled management and the board to have data-driven discussions about where additional opportunities lie for generating revenue. Rock City’s leadership placed a high priority on generating surpluses, while refusing to cut staff and expenses. Within this context, staff and board reached a compromise that they would begin charging fees for their music education and mentor programs—but only in combination with increasing scholarship dollars; no child would exit the program due to fees. The education program was already producing a surplus, and some adjustments to the structure enabled Rock City to increase that surplus by about \$80,000.

Following (Figure 3) is the breakdown of projected profitability after the changes were made within each program.

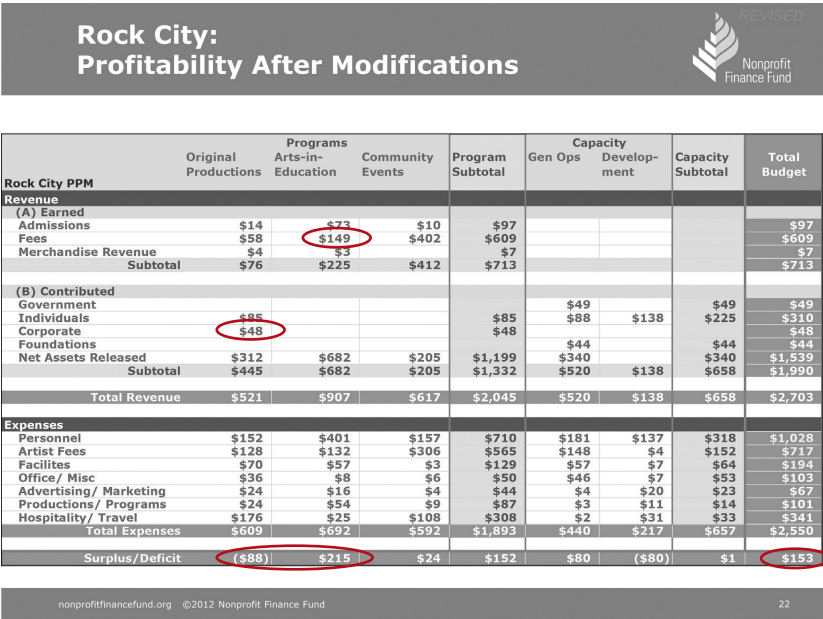
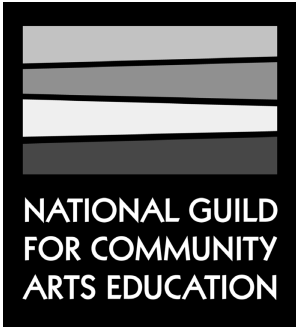


Figure 3

After some frank discussions and a difficult decision about charging fees, Rock City projected a bottom line \$153,000 surplus! Leadership was confident in the decision because they believed the changes to be well considered and necessary, ultimately helping to generate a surplus in 2010 (and in future years as well). Of note, all of the adjustments were made on the revenue side—not by cutting expenses.

SUMMARY: 6 STEPS TO ASSESSING PROGRAM PROFITABILITY

1. Identify key programs, subprograms, and areas of overhead/capacity.
2. Reach consensus on the relative mission contribution of each program.
3. Consolidate expense lines from the chart of accounts.
4. Start by assigning personnel to program. Start by assigning personnel to program. If staff positions exist regardless of program, assign them to overhead/capacity. This will be difficult!
5. Fill in the model for both expenses and revenue. The ED should be involved to ensure that the numbers are correct.
6. Use the model to inform strategic conversations—alongside a completed money/mission matrix.



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