Effective Financial Governance

FOR INDEPENDENT SCHOOL TRUSTEES

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Foreword by John Gulla

NBOA
National Business Officers Association

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About NBOA: The National Business Officers Association (NBOA) is the only national nonprofit membership association dedicated to developing, delivering and promoting best business practices to advance independent schools. The association has grown from 23 founding member schools in 1998 to more than 1,500 member schools from the U.S., Canada, Mexico and 23 other countries around the globe. The association offers in-person programming, including the NBOA Annual Meeting and Business Officer Institute; online professional development; original research; and an award-winning magazine, Net Assets. Each offering covers timely and relevant topics for independent school business and operations professionals, including finance, accounting, tax, compliance, human resources, risk management, facilities and information technology.

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4

RESOURCE ALLOCATION

KEY TAKEAWAYS

- The business officer should clearly define, and board members understand, the process used to allocate resources, i.e., the sources of funding.
- The school's strategic plan should guide allocation of resources.
- The business officer, head and board should consider information on funding strategic priorities and on the financial performance of the entire school as well as lower levels (divisions, programs, grades, etc.).
- The board should assess resource allocation in light of intergenerational allocation of equity.
- The business office should routinely prepare reports of financial margin by division and lower levels, if needed, as well as reports on school and division capacity and breakeven points.

BACKGROUND

Resource allocation is a key tool in implementing the school's strategy and setting priorities for spending available resources in the operating and capital budgets. Ideally, a school's strategic plan identifies its priorities, and its annual operating and capital budgets reflect those priorities.

Resources that are available to meet these spending priorities can come from four sources: additional revenues of all kinds, reserves, debt proceeds or reallocation of existing resources. Some combination of all four sources may be needed. Further, the school should periodically evaluate whether the resources are sufficient to fund the spending priorities. If not, then the amount, timing and nature of the spending priorities may have to be revised.

One source of funds is the reallocation of resources away from areas that are lower priorities to those that are higher priorities. Schools find this process very difficult because parents, current and former board members, donors, and other constituents may be involved in governance. The board may also lack readily available, widely used and widely understood financial metrics at the division level. Further, as we discuss in Chapter 6 "Budgets," many schools use an incremental approach to budgeting, whereby each division or unit receives more resources, within a range, than the previous year. Rarely do schools holistically assess all divisions for performance, including financial performance, and revise their spending levels to conform to the school's goals and priorities.

The individual operating division performance, both academic and nonacademic including auxiliary programs, represents the granular activities that comprise the overall school performance. Because the overall approach and plan for allocating resources needs to be

KEY QUESTIONS

Governance

- How well does resource allocation align with the school's strategic plan?
- Is each initiative of the strategic plan priced so that the finance committee understands the operating and capital risks associated with the initiatives?
- What funding sources will cover the strategic plan's costs?
- Does the school periodically assess each division's performance, including financial performance?
- How is the school's investment in new initiatives balanced among existing divisions?
- Is the allocation of resources sustainable for generations to come while serving current students' needs?
- What are the policies governing resource allocation?
- What are the policies governing revising or terminating programs or divisions that are not performing financially?
- What are the policies governing adding programs or divisions?

Process and Content

- What approach does the school use to determine the allocation of resources?
- Does the school regularly assess investment opportunities in new initiatives? What is the process for investing in new initiatives?
- Does the school regularly assess programs or divisions? What is the process to sunset programs or divisions that are either ineffective or inefficient?
- How does the school demonstrate whether its investments in strategic initiatives are appropriate and report strategic gaps, if any?
- How often does the school measure or reevaluate the academic divisions and administrative units, and what criteria and metrics are used?

correlated to the strategic plan, the individual divisions' plans should link directly to the overall school operating plans. If a divisional plan appears at odds with the overall school plan — whether it be the strategic plan, academic plans, or the operating or capital budget — the resource allocation should be challenged.

ESSENTIAL TRUSTEE KNOWLEDGE

One of the more important functions of the finance committee and board is assisting the business officer with developing metrics and then reviewing and overseeing the school's resource allocation process. Decisions relating to the nature, scope and type of academic divisions and other services are at the core of the school's mission, and providing divisions with adequate funding through the budget process is one of the finance committee's prime responsibilities.

The finance committee should ensure that school administration effectively performs certain key functions. The business officer must explicitly:

- Provide cost estimates and funding sources for the strategic plan's goals and initiatives.
- Show how the costs of implementing the strategic plan are linked with the annual operating and capital budgets.
- Periodically assess the performance of administrative departments and all academic divisions, including their financial performance, and show how those results were incorporated into the annual operating and capital budgets.
- Describe the processes used to ensure that all school priorities, including new initiatives, are funded adequately for the in-between periods of program assessment and re-evaluation of strategic plan goals.

Assessing the Financial Performance of Academic Programs

The environment for education is as challenging today as it has ever been; in fact, this challenge may represent a "new normal." Independent schools are especially dependent on tuition to maintain a student body that meets the needs of a school both financially and from an academic quality perspective, adding pressure to their operations. Private education is well past the time when modest modifications to operating budgets would provide ensured financial viability. Most schools will have to reexamine how they deliver services to students, faculty, staff and all other constituencies if their business models are to remain sustainable.

All areas of the school must be subjected to this scrutiny, and the solutions will lie in the ability to blend new technologies, improve processes and develop a highly skilled and likely smaller workforce. Critical to the success of this analysis will be the changes that are made within the academic functions. Often academic activities have focused mainly on growth of divisions and programs, as opposed to reassessing and repositioning those divisions and programs. This has taken place in an environment where student interests and the cost of attendance have changed substantially.

There are many approaches used to assess programs' academic and financial performance. One factor for success in all the models is effective and meaningful involvement by program/division faculty and key staff. In addition, the school's accreditation efforts and the metrics used by the accrediting bodies will also help understand and assess performance.

Over time, most schools have developed a series of metrics related to faculty workload that often is stated in terms of teaching loads and student-to-faculty ratios. Often these policies are developed partly in consideration of a comparison to a peer group or comparison to public schools. The issue generally is not that the school comparisons are out of balance. It is that the cost structure may not be affordable for the school, particularly considering the changes in net tuition that many schools are experiencing.

Cost of Instruction

The finance committee must understand the direct cost of instruction and its correlation to the school's revenue-generating capacity. Analyzing a division margin report, both for the budget and actual results, is critical; the business office can prepare this, and the appropriate stakeholders as well as the finance committee should review it.

A division margin report identifies direct revenues related to the specific divisions along with direct expenses, such as salaries, benefits, supplies, educational expenses and costs of leased space, if any. In addition, allocable expenses are also identified and allocated to the various divisions, such as facilities costs, depreciation, administrative net overhead and other non-specific costs. Preparing this report for both the annual budget as a supplemental report as well as showing the fiscal year actual results will greatly inform the finance committee and board on how resources are allocated and generated.

Allocations — There are three types:

- **Direct —** Revenues or expenditures that can be identified with a specific division and benefit that division. Direct costs are divisional, instructional or other program delivery costs limited to educational expenses and salaries and benefits.
- **Direct-Assigned —** Assigned costs are those that can be identified as pertaining to more than one division with a high degree of accuracy and causality. Costs are assigned to divisions based on student headcount or space square footage used.
- **Allocated —** Allocated costs are those that benefit all divisions and consist primarily of reallocation of administrative costs, including fundraising, to academic divisions based on student headcount.

Divisional Margin Report Example

Note: Allocation approach and basis of revenues and expenditures can be found on the following page.

Direct Revenues and Expenditures	Pre-K&K	Elementary (1-5)	Middle (6-8)	Upper (9-12)	Athletics	After School Programs	Summer Camps & Programs	School Total
Direct Revenues								
Tuition, net of discounts	2,569,687	3,714,065	3,696,121	3,588,595	—	341,980	155,500	14,065,948
Fees	110,295	128,510	128,170	120,400	50,000	—	—	537,375
TOTAL Direct Revenues	2,679,982	3,842,575	3,824,291	3,708,995	50,000	341,980	155,500	14,603,323
Direct Expenditures								
Faculty Salaries, Taxes and Benefits	2,288,957	3,146,553	3,144,882	3,171,088	75,000	236,355	122,733	12,185,568
Other Educational Expenditures	97,200	106,000	120,500	158,500	15,000	550	12,700	510,450
TOTAL Direct Expenditures	2,386,157	3,252,553	3,265,382	3,329,588	90,000	236,905	135,433	12,696,018
Net Direct Margin	293,825	590,022	558,909	379,407	(40,000)	105,075	20,067	1,907,305
Assigned Costs								
Food Costs for Lower Programs	80,400	—	—	—	—	5,000	4,000	89,400
Facility Rent	100,000	—	—	—	—	—	—	100,000
Debt Service for Main Campus	—	124,500	100,000	85,000	25,000	—	—	334,500
Maintenance & Utilities for Main Campus	—	84,000	75,000	65,000	25,500	—	—	249,500
TOTAL Assigned Costs	180,400	208,500	175,000	150,000	50,500	5,000	4,000	773,400
Net Margin After Assigned Costs	113,425	381,522	383,909	229,407	(90,500)	100,075	16,067	1,133,905
Net Margin as a % of Direct Revenues	4.2%	9.9%	10.0%	6.2%	-181.0%	29.3%	10.3%	7.8%
Allocation from Administration — Based on Student Headcount								
Annual Fund Transfer	(15,750)	(13,300)	(12,700)	(14,250)	—	—	—	(56,000)
Other Revenues	(6,709)	(2,143)	(1,770)	(1,491)	—	—	—	(12,113)
Salaries, Payroll Taxes & Benefits	223,003	239,293	232,459	227,334	—	—	—	922,089
Other Educational Expenses	19,435	16,208	15,129	14,319	—	—	—	65,091
Maintenance & Utilities of Administrative Space	16,743	15,348	14,418	13,721	—	—	—	60,230
Other Admin Expenses	22,038	17,040	15,816	14,897	—	—	—	69,791
Debt Service Related to Administrative Space	18,854	12,828	12,336	11,968	—	—	—	55,986
Strategic Initiatives	12,676	1,855	1,706	1,595	—	—	—	17,832
TOTAL Allocated Costs	290,290	287,129	277,394	268,093	—	—	—	1,122,906
NET OPERATING SURPLUS/(DEFICIT)	(176,865)	94,393	106,515	(38,686)	(90,500)	100,075	16,067	10,999

Sample Approach to Allocation of Revenues and Expenses	
REVENUE/EXPENDITURE TYPE	**ALLOCATION APPROACH & BASIS**
Tuition revenue	Assigned directly to division. Tuition discounts for multi-child, referrals and miscellaneous revenues charged/credited to administration. Financial aid charged directly to division.
Fees	Charge to division if identifiable, otherwise credited to administration.
Other revenues	Credited to administration.
Salaries, payroll taxes and benefits	Specific salaries for staff charged to that division. Administrative staff charged to administration. Food staff charged to administration. Substitutes charged to administration. Education specialists charged to division if identifiable; otherwise charged to administration. Benefits and taxes allocated with salaries.
Other educational expenses	Assigned directly to division, otherwise charged to administration.
Food	Allocated to Pre-K & K, afterschool or summer camp as free food costs are only for Pre-K and K students.
Maintenance & utilities for main campus	Assigned to specific division on a square footage of space used (divisions are housed in separate buildings) unless it can be attributable to a specific division. Cost related to Pre-K & K division included in facility rental.
Other administrative expenses	Allocated to administration.
Pre-K & K leased facility	Assigned to Pre-K & K division, as that is the only division that leases space.
Debt service for main campus	Operating credit line interest, if any, allocated to administration. Debt service on mortgage allocated to administration, elementary, middle and high schools since it is for the main campus site, and assigned on a square footage basis.
Strategic initiatives	Identified as to type and allocated to that division, otherwise charged to administration.
Transfer from annual fund — used to balance operating budget	Credited to administration.
Administrative overhead allocation	Generally assigned proportionately based on student headcount. Administrative costs not allocated to athletics, before/after school and summer programs since no additional significant marginal costs incurred and lack of causal allocation methods.

Intergenerational Allocation of Equity

The term **"intergenerational allocation of equity"** represents the balance between making investments to meet the needs of current students, faculty and staff and preserving resources to ensure the continued quality of the school's offerings for future generations.

In many schools, when the effectiveness of resource allocation is assessed, academic financial performance is excluded. Often discussions of intergenerational allocations of equity are tangential and confined to a discussion of spending rates on endowment funds.

The finance committee and full board should formally discuss the amount of resources to be used for today's students versus those to be saved and used for tomorrow's students. This discussion usually involves endowment spending versus return rates, but it should also include a broader examination of all resource sources and uses. School viability and stability requires:

- Retaining resources in a planned fashion so that capital replacements are adequately funded over time prior to their need, sometimes referred to as **funding depreciation**.
- Creating operating surpluses to ensure availability of resources for investment in such matters as new program initiatives or changed delivery models. The size of the surpluses required are dependent on each school's specific circumstances, particularly related to levels of expendable resources, condition of facilities and plans for programmatic adjustments.
- Maintaining a long-term sustainable spending rate on endowment and similar funds.
- Investing in current programs and divisions to ensure consistent quality of academics, support for student life, maintenance of capital assets on a current basis, and so on.

Any approach used to assess academic divisions' academic and financial performance should contain assessments of four perspectives: mission and importance, financial performance, internal competencies, and program or major market trends.

Mission/Strategic Plan

While everyone talks about the importance of mission, the difficulty lies in translating mission into actionable plans. Mission should be the guiding force that drives everything. In fact, it represents the key determinant of a school's ability to succeed.

Depending on the school, "mission critical" may be measured in terms of divisions. The school can measure outcomes of the beneficiaries of the school, such as student success (graduation rates), programmatic improvement (retention rates or perhaps enrollment yield) or faculty development (percentage change in faculty degrees). Whatever the focus, mission should be defined in clear, compelling terms that spur commitment and action. Articulating a mission that achieves this goal is not a simple matter. For example, a mission of "educating students" is so broad it cannot coalesce people around a specific set of actions. Conversely, a mission that is too narrow, such as becoming the preeminent provider of STEM (science, technology, engineering and math) education, precludes active participation by a large portion of the school.

Financial Performance

If mission is the institutional driver, financial health is the measure of affordability. Affordability is a delicate matter. While these issues should not drive decisions, ignoring them could jeopardize the entire school. It may be entirely appropriate to support initiatives that do not have a quantifiable return; however, school leaders must appreciate the impact of diverting resources from other areas. Financial performance can be measured in many ways, depending on what the school views as critical. The criteria for financial success are school-specific and may be the result of a combination of factors, such as operating results, budget size and return on net assets. A few high-level measures, consistently used, can provide the best indication of financial performance.

NBOA RESOURCES ON RESOURCE ALLOCATION

The NBOA Long-Range Financial Model for Independent Schools (tool)

Composite Financial Index (CFI)SM (tool)

The NBOA Financial Dashboard for Independent Schools (tool)

Financial State of the Industry (white paper, 2020)

Key Financial Indicators of Vitality for Independent Schools (white paper, 2018)

To effectively manage resource allocation, leaders must have a clear understanding of what the school does well (or can do well), what it is known for, and how it compares to its peers.

Internal Competencies

To effectively manage resource allocation, leaders must also have a clear understanding of what the school does well (or can do well), what it is known for, and how it compares to its peers. Competency refers to the accumulated value of resources, programs, processes, relationships, infrastructure, and abilities of faculty, staff, students and other stakeholders. To maintain competencies or improve them, the school must have a plan for identifying and quantifying human and capital investments — and a plan for generating or reallocating funds to these investments.

Market Trends

Which instructional programs or divisions will be hot? Which will not? What does this mean for the school? Is the market large enough to support the strategy? Questions like these must be answered to understand the impact of outside forces on the school. Analyzing market trends based on data such as the demand for particular programs and divisions and demographic changes in the student body will provide an external view of the school. Measures may vary by division but should identify the criteria most important to the school and draw on empirical evidence. Examples include numbers of matriculating (and paying) students in programs.

This is not to say that market forces should determine school spending decisions. On the contrary, market forces are one element that, when paired with the others, can help answer important questions. Additionally, when embarking on a strategic plan that will result in new investments, it is important not to look at where the funding is today but rather where it is likely to be tomorrow.

Administration needs to develop a process to periodically evaluate all the school's divisions and departments using the perspectives described above. These processes need to be accepted by important constituents, such as faculty and unit heads, who should be part of the process. Although these assessments take considerable time and effort, they need to be done periodically to ensure continued relevance and program vitality. One approach for frequency is to coordinate these assessments with the accreditation reviews, including the mid-cycle update.

Administration should summarize the assessment processes and results and present them to the finance committee as part of budget development and approval. In addition, this process should be integrated into strategic planning efforts and processes.

Between assessment periods, administration must ensure that the annual operating and capital budgets reflect the priorities noted in the strategic plan and program assessments. Budgeting processes should include procedures to ensure that priorities are funded appropriately to meet goals and objectives, with at least some of the funding coming from reallocation from nonpriority divisions and programs and units.

Models

Different resource allocation and decision-making models may be useful. These include responsibility center management (RCM) and cost-center management (CCM) among others. The basic difference between the two is that RCM assigns revenues and costs to the divisions, which are treated more on a stand-alone basis, while CCM may allocate costs to the divisions but revenues are pooled centrally. More authority is delegated to division leads under RCM, while the head maintains almost exclusive authority under CCM. A school needs to adopt an approach or model appropriate for both the school generally and at its specific point in time. Questions such as what the operating size should be (how many students), what types of divisions and programs to offer, how to offer them, and similar issues need to be addressed. There is no one correct or appropriate approach for all schools, but any allocation model must be correlated to the strategic plan if the school is to achieve its goals.

FUNDAMENTAL INFORMATION

Governance

- Summary of strategic plan initiatives and related costs and funding sources.
- Summary of divisions and programs that are priorities.
- Policy on adding or deleting divisions, programs and initiatives.
- Policy on allocating resources so that they reflect school priorities.
- Policy on intergenerational equity.
- Description of how the strategic plan initiatives will be funded in operating and capital budgets.

Process and Content

- Description of process to develop operating and capital budgets, compared to strategic plan initiatives.
- Narrative describing the process to conduct periodic review and financial assessment of divisions.
- Description of process to periodically review market trends for divisions.
- Description of process to annually allocate resources in the operating and capital budgets.
- Matrix or scorecard summarizing results of four assessment areas in each academic division: mission and importance, financial performance, program or major market trends, and internal competencies.
- Comparison of actual strategic plan costs and financial outcomes compared to expected costs and outcomes.

The finance committee should receive periodic reports on the results of the various assessments in summarized form. The busines office should include a narrative about how the results affect the annual operating and capital budgets.

The finance committee must hold administration responsible for ensuring that the goals and funding needs of the two primary efforts to identify and establish priorities — the strategic plan and the academic divisions' periodic performance reviews — are incorporated into annual operating and capital budgets. These two efforts are also linked. The strategic plan requires funding sources, including reallocation of resources from current funding levels, while the program performance reviews result in identifying potential resources that can be reallocated. The program performance reviews also inform the strategic plan and which divisions should receive more funding and priority.

Boards of trustees and their finance committees can better fulfill their stewardship and fiduciary responsibilities with an enhanced understanding of the financial model and related drivers of K–12 nonprofit independent schools. This book provides board members with essential knowledge of key concepts and strategic considerations as well as the questions they should ask school administration. It also addresses how school leadership — the business officer, head of school and other administrators — can work effectively with the board on financial matters, respond to trustee needs and communicate in a relevant, concise and actionable way with the goal of driving consequential discussions.

NBOA
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The National Business Officers Association is the only national association focused exclusively on supporting independent school business officers and business operations staff, and fostering financial and operational excellence among independent preschool–grade 12 schools. NBOA membership includes more than 1,500 schools from every region in the United States as well as international schools from more than 20 countries around the globe.

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