Capitalization, Scale, and Investment: Does Growth Equal Gain?

A Study of Philadelphia's Arts and Culture Sector 2007 to 2011

Commissioned by the William Penn Foundation

Capitalization, Scale, and Investment: Does Growth Equal Gain?
A Study of Philadelphia's Arts and Culture Sector, 2007 to 2011

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Allison Crump and Nathalie Woolworth, contributors

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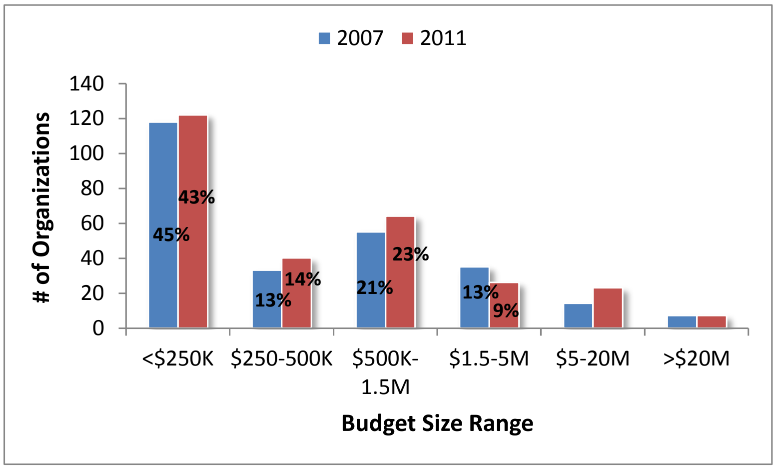
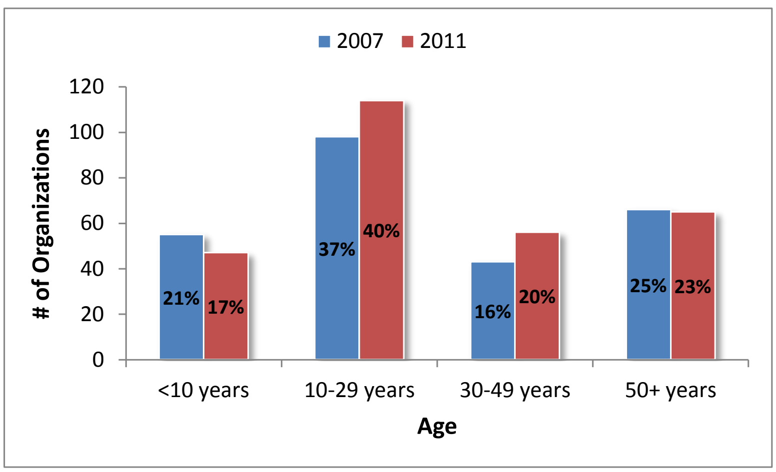
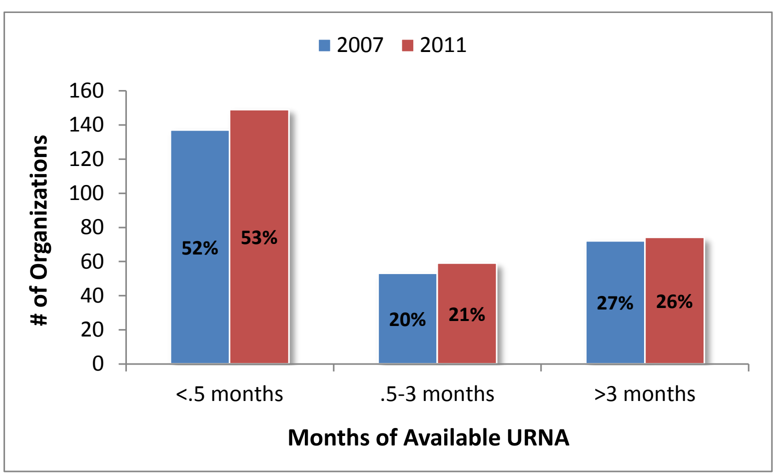
(Budget Size, Age, Months of URNA)







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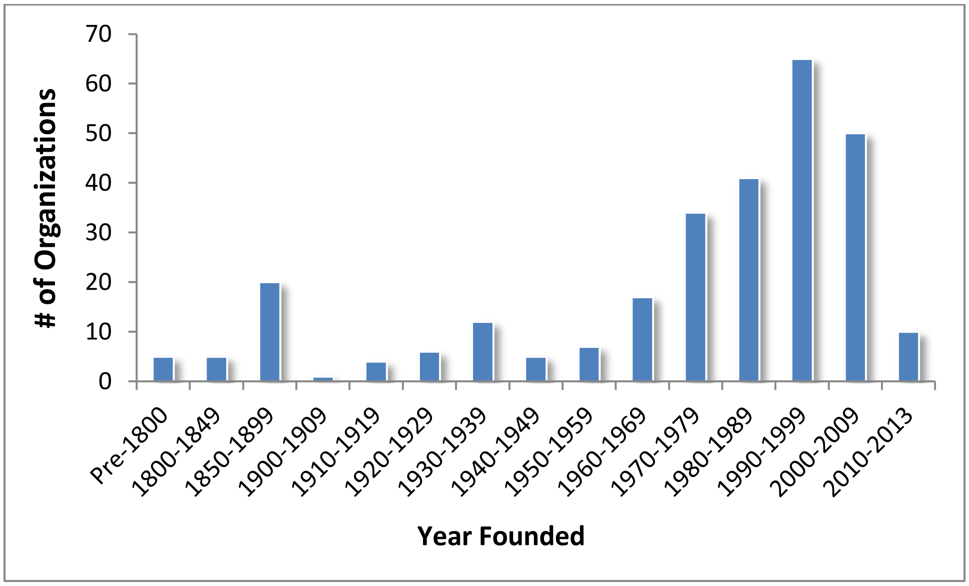
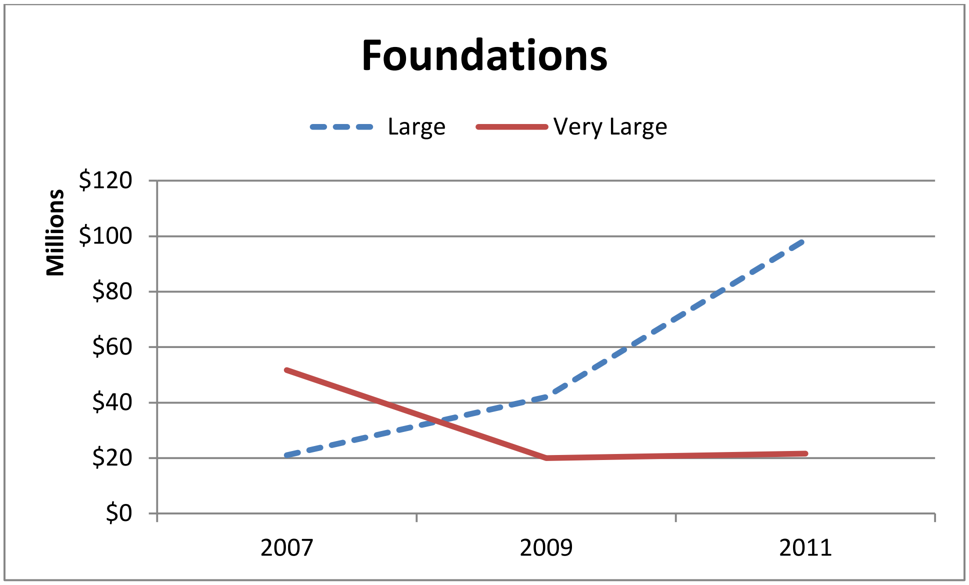
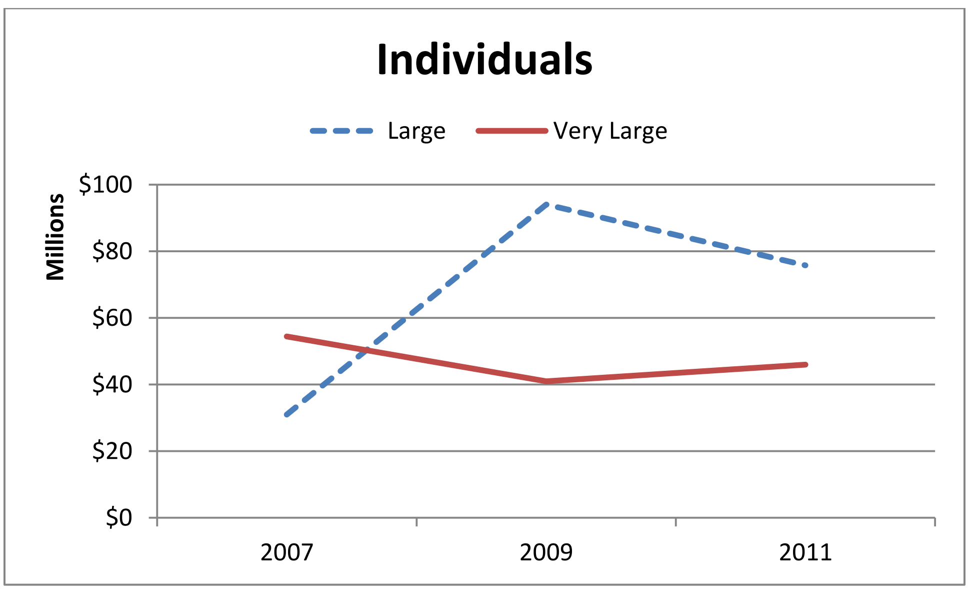
(CDP Population)

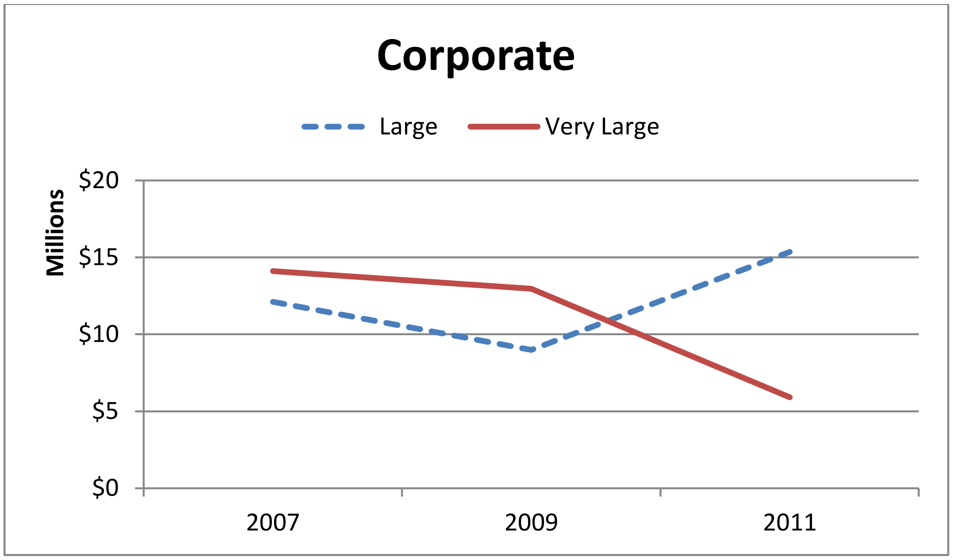


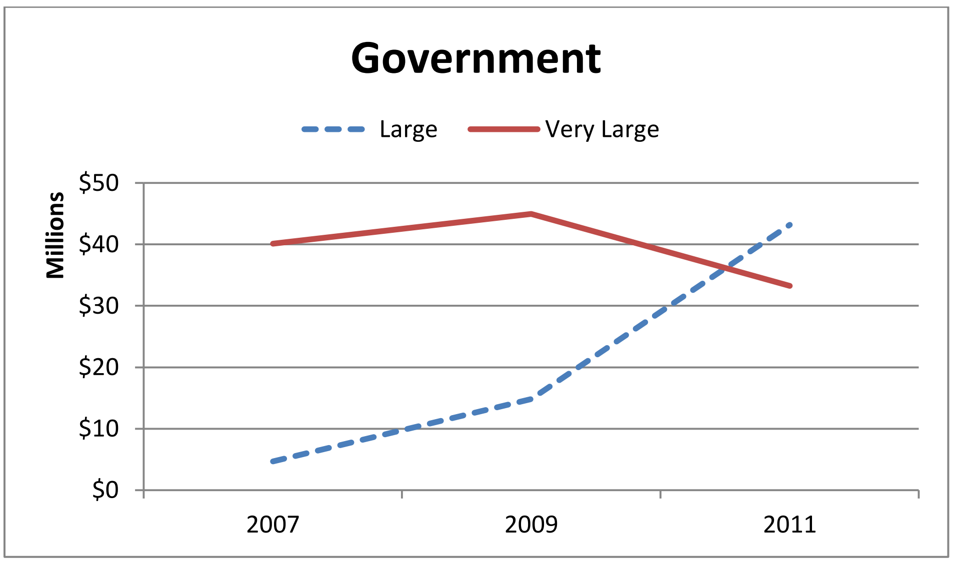
C. Aggregate Contributed Revenue for Large ($5-$20M) Cohort and Very Large (>$20M) Cohort

(CDP Population)





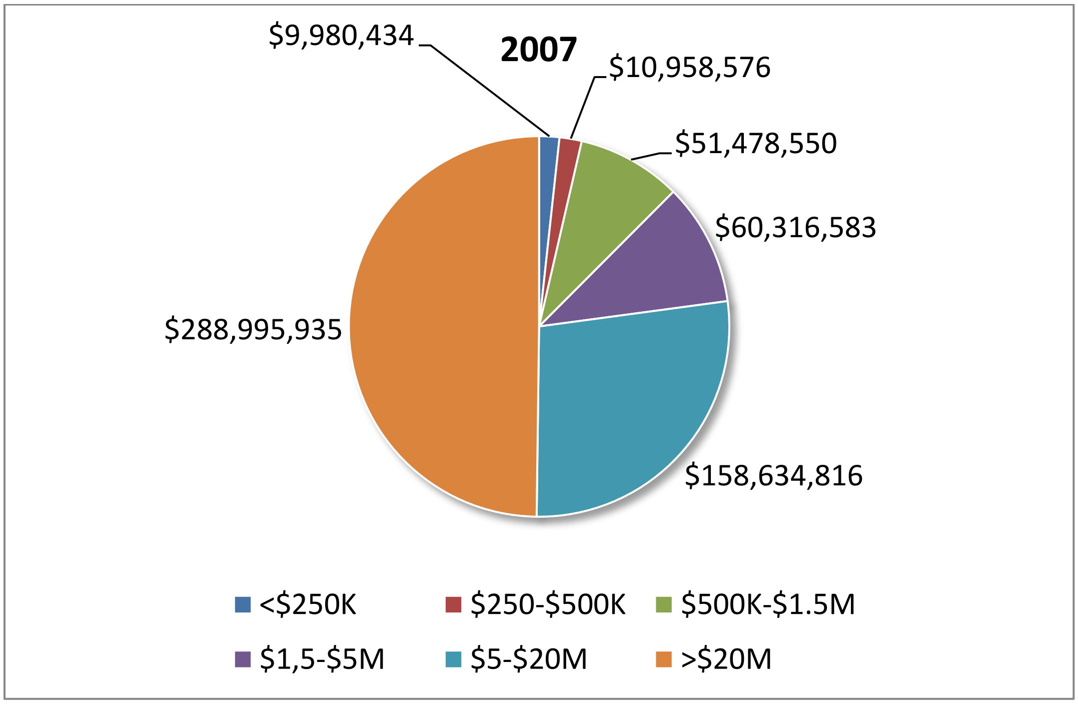

Corporate
Large
Very Large
Millions
$20
$15
$10
$5
$0
2007
2009
2011

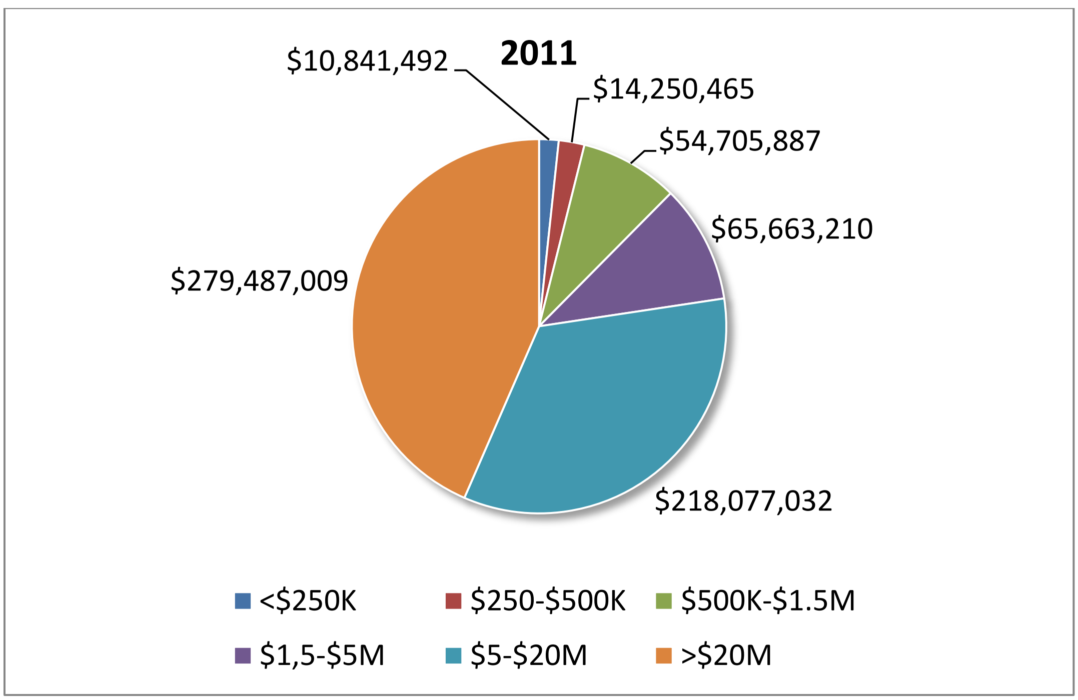

Government
Large
Very Large
Millions
$50
$40
$30
$20
$10
$0
2007
2009
2011


Membership/Special Events
Large
Very Large
Millions
$50
$40
$30
$20
$10
$0
2007
2009
2011

D. Total Expenses by Budget Size

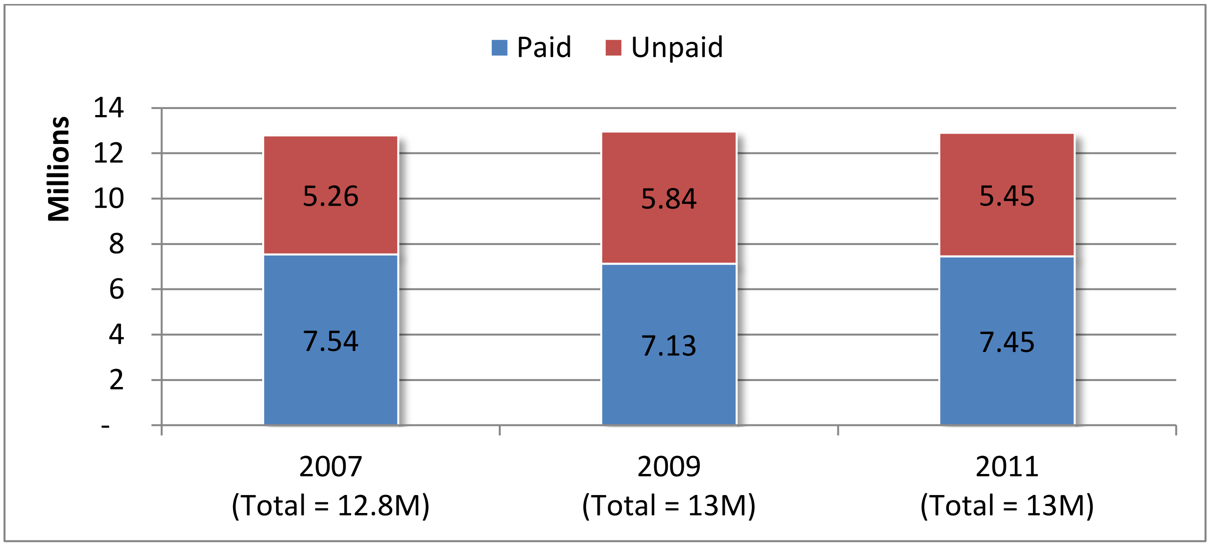
(CDP Population)





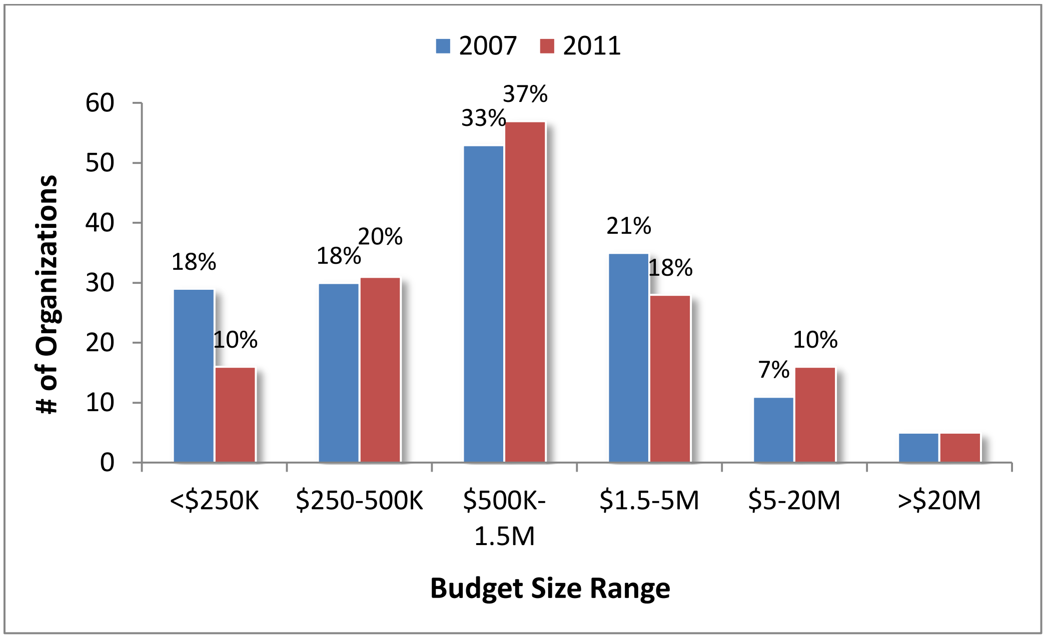
E. Breakdown of Patrons

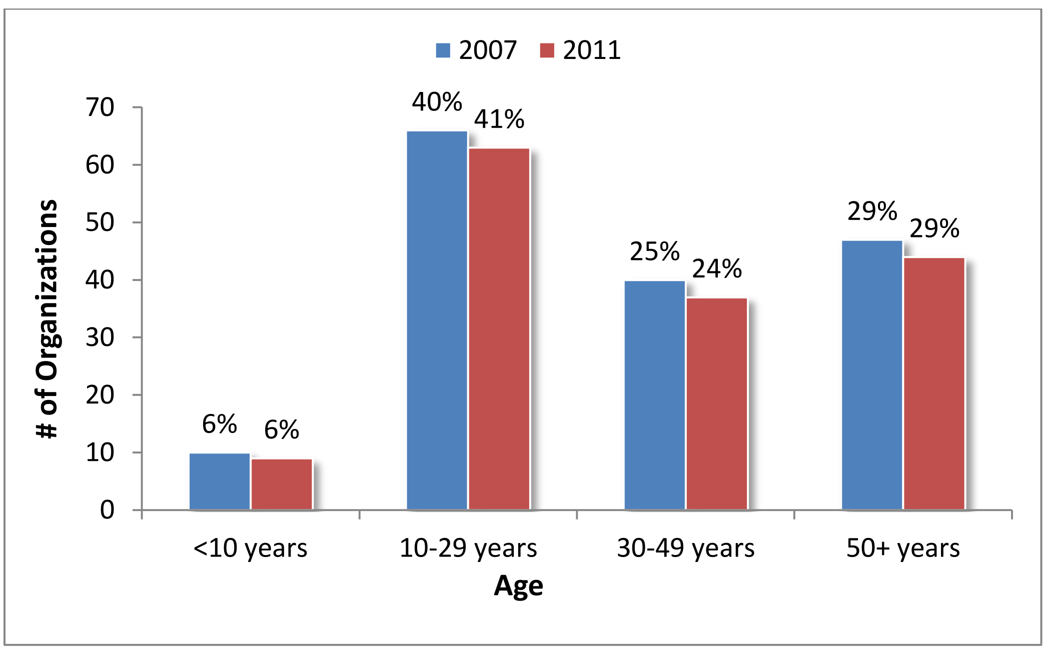
(CDP Population)

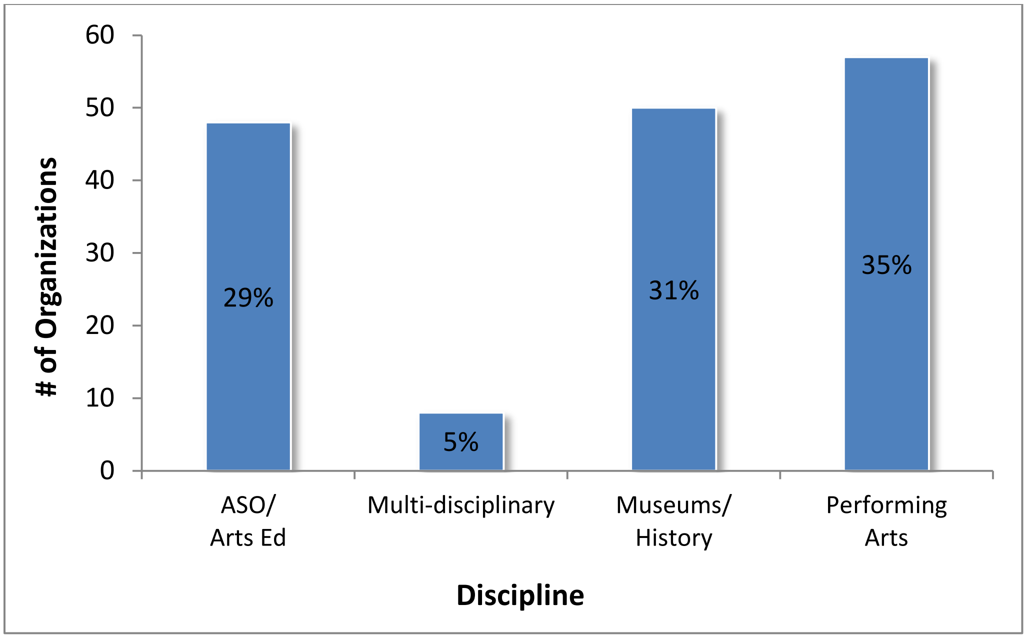


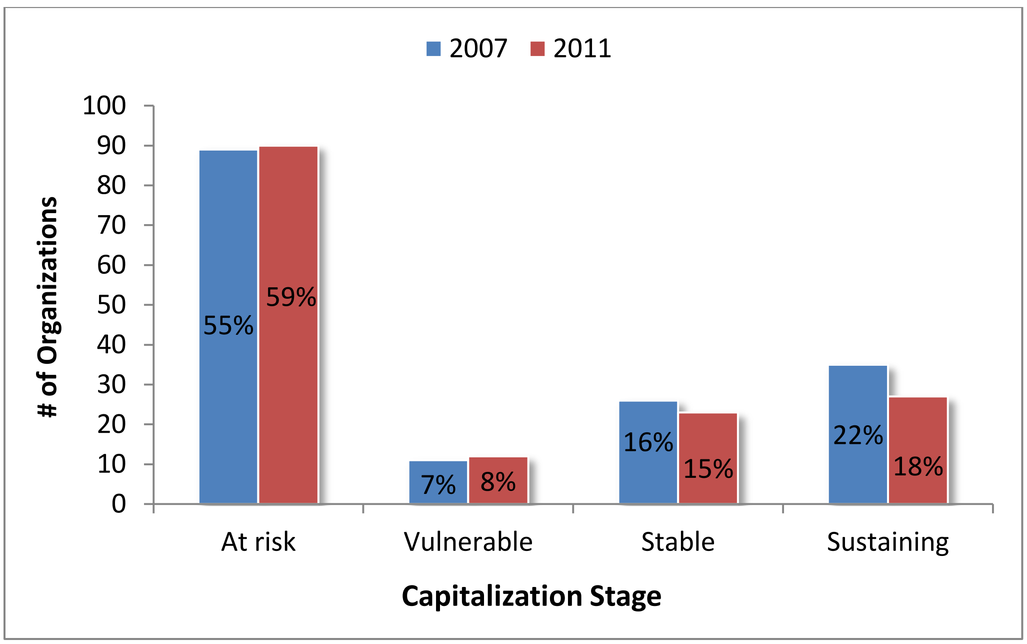
F. Study Sample Breakdowns

(Budget Size, Age, Discipline, Capitalization Stage)



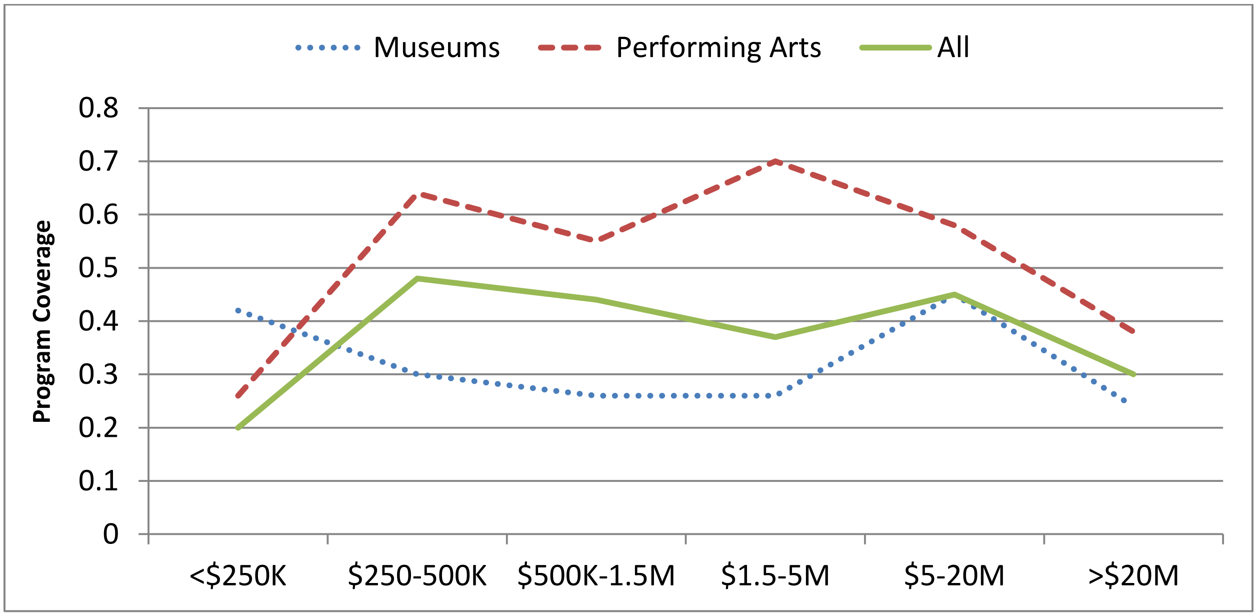



60
50
40
30
20
10
0
# of Organizations
29%
5%
31%
35%
ASO/
Arts Ed
Multi-disciplinary
Museums/
History
Performing
Arts
Discipline


2007
2011
100
90
80
70
60
50
40
30
20
10
0
# of Organizations
55%
59%
7%
8%
16%
15%
22%
18%
At risk
Vulnerable
Stable
Sustaining
Capitalization Stage

G. Program Coverage

(Study Sample)



Program coverage indicates the ratio between direct program revenue and program expense.

II. Guide to CDP Analysis

To analyze organizations in our Study Sample and the CDP Population TDC decided upon a menu of raw data and calculated indicators that would help us look at organizations' financial, operational, and patron data in consistent ways over time. For the purposes of this study we looked at data in aggregate using the categories of raw data and pre-calculated indicators explained in the table below.

To help users navigate this table, it is divided into the five sections described below.

A. The **Basic Identifiers** section overviews some of the primary ways TDC looked at the data, including budget size, discipline, and age.
B. The **Operating Indicators** section includes the principal categories of operating revenues, expenses, and net income or deficit, as well as a series of calculations exploring the role of revenue, expense, and net contributions from program operations to support overhead.
C. Data in the **Revenue Mix** section looks at dependency on different revenue streams, including earned revenue, and revenue from foundations and individual donors.
D. Data included in the **Investments and Efficiencies** section overview the scale and efficiency of investments made in marketing, fundraising, and programs.
E. The **Balance Sheet and Capitalization** section includes a series of codings developed to analyze balance sheet health and capitalization strength.

When possible, we indicated in the category name field in which section of CDP the base data for the calculation can be found.

A. Basic Identifiers

Category Name	Description	Category Detail/Calculation	Notes
Budget Size	Breaks down organizations into six groups based on total expenses.	<$250K $251K-$500K $501K-$1.5M $1.5M-$5M $5M-$20M (Large) $>20M (Very Large)	
Change in Budget Size	Change in total expenses from 2007 to 2011.	Grew: Budget size grew by one or more categories Stable: Budget size remained stable throughout or bounced around in the middle (2007 and 2011 coding the same) Decreased: Budget size decreased by one or more categories	
Specific Discipline	Breaks down organizations into 12 discipline categories.	Art Museums Humanities Arts Education Music ASO (Arts Service Organizations) Other Museums Dance PAC (Performing Arts Centers) Film Theater History (Museums and Historical Societies) Visual Arts	
Broad Discipline	Breaks down organizations into four discipline categories.	ASO/Arts Ed: Arts Education, ASO, Humanities Museums/History: Art museums, Film, History, Other museums, Visual arts Performing Arts: Dance, Music, PAC, Theater Multidisciplinary	
Age	Breaks down organizations into four categories based on the year they were founded.	Less than 10 years 10-29 years 30-49 years 50+ years	
Location	Determines whether organizations are located in Philadelphia County or outside.	Philadelphia: Philadelphia County Outside Philadelphia: Bucks, Chester, Delaware, Montgomery counties	

Category Name	Description	Category Detail/Calculation	Notes
Culturally Specific	Determines whether an organization serves a specific minority audience.	Culturally specific vs. non-culturally specific	These designations were made by WPF staff. It should be noted that staff were not familiar with all of the organizations in our sample, so they only identified the organizations they could confirm as "culturally specific."
Facility	Facility ownership or effective control magnifies an organization's need for reserves, and has implications for financial health.	Y or N: If Space owned square footage > 1000, or if Fixed assets in land, building + leasehold improvements exceeds 20% of Total expenses	This calculation is designed to filter out minor facility investments, which do not have significant impact on the organization's financial position.
Collections	Stewardship of collections magnifies an organization's need for reserves and indicates a longer time horizon, both of which have implications for the evaluation of financial health.	Y or N: If Collections conservation + Collections management expenses > 10,000, or if NISP institution type is museum, library, or historical society	Because collections are not explicitly identified within CDP, and many collections do not appear on the balance sheet due to accounting rules, this calculation is designed to flag the organizations most likely to have responsibility for collections management.
Innovation	Measures an organization's degree of innovation.	Innovative: Have >0 premieres or commissions Not innovative: Have 0 premieres or commissions	
Sweat Equity	Measures the degree to which an organization is run by employees who are unpaid or paid under market rate.	<$30K per person: High sweat equity $30-$49K $50-$75K $75K+: Low sweat equity No paid staff: Highest sweat equity	

B. Operating Indicators

Category Name	Description	Category Detail/Calculation	Notes
Unrestricted Revenue			
Direct Program Revenue (Section 3)	The portion of earned revenue generated in response to core program activity, including sponsorships.	Admission + Ticket sales + Tuitions + Workshop & lecture fees + Touring fees + Special Events Non-fundraising + Subscriptions performance + Subscriptions media + Contracted services + Sponsorships (unrestricted)	Sponsorships are classified by some organizations as corporate contributed revenue. However, they are typically transactional and require visibility for the sponsor, and therefore function as advertising.
Ancillary Program Revenue (Section 3)	The portion of earned revenue generated by shop sales, facility rentals, and other accessory activities, primarily undertaken to generate unrestricted income to support overhead and facilities.	Gift shop/merchandise sales + Gallery/ Publication sales + Food Sales/ Concession revenue + Parking Concession + Rental Income + Royalties/ Rights & Reproductions + Advertising Revenue + Other Earned revenue (unrestricted)	
Investment Return (Section 3)	The portion of earned revenue representing total return on investments of all types, including earnings and market gains/losses.	Investments realized gains & losses + Investments unrealized gains & losses + Interest & dividends (unrestricted)	CDP commingles total return with ordinary revenue, but common practice segregates this revenue from operating income, after the calculation of operating results. This presentation is especially problematic for endowment-driven organizations with a defined spending policy to support operations.
Contributed Revenue with Memberships (Section 3)	Contributed revenue from all philanthropic sources to support current operations, including memberships, gifts, grants, in-kind donations, & restricted releases.	Total contributed revenue + Membership dues/fees (unrestricted)	Membership is classified by CDP as earned revenue, but is viewed by many organizations as an extension of fundraising activity.
Total Revenue (Section 3)	All operating revenue as defined by CDP.	Sum of all unrestricted revenue	See note above under Investment Return.

Category Name	Description	Category Detail/Calculation	Notes
Unrestricted Expenses			
Program Expenses (Section 6)	Operating expenses are classified by CDP as program, fundraising or G&A, following accounting and IRS standards.	Total program expense	Individual organizations follow allocation methods that may or may not distribute personnel costs among these expense classifications.
Fundraising Expenses (Section 6)		Total fundraising expense	
General & Administrative Expenses (Section 6)		Total G&A expense	
Total Expense (Section 6)		Sum of all expenses	
Net Surplus/Deficit			
Net Surplus/Deficit Per CDP (Section 6)	Net operating surplus/deficit as defined by CDP, including total return on investments.	Total Revenue – Total Expense (unrestricted)	Results of organizations with significant investments are subject to volatility from market swings in valuation, as well as the CDP's substitution of total return for spending rate to support operations.
Funds Functioning as Endowment (Section 8)	Funds held in investment portfolios which are assumed to be held for income generation to support operations, not direct spending.	Y or N: Any value displayed on the balance sheet in Endowment investments board-designated, term or permanently restricted (all funds)	Investments characterized as endowments regardless of formal restriction. This is the only view in CDP of board-designated funds held as endowment.
Net Operating Income (Adjusted if Yes)	Recalculation of net income for organizations with funds functioning as endowment, substituting estimated spending rate for total return. Displays N/A if no endowment funds.	If Funds Functioning as Endowment is Yes, Total Revenue – Total Expense (unrestricted) as calculated in Net Analysis section. If No, then N/A.	This calculation is a fair estimate of true operating results, based on assumptions about the purpose and spending policies of the endowment. See Endowment Test below for alternate possibilities.

Category Name	Description	Category Detail/Calculation	Notes
Program Analysis			
Direct Program Revenue (Section 3)	The portion of earned revenue generated in response to core program activity, including sponsorships.	Admission + Ticket sales + Tuitions + Workshop & lecture fees + Touring fees + Special Events Non-fundraising + Subscriptions performance + Subscriptions media + Contracted services + Sponsorships (unrestricted)	
Total Program Expense (Section 6)	Total program expense adjusted by cost of sales.	Total program expense – Cost of sales program	Cost of sales adjustment eliminates potential double-counting with net ancillary revenue
Program Revenue: Program Expense	Ratio of program costs that are supported by direct program revenues.	Total direct program revenue ÷ [Total program expense – Cost of sales program] (unrestricted)	The calculation will result in more than 100% if there is a surplus on a direct basis.
Program Revenue Gap	The share of program costs that needs to be provided through contributed sources.	1 - [Total direct program revenue ÷ (Total program expense – Cost of sales program)]	This calculation is the inverse of the prior metric, and together they equal 100%.
Marketing Analysis			
Marketing Expense (Section 7)	Total marketing expense, as self-reported by the organization. This cuts across program, fundraising and G&A classifications.	Total marketing expense	Amounts may or may not include allocations of personnel expense, depending on the organization's practice.
Marketing Expense: Program Revenue	Measures the impact of marketing investments against the total program revenue generated. Trends can help to evaluate the effectiveness of spending on marketing to generate direct revenue.	Total marketing expense ÷ Total direct program revenue (unrestricted)	Increased revenue can be a result of sales volume, pricing, or both.

Category Name	Description	Category Detail/Calculation	Notes
Number of Patrons – Paid (Section 11)	Paid physical attendance as reported by the organization.	Total paid physical attendance	Paid attendance is most relevant to evaluation of marketing, depending on the organization's strategy. While virtual attendance can also be a strategic focus, reported numbers often appear inflated and even more inconsistent than physical attendance.
Number of Patrons – Unpaid (Section 11)	Free physical attendance as reported by the organization.	Total free physical attendance	
Number of Patrons – Total (Section 11)	Total physical attendance as reported by the organization.	Total physical attendance	
Marketing Expense: Patron	Measures the impact of marketing investments to attendance on a per capita basis. Trends can help to evaluate the effectiveness of spending on marketing in reaching audience.	Total marketing expense ÷ Total physical attendance	
Ancillary Analysis			
Total Ancillary Revenue (Section 3)	The portion of earned revenue generated by shop sales, facility rentals, and other accessory activities, primarily undertaken to generate unrestricted income to support overhead and facilities.	Gift shop/merchandise sales + Gallery/ Publication sales + Food Sales/ Concession revenue + Parking Concession + Rental Income + Royalties/ Rights & Reproductions + Advertising Revenue + Other Earned revenue (unrestricted)	
Total Cost of Sales Expense (Section 6)	Direct costs associated with ancillary revenue, such as inventory, catering, security.	Total cost of sales expense	
Contribution from Ancillary Activity	Net contribution to support overhead from ancillary activity needs to be evaluated in the context of its intended impact and the opportunity cost it represents against the organization's capacity.	Total ancillary revenue – Total cost of sales expense (unrestricted)	Cost of sales is unlikely to include allocations of personnel expense, depending on the organization's practice. As a result, net revenue is likely to be somewhat overstated on a full-cost basis.

Category Name	Description	Category Detail/Calculation	Notes
Fundraising Analysis			
Fundraising Expense (Section 6)	Total fundraising expense adjusted by cost of sales.	[Total fundraising expense – Cost of sales fundraising]	Amounts may or may not include allocations of personnel expense, depending on the organization's practice. Cost of sales adjustment eliminates potential double-counting with net ancillary revenue.
Total Contributed Revenue (All Funds) (Section 3)	Contributed revenue from all sources committed in the current period, whether to support current or future operations or for special purposes, including memberships, gifts, grants, & in-kind donations.	Total contributed revenue (all funds) + Membership dues/fees (unrestricted)	Membership is classified by CDP as earned revenue, but is viewed by many organizations as an extension of fundraising activity.
Fundraising Expense: Contributed Revenue	Measures the impact of fundraising investments against the total contributed revenue generated. Trends can help to evaluate the effectiveness of this spending in revenue generation.	[Total fundraising expense –Cost of sales fundraising] ÷ [Total contributed revenue (all funds) + Membership dues/fees (unrestricted)]	The inclusion of restricted gifts, and exclusion of releases from restriction representing prior years' commitments, is a more accurate representation of the yield from current investments in the development function. However, it is important to remember that current spending in this area also includes investments in laying the groundwork for future gifts.

Category Name	Description	Category Detail/Calculation	Notes
Total Campaign Fundraising Revenue (Section 11)	Indicates campaign activity taking place in addition to normal development activity to support operations. If an organization's ordinary fundraising is declining, it may be a connected to a larger campaign effort.	Capital and Endowment funds raised at the end of the fiscal year	While campaigns most often have dedicated development staff and consultants, as well as extensive board participation, overlaps in the donor base also mean that some cultivation can result from the efforts of core development staff. As a result, an active campaign may be helpful context to understand other fundraising metrics.
Change in Temporarily Restricted Funds (Section 8)	Measures the depth and consistency of this resource from year to year.	Total temporarily restricted revenue	Total temporarily restricted revenue includes new gifts less releases to current operations. Ideally, a portfolio of temporarily restricted revenue is constantly renewed to maintain an even flow of funds to operations. Other patterns may reflect the redemption over time of campaign pledges or some other special project.
Number of Donors (Section 11)	Total donors in all categories as reported by the organization.	Total contributors individual + Total contributors board + Total contributors corporate + Total contributors foundation + Total contributors government	The organization's strategy has an important impact on the size and strength of the donor base.
Fundraising Expense: Donor	Measures the impact of fundraising investments to the donor base on a per capita basis. Trends can help to evaluate the effectiveness of this spending in expanding or deepening the donor base.	[Total fundraising expense – Cost of sales fundraising] ÷ Total Donors	The organization's success in attracting support from a relatively small number of major individual donors or institutional donors can have a disproportionate impact on this metric.

Category Name	Description	Category Detail/Calculation	Notes
Operating Indicators: Overhead Analysis			
Total General & Administrative Expense (Section 6)	Total G&A expense adjusted by cost of sales.	Total G&A expense – Cost of sales G&A	Some expenses may or may not be included in overhead, depending on the organization's cost allocation methodology. Cost of sales adjustment eliminates potential double-counting with net ancillary revenue.
G & A Expense: Total Expense	Measures the overhead rate compared to the organization's overall budget.	[Total G&A expense – Cost of sales G&A] ÷ Total expense	Because of methodology variation, it is most valid to observe one organization's pattern over time rather than to use an overhead rate as a gauge of comparative efficiency across organizations.
Endowment Test			
Total Funds Functioning as Endowment (Section 8)	Funds held in investment portfolios for income generation to support operations, not direct spending.	Sum of all values in Endowment investments board-designated, term or permanently restricted (all funds)	Investments characterized as endowments regardless of formal restriction. This is the only view in CDP of board-designated funds held as endowment.
Investment Outflows (Imputed Draw) (Section 9)	Outflows are composed of all funds transferred from endowment portfolios, regardless of purpose. Reasons can include spending rate to support operations, additional transfers to support deficits, legitimate special purposes such as capital investments, reclassifications among categories of restriction.	Sum of values in Funds out of Endowment investments board-designated, term or permanently restricted (all funds)	Calculation uses absolute value of the sum, to produce a positive value for imputed draw. As the actual amount of transfers from endowment, this is the most valid proxy for spending rate, although observed values frequently deviate significantly from conventional practice, without any consistent ability to attribute cause.
Imputed Draw: Total Expense	Measures the impact on operations of endowment outflows, assuming those outflows support ordinary spending (see description above).	Investment outflows ÷ Total expense	Since the purpose of endowment is typically to stabilize operating revenues, this calculation provides a gauge of success in meeting the goal of meaningful levels of endowment.

Category Name	Description	Category Detail/Calculation	Notes
Estimated Draw @ 5% (Section 8)	Calculates the typical spending rate policy, applied to the value of Funds Functioning as Endowment.	5% of Average of three prior years' sum of all values in Endowment investments: board-designated, term or permanently restricted	This calculation offers a reality check, to provide a context for evaluation of the investment outflows as a fair representation of endowment spending.
Estimated Draw @ 5%: Total Expense	Measures the impact on operations of a standard 5% draw, assuming it supports ordinary spending.	Estimated 5% endowment draw ÷ Total expense	Since the purpose of endowment is typically to stabilize operating revenues, this calculation provides a gauge of success in meeting the goal of meaningful levels of endowment.
Variance of Outflows > Estimated Draw	Calculates the spread between actual Endowment investment outflows and the typical 5% spending rate.	Investment outflows – Estimated 5% draw	Provides a gauge of the degree of departure from standard practice that actual outflows represent.
Net Analysis			
Direct Program (net surplus/deficit)	Measures the program gap, or the portion of program expense that is not supported by direct revenue.	Total direct program revenue - [Total program expense – Cost of sales program] (unrestricted)	This calculation represents the net impact from program activity, derived from the Program Analysis section.
General & Administrative Expenses	Represents true overhead, prior to application of discretionary revenue.	Total G&A expense – Cost of sales G&A	This calculation represents the net impact from administrative activity, derived from the Overhead Analysis section.
Subtotal	The sum of the program gap and overhead produces the total operating gap not met with direct revenue.	Direct program net + G&A expense (adjusted for associated cost of sales)	This calculation defines the need for discretionary revenue to attain breakeven operations.
Unrestricted Contributed Revenue (net)	Applies net contributed revenue, or the excess of contributions over the direct expense of raising it.	[Total contributed revenue + Membership dues/fees (unrestricted)] - [Total fundraising expense – Cost of sales fundraising]	This calculation represents the net contribution from fundraising activity, derived from the Fundraising Analysis section.
Ancillary Revenue (net)	Applies net ancillary revenue, or the excess of auxiliary revenue over the direct expense of raising it.	Total ancillary revenue – Total cost of sales expense (unrestricted)	This calculation represents the net contribution from ancillary activity, derived from the Ancillary Analysis section.

Category Name	Description	Category Detail/Calculation	Notes
Estimated Draw @ 5%	Applies the estimated contribution to operations from endowment, estimated as the typical 5% spending rate calculation.	5% of Average of three prior years' sum of all values in Endowment investments board-designated, term or permanently restricted (all funds)	This calculation represents the estimated operating impact of endowment, derived from the Endowment Test section.
Operating Surplus/(Deficit)	The net margin analysis provides an alternate means of understanding the organization's net surplus or deficit.	Program and G&A gap subtotal + net contributed revenue + net ancillary revenue + estimated 5% endowment draw	This calculation integrates the preceding analyses that focus on the net contribution of each component of operations, for an overall assessment of the organization's financial effectiveness and productivity.
Required Uses of Surplus from Operations			
Depreciation Expense (Section 6)	Depreciation expense represents the allocation of investments in fixed assets spread over the estimated lifespan of the building or equipment. Because the cash was actually spent at some prior point, many organizations do not budget to cover this expense.	Total depreciation expense	Because depreciation expense does not require a current cash outlay, it provides a convenient allowance to build facilities replacement reserves, and the failure to take advantage of this opportunity is short-sighted. However, if an operating deficit is less than this amount, it may signal that the organization has another strategy to meet replacement needs, and has chosen not to fund depreciation.
Change in Investments in Fixed Assets (Section 8)	The change in Investments in Fixed Assets year over year represents purchases or sales/disposal of fixed assets, not including accumulated depreciation.	Current year Fixed assets values - (unrestricted) - prior year Fixed assets values (unrestricted)	A substantial surplus from operations sometimes reflects capital grants which inflate annual revenue, while the related expense is recognized over time as depreciation. A corresponding change in Investments in Fixed Assets provides strong evidence of this activity, which would preempt the possibility of using the surplus to build reserves (because it has been physically invested.)

Category Name	Description	Category Detail/Calculation	Notes
Current Principal Due on Long Term Debt (Section 8)	This represents the amount of principal repayment due to the lender in the current year, not the amount actually paid. Since loan payments are not counted as an operating expense, the ability to meet this obligation is evidenced by an operating surplus of at least this amount.	Prior year's Current Mortgages payable + Other loans & notes payable (unrestricted), if the combined value of all Other loans & notes payable is at least $500K. If the combined value of all Other loans & notes payable is less than $500K, then only Current Mortgages payable.	The amount due in the current year is the estimate from the prior year's financials, which is the value shown. While the principal due on a conventional loan may be quite similar year to year, loans can be structured with specific chunks of principal due on a defined timetable. Principal amounts also increase sharply in the later years of a loan amortization schedule. Other loans & notes payable can include bond financing to support facilities and/or general operations, and loans from friends and family. The $500K threshold attempts to filter these personal obligations from collateralized debt.
Interest Expense (Section 6)	The interest component of debt service is included in operating expenses, so is not a required use of surplus. It is listed here to provide context.	Total interest expense	Interest expense can also include interest due on other debt, such as credit lines, credit cards, and even past-due vendor accounts.
Debt Service (Imputed)	Debt service is the combination of interest and principal payments to meet the repayment schedule.	Prior year Current principal due + Interest expense	Debt service represents the full cost of borrowing on an annual basis, and can dictate liquidity needs.
Debt Service: Total Expense	Measures the impact of debt service on the operating budget.	[Prior year Current principal due + Interest expense] ÷ Total expense	Debt service is usually inflexible, and creates pressure on operations, since it represents a use of funds that could otherwise support core activity. In addition, it takes priority over other expenses, so can have a direct adverse effect on program delivery.

C. Revenue Mix

Category Name	Description	Category Detail/Calculation
Earned Revenue Dependence	Measures an organization's dependence on earned revenue.	Earned revenue <20% of total unrestricted revenue Earned revenue 20-49% of total unrestricted revenue Earned revenue 50-79% of total unrestricted revenue Earned revenue >80% of total unrestricted revenue
Earned Revenue Dependence Change Over Time	Change in dependence on earned revenue between 2007 and 2011.	Grew: Earned dependence increased by one or more categories Stable: Earned dependence remained stable throughout or bounced around in the middle (2007 and 2011 coding the same) Decreased: Earned dependence decreased by one or more categories
Total Contributed Revenue Breakdown	Looked at the following five buckets of contributed revenue: individual, corporate, foundation, government, and other.	Individual: Total Individual + Total Trustee/Board Membership and Special Events: Total Membership + Total Special Events Corporate: Total Corporate Revenue Foundation Revenue: Total Foundation Revenue Government: Total City + County + State + Federal Government Revenue Other: Total Tribal Contributions + Total Other Contributions + Total Parent + Total Related Org + Total In Kind + Total Net Assets Released
Foundation Revenue Dependence	Measures an organization's dependence on revenue from philanthropic foundations.	Foundation revenue <20% of total contributed revenue Foundation revenue 20-49% of total contributed revenue Foundation revenue 50-79% of total contributed revenue Foundation revenue >80% of total contributed revenue
Foundation Revenue Dependence Change Over Time	Change in dependence on foundation revenue between 2007 and 2011.	Grew: Foundation dependence increased by 1 or more categories Stable: Foundation dependence remained stable or bounced around in the middle (2007 and 2011 coding the same) Decreased: Foundation dependence decreased by 1 or more categories

Category Name	Description	Category Detail/Calculation
Dependence on Individual Giving	Measures an organization's dependence on revenue from individual giving.	Individual revenue <20% of total contributed revenue Individual revenue 20-49% of total contributed revenue Individual revenue 50-79% of total contributed revenue Individual revenue >80% of total contributed revenue
Dependence on Individual Giving Change Over Time	Change in dependence on individual giving between 2007 and 2011	Grew: Individual dependence increased by 1 or more categories Stable: Individual dependence remained stable throughout or bounced around in the middle (2007 and 2011 coding the same) Decreased: Individual dependence decreased by 1 or more categories
Endowment Driven	Measures an organization's degree of dependence on draw from its endowment.	Endowment driven: >10% of total revenue from endowment Not endowment driven: <10% of total revenue from endowment

D. Investments and Efficiencies

Category Name	Description	Category Detail/Calculation	Notes
Program Investment	Measures degree of investment in programs by looking at the percent of budget that goes towards programs.	Significant investment: significant sustained investment over time Modest investment: modest investment over time No investment: Irregular investment or de-investment over time	Go to Section IV of the Appendix for the detailed investments coding rubric.
Fundraising Investment	Measures degree of investment in fundraising by looking at percent of budget that goes towards fundraising.	Significant investment: significant sustained investment over time Modest investment: modest investment over time No investment: Irregular investment or de-investment over time	Go to Section IV of the Appendix for the detailed investments coding rubric.
Marketing Investment	Measures degree of investment in marketing by looking at percent of budget that goes towards marketing.	Significant investment: significant sustained investment over time Modest investment: modest investment over time No investment: Irregular investment or de-investment over time	Go to Section IV of the Appendix for the detailed investments coding rubric.
Marketing Efficiency	Measures efficiency of marketing spend (marketing expense: program revenue).	Most efficient: <15% 15-29% Least efficient: 30%+	
Marketing Efficiency Change Over Time	Change in efficiency of marketing spend between 2007 and 2011.	Grew: Marketing efficiency increased by one or more categories (declined efficiency) Stable: Marketing efficiency remained stable or bounced around in the middle (2007 and 2011 coding the same) Decreased: Marketing efficiency decreased by one or more categories (improved efficiency)	
Fundraising Efficiency	Measures efficiency of fundraising spend (fundraising expense: contributed revenue).	Most efficient: <15% 15-29% Least efficient: 30%+	

Category Name	Description	Category Detail/Calculation	Notes
Fundraising Efficiency Change Over Time	Change in efficiency of fundraising spend between 2007 and 2011.	Grew: Fundraising efficiency increased by one or more categories (declined efficiency) Stable: Fundraising efficiency remained stable or bounced around in the middle (2007 and 2011 coding the same) Decreased: Fundraising efficiency decreased by one or more categories (improved efficiency)	
Program Efficiency	Measures efficiency of program spend (program revenue: program expense).	Least coverage: <30% 30-59% Most coverage: 60%+	
Program Efficiency Change Over Time	Change in efficiency of program spend between 2007 and 2011.	Grew: Program efficiency increased by one or more categories (improved efficiency) Stable: Program efficiency remained stable or bounced around in the middle (2007 and 2011 coding the same) Decreased: Program efficiency decreased by one or more categories (declined efficiency)	
Product Volume	Measures product volume for different discipline groups.	Humanities, Arts Ed, ASOs Art Museums, Other: Lectures and Classes Museums, History, Visual Arts, Film: # of exhibits and screenings Dance, Music, PAC, Theater: # of Productions, and # of Performances (2 different ways to look at volume)	

E. Balance Sheet and Capitalization Indicators

Category Name	Description	Category Detail/Calculation	Notes
Capitalization Stage	Measures financial health by looking at an organization's unrestricted net assets (URNA), operating cash, flexibility, and surplus/deficit.	At risk: Broken business model, negative URNA, structural deficits, negative cash Vulnerable: Weak operating model, thin balance sheet, breakeven or deficit, <1 month of cash Stable: Working operating model, thin balance sheet (in context of flexibility), breakeven or better, undercapitalized (in context of flexibility) Sustaining: Stable operating model, healthy balance sheet (in the context of flexibility), regular surpluses, well capitalized (in the context of flexibility)	Go to Section III of the Appendix for the detailed financial health coding rubric.
Change in Capitalization Stage	Change in financial health between 2007 and 2011.	Grew: Improved by one capitalization stage Grew+:Improved by two capitalization stages Grew++: Improved by three capitalization stages Stable: Stable throughout or bounced around in the middle (2007 and 2011 coding the same) Declined: Declined by one capitalization stage Declined+: Declined by two capitalization stages Declined++: Declined by three capitalization stages	

Category Name	Description	Category Detail/Calculation	Notes
Liquidity Analysis			
Total Expense (Section 6)	Total operating budget, as represented by annual expenses, provides important context for balance sheet indicators.	Total expenses	Total operating budget is referenced both in annual form and as a monthly estimated "burn rate", by dividing annual expenses by 12 months.
Operating Cash (Section 8)	Cash available to support operations without borrowing from restricted funds or deferred revenue is a critical indicator of adequate cash flow and the ability to support operations from internal sources.	Cash & Cash equivalents - Deferred revenue (unrestricted)	Since CDP segregates assets by restricted classification, only adjustment for deferred revenue is required to isolate operating cash. However, cash may also represent borrowing from a credit line or by allowing payables to float to unusual levels. Cross referencing the summary balance sheet can help to evaluate this possibility.
Months of Operating Cash	Months of operating cash calculates the period of time that operations can be sustained without receipt of additional revenue.	Operating cash ÷ [Total expenses ÷ 12]	Less than one month of cash creates serious stress on operations and represents a significant distraction to management.
Operating Cash & Investments (Section 8)	An alternate calculation of operating cash adds non-endowment investments as a potential source to support operations.	Cash & Cash equivalents + Investments all other - Deferred revenue (unrestricted)	Organizations with investment portfolios sometimes follow a cash management strategy that deliberately keeps all excess cash invested to maximize return, transferring funds as needed to cover operating expenses.

Category Name	Description	Category Detail/Calculation	Notes
Months of Operating Cash & Investments	See above explanation of months of operating cash.	Cash & Cash equivalents + Investments all other - Deferred revenue (unrestricted) ÷ [Total expenses ÷ 12]	Unrestricted investments can represent both free cash deposited in the investment portfolio to maximize return, as well as board designated reserves. This calculation offers a possible mitigating factor for low cash.
Cash Coverage of Restrictions (Section 8)	The ratio of available cash to cover the cash portion of restricted funds and deferred revenue (such as advance ticket sales). If less than 100%, low liquidity may be forcing the organization to borrow from funds required for future use to support current operations. While 100% provides minimum coverage, a higher ratio provides assurance that the organization has adequate working capital.	(Total cash + Investments) ÷ [(Deferred revenue + Temporarily restricted net assets + Permanently restricted net assets) - (Restricted pledges receivable)]	Pledges and grants receivable are the principal non-cash source of coverage of restrictions, and are subtracted from restricted net assets to determine restricted cash. CDP's classification of restricted assets simplifies this analysis.
Current Ratio (Section 8)	Compares current/short-term operating assets to current/short-term liabilities. A current ratio of 1.0 indicates minimum coverage. This calculation quantifies the risk of not having enough working capital to meet operating needs.	[Cash + Current receivables + Inventory + Prepaid expenses + Other current assets] ÷ Current liabilities (unrestricted)	Current is an accounting term that indicates the expectation of realization within one year.
Months of Liquid Working Capital	Measures liquidity against short-term obligations, in the context of monthly expenses.	(Unrestricted cash + Investments - Current liabilities) ÷ [Total expenses ÷ 12]	Note this is a kind of stress test, as typical definitions of working capital include short-term assets such as current receivables.

Category Name	Description	Category Detail/Calculation	Notes
Flexibility Analysis			
Net Operating Income (Adjusted)	Surplus or deficit resulting from operations alone.	Operating revenue – Total expenses (unrestricted)	If there are funds Functioning as Endowment, then net income is adjusted as shown in Net Analysis section.
Operating Margin	Measures operating results against the annual budget, to gauge the organization's ability to meet debt payments, and build working capital and reserves.	(Unrestricted operating revenue – Total expenses) ÷ Total expenses	Operating results within a range of -5% to 5% are considered as essentially breakeven, with the strong probability of small surpluses absorbing offsetting deficits over time.
Unrestricted Net Assets (URNA) (Section 8)	Accumulation of surpluses and deficits over the organization's lifetime. This is the starting point for the calculation of Available URNA to support operations.	Unrestricted net assets	Annual change in URNA should in theory reflect the current year's operating results, but can be impacted by one--time events, prior period adjustments, or other non-operating items.
- Net Fixed Assets (Section 8)	This represents the equity invested in fixed assets, which is therefore no longer liquid and available to support operations.	Fixed assets less accumulated depreciation (unrestricted)	On the balance sheet, fixed assets valuation is usually shown as net of accumulated depreciation, or the remaining balance that has not yet been expensed. Annual change that does not tie to depreciation expense (see Required Uses of Surplus below) indicates purchase or sale of fixed assets.

Category Name	Description	Category Detail/Calculation	Notes
+ Debt Associated with Fixed Assets (Section 8)	This represents the portion of investment in fixed assets which is borrowed, and therefore replaces some equity investment. As a result, it is added back to the calculation of available URNA.	Current & Non-current Mortgages payable + Current & Non-current Other loans & notes payable (unrestricted), if the combined value of all Other loans & notes payable is at least $500K. If the combined value of all Other loans & notes payable is less than $500K, then only Mortgages payable.	Mortgages are loans specifically collateralized by property. Other loans & notes payable can include bond financing to support facilities and/or general operations, and loans from friends and family. The $500K threshold attempts to filter personal obligations from collateralized debt. Annual change not tied to current principal due (see Required Uses of Surplus below) may indicate refinancing or new debt.
= Available URNA (Section 8)	Available URNA is the resource base the organization can deploy to support operations. Available URNA adjusts unrestricted net assets for the amount that's invested long term in fixed assets.	Unrestricted net assets - (fixed assets net of accumulated depreciation - associated long-term debt)	While facilities can be financed or sold, this process is time-consuming, and may not be in the organization's best interests unless it is facing liquidation.
Months of Available URNA	Measures available URNA in months of operations, to gauge the degree of flexibility to address needs for working capital and basic operating reserves, as well as other reserves for facilities or risk capital.	Available URNA ÷ [Total expenses ÷ 12]	Rules of thumb, such as 3 months of operations for working capital, are less helpful than internal assessments of an organization's specific needs, but levels below two months suggest inadequate capacity by any measure.

Category Name	Description	Category Detail/Calculation	Notes
Lifespan of URNA if Negative Net Income	This calculation does not apply to surplus operations, or when available URNA is already negative. For those organizations running a deficit, it measures how long it would take at the current rate of deficits to consume all the organization's available URNA.	If negative net income: Available URNA ÷ Net income (unrestricted)	Calculation uses absolute value of the deficit, to produce a positive value for lifespan. N/A displays when operations are in surplus. Negative URNA displays when there is no available URNA present.
Debt Ratio (Section 8)	Total amount owed to others divided by total resources of the organization quantifies the risk of being unable to meet all these obligations (debts).	Total liabilities ÷ Total assets (unrestricted)	
Unrestricted Assets			
Cash (Section 8)	See Calculations for how line items are aggregated.	Cash & Cash equivalents (unrestricted)	
Receivables (Section 8)		Current & Non-current Accounts, pledges, grants, contracts and other receivables (unrestricted)	
Prepaids & Other Assets (Section 8)		Prepaid expense + Inventory + Current & Non-current Other assets + Interfund balances (unrestricted)	
Investments (Section 8)		Endowment and other investments (unrestricted)	
Fixed Assets (Section 8)		Fixed assets net of accumulated depreciation (unrestricted)	
Total Assets (Section 8)		Total assets (unrestricted)	

Category Name	Description	Category Detail/Calculation	Notes
Unrestricted Liabilities & Net Assets			
Payables & Accrued Expenses (Section 8)	See Calculations for how line items are aggregated.	Accounts payable + Accrued Expenses + Current & Non-current Grants payable + Current & Non-current Other Liabilities (unrestricted)	
Line of Credit (Section 8)		Credit line payable (unrestricted)	
Deferred Revenue (Section 8)		Deferred revenue (unrestricted)	
Debt Associated with Fixed Assets (Section 8)		Current & Non-current Mortgages payable + Current & Non-current Other loans & notes payable (unrestricted), if the combined value of all Other loans & notes payable is at least $500K. If the combined value of all Other loans & notes payable is less than $500K, then only Mortgages payable.	Mortgages are loans specifically collateralized by property. Other loans & notes payable can include bond financing to support facilities and/or general operations, and loans from friends and family. The $500K threshold filters out personal obligations.
Other Debt (Section 8)	See Calculations for how line items are aggregated.	Current & Non-current Other loans & notes payable (unrestricted), if the combined value is less than $500K.	Other loans & notes payable that total less than $500K. Friends and family loans can be a signal of extreme financial distress. If Other loans & notes payable are greater than or equal to $500K, the value is included in the Debt Associated with Fixed Assets calculation above.
Total Liabilities (Section 8)		Total liabilities (unrestricted)	
Net Assets (Section 8)		Unrestricted net assets	
Total Liabilities & Net Assets (Section 8)		Total liabilities & net assets (unrestricted)	

III. Financial Health Coding Rubric

To best describe an organization's level of financial health, TDC places it in one of four *stages of capitalization*:

- **At Risk.** Organizations with negative available unrestricted net assets and structural deficits. These organizations need infusions of recovery capital in order to stabilize operations and plan for the future.
- **Vulnerable**. Organizations with thin balance sheets, limited cash, and operating models that hover around breakeven but sometimes go negative. These organizations must cut in response to any downturn. They need strong planning and infusions of change capital to transition to a better functioning business model.
- **Stable**. Organizations with thin balance sheets and operating models that generate consistent breakeven or better results. These organizations can address some facilities needs and weather a short downturn, but need external capital to invest in new ideas.
- **Sustaining.** Organizations with strong balance sheets and operating models that generate consistent surpluses. These organizations are positioned to deploy their capital, meet facilities needs, and maintain their strength by investing in new ideas.

Characteristics of capitalization stages				
At Risk	Broken operating model	Negative URNA	Structural deficits	Negative cash
Vulnerable	Weak operating model	Thin balance sheet	Breakeven or deficit	Less than 1 month cash
Stable	Working operating model	Thin balance sheet	Breakeven or better	Undercapitalized
Sustaining	Stable operating model	Healthy balance sheet	Regular surpluses	Well capitalized

TDC has developed four tests to gauge an organization's solvency: 1) its access to cash, 2) ability to generate cash, 3) scale of need for capital, and 4) ability to post surpluses over time.

Since the actual amounts of capital needed for a single organization to achieve each stage varies depending on that organization's size and the nature of its business model, we use the device of normalizing by one month of annual operating expenses. Once normalized in this manner, these tests give us enough information to diagnose organizations' current conditions in the context of a large study sample.

Below we explain in detail the tests we conduct to place organizations in a stage of capitalization:

Available URNA Test. First, we look at the heart of the matter: available unrestricted net assets (URNA). This is TDC's measure of basic solvency. Available URNA is calculated by subtracting equity in fixed assets from URNA as shown on the balance sheet. We then scale this amount to the organization by dividing it by a month of expenses (i.e. total expenses divided by 12). To get a sense of where organizations lie on the URNA spectrum we divide them into three groups based on their months of available URNA: <.5 months, .5-3 months, and >3 months. Organizations with <.5 months of available URNA are automatically categorized "at risk" since we can assume they struggle to meet their operating as well as capital needs. Organizations with >.5 months of URNA are subsequently put through the following three tests to determine their financial health.

Operating Cash Test. Next, we look at an organization's ability to meet immediate needs without borrowing restricted cash, including amounts generated from deferred revenue (e.g. advance ticket sales). Operating cash is defined as *unrestricted* cash minus deferred revenues. If an organization does borrow from restricted funds, it is possible that operating cash on the balance sheet can be negative! As with available URNA, we divide organizations into three groups based on their months of operating cash: <.5, .5-3, >3 months. We then place organizations in a stage of capitalization based on a joint look at their months of URNA and months of operating cash (see table below).

	<.5 months oper. cash	**.5-3 months oper. cash**	**>3 months oper. cash**
<.5 months URNA	At risk	At risk	At risk
.5-3 months URNA	At risk	Vulnerable	Stable
>3 months URNA	Look back at[1]	Sustaining	Sustaining

Flexibility Test. Next, we look at the presence of owned facilities and collections. Either or both of these conditions mean that an organization has more intense capital requirements, and therefore higher thresholds for adequate capitalization. To account for their greater capital needs, organizations with facilities and/or collections are moved down one capitalization stage if they have <3 months of URNA. Organizations that do not have facilities and/or collections, or have >3 months of URNA, remain in the capitalization stage they were placed in based on months of URNA and operating cash.

Surplus Test. Finally, we review the organizations' track record of generating cash and URNA from operations over time by determining if organizations posted surpluses or deficits over three years.[2] We are careful to include only unrestricted operating revenues, disaggregated from restricted revenue for future periods or gains and losses on restricted endowments. As with URNA and operating cash, we look at months of surplus/deficit in order to normalize across organizations of different size. Organizations are divided into two groups for each year: <.5 months, >.5 months. Organizations with a "surplus trend" of >.5 months for three years running, and organizations that bounce between surplus and deficit, maintained their previously designated capitalization stage. However, organizations with a "deficit trend" of <.5 months for three years are moved down one capitalization stage.

[1] Since it is an unusual circumstance for an organization to have <.5 months of operating cash and >3 months of URNA, TDC looked back at organizations that fit this description on an individual basis to determine their capitalization stage.

[2] Given that we are looking at a three year surplus/deficit trend for this test, we only had the data to conduct this test for our sample's last year (2011). Our financial health coding for 2007 and 2009 include the available URNA, operating cash, and flexibility tests, but not the surplus test.

IV.Investments Coding Rubric

One of the key questions we had coming into this study was if sustained investment in the areas of marketing, fundraising, or program impact an organization's financial health. To get at this idea, TDC developed a coding that measures organizations' level of investment in these areas by asking three core questions: Did the organization's investment increase relative to inflation? Did it keep pace with the organization's change in budget size? Was investment sustained over time (three years)?

Ultimately, these codings (which were calculated in the same way for marketing, fundraising, and programs investment) place organizations in one of the following four buckets:

- **No Investment.** An organization de-invested relative to inflation and its change in budget size for three years in a row.
- **Modest Investment.** An organization modestly invested relative to inflation and its change in budget size for three years in a row.
- **Significant Investment.** An organization increased its spend relative to inflation and its change in budget size in year one, and sustained this level of significant investment for two additional years at either a modest of significant level.
- **Erratic Investment.** An organization's pattern of investment was not consistent in any way over time.

Below, we explain in detail how we answered each of these questions by looking at CDP data.

Did the organization's investment increase relative to inflation? To answer this question, we first calculate the percent change in investment (ie: program, marketing, or fundraising expense) from year to year. Using the inflation rates for each year of the study below, we compare the organization's change in spend relative to the inflation rate. The organization is subsequently placed into one of the following three categories: 1) investment decreased relative to inflation (change in spend < inflation), 2) investment increased relative to inflation (change in spend > 3x inflation), 3) investment stayed abreast of inflation (change in spend > inflation < 3x inflation).

Year	Inflation Rate
2007-2008	3.84%
2008-2009	(0.36%)
2009-2010	1.64%
2010-2011	3.16%
2011-2012	8.49%

Did the organization's investment keep pace with its change in budget size? First, we take the percent change in the organization's budget size (total expenses) from year to year. Similar to above, we compare this number to the percent change in investment/spend. An organization is grouped into one of two buckets: 1) investment kept pace with change in budget size (change in spend > change in budget size), 2) investment did not keep pace with change in budget size (change in spend < change in budget size). We then place organizations in one of the categories described above by looking jointly at investment relative to inflation and budget size.

	Kept pace with budget size	**Did not keep pace with budget size**
Decreased relative to inflation	No investment	No investment
Stayed abreast of inflation	Modest investment	Modest investment
Increased relative to inflation	Significant investment	Modest investment

Was investment sustained over three years? The last step is to look at the year to year measure of investment over time. We chose to look at trends over three years since we felt that three years of investment was enough time for that investment to have an impact. Since we were interested in the impact of an organization *increasing* its investment, those bucketed as significant investors had to invest in their *first* year and then sustain that investment over time (at either a “modest” or “significant” level).

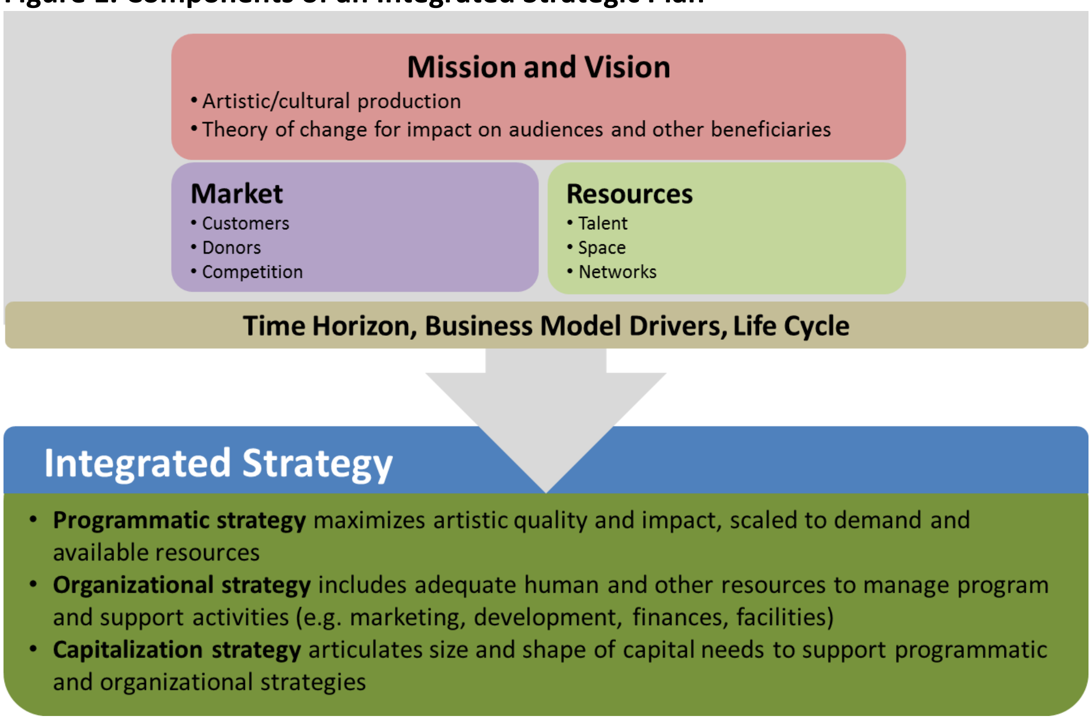
Categories of Investment Level	**Criteria**
No investment	Three years running of “no investment” (starting 07-08 or 08-09)
Modest investment	Three years running of “modest investment” (starting 07-08 or 08-09)
Significant investment	First year of “significant investment” followed by two years of either “modest” or “significant” investment (starting 07-08 or 08-09)

V. Integrating Capitalization into Planning

TDC recommends that organizations craft a capitalization strategy within the context of a larger strategic plan. A full planning process, in TDC's estimation, integrates an organization's thinking and analysis of its mission and vision, external marketplace, and resource needs. To fully respond to all of these market conditions, a plan should include a programmatic strategy, an operational strategy, and a capitalization strategy. The graphic below illustrates TDC's concept for a complete and integrated plan and planning process.

This section of the Appendix describes in detail TDC's approach to developing a capitalization strategy as part of the full planning process.

Figure 1. Components of an Integrated Strategic Plan



A. The Components of a Capitalization Strategy

Before we dive in, Table 1 identifies the types of capital funds that an organization might need.

Table 1. Types of Capitalization Funds

Fund	Description of use	Who Needs It
Working capital	Working capital smooths cash flow bumps that arise from predictable business cycles.	All
Operating reserve	Unlike working capital, operating reserves are held in order to protect against unexpected downturns, i.e. the "rainy day."	All
Facilities reserve	A cash fund that organizations with facilities or significant leasehold improvements maintain to realize facilities replacement plans.	Facilities owners
Opportunity or risk capital	Opportunity or risk capital gives organizations the freedom to try out new ideas such as product extensions, new marketing campaigns, earned income ventures, major growth, or a new strategic direction. Risk capital should be used to address large environmental shifts that demand a change in strategic direction.	All
Recovery capital	Recovery capital is necessary for an organization with negative net worth and structural deficits to recover and maintain operations. Recovery capital provides interim working capital, moves unrestricted net assets out of the red, and enables the organization to pay off past debts.	Organizations with negative URNA and/or evergreen debt
Change capital	Change capital represents resources critical for organizations transitioning from the recovery stage to the strengthening stage. Change capital is required to test and execute a new business model.	Organizations with a broken or weak business model
Endowment	Endowments ensure the longevity of organizations with long-term time horizons through investment earnings dedicated to ongoing fixed costs, such as long-term labor contracts or maintenance of a historic building.	Organizations with a time horizon in perpetuity

TDC believes that all organizations need the three shaded funds. Everyone needs working capital to pay their bills in a timely fashion. Everyone needs operating reserves because no one can accurately predict the future in budgeting. And, everyone needs opportunity capital because it's important for all organizations to stay relevant by trying new approaches and experimenting with new programs. The other four funds are dependent on an organization's circumstance, and are not applicable to all.

All of these funds (with the possible exception of working capital) are built with money *on top of* what an organization needs to cover its annual cost of operations. Similar to savings that an individual may have for retirement or for home improvements, capitalization funds are pots of capital that an organization holds to mitigate risk, try new things, or generate income.

B. Identifying the Needs

To understand which of these funds an organization needs, it is important to understand the essential nature of the organization's business model as well as its current condition. As introduced in the body of this report, TDC suggests analyzing the following four factors to determine an organization's capitalization needs:

- Time Horizon
- Flexibility
- Lifecycle
- Capitalization Stage

Time horizon. An essential consideration in determining a capitalization strategy is the length of time an organization needs to fulfill its mission. On one end of the spectrum are organizations that live in the present, seeking to address the needs of the current-day population and realize a single person's innovative idea or artistic voice. In the middle range are organizations that are invested in a brand and regular audience: it takes multiple years to build up a brand. At the long-term end of the spectrum are institutions that are committed to a perpetual vision, such as the stewardship of historic buildings and collections.

A longer time horizon implies that an organization needs a higher degree of operating reserves and, perhaps, access to endowment. Organizations with shorter time horizons do not need to worry as much about saving for a rainy day, and can exist with a smaller operating reserve relative to their budgets.

Matching the need with the fund is important. Organizations focused on present-day needs require more flexible capitalization, while those with the obligation to look to the future need permanence and stability. Matching becomes harder when there are programs with different time horizons in the same organization. For example, at a museum, collections stewardship has a long-term time horizon while education programs are short- or mid-range endeavors.

A final note: Time horizon is not necessarily related to an organization's lifespan: a current-day organization can persist for decades, and many do. The difference is that it does not have the *obligation* to do so.

Flexibility. An organization's flexibility is based on the amount of large fixed costs it must incur to carry out its program. Examples of large fixed costs are owning a dedicated, purpose-built building and long-term union contracts. For example, many museums are inflexible organizations, due to the constraints of fixed costs. Organizations with low flexibility require larger reserves since their operations are dependent on being able to cover these costs. They may also need greater amounts of working capital depending on the timing of the costs. Some degree of endowment may also be helpful to ease the burden each year of meeting those costs.

A final note on flexibility: Many organizations own assets that are not necessarily essential to achieving their missions. If an organization is in difficult financial circumstances, it has the option to sell valuable but non-essential assets in order to replenish capital funds that are necessary for stable operations.

Lifecycle. Capital needs are also determined by an organization's place in the organizational lifecycle. Moments of change – Start-up, Growth, Decline, Renewal – are the places where organizations have more intense capital needs. These organizations need funds to try new approaches and to mitigate risk. Organizations at inflection points require change capital to invest in and transition to a new operating model. Change capital is distinct from ongoing opportunity or risk capital, which are set aside to ensure regular investment in innovation and new product development.

Capitalization Stage. Lastly, it is important to take into account the organization's current state of capitalization. Certain types of funding are generally required by an organization in each stage of capitalization. The table below enumerates these funds.

Table 2. Capital Funds Needed at Each Stage

<table>
<tr><th>Stage</th><th colspan="5">Capital Funds Needed</th></tr>
<tr><td>Recovery</td><td colspan="2">Recovery Capital</td><td colspan="2">Change Capital</td><td>Working Capital</td></tr>
<tr><td>Transition</td><td colspan="2">Change Capital</td><td colspan="2">Working Capital</td><td>Endowment (if applicable)</td></tr>
<tr><td>Strengthen</td><td>Working Capital</td><td>Operating Reserve</td><td>Facilities Reserve (if applicable)</td><td>Endowment (if applicable)</td><td>Risk or Opportunity Capital</td></tr>
<tr><td>Deploy & Maintain</td><td>Working Capital</td><td>Operating Reserve</td><td>Facilities Reserve (if applicable)</td><td>Endowment (if applicable)</td><td>Risk or Opportunity Capital</td></tr>
</table>

Note: Table 1 offers a full description of each of the capital funds named in the table above.

This table recognizes that capitalization exists in a hierarchy of needs, depending on an organization's circumstances. For example, an organization in the Recovery stage does not need a facilities reserve, even if it owns a facility, as immediately as it needs to invest in fixing its broken business model.

C. Quantifying the Needs

Identifying a numerical target for each fund entails some careful thinking about all of these factors. Below, we offer some thoughts on how to quantify each type of fund.

Table 3. Methods to quantify capital funds

Fund	Quantification method
Working capital	Identify the months in which an organization runs short on cash, due to predictable cycles in its season or funders' payment schedules. Calculate how much cash the organization is short to pay its monthly bills during those months, and for how long the shortfall persists.
Operating reserve	Identify the most risky aspects of an organization's annual budget. For example, the percentage of budgeted fundraising revenue coming from as-yet-unidentified sources, or a major expense that is uncertain.
Facilities reserve	Analyze an organization's systems replacement plan in place to identify its facilities reserve targets. If an organization does not have a facilities replacement plan, the Nonprofit Finance Fund offers this helpful service.
Opportunity or risk capital	Talk to artistic and education staff about changes they want to make to its programs in the coming three years, and what level of investment or risk will result.
Recovery capital	Include an organization's working capital needs, negative unrestricted net assets, and evergreen debt.
Change capital	Create an integrated business plan that describes the organization's new business model, identifies key investments it will need to make, and a lays out a timeline for achieving its goals. Change capital is the amount an organization needs to invest in its new plan upfront in order to test the new initiative and cover any gap in annual operations incurred.
Endowment	Consider the amount of the annual budget that needs to be filled by endowment draw. Divide by 4% or 5% (representing the generally accepted level of draw).

Two notes of caution:

- First, if an organization is changing its business model, it should consider the calculations in the context of the *new* business model. For example, if an organization is adding a new series to its season, its working capital needs will likely change since its operating budget will grow.
- Second, it's very important to note that these needs are separate. A common practice that TDC has observed is an all-purpose reserve. Unfortunately, it's not possible to spend the same dollar twice, and so having one fund may leave an organization in the Solomon-like position of choosing between the HVAC system and covering an unexpected shortfall.

Totaling all of these sums can generate a number that appears to be (or actually is) not achievable. If this is the case, TDC advises organizations to consider the funds as a hierarchy of need. If an organization can't fund everything, it is best served to start with the basics, and build up to the rest as it is able. The funds identified in Table 3 are presented as a hierarchy, with the most immediate needs on the left and the less immediate needs on the right.

D. Identifying Where to Get the Money

Defining a capitalization strategy is often an iterative process that includes defining the need and identifying sources of capital to meet that need. As an organization identifies sources, it should consider the following questions:

Does the organization have access to unrestricted funds on its balance sheet right now? Especially for an organization in the Strengthen or Deploy & Maintain stages, it may already have the funds on its balance sheet, although they may not be segregated for a particular purpose. Crafting a capitalization strategy may be as easy as creating a formal reserve and adopting a board policy to manage it.

Does the organization's business model produce surpluses? Just as individuals save for retirement by putting aside a portion of each paycheck, organizations can put excess revenues toward reserves. This method is especially helpful for planned needs, such as facilities renewal, where an organization can squirrel away funds on a timetable. Ideally, an organization should self-fund a working capital reserve, operating reserve, facilities reserve, and opportunity capital from surpluses. The nature of these funds is that they are spent down over time. As such, if an organization has no plan for replenishment, it is back at square one after the first rainy day.

Is the organization positioned to succeed in raising cash from capital markets? In general, organizations must turn to outside supporters for recovery capital, change capital, and endowment, often in the form of a capital campaign. Also, in general, the donors who will contribute are its closest supporters: people and institutions who have a keen interest in seeing the organization reach sustainability. Organizations can also turn to the capital markets to "catch up" on saving for facilities renewal or to source working capital for a long-term programmatic expenditure. It's also possible that an organization has a "go-to" source for opportunity capital: someone interested in funding innovation.

To be competitive in the capital markets, an organization needs alignment with values and priorities of funders and donors, close relations with the philanthropic network, and fundraising expertise. Organizations without these competencies should be cautious when setting fundraising goals.

Does an organization have access to affordable debt? Debt is a double-edged sword. Without a clear-eyed strategy to pay it back, it can become a permanent yoke around operations.
In general, there are a few scenarios in which debt is the sensible solution.

- First, an organization has access to low cost debt and has a business model that produces reliable surpluses to go toward debt service.
- Second, an organization has firm pledges in hand from its capital campaign but it needs to begin its project before the pledges are due for payment.

- It's also possible to use a line of credit as an organization's working capital. That said, this should only be done if an organization's business model produces enough revenue to clear the line of credit once a year for more than five minutes!
- A similar strategy is to use an organization's own restricted funds or deferred revenue as an internal line of credit. This is a very common practice. However, this should *only* be done if an organization's business model is solid enough to ensure that it will be able to replenish those funds in a timely fashion.

E. Crafting a Capitalization Strategy

After conducting thinking through the steps reviewed above, an organization is ready to hold planning meetings to settle on a capitalization strategy. We have prepared the worksheet in Table 4 to act as a guide for organizations as they articulate their capitalization strategies.

- **Current Amount.** What does the organization already have? What's the starting point?
- **Future Need.** What target is the organization aiming to build towards?
- **Source.** Where will the organization get its initial investment? How will funds be replenished?
- **Phasing.** What's the timeline for amassing funds? What are the interim milestones the organization plans to hit on its way to the full targets?

Table 4. Capitalization Strategy Worksheet

Fund	Current Amount	Future Need	Source	Phasing
Working capital				
Operating reserve				
Facilities reserve				
Opportunity or risk capital				
Recovery capital				
Change capital				
Endowment				