The For-Profit Institution

By Robert DeColfmacker

CFO Perspectives

1962 2012
NACUBO

Additional Perspectives

CFO Perspectives: The For-Profit Institution is one in a series of white papers that looks at the role of the CFO within different institutional or operational settings. Each white paper, available free from NACUBO and released during 2012, the 50th anniversary, focuses on the unique demands of a particular type of institution and how to manage strategy and business operations within that distinctive context.

Written by authors with extensive experience in financial operations, the white paper series offer insights that may prove helpful to new CFOs or board members, presidents, senior administrators, faculty, and staff. For a list of the other titles available in this CFO Perspectives series, please visit www.nacubo.org.

Acknowledgement

A special thank you to **Michael Townsley**: for his contributions in developing publications for the business office. NACUBO would like to recognize his leadership in bringing together a collection of articles that cover key topics and issues that will resonate with NACUBO members for years to come.

Although some for-profit colleges are rightly criticized for low standards, high attrition rates, and heavy debt loads for dropouts, others have earned a reputation for efficient operations and strong financial management. The sine qua non of proprietary institutions—that they must survive and generate a profit based on the sale of their services—means their main source of working capital is cash generated from operations or from the original capital contributions made by equity holders. Gifts and endowments play little or no role in their financial structure because donors do not receive a tax benefit and endowments deplete the capital needed for operations.

Simply put, a for-profit college can survive only if it devotes most of its expenses to the delivery of instruction or to sales. Providing the same scale of student services found at a nonprofit private or public institution would deplete the income required to produce a profit. Yet as different as for-profit and not-for-profit institutions may appear, they have several commonalities: Both types of institutions need to capitalize their operations, both need to achieve financial viability scores to receive federal funding, and both must fund depreciation and capital expenses.

Three Useful Tools

In a sense, a for-profit college and a nonprofit institution are similar in financial structure—with one notable exception. Typically, the former must pay appropriate federal and state taxes, while the latter must contribute an equivalent amount of "community benefit" to retain its legal status. Perhaps it's time to simply forget the "for-profit versus non-profit" distinction and refer to these schools as either taxable or tax-exempt entities.

With that in mind, taxable entities may provide CFOs of tax-exempt institutions with valuable lessons—especially those related to establishing a financial management system that consistently controls costs, produces a reliable string of positive net income, and generates cash from operations. To accomplish these goals, for-profit institutions typically use three financial tools:

1. Cost Controls. Cost controls begin with the unit cost of conducting some activity, such as recruiting, instructing, retaining, and graduating a student. Once unit costs are understood, policies can be established to control those costs.

Most proprietary institutions, for example, carefully monitor cost per lead, cost per enrollment, and cost per new student start. This requires reliable data on the scale of the activity being measured: A unit cost computation becomes worthless if the unit is not counted correctly. For instance, if the unit is the number of enrolled students, the count of students must be tracked precisely to cover the usual factors such as dropouts and withdrawals.

Computing the unit cost of a particular activity requires an accounting system with a chart of accounts that accurately assigns costs to a particular activity. Once the chart of accounts and unit counting system are set up, the president—with the advice of the CFO—must determine the appropriate performance level for the unit cost ratio. The benchmark may be established by comparison with similar institutions or by determining what is reasonable for the particular college.

A continuous financial reporting system enables administrators to know critical unit costs at any time. Many presidents of proprietary colleges, in fact, receive a daily "flash report" monitoring enrollment and retention and detailing certain revenue and expense items.

Presidents at all types of colleges should know what is happening with the critical cost drivers that have a direct impact on the bottom line. These drivers include:

- Marketing and admission cost per admitted student.
- Instructional cost per section.
- Marketing, admission, instructional, and refund cost per dropout or per withdrawal.
- Compensation cost per faculty member.
- Compensation cost per administrator.
- Operating (building and grounds) cost per square foot.

2. Budget Systems. Like cost controls, budget systems depend upon a chart of accounts that assigns revenue and/or expenses to organizational levels matching revenue centers, administrative and support departments, capital expenses of the operation, and performance metrics. As a result, budget systems in for-profit colleges—

as in nonprofit institutions—must be tightly linked to non-financial data, cost controls, and financial reporting.

At both for-profits and nonprofits, budget systems must include the tools to forecast budgets, manage variances, and generate financial reports. At a for-profit college, however, the budget forecast is designed to estimate revenue and expenses to its income centers, its administrative cost structure, and its academic schedule. The income center budgets include enrollments, sections, personnel assigned to the center, revenue, and expenses by academic period. Administrative expenses include relevant metrics, such as the admissions funnel for marketing, administrative costs per student, personnel pay ranges, and expenses allocated by academic period.

In addition, the budget includes metrics pertinent to profitability, such as cash flow or receivables per student. The forecast budget also serves as the basis for variance management and budget reports during the fiscal year.

The budget system at a for-profit college must be sufficiently flexible to allow quick intervention should plans go awry—or go better than expected. Revenue and variable expenses during the fiscal year should change relative to the unit measures for revenue and expenses. Fixed expenses should represent a fixed line not subject to a step-up (or step-down) unless major changes occur in the scale of operations. For instance, fixed expenses would not change unless enrollment increased or decreased by 10 percent.

Budget reports at for-profit colleges must be accessible daily to show whether performance is above, below, or on-target. The for-profit will not survive if managers routinely ignore budgetary policies, procedures, and report systems. In fact, rigorous accountability is a fact of life at for-profits because performance defines the terms of the job.

3. Strategic Metrics. These ensure the budget direction within the fiscal year conforms to the college's expected strategic direction. Reviewing them provides a "quick read" way to determine if the institution is on track with both its budget and strategic plans.

Strategic metrics fall into six categories: new students, enrollment, cost performance, revenue, net income, and cash flows. The new student funnel, for example, establishes yield rates, absolute number of potential students, net tuition generated, and the cost per student for the marketing effort.

The last two strategic metrics will determine if the college is generating the financial outcomes that fit annual budgetary and strategic parameters: net income before interest, debt, and amortization (EBIDA) and free cash flow from net operations. Free cash flow also indicates how an institution is performing after it has made allowance for capital expenses.

Linking Non-Financial and Financial Data

For any educational institution, financial viability depends on the institution's capacity to act as a single strategic entity rather than as a set of separate pieces acting in their own self-interest. Budget reports have a significant role to play in fostering the sense that the instructional managers, as well as senior managers, are responsible for the success of the institution.

Budget reports that divorce revenue and expenses from the centers that generate revenue, for example, reinforce the idea of an institution as a set of independent fiefdoms. Such reports literally suggest that enrollment is another department's problem.

Financial reports at for-profit college show net income flowing from enrollment, sections offered, and variable and fixed expenses. Often, they also show the financial performance of each specific program offered at the institution. These comprehensive reports provide the global picture for the college and the financial picture for income and expense centers. They are management tools containing sufficient information for the president, CFO, and budget managers to take action when performance lags.

On the other hand, nonprofit colleges often treat budget reports as expense reports—with revenue and net income reserved for the president and senior leadership. As a result, instructional program managers are not held responsible for revenue, enrollment, or even instructional efficiency because someone at the senior level has responsibility for those areas. A case in point would be budgetary reports for a business program that show only expenses, while ignoring revenue, net income, allocated expenses, program enrollment, and sections taught. As a result, the manager closest to providing direct saleable services to students is not expected to do much to improve the program's marketability or operating efficiency.

At a minimum, performance reports should include the following information for each level of the organization:

Instructional Income Centers (by month, academic period, and year-to-date)

— Enrollment

— Sections

— Revenue

— Expenses

— Net from revenue

— Operational efficiency metrics

Expense Centers

— Personnel assigned

— Expenses

— Operational efficiency metrics

President and Senior Managers

— Same information as for income and expense centers

— Additional information: net income, cash flow, and credit line draws

— Operational efficiency metrics

— New student funnel

In addition, proprietary colleges issue "flash reports" to focus the attention of the president and senior officers on important factors that drive operations. These reports typically include enrollment, changes in enrollment, leads, admission yield rates, sections, and EBIDA. Because these items are critical for the college's success, administrators at for-profit schools insist on receiving them daily.

Robert DeColfmacker is a former president of a proprietary college.

Take Away Points

- Use metrics to manage operations and report performance during and after registrations and at the end of academic periods.
- Develop metrics to measure admissions flow, class size, drop-outs, and EBIDA (earnings before interest, depreciation, and amortization).
- Issue flash reports that enable the president and senior administrators to track performance daily.