Nonprofit Income Portfolio Analysis

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Definitions

Income portfolio analysis involves a detailed examination of the performance, composition, and characteristics of an organization's source(s) of revenue. Nonprofit income portfolio analysis applies this examination to nonprofit organizations. *Revenue* is the total amount of money an organization obtains from various sources. *Income* represents total profits, or net income, after expenses are deducted from revenue.

Application of Income Portfolio Analysis to the Nonprofit Sector

Income portfolio analysis is a widely used analytic tool for financial management in the for-profit world. Indeed, for-profit managers frequently engage in extensive examinations of the performance, composition, and characteristics of their source(s) of revenue in order to improve overall returns for their shareholders.

Nonprofit organizations also rely on income portfolio analysis for sound financial management. However, unlike in the for-profit world, the goal of this analysis is not to maximize shareholder investments but to maximize mission-related outcomes. Maximization of these outcomes allows nonprofits to build and maintain critically needed income required for them to pursue their missions and "do the work" they were established to do.

Undoubtedly, then, having an intimate understanding of the performance, composition, and characteristics of revenue sources, whether charitable donations, government and corporate grants, service fees, and/or private philanthropy, is one of the most important responsibilities that nonprofit leaders have to uphold. In this chapter, we review several key concepts and considerations regarding nonprofit income portfolio analysis, and we conclude with a brief overview of how this analysis is undertaken.

Components of Nonprofit Income Portfolio

Defining revenue sources for nonprofit organizations typically include private donations, government funding, program service revenues, and investment income. *Private donations* are voluntary monetary contributions. *Government funding* includes government grants, contracts, and cooperative agreements. *Program service revenue* generally consists of direct payments received from nonprofit service provision. *Investment income* refers to dividends, interest, and capital gains.

Although these definitions appear to be straightforward, nonprofits categorize the income received from each of these sources of revenue in different ways. For example, some nonprofits only consider *private donations* to include income received from individuals, foundations, and corporations. Other nonprofits, however, consider *private donations* to include income received from additional sources, such as fundraising events, special events, federated campaigns, government grants, and other nonreciprocal transactions.

Nonprofits also categorize *program service revenue* in different ways. Indeed, this type of income can include any combination of direct payments received from service provision, net rental income, royalties, and the sale of other assets. Moreover, while *commercial income* generally refers to income obtained from commercial investments related to a nonprofit's tax-exempt purpose(s), this type of income can also signify profits made from commercial activities that are unrelated to an organization's tax-exempt purpose(s), which the organization categories as program service revenue.

Given wide variability in how sources of nonprofit income can be categorized, it is important for nonprofit managers to have a complete and accurate picture of their own organization's income landscape; and, a useful financial management tool for doing so is the income portfolio. An income portfolio provides a risk-focused analysis of the net income received from each revenue source that an individual nonprofit relies on. At a minimum, this analysis focuses on income derived from each of the defining sources of nonprofit revenue (i.e., private donations, government funding, program service revenue, and investment income). However, as a nonprofit's revenue source(s) become more complex, additional income categories are included (e.g., gaming income and income generated from the sale of inventory).

Determinants of Nonprofit Income Portfolio

Several factors determine whether a nonprofit relies on a particular revenue source more than others for obtaining income. For one, organizational mission dictates the revenue sources that are appropriate for an organization to pursue. Indeed, the mission of a nonprofit is the "North Star" that (at least in theory) guides every activity that takes place in the organization. Nonprofits with

missions focused on assisting vulnerable populations (e.g., shelters, soup kitchens, and food pantries) tend to rely more on private donations than nonprofits with more commercially-oriented missions (e.g., hospitals and universities).

Another factor that contributes to the make-up of a nonprofit's income portfolio is its organizational life cycle stage. At the start-up stage of organizational life, nonprofits often rely on seed funding to launch programs and sustain their operations. As nonprofits grow and mature, they rely less on seed capital and more on community support in the form of individual donations. This type of support helps the organization build legitimacy and expand its market share. By the time nonprofits reach maturity, they often possess the capacity to diversify revenue streams, and in turn, income sources, as needed.

Perhaps most determinative among factors that make up a nonprofit's income portfolio, however, are the accounting and managerial decisions that must be made prior to pursuing a particular source of income. Indeed, there are long-standing debates about the effects of crowding-in and crowding-out on different nonprofit revenue sources. As such, nonprofit managers must consider a number of possibilities, such as whether greater funding from the government will reduce the public's willingness to donate to their organizations or whether more earned income will crowd out their ability to obtain government funding.

Income Portfolio Diversification

Although not originally developed to assess variability in income, the Herfindahl-Hirschman index (HHI) is a commonly used measure of diversification. For income analysis, HHI is calculated by taking the ratio of each income stream, squaring each one, and then summing them together. A low(er) HHI suggests greater diversification of income.

One might ask: *Should nonprofits maintain a diversified income portfolio?*

Hung and Hager (2019) synthesized the advantages and disadvantages of revenue diversification in the nonprofit sector. On the advantages side, nonprofits with diversified income portfolios are often more stable and resilient to shocks in the market. Diversification can also provide nonprofits with greater organizational autonomy as well as balance stakeholder voices. On the disadvantages side, however, a diversified nonprofit income portfolio inevitably means greater complexity in management. Indeed, adding new sources of income requires adaptation, which can create uncertainty and risk for many organizations. Managing multiple income sources can also increase administrative costs and burdens, lead to organizational mission drift, and (as noted above) crowd-out income derived from other sources.

Analyzing a Nonprofit's Income Portfolio

To conduct an income portfolio analysis, Kearns (2007) suggested a *multiattribute utility approach* that involves mapping income *attractiveness* and *capacity*. According to this approach, a nonprofit should consider five attributes when assessing the percentage of each income stream that is most attractive for their organization:

1. Mission appropriateness: the consistency of the income source that supports the mission of the organization.
2. Significance: the amount and potential growth of the income source to fulfill the financial need of the organization.
3. Risk: the likelihood of significant decline of the income source.
4. Opportunity costs or trade-offs: the effort and resources required to pursue and sustain an individual income source.
5. Autonomy: the level of restriction(s) that the income source brings to the organization.

Once a determination has been made about the *attractiveness* of a particular income source, organizations must then decide whether there is enough *capacity* to generate and/or sustain that income. This capacity includes staff and volunteer competence, infrastructure support, community reputation and image, and culture and tradition.

Obviously, income sources high in both attractiveness and capacity are appealing to nonprofits, and Kearns suggests that this type of income should be prioritized. High attractiveness but low capacity income sources, while generally not advisable for most nonprofits, require careful scrutiny and examination since these income sources may require a significant reallocation of resources. Efforts to pursue income sources that are low in attractiveness and high in capacity should be diverted to other income options.

Nonprofit income portfolios vary from organization to organization. As such, nonprofit managers must consider the variance and covariance between different revenue streams and balance their portfolio's attractiveness with their organization's own capacity.

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