The Bridgespan Group

Costs Are Cool

The Strategic Value of Economic Clarity

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Collaborating to accelerate social impact

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For most nonprofit organizations, the art of making trade-offs is a condition of survival as well as a key element of success. With limited means to address substantial social challenges, nonprofit leaders constantly make choices about the most effective way to allocate available resources among competing priorities. The consequences of these trade-offs are visible daily: in the activities a nonprofit offers, the programs it supports, and the initiatives it pursues. Together, they constitute the engine that either drives the organization's strategy forward or renders it irrelevant. That is why resource-allocation decisions present one of the most powerful levers nonprofit executives can apply to achieve their organization's goals.

Given this fact, the scope of the financial data available in many nonprofits is worrisome. Although information about revenues (in the form of donations, grants, and earned income) is usually fairly solid, organizational knowledge about costs tends to be weak. This is particularly the case when it comes to the true, all-in costs of providing services, running programs and otherwise operating the organization. Lacking this information, nonprofit executives often end up having to make important resource-related decisions on the basis of intangibles such as intuition, the skills and knowledge of the program staff, or the preferences and inclinations of the organization's funders. As a result, they run the risk of undermining their organization's mission (however inadvertently), by failing to allocate resources to the *right* programs and services—that is, to those that have the greatest impact.

Several factors contribute to the dearth of good financial information in nonprofit organizations. However, none of them looks very substantial—or defensible—when set against the gains in social impact that can come from truly well informed decision-making. To demonstrate the strategic value of good cost data, we will draw on examples from Bridgespan's experience with a variety of nonprofit organizations. We'll start by looking at some of the ways in which economic clarity—understanding fully the true costs of providing programs and services—can inform important, stand-alone resource-allocation decisions. Then we'll turn to ts impact on the organization as a whole and explore how—and why—it provides a building block for sound strategies. Finally, we'll look at some of the existing barriers to economic clarity and offer some suggestions for overcoming them.

Economic Clarity Informs Critical Resource-Allocation Decisions

To make resource-related decisions intelligently, that is, in a way that maximizes an organization's impact and promotes its mission, nonprofit leaders need to have a clear picture of the *full costs* of operating their programs and services. (For a definition of this term, see Appendix: "What Are Full Costs?") Among the reasons such clarity is essential, one simple explanation stands out: you can't spend the same dollar twice. Funds that an organization uses for one purpose can't be used for something else. And when resources are scarce—as in nonprofits they invariably are—it is critically important that they be devoted to the programs and activities that advance the mission most.

By complementing a strong sense of mission with a strong understanding of their organization's operating costs, nonprofit decision makers can equip themselves to make the right allocation choices. The economic clarity that full cost data creates can provide invaluable input to decisions about how to allocate resources among programs and across them, whether to expand into a new location, and where to set the level of funding required to sustain the organization's operations. In the next few pages, we'll look at each of these in turn.

Which programs do we fund?

Resource-allocation decisions take many forms and occur on many levels. Nonprofit executives routinely make choices about how to divide funding among programs within a single department. Many also face the need to allocate resources across various departments and/or to distribute funds among the organizations or sites in a network. By making the true costs of operating an organization transparent, full cost information enables decision-makers to modify the flow of resources to maximize impact and manage all-too-scarce resources effectively.

The most basic resource-allocation decisions relate to funding multiple programs in a single department. For example, one of Bridgespan's clients was providing a variety of counseling, adult education, youth, and economic development services to its clients to help them become more self-sufficient. An analysis of this organization's costs showed that within the economic development department, the employment-services program and the resume-services program were incurring the same expense. In other words, it was costing the organization the same amount of money to place a client in a job as it was to help her prepare a resume. Because having a job provides clients with greater economic self-sufficiency than simply having a resume on hand, the organization decided to focus its resources on the employment-services program instead of growing the resume-services program as it had originally planned.

Similar logic led to an increase in funding for the organization's youth-services program. Here, again, the catalyst was data from the cost analysis, which established that the youth-services program was delivering high-impact results at a relatively low cost. As a result, the organization decided to focus additional resources on expanding this program relative to the rest of its other departments.

Full and accurate cost data can be equally illuminating when an organization's leaders are wrestling with the best way to divide resources among multiple sites. This was the situation confronting a nation-wide educational organization with seven regional affiliates. Because the organization's existing accounting system reported all its financial information on a line-item basis, regional cost data had never been collected. When this data was gathered and analyzed, the organization learned that the cost of training teachers varied greatly by locality. These findings prompted a reevaluation of the regional offices, which led to both the allocation of additional resources to efficient regions and the initiation of efforts to help the other offices learn from their peers and become more cost-effective.

Should we expand to a new location?

Many successful organizations grapple with questions of whether and when to take one or more elements of their organization to a new geographic location. Funders, who often favor giving seed money to organizations for new endeavors, might express an interest in backing a proven program in a different region. Communities might hear about a program and lobby for it to come to their area. For a variety of reasons, the time might seem ripe to bring a successful program to a new locale.[1] Whatever the catalyst, when an organization is seriously contemplating expansion or replication, an understanding of the way its costs are distributed can help inform the decision-making process.

Opening a new site brings the potential advantage of increased efficiency, because some of the organization's costs (such as fundraising, marketing, and human resources) can be shared between locations, lowering the cost for each by creating economies of scale. On the other hand, many costs cannot be shared: the unique start-up costs required to establish a program in a new region, for instance, as well as site-specific costs such as rent, direct labor, and materials. Understanding the mix of costs that will recur at the new location and costs that can remain at the original site (and thus be leveraged by the new operation) is essential in evaluating the full cost of replication.

Such understanding was invaluable for the leaders of one West coast organization that runs a successful workforce-development program. Year after year, this program has produced amazing success stories, which have earned the organization national attention as well as local praise. Single mothers on welfare have enrolled in training and six months later were able to command $45,000 a year. People who had been living in homeless shelters found themselves being courted by multiple potential employers after participating in the program. Not surprisingly, many voices were urging the organization to expand, including

1 Melissa A. Taylor, J. Gregory Dees, and Jed Emerson, "Chapter 10: The Question of Scale: Finding an Appropriate Strategy for Building on Your Success" p. 2

one funder that was particularly enthusiastic about seeing the training program established in a new geographic region. The offer of guaranteed funding seemed appealing, and the organization was tempted by the proposal.

After much careful thought, however, the staff decided against the expansion. The decision was informed in part by an examination of the organization's cost structure, which showed that overhead costs constituted a significant portion of its total operating costs. As long as these costs were divided among several existing programs, the organization could absorb them without compromising its viability. But if one program had to carry them alone, as the training program would have to do if it were replicated in the new location, the burden was unlikely to be sustainable. Coupled with an understanding of the risk of starting a long-term program with guaranteed short-term funding and a determination that the economic climate wasn't right for expansion, this analysis convinced the organization that replication would not be a prudent decision.

In addition to knowing how costs are distributed among programs, organizations also need to have a strong understanding of their "cost per outcome." This measure links the unit-level economics of an operation with the impact that the organization wishes to have. To take a simple example, a nonprofit that delivers meals to the elderly might measure its impact by the number of meals served. To arrive at its cost per outcome, therefore, it would divide the full cost of its meals program by the number of meals it serves.

As this example indicates, determining unit-level costs requires an organization to have clarity around the outcomes it seeks to achieve as well as around the full costs of its programs. Both can be challenging to establish, particularly if the organization's desired impact is something that is hard to quantify such as educating a child or providing a support structure for disadvantaged people. But they are critical to any organization's future success, and especially so for those looking to grow to new sites.[2]

The chance to take a successful program to a new location presents nonprofits with an appealing but difficult opportunity. They welcome the opportunity to bring the program's benefits to more people, but they also understand that the risks of failure can be great. Clarity around the structure and level of their operating costs provides organizations and their leaders with crucial information that they can bring to bear on this challenging decision.

How much money do we need to sustain our programs?

While nonprofits frequently remain uncertain about the cost side of running their programs, most are all-too-well acquainted with the revenue side of their operations. Executive directors and development staff feel the burden of raising

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2 Jeffrey L. Bradach, "Going to Scale," Harvard Business School Working Paper, Social Enterprise Series No. 9

money to sustain their organizations on a daily basis. Many nonprofit employees can provide a laundry list of their organization's funders and describe in detail the specifications of their respective grants: whether the money is restricted or unrestricted, the length of the grant term, and the reporting terms required by the foundation. Organizations become skilled at painting compelling pictures of their programs to funders and managing multiple grants simultaneously.

In setting the amounts for their proposals, however, the best that organizations lacking good cost information can do is approximate. One common approach is to match the anticipated organizational expenses to the level of support the organization expects to receive from a specific donor. A nonprofit that expects to receive a $100,000 grant from a foundation for a youth-literacy program, for example, will often simply list the cost of the program at $100,000. Understanding the full cost of providing services thus allows an organization to better ascertain the proper amount and types of funding necessary to sustain its programs.

Most nonprofits rely on contributed revenue (money in the form of grants from foundations and donations from individuals) to support at least a portion of their activities. Since so few organizations have an accurate understanding of the true costs of running their programs, it's not unreasonable to think that those that do possess such data might thereby enhance their credibility with donors. And while it may be idealistic to hope that funders might even be willing to increase their level of giving to meet an organization's real, demonstrated needs, it is undeniable that a firm grasp of those needs provides the best place for funding discussions to start.

In addition to contributed revenue, a growing number of organizations also provide products or services that serve as sources of earned revenue. Given nonprofits' natural inclination to charge as little as possible for these products and services, the prices are often set at levels that fail to cover the actual costs. This was the case for a nonprofit that offers affordable classes on technology-related subjects ranging from basic video production to advanced HTML programming to independent artists and employees of nonprofits. The organization charges fees for the classes, and its management had always believed them to be a source of earned income, not just additional revenue. However, a close examination of the organization's cost structure showed that the classes were actually a net drain on resources. Armed with this new information, the organization's management revisited its strategy and implemented operational initiatives to increase the classes' financial contribution. Accurate cost data allowed the staff to ask—and answer—concrete questions about class size, cancellation policies, and the types of classes to offer.

Maximizing Impact through Economic Clarity

Striking as the effects of economic clarity are on individual decisions, the impact on an organization's strategy can be even more powerful. The reason is that accurate cost data also make it possible to look at program finances from a strategic perspective, to see the flow of funds within the organization as a whole. With a full understanding of all their programs' costs, decision makers acquire a clear view of how, precisely, the organization's scarce resources are being allocated: which programs are covering their own costs or even generating surplus funds, and which ones require subsidies. As a result, they can determine whether those scarce resources are being used in the ways that most effectively advance the organization's mission.[3]

The calculations themselves are relatively straightforward. Since nonprofits generally have fairly accurate data around their programs' earned and contributed revenues, once they have a comparably strong understanding of their full program costs, they can match program revenues to costs in order to determine each program's net contribution. This approach makes the economics of the organization transparent; it also represents a considerable departure from the way in which nonprofits historically have considered their program finances.

Many nonprofit executives still think about the revenue side of their organization separately from the cost side; and as long as total revenues are sufficient to cover total expenses, they tend not to calculate whether individual programs are "earning" or "losing" money. This approach is all the more attractive for the many nonprofits in which costs historically have been bundled into financial categories that basically tell you nothing about what the costs actually do. Capturing and allocating full cost data properly is difficult enough when it's done from the start. Recasting historical data (which often consists of people's time) is truly hard to do.

The value of persevering and developing these calculations lies entirely in their ability to highlight situations in which program economics are out of line with mission-driven priorities. Cognizant of which programs contribute positively to the organization and which represent a net drain on its resources, decision makers can examine the flow of funds within their portfolio of services to make sure that their allocations are supporting—and not undermining—the organization's desired impact and focus.

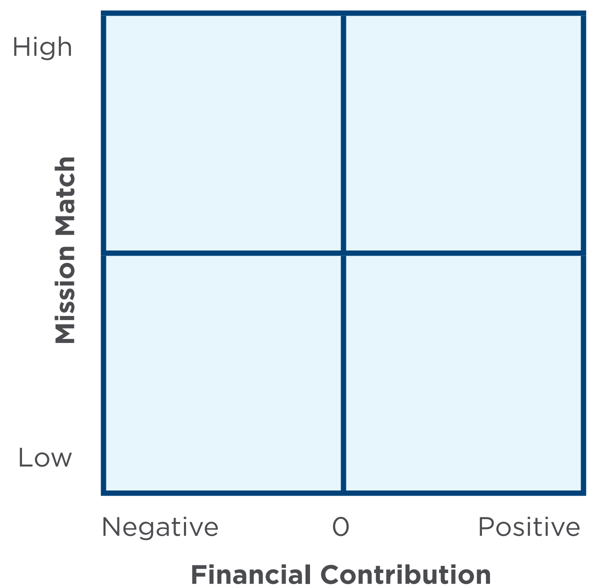
Clarity around the full costs and net contribution of each program may appear at first glance to be heavily profit-focused. In fact it is simply a useful tool to help nonprofits craft strategies that allow them to maximize their mission-related impact. Like all tools, it comes with operating instructions, which begin with the reminder that for nonprofits, evaluating programs on the basis of their financial contribution alone presents only one side of the story. There is no question that organizations have to maintain financial health if they are to remain viable. But viability loses its meaning in the absence of mission. To be successful, nonprofits have to manage both bottom lines simultaneously.

This imperative explains why nonprofits have varying motivations for the activities they undertake. While many programs may be intended to achieve both goals—

3 For another perspective on this topic see Robert E. Gruber and Mary Mohr, "Strategic Management for Multiprogram Nonprofit Organizations," California Management Review, 24/3 (Spring 1982) 15.

furthering the mission and contributing to financial sustainability—in practice each will favor one more than the other. Recognizing and being explicit about which programs serve which purpose allows organizations to ensure that their activities strike the balance they desire.

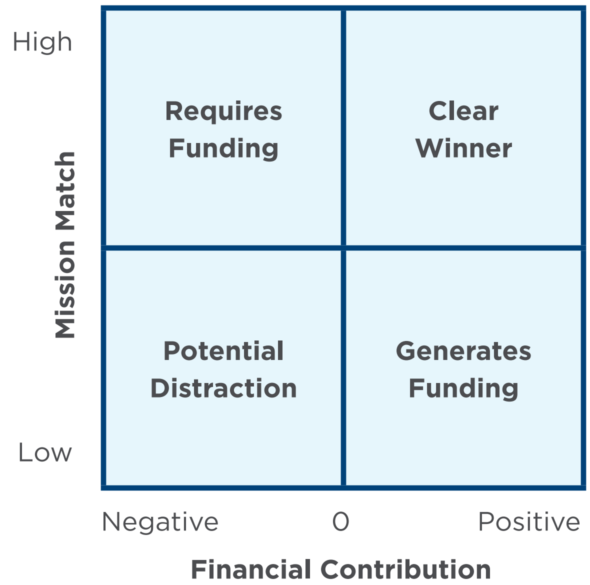
Gaining this overall clarity starts with assessing the extent to which each individual activity or program corresponds with the organization's mission and/or contributes to it financially. A matrix that incorporates both mission alignment and financial contribution makes this framework concrete.



The framework consists of two components: "Mission Match," which appears along the Y-axis of the matrix, and "Financial Contribution," which is plotted along the X-axis. Assessing a program's financial impact is a quantitative challenge: analysis of the organization's full costs and revenues will provide insight into the position of each program relative to the financial contribution axis. Determining each program's mission alignment presents a more qualitative challenge, because it requires the organization to consider how closely the program's objectives, beneficiaries, and activities match its central mission and to make corresponding value judgments. Getting clear about what is "high" or "low" mission is a challenging activity, which often raises questions that go to the core of what an organization is about. Positioning each program within the mission-match/financial-contribution framework forces organizations to be clear about the purpose of each of their activities.

Once all of an organization's programs have been evaluated on both dimensions, its leadership will be better positioned to make strategic decisions about them.

Returning to the matrix, the organization can classify programs according to the quadrant with which they correspond and then identify opportunities for each one's future strategic direction.



For programs that fall into the top right quadrant (high mission match and positive financial contribution) and those that fall into the bottom left quadrant (low mission match and negative financial contribution) the strategic implications are relatively straightforward. Organizations should seek to expand the "clear winners" and either identify ways to increase the mission alignment and revenue-generating ability of the "potential distractions" or else exit these draining programs altogether.

The implications are less clear for programs that fall into the top left and bottom right quadrants. For programs that require funding (high mission match but negative contributors), it makes sense to try to identify revenue-generating opportunities, even if this ultimately proves impossible. It is also worth taking the time to evaluate explicitly the trade-offs between the programs' importance to mission and the costs of funding them. Programs that fall into this quadrant may always "cost" the organization money and require it to earn income somewhere else or raise more in contributed funds; that's fine as long as their impact on mission warrants it. The important thing is to know that's where they are—and what they need. Conversely, for the programs that generate funds (low mission match but positive financial contributors), the organization can explore ways to align them more closely with the mission as well as evaluate the trade-offs between their financial benefits and the costs of mission divergence.

Making Full Cost Data Less Elusive

Understanding the true costs of programs and services can be difficult for reasons that will sound familiar to both nonprofit veterans and novices alike. Nonprofit financial and reporting systems, the culture of many nonprofit organizations, and the funding environment in which nonprofits operate all work to obscure true-cost information or make it unnecessarily difficult to obtain. None of these obstacles is likely to prove insurmountable, however, once nonprofits and their funders agree not only on the importance of good data but also on what each party must do—or cease doing—to make it more readily accessible.

Introducing more fully developed financial and accounting systems into nonprofits is an obvious first step. Most nonprofits have only rudimentary financial systems, and the standard accounting packages on which they tend to rely are seldom conducive to tracking and understanding the true costs of operation. Nonprofits aren't alone in this situation: the accounting systems in some businesses also fail to provide an accurate picture of their true costs. But because the success of for-profit companies depends on their ability to generate profits, most managers have a strong interest in understanding the true financial performance of their various product lines, even if their systems don't automatically provide them with the relevant data. In contrast, for many nonprofits, focusing more than a modest amount of money and attention on understanding such traditionally commercial matters as costs represents a diversion of valuable resources from activities that further the organization's mission.

Other cultural elements also play a part in making economic clarity more difficult to achieve. To take one example, staff labor costs (people's time) represent many nonprofits' single biggest cost, but the culture in most of these organizations isn't conducive to tracking how employees spend their time, so that those costs can be allocated to the relevant activities and programs. Unlike law or consulting, where employees are accustomed to documenting their time in order to assign it to clients, nonprofit employees are not only unlikely to be familiar with such recording systems but also may resist any efforts to quantify the cost of their activities.

Lastly, the capital market in which nonprofits operate pushes against economic clarity in a variety of ways. Many funders seems to create incentives—albeit unintentionally—that encourage organizations to distort their costs. For example, they prefer to support programs and projects rather than overhead expenses such as fundraising and administrative costs. (How many funders would be enthusiastic about donating $100,000 or more for a good activity-based accounting system, for instance?) They also tend to prefer providing seed money to support new programs rather than sustain existing ones.

Not surprisingly, many nonprofits respond to these funding preferences by becoming "creative" in their cost allocations. In order to finance current programs and provide for organizational overhead, they allocate the costs associated with these items in ways that match funding resources rather than in ways that accurately reflect how the costs were incurred. Since few nonprofits have the time and other resources to maintain two sets of books—a set for funders and a separate set to be used as a management tool—the misallocated costs frequently become the only ones available, obscuring the true costs of operating programs from the organizations themselves.

The increasing prevalence of ratios that attempt to measure efficiency provides additional incentive for creative accounting. These ratios aim to disclose information about the sums spent on two highly sensitive areas, overhead and fundraising, and they typically measure fundraising and administrative costs as a proportion of total expenses and fundraising costs as a proportion of total contributions. As websites such as Guidestar make nonprofits' financial information readily available to the public, and potential donors increasingly seek quantitative indicators of organizational viability and success, watchdog organizations have responded by setting maximum (and often arbitrary) levels of expense accountability and by using these ratios to compare organizations with one another. Aware that donors prefer to give to organizations that will use all or most of the donation to support programs, nonprofits strive to appear efficient: for example, by using book-keeping techniques such as joint accounting that allow considerable leeway in classifying expenditures.

Given all these considerations, it is not surprising that few nonprofits are aware of the true costs of running their programs. The staffs of nonprofits are neither financially incapable nor deceptive by nature. Rather, they are responding rationally to market forces in order to ensure their survival, and these incentives neither encourage nor support accuracy in tracking costs and reporting financial information.

Competitive forces of many kinds increasingly shape the world that nonprofits inhabit. Within the sector itself, more organizations are competing for scarce resources such as funding and staff. Nonprofit start-ups appear with startling regularity. For-profit businesses continue to enter the marketplace in growing numbers in industries such as health care and education. To participate successfully in this new environment, nonprofits must be able to articulate coherent, well-structured strategies that will allow them to deliver on their chosen mission. Economic clarity is an invaluable—and essential—input to this work. For today's nonprofits, accurate cost information may prove to be priceless.

Appendix: What Are Full Costs?

The term "full costs" underscores the need to take into account all the costs of running a program when trying to evaluate its financial impact, not simply those that are directly associated with its production. To illustrate, consider an organization that runs an after-school center, which offers art classes and a youth soccer program. The direct costs for the art classes include all the materials and supplies used in the classes, the salaries of the teachers, and the snacks provided during class. Similarly, the direct costs of the soccer program include the equipment, the salaries of the coaches and referees, and the fees for renting practice fields. Connecting these costs with the specific activities to which they relate is straightforward, because they are, as their name suggests, incurred directly in providing the activities.

The after-school center has other expenses, however, that can't easily be attributed directly to either program yet nonetheless support them both. The salary and benefits of the executive director and other administrative staff who coordinate the center, the rent and utilities for the center's facility, and the printing and postage expenses for the organization's monthly newsletter all fall into this second group of expenses, which are called indirect costs. Indirect costs are incurred outside the production of a particular program or service and, as their name suggests, they cannot be directly assigned to any one program in particular.

Most organizations have a good understanding of the direct costs incurred by their programs. To arrive at the full costs of running those programs, however, it is essential to allocate their indirect costs to them as well. Allocating indirect, or overhead costs to programs helps make the economics of providing those programs more transparent. Returning to the after-school center example, this would require assigning a portion of the administrative, facility, and mailing expenses to both the art and the soccer programs, so that the organization can gain a clearer understanding of the true costs of operating each.

Ignoring indirect costs can paint a misleading picture of the economics of performing different activities, and this, in turn, can have potentially mission damaging consequences. For example, the after-school center might charge a fee to participants in the soccer program in order to cover the cost of running it. But if the organization has failed to account for the indirect costs associated with the program, the fees paid by the participants will not suffice, and the program will actually be operating at a deficit. Moreover, if the staff doesn't realize that the program represents a financial drain on the center's resources, it might well decide to expand it, which could potentially endanger the viability of the entire organization.

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