True Cost Accounting: The Allocation of Social Costs in Social Purpose Enterprises

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Farber Intern 1997

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Introduction

The Roberts Enterprise Development Fund (REDF) is a social venture capital fund based in the San Francisco Bay Area. The REDF portfolio is made up of seven nonprofit organizations operating 23 social purpose enterprises[1] employing very low-income and homeless people. In its experience working with nonprofit managers to operate these businesses, REDF has become aware that traditional, nonprofit approaches to accounting would not generate the type of information necessary to effectively manage the businesses. Specifically, on the revenue side, traditional nonprofit accounting consolidates revenue sources (in this case, both sales and grant revenue). This distorts "true" sales figures, making it difficult to assess the performance of the venture. At the same time, traditional nonprofit accounting methods do not allow the standard costs of a nonprofit (what we refer to as "social costs"), to be adequately tracked and documented separate from those of a mainstream business in the same sector.

This inability to understand social program cost versus business enterprise cost makes it impossible for managers to develop an accurate assessment of the success or failure of the business. Without separating social program from business costs, one cannot assess how well the business is doing as a business. And, similarly, one cannot assess what true social program expenses are incurred by a social purpose enterprise, but not by its for-profit counterpart. In order to understand the true cost and benefit of engaging in social purpose enterprise development, accounting systems must be in place to provide managers with sound data upon which to make operational decisions. And such systems are critical to outside, charitable investors seeking accurate information regarding how funds are applied and what leverage they achieve toward the attainment of social goals.

This issue of achieving accurate accounting for social and enterprise costs has been a theme throughout the nine years The Roberts Foundation has supported nonprofit work in this field. The Foundation first presented its framework for "true cost accounting" in its 1996 report, *New Social Entrepreneurs: The Success, Challenge and Lessons of Nonprofit Enterprise Creation.* Other reports and publications of the Foundation explore various aspects of measuring the impact of social purpose enterprises and the role of philanthropy in supporting the development of the field.[2]

With the creation of REDF in January of 1997, The Foundation began working with its partner investees to formally analyze the challenge of accounting for the "true costs" and financial/social returns of operating a social purpose enterprise. That process has been called the Social Return on Investment Project and is fully described in this book's chapter on Social Return on Investment. Suffice it to say that without the ability to isolate the social cost of a social purpose enterprise, there is no way to fully understand what social returns may be generated by philanthropic or other investments. For this reason a True Cost Accounting Analysis becomes critical to both practitioners and philanthropic investors.

True Cost Accounting Analysis (TCAA)

This chapter, "True Cost Accounting: The Allocation of Social Costs in Social Purpose Enterprises," is the product of a crosscutting analysis of REDF portfolio organizations. The intent was to assess how various organizations have and are attempting to account for the social costs of their social purpose enterprises. It would be presumptuous to believe this small sample is completely representative of all organizations involved in the operation of social purpose enterprises. Nevertheless, the REDF portfolio does represent a good cross section of organizations presently active in the field. Many of the organizations in the REDF portfolio have operated such ventures for a number of years and have approached their work with a great deal of strategic intent. Historically, nonprofit organizations have not thought in terms of the social costs of their enterprise activities. They have, instead, operated with accounting systems that allow for "hidden" subsidies of losses or costs incurred as a result of their social mission. By contrast, REDF portfolio organizations have worked to establish accounting systems that move beyond that practice.

REDF's analysis of the use of "true cost accounting" among the enterprises in its portfolio yielded much data, and several noteworthy conclusions. Chief among them is the fact that due to the demands of operating any business venture, very few of the business managers have had the time, resources or inclination to do a thorough study of the social costs they incur in their businesses. Most social purpose enterprises inherit the operating and management information systems of their parent organizations and, naturally, since most nonprofits do not differentiate "social costs" as part of their accounting and MIS infrastructure, these systems are not in place for use by managers.

Even managers who have thought about the issues involved in social cost accounting and have attempted to break out some of these costs on their financial statements will readily admit they still have a long way to go. Defining what is and is not a social cost is a difficult task that often necessitates a level of detail in cost accounting that is well beyond current practice in the nonprofit community.

In actuality, most business managers are relying on their experience, gut feelings, limited time studies and observation of day-to-day activities to estimate their social costs. With few exceptions, the present "state of the field" is that managers will periodically

- estimate how much time they spend on mission-related issues as opposed to business issues,
- count up the hours their employees spend in special training sessions above and beyond industry standard training,
- calculate/estimate their productivity levels versus those of a mainstream business,
- compare the wages they offer with those at similar, for-profit businesses, and perhaps
- allocate the wage premium to social cost line items in their budgeting/accounting process.

Another practice is for managers to simply look over their entire operation and choose a percentage of operating costs that they feel honestly reflects their social costs. This percentage is then used as a general allocation ratio when separating social costs out on the income statement.

While the lack of systemization and rigor in this area makes it difficult to define specific frameworks that can be used for accurately quantifying social costs,it is clear that organizational structure is an important determinant of where these social costs can be found. The relationship between the parent nonprofit,the social purpose enterprise and the training programs that serve the employees of the enterprise is significant in alerting us as to where to look for social costs,and in telling us how accurate our social cost analysis will be. We now turn to such a discussion.

Nonprofits and Social Purpose Enterprises: A Typology of Organizational Structures

The social purpose enterprises in our study were all operated as programs of a parent 501(c)(3) nonprofit organization. We refer to such an organization as the "parent nonprofit." In no case were the social purpose enterprises for-profit subsidiaries of a nonprofit; nor were they independent for-profit corporations. In general, the organizations reviewed in this analysis fell into the three types: Integrated, Connected and Divisional. This section presents three fictitious organizations to represent each type.

In some cases the parent nonprofit's sole mission is to run small businesses as vehicles to train and employ members of some defined population. This type of enterprise is "Integrated." We will use the fictitious "Operation WorkFirst" as an example of this type of nonprofit.

> *Operation WorkFirst is a small, urban nonprofit operating a flower shop, sandwich cart and delivery service in BigCity, USA. They began operations in 1991 with the goal of providing on-the-job vocational training and support to disadvantaged young adults between the ages of 16 and 26. They focus all of their energy on hiring, training, mentoring and otherwise supporting these youth, preparing them to find employment and succeed in the mainstream labor market.*

Other parent nonprofits have more broad-based missions, and have multiple programs serving one or more constituencies. One or more of these programs may involve the operation of small businesses, while others may be social service programs independent of the business and serving a client population that may include, but is not limited to, employees of the business(es). This type of enterprise is "Connected." We will use "BC Services" as an example of this type of nonprofit.

> *BC Services is a 40-year-old nonprofit serving the homeless population of BigCity, USA. They provide transitional housing, a meals-on-wheels program, day care, mental health counseling, clothing repository and resume/cover letter/interviewing workshops for homeless individuals. Several years ago they started a painting business in order to provide employment and training to some of their clients. All of the employees of the painting business benefit from the entire range of BC Services programs. The training is integrated with the running of the business, and thus employees are learning on the job.*

A third type of parent nonprofit runs one or more small businesses for employment purposes, but also has a separate program for providing job-readiness and job-skills training to a broader range of individuals. Such an organization may also provide other services to the community and may be labeled as "Divisional." We will use "Community Chest" as an example of this type of nonprofit.

> *Community Chest is a large nonprofit serving multiple constituencies in BigCity, USA. They are organized into several "divisions," or program areas: Housing (providing transitional housing and assistance locating and securing housing), After-School Programs (providing after-school enrichment programs for children ages 4 to 18), Health Services (sponsoring a local clinic for health screening and referral), and Vocational Training (a three-month training program for hard-to-employ adults which helps prepare them for obtaining a job). Community Chest also started a business–BizKlean–several years ago, which hires graduates from its own and other vocational training programs to further assist them in acclimating to the work environment and to provide them with more mainstream work experience.*

Operation WorkFirst, BC Services and Community Chest are all nonprofit organizations with missions that have led them to start and operate social purpose enterprises. As such, these enterprises are held to a "double bottom-line;" to be successful they must generate revenue (at least enough to cover their costs) and fulfill their social mission. All three of our example organizations have structured themselves differently, however. They represent the three types of organizational structure that we found in our research with the REDF portfolio.

Identifying Social Costs in Each Organizational Structure

There are numerous costs to running a social purpose enterprise that can be attributed directly to the sponsoring organization's social mission or the social mission of the business. Many of these are found within the business itself. Examples of the social cost often carried by a social purpose enterprise are:

- a lower level of productivity among employees,
- increased materials wastage,
- time spent addressing employees' personal issues,
- employee time spent with job counselors,
- employee time spent involved in support groups or other support activities,
- higher insurance rates that may need to be paid for certain types of employees,
- additional management and supervisory costs of managing such an enterprise,
- increased employee turnover.

The specific social costs incurred will vary with each organization and business depending upon the actual social mission of the parent nonprofit and other factors. Additional costs can be traced more directly to the training many employees need before they can start working at all.

Still other costs stem from the interaction of the business staff and the parent nonprofit staff:

- meetings to coordinate services and policies,
- presentations by the business managers to the nonprofit board,
- fundraising done by nonprofit staff for the benefit of the business,
- tours and site visits which take the manager away from the day-to-day responsibilities of operating the business.

Identifying all of these additional social or mission-related costs is no small task, and depends on how the nonprofit interacts with the enterprise, and how the relationship between the two is structured. To illustrate, we will diagram the structures of our three sample organizations.

Defining our terms:

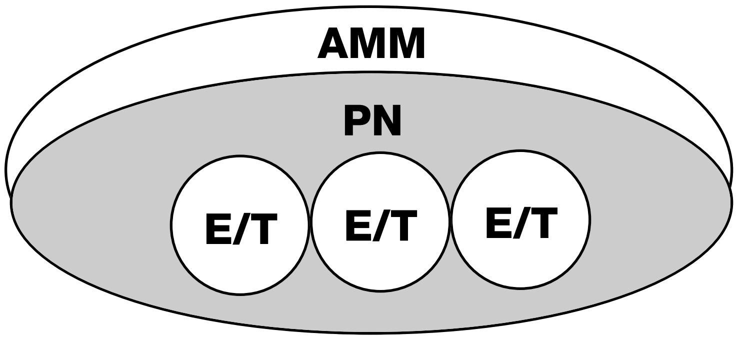
In the following diagrams,

- 'PN' will denote the parent nonprofit in each case. The parent nonprofit provides oversight of all programs, enterprises and activities run by or under the auspices of the nonprofit, and is headed by an executive team and a board of directors.
- 'E' represents a social purpose enterprise run by the nonprofit.
- 'P' represents other, more traditional programs run by the nonprofit.
- 'T' represents the vocational training element of the nonprofit's mission. 'T' can be either integrated with the operation of the business enterprise, or a wholly separate program.
- "AMM" represents the functions of accounting, MIS and management that

are often spread between the organizational entities.

Using these symbols, we can diagram our three sample organizations as follows.

Operation WorkFirst – An “Integrated” Organizational Structure



- Operation WorkFirst: a parent nonprofit operating three businesses,each with integrated training functions.

- Accounting, MIS, and management for the three businesses are done at the level of the parent organization. In an “Integrated” organization, separate financial statements may be prepared for each business, but are most often all prepared by the same central accounting person or department based on information gathered from the business managers.

In this type of organization, social costs for each business can be found in the consolidated financial statements of the parent nonprofit. All costs of the parent nonprofit are, in effect, social costs to the business, since the parent exists only to perpetuate the social mission of the businesses. While COGS, labor costs, training costs, etc. can be identified for each individual business based on its independent financial statements, the true social costs of the businesses will be found both at the business level and at the level of the parent nonprofit.

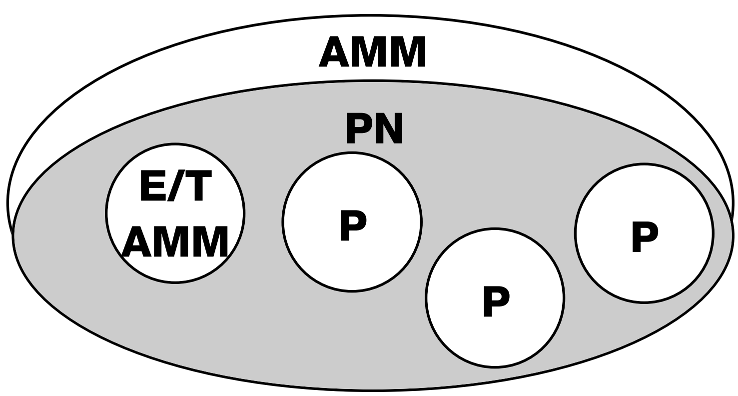
- BC Services: a parent nonprofit running one business and several other more traditional social service programs. All vocational training takes place on the job, within the business.

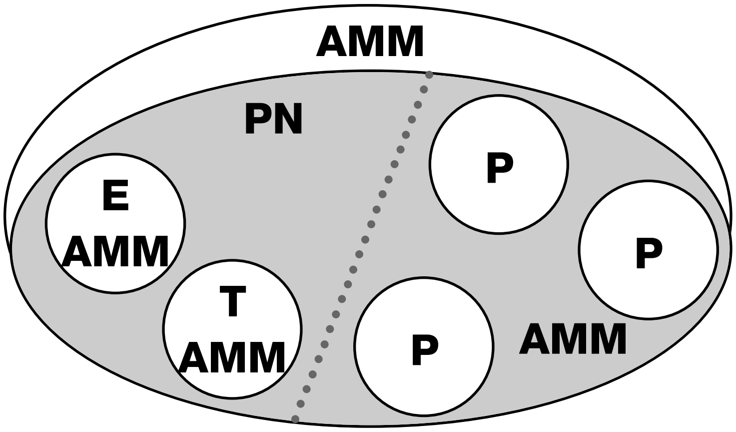
- Much of the accounting, MIS and management for the business is done within the business itself (though under the guidance of the parent nonprofit), with financial information then being fed to the parent nonprofit’s central system, and integrated with the parent’s reports.

In this type of organization, social costs for each business can be found in the financial statements of the business, as well as in the consolidated financial statements of the parent nonprofit. Unlike the integrated organization, however, not all costs of the parent nonprofit can be considered social costs of the business. Care must be taken to identify the resources of the parent that go to the business, and then to differentiate which of those resources should be considered business costs and which social costs.

A traditional small business, for example, would probably hire an accountant to prepare some amount of financial information. If the business manager handles his or her daily inflows and outflows, but then passes the files to the nonprofit’s accountant for final report-

BC Services — A “Connected” Organizational Structure





ing, the cost of the parent's accountant should properly be considered a (business) cost of the business. On the other hand, if the development director of the parent nonprofit spends time soliciting donations of subsidy funds for the business, the cost of that person's time should properly be considered a social cost of the business.

Community Chest – A "Divisional" Organizational Structure

- Community Chest: a parent nonprofit organized into "divisions," or quasi-independent programs that operate apart from each other. A primary differentiator for our purposes is that the parent nonprofit operates a workforce training program that is separate from its business, and training is provided to non-employees of the business, as well as to employees and future employees of the business.

- As with the connected organizational structure, much of the accounting, MIS and management for the business is done within the business itself (though under the guidance of the parent nonprofit), with financial information then being fed to the parent nonprofit's central system, and integrated with the parent's reports. This is also the case for the training program, and may be the case for one or more of the other programs run under the auspices of the parent nonprofit.

In this type of organization, social costs for each business can be found in the financial statements of the business, the financial statements of the training program (assuming that at least some trainees from the program make their way into the business when they finish the training program), and in the consolidated financial statements of the parent nonprofit. Once again it is important to look carefully at the various costs (both social and business) incurred by each division, and by the "umbrella" of the parent. Costs attributable to the business or the enrichment of its employees should be allocated first to the business, and then to either the "business cost" or "social cost" category.

Allocating Social Costs – The Challenge

When an entrepreneur starts up a small business on his or her own, it is fairly easy to identify the costs of doing so. With few exceptions, the business itself bears all costs of operations. As we have seen above, it is somewhat different in the world of social purpose enterprise. A parent nonprofit, other social service programs, other activities run by the parent nonprofit, donors or volunteers may all bear some portion of the costs to make the business successful. If the mission of a nonprofit-sponsored business is to train, employ, and serve at-risk youth, for example, is the cost of educational enrichment programs that encourage the attainment of a GED a social cost of the business or a program cost of the parent nonprofit organization? At some point those analyzing appropriate costs must draw a line between one organizational program and another.

Our research has led us to one possible approach that may clarify these issues:

First, an organization must clearly understand and state its mission relative to the social purpose enterprises it operates. Is the mission to simply generate revenue for the parent nonprofit? Is it to employ a given population? Is it to both employ and train a given population? Or is it to employ, train and educate a given population?

Second, having clarified its social mission, the organization must then clarify the definition of success for its business. It is our position that social purpose enterprises operated by nonprofit organizations must first and foremost embrace the core mission of operating *with no significant net loss* to the business. Presently, many social purpose enterprises operating in the United States operate at a loss—and that loss is often justified by management as "the cost of our social mission." This approach makes it both impossible to manage the enterprise with any true sense of business discipline and prevents organizations from ever being able to truly value the social cost carried by their enterprise.

We are not saying all social purpose enterprises must always operate on a break-even or profitable basis. In fact, some of the stronger organizations we have seen over past years are those that generate significant revenue from their activities, but still operate at some level of subsidy in order to achieve their social mission. What we *are* saying is that if practitioners expect to contract with market-based customers and identify themselves as social entrepreneurs they must have the ability to track all costs and revenues accurately before adding in the social cost they carry by virtue of their social mission and community commitments. In a phrase, they must understand and be able to quantify their "true" costs and not simply bury those costs within the financial statements of the organization.

Third, having clarified the core goal of the business, one may then address the business's social purpose. Is the mission to successfully transition people off welfare, and provide them with opportunities for long-term employment after they leave the social purpose enterprise? Or is it to provide transitional employment for the period of time that they are employed by the enterprise? This brings us back to the social mission of the nonprofit parent organization: if the mission is clearly defined, it will be easier to identify when an enterprise has succeeded in fulfilling its part of that mission and what costs it incurs in doing so.

Finally, the managers of both the parent and social purpose enterprise must agree upon what will be considered the "true" costs to the business enterprise of fulfilling that social mission. These costs are not always easily found within the typical business financial statements or information systems, and, in fact,a second type of report may be needed to accurately describe the total social costs being carried by the business.

Social Costs and Subsidies:

Before leaving this discussion of social versus enterprise costs,it must also be acknowledged that there are social costs that in many cases are carried by *neither* the business nor the parent nonprofit organization. These costs are those covered by nonprofits in the larger community that provide various supports to the employees of the social purpose enterprise. Such costs may be thought of as social subsidies and could include programs such as:

- Childcare
- Substance abuse counseling
- General support services
- Housing support
- Educational services

These are all very real social costs which may best be thought of as being carried by society, the provision of which help make for the ultimate success of the business and its employees or trainees.

In traditional, for-profit accounting such costs, and the fact that society will pay them, are largely taken for granted. While a mainstream business may budget for the cost of training employees on a particular piece of equipment or manufacturing process, it does not factor into its *own* cost structure the potential costs carried by the larger society and paid for largely by the taxes of individual taxpayers. Indeed, it is standard for-profit practice to off-load as much of one's cost structure as possible to outside entities—for example, the logging industry's use of the Forest Service to build access roads into wilderness areas slated for harvesting. A critique of this for-profit practice is beyond the scope of this paper, but its implications for social purpose enterprises are clear: those involved in the operation of social purpose enterprises must be aware of the existence of such costs,taking steps to assure they are honest about whether those costs contribute to the success of their own efforts, even though tracking the costs is beyond the current capacity of nonprofit information systems.

Getting There from Here: The Challenging of Incorporating a Social Cost Accounting System into Traditional Nonprofit Accounting Structures

As the field of "social entrepreneurship" has received increasing attention in recent years, and as the work of The Roberts Enterprise Development Fund has gained greater visibility, our office continues to receive numerous calls from practitioners engaged in various types of social purpose enterprise development. Many of these practitioners claim to be "doing what REDF does," yet, upon closer examination, we find the field to be highly fragmented, with many different approaches and various degrees of sophistication of analysis. In addressing the challenge of how nonprofits approach accounting for their social and enterprise activities, we have found it difficult to successfully frame the field's best practices and approaches to social cost accounting. Moving from current practice to greater incorporation of social cost accounting systems would appear to involve four primary considerations:

Time Frame:

The transition from current to future practice will take place over a period of years. The current state of nonprofit accounting and management information systems is relatively poor. Nonprofit organizations have historically been funded to provide services and address charitable needs—not account for cost centers and allocate resources accordingly. Improving management and accounting practice in the nonprofit sector has been a goal of organizations such as The Management Center and The Support Center, in partnership with others, for many years. Despite these efforts, we have a long way to go.

For the purpose of The Roberts Enterprise Development Fund, we view this process as taking place over a five-year timeframe. During this period it has been our intention to evaluate the accounting systems represented in our own portfolio and assist our funded organizations in achieving the highest level of confidence possible. Many REDF organizations are on their way to meeting that goal well in advance of the five-year period. We set that limit to reflect our awareness of the degree of complexity involved in analyzing an organization's financial reporting system, designing more effective systems and getting those systems on-line and in use by operations managers.

We encourage our funding colleagues to support such a multi-year strategy with their own grantees and, when possible, jointly with other funders. This is not a goal foundations will achieve simply by placing "accurate accounting systems" as one more criteria by which funding is awarded. It will take many years of honestly assessing current systems and building better ones before the field will achieve the standards we are calling for. However, with those standards in place, those involved in the field will be in a better position to successfully argue for increasing both financial commitments and the expected outcomes achieved through those philanthropic dollars.

Accounting Systems Development:

Current accounting systems assist managers and funders in monitoring the operations of nonprofit organizations running social purpose enterprises. The accounting systems of these organizations fall along two tracks: business accounting and social cost accounting. Presently, in our own portfolio, there is greater expertise at managing the business accounting systems than the social cost accounting systems. From the contacts we have had with other organizations across the country, we suspect the degree of development in these areas in the field as a whole is even less advanced. Initially, we have assessed how well these systems operate within the REDF portfolio and are developing strategies with each organization to create better, more accurate systems with the high degree of automation needed to be of real use to both managers and those who invest in their work.

Degree of Integration:

Initially, most organizations begin with one nonprofit accounting system in place. These systems often have various degrees of accuracy and provide little in the way of meaningful data for use by business managers.

As one step to securing the information they seek,some managers layer secondary systems to track the business operations of the organization. These systems are seldom well integrated into the larger organization and often do not reflect the total cost of managing a social purpose enterprise. The accuracy of their social cost estimates is questionable in that they are often based on "gut" assessments. However, they represent an improvement over many of the systems otherwise in use and are best thought of as a transitional stage in accounting system development.

With such dual systems in place, however, organizations are positioned to conduct formal time studies that may be used to generate annual "allocation ratios" for use in assigning social and business costs. Such studies may be implemented at various points (annually, quarterly, etc.) in order to gauge various costs incurred during that time and assign those costs to the appropriate cost center, whether social or business.

The ultimate goal is the creation of a wholly integrated accounting system that accurately tracks the business functions, the social costs of the enterprise and any additional social costs of the parent nonprofit. Such systems will provide a full and accurate picture to all involved regarding the revenue and expense picture of the organization and its various programs/businesses.

Investment Grade:

Finally, with these systems successfully in place, the field will be able to establish standards that could lead to formal investment grades for nonprofit organizations. These grades could be the composite valuation of an organization's ability to achieve its stated goals, both social and business. Organizations with lower investment grades might be those in a start-up or expansion stage, which encounter greater program and organizational risk. Others which have proved not only the integrity of their program design, but the management of their organization, could be viewed as "higher" grade and worthy of support in addressing their needs to expand and sustain their efforts. A companion chapter addresses the concept of social return on investment in greater detail; suffice it to say, however, that unless we increase the accounting and general management standards for the field as a whole, our ability to intelligently choose our "investments" in the social and charitable future of our communities will be greatly limited.

Conclusion

This chapter has presented three organizational "types" for understanding how nonprofits structure their accounting systems and the degree to which those systems provide managers and outside investors with accurate, reliable data upon which to base decisions. Our vision for the field is based on the assumption that social purpose enterprises operated by nonprofit organizations require accounting systems able to accurately track the "true" costs of pursuing a social mission through a market-based business. We conclude by challenging the field to increase the accepted standards of practice and embrace a more sophisticated approach to accounting for the social investments required to achieve the community goals of a social purpose enterprise.

The Development of Social Cost Accounting Systems

TIMEFRAME (T=FY)	The Field	T_0 The REDF Portfolio		T_5
ACCOUNTING SYSTEMS DEVELOPMENT Business Accounting Systems: Social Cost Accounting Systems:				
DEGREE OF INTEGRATION	Overlapping systems with no capacity to appropriately track or assign true social or business costs	Dual **Business** **Social Costs** (Estimates)	Dual (Time Study)	Integrated (Operating Systems)
INVESTMENT GRADE	No standards to accurately grade organization or operating systems across the sector	Grade BBB	Grade B+	Grade A

Footnotes

1 Presently, the field makes use of terms such as social purpose businesses, nonprofit enterprise, training businesses and a number of others to refer to a nonprofit organization operating a revenue generating venture as part of its social mission. This chapter uses the term “social purpose enterprise.”

2 In addition to the referenced book, other related documents are available through the REDF office or from our web site at www.redf.org.