

Quantifying Social Costs: A Case Example from Rubicon's Buildings & Grounds Business

By Kim Starkey

Farber Fellow, 1998 - 1999



As a result of their commitment to pursuing both economic and social goals, social purpose enterprises will inevitably face social costs. Social costs are the additional costs, above and beyond regular

business costs, that are incurred in pursuing a social mission. For instance, in providing training opportunities to its target population, Rubicon Programs' buildings and grounds maintenance business faces two major social costs:

- ◆ First, its employees are less productive than those in private sector firms, making labor costs higher.
- ◆ And, second, Rubicon's unique workforce requires extra supervision, making supervisory costs higher.

If the enterprise uses traditional private sector financial reporting, these additional social costs are not differentiated from ordinary business costs, distorting our view of the enterprise's performance: social costs remain buried in line items for standard business costs. For example, suppose that 30% of a manager's time is devoted to "extra" tasks necessitated by the challenges faced by the social purpose enterprise's labor force. Under traditional financial reporting, all of the manager's salary might be included in the "administrative expense" line item. Doing so, however, would overstate administrative expenses, and thus result in lower net income. Because social costs are the additional costs

resulting from a *social* mission, they need to be differentiated from *business* operating costs in order to allow the business managers to understand what component of business activity is related to the core operation and what component reflects the pursuit of the social mission.

Therefore, a more useful approach to financial reporting for social purpose enterprises is to distinguish social costs from ordinary business costs. This goal can be achieved by calculating social costs and listing them separately. Thus, in the above example, 30% of the supervisor's wages and benefits would be placed into a separate line item called social costs. Social purpose enterprises within the REDF Portfolio do this with an income statement that has two "bottom lines:" the first net income line ("net income before social subsidies and costs") provides an accurate picture of how the social purpose enterprise is doing as a business. Social costs are shown beneath it. "Net income after social subsidies and costs" can then shed light on how the enterprise is performing as a social purpose enterprise.¹

The Advantages of Accounting for Social Costs

Distinguishing social costs from ordinary business costs is advantageous for several reasons. First, "net income before social costs" reflects true business costs, thereby enabling managers of a social purpose enterprise to compare their performance with other players in the industry and make informed business decisions. Knowledge of the extent to which a social purpose enterprise is profitable as a business should shape every strategic and operational decision made by management. In addition, the ability to assess a social purpose enterprise as a stand-alone business can facilitate the development of a social purpose enterprise's competitive strategy. By making the social purpose enterprise's financials directly comparable to those of other similar businesses, managers will have a benchmark against which to measure business performance. Benchmarking is important because it can inform management

about where cost reduction efforts may be possible and necessary in order for a social purpose enterprise to be competitive. Moreover, understanding a social purpose enterprise's financial performance vis-a-vis for-profit colleagues can help shape strategic decisions on issues such as pricing, expansion, market entry and exit, etc.

In addition to facilitating informed decision making on business issues, accounting for social costs facilitates informed decision making regarding the social mission. Each month, managers can weigh social costs against estimates of social impact. Moreover, managers can track social costs over time to ensure that social costs are increasing only to the extent that estimated social impact is also increasing. In some instances it may be possible to decrease social costs without detracting from the social mission. For example, in some social purpose enterprises, materials wastage

is high because employees have little experience and low skill levels. To the extent that this inefficiency is a result of the enterprise's social mission, it may be categorized as a social cost. Ongoing efforts to improve work habits can be enhanced by quantifying and tracking their effects.

How to Quantify Social Costs

While in future years the field will develop more accurate systems for identifying and charging social costs, at the present time quantifying social costs can be a subjective and ambiguous process specific to each venture. Sometimes, it is unclear what constitutes a social cost. Once social costs facing a particular business have been pinpointed, subjective decisions must be made when addressing the methodological challenges that arise in quantifying them.

It is important to involve a number of different people at all stages of the process of calculating social costs. This will remove personal bias from the process and will ensure greater accuracy. At the same time, however, one individual should be ultimately accountable for the work. That individual should oversee the process of involving a number of outsiders (funders, consultants, etc.) and insiders from within the social purpose enterprise. Collectively, these individuals can help with brainstorming and "thinking out of the box" while providing a useful reality check.

In the effort to accurately represent social costs in a social purpose enterprise's income statement, the degree of precision is a function of the amount of time invested. Given this relationship, it is important to clarify objectives in advance based on the individual circumstances of an organization and managerial goals. There are several key questions to consider, such as:

- ◆ Do you want a quick, back-of-the-envelope estimate?
- ◆ Or is your organization willing to invest the time necessary to obtain a more accurate representation of social costs?

However an organization decides to weigh the importance of social cost accounting, it should consider using the four steps delineated below to determine what social costs to track and how to represent them.²

Step 1) Brainstorm the types of social costs that are significant for your business and assess the likely magnitude of each.

If the social costs facing your business are not immediately clear to you, it might be useful to begin your analysis by thinking about the nature of your business as reflected in the components of its cost base. For example, if you have a large number of trainees and labor is the largest component of your enterprise's cost base, then it is likely your most significant social costs are related to employee inefficiency or additional supervisory time. On the other hand, if you employ trainees and are manufacturing a product made with expensive materials, then wastage might be your most significant social cost.

To ensure you list all of the social costs relevant to your business, request input from as many of the business' staff as possible. These individuals can alert you to any dimensions you have missed or to instances where you have defined a social cost too broadly. Supervisors and other individuals who are involved in the day-to-day operations of the business can be especially helpful in analyzing the additional costs incurred by a social purpose enterprise carrying out a social mission.

Once you have made a comprehensive list of pertinent social costs, make a preliminary assessment of the likely magnitude of each social cost category. While these assessments need not be quantitative, they should at least rank social cost categories (e.g., "high", "medium", "low") in order of perceived importance. This could also be expressed as an estimated percentage of time or expense.

Step 2) Outline the methodology that could be used to quantify each type of social cost and pinpoint methodological challenges.

The next step is to outline the methodology that could be used to quantify each type of social cost. Most methodologies will encounter inherent challenges that should be noted and addressed where possible. Furthermore, it is also useful to outline alternative methods of quantifying each type of social cost.

Social cost accounting is more of an art than a science. A decision about how to quan-

tify additional supervisory costs, for example, might be made by balancing which approach will be most accurate with which approach will be most likely to be completed on a monthly basis. It is important the organization document the approach it will use; then, when management analyzes past performance and revises budgets, or when outsiders challenge methodologies, the organization's clearly enunciated assumptions will make it possible to understand and explain the resulting numbers.

Step 3) Decide which social costs to include in the analysis by weighing methodological challenges and the estimated magnitude of each social cost.

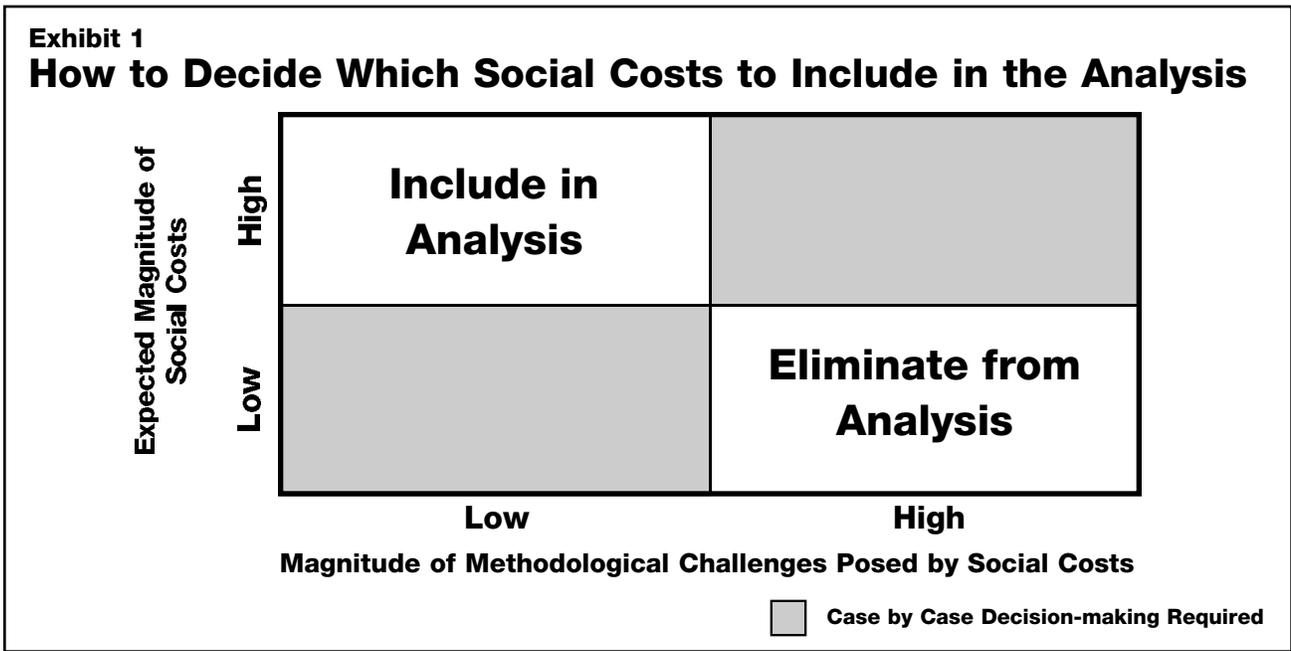
You probably will not end up quantifying all of the social costs that are relevant to your business. Some social costs are likely to be eliminated from your analysis because they pose methodological challenges that are too great or because they are extremely small. Most decisions about whether to include or eliminate a social cost from the analysis should be made on a case-by-case basis. The need to gather and track social cost data is offset by the challenge of doing so successfully. A decision to gather and track particular data makes sense when the costs being tracked are large in dollar impact and the methodological challenges are small. This dynamic is illustrated in the decision-making matrix [Exhibit 1].

On the other hand, it doesn't make sense to track a particular social cost if it has a small dollar impact and will entail large methodological challenges. All other circumstances require case-by-case decision making.

Step 4) Carry out planned methodology; represent social costs in income statement.

After deciding which social costs to include in the analysis, the business should carry out its planned methodology. Where time and capacity permit, it can also be useful to actually carry out two or three different methodologies for quantifying the same social cost. In this way, a social cost is assessed from a number of perspectives in order to ascertain the most accurate figures. If the figures obtained from each of the methodologies are similar, you can be more confident in your analysis.

You must work with your organization's accounting department to capture the total social costs in the income statement. In this endeavor, be careful to avoid double counting. In order to place social costs in a separate line item, one must subtract each social cost from the standard expense line item. In other words, the effort to capture social costs is not an exercise in discovering new costs but rather is a clarification of costs already represented in the income statement.



A Case Example from Rubicon Programs' Buildings & Grounds Business

Rubicon's Buildings & Grounds business was established in 1987 to provide janitorial and landscape maintenance training opportunities for mentally disabled people in Contra Costa County. Between 1994 and 1999, the business acquired several large landscape maintenance contracts that enabled it to create a substantial number of stable jobs and generate net revenues that have contributed significantly to the support and expansion of Rubicon's social programs. The business currently has 70 employees throughout the San Francisco Bay Area, 45 of whom are disabled or economically disadvantaged. During the 1998-1999 fiscal year, the business is expected to generate \$3.5 million in revenues and \$750,000 in net income that will be used to expand the business and support agency programs. In August of 1998, the director of Rubicon Buildings & Grounds decided that I, as the financial manager for all three of Rubicon's enterprises, would spearhead the effort to quantify Buildings & Grounds' social costs. In each step of the process I sought the guidance and perspectives of others, such as supervisors from the field, the director of the business, a consultant from Keystone Community Ventures, and the executive and associate directors of The Roberts Enterprise Development Fund.

My first priority was clarifying, at the outset, how much time we were willing to invest in order to be precise. The consensus was that we should choose a middle path in this tradeoff: while we wanted our accounting for costs to be reasonably accurate, I had limited time in which to complete the project. We agreed that, where necessary, I would use estimates. I approached each of the steps with this middle path in mind.

Step 1) Brainstorm the types of social costs that are significant for your business and assess the likely magnitude of each.

I worked with the director of Buildings & Grounds, supervisors from

the field, and the consultant to brainstorm a list of the types of relevant social costs that would be useful in our analysis. Because Buildings & Grounds is a service business in which labor is the largest component of the cost base, the most obvious social costs involved labor and supervisory time. We listed the following social costs:

Type of Social Cost	Definition	Expected Magnitude of Social Cost
Allowance for Employee Inefficiency	The additional time needed to complete a job due to the disadvantaged nature of labor	High
Extra Supervisory Time Incurred	The additional time supervisors must devote to recruiting, supervising, counseling and paperwork due to the disadvantaged nature of labor	High
Wage Rate Premium	The difference between Rubicon's wage rate and the industry standard, due to Rubicon's mission	Medium
Wastage	Wasted materials (e.g., spilled fertilizers, pesticide, etc.) due to employment of a workforce that is still in training	Medium
Time devoted to funder activities	Time devoted by management to those funder events which does not add direct value to the social purpose enterprise	Low
Time devoted to non-profit-related activities	Time devoted by management to nonprofit-related activities (e.g., giving tours to other nonprofits, etc.)	Low

Step 2) Outline the methodology that could be used to quantify each type of social cost; pinpoint methodological challenges.

After listing the types of possible social costs, I outlined the methodology needed to calculate each type of social cost, and pinpointed the challenges of each.

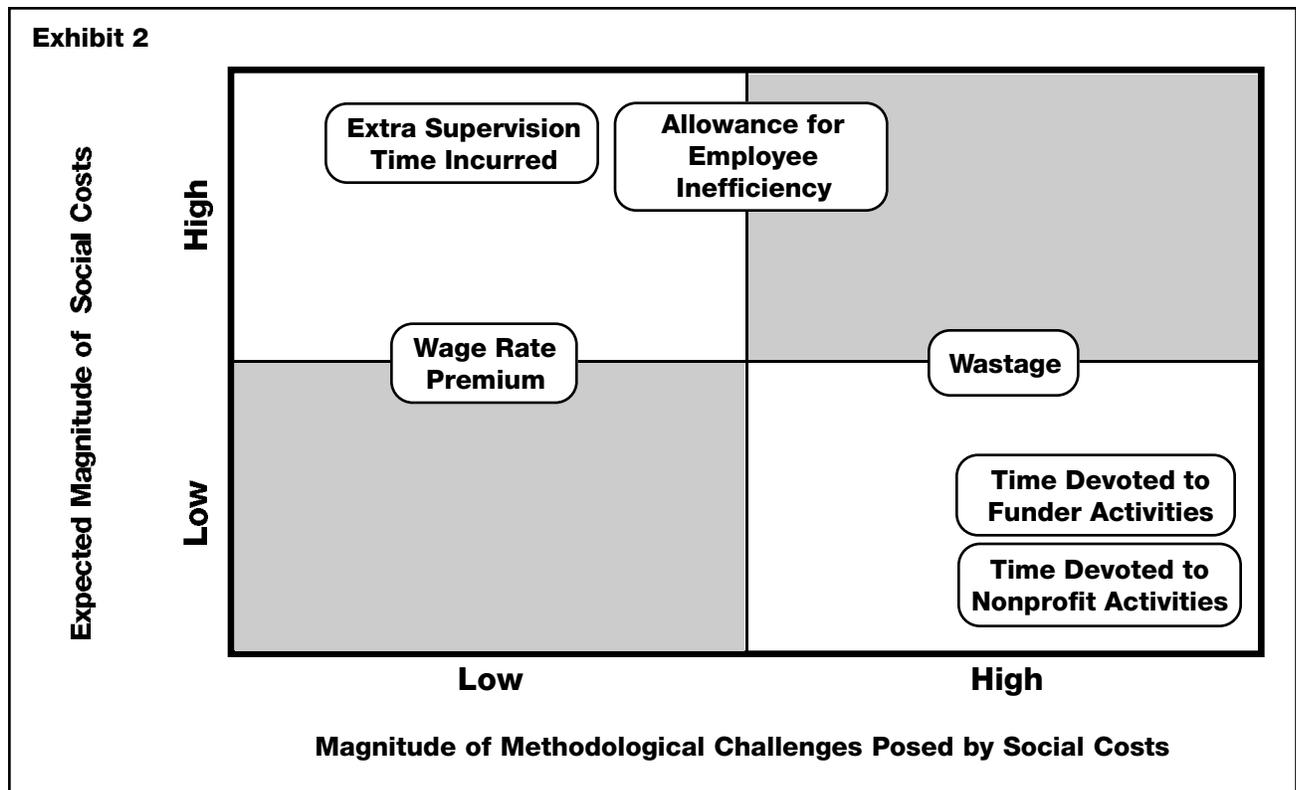
Step 3) Decide which social costs to include in the analysis by weighing method-

ological challenges and the estimated magnitude of each social cost.

I then assessed each type of social cost in light of its likely magnitude (dollar impact) and the methodological challenges of measuring it, in order to decide which social costs to include in the analysis and which to eliminate.

A large expected magnitude (dollar impact) and small methodological challenges pointed toward inclusion of two of the social costs: extra supervisory time and allowance for employee

Type of Social Cost	Methodology for Calculating	Challenges of Methodology	Magnitude of Methodological Challenges
Allowance for Employee Inefficiency	Director of Buildings & Grounds estimates efficiency of each job	Estimates will be based on viewpoint of one person; time studies too time-consuming to perform	Medium
Extra Supervisory Time Incurred	Each supervisor interviewed and asked to estimate number of hours per week spent on activities related to disadvantaged nature of workforce	Based on compilations of opinions/surveys of supervisors; time studies too time-consuming to perform	Medium to Low
Wage Rate Premium	Research industry wage rate and compare with Rubicon's wage rate to determine whether Rubicon's pay rate policies lead to higher-than-market rates		Low
Wastage	Compare amount of materials purchased with estimate of amount needed; conduct surveys, interviews of workers and supervisors	Difficult to discern whether wastage due to disadvantaged nature of workforce	High
Time devoted to funder activities	Track time devoted by director of Buildings & Grounds to funder activities	Social costs of funder activities likely outweighed by benefits	High
Time devoted to activities necessitated by nonprofit status (e.g., giving tours to managers of other nonprofits)	Track time devoted to nonprofit-related activities	Social costs of nonprofit related activities likely outweighed by advantages of nonprofit status	High



inefficiency. Similarly, a small expected dollar impact and large methodological challenges pointed toward omission of two of the social costs: time devoted to funder activities and time devoted to activities related to the nonprofit status. By contrast, medium expected magnitude pointed toward case-by-case decision making for the remaining two types of social costs: wage rate premium and wastage. I decided to include wage rate premium because of its small methodological challenges. I omitted wastage because of its high methodological challenges.

Step 4) Carry out planned methodology; represent social costs in income statement.

Rubicon Buildings & Grounds is a contract business comprised of 12 total contracts. Because costs vary from contract to contract, I calculated social cost on a contract-by-contract basis. I placed each job on a separate spreadsheet that can be utilized and changed as pay rates or other contract circumstances change.

Methodology Used in Each Category Where Extra Supervisory Time Incurred

In order to calculate extra supervisory time incurred, I conducted interviews with supervisors. First I asked each supervisor to estimate the total number of hours per week that he or she worked. Then I asked each supervisor to estimate the number of hours per week he or she spent on the following activities:

Activity	Definition
1) Recruiting	Time spent advertising, finding, interviewing and hiring disadvantaged workers (time that is not necessary for recruiting workers from the mainstream labor market)
2) Supervising	Time spent supervising and training disadvantaged workers (time that is not necessary for supervising other workers)
3) Counseling	Time spent counseling and correcting disadvantaged/disabled workers (counseling that would not be necessary if the workers were not disadvantaged or disabled)
4) Paperwork	Time spent filling out forms, reports and evaluations of disadvantaged workers (paperwork that would not be necessary if the workers were not disadvantaged or disabled)
5) Other	All other tasks and activities

I wanted to ensure as much accuracy in these estimates as possible. Sometimes supervisors' estimates of their hours spent on the five types of activities was higher or lower than their weekly total hours worked. In each case I checked for discrepancies; when I found one, I helped the supervisor adjust his or her estimates. Once each supervisor and I both felt that the various estimates were as accurate and consistent as possible, I summed the hours spent on the first four categories (recruiting, supervising, counseling and paperwork) in order to obtain the total extra

supervisory time incurred by each supervisor. I then divided the total extra supervisory time incurred by the total hours worked per week in order to express this social cost as a percentage of each supervisor's time.

Allowance for Employee Inefficiency

The allowance for employee inefficiency was calculated based on the director of Buildings & Grounds' estimates of the additional time needed to complete each job due to the disadvantaged nature of labor force. The director made these estimates according to an industry standard developed based on his past work experience in private sector buildings and grounds businesses. After the director had completed his job-by-job estimates of employee inefficiency, I met with the supervisors for each job. Without disclosing the estimates that the director had made, I asked each of the supervisors to make their own estimates of how long it would take their employees to finish a job, versus the time it would take employees in the private sector. For the most part, the estimates of the director and the supervisors were very similar. In instances where there were substantial discrepancies, I facilitated discussions to reach a consensus.

Wage Rate Premium

The wage rate premium was determined by calculating the difference between Rubicon's wage rate and an industry wage rate. We could have used any of a number of different sources to determine the industry wage rate, such as Department of Labor statistics, newspaper want ads, and listings of California state-wide wage rates. We ultimately decided that the wage rate information published in the San Francisco Occupational Outlook Report was sufficient for our purposes. This report provided high, low and median hourly wages for gardeners and groundskeepers in the Bay Area, with segmentations based on levels of experience. We found that Rubicon's hourly wages were not significantly different from the industry wage rate and therefore concluded this social cost was minimal, and not worth tracking.

Capturing Social Costs in the Income Statement

After completing my analysis of each of the three social costs we selected to track, I worked with Rubicon's controller to sort them out from the (regular) business costs and show them in the income statement. In this endeavor, we had to be careful to avoid double counting: in order to place social costs in a separate line item underneath net income, I had to subtract each social cost from the standard expense line item above net income. For example, because I determined that 18% of a crew leader's time was "extra supervisory time incurred," I subtracted 18% of that crew leader's wages and benefits from the standard labor expense line item (above net income) and then added the 18% into social costs, underneath net income. If I had not first subtracted the 18%, then a total of 118% of the

crew leader's wages and benefits would have been charged overall. While the total amount spent on the crew leader remained the same, our new report shows us what net income for the business is, without the cost of extra time needed because of Rubicon's employee base. It also breaks out the cost to Rubicon of this additional time.

It is especially important to understand that efforts to report on social costs should result in a "wash:" the analysis is not discovering new costs, but instead delineating costs that already exist and showing them in a more useful way. This is a critical point for the reader to understand. Conducting a social cost assessment should not be viewed by business managers as a way to carry inefficiencies in the business operations or "bury" costs, since the total costs are still a part of the overall performance of the enterprise.

Conclusion

The case example from Rubicon's Buildings & Grounds shows how a business can be systematic, carefully enunciate assumptions, and document methodologies and calculations while quantifying social costs. At times this process may be difficult, but the benefits of quantifying social costs make it worthwhile. Distinguishing social costs from ordinary business costs enables managers to understand the extent to which a social purpose enterprise is profitable as a stand-alone business and in turn shapes important strategic and operational decisions.

In addition to facilitating informed decision making on business issues,

accounting for social costs facilitates informed decision making regarding the social mission. For example, each month managers can weigh social costs against estimates of social impact and ensure they are appropriately in line. In instances where they are not in line, managers can undertake cost reduction efforts or can take steps to maximize social impact. More informed and effective decision making on business issues and the social mission ultimately enhances a social purpose enterprise's ability to achieve both economic and social goals. Social costs cannot be ignored, for they lie at the very heart of social enterprise.

Footnotes

- 1 This concept was originally introduced in *New Social Entrepreneurs: The Success, Challenge and Lessons of Nonprofit Enterprise Creation* in its chapter on True Cost Accounting. Copies of that book and other REDF publications may be found at www.redf.org.
- 2 For an overview of True Cost Accounting and additional issues involved with True Cost Accounting, please refer to Chapter 6 and Chapter 4.