Do You Have Enough Cost Information to Make Good Decisions?

A survey of nonprofit leaders reveals some alarming attitudes about cost information. Here are the survey results—and ideas for providing better cost information for nonprofit decision-making.

BY JAMES CUTT, DENISE BRAGG, CURTIS HANNIS, ARIF LALANI, VIC MURRAY, & BILL TASSIE

Nonprofits face the twin problems of competing for dollars and allocating money internally. To deal with both problems, they need answers to certain basic questions about costs. For example: What do administrative services cost compared with program expenses? When government funders offer to purchase a service, will it "pay" the organization to supply it? How much does Program "X" cost compared to Program "Y"? How does the cost of treating clients in a branch office compare with treating them in the head office? Can the organization prove its efficiency compared to other nonprofit and commercial alternatives?

Clearly, these are crucial questions. Yet many nonprofits make decisions without the answers. Why do they neglect such cost data? How can they obtain the information they need? And how can they use it to improve decision-making?

A recent survey provides some insights. The researchers asked managers and board members in four nonprofit organizations in Victoria, B.C., Canada, what kind of cost information they collected, how they used it, and what additional cost data they would like to have for their policy decision-making.[1] This article discusses their responses and explains a simple cost accounting model for a nonprofit organization.

How Do Nonprofits View Cost Information?

Without exception, the managers and board members interviewed observed that their major preoccupation was living with tight budgets. They also reported that their organizations created detailed financial information on line items such as rent and salaries. They regularly compared this information to previously prepared budgets. Many provided weekly reports of "budgeted to actual" costs to managers and even board members. Most provided such budget updates at least monthly.

This line item budgeting was the most common category of information on the organization's financial performance. Given this tight control over expenditures, the managers and board members interviewed assumed that they had adequate cost information. For them, "living within the budget" meant that they were getting the most from limited resources.

In fact, however, this kind of financial information is only the first step in learning the full cost of an organization's programs. Much more useful for many nonprofits is to know the costs of their internal support services (such as administration or building maintenance), the full costs of their client service programs, and the average cost of units of direct service (such as the cost of a counseling visit).

As startling as the belief that they already had adequate cost information was the managers' reaction when asked if they would like information on unit costs and direct and indirect service costs. Most of those interviewed considered such information of lower priority than, say, information on client satisfaction or staff morale. Some board members even claimed that such cost information was unnecessary and inappropriate for nonprofits to create. They felt it would focus too much attention on cost rather than quality and quantity of service.

Clearly, respondents' attitudes reveal some unfamiliarity with how they could use cost information in policy decision-making. The responses also reflect other surprising perspectives on cost in nonprofit organizations.

As one respondent put it: "That kind of cost information isn't really necessary because organizations like ours do not sell their products. Cost information is the first step to determining a selling price but if no price is to be charged, this kind of information isn't necessary. Line item budgets are fine."

Most respondents shared this belief that cost information is of scant interest to nonprofits. They did note one exception—organizations reimbursed from government contracts based on units of service. For example, they acknowledged that hospitals and nursing homes, which are often paid based on "patient days," must pay attention to unit costs. With this exception, however, most respondents didn't share the commercial sector's incentives for developing sophisticated cost information—competitive survival and profit maximization.

There were other reasons for the antipathy to going beyond line item budgeting. After much probing, two respondents offered both political and philosophical arguments for their positions. They pointed out that calculating total and unit costs of programs and administrative support might prove politically embarrassing both within the organization and between it and its funders. This is because such information ties an organization's declared priorities to its actual resource allocation. The respondents suggested that these comparisons might reveal the difference between rhetoric and reality, thus causing political problems for managers. This argument has substance; there is no question that total and unit cost information could reveal a gap between espoused and actual priorities.

> Many nonprofits make decisions without crucial information.

The philosophical argument is closely related: Cost information, respondents pointed out, is rather vulgar. It connotes a willingness to apply crass, materialistic interests to the organization's deep underlying values. Concerns with pricing seem to lessen the significance of the organization's mission and its vow to care for its clients above all else. Such concerns amount to placing a monetary value, quite inappropriately, on the suffering the organization was created to help alleviate. "Doing as well as possible with limited resources" is an unworthy sentiment, according to respondents, compared to the belief in "doing good as long as there is good to be done."

If nonprofit managers view cost information as unimportant, politically awkward, and philosophically inappropriate, why should they bother to go beyond line item budgeting? As the following section makes clear, there are many good reasons to seek out more sophisticated cost information, despite its potential for uncovering embarrassing realities.

How Useful Is Cost Information?

Although the managers in the organizations studied were not concerned about pricing and profit maximization, they should be vitally concerned about the question of efficiency—delivering services at the least cost consistent with a given standard of quality. This information is important for decisions at each stage of the management cycle and is a major tool to establish performance accountability. The key is to discover how to make the best use of scarce resources.

Internally, at the planning stage, managers need cost information to help them decide which programs and activities they should keep, drop, add, or modify. They also need it to decide how they can provide vital indirect support services more efficiently. Such information at the "front end" also lets nonprofits base their resource allocation decisions on priorities developed in their strategic plans.

Furthermore, program-based cost information provides benchmarks by which the organization can track how it is doing and how it has done. Comparisons of actual to budgeted costs in line item budgets don't help much in pinpointing which programs or services are running over or under budget and why.

Externally, the same argument holds. Funding proposals will be stronger if they price proposed programs and demonstrate internal systems to monitor efficiency. For their part, funders are increasingly likely to require periodic reports that relate costs directly to the objectives for which they gave the funds.

(Admittedly, funders have traditionally limited evaluation to auditing the accuracy of financial reporting rather than assessing organizational performance against stated goals. However, a strong movement is underway to introduce more "impact" or "outcome" evaluation, which measures program benefits and costs. If nonprofits don't design improved evaluation systems on their own, they will likely find funders imposing such systems as a requirement for continued support.)

Clearly, then, sophisticated cost information is useful, interesting, and appropriate. In these tough times it may even be essential for nonprofit managers, boards, and external stakeholders to have such information as:

- the relative costs of the organization's front line services delivered to clients
- costs of outputs either in average terms (say, the average cost of a counseling visit versus that of a clinical visit), or the cost of a package of services delivered to a particular client
- the relative costs of support or overhead activities.

The next question for nonprofits is: How easy will it be to move from basic line item data to more sophisticated cost systems? If the procedure is too complex, it may not be worth taking this extra step.

To answer that question, let's look at a typical nonprofit and see how it set up a cost-accounting system. As this example shows, the steps are relatively simple and defensible. Indeed, they simply formalize what effective managers perceive intuitively.

The survey reflects surprising perspectives on cost in nonprofit organizations.

How Can You Use a Cost Accounting Model?

Youth Link is a nonprofit organization formed to help the increasing number of "street kids"—homeless adolescents—in the downtown core of a small city.[2] Its objectives are to counsel clients and provide school or job training. On entering the program, clients participate in a series of counseling sessions. They then join either a program to increase basic schooling or a program to provide job skills. The organization occupies a two-story building in the downtown core where all activities take place.

At the end of fiscal year 1992, the executive director reported that the organization had served 175 clients that year. Of these, 85 entered the job training program, 65 entered school training, and 25 dropped out after the counseling sessions. The organization had 8.5 full-time equivalent employees: the executive director, administrative assistant, bookkeeper, janitor, counselor, job trainer, one half-time assistant trainer, and two teachers. The budget for the year was $311,095, divided over 11 line items of expenditure. The largest line item was $225,000 for salaries.

The organization was funded by a grant of $100,000 from United Way, two government grants ($50,000 from the Ministry of Health and $150,000 from the Ministry of Job Training), and $5,000 in miscellaneous donations. Total revenue for 1992 was $305,000 with the shortfall ($6,095) made up from previous years' revenues. Figure 1 shows the year-end financial statement of revenues and expenditures for Youth Link.

Figure 1: Youth Link
End Year Statement of Revenue and Expenditures

Revenue	United Way Funding	$100,000.00
	Min. of Health	50,000.00
	Min. of Job Trn.	150,000.00
	Reserves	6,095.00
	Donations	5,000.00
	TOTAL	**$311,095.00**
Expenditure	Audit	$1,500.00
	Benefits	22,500.00
	Contract	11,000.00
	Utilities	1,800.00
	Insurance	2,300.00
	Office Supplies	8,295.00
	Phone	4,100.00
	Program Exp.	11,100.00
	Rent	20,000.00
	Salaries	225,000.00
	Transportation	3,500.00
	TOTAL	**$311,095.00**

At a recent board meeting, board members noted that the government planned to replace its general grants with a per-client reimbursement formula. This shift would require detailed cost documentation. Thus, the board wanted to know the cost of Youth Link's administrative support, cost of each program it delivered to clients, unit cost of training general clients, and unit cost of training special-needs clients sent by the Ministry of Health.

When the executive director couldn't provide this information, she decided to implement a cost-accounting system.[3] This model has five steps:

The managers and board members interviewed assumed that they had adequate cost information.

1. Choose Cost Objects.

The cost object is the "what" in the "cost of what?" question. It is the activity for which we need cost information. It could be a unit of output or a group of such units, a whole program or part of a program.

In Youth Link, the cost objects—activities for which the board wanted to know the cost—were:

- cost of total administrative support
- cost of each of the three front line programs provided to clients (counseling, job training, and school training)
- unit cost of training general clients
- unit cost of training special-needs clients.

2. Create Cost Centers.

Cost centers are artificial categories of an organization's activities. We create these categories as a way to classify costs for later analysis. Each cost center contains a certain program or activity, such as a counseling program or administrative activity. There are two types of cost centers:

1. Mission centers. These contain activities which deliver services directly to clients.
2. Support centers. These activities support mission center activities but don't deal directly with clients.

For Youth Link, it made sense to create five cost centers: counseling, job training, and school training (all defined as mission centers), and administration and building facilities (defined as support centers). Figure 2 shows the line items of expenditure and the set of mission and support centers.

3. Distinguish Direct and Indirect Costs.

The next task was to distribute the expenditure totals across the five cost centers. The first part of this task was to make a decision about direct and indirect costs.

Direct costs are those that we can clearly associate with a particular cost center. For example, rent is a direct cost related to the "building facilities" cost center.

Indirect costs are spread over more than one cost center. Office supplies would be an example. Rather than assigning them directly to a cost center, we must divide indirect costs as fairly as possible among centers.

In Youth Link, the executive director classified the following as direct costs: salaries and benefits, utilities, insurance, program expenses, rent, auditing, and contract prepa-

Figure 2: Youth Link Center Allocations

	MISSION CENTERS			SUPPORT CENTERS		
Line Items	**Counsel**	**Job Trn.**	**Sch. Trn.**	**Admin.**	**Bldg.**	**Total**
Direct Costs						
Audit				$1,500		$1,500
Benefits	$3,300	$4,700	$7,000	$6,500	$1,000	$22,500
Contract	$2,500	$8,000	$500			$11,000
Utilities					$1,800	$1,800
Insurance				$2,300		$2,300
Program Exp.	$1,600	$6,000	$3,500			$11,100
Rent					$20,000	$20,000
Salaries	$33,000	$47,000	$70,000	$65,000	$10,000	$225,000
Subtotal	**$40,400**	**$65,700**	**$81,000**	**$75,300**	**$32,800**	**$295,200**
Indirect Costs						
Office Supplies	$2,074	$1,176	$898	$4,148		$8,295
Phone	$500	$1,000	$500	$2,100		$4,100
Transportation	$525	$1,050	$1,050	$875		$3,500
Subtotal	**$3,099**	**$3,226**	**$2,448**	**$7,123**	**$0**	**$15,895**
Total	**$43,499**	**$68,926**	**$83,448**	**$82,423**	**$32,800**	**$311,095**

ration costs. She assigned these costs directly to the three mission centers and two support centers, as the top portion of Figure 2 shows.

She classified the following as indirect costs: phone, office supplies, and transportation. Next, she created formulas to divide these indirect costs across centers. She used her experience with the organization, plus input from other managers, to create formulas that related each indirect cost to the appropriate centers.

For instance, she created the following formula for allocating phone calls:

- First, she assigned 50% of the cost of phone calls to the central administration area.
- Of the balance, she assigned 50% to job training (because it has heavy external involvement and requires more phone calls than the other programs).
- Of the balance, she assigned 25% each to counseling and school training.

For office supplies, she determined the following formula:

- She assigned 50% of the cost of office supplies to the central administration area.
- Of the remaining 50%, she assigned half to counseling (which deals with all clients).
- She assigned the balance according to client numbers (85/150 to job training, and 65/150 to school training).

For transportation, she created this formula:

- 24% to administration.
- Of the balance, 20% to counseling, 40% to job training, and 40% to school training.

The bottom portion of Figure 2 shows the assignment of indirect costs across the five cost centers.

> Total and unit cost information may reveal a gap between espoused and actual priorities.

4. Allocate Support Center Costs.

There was still much to be done. The executive director had to address the board's interest in the full cost of administration (now defined as a support center) and of the front line programs (now classified as mission centers). Also, to show the unit cost of dealing with clients, she had to distribute the support center costs to the mission centers. Thus, she moved to the next step of the model, the cost allocation stage.

Cost allocation is the process of distributing support center costs among mission centers to determine the full cost of each. Selecting the bases of these allocations is similar to using formulas to assign indirect costs among mission and support centers, as we did in the previous step.

The allocation formulas must recognize that support centers may serve other support centers as well as mission centers. The executive director solved this problem by using what is termed the step-down process (see Figure 3). To do so, she allocated the costs of each support center, one at a time, to the remaining support and mission centers until all support center costs were allocated to mission centers.

After consultation with the managers concerned, the executive director used square footage as the fairest base for allocating building costs: 10% to administration and the balance equally across the three mission centers. The costs of the administration support center, now increased by its share of building overhead, were then allocated to the three mission centers.

Again after consultation, the executive director estimated the time spent by support staff with each mission center. She allocated total administration costs accordingly: 15% to counseling, 50% to job training, and 35% to school training.

Figure 3: Step Down Process Youth Link

SUPPORT CENTERS		BLDG/MAN	ADMIN	TOTAL
BLD/MA	$32,800			
ADMIN	$82,423	$3,280		
MISSION CENTERS				
COUNSEL	$43,499	$9,840	$12,855	$66,194
JOB TRN.	$68,926	$9,840	$42,852	$121,618
SCH. TRN.	$83,448	$9,840	$29,996	$123,284
TOTAL	**$311,096**	**$32,800**	**$85,703**	**$311,096**

Figure 4: Counseling Program

DIRECT COSTS
$40,400

INDIRECT COSTS
$3,099

BLD/MA
$9,840

ADMIN
$12,855

TOTAL PROGRAM COSTS
$66,194
TOTAL CLIENTS=175
COST PER CLIENT=$378.25
(COST/#OF CLIENTS=COST PER CLIENT)

Figure 5: Job Training Program

DIRECT COSTS
$65,700

INDIRECT COSTS
$3,226

BLD/MA
$9,840

ADMIN
$42,852

TOTAL PROGRAM COSTS
$121,618
TOTAL CLIENTS=85
COST PER CLIENT=$1,430.80
(COST/#OF CLIENTS=COST PER CLIENT)

As you might imagine, the allocation formulas were sometimes a matter of debate. Such debates are healthy and usually easily resolved. What *can* create problems is to make these allocation decisions unilaterally without the input of everyone involved.

The executive director was now in a position to address the board's cost concerns. The total cost of administration, including building operation, was $85,703 or 27.5% of the total budget. The full costs of the three mission centers, including their fair share of organizational overhead, were as shown in Figure 2. How these costs should be interpreted depends, of course, on comparable costs in similar organizations and on costs for previous years for Youth Link.

5. Calculate Cost Per Unit.

The board also asked for unit costs. The first task in calculating unit costs is to define what unit you wish to measure. Youth Link's executive director defined "unit" as "number of clients completing the program." To calculate cost per client, she had two choices: the process method and the job order method.

We use the process method when all units of output are homogenous. We use the job order method when units of output are different. Using the process method, we would calculate mission center costs using the steps described above. We would then divide these costs by the number of units of output. The result would be the unit cost. Using the job order method, we would record direct costs associated with a particular job. We would then assign indirect costs to each job using an overhead rate. Many cost accounting systems have features of both process and job order costing.

If nonprofits don't design improved evaluation systems on their own, they will likely find funders imposing such systems.

Youth Link's executive director decided that, to calculate unit costs in the three mission centers, a process method would suffice. Figure 4 illustrates her calculations for the counseling program. All 175 clients participated in some or all of this program.

The executive director decided to ignore for the moment the problem of dropouts. She divided the total cost of the counseling program ($66,194) by number of clients (175). The result was a cost per client of $378.25. Figure 5 provides a corresponding figure for the 85 clients who *completed* the job training program ($1,430.80). The executive director added these two unit costs ($378.25 and $1,430.80) to obtain the unit cost of clients completing both the counseling and job training programs ($1,809.05). Figure 6 shows these calculations.

The executive director also knew that the Ministry of Health planned to change its payment method. Rather than awarding a flat grant, the government would pay for Youth Link's special-needs students on a grant-per-student system. She therefore needed to figure out the full per-student cost.

Figure 6: Youth Link Client Process Costing

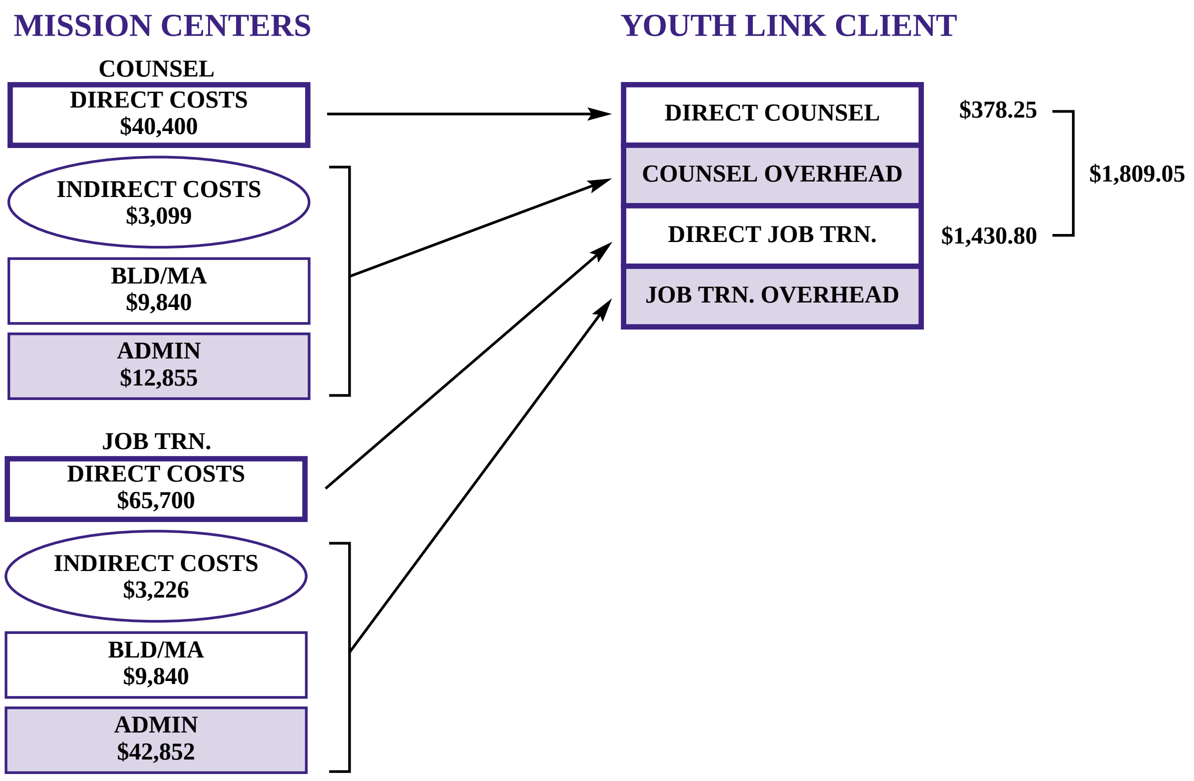
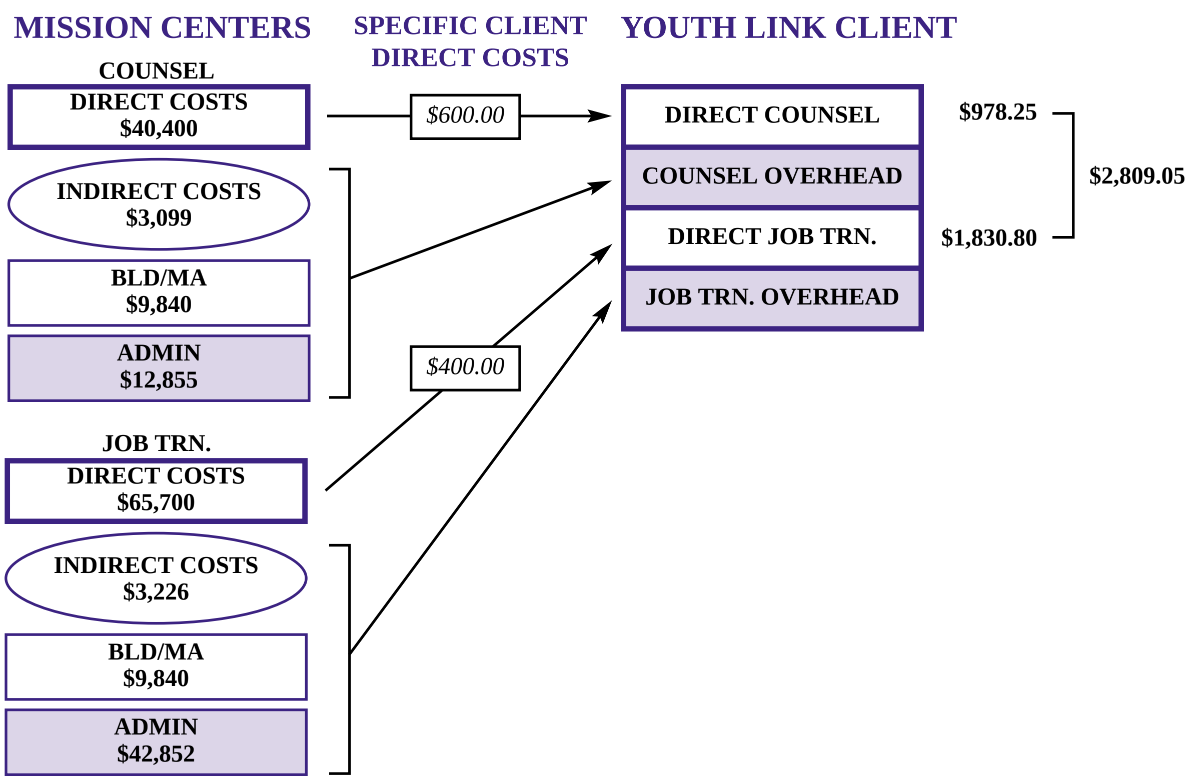


Figure 7: Youth Link Client Job Ordering Costing



She knew that these special-needs clients needed extra counseling and training time. Thus, she chose the job order method to calculate cost per special-needs client.

To do so, she first chose a special-needs client she considered typical. Then she went over that client's record using the cost accounting model. Figure 7 shows how she calculated the full cost of treating this client.

Specifically, the client required 30 additional hours of counseling and 20 extra hours of job training. These activities were priced at $20 an hour. Thus, incremental charges to the general unit costs were $600 and $400 respectively. The total "job order bill" came to $2,809.05.

Accordingly, the executive director knew that she should not accept a per-client payment arrangement from the government that was less than $2,809.05. If she did, she would lose money on the project and have to cover it from some other source.

Is the Cost Worth the Benefit?

While this article has focused on nonprofits' need for more sophisticated cost measurements, it is necessary to end with a caveat. It is useful to discuss relative costs only *in conjunction with* relative benefits or outcomes. In periods of scarce resources, funders and even some managers tend to consider costs alone. They may cut the budgets of higher-cost organizations and programs despite their benefits. The approach advocated here has the advantage of allocating costs by programs or units. Thus, it directs attention to front line services—the mission centers. After allocating costs, however, someone must decide whether these costs are "worth" the benefits obtained.

Take the case of Youth Link. Suppose the government evaluated it against comparable organizations. Say that Agency X provides counseling and training at a cost of $1,000 per client compared to Youth Link's $1,430.80. When the government evaluates the two programs, however, it finds that 70% of Agency X's clients are still on the street a year after completing their program. Only 40% of Youth Link's clients are still on the street a year later. The question then becomes: Is the extra $430 per client "worth" these gains in impact?

If we focused exclusively on costs, we might punish Youth Link for being too costly. Conversely, if we looked only at "outcomes," we might reward an organization for its "success" yet overlook unit costs that are four or five times higher than an organization with nearly as great a success rate.

Cost-benefit analyses are tough to carry out. How can we measure, for example, the "artistic value" of a dance troupe whose performances fail to fill even half the seats? What is the benefit of offering university courses in which few students enroll (so that the cost per student is far higher than for other courses)?[4]

Most "benefits" or "outcomes" cannot be measured as precisely as costs. Instead there must be a "negotiated interpretation of reality" between the evaluator and evaluatee. In an ideal world, this negotiation would use the best available data on both costs and outcomes while recognizing their inevitable weaknesses. This article has explained the value of sophisticated cost analysis. Such cost analysis is a neglected and often mishandled half of the challenge of effective policy decision-making but, in the end, only half. ■

Footnotes

[1]This survey was part of a broader research project investigating evaluation of organizational performance across the management cycle—from planning and budgeting to internal evaluation and external audit. The four nonprofits studied were: (1) A large mental health service organization offering programs for people with mental illness and their families throughout the Greater Victoria area. Its budget was approximately $1,800,000. (2) A community service organization offering support services primarily to single parent, low-income families headed by women in a particular section of the city. Its budget was about $530,000. (3) A medium-sized charity which raised money to help victims of a particular disease throughout Vancouver Island. Its budget was in the vicinity of $750,000. (4) A social service agency for seniors providing a range of non-medical services for low-income and isolated seniors in the Victoria region. Its budget was around $660,000. Altogether, researchers conducted 62 interviews with management staff, board members, and representatives of six funding organizations. They also examined the organization's internal and public financial reports.

[2]Youth Link is a hypothetical nonprofit derived from several real organizations.

[3]This cost-accounting system is modeled on those suggested in the writings of Anthony, R.N. and D.W. Young, *Management Control in Nonprofit Organizations*, 5th ed., Burr Ridge, IL: Irwin, 1994, and Young, D.W., *Financial Control in Health Care*, Homewood, IL: Dow Jones-Irwin, 1984.

[4]These issues have been discussed in detail elsewhere—e.g. Murray, Vic and Bill Tassie, "Evaluating the Effectiveness of Nonprofit Organizations" in Robert D. Herman (Ed.) *The Jossey-Bass Handbook of Nonprofit Leadership and Management*, San Francisco: Jossey-Bass, 1994.

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These articles are available through the Society for Nonprofit Organizations' Resource Center. For ordering information, see the Society's *Resource Center Catalog*, included in this issue, or contact the Society at 6314 Odana Road, Suite 1, Madison, Wisconsin 53719 (800-424-7367).

James Cutt is professor of public administration and economics at the University of Victoria. Denise Bragg is a graduate of the MPA program at the University of Victoria and is manager of finance and support services, Environmental Protection Department, Ministry of Environment, Lands and Parks, Government of British Columbia. Curtis Hannis is a graduate of the MPA program at the University of Victoria and is a policy analyst in the Ministry of Finance and Corporate Relations, Government of British Columbia. Arif Lalani is completing the MPA program at the University of Victoria and is a planning analyst in the Corporate Planning Division, Policy and Communications Branch, Ministry of the Attorney General, Government of British Columbia. Vic Murray is adjunct professor, School of Public Administration, University of Victoria, Victoria, British Columbia. Bill Tassie is a recent Ph.D. graduate from York University and a long-time management consultant specializing in public and nonprofit organizations.

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