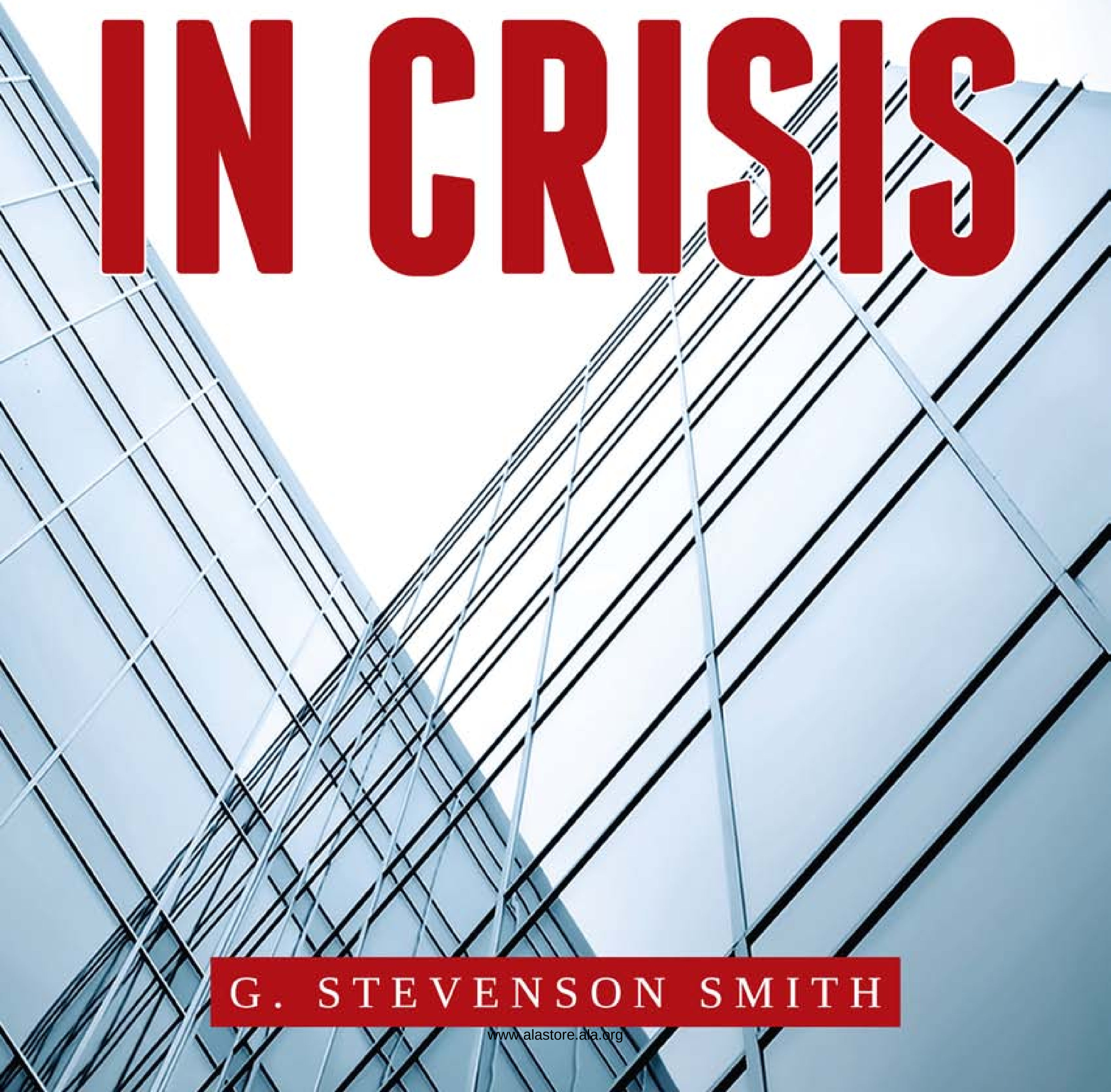
COST CONTROL FOR NONPROFITS IN CRISIS



G. STEVENSON SMITH

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CONTENTS

INTRODUCTION TO COST CONTROL FOR CULTURAL ORGANIZATIONS

The well-born gentleman avoids the mention of names exactly as he avoids the mention of what things cost; both are an abomination to his soul.

Emily Post, *Etiquette*, 1922

The purpose of this book is to describe decision-making techniques helpful to managers of cultural organizations such as libraries, museums, art councils, civic organizations, theater groups, music societies, professional associations, country clubs, religious organizations, public opera guilds, zoos, community aid organizations, and symphonies. Today, many of these organizations are facing cutbacks in funding that are threatening their existence. For that reason, it is important to determine the most cost-effective method to provide services to their clients or patrons. Yes, Emily, it is necessary to mention "cost."

WHERE'S THE FUNDING?

Forty-one percent of states report declining state funding for U.S. public libraries in fiscal year 2009, according to a survey of the Chief Officers of State Library Agencies (COSLA) conducted by the American Library Association (ALA). Twenty percent of these states anticipate an additional reduction in the current fiscal year.[1]

The techniques outlined here provide the reader with the ability to develop a skill set to identify if costs are being efficiently incurred, monitor financial and nonfinancial performance, cut out "non-value" activities, and develop strategic plans. By using this book, questions such as the following can be answered:

- How do I efficiently plan for the future?
- How do I know if today's decision fits within our mission and vision?
- Can I save money by buying more expensive equipment?
- How do cash flows affect my purchase decisions?

Although budget-setting strategies—such as the give-and-take process—are important, they are not one of the topics discussed in this book. The techniques described in this book allow the manager to identify how to effectively use the budget they are given by making their dollars go as far as possible.

To understand the focus of the book, one must first be aware of differences between managerial decision making and financial accounting as for-profit analytical methods may not be used in a standardized fashion in the nonprofit environment.

MANAGERIAL DECISION MAKING AND COST CONTROL

Managerial decision making is performed on a daily basis by managers in a cultural organization. The decisions made by these directors, department heads, and other supervisors are influenced by managerial cost reports presented to them. Unlike financial accounting statements, managerial reports are not required to follow a prescribed format. Instead, managerial reports provide useful information to the manager so that efficient decisions can be made. These reports may show cost information such as the shelved cost per book or nonfinancial information such as levels of patron satisfaction with a specific program. In most cases, the operation manager will have to request that these reports be prepared as they are not the standardized financial reports usually prepared by an organization's accounting staff.

Unlike financial accounting, where statements are issued at the end of yearly or quarterly periods, managerial reports are prepared as they are needed by managers. The purpose of financial reports is to show what occurred in terms of revenues and expenses in the past year. These reports are not forward looking. With managerial reports, the purpose is to help change or influence decisions occurring in the future. Unlike the aggregated organizational information in financial reports, managerial reports contain specific and detailed information about subunits within the organization. Aggregated financial statement data or budget information cannot take the place of a properly prepared managerial report, nor can the former provide the manager with the information required to make cost-control or strategic decisions. *A manager cannot control his or her organizational costs by using annual financial reports.*

The information in managerial reports goes beyond the reporting found in financial statements. For example, managerial reports can (1) help in analyzing variances from budgeted costs; (2) trace future cost flows, such as maintenance costs, to help in equipment selection decisions; (3) aid in equipment purchasing versus leasing decisions; and (4) determine the break-even level of a service (the point where costs equal support or revenues).

FINANCIAL ACCOUNTING

Financial accounting uses a prescribed set of accounting guidelines in preparing an organization's financial statements. The three financial statements that are prepared under these guidelines are (1) the balance sheet, (2) the income statement, and (3) the statement of cash flows. These financial statements are prepared using prescribed rules called generally accepted accounting principles (GAAP). In the nonprofit area, the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB) establishes GAAP.[2]

If financial statements are prepared for a nonprofit organization on a basis other than that prescribed by the two boards, and these statements are audited by an independent certified public accountant (CPA), the CPA or auditor will not provide what is known as a "clean" opinion. The CPA's opinion consists of a statement regarding the fairness of presentation in the financial statements. An opinion usually contains boilerplate language about the financial statements, but if material problems occur in the audit, these difficulties need to be reflected in the CPA's opinion. An opinion of this nature is called a qualified opinion, and it is not a clean opinion. Such an opinion would highlight the fact that the financial statements are misleading in some material manner.

In other words, financial accounting places restrictions on the manner in which information can be presented for external reporting. It also can enforce these reporting standards with the auditor's opinion. Of course, there is a reason for this. If prescribed accounting standards are not followed, the consistency and comparability of the financial statements from period to period cannot be assured.

Financial accounting's requirements for following specifically prescribed practices make its practices less concerned with internal cost control and more oriented toward reporting for external groups and stakeholders.

FOR-PROFIT AND NONPROFIT CONTRASTS

In the basic planning for a new project, a comparison is usually made between a periodic series of revenue inflows and expense outflows. The first objective is to ascertain, as best as possible, if the cash inflows from the activities will exceed the outflows. The second objective, if several choices are available, is to select the project with the highest net inflow. Generally, if projected cash inflows exceed outflows on a project, the decision criteria will allow for acceptance of the project. The greater profit premise is basic to the managerial analysis that is performed in a *for-profit* context.

In nonprofit organizations, earning a profit has limited application. Measures of nonprofit success are not marked by earning the highest monetary profit. In most nonprofit operations, managerial emphasis is placed on the level of services provided to patrons. If costs are not recovered, the service may be provided anyway and funded from other sources such as donations or grants. A nonprofit organization's operations may generate cash outflows which always exceed cash revenue inflows. For example, the operating costs of zoological or botanical parks have always exceeded any fee revenues charged to the users of these parks. Therefore, the techniques of for-profit analysis needed to be changed if they are used in a nonprofit context.

Not using profit generation as a measure of success indicates that decision making in a nonprofit organization is at variance with decision making in a for-profit company. As an example, consider depreciation expense in for-profit and nonprofit contexts. Depreciation expense is an accounting allocation where the purchase price of an asset with a life of more than one year is assigned to the time periods over which the asset is used. This allocation procedure assigns the asset's purchase price in a "reasonable" manner to the time periods of estimated asset use, but no cash outflows arise from this allocation procedure. The only cash outflow that might have occurred took place when the asset was originally purchased.

Depreciation expense in a for-profit context is important because it reduces the taxes that a corporation pays; depreciation is a tax-deductible expense. Without a reduction of revenues from depreciation expenses, higher taxes result in larger cash outflows to the Internal Revenue Service. Therefore, depreciation expenses are important in making managerial decisions in a for-profit business. But, in organizations that do not pay taxes, the importance of depreciation expense to decision making is reduced. In fact, recording depreciation may be a nuisance to managerial decision makers because noncash depreciation expense deductions must be added back to determine the total cash flowing into an organization. The managerial importance of depreciation expense in a nonprofit context is restricted to providing an indication as to the extent to which facilities' usefulness has vanished over the years. Here, the sum of all the recorded depreciation provides an indirect insight into the usefulness of an organization's infrastructure.

For a nonprofit organization, a more important asset question than accumulating depreciation is: "How well have the assets been maintained?" For any organization, but especially for a nonprofit entity, the amount spent to maintain assets is more pertinent than knowing the amount of accumulated depreciation of a specific asset. The level of normal preventive maintenance on an asset can be established by manufacturer's guidelines within a fairly specific range. If these preventive maintenance procedures are not followed, the expected life of the asset is reduced prematurely. It is fairly common to see public infrastructures literally collapsing because of curtailed maintenance. In these instances, maintenance was stopped in an attempt to save budget dollars. Without proper maintenance of facilities, public funds in excess of initial projections will have to be used to replace prematurely deteriorated facilities or to fund above-normal, emergency maintenance repairs. Even though maintenance expenditure information is not specifically reported in the financial statements, it can be recorded in managerial reports. Information about the amount of deferred maintenance can be more important to a nonprofit manager than the annual depreciation expense recorded. This illustrates another basic difference between managerial decision making in for-profit and nonprofit organizations.

Care should be taken to separate the practices used in for-profit organizations from those used in nonprofit organizations. The approach taken in this book is to explain the practices of nonprofit managerial decision making.

WHO'S YOUR AGENT?

A primary nonprofit managerial accounting objective is to provide the greatest amount of cost-efficient services to the largest number of people. The best nonprofit financial techniques are used to achieve this objective. Often, however, when the final course of action is chosen, it may be different than the recommended solution arrived at through the use of financial analysis. Why does this occur?

Financial analysis uses the best analytical techniques for arriving at a managerial decision, but it does not incorporate political and behavioral factors that are very real influences in nonprofit organizations. So, it is necessary for analytical methods to consider political and behavioral factors as they affect managerial decision making. Agency theory is used to describe these effects on managerial decision making.[3]

The basic premise in agency theory is that someone other than the owner of the organization (the agent) manages the organization. In nonprofit organizations, this manager is the director, and the owners are either the groups that provide monetary resources or, in some cases, the groups that are receiving services. In a nonprofit, an agency relationship exists between the director and the board, the director and the governmental entities providing funding, and the director and the service groups. Agency theory relationships are present any time decision-making authority has been delegated to a subordinate, such as the director or other manager. A basic assumption of agency theory is that the managers are out to maximize benefits to themselves. The agent is chiefly concerned with satisfying his or her own self-interests without regard to the needs of the owners or the organization. Agency theory forms the basis for changing those relationships from self-interest to one which optimizes the welfare of the organization and the groups it serves.

Under agency theory, methods are used that attempt to overcome the self-interest or opportunism of the managers. Opportunism occurs when a manager selects solutions to a problem that are in the best interests of that manager but not necessarily in the best interests of the organization or the groups the manager serves. For example, the best solution for a manager may mean exercising the least amount of effort regardless of the outcome.

The lack of congruence between the manager's goal and the service goals of the organization should be a concern in nonprofit management. Personal ambition or the rewards of prestige that come from a position may be factors in a manager's decision-making process that determine whether he or she will accept higher levels of career risk in order to provide better services.

SO WHAT?

As the administrator of a Fannie Mae grant for community organizations serving low-income clients, the author was confronted with two administrators who were not interested in receiving additional funding that accompanied consulting services to increase the delivery effectiveness of their services. The reason: "We are only interested in getting next year's grant monies. This doesn't help."

A great deal of the analysis used by managers is based on estimates, and estimates are often biased because of a managerial manipulation of information. The manager, in direct control of an operation, usually is assumed to have the best information about its operation. Therefore, it may be difficult for others to determine if an estimate is unbiased or if it is biased to further the manager's interests.

A manager may be asked to make estimates of such things as the time it takes to finish a project, personnel requirements, or the amount of use a new service will receive once it is offered. The estimate that is received from the manager is used to prepare an internal report, to evaluate the feasibility of a project, or to develop a grant proposal. Any bias introduced into the manager's estimate is often difficult to detect because evaluative information is only received after the action has been implemented. Therefore, the accuracy of managerial estimates can be determined only on the basis of historically collected information. Agency theory is directed at correcting the causes of these managerial contrivances.

WHAT ABOUT . . . NO HOMEWORK FOR THE TEACHER

A high school teacher provides a brief explanation of one math problem in the classroom, and then hands out exercises for the students to work for the rest of the class period. While the students are working, the teacher grades papers or reads. Is the teacher using instructional time to grade papers so that she does not have to work on them in the evening? Does the teacher realize the students' attention spans are so short that making a long presentation would be futile? Is this an example of slacking or not?

As an example, assume a director is on an upward career path. In accepting a new position, this person is mainly concerned with how personal accomplishments in the new job will have an impact on his or her next job. For a manager, establishing a track record of accomplishments is important. This track record is oriented toward the short term (three years). The director will seek out projects that contribute positively to his or her three-year record of performance. Some of these decisions may not be in the best interests of the nonprofit organization. For example, the director might install computers for the public to use in order to list a computer initiative on her vita. In implementing this initiative, the cheapest computers are purchased, with little technical support, no maintenance agreement, and hardly any software. In this example, the computers will have to be completely discarded within a four-year period, after providing little public service. The limited four-year life of these computers is not important to the manager because he or she is likely to have found another better-paying job before the limitations of the initiative become apparent. Additionally, if the cheapest computers are purchased, funds may be left over so that the director can start another "initiative" that will make his or her résumé even more impressive. Agency theory is concerned with establishing contractual relationships to prevent this type of behavior from occurring.

One particularly difficult nonprofit managerial problem is how to monitor an individual's performance to prevent nonproductive behaviors. In a for-profit organization, a worker's profit performance can be easily seen and evaluated, but in most nonprofit organizations, it is particularly difficult to evaluate performance. How can a nonprofit organization determine if the director is not interested in an upward career path but instead is more interested in expending a minimum amount of effort?

These examples illustrate the special problems that may arise when traditional managerial methods are introduced into the nonprofit organization. Nonprofit organizations have been criticized for not adopting the modem methods of business; however, these methods may not have been properly modified for the context of the nonprofit organization, and do not take into consideration the managerial behavioral characteristics described in agency theory. It is possible to correct for this behavior in several ways, as is explained later.

WHAT IS NONPROFIT COST MANAGEMENT?

With the differences between nonprofit and for-profit entities in mind, what is nonprofit cost management? Nonprofit cost management adapts the techniques of for-profit analysis to a nonprofit environment to control operating costs. It adapts the best analytical techniques in the corporate world to the special environment of nonprofit organizations.

The major emphasis in business is for profits to exceed costs by as much as possible. In nonprofit managerial accounting, cost containment is important if the nonprofit organization is to remain viable so that quality services can be provided to patrons. Cost performance needs to be evaluated to determine how efficiently services are being provided. Without cost control, the resource base within the organization erodes to a level that results in the organization's service activities deteriorating or even being discontinued. Facilities are run down. Staff is let go. And the only way the organization can continue is with a severe curtailment in its services or quality. Here, we are looking for a way around that outcome. These methods use both short-term crisis control and long-term goals. Yet, if your nonprofit organization is faced with shutting its doors, there is little anyone can do for you at that point.

HOW MUCH DOES IT COST?

Children's Museum of Wilmington Executive Director Mark Kesling said, "We think we have great value here and a lot to offer. When we first opened we really did take a shot in the dark as to what it would take to operate this new building and this new facility and so we needed to make this adjustment, based on what it really does cost for us to do this."[4]

WHO WILL BENEFIT FROM THIS BOOK?

Cost control, project evaluation, and strategic planning are the primary topics in this book. Managers in a nonprofit organization who are required to control costs or make choices between service levels as budgets are curtailed will find this book useful. Nonprofit boards interested in controlling costs can use the illustrations in this book to request that similar reports be prepared within their organizations. In a period of budget reductions, downsizing, and cost curtailment, the importance of an efficient and cost-effective organization needs to be emphasized. Therefore, it is important to be familiar with the techniques described in this book. The book describes methods that allow nonprofit managers to determine whether the organization's mission is being efficiently accomplished. Readers who are likely to benefit from the material in this book are those individuals who have operating responsibility within a nonprofit organization.

SUMMARY

The purpose of this book is to illustrate to those who have operating responsibility within a nonprofit organization that there are techniques for guiding them as they evaluate projects and make managerial decisions.

Further, managerial nonprofit decision making cannot unhesitatingly adopt the techniques used by for-profit organizations. A director should not expect to make managerial decisions based on the annual financial statements and reports prepared for external stakeholder's use. Further, budgets provide the rules on spending levels and variances from approved dollar amounts. These budgets do not provide for the underlying managerial analysis of how much should be provided in the first place. . . . what is the cost of efficient operations. They, too, can be used for budget line cost control, but they do not provide the means to arrive at cost efficient operations.

NOTES

1. "State Funding for Many Public Libraries on Decline," American Library Association Press Release, February 10, 2009, www.ala.org/ala/newspresscenter/news/pressreleases2009/february2009/orscosla.cfm.
2. The Governmental Accounting Standards Board (GASB) sets accounting standards for state and local governments, and the Financial Accounting Standards Board (FASB) sets accounting standards for business organizations. The organizations set standards with the issuance of statements and with audit guides. When a library is part of a state and local government, its financial statements are not prepared separately from those of the state and local government, and the library is considered to be part of the state or government organization. Usually, the only separate financial reports this type of library receives are related to budgetary data. If a library is not considered to be part of a government organization, its financial statements must be prepared using a different method of accounting than used by the state and local government.
3. For a basic introduction to agency theory, read D. B. Thornton, "A Look at Agency Theory for the Novice: Part 1," *CA Magazine* (November 1984), 90–97; and D. B. Thornton, "A Look at Agency Theory for the Novice: Part II," *CA Magazine* (January 1985), 93–100.
4. "Children's Museum Price Increase Upsets Parents," wwaytv3.com, February 8, 2007, www.wwaytv3.com/node/231/.

USING THE VALUE CHAIN FOR STRATEGIC ANALYSIS

If things are not going well with you, begin your effort at correcting the situation by carefully examining the service you are rendering, and especially the spirit in which you are rendering it.

Roger Babson

Michael Porter (1985) described the concept of the value chain.[1] The value chain links the activities of an organization together to help the organization identify the activities it performs to create value for its patrons, clients, or customers. The value chain is used to chart the organizational processes that create value for stakeholders. The links begin with "raw materials" and end with the valued "product" that the client or customer receives. The separation of activities into the value chain eventually allows for a clear view of the organization's cost structure and how the expending of those costs is contributing to activities that create value for the organization. For a university, the beginning of the value chain or its "raw materials" starts with the new students entering college as freshman. The work that lies ahead for the university to create value for its patrons is dependent on the abilities of the entering freshmen. If they have been well-prepared, the university's job becomes easier. If they are unprepared, the university may find it necessary to have a sequence of remedial courses in order to get these students ready to take college courses. Consequently, it is necessary for the university to incur educational costs that should have been incurred by the high schools these students attended. Regardless, the value chain for the university begins outside its campus and ends with a "product" that is a graduate of the university.

What is the final product of a corporate research library? The final product from the research library is related to the research reports the library supported. What is the final product from a museum? The final product is the exhibits displayed. What is the final product from a civic organization? The services provided to patrons.

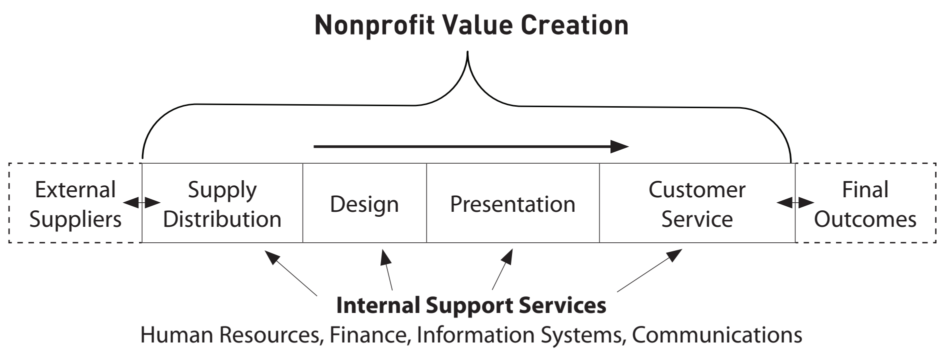
The amount by which revenues exceed costs (i.e., profits) is not a method for judging such nonprofit organizations (NP), but the value created for their customers or patrons is a method that can be used to judge their performance.

A generalized nonprofit value chain is illustrated in figure 2.1. Each NP should have a strong understanding of how they create value for the users of their services.

The value chain in figure 2.1 includes activities that occur both inside and outside the organization's physical boundaries. These activities move from the left to the right in the illustration. The external suppliers as well as final outcomes exist beyond the organizational boundaries, but they are still part of the NP's value chain. An organizational objective is to have suppliers providing services or resources in a manner that reduces organizational costs or at least does not increase the costs of operations. These external suppliers are usually considered to be suppliers of material used in operating the nonprofit organization. Yet, these suppliers can also be donors or grantors of funding. For this reason, suppliers should be considered to be anyone or any organization contributing resources to the NP and not just supply vendors. All suppliers bring their own overhead costs as they provide resources to the organization.

For example, software suppliers may sell software packages that need to be continually updated. The objective of the software seller may be to market a software package as early as possible in order to capture a large market share. Consequently, the labor cost related to

FIGURE 2.1
The Nonprofit Value Chain



Typical Internal Value Creation Activities

1. *Supply:* Receiving/unpacking, internal distribution of supplies, and inventory management. Distributing funding resources within the organization.
2. *Design:* Strategic planning, training, screening employees, facility maintenance, and continuing professional development
3. *Presentation:* Tactical planning, promotion, technical assistance, building security and theft.
4. *Customer Service:* Establishing rapport with customers or clients, handling inquiries or complaints, and providing *actual* helpfulness in meeting the service needs of the client.

Typical External Contributions to the Value Chain

1. *External Suppliers:* The efficiency of these suppliers in providing resources affects the organization's value creation abilities.
2. *Final Outcomes:* These outcomes are what are internalized by the individuals who use the nonprofit's services. The perspective developed by these user groups may or may not be what was intended by the nonprofit organization.

making the updates along with downtime costs are passed on to the NP from the software manufacturer. This is an example of outside overhead costs being passed downstream as well as a way in which value creation becomes curtailed due to a reduction in resources.

Even funding provided to an NP comes with its own costs. For public funds, these costs may be related to the hours needed to prepare fund-use reports, provide seminars to funding agencies, special meetings, and attendance at agency briefing sessions. For donor funding, the costs may be more subtle but nonetheless required for the continuation of additional support from this donor. Such donor-related costs may involve providing special lectures, additional formal evening gatherings at the NP's facilities, and changes in the schedule of exhibits. All these costs can be considered to be overhead associated with the receipt of resources given to the NP, and again a possible distraction from providing patron services.

As the NP meets the requirements and needs of these suppliers using its finite resources, the result can be a reduction in the overall ability of the organization to meet its core function of providing public services. But, in order to make that statement, the NP needs to have identified its core functions. Depending on the NP, those core functions involve activities such as providing research support, developing new exhibits, financial aid for low income clients, quality reviews of service activities, expanding outreach to the public, and updating of databases. Whether resources are provided by a donor or purchased, they all come with a cost that needs to be explicitly identified and compared with the funding provided to the NP. In some cases the costs may outweigh the benefits received. In those cases, such funding reduces the ability of the organization to create its core values and service its clients.

Figure 2.1 shows the internal processes in the value chain as supply, design, presentation and customer service. In a manufacturing firm, these processes would be related to the production of products. Here, supply refers to internal distribution of resources to the NP's departments and personnel. The distribution can be done by the personnel who receive the supplies and agency funding or by an NP director who may distribute discretionary donor funds. Supply is not confined to one department in the NP's organizational structure such as a receiving department. Supply relates to managers who have the authority to distribute incoming resources. Similarly design refers to long-range activities that contribute to value creation in the organization. Again these functions are not restricted to one specific department, but all departments involved in these activities need to be closely coordinated. Design is composed of developing the strategic organizational processes including recruitment, professional development, planning, budgeting, developing performance evaluation standards, mission statement creation, and identification of objectives to meet the organizational mission. Presentation is related to the actual implementation of short-range processes used to satisfy strategic performance goals. It is called "presentation" because these are the activities that are apparent to those who use the NP's services. Value creation in the presentation stage are represented by good building security, cleanliness of the facility, effectiveness of programs presented to the public, strong technical abilities of service personnel, organizational coordination used to meet strategic objectives, successful program outcomes, and well-maintained and technological up-to-date equipment. Again, the activities in presentation need to be coordinated, but they do not have to occur in one department as in a traditional organization. The input processes used in the presentation stage are tangible and can be measured. Their effects translate into customer service and final outcomes in the value chain. Customer service relates to how customers or clients view and react to the NP's presentation processes. Building rapport with an NP's service group occurs at this point in the value chain. For example, the manner in which inquiries and complaints are handled is an important part of the customer service mission. Customer service allows an NP to build a supportive relationship with their customers based on the customer-perceived usefulness of the provided services and the manner in which those services are provided to the service group.

Presentation inputs provide the potential for creating a perspective of usefulness, but the customer must also believe they are receiving a worthwhile benefit. The presentation is creating value for the organization if the customer believes service *value* is being created for *them*. Final outcomes are internalized by the individuals who use the nonprofit's services. The perspective developed by these user groups may or may not be what was intended by the nonprofit organization. These user groups can be the clients served by the NP, the NP's donors, or the agencies that provide financial support. The effects of these views have the potential to increase or decrease future support provided to the NP.

The four internal-value creation processes are based on the core competencies found within an NP. These activities are central to the successful operation of an NP, but there are also activities that support those core processes. These functions are shown in figure 2.1 as internal support services. They are represented by departments such as human resources, finance, information systems, and communications. These support activities are needed by the NP organization, but they are not the reason an NP is in existence. Therefore, these support functions should be scrutinized to determine if their costs can be reduced. For-profit organizations have faced the same issue and they have responded by outsourcing many of their support functions without any loss in the quality of their products or services.

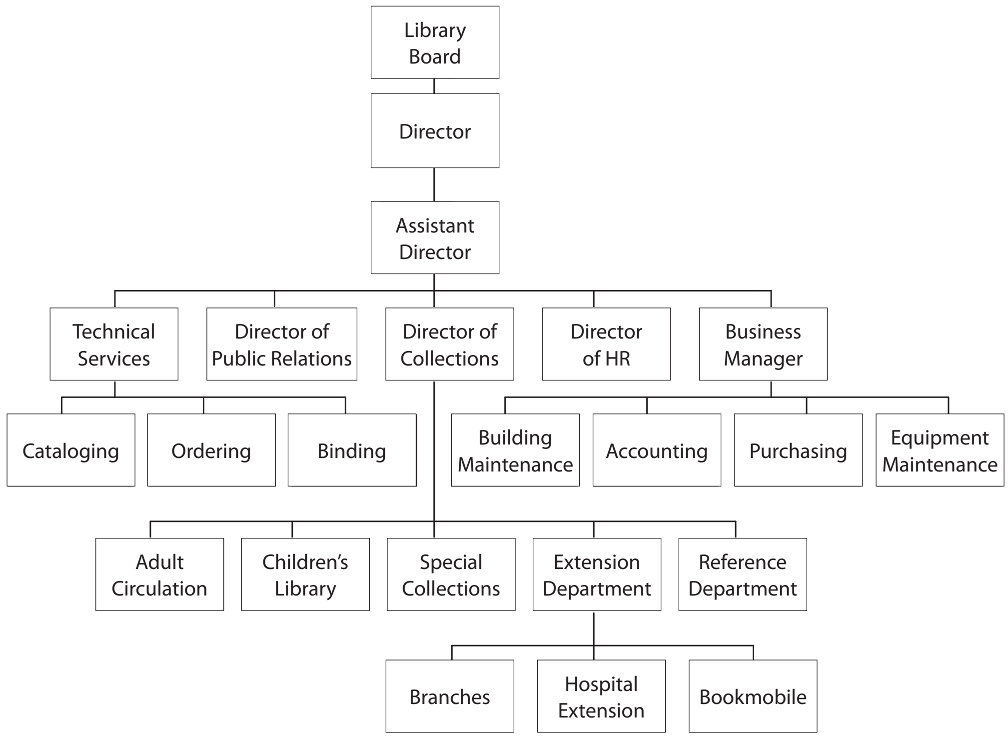
VALUE CREATION IN THE ORGANIZATION: DOES IT WORK?

Every NP wants to create value for its service group, but it seems that many auxiliary issues arise that create non-value activities. Non-value activities are those organizational functions that do not increase service value to the NP's patrons. Governmental and nonprofit organizations have a tendency to expand their non-value activities. The consequence is that these functions have the potential to override the organization's ability to provide its core services. For example, the traditional organization chart of an NP is not usually organized around the value creating activities outlined in figure 2.1. Instead the organization is organized in a very traditional manner, and managerial efforts are made to squeeze value from a traditional organization hierarchy such as the one illustrated in figure 2.2.

For the medium-sized library in figure 2.2, various directors are responsible for evaluating the functions of the departments under their responsibility. They, too, are being evaluated with final authority resting with the library board or other such group. These activities are creating internal value among departments, but where are the interactions with the organization's service group (i.e., its patrons, clients, or customers) taking place? Those services are directly provided within the lowest levels of the organizational chart. For this library they are provided through Adult Circulation, Children's Library, Special Collections, the Extension Department (Branches, Hospital Library, and Bookmobile) and Reference. In the nonprofit value chain, this is where the processes of presentation, customer service, final outcomes and some design processes are located. These departments are where the core values are provided to patrons.

Although the example in figure 2.2 represents a library, the situation is similar for most NP organizations. In figure 2.2, the patron value-creating processes occur in the lowest rungs of the organization's hierarchy; while value creation related to indirect support functions such as ordering, cataloging, asset maintenance, purchasing, accounting, and administrative functions occur in the highest rungs of the organization chart. The latter grouping is where the largest section of organizational operating cost is expended in the traditional organization.

FIGURE 2.2
Traditional Organization Chart for a Library

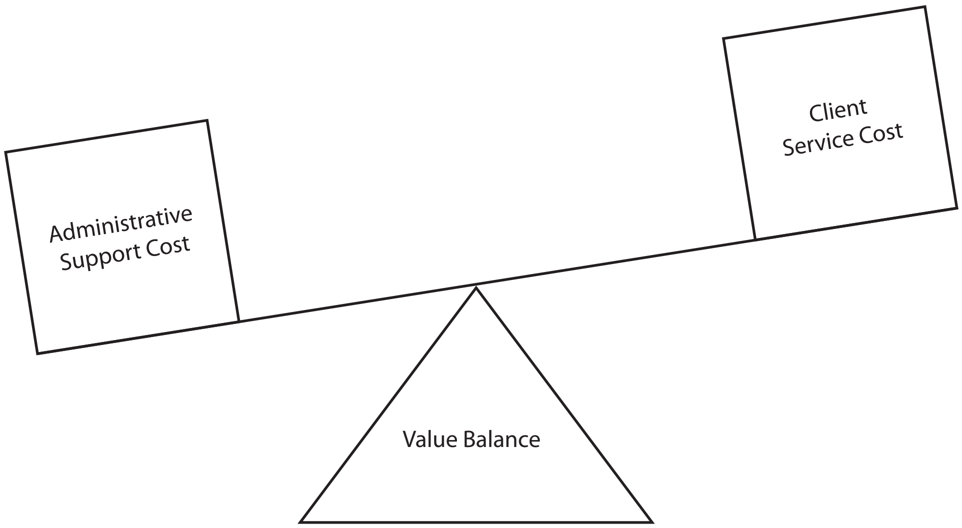


For this reason, it can be seen that indirect value creation costs are the major expenditures in the traditional organization. When cost control is necessary, these are the costs that need to be curtailed—not the costs related to patron services.

Each organization's core value creation processes need indirect support, but the question becomes one of determining what percentage of total expenditures should be made up of indirect costs. Within government and NPs, support processes tend to become a natural end in themselves while the provision of actual customer or patron services turns into a secondary activity. Support functions need to be annually reviewed to determine if they have reached an *unbalanced value point* within the organization. All organizations tend toward such a point of imbalance. Once the organization reaches value imbalance, it needs to be determined how to go back to a balance between value creation and support activities. Figure 2.3 illustrates an NP whose cost structure is out of balance because its administrative support expenditures are outweighing its client service costs. Steps to rebalance the organization may require the outsourcing of non-value-creating support activities such as cataloging or accounting, or rebalancing administrative structure to ensure the largest share of expenditures are made in the client service area.

The value chain and organizational hierarchy structures tend not to work together to achieve the organization's objectives. As long as there is a separation between the two systems, it will result in either a decrease in value creation or value creation only at a higher cost to the organization. Even so, the traditional hierarchical organization continues to dominate management structures in NPs.

FIGURE 2.3
An NP whose administrative support costs are out of balance with its client service costs



EVERYONE WANTS TO BE AN ADMINISTRATOR

New evidence suggests that a growing percentage of public school funds are being spent on district administration rather than on teaching. According to Standard & Poor's, the private company hired by the state to analyze school data from Michigan public schools and public school academies, central administration costs have risen more than twice as fast as instructional expenses, including teacher salaries, over the past three years.[2]

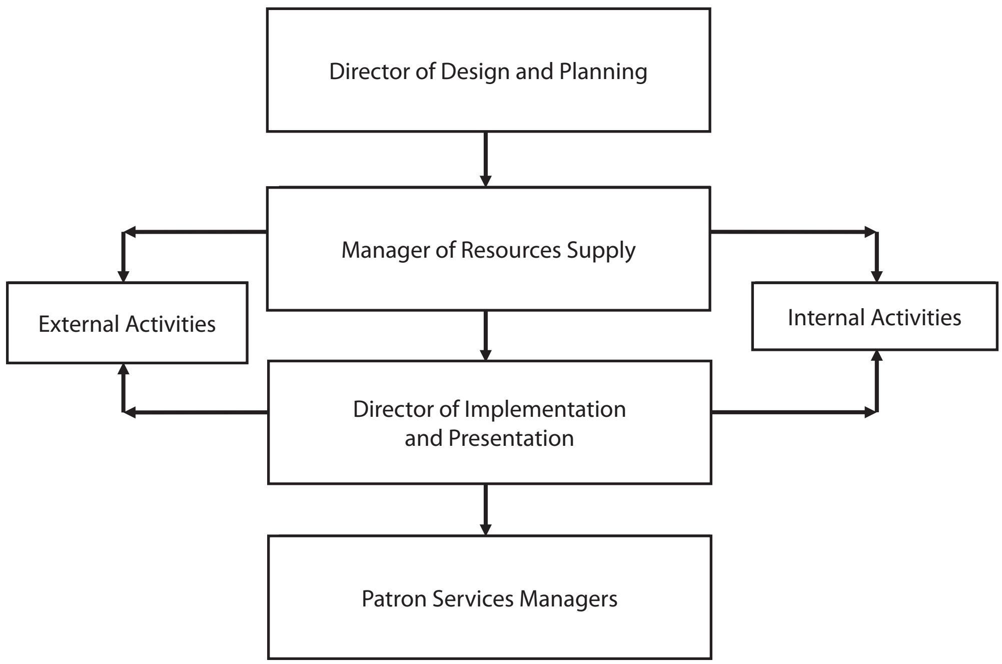
. . . assumes universities apply public funding to their stated goals of educating students and conducting research, which is not always the case. A recent audit of UNC-Chapel Hill found millions in potential savings by reducing spending on administrative costs, which have accelerated at a greater rate than spending on academics.[3]

STEPPING BEYOND THE TRADITIONAL ORGANIZATIONAL CHART TO CREATE VALUE

Once it is recognized there is a difference between value creation and traditional management control systems, the question needs to be asked if there is a way for these two systems to work together or overlap one another.

The first step in trying to make the traditional organization increase its value output is to determine its unbalance value point status. This review is done by looking at an up-to-date organization chart and identifying each unit in the chart that creates direct value for customers or clients. The percentage expenditure mixture needs to be estimated. If the non-value-creating part of the organization is 60 percent or more of its expenditures, the

FIGURE 2.4
Generalized Value Chain Organizational Chart for an NP



organization is in an unbalanced state and such an organization is not going to be able to deliver satisfactory services to its service groups. At a minimum, the value creation activities need to include more than 50 percent of all expenditures in a service organization—that is, 60 to 70 percent of organizational expenditures.

Traditional organizations attempt to create value with ad hoc management groups. For example, to increase the value creation activities in such organizations ad hoc committees are formed. These committees are used to operate outside the traditional organization lines of authority to attempt to create value. The committees formed under Total Quality Management guidelines are examples of such a structure. Unfortunately, the lines of authority and responsibility follow the lines in the organization chart, and therefore the work of these committees is restricted to limited areas, and in many cases their recommendations are ignored. Therefore, their value creating ability is generally limited or nonexistent.

There may be other ways to view the NP that go beyond the traditional organizational chart. For example, depending on the NP, it may be able to base its organizational chart and the lines of organizational authority around the value chain rather than a functionally based departmental structure (e.g., accounting, business department, etc.). Figure 2.4 is an example of such a structure.

Figure 2.4 illustrates a generalized value chain organizational chart. The large numbers of departments and divisions in figure 2.2, the traditional organizational chart for a library, have been collapsed into a series of units related to the core values created by the NP. In figure 2.4, the departments correspond more closely with the value creating activities that are found in the value chain in figure 2.1. These activities begin with the design and planning process. The director of design and planning is responsible for overseeing the daily activities of the organization as well as strategic planning. In order to be able to adequately focus on those daily operations, non-value-adding activities of the organization are outsourced. For example, cataloging, accounting, certain routine activities in human resources, binding, building and equipment maintenance are prime candidates for outsourcing. Other activities would need to be eliminated. The operations within a separate public relations department could be eliminated. With training, public relations could become a natural function of many employees' jobs just as quality control has become part of many employees' jobs in a production facility. Purchasing is moved into manager of resources supply. The manager of this unit is responsible for providing the materials needed to implement the strategic plans developed in conjunction with the director of design and planning or providing information as to the reason a proposed plan cannot be implemented. Obviously, the ability to implement plans needs to be evaluated by these two units *before* they are completed.

The various library departments such as Children's Library and Adult Circulation are collapsed into the unit under the director of implementation and presentation. There are both internal and external value-adding activities under the responsibility of the director of implementation and presentation and manager of resource supply. The external activities are what are seen and/or used by the NP's patrons. The internal activities, such as training, are viewed by the employees who are working to provide services (presentation) to these patrons. Patron services managers are working to ensure the services provided to patrons are furnished in a professional manner. They are not responsible for assessing the quality of the services provided. Such an assessment must be done by an independent entity separate from the services manager's area of authority to ensure an independent assessment is completed.

The driver behind such an organization chart is value creation based on the organization's core activities—that is, what it does best. Another purpose of such an organizational chart is to keep the subdivisions within the organization focused on value creation rather than on keeping their "turf" intact. Can a traditional organizational chart be changed into a value creating organizational chart? For many organizations the answer is "no" and these organizations must continue to try to create value for their patrons under the authorizations in a traditional organizational chart.

CAN IT BE DONE?

Vera Institute of Justice is a research and policy-developing NP. Its mission is to make the U.S. justice system more humane. In the mid-1990s, Vera reorganized itself around its value chain. The elements in its value chain were identified around Vera's research expertise as:

1. Research to evaluate new and ongoing projects
2. Planning to develop new programs
3. Demonstration by beginning demo projects
4. Spinoffs for implementing successful demonstration projects within another NP or government agency

The new organizational network helps create significant more NP value through the development of a series of more successful projects.[4]

WHAT STOPS VALUE CREATING ORGANIZATIONAL CHARTS FROM BEING USED?

Changing a traditional organization to a value-based organization requires a deep revision that goes down to the basic foundation of the NP. It needs to be remembered that the concept of the traditional organizational chart developed as small manufacturing firms grew into diverse enterprises. The organizational chart was used to control the diverse branches of these larger organizations. Later, the chart was adapted to NP organizations. These charts were developed when the idea of value-adding activities was not yet conceived. The charts are from a time when outsourcing consisted of using a local machinist shop for producing automobile components and not outsourcing to another country half way around the world. The chart was developed when using overnight secretarial services in China to complete documents for use the next morning in the U.S. was inconceivable or when technological value creation for the U.S. market occurred in the U.S., not in India. Even though it is a different world today, the traditional organizational chart based on competing departments dominates operational manager's thinking. Therefore, the effort to change to a value-based organizational chart is not readily acceptable.

Another reason for not changing to a value-based chart may be related to legal requirements or politically mandated rules to maintain certain separate departments within an NP's organizational structure. This is especially true for government-based NPs. Nongovernment NPs have the ability to change to a value-based approach with less difficulty.

SUMMARY

The traditional organization chart shows the authority relationships among job holders, and job holders are concerned with supporting upper-level authority holders in order to be successful in their jobs. Consequently, in order to make the organizational authority chart work, it is necessary to perform activities that do not necessarily add value to the patron services provided by the NP. The traditional organizational chart shows the chain of command, but not necessarily how value is created in the organization. The value chain does show how activities contribute to providing valued service to patrons. Although there may be an overlap in the two, there is no guarantee that they overlap each other in any manner. Furthermore, there is a natural tendency in service organizations to develop a high level of supporting activities and unintentionally minimize the level of direct service provided to its patrons. The next chapter discusses how to eliminate non-value-added activities and reduce the operating costs for NP organizations as they struggle to maintain their service levels in an era of diminishing funding support.

NOTES

1. Michael E. Porter, *Competitive Advantage: Creating and Sustaining Superior Performance* (New York: Free Press, 1985).
2. "Michigan Administrative Expenses Top $1.4 Billion," *Education Report*, May 30, 2002, www.educationreport.org/pubs/mer/article.aspx?id=4366.
3. "College Costs: Hold Constitution's Principle on Tuition," *Reflector.com*, November 25, 2009, www.reflector.com/opinion/college-costs-hold-constitutions-principle-on-tuition-976820.html.
4. "Effective Capacity Building in Nonprofit Organizations," *Venture Philanthropy Partners*, 2001.

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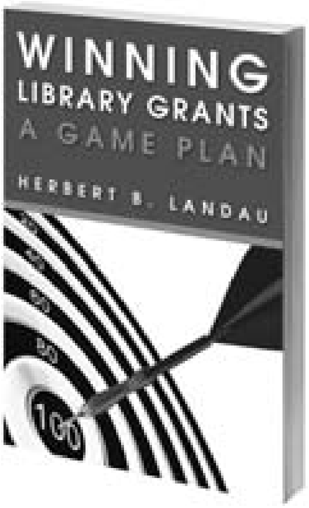

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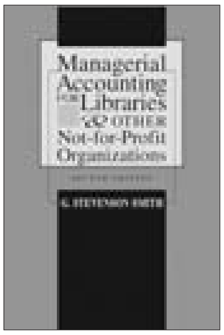

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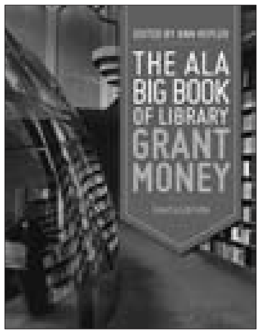

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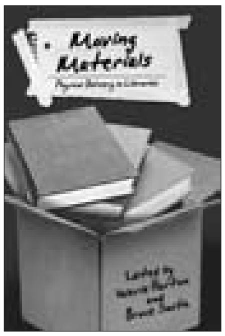

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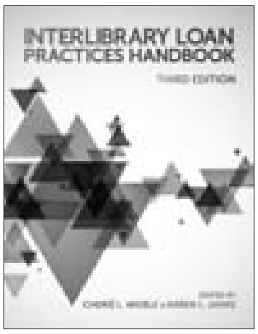

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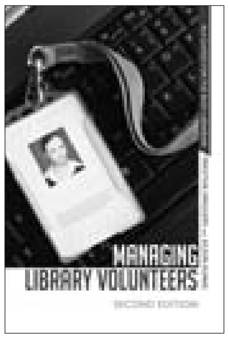

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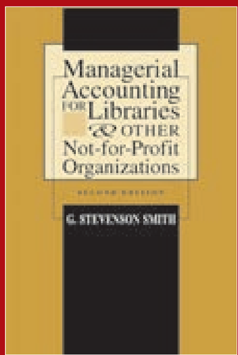

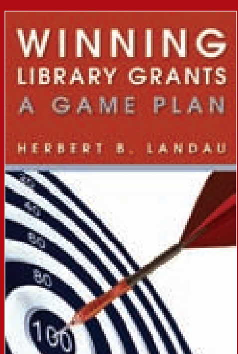

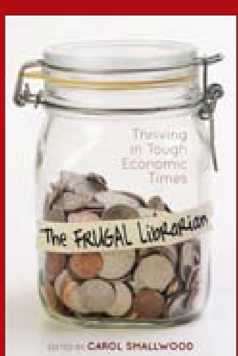

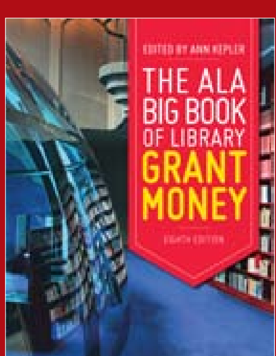

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