Costing dynamics in a Social Enterprise: a Case Study

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Abstract

Purpose

This case study reviews the thematic outcomes on the dynamics of products and services costing in a not for profit organisation that is transforming itself into a Social Enterprise. The adoption of a social enterprise business model means that it has to grapple with the adoption of many commercial practices such as, product and service costing and pricing, as it seeks to replace grants and donations with earned income from sale of its products and services. Invariably, this means that it has to balance the intricacies of its core mission (social service) with its entrepreneurial mission (earned income). This requires shifting from the traditional inherent "caring" culture to a blend of "caring" and "commercial" cultures.

The aims of the study were to: (1) undertake a literature review of scholarly work on costing in social enterprises (2) undertake a case study in the organisation in order to capture in-house intelligence on the dynamics of product and service costing (3) undertake a thematic analysis of the responses in order to determine participant's personal views on product and service costing.

Methodology

A case study methodology, semi-structured interviews and thematic analysis were used to allow an examination of a contemporary phenomenon within its real context. The intention of the study was to have an inside look at participants' perceptions on the dynamics of product and service costing in the organisation.

Interviews were conducted with ten executive staff and trustees and structured around the following questions: (1) What is your understanding of the term "costing"? (2) How do you cost your products and services now? (3) Why do you cost your products and services the way you do? (4) What do you think are the advantages and disadvantages of your current costing methodologies? And (5) What changes would you make to your current costing methodologies and why?

Findings

There was a very strong pattern in the views expressed about the current and the desired state of products and services costing in the organisation. It was felt that Product and service costs were becoming of growing importance in their decision making process. Consequently, whilst the products and services costing methodologies were evolving, it needed to be improved to reflect “true” costs to enable the organisation to make evidence based commercial decisions.

Limitations

As a result of a constructionist epistemology, this work is interpretive and cannot therefore claim validity through exact replication studies and cannot claim any degree of generalisabilty. However, the findings acquire meaning to the extent that it was situated in the specific time and organisational context.

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1. Introduction

A social enterprise is any not for profit owned revenue-generating venture created for the purpose of contributing to a social cause while operating with the discipline, innovation and determination of a for-profit business. (http://virtueventures.com)

Skylight describes itself as a not-for profit charitable trust, which has to operate as a social enterprise in order to have the financial ability to support over 4500 people directly and indirectly through calls and service requests. It claims that it had to shift to a Social Enterprise business model because the funding it receives from grants and donations is only a notional contribution to the cost of service provision. Consequently, it has to rely on earned income from the sale of its products and services in order to deliver its social mission. (Awan, 2008)

The adoption of a Social Enterprise business model means that it has to grapple with adoption of many commercial practices such as, product and service costing and pricing, as it seeks to replace grants and donations with earned income from sale of its products and services. Invariably, this means that it has to balance the intricacies of its core mission (social service) with its entrepreneurial mission (earned income). This requires shifting from the traditional inherent "caring" culture to a blend of "caring" and "commercial" cultures.

What role is product and service costing playing in this transformation journey?

This question led to the establishment of the study to: (1) undertake a literature review on scholarly work on costing in social enterprises (2) undertake a case study in the organisation in order to capture in-house intelligence on the dynamics of product and service costing (3) undertake a thematic analysis of the responses in order to determine participant's personal views on product and service costing.

The rest of the paper provides a brief background on Skylight, the literature reviewed, the methodology used, findings and ends with conclusions and observations.

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2. Background

Skylight's core Business Programmes are described in their Annual Report as: (1) Professional Development and Training: delivering training programmes throughout New Zealand, (2) Resource and Information Services: developing and/or acquiring resources (books, brochures, CDs, DVDs) for sale or loan, (3) Counselling and Support: providing counselling/support services that cover the Wellington region, (4) A targeted small group, school-based programme for young teens that helps them build resilience, enhance connectedness and move forwards through tough times. Skylight also has the licence to offer this programme internationally and has, so far, introduced the programme into a country in Europe, and (5) the business programmes and the operation are supported by the fundraising/ sponsorship programme and central administration.

In terms of financial management, it uses popular small business financial system software that includes basic accounting (including payroll accounting) and reporting activities. Its monthly financial statements (income and expenditure), compares actual with budget, are produced for the total organisation, for each of the programmes and for fund raising and central services (administration).

The accounting is done centrally by the operations manager supported by a part time administration officer. Both of these parties, while not professionally qualified accountants, have other business or accounting qualifications in addition to applied experience in the routines of accounting and reporting.

The costing and pricing accountability essentially lies with the programme managers supported by the operations manager. On a need to basis, external professional help is accessed for services such as: accounting, information systems and legal.

3. Literature Review

Literature abounds on product and service costing and it was not the intention in this study to undertake an exhaustive review of this literature. Rather the focus was on review of scholarly work on product and service costing in social enterprises. In this regard, literature was scarce. Consequently, a fit for purpose selective review was done on general literature on the topic and also on literature on the topic as it related to not-for-profit organisations. Heavy reliance was placed on one such work.

All organisations incur costs, and managers need information to understand and manage them. Many short-term and long-term decisions require an understanding of costs. (Page 43, Langfield-Smith et al). Later (page 262) and in the context of service costs, they say that managers can use costs to (1) assess service profitability (2) decide which services to produce (3) set service prices/fees, and (4) plan and control costs.

In the context of not for profit organisations, Colby and Rubin (page 27, 2005), claim that most financial systems do not contribute to organisational knowledge about the true, total costs of providing services, running programmes and otherwise operating the organisation. They maintain that working without this information, non-profit executives often have to make decisions on the basis of intuition, the skills and knowledge of the programme staff, or the preferences of the organisation's founders.

They go on to say (page 32) this is because the non-profits financial and reporting systems, the culture of many non-profit organisations, and the funding environment in which non-profits operate all work to obscure information about true costs, or make it unnecessarily difficult to obtain.

As an initial obstacle, most non-profits have only rudimentary financial systems which are not conducive to tracking and understanding the true costs of operation. The culture of many nonprofits can also work against true cost assessment. For many, focusing more than a modest amount of money and attention on understanding such traditionally commercial matters as costs represents a diversion of valuable resources from activities that further the organisation's mission. Additionally, the funding environment in which non-profits operate contributes to the problem because most fund providers prefer to support programmes and projects rather than overhead expenses, such as, the cost of implementing an activity based costing system for example.

Nevertheless, to make resource related decisions in a way that maximizes an organisation's effectiveness and promotes its mission (page 27), non-profit leaders need to have a clear picture of the full costs of operating their programmes and services. While most non-profits have a good understanding of the direct costs incurred by their programmes, many do not account for indirect costs. Full cost data can provide invaluable input to decisions about how to allocate resources among programmes, whether to expand into new locations, and what level of funding is required to sustain the organisation's operations.

The term "full costs" (page 28) underscores the need to take into account all the costs of running a program, not simply those that are directly associated with its provision. Although most organisations have a good understanding of the direct costs of running their programmes, the full costs of running programmes require them to take into account their indirect costs as well. Allocating indirect or overhead costs to programmes provides an accurate picture of these true costs. Ignoring them can paint a misleading picture of the economics of performing different activities and in turn can have potentially mission-damaging consequences.

In the context of full costs, Chlala et al (page 3, 1995) say that many non-profits often use the services of volunteers and this should be kept in mind when undertaking any costing of products and services. By valuing these services and accounting for them, it is possible to estimate the actual cost of programmes. To this end, all costs related to volunteers such as travel expenses, equipment and supplies that they require, as well as training and coaching expenses should be captured. Such information would be used not only to make management aware that volunteer services are not free, but also to complement applications for funding. They go on to state that, under certain circumstances, it could prove useful to determine the opportunity cost of this labour pool by establishing the imputed compensation.

Accurate allocation of costs, especially in-direct or overhead costs to products and/ or services are crucial. Yet, it is acknowledged (see for example Langfield-Smith at al page 135) that a major difficulty in costing product and services is how to allocate overhead costs. The suggested allocation methods can range from the sophisticated and more accurate driver based allocation method to rather less accurate methods such as basing the allocation on direct labour cost.

The overhead costs that require an allocation can, to all intent and purposes, be considered as joint costs where an organisation has multiple product/service portfolios. Tishlias (pages 2-3, 1992), suggests that one reason non-profit organisations incur joint costs is the expectation that programmes, administration and fund raising activities can be served simultaneously for less cost than if these goals were pursued separately. The allocation problem arises from the premise that each segment benefiting from a joint action should share in its costs.

He discusses four methods of allocation of overhead costs. The first is the activity based allocation because it is consistent with the cause and effect and the benefits related criteria. It also provides a level of detail that can make the resulting allocations more defensible. The second method is to allocate the joint costs equally. The third method is to allocate on the basis of standalone cost. This method, which ensures that all participants benefit, allocates joint costs in proportion to the amount of cost that would have been incurred. Lastly, the fourth method is to allocate joint costs in direct proportion to a segment’s actual cost savings.

However, he cautions that many non-profits do not have sufficiently sophisticated accounting systems to perform the more complex allocation such as activity based allocation - the resources required to gather the necessary data to do this may not be cost effective.

Colby and Rubin (page 32 2005) argue that competitive forces of many kinds are shaping the world that non-profits inhabit. To participate successfully in the new environment, non-profits must be able to design coherent well-structured strategies that will allow them to deliver on their chosen mission. Knowing which programmes are meeting expectations and which are not is an invaluable and essential part of this work. For forward thinking non-profits, accurate cost information may prove to be mission-critical data.

4. Methodology

As a result of a constructionist epistemology, this work is interpretive and cannot therefore claim validity through exact replication studies and cannot claim any degree of generalisabilty. However, the findings acquire meaning to the extent that it was situated in the specific time and organisational context.

Case study methodology was adopted primarily because it allowed investigation of a contemporary phenomenon within its real context (Azofra, Prieto, & Santidrian, 2003). In this study, the case study methodology has allowed an inside look at the dynamics of product and service costing in the subject organisation.

The empirical research conducted in this study used semi-structured interviews with staff and trustees of the organisation. The aims of the interviews were to uncover deeper understanding (Strauss & Corbin 1990) of issues connected with product and service costing in the organisation.

Interviews were conducted with ten out of the eighteen complement of staff and trustees and included: The Chairman of the Board of Trustees, The Chief Executive Officer, Two other members of the Board of Trustees and Six senior staff members - five programme heads and one head of operations.

The interviews were structured to solicit the personal views of interviewees on the following questions which were essentially informed by the literature review: (1) What is your understanding of the term “costing”? (2) How do you cost your products and services now? (3) Why do you cost your products and services the way you do? (4) What do you think are the advantages and disadvantages of your current costing methodologies? And (5) What changes would you make to your current costing methodologies and why?

The interview notes and comments were subjected to thematic analysis following the guidelines adapted from Owen (1984) by Zorn (1998).

The first step was to collect the data. This was done via notes taken during the face-to-face interview with the participants and which was based on pre-set interview question. The second step was to transcribe the interview notes and to return them to each of the participants for their validation and feedback. All suggested changes resulting from this validation and feedback process were then incorporated in the final copy of the transcriptions. The third step was bringing together all the data that related to the question. The fourth step was to combine and catalogue related patterns of responses into a theme. The fifth step was to build a valid argument for choosing the theme by reading the related literature.

5. Findings

There was a very strong pattern in views expressed about the current state and what needs to be done about product and service costing in the organisation. Essentially, costing is seen as an important element in the decision- making process, including pricing of products and services, and needs to be designed to help the organisation get robust information on the costs of their products and services.

The specific findings on each of the questions were as follows:

What is your understanding of the term “costing”?

The term costing was well understood by the participants and was linked to the finding out of what it costs to produce and deliver products and/or services. Those dealing with products described this in context of products and those dealing with services described this in context of services. The Chief Executive and the directors’ responses related to both product and services and tended to be more elaborate.

How do you cost your products and services now?

The common theme was that whilst costing was done, it was rudimentary in the sense that it was based on estimates and judgement and did not reflect the total costs of products and services. This was because certain costs such as central overheads and volunteer time were not included.

Programmes were essentially responsibility centres. Most costs were traced directly or allocated to these centres except what was termed as “national” which was central administration. Sub-programme or initiatives within a Programme were costed informally based on manager/staff judgement and experience.

Some costs were ignored in product and service costs and were described as hidden costs. These included costs such as programme manager’s time spent on products and services of other programmes.

Why do you cost your products and services the way you do?

The common theme was that the methodology used has evolved over time and that this evolution would continue in the future on a need-to basis.

Cost estimating worksheets have been used in some programmes and these have evolved over time with experience. It was acknowledged, however, that improvements were required.

What do you think the advantages and disadvantages of your current costing methodologies are?

The common theme in advantages was that the current methodology was simple to use and understand. It was considered simple to apply and not an exhaustive process. It avoided hard and possibly contentious questions on "true" costs as exemplified by this quote:

> *"It is simple/easy to do and morally not offensive, in the sense that if true cost were known then we would be looking at higher prices"*

The common theme in disadvantages was that the methodology did not capture all the costs and therefore there were unrealistic expectations of true cost and lack of transparency of the process. This resulted in too much reliance on what happened in the past.

What changes would you make to your current costing methodologies and why?

All participants agreed that the methodology needed to be improved to capture all the relevant costs without making the process too complex. There was a need to introduce a structured methodology not only for product and service costing but also for project costing to enable the organisation to adopt a more commercial view on pricing and other relevant decisions.

6. Conclusions and observations

The participants of this study clearly felt that costing was an important factor in their decision-making process. Equally, they felt that improvements were needed to their current costing methodologies and models in order for them to fully understand the nature and behaviour of their costs. Most of the participants not only had a clear view on the limitations of the current methods but also what should be done to improve these.

The literature reviewed certainly underscores the importance of costing and the need to understand the true cost of programmes.

The first observation is that the financial systems are not sophisticated enough to capture the true costs of programmes. Given financial constraints, technology elegance and sophistication has to give way to what is essential and a workable model using popular spreadsheets.

The second observation is that the organisation is not in a financial position to hire costing and modelling specialists. Hence, costing activity will continue to reside with the programme heads supported by any pro bono assistance they can get. This means that the organisation needs to ensure smart management of programme heads' time between the provision of the core service and the preparation costing information.

The third observation is that the organisation seems to have a relatively good grasp of its direct costs, but have issues with the allocation of indirect or overhead costs. This is not surprising as the general issues surrounding cost allocations are widely covered in management accounting literature and textbooks. The important consideration here is that a pragmatic approach is required on cost allocations.

The fourth observation is that a costing framework needs to be developed and implemented to ensure a shared understanding and application of costing principles and methodologies in the organisation.

The fifth observation is that it is clear that product and service costing is in the thick of the transformation journey. At this stage it is at the “we think it is about right”; this needs to evolve to “we know that it is right.” This will require the organisational culture to shift from the “fear of knowing true costs and implications of true costs on pricing” to that of ensuring that decisions are informed by the “true” costs of products and services.

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