



## Social costs: what are they and how do we identify them?

### What are social costs?

Social costs are any cost incurred by a social enterprise *above and beyond ordinary business costs* in order to fulfill its mission. In social enterprises with an employment mission, these costs are often related to providing the extra training, supervision, and support that enable individuals with significant barriers to employment to become successful employees.

On the other hand, social costs are **not**:

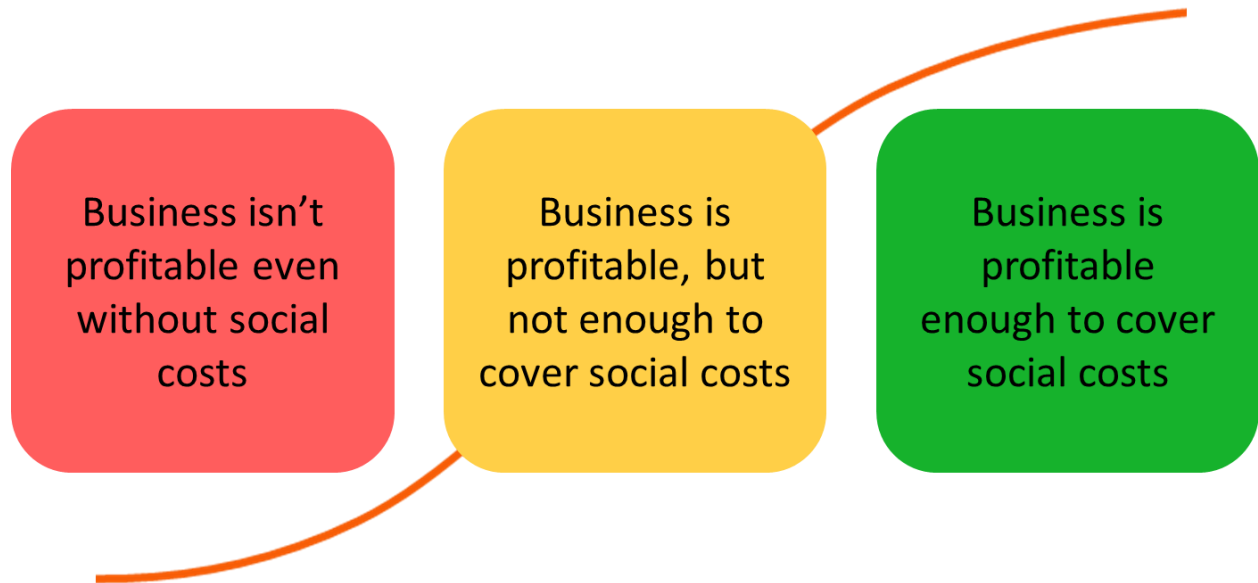
- General inefficiencies – some inefficiency is inherent in all businesses
- All training costs – most businesses require some training
- General overhead
- Revenue opportunity costs (i.e. potential revenue lost due to mission)

Whatever the specific social mission is, incurring social costs is not an accidental matter; it is a by-product of doing social mission work. Social enterprises are set up to accomplish special tasks and those tasks generally cost extra money. There are numerous costs to running a social enterprise that can be attributed directly to the sponsoring organization's social mission or the social mission of the business. Many of these are found within the business itself. Examples of the social cost often carried by a social enterprise are:

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

### Why Do We Care?

Why do we care whether a cost is a social cost? In our work with social enterprise, REDF often hears “we just want to know if our total revenues cover our total costs; figuring out what the enterprise's social costs are isn't going to change what the enterprise's total costs are.” We agree that an analysis of costs won't in itself change the costs, of course. But it's usually necessary to dissect an enterprise's total revenues to know more about what the business dynamics are and what options are available. Similarly, more in depth analysis of costs is part of figuring out the puzzle of how to make a business work. An analysis of social costs adds valuable information to categories like “manufacturing costs” or “production costs” in giving managers input for making decisions and directing strategy. No one would advise running a manufacturing company without knowing which costs are generated by the company's manufacturing activity. Similarly, no one should expect to run a social mission enterprise without assessing which costs are generated by its social mission activity. This information can be used to raise funds targeting the social costs or to guide any cost control measures implemented.



### **Is doing the analysis worth the work?**

Although the analysis required for estimating social costs takes some time initially, the time spent on it can pay off.

In several cases, the social costs of a nonprofit-run enterprise were being absorbed by its parent agency and didn't show up as enterprise costs. Until this was rectified, agency and enterprise managers didn't know the true costs of their enterprise. They thought it was more profitable than it was, and did not understand why their agency overhead costs had increased. In one food service business, an analysis of costs showed higher food wastage costs than industry experts considered "normal". Further investigation revealed that though good controls had been put in place, the extra waste was unavoidable as long as the enterprise continued its on-the-job training and transitional employment strategies. Agency leaders assessed the financial implications and decided to accept these additional "social costs" as a standing, predictable cost of implementing their social mission strategy. The enterprise's manager was able to plan for the part of wastage costs that would be unavoidable. Upper management was able to gauge the enterprise's financial and social mission success more accurately. Although the bottom line profit was not changed, management knew more about what its financial performance/social mission trade-offs were, and could plan accordingly.

In some nonprofits an analysis has helped management decide which parts of an enterprise to expand or contract. In others, having a credible estimate of social costs has helped managers with goal setting and budgeting, enabling them to sort out and compare costs to commercial industry standards.

Whether you're a social enterprise newcomer or a social enterprise old-timer, estimating social costs is good practice.

### **Identifying Social Costs**

Distinguishing social costs from regular business costs is not always easy, and generally requires experienced judgment and periodic updating. We advise thinking of it in this way: "If a cost would be incurred by a similar for-profit business, consider it a regular business cost; if a cost is incurred for activities that are needed in order to accomplish a social mission, consider it a social cost." REDF has helped social enterprises estimate their social costs with a variety of approaches. Some have used industry benchmarks together with observations of their own workforce to estimate which of their costs

are regular business costs and which are social costs. Some have conducted snapshot time studies to answer questions like “how much time does it actually take employees to accomplish specific tasks?” Some have brought in third-party experts to help make estimates. Like most analysis of financial information, a balance needs to be struck between the level of detail and accuracy, the amount of effort it takes to perform the analysis, and the value it brings to managers.

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

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

### **Quantifying social costs**

Once you have identified *what* the biggest cost drivers are, you can begin to estimate *how much* can be attributed to social mission. Some costs, such as those related to employee support, will be clearly attributable to the social mission. Others, such as wastage, will be less clear. Is the amount of wastage the result of employing a less experienced workforce as part of your enterprise’s mission, or is it simply the result of poor business management? While there is simply no way of answering this question with absolute certainty, you can make a more informed and confident estimate after some thoughtful and critical analysis.

When making these estimations, make sure to incorporate the expertise from throughout your organization. The people closest to the front-line will often best understand the impact of the mission on business operations and costs. It is also good practice to collect internal data and compare it with external benchmarks.

Cost category	Collect internal enterprise data...	and compare externally (if needed)
1 Direct Labor	<ul style="list-style-type: none"> <li>▪ Determine employee efficiency               <ul style="list-style-type: none"> <li>○ Time studies, observations</li> <li>○ Compare payroll to billing</li> <li>○ Attendance records</li> <li>○ Staff interviews</li> </ul> </li> <li>▪ Determine average wage paid</li> </ul>	<ul style="list-style-type: none"> <li>▪ Industry average efficiency               <ul style="list-style-type: none"> <li>○ Time spent per job</li> <li>○ Average re-work rate</li> </ul> </li> <li>▪ Industry average wages</li> <li>▪ Manager experience at comparable for-profits</li> </ul>
2 Supplies	<ul style="list-style-type: none"> <li>▪ Track inventory turns</li> <li>▪ Observe average wastage</li> <li>▪ Raw material unit cost</li> </ul>	<ul style="list-style-type: none"> <li>▪ Industry average inventory turns</li> <li>▪ Industry average wastage</li> <li>▪ Industry average cost of materials</li> </ul>
3 Management	<ul style="list-style-type: none"> <li>▪ Self-reported time estimates</li> <li>▪ Basic time studies</li> </ul>	<ul style="list-style-type: none"> <li>▪ Average management or supervisor-to-employee ratio</li> </ul>
4 Training	<ul style="list-style-type: none"> <li>▪ Salaries for training personnel</li> <li>▪ Salaries for case management</li> <li>▪ Case management records</li> </ul>	<ul style="list-style-type: none"> <li>▪ Average training cost per market employee</li> </ul>
5 Fundraising, admin, other	<ul style="list-style-type: none"> <li>▪ Track marketing time and cost</li> <li>▪ Interview development staff</li> <li>▪ Interviews with other staff</li> </ul>	<ul style="list-style-type: none"> <li>▪ Average marketing cost per unit</li> <li>▪ Industry average overhead %</li> </ul>

Once you have identified the amount of each cost you can reasonably attribute to the social mission, simply apply those percentages to each of the corresponding line items.

	Current Cost	% of cost related to social mission
Supplies and Materials	\$ 1,000	20%

For each relevant category, compare the enterprise cost to industry average. Differences might be attributable as social costs.

Supervisor	\$ 8,000	15%
Employment Supports Specialist	\$ 5,000	100%

For each position, estimate the amount of time that is dedicated to supporting the mission. For some positions, the entirety will be social.

Equipment Leasing	\$ 1,000	0%
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Many, if not most, items are expenses that the enterprise would incur regardless of its social mission. As a result, these items have no associated social cost.

Throughout this process, it is worth keeping in mind that it is as much an art as it is a science. Don't get hung up on perfection and remember that the goal is to come up with estimations that are backed up by thoughtful and critical analysis. At the end of the day, this process aims to help your enterprise have a clearer understanding of its costs in order to isolate potential areas for improvement. It would not serve your enterprise well to over-account for social costs and, in doing so, cover up general inefficiencies.

Managing your double bottom line is a continuous process. REDF recommends that you review and revise your social cost methodology regularly because:

- Your business cost structure may change over time (e.g. growth may provide scale benefits)
- You may revise your social mission (e.g. hiring people with different barriers to employment)
- External conditions may change (e.g. regulatory changes, funding)

However, it is important to clearly document your current methodology and rationale for social cost allocations in order to make future revisions much easier.

### **In Summary**

At times this process may be difficult, but the benefits of quantifying social costs make it worthwhile. Distinguishing social costs from ordinary business costs enables managers to understand the extent to which a social purpose enterprise is profitable as a stand-alone business and in turn shapes important strategic and operational decisions.

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