

Victims of Success

Reducing Complexity for Nonprofits

Many nonprofits are in trouble—and ironically, they may be victims of their own success. A 2004 survey of major U.S. nonprofits found that nearly 90 percent were experiencing some degree of fiscal distress, with 51 percent describing their distress as “severe.”¹ While the study blamed their financial problems on government budget cuts and the rising cost of employee benefits, we believe the deeper cause of their distress is the organizational complexity that’s grown up as nonprofits have met so many different needs and cultivated donors to support their ever-broadening missions. To meet expanded mandates and service commitments, many nonprofits added capabilities and structure piecemeal, without considering the long-term implications of such ad hoc additions for their organization. At the same time, through a similarly improvised process, the piecemeal growth led to less focused and directed development programs as new marketing channels were created to reach donors to fund new services.

This haphazard evolution typically leads organizations to grow increasingly unwieldy and less effective over time. Frontline managers begin to see the head office not as a source of support but as a bureaucracy that issues endless and often conflicting directives, which they must work around and even ignore if they

are to get anything accomplished. Clients become frustrated by a lack of organizational responsiveness to their needs. Donors, impatient with this state of affairs, naturally decide they need to add more strings to ensure that their gifts don’t vanish into administrative overhead, a move that further weakens an organization’s ability to fulfill its mission.

In the commercial sector, this kind of creeping complexity generally continues to grow indefinitely, increasing costs and lowering customer satisfaction a little every year. It is only when customer expectations suddenly change—typically because of the entry of a new, innovative competitor—that the organization is jolted into reforming its practices or risk being left behind. For example, consider the U.S. automotive industry after Toyota and Honda raised the bar for quality, or the U.S. airline industry after Southwest Airlines altered customer expectations on price.

Many in the nonprofit world are undergoing just such a sea change, brought on by the rising expectations of what a large nonprofit should accomplish. Donors are demanding greater transparency in nonprofit financials and operations, and greater accountability for their contributions. As a director of the International Rescue Committee said recently, “What were once open pledges of financial support now come with strings and caveats and expectations.”² Even small donors frequently do some due diligence of their own, thanks to databases such as the Charity Navigator, an online directory based on IRS Form 990 returns.

¹Lester M. Salamon and Richard O’Sullivan, *Stressed but Coping: Nonprofit Organizations and the Current Fiscal Crisis* (Johns Hopkins University, 2004), <http://www.jhu.edu/listeningpost/news/pdf/comm02.pdf>.

²Andrea Elliott, “From a Staten Island Mosque, Quake Aid That’s Made to Order,” *The New York Times*, Oct. 13, 2005.

The fact that so many of today's most sophisticated donors compare themselves to venture capitalists is evidence of their perception that nonprofits are highly inefficient and thus in need of their expertise as well as their money. The Heinz Family Philanthropies, for example, declares, "Like many other foundations, we see that the open hand of charity... is generally less effective than the helping hand of strategy," while Social Venture Partners is a community of 1,100 philanthropists in 23 cities who invest time and money in "capacity building partnerships" with a variety of nonprofits. Such venture grantors typically take a disciplined approach to their grants (which they often describe as a kind of societal investment) and stop funding if an organization's performance fails to match their high expectations. The Bill and Melinda Gates Foundation, for instance, is known for being unafraid to pull out of a project that isn't working.

Another clue as to how serious an issue this perception of inefficiency has become for the nonprofit world is the fact that some members of Congress are beginning to discuss whether there is a need for regulation of nonprofit enterprises in the style of Sarbanes-Oxley. Although the nonprofit community has not fallen prey to the kind of scandals that shook public confidence in corporations, the fact that regulation is even a possibility is an indication of public sentiment.

Fortunately, there is a solution. Executives in for-profit enterprises have struggled with similar issues of coping with scale for decades, and developed a number of techniques to mitigate this kind of creeping complexity. One of the best ways is through a technique we call Smart Customization. Although not well-known in the nonprofit world, we believe it can actually be adapted quite easily. But first, it's worth examining the sources of complexity.

How Complexity Creeps Up

Large nonprofits have a natural and indeed healthy tendency to be all-embracing. Often led by an energetic and empathetic executive team eager to take on new missions, new constituencies, and new fund

ing streams, the reach of the large nonprofit organization almost always exceeds its grasp.

As noble as the tendency toward such "mission creep" might seem in the beginning, it can lead to counterproductive and even cruel results in the end. If the money is not actually available to support these new initiatives, one of two things generally happens. The fund-raising division may make a mad scramble for donations and revenue, jeopardizing more established fund-raising channels; for instance, they may burn out long-time donors, as in the painful and public loss of the Guggenheim Museum's key donor after decades of reckless global expansion.³ The other alternative is for the organization to renege on its promises, leaving staff and clients feeling frustrated, betrayed, and helpless.

In a nonprofit, complexity tends to accumulate in several ways. The most common situation is when the head office takes on a new commitment without understanding how it will contribute to total operational costs. Other times, complexity is added at the local level: Field officers act on their own initiative, not realizing that their actions have consequences for the organization as a whole and not just the communities they serve. Finally, donors sometimes push initiatives that would otherwise not be at the top of the agenda.

Despite good intentions all around, it's easy for organizations to founder when they expand in this haphazard way. If this tendency is unchecked, the nonprofit will evolve progressively into a collection of unassociated projects that gain few advantages from being part of a larger enterprise—and ironically, the more successful the organization is in the beginning, the worse these problems are likely to grow in the end.

This is true in the private sector as well. The reason is that over time, good companies often understand more and more about what each segment of the market needs, and naturally endeavor to deliver what their customers want. They add new elements to their products, or create new versions of those products, to try to capture customers' unmet needs. Eventually, however, this tailoring increases costs, and all those

³David D'Arcy, "Guggenheim Tests the Limits of Generosity," *The Wall Street Journal*, June 23, 2005.

incremental additions eliminate the economies of scale that made it possible to deliver the product cost-effectively in the first place.

How to Break the Cycle

Smart Customization is a technique that uses a better system for introducing new product and service variation, enabling companies to trade off the value of providing customers with more variety against the costs of adding more complexity into the business model to support that variety. Whether their product is a corporate treasury account or an airplane, companies that employ Smart Customization:

- Understand which elements of their offering will always stay the same;
- Define the modifications customers want most; and
- Confine variation to those elements that can be changed profitably—i.e., they let the customer choose the color, not redesign the engine.

It sounds simple, but Smart Customization works: A Booz Allen Hamilton study of 50 product and services companies found that “Smart Customizers” typically outperform peers two-to-one in revenue growth and have profit margins 5 percent to 10 percent above competitors. Some companies have done even better: One national bank, for example, developed differentiated approaches to customer service that improved service levels while reducing total costs by 20 percent, while an airline manufacturer shaved off 30 percent of its cost structure using the methodology—with no sacrifice in quality or customer satisfaction.

In a nonprofit, Smart Customization would require the development of programs that operate in similar ways across a variety of locations. The goal is to separate those elements that are always necessary (an example would be food in a relief operation) from those that change depending on the environment (such as security needs in a war zone versus security in a peaceful countryside). This kind of detailed planning could reduce costs for nonprofits by showing where scale economies are possible—for instance, for back-office operations such as donor-payment processing—and where they are not.

Creating such modular architecture could also help each operational unit benefit from the knowledge gained from similar experiences in other places. Without modular architecture, each project is unique and the chances of duplication are enhanced. While some local managers might argue that such architecture would limit innovation, in fact the converse is more often the case: A lack of fixed architecture means that the organization spends more time and money perpetually building the same services (not to mention the same problems) over and over again—perpetually reinventing both the wheel and the pothole.

Such planning can also make it easier to achieve a greater understanding of the overall cost of a given operation. Our analysis suggests that the majority of a typical project’s cost is determined the day before the project starts. Many of those costs tend to be out of the control of ground managers from Day One, since property leases, equipment leases, and most local staffing costs are determined long before actual service work begins. Better cost-to-serve numbers can simplify budgeting, and also help make donors more comfortable, by giving them some reassurance that the organization knows its business in detail.

Smart Customization can also be applied to fundraising. Typically, development staff keep trying to reach an ever-widening group of potential donors. They reach further and further out, prospecting for an ever-widening range of potential donors at different price points, for different purposes, through different channels, and yielding different donor experiences, in order to maximize yield and segment penetration. Yet, as on the service side, there’s often surprisingly little analysis about which groups will be the most profitable to pursue and how they should be pursued. The result is frequently a collection of unrelated tactics and often, the development officer ends up asking for the wrong amount of money from the wrong target at the wrong time.

Smart Customization is useful in limiting these kinds of mistakes in two ways: Not only does it help mobilize an organization to do the right thing, it also gives the organization the discipline to *not* do things. For example, requests by deep-pocketed donors to

take on new projects that don't quite align with the organization's mission may look appealing in the short run (especially for a cash-strapped enterprise) but in the long haul, they drive costs up and efficacy down. Learning to say "no" to such projects is an important way to limit the growth of complexity, since the discipline limits both the costs and operational risks that can undermine already successful programs.

As the late management thinker Peter Drucker said in a *Forbes* interview last year, choosing when to stop is a crucial element of managerial success in both for-profit and nonprofit organizations. Drucker said he always told Dr. Rick Warren, the founder and head of the fast-growing Saddleback Community Church in Lake Forest,

Calif., "Don't tell me what you're doing, Rick. Tell me what you stopped doing."⁴

Though Smart Customization is easier to understand than to execute, it has the benefit of rapid returns. Executives can use the methodology to begin making noticeable and sometimes dramatic improvements in performance almost immediately, even if they can only proceed at first with incremental steps. In the long run, however, everybody wins with Smart Customization: Clients get more and better services, staff get more responsibility, and development officers make donors happy. Customization that reduces costs and complexity while improving the lives of clients and increasing performance is in everyone's best interest.

⁴Rich Karlgaard, "Peter Drucker On Leadership," *Forbes*, Nov. 19, 2004.

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