
# Meyer Foundation Releases Report on Outsourcing Back-Office Services in Small Nonprofits

The current economic situation has only intensified the ever-present need of executives of small and mid-sized nonprofits to find cost-effective ways to reduce overhead costs. According to a new report released by the Meyer Foundation and the Management Assistance Group (MAG), outsourcing is a promising strategy for these nonprofits to meet their back-office needs, but there are many barriers that prevent outsourcing success.

The study, **"Outsourcing Back-Office Services in Small Nonprofits: Pitfalls and Possibilities,"** is based on a survey of grantees of the Foundation, interviews with grant makers, consultants, and a range of back-office service providers, and a review of current literature on the subject. The goal for the collaboration was to survey and identify alternative back-office services that could strengthen operations, relieve the pressures on executive directors, and lead to greater efficiencies, particularly in this difficult economic climate.

Key findings include:

- Outsourcing may not offer short-term cost savings but can offer significant long-term benefits and cost savings.
- Current business models for outsourcing are often not well suited for serving small to mid-sized organizations, many of which are complex and have significant unmet needs.
- There is a significant opportunity for business entrepreneurs with a deep knowledge of and sensitivity to the nonprofit sector and innovative new business models.
- Areas most in need of better solutions include human resources, marketing and communications, and financial planning.
- Barriers that prevent nonprofits from outsourcing back-office services include the inability to find specialized skills at a reasonable cost, lack of time to find and contract with providers, and negative past experience.

The 48-page study offers ideas for grant makers, back-office service providers, nonprofit executives, and business entrepreneurs as they consider how to better meet the back-office needs of nonprofits and proposes a framework for evaluating outsourced back-office services.

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- Executive Summary
- Full Report

# Outsourcing Back-Office Services in Small Nonprofits: Pitfalls and Possibilities

### A Study Conducted by the Management Assistance Group
### In Partnership with the Eugene and Agnes E. Meyer Foundation

## Executive Summary

The current economic collapse has only intensified the ever-present need of executive directors of small and mid-sized nonprofits to find cost-effective ways to reduce overhead costs and meet their back-office needs. In many of these organizations, the executive director also serves as the chief financial officer, the human resources director, and the chief technology officer—managing important back-office functions with little formal training and very few resources.

*Daring to Lead 2006*, the widely circulated report on nonprofit executive directors produced by CompassPoint and the Meyer Foundation, cited limited management infrastructure and lack of administrative support as key contributors to executive director burnout and turnover—particularly for small and mid-sized community-based nonprofits. As a follow-up to *Daring to Lead*, the Meyer Foundation made a grant to the Management Assistance Group (MAG) to support a study to assess the back-office needs of Meyer grantees and to identify alternative approaches, such as outsourcing or shared services, that could relieve the pressures on executive directors and help organizations function more effectively.

The full 44-page study is available on the websites of the Meyer Foundation and MAG, and is based on a survey of Meyer grantees, interviews with 16 industry experts and a review of the literature on outsourcing and shared services in both the for-profit and nonprofit sectors. Among the highlights:

- **Outsourcing shows promise as a strategy for helping nonprofits improve their back office operations.** Outsourcing can offer nonprofits access to higher level professional skills than they can afford to hire on staff and can reduce the management and administrative workload of executive directors. However, current business models for outsourcing are often not well suited for serving organizations with annual budgets of less than $3 million. These small and mid-sized organizations have significant unmet back-office needs that are just as complex as those of larger nonprofits.
- **Entrepreneurs and businesses that offer outsourced services have a significant opportunity to create new business models to serve more nonprofits.** The back-office needs of small and mid-sized nonprofits (the vast majority of nonprofits) are urgent and largely unmet. However, service providers should be realistic about price point and scope of services offered. The study suggests that most existing business models do not work for serving small to mid-sized groups, and that thoughtfully designed combinations of technology and innovative business models are required to dramatically reduce costs.
- **For those organizations most in need of better back-office services, outsourcing may not offer short-term cost savings, but can offer significant long-term benefits and savings.** Nonprofits that are spending very little to perform a function poorly won't save money by

transferring it to an outside firm. However, the long-term benefits and cost savings could be significant if outsourcing allows the executive director and other key staff can spend more time on program and strategy and they are less distracted by important work for which they have little time or training (or by the serious and sometimes costly consequences of neglecting back-office functions).

- **Executive directors need to develop the skills required for successful outsourcing**. In addition to cost, lack of knowledge about outsourcing, lack of time to research service providers, inexperience in writing good outsourcing contracts, and negative past experiences are significant barriers that prevent nonprofits from outsourcing back-office functions. Intermediary organizations, such as nonprofit associations and management support organizations, could address these barriers by creating basic reference material about outsourcing, offering training or peer support sessions, and facilitating a network of service providers that understand the needs of small to mid-sized organizations and are willing to design appropriate business models to serve them.
- **Grantmakers should proceed with caution as they encourage grantees to consider outsourcing.** Funders have limited knowledge of the nuts-and-bolts back office functions of their grantees and are not generally well positioned to select specific vendors. Grantees may feel obligated to use back-office services suggested or paid for by funders even if the fit is not right for their needs, and may be reluctant to offer critical feedback. Productive roles for grantmakers include listening carefully to grantees to identify common needs, engaging in continuous learning about new outsourcing service providers and business models, educating grantees, and facilitating conversations among grantees and outsourcing service providers.

The project included a survey of small and mid-sized grantees of the Meyer Foundation, interviews with key informants, and a literature review. The 16 interviewees included grantmakers, consultants, and a range of back-office service providers. Mark Leach, a senior consultant at MAG, led the project and reported its findings.

**Grantee Survey Highlights**

The online survey, which was completed by 89 of 177 recipients, asked executive directors of selected Meyer grantees how they currently handled key functions in finance and administration, human resources, communications, and technology, and how satisfied they were with how the function was handled. The survey also asked executive directors to identify their two most pressing back office needs, the barriers to meeting those needs, and the impact of leaving the need unaddressed. Among the major findings:

- Areas most in need of better solutions included human resources functions related to finding and keeping good staff, financial planning, and communications and marketing.
- Many organizations expressed great dissatisfaction with the state of their communications and marketing plans and saw this—along with the need for improved publications and marketing materials—as their most pressing need.

- Almost a third of respondents are dissatisfied with their lack of financial planning and say they don't have the capacity to raise more money to escape chronic problems with cash flow and episodic funding.
- Human resource functions are handled poorly or not at all in many of the respondents' organizations (especially in those with 5-20 employees), resulting in inefficiency, poor performance, burnout, and high staff turnover.
- A large percentage of respondents, particularly those leading small organizations, are performing back-office functions themselves, and most of them are dissatisfied with their own performance.
- For some functions (financial planning, human resources, marketing/communications, and IT), high levels of dissatisfaction are reported whether the function is performed by in-house paid staff, external consultants, or pro bono professionals.

The impacts of not finding better solutions to back-office needs include: inefficiency and burnout, high staff turnover, cash flow crises, loss of funding, missed opportunities for expansion and collaboration, diminished impact, and threats to growth and sustainability. At best, these are enormous distractions for leaders of small nonprofits. At worst, the lack of adequate back-office infrastructure reduces effectiveness at achieving mission and wastes human and financial capital.

**Report Overview**

The full report provides:

- Descriptions of the most pressing needs of small and mid-sized nonprofits, drawing on data from the Meyer grantee survey, other studies, and the expert interviews.
- The best reasons for outsourcing and better understanding of the barriers that prevent nonprofits from outsourcing back-office services, including the inability to find specialized skills at a reasonable cost, lack of time to find and contract with providers, and negative past experience.
- A disciplined analysis of several distinct business models, revealing why some back-office service providers can provide affordable and high quality services to nonprofits—and why those nonprofits most in need of better solutions (groups with annual budgets below $3 million) are difficult to serve without innovative business models or some form of third-party subsidy.
- A framework for evaluating outsourced back-office services based on affordability, quality, scalability, demand, range of services, transaction costs, and cost of transition.
- Ideas for grantmakers, back-office service providers, nonprofit executives, and business entrepreneurs as they consider how to better meet the back-office needs of nonprofits.

To explore these issues further, download the full PDF report at:

[www.meyerfoundation.org](www.meyerfoundation.org) or [www.ManagementAssistance.org](www.ManagementAssistance.org)

# Outsourcing Back-Office Services in Small Nonprofits: Pitfalls and Possibilities

### A Study Conducted by the Management Assistance Group
### In Partnership with the Eugene and Agnes E. Meyer Foundation

## Overview

This paper was researched and written by the Management Assistance Group (MAG), with funding by and substantive collaboration with the Meyer Foundation. It is Phase II of a study intended to identify innovative approaches to help smaller, community-based social change organizations address their administrative, finance, and other office support needs. The overall study was also intended to discover the conditions under which certain approaches work well and identify barriers that prevent organizations from taking advantage of alternative approaches to handling various back-office support functions.

Phase I was the Meyer Grantee Back-Office Survey conducted by MAG in the summer of 2008. That survey identified how the Meyer grantees were handling critical back-office functions (in finance, administration, human resources management, public relations, communications, and information technology) and which functions were most in need of new solutions. The survey also examined other issues including the impact of not finding better solutions and the barriers to doing so.

This paper and the Phase I survey report were written as "source documents" for use by the Meyer Foundation, with the understanding that the Meyer Foundation would be responsible for any additional synthesis, editing and publication. As such, this paper does not restate or fully integrate all the findings of the survey report but refers to selected results when necessary.

## Context

### Ongoing Needs of Small Nonprofits

Small nonprofits[1] have always struggled to meet their needs for the administrative and professional services that support their core program work. Often referred to as "back-office" needs, these services have typically included:

- Finance and administration (e.g., routine book keeping and accounting, financial planning, budgeting and reporting, vendor management, etc).

[1] We define "small" as under $3M budget and less than ~20 staff. According to research done by Jeff Russell of Easy Office, nonprofits in the $450K to $3M range (which constitute 270,000 of the 1.1 million US nonprofits) are the segment least able to adequately meet their back-office needs.

- Human resources (e.g., benefits administration, payroll processing, policy development, recruiting, personnel management, etc).
- Information technology (e.g., computer hardware and software procurement and maintenance, database management and support, website development and updating, etc).

While less commonly understood to be "back-office" functions, the Meyer grantee survey also identified "public relations, communications, and marketing" and "fundraising and development" as pressing needs for which better solutions are urgently needed.

Experts interviewed for this study confirmed the Meyer grantee survey findings that:

- HR issues almost always poll highest in polls of most needed back-office services.
- Finance and IT are the most in-demand services for outsourcing by small nonprofits.
- Development and fundraising assistance by outside firms is in great (and increasing) demand.

The Phase I survey revealed that large percentage of small nonprofit executives are performing many of these back-office functions themselves, and many or most of them are dissatisfied with their own performance. For some functions (financial planning, human resources, PR, communications, and IT), high levels of dissatisfaction are reported even when performed by in-house paid staff, external consultants or pro bono professionals. The impacts of not finding better solutions to these back-office needs include: inefficiency and burnout; high staff turnover, cash flow crises, loss of funding, missed opportunities, diminished impact and threats to growth and sustainability. At best, these are enormous distractions for leaders of small nonprofits. At worst, the lack of adequate back-office infrastructure is responsible for their ineffectiveness in achieving their mission (Non-Profit Overhead Cost Study, Brief No. 3, August 2004) and incalculable human and financial waste.

**Impact of the Faltering Economy**

The current economic collapse has only intensified the ever-present need small nonprofits have to find cost effective ways to meet their back-office needs. As a result there has been greatly increased interest in the nonprofit sector to reduce overhead costs in a variety of ways, including a revival of interest in mergers, shared services, outsourcing, shared space, and even eliminating smaller organizations entirely. Interviews for this study indicate that many people do not have a way to sort through the avalanche of ideas and proposals coming from providers, foundations and nonprofits and make informed decisions about how best to meet back-office needs of small nonprofits.

It is the purpose of this paper to shed some light on just one of these alternatives—outsourcing. In discussion with the Meyer Foundation, it was agreed that this alternative was one of the least well understood and on which the least has been written.

## Outsourcing and Shared Services

Before going further in defining the purpose and the methods of this paper, let us clarify the difference between *outsourcing* and *shared services*, as used in this paper. They are often used interchangeably, but they are not the same and the distinctions matter.

- **Terms Defined**

  For our purposes, **outsourcing**[2] occurs when a nonprofit contracts with an outside provider to conduct some of the nonprofit's recurring internal activities—such as preparation of financial reports, database maintenance, or managing the process of recruiting and hiring staff. *In outsourcing the "factors of production" (i.e., the staff, technology and other resources needed to provide the service), are owned by the outsource provider, not by the nonprofit. In addition certain "decision rights" (Greaver, p.3) may also be given over to the provider (e.g., an outsourced accounting firm that processes a nonprofits accounts payable and receivables would make the decisions about what software they would use internally to capture the information or would decide how to deploy and manage their own data entry staff).*

  By contrast, in **shared services**, two or more nonprofits (or programs of different organizations), agree together to share the factors of production (e.g., a client management database, an on-call HR consultant, a bookkeeper, etc). In shared services, all the factors of production (the people, equipment, technology, etc.) are managed, and in many cases, owned by one or more of the nonprofits. Some sort of agreement is typically drawn up for managing how the shared resource will be allocated among the nonprofits, and how the owner (or employer) of the resource is to be compensated.

- **Evolution and Relationship between Outsourcing and Shared Services**

  There is an important historical relationship between shared services and outsourcing in the for-profit and public sectors, which may be instructive for the nonprofit sector. The corporate and public sector began extensive use of shared services in the 1990s, with small businesses following suit in 2003 – 2004. However, due to a variety of problems implementing shared services models, the corporate sector is now moving away from shared services to outsourcing. For some companies, these problems were anticipated. For these companies, the intent all along was to develop a shared services center, and then spin it off as a separate profit center, selling services on an outsourced basis not only to the founding company but to other companies as well.

  Shared services, *except in the context of fiscal sponsorship arrangements,* appear extremely difficult to sustain. Many service providers and nonprofit sector experts interviewed for this study say that while all parties to share services arrangements "want the benefits of the shared resource, no one wants to run it, implement it, or have ownership of it." These arrangements fall apart on issues of "turf and personalities," and on technical,

[2] Outsourcing is frequently referred to in the industry as "Business Process Outsourcing" or "BPO"

legal, and psychological barriers—questions of who is in control, who owns the data, and of fairness in the allocation of the shared resource's time and attention. Even when users in shared service arrangements enter with high trust, clear contracts, and great expectations, their energy for maintaining and governing the shared service arrangement seems to decay over time. As one well-informed and experienced provider of back-office services put it, *"we hope the nonprofit sector will just skip this step of shared services and move to the better solution of outsourcing from the start."*[3]

Having not investigated shared services in the nonprofit sector in any depth, MAG has no opinion on whether shared services can be made to work well in the nonprofit sector outside of fiscal sponsorship arrangements. However, the experience of these other sectors and of nonprofit service providers, funders, and other experts provide fair warning that shared services have significant challenges in implementation.

**Purpose and Key Questions**

This paper addresses three questions[4]:

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[3] While it would be easy to dismiss this observation as reflecting the self-interest of an outsourced service provider, this could be risky given other non-provider observations on the difficulty of sustaining shared service operations.

[4] The purpose and key questions of this research for and with the Meyer Foundation have evolved as our understanding of the back-office needs of small nonprofits has evolved. It began with a desire to *"identify the range of innovative approaches available to help organizations address their back-office needs (including models that exist outside the nonprofit sector), analyze and describe the conditions under which these approaches work well, and identify the barriers that prevent organizations from taking advantage of alternative approaches to handling back-office operations."* As the scale of this task became apparent, MAG and the Meyer Foundation agreed that we would narrow the inquiry by pinpointing the back-office supports which the Meyer grantees were most struggling to acquire—hence the Phase I survey.

We decided to focus on outsourcing for the remainder of the study for several reasons. First, survey results showed that outsourcing was experienced by Meyer grantees as something they were interested in, that had greatly increased satisfaction rates with certain functions for some, and that were very problematic for others. Second, it became clear that there was less information available on the structures, advantages, and barriers to outsourcing in the nonprofit sector than there were for other potential solutions (e.g., mergers, shared services, shared space, fiscal sponsorship, incubators, strategic alliances, etc.) Third, we learned that the Tides Foundation had already begun an extensive case research / best practices study of its own, principally, but not solely focused on shared services in the context of multi-tenant nonprofit centers. Finally, there was significant interest within the Meyer Foundation in answering two questions:

a) Are "one-stop" outsourcing centers a solution for increasing the quality and decreasing costs of back-office services for small nonprofits? and

b) How viable is the idea of creating an outsourcing intermediary that would help match and manage the relationship between small nonprofits and outsource service suppliers?

With these considerations and questions in mind, we began Phase II qualitative interviews and our initial findings caused us to further refine the questions we wanted to answer. It became clear that answering the questions about one stop outsourcing centers and the viability of an outsourcing intermediary, could not be done without an overall understanding of the industry, cost structure, and business models involved in providing outsourced back-office services. Without this understanding, answers to these questions could be based on invisible and quite likely erroneous assumptions and result in poor decisions with unintended consequences.

1) Why is providing the needed range of affordable high-quality services to small nonprofits (through outsourcing or any other means) so difficult?
2) How do we evaluate the existing and ever-growing options for outsourcing for small nonprofits?
3) What principles should guide the choices of nonprofits, foundations, and providers regarding future initiatives in nonprofit outsourcing?

This report provides a way to think structurally about nonprofit outsourcing and is another lens through which nonprofits and funders can sort their way through the bewildering array of business propositions, "best practice" reports, and foundation initiatives that are currently coming out related to outsourcing and shared services.

Given how little is known in this field, we hope to help people understand what some of the most important questions to ask about outsourced services are and how to better evaluate the answers. This is a field in flux, and definitive solutions are not yet at hand. To claim any best practices at this point would be, to paraphrase Barbara Blumenthal, "magnifying ignorance."

We hope to set the stage for more informed and productive conversations about how to meet the back-office needs of small nonprofits and to help funders, nonprofits and providers explore innovative solutions on a bigger scale. This is challenging stuff. It requires providers to be honest about what they can and cannot provide within their existing business models. It encourages funders to re-examine their allocation of resources for back-office services. And this should challenge some nonprofits to go beyond easy answers about lack of time and money as reasons for having under-developed back-office infrastructure that cripples growth and impact.

To understand the structure of nonprofit outsourcing as business and an industry, MAG conducted confidential phone interviews with 16 informants (providers, researchers, and nonprofit sages—some of whom wear more than one of these hats). We also reviewed numerous providers and intermediary websites and read background information from books, articles and other research studies (see Appendix B: References).

There are limitations to this research. Budget and time constraints limited deep case research into all the experiences and information cited by nonprofit experts and providers interviewed for the study. This is also not a how-to guide on outsourcing. (The author hopes the forthcoming Tides Foundation study will be a beginning on that task, at least for several existing models.) Finally, the conclusions offered here are the combined result of surveys of nonprofit organization leaders, insights of longtime nonprofit experts, providers of different kinds of outsourced services, and the author's own analysis, based on his experience and training in multi-sector industry analysis as a nonprofit consultant. As a relatively unstudied field, any conclusions must be held provisionally and are subject to the thoughtful use and application by any of us looking to advance this field.

# I. Structure of the Back-Office Services Industry

## Introduction: What Small Nonprofits Want and Need

**Most Needed Services**

- The specific services most desired by Meyer grantees are carefully detailed in the Phase I survey report. As noted above, these results are consistent with (although not identical to) a study conducted by Easy Office—a back-office service provider based in Boise, Idaho—that received ~300 responses from nonprofits nationally, and with the observations of several experts, we interviewed each with decades of experience and a national view on the nonprofit sector. Rather than repeat that data here, it is enough to note that there are real barriers to nonprofits getting what they need in back-office services, especially for those with budgets less than $3M.

- The services that are easiest and cheapest to provide on an outsourced basis (routine financial bookkeeping, accounting and reporting, human resources payroll, and benefits management) are not in all cases the ones nonprofits feel the most pressing need to acquire (e.g., strategic financial planning, recruiting, training and supervising staff, development and fundraising)

- Nonprofits may be satisfied with the quality of some functions they are currently performing in-house without understanding how poorly they are actually performing these functions and the long-term impact of this.

- The Meyer grantee survey shows that nonprofits know there are costs and risks in not handling back-office functions adequately. But they may not have taken the time to calculate the true cost to them of erroneous overhead-to-program cost ratios[5] rates, poor financial planning, bad hires and high turnover, inadequate communications, disorganized databases, or antiquated IT systems.

- Small nonprofits are at a disadvantage in comparisons of overhead rates with larger nonprofits. While there are good reasons to question the validity of some of the financial comparison data, small and medium nonprofits spend 20 to 25% on overhead, while large nonprofits (greater than $50M) spend less than 10% on overhead.

[5] See "The Quality of Financial Reporting by Non-Profits: Findings and Implications" (2004) for examples of how the poor quality of financial reporting (just one of many back-office functions), even when conducted by trained CPAs from firms with nonprofit experience, can damage nonprofits' long-term prospects and effectiveness.

**Reasons for Outsourcing**
Systematic studies (Russell, 2007; Greaver 1998) from multiple sectors converge on the following sets of reasons for outsourcing:

- **Reduce operating costs** and reduce capital investments
- **Increase organizational impact** by allowing staff to focus on core business
- **Access to technology, skills and insights** not otherwise available or affordable
- **Increased flexibility** and responsiveness

Other reasons include improving quality and providing an alternative to building capacity in-house (Russell, 2007), improved management and control, improved credibility and image through association with superior providers, and accelerating growth (Greaver, p.4).

Small, complex nonprofits face at least two kinds of staffing problems that larger organizations do not. First, they may need a senior level professional but they do not have enough work to occupy the person full time or pay their salary. Second, they experience periodic "spikes" in the need for higher skilled back-office staff. For example, small organizations often lose or cannot hire good accounting staff or web designers because these highly trained people often do not want to do the repetitive, routine work required between spikes in demand for their higher levels of expertise.

Designed properly, outsource business models that combine the availability of an "expert on hand" with the ability to do repetitive tasks could be very valuable to small nonprofits. Several respondents noted that small nonprofits already outsource many functions (e.g., bookkeeping payroll, tax filing, audit, health benefits, 401(k) plans, building services, etc.) although they may not think about it in this way. While recognizing this helps some nonprofit staff be more open to outsourcing, other barriers still remain.

**Barriers to Outsourcing**
Depending on whom one asks, different pictures of the barriers to outsourcing emerge. In this study we're drawing primarily on the 2008 Meyer grantee survey, interviews with outsourced providers and nonprofit sector experts, and on data from a survey with ~300 nonprofit respondents conducted by Jeff Russell when he was developing his business plan for Easy Office. Understanding the differences in the pictures that emerge from each source may be as valuable as the information itself.

In the 2008 Meyer grantee survey, respondents said the top barriers to outsourcing were:

- Inability to find specialized skills at a reasonable rate
- Lack of time to find and contract with providers
- Prior experience with expensive consultants who do not understand the organization or did not follow through

In MAG's experience with many hundreds of small nonprofits all over the US, these reasons for keeping back-office functions in-house sound familiar. The first reason is relatively straightforward, and we'll address below in discussion of "the Cost Gap." The second is either in the category of poor management or more generously explained as "it's hard to remember that your aim was to drain the swamp when you're up to your [ankles] in alligators."

The last reason is more complex and could explain not only why more nonprofits do not use outsourced services, but may also explain some interesting differences in perception between some nonprofit managers and some outsourced services providers. In MAG's experience, leaders of many nonprofits, especially small nonprofits, do not believe that many outsourced service providers understand them or their organizational needs. First, *small organizations do not necessarily have less complex needs than larger ones*. For example some small, effective advocacy nonprofits are simultaneously managing a 501(c)3, a 501(c)4, and a political action committee. It takes a specialized provider (whether in accounting, database management or communications), to deal competently with this level of complexity. Likewise, many direct service nonprofits are masters at blending multiple funding streams—from individual, foundation, and public sector donors, membership dues, earned income, to in-kind contributions of time, space and materials, and so forth—to maintain a range of mission critical programs with overlapping staff. How many outsourced providers in fundraising or strategic financial planning could convince a seasoned nonprofit CEO that they could do a better job than an internal person of handling such a complex blend of funding streams? How many pre-designed databases or financial management systems can manage this sort of complexity without massive customization?

Second, *it can be hard for some outsourced providers to understand that some small nonprofits have good reason to stay small* (e.g., outside of big metropolitan markets an organizations with ten staff may be the biggest, highest quality game in town, with no prospects for additional revenue). Or a nonprofit serving a small, culturally marginalized immigrant group may have good reasons to remain small, providing services no one else can and politically wise to not merge with a larger mainstream organization. The "grow or die" assumption (that some providers accustomed to working with for-profit businesses hold) translates poorly to some nonprofit organizations and can create a sense of mistrust between outsourced provider and potential client.

In Russell's 2007 survey the following were cited as the top three reasons nonprofit leaders gave as barriers to nonprofit outsourcing:

- Loss of control (59%)
- Inadequate business case (cannot justify cost based on perceived benefits) (34%)
- Organization philosophy / culture (33%)

Other top barriers were:

- Services are perceived to be "core" functions

- Protection of intellectual property and confidential or sensitive information (e.g., donor information, detailed cost structure data, program methods, etc.)
- Not wanting to be dependent on an external supplier

The two surveys agree that finding services that are worth the cost is a key barrier.

On the surface, this appears to contradict the fact that cost *savings* is one of the principal reasons given for outsourcing. However, nonprofit leaders who say they cannot justify the cost are often right—at least in the short-term. Outsourcing of some services for some organizations will not save money. Outsourcing sometimes requires an *additional* expenditure, over and above what the organization is already spending on that function This is because functions done completely and properly by a competent outsourced professional (e.g. in finance or HR) will cost more—in the short run—than if they were done less well by an in-house generalist, or were never done at all. So the most compelling reason for small nonprofits to outsource is that it gets these back-office functions off the plates of leaders and program staff who often have neither the interest nor training to perform them well, and whose time is better spent elsewhere. Still, it is difficult to convince some nonprofits (or their funders) that the long-term benefits of an incremental increase in overhead make sense.

A striking difference between the Russell and Meyer surveys is that the former identifies nonprofit CEO unwillingness to relinquish control as the major barrier, while the latter does not identify this barrier at all. However, this difference may be more apparent than real. MAG suspects (but cannot prove from this study) that in some cases these are simply two sides of the same coin, and that the explanation lies in *why* nonprofit leaders are unwilling to give up control. Some CEOs may (as several providers said) refuse to delegate control because they are unwilling to "let go of control in order to really build a more effective organization." However, in MAG's experience, a much larger number of nonprofit leaders are unwilling to relinquish control because they do not think the provider really understands how their organization works and are unwilling to be the training ground on which the provider learns. This barrier appeared clearly in the Meyer survey.

Finally, nonprofit receptivity to outsourcing varies by function. Easy Office found that 70% of their almost 300 survey respondents were open to outsourcing financial services. Other services (such as staff recruitment, development and fundraising, database management) are seen by some nonprofit executives as either too close to core program work to outsource, or they are afraid of losing control of sensitive data by accident or by bad intent. It is in these gray areas (where larger organizations have been successfully outsourcing services for years) where small nonprofit executives need to ask whether their fears are justified, or if it has more to do with their need for control or general discomfort with a new way of operating.

Providers also find increased resistance by nonprofits to outsourcing in organizations that are not growing (often these are organizations in the $2M to $3M budget range). While possibly a chicken and egg situation, nonprofit CEOs report an unwillingness to let go of or reassign existing, loyal staff, even if that person's performance is hurting the organization. Or they may simply have a hard time justifying increasing overhead expenditures when no new revenue is on the horizon.

## Three Business Models

There is an almost endless combination of services, delivery models, pricing structures, market segments, etc. in the nonprofit outsourcing world. In order to get a handle on these, and therefore to be able to know what kinds of solutions are likely to work in what situations, it is valuable for our purposes in this paper that we have a shared understanding of what a business model is and what types exist. This is not an academic exercise. With so many new outsourced service models being proposed all the time, and no agreement on best practices, these are essential tools for sorting through what is likely to work and where the pitfalls lie.

**Elements of a Business Model**[6]
Paraphrasing and quoting Christensen (2009, p. 9) a business model has four components, all interdependent and designed to work together:

- **Value proposition:** A product or service that can help targeted customers to more effectively, conveniently, and affordably do a job they've been trying to do.
- **Resources:** The people, products, intellectual property, supplies, equipment, facilities, cash, and so on required to deliver the value proposition to the customer.
- **Processes:** Habitual ways of working together that emerge as employees address recurrent tasks repeatedly and successfully. These processes define the resources that are combined to deliver the value proposition.
- **Profit [or Surplus] Formula:** This includes the required price, margins, asset turns, and volumes needed to produce revenue equal to or more than the costs of resources and processes.

Since all four elements of the business model are designed to work together, it becomes difficult to change any one part of the model and have it be sustainable and effective. For our purposes, evaluating any proposed outsourcing model requires understanding how these elements will work together successfully. Many outsourcing failures are directly traceable to trying to adapt one business model to a clientele or purpose for which it was not designed.

There are three generic types of business models (Christensen). Each one has particular attributes that make it particularly well-suited or not to the delivery of certain outsourced services to small nonprofits.

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[6] Do not be put off by the use of "business" language here. While the author does not believe all business concepts translate well to the nonprofit sector (and some have done great damage), these are powerful concepts for understanding the usefulness and sustainability of any service provider's system whether for-profit or nonprofit.

**Experts-On-Hand (or "Solution Shop")**
Most small nonprofits have recurring need for *highly skilled back-office service providers who can "diagnose and recommend solutions to unstructured problems."* Examples of the sorts of back-office functions provided by experts-on-hand, include managing staff recruitment, designing and ensuring proper implementation of performance evaluation systems, HR policy development, strategic financial planning, communications and media planning, database development, IT system planning, and development and fundraising.[7]

Providers of such services rely on extensive training, experience, instinct and judgment in order to assess and solve recurring but complex problems. Small nonprofits rarely need people at this level of skill on a full-time basis. Rather they need a part-time CFO, part-time fundraiser, part-time PR firm, part-time HR director, etc. The key difference between an expert-on-hand and a consultant is the long-term and recurring nature of the provider – nonprofit relationship.

**Repetitive Process Business [or "Value Added Process Businesses (VAP)"]**
Small nonprofits also have need for someone to do routine, repetitive tasks such as managing accounts payable and receivable, bookkeeping, accounting, routine financial reporting, payroll processing, HR benefits processing, printing marketing materials, website management and updating, and routine IT system maintenance. Because tasks like these require *"transforming inputs of resources—people, materials, energy, equipment, information, and capital—into outputs of higher value,"* people and firms that do them are called value added process businesses, or "VAP." For example, an outsourced provider of repetitive process financial services would take raw data (e.g., staff timesheets, vendor invoices, expense records, donor contributions, etc.) and turn them into higher value products such as cash flow statements and quarterly financial reports.

As Christensen says, *"because value adding process organizations do their work in repetitive ways, the capability to deliver value tends to be embedded in processes and equipment. They are not nearly as dependent upon the instincts of people as is the case with solution shop [expert-on-hand] businesses. Because of this, VAP businesses that focus on process excellence can consistently deliver high-quality services and products at lower cost."* In our research, outsourced providers who had figured out how to deliver high quality, affordable repetitive process services to small nonprofits had either: a) invested heavily in new, sophisticated technology (such as a web-based platform on which hundreds of nonprofits could manage most aspects of their accounting and financial reporting, as well as retirement accounts, health insurance and other employee benefits, or b) had created new uses for existing, simple technologies (such as QuickBooks and high-speed scanners) and used these as core elements of their business model.

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[7] Reasonable people can disagree as to whether some of these services should be considered core or "back-office," but there can be no disagreement that these are essential services nonprofits have difficulty obtaining and which are routinely outsourced by many larger organizations.

**Facilitated Network Businesses**

In this business model, an organization earns at least some of its revenue by helping broker relationships between nonprofits who want to buy services and providers who want to sell them (often at a reduced rate). *"[F]acilitated networks comprise institutions that operate systems in which customers buy and sell, and deliver and receive things from other participants... The companies that make money in network industries are the ones that organize, facilitate, and maintain the effective operation of the networks."* (Christensen, p. 24)

In our research, we found several examples of Facilitated Network businesses serving small nonprofits including:

- A web-based, nonprofit "purchasing co-op" which provides members with a list of outsourced back-office service providers (in areas such as HR, communications, fundraising, and financial planning) who have been vetted for quality, experience in the nonprofit sector, and with whom the purchasing co-op has negotiated reduced rates for co-op members. Co-op members not only receive services at a discount, but are also provided a platform for sharing information and experiences with one another.

- Regional nonprofit associations, MSOs and co-ops who similarly keep lists of preferred, vetted providers to whom their members can go for discounted services.

The facilitated networks we saw sustained themselves through a combination of revenue streams including member fees, foundation and corporate donations, and taking a percentage on fees paid to providers for work arranged through the network.

*… In many network business models the dependency among customers is the main product delivered. Said another way, to the network users themselves are the key part of the product, and the size and composition of the customer base are therefore the critical drivers of value…While [most of the literature emphasizes] the size of the network, the compatibility of members is more important." (Christensen, pp. 24-25)*

For small nonprofits it is not the type of back-office service available through a facilitated network that may be the critical feature of this business model. In fact, in our research we found several examples of facilitated networks making a wide range of services, from the most routine to the most customized, available to network members. Rather, it may be the ability to pool users for negotiated fee reductions and shared technology, the presence of a trusted intermediary to vet suppliers, and the ability of the facilitated network to provide access to both expert-on-hand and repetitive process business that make this model valuable.

## The Cost Gap for Small Nonprofits

**The $3M Cutoff and $1M-$2M Limbo Range**

At one level our research confirms Meyer grantees' view that the main barrier to their greater use of outsourced services was cost. Most providers say they cannot afford to serve organizations below $3M in revenue (or approximately 15-20 or fewer staff) with the back-office functions with which Meyer grantees were most dissatisfied or for which they felt the most pressing need. These are typically, but not exclusively, the more expensive expert-on-hand services such as strategic financial planning, HR support to recruit and retain staff, communications and media, etc.

Several other providers commented that organizations between $1M and $3M often had trouble growing—typically, in their view, because it required growing the organization to a size larger than what the leadership was comfortable with or because they had not figured out how to raise sufficient funds.

- An organization specializing in development services said organizations in the $3M - $5M range were their target because the leaders knew how to give up control and were sophisticated partners, and that organizations under $1M did not spend enough on fundraising and development to give high enough margins on which to build a business. They worked with organizations between $1M and $3M only if convinced that the leaders truly wanted to grow their institutions and were open to having other strong leaders in their organization. A human resource consulting firm with a strong commitment to nonprofits, typically served organizations over $5 million because their business model was focused around outsourcing the entire HR management function. They had not yet figured out how to serve organizations under $3 million and make enough money to cover their costs.

- A facilitated network organization that negotiated discounted fees for its members with providers supplying many higher end, desired services (HR, communications, fundraising, and financial planning) was able to deliver ~20% fee reductions. Although we do not have provider data about how many small nonprofits can actually afford these discounted rates on expensive services, we do know that only 25% of the networks members are under $3 million and have less than 20 employees. The network appears to be developing a business model well suited to organizations more able to pay.

It is important to remember that these are all providers who are deeply committed to serving the nonprofit sector, and have been doing so for decades. Their inability to serve smaller organizations is largely because they have built business models that are only profitable for larger clients or because they have only chosen to work with smaller ones that exhibit the leadership and culture required to have larger and higher impact. Whether or not these providers understand that some nonprofits should and must remain small to effectively pursue their mission, their business models are not currently designed to accommodate smaller, non-growing nonprofits.

Changing business models is extremely difficult once an organization has been established. It would not be reasonable to expect any of these dedicated providers to just begin serving smaller organizations—their organizations would gradually become unsustainable and unable to serve anyone.

**Generic Solutions to Cost Gap**

Interviews surfaced four significantly different methods for closing the cost gap and making it possible to provide services to small nonprofits. Each one, to be sustainable, must be part of an integrated business model, and not simply an added feature or component of a model not set up to serve small nonprofits. These solutions must be deliberate, deeply structural, and an integral part of the philosophy and way the providers conduct and develop their business. Our research suggests that the most sustainable solutions to closing the cost gap often combine two or more of these methods.

The generic solutions for closing the cost gap are:

- ***Third-party subsidies:*** In this solution, a foundation, corporate sponsor, or other donor fills the gap between the providers' cost of service, and what a user can afford to pay. This is obviously attractive to providers, because it allows them to expand their clientele with minimal impact on their business model. It also means that a broader range of providers is available to serve the nonprofit sector, often including high-quality for-profit and nonprofit providers accustomed to working with larger organizations.

  There are numerous pathways for the provision of these subsidies, including:
    - Regional membership associations supported by area businesses and foundations (one large, regional association serves hundreds of mainly small nonprofits with a range of back-office services. But since the financial service area is the only one that comes close to covering its own costs, the association relies on corporate and foundation grants to remain in business.)
    - Cost sharing between a small nonprofit (or group of nonprofits) and a foundation (one foundation representative helped a group of grantees to identify a shared back-office need, let the grantees research and select the provider with whom they all wished to work and then subsidized the cost of the service on an ongoing basis.)
    - Subsidy funds created by an independent outsourcing firm (MAG raises money every year from individual donors to subsidize services for small organizations who do not have adequate funds for needed consulting services. While the continual, recurring nature of expert-on-hand services introduces a different set of issues than for one-off consulting, there's no obvious reason this model couldn't be adapted for use in this way.)

One downside of this solution is that the business model is not sustainable without a constant infusion of external funding; when funding ends the services end. A related downside is that the outsourced service providers are never forced to develop a business model that is sustainable without subsidy, and potentially could hide serious inefficiencies on the part of the provider. Finally, if the subsidies are tied to specific providers—and especially if a grantee's funder is offering the subsidy—it creates a strong incentive to use that provider even if the fit with client needs is wrong. Alternatively, this "power of the purse" can increase the use of needed services and encourage reluctant nonprofit CEOs to relinquish control and expand their organization's capacity.

- ***Internal cost shifting:*** In this solution, the provider's business model includes a sufficient number of higher-paying, large clients to internally cross subsidize smaller clients. We found this model operating in:
    - Several for-profit back-office services providers and in several fiscal sponsorship organizations allowed them to serve clients as small as $300K - $400K.
    - A for-profit expert-on-hand firm that specifically designed a different set of services, delivery system and rate structure to serve small nonprofits. This business model still required subsidy from larger, full-pay clients. Notably, the organizations that use the cross subsidy strategy are highly selective about the small nonprofits they chose to subsidize—selecting those with the most promise for impact and future growth. They were not interested in subsidizing organizations that appeared plateaued at one size or were shrinking.
    - An individual provider who relied on higher fees from its for-profit clients to subsidize its services for small nonprofits.

  Providers engaging in internal cost shifting were typically (but not exclusively) firms with multiple staff or an available stable of pre-vetted consultants capable of serving nonprofits of varying size. Depending on the service offered, it is conceivable but less likely that cost shifting on any significant scale could be accomplished by very small firms or individual providers.

- ***Pooling clients for reduced rates and economies of scale:*** This solution appears critical to filling the cost gap in almost every truly sustainable business model for serving small nonprofits. In this solution, numerous small clients are bundled together to reduce costs in one of two ways.

  First they can use their collective bargaining power to negotiate reduced rates from high-quality providers or providers offering inherently more expensive (i.e., expert-on-hand) services. The provider gets an expanded and in some cases captive clientele, often gets increased visibility through some sort of preferred provider status, and the nonprofit gets more affordable services. We found these reduced rate arrangements brokered by regional membership associations, fiscal sponsorship organizations, and regional and web-based purchasing co-ops.

Secondly, a pooled group can be used to spread the overhead costs of the technology and centralized staff needed for value added processes. For example, the nonprofit fiscal sponsorship organization mentioned earlier invested over $1 million to develop a proprietary web-based platform at the heart of its finance and HR benefits system for its hundreds of members. Economies of scale in repetitive process providers can also be created by enforcing the widespread use of commonly available technologies like QuickBooks, which are then used by centralized staff to perform repetitive bookkeeping and financial reporting functions.

- ***Providers willing to work at below market rates:*** This solution depends on the willingness of back-office service providers (either individuals or firms) to work at below market rates. For example, there exist some terrific "part time CFOs" and "part time development directors" who know the needs of small nonprofits intimately, and choose to work at below market rates for organizations whose mission they value. Unlike providers who work at below market rates in return for preferred provider status and expanded clientele, the best of these providers do it because of their commitment to the mission of organizations in this sector. In the author's research and experience, such providers appear to exist in many different kinds of providers, including individuals, for-profit and nonprofit firms, regional membership associations, fiscal sponsorship organizations, and collective purchasing groups.

  The primary drawback to this method of closing the cost gap is lack of scaleability. While any particular nonprofit might get lucky and find such a provider, the model is not replicable at anything like the scale needed to address the needs of small nonprofits.

  Unfortunately there is another class of providers, the so-called "bottom feeders," also willing to work at below market rates. These providers have no choice but to work below market because their services lack the quality to compete effectively for higher-paying or more discriminating clients.

## Critical Dimensions for Evaluating Outsourcing Models

As should be evident by now there is a huge number of combinations of business models and types of providers out there. It should also be evident that each business model and type of provider will be good at some things and less good at others. This does not make one model good or bad in any absolute sense, but only in relation to what a particular nonprofit or group of nonprofits needs. The key to successful outsourcing, is to decide which attributes are the most important to optimize and on which you need to accept some compromise. There is no single one-size-fits-all best model. The following dimensions constitute a menu for evaluating which model is right for your organization, your membership, your grantees or your clients.

Each is described here, and then in Section II we evaluate the most common existing models according to these criteria.

**Affordability (Closing the Cost Gap)**
Obviously one important criteria is the ability of a particular business model and delivery structure to provide needed services at a price the nonprofit can afford. While this may appear simple, the calculation of cost to benefit may not be so simple. In addition to considering the incremental cost to the organization's budget, the decision on affordability should also take into account the hidden costs of not performing the functions competently.

For example, many nonprofit leaders want—but believe they cannot afford—professional assistance in recruiting for key positions. Indeed many understand the risks and expense of making a bad hire. But they can barely raise enough money for key program positions let alone coming up with 25% to 35% of that person's salary to pay for professional recruiting help. In addition, experience has taught some nonprofit leaders that recruiting help from a provider that does not really understand the organization can still lead to a bad hire. So these leaders will either oversee the process themselves or patch together a search committee composed of board members and others in their network.

Looked at another way, skimping on professional help for key hires, or in developing a decent finance system is only a rational calculation if one ignores the massive long-term costs of not investing in this help. What does it cost a nonprofit (in turnover, time invested in orientation and training, lost productivity, perceptions of instability by funders and other stakeholders, reputation among future potential candidates, etc) for hiring the wrong person? And what are the long-term costs of a financial system, which does not allow the nonprofit to pass an audit, demonstrate its effectiveness to funders, or which collapses when the only person who understands the books retires?

**Quality**
This is the difference between getting the job done and getting the job done right. In business model terms, it means that the outsource provider has the skills, technology, experience and incentive to provide the back-office function (i.e., value proposition). Small nonprofits should beware of firms with a high quality reputation who will only make their less experienced staff available. We heard several examples in research interviews of firms (both expert-on-hand and repetitive process businesses) who used smaller nonprofits as the training ground for new employees. Once they had learned from their mistakes at the expense of the smaller nonprofit, they were permitted to work on higher paying contracts with larger organizations.

Quality of outsourced services is not just an attribute of the provider. It is also an attribute of the relationship formed between provider and client. Quality will increase to the extent the client is willing and able to make information, data and decisions available to the provider in a timely way, and to truly delegate important functions.[8] Both parties become skilled in quickly identifying and working to resolve problems that emerge in the relationship will also impact quality. Good outsourcing relationships should be considered long- term investments.

**Scaleability**

Different business models are capable of serving different numbers of nonprofits, either through their ability to pool users, or to replicate a local model in multiple regions. What scale is desirable will depend upon the needs and incentives of the funders and nonprofits involved. For example, a fiscal sponsorship organization operating nationally may wish to make a common set of back-office services available to all its members everywhere in the country. Or a municipal area foundation may wish to address the lack of fundraising or human resource management competency among its most promising, small grantees.

Each of these back-office service goals requires a very different scale of intervention and a very different business model. The first require a huge investment in web technology available to members. The latter might require sophisticated diagnosis of individual grantees (their missions, core values, current capacities, CEO's leadership style, etc.), in order to design the right solution for that particular set of grantees.

Larger scale may often be in tension with the next dimension for evaluating back-office service delivery models.

**Supply or Demand Driven Services (Captive Markets)**

Different business models depend on greater or lesser degrees of user influence or control over the choice of provider and services delivered. At one extreme are demand driven services in which an individual nonprofit or group of nonprofits identifies the services they most need, search for, select, and contract with the provider who will give them precisely what they're looking for. This would include contracts arranged through purchasing co-ops, or brokered through facilitated networks or fiscal agents that have a wide range of competing (yet vetted)

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[8] This is a particularly tricky area in outsourced provider—nonprofit leader relations. In small, complex organizations the impact of a bad decision or bad fit of a technology or system can have a devastating impact on the entire organization. A nonprofit leader will be very unwilling to let go of a task or decision-making authority unless convinced that the outside provider understands all the ramifications of decisions and recommendations. In most instances of outsourced "expert on hand" services, letting go of control looks like setting out the larger parameters in context, and expecting the outsourced provider to come back with a strong recommendation and rationale for that recommendation. There are often legitimate reasons for leaders of small nonprofit organizations to stay involved in decision-making in areas that would be more fully delegated to an outsourced supplier in a bigger organization. That said, there are indeed small nonprofit founders and leaders who keep control simply because they want control and are uncomfortable with delegating, having other competent staff around them, or letting their organizations grow beyond what they themselves can control.

service providers available to their members. It could also include regionally defined groups of grantees such as the one described in the "quality" example above.

At the other extreme are supply driven services, in which nonprofit users experience little choice among the providers with whom they can work. These could be considered "captive markets," and examples include: regional membership associations in areas where the association is the only source of affordable back-office services for small nonprofits; foundations that make a particular, preferred back-office service provider available to grantees (and who sometimes may also make it politically costly to decline the help); and fiscal sponsorship organizations that require members to use the fiscal sponsor's own back-office services.

These are the extremes, but a limitless number of shades of grey exist between these extreme ends. Each point on the continuum represents a balance among affordability, user control, and scale. None is inherently better than another in all situations. The creators and users of these systems need to be awake to the trade-offs they are accepting.

**Range of Services**

Different business models are more or less suited to providing a range of outsourced back-office services. Since the four elements of any business model must be integrated and work well together, it makes sense that it should be more difficult for one outsourced provider to provide multiple services than a single service or closely related set of services. Our examination of existing models and interviews with providers give overwhelming evidence that this is true in the real world. We have learned several things about single service providers and multiple-service providers.

***Single Service Providers:***

- Are much more common than multi-service providers.
- Often provide a full range of services within one overarching functional area (e.g., a financial services firm might supply bookkeeping, accounting, payroll, accounts payable and receivable, financial reporting, strategic financial planning, CFO level consulting and still consider itself a single service provider.) Providers claim they can usually integrate sub-services within a functional area like this more efficiently and with better quality than if the sub-services are outsourced to multiple providers.
- Offer as part of their value proposition the ability to buy some or all needed services on an à la carte or "cafeteria" basis, ensuring that clients pay only for the services they most need.
- Allow nonprofits to select the provider with the best reputation with the best fit for each functional area they choose to outsource.
- Can generate high transaction costs (for writing and monitoring multiple contracts) for nonprofits that outsource multiple functions.

***Multiple Service Providers:***

- Require a high degree of business acumen to create and manage multiple business models within a single firm or organization.
- Sometimes claim to provide many different functional areas, but in reality, do the majority of their work in only one or two functional areas.
- Report highly uneven profitability of the different service areas, with finance being the most prevalent one on which breaking even is possible when serving small nonprofits.
- Can assemble teams of service providers to address multiple and complex back-office needs of a single client. Teams can provide holistic understanding of the client and of how various functions relate.
- Reduces user transaction costs for managing multiple outsourced services.
- Face a range of management challenges: different cost structures, distribution channels, price points, suppliers, and delivery mechanisms (remote *and* local presence); discipline to not extend beyond true expertise; client skepticism that one organization can deliver well on broad range of functions. (The author heard several examples of aspiring one-stop shops cutting back service offerings after initial attempts and eliminating the services requiring extensive on-location client work or requiring a expert-on-hand business model; each refocused on services suited to repetitive process business model, which is repetitive, delivered at remote location, technology dependent.)

Fiscal sponsorship organizations with their own staff of back-office service providers are the most common multi-service providers we found—and they are reported to vary enormously in quality. One of these fiscal sponsorship organizations had very few of their own staff, but have a stable of consultants from which the organization drew individual consultants or teams of consultants, and for which the organization took contractual responsibility for operations and results.

We only found one for-profit organization designed to provide multiple back-office services to nonprofits. The organization had a staff of 30 highly trained consultants and typically could not afford to serve small nonprofits. One regional membership association had its own staff to provide several outsourced services. It also had a set of independent providers to whom they referred members for services their own staff could not provide.

All other multi-service providers were in fact not providers themselves, but facilitated networks brokering relationships between users and single service providers in multiple functional areas (e.g., purchasing co-ops, regional membership associations, and web-based facilitated networking sites offering negotiated reduced fees from a small range of preferred providers).

**Transaction Cost and Transaction Assistance to the Nonprofit**

Finally, the different business models and delivery mechanisms vary in the degree to which they place administrative or financial burdens (transaction costs) on the user. One significant cost (highlighted by the Meyer grantees) is determining which providers really have the experience and skill to work with a small, complex nonprofit, and how much they will need to learn on the job.

Pre-vetted, preferred provider lists can potentially save users a tremendous amount of time in identifying and retaining a quality provider, but have the downside of limiting user selection. In this research, we did not independently evaluate service quality or client satisfaction with these preferred providers.

Other transaction costs associated with back-office outsourcing include: time spent supplying the outsourced provider with necessary information and supervision; making the process and staff changes necessary to integrate the outsourced service into the nonprofit; monitoring and making adjustments to the service relationship and contract.

The Meyer grantee survey indicated that many small nonprofits are dissatisfied with their ability to hire the right staff for a job. There is little reason to think the same organizations would do any better hiring and building a relationship with the right provider without some help.

## II. Evaluating Current Outsourcing Models

### Introduction

By "outsourcing models," we mean here *the business model* (expert-on-hand, repetitive process business, facilitated network), and the *package in which this business model comes wrapped*. These "packages" include: for-profit, nonprofit, regional management association, individual provider, multi-staff firm, foundation sponsored services, collective purchasing groups and Civic Ventures, etc.

It is beyond the scope of this research to do a comprehensive evaluation of the effectiveness of each model. However, using our menu of evaluation criteria, it is possible to identify which criteria are likely to be optimized (and which are most compromised) in each model.

The next section describes the range of existing outsourced services delivery models we found and gives examples of each. Then we summarize in chart form the ability of each model to perform on each of the six critical dimensions just described.

### Existing Outsourced Services Delivery Models for Nonprofits [9]

**Individual, Freelance Providers**

*Key Features*

- Exclusively for-profit.
- Expert on hand (or *very* small repetitive process operation.)
- Single service.

*Examples*

- A highly skilled financial planning and accounting systems specialist who functions as a part-time CFO for several small nonprofits whose missions the provider supports. The provider subsidizes the nonprofit work with fees from for-profit clients.

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[9] This study did not examine two other models of nonprofit back-office service delivery, since, for different reasons, each did not address the issues of most concern to small nonprofits. The two are: "Civic Ventures" where a for-profit group selects a small number of organizations in which to make program related investments in their growth and success; and, "association management firms" which typically provide a very narrow and specialized range of back-office services (e.g., member data base, conference organizing, information dissemination) to membership associations. We did not find any association management firms that also provided back-office services to program delivery nonprofits.

- A "circuit rider" who provides outsourced IT system maintenance services to geographically dispersed nonprofits. Services are subsidized by a regional foundation.

**Single Service Professional Firms**

*Key Features*

- Focus on one overarching back-office service area (HR or finance or IT, etc.)
- Larger ones usually provide range of sub-services within this one overarching back-office area.
- Multiple staff.
- For-profit or nonprofit.
- Expert-on-hand and/or repetitive process (larger firms most likely to have sub-units operating under multiple business models.)

*Examples*

- Full-service HR firm with more than 30 employees, with deep experience in both for-profit and nonprofit sectors. Nonprofit services operate under different business model than for-profit services. Small nonprofits (from 2-15 employees and between $150K to $1M budgets) get a package of HR consulting services on a monthly retainer basis (e.g., $250 per month). Services are delivered by nonprofit specialists, often by phone or e-mail. Discounted rates for smaller nonprofits are subsidized by cost shifting from larger clients.
- One for-profit outsourced finance and accounting services provider designed their business model specifically to serve the $50K to $1M nonprofit market. The firm provides low cost repetitive process services (bookkeeping, such as recording transactions, paying bills, processing donations, monthly bank reconciliations; financial reporting; preparation of IRS 990 forms). It keeps prices of these repetitive process services low by having all clients use the same readily available bookkeeping platform (Quickbooks) and by centralizing its operations in a part of the country where wage rates for bookkeeping and accounting labor is significantly lower than in the metropolitan areas where its target clients are located. Clients are supplied with high-speed scanners and information is transferred electronically and through express mail services. While not a major part of its revenue model, the same firm also makes finance and accounting consulting available to clients on an hourly basis, and at the lower end of costs for finance experts nationally. A regional sales and support team are available to resolve and correct problems on site. The firm sells its services to individual nonprofits and has recently become the sole, preferred provider of financial back-office services for a metropolitan area nonprofit association.

**Multiple Service Firm (Directly serving separate, independent nonprofits)**

*Key Features*

- Delivers services in two or more major back-office service areas (e.g., fundraising, finance, HR, insurance, finance, web design, and bookkeeping.)
- Large staff provides multiple sub-services within multiple back-office service areas.
- Examples we found were for-profit.
- Expert-on-hand and repetitive process.

*Examples*

- High quality provider using highly trained staff in areas of development, finance, and HR. Business model geared to clients in $3M - $5M budget range whose leaders are accustomed to delegation and skilled at partnering. Will work with carefully selected $1M - $3M nonprofits if leaders are committed to aggressive growth and expanded impact.
- There are very few of these because of difficulty blending multiple business models. We heard several examples of organizations that aspired to be "one-stop" nonprofit back-office providers, but which scaled back to provide fewer services once implementation difficulties became clear.

**Regional Membership Organizations**[10]

*Key Features*

- Regional organization itself is nonprofit, with nonprofit members.
- Services are delivered by regional organization's own staff or by providers vetted by the regional organization, and available on a preferred or sole-source provider basis.
- Services of external providers made available at discount to members.

*Examples*

- A regional membership organization covering a large geographic area (both urban and rural), and providing a range of outsourced back-office services including finance and accounting, web design, HR consulting, and health benefits. Majority of members are under $250K budget, and less than 10% of the members have budgets over $3M. The organization fills the substantial cost gap created by serving so many small organizations, using a hybrid funding model of member fees (40%), dedicated grants (40%), and dedicated corporate and foundation grants (20%). Staff and consultants generally work at below market rates due to strongly shared commitment to the sector.

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[10] A related model is that of national organizations with state or local affiliates that receive some back-office support from the national organization (e.g., web design and hosting, IT and database systems, PR and communications support, and so on). Depending on the funding formula between the national organization and the affiliates, the back-office services can be considered either shared services owned by all the affiliates or outsourced services purchased from national.

Scaleability is limited by need for constant infusion of external funding and dependence on high-quality, below-market rate providers.

- Municipal and state associations of nonprofits fall into this category. It was beyond the scope of this study to inventory the full range of services provided by all these associations. However, they appear to vary considerably in the mix of services offered. Notably, they vary in the amount of assistance provided to members in identifying high quality, affordable back-office service providers. Many appear to provide no ongoing back-office services at all (either through their own staff or through negotiated discounts with external providers), focusing instead on capacity building efforts and information exchange. Several nonprofit experts noted that regional associations may be reluctant to get into the politically tricky business of evaluating providers, publically recommending one set of providers over another, or having to deal with the difficult situation of a preferred provider who offers poor service.

**Foundation-Sponsored Services to Grantees**

*Key Features*

- Nonprofit foundation that facilitates and subsidizes back-office services for grantees.[11]
- Actual service providers are usually nonprofits, but need not be.
- Most likely to support expert-on-hand services, although repetitive process models are possible.

*Examples*

- One program officer identified a group of high-priority grantees and then helped them determine the most critical back-office need they shared—access to better HR services. After the foundation convened them, the grantees agreed on the kinds of services they most wanted, and launched an open search for a provider. They interviewed various providers and selected one—without involvement of the foundation. Together the grantees negotiated a fee with the HR expert and shared the cost of the providers among themselves and received ongoing subsidy from the foundation.
- Another program officer made a large grant to a communications firm (selected with active involvement and input from grantees), so that the firm could acquire a deep knowledge of the grantees' field. The firm was then available to multiple grantees to enhance and improve their dissemination of information.

[11] Although the foundation is involved in brokering, a grantee/service provider connection cannot be considered a facilitated network business. This is because the foundation does not derive its revenue from this brokering of relationships.

In both of these examples, not only were ongoing services made available to individual grantees, but also a "community of practice" was formed around the issue (HR, communications) in which grantees regularly convened for sharing information and learning from each other and the subsidized service provider.

**Collective Purchasing Groups**

*Key Features*

- A membership network or co-op pools member organizations and uses their collective purchasing power to negotiate reduced fees for member organizations from outside providers.
- The purchasing group is itself a nonprofit, but makes reduced fee services available from both nonprofit and for-profit providers.
- Providers are vetted for quality, familiarity with member needs, and reduced cost.
- Multiple providers may be made available for the same service or a single preferred provider may be selected.
- Typically both expert-on-hand and repetitive process services are made available, so the purchasing group becomes a "one stop" source for multiple services, even though the purchasing group itself has no back-office provider staff of its own.
- The basic business model is a facilitated network

*Examples*

- A web-based purchasing network has identified some of the hardest to obtain back-office services (e.g., HR, communications, fundraising, financial planning) and has negotiated discounts of about 20% on these services for network members. The selected providers were chosen for their reputation as high-quality providers and nonprofit experience and for the level of discount in their overall value proposition for nonprofits. Network members sign up online and are referred by other network members. Members geographic location is somewhat limited by the location of the providers. 75% of the purchasing network members have budgets greater than $3 million and more than 20 employees. It is not clear whether discounts of 20% for high-end expert-on-hand services close enough of the cost gap to allow very many small organizations to participate. The network is sustained by member fees and by a subsidy from one of the founding network members who also happens to be a provider.
- A geographically based purchasing co-op makes discounted services available to members from preferred providers, including a range of back-office needs and employee benefit plans. As a true "co-op" it is jointly owned and democratically controlled by the members themselves, increasing

the chances that services are affordable to most members and targeted to their needs.

**Fiscal Sponsorship Organizations**

*Key Features*

- A fiscal sponsor is a 501(c)(3) that provides unincorporated groups with tax exempt status. Sponsored groups and their staff are legally part of the fiscal sponsor, but retain control of program and strategy decisions, and are responsible for their own fundraising (Spack, 2005).
- Typically includes expert-on-hand and repetitive process back-office services primarily in accounting and human resources.
- Back-office costs are covered by an administrative charge to the sponsored program, and in some cases by corporate and foundation subsidies.
- Back-office services are either provided by the fiscal sponsor's own staff or by external providers on a preferred provider or sole-sourced basis.

*Example*[12]

- One fiscal sponsorship organization with national reach, and serving only organizations in the health sector, comes as close as any we found to being a "one stop" resource for high quality back-office services. It combines a highly facilitated consultant network for extensive expert-on-hand services, with a unique web-based platform for repetitive process tasks in finance and HR (timesheets; benefits management; accounts payable/receivable; billings; budgets, etc). This organization can serve organizations with budgets as low as $200K because of several features of its business model: $1M investment in sophisticated, proprietary technology; hundreds of sponsored programs to spread cost of technology investment; takes short-term losses on selected, smaller clients that are predicted to grow (due to nature of client's program niche, quality of leadership, and funding source); cost shifting from larger to smaller clients. Holds itself to extreme quality standards by: a) competing with other providers to sell services to non-sponsorship, independent nonprofit organizations; and b) contracting nationally recognized nonprofit back-office service providers, at reduced, negotiated fees, when users need services outside the sponsor's area of expertise. The fiscal sponsor ran the expert-on-hand portion of the business like a consulting firm, taking responsibility for identifying the needs of the user and then recruiting a team of providers to meet those needs.

[12] "Professional Employer Organizations" (PEO) are a for-profit variant of fiscal sponsorship in which a company's staff legally become the employees of the PEO, and the PEO "leases back" the employees to the company. Pooling employees across many organizations allows reduced rates on workers' compensation, payroll management, employment practices liability and employee benefits insurance. Some PEOs also provide expanded HR services consultation. PEOs have been growing rapidly as a solution for small businesses that want to provide better benefits to employees and want to focus management attention on the core business.

The chart below, "Fit of Outsourcing Provider Designs with Needs of Small Nonprofits," describes how each of the outsourced services delivery models just described performs on each of the six critical dimensions for assessing outsourced back-office services for small nonprofits.

**FIT OF OUTSOURCING PROVIDER DESIGNS WITH NEEDS OF SMALL NONPROFITS**

| DESIGN OF PROVIDER SYSTEM ◎ | Critical Dimensions for Evaluating Outsourcing Models | | | | | |
|---|---|---|---|---|---|---|
| | **AFFORDABILITY** (Options for Closing Cost Gap on Sustainable Basis) | **QUALITY** (What to Watch For) | **SCALEABILITY** | **RANGE OF SERVICES** | **PROVIDER VS. USER DRIVEN** (Degree of User Choice & Level of Customization) | **TRANSACTION COST & ASSISTANCE TO USER** |
| **INDIVIDUAL, FREELANCE** | • Expert-on-hand services probably not affordable to small NP —unless designed for working below market rate, receiving external subsidy, or provide reduced service package for small NPs.<br>• Repetitive services may be affordable (but lower tech.) | • Can vary tremendously.<br>• Likely to be high if competes successfully for larger clients.<br>• Check references VERY carefully.<br>• Avoid bottom feeders, even if it's all you can afford. | • Not scaleable beyond capacity of one person or relatively simple technology. | • Narrow (but OK if only NEED narrow.)<br>• No benefits packages. | • Provider defines services offered.<br>• High degree of user choice if selected on open market.<br>• Low degree of user choice if only affordable as sole-sourced, preferred provider.<br>• Potentially good at customization w/in narrow service offering (esp. for expert-on-hand services.) | • User on their own for all transaction costs (identify potential provider, evaluate quality, negotiate terms, manage difficulties.)<br>• Low switching costs. |
| **SINGLE SERVICE FIRM** | • Expert-on-hand services affordable if have internal cross-client or external subsidy.<br>• Repetitive process services affordable if | • Can vary tremendously<br>• Likely to be high if competes successfully for larger clients.<br>• Check references | • Expert-on-hand services limited by size of firm, and by caps on internal and external | • Look for ability to provide wide range of sub-services *within* functional area (will depend on size of firm.) | • Some provider flexibility in services offered.<br>• Look for willingness and demonstrated ability to customize | • High transaction costs if provider firm is engaged via open market.<br>• Medium if engaged via preferred provider status. |

| | | | | | | |
|---|---|---|---|---|---|---|
| | invest in technology and/or pool clients at sufficient scale.<br>• Look for business model that permits inexpensive, on call support, a la carte or at affordable monthly retainer. | VERY carefully.<br>• Make sure NP is not training ground for inexperienced provider staff. | subsidies.<br>• Repetitive process services could be at significant scale. | • Look for ability to access sub-services ala carte and remotely. | for user needs.<br>• High degree of user choice if selected on open market.<br>• Low degree of user choice if only affordable as sole-sourced, preferred provider. | • Low if sole sourced from intermediary (foundation, fiscal sponsor) that is also covering cost gap.<br>• Moderate switching costs if buying multiple services w/in functional area. |
| **MULTI SERVICE FIRM**<br><br>**(Not incl. 4 models below—though which multiple services may be accessed)** | • Same as Single Service Provider, AND…<br>• If profit formula bias is for outsourcing multiple services package, small users may be at disadvantage--unless seen as investment for later returns. | • Same as Single Service Provider, AND…<br>• Ensure that firm has high quality for ALL needed services, not just 1 or 2 primary ones. | • Same as Single Service Provider. | • Depends on firm.<br>• Examine how much of firm's business is in each functional area. | • Substantial provider flexibility in services offered.<br>• Look for willingness and demonstrated ability to customize for user needs.<br>• High degree of user choice if selected on open market.<br>• Low degree of user choice if only affordable as sole-sourced, preferred provider via an intermediary. | • Transaction costs can be lower than using multiple Single Service firms since dealing with one provider.<br>• Can provide significant assistance in convening needed teams to serve user.<br>• BUT…if problems arise switching costs VERY high. |
| **REGIONAL MEMBERSHIP ORGANIZ'N.** | • Discounted fees negotiated for members.<br>• May or may not be affordable by small nonprofits unless provider profit | • Varies greatly.<br>• Structural factors that work against quality: reluctance to challenge local providers on poor performance; captive | • Depends on number of RMO staff or size of preferred provider list.<br>• Examine | • Varies greatly, depending on size of direct service staff and size and diversity of preferred | • User choice limited by services directly provided, and/or by size of preferred provider list.<br>• Depending on governance | • Low transaction costs if RMO has done good job of vetting providers, and negotiating reduced fees.<br>• Look for amount of |

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| | formula also includes receiving external subsidy or internal cross-client or cross-service subsidy.<br>• Some RMOs depend on continual external subsidy to breakeven on most services. | member market if other affordable services unavailable; small provider list reduces competitive pressures for quality; if RMO derives revenue from the arrangement it may not be honest broker<br>• Structural factors that support quality: Preferred provider reluctant to lose major client base. | business model of actual service providers to see if it is designed for scale. | provider list.<br>• Many RMOs only do capacity building, not outsourcing, with own direct staff.<br>• Often includes volume discounts on benefits packages (insurance, health care, etc) and common back-office vendors (e.g., office supplies, printing) | structure, members will have more or less opportunity to influence available services and provider list.<br>• Customization depends on capacity and business model of provider | assistance available to member nonprofit in determining needs and assembling team of providers; varies by RMO. |
| **FOUNDATION SPONSORED SERVICES** | • Closing cost gap to make services affordable is central purpose of this model.<br>• Funds channeled several ways: grants to individual grantees who select own provider; foundation gathers group of grantees with shared need and funds a provider chosen by | • Varies with quality of service provider selected by grantee or made available by funder.<br>• Ensure provider's business model is compatible with structure of service provision established by funder. | • Limited by level of funding available and capacity of provider(s). | • In theory, unlimited.<br>• In practice, limited by foundation decisions about service area priorities for grantees. | • Depends on amount of choice funder gives grantee over provider selection.<br>• Captive market/sole source models not considered best practice by experienced foundations.<br>• Fee caps or requirements to use package of pre- | • Low transaction cost if funder does vetting of provider(s) and negotiation of basic contract terms.<br>• Maximum transaction costs if group of grantees must collectively identify, select and contract with provider on their own.<br>• Switching cost |

| | | | | | | |
|---|---|---|---|---|---|---|
| | group; foundation makes time of a pre-selected provider available to grantees selected according to some criteria.<br>• Sustainability uncertain. | | | | designed services may limit customization. | varies by provider and type of service(s) chosen.<br>• Some foundations assist grantees to create pooled user group and guidance on how to select provider. |
| **COLLECTIVE PURCHASING GROUP**<br><br>**[Regional co-op or web-based facilitated network]** | • Cost savings from reduced fees negotiated for members by the purchasing group. Negotiated fees may or may not be affordable by small members.<br>• True coops (meaning high inclusion, highly democratic governance by membership) more likely to arrange for services affordable by all members.<br>• Web-based network has less incentive to negotiate affordable rates for its smallest members: Smaller organizations may require additional | • Varies with quality of service provider(s) selected by purchasing group.<br>• Likely to be high quality if purchasing group vetting is done well, and provider gives highest quality work to discount clients.<br>• Nonprofits should still do own due diligence | • Scale of expert-on-hand services limited by number and size of preferred providers, and capacity to absorb reduced fee clients.<br>• Repetitive process services could be at significant scale. | • In theory, unlimited.<br>• In practice, limited by purchasing group ability and willingness to negotiate reduced fees with a wide range of providers. | • User choice limited by services directly provided, and/or by size of preferred provider list.<br>• Depending on governance structure, members will have more or less opportunity to influence available services and provider list.<br>• Customization depends on capacity and business model of provider. | • Low transaction costs if purchasing group has done good job of vetting providers, and negotiating reduced fees.<br>• Assistance in making match likely to be hire in place-based coop than in web-based network. |

| | | | | | | |
|---|---|---|---|---|---|---|
| | subsidy from provider or foundation. | | | | | |
| **FISCAL SPONSORSHIP** | • Typically very affordable.<br>• Services are specifically designed for use by pool of sponsored organizations. | • Highly variable, especially for services provided by own staff or<br>• Captive market can create structural isolation from competition.<br>• Quality likely to be greater if sponsorship organization services are also sold successfully on competitive basis to freestanding organizations. | • Highly scaleable.<br>• Scale of expert-on-hand services limited by number and size of own staff and number of preferred providers.<br>• Repetitive services designed to serve all sponsored organizations (and sometime others also.) | • In theory, unlimited.<br>• In practice, limited by fiscal agent's choices about what service to provide directly or through preferred providers.<br>• Typically provide benefits packages. | • Most captive market of all models.<br>• Choice of available services mostly in hands of fiscal agent. | • Minimal transaction costs.<br>• Significant assistance available for defining needs and convening provider teams.<br>• Switching costs very high due to multiple dependencies on fiscal agent. |

## III. Ideas to Guide Future Choices and Initiatives

Based on this study's findings, this section presents ideas that foundations, nonprofits and back-office service providers may wish to consider. The main purpose of these ideas is to stimulate the creation and use of more effective and appropriate back-office services for small nonprofits.

### Ideas for Grantmakers

**Help Nonprofits Access the Most Needed Services**

Routine repetitive process services (financial accounting and reporting, HR benefits administration, payroll) are the most widely available and affordable back-office services for small nonprofits. However, as the Meyer grantee survey report showed, the most readily available services are not always the ones grantees most need.

The real challenge is how to identify and provide services that will most enhance the impact of small organizations—such as fundraising strategy, long range financial planning, communications, and assistance with hiring and retaining excellent staff.

Before investing in subsidizing or brokering back-office services, grantmakers may decide to engage in a needs analysis with grantees to pinpoint the services that will most help the grantmaker's highest-priority grantees. Conducting a survey similar to the one MAG conducted with the Meyer grantees, or at least confirming with grantees that the grantmakers assumptions about most needed services are accurate, can help target scarce back-office service dollars where it will do the most good. Back-office services should be demand and impact driven, *not* supply driven.

**Re-examine Two Tough Choices**

***Rebalance program funding and back-office support to increase impact***

The Meyer grantee survey was a striking reminder of the devastating consequences of inadequate infrastructure support in small nonprofits. Perhaps grantmakers (and individual donors) would revise what they consider to be acceptable program-to-overhead cost ratios if they truly understood the tremendous human and financial waste and damage to mission when back-office infrastructure is under-funded. Funders understandably want most of their money to support core program services and want to support as many good initiatives as possible. However, it may not be possible to support as many small nonprofits as funders would like with the infrastructure services that are realistically needed to function effectively.

A deep structural problem in providing needed back-office services is the inaccuracy of program-to-overhead cost ratios. IRS Form 990 was not designed to determine program/overhead ratios, but is often used that way in donor assessments of grantees. As currently calculated these ratios are inaccurate and misleading, and we need a new framework for understanding the efficiency of programs. Nonprofits know that most donors prefer lower overhead rates, so they game their reporting, are fearful of telling the truth about what it really costs to run their organizations well, and are reluctant to hire essential back-office staff and outsourced providers.

***Discerning when to pull the plug on "stuck" nonprofits***

Results of the Meyer grantee survey and MAG interviews indicate a large number of nonprofits are plateaued between the $1 million and $3 million levels—levels at which better back-office services are desperately needed and at which affordable, high-quality service providers are difficult to find. Outsourced services providers sometimes laid responsibility for this "stuckness" at the feet of nonprofit leaders who either lack the ability or willingness to grow their organizations. But as we discussed, there are sometimes good reasons for small, effective niche players to remain in business and to not grow. So grantmakers need to carefully discern the reason for the stuckness before deciding how to proceed on back-office support.

For small, effective niche organization that have good reason to remain small and whose missions are consistent with what the grantmaker wants to create, the grantmaker needs to help figure out back-office service provision at realistic levels. This could include subsidizing the services of high quality outsourced providers and brokering the grantee-provider relationship.

But for small organizations that really must grow to adequately meet the need and pursue their mission, the reason needs to be carefully diagnosed. If it is not growing because the leader is drowning from lack of back-office support, then funding for additional administrative or financial staff, infusions of capacity building, and subsidized outsourced services may get them unstuck.

If the organization is stuck because the current leadership is unwilling to relinquish control or to delegate back-office matters even to highly competent providers, or the organization is occupying an unsustainable program niche, then additional back-office services will not help. Rather, the nonprofit's board, leadership and funders need to consider if the organization should really remain in business as a separate nonprofit. Perhaps a smaller portfolio of the most needed and viable programs could get its back-office needs met through becoming a program of a larger nonprofit or finding a fiscal sponsor. As the head of an innovative nonprofit recently told MAG, *"people need to understand that everybody does not have a God-given right to have a nonprofit."*

**Consider Nonprofit Choice and Control**

This paper cites numerous examples of outsourced services requiring varying degrees of foundation involvement. The most common, and most empowering, form of involvement is general operating support or adequate core support in program grants. But beyond that, the following principles may be helpful in maintaining appropriate boundaries between grantees and foundations when becoming more directly involved in making outsourced services available:

- Only intervene where markets fail. (Do an analysis of unmet needs and providers and only get involved in creating new delivery systems if necessary.)
- Optimize client choice within a given model. (Preferred and sole-sourced provider services tend to reduce in quality and innovation when providers do not have to compete to get clients; for purposes of keeping appropriate boundaries between donors and grantees, it is also important that grantees exercise choice over the providers they use and have some control over what information gets shared back with the funder.)
- Balance control by small nonprofit users with scale, cost and transaction efficiencies. (Maximizing grantee participation can add to overall cost, efficiency and work against scaleable solutions.)

**Seek Dialogue with Providers and Nonprofits to Increase the Supply of Quality Outsourced Services**

This study makes it clear that many outsourced services providers do not have business models suited to the needs of small nonprofits. Dialogue that will help providers better understand how they can create viable business models that also meet the most pressing needs of small nonprofits is an important next step.

Foundations can also seek to support the business models created by providers to serve small nonprofits. This could include fee subsidies (made to grantees, not to specific providers), assisting in identifying grantee needs, creating larger user-pools of carefully selected grantees, contributing resources to support to grantees in contracting with service providers, developing and managing contracts, or resolving problems as they arise.

The many examples and delivery models discussed here could be rich fodder for these discussions.

**Contribute to Disruptive Innovation**

These provider/foundation/grantee dialogues might benefit from considering ways to introduce more "disruptive innovations" into the nonprofit back-office services field.

Disruptive innovation, a term, coined 15 years ago by Clayton Christensen, describes a situation in which a combination of technology and innovative business models work together to make services available to "customers who were previously non-consumers because they have lacked the money or skill to buy and use the products sold in the original [competitive market]… Competing on the basis of simplicity, affordability, and accessibility, these disruptions are able to establish a base of customers in an entirely different plane of competition. In contrast to traditional customers these new users tend to be quite happy to have a product with limited capability or performance because it is infinitely better than their only alternative, which is nothing at all." (Christensen, pp. 6 – 7)

The example given earlier of the financial services firm that relies on relatively simple technology (Quickbooks and high speed scanners), and an innovative business model (locating repetitive process services in low cost area of the country, combined with regional face-to-face sales/support staff) is a perfect example of a disruptive innovation. Given the stakes for not finding ways to provide affordable, quality back-office services, we need the best minds working on new business models and on ways to use technology for step-wise increases in the scale of available services.

Some disruptive innovations are underway and need to be better known and scaled. They typically seem to require entrepreneurial thinking, boldness in approach, jettisoning some old assumptions about how nonprofits function. Others are yet to be found.

**Educate Grantees in Outsourcing Management**
Foundations could provide training to nonprofit CEOs in how to select good outsourced providers, contract with them, monitor their performance, and renegotiate terms if things are not working to their satisfaction.

**A Caution to Grantmakers**
Resist the temptation to recommend a particular provider or to directly buy a provider's services for your grantees. There are a number of pitfalls here, including:

- You are likely to attract a never-ending stream of vendors soliciting you to buy their services.
- Most program officers don't have sufficient knowledge of the day-to-day operations of their grantees to make a good choice.
- Grantees will be reluctant to refuse your offer, even if they know the fit isn't a good one—and you're unlikely to hear negative but true feedback about the provider.
- It absolves grantees of the difficult, but essential work of defining what they really need, and of owning the decision to work with particular provider in a particular way, on a sustainable basis.
- Preferential treatment of different providers can distort the market, both in terms of price, competition and overall growth of the provider sector.

## Ideas for Nonprofits

**Be open to new ways of doing business.** A few decades ago, the idea of entrusting a sensitive organizational function such as payroll would have been unthinkable; now the practice is almost universal. Technology firms can now provide routine maintenance from remote locations. Be open to other innovations.

**Investigate your options thoroughly.** The fact that a funder or an intermediary organization has identified an outsourcing option does not relieve you of the responsibility for conducting due diligence or making the final decision about outsourcing. This due diligence includes:

- Talk to other clients using the service.
- Make sure there are no hidden costs, and that you understand exactly how the relationship would work. Research what a good outsourcing contract should include.
- Research two or three comparable options before making a decision.
- Don't ask a business model to do something it wasn't built for. Evaluate for yourself whether an offered or available outsourced solution will meet your needs or is a set-up for frustration.

**Don't assume that outsourcing will save money in the short-term.** Most nonprofits are chronically underspending on their infrastructure, and outsourcing back-office functions won't save money if you're not spending enough on them in the first place. Outsourcing may allow key staff to focus more on program and fundraising; will provide access to more appropriate levels of expertise; and may reduce risk—all of which needs to be factored into the cost equation. Also, keep in mind that outsourcing still requires staff and responsiveness from your organization.

**Get educated about outsourcing.** Talk to providers and nonprofits experienced in outsourcing; create a peer learning group around nonprofit outsourcing. Read (this paper, Greaver, provider websites, briefings and tools from the Indiana University nonprofit cost study, to name a few starting places).

**Be realistic about what it really takes to fund your mission.** If you have good strategic reason to stay in that hard-to-support $1M - $3M budget range, make the case to funders for why staying small makes sense,[13] and fight for the resources needed to support your back-office adequately. If you cannot function effectively (including adequate back-office support), at below $3M, and cannot or do not want to grow your organization, then you may need to consider another structure for your program—including fiscal sponsorship or becoming a program within a larger organization.

**Be realistic with yourself and funders about the costs of not addressing your most pressing back-office needs.** 990s were never designed for doing accurate comparisons of indirect cost rates. Calculate the cost to your organization financially and in terms of your reputation for sub-par performance in recruitment and retention, inadequate strategic financial planning, fundraising and development, communications, etc. Act on these calculations and work collectively with other nonprofits and funders to design solutions that will work for you.

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[13] As the field considers whether or not to invest in small, not-likely-to-grow nonprofits, it is worth looking at MacMillan (1983) and the kinds of programs he calls "the soul" of a nonprofit agency. MacMillan's ideas about how to sustain these programs feel like fresh and valuable insights for understanding why the "grow or die" logic of some back-office providers is so at odds with the nonprofit's perspective in some situations. These "soul" programs have "strong position, low program attractiveness, and low alternative coverage…thus the agency is the client's last hope."

**Influence the governance of membership organizations and purchasing groups.** A greater range of better quality, scaleable services may be created if members of regional associations and place-based or web-based purchasing groups are willing to get involved in the organization's governance. If the governance structure is closed, interested members could advocate for opening it up.

## Ideas for Providers

**Do not ask your business model to do something it wasn't built for.** Although the market for outsourced nonprofit services appears poised for resurgence, do not assume you're positioned to join the bandwagon with small tweaks to your business model. Be realistic about what you can afford to provide small nonprofits on a sustainable basis and at high quality. Stay out of the small nonprofit market unless you have a business model designed specifically to serve them.

**Consider ways to alter or "complexify" your current business model to serve smaller nonprofits.** See which of the generic ways to close the cost gap might work for your organization and what other changes would be needed in all four areas of your business model to implement these gap closing measures. Consider how existing technologies, or investments in new technologies, could be used to significantly reduce the costs to a pool of nonprofit users, and how you might create or tap into an existing user pool.

**Develop the ability to know the difference between**:

- Small nonprofits that shouldn't grow for sound, strategic reasons, and
- Small nonprofits that could grow given the proper investment in back-office support, and
- Small nonprofits that need to grow but never will because the leadership will not allow it or the programs are too unattractive to be sustainable

**Dialogue with local foundations, associations and other providers to create new business models.** Share your ideas for business models that could work for organizations under $3M. Explore with intermediaries (i.e., regional associations, purchasing groups, fiscal sponsorship organizations), how altering your business model (internal cross-subsidies; preferred provider status; helping to pool clients, etc.) might make it possible for you or your firm to diagnose and meet the needs of small nonprofits.

### A Caution to Providers

The last thing most grantmakers want is an onslaught of vendors asking the grantmakers to "buy" their services for grantees. This approach is financially unsustainable, and foundation program staff generally don't have enough knowledge about the day-to-day operations of grantees to be effective at selecting providers. In the long term, direct grantmaker selection or sponsoring of specific outsourced providers distorts the market in unhealthy ways. Grantees would be reluctant to say "No" or to provide negative feedback about the grantmaker-sponsored provider, and quality and competition would be the casualties.

**Final Thoughts on Back-office "Intermediaries"**

One of the original research questions of interest to the Meyer Foundation was "how viable is the idea of creating an outsourcing intermediary that would help match and manage the relationship between small nonprofits and outsource service suppliers?"

This study shows that intermediaries that help connect back-office service users and providers currently exist in the nonprofit arena—in the form of regional associations, web-based and geographically based purchasing groups, and as part of services provided by some fiscal sponsorship organizations. A few foundations also have taken steps to link particular groups of grantees to providers in specific back-office areas.

Intermediaries, in theory, provide the following benefits:

- Approximate "one stop shopping" for back-office services.
- Provide referrals from a trusted intermediary that knows its provider and buyer market.
- An intermediary with skilled staff (e.g., some MSOs and some fiscal sponsorship organizations) can get to know a particular buyer well, help identify, convene, and manage a team of providers to address the buyer's back-office needs.
- Can support in-person or virtual "communities of practice" that help nonprofits improve their understanding and use of back-office functions and services.

But each of the current models have some significant limitations on their role as intermediaries (refer to chart above). The challenges to creating an intermediary that can overcome these limitations fall in two categories—quality and affordability, and financial sustainability:

- Quality and affordability constraints on intermediaries
    - It is politically and financially difficult for many intermediaries, especially geographically based ones (e.g., MSOs or regional membership associations) to set themselves up as the arbiter of provider quality and to sanction preferred providers that do not perform. (These disincentives to quality control are compounded when the intermediary is a regional association that also recruits providers as members.)
    - Good identification of needs and matching of buyers to providers requires highly nuanced assessments by experienced people.
    - There are a limited number of providers in any given area whose experience and business models are truly designed to serve the small nonprofit market with quality repetitive process or expert-on-hand services for the small nonprofit.

- Financial sustainability constraints on intermediaries

- Significant, sustained funding (either from user fees or grantmaker subsidies) of the intermediary is needed to generate well-vetted provider listings, develop rating and monitoring systems, negotiate prices, and build a procurement system. Intermediaries that earn revenue when services are purchased from preferred providers solve the financial sustainability problem, but at the cost of their own objectivity and reputation as honest brokers. There is some buyer resistance to intermediaries who want to be paid for brokering relationships—especially if the service is not seen as adding enough value at critical stages (vetting quality; helping the nonprofit define what it really needs; negotiating and monitoring the contract; helping resolve problems when they arise, etc.). One very experienced nonprofit expert said of intermediary organizations "this has been attempted many times, but they do not last. [Except for fiscal sponsorship arrangements], there's no business model there." Another said, "No one has the incentive to provide the funding necessary to support all the needed pieces."
- Unless foundations and corporate donors are prepared to make a long-term investment to underwrite the significant costs associated with a well-designed, high value-added intermediary, it is unlikely that this model will exist sustainably outside of member co-ops and fiscal sponsorship organizations.

## Conclusion

We hope this paper has provided some analytical tools and ideas to catalyze more creative solutions to the back-office needs of small nonprofits. Outsourcing is just one way, but a promising way, to meet these needs. New solutions will not spring full-blown from people in any one foundation, provider or nonprofit, but from sharing of needs, perspectives and new ideas about this complicated area, and being much more disciplined in our analyses of what can work—and why—in any particular situation.

## APPENDIX A: List of People Interviewed

**Jackie Cefola**, Non-profit Center Program Coordinator, Third Sector New England, Boston, MA.

**Roxanne Hanson**, Associate Director, The Non-Profit Centers Network (and lead researcher on Tides Shared Spaces forthcoming shared services study) San Francisco, CA.

**Sam Husney**, President and Managing Director, HR Dynamics, New York, NY

**Barbara Kibbe**, The Monitor Group (Previously led Packard Foundation capacity building program), San Francisco, CA

**Sheila Moore**, Vice President, The Alliance for Non-profit Growth and Opportunity (TANGO)

**Dennis McMillan**, President, The Foreaker Group, Anchorage, Alaska

**Lisa Brown Morton** , President, Non-profit HR Solutions, Washington, DC

**Stephen K. Orr**, Orr Associates, Washington, DC

**Jeff Russell**, founder of Easy Office, Boise, Idaho

**Daniel Saat**, Senior Financial Analyst, The Tides Foundation, San Francisco, CA

**Russell Schuster**, President, The Alliance for Non-Profit Growth and Opportunity (TANGO)

**Raju Shankar**, CFO, The Foreaker Group, Anchorage, Alaska

**Gerald Soloman**, Executive Director, Samuelli Foundation (Previous President of Public Health Foundations Enterprises), California

**Jonathan Spack**, Executive Director, Third Sector New England, Boston, MA

**Charles Schwartz**, Director of Business Development, All Sector Technology Group, Inc., New York. NY

**Laurie Wolf**, Vice President, The Foreaker Group, Anchorage, Alaska

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### *About the Author*

Mark Leach is a researcher and management consultant with a particular interest in strategy, leadership development and transition, and issues of diversity and inclusion in organizations. As a consultant and coach at the Management Assistance Group (MAG), he has worked with a range of social justice nonprofits and funders, primarily in the civil liberties, reproductive health, and environmental arenas.

Prior to joining MAG, Mark worked as a consultant and researcher in nonprofit and private-sector settings. His work has covered international development, inter-organizational collaboration, and diversity and inclusion in organizations. In the past twenty years, Mark has conducted his research and consulting at the Kaleel Jamison Consulting Group, the Institute for Development Research, and at John Snow, Inc. Mark's academic background includes a Masters in Public and Private Management from the Yale School of Management, and a Doctor of Business Administration from Boston University.

Mark's recent publications include "Organization Development for Social Change," in Cummings, T. (ed.) *Handbook of Organizational Development*, SAGE Pubs., 2008, co-authored with L. David Brown and Jane Covey, and "Changing Organizational Systems from the Outside: OD Practitioners as Agents of Social Change," in Jones, B. and Brazzel, M. (eds.) *The NTL Handbook of Organization Development and Change: Principles, Practices and Perspectives*, NTL Institute for Applied Behavioral Science, San Francisco, Pfeiffer/Wiley, 2006, and Table for Two: Can Founders and Successors Co-Exist So Everyone Wins? MAG monograph, forthcoming, June 2009.

### *About the Management Assistance Group, Inc.*

The Management Assistance Group (MAG) was founded in 1980 to strengthen groups working on the front lines of progressive social change. Since then, MAG has worked with thousands of organizations, pioneering the adaptation of rigorous management thinking to social change and advocacy.

Working exclusively with social justice organizations, MAG consultants understand the strategies – such as public education, litigation, advocacy/lobbying, community organizing, coalition building, policy analysis, and grassroots mobilization – that anchor social change. MAG is known for its tailored approach to consulting, and for asking tough, necessary questions that result in lasting, powerful organizations.

Rooted in its extensive client work, MAG identifies key trends and issues affecting the sector, and uses these as a starting point for the development of in-depth research projects and innovative products, publications, and services. MAG is committed to sharing what we learn in order to strengthen the social justice sector at large.