

# A DELICATE BALANCING ACT

*Mission-Driven Organizations Must Meet Both  
Economic and Noneconomic Goals*

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A commonly accepted economic maxim is that the focus of *for-profit* organizations is to maximize the wealth of their shareholders. The orientation of for-profit organizations tends to be short term in nature, typically focusing on actual versus projected quarterly financial performance. In contrast, the core purpose of *mission-driven* organizations, especially Catholic health care facilities, is to maximize the physical, spiritual, and emotional health of their stakeholders, who encompass all members of society.

Mission-driven organizations typically have a long-standing and long-term commitment to their stakeholders. The goal of Catholic health care organizations is to ensure the well-being of the body and mind of the human person by responding to the spiritual and health needs of vulnerable persons—with emphasis on the poor, sick, and dying. This charitable mission, however, does not obviate the need to address key economic issues. Rather, mission-driven organizations have both economic and noneconomic goals that must be identified and met. Capital allocation in these organizations requires an explicit and objective identification of the economic and mission trade-offs among strategies. Failure to articulate and recognize these trade-offs will likely result in suboptimal allocation of capital, which leads to undesired results at best and organizational chaos at worst.

Because mission-driven organizations operate in two worlds, competing with for-profit firms for labor, material, and capital while serving their charitable purposes, strategic planning for these not-for-profit organizations is significantly more complex than for their for-profit counterparts. The challenge of incorporating mission considerations into strategic investment decisions is that,

without a structured approach, bad business decisions can be rationalized by claiming that they “support the mission.” This article recommends a disciplined approach to capital allocation that addresses this challenge.

## DEFINING MISSION-FOCUSED ACTIVITIES

The first step in developing a process to incorporate mission objectives into investment decisions is to define clearly what constitutes a mission-focused activity. In mission-driven organizations, it is quite tempting to state that “everything we do supports the mission.” Arguing with such a statement is difficult; however, this type of mindset is not particularly useful when management must make difficult decisions about how to allocate scarce capital resources most effectively.

Mission activities must be differentiated from “loss leaders” or poor alternatives. This differentiation requires honest soul searching by the decision-makers. To be mission-focused, the activity must clearly advance the mission/charitable purpose of the organization and not be expected to generate the organization’s minimum required rate of return; therefore it needs to be subsidized.

## ALLOCATING FINANCIAL CAPABILITY TO MISSION-FOCUSED ACTIVITIES

One of the uncontested facts of life is that financial demands will often exceed available resources. At its most basic, financial planning can be characterized as a balancing act between the organization’s financial capability and its mission. Each organization must strive to establish equilibrium among the interests of diverse constituencies (e.g., sponsors, management, physicians, and the local community) and financial viability.

Financial capability is the amount of capital, in both debt and liquid investments, that an organi-

zation can use to finance strategic alternatives, including mission activities, while safely maintaining its operations. Four sources of financial capability exist—current cash and investment balances, cash flow from future operations, additional borrowings, and fund raising (see **Figure** below).

For most not-for-profit health care organizations, the future availability of each of these sources is uncertain. Many hospitals are increasingly relying on investment income to bolster declining operating margins. This reliance on investment income puts hospitals in a vulnerable position due to market volatility. The Balanced Budget Act of 1997 and unfavorable managed care contracts have had a significant negative impact on most health care organizations, an impact that will likely continue into the future. Although a booming economy has resulted in record levels of charitable giving, not-for-profit organizations are facing increased competition for their share of the funding pie. Furthermore, an economic downturn could significantly reduce charitable giving. Finally, future availability of debt financing is uncertain. According to a recent survey,<sup>1</sup> not-for-profit hospitals will face a deteriorating credit environment in 2001 and 2002, reflecting continued pressures from both commercial and government payers; declining liquidity and high leverage from capital needs; continued difficulties implementing integration or disintegration plans; nursing shortages; and competition from specialty hospitals.

The uncertain future of sources of financial capability increases the difficulty of the board and management decisions regarding allocation of these amounts to various organization and community needs. The uses of financial capability typically fall into five pools—continuing operations, maintaining the core asset base, accumulating financial reserves for contingencies (safety stock), funding mission activities, and undertaking strategic initiatives. Decisions must be made to allocate financial capability to each pool, establish policies and procedures for spending the funds allocated to each pool, and specify policies and procedures for replenishing these pools over time.

Management and the board must also determine how unanticipated changes in the business environment will alter funding of these pools. Changes in the regulatory and competitive environments, as well as the organization's own actions and investment decisions, affect financial capability, which, in turn, has an impact on allocations to the pools. Therefore, organizations must regularly monitor their financial capability (at least quarterly) and be

prepared to alter decisions regarding resource allocation in light of new information.

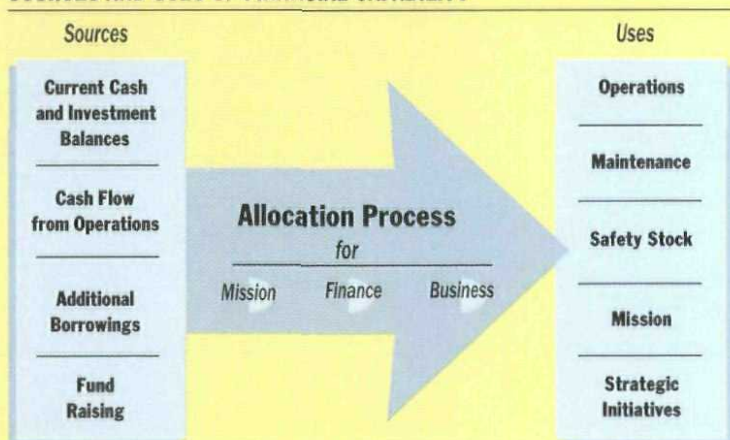
In the event of reduced financial capability, amounts earmarked for mission-focused activities may have to be reduced to ensure the long-term viability of the organization. Consequently, management should be cautious in making multiyear fixed commitments to mission-focused activities. We recommend that during the planning process, analyses be performed (sensitivity analyses) to determine the dollar impact on financial capability of environmental changes (e.g., increased levels of uninsured patients, reduced payment rates, declining inpatient services utilization) and contingency plans be formed, especially with respect to funding mission-oriented activities.

Organizations that use this process typically allocate a percentage of their financial capability to mission activities. Funding is ordinarily from current investment balances, operations, and fund raising. Rarely is debt used to fund mission-focused activities.

### SELECTING AMONG MISSION-FOCUSED ALTERNATIVES

The value of mission-focused activities is impossible to measure and compare directly. For example, how does the mission value of providing immunizations to an indigent population compare to providing the only burn unit in the region? To resolve this thorny issue, we recommend that mission objectives be quantified in a set of decision criteria. The criteria should be clearly defined (i.e., not subject to creative interpretation), measurable and quantifiable, and weighted according to relative importance to the organization. Such a coordinated process will lead to prudent and just decisions. To that end,

Figure 1  
**SOURCES AND USES OF FINANCIAL CAPABILITY**



four mission criteria must be considered: mission effectiveness, mission efficiency, capital effectiveness, and capital cost (see **Table 1** below).

*Mission effectiveness* evaluates the need for the service and the unique qualifications of the organization to provide the service (i.e., are others willing and able to provide the service?). More weight is given to activities for which the organization is the only one in the area willing to provide the service.

*Mission efficiency* assesses the relative focus of the activity on the poor and underserved, with more weight given to services that exclusively serve the materially poor.

*Capital effectiveness* addresses the effective deployment of financial resources by evaluating the time frame over which the activity will achieve maximum productivity (i.e., no excess capacity).

*Capital cost* focuses on the economic performance of the activity and is discussed more fully later in the article.

Several key observations can be made about the criteria used to select among mission-focused alternatives:

- Typically, having more criteria than the four presented would be acceptable, but the number should be kept to a minimum and subject to addressing all the organization's key mission objectives.

- The weights assigned to the criteria reflect the relative importance of each to the organization.

- Negative weights can be assigned for dramatic impact.

- In all likelihood, no single investment will hit the maximum score for all criteria.

- Criteria can be quantitative or qualitative. It is particularly important that someone not championing the investment score the qualitative criteria (i.e., a standing project review committee should assign the score).

#### DETERMINING THE "COSTS" OF MISSION-FOCUSED ACTIVITIES

Comparing the economic value of diverse mission activities can be difficult. Therefore, to calculate the "voluntarily foregone economic value," or cost of the activity, we recommend a process that compares the economic value of the mission-focused activity to that of an activity undertaken mainly for economic reasons. Three methods are commonly used—cost of capital, return on investment, and cash subsidy.

**Table 2** on p. 33 presents examples of the costs for each of these methods. The investment in question has an initial cash outlay of \$1.2 million and is forecast to generate an annual net cash flow of \$50,000 per year for 10 years.

In the first method, the cost is measured as the difference between the risk-adjusted rate of return the activity should generate if it were being evaluated in purely economic terms and the rate of return the activity is forecast to generate. Discounting the net annual cash flow of \$50,000 at 10 percent (the organization's minimum required

Table 1

#### SAMPLE DECISION CRITERIA

| Criterion: Mission Effectiveness  | Score |
|---|-------|
| A demonstrated need exists for the proposed investment and we are the only organization that will make this investment.                                 | 10    |
| The proposed investment is for an underserved portion of the targeted community, and it is unlikely that another organization will make the investment. | 5     |
| We would be one of many providers to undertake such an activity.  | 0     |
| <b>Criterion: Mission Efficiency</b>  |       |
| The proposed investment focuses resources exclusively on those who are materially poor.   | 8     |
| The proposed investment focuses resources primarily on those who are materially poor.   | 5     |
| The proposed investment will serve the community as a whole.  | 0     |
| <b>Criterion: Capital Effectiveness</b>   |       |
| The proposed investment will achieve maximum productivity (i.e., no excess capacity) within three years.  | 5     |
| The proposed investment will achieve maximum productivity (i.e., no excess capacity) within five years.   | 0     |
| The proposed investment is not expected to achieve maximum productivity (i.e., no excess capacity) over the foreseeable future.                         | -5    |
| <b>Criterion: Capital Cost</b>  |       |
| Cost of total subsidy is less than \$0.5 million.   | 3     |
| Cost of total subsidy is greater than \$0.5 million but less than \$1.5 million.  | 0     |
| Cost of total subsidy is greater than \$1.5 million but less than \$5 million.  | -3    |
| Cost of total subsidy is greater than \$5 million.  | -10   |

annual rate of return) results in a present value of \$307,000, giving an economic subsidy of \$893,000. This latter amount is the difference between the initial investment of \$1.2 million and the present value of the cash flows of \$307,000. To undertake this activity, the organization surrenders \$893,000 of its value to the community to serve its mission.

In the second method, the cost is measured against what the funds could earn as investments. Discounting the net annual cash flow of \$50,000 at 5 percent (the rate the organization earns on investments) results in a present value of \$386,000. Thus the economic cost is \$814,000.

In the third method, the cost is the difference between the total cash flows generated over the life of the project and the initial investment. Under this measurement the investment is forecast to generate net cash flow of \$50,000 per year, or \$500,000 over the life of the project. The cost of the subsidy is the difference between the \$500,000 in net cash flow forecast to be generated and the \$1.2 million investment, or \$700,000 of value provided to the community in mission subsidies.

Which of these alternatives is the best approach? The answer depends on one's perspective. The first measurement considers all the key risk factors in the investment decision. From a financial/business perspective, it is the most appropriate measurement of value provided to the community in the form of a subsidized service.

The second alternative is consistent with preserving fund balances and, therefore, could be reasonably interpreted as being consistent with the objectives of a not-for-profit organization. However, this method ignores the inherent risk of the proposed investment.

The third measurement, a cash subsidy approach, ignores the time value of money and the inherent risk of the investment; it should not be used as a management tool. However, it is a favorite of politicians, regulators, and others reporting on levels of charity care provided by health care organizations.

### APPLYING DECISION CRITERIA

The following example demonstrates the use of decision criteria. Hospital A is considering two mission-focused alternatives. The first is developing a program to provide immunizations to the indigent population of the service area. Management has estimated that it will cost \$100,000 to initiate the program and will require an annual

Table 2

### COST OF MISSION SUBSIDY

|  | Cost of Capital | Return on Investment | Cash Subsidy |
|--|-----------------|----------------------|--------------|
| Initial Investment (A)                       | \$1,200,000     | \$1,200,000          | \$1,200,000  |
| Implied Discount Rate                        | 10%             | 5%                   | 0%           |
| Investment Maturity                          | 10 years        | 10 years             | 10 years     |
| Annual Cash Flow Generated                   | \$50,000        | \$50,000             | \$50,000     |
| Present Value of Cash Flow Generated (B)     | \$307,000       | \$386,000            | \$500,000    |
| Net Present Value of Mission Subsidy (A - B) | \$893,000       | \$814,000            | \$700,000    |

subsidy of \$50,000 for 15 years. Assuming that the required rate of return for this investment is 10 percent, the cost is approximately \$480,000 (\$100,000 initial cost plus the present value of ongoing subsidies).

The second mission-focused alternative is developing a burn unit. The hospital has been offered a grant to cover the cost of developing the unit, but management expects that the unit will require annual subsidies of \$250,000 for 15 years. Again assuming a required rate of return of 10 percent, the cost is approximately \$1.9 million (the present value of ongoing subsidies).

Management has reviewed both alternatives and has assigned scores for each of the decision criteria.

**Mission Effectiveness** Management believes that another organization would likely sponsor the immunization program, so a score of 0 is assigned. Management also believes that the hospital is the only organization that would develop a burn unit, so a score of 10 is assigned.

**Mission Efficiency** Although the immunization program is focused on the indigent, management

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Table 3

### EXAMPLE OF APPLICATION OF DECISION CRITERIA

| Criterion             | Immunization Program | Burn Unit |
|-----------------------|----------------------|-----------|
| Mission Effectiveness | 0                    | 10        |
| Mission Efficiency    | 5                    | 0         |
| Capital Effectiveness | 5                    | -5        |
| Capital Cost          | 3                    | -3        |
| <b>Total Score</b>    | <b>13</b>            | <b>2</b>  |

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believes that developing a screening process to ensure an exclusive focus on the materially poor would not be possible. A score of 5 is assigned. By contrast, the burn unit will serve the entire community, so a score of 0 is assigned.

**Capital Effectiveness** Management's analysis indicates that the immunization program would achieve maximum capacity within two years, yielding a score of 5. However, the burn unit is not expected to be at capacity in the foreseeable future, yielding a score of -5.

**Capital Cost** The calculated cost of the total subsidy for the immunization program is \$480,000, resulting in a score of 3. The \$1.9 million cost for the burn unit yields a score of -3.

Although both are worthy initiatives, the total scores of 13 for the immunization program and a score of 2 for the burn unit indicate that the immunization program would better serve the mission (see Table 3, on p. 33).

### RECOGNIZING ONGOING FUNDING REQUIREMENTS

Mission-focused activities have unique problems. Such activities require initial funding and possibly ongoing subsidies. How should the organization fund ongoing activities? Two possible approaches are:

- Completely fund the mission activities in the year they are initiated. This approach would require segregating amounts in the mission fund to be consumed in future periods for specific mission activities.

- Commit to funding annual cash flow subsidies from annual financial capability allocations to the mission fund.

Because these amounts represent "senior claims" on the mission pool, accurate tracking of mission projects implemented in prior years and very strong control mechanisms are required to ensure that the process of funding proceeds as intended. Monitoring is further complicated by events that could have an adverse impact on

the organization's financial capability and the allocation of funds to mission activities in future years.

In either case, implementing an ongoing monitoring system is important after mission activities have been approved for funding. The health care environment is dynamic, and organizations must be diligent to ensure that they continually deploy resources in the most effective manner. Too often, initiatives (whether mission or strategic) are approved and never reexamined. Initiatives may need some adjustment or possibly divestiture. Unfortunately, many health care organizations are reluctant to confront these difficult decisions because doing so may be viewed as admitting failure.

### BENEFITS OF THE PROCESS

Implementing an investment review process based on a set of criteria that address the organization's unique needs can facilitate the decision-making process. The organization can use such a structured process to consider all alternatives with a common framework, thus eliminating some of the politics of resource allocation.

Incorporating the nonfinancial objectives of a mission-driven organization into its decision making process is legitimate as well as critical for optimal resource allocation. However, without a disciplined review process, poor investment decisions may be passed off as supporting the organization's mission or may continue past their usefulness, thus consuming valuable resources in a suboptimal manner. The key is to identify mission activities during the review process and quantify the value the organization is providing to the community by undertaking those activities. □

### NOTES

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## GOVERNANCE AT THE CROSSROADS

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