

Board Structure and Accountability: A Not-for-Profit Governance Perspective

Abstract

Not-for-Profit (NFP) entities in Australia play a significant role in the economy in terms of their contribution to GDP and employment (ABS 2002). This paper explores the governance mechanisms utilised to monitor and control these entities. As directors on the board are mainly voluntary, the question explored is how much control is exercised and how much monitoring takes place in a sector dominated by time and budgetary constraints? Data was collected from a representation sample of 20 NFP entities and analysed to determine if NFPs demonstrated good corporate governance in relation to accountability, the board of directors, the use of independent directors and dual roles of chairperson and CEO. It is concluded that although some NFP entities are embracing what is termed *NFP governance*, many more need to voluntarily embrace NFP governance, particularly in the current disastrous economic climate to ensure they continue to exist in the long term.

Keywords: Corporate Governance, NFP governance

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1. Introduction and Purpose of the Study

According to BRW (2008) there are between 700,000 – 750,000 Not-for-Profits (NFP) entities operating in Australia. They employ 8.5% of the nation's entire workforce, and for 2006-2007 reported net assets of \$36.1 billion. They contribute 3.5% to the GDP (ABS 2002). During 2004, 3.4 million individuals contributed \$5.7 billion to charity, whilst corporations contributed \$3 million in 2003-2004.

Although NFPs are a significant contributor to the Australian economy they are not required by law to demonstrate their adherence to any corporate governance regimes such as the Australian Stock Exchange (ASX 2007) listing rules or the international OECD (2004) voluntary principles. This paper proposes that compliance to such rules may encourage further individual donations and corporate contributions, the main income stream of the NFP sector in Australia, and allow for survival of the NFP entity in the long term.

The study sought to ascertain to what extent a sample of 20 Australian NFPs demonstrated good corporate governance, according to specified criteria, and to gain a clearer understanding of the strengths and weaknesses they might exhibit in terms of their governance and contribution to society. Consulting the literature constituted the first step in achieving this intent.

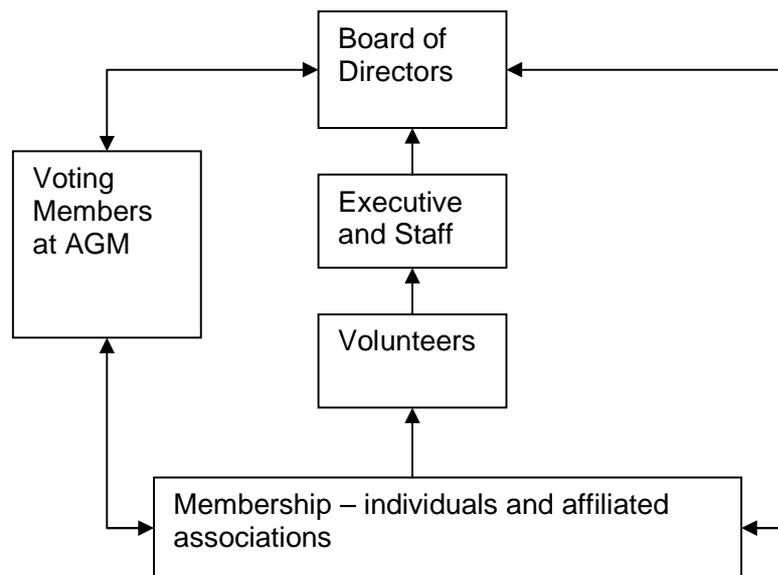
2. NFP Governance: The Literature

2.1 Not- for- Profit Definition and Contribution

NFPs contribute towards social capital, and are generally perceived in the literature as being networks enjoying social trust, facilitating and coordinating for the mutual benefit of society (Putnam, 1995). NFPs have different structures than *for profit* businesses, insofar as they frequently have the added complexity

emerging from paid professionals working with volunteers and being accountable to society. The literature on corporate governance applications, in relation to NFPs in particular, focuses on the significant differences between for profit entities and charitable organisations. Figure 1. outlines the typical NFP organisational structure.

Figure 1: NFP Organisational Structure



The survival of a not-for-profit organisation depends on its ability to meet community needs more efficiently and effectively than its competitors. According to Drucker (1990), non-profit organisations differ from corporate entities due to their difference in the decision-making structures and processes. Although their management techniques may be similar, fundamentally the governance framework adopted will be different. Others, such as Young (1986), Mason (1984) as well as Alexander and Weiner (1998) agree with Drucker (1990) that profit orientated and not-for-profit organisations will differ in their governance frameworks.

Mason (1984) identified many differences between non-profit and profit seeking organisations. The differences however, appear to be superficial, as NFPs are subjected to much the same threats and constraints as other businesses. To

some extent their 'public image' is contingent on explicit governance mechanisms. The two main corporate governance issues concerning NFPs are board structure, and the relationship between boards and executives (Golensky 1993, Heimovics, Herman and Jurkiewicz 1993, Murray, Bradshaw and Wolpin 1992). Conflict between paid professionals and volunteers regarding the control of the organisation and the process of decision making has been researched by Auld (1997), as well as Kikulis, Slack and Hinings (1995). Their findings show paid professionals and volunteers tend to have differing views about how the business ought to be run, and the relationship they should have towards each other, especially if volunteers are not held accountable for their performance.

The not-for-profit model "stresses the values of community participation, due process and stewardship (whereas) the corporate model stresses the value of strategy development, risk taking and competitive positioning" (Alexander and Weiner 1998 p.224). Although it appears the two models have significant differences, we also acknowledge that each must, first, be financially viable. That is, all businesses whether NFPs or not, must *make* money to be able to distribute it.

While Lyons (2001) perceives non-for-profit organisations' governance frameworks as being democratic, and the values pursued by those managing NFPs differ from those driving the operations of profit-seeking firms, he recognises that systems of revenue generation, difficulty in accountability and ability to judge performance, and a heavy reliance on volunteers, may lead to conflict between boards and employees.

According to McFarlan (1999), governance structures of not-for-profit and profit seeking organisations are impacted by their characteristically idiosyncratic missions, performance measures, evaluation of leadership, and their preferences for specific board compositions. The literature has shown the applicability of corporate governance to large businesses, and Small to Medium Enterprises

(SMEs) which are also NFPs, but exhibit a deficiency regarding guidelines and principles specifically focused on the governance of the *for profit* SME sector.

2.2 Corporate Governance

“Public trust in boards of directors depends on transparent governance structures and processes and clear accountability to stakeholders” (Gill et al. 2005). Furthermore, clearly the overriding common objective of governance regimes is to create and maintain an orderly commercial environment, for the benefit of the public interest. Corporate governance itself has a long history. Although the term was not used by such economists as Smith (1776) and Spencer (1862), the idea of running a corporation ethically, that would bring profits to the corporation and by default economic benefit to society, underpinned their discussions.

Indeed, Drutman and Cray (2004) noted that corporations were perceived originally to be ‘arms of the state’. Viewing corporate America, following the merger and trust movements at the end of the nineteenth century, Berle and Means (1932) popularised the idea that whereas entrepreneurs were good with ideas, specialist managers should run businesses. Also, because of the emerging corporate structure, professional managers had to be engaged. Thus, by the early 1930s the notion of the potential problems associated with the separation of ownership from control were firmly embedded in the corporate regulatory literature; as an ultimate consequence of what Bryers (1993) labelled the *socialization of capital*.

Those potential problems underpin Jenson and Meckling’s (1976) discussion of the costs associated with agency monitoring initiatives. Agents’ propensities not to always act for the benefit of their principals in preference to gaining a personal benefit, created an ethical dilemma provoking and justifying the development of legislative and other impositions of corporate governance principles. It has also been noted that a generalisation is set in the specific context of publicly listed

companies in which shareholders are typically divorced from any active association in or with management.

A definition by Royal Commissioner Neville Owen observed:

"The governance of corporate entities comprehends the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations" (2004, p.101).

Thus, corporate governance is not limited to entities registered as corporations under the Corporations Act of Australia (2001). Although there is no specific legislation in relation to the governance of NFP entities, both international entities such as the OECD (2004) and Standards Australia (2003) endorse the use of governance mechanisms by NFP entities. Obviously, not all of the governance regimes would apply to NFP entities such as equitable treatment of shareholders for example. However, such mechanism as a governance framework, characteristics of board of directors such as the use of independent board members, and separation of the roles of CEO and chairperson would also be relevant to NFPs. Other applicable mechanisms would be accountability and transparency of information. Each of these will be explored in the 20 charities analysed.

Balser and McClusky (2005) focus on who NFPs see as their stakeholders, their expectations and how they manage these business relationships, such as with creditors, debtors, customers, employees etc. They suggest that if external relations are based on recognisable good management they will be rated as more effective by external evaluators. Speckbacher (2008) states that NFP governance should provide mechanisms that support the strengths of the NFP character and repair its weaknesses.

2.3 Board of Directors

Directors

The role of the directors is clearly defined : “the management role undertaken by directors requires that in the exercise of power they act honestly and in the best interests of shareholders and creditors” (Hinchy & McDermott, 2006, p.121). Whereas in the past, some boards of directors were made up of members elected because they knew someone on the board, they are now elected for their skills and their ability to add value to the board and by default the business. Boards of directors for NFP entities must exhibit as much of their fiduciary duties as they would to a corporation, as they are still under Corporations Law (2001) legislation in the carrying out of these duties.

Friedman and Phillips (2004) suggests that the traditional structure of a large NFP council (Board of Governors) and a plethora of committees seems unsuited to a context of complexity and change. Structure must be proactive, determining mission, strategy and a responsive approach. They draw on other research that suggests smaller governing boards with memberships between 8 and 12 or 12 to 15. Large boards correlates with lack of strategic direction and a reactive style of management. “The Board is a critical asset for every nonprofit organization” (Brown, 2007).

Independent Board Members

The Joint Code of Professional Conduct defines independence as being free, in fact and appearance of any interest which might be regarded, whatever its actual effect as being incompatible with integrity and objectivity (Section B.4 Dellaportas, et al., 2005). “The field of corporate governance is concerned with the rules and principles that regulate the power relationship among owners (shareholders), directors and managers” (Goodman and Schwartz, 2004).

International Corporate Governance Network (ICGN) Statement on Global Corporate Governance Principles asserts “Corporate boards should be

independent”. Corporate governance rating organisations such as Glass and Lewis and Co. looks at economic consequences of corporate governance such as board independence. The NYSE, the Nasdaq and AMEX all require a majority of directors to be independent (2008). “An independent director is someone whose only nontrivial professional, familial, or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.”

Hoye (2006) suggests that the source of leadership within voluntary sports organisation boards may emanate from either board chairs or executives and that when the individuals fulfilling these roles are able to develop mature relationships, the ability of the board to perform is enhanced. NFP entities then should also encourage the presence of independent directors on their boards, and if possible have a majority of directors to be independent as endorsed by most international stock exchanges.

Independent Chairperson

This concept is well supported by international stock exchanges. It states the obvious – that the chairperson will be able to do their job more effectively if they exhibit true independence – that there is no other engagement with the company apart from their roles on the board. This allows the chairperson to run the meeting without any links to either the company, the Chief Executive Officer (CEO) or other board members. The promotion of ethical conduct amongst board members, should allow for decisions to be made truly in the company’s interests. Thus NFP entities should promote the use of an independent chairperson.

Duality of Roles of CEO and Chairperson

To avoid a board room that exhibits too much control, the roles of chairperson and the CEO should be performed by different incumbents. This is particularly true for family owned-and-run companies (such as those in Europe and the Nordic regions), where a family member typically controls the board. International

evidence suggests that this duality yields too much power and control to one board member, whereas the separation of the roles encourages the corporation to acknowledge the input of all board members to enable them to add value to the decisions made by the board, without one person dominating the decision-making process. Once again, it appears there is wisdom in the NFP entity separating the roles of CEO and chairperson.

Overall then, the literature points to the implementation of governance mechanisms such as the use of independent directors, and separation of the roles of CEO and chairperson. These mechanisms although endorsed by many stock exchanges on an international level, would also be applicable to NFP governance.

2.4 Transparency and Accountability

Trussle and Parsons (2008) found that certain information can impact donations.

Examples are:

- (1) efficiency in allocating resources to its programs,
- (2) the financial stability of the organisation,
- (3) the information available to donors,
- (4) the reputation of the organisation.

Parsons (2007) suggests that some donors who have previously donated use financial accounting information when making a donation decision. Some donors are more likely to respond to a fundraising appeal if it includes positive financial accounting information. There is evidence that not only can financial accounting information directly impact an individual's giving decision, but, together with nonfinancial disclosure, may impact donors' views of a NFP organisation.

In normal circumstances donors rely on the antecedents of commitment and trust to decide who should receive a donation. However, in a crises, they depend on a third party that donors trust because of their belief in its competence and integrity. In the case of the Indonesian tsunami this third party was the Australian

government (Abraham 2007). ACFID is a coordinating body for Australian non-governmental agencies that agree to conduct their activities with integrity, transparency and accountability. The ACFID code requires organisations to use reporting mechanisms which facilitate accountability to members, donors, and the general public.

Merchant and Ford (2007) argue that charitable giving has stagnated. Charities in the UK are finding it increasingly difficult to raise funds. Reasons include: the smallness of individual contributions, that most donors are older, and an increase in the number of charitable organisations — all of which raises the competitive intensity for donor funds. The authors suggest that nostalgia is a strong motivator for some giving. Sargeant and Hudson (2008) show that, in the UK, NFPs have engaged in a variety of techniques to raise voluntary income from members of the public. Recently there has been a rapid increase in the use of more personal techniques especially face-to-face soliciting. Agencies are used to recruit collectors. Donors are concerned about the impact of their gift but have no objective way of assessing this relying, instead on charity generated communication to provide insight. An underlying issue is that of trust which is an antecedent of commitment.

Madden (2006) suggests that NFPs face significant challenges in raising donations. By comparing Australia with the USA, he shows that the cultural shift to philanthropy has a long way to go (0.68% of GDP versus 1.6% in the US) NFPs will have to widen their revenue base including increasing donations from the general public.

Changes in the form and shape of NFPs has led to a change in culture from small homely organisations to large sophisticated entities, requiring a more competitive approach to fund raising (Dolnicar et al. 2008). The challenge is to manage competitive grant funding without losing mission imperatives. Haigh and

Gilbert (2005) point out that NFP organisations are putting increased emphases on branding their organisations in order to enhance their marketability to donors.

Lee (2004) questions whether NFP organisations are accountable to the public at large. He proposes that because they receive certain tax benefits, they should render an account to the public, his view being that an informed public is one of the cornerstones of a democracy. As was the case in Australia, with significant reaction to reporting of the use of donated funds after the Bali bombing, so in the US, questions were also raised about aid funds after 9/11. Accountability is two-fold: firstly it refers to accountability *to* an external constituency. Second it refers to the *method* of legally requiring information to be submitted. Lee (2004) argues “the benefit of viewing the mass public as a stakeholder includes the potential for converting them into contributors and volunteers.” This may be addressed by means of public reporting through issuing financial reports.

Cairns et al. (2005) state very clearly that NFPs are expected to deliver value for money and “to demonstrate that they are doing so.” Christensen and Ebrahim (2006) state “A central challenge for nonprofits and funders alike lies in creating a culture of accountability that is built on mission and purpose rather than on external scrutiny.”

Eveland and Crutchfield (2006) suggest communication strategy will vary depending on the potential donor group that is targeted. For example corporate donors may require reports or requests that focus on their needs, whereas personal donors may not require full financial statements, but instead have approaches that draw on emotional content. Overall however, notes Waters (2007 p,71), “the public is demanding that nonprofit organizations be held accountable for their actions and become more transparent in how donations are being used.”

3. Method of Enquiry

The review of the relevant literature has assisted in clarifying significant concepts and focusing the research questions. They will now be delineated. Data were collected using the archival case method (Scheele, 1967) to answer the following research questions:

Do NFP entities exhibit NFP governance by

- 1) initiating a governance framework?
- 2) encouraging the use of independent directors on their boards?
- 3) separating the roles of CEO and chairperson?
- 4) being transparent and accountable?

The Archival Case method has is useful for describing an actual business situation to understand concepts, principles and techniques applied by the organisation. Case studies are generally employed by researchers to investigate a particular situation or problem. The adopted methodology was considered the most appropriate and suitable to source archival data from publically available sources.

4. Data Analysis

4.1 Corporate Governance and Directors

Of the 20 NFPs randomly selected via convenience sampling (see appendix A), seven issued a corporate governance statement. According to listing rule 4.10 of the Australian Securities Exchange, only listed corporations are required to “comply or explain”. The OECD introduced its voluntary initial corporate governance *principles* in 1999, and a revised version in 2004. Those principles were specifically aimed at the protection of investors, directly in corporations and indirectly through stock exchanges, universities, and charities and were aimed at diverse countries and regions (OECD, 2004) to encourage economic growth and

stability. They are non-binding and used to encourage and inculcate ethical behaviour and values in international market places.

Table 1 : Compliance with NFP Governance Framework (N=20).

<i>NFP Governance Mechanism</i>	<i>Compliance</i>
Governance Framework	7
Average number of meetings held	8
Auditors	14
Size of board for effectiveness	9
Gender ratios of board	6 males : 3 females
Separation of CEO and chairperson	20

Of the nine entities that detailed the number of meetings held throughout the year, the average appeared to be eight meetings per year. Of the entities that indicated the names of their auditors (14 of the entities), three of the auditors were from 'big four' firms (KPMG, Deloitte, PWC and Ernst and Young), one was the Attorney General, and the remaining ten were audited by firms that were not big four firms. Of the 20 NFPs analysed, the average number of board members was 9, and this was made up of on average 6 males and 3 females.

4.2 Independent Board Members

Of the seven entities that indicated they had non-executive directors, (a total of 59 directors), 39 indicated to be non-executive, being 66% - thus a majority of board members appeared to be independent. The analysis also showed that where indicated, the seven NFP entities all had independent chairpersons. It is thus apparent NFP entities are complying with both Australian and International governance recommendations in this area of board transparency. This appears to auger well for Australian NFPs, as effectiveness of individual directors is a function of independence, competence and behaviour. Also the role of the board chair is viewed as crucial and determinative of effectiveness (Hough 2006).

Overall then, some of the entities are indeed exhibiting NFP governance initiatives such as the use of governance frameworks, independent directors on the board and separation of the roles of chairperson to CEO. However, it must be noted that only seven of the NFPs out of twenty had a governance statement. In terms of transparency of information, only 9 NFP indicated how many meetings were held and 14 listed the names of their auditor. The size of the boards (average nine members) were in line with other research indicating boards should be between 8 and 12 in size for efficiency. All charities separated the roles of chairperson and CEO, and of the seven entities that included information on independence of directors, 66% of their directors were independent. Overall however, NFP entities need to be more transparent in their disclosure of governance mechanisms in place.

4.3 Duality of CEO and Chairperson

None of the NFP entities exhibited a duality of CEO to chairperson role, showing they agree with the literature that the roles should be separated to enhance the workings of the board. The fact that no one person has ultimate control allows the board members to contribute equally and no balance of power remains.

4.4 Transparency and Accountability

Rosen (2005) stated that “maintaining and enhancing public trust is essential for organizations that want to raise money.” Table 2 exhibits the combined financial information (2006 and 2007) of the 20 NFPs while Table 3 shows the various sources of revenue generation.

Table 2 : Financial Information for the sample of NFPs (N = 20)

Financial information	2007	2006
Profit	1,058,083	1,031,959
Net Assets	17,466,265	15,074,290

Table 3 : Type of Revenue Generation of sample of NFPs (N = 20)

Revenue	2007	%	2006	%
Grants	375,255,001	65.91	342,187,450	66.70
Trusts	2,640,829	0.46	5,536,703	1.08
Sponsorship	1,834,498	0.32	1,184,570	0.23
Interest Income	4,133,138	0.73	9,887,966	1.93
Donations	47,377,139	8.32	38,608,854	7.53
Service Fees	88,971,034	15.63	86,038,462	16.77
Rental Income	15,711,399	2.76	685,663	0.13
Members Subscriptions	3,674,676	0.65	12,078,311	2.35
Conference	441,017	0.08	299,888	0.06
Dividend Income	1,716,439	0.30	891,574	0.17
Investment Income	12,027,503	2.11	1,454,371	0.28
Other Income	3,905,099	0.69	5,083,367	0.99
Disposals	11,617,414	2.04	9,100,553	1.77
Total Income	569,325,186	100.00	513,037,732	100.00

The data in Table 2 and Table 3 show that the 20 randomly selected representative NFP entities exhibit a high monetary value in terms of assets held, profitability and funds raised. It is interesting to note that a significant contribution to revenue is generated by grants, usually from Federal or State Government. Also, given that donations are a significant part of revenue would indicate that more transparency may well lead to even higher income from grants and

donations if stakeholders are informed that they have NFP governance mechanisms in place to encourage long term sustainability of the charity.

5. Conclusions and Recommendations

What can be concluded from the analysis of data in relation to the four posted research questions?

1. Do NFP entities exhibit NFP governance by initiating a governance framework? Only a minority of entities issued a governance statement. Whatever the reason for this lack—while not illegal, it may indicate an unawareness of best practice—it could have unforeseen long-term negative consequences. Those NFP organisations identified by this lack would do well to become learning organisations.
2. Do NFP entities encourage the use of independent directors on their boards? Of the seven entities that indicated they had non-executive directors, (a total of 59 directors), 39 indicated to be non-executive, being 66%, thus a majority of board members appeared to be independent. The seven NFP entities that indicated the presence of independent directors also had independent chairpersons. The use then of independent directors on the boards of NFP entities again shows a lack overall in terms of the use of directors and the transparency of communicating information on the board. NFP entities could do well to review the literature that shows the positive effects of independent directors on boards.
3. Do NFP entities separate the roles of CEO and chairperson? As none of the NFP entities had a duality of these roles, it is one NFP governance mechanism that is fully embraced by NFPs.
4. Are NFP entities transparent and accountable? The one area in which NFP entities are communicating well is in terms of financial information. This could be due to the fact that many government grants stipulate the annual audit of accounts, and to retain charitable status they need financial information to be verified by an independent third party such as

an auditor. Certainly the more transparent NFPs are, the more it encourages donations from both business and individuals by showing how the money is being in society.

Overall the analysis would indicate that a minority of NFP entities are exhibiting some corporate governance initiatives, but that more needs to be done in terms of encouraging greater adherence to governance recommendations such as the use of a governance framework, disclosure of board of directors information, and the use of independent directors, because of their significant contribution to the economy in terms of GDP and employment.

Where to from here? As “the gap between public understanding and nonprofit reality is not sustainable” (Saxton, 2004), NFPs need to exhibit true NFP governance to bridge this gap and encourage future investment through grants and donations. NFP entities are taking on more responsibility for addressing public needs and concerns and should be more accountable and transparent to those stakeholders who need to know how they allocate their scarce resources, and how they direct and control them in terms of the board. NFP governance then is one mechanism to enhance long term sustainability, but needs to be modeled and encouraged to enable other NFP entities to embrace its merits.

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7. Appendices

Appendix A : List of NFP entities

Number	Name
1	Endeavour Foundation
2	Camp Quality
3	Baptist Community Services
4	YWCA NSW
5	People living with HIV/Aids (NSW)
6	Parkside
7	Cancer Institute NSW
8	RFDS
9	Kidney Health
10	Division of General Practice CC
11	RSPCA
12	MECWA
13	Masonic Youth Welfare Fund
14	K.I.D.S Foundation
15	MacKillop Family Services
16	Good Shepherd
17	Bone Marrow Donor Institute
18	Arthritis Australia
19	Arafemi
20	Anglicare