The Non-profit Sector and its Challenges for Governance

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Non-profit organisations make up a considerable percentage of economic activity in many economies, yet their governance requirements and structures have historically tended to be ignored, or sometimes assumed to be similar to those for other organisations, including large publicly listed corporates. This is not the case. This paper identifies some of the frameworks proposed for evaluation of governance in NPOs, explores some characteristics of non-profit organisations that have significance for governance and it raises questions about its shape and direction. Much of the discussion involves the non-profit sector in Australasia but has relevance to many such organisations regardless of location.

INTRODUCTION

"Non-profit organisations" (NPOs), otherwise known as "third sector" organisations (TSOs) include NGOs or non-governmental organisations, charities, public-service organisations and clubs, societies and unions. They are defined as "organisations that operate for social or community purposes, do not distribute profits to members, are self-governing and independent of government" (Australian State Services Authority, 2007, p.15) although Salamon (2010) points out that the definition is somewhat more complex and to some extent a function of social or political mores. They fulfil "a broad range of essentially 'expressive' functions such as civic and advocacy, culture and recreation, environmental protection, and business, labour, and professional representation as well as the more commonly perceived 'service' functions such as education, health care, and social services" (Salamon, 2010, p.185).

As some indication of their ubiquitous presence, in the United States as of 2009 there were approximately 1.5 million tax-exempt organisations with over US$1.4 trillion in revenue (National Centre for Charitable Statistics (NCCS), 2009; Wing, Roeger and Pollack, 2010) and as of 2004 involving some 8.9% of the total workforce (Sanders, O'Brien, Tennant, Sokolowski and Salamon, 2008) . In New Zealand in 2005, the number of NPOs totalled 97,000 (not-for-profit.org.nz, 2006-9), with 2004 revenue calculated at over NZ$8 billion and 8.9% of the total workforce (Sanders et al, 2008). Comparative Australian figures are 700,000 with AU$76 billion in revenue and 8.6% of the total workforce (National Roundtable of Nonprofit Organisations, 2009). In the UK, there are over 700,000 registered charities (Knowhow non-profit, 2011) while in 2008 the average of total workforce participation over 41 countries was 5.6% (Sanders, et. al., 2008).

In 2000, as a consequence of the sector being perceived as the "lost continent on the social landscape of modern society" (Johns Hopkins University Nonprofit Sector Project as quoted in Pascoe, 2008, p.6), almost forgotten in discussion and debate over the actual and ideal relative contribution and participation rates of Government (public sector) and for-profit businesses or private sector, efforts have been made to draw research attention to the sector, its contributions, needs and management. The Johns Hopkins

University research program involved teams from 24 countries around the world in examining the significance and nature of non-profits in their country and region. Other research has involved, *inter alia*, issues relevant to governance, including the influence of stakeholders on strategic direction (Inglis and Minahan, 2005); the influence of the economic market on non-profit governance (Auteri and Wagner, 2006); governance practice (LückerathRovers, Quadackers, and De Bos, 2009; Steane and Christie, 2001); difficulties surrounding governance and its purpose (McDermont, 2007); regulation and its role in governance (Pascoe, 2008) and means of evaluation (Mueller, 2007; Mueller, Williams, Higgins and Tou, 2005) to name just a few.

There is no doubt that credibility for NPOs is positively linked to good governance which in turn has a strong positive link to the ability of such organisations to obtain the necessary funding and popular support to achieve their objects. In particular, Mueller et al (2005) and Mueller (2007) highlight the importance for NPOs to maintain strong credibility when facing such challenges as scarce funding and burgeoning demand as governments withdraw from direct involvement in aspects of social welfare work (McDermont, 2007; Mueller, et. al., 2005), the emphases and objectives of funding agencies shift and personal spending and gifting patterns change (The Urban Institute, 2007). In addition, and in the aftermath of an assortment of financial scandals impacting the non-profit sector (Buckhoff and Parham, 2009; Hawkes Bay Today, 2005; Smith, 2006; Strom, 2006), the emphasis is very much on appropriate and transparent governance.

The purpose of this paper is to contextualise the messages from the literature surrounding the governance issues facing non-profit organisations with the objective of highlighting the problems in devising effective governance approaches. It begins with an introduction to the concept of "corporate governance" and continues with a brief overview of various frameworks that have been proposed for evaluating governance of organisations in this sector. This is followed by discussion of the challenge faced by non-profit organisations in devising and implementing appropriate governance structures, given their multiplicity of funding, size and purpose and finishes with a series of questions that could usefully be the focus of further research as to how good governance should or can be achieved. In the interests of clarity, the principal focus is on NPOs in Australia and New Zealand, although clearly the issues are common to many NPOs regardless of location.

Corporate governance, or "rules, standards, procedures and institutions intended to guarantee good and responsible management and to overcome deficits of corporate control" (Leyens, 2007, as quoted in Ott, 2009, p.255) is encapsulated in the principles of good corporate governance (OECD, 2000 and 2004), in various statutory instruments (including the Corporations Act 2001 (Cth, Australia) and the Companies Act 1993 (NZ) and standards (such as the Australian 8000-2003). It has also emerged as a prominent theme in corporate law and management literature since the abuses thrown up by the "corporate greed of the 1980's" (Francis, 2000, p.10). However, despite there being recognition that non-profit organisations need to observe good governance practices, these principles are largely devised, composed and of particular relevance for the large publicly listed corporate fitting the Anglo-American model (Hough, McGregor-Lowndes and Ryan, 2004). Herein lies a problem. There is a growing resistance to this idealised "shape" of corporate governance with arguments framed by cultural and political diversity and different political and legal systems (Mason, Kirkbride and Bryde, 2007; Nwabueze and Mileski, 2006). Even more do these arguments resonate with the non-profit sector (Millar and Abraham, 2006) due in part to the quite different needs, focus and accountability of NPOs as compared to corporates.

Consequently, various researchers have proposed a range of frameworks for evaluating governance in NPOs. Millar and Abraham (2006) discuss and offer critiques on four of these, including the integrated model proposed by Zahra and Pearce (1989), the conceptual framework devised by Bradshaw, Murray and Wolpin (1992), the Six Dimensions Framework formulated by Jackson and Holland (1998) based on research by a team from the University of Georgia, and Nicholson and Kiel's Intellectual Capital framework.

Briefly, Millar and Abraham judge the integrated model (Zahra and Pearce, 1989) as being of limited relevance to the non-profit sector as it concentrates on organisational and structural issues affecting corporates. Bradshaw, Murray and Wolpin (1992) endeavoured to develop their framework to analyse the

contribution of board structure and process dynamics to board and organisational effectiveness of Canadian NPOs, but Millar and Abraham (2006) consider that it failed to contribute to understanding how relationships between board members could contribute to overall governance. Jackson and Holland's identification of "six dimensions" of board competency is considered useful in extending the understanding of governance into interpersonal phenomena but "failed to demonstrate the actual relationships that existed between each of their six dimensions and the effect that one dimension might have on another" (Millar and Abraham, 2006, p.8). Finally, although the intellectual capital framework developed by Nicholson and Kiel (2004) acknowledges the role of the intellectual capital vested in the board in adding value to the organisation, Millar and Abraham (2006) conclude that it fails to address how the dynamics of the system as revealed in individual director behaviour would determine whether the capital is used in a way that adds value.

Cahill, Armstrong and Storey (2001) propose a framework to foster social capital formation, while Mueller, et. al. (2005) offer the Gap Evaluation Tool or GET as a self-evaluation tool for NPOs to test themselves on their governance and management practices. Millar and Abraham (2006b) move away somewhat from a capital or management perspective (with a focus on achieving a desired outcome or end) in proposing the application of Habermas' theory of communicative action to governance of NPOs on the premise that awareness, support, cooperation and drive of those involved in such organisations are critical in shaping their contribution to society.

The final evaluation framework that should be mentioned here is stakeholder theory which, while addressing a broader range of issues than governance structures, is of clear relevance. However, there is little consensus as to whom or what is a stakeholder. While Freeman (1984) classified shareholders, suppliers, employees, customers and the community as the "big five" stakeholders for a commercial organisation (or their equivalents for an non-commercial), he did not limit the definition to those five groups: his "now-classic" (Mitchell, et. al., 1997, p.855) definition includes "any group or individual who can affect or who is affected by the achievement of the organization's objective" (Freeman, 1984, p.25), a potentially limitless class.

Indicatively, Mitchell, et. al. (1997) describe no fewer than 28 different definitions of stakeholder that range from the relatively narrow (voluntary or involuntary riskbearers (Clarkson, 1995)) to the very broad (Freeman and Reed, 1983) as delivering a "maddening variety of signals" (Mitchell, et. al., 1997, p.853). Those described as having a "direct" or "primary" relationship, influence, effect or interest (including shareholders/members, employees, customers/clients, suppliers, debtors and creditors/providers of funds) are joined by those whose relationship, influence, effect or interest is "indirect" or "secondary" (Waddock, Bodwell and Graves, 2002). Examples of the latter include such disparate and overlapping collectives or social concepts as competitors, the media, Government, special interest or pressure groups in the community, the community itself (however defined), the public, the environment (Brenner and Cochran, 1991; Donaldson and Preston, 2005; Freeman, 1984; Goodpaster, 1991; Tsogas, et. al., 2005), those usually thought of as having an interest or stance that is adversarial (Tsogas, et. al., 2005), and even terrorists, blackmailers and thieves (Jensen, 2002). For NPOs in particular, there is an additional issue: how to identify stakeholders and to prioritise and/or reconcile their frequently disparate demands and needs. This is an issue addressed by Mitchell, et. al. (1997) with their identification/salience framework to establish whom Management/Boards should and do consider in making decisions.

What these various proposed frameworks (and their critiques) highlight more than anything as posing challenges to effective governance is the multiplicity of interests NPOs seek to address along with their diversity in focus, size, direction and accountability. Also of importance is the potential and actual pressure on NPOs exerted by outsiders (including funders, supporters and clients). The following sections explore these aspects of NPOs and the governance challenges they pose.

THE NON-PROFIT SECTOR- ACCOUNTABILITY

The concept of the stakeholder and the theory (Stakeholder Theory) that underpins it has attracted increasing attention when it comes to issues of governance in many different situations and contexts (for

example, Donaldson and Preston, 1995; Heath and Norman, 2004; Kusnanto, 2002; Mitchell, Agle and Wood, 1997; Scholl, 2001) and increasingly, organisations of various types and in virtually all sectors (private, public and third) acknowledge the need to consult, involve and consider them and their interests. More specifically, it is almost a given that for the following reasons, "stakeholders" (as opposed to profit-seeking contributors of capital) are of particular importance in the NPO context.

NPOs by virtue of their definition do not have "owners" or anyone entitled to receive residual profits (LückerathRovers, et. al., 2009; Jamali, et. al., 2010). Consequently, one of the pivotal foundations of the major alternative agency theory is absent (Millar and Abraham, 2006). It is also arguable that the fundamental tenet – that an agent (or in the corporate context, the CEO or Manager) is self-serving – runs contrary to the traditional perception of the leader in a NPO as a person wanting to do good rather than do well, and that there are good reasons why a Board (if it has one) should wish to collaborate with a CEO or Manager rather than control (Hough, et. al., 2004).

Lacking a paramount objective of profit maximisation, the strategy, objectives and behaviour of NPOs are multifaceted and fluid as they respond to social, economic and political change in an attempt to remain relevant and functional. Where, for example, Government assumes responsibility for public health, an NPO previously active in that area may turn to providing support for the families of the sick, or where tenant participation in community housing schemes is actively encouraged by Government as a weapon against local authorities (McDermont, 2007), so those affecting or affected by the NPO and its objectives (Freeman, 1984) also alters.

It is assumed that NPOs have a mission or missions (Millar and Abraham, 2006; Mueller, et. al., 2005) or some other agreed value(s) (Auteri and Wagner, 2006) that provide a focus for those involved at various levels and in different ways both materially and otherwise; funders, workers and users. As part of that it can be argued that for many of those individuals and groups there is a greater personal connection and even a sense of loyalty to the NPO than may be the case for commercial corporations.

Despite these commonalities, the non-profit sector (and by analogy stakeholders) is far from homogenous (LückerathRovers, et. al., 2009; Millar and Abraham, 2005; National Roundtable of Nonprofit Organisations, 2009; Pascoe, 2008). In addition, the characteristics of the individual organisations and the nature of the sector itself can shift over time and place. The resultant complexity and diversity (and the implications for stakeholders) also have implications for governance. These are the focus of the following discussion.

THE NON-PROFIT – DIVERSITY AND THE STAKEHOLDER

Purpose

There are almost as many purposes as number of NPOs. However, and in the interests of clarity, in their study of the New Zealand NPO sector, Sanders, et. al. (2008) classify NPOs by reference to two functions: a service function (involving the delivery of such direct services or facilities as education, health, housing, community development and the like) and an expressive function (supporting advocacy for and promotion of culture, religion, professional development and policy values).

Service organisations normally have quite clearly defined and articulated roles and functions, including providing health care, managing or providing accommodation, education or some other community-based support. As the providers of funds (such as Government, local authorities and charities) often look to support such organisations for specified outcomes, their assessment of any finding application or renewal/extension of funding will most likely take into account the extent to which the organisation has and/or can fulfil those roles and functions (that can be very specific, such as number of people settled, number of operations in particular categories performed, number of meals provided to the homeless). However, the expressive function is less easily quantified and outcomes potentially harder to assess or measure. In addition, their sources of funds can be affected by changes in the way donors and regulators perceive them (for example as charities or as political organisations). What makes the situation more unclear is the fact that many NPOs pursue a range of activities where the boundary between them

may be quite blurred (such as health and social support services as well as public advocacy or health and lobbying for political change).

Funding

Funding for non-profits comes from a variety of sectors, and can differ dramatically depending on the jurisdiction, focus (purpose) of the NPO and its size. By way of indication, the Sanders, et. al. (2008) report that in 2004, 32% of Australian NPO funding came from Government sources in the form of either grants or contract monies and for New Zealand, 25%. Other sources of funds include foundation and other large private sector donors as well as one-off or on-going individual public donations, fees or subscriptions (again for Australia and New Zealand those figures are 10% and 20% respectively from "private philanthropy" (Sanders, et.. al., 2008, p.19) and 58% and 55% respectively from fees and subscriptions).

Providers of funds to NPOs are clearly important stakeholders as their decisions as to the level of funding (if any) and the purpose to which they must be put may be crucial to the viability and on-going success of the NPO (Mueller, et. al., 2005). Where Government is a major contributor, and with the emphasis in new institutional economics on the contractualisation of the relationship with the NPOs, high levels of accountability and transparency will be expected (Steane and Christie, 2001), a requirement that challenges to some extent the notion that NPOs are "independent of government" (Australian State Services Authority, 2007, p.15). Large or significant donors are also arguably in a position to influence governance practices (Fama and Jensen, 1983; Williamson, 1983) in contrast to small donors and members (depending on the size, operation and form of the organisation) and can challenge the idea that NPOs attract support from a variety of stakeholders because they share a single vision or mission.

Such could arise where, for reasons of funding, an NPO mimics a corporation. Indicatively, Lohmann (2007) discusses the pressures on NPOs caused by what he terms "philanthropic insufficiency" (Lohmann, 2007, p.440); a state that forces such organisations into seeking alternative forms of financial support (including user fees, sponsorship and result-based funding from Government or other bodies).

For such organisations then, there will be at least two principal stakeholders or claimants. First, the funders who at the very least would expect the NPO to do an adequate job in spending the money. However, potentially in conflict with this stakeholder is the membership and/or workforce (who may also be involved directly or indirectly in determining how the money is to be spent) (Auteri and Wagner, 2006) and/or those who benefit from the work of the NPO (Krashinsky, 1997). Where the NPO has multiple purposes, the complexity becomes greater as stakeholders with different expectations and demands cause the attention of those involved to "drift" (Jamali, Hallal and Abdallah, 2010, p.592), muddying the waters, creating tensions (Krashinsky, 1997) and reducing trust and loyalty on the part of those who consider the NPO has lost direction. An obvious example would be where an organisation offering social support services wins Government funding to achieve specific client numbers and performance levels. Where demand is higher than funded numbers the organisation may be forced to ration its services with deleterious effects on its reputation (as a philanthropic organisation), employees (who believe that the organisation has become unreasonably mercenary and managerial) and on those parts of its client base that do not satisfy the funding criteria.

Character

NPOs are commonly seen as having an essential social (as opposed to commercial) culture (Hermann and Associates, 2005; Millar and Abraham, 2006) although Lohmann (2007) adds the caution that as NPOs frequently act in a very similar way to commercial operations, even that raises definitional and perceptual difficulties.

More generally, although "third sector", "non-profit sector" and similar terms are often used as collective nouns, organisations deemed to fall within them are just not uniform and can in fact be poles apart. Religious/secular; national/international; charitable/non-charitable; human/non-human focused are just some of the possible dichotomies that can be applied to such organisations. Salamon (2010) discusses at some length the range of organisations that can fit this definition and how it can vary and change

depending on context (a curious example he cites in a footnote to p.176 is the charitable status granted a 15th century English organisation (Week's Charity) that distributed faggots free to the citizenry for the burning of heretics). This categorisation can be significant when it comes to governance as social norms and expectations can be powerful disciplines for those involved.

Size

Non-profit organisations range from very large and/or multi-national structures (the International Red Cross and World Vision being two obvious examples) to very small, this latter group potentially involving only a very small number of active individuals (also often volunteers) (sometimes referred to as "micro" organisations (Clark, Kane, Wilding and Wilton, 2010)). Although detailed statistics on the size range of NPOs is scarce, some indication of size can be obtained from the percentage of NPOs staffed entirely by volunteer labour (and based on the assumption that a small NPO is likely to be in this position whereas a larger is more likely to have paid staff). In New Zealand some 90% of the 97,000 NPOs rely solely on voluntary labour. In Australia, the percentage is even higher, with only 5% of the approximately 700,000 organisations with paid employees. Finally, in the UK, Clark, et. al. (2010), report that only 22% of 171,074 voluntary (NPO) organisations in 2008 employed staff – most of those in the organisations classified by them as large or major.

The overwhelming implication from this predominance of volunteer participation in NGOs (that often includes members of the Board, if there is one (Steane and Christie, 2001)), is that those involved are committed to the ideals or objectives of the organisation – why else would they give their time and expertise? (Taylor, Chait and Holland, 1996). Such individuals are stakeholders because they are interested in the survival of the organisation. In addition, because those volunteers have chosen to be involved in the organisation for reasons other than remuneration, it is arguable that they are motivated to monitor the organisation to ensure that it fulfils its objectives.

However, not all volunteers are the same and their motivation may be a function of the nature of the organisation itself. They elect to join an organisation for a variety of reasons, including the desire to do good, family involvement (for example children or partner), social reasons or for other personal purpose. Insofar as those joining boards or committees are concerned, election can be recognition of demonstrable contribution but can also be a function of personal relationships, manipulation, popularity or power. In addition, once on the board or other governing body their talents and expertise may be poorly used and governance concentrated in the hands of a few or one (Taylor, et. al., 1996), a trait that further supports the conclusion that motivations for such participation are quite complex. It is also reasonable to suggest that only larger NPOs are likely to have a Board or equivalent with smaller ones relying on a committee structure at the most.

Insofar as size is concerned, there is another important matter that should be mentioned - regulation. Although it is estimated that less than half of all NPOs in Australia are incorporated (some 380,000 out of a total of 700,000 (National Roundtable of Nonprofit Organisations, 2009)) and only around 20% of the 97,000 in New Zealand (Statistics NZ, nd), the larger NPO is very likely to be structured as a separate legal person (in Australia most commonly as an Incorporated Association (under the various state-based Acts having that purpose and focus)) and in New Zealand as an Incorporated Society (under the Incorporated Societies Act 1908) (one good reason being that tax advantages and Government funding opportunities normally require incorporation). All these statutes require that registered organisations operate under a constitution (that, *inter alia*, spells out the procedures to be followed in making decisions) and, in the interests of accountability, have their annual accounts independently audited. Members then have access to those audited statements which are also filed with the responsible statutory body such as the Office of Fair Trading (NSW) Consumer Affairs (Victoria) (both Australia) and the Registrar for Incorporated Societies (New Zealand).

In addition to organisational-oriented regulation there is regulation affecting activities of NGOs (including that specifying obligations of those running events, those protecting the safety and rights of employees and volunteers, specific requirements over fund-raising activities etc (Pascoe, 2008)). There have been concerns expressed over the burden posed to small business and small NPOs in particular as a

result of this regulation (Pascoe, 2008). Also, such regulation can pose a challenge for governance as small NPOs may lack the expertise, funds and strategies to manage the consequential legal risk.

In brief then, an organisation may be a private, independent, non-profit seeking organisation whose surplus is not distributed to members and that is established to fulfil some social or community purpose (Australian State Services Authority, 2007), therefore deemed an NPO according to commonly applied criteria. However, even the terms "independence", "private" and "non-profit" are coming under increasing pressure as organisations in this sector face greater demands, expectations and costs from a range of directions and locations. In addition, and as indicated in the above discussion, the definition provides little guidance as to what governance structures are appropriate, useful or measurable in terms of their efficiency or effectiveness.

Despite the economic importance of NPOs as identified in the introduction, therefore, there are few characteristics that are common to all apart from their principle purpose: this sector-wide complexity raises issues over what if any governance framework is appropriate and relevant to NPOs and that would address the objectives of accountability, compliance and effectiveness. More research is needed. The final section of this paper raises questions on governance issues of particular relevance to the NPO sector and point the way to further research.

ISSUES FOR FURTHER CONSIDERATION AND RESEARCH

A series of questions may assist in reflecting on the governance issues that arise from the above discussion and point the way to further research in the area.

Is there an argument for applying similar concepts to those underlying public sector reforms that have occurred in a variety of economies including New Zealand - making clear structural and governance distinctions between Government – funded services that can be or are exposed to market discipline and those with a pure or primarily social function – to the non-profit sector? A clear example can be found in health, where competitive processes have been used to identify providers of long-term care, rehabilitation services, some specialist operative services and patient transport while preserving others to the public sector where deemed economically or politically appropriate (Lawrence, Alam and Lowe, 1994). If imperatives of "good governance" were determined by whether a particular organisation is or is not affected by market or quasi-market forces (such as vying for state funds or other contributions on a competitive basis), what does this mean for organisations with mixed funding, participation and management models? If such organisations split into two or more to quarantine activities fitting the criteria laid down by funders from those that are not, how does this shape their governance?

Can NPOs be categorised in terms of optimum governance by reference to the range and prioritisation of stakeholders (possibly using the identification and salience framework as devised by Mitchell, et. al., 1997)? In this case, how are governance structures to be shaped? The potential for tension between the needs and expectations of different stakeholder groups is not only clear; it also changes as the organisation adapts to changes in its legal, economic, social and cultural environment.

Is it possible to determine the optimal governance structure for any particular NPO based on its overall classification (character, funding sources, size and purpose)? If so, is it possible to classify NPOs according to some overall score?

Given the social capital function, the multiple objectives and diverse stakeholder interests served by many NPOs, would regulation be the best means of ensuring appropriate governance processes and practices or does this imply greater burdens and costs for such organisations that are simply too much to bear?

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