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Governance in the Not-For-Profit Sector: In International Perspective

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Abstract

The Global Financial Crisis demonstrated the importance of accountability, transparency and good corporate governance for both not-for-profit (NFP) or for-profit organisations. Not-for-profit entities on an international basis play a significant role in world economies in relation to welfare, economic growth and employment (OECD 2009). This research explores the current type of governance mechanisms used to monitor and control international not-for-profit (NFP) entities and to compare to current practices for Australian NFPs. The question explored is how much control is exercised by mainly voluntary directors in a sector dominated by time and budgetary constraints. NFP entities were analysed for their corporate governance in terms of accountability in their annual reports, which also includes analysis of the board of directors. Although international not-for-profit entities are a significant contributor to international social responsibility as well as employment and GDP, this research shows a significant lack of accountability by reviewing their 2010 annual reports. The Australian NFPs demonstrated greater transparency and governance in their annual reports than international NFPs.

Key Words: Corporate Governance, NFP Governance, Social Responsibility.

General Topic: Corporate Governance

Governance in the Not-For-Profit Sector: In International Perspective

Introduction

According to the United Nations (2003, p.3), not-for-profit institutions (NFP) "constitute a significant and growing economic force in countries throughout the world," and Lewis (2005) argues that this sector is a growing worldwide phenomenon. Given the importance of this sector, this paper argues that the governance and accountability of these organizations should be monitored. Because NFP entities are a significant contributor to social responsibility, employment and GDP (OECD, 2009), it is important that directors are aware of their responsibilities, which at times, are higher than that of paid board members (AICD, 2012).

The Australian Charity and Not-For-Profits Commission Bill (2012) places "personal liabilities" on volunteer directors, over and above that of the current corporate law (Corporations Law, 2011). It effectively states that as the directors are volunteers they do not need to be protected against the corporate veil. The Australian Institute of Company Directors stated that Australia should avoid becoming "the first country in the world to make it more onerous for directors to sit on a NFP Board" (AICD, 2012). This is also echoed by the Chartered Secretaries of Australia who state that the Bill imposed "obligations, liabilities and offences" for those responsible for NFP entities.

In Australia the importance of directors and disclosure in NFP entities was recognised in the 2008 Senate Standing Committee on Economics Report – "Disclosure regimes for Charities and Not for profits Organisations", which recommended that new disclosure regimes should include numeric as well as narrative reporting, acknowledging that stakeholders need more information than NFPs were currently giving. Under this legal setting, it is understood that the formal director's duties are just as important in corporations and NFP entities, and that corporate governance as a mechanism is an important part of the running of such entities as it is for other businesses. This paper builds an assessment of the literature that provides the framework for assessing the NFP organisation sampled. Against this background this research is focused, firstly on the use of corporate governance by NFP entities on an International basis, and then specifically on Australian NFPS and their level of corporate governance disclosure. The paper concludes with a summary of key findings and makes several recommendations for NFP organisations to consider.

Not-For-Profit Entities and Governance

Mason (1984) identified many differences between non-profit and profit-seeking organisations. The differences, however, appear to be superficial, as NFPs are subjected to many of 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 Kikulis, Slack and Hinings (1995) and Auld (1997). 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 NFP 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 NFP 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, the 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 both NFP and profit seeking organisations are impacted by their characteristically idiosyncratic missions, performance measures, evaluation of leadership, and their preferences for specific board compositions. The definition of NFPs on an international level can be varied and Table 1 shows four definitions of NFPs used by Australia, Canada, New Zealand and the USA.

Table 1: International Definitions of NFPs

Country of Origin	***Definition of NFP***
Australia	An entity whose principal objective is not the generation of profit (AASB114 para AUS 8.1, 2004)
Canada	Guidance criteria of an NFP (CICA, 2013) A NFP organisation is an "entity, normally without transferable ownership interests, organized and operated exclusively for social, educational, professional, religious, health, charitable or any other not-for-profit purpose".(CICA, p.4, 2013)
New Zealand	Determined by its primary objective with key and supporting indicators (ICANZ 2005)
USA	Non-business organisations (FASB, 1980)

It is interesting to discover an array of literature on the application of corporate governance for NFPs. NFPs contribute towards social capital, and are generally perceived 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.

The survival of a NFP organisation depends on its ability to meet the community need more efficiently and effectively than its competitors. According to Drucker (1990) NFP organisations differ from corporate entities due to their differences in the decision-making structures and processes; that although their management techniques may be similar, fundamentally the governance framework adopted is different. Others, such as Young (1986), Mason (1984) as well as Alexander and Weiner (1998) agree with Drucker (1990) that profit-orientated and non-profit organisations differ in their governance frameworks. A study by Barnes (2011), showed that a comparison of recommended international governance regimes, indicated that only five governance regimes were applicable in the NFP sector as shown in Table 2. In this table the tick (✓) indicates the presence of this requirement and a cross (✗) indicates that it is not present.

Table 2 Applicable Guidelines for NFP Governance

	OECD (2004)	Sarbanes Oxley (USA) (2003)	Combined Code (UK) (2004)	Australia Securities exchange (2004)
Governance Framework	✓	✗	✗	✓
Disclosure and Transparency	✓	✓	✓	✓
Stakeholders	✓	✗	✗	✓
Ethical Decision Making	✗	✗	✗	✓
Risk Management	✗	✗	✗	✓

Significance of Research

Broadbent and Guthrie (2008, p. 130) state that, "public services are progressively seen by policy makers to be as significant as the commercial sector in the context of wider economic and social development." In their paper they illustrate this increased importance by drawing on World Bank documents. For example, according to BRW (2008) there are between 700,000-750,000 NFP entities operating in Australia alone. They employ 8.5% of the nation's workforce, and for 2006-2007 reported net assets of A$36.1 billion. They contributed 3.5% to the GDP (ABS 2002). Previous data in relation to NFP contributions indicated that in Australia, 3.4 million individuals contributed A$5.7 billion to charity, while corporations contributed A$3 million in 2003-2004. The charitable sector is often taken for granted and yet it contributes more to the Australian GDP than the communications sector and has more employees than the mining sector. "But getting a clear picture of the sector is not so easy. Extraordinarily for a sector that plays such a big economic role, there has never been a complete survey of all its participants, . . . " (Parkinson, 2009, p.30).

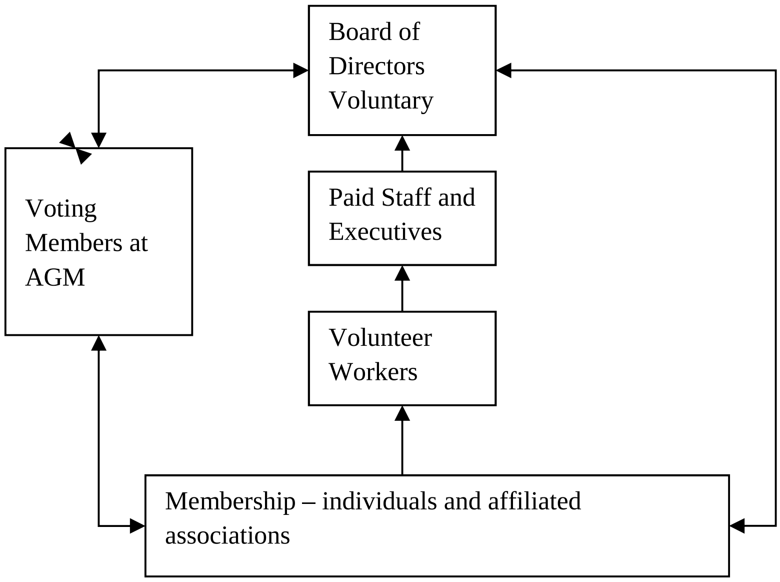
NFP entities in Australia in 2010 had nearly 5 million volunteers contributing an additional $14.6 billion in unpaid work (Productivity Commission Research Report 2010). With this significant contribution to the economy, the governance and accountability of these organisations should be monitored. The recent (Australian) Directors Social Impact Study (2011) found that 58% of directors surveyed sat on both NFP and corporate boards, with 89% of respondents indicating that they performed their role on a voluntary basis. Lewis (2005) argues that this sector is growing worldwide and it can also be argued that international NFP organisations should be noting how these issues impact their operations.

NFP Board of Director Governance

Management is concerned with organising, planning, controlling, and leading organisations with limited resources to achieve goals (Robbins, Bergman, Stagg and Coulter 2000), but governance also involves the limitation of powers to control and direct, and regulate organisations (Tricker 1984). Governance is necessary for corporate entities, nation states, associations, clubs, and societies to function legitimately and efficiently for the benefit of those for whose wellbeing they are argued to have been created.

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 a typical NFP organisational structure.

Figure 1: NFP Structure



Corporate Governance Framework

It is important to acknowledge Owens' (2004) framework approach to corporate governance, of encompassing rules, regulations, systems and processes. It is reasonable to assume that those dealing with NFPs would prefer to do so with one that worked within an explicit and good governance framework, than with one that failed to do so. Thus the framework approach being all-inclusive should be particularly important to NFPs as it does not dictate specific obligations, but takes a general approach, which for NFPs will include the acknowledgement of the previous principles of stakeholders, risk management and ethics.

The governance framework should include information on the members of the board, their specific experience and how they "add-value" to the decision-making processes of the board. In the same way the separation of the roles of Chairman and CEO should be clearly indicated, as well comments on the independence of directors, and board equity.

Hinchy & McDermott (2006, p.121) clearly define the role of directors, saying that ". . . 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." 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) suggest that the traditional structure of a large NFP council (Board of Governors) and a plethora of committees seem unsuited in 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 to 15 are more appropriate. Large boards correlate with a lack of strategic direction and a reactive style of management. As has been noted, "The Board is a critical asset for every nonprofit organization" (Brown, 2007). The next section evaluates the characteristics that this paper considers important in terms of good corporate governance within the NFP sector.

a) 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).

The 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. look at economic consequences of corporate governance such as board independence. "An independent director is someone whose only non-trivial professional, familial, or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship." (Nasdaq 2008). The NYSE, the Nasdaq and AMEX all require a majority of directors to be independent.

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, which concept is endorsed by most international stock exchanges.

b) Duality of Roles of CEO and Chairperson

This concept is also well-supported by international stock exchanges. 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."

It states the obvious: that the chairperson will be able to do his or her 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.

To avoid a boardroom 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) 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 enabling 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.

The literature refers 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. It has already been shown that good corporate governance is based on two important premises: transparent governance structures and accountability to stakeholders (Gill et al. 2005). These two concepts build on the previous literature review and are now the object of further examination.

c) Board Equity

The Global Financial Crisis demonstrated the importance of corporate governance. A recent review of regulatory regimes by the Corporations and Market Advisory Committee (CAMAC, 2010) also advised that the composition of boards, its structure and codes of conduct are most important for continued business sustainability. The report highlighted three areas particularly, (1) board composition in terms of its knowledge and skills, (2) Board structure in terms of its ability to monitor and challenge management and (3) sociological and psychological factors such as composition, size and commitment to discharge its responsibilities and duties.

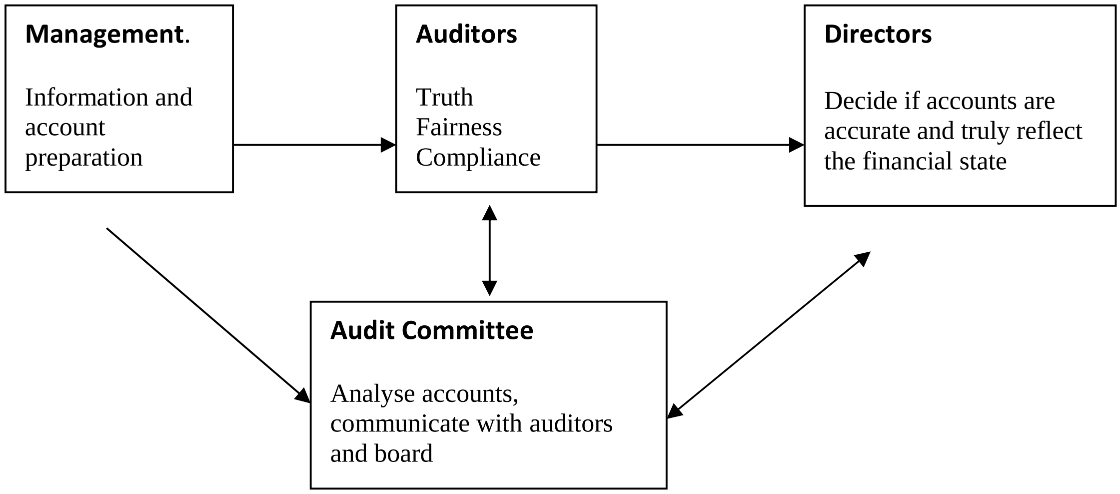
In order to achieve this boards are encouraged to show diversity to gain a wider range of skills in terms of age, gender, race, education, industry experience and business experience. This in turn should foster an environment with divergent views and create robust discussion. Board equity is examined as part of this research.

The literature review highlights that NFPs are significant players in the global economy. These organisations play an important role in meeting community needs. Positive financial and non-financial information may impact donors' views of a NFP organisation. The issue of accountability to both specific donors and the public at large increases demands for transparency in communication. Good corporate governance is therefore an appropriate issue for such organisations.

d) Audited Financial Accounts

Accounts should be used to assess the overall wellbeing or health of the organisation, and is part of the system of good corporate governance and risk management. Accounts should be prepared for stakeholders to allow them to assess the organisation to be true and fair to its financial state. The role of the audit report is a risk management mechanism to enhance the transparency and accountability of the organisation to the board, as shown in Figure 2.

Figure 2: Role of Audit Report



"Public trust depends on transparent governance structures and processes, and accountability to stakeholders for the way in which business is conducted, how resources are used and the results that are achieved" (Gill, 2006. P.63). As stated by Catherine Bromilo, a partner at PwC, "people expect more from audit committees today" (2011), and The Institute of Internal Auditors (2011) stated that "audit committees . . . play an integral role in ensuring that the internal audit activity performs in the most professional and effective manner possible" (2011). Kent, Routledge and Stewart (2010) reiterated the importance of audit committees in relation to the reliability of reported earnings, and the use of the audit report.

Following on from the literature, the *research problem* then is what type of governance do NFP entities demonstrate? Specifically the *research questions* are as follows:

Do International and Australian NFP entities exhibit NFP governance by:

Research Question 1) Using ***independent directors*** on their boards?

Research Question 2) ***Separating*** the roles of CEO and chairperson?

Research Question 3) Encouraging a ***diverse*** board?

Research Question 4) Presenting ***audited*** financial information?

Method of Enquiry

The review of the relevant literature has assisted in clarifying significant concepts and focusing the research questions. According to Yin (1989) and McBurney (1994), the appropriate research method should be selected according to the specific circumstances of the research objectives. They identify five research methods: being case study, experimental research, archival research, observational research and questionnaire research. It is accepted that the selection of the research method for a study is critical, for it determines the appropriate information collection method within the research design (Aaker Kumar and Day 2004). The adopted methodology of sourcing archival data from publicly available sources was considered the most appropriate approach (Scheele, 1967).

The 20 Australian NFPs chosen and the 247 International charities, while not a fully representative sample, are a purposive or judgment non-probability based sample and were selected on the basis of being an appropriate registered charity (Deductible Gift Recipient, ATO 2008) for analysis (King 2004, Cavana, Delahaye and Sekaran 2001). The chosen charities were each from separate studies completed a) In Australia (20) and on an international basis (247). In terms of this research paper only archival data is analysed to collect information and in this regard annual reports were analysed for their financial information (accountability), and any information relating to directors transparency, namely: duality of roles, independence and equity.

The charities studied were chosen by random sample of the 247 Wikipedia listing of international charity organisations, as were 20 Australian charities. These were as a result of two previous studies undertaken, and were used to test any correlation between the two studies.

Data Analysis

The listed international charities totaled 247, of which only 68 or 28% had a 2010 annual report listed on their website, thus 179 or 72% did NOT issue an annual report shown on their website. All 20 of the selected Australian NFPs had 2010 Annual Reports. There is a significant gap in accountability on the part of the international NFP entities, as it not only discourages donors and government grants, but it also raises the question of who are they accountable to? This alone shows a distinct lack of corporate governance with 72% of the International charities giving no financial information in terms of accountability and transparency.

Of the 247 international NFPs randomly selected via convenience sampling 11 or 16% of those with an annual report issued a corporate governance statement (or 4.45% of the total 247 NFP listed). 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. With this small disclosure of corporate governance by NFPs, the message of the importance of governance disclosure is still underwhelming in the NFP sector, which shows a significant gap in both financial and governance disclosures. Of the 20 Australian charities only 2 had a separate corporate governance statement. This data is summarised in Table 3 below.

Table 3: Annual Reports and Governance Statements

	International NFPs n = 247	Australian NFPs n = 20
Annual Report	68 28%	20 100%
Corporate Governance Statement (From those who had an annual report)	11 16%	2 10%

Independent Board Members (Research Question 1)

None of the International NFPs listed whether or not their directors were independent. The definition of independence usually relates to *material* dealings or previous employment or share ownership (ASX, 2007). As directors usually play a voluntary role, the issue of independence may not be significant in the NFP sector, however the literature still encourages the use of outside or independent directors to create a more balanced board. It is suggested that NFP boards disclose if directors are independent or not.

For the Australian NFPS, seven entities indicated they had both independent (non-executive) and executive directors (a total of 59 directors), 39 or 66% indicated they had non-executive board members, thus a majority of board members appeared to be independent. It is thus apparent NFP entities are complying with Australian governance recommendations in this area of board transparency. The effectiveness of individual directors however, is a function of independence, competence and behaviour.

Duality of CEO and Chairperson (Research Question 2)

None of the 20 Australian NFP entities and none of the international NFPS exhibited a duality of CEO/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. Further the role of the board chair is viewed as crucial and determinative of board effectiveness (Hough 2006). NFP boards should continue this practice as part of their NFP governance initiatives.

Board Diversity (Research Question 3)

Of the 247 NFPs analysed, only 32 (just under 8%) listed the number of people on their board, with an average of just under 8 board members being the usual size of the board, which agrees with the research done by Brown (2007) where it was suggested a board size of 8 was average. Of the NFPs that indicated the names of the board members, there was on average, twice as many male board members as there were female members. Of the 20 Australian NFPs analysed, the average number of board members was 9, and this was made up of 6 males and 3 females. Table 4 provides a summary of these findings.

Table 4: Board Equity

	International NFPs	Australian NFPs
Average Board Size	8	9
Male Board Members	67%	67%
Female Board members	33%	33%

Audited Financial Statements (Research Question 4)

Only 10 International NFPs or just over 4% were NOT audited, this is possibly due to the fact they were a smaller branch of a larger home organisation, or that the audit report was not available as yet. Thus 237 or 96% presented audited financial statements. This result affirms that the NFP entities reviewed are being accountable in terms of their financial statements, a significant governance initiative. All of the 20 Australian NFPS had audited financial statements. Of the 14 entities that indicated the names of their auditors three of the auditors were from 'big four' firms (KPMG, Deloitte, PwC and Ernst & Young), one was the Attorney General, and the remaining ten were audited by other firms.

Conclusions and Recommendations

NFPs need to be more transparent in relation to their governance initiatives, especially in relation to individual board members and their qualifications. Rosen (2005) stated that "maintaining and enhancing public trust is essential for organizations that want to raise money." It is recommended that NFP entities include in their annual reports a governance statement, which includes the following:

1. Board of Directors information including qualifications and other directorships held.
2. Specific details of the separation of the roles of chairman and CEO.
3. Encouragement of the continuing need for board equity in terms of directors gender and qualifications.
4. The continuing of audited financial statements in the annual report.

The literature demonstrates that NFPs on an international basis are significant in terms of what they provide to communities, as well as their contribution to GDP and employment. Corporate governance in the literature has also been shown to be an important part of business sustainability. As yet the NFP sector has not fully embraced corporate governance initiatives, and it is hoped that this research further encourages NFP entities to initiate a governance framework which includes detailing directors qualifications, the use of independent directors, a diverse board, and the continuation of the separation of the CEO and chairman roles. It is also hoped that NFPs continue to release audited financial statements to increase their accountability and transparency, 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 sustainability through grants and donations.

This research was limited to archival data via annual reports. As the majority of NFP entities were subject to audit, it is also suggested for future research that the notion of audit committees in a NFP context be further researched as well as other related governance areas. Similarly related areas of good governance could provide fruitful areas for further study.

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