

# Board Competencies, Network Ties And Risk Management Disclosure Practices In Non-Profit Organizations

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## ABSTRACT

*In the current challenging economic environment, non-profit organizations (NPOs) are exposed to an array of risks and some of these risks are unique due to the characteristics of the organizations. Understanding and managing these risks are crucial in ensuring sustainability of the NPOs and the responsibility lies with the board. However, risks management and disclosure of risks in NPOs is less well developed relative to for profit organizations and this may affect boards' role in enhancing risk management practices of these organizations. As such, this study aims to examine the relationships between certain board characteristics: board competencies, network ties and risk management disclosure practices in NPOs. Information on these variables are obtained from content analysis of annual reports and Financial Information Forms of 219 NPOs registered with Companies Commission of Malaysia for the financial period 2011. Results of this study reveal that the overall extent of risk management disclosure practices is at a moderate level. In addition, only board competencies are significantly positively related to the extent of risk management disclosure practices while network ties are not. This infers that some board members acknowledge the importance of being engaged in risk management decision. However, lack of specific guide on risk management in NPOs may reduce the motivation of some board members to do so. The guidelines and relevant trainings to board members provided by relevant authorities may increase the understanding of key risks and management of these risks as part of good governance in NPOs.*

**Keywords:** Non-profit Organizations; Board Competencies; Network Ties; Risk Management Disclosure Practices

## INTRODUCTION

Non-profit organizations (NPOs) are generally defined as societies, associations, charities, and other voluntary organizations that are formed not for making profits but rather to provide social services such as healthcare, social care, transport and waste collection. Nevertheless, NPOs are equally exposed to an array of risks such as funding risks, reputational risks and capacity risks that can subsequently have a negative impact on the sustainability of their organisations. Some of these risks are unique due to the characteristics of the NPOs (CBIZ, 2012), such as types of funding, non-profit maximization and the use of volunteers. Regardless of the types of risks, NPOs can mitigate these risks if there is an anticipated plan of risk management (Laroche & Corbette, 2010, Thornton, 2013). However, for effective risks management, it is crucial to identify the risks, analyze the risks identified and monitor the risk management process.

Identification and management of risks are integral to effective governance in any NPOs. In this context, the ultimate responsibility lies with the board of directors of the NPOs. The availability of effective risk management in NPOs allows the board to concentrate on strategic planning and other matters to ensure long term sustainability of their organizations in delivering their social objectives. This implies that effective boards contribute to good governance practices in NPOs. The composition of an effective board should include a variety of personalities, with a range of skills and experience to enable them to discharge their duties and responsibilities effectively (Ansari, 2010). For example, the resource dependence theory (RDT) argues that board members with professional backgrounds are more capable to assist the NPOs in understanding and analyzing the key risks the NPOs is exposed to. In addition to the

characteristic of the board members, it is equally important for regulators to provide some guidance on risk management in NPOs. To date, risks management as well as disclosure of risks in NPOs is less well developed relative to for profit organizations. Risks reporting through the annual reports of NPOs in particular, allow the NPOs to communicate to their relevant stakeholders and in turn gain continuous support for their missions. However, there is little empirical evidence on the relationship between board characteristics and the extent of risk reporting in annual reports of NPOs. Hence, this study aims to examine the relationships between certain board characteristics, board competencies and network ties, and the extent of risk management disclosure practices in NPOs.

This paper will proceed with the background of NPOs in Malaysia. It will then review the literature on the relationships between board competencies, network ties and risk management disclosure practices from the resource dependence theory perspective. Hypotheses will be developed from these reviews. Finally, this paper will proceed to the empirical stage of variable measurement, sampling, data analysis, discussion of results, limitations and suggestions for future research.

### **NPO SECTOR IN MALAYSIA**

Generally, there are two categories of NPOs in Malaysia. First, NPOs with revenue of less than RM1 million are required to register with the Registry of Societies (ROS) and must comply with the Societies Act 1966. Second, NPOs with revenue of more than RM1 million can be registered as companies limited by guarantee (CLBGs) with the Companies Commission of Malaysia (CCM) and must comply with the Companies Act 1965.

CLBGs are formed as public limited companies with the word “BHD” or without the word “BHD”. The company may be exempted from using the word “BHD” if they get approval from the Minister. NPOs can use the word foundation, institute, academy, corporation, alliance, chamber, council, federal, fund, memorial at the centre or at the start or end of its name. In addition, CLBGs are also bound by certain specific requirements: engaged in activities limited to the above categories; any surplus arising from promoting its objects will not be distributed as dividends to their members; board members are not entitled to remuneration and the Minister-in-charge may from time to time impose additional requirements.

NPOs that are registered with CCM have the same statutory obligations as other companies under the Companies Act 1965. There are also governance requirements to be complied by the NPOs such as the requirement of boards in terms of appointment and numbers of boards, requirement to hold annual general meeting in addition to other meetings and a duty to ensure the appointment of a company secretary and a registered office. NPOs are required to lodge the relevant information of the company such as annual returns, audited accounts, change of directors, change of shareholders, change of business activities and change of company status with the CCM on a timely basis. As at 31 December 2011, a total of 1,587 CLBG were registered with CCM.

While NPOs registered with CCM are more regulated in terms of reporting, there is no specific regulation or accounting standard for NPOs under ROS. These NPOs are however encouraged to comply with the International Financial Reporting Standards issued by International Accounting Standard Board and adopted by the Malaysian Accounting Standard Board or reporting standards applicable for private entities in the preparation and presentation of their financial statements (Arshad et.al 2013). Even though the NPOs registered with CCM are more regulated, the regulations are not specific to NPOs, including requirements or guidelines for risk management.

### **LITERATURE REVIEW AND GENERATION OF HYPOTHESES**

#### **Resource Dependence Theory, Board Composition and Risk Management Disclosure Practices**

The annual reports provide a useful mechanism for NPOs to report the key risks they are exposed to and reviewed by the board and the procedures or systems implemented to manage them. This is more critical in the current challenging economic environment for NPOs to communicate their risk management to the relevant stakeholders in sustaining and building greater trust. In the context of the RDT perspective (Pfeffer & Salancik, 1978), it is important that board of directors in NPOs understand the importance of being engaged in decisions on key risks so that they can reduce environmental uncertainty and dependence. However, the current literature on risk management in NPOs provide little

evidence with regards to the characteristics of board members and the extent of risk management disclosure practices in annual reports of the NPOs. The findings on this strand of research can facilitate policy makers and relevant authorities in providing the relevant training to board members and guidelines on risk management in NPOs. In filling this gap, this study focuses on two main board characteristics: board competencies in terms of board efficiency and board with leadership support and commitment and board network ties in terms of board with political connection and board with professional affiliation.

### **Board Competencies and Risk Management Disclosure Practices**

Board competencies are generally associated with the human capital possessed by the board members. Examples of human capital are commitment, knowledge, skills, motivation and loyalty. These various skills can be translated into enhancement of board efficiency. Previous studies provide empirical evidence that human capital efficiency have positive influence on various forms of organisational strategies, i.e. the efficiency of the organisation; the value creation of the organisation; the competitive advantage as well as performance (e.g. Barney, 1991; O'Donnell et al., 2009). This implies that human capital possesses by board members enhance their ability to take advantage of market opportunities as well as to reduce the effect of potential threats. In the context of risk management, this group of board members are more likely to acknowledge the importance of managing risk and reporting the relevant information in the annual reports. Following this argument, the following hypothesis is developed:

**H1:** Board efficiency is significantly positively related to the extent of risk management disclosure practices.

One of the above component of human capital possess by the board is commitment. In the current economic environment, NPOs face many challenges and risks in achieving their mission and meeting their stakeholders' expectations. The commitment and support from the leaders are important in ensuring their mission is achievable. The presence of this commitment could be shown through effective leadership. In addition, the strong commitment and support of corporate leaders could be presented through external channel by documenting the mission and vision of the organizations (D'Amato & Roome, 2009). The communication of risk management objectives and strategies between the top management and their stakeholders are also a signal that top management shows their commitment towards safeguarding their stakeholders' interest (Liebenberg & Hoyt, 2003; Othman & Ali, 2012). In this study, board with leadership support and commitment are expected to have a positive impact on the voluntary risk information disclosure in the NPOs. Based on this reason, the following hypothesis has been developed:

**H2:** Board with leadership support and commitment is significantly positively related to the extent of risk management disclosure practices.

### **Board Network Ties and Risk Management Disclosure Practices**

Pfeffer & Slancik, (1978) proposed that board functions as a resource to NPOs and provide an important link between the organization and their stakeholders. This in turn suggests that it is important that the organisation develops and maintains healthy relationships with the various stakeholders (Mwenja & Lewis, 2009). In the current complex economic environment, risks evolve continuously and the board needs to communicate that the organisation has a sound management of risk. Board members with political connection are visible members of the society and they are more likely to have the motivation to portray that their organisation has good risk management practices. Concurrently, NPOs with politically connected board members are also more likely to disclose their risk management practices as past studies provide evidence that these board members are associated with various value creations (e.g. Carpenter & Westphal, 2001, Hasnan, Rahman & Mahenthiran, 2013). For example, Goldman, Rocholl, and So (2009) found that the appointment of directors with political connection affect shareholders' value. Following this argument, the following hypothesis is developed:

**H3:** Board with political connection is significantly positively related to the extent of risk management disclosure practices.

In addition to board members with political connection, board members with professional backgrounds are also visible members of the society. Chalmers and Godfrey (2004) argue that this can be associated with their concerned to

maintain and enhance their professional reputation. They are also obliged to comply with their professional commitments and are more motivated to contribute positively to the specific environmental needs facing the organizations (Carcello, Hermanson, Neal, & Riley Jr., 2002). The capability of the board members with professional backgrounds also allows them to assist the NPOs in analyzing and understanding the complex environment under which the NPOs operate (Mwenja & Lewis, 2009). One aspect of such complexity is related to managing organizational responsiveness to the key risks faced by the organization. Hence, the following hypothesis is developed:

**H4:** Board with professional affiliation is significantly positively related to the extent of risk management disclosure practices.

## **METHODOLOGY**

### **Sample and Data Collection**

The sample consists of 219 CLBGs registered with the CCM and having total assets of at least RM500,000 for the financial year 2011. NPOs in Malaysia are classified under 13 categories and the sample size of this study was derived from a random selection of those categories. The research approach involves content analysis of annual reports and Financial Information Form (BMK). Annual reports contain information on directors, financial information as well as their program activities whereas the BMK provide information on the detail annual expenditure. Content analysis has been widely employed in prior studies to measure voluntary and mandatory disclosures in annual reports (e.g. Hackston & Milne, 1996; O'Donovan, 2002; Clemens & Douglas et al., 2006).

### **Extent of Risk Management Disclosure Practices**

The dependent variable used in this study is risk management and has been measured by using self-constructed Risk Disclosure Index (RDI). The development of the RDI is guided by the review of prior studies relevant to risk disclosure in NPOs and related authorities (e.g. Laroche & Corbett, 2010; Thornton, 2013). RDI is measured by comparing the contents of each annual report that have been marked as '1' if the item in the RDI has been disclosed and '0' for otherwise.

The items in the RDI were selected based on previous studies and applicability to the Malaysian non-profit environment. The preliminary list presented six types of risks: governance risks, operational risks, compliance risks, financial risks, reputational risks and money laundering risks. Based on this preliminary content analysis, a review of the categories and disclosure items was made and minor modifications were made to the items of disclosure. In addition, items related to money laundering risks were dropped from the RDI.

The total score of RDI represents the number of points scored by each organization and it is an ordinal measure of the extent of disclosure for each organization. The score is additive and unweighted. Unweighted scores are used in this study by assuming each item disclosed is of equal importance to each stakeholder to make their decisions. The degree of importance is generally based on rankings obtained from pooled opinions of a group of subjects (e.g. APG assessment team or any preferred user group). The subjective judgments are affected in assigning the weights and reduces the objectivity of the index as a measure of the extent of disclosure (Gray et al., 1995). Furthermore, Chow & Wong-Boren (1987) suggest that the use of weighted or weighted disclosure index is interchangeable because they find almost equivalent results using either one of the index. It is also supported by prior studies that employed and adopted the same approach on disclosures (Haniffa & Cooke, 2005; Gray et al., 1995). For each NPO, the disclosure index is calculated as a ratio of the actual score awarded to NPOs divided by the maximum potential score awarded to those NPOs. The score is calculated as follows:

$$RDI = \frac{\sum_{i=2}^{n_j} X_{ij}}{n_j}$$

Where  $n_j$  = number of items expected for  $j^{th}$  organisation,

$n_j$  is  $\leq 25$ ,

$X_{ij}$  = 1 if  $i^{th}$  item disclosed and

0 if  $i^{th}$  item not disclosed,

So that  $0 \leq I_j \leq 1$

**MEASUREMENT OF VARIABLES**

There are four independent variables in this study: board competencies as measured by board efficiency, board with leadership support and commitment, board with network ties as measured by political connection and board with professional affiliations. In addition to the identified independent variables, this study also includes one organizational characteristic identified in prior research as a determinant of management disclosure decision (e.g. Gray et al., 1995; Haniffa & Cooke, 2005) as control variable. This variable is size. The definition and measurement of variables used in this study are listed in Table 1.

**Table 1.** Definition and Variables Measurement

<b>Variable Acronym</b>	<b>Definition</b>	<b>Measurement</b>
RISK_MGT	Risk Management Disclosure Practice	Self-constructed risk disclosure index (RDI).
BOD_EFFCY	Board Efficiency	Total revenue to total number of board members.
BOD_COMM	Board with leader support and commitment	Dichotomous score of 1 if there is additional Risk Management section being reported; 0 if otherwise
BOD_POLCONN	Board with political connection	Percentage of board members with political connections to total number of board members.
BOD_PROF	Board with professional affiliations	Percentage of board members with professional affiliations to total number of board members.
ORG_SIZE	Size of Organization	Total Assets.

**ANALYSIS AND RESULTS**

**Descriptive Statistics on the Risk Management Disclosure Practices**

**Table 2.** Descriptive Statistics on Risk Management Disclosure Index

	<b>N</b>	<b>Range</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
RISK_MGT (%)	219	0.50	0.26	0.76	0.4961	0.3610

*RISK\_MGT represents score in Risk Disclosure Index*

Table 2 reported the descriptive statistics on the dependent variable of RDI. From the 219 sample size selected, the mean of RDI was 0.4961. This indicates that the overall level of risks disclosure is still at a moderate level. The mean values range from a minimum of 0.50 to a maximum value of 0.76.

**Table 3.** Descriptive Statistics on the Overall Extent of Risk Disclosures

	<b>N</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
Gov_R	219	0.00	0.33	0.3285	0.0223
Ope_R	219	0.00	1.00	0.2679	0.2258
Comp_R	219	0.33	0.67	0.5644	0.1576
Fin_R	219	0.25	1.00	0.7226	0.2726
Rep_R	219	0.40	0.80	0.5973	0.1464
Valid N (listwise)	219			0.4961	

**Legend:** Gov\_R represents of Governance Risk, Ope\_R represents Operational Risk, Comp\_R represents Compliance Risk, Fin\_R represents Financial Risk, Rep\_R represents Reputational Risk

Table 3 reported the descriptive statistics on the five types of risks included in RDI. The results indicate the highest mean of the sample is 72.26% for financial risk and the lowest disclosure score was 26.79% for operational risks. The results also indicate that more than 50% of the disclosure items reported in the annual reports emphasized on the financial, reputational and compliance risks rather than on governance and operational risks.

**Table 4.** Descriptive Statistics for Independent Variables and Control Variable

	<b>N</b>	<b>Minimum</b>	<b>Maximum</b>	<b>Mean</b>	<b>Std. Deviation</b>
BOD_EFFCY(RM)	219	0.00	36,116,392.40	7.11194.48	2.650027.94
BOD_COMM	219	0.00	1.00	0.6667	0.4724
BOD_POLCONN (%)	219	0.00	1.00	0.4429	0.3610
BOD_PROF (%)	219	0.00	0.83	0.1438	0.1969
ORG_SIZE (RM)	219	9208.00	1.042947386.00	2.4006046.70	1.04212814.8
Valid N (listwise)	219				

**Legend:** BOD\_EFFCY refers to Board Efficiency, BOD\_POLCONN refers to Board with Political Connection, BOD\_PROF refers to Board with Professional Affiliation, BOD\_COMM refers to Board with Leadership support and commitment, ORG\_SIZE refers to organisation size

Table 4 shows the descriptive statistics for the independent variables of board efficiency, board with leadership support and commitment, board with political connection, board with professional affiliation and control variable which is the organization size. Table 4 reported that the mean value for board efficiency is RM7.11194.48 with a minimum value of RM0.00 to a maximum of RM36,116,392.40. This indicates that some NPOs generate fairly large amount of revenue. Table 4 also reported that some NPOs have 100% board members with political connection while others have 100% board with leadership support and commitment. The results also indicated that some NPOs have 83% board with professional affiliation. Finally, Table 4 reported some NPOs are very small with revenue of RM9208.00 to fairly large size NPOs with a maximum value of RM1.043 million.

### MULTIVARIATE ANALYSIS

The multivariate test was also conducted to test the hypotheses developed for this study by using multiple regression analysis. The hypothesized relationships are modeled as follows.

$$\text{RISK MANAGEMENT} = \beta_0 + \beta_1\text{BOD\_EFFCY} + \beta_2\text{BOD\_COMM} + \beta_3\text{BOD\_POLCONN} + \beta_4\text{BOD\_PROF} + \beta_6\text{ORG\_SIZE} + \Sigma t$$

The result of multiple regression analysis in Table 5 reported that the adjusted R<sup>2</sup> is 0.474 which indicates 47.40% of the portion of the total variation in the dependent variable could be explained by variation in the independent variables of the board competency and organization size of the study.



Table 5. Multiple Regression Results for Factors Affecting the Level of Accountability

Dependent Variable	RISK_MGT		
R square		.486	
Adjusted R square		.474	
F		40.225	
Sig		.000	
Model	Beta	t	Sig.
(Constant)		.698	.486
BOD_EFFCY (RM)	.184	3.123	.002***
BOD_POLCONN (%)	-.068	-1.246	.214
BOD_PROF (%)	-.021	-.394	.694
BOD_COMM (DS)	.621	12.572	.000***
ORG_SIZE (LOG TA)	.111	1.873	.062*

\*Significant at 10% level (1-tailed test); \*\*Significant at 5% level (1-tailed test);

\*\*\*Significant at 1% level (1-tailed test.)

Legend: BOD\_EFFCY refers to Board Efficiency, BOD\_POLCONN refers to Board with Political Connection, BOD\_PROF refers to Board with Professional Affiliation, BOD\_COMM refers to Board with Leader support and commitment, ORG\_SIZE refers to organization size.

H1 predicts that Board Efficiency is positively significantly related to the extent of RDI and the results supported the hypothesis. Therefore, H1 is accepted. These results suggest that board efficiency is a vital resource to NPOs in the implementation of risk management disclosure practices. These board members are more likely to monitor the strategic challenges faced by the organization including risk and uncertainty. This in turn increases the motivation of board members with relevant efficiency to implement proactive plan through risk reporting for mitigating risks and managing relationships with stakeholders.

With regards to Board with Leadership Support and Commitment, results in Table 5 revealed a positive relationship between board commitment and RDI. Thus, H2 is accepted. This is consistent with past studies where communication of risk management objectives and strategies between the top management and their stakeholders are a signal that top management shows their commitment towards safeguarding their stakeholders' interest (Liebenberg & Hoyt, 2003; S. Othman, 2011). Overall, the results of both H1 and H2 indicate board competencies are significantly positively related to the extent of RDI.

In contrast, Table 5 reported an insignificant relationship between Board with Political Connections and RDI. H3 is therefore rejected. This result indicates that network ties of board through political connection do not influence the extent of RDI. Results in Table 5 also revealed an insignificant relationship between Board with Professional Affiliation and RDI. Hence, H4 is therefore rejected. While these two types of board members are expected to be associated with higher disclosure of risk management practice, the absence of more specific guidelines on risk management for NPOs may reduce their motivation to do so. If such guidelines exist, they are more likely to have the motivation to portray that their organisation has good risk management practices in meeting the expectations of the society and other stakeholders.

## SUMMARY AND CONCLUSION

This study provides empirical findings on risk management disclosure practices for a sample size of 219 NPOs. Overall, the results found that board efficiency and board with leadership support and commitment are significantly related to RDI. However, board with political connections and professional affiliation indicate insignificant results to RDI. These findings indicate that some board members acknowledge the importance of being engaged in risk management decision. However, lack of specific guide on risk management in NPOs may reduce the motivation of some board members to do so. The guidelines and relevant trainings to board members provided by relevant authorities may increase the understanding of key risks and management of these risks as part of good governance in NPOs.

However, there are some limitations in this study. Firstly, this study focuses on risk information disclose in the annual reports. Future studies may use questionnaires distributed to NPOs boards and members to get a clearer understanding of risk management and disclosures. Secondly, the study was only conducted for the year of 2011 and the conclusion could not be generalized. Future research can extend this study by including several accounting periods. Finally, this

study only focuses on four independent variables. Other variables such as board meetings, board interlocking, board duality is not included and may give an effect to the extent of risk management disclosure practices of NPOs. Despite these limitations, this study provides useful insights in understanding the relationships between various board characteristics in enhancing the extent of risk management disclosure practices of NPOs in Malaysia.

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**NOTES**