A framework for the governance of social enterprise

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Abstract

Purpose – This paper aims to assess the appropriateness of two contrasting models of governance to organisations within the social enterprise sector.

Design/methodology/approach – In order to achieve this aim the paper draws on theories of for-profit governance, particularly the stewardship model, and theories of non-profit governance, particularly the democratic model. Theoretical insights from these literatures are then combined with the emerging literature on social enterprise.

Findings – Two propositions result from this which posit that social enterprise, despite being located within the non-profit sector, may be more likely to exhibit for-profit forms of governance.

Practical implications – Practitioners within social enterprises, and those operating in advisory roles to the sector, could benefit from the argument advanced in the paper in that it offers a potential governance solution to the distinctive management challenges being faced by social enterprises.

Originality/value – The paper contributes a framework for examining governance within social enterprises, and offers a guide for future research into social enterprise governance.

Keywords Corporate governance, Corporate social responsibility

Paper type Conceptual paper

Introduction

The governance of organisations has received much attention in recent years. A useful definition for this concept is that governance “is the relationship among various participants in determining the direction and performance of corporations” (Monks and Minow, 1995, p. 1). This can be adapted to embrace sectors beyond for-profits by replacing “corporations” with “organisations” more generally. Participants within the governance function of corporations typically include shareholders, senior management and the board of directors. They have rights and obligations that are enshrined in law. In contrast, participants in the not-for-profit sector do not have the same legal entitlement to participation in governance. For example, the beneficiaries of a charity may wish to influence the direction of a charity but have no recourse to law if their lobbying is overlooked.

This paper is concerned principally with boards as the locus of organisational governance. It is at board level that critical decisions are made. Other parties may influence these decisions through mechanisms such as motions put down at annual general meetings but ultimately the board has a significant degree of autonomy to do as it pleases. The board “bears the ultimate responsibility for the integrity of the corporation [and] general compliance with law” (OECD, 1998, p. 49) and so requires its members to have a commitment to the well-being of the organisation and both the skills and experience to discharge such a role.
The importance of governance has been acknowledged by academics and policy-makers alike in recent years. Academic research has been wide-ranging and not confined to any particular sector of the economy, with public, private and voluntary organisations all being analysed. The issues dominating each have varied. The public sector has been subject to debates over the decentralising of decision-making resulting from policies of outsourcing service provision. This has promoted analyses that have examined the role played by citizens, rather than solely government officials, in formulating services and monitoring their quality (Rhodes, 2000). Research into the private sector has tended to focus on issues such as how to reduce the incidence of fraudulent behaviour by corporate executives. This is not surprising given the spate of corporate scandals that have emerged. One principal mechanism that has been examined is the role played by non-executive directors (Dunn and Riley, 2004). Voluntary sector governance research meanwhile has sought to investigate a range of aspects including the function (Abzug and Galaskiewicz, 2001) and composition (Iecovich, 2005) of boards of management. The emphasis in this body of work, in common with private sector governance issues, is often on the identification of some notion of good practice in board operations.

This paper examines governance specifically within social enterprises. This is a critical part of social enterprise management. Whether referred to as a board of directors or a management committee, this is the area of management that sets the overall framework within which the organisation operates. It is a neglected area to date within social enterprise research where the focus has tended to be on the political (Dart, 2004; Fowler, 2000) or the micro-operational (Dees et al., 2001). Co-operative research has paid attention to governance (Infield, 1998) but the wider forms of social enterprise, for example, company limited by guarantee, have received little attention. This absence is significant as the governance dynamics within social enterprises constituted as companies have the potential to be quite distinct from those within co-operative, mutual benefit organisations. These company dynamics, and the governance responses that may be necessary to deal with these dynamics, will be identified in the paper. This provides a platform for theorising about social enterprise governance in order to begin to address the gap in existing research.

In order to provide a base on which to build a theory specifically for social enterprise governance, the limited company form of social enterprise (mainly limited by guarantee, but can include by shares) can be usefully compared to voluntary sector organisations that are governed by boards or management committees, and inevitably to the limited company form found in the corporate sector (limited by shares). Therefore, the paper begins by examining both stewardship and democratic models of governance. The next section examines the rationale for treating social enterprises as a form of organisation that is distinct from more traditional for-profits and non-profits. This rationale then forms a foundation for a consideration of governance within social enterprises and how this might also be distinctive. This section offers two propositions focussing on social enterprise governance. The paper concludes by detailing the research that is necessary to investigate these propositions and that can meet the need for sector specific studies which are necessary for theory-building.
Governance theory

The theoretical thrust of governance research varies depending on which sector is under investigation. Within corporate governance theory the dominant paradigm is that of a stewardship model of governance (Muth and Donaldson, 1998) which emphasises “the capacity and willingness of managers to balance different interests in the professional pursuit of company strategy” (Clarke, 2005, p. 604). In most if not all cases the company strategy is financial maximisation either through sales, share value, dividends or other financial measures. Whichever measure is used the aim is the same – to maximise the wealth of shareholders. The concept of stewardship emphasises the role of the board in their capacity as agents of shareholders and whose primary task is to utilise share capital in ways that will result in increased value. The board are believed to have a duty to act in the interests of the owners of the corporation and so are responsible for facilitating organisational performance through effective decision-making which is achieved by electing board members on the basis of their expertise (Iecovich, 2005).

The idea that boards do act in a stewardship capacity has been challenged by successive corporate scandals. In the aftermath of the Enron scandal in the US, Clarke (2005, p. 604) noted that:

... it was in their fundamental failure to uphold their stewardship and fiduciary duties that the Enron executives were most irresponsible.

This and other scandals have promoted a number of governance reviews which have sought to attempt to combat the problem of corporate fraud. These reviews have focussed on both the operation and composition of boards. For example, Higgs (2003) advocated a greater role for non-executive directors in governance as one mechanism to reduce the threat of what he referred to as “lapses”. In addition he argued that these directors be drawn from a wider pool in order to reduce the cosiness that is seen as encouraging less rigorous governance activities. Whether the board always acts in reality in accordance with the theoretical stewardship model is therefore questionable. However, as a guiding ideal it remains in place, in law if not always in practice.

Within the theoretical analysis of non-profit boards a counter view of governance dominates, with the board being modelled as a tool of democratic participation. These contrasting views are related to the tension between shareholder and stakeholder perspectives of the corporation. The corporate governance literature proceeds from the assumption that mechanisms should be in place to ensure that corporate managers meet the interests of shareholders (Child and Rodrigues, 2004). Hence there is a preoccupation in the literature with topics such as the role and effectiveness of non-executive directors in the monitoring of executives (Long et al., 2005). The stakeholder corporation literature however is founded on the assumption that giving such prominence to shareholders is problematic and that corporate governance should in fact be the arena for attending to the legitimate interests of all stakeholders through mechanisms such as giving board positions to stakeholder representatives (Donaldson and Preston, 1995; Goodpaster, 1993). Much of this debate can be traced directly to beliefs about the claims that exist on the assets of the organisation. Shareholder claims on the corporation are questioned by stakeholder theorists who take issue with the principle of private property freedoms, despite their protestations to the contrary (Goodpaster, 1993).
Social enterprises are widely viewed as stakeholder organisations not least because of the assumption about their asset base. Non-profits are theoretically owned by the community rather than by shareholders (Pearce, 2003). They may have assets but these are held in trust and so are locked-in for community benefit (Dunn and Riley, 2004). There is no direct claim to be made on these assets other than by creditors in the case of insolvency. Therefore, the democratic model has at its heart the idea that:

...the major role of governing boards is to represent the interests of various constituencies and groups (Iecovich, 2005, p. 162).

The guiding principle of such a perspective is organisational legitimacy (Suchman, 1995). This view of organisations relies on a perspective that assumes that the external environment is a powerful force acting upon the organisation, and that those outside of the organisation confer a form of approval on the actions of the organisation. This contrasts with the stewardship model as it opens up the prospect that organisations can be judged not only from above (by shareholders) but also from below by stakeholders at large (Abzug and Galaskiewicz, 2001).

Implicit to the democratic model is the notion that individual expertise in governance is secondary to a claim to be a representative of a particular stakeholder group. Although this suggests that governance expertise is mutually exclusive to representative status – a telling observation about theorists’ beliefs about stakeholder capabilities – more importantly it highlights the tension between theories of corporate and non-profit governance. Corporate governance believes in board members qualifying purely on the basis of expertise in managing and accumulating assets. In contrast, non-profit governance is built on the notion that those managing an organisation at the highest level should be on the board because of who they represent rather than their ability to manage the assets of the organisation. It follows therefore that the performance of a non-profit will be judged in part on the basis of who is on their board rather than what they achieve whilst in that role (Abzug and Galaskiewicz, 2001). These broad perspectives are summarised in Table I.

### Social enterprise governance

The preceding discussion frames the polarity between the role and purpose of boards within the for-profit and non-profit sectors. Attention is given in this section to a consideration of what relevance these models might have for social enterprise governance. The notion that social enterprises form a distinct sector in their own right has become an acknowledged fact. They tend to be categorised as a sub-set of the non-profit sector (Pearce, 2003; Dunn and Riley, 2004). This would suggest that social enterprises will exhibit a democratic model of governance. However, as Dart (2004, p. 415) notes, social enterprises “enact hybrid non-profit and for-profit activities”. This suggests that, in theory at least, social enterprise governance may in turn be a hybrid of for-profit stewardship and non-profit democratic models. This section examines to

<table>
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<th>Category of organisation</th>
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<td>For-profit</td>
<td>Shareholders have claim on assets</td>
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<td>Non-profit</td>
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Table I. Governance models in different sectors
what extent these competing views of governance might apply to social enterprises and therefore what this might tell us about social enterprise governance practice.

Social enterprise and the non-profit sector
In order to frame this examination of social enterprise governance it is first necessary to examine the claim that social enterprises are a distinct group of organisations, and to isolate just what it is that makes them different. Dart (2004, pp. 414-5) characterises nonprofits as “voluntaristic, prosocial, and civic”, which offers little as a set of distinguishing factors as social enterprises also tend to exhibit these characteristics. Of more use is Dart’s contention that non-profit organisations are “distinct from business organisations”. This is in sharp contrast to social enterprises which tend to go to great lengths to present themselves as not being distinct from businesses. They wish to be seen as possessing rigorous performance objectives, not least in financial management terms. Social enterprises therefore “blur boundaries between nonprofit and for profit” in part through the use of “corporate planning and business design tools” (Dart, 2004, p. 415).

An argument against the identification of social enterprises as a sector separate from other non-profits is that many charities, notably the bigger ones, have formalised trading activities in addition to their service provision and advocacy work. These trading activities often take the form of retail outlets that sell a range of items, many of which are donated by the same people that shop there. However, the fact that these organisations explicitly hive off trading into subsidiaries that invariably covenant profits back to the centre, actually reinforces the case for identifying a separate sector. The social enterprises that come to mind in this case are those that are explicitly community located and that primarily sell their actual services rather than sell something separate (often donated goods) to their services. These social enterprises may share legal forms with the trading arms of charities, typically companies limited by guarantee, but that is where the similarity ends. Two illustrative examples are offered of this form of social enterprise. Whilst these cases are real and based on the author’s consultancy experiences, in formal research terms they are essentially anecdotal. Therefore, no claim is made for their rigour or representative status. Rather, these examples merely highlight the tensions that can exist within social enterprises and, it is contended, that only the governance function can adequately address.

Case one
As the first illustrative example of this form of social enterprise, consider a community-based company that runs a facility that hosts community group activities. This facility is of high enough quality, and in the right location, to house offices suitable for a professional services provider such as a commercial legal practice. In addition it has the capacity to host trade conferences. Therefore, the social enterprise has the opportunity to engage in high margin activities such as lettings and conferences which offer minimal social benefit but which maximise income and hence impact positively on financial stability. Offering such services can impinge on the ability to provide space for the core socially valued activity which the company was set-up to deliver in the first place. For example, in place of an office the company could allow a community group to use a room at minimal cost for some socially positive group activity such as an aerobics class.
Case two

A second example of this form of social enterprise is that of a childcare provider. This enterprise may have built a decent reputation in a given area and as a result been offered a deal to block sell the majority of its places to a local private sector employer. This would offer a regular and consistent source of income. If the childcare company decided to turn down this contract, they would then leave themselves open to the possibility of lower income from serving low-paid parents who require irregular times and variable periods for their children to be cared for (for example, shift workers on short term contracts). The resultant variability in take-up would be likely to reduce the occupancy below that to be expected from a block booking. However, by refusing the contract they would retain the ability to offer the greatest choice to those with the greatest need.

Both of these cases emphasise the heightened sense of conflict that can emerge between social and financial objectives in social enterprises of this nature. This is in contrast to the subsidiary model of enterprise where such conflicts are less likely to occur. If a single organisation is trying to provide social provision while trading using this same provision then a management style that can embrace both is required. Fowler (2000, p. 652) identifies the difficulty of:

...managing the interplay between potentially competing sets of values – social action set against the demands of market behaviour.

For the enterprise involved, the non-profit mantra of “can’t pay, use our service anyway” must shift to incorporating a view that if they “can pay, then make them pay”. This duality requires highly sophisticated judgements about the use to which company assets are put.

Governance models applied to social enterprise

This management challenge is played out at all levels but ultimately responsibility for addressing it rests at board level. As Fowler (2000, p. 645) concludes, social enterprise “calls for a specific type of capability to manage a non-profit-for-profit organisation all ‘under one roof’”. This view was reinforced by an analysis of the sector that noted that enterprises:

...often have boards of directors or trustees who come from a voluntary sector rather than a business background. This can lead to a lack of business focus and prevent social enterprises from truly reaching their potential (DTI, 2002, p. 62).

The situation faced by social enterprises suggests that they must be capable of using the assets they have to maximum effect. This requires that they make decisions that reflect the needs of their community interest whilst ensuring financial sustainability. The democratic form of governance would appear therefore to be of limited use in these circumstances. This gives rise to the proposition:

P1. Social enterprises boards are more likely to exhibit a stewardship model of governance than the democratic model found in other non-profits.

The assumption behind this proposition is that organisations that are attempting to operate using a transactional model will require a different form of governance to those organisations that are grant-dependent. These grant driven organisations tend to have
a board that is democratic with representation from service-users, funding bodies, local authorities and the like. The complexities of trading are likely to drive a requirement for a more stewardship driven form of governance that relies less on representing diverse interests and more on a board that is capable of managing assets for greater return. Unlike private sector stewardship though, the surplus generated is not designed to increase shareholder wealth but is to be used to maximise social benefit. The focus on asset management contrasts with the democratic governance model that attempts to achieve greater social impact through a focus by the board on fundraising through their contacts or application writing skills (Mathiasen, 1998). As the emphasis of the board’s activity is different in social enterprise, it therefore follows that it is likely that the composition of the board will be different. This gives rise to a second proposition:

\[ P2. \] In order to enact the stewardship model social enterprise boards are more likely to recruit members on the basis of expertise rather than representative status

The expertise being referred to in this proposition is essentially business experience. Board members who have experience of managing organisations that reward profit margin rather than social impact will tend to be useful in strategic decision-making about how best to use the assets of the organisation. There may well be some resistance to this notion of candidates for boards being judged on their commercial abilities, with some stakeholders likely to cast it as anti-democratic (Low and Cowton, 2004). However, the counter-argument to this is that too much influence by representatives whose preoccupation is social rather than financial could result in the company turning away contracts that could offer financial sustainability.

An additional factor that supports this contention that boards are likely to become more stewardship orientated concerns the current orthodoxy around social enterprise and financing. A recent report advocated that social enterprises should aim for growth through standard forms of financing including equity (Bank of England, 2003). The UK government has created a legal form explicitly for this purpose, the Community Interest Company (CIC). The CIC form requires an organisation to have an explicit social mission and also places a cap on shareholder dividends, thereby protecting the company from an emptying out of assets (Dunn and Riley, 2004). This move towards external sources of finance is likely to increase the tendency of enterprises to adopt a stewardship approach to the governance function as the organisation will be handling shareholder funds and attempting to manage them to maximum effect.

Concluding remarks
There is a need for research of the social enterprise sector in general but this paper suggests that the governance function requires more attention than others due to its significance. Social enterprise governance is an area that attracts much attention from those seeking to decide whether an organisation should be eligible to be considered for government contracts or alternately apply for grants (Walmsley, 2003). Evidence is demanded by external parties that demonstrate that social enterprises have democratic legitimacy through the involvement of stakeholders at the highest levels of the organisation (Pearce, 2003). Therefore, any suggestion of a shift towards a stewardship model, which can be cast as anti-democratic as it will inevitably exclude some stakeholders on the basis of expertise, requires mapping. In theory, if not necessarily in
reality, a move towards a stewardship model is likely to be seen as a shift from a stakeholder to a shareholder focus. This is despite the introduction of limits on shareholder control such as those outlined in the CIC legislation, which explicitly demands that community interests should be the main driver of decision-making rather than financial returns for shareholders (CIC Regulator, 2005). A further rationale for research into social enterprise governance is that if organisations are shifting from one governance model to another then the impact that this can have on other elements of the organisation and its performance should be examined. If the assumption that is often stated in the governance literature, that governance is critical to an organisation’s performance (Child and Rodrigues, 2004; Rhodes, 2000), is to be tested then this is an ideal opportunity to do just that.

The origins of the corporate governance literature, with its focus on the separation of ownership and control (Berle and Means, 1932), have resulted in a preoccupation with shareholders. The crisis of confidence in publicly limited companies, which has been observed in recent years due to executive fraud, has had to be addressed to reduce the likelihood of a reduction in the shareholder base as investors seek other mechanisms for financial return. Social enterprise is unlikely to be immune to the need to project an image of probity in its ability to manage assets, nor is it likely to be immune to senior managers wishing to commit fraudulent acts. Therefore, the findings and theories that constitute the corporate governance literature are likely to become more applicable over time to the practice and theory of social enterprise governance.

If social enterprises are to attract investment then it seems inevitable that the stewardship model of governance will emerge in part to operate as a signal to investors about the effectiveness of asset management within these organisations. Studies of corporate governance, and in particular the focus on the stewardship model, are relevant to social enterprise in that they emphasise the need for organisations to have mechanisms in place to bring directors to account. The new social enterprise legal form being encouraged at present, the CIC, explicitly limits accountability within social enterprises by limiting shareholder voting powers while at the same time offering only a modest increase in other stakeholder powers (Dunn and Riley, 2004). This has the potential to open up social enterprises to the threat of the misappropriation of shareholder assets seen all too often in recent years. Regardless of whether the assets of social enterprises are in fact owned by shareholders or the community, the point remains that these assets must be devoted to community benefit, while at the same time being protected from misappropriation by senior managers.

The argument advanced in this paper is undoubtedly a contentious one given that it proposes that social enterprises, despite being a sub-set of the non-profit sector, are unlikely to exhibit the model of governance typically found in that sector. Such claims require rigorous research within empirical contexts in order to give them more than just theoretical value. The present climate offers particular opportunities to test the claims made. Many new organisations are appearing who refer to themselves explicitly as social enterprises. An examination of their boards in terms of how they operate and who they elect can shed light on the dominant form of governance in evidence. In addition there are many non-profits who are attempting to make the transition to social enterprise. This offers another angle on the governance issue as it creates the ideal situation in which to track changes in board operation and membership over time and so examine live the process of change through which organisations go. If boards
are seen to change significantly over this period of transition it would support the proposition that social enterprises, whether wholly new organisations or those emerging from other organisational forms, exhibit a distinctive stewardship model of governance.

Two additional questions arise for investigation. First, the identification of a dominant governance model in the social enterprise sector does not necessarily mean that this model is the most effective. To assess board effectiveness is never easy but it is made more difficult in this case because hard decisions have to be made about the measures that could be used. In corporate governance research a focus on financial measures can be utilised. For social enterprise, researchers must create criteria that reflect the split between financial and social objectives. As part of the proposed research attempts could be made to pilot different sets of criteria to address the effectiveness issue. The second question that arises is concerned with whether the non-profit organisations themselves perceive that there is a distinctive challenge awaiting them in the social enterprise form and whether they intend to actively change the composition of the board to reflect the change to social enterprise. It may be that non-profits merely continue with the democratic model that has served them well in the past. They may only change when situations present themselves that reveal the inadequacy of the board in dealing with the complexities that social enterprises must navigate in balancing social and trading objectives.

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