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Assessing the self-governance and value creation in non-profit organisations

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Abstract

The purpose of this study is to examine the relationships between self-governance through board members and firm performance. Results of this study revealed significant relationships only between some board characteristics and some measures of financial performance. Overall, the findings indicate that board members are not promoting good governance in their organizations. This indicates the need of a specific governance framework to guide board members of nonprofit organisations (NPOs) to engage in good self-governance for the benefits of the NPOs and their relevant stakeholders.

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Keywords: Self-governance; Value Creation; Non-profit Organisations; Board Characteristic.

1. Introduction

In the current economic environment, many non-profit organizations (NPO) are facing funding cuts and reduced voluntary donations. While many NPOs are facing the reductions in income, the demand for their services continues to grow (Cornforth, 2012). In this context, Charity Governance Review (2013) by Grant Thornton proposes that good governance practice is crucial as it can facilitates NPOs to respond effectively and timely to meet emerging challenges and in turn continue to deliver their social objectives. At an organizational level, the board or the trustees are responsible to ensure that good governance is being practiced. Good governance promotes compliance with the law, transparency and the overall effectiveness of the NPOs (e.g. Cornforth, 2012 and Ostrower, 2007). This infers an important link between the governing body of the NPOs, the board and organizational effectiveness. From a resource

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dependence theory (RDT) perspective, organizational effectiveness can be achieved through effective boards. The RDT literature contends that board members are associated with various skills and expertise that will enable them to manage the flow of resources and reduces the uncertainty in their environment (Pfeffer and Salancik, 1978). Hence, this study aims to examine the relationship between board composition and organizational effectiveness as a measure of value creation in non-profit organizations.

While good governance has been recognized to be an important element for effective functioning of the NPOs, the current governance framework in many countries are not legislated (Cornforth, 2012). Nevertheless, Cornforth (2012) argued that the contemporary thinking about non-profit governance originated in legislation aimed at businesses. Hence, this study contends that good governance through self-governance in NPOs is expected to influence organisational effectiveness. In line with the current proposition, good governance in this study focuses on board composition. Findings from this study contribute to policy formulation by regulators in promoting self-governance in the non-profit sector.

This paper will proceed with the review of past literature from which hypotheses will be developed. The paper will then proceed to the empirical stage of variable measurement, sampling, data analysis and discussion of results. The final part of this paper presents the conclusion, limitations and suggestions for future research.

2. Literature Review and Hypotheses Generation

2.1 Resource dependence theory, board composition and firm performance

The growing number of NPOs and the current economic environment has lead to reductions in income to many NPOs around the world. According to resource dependence theory (RDT), an organization operating in this environment will survive if they can reduce the uncertainty in their environment (Pfeffer and Salancik, 1978). The RDT contends that board of directors enable organizations to minimize dependence on resources or gain resources in ensuring optimal delivery of their social objectives. In other words, the boards are exercising good or strong governance in overseeing the delivery of the organisation's strategy as well as safeguarding the assets of the NPOs. Prior empirical evidence suggests that characteristics or compositions of board members are associated with organizational effectiveness (e.g. Pfeffer, 1973 and Sanders and Carpenter, 1998). Hence, this study focuses on four types of board composition: board size, board professionalism, board members with political connections and ethnic minority on boards.

2.1.2 Board size and firm performance

The RDT literature suggests that board size in NPOs is likely to vary with the amount of complexity and uncertainty in the external environment (Boyd, 1990; Dess and Beard, 1984; Pfeffer, 1972, 1973; Pfeffer and Salancik, 1978). For example, more board members with link to important resources in the external environment will be recruited on the boards of NPOs. This suggests that the size of the board in NPOs is likely to be fairly large. Proponents of small board size argued that large board size reduces effective communication, coordination, decision making process and the ability to control, monitor and supervise organisational activity (e.g. Yermack, 1996 and Mak and Kusnadi, 2005). However, this study argues that in order to effectively sustain an organization in meeting the current challenges facing the NPOs, larger boards are more likely to be able to fulfill these obligations as they are more likely to be comprised of members with various experience, expertise, knowledge and experience. Based on this reasoning, the following hypothesis is developed:

H1: The size of the board is significantly positively related to firm performance.

2.1.3 Board professionalism and firm performance

The human capital of the board members consists of experience, expertise and reputation (Brown, 2005) and this can facilitate them to guide the strategic direction of the NPOs. Mwenja and Lewis (2009) argue that these board members are an important resource to the NPOs as they are more capable in directing the strategic mission of the organization. Hence, it is expected that board members with professional backgrounds are more capable to assist the NPOs in analysing and understanding the complex environment under which the NPOs operate. In addition to their experience and expertise, board members with professional backgrounds are expected to be concerned with maintaining and enhancing their reputation. The reputation of professionally qualified board members is associated with their membership in the professional bodies. In general, they are obliged to comply with their professional commitments (Chalmers and Godfrey, 2004) as well as other legal compliance. Overall, they are more likely to contribute to the exercise of good governance with consequent positive impact on firm performance. Hence, the following hypothesis is developed:

H2: The percentage of board members with professional affiliations is significantly positively related to firm performance.

2.1.4 Political connections and firm performance

In managing emerging challenges, particularly in sustaining the flow of income into the organisation, it is important that the organisation develops and maintains healthy relationships with the various stakeholders (Mwenja and Lewis, 2009). Mwenja and Lewis (2009) argue that through these relationships or external social networks, the organization will be able to expand the organisation's donor base and consequently bring in resources into the organization. This argument is in line with the evidence provided by past studies where board members with political connections are associated with preferential access to funds (e.g. Claessons, Feijen and Leaven, 2008; Faccio, Masulis, McConnell, 2006). In relation to maintaining the network ties with the various governmental agencies and regulatory authorities, the board members are expected to be more supportive of the various calls for good self-governance in NPOs promoted by these bodies. In this context, this increases the board members involvement in strategic decisions (Carpenter and Westphal, 2001). Overall, this infers that these board members will be able to make more meaningful contributions in enhancing the governance of NPOs and enhanced firm performance. Following this argument, the following hypothesis is developed:

H3: The percentage of board members with political connections is significantly positively related to firm performance.

2.1.5 Ethnic minority representations on board and firm performance

As NPOs exist to deliver social objectives to the society, some studies argue that board diversity offers a representation of the diverse stakeholders which is in line with the function of the board in protecting the interests of stakeholders and society at large (e.g. Erhardt, Werbel and Shrader, 2003 and Haniffa and Cooke, 2002). These literatures argue that board diversity increases discussion, exchange of ideas and the overall performance of the board. As Malaysia is a multiracial country, it is expected that the board members to be diverse. This study refers to ethnic minority representations as represented by non-Bumiputra board members. While studies on the relationship between board diversity and various measures of firm performance in Malaysia provides inconclusive evidence (e.g. Haniffa and Cooke, 2002; Ramasamy, Ling and Ting, 2007), this study expects representations of ethnic minority on the boards of NPOs are associated with higher firm performance. In line with past studies in Malaysia, this study argues that Bumiputra board members practice selective governance practices and this can reduce the overall effectiveness of the governance framework within the NPOs. Following this argument, the following hypothesis is developed:

H4: The percentage of ethnic minority on boards is significantly positively related to firm performance.

3. Methodology

3.1 Sample and data collection

The sample consists of 250 NPOs registered with the Registrar of Societies (ROS) for the financial year 2010. The research approach involves the content analysis of societies' annual reports. The sample selected comprises of NPOs registered in the States of Selangor, Wilayah Persekutuan Kuala Lumpur, Terengganu, Kelantan, Sabah, Kedah, Perak and Johor.

3.2 Measurement of variables

3.2.1 Independent variables

There are four independent variables in this study, board size, board members with professional affiliations, board members with political connections and ethnic minority representations on board. In addition to the identified independent variables, this study also includes size as a control variable. The definition and measurement of variables used in this study are listed in Table 1.

Table 1. Definition and measurement of variables

Variable Acronym	Definition	Measurement
B_SIZE	Board size	Total number of board members.
B_PROF	Board members with professional affiliations	Percentage of board members with professional affilitations to total number of board members. Professional affiliation refers to members with professions in areas such as accountin; management, engineering, architecture and medical.
B_POL	Board members with political connections	ercentage of board members with political connections to total number of board members. olitical connections refer to members being conferred awards by the Government of Malaysia. For example, board members with Dato', Tan Sri and Datuk Paduka.
B_EM	Ethnic minority representations board	Percentage of non-Bumiputra on board to total number of board members.
SIZE	Size of society	Natural log of total assets

3.2.2 Firm performance

Firm performance measurement in this study is adopted from Winand, Zintz, and Scheerder (2012) and Abraham (2006). Following these literatures, firm performance is classified into financial balance and mission based financial support. The definition and measurement of firm performance used in this study are listed in Table 2.

Table 2. Definition and measurement of firm performance

Variable Acronym	Definition	Measurement
FB1	Financial balance Measure financial stability of organization	Ratios of benefits =Total revenue / total expense
FB2	Financial balance Measure financial stability of organization	Ratios of benefits in comparison with revenues =Net revenue / total revenue
FS	Mission based financial support Measure whether financial resources are sufficient and available to support mission of the organisation	Primary reserve ratio = organization operating commitments = net current assets /total expenses

4. Analysis and Results

4.1 Descriptive statistics

Table 3 presents the descriptive statistics on the dependent variable, FV. The results of the descriptive statistics for continuous independent variables and control variable are presented in Table 4.

Table 3. Descriptive statistics for firm performance

Number of NPOs = 250				
Firm Performance (%)	Minimum	Maximum	Mean	Std. Deviation
FB1	0.000	8.198	1.387	1.091
FB2	-37.420	1.000	-0.155	2.464
FS	-4.113	94.037	3.831	8.970

Table 3 indicates that the mean value of 3.831% for FS is the highest relative to the mean values for FB1 and FB2. The mean value of -0.155% for FB2 indicates that the nett revenues of the NPOs in the sample are very low.

Table 4: Descriptive statistics for independent and control variables

Number of NPOs = 250				
Independent and Control variables	Minimum	Maximum	Mean	Std. Deviation
B_SIZE	4.00	33.00	13.74	5.39
B_PROF (%)	0.00	1.00	0.13	0.23
B_POL (%)	0.00	1.00	0.05	0.15
B_EM (%)	0.00	1.00	0.64	0.42
SIZE (RM'000)	0.00	33,242,464.00	883,627.45	3,098,781.35

Table 4 reported that board size of NPOs ranges from a minimum of 4 members to 33 members. Consistent with prior studies (Boyd, 1990; Dess and Beard, 1984; Pfeffer, 1972, 1973; Pfeffer and Salancik, 1978), this result indicates that some NPOs are fairly large in size. In relation to board composition, Table 4 reported that some NPOs have 100% members with professional affiliations, 100% board members with political connections and 100% ethnic representation on board. Finally, Table 4 reported that some NPOs are very small with no revenue to a fairly large size NPO with maximum revenue of RM33, 242,464.00.

4.2 Multivariate analysis

In this study, linear multiple regression is used as the basis of analysis for testing H1 to H4. The hypothesized relationships are modeled as follows.

$$FB1 = \beta_0 + \beta_1 B\_SIZE + \beta_2 B\_PROF + \beta_3 B\_POL + \beta_4 B\_EM + \beta_4 SIZE + \varepsilon_t \qquad (1)$$

$$FB2 = \beta_0 + \beta_1 B\_SIZE + \beta_2 B\_PROF + \beta_3 B\_POL + \beta_4 B\_EM + \beta_4 SIZE + \varepsilon_t \qquad (2)$$

$$FS = \beta_0 + \beta_1 B\_SIZE + \beta_2 B\_PROF + \beta_3 B\_POL + \beta_4 B\_EM + \beta_4 SIZE + \varepsilon_t \quad (3)$$

where variable definitions are given in Table 1.

In the above regression models, multicollinearity was tested using the variance inflation factor and tolerance levels, and found to be well within the satisfactory range. The results of the regression analysis are presented in Table 5 and are now discussed in terms of tests of each of the hypotheses.

Table 5: Multiple regression results for factors affecting the firm performance

Dependent Variable	Financial Balance						Mission Based Financial Support		
	FB1			FB2			FS		
R^2	0.050			0.046			0.136		
Adjusted R^2	0.031			0.026			0.118		
F	2.564			2.346			7.660		
Sig	0.028			0.042			0.000		
Model	Beta	t	Sig	Beta	t	Sig	Beta	t	Sig
(constant)	0.000	0.193	0.847	0.000	0.164	0.870	0.000	0.103	0.918
BOD_SIZE	-0.042	-0.652	0.515	-0.089	-1.390	0.166	-0.087	-1.145	0.158
BOD_PROF	0.050	0.780	0.436	0.056	0.874	0.383	0.126	2.074	0.039
BOD_POL	-0.182	-2.736	0.007	-0.157	-2.360	0.019	-0.168	-2.648	0.009
BOD_EM	-0.101	-1.523	0.129	-0.066	-1.002	0.317	-0.070	-1.105	0.270
SIZE	0.189	2.762	0.006	0.174	2.538	0.012	0.360	5.504	0.000

Results of the multiple regression analysis in Table 5 report that the adjusted R^2 is 0.031, 0.026 and 0.118 respectively. H1 predicts that B_SIZE is significantly positively related to various measures of firm performance. The results in Table 5 reveal insignificant relationships. Hence, HI is rejected. These results indicate that B_SIZE board composition instead of size matters in ensuring good governance and firm performance. This is consistent with prior studies where type of directors on the board is associated with different benefits to the organizations (Luoma and Goodstein, 1999; Johnson and Greening, 1999). Hence, an optimum board compositions instead of board size that matters in contributing to firm performance.

With regards to board members with professional affiliations, the results in Table 5 reveal significant relationship only with FS. Hence, H2 is partially accepted. H2 posits that B_POL are obliged to comply with their professional commitments and are more likely to direct their organisation to engage in strategic activities in line with delivery of social objectives. However, these results indicate that B_POL are more concerned with safeguarding the financial resources of the organization in order to meet its mission and not engaging in more strategic actions to enhance other measures of firm performance.

H3 predicts B_POL is significantly related with firm performance through their networking with the various stakeholders. Table 5 reported significant negative relationships between B_POL and FB1, FB2 and FS. Hence, H3 is rejected. It is possible that the unavailability of specific governance framework for NPOs in Malaysia leads these board members in opposite directions with negative impact on firm performance. Finally, H4 predicts that B_EM is significantly positively related to various measures of firm performance. The results in Table 5 reveal insignificant relationships. Hence, H4 is rejected. Even though the descriptive statistic results revealed that most of the board members in the sample are represented by ethnic minority, this does not contribute to better firm performance. A possible explanation for this insignificant relationship can be consistent with the explanation with regards to the relationships between B_POL and firm performance. This point is significant to the need of a specific governance framework to guide board members of NPOs to engage in good self-governance for the benefits of the NPOs and their relevant stakeholders.

5. Conclusion and Limitations

This study examines the relationships between various board compositions and various measures of firm performance. The findings in this study provide two main inferences. First, the insignificant positive relationships between most board characteristics and firm performance indicates lack of guidance with regards to best practice of good governance specifically for NPOs. It is important to acknowledge this issue as it can reduce the board members effectiveness in meeting various challenges faced by NPOs. The second inference is related to the insignificant relationships between B_SIZE and firm performance. This indicates that an optimum mix of board members is paramount in ensuring good governance in order to enhance firm performance.

Finally, there are some limitations in this study. First, this study focuses on only four board characteristics. Future research may consider other board characteristics as well as other measures of firm performance. The practice of good governance can also be measured based on questionnaires sent to board members or members of the NPOs. Despite these limitations, this study provides useful insights in understanding the relationships between various board characteristics in measuring the practice of self-governance and performance of NPOs in a developing country environment.

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