

# Board Effectiveness and Financial Sustainability of Non – Profit Organizations

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*Abstract*— The purpose of this study is to examine the influence of board effectiveness on the level of financial sustainability for NPOs in Malaysia. Identifying the level of financial sustainability in NPOs is important in predicting their survival. In this study, 202 NPOs registered under Companies Commission of Malaysia (CCM) had been chosen for the financial period 2011. Financial sustainability indicators are equity ratio, revenue concentration, administrative cost ratio and operating margin ratio. While the board effectiveness represented by board planning effectiveness and board characteristics. The result of this study found that only Board Characteristics had significant and positive relationship with the financial sustainability of organizations. Overall, the findings in this study provide useful information to regulators in their continuous efforts to improve financial sustainability in the non-profit sector.

*Keywords*— *Non-profit Organizations; Financial Sustainability; Board Effectiveness; Board Planning Effectiveness; Board Characteristics*

## 1. INTRODUCTION

Non-profit organizations (NPOs) are generally defined as associations, charities, and voluntary organizations formed to further cultural, religious or public service objectives [1]. NPO objectives are not only on profit maximization [2], but also for creating social values and financial feasibility [3]. Their major sources of funds are from public and personal contributions and assistances. During the last three to five years many NPOs have been forced to close due to a lack of funds [4]. NPOs pursue a mission that is neither financially sustainable using a for-profit business model, nor for which is their public support sufficient to move government to action and the expenditure of taxpayer funds [5]. For the NPO, the information that has been reported and compared for analysis purposes sometimes was not always clearly linked to the mission and vision of the organizations. However, the primary concern of a funder, a donor, a board member, the community, or any other stakeholder should be whether the NPOs has achieved its mission or not and also can sustain for their financial or not [5].

Senior executives, financial professionals, and board members of NPOs face similar challenges that others in for-profit organizations have faced or are still facing: what are the relevant indicators of performance, and how should they be measured on their financial to sustain in their industry, how board of director of NPOs can help their organizations to succeed and sustain on their financial? Thus, [6] provide guidance on how to design comprehensive financial performance measurement systems to better manage and improve performance of NPOs. The Guideline's specific objectives are: (i) To present existing best practices in measuring financial and non-financial performance of NPOs including the performance measures and various approaches used in different types and sizes of NPOs; (ii) To provide new guidance and tools, for examples to measure and report performance of NPOs; and finally, (iii) To provide recommendations for senior managers, financial professionals, and board members in improving the governance, management, and performance of NPOs.

Besides that, there is lack of studies in examining financial sustainability mechanism practices of NPOs in Malaysia. However, beyond the general assumption that organizations are more likely to disclose when they are concerned with donations and/or accountability, lack of studies posit testable hypotheses regarding specific factors that lead to increased financial sustainability [7]. Thus, this study will focus on board effectiveness and financial sustainability of NPOs in Malaysia which will give a significant contribution to knowledge and the public at large.

## 2. LITERATURE REVIEW AND HYPOTHESES GENERATION

### 2.1. Board planning effectiveness and financial sustainability

The resources dependency theory also stresses to the acquisition and maintenance of human, financial, and other resources is essential for organizational survival and is relevant to this aspect of planning performance [8]. The role played by board of director in strategic decision planning is the most important principles of resource dependence theory [9]. [10] suggested that board process characteristics like strategic planning efforts and how board meetings are conducted, also as are sources and give affected to the financial sustainability of the organization.

The board must ensure that the organization has a strategic planning; for instance, a clear objective, mission and vision. Based on the resources dependence theory (RDT), the vital aspect of performance is securing the necessary resources in performing the organization's objectives or mission [8]. [6] and [11], found a clear objectives like mission and vision statement significantly determines the success of NPOs. [12], examined that the majority of companies in the Spain, Argentina and Brazil can success and sustain in their industry because they have many formal ethics documents such as corporate mission, corporate activities and corporate value statements.

NPOs in Malaysia must follow the rule and regulation under the Companies Act 1965. NPOs are encouraged to comply with rule and regulation of the financial reporting standards (FRS) and required to hold annual general meeting (AGM) at least once in a year [13]. According to [13], reassessing the laws and regulations that apply to the NPO such as conducting the annual general meeting at least annually will help to ensure the board's responsibilities remain up-to-date. While [14] and [15] argued that when organization adopting FRS it will show an improvement in reporting quality and upgrading their financial sustainability.

The boards and their members must be aware and alert of the possibility that courts will apply new standards or interpret existing standards due to increase of board responsibility for risk management in their organization [13]. Thus, the board must understand and evaluate how risk is interrelated, how risk affect to the organization and how staff addresses these risk. As we know, if NPOs with less financing risk, it is likely to be more sustain and have capabilities in order to achieve their goals [16].

Disclosure relevant information to the current and future resource providers is an important matters in strategy planning process for the financial sustainability of the organization. This is because it can lead to negative perceptions about the board's effectiveness in managing their resources [17]. For NPOs, transparency financial report is essential to the stakeholders, mainly the donors who have previously made some amount of donations. According to [18], some donors are more likely to react to a fundraising accounting information is provided because it shows the financial stability of the organization and the reputation of the organizations. Therefore, the following hypothesis is proposed.

H1: Board planning effectiveness is positively and significantly associated with financial sustainability of non-profit organizations.

### 2.2. Board characteristics and financial sustainability

[19], stated that the perspective of resource dependency theory (RDT) is envisages a role for directors in providing access to resources, including information. They also defined board characteristics as sets of relationship and resources. [20] argued that these board members are an intellectual capital as their important resources to the NPOs as board's role in the strategic direction of an organization is a significant contribution to the long-term survival of the NPOs.

Based on the RDT literature, board size in NPOs is likely to vary with the amount of complexity and uncertainty in the external environment [9]. However, both small and large size of board had negative and positive impact according to the size and goals of the organization. The ability to manage, supervise and control the activities of the NPOs will depend largely on their board of directors [21]. They found that larger NPOs boards are more effective to monitor which results in a better non-profit performance. However, [22] argued that smaller number of boards are more effective in monitoring the CEO's action.

Director also needs to be both credible and forceful, as they need to be effective in board situations where not everyone has bought into the importance of accepting financial sustainability as a key corporate strategy driver [23]. By having board members with a various range of expertise, the firm strengthens its human capital competitiveness. The combination of composition and knowledge and skills of board of directors that will have vital impact on their effective performance of oversight roles [24].

As the board functions as a resource for the NPOs [9], the board provides a significant relationship between various stakeholders and the organization. [20] suggested that it is imperative that the organization develops and maintains healthy relationships with the various stakeholders. They argued that through these relationships or external social links, the organization will be able to

expand the organization's donor base and therefore can bring resources into the organization. This suggests that when board members have political connection, they can exert more influence in attracting and sustaining continuous flow of critical resources by external social networks and reputations.

Leadership support and commitment by top management are the key elements in setting the directions, creating alignment and maintaining commitment of the organization [25]. Study done by [26] indicated that leadership and commitment support can influence the enhancement of financial result and company's performance. In relation to NPOs financial sustainability, effective fund raising is one measure of the board's capabilities, commitment and influence. Therefore, the following hypotheses are formulated:

H2: Board characteristics are positively and significantly associated with financial sustainability of non-profit organizations.

### **3. METHODOLOGY**

#### *3.1. Sample and data collection*

The sample of this study was selected from the companies that registered under Companies Commission of Malaysia (CCM). Then, the data were gained from the annual reports and the Borang Maklumat Kewangan (BMK). Annual reports comprised the information of non-profit organization's directors, financial as well as their program services. Furthermore, the BMK containing additional information of non-profit organization's such as details of bank information and details of their annual expenditure. Non-profit organizations in Malaysia are classified by categories and consist of 13 categories all together as classified by CCM. This study randomly selects the organizations from 13 categories such as education, recreation, health, sports, and other categories for the year 2011. The final sample used in this study is 202 non-profit organizations. By using the simple random sampling, all elements in the population are already considered, where each element has equal chance and possibility of being chosen as the subject [27].

#### *3.2. Level of financial sustainability*

The dependent variable in this study is the financial sustainability model of the NPO. The financial sustainability model of the governance practices extends the work by [28]. However, based on previous literature of financial ratios [29] there were other ratio identified that are relevant in assessing financial sustainability. There are four operational criteria which should be considered in relation to the financial sustainability of nonprofit organizations which are high equity balances, multiple sources of revenue, high administrative costs and surplus of operating margin [29]. The results were ranked into quintile and five level of sustainable were assigned to the samples. An organization is considered as financially sustainable if any one of these ratios fall in the bottom quintile of the sample [28]. Financially sustainable organization is classified as very poor performance if all of the indicators are not present, poor performance if any one of the indicators is present, medium performance if two indicators are present, good performance if three indicators are present and very good performance where all of the indicators are present.

#### *3.3. Measurement of variables*

The score for each category was then added to obtain the final score of the organization. Organization size has been identified to be the control variable. Organization size used in this study is measured by the total assets owned by the organization. The identification and measurement of variables used in this study are listed in Table 1.

Table 1: Definition and Measurement of Variables.

Variable Acronym	Definition	Measurement
BOD_PLAN	Board Planning Effectiveness	Dichotomous score of 1 if it is disclosed mission, vision and principle activities, comply with rule and regulation , disclosed financial risk management and disclosed financial position and performance of financial policies ; 0 if otherwise
BOD_CHARAC	Board Characteristics	Dichotomous score of 1 if total board 12 to 15 members, board member with professional qualifications, board member have political connection and fund raising activities ratio less than 35%; 0 if otherwise
SIZE	Size of the organization	Log of Total assets (RM)

## 4. FINDINGS

### 4.1. Descriptive Statistics

From 202 samples selected, only 4 (2%) NPOs are classified as poor performance, 33 (16%) NPOs are classified as medium performance, 92 (46%) NPOs are classified as good performance and 73 (36%) NPOs are classified as very good performance. Thus, NPOs with poor performance should be closely monitored by their board members and also management groups.

### 4.2. Multivariate analysis

In this study, linear multiple regression is used as the basis of analysis for testing H1 and H2. The hypothesized relationships are modeled as follows.

$FIN. SUSTAIN = \beta_0 + \beta_1 BOD\_PLAN + \beta_2 BOD\_CHARAC + \beta_3 SIZE + \sum t$  where variable definitions are given in Table 1.

In the above regression model, multicollinearity was tested using the variance inflation factor and tolerance levels, and found to be well within the satisfactory range. From the analysis, the results shown that the board planning effectiveness had a negative relationship with the level of financial sustainability. Besides that, the initial hypothesis could not be supported, showing that there was no statistically significant relationship between board planning effectiveness and level of financial sustainability in an organization. This result was in contrast with the study by [8] whereby boards of the NPOs are holding responsibility for the planning process and also for performance of the organizations in order to achieve their goals and objectives. This finding also inconsistent with the previous study of [11] that found information regarding strategic planning, comply rule and regulation, disclosure financial risk management and transparency financial reporting of the organizations are important to the institutional donors from the NPOs. This inverse and insignificant relationship between board planning effectiveness and the level of financial sustainability might have been resulted from the organizations that have unclear strategic planning. Most of the companies do not disclose clearly on the mission and vision of the organization that are being used to measure the strategic planning. Strategic planning is used to measure the board planning. Furthermore, it can be supported by the argument whereby many researchers agreed that when the boards have no clear mission and vision statement, it will significantly determines the unsuccessfully of NPOs [12]. Other than that, a study by [13] argued that the rule and regulations and disclosure financial risk statement [17] that apply to the NPOs will help to ensure that the board's responsibilities remain up-to-date, improvement in reporting quality [14] and also will enhance the financial sustainability of the organizations. According to [18], they suggested that boards must developed a transparency financial reporting in order to align with mission and vision because some donors were interested with financial or fundraising accounting information to made some amount of donations. Hence, this might be a possible reason that board planning effectiveness had inverse and insignificant relationship with the level of financial sustainability in this study. Therefore, since the first independent variable had shown an insignificant result that was based on the p-value being more than 0.05, the first hypothesis was rejected.

The hypothesis two (H2) anticipated that there is a positive relationship between board characteristics and the financial sustainability of non-profit organization. The result showed that the t-value for board characteristics (BOD\_CHARAC) was 3.246 and the p-value of 0.001 at significance level 5 per cent, which indicated that there is a significant relationship between board characteristics and the financial sustainability of NPOs. It further indicated that the effective board characteristics would increase the financial sustainability of the NPOs. This was consistent with the finding of [20], where they found board members as an intellectual capital to the NPOs since they can provide the strategic direction to their organization, thus the board characteristics had shown significant contribution to the long-term survival of the NPOs. Besides that, the ability to manage and control the activities of the NPOs will depend on their board of directors. Thus, larger boards are more effective than smaller due to better monitoring management action [21], able to make effective communication among donor [13] and also had diversity of expertise. Furthermore, when NPOs have more board members with a specific expertise on their educational background, they will bring the idea to improve the effectiveness of a board. This is because appointing directors with specific expertise will enhance the quality of information gathered, assist the NPOs in analyzing and understanding the complex environment [24]. Other than that, this result is consistent with the argument that the appointment of directors with political connections affects the board effectiveness and also can attract and sustain continuous flow of resources [30]. To add, [26] found that the board commitment also had been one of the effective in board characteristics to enhance the financial result and NPOs performance due to their ability to raise amount of fund or donations from the donors or public. Hence, this might be a possible reason that leads to the effective board characteristics and then will help to increase the level of financial sustainability of NPOs. In relation to control variable, the results explained that the t-value and p-value of the size 6.231 and 0.000 respectively and it indicates that the size of the organizations was significantly and positive associated to the financial sustainability of the.

## 5. CONCLUSION AND LIMITATIONS

Besides the main objective of the study is to examine the relationship between board effectiveness mechanism and the level of financial sustainability of NPO in Malaysia, several implications are also identified in this study. First, this study was designed to identify ways in which NPO can become effective and more sustain sound by generating income that is not solely dependent on donor giving. This study extends the study done by [28], which identified four financial indicators to develop a financial sustainability prediction model. Thus, the result of the study also can give benefits to the stakeholder which is the user of financial information especially the donors to get the knowledge regarding the performance and sustainability of the organization before contributes to that organization. Secondly, the efficiency and effectiveness of performance framework developed in this study is being the first of its kind, may help to determine financial health of NPO as it is crucial to the continuous existence and operation of these organizations. More importantly, given that a NPOs everlasting existence lies in its financial strength, determining its performance is crucial. The results of this study are predictable to assist the regulators body such as Companies Commission of Malaysia (CCM) to identify NPOs with good performance to sustain in long time and therefore closer monitoring can be carried out on good performance of NPOs. Thirdly, this study was intended to examine the effect of board planning and board characteristics on the level of financial sustainability of NPOs. Thus the findings will provide more literature regarding the control mechanisms as incentive to a better sustainable in Malaysia's NPOs since there are a few studies had been done on NPOs before. Hence, it will provide a new dimension and direction to control mechanism research and expand the root of knowledge of this area of current research outputs and findings.

There were some limitations in this study, which could provide initiatives for future research. Firstly, the sample size is limited to one year observation only which is 2011 for 202 organizations. Due to only one year data has been used, the findings could not be generalized. The findings would be more beneficial if more than one year period data is used and the explanatory power of result can be improved. Secondly, this study employs only two variables that are related to the board planning and board characteristics. So, this study did not include other factors for example, board meetings, board interlocking or rotation of members that also might affect the level of sustainability of the organizations. Furthermore, the research instruments used in this study is only content analysis. Instead of utilizing content analysis as the approach to gather or collect information, the other methods such as in-depth interviews with board of directors and questionnaires could be considered as an effective method to get more information on the governance information and the activities related to the non – profit organizations.

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