

## ***Desired board capabilities for good governance in non-profit organizations***

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**Abstract:** *Non-profit organizations (NPOs) significantly influence society as they support socio-economic growth. Within these organizations, NPO boards play a critical role in ensuring that they are appropriately governed. Despite considerable interest in understanding the role of NPO boards, a review of literature reveals that research has primarily focused on the role of NPO boards in for-profit organizations. This paper draws specific attention to boards in NPOs by critically reviewing literature that includes industry publications and a survey of NPO board members. The findings reveal that experience, expertise and social relations are most desired capabilities in NPO board members. These capabilities are consistent with those discussed in relation to board human capital. Having identified these desired capabilities, the listed capabilities of 358 directors from 50 selected NPOs in Malaysia were examined to determine the extent to which Malaysian NPO board members possessed the aforementioned capabilities. The results revealed that only 34% of board members possessed evidence of all three capabilities while 32% possessed two capabilities, namely experience and expertise. The findings serve to extend knowledge about the desired capabilities of NPO directors. An appreciation of these capabilities have implications for NPOs as their success is dependent on ensuring that the most qualified board members are appointed, and this in turn makes organizational synergy possible.*

**Keywords:** *Boards of directors, Non-profits organization, Element of capabilities, Board human capital.*

**JEL:** G3, L31, J24

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### **Introduction**

Non-profit organisations (NPOs) are generally defined as associations, charities, and other voluntary organizations formed to further cultural, religious, public service objectives, and resolve social issues. Traditionally, these

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organisations have been funded through donations and government grants. Although such funding is more difficult to source due to uncertain times, demand for social services continues to increase. In resolving these challenges, various innovative approaches have been employed to help NPOs continue providing their social services. One such approach is the emergence of social entrepreneurship, where NPOs employ business operations and marketing techniques to improve their efficiency in offering products and services to serve the community better (Jiao, 2011). A large body of literature on social entrepreneurship argues that it is an important mechanism that can reconcile disparities in wealth, opportunity, educational access and overall socio-economic wellbeing. Concurrently, the same literature also highlights how various factors, such as the decision-making process, human capital, social capital and institutional environment, affect the desirability and feasibility of the concept and practices of social entrepreneurship in the NPOs sector. Besides social entrepreneurship, another emerging innovation in the social sector is the practice of collaboration, often involving partnerships between governments, private organisations and NPOs.

Consequently, NPOs must be able to demonstrate their capabilities in managing resources efficiently and effectively. Within NPOs, the responsibility to strategise, govern and safeguard assets in line with the changing landscape lies with the NPO boards (BODs). While there is a large body of literature on board capability in the for-profit sector, the relevant capabilities of BODs in the NPOs sector is relatively under-explored. The purpose of this paper is therefore to address this gap in the literature by evaluating the theoretical and empirical developments in BODs capabilities in order to propose the desired capabilities for NPO BODs. Using resource based view theory (RBV), this paper identifies these capabilities and analyses the capabilities of NPO BODs in Malaysia. The paper is organised as follows. First, the definitions and concepts of capability from the RBV perspective are discussed. Next, the paper examines the proposed capabilities as presented in industry practice documents and academic literature to determine the desired capabilities for BODs in NPOs. In the last section, the paper presents the results of a survey identifying NPO BODs capabilities in Malaysia.

### **1. Definitions and concepts of capability from the RBV perspective**

Capability in general is the ability to perform or achieve certain actions or outcomes. Capability refers to the ability of an organisation in performing a particular activity through specific and conscious action (Dosi, Faillo, & Marengo, 2008). Amit & Schoemaker (1993) further define capability as the ability of the organisation to deploy resources through the organisational process in order to achieve a given end. The specific definition with regard to BODs is to have competent people in key roles who use their competencies to build internal capabilities at all levels (including within the board) and also use them in the pursuit of innovation for competitive advantage (Lim, Stratopoulos, & Wirjanto, 2012). Originally, the RBV considered capability as part of resources (Wernerfelt,

1984). Later, Barney (1991) affirmed that the concept of resources includes all assets, capabilities, organizational processes, firm attributes, information, and knowledge controlled by a firm. Possession of such resources would enable a firm to conceive of and implement strategies that can improve its efficiency and effectiveness. Between 1990 and 2000, different authors further refined RBV and distinguish resources and capability. Later, Amit & Schoemaker (1993) drew a similar distinction between the two and defined capability as a firm's capacity to deploy resources, usually in combination, using organizational processes, to produce a desired effect for sustained competitive advantage; while resources were defined as stocks of available factors that are owned or controlled by the firm, which are then converted into final products or services.

Other scholars then extended the discussion on resources by dividing resources in two broad categories; tangible resources and intangible resources. Tangible resources refer to the fixed and current assets of an organisation, which has a fixed long-run capacity (Wernerfelt, 1984). The intangible resources refer to abstract assets that are relatively resistant to duplication efforts by other competitors due to the inherent complexity and specificity of their accumulation process that hinders imitability and substitutability in the short/medium term (Fahy, 2000). These intangible and abstract assets were later named intellectual capital (IC) and divided into human, structural and relational capital. Capabilities in turn are part of combining different intellectual capital assets including complex interactions of individuals, groups, and organizational routines through which the entire firm's resources are coordinated (Amit & Schoemaker, 1993). In 2001, this concept was extended by Makadok (2001) who defined capability as an embedded non-transferable firm-specific ability whose purpose is to improve the productivity of other resources possessed by the firm. In sum, resources are stocks of available factors that are owned or controlled by the organisation, and capabilities are the organisation's capacities to deploy resources (Amit & Schoemaker, 1993; Mura et al., 2017; Ohanyan, Androniceanu, 2017). At higher corporate levels, capabilities result from the combination of physical, human, technological and reputational resources developed over time (Amit & Schoemaker, 1993).

## **2. Part one – Identification of suitable BODs capabilities**

This part reviews the suitable capabilities for BODs by drawing on industrial practice, academic literature and surveys.

### **2.1 Industrial practice**

In general, there is no specific industrial setting to examine the capabilities of BODs in NPOs. Nevertheless, some practices of for-profit organisations can be observed since the background of BODs for both sectors are similar. In the UK, the Institute of Directors (IOD) has produced a director competency framework, which built around three dimensions; (1) knowledge; (2) skills; and (3) mind-set. This framework provides an accessible, measurable and achievable guide to

comprehend the knowledge, skills and mind-set required to perform effectively as a BOD and to lead the organisation, regardless of sector, industry or location. Other organisations, such as the Organization for Economic Co-operation and Development (OECD), also summarise the capabilities that are important across all jobs that they believe collectively contributes to overall success. The summary contains three clusters which are “delivery-related” (capabilities required to achieve results), “interpersonal” (capabilities required for building relationships) and “strategic” (capabilities that relate to future planning). In all clusters, fifteen core competencies are required to perform a given job within the specific job specification set by the OECD.

In Australia, the Australian Institute of Company Directors (AICD) has stated that an effective governance standard includes a focus on directors’ skills. These skills are divided into four domains, which are (1) behavioural; (2) governance; (3) technical; and (4) industry. Moreover, the “Good Governance Guide” was produced by the Governance Institute of Australia (GIA) as a guide to create a skills matrix in relation to its BODs. A skills matrix identifies the skills, knowledge, experience and capabilities desired of a BOD to enable it to meet both the current and future challenges of the entity. Within the guidelines is a set of criteria that can be applied for assessing the existing skills, knowledge, experience and capabilities of the BODs. The criteria include executive and non-executive experience; industry and sector experience or knowledge; subject matter expertise; strategic thinking; governance; geographic experience and leadership. According to the guide, the criteria are not exhaustive, but depend on the requirements of the organisation as determined by the nature of business or operation.

In addition, various regulations influence the required capabilities of BODs. For instance, the US Sarbanes–Oxley Act (SOX) of 2002 mandates every board to create audit committees composed of at least one financial expert. Thus, academics, consultants, firm leaders, shareholders, and regulators, all call for specific expertise on corporate BODs. In Malaysia, no rules or guidelines for corporate governance call for this, particularly in the case of NPOs. The Malaysian Companies Act (2016) for example states an age requirement for company directors in Section 122(2) (1). While, the Malaysian Code of Corporate Governance (MCCG) recommends that Malaysian listed companies should have well-balanced and effective BODs that are both credible and independent, the code does not specify competencies of directors (e.g. experience, qualifications and experience). In 2002, the Kuala Lumpur Stock Exchange (KLSE) listing requirement required all listed companies in Malaysia to appoint a qualified accountant or a person deemed to possess accounting expertise as at least one member of the audit committee (see Para 15.10 of the KLSE Listing Requirement, in Bursa Malaysia, 2002). However, the focus of this requirement is to ensure the effectiveness of audit function.

## **2.2 Research on BODs**

Literature on corporate governance lays great store on BODs procedures, emphasizing the importance of directors' capabilities. Research published over the last 30 years shows that BODs appear to require various clusters of capabilities. For example, an early study by Hambrick & Mason (1984) revealed two types of essential competencies for a company's directors, namely functional knowledge and firm-specific knowledge. Functional knowledge in finance, accounting, legal matters, marketing and economics (Carmeli, Gelbard, & Reiter-Palmon, 2013; Forbes & Milliken, 1999; Hambrick & Mason, 1984; Siekelova et al., 2017), and firm-specific knowledge relates to detailed information about the firm and its operations (Hambrick & Mason, 1984). Meanwhile, current literature focuses on the capabilities of the BODs in general, and does not really move away from Hambrick & Mason's (1984) view. Salancik & Pfeffer (1978) who were among the original proponents of the RBV, stressed that when a company nominates BODs, it expects the new BODs to channel their resources to the organization, thus, according to the RBV, the BODs could benefit the organization in two ways – first, through knowledge and expertise, and second, through their ties and networks with the external environment.

Literature on NPOs also refers to BOD capabilities whereby Vermeer, Raghunandan, & Forgiione (2006) noted that NPOs that receive more government grants and have an internal audit function are more likely to have a financial expert on the audit committee. By using data collected through a survey of NPO colleges and universities, Harris (2014) provided evidence that both diversity and expertise of BODs correlate with better performance. Her work makes important initial forays into the relationship between BODs capabilities and NPOs performance. Willems et al. (2015) investigated the BODs of NPOs who have additional directors' positions in other NPOs. They acknowledge that the appointment to a BOD is dependent on one's networking as well as skills and expertise. Jaskyte (2012) indicates that BODs with experience and social skills (useful contacts in business, financial and political circles) are able to create a climate, which is conducive for innovation and sharing of new ideas in NPOs initiatives. These initiatives include fundraising and the representation of board members within the community.

## **2.3 Survey**

Besides references to industrial practices and academic literature, surveys also have been referred to provide a broader perspective on the capabilities of the BODs. The "2015 survey on the board of directors of non-profit organizations by Stanford Graduate School of Business" revealed several observations that can be matched to capabilities:

**Table 1. Findings from the “2015 survey on BODs of NPOs by Stanford Graduate School of Business”**

| No. | Findings  | Associated capabilities |
|-----|---|-------------------------|
| 1.  | Too many directors lack a deep understanding of the organization  | Experience              |
| 2.  | Many directors are not engaged, do not understand their obligations                                     | Expertise               |
| 3.  | Fundraising is seen as a central obligation   | Social                  |
| 4.  | Most directors are satisfied with the performance of their executive director/CEO, board & organization | Interpersonal           |

(Source: Lacker et al., 2015)

In the PricewaterhouseCoopers (PwC) 2016 Annual Corporate Directors Survey, the most important director attributes continued to be financial expertise (93% described it as very important), followed by operational expertise (69%), industry expertise (68%), and risk management expertise (63%). These core areas are fundamental to a board member’s ability to contribute effectively. In addition, 37% of directors believe cyber risk expertise is a very important attribute. Human resources and legal expertise were considered less important, with less than one in five directors describing these attributes as very important. Meanwhile, the 2015 Ernst & Young (E&Y) review of Corporate Governance Statements released between 1 July 2015 and 30 September 2015 by companies within the ASX 100 index in Australia provided views in relation to disclosure approach, extent of disclosure, types of skills, capabilities as well as views on potential improvement for future disclosures. The review highlights the categories of skills and capabilities that were considered important to a majority of BODs as follows; (1) Financial acumen (98%); (2) Industry expertise (89%); (3) Executive leadership (85%); (4) Governance (76%); International (73%); and International (73%).

#### **2.4 Conclusion on the element of capability**

There are at least three important capabilities that can be extracted from the above three perspectives. They are experience, expertise and social relations. Further explanations are as follows:

##### **2.4.1 Experience of board members**

Experience is an important element for BODs in all types of organizations. In NPOs where social relations and fundraising are important, BODs with vast experience is important. NPOs can benefit from having a group of people who can share ideas and perspectives. BODs experience may also bring a different and wider range of perspectives to the NPOs than are typically found in privately held and family-owned businesses. Indeed, board members with experience are expected to affect the monitoring capability, impact the quality of advice to the senior management (Custódio & Metzger, 2013), set the strategic and operational direction (Armstrong, Guay, & Weber, 2010; Brickley & Zimmerman, 2010),

support better acquisition decisions (Kroll, Walters, & Wright, 2008) and generally have more influence on the board (Westphal & Milton, 2000).

#### ***2.4.2 Expertise of board members***

Expertise in general can be defined as “expert skill or knowledge in particular areas” (Rindova, 1999). The most widely researched area of BODs expertise is financial expertise and its relationship with corporate financial decisions, financial performance, and the firm’s access to funding (see for example Agrawal & Chadha, 2005; Burak Güner, Malmendier, & Tate, 2008; Defond et al., 2005). Several studies have also investigated other types of expertise in specific contexts. For example, Amy J. Hillman, Cannella, & Paetzold (2000) found that there is a greater likelihood of certain types of “support specialists” (experts) such as BODs with legal and financial expertise. Recent studies focus on the industry related expertise of directors (see for example Dass, Kini, Nanda, Onal, & Wang, 2014; Drobotz, von Meyerinck, Oesch, & Schmid, 2013). In NPOs, evidence documented by Vermeer, Raghunandan, & Forgione (2006) found that NPOs received more government grants when they were found to have a financial expert on their audit committee. Therefore, director expertise is indeed related to education level since qualifications are often needed to be regarded as an expert in specific areas.

#### **2.4.3 Social relations of board members**

Social relations refer to the various types of social relationships that board members engage in for the success of the organization. NPOs are principally responsive to the social context because of the nature of their resources and socio-political factors that govern them (Brown, Andersson, & Jo, 2016). Stakeholders’ relationships are instrumental in the NPO system, and managing and developing those relationships with stakeholders create social capital (King, 2004). Board members are the main actors in this relationship as they become a “bridge” between the NPOs and stakeholders (Putnam, 2000). Therefore, BODs with good social relations are needed by NPOs in order to establish successful relationships. Tied to understanding the social relations of BODs is the use of honorific titles. It is assumed that BODs with honorific titles like Datuk, Dato’, Datuk Seri, Tan Sri or Tun (used widely in Malaysian society) are those with special links to the community and have a respectable position in society. It is also widely held in Malaysian society that people with honorific titles are of higher social standing. Very often, individuals holding honorific titles are successful businessmen, senior government officers, industrialists, and politicians who have established successful networks. For that reason, they are able to better connect NPOs with stakeholders.

### 3. Part two – Quantitative approach

#### 3.1 Approach

This part of the paper reports on an examination of information extracted from the biographies of board members to construct a descriptive exploration of relevant experiences, expertise and social relations for each director. The analysis of information was repeated to ensure that data extraction was thorough. A total of 50 Malaysian NPOs were selected from a SSM list available at the CLBG website. The NPOs were individually assessed based on their websites and annual reports. Once the selected NPOs were identified, information on the directors was gathered. Data was collected in two phases; the first phase involved extracting the descriptive information of NPOs in relation to the type of NPO (whether the NPO was a fundraising or non-fundraising organisation), nature of their work (whether the NPOs undertook specific activities or operated on the fringes of the public sector or were they those who responded to crises) and the number of BODs on the NPOs between 2015 to 2016. The second phase involved the examination and verification of specific information on the BODs. Information gathered on each BOD was based on the following structure as a result of the framework presented in part one of this paper; (1) The BOD has experience only; (2) The BOD has expertise only; (3) The BOD has social relations only; (4) The BOD has both, experience and expertise; (5) The BOD has both, experience and social relations; (6) The BOD has both, expertise and social relations; and (7) The BOD has all, experience, expertise and social relations. In addition, this study used the following measurements to determine the capabilities of BODs; (1) Board experience for relevant experience; (2) Board expertise for level of education; and (3) Board social relation for board social status in the society. When information on the BODs was not sufficient to identify capabilities, information was gathered through alternative resources such as Facebook, Google people search, and LinkedIn. In certain cases, the BODs' offices were contacted in order to verify information. In order to ensure the validity of the sample, a checklist was used to ensure that only valid samples were selected and that no information on NPOs and BODs had been omitted or contradicted. SPSS was then used to analyse the data.

#### 3.2 Descriptive analysis and findings

The participating NPOs were involved in a variety of charitable activities ranging from social services and international and religious activities to conservation and culture. The next table shows the distribution of capabilities according to criteria that has been pre-determined.

**Table 2. Distribution of board members' capabilities by types of NPOs**

| No | Element of capability / Types of NPOs    | Fundraising | Non-fundraising | Total      |
|----|--|-------------|-----------------|------------|
| 1. | Experience                               | 24 (21%)    | 30 (12%)        | 54 (15%)   |
| 2. | Expertise                                | 3 (3%)      | 13 (5%)         | 16 (4%)    |
| 3. | Social relation                          | -           | 1 (1%)          | 1 (1%)     |
| 4. | Experience + Expertise                   | 53 (47%)    | 64 (26%)        | 117 (32%)  |
| 5. | Experience + Social relation             | 11 (10%)    | 35 (14%)        | 46 (13%)   |
| 6. | Expertise + Social relation              | -           | 1 (1%)          | 1 (1%)     |
| 7. | Experience + Expertise + Social relation | 22 (19%)    | 101 (41%)       | 123 (34%)  |
|    | <b>Total</b>                             | <b>113</b>  | <b>245</b>      | <b>358</b> |

(Source: Arshad et al., 2018)

The results indicate that BODs who have all capabilities (34%) were those most likely to be chosen to serve in the organizations. It means that NPOs in Malaysia are looking for individuals who have a combination of these capabilities. Nonetheless, the result also indicate that BODs with experience and tertiary education (32%) are also significant since any organization need for these capabilities in performing their duties as per Johnson, Schnatterly, & Hill, 2013; Volonté & Gantenbein (2016) view. Meanwhile, in the Malaysian context, social relations, represented by the use of honorific titles, also appears important in appointing people to the BODs of NPOs. Honorific titles in Malaysia is considered *a sign of reputation and status* and this is likely why Malaysian NPOs tend to have BODs with honorific titles. These members are probably believed to raise organisational reputation that matters a great deal in the world of NPOs. Nevertheless, some NPOs (see item 5 with 13%) do not consider expertise when appointing their BODs, and this is especially the case with NPOs involved in fundraising and responding to crises. Perhaps the reason is, because these NPOs need BODs who can be directly involved in their operational activities rather than someone who only sits on the BODs with honorific titles. According to the results also, those who have high academic qualifications (see items no. 4 and 7), that is, with a first degree or higher, and majoring in specific professional areas are more likely chosen to serve in the BODs of NPOs. This affirms the findings of Wan Yusoff & Armstrong (2012) who concluded that eight competencies relevant to Malaysian directors are finance and accounting, corporate planning, business forecasting, legal matters, risk management, marketing, human resource and internal business. Besides that, there are some BODs who have experience and honorific titles but do not have tertiary education (see item 5 for 13%). Most of the BODs in this category are people involved in family business, perhaps for generations whereby they have gained practical experience from experts or possess sufficient knowledge through their secondary school education. However, due to the success of their business as well as achievements in other areas, they have received honorific titles. Examples of NPOs with these board members can be observed in Yayasan (trans. Foundations) which were established by prominent

families. Other than that, result 3 indicates that just one BOD was appointed based on his or her social relations. This person had no experience in specific NPOs and no education but had an honorific title. Clearly, the honorific title added value to the NPO. Item 6 reveals BODs who possessed tertiary education and honorific titles but had no experience related to the nature of the NPOs. These individuals were possibly appointed to advise the organization within their areas of specialisation. The results indicate that NPOs seek specific capabilities when appointing members to their BODs. This is most likely because of the nature of NPOs that is to serve society. There is a need to ensure that only appropriate members possessing the right capabilities are included in the BODs of NPOs. This is in line with the RBV concept that stresses that the capability of BOD members is considered as a resource for the organization. The study also concludes that experience and expertise is representative of human capital capability. A social relation, in contrast, is a characteristic for social capital capability. This conclusion is in line with conclusions drawn by Certo (2003); Dalziel, Gentry, & Bowerman (2011); Hillman & Dalziel (2003); Jensen & Zajac (2004). A recent study by Berezinets et al. (2016) has also elucidated this concept that “the human capital of board members is the ability of the board of directors to extract future economic gains from the knowledge, experience, and skills of the members of the board of directors, whose knowledge, experience, and skills inherently belong to the board”. They further add, “The social capital of the BOD is the ability of the board to extract future economic benefits from the resources that arise from the board members’ external relationships”.

#### **4. Conclusion, limitation and recommendations**

NPOs are currently operating in a rapidly changing environment that requires innovative approaches to resolve social issues. In meeting these changes, boards in NPOs play a crucial role to support NPOs in their role of serving the community better. The central contribution of this paper is the operationalization of the definition and concept of capability for board members in NPOs. Providing this operational definition is necessary in helping NPOs enhance the role of the board and allow them to remain competitive. Specifically, this paper has developed a conceptual model of board capability based on the relationship between organizational resources, capability and competitive advantage using the RBV perspective. Next, the definition and concept of board capability was further clarified through current evidence from both the non-profit and for-profit sectors. Three desirable board capabilities were identified: experience, expertise and social relations, and the presence of these capabilities were assessed through an examination of a sample of board members in Malaysian NPOs. The proposed model can further move discussions among policy makers, practitioners and academicians in enhancing the capabilities of board members in NPOs. Policy makers can facilitate boards in NPOs to discharge their responsibilities more effectively by providing relevant training and formulating a code of governance. Universities and the government can also work together to provide empirical

findings and promote more comprehensive concepts and definitions of board capabilities in NPOs which in turn can cultivate an enabling institutional environment in the social sector. The proposition developed in this study has some limitations. First, the availability of information on NPOs and their BODs on websites was limited. Some NPOs have not updated their websites, others do not reveal much information on their BODs and some NPOs do not have websites. This study also did not consider the financial standing of the NPOs as information on this could not be accessed. Future research can develop further the capability model proposed in this paper. This can include a mixed method approach in extending the theoretical model and testing the extended model empirically in various contexts relevant to the non-profit sector. Such contexts can include the relationships between board capability and accountability, as well as sustainability and social impact. Finally, it is hoped that the insights derived from this study will help Malaysian NPOs establish boards that can contribute to their continued growth.

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