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CONTROL MECHANISMS AND ACCOUNTABILITY CHALLENGES IN NONPROFIT ORGANIZATIONS

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ABSTRACT

Nonprofit Organizations (NPOs) face numerous challenges in maintaining accountability. The lack of financial accountability creates risks in goal achievement. An environment of accountability positively contributes to the effectiveness and efficiency of operations. We interviewed 22 participants from 6 NPOs in the State of Delaware in our qualitative phenomenological study. We identified themes defining accountability, control mechanisms, and ethics. The greatest challenges affecting control mechanisms include expenditures controls and transparency. The results suggest that while most managers have a high awareness of controls and accountability, smaller NPOs struggle because they lack sufficient resources. The study adds to the understanding of best practices, which could benefit communities in which NPOs operate and encourage accountability to beneficiaries and other stakeholders.

JEL: M10, M40

KEYWORDS: Nonprofit, Accountability, Control Mechanism, Transparency, Ethics

INTRODUCTION

The number of Nonprofit Organizations (NPOs) in the United States increased from 1.16 million in 1998 to 1.51 million in 2008, representing a 31% increase (Wing, Roeger, & Pollak, 2012). NPOs are involved in almost all areas of the economy, including education, health, religious, charitable, scientific, and human services (Kistruck, Qureshi, & Beamish, 2013). Thus, NPOs play an important role in the socioeconomic development of the economy. In this research, we used a qualitative phenomenological design to explore the process of accountability in U.S. based NPOs. The purpose of this study was to gain an understanding of NPO financial accountability, operational controls and efficiency, and management challenges over accountability. We interviewed 22 participants from six NPOs in the State of Delaware. NPO manager comments obtained through face-to-face interviews form the basis of data used for analysis. We identified themes defining accountability, control mechanisms, and ethics. The greatest challenges affecting operational controls include controls over expenditures and transparency. The results suggest that while most managers have a high awareness of controls and accountability, smaller NPOs struggle because of the lack of resources. The results of this study could benefit NPO operations and the communities in which NPOs operate by encouraging accountability to all stakeholders. The remainder of the paper is organized as follows. The next section describes the literature review. Next, we present the methodology used in this paper. The results are reported in the following section. The final section contains conclusions and recommendations for future research.

LITERATURE REVIEW

NPOs traditionally provide social services and advocacy functions to underserved populations. These organizations experienced rapid changes during the recent economic downturn. The economic situation created a need for additional public services (Williams, 2010). The typical role of NPOs is to provide services when the market or governments fail to meet social services, health, and economic development needs of citizens (Moulton & Eckerd, 2012). The critical nature of public services offered by NPOs increases the need to improve governance. Baur and Schmitz (2012) indicated that the ability to adapt is related to the strength of accountability.

Accountability

Accountability represents an obligation to perform and to account for the organization's performance (Oakes & Young, 2008). Organizations achieve a level of accountability when individual managers agree to execute their duties within an environment of trust and high ethical standards (Fowler, 2008). Costa, Ramus, and Andreaus (2011) suggested that accountability involves three elements: (a) financial sustainability, (b) social responsibility, and (c) value creation. Argandoña (2009) operationalized accountability by focusing on three activities including (a) measuring and reporting on performance, (b) developing a process to handle complaints, and (c) measuring client satisfaction. While organizations must be accountable, accountability requires a commitment at the individual manager level (Songelwa, 2011). Accountability implies that there are people and groups who are on the receiving side of an organization's accountability. However, NPOs do not follow the agency theory structure of principals and agents (Jensen & Mackling, 1976). It is not clear who the principal is in the organization structure because no single person or group can claim ownership (Ebrahim, 2005). NPOs are responsible to numerous stakeholders including donors, regulators, and beneficiaries of NPO services (Moulton & Eckerd, 2012). The greater the complexity in transactions and corporate strategy, the more important accountability becomes. Accountability also adds to the transparency of management decisions. Transparency and accountability work together to add to the consistency of management actions (Crofts & Bisman, 2010; Szper & Prakash, 2011).

Organizational Governance Structure

An organization is successful when well-structured internal control mechanisms are in place and governance embraces a corporate strategy (Rost, Osterloh, Frey, & Inauen, 2010). Embracing governance as part of a corporate strategy is in line with the control environment framework as outlined by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission (COSO, 2012). COSO (2012) defined the control environment as a top down structure that emanates from the board of directors and corresponding subcommittees including the audit committee. While the board is a critical element of the control environment, studies suggested that many board members lack the expertise to provide quality oversight (Sun & Anderson, 2012). Arena and Renz (2009) noted that there is a governance gap in the operations and development of ethics and accountability in NPOs. The gap applies to the governance of public sector and stakeholder's accountability. Ineffective governance increases the risk of corrupt activities, which may have significant consequences for organizational economic growth (Dennis, 2011).
Corporate governance includes the need to monitor management in ways that will ensure compliance to corporate policies (Marx & Davis, 2012). There is also a need for collaboration between management and board members to develop and manage the organization's purpose and strategy (Marx & Davis, 2012).

A corporate governance model provides a critical competitive advantage for NPOs as they compete with other NPOs for donations and a client base (Brickley, Van Horn, & Wedig, 2010; Mersland, 2011). In addition, the NPO governance model should consider and support other stakeholders that the organization serves (Curran & Totten, 2010). Stakeholders including donors, supporters, and governmental agencies are the primary users of an NPO's financial information (Moxham, 2009). Audited financial statements provide information about the financial position of an organization. Stakeholders use this information to monitor the financial effectiveness and efficiency of the NPO (Li, McDowell, & Hu, 2012). Audited financial statements give donors assurances over the appropriate use of their donations (Clark, 2006; Mayhew, 2012). The success of an organization involves many challenges, not only for its current operations but for the development of future projects (Johnston & Kouzmin, 2010). Governance involves a top-down approach to direct, control, and regulates activities within an organization (Ferkins, McDonald, & Shilbury, 2010). The development of an effective long term strategy requires a strong governance structure (Carman & Fredericks, 2010). To develop organizational effectiveness, management must adopt control strategies that monitor goal attainment (Williams, 2010). Both management and the board have a crucial role in the long term growth of the NPO. Both are responsible for developing and achieving strategic goals (Wood & Winston, 2005). Leaders of organizations also require personnel who have the appropriate training and understanding of accountability and a strong ethical base (Fowler, 2008). A strong top-down ethical environment is required if an organization hopes to hire and keep personnel who are appropriate for their roles (Ferkins et al., 2010). Corporate governance is ultimately the responsibility of individuals or persons entrusted with supervision, control, and the direction of an entity. A governance structure increases assurances that the organization adheres to all applicable laws and policies, avoids conflict of interest, protects assets, and presents financial reports that conform to IRS reporting standards (Elson, O'Callaghan, Holland, & Walker, 2012; Neely, 2011). Elson et al. (2012) contended that accountability forms the framework of the organization's governance framework.

Internal controls embedded in a governance structure impacts the (a) effectiveness and efficiency of operations, (b) reliability of financial reporting and (c) compliance with applicable laws and regulations (COSO, 2012: Helmer & Deming, 2011). Controls should be consistently reviewed and monitored (Ionescu, 2011). Organizations that have internal audit departments are most likely to implement programs such as periodic assessments of operational and financial controls (Iyer & Watkins, 2008). Policies and procedures form the basis of controls that ensure the completion of the corporate mission and development of the organization goals (Mayer, 2012). Preventing internal control failures can be an enormous challenge (Elson et al., 2012; Petrovits, Shakespeare, & Shih, 2011). Keating, Parson, and Roberts (2008) indicated that many NPOs, irrespective of size, fail to report all costs associated with fundraising. Smaller NPOs are likely to have just a few administrative staff members, thus it is difficult to segregate duties and implement complete and thorough review policies (Williams, 2010). In addition, these organizations may not have managers or board members with sufficient financial, regulatory, or control knowledge (Petrovits et al., 2011).

Transformational Leadership

Managers of NPOs face financial and operational accountability challenges that start with leadership (Beal & Griffin, 2012). There is a link between leadership and the internal control environment. Leadership is the ability to influence a group toward the achievement of its goals (Conlon et al., 2012; Smandek, Barthel, Winkler, & Ulbig, 2010). Leadership includes a variety of activities such as governing decision making, formulating goals and objectives, developing policies and regulations, and carrying out the day-to-day operations of an organization. Bass (1999) indicated that transformational leader is an individual who are able to inspire followers. Transformational leaders charge followers to merit the leaders' expectations, perceptions, and motivations to work toward their desired goals. This theory explains how leaders are able to successfully challenge followers to explore new ways to learn.

Transformational leaders create an open communication with individual followers in order to enhance the aim of the organization. McMurray, Pirola-Merlo, Sarros, and Islam (2010) indicated that leaders inspire followers by creating an understanding environment for parties through motivation and sense of attainment. To build trust for followers, leaders must be consistent with their beliefs and values. Leaders inspire subordinates through communication and empowerment within the organization. The power of the leader comes from the situation and the position held (Burns, 1978). Transformation leaders challenge followers to be vigilant and provide a high level of performance. Leaders encourage followers to provide their very best efforts toward the achievement of organizational goals (Schaltegger & Burritt, 2010; Homer & Baron, 2010). Leaders hold followers accountable and encourage transparency in all levels of management (Warrick, 2011). Leaders also serve as role models to the followers, which could influence the individual followers or internalize their ideas.

METHODOLOGY

We chose a phenomenological design because we wanted to explore the lived experiences of participants (Wolcott, 2009). This approach provided the framework for an extensive examination of multiple themes related to accountability and control mechanisms. Our overreaching research question was:

How can NPO leaders develop appropriate control mechanisms and meet the challenges influencing accountability? Data included 22 interviews over a 6 week period occurring in the fall of 2013. Participants worked as managers in one of six NPOs registered in the State of Delaware with annual revenue ranging from $100,000 to $212 million. Prior to our visits, we reviewed their individual IRS 990 forms to gain an understanding of the financial background of each NPO. Through the use of open-ended questions (see Appendix A), we explored what attributes are necessary to build and maintain accountability and control mechanisms. We recorded each interview and transcribed the recordings. This data was subsequently processed through nVivo 9.0 software in order to discern themes from the narrative segments.

RESULTS

Based upon our review of interview data, we identified three distinct themes. The following summarizes the three themes identified in our analysis of narrative segments.

<u>Thematic Label 1: Defining Accountability</u>

Many of the comments from participants related to the application of accountability from the view point of day-to-day operations. Several subthemes emerged in the analysis of the data related to accountability. Most comments related to financial accountability. However, comments covered the NPOs social responsibility and sustainability. Participants stated that financial accountability refers to their role in donor fund utilization and transparency. For expenditure controls, ten participants suggest that accountability is a reflection of the NPO leaders' commitment to community development projects that have been approved and allocated for implementation. Participant 18 (P18) made this comment as it relates to this control issue: "the resources that we receive from donors need to be used for the purpose for which the money was given." Participant 8 (P8) emphasized that accountability should reflect the efficiency and effectiveness of the NPO in utilizing donor funds. This way, "we are able to maximize our reach to those we serve." In addition, P8 stressed the importance that funding has on the sustainability of the organization.

Donor Fund Utilization: Participant 1 (P1) stated that financial accountability means that "each employee to hold themselves accountable." He stated that each employee has a responsibility to "bring in money to the organization and to make sure the funds are allocated to the appropriate places." P1 suggested that leaders have the responsibility of re-allocating any excess funds from individual projects in such a way to match the intent of donors with the strategic plan of the organization. Reallocation occurs when NPO leaders do not have sufficient donors to support operational needs of the organization. P1 emphasized that accountability should be a continuous process of resource augmentation so that funding for individual programs are appropriately allocated.

Participant 2 (P2) supported these comments by stating that the primary role of leaders is in working with the donors, particularly in reporting the details of how funds are used. P2 indicated that accountability includes the accounting of how donors want their donations be used and then how these funds are actually used. P1 articulated the term "fiduciary responsibility" to refer to the need for NPOs to account for donor fund utilization. P2 shared that accountability is "making sure that I am following all the procedures and policies and appropriately discharging my duties." P2 stated that policies and procedures form the basis of accountability. These policies take the guessing out of what we should do. Participant 3 (P3) supported this definition by stating that "financial accountability is making sure that we are spending the money the way it supposed to be." P3 reported that financial accountability is a necessary quality for NPOs as they request donor support and additional funding. P3 narrated that when NPOs are unable to account for funds in appropriate manner, "donors are not going to give any more money." Participant 7 (P7) also stressed that accountability occurs when we show our supporters that "services are in place and we are not misusing donations."

P7 and Participant 10 (P10) discussed the importance of knowledge of finances and how this knowledge is translated in the implementation of community projects. P7 stated that their finance department is charged with the responsibility of proving information and communicating the results of activity. P10 also stated that one of the roles of the business manager is communicating financial information to stakeholders. P8 described accountability as including a strong financial understanding of costs and related company resources. P8 implied that NPO leaders must possess the ability to manage a balance and sustainable means of financing the operational needs through the donations.

Transparency: Twenty participants indicated that operational controls and efficiency are addressed through the establishment of an environment of transparency. Both transparency and accountability are crucial in their sustainability. Participants linked transparency to financial accountability. Ten participants specifically used the term *transparency* to refer to the information shared by the organization to their respective stakeholders. Several participants suggested that NPOs implement system to ensure transparency. For instance, Participant 9 (P9) narrated his experiences on implementing a fund liquidation process and the mechanism to ensure transparency of financial use. P9 indicated that this includes documenting every transaction and making the documentation available to stakeholders.

The participants emphasized that control mechanisms are sometimes difficult with smaller organizations. P9 also indicated that transparency is difficult with smaller NPOs that lack sufficient resources to have appropriate control mechanisms. Participant 11, Participant 12 (P12), and Participant 13 (P13) indicated that their individual NPOs use financial monitoring controls to enhance transparency over the use of donor funds. P12 shared the process of receiving, recording, utilizing, and reporting of funds from donors. P13, on the other hand, used the term "reconciliation" to refer to the reporting process of donor fund utilization. Participant 15 also indicated that his NPO uses a "lot of checks and balances to make sure that we are not misappropriating funds and to make sure that we are not billing for what has not been completed."

Ten of the participants suggested the role of NPO leaders is in ensuring the integrity of the organization and the effective and efficient use of program funds. Participant 19 (P19) described this role as "using them [the monies] appropriately…we want to make sure that the purpose of those monies has been discharged appropriately, and so in view of that we are so strict in financial accountability." P19 further suggested that their integrity as an organization must be supported with mechanisms that ensure efficiency and productivity.

Thematic Label 2: Control Mechanisms

Internal control mechanisms that participants discussed included participative management, segregation of duties, and monitoring mechanisms. Seventeen of the participants shared that local offices actively participate in home office financial reporting. P4 said that their organization is very keen in monitoring the allocation and utilization of program funds. P4 shared that at the local level, project implementers are given the responsibility of ensuring that all support and purchases are accounted for. Further, P4 stated that "we document every piece of information with backups and record all data into our financial records." These reports are then discussed in operational meetings. P4 indicated that the management team meets regularly. The primary focus of the discussion is the accounting of expenditures. The management team reviews the justification and approves these expenses. Segregation of duties and accountability at the local level can also be seen by reviewing field financial documentation. P8 shared that, "I must have receipts for everything and must account for all items. It is very detailed.

In addition, I need my supervisor to approve all my expenses." P9 shared that "each home office is responsible for monitoring the influx of monies in and out of their homes. Never ask me about cash, because we do not carry cash, instead we use purchase card provided by the organization. The purchase card serves as a mechanism in ensuring that the financial process is secured and valid." P8 continued that their responsibilities entail "ensuring saving receipts related to any type of transaction that is carried out." P9 suggested the importance of monitoring as an additional control. His comments specifically focus on the performance of staff and the coordinators. The focus of monitoring not only includes expenses, but also time allocation between projects.

Thematic Label 3: Promoting Ethical Values

The analysis from the participant's comments on promoting ethical values generated three subthemes: (a) implementation of stakeholders' policies, (b) leading by example, and (c) organizational integrity.

Implementation of stakeholders' policies: The participants in the study shared that NPOs staff and leaders are compelled to follow the rules and regulations of program stakeholders. Within the NPO organization, each individual employee is required to abide by organizational policies. This has been clearly demonstrated in the case of P7. He shared that before a new employee starts to work in the program, he or she must sign an agreement as a condition of employment that stipulates that organizational policies will be followed. In addition, P7 implied that many policies in their organization are influenced by the donor agencies. P7 stated that "some donors set policies and standards including giving specific orders as to the use of their funding." P7 shared that the implication of not following the policies could mean losing funding or being banned from implementing further programs and projects in the community.

P7 said that "these standards are important to us, and we have no choice other than following the standards, otherwise we lose donor support." In addition to the donor driven organizational policies, there are community standards that we must abide to. P7 indicated that the community set standards for our operation in the neighborhood and we must ensure these standards are followed; otherwise we will lose the community support. P7 summarized that our role is to be accountable to all stakeholders. He stated that we are accountable to everyone who supports us, and our policies are a reflection of this support. Thus, our success depends upon following the guidance outlined in these policies. P13 also supported this comment by sharing that the practices of their organization reflect the intent of donors and other stakeholders. P13 shared that employees are guided by the principles reflecting the values of beneficiaries and other program stakeholders. This guidance drives their efforts to ensure transparent and accountable program implementation.

Leading by example: This subtheme suggests that a part of the leadership framework is leaders who recognize that policies will not be enforced by the organization unless they are able to implement personal accountability. The comments from P1 reflect this understanding: "I try to lead by example. I think the work I do is transparent and that what I do is based upon a high understanding of ethics." P2 supported P1's comments by stating that leading by example only occurs when each leader develops personal accountability. P2 indicated that NPOs "are not perfect and that people can and do make mistakes." However, he further stated that when mistakes occur, individuals must be accountable for these mistakes. Being able to identify what you did wrong and then being allowed to follow through to correct the mistake is a part of accountability and a reflection of an ethical leadership framework. Participant 5 also shared that in addition to being a follower of the organizational policies, accountability starts with individual ethical standards. Similarly, P6 shared that "as an executive director, I try to promote accountability by my own personal example of leadership and ethics."

Promotion of organizational integrity: This subtheme is the reflection from participants who articulated the need for all NPO employees to maintain high ethical values and practices in all their field activities. The integrity of the organization is a critical element that determines the sustainability of its continued value. P3 described the value of integrity to an NPO. He stated that promoting individual and organizational integrity creates value. These organizations are rewarded with sustained donor and community support. P4 commented that integrity is a requirement for employment. P4 stated that, "integrity and high standards at this organization start from the very first day at new hire orientation." P4 shared that the content of the new hire training stresses the importance of accountability in the light of the goal to achieve organizational integrity. P8 also shared the potential outcome from employees who do not observe a high level of integrity. The integrity of each employee impacts the reputation of the organization. P8 indicated that the reputation of the organization is a reflection of its leadership, accountability, and integrity. P4 shared "we all have to be accountable. I strive to be accountable to employees and stakeholders. I think honesty and integrity are important values."

CONCLUSION AND RECOMMENDATIONS FOR FUTURE RESEARCH

Accountability is achieved when individual managers agree to execute his or her duties within an environment of trust and high ethical standards (Fowler, 2008). Organizational research scholars suggest that accountability and responsibility may have similar meanings but are focused in achieving different results (Fowler, 2008). In the context of the organizational partnership, accountability defines the commitment of an individual to another individual in the delivery of agreed results. Accountability emerged as a concept of tangible achievements of a commitment to individual and organizational values (Costa et al., 2011; Oakes & Young, 2008).

The participants focused on financial accountability and articulated the themes related to expenditure controls and the establishment of transparency mechanisms. The themes extracted from the narrative segments embrace the concepts that are embedded in many of the participants' operations. The themes we identified related to the importance of accountability are significant. Developing accountability within NPOs allows an organization to meet the demands of stakeholders. The application of financial accountability differs depending upon the size of the organization. Accountability in the context of larger NPOs includes monitoring systems over programs, purchases, and expenditures. However, smaller NPOs do not have structured control systems and are not able to implement best practices related to segregation of duties. This lack of structure could affect the overall sustainability of the program. Our results suggest that monitoring and evaluation of program processes is not always the priority of smaller NPOs.

While all the NPO participants in this study understood their individual responsibility, some NPOs lacked sufficient structure and staff to develop an appropriate accountability structure. A few of the organizations participating in the study did not have sufficient full time staff which is necessary to manage and monitor operations. Insufficient and untrained staff creates an environment of weak internal control structures. These circumstances increase transaction risks. However, staffing issues are not unique to small organizations. Even some of the larger NPOs we interviewed had minimal accounting staff to operate. Our results suggest that managers have a good understanding of internal control mechanisms. However, these managers depend upon the work of others who may not have the same understanding of accountability. The concept of accountability has been associated with the responsibilities and action of leaders (Behnam & MacLean, 2011). The findings of the study reiterated the value of best practices over internal control structures in the delivery of quality results (Lafont, 2010).

However, the results also suggest that these controls are not always implemented due to lack of resources. The challenge facing these firms is to find a system of controls that meets the needs of each individual organization. The challenges of small NPOs could be further explored by examining the areas of weaknesses in order to determine how these organizations can potentially strengthen the control environment. In this study, we assumed that implementation of financial accountability is an element that could provide financial advantage to NPOs. An exploration of how these practices are implemented in small, medium, and large NPOs can provide a framework guiding NPO leaders in the most effective strategies to achieve operational sustainability. Insufficient and unqualified staff leaves small NPOs susceptible to control risks. In addition, managers of smaller NPOs often have less experience as compared to those in larger organizations. As such, it can be difficult for an organization with limited resources to hire qualified staff. Without financial expertise, staff members struggle to analyze and organize financial data. Therefore, exploring what training is most effective for these organizations is a worthy research stream.

APPENDIX

Appendix A – Semi-structured Interview Questions

How has the board or the regulator influenced the management of your company?
How are your operations supervised by the regulatory authority if it is different from the board?
What financial and operational controls exist in your day-to-day operations?
What code of conduct exists in your organization and how does it influence the work output of management and staff of your company?
What operational challenges do you face?
How are your operations monitored and regulated?
How are people recruited into your company?
What mechanism is in place to identify training needs for management and staff to receive training to enhance their skills?
What mechanisms are in place for management and staff to meet and share ideas on operational and welfare matters?
What performance-related incentives exist to motivate employees in your company?

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