

THE LINK BETWEEN FINANCIAL MANAGEMENT, ORGANIZATIONAL CAPACITY BUILDING AND EFFECTIVENESS IN NOT-FOR-PROFIT ORGANIZATIONS: AN EXPLORATORY STUDY

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Abstract

The third sector literature argues that organizational capacity is important for Not-For-Profit (NFP) organizations to achieve their missions. Financial management skills are important for the enhancement of effectiveness, accountability and viability of NFP organizations. While effectiveness is a contested concept its attainment is an important aspect of NFP management. This paper examines the relationship between financial management, the development of capacity and the encouragement of effectiveness. A survey of 67 NFP organizations affiliated with the Victorian Council of Social Services (VCOSS) was conducted and the findings establish a link between financial management and organizational capacity.

Keywords: Earnings Informativeness, Split Share Structure, Agency Problems

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Introduction

Not-For-Profit (NFP) organizations are established to address a need or problem in their community (Holland and Ritvo, (2008). A NFP organization is considered to be effective if it achieves its stated objectives and reduces the need or introduces the desired change. However, effectiveness is a contested concept and therefore the methods of achieving organizational effectiveness are unclear. Intuitively, the ability to undertake programs, manage funds assess performance and develop strategy should lead to organizational effectiveness. These skills can be grouped under the heading of “capacity” and the enhancement of those skills referred to as “capacity building”. However, the development of capacity cannot happen in isolation but requires antecedent conditions to be present. An important component of those antecedent conditions is the existence within the organization of financial management skills (FMS).

An important aspect of the governance in NFP organisations is the ability to monitor the continued viability of the organisation, and the ability to plan and implement programs fulfilling the mission of the organisation. This paper explores the link between financial management skills, capacity building and organizational effectiveness. It will be argued that if a link can be established then a case can be made for the development of FMS in NFPs being an important part of governance of third sector organizations.

The model being suggested in this paper is that the acquisition of financial management skills will

enable a NFP organization to develop capacity. The development of capacity enables a NFP organization to operate effectively. According to Herman and Renz (2008) effectiveness in third sector organizations is a contested concept and it is also a socially constructed concept. However, they argue that it is not an arbitrary concept. Herman and Renz (2008) point out that there are meaningful dimensions of effectiveness such as financial condition, fundraising performance or program outcomes that can be supported by hard data. Further, they argue that the use of generally accepted accounting principles can provide evidence about revenues, costs, and surplus that can provide indications of an organization’s ability to manage resources. The aim of this paper is to examine the relationship between FMS, capacity building and organizational effectiveness. The study reported in this paper will focus on the FMS that may lead to the enhancement of capacity in a NFP organization and the development of organizational effectiveness. This is an exploratory study that seeks to understand how FMS might lead to enhanced capacity and the ability for a NFP organization to operate effectively.

In the next section of this paper the literature regarding capacity building and effectiveness will be discussed. This will be followed by the posing of the research question and an explanation of the research method. The findings will then be reported followed by a discussion of the results. Finally, conclusions will be suggested.

The relationship between FMS, capacity and effectiveness

For the purposes of this paper FMS includes the ability to: understand an organization's accounting system and financial statements; to be able to analyse the organization's financial statements and use the information to assess the viability of the NFP and likely impact of the organizations strategic direction; to manage cash and develop monitor budgets. These skills are important for the enhancement of an organization's ability to achieve its mission. Without capacity a NFP is limited in its ability to operate effectively. The acquisition of FMS, as described above, is an important component of a NFP organization's capacity building.

Capacity is defined by Eisinger (2002) as: *a set of attributes that help or enable an organization to fulfil its mission* He goes on to point out that effective organizations have a broad range of capacity attributes and the ability to use that capacity to meet organizational objectives. Eisinger argues that, based on the findings of others, that the critical components of capacity include acquiring appropriate resources, effective leadership, skilled and sufficient staff, a certain level of organizational structure and links to the broader community from which the organization can receive assistance.

According to Wagner (2003) there is no one single initiative that increases the effectiveness of Not-For-Profit (NFP) organization but rather a systematic approach to improve the organization's capabilities at all levels. However, Wagner (2003) goes on to point out that building capacity utilizes many resources that NFP management would prefer to use on programs. Wagner (2003) argues that donors have sought to increase the leverage from their donations by encouraging NFP capacity building. He continues that donors are justified in their demand that organizations undertake systematic capacity building to improve their effectiveness. However, Wagner (2003) also points out that NFPs have been impeded in their efforts to develop capacity by a lack of knowledge about how to do so.

It is argued by Fredericksen and London (2000) that internal organizational capacity enables organizations to implement programs and achieve goals and is derived from various elements within the organization. They propose that there are four elements of organizational capacity: 1) Leadership and Vision, 2) Management and Planning, 3) Fiscal Planning and Practice and 4) Operational Support. Financial management is a significant component of elements 2 and 3. Management and Planning and the ability to adapt to changing circumstances are essential to the survival of NFP organizations. While Fiscal Planning and Practice enables a NFP organization to support operations with adequate and predictable financial resources.

Fredericksen and London (2000) emphasize that this element of capacity is centred upon the existence and use of a formal fiscal systems incorporating fundraising, financial tracking systems and financial reporting systems. A formal fiscal system provides important information for planning as well as evidence of accountability. The elements of capacity operate interdependently with other organizational components such as the existence of a budget and the process of developing the budget both indicate the ability of an organization to adapt to its environment (Fredericksen and London (2000)).

Dart (2010) states that effectiveness can be defined in a number of ways but argues that the concept of effectiveness centres on the extent to which a NFP fulfils the purpose for which it exists. However, Dart continues that there is no evidence that effectiveness is understood beyond the initial steps which commence but do not fulfil the causal chain required to produce the change to which the NFP aspires. He goes on to state that effectiveness is linked to the ability to evaluate an organization's programs and the accountability of the organization. Both require the existence of FMS within the NFP. In keeping with Dart (2010) is the argument made by Chenhall et al. (2010) that within the resource dependent environment in which most NFPs operate the ability to attract resources is linked to the ability to plan and demonstrate that actions are consistent with plans and that governance is maintained.

Herman and Renz (2008) state that a key element found in the more effective organisations is that they are more likely to use accepted management practices. They also note that some NFP leaders are uncomfortable with the idea that NFP effectiveness is a social construct. However, they go on to say:

" although effectiveness is socially constructed, there are useful dimensions of effectiveness (for example, financial condition, fundraising performance, or program outcomes) that can be grounded in hard data. For example, use of generally accepted accounting principles provides solid evidence about revenues, costs, and surplus. Other dimensions of effectiveness, such as those related to community collaboration or working with volunteers, are likely to be less amenable to hard evidence. We support and encourage the use of hard evidence to the extent it is legitimately possible." (p. 410)

Thus, the effective operation of an NFP organization is linked to capacity of which FMS is an important element. The link between capacity and effectiveness was further reinforced by Eisinger who quoted Forbes (1998) as defining effectiveness in two ways: 1) the extent to which an organization achieves its goals; and 2) the extent to which an organization has the ability to acquire and use resources to function and sustain its own survival.

The ability of an organization to achieve its goals and marshal resources is enabled by the organization's capacity. While capacity is linked to

the ability to undertake the following activities: strategic planning, budgeting, costing, recording and reporting financial transactions, monitoring cash-flow, measuring financial and non-financial performance (Anthony and Young 2003, and Zietlow Hankin and Seidner, 2007). In addition Ritchie and Kolodinsky (2003) point out that a significant

component of organizational capacity and effectiveness is supported by management skills, particularly financial management skills. They argue that the ability to use financial analysis by NFP managers is important for ensuring sound financial management of NFP organizations and enabling the organization to fulfil its objectives.

Table 1. Correlations

Statements	1	2	3	4	5	6	7
1	1						
2	.557** .000	1					
3	.354** .004	.600** .000	1				
4	.417** .001	.294* .020	.400** .001	1			
5	.299** .017	.238 .063	.509** .000	.647** .000	1		
6	.327** .009	.255* .046	.464** .000	.457** .000	.625** .000	1	
7	.866** .000	.609** .000	.313* .013	.215** .049	.135 .259	.130 .312	1

** Correlation is significant at the 0.01 level.

* Correlation is significant at the 0.05 level.

Statements

1. We are able to analyse the information presented on our organizations financial statements.

2. We have used information presented on our financial statements to make decisions about our organization's activities.

3. We have used information presented on the financial statements in the budgeting process.

4. There is an informed discussion about the budget every month

5. Our organization is very good at managing cash

6. The information provided on our organization's financial statements is useful for planning.

7. We understand the information presented on our organization's financial statements.

The strongest correlation reported in Table 1 shows an association between statements 1 and 7 showing that the ability to understand the information presented on an NFP's financial statements enable the analysis of the financial statements. Being able to understand the information reported in a NFP's financial statements was also correlated with the ability to use financial information to make decisions about the organization's activities. The ability to understand financial statements supports the ability to analyse the NFP's financial results and using financial information in decision making. This relationship is

confirmed by the correlation between statements 1 and 2 (see table 1).

A statistically significant correlation was found to exist between statements 2 and 3 (see table 1) showing a link between using financial information to make decisions about the NFP's activities and constructing a budget. Statement 3 also correlates significantly with statement 4 (see table 1) indicating that there is a relationship between being able to use information on the financial statements in the budgeting process and there being informed discussions about the budget. Being able to have an informed discussion about the budget is also correlated with the ability to analyse the financial statements.

The ability to analyse an organization's financial statements enables the development and use of financial management skills. Having an understanding of the information presented on an organization's financial statements correlates with the ability to analyse the statements. The ability to analyse an organization's financial statements is correlated with an ability to make decisions about an organization's activities and encourage discussion about the budget. Using information from the financial statements in the budgetary process is correlated with making decisions about the organization's activities, having a regular discussion about the budget, believing that the organization is good at managing cash and believing

that information provided by the financial statements is useful for planning.

The results reported in Table 1 suggest that there is a relationship between being able to analyse

financial statements and being able use information presented on our financial statements to make decisions about our organization's activities.

Table 2. Correlations

Statements	1	2	3	4
1	1			
2	.374** .002	1		
3	.566** .000	.509** .000	1	
4	.290* .019	.460** .000	.345** .005	1

** Correlation is significant at the 0.01 level.

* Correlation is significant at the 0.05 level.

Statements

1. *Financial management is an important aspect of capacity build in our organisation.*

2. *We have used the information presented on our organization's financial statements in the budgeting process.*

3. *Our organisation is very good at managing cash.*

4. *We are able to determine the reasons for the difference between our budgeted and actual results.*

The correlations reported in Table 2 are all statistically significant however only three are of moderate strength. There is a correlation between considering financial management being an important aspect of organizational capacity building and the perception that the organization is good at managing cash. The belief that the organization is good at managing cash is also correlated with using information presented in the organization's financial statements in the budgetary process. This last statement is also correlated with the ability to determine the reasons for the differences between actual and budgeted results.

Discussion and Conclusions

The research reported in this paper has investigated the link between FMS and the enhancement of capacity in a NFP organization and the development of organizational effectiveness. This was an exploratory study that sought to understand how FMS might lead to enhanced capacity providing the ability for a NFP organization to operate effectively. The results reported in this paper indicate that there is an association between the acquisition and use of FMS, the strengthening of organizational capacity and the creation of an environment in which organizational effectiveness could be enhanced.

The results reported in Tables 1 and 2 show that having the FMS of being able to understand and

analyse an organization's financial statements encourages the use of financial statement information in budgeting and planning and is also linked to good cash management. Good cash management is fundamental to the continued viability and development of NFP organizations.

It should be noted that the FMS of being able to analyse a NFP organization's financial statements was correlated with using financial statement information to make decisions (capacity building), understanding and the financial statements (a financial skill) and having informed monthly discussions about the budget (capacity building), indicating that it is the understanding of and ability to analyse the financial statements that form the basis for capacity building. Having the FMS to understand and analyse an organization's financial reports encourages capacity building by providing useable financial information that can be used in planning and budgeting. This process was also supported by informed budgetary discussions.

The results reported in tables 1 and 2 point to an association between FMS and capacity building that is non-linear. The presence of FMS skills creates opportunities for the development of capacity as suggested by the literature. The ability to understand and analyse a NFP's financial statements allows the staff and board of the NFP to understand the implications of their decisions and to better monitor the financial management of the NFP.

However, the evidence for effectiveness to develop directly from capacity is not as clear. While capacity must be present for a NFP organization to operate effectively a direct link between the two is difficult to substantiate. Capacity enables an organization to plan, enhance decision making and encourages a discourse around purpose therefore providing the initial steps towards effectiveness as suggested by Dart (2010).

As stated initially this was an exploratory study to understand whether there is a correlation between the acquisition and use of financial management skills, the strengthening of organizational capacity and the creation of an environment in which organizational effectiveness is enhanced. The findings reported in this paper indicate the presence of FMS can support capacity building leading to the development of effectiveness in a NFP organization. However, this conclusion must remain tentative until further research can be undertaken, in particular, qualitative research to investigate the nature of the relationships between FMS, capacity and effectiveness.

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