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An embedded model for understanding the development of accounting control systems in a nonprofit organisation

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How do nonprofit organisations (NPOs) demonstrate increased accountability? How can they develop appropriate accounting systems? Can accounting control systems be considered in isolation from organizational structure and culture? This study focuses on the application of an embedded model approach to understand the development of financial control systems in NPOs. This is illustrated by a historical case study of single NPO which, in turn, has implications for the understanding and design of accounting control systems across the nonprofit sector.

Keywords

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An Embedded Model for Understanding the Development of Accounting Control Systems in a Nonprofit Organisation

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ABSTRACT

How do nonprofit organisations (NPOs) demonstrate increased accountability? How can they develop appropriate accounting systems? Can accounting control systems be considered in isolation from organizational structure and culture? This study focuses on the application of an embedded model approach to understand the development of financial control systems in NPOs. This is illustrated by a historical case study of single NPO which, in turn, has implications for the understanding and design of accounting control systems across the nonprofit sector.

INTRODUCTION

The problem of how to develop appropriate accounting systems for nonprofit organisations (NPOs) continues to challenge both practitioners and researchers. With the increase in the scope and size of the nonprofit sector have come calls for need for increased accountability (Churchill 2003; Robinson 2003; Ospina, Diaz and O'Sullivan 2002; Brown and Moore 2001; Maude 1999; Herzlinger 1996; Courtney 1994; Blickendorfer and Janey 1988). The public, in the role of volunteers, donors and taxpayers, have made a significant contribution to the development and resources of the nonprofit sector and are thus entitled to effective systems of accountability. Since "accountability relies upon the provision of up-to-date, accurate and relevant information relating to the operations and finances of organisations" (Industry Commission 1995, 201), it is appropriate to focus on effectiveness of accounting systems in order to gain this increased accountability. To understand these systems, it is necessary to consider the variables which have influenced their development.

The development of accounting control systems can be viewed as social constructions by the players set within an organizational culture permeated by history and environment. This paper presents accounting as it is intertwined with organizational functioning (Hopwood 1987), and as such, seeks to add to the increasing body of knowledge on the research of accounting in its organizational context (Irvine 2002; Abraham 1999; Booth 1993; Ezzamel and Bourn 1990; Laughlin 1988; Nahapiet 1988; Hopwood 1983, 1986).. This study considers the development of accounting practices in an NPO by focusing on the influences of organizational structure and culture, together with the external environment in which it has operated, and draws implications for other NPOs.

The next section of the paper briefly addresses the nature of management control systems and their relationship to accountability and then addresses the need for an understanding of the development of such systems in NPOs. The third section discusses the relevance of an embedded model to NPOs and the fourth section illustrates this model with a case study. The final section considers the implications for the application of this model to other NPOs.

ACCOUNTABILITY AND MANAGEMENT CONTROL SYSTEMS

It is generally agreed that the requirements for good internal management control include competent personnel, assignment of responsibility, division of work, separation of accountability from custodianship, adequate records and equipment, rotation of personnel, internal auditing and physical protection of assets (Hoggett et al 2006; Anthony and Young 1994). However, accountability expectations extend management control into areas of planning and budgeting, raising funds, allocating resources, record keeping, monitoring and evaluating, reporting and auditing (Glynn et al 2003; Elkin 1985). Such controls are essential given the unique culture and mission of NPOs because whereas "most nonprofit leaders trust that people will 'do the right thing' … errors and fraud do occur if proper controls aren't in place" (Lambert, Main and Lambert 1998, 46). Many potential problems can be overcome if appropriate accountability procedures are adopted. Internal control systems also provide measures which prevent and detect errors and frauds by implementing various checks and balances (McNeal and Michelman 2006; Flock and Olsen 2003; Gallagher. and Radcliffe 2002; Smith 1997; Barton 1996).

Rather than advance planning, NPOs have often tended to react to changing circumstances and events (Katz 2006; Krenek 2006; Callen, Klein and Tinkelman 2003; Paige 1992). Thus, their systems have developed as responses not as initiatives, the nature of financial management has been reactive rather than proactive. Arnaboldi and Lapsley (2004) reported that even when an NPO adopted a financial management technique (in their case, activity based costing), it did so to present itself as being "up-to-date and modern to its external controlling environment" (Helmig, Jegers and Lapsley 2004, 105), rather than to actually implement the technique to improve its financial management system. Baraldi (1998, 146) identified some NPOs as having a management orientation which can be classified as a "day by day or erratic style" which directly impinges on the effectiveness of the core control system. It has also been suggested that for a number of NPOs, financial management has only gained importance in times of crisis (Abraham 2006; Savage et al 2003/2004).

While many of the financial management practices of business "are useful and long overdue in the nonprofit world" (Langan 1998, 75), the combination of unique forms of governance, heavy reliance on volunteers, varying tax and legal considerations, and the absence of a profit motive, mean that there are also important distinctions in financial practices between for-profit and nonprofit organisations (Herman et al 2005; Flock and Olson 2003;). In addition, frequent turnover of nonprofit leadership, due to the voluntary nature of the organisation, may lead to delays and confusion in implementing various financial strategies (Ezell 2002; Clingermayer and Feiock 1997).

However, the nature of the NPO's mission and the sources of its revenue demand a high degree of accountability which in turn demands a sound internal control system (Sopher 1998; Robinson 1997; Booth 1995). Nevertheless, there has been little consensus on the identify of the variables affecting the design of nonprofit management accounting systems. Moreover, accounting systems in NPOs have often been studied in isolation from other parts of the organizational control system. Viewing the accounting information system outside its context is anomalous because:

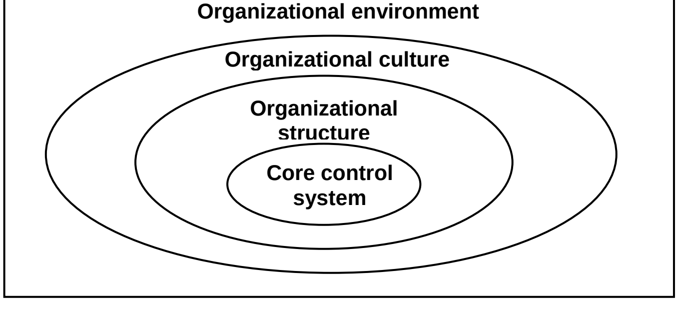
- an appropriate accounting information system will be influenced by the overall aims of the NPO as well as the control processes;
- organizational performance may not be affected only by control processes but also by variables such as the ability and personality of the managers and inter-organizational arrangements, and
- effective organizational performance should be measured in terms of the objectives or mission of the NPO, and not merely by some externally imposed standard.

These criticisms imply that there is the need to study the accounting systems of NPOs within their organizational context and to consider the concept of organizational effectiveness in the light of organizational objectives. Thus, it is valid to examine the extent to which an organization's accounting systems has aided its organizational performance, as well as to associate various contingency variables with the accounting system. However, it is not appropriate to expect to reduce all information into quantitative terms to which statistical methods of analysis can then be applied. The complexities of an organization defy the ability to be successfully reduced to quantitative surrogates. The interactions and the power structures within an organization call for closer involvement.

THE CASE FOR AN EMBEDDED MODEL OF ACCOUNTING CONTROL SYSTEMS

Given the centrality of mission, culture and history to NPOs, it is appropriate to use an embedded model (as shown in Figure 1) to depict the relationship between accounting and control in an organizational context. Such a model recognizes the inappropriateness of to studying accounting in isolation from other control systems. It also provides the intermediary links of organizational structure and organization culture between the environment and the control system.

Figure 1: Example of an embedded framework



Core Control System

At the core of the model is organizational control, defined in this paper as any action or activity that will increase the probability that people will behave in a manner which will promote the attainment of organizational goals (Bouillon 2006; Ekanayake 2004; Flamholtz 1983, Otley and Berry 1980). Organizational control is concerned with both strategic and operational issues (Emmanuel, Otley and Merchant 1990), where strategic issues represent the position of the organization in relation to its environment and operational issues refer to the effective implementation of plans designed to achieve organizational goals.

Organizational Structure

Otley and Berry suggested that an "organization can itself be viewed as a control process, occurring when groups of people feel the need to co-operate in order to achieve purposes which require their joint actions" (1980, 232). Organizational structure can be described as relationships between individuals, groups, and larger units. This may include the assignment of individuals to various positions (and the respective authority, responsibility and privileges of these positions) and the grouping of these positions into larger units. Awasthy and Gupta (2004) suggested that the salience of boundaries in relation to communication and coordination bore a direct relationship to organizational structure. It may also involve standard operating procedures and other established mechanisms for handling coordination and human resource management.

The organizational structure is more static than the central core, in that it takes longer to change and is more difficult to change. The structure develops in response to management culture and will change and adapt in response to its environment. The structure may also be affected by the central core, particularly in times of crises. Indeed, it has been suggested that "organizational structural change has been one of the most topical issues in management and organizational studies over the last two decades" (Ogbonna and Harris 2003, 512).

Organizational Culture

In its most general sense organizational culture has been defined as

> shared norms, values, beliefs and assumptions, and the behavior and artifacts that express these orientations – including symbols, rituals, stories, and language. Culture includes norms and understandings about the nature and identity of the organization, the way work is done, the value and possibility of changing or innovating, relations between lower and higher ranking members, and the nature of the environment (Harrison, 1994, p. 3).

Thus culture has both an ontological aspect, in that it assigns reality to the organizational players and their actions, and also a significatory aspect in that it legitimizes the roles of those players and actions (Meyer, Boli and Thomas 1987). Thus, the organizational culture is a medium by which the actions of the members of the organization are influenced. Organizational culture, as influenced by the environment in which it operates is, therefore, a determining feature of the structure and the central core. A further dimension is added by the newly emerging literature on spirituality in the workforce which in turn leads to a "collective creation of a motivational organizational culture" (Marques 2005, 285).

THE CASE STUDY

The Nature of the Study

This research adopted a case study approach to apply the embedded model in order to understand organizational culture and structure and their relationships to the use of accounting control mechanisms in an NPO. The study involved interviews and participant observation over a three year period, together with analysis of archival material, such as minutes of meetings, annual reports and personal correspondence.

The Nature of the Organization

The particular NPO started in Australia on a formal basis in 1920, (although it had informal beginnings as early as 1910) and has operated continuously ever since. It had its roots in a British organization, which was formed a few years earlier, and which grew out the military training techniques of its founder. Its members wear uniforms, subscribe to a code of behavior and make certain promises upon joining. The activities of the members follow a program, designed to develop the individual's character and public service, while providing fun, fellowship and a sense of purpose. It is part of an international affiliation of similar NPOs, this affiliated body being the largest of its type in the world.

The Australian organization has around 50,000 members, while its counterpart organization in the United States has over 3,000,000 members. Although started around the same time and from the same roots, their development has been quite different, both in the past and more recently. The major differences have revolved around history, geography and population size. Today, the population of Australia is less than 7.5% of the population of the United States, despite the land mass of Australia being a comparable size to the contiguous States. Further, the center of Australia is largely desert and uninhabited, with 40% of the population living in the two major cities. By 1910, the United States had 400 years of history behind it, transportation throughout the country was established and growing rapidly; the population was of a significant size. On the other hand, Australia only came to nationhood in 1901, and so by 1910, had a very new history. Distances were vast, and transport was usually by sea, since roads and railways did not exist across the country. The small population tended to congregate on the eastern and southern seaboards, with those living in the interior being extremely isolated. These distances and isolation meant that growth of the organization was considerably slow. In the early days, the Australian organization maintained strong links with its British parent, with correspondence one way taking over 3 months by ship.

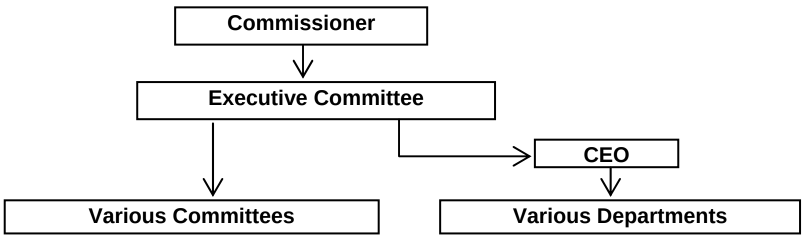
In the late 1970s, the American organization employed a new CEO who found "a somewhat dispirited organization. Some of the members feared that the days of its former glory were gone. … membership were waning and revenues dropping. … The organization had a strong sense of its heritage, one it was reluctant to change" (Herzlinger and Nitterhouse 1994, 3-4). This new CEO implemented sweeping changes centering around financial analysis and managerial control, so that by the early 1990s the organization "was completely turned around: membership at an all-time high, positive staff morale, and stable finances" (Herzlinger and Nitterhouse 1994, 4).

The Australian organization has not experienced this transformation, but is currently struggling to remain financially viable. The organization is asset-rich, cash-poor and has a declining membership, a similar state of affairs to that of the American organization in the 1970s. Its management structure, and thus its accounting systems, are permeated by its rich historically-derived culture, as are those of so many other NPOs. It is thus an interesting case in which to investigate the relationship between the effects of organizational environment and organizational culture on the financial management of an NPO.

Organizational culture, structure and control

Given its strong British roots, and its militaristic beginnings, the organization adopted a very hierarchical form of governance. Its staff consists of both volunteers and remunerated workers, with lines of authority not being clear cut, and where volunteers are often in the position of giving instructions to paid staff. A board of volunteers makes policy, and it is then the responsibility of employees and other volunteers to implement these policies. The organizational structure is shown in Figure 1. The Commissioner and the members of all committees are volunteers. The CEO, an employee, is appointed by the Executive Committee. The employees in the various departments are appointed by the CEO.

Figure 2: Organizational structure of the nonprofit organization



Control of the organization has always been vested in the Executive Committee. The CEO is employed to manage the day to day operations and to carry out the policies of the Executive Committee. The rule book of the organization describes the functions of the CEO, the Commissioner, and various committees, but it is silent on the responsibilities or functions of the Executive Committee. Why? Perhaps, because the Executive Committee has always controlled and therefore did not have to define its own function. The Executive Committee does not concern itself with policy issues only, as might be expected for a governing board, but also focuses on implementation. The 23 members of the Committee come as representatives of various parts of the organization, and, as a result, there are often conflicts of loyalty over what is best for the organization as a whole and what is best for the sub-units of the organization, a conflict which can lead to dysfunctional decision making. However, in recognition of the need for increased accountability, the Executive Committee is currently in the process of developing a description of its own responsibilities and functions to add to the rule book.

Accounting, accountability and financial control

The culture of the organisation permeated financial decision making as early as the first recorded meeting of the Executive Committee, held at Government House in Sydney on 28 October 1920. There were four resolutions passed at that meeting. The first was that "it was decided to put notice in daily papers re the formation of the [organization]", and the second, "that this present Executive Committee be provisional for six months". Having dealt with publicity and governance, the committee the moved to membership, its third motion being, "to write to already formed [groups] and enquire if they are already registered". Ties with Britain were strong, with some of the members of the Committee being English and others, although Australian-born, holding Britain as "home". Thus, in terms of this organization, they perceived that their roots and their first allegiance belonged there, and so the final resolution of that first meeting was "to pay registration fees to National Headquarters in London, and later appoint a Representative on National Council". Thus, the first financial decisions of the Executive Committee were passed, not with any financial plan in mind, but rather because of the need to advertise and the desire to belong to the parent organization. These first decisions firmly indicated the culture underlying the organization.

From the beginning, responsibility for day to day operations was in the hands of the Honorary Treasurer – this involved paying salaries and other accounts, receipting and banking, and presenting a regular report to the Executive Committee. When the first Treasurer became seriously ill in May 1923, the replacement "was not able to undertake the Treasurership until July, and so has had a particularly trying experience in straightening out its affairs as the Treasury department was in abeyance for over three months" (1923 Annual Report, 5). Although the Treasurer was soon assisted, first by a part-time and later by a full-time accounts clerk, it was not until the late 1980s that the organization employed its first accountant. Day to day financial management is in the hands of the Accountant, but only within the limits set by the Executive Committee. However, due to historic reasons embodied in the constitution, employees cannot attend Executive Committee meetings, and so the Honorary Treasurer liaises with the Accountant and then reports to the Executive Committee. It is also the Treasurer who signs off the annual accounts as being a true and fair record and presents financial reports to the Council Body at general and annual general meetings.

In 1937, the Executive Committee, acknowledging that its members did not have appropriate financial expertise, established a Financial Subcommittee to advise it on financial matters. However, the Executive Committee was not in any way obliged to take the advice of this subcommittee. There are certain times in the organization's history when experienced members of the Finance Subcommittee, such as bank managers and accountants, have resigned because of frustration over the Executive's lack of response to their recommendations. This tension continues today. After receiving an unwelcome recommendation from the Finance Subcommittee, one Executive Committee member recently expressed bewilderment:

> I don't know what those people on Finance think they are doing. They are worrying about every dollar. Haven't they got other things to think about? Why do they keep on suggesting the same things? (Recorded at an Executive Committee meeting, October 1998).

It was at the suggestions of various auditors that certain practices were put into practice, even such fundamental controls as daily banking of cash and using a locked mailbox. Internal control systems developed as the organization developed, with controls being put in place on an exigency basis. In addition, lack of understanding of basic accounting concepts such as the operation of an imprest petty cash account and the meaning of depreciation, has led to significant misunderstandings of both control and accountability. Although accountability has always been perceived as being important, implementing it has been another matter. A previous Treasurer commented that

> [t]his a nonprofit organization. The people are "nice". I could even say they suffer from "terminal niceness". So how can they rebuke a volunteer for stepping over the line? It is excused by cries of "but they didn't know any better" or "it didn't really matter; even though the spending was unauthorized, they made a profit", or "they have done so much for the organization, we will have to reimburse them for what they have spent even though they bought it without approval" (Recorded at a planning conference, May 1998).

Routinely, at each meeting since October 1920, the Executive Committee has been given a financial report, but it is extremely rare to read any comments about it in the minutes, except in times of overt financial crises. It is then recorded that "something needs to be done to address the financial affairs" or that "we need to call another meeting to discuss our precarious financial position". Money is perceived as being somewhat "unclean". The organization's mission of service and personal development has always been seen as central, even at the expense of wise financial management. Extra funds have been spent on unbudgeted items which have not been part of any larger plan. Indeed, the organization today still has no strategic plan; instead, it operates from year to year, and often from crisis to crisis. At a recent Finance Committee meeting, there was a discussion of the capital budget submissions. A relatively new member asked "But why are you asking for submissions? Isn't the capital budget in line with the organization's strategic plan?" The Commissioner replied "Whereas that is good in theory, and we would like to be doing that, you have to remember that this is a nonprofit organization, and things just don't happen that way."

The very size and the composition of the Executive Committee mean that any financial plan that is presented has difficulty in being accepted. The many interests at stake combined with inadequate business expertise mean that the Committee tends to vote in favor of the status quo. Decisions such as selling property are perceived to involve divisions of loyalty, and since no one wants to "hurt" anyone, such decisions are defeated because they are too difficult. The people faced with these decisions, although well-intentioned and dedicated to the good of (their section of) the organization, often do not have the management or financial backgrounds necessary to make such decisions. They are not selected to be members of the Executive Committee for their expertise in management, but rather for their involvement with the membership of the organization.

CONCLUSIONS AND IMPLICATIONS

This NPO has existed for almost 80 years and has been successful in achieving its mission of service and character development. Yet, it has had a repeated history of financial crisis, followed by financial revival. What has influenced the organization's lack of formal organizational control, and in particular the failure to use accounting information to facilitate its decision making? This can be understood by its mission: it came about to plan events, design programs, train leaders and service its members, and it has been successful at doing this. It was established without a professional management orientation, and thus, long term planning has never been a part of its culture. There was no budget process until the late 1990s, the only accounting being a cash based receipts and expenditure comparison. Liquidity was defined in terms of ability to meet the current month's expenses, which if they could not be met, needed to be prioritized and paid as money became available. If expenses increased, then they would have to be met. The culture of the organization demanded that the mission not be subjugated to the finances.

The rise of accounting at various times in the organization's history appears consistent with times of crises. The organization has held special meetings, special conferences, and employed facilitators to attempt to improve the situation. This is consistent with Meyer's conclusion that "accounting arises in partially rationalized (or partially bureaucratized) settings (1994, 129). He argued that

> when an organization is relatively complete, controlling its own definition of reality, accounting becomes less necessary, and sometimes intrusive. …We thus expect to find accountants in greater numbers where [an] organization is not self-sufficient (Meyer 1994, 129-130).

These findings have implications for the development of appropriate accounting systems in other NPOs. Conflicts may arise if boards and managers do not understand the extent to which the influence of accounting is intertwined in the whole organizational culture and structure and if they fail to recognize that accounting cannot be seen in isolation as a control system. This has specific consequences on the call for increased accountability by NPOs. If all that is meant is the provision of financial reports, present accounting systems may suffice. But if accountability means responsibility for day to day operations, adoption of a professional business approach, financial activities that are consistent with goals, long term planning and progress reports, the accounting systems of many NPOs prove inadequate.

It would appear that an accounting system can operate in an NPO and yet not function as a control mechanism or as a mechanism to provide accountability. In an organization that values informal relationships, voluntary participation and "niceness", the idea of accountability is somewhat alien. Although the need is acknowledged, it is necessary to ensure than an organization's culture incorporates accountability as a positive value. It is important to train managers so that they can be more professional in their duties. It is necessary for the managers of an NPO, whether volunteers or employees, to work together to define, and refine, the various objectives of the organization, to devise plans for their achievement and to develop measures by which success can be indicated.

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