

## THE MECHANISMS OF GOVERNANCE IN NONPROFIT ORGANIZATIONS

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### Abstract

This paper discusses the governance issues in nonprofit organizations (NPO). The theoretical framework of agency theory is used to analyze the relationship between agents and principals (donors and volunteers) in such kinds of organizations. Similarly to the for-profit organizations, the mechanisms of incentives and monitoring are crucial to the alignment of interests among principals and agents. However, considering the NPO's intrinsic characteristics, due to the difficulty to implement external and internal governance mechanisms, the challenges of alignment are far more complicated. The NPOs are idiosyncratic, being in many situations complex to establish performance comparisons with similar organizations.

**Keywords:** Governance, Nonprofit, Agency theory

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### 1. Introduction

What parameters can the donors use to monitor the effectiveness of social projects implemented by a nonprofit organization? How can these parameters be unfolded in efficiency indicators in the allocation of the donated resources? What is the role of governance mechanisms faced with these demands? These questionings are more and more frequent in the nonprofit organizations (NPO).

The nonprofit organizations, more specifically those included under the third sector framework, are constituted by organizations which belong neither to the State nor to the market. They are nonprofit and nongovernmental organizations. According to the BNDES (2000), the third sector is defined as:

“The group of private activities with public purposes and nonprofit purposes, composed by civil (of any origin) - religious, community institutions, institutions of workers, institutes and corporate foundations, nongovernmental organizations and others - differing from the government's strict logic (public with public purposes) and of market (private with private purposes)”.

Just as in the for-profit organizations, in the nonprofit organizations the implementation of incentive mechanisms and monitoring over the management are crucial for the organization's effective performance. Zylbersztajn (2003) supports

this verification, questioning the still incipient discussion of the governance theme in nonprofit organizations. Regarding its scope it becomes very important to understand the governance dimension of nongovernmental organizations, due to its growth and enlargement of the focus on the social capital.

The concept of Corporate Governance is based on the principles of transparency, equity, accountability and ethics. The Brazilian Institute of Corporate Governance (IBGC) defines it in the following way: “They are practices and the relationships among the shareholders / stockholders, board of directors, management, independent auditing and fiscal council with the purpose of optimizing the company's performance and facilitate access to the capital.” (IBGC, 2001)”.

According to Zylbersztajn (2003), in its most basic form the problem of corporate governance appears when a shareholder wants to control making decisions which differ from the directors of an organization.

In the heart of governance practices is the need to reduce the "Agency Costs", in a way to search to reconcile the undertaking's long-term interests. From the seminal work of Spence and Zeckhauser (1971) and Ross (1974), the scholars of the science of organizations started giving more attention to the development of "Theory of Agency" developed later by Jensen and Meckling (1976), Fama and Jensen

(1983a). The agency problem is an essential element within the company's contractual view, brought by Coase (1937). The agent-principal relationship is always conflicting when a certain individual - agent - acts on behalf of the other, the one named "principal", and the objectives of both don't fully coincide.

The issue of property and control separation within modern organizations was brought to discussion by Berle and Means (1932), and today it has a central position in the development of the theory of organizations, as emphasized by Demsetz and Lehn (1985).

Thus in a relationship principal/agent, for instance, employer / employee, shareholders/executives or institutors/executives, the "principal" tries to implement an incentive and monitoring structure aiming at aligning the interests of the agent to its interests. The alignment in agency relationships takes place when some premises are reached:

A) Agents don't have hidden information (absence of informational asymmetry). The principal knows what constitutes an efficient action and which the expected product is.

B) The principal has complete information on the actions and results.

C) The agents act under low risk.

From this conceptual discussion, the present paper will discuss the NPO's characteristics and the governance mechanisms susceptible to implementation in order to reach efficient social performance. The premises presented in items A and B can generate an important unfolding for the study of the agent-principal relationship in NPO, because the separation between property and control takes place in both the company as well as in this type of organization. Even though they don't distribute financial results there is an agency relationship among the organization's managers (agents) and their donors and volunteers (principals).

The structure of this paper is divided in the following way: the introduction positions the reader about the theme in analysis. Topic 2 presents the evolution and the intrinsic characteristics of NPO and the inherent governance problems. Topic 3 discusses the main classic governance mechanisms, making a parallel between the companies and NPO. Finally, in topic 4 an investigation agenda on the subject is proposed.

## 2. The Governance Problems in NPOs

### 2.1. Characteristics of Nonprofit Organizations (NPO)

According to Cardoso (2000), it was the American John D. Rockefeller who coined the expression Nonprofit, publishing in 1975 the first detailed study on the importance of the business initiatives with public meaning in the American society. In the

eighties, the term also became popular in Europe. In Brazil, that happened in the 90s, with researchers such as Landim and Fernandes (Coelho, 2000).

In Brazil, a strong relationship is evident between the performance of organizations of civil society and the performance of the State. Landim *apud* Mendes (1999) indicates the role of the Catholic Church in the configuration of Brazilian society and in the legitimacy of the colonizing State: *Where there were, in the first centuries of colonization, organizations in charge of social welfare, teaching and health, we will find, together, the Church - with the State mandate - in its fostering.*

The relationship with the State was also clear in the appearance of the unions and Brazilian non-government organizations. Herbert de Souza *apud* Santana (1992) mentions the period between the 1960s and 80s as the landmark of the appearance of NGOs, born due to the society's political fight against the authoritarian regime. Within this context, they acted very closely to secrecy, linked to base social movements coming from the Church - which, acting by pastoral action, assumes a critic position and opposition to the dictatorial State -, union and popular movements. In the appearance process of non-government organizations the international organisms also had a base role (Medina, 1997). It is necessary to remember that nonprofit organizations include all kinds of nonprofit entities and that, therefore, they are not homogeneous in scope. Fernandes (1994) comments: "Thinking about nonprofit organizations means to gather under a same conceptual class so many different activities that, in the past used to be seen as contradictory or even antagonistic. To realize the importance of this possibility of ideal grouping implies to move a step to make it effective."

Fischer and Falconer (1998) argue that "part of this difficulty lies on the definition of what these nonprofit organizations are, of how the organizations are which can be considered as components of these NPOs".

Therefore, due to the need to make international comparisons among organizations of this nature, Salamon and Anheier (1992) proposed a structural-operational definition for NPOs. Thus they should be: *formal; private; non-distributive of profits; autonomous and voluntary.*

To be considered part of NPO sector, an organization has to have all these five criteria and should have their own governance procedures. This definition is not based on the organization's function, opening a space so that a wide range of social undertakings can fit under the scope of nonprofit organizations.

In spite of an increasingly common use of that expression, little is known about the organizations that are part of nonprofit organizations.

## 2.2. Separation of property and control at NPO

The separation tendency between principal and agent at the NPO's, takes place mainly due to two aspects: the first one, of internal character, refers to the founders and idealists of the organizations who have been leaving the administrative function in order to meet the need for professionalism of the sector; the second one, of external character, is related to the increase of strictness in the accountability to the principals, especially the partners and donors. However, in the absence of dividends, *what is the incentive the principal have to control the agents?*

O'Neill *apud* Falconer (1999) mentions some specificities regarding NPO. Unlike the for profit companies, the principals (institutors) don't have residual rights based on the percentage of participation of the shares and quotas. The characterization itself of *who* are the principals is more fluid and there are among them individuals with fewer incentives to the monitoring and the control. The donors and volunteers act to protect, instead of dividends, the positive externalities created by organization's activities (Herrero, Cruz and Merino, 2002).

However, Glaeser (2001) defends that, in the same way that in any economy sector, the maximization of the objectives of donors' and societies is not inherent to the administrative activity. Even when the manager is a volunteer, the agency problem remains, for the altruism - the concern with the welfare of others - doesn't make an individual a perfect agent - one who acts on behalf of the principal (Misorelli, 2003). That means that the agency problem cannot be solved only by the incentive to the increase of altruism in people (Jensen, 1994).

Ricketts (1994 *apud* Misorelli, 2003) affirms that the principals of a nonprofit organization have little incentive to monitor the manager's efficiency, giving him a considerable discretionary power, also to reallocate resources aiming at his own benefit.

According to Herrero, Cruz and Merino (2002) this lack of the donors' interest in monitoring happens since usually after the donation, the concerns with the generated results are small and there are a few mechanisms to control the process. That happens, mainly, for three reasons:

The motivation, which leads the individual to make the donation, is usually little focused in measurable results.

The lack of understanding by donors about the object of the organization's work.

The manager's difficulty in communicating the object of the organization's work in a clear way.

To analyze this situation, it is necessary to consider two aspects related to the donors and to the beneficiaries:

As Fama and Jensen (1983b) recognize, the inexistence of dividends doesn't mean that there are no risks of losses for both the donors and for the beneficiary public. And since the beneficiary public, many times, does not have the means to monitor the services, the donors end up by assuming the risk of allocating resources given by the organization.

Internal management mechanisms which assure the principals that the resources were not expropriated by the agents are necessary (Fama and Jensen, 1985).

This way, the process of selecting an organization which will receive resources indicates the donor's concern as for its use and the maximization of results. Thus it becomes essential for nonprofit organizations to develop and show which and how effective their control mechanisms are to keep the managers within the discretionary acceptable limits.

The next topic deals with the internal and external governance mechanisms, with the objective of minimizing the misalignment problems among the managers (agents) and principals (donors) at NPOs.

## 3. The Governance Mechanisms and the Organization for NPOs

According to Jensen (1993) there are four control forces for a company that can solve problems caused by divergences among the decisions taken internally and those which would be better from the society's point of view. These control mechanisms can be classified in:

- a) external - political-legal and regulatory system; stock and product markets;
- b) internal - board of directors, compensation incentives and internal auditors.

Although imperfect, the monitoring and incentive mechanisms in the *for-profit* companies are for the reduction of misalignment of interests among managers and principals, having as base the decrease of informational asymmetry.

From that classification it is possible to draw some parallels between the application of internal and external governance mechanisms in the *for-profit* and non profit organizations.

### 3.1. Stock Market and the Donation Market

The institutional mechanisms for private companies, the state and self enforced regulatory devices and the market itself, although imperfect, have a disciplinary role to guide the conduct of agents. In other words, the administration inefficiency can be reflected on the prices of shares in the market, and due to that, the principals have a stronger incentive to monitor the manager's activities and the destination of their resources.

The stock market, in the developed countries, acts as a governance mechanism for the companies, because they reflect directly or indirectly its performance. In the event of administration inefficiency (company's potential value less than its real value), there is in theory, a strong incentive for external investors to takeover the control of the company (hostile takeovers). This way, the threat of control change becomes an incentive for the managers to keep the value of the company high, aligning this way, their interests with that of the shareholders' (Denis MacConnell *apud* Okimura, 2003).

In the third sector organizations this possibility is inexistent. The "stock market" of nonprofit organizations is represented by the "donation market", based on the donors' freedom to address their resources to the organization they choose. However, this choice is not based on a transparent relationship, because there is a strong informational asymmetry between the organization manager and what is widely published and that influences the donors' choice (Akerlof, 1970).

The institutional environment can also have an important role to inhibit the manager's opportunistic attitudes, under the penalty of the loss of the organization's reputation. The "donation market" could this way regulate the agents' behavior in the reception and, mainly, in the use of resources for the financing of social projects. The more restricted the "donation market" is the higher is the agents' concern with the maintenance of the organization's reputation capital.

### 3.2. The Board role

In a NPO, the board gains importance before the fragility of the external ways of monitoring the organization's activities. However, the board's participation as a control tool has been incipient. The motivation of their members to monitor the organization's results is small, since its composition rarely takes into account the technical skill and the representation of the stakeholders. (Herrero, Cruz and Merino, 2002).

According to Jensen (1993), some of the council's lacks of commitment causes have fallen on their size, composition and independence. In NPOs, the council tends to be less efficient than at the companies, due to the difficulty in establishing indicators of individual and organizational performance associated to the object of social performance. Even in an organization, which acts in a transparent way, the efficient allocation of resources is not easily susceptible to monitoring by the donors. The agency problem, in this case, is associated to the difficulty of the principal in certifying that the donated resources - financial and non-financial - were not expropriated or used in little effective projects (Shleifer and Vishny, 1997).

Each principal needs to develop ways of control and monitoring the resources in order to avoid its expropriation by the agent (Becht, Bolton and Röell, 2002). However, the difficulty in evaluating the manager's efficiency still remains, mainly due to the lack of clear information and of specific knowledge, since the results are, most of the times, intangible and the indicators which enable the comparison among organizations are rare since it is difficult to establish parameters of efficiency indicators.

Some authors consider that the efficiency of a nonprofit organization should be measured by indicators related to social welfare. However, Frumkin and Keating (2001) argue that it is difficult to obtain this measurement due to the complexity of activities and to the social benefits which can only be reached in the long run, associated to the projects. It is not always possible to establish causality between the accomplished programs and the effects to the beneficiaries. The measures would need to match the manager's role and the organization's philanthropic reputation.

In the third sector, in spite of the efforts to improve the evaluation of results in nonprofit organizations (Chianca, 2001; Cohen, 1994; Roche, 2000) the culture of evaluation is still little developed. The difficulty in creating performance indicators and of social impact gives rise to moral hazard, in other words, the principal becomes dependent on the information provided by the agent. The moral hazard happens when one or more parts of a relationship have post-contractual opportunistic behavior (ex-post) due to the informational asymmetry (Akerlof, 1970). The minimization of this risk implies an increase of information cost that in turn, increases the transaction cost.

### 3.3. Remuneration policies of NPO's managers

In the for-profit companies' logic, the manager's role in the maximization of the shareholders' wealth is directly proportional to the reward he receives at the end of the period. Therefore, participation policies in the organization's results or stock options, among others, are ways, although imperfect, which, at the companies, can provide a better alignment of interests between managers and shareholders.

In the nonprofit organizations, the alignment through financial benefits is inexistent. There is no expectation of this type of return, but of social gains or for a specific cause.

### 3.4. Property Structure

There is a parallel between the property structure of a company and the one of an NPO, which needs more conceptual deepening and empiric studies.

There is a wide debate in the Governance literature, analyzing property structure of the for-

profit companies and the possibility of better monitoring and alignment among agents and principals (Becht et.al., 2002). Two models of property structure can be referred: The Anglo-Saxon model, in which the companies' property structure is dispersed, and the shareholders individually have less control power and the Nipo-Germanic model, characterized by property structures with concentrated capital.

In the first case, the conflict of interest takes place among the external investors (dispersed shareholders) and the managers. Zylbersztajn (2003) summarizes: "The dispersed property of actions makes the problem more serious, generating interest conflicts among the holders of dispersed decision rights. It is a typical collective action problem among investor".

In the event of concentrated property structure, the conflict takes place among the controlling shareholders and the minority shareholders. In this case, the blockholders, if on one hand they have better incentive to monitor the agents, unlike the small dispersed investors; on the other hand they can generate conflicts with the minority one. In Brazil, the concentrated property structure prevails, with the control of companies being held by family groups.

In the nonprofit organizations, according to Herrero, Cruz and Merino (2002), there are no studies, which prove that the existence of a big donor implies in a better monitoring. However, it can be thought that the hypothesis that in NPOs with big donor, the risk of non-alignment would be smaller, because the hegemonic donor would have better incentives to monitor the agent. In the event of an organization with dispersed donors, the incentive of each donor for monitoring the use of resources would be comparatively smaller.

In a nonprofit organization, which is maintained with dispersed donors' resources, it prevails among the donors the hypothesis that the agents will allocate the resources in the most efficient possible way, but that is not assured by a wide monitoring from the principals. In this case, the governance mechanisms to reduce the conflict of interest between donors and managers can be characterized as a typical problem of the donors' group action.

#### 4. Final considerations

The need to deepen the study of several corporate governance dimensions in the nonprofit organization is clear. This paper attempted to approach the intrinsic implications of NPOs and their relationship with the problems arisen from corporate governance, starting from a revision of the Theory of Agency concepts. The deepening of this discussion is pertinent from the viewpoint of practical application and aims at offering inputs for a better management of NPOs.

An agenda of effective investigation should stimulate the development of empiric studies to evaluate the external and internal mechanisms of applied governance to non-profit organizations:

External mechanisms - It is important to follow up the regulatory guidelines and the unfolding analysis of the legislation's proposal in the improvement governance of different types of nonprofit organizations. Still among the external mechanisms, the role of "donation market" and of the reputation in the reception of resources by NPOs needs to have an analytical increase.

Internal mechanisms - The role, composition and *modus operandi* of the council are extremely relevant and can improve the governance practices and of management at NPOs.

Future researches can investigate the subject of performance indicators for the NPO's agent's evaluation in subsidizing the council's strategic decisions. This subject will grow in importance more and more as NPOs become professional and need to compete for scarce donations.

The active professional remuneration systems study in the nonprofit organization is another extremely important investigation issue. Due to the NPOs intrinsic characteristics, empiric researches can be developed to a deeper understanding of the profile of the NPO's professionals, enabling the proposal of suitable remuneration policies.

Another research line to be deepened refers to NPO's structure and the unfolding regarding Governance. Are NPOs with dispersed "principals" less efficient in relation to NPO with few institutors?

In spite of the conceptual and methodological limitations, this paper had as scope the contextualization and the analytical deepening of the central issues of Governance applied to nonprofit organizations enlarging the empiric investigation field of Administration of Nonprofit Organizations.

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