# 18

# Further performance management

| Topic list | Syllabus reference |
|---|---|
| 1 Not-for-profit organisations | E6 (a), (c) |
| 2 Performance measurement in not-for-profit organisations | E6 (b) |
| 3 Value for money | E6 (d) |
| 4 External considerations | E7 (a), (b), (c) |
| 5 Behaviour aspects of performance management | E7 (d) |

## Introduction

This final chapter on performance measurement looks at performance analysis in not for profit organisations and the public sector. The problems of having **non-quantifiable** and **multiple** objectives are discussed.

We then go on to consider how **external considerations** are allowed for in performance measurement and finally identify and explain the **behaviour aspects** of performance management.

# Study guide

| | | Intellectual level |
|---|---|---|
| **E6** | **Performance analysis in not for profit organisations and the public sector** | |
| (a) | Comment on the problems of having non-quantifiable objectives in performance management | 2 |
| (b) | Explain how performance could be measured in this sector | 2 |
| (c) | Comment on the problems of having multiple objectives in this sector | 2 |
| (d) | Outline Value for Money (VFM) as a public sector objective | 1 |
| **E7** | **External considerations and behavioural aspects** | |
| (a) | Explain the need to allow for external considerations in performance management, including stakeholders, market conditions and allowance for competitors | 2 |
| (b) | Suggest ways in which external considerations could be allowed for in performance management | 2 |
| (c) | Interpret performance in the light of external considerations | 2 |
| (d) | Identify and explain the behaviour aspects of performance management | 2 |

# Exam guide

Scenarios in your exam may relate to not-for-profit organisations and the public sector and you need to understand their particular needs and issues. Always **apply** your answers to the specific organisation.

# 1 Not-for-profit organisations

FAST FORWARD

One possible definition of a **not-for-profit seeking organisation** is that its first objective is to be involved in non-loss operations to cover its costs, profits only being made as a means to an end.

Although most people would 'know one if they saw it', there is a surprising problem in clearly defining what counts as a not-for-profit organisation.

Bois has suggested that not-for-profit organisations are defined by recognising that their first objective is to be involved in **non-loss operations** in order to cover their costs and that profits are only made as a means to an end (such as providing a service, or accomplishing some socially or morally worthy objective).

Key term

A **not-for-profit organisation** is '… an organisation whose attainment of its prime goal is not assessed by economic measures. However, in pursuit of that goal it may undertake profit-making activities.' (*Bois)*

This may involve a number of different kinds of organisation with, for example, differing legal status – charities, statutory bodies offering public transport or the provision of services such as leisure, health or public utilities such as water or road maintenance.

## 1.1 Objectives and not-for-profit organisations

FAST FORWARD

Not-for-profit organisations have **multiple objectives** which are **difficult to define**.

A major problem with many not-for-profit organisations, particularly government bodies, is that it is extremely **difficult to define their objectives** at all. In addition they tend to have **multiple objectives**, so that even if they could all be clearly identified it is impossible to say which is the overriding objective.

## Question

**Objectives**

What objectives might the following not-for-profit organisations have?

(a) An army
(b) A local council
(c) A charity
(d) A political party
(e) A college

## Answer

Here are some suggestions.

(a) To defend a country
(b) To provide services for local people (such as the elderly)
(c) To help others/protect the environment
(d) To gain power/enact legislation
(e) To provide education

**More general objectives for not-for-profit organisations** include:

- Surplus maximisation (equivalent to profit maximisation)
- Revenue maximisation (as for a commercial business)
- Usage maximisation (as in leisure centre swimming pool usage)
- Usage targeting (matching the capacity available, as in the NHS)
- Full/partial cost recovery (minimising subsidy)
- Budget maximisation (maximising what is offered)
- Producer satisfaction maximisation (satisfying the wants of staff and volunteers)
- Client satisfaction maximisation (the police generating the support of the public)

It is difficult to judge whether **non-quantifiable objectives** have been met. For example, assessing whether a charity has improved the situation of those benefiting from its activities is difficult to research. Statistics related to product mix, financial resources, size of budgets, number of employees, number of volunteers, number of customers serviced and number and location of facilities are all useful for this task.

The primary objectives of commercial manufacturing and service organisations are likely to be fairly similar and centre on satisfying shareholders.

**Exam focus point**

In an exam, if faced with a question on the public sector, remember that you are likely to have had extensive contact with a variety of public sector organisations and have seen something of how they work. Your greatest contact is likely to have been with the public education system, but you will probably have had contact with some local government authorities which provide a wide variety of services from street cleaning, to leisure facilities, to fire services. You may also have had contact with the health service.

Think now about your experiences and use them in the exam.

# 2 Performance measurement in not-for-profit organisations

FAST FORWARD

There are a range of problems in measuring performance of not-for-profit organisations.

Commercial organisations generally have market competition and the profit motive to guide the process of managing resources economically, efficiently and effectively. However, not-for-profit organisations cannot by definition be **judged by profitability** and do **not** generally have to be **successful against competition,** so other methods of assessing performance have to be used.

As we have already said, a major problem with many not-for-profit organisations, particularly government bodies, is that it is extremely **difficult to define their objectives** at all, let alone find one which can serve a yardstick function in the way that profit does for commercial bodies.

## Question

**Objectives for non-profit seeking organisations**

One of the objectives of a local government body could be 'to provide adequate street lighting throughout the area'.

(a) How could the 'adequacy' of street lighting be measured?

(b) Assume that other objectives are to improve road safety in the area and to reduce crime. How much does 'adequate' street lighting contribute to each of these aims?

(c) What is an excessive amount of money to pay for adequately lit streets, improved road safety and reduced crime? How much is too little?

## Answer

Mull over these questions and discuss them in class or with colleagues if possible. It is possible to suggest answers, perhaps even in quantitative terms, but the point is that there are no **easy** answers, and no right or wrong answers.

You might consider (partly depending upon your political point of view) that it is therefore not necessary to measure performance in not-for-profit organisations. However, few would argue that such bodies should be given **whatever amount of money** they say they need to pursue their aims, with no **check** on whether it is spent well or badly.

(a) Without information about what is being achieved (outputs) and what it is costing (inputs) it is impossible to make **efficient resource allocations**. These allocation decisions rely on a range of performance measures which, if unavailable, may lead managers to allocate resources based on subjective judgement, personal whim or in response to political pressure.

(b) Without performance measures managers will not know the **extent to which operations are contributing to effectiveness and efficiency;** when diagnostic interventions are necessary; how the performance of their organisation **compares** with similar units elsewhere; and how their performance has **changed** over time.

(c) **Government** may require performance information to decide how much to spend in the public sector and where, within the sector, it should be allocated. In particular they will be interested to know what results may be achieved as a consequence of a particular level of funding, or to decide whether or not a service could be delivered more effectively and efficiently in the private sector. Likewise **people who provide funds for** other kinds of not-for-profit organisations are entitled to know whether their money is being put to good use.

## 2.1 How can performance be measured?

FAST FORWARD

Performance is judged in terms of inputs and outputs and hence the **value for money criteria** of **economy, efficiency** and **effectiveness.**

Performance is usually judged in terms of **inputs and outputs** and this ties in with the 'value for money' criteria that are often used to assess not-for-profit organisations (covered in Section 3).

- **Economy** (spending money frugally)
- **Efficiency** (getting out as much as possible for what goes in)
- **Effectiveness** (getting done, by means of the above, what was supposed to be done)

More formal definitions are as follows.

**Key terms**

**Effectiveness** is the relationship between an organisation's outputs and its objectives.

**Efficiency** is the relationship between inputs and outputs.

**Economy** is attaining the appropriate quantity and quality of inputs at lowest cost.

We will look at these concepts in more depth in Section 3.

## 2.2 Problems with performance measurement of not-for-profit organisations

(a) **Multiple objectives**

As we have said, they tend to have multiple objectives, so that even if they can all be clearly identified it is impossible to say which is the overriding objective.

(b) **Measuring outputs**

Outputs can seldom be measured in a way that is generally agreed to be meaningful. (For example, are good exam results alone an adequate measure of the quality of teaching?) Data collection can be problematic. For example, unreported crimes are not included in data used to measure the performance of a police force.

(c) **Lack of profit measure**

If an organisation is not expected to make a profit, or if it has no sales, indicators such as ROI and RI are meaningless.

(d) **Nature of service provided**

Many not-for-profit organisations provide services for which it is difficult to define a cost unit. For example, what is the cost unit for a local fire service? This problem does exist for commercial service providers but problems of performance measurement are made simple because profit can be used.

(e) **Financial constraints**

Although every organisation operates under financial constraints, these are more pronounced in not-for-profit organisations. For instance, a commercial organisation's borrowing power is effectively limited by managerial prudence and the willingness of lenders to lend, but a local authority's ability to raise finance (whether by borrowing or via local taxes) is subject to strict control by central government.

(f) **Political, social and legal considerations**

(i) Unlike commercial organisations, public sector organisations are subject to strong political influences. Local authorities, for example, have to carry out central government's policies as well as their own (possibly conflicting) policies.

(ii) The public may have higher expectations of public sector organisations than commercial organisations. A decision to close a local hospital in an effort to save costs, for example, is likely to be less acceptable to the public than the closure of a factory for the same reason.

(iii) The performance indicators of public sector organisations are subject to far more onerous legal requirements than those of private sector organisations.

(iv) Whereas profit-seeking organisations are unlikely in the long term to continue services making a negative contribution, not-for-profit organisations may be required to offer a range of services, even if some are uneconomic.

## 2.3 Solutions

### 2.3.1 Inputs

Performance can be judged in terms of inputs. This is very common in everyday life. If somebody tells you that their suit cost $750, you would generally conclude that it was an extremely well-designed and good quality suit, even if you did not think so when you first saw it. The drawback is that you might also conclude that the person wearing the suit had been cheated or was a fool, or you may happen to be of the opinion that no piece of clothing is worth $750. So it is with the inputs and outputs of a not-for-profit organisations.

### 2.3.2 Judgement

A second possibility is to accept that performance measurement must to some extent be subjective. Judgements can be made by **experts** in that particular not-for-profit activity or by the **persons who fund the activity**.

### 2.3.3 Comparisons

We have said that most not-for-profit organisations do not face competition but this does not mean that all are unique. Bodies like local governments, health services and so on can judge their performance **against each other** and **against the historical results of their predecessors**. And since they are not competing with each other, there is less of a problem with confidentiality and so **benchmarking** is easier.

In practice, **benchmarking** usually encompasses:

- Regularly comparing aspects of performance (functions or processes) with best practitioners
- Identifying gaps in performance
- Seeking fresh approaches to bring about improvements in performance
- Following through with implementing improvements
- Following up by monitoring progress and reviewing the benefits

### 2.3.4 Quantitative measures

**Unit cost measurements** like 'cost per patient day' or 'cost of borrowing one library book' can fairly easily be established to allow organisations to assess whether they are doing better or worse than their counterparts.

**Efficiency measurement of inputs and outputs** is illustrated in three different situations as follows.

(a) **Where input is fixed**

$$\frac{\text{Actual output}}{\text{Maximum output obtainable for a given input}}$$

25/30 miles per gallon = 83.3% efficiency

(b) **Where output is fixed**

$$\frac{\text{Minimum input needed for a given output}}{\text{Actual input}}$$

55/60 hours to erect scaffolding = 91.7% efficiency

(c) **Where input and output are both variable**

Actual output ÷ actual input
compared with
standard output ÷ standard input

$9,030/7,000 meals = $1.29 per meal

$9,600/7,500 meals = $1.28 per meal
Efficiency = 99.2%

As a further illustration, suppose that at a cost of $40,000 and 4,000 hours (inputs) in an average year two policemen travel 8,000 miles and are instrumental in 200 arrests (outputs). A large number of possibly meaningful measures can be derived from these few figures, as the table below shows.

| | *$40,000* | *4,000 hours* | *8,000 miles* | *200 arrests* |
|---|---|---|---|---|
| *Cost $40,000* | | $40,000/4,000 = $10 per hour | $40,000/8,000 = $5 per mile | $40,000/200 = $200 per arrest |
| *Time 4,000 hours* | 4,000/$40,000 = 6 minutes patrolling per $1 spent | | 4,000/8,000 = ½ hour to patrol 1 mile | 4,000/200 = 20 hours per arrest |
| *Miles 8,000* | 8,000/$40,000 = 0.2 of a mile per $1 | 8,000/4,000 = 2 miles patrolled per hour | | 8,000/200 = 40 miles per arrest |
| *Arrests 200* | 200/$40,000 = 1 arrest per $200 | 200/4,000 = 1 arrest every 20 hours | 200/8,000 = 1 arrest every 40 miles | |

These measures **do not necessarily identify cause and effect** (do teachers or equipment produce better exam results?) **or personal responsibility and accountability**. Actual performance needs to be compared as follows.

(a) With standards, if there are any
(b) With similar external activities
(c) With similar internal activities
(d) With targets
(e) With indices
(f) Over time, as trends

Not-for-profit organisations are forced to use a **wide range** of indicators and can be considered early users of a **balanced scorecard** approach (covered in Chapter 14).

# 3 Value for money

FAST FORWARD

Public sector organisations are now under considerable pressure to prove that they operate economically, efficiently and effectively, and are encouraged from many sources to draw up action plans to achieve **value for money** as part of the continuing process of good management.

Although much has been written about value for money (VFM), there is no great mystique about the concept. The term is common in everyday speech and so is the idea.

**Key term**

**Value for money** means providing a service in a way which is economical, efficient and effective.

To drive the point home, think of a bottle of Fairy Liquid. If we believe the advertising, Fairy is good 'value for money' because it washes half as many plates again as any other washing up liquid. Bottle for bottle it may be more expensive, but plate for plate it is cheaper. Not only this but Fairy gets plates 'squeaky' clean. To summarise, Fairy gives us VFM because it exhibits the following characteristics.

- **Economy** (more clean plates per pound)
- **Efficiency** (more clean plates per squirt)
- **Effectiveness** (plates as clean as they should be)

The assessment of economy, efficiency and effectiveness should be a part of the normal management process of any organisation, public or private.

(a) Management should carry out **performance reviews** as a regular feature of their control responsibilities.
(b) Independent assessments of management performance can be carried out by 'outsiders', perhaps an internal audit department, as **value for money audits (VFM audits).**

Value for money is important **whatever level of expenditure** is being considered. Negatively it may be seen as an approach to spreading costs in public expenditure fairly across services but positively it is necessary to ensure that the desired impact is achieved with the minimum use of resources.

## 3.1 Economy

Economy is concerned with the cost of inputs, and it is achieved by **obtaining those inputs at the lowest acceptable cost**. Economy **does not mean straightforward cost-cutting,** because resources must be acquired which are of a suitable **quality** to provide the service to the desired standard. Cost-cutting should not sacrifice quality to the extent that service standards fall to an unacceptable level. Economising by buying poor quality materials, labour or equipment is a 'false economy'.

## 3.2 Efficiency

Efficiency means the following.

(a) **Maximising output for a given input**, for example maximising the number of transactions handled per employee or per $1 spent.

(b) **Achieving the minimum input for a given output**. For example, a government department may be required to pay unemployment benefit to millions of people. Efficiency will be achieved by making these payments with the minimum labour and computer time.

## 3.3 Effectiveness

Effectiveness means ensuring that the **outputs** of a service or programme have the **desired impacts**; in other words, finding out whether they **succeed in achieving objectives**, and if so, to what extent.

## 3.4 Studying and measuring the three Es

Economy, efficiency and effectiveness can be studied and measured with reference to the following.

(a) **Inputs**

(i) Money
(ii) Resources – the labour, materials, time and so on consumed, and their cost

For example, a VFM audit into state secondary education would look at the efficiency and economy of the use of resources for education (the use of schoolteachers, school buildings, equipment, cash) and whether the resources are being used for their purpose: what is the pupil/teacher ratio and are trained teachers being fully used to teach the subjects they have been trained for?

(b) **Outputs**, in other words the **results of an activity**, measurable as the services actually produced, and the quality of the services.

In the case of a VFM audit of secondary education, outputs would be measured as the number of pupils taught and the number of subjects taught per pupil; how many examination papers are taken and what is the pass rate; what proportion of students go on to further education at a university or college.

(c) Impacts, which are the effect that the outputs of an activity or programme have in terms of achieving policy objectives.

Policy objectives might be to provide a minimum level of education to all children up to the age of 16, and to make education relevant for the children's future jobs and careers. This might be measured by the ratio of jobs vacant to unemployed school leavers. A VFM audit could assess to what extent this objective is being achieved.

As another example from education, suppose that there is a programme to build a new school in an area. The **inputs** would be the **costs of building** the school, and the resources used up; the **outputs** would be the **school building** itself; and the **impacts** would be the **effect that the new school has on education in the area** it serves.

# 4 External considerations

FAST FORWARD

Performance management needs to allow for **external considerations** including stakeholders, market conditions and allowance for competitors.

## 4.1 Stakeholders

Key term

**Stakeholders** are groups of people or individuals who have a legitimate interest in the activities of an organisation. They include customers, employees, the community, shareholders, suppliers and lenders.

There are three broad types of stakeholder in an organisation.

- **Internal** stakeholders (employees, management)
- **Connected** stakeholders (shareholders, customers, suppliers, financiers)
- **External** stakeholders (the community, government, pressure groups)

The stakeholder approach suggests that **corporate objectives** are, or should be, **shaped** and **influenced** by **those** who have **sufficient involvement or interest** in the organisation's operational activities.

### 4.1.1 Internal stakeholders: employees and management

Because employees and management are so **intimately connected** with the company, their objectives are likely to have a **strong influence** on how it is run. They are interested in the following issues.

(a) The **organisation's continuation and growth**. Management and employees have a special interest in the organisation's continued existence.

(b) Managers and employees have **individual interests** and goals which can be harnessed to the goals of the organisation.

- Jobs/careers
- Money
- Benefits
- Satisfaction
- Promotion

For managers and employees, an organisation's social obligations will include the provision of safe working conditions and anti-discrimination policies.

### 4.1.2 Connected stakeholders

**Increasing shareholder value** should assume a **core role** in the strategic management of a business. If management performance is measured and rewarded by reference to changes in **shareholder value** then shareholders will be happy, because managers are likely to **encourage long-term share price growth**.

| Connected stakeholder | Interests to defend |
| --- | --- |
| Shareholders (corporate strategy) | • Increase in shareholder wealth, measured by profitability, P/E ratios, market capitalisation, dividends and yield<br>• Risk |
| Bankers (cash flows) | • Security of loan<br>• Adherence to loan agreements |
| Suppliers (purchase strategy) | • Profitable sales<br>• Payment for goods<br>• Long-term relationship |
| Customers (product market strategy) | • Goods as promised<br>• Future benefits |

Even though **shareholders** are deemed to be interested in return on investment and/or capital appreciation, many want to **invest** in **ethically-sound** organisations.

### 4.1.3 External stakeholders

External stakeholder groups – the government, local authorities, pressure groups, the community at large, professional bodies – are likely to have quite diverse objectives.

| External stakeholder | Interests to defend |
|---|---|
| Government | • Jobs, training, tax |
| Interest/pressure groups / charities / 'civil society' | • Pollution • Rights • Other |

It is external stakeholders in particular who **induce social and ethical obligations**.

### 4.1.4 Performance measures

Organisations may need to develop performance measures to ensure that the needs of stakeholders are met.

| Stakeholder | Measure |
|---|---|
| Employees | Morale index |
| Shareholders | Share price, dividend yield |
| Government | Percentage of products conforming to environmental regulations |
| Customers | Warranty cost, percentage of repeat customers |

There is a strong link here to the balanced scorecard approach and the need to have a range of non-financial performance indicators as well as financial performance indicators.

## 4.2 Economic environment

**Economic growth**

- Has the economy grown or is there a recession?
- How has demand for goods/services been affected?

**Local economic trends**

- Are local businesses rationalising or expanding?
- Are office/factory rents increasing/falling?
- In what direction are house prices moving?
- Are labour rates on the increase?

**Inflation**

(a) Is a high rate making it difficult to plan, owing to the uncertainty of future financial returns? Inflation and expectations of it help to explain short termism.

(b) Is the rate depressing consumer demand?

(c) Is the rate encouraging investment in domestic industries?

(d) Is a high rate leading employees to demand higher money wages to compensate for a fall in the value of their wages?

**Interest rates**

- How do these affect consumer confidence and liquidity, and hence demand?
- Is the cost of borrowing increasing, thereby reducing profitability?

**Exchange rates**

- What impact do these have on the cost of overseas imports?
- Are prices that can be charged to overseas customers affected?

**Government fiscal policy**

(a) Are consumers increasing/decreasing the amount they spend due to tax and government spending decisions?

(b) How is the government's corporation tax policy affecting the organisation?

(c) Is VAT affecting demand?

**Government spending**

Is the organisation a supplier to the government (such as a construction firm) and hence affected by the level of spending?

## 4.3 Competition

We considered the effects of competitors' behaviour in Chapter 5 when we looked at **pricing strategies**. Performance management must consider information on competitors' prices and cost structures and identify which features of an organisation's products add most value. Management accounting information has to be produced speedily and be up-to-date so that managers can react quickly and effectively to **changing market conditions**.

# 5 Behaviour aspects of performance management

FAST FORWARD

It is generally considered to be unreasonable to assess managers' performance in relation to matters that are beyond their control**.** Therefore **management performance measures** should **only include those items that are directly controllable by the manager** in question.

If people **know** that their performance is being **measured** then this will **affect the standard** of their performance, particularly if they know that they will be **rewarded** for achieving a certain level of performance.

Ideally, performance **measures** will be devised that **reward behaviour** that **maximises the corporate good**. In practice, however, it is not quite so simple.

(a) There is a danger that managers and staff will **concentrate** only upon what they know is **being measured**. This is not a problem if every important issue has a measure attached to it, but such a system is difficult to devise and implement in practice.

(b) **Individuals** have their own goals, but good performance that satisfies their own sense of what is important will not necessarily work towards the **corporate good**. Each individual may face a **conflict** between taking action to ensure organisational goals and action to ensure personal goals.

Point (b) is the problem of **goal congruence.**

## 5.1 Example: Performance measurement and behaviour

(a) As we saw in Chapter 17, a divisional manager whose performance is assessed on the basis of his division's ROI might reject a proposal that produces an ROI greater than the group's target return if it reduces his division's overall return.

(b) Traditional feedback control would seek to eliminate an adverse material price variance by requiring managers to source cheaper, possibly lower quality, suppliers. This may run counter to an organisational objective to implement a system of TQM with the aim of reducing quality costs.

## 5.2 Measuring managerial performance

It is difficult to devise performance measures that relate specifically to a manager to judge his or her performance as a manager. It is possible to calculate statistics to assess the manager as an employee like any other employee (days absent, professional qualifications obtained, personability and so on), but this is not the point. As soon as the issue of **ability as a manager** arises it is necessary to **consider him in relation to his area of responsibility**. If we want to know how good a manager is at marketing the only information there is to go on is the marketing performance of his division (which may or may not be traceable to his own efforts).

## 5.3 The controllability principle

As we have seen, the **controllability principle** is that managers of responsibility centres should only be held accountable for costs over which they have some influence. From a motivation point of view this is important because it can be very demoralising for managers who feel that their performance is being judged on the basis of something over which they have no influence. It is also important from a control point of view in that control reports should ensure that information on costs is reported to the manager who is able to take action to control them.

## 5.4 Reward schemes and performance measurement

In many organisations, senior management try to motivate managers and employees by offering organisational rewards (more pay and promotion) for the achievement of certain levels of performance. The conventional theory of reward structures is that if the organisation establishes procedures for formal measurement of performance, and **rewards individuals for good performance**, individuals will be more likely to direct their efforts towards achieving the organisation's goals.

### 5.4.1 Problems associated with reward schemes

(a) A serious problem that can arise is that performance-related pay and performance evaluation systems can **encourage dysfunctional behaviour.** Many investigations have noted the tendency of managers to pad their budgets either in anticipation of cuts by superiors or to make subsequent variances more favourable.

(b) Perhaps of even more concern are the numerous examples of managers making **decisions that are contrary to the wider purposes of the organisation.**

(c) Schemes designed to **ensure long-term achievements** (that is, to combat short termism) **may not motivate** since efforts and reward are too distant in time from each other (or managers may not think they will be around that long!).

(d) It is questionable whether any performance measures or set of measures can provide a **comprehensive assessment of what a single person achieves** for an organisation. There will always be the old chestnut of lack of goal congruence, employees being committed to what is measured, rather than the objectives of the organisation.

(e) **Self-interested performance** may be encouraged at the **expense of team work**.

(f) High levels of output (whether this is number of calls answered or production of product X) may be achieved at the expense of **quality**.

(g) In order to make bonuses more accessible, **standards and targets may have to be lowered**, with knock-on effects on quality.

(h) They **undervalue intrinsic rewards** (which reflect the satisfaction that an individual experiences from doing a job and the opportunity for growth that the job provides) given that they promote extrinsic rewards (bonuses and so on).

# Chapter Roundup

- One possible definition of a **not-for-profit seeking organisation** is that its first objective is to be involved in non-loss operations to cover its costs, profits only being made as a means to an end.
- Not-for-profit organisations have **multiple objectives** which are **difficult to define**.
- There are a range of problems in measuring performance of not-for-profit organisations.
- Performance is judged in terms of inputs and outputs and hence the **value for money criteria** of **economy, efficiency** and **effectiveness.**
- Public sector organisations are now under considerable pressure to prove that they operate economically, efficiently and effectively, and are encouraged from many sources to draw up action plans to achieve **value for money** as part of the continuing process of good management.
- Performance management needs to allow for **external considerations** including stakeholders, market conditions and allowance for competitiors.
- It is generally considered to be unreasonable to assess managers' performance in relation to matters that are beyond their control. Therefore **management performance measures** should **only include those items that are directly controllable by the manager** in question.

# Quick Quiz

1 What general objectives of non-profit seeking organisations are being described in each of the following?

(a) Maximising what is offered
(b) Satisfying the wants of staff and volunteers
(c) Equivalent to profit maximisation
(d) Matching capacity available

2 The public service funding system operates on the basis that performance against non-financial objectives leads to a reduction in the level of funding. **True or false?**

3 *Match the definition to the term.*

| *Terms* | *Definition* |
|---|---|
| (a) Economy | (1) Ensuring outputs succeed in achieving objectives |
| (b) Efficiency | (2) Getting out as much as possible for what goes in |
| (c) Effectiveness | (3) Spending money frugally |

4 Economy means cost cutting. **True or false?**

5 Six problems of measuring performance in non-profit seeking organisations were described in this chapter. Which two are missing from the list below?

(a) Multiple objectives
(b) Measuring output
(c) Lack of profit measure
(d) Nature of service provided

# Answers to Quick Quiz

1 (a) Budget maximisation
(b) Producer satisfaction maximisation
(c) Surplus maximisation
(d) Usage targeting

2 False

3 (a) (3); (b) (2); (c) (1)

4 False

5 Financial constraints
Political/social/legal considerations

**Now try the question below from the Exam Question Bank**

| Number | Level | Marks | Time |
|---|---|---|---|
| Q22 | Examination | 20 | 36 mins |

# 10a

# Strategic performance measures in not-for-profit organisations

| Topic list | Syllabus reference |
|---|---|
| 1 Diversity in objectives | D4(a) |
| 2 Not-for-profit organisations | D4(b) |
| 3 Achieving objectives in the public sector | D4(b) |
| 4 Performance measurement in not-for-profit organisations | D4(c),(d) |
| 5 Politics, performance measurement and undesirable service outcomes | D4(e) |
| 6 Value for money | D4(f) |

## Introduction

In Chapter 8 we looked at performance measurement in profit-seeking organisations in the private sector. However, we also noted that in your P5 exam you may need to discuss performance measurement and strategic performance measurement techniques in a range of different organisations.

Accordingly, in this chapter we now focus on performance measurement in not-for-profit organisations.

We will start with a look at objectives and how these differ according to the type of organisation.

# Study guide

| | | Intellectual level |
|---|---|---|
| **D4** | **Strategic performance measures in not-for-profit organisations** | |
| (a) | Highlight and discuss the potential for diversity in objectives depending on organisational type | 3 |
| (b) | Discuss the need to achieve objectives with limited funds that may not be controllable | 2 |
| (c) | Identify and discuss ways in which performance may be judged in not-for-profit organisations | 2 |
| (d) | Discuss the difficulties in measuring outputs when performance is not judged in terms of money or an easily quantifiable objective | 2 |
| (e) | Discuss how the combination of politics and the desire to measure public sector performance may result in undesirable service outcomes | 3 |
| (f) | Assess 'value for money' service provision as a measure of performance in not-for-profit organisations and the public sector | 3 |

# Exam guide

The syllabus states that candidates should be able to **apply appropriate strategic performance measurement techniques in evaluating and improving organisational performance**.

In other words, you must be able to assess performance in, for example, a not-for-profit organisation using **suitable performance measures.** You must also be prepared to **discuss** your measures and make suggestions for **improvements.** Question 1 of the Pilot paper provides an example of the type of question you could face.

Also you must think about the action words used in the study guide so you need to **'discuss'** and **'identify'** in your exam answer.

**Exam focus point**

The June 2010 exam included twelve-marks for an analysis of VFM including the roles of principal and agent and the three 'E's. The final eight marks of this optional question tested candidates' knowledge of the characteristics of services.

The December 2007 exam asked candidates to compare a not-for-profit and a profit-making organisation. They needed to comment on the problems in doing so and what other information would help assess performance. The examiner commented that this part of the question was answered well though many candidates had difficulty in listing the additional information needed.

The pilot paper asked candidates to consider performance measures in a not-for-profit organisation in contrast to a profit-seeking organisation. The question also asked candidates to state performance measures appropriate to either type of organisation.

So you are likely to be asked to calculate **appropriate** performance measures for a not-for-profit organisation and to also **compare these** with those you would use to **measure profit-making organisations**.

*Student Accountant* published two handy articles in September 2009 and October 2009, with the first explaining what not-for-profit organisations are, and the second looking at charities in depth. You should read these articles as background and an introduction to not-for-profit organisations if you are not familiar with them.

# 1 Diversity in objectives

FAST FORWARD

**Corporate objectives** concern the firm as a whole. **Unit objectives** are specific to individual units of an organisation. These will differ depending on the organisation. We have given examples of objectives found in different types of organisation. You may have examples of your own.

## 1.1 Examples of types of objective

**Corporate objectives** are set as part of the **corporate planning process**, which is discussed in more detail in Chapter 1. In Chapter 7 we gave some examples of corporate objectives which are based on the **key factors for business success**. However, corporate objectives vary for different types of organisation.

Referring back to Chapter 7 where necessary identify some **unit objectives found in different types of organisation**.

| Types of organisation | Examples of objectives |
|---|---|
| **Commercial** | •<br>•<br>• |
| **Public sector** | •<br>•<br>• |
| **General** | •<br>•<br>• |

## 1.2 Stakeholders in not-for-profit organisations and the scope for conflict between them

One of the key reasons (if not *the* key reason) why not-for profit organisations have different objectives to profit-seeking commercial ones is the difference in key stakeholders between the two types of organisation.

The aim of commercial organisation is to make a profit for their shareholders. However, not-for-profit organisations **do not have shareholders**. Consequently (as their name suggests) their primary objective is not to make a profit. Instead, they provide value in other ways – for example through health care or education.

Another characteristic of not-for-profit organisations is the **range of different stakeholders** they have – for example, beneficiaries; local authorities; managers; staff; financial backers – who have an interest in their activities.

Managers in not-for-profit organisations need to take account of the range of stakeholders and stakeholder views when making decisions. However, the number of different stakeholder groups involved means there can be considerable scope for conflict between the interests of different stakeholders.

We can illustrate this by looking at an example of a hospice in the UK. The **stakeholders** include the **trustees** who are responsible for overseeing the running of the hospice and reporting to the Charity Commission. **Clinical staff** provide medical care for the terminally ill patients the hospice looks after. **Therapists** provide therapies including massage and aromatherapy. The **National Health Service (NHS)** contracts with the hospice to provide care for terminally ill patients. **Support staff** will also be stakeholders and they include marketing, human resources, and finance staff. The **patients** who attend either fulltime or respite care are important stakeholders, as are their relatives. **Fund raisers** who are volunteers are unpaid stakeholders. A **medical director** who is responsible for ensuring the upkeep of medical standards is an essential stakeholder.

**Possible conflicts** that might occur include those between stakeholders with commercial and charitable interests. The **trustees** may want the hospice to cut back on spending but the **clinical staff** will see quality of care as a priority. **Patients** (and their friends and relatives) as well as the **medical director** will monitor service standards and will veto anything that compromises the quality of clinical care offered; for instance, permitting open days that allow visitors to tour certain private therapy areas. The **NHS,** as a contractor and also a provider of funding, may want some say in how the hospice is run and how much it is willing to pay for funding patient care.

# 2 Not-for-profit organisations

FAST FORWARD

One possible definition of a **not-for-profit organisation** is that its first objective is to be involved in non-loss operations to cover its costs, profits only being made as a means to an end.

Although most people would 'know one if they saw it', there is a surprising problem in clearly defining what counts as a not-for-profit organisation.

**In this chapter we use 'not-for-profit' and 'non-profit-seeking' interchangeably** and many writers use one or the other to mean the same type of organisation. The syllabus refers to 'not-for-profit'.

Bois has suggested that non-profit seeking organisations are defined by recognising that their first objective is to be involved in **non-loss operations** in order to cover their costs and that profits are only made as a means to an end (such as providing a service, or accomplishing some socially or morally worthy objective).

Key term

A **not-for-profit organisation** is an organisation whose attainment of its prime goal is not assessed by economic measures. However, in pursuit of its primary goal it may undertake profit-making activities, and then use any surplus funds to help pursue its goal.

## 2.1 Objectives and not-for-profit organisations

FAST FORWARD

The range of **objectives** of not-for-profit organisations is as wide as the range of not-for-profit organisations.

A major problem with many not-for-profit organisations, particularly government bodies, is that it is extremely **difficult to define their objectives** at all. In addition they tend to have **multiple objectives**, so that even if they could all be clearly identified it is impossible to say which the overriding objective is.

Question — Objectives

What objectives might the following not-for-profit seeking organisations have?

(a) An army
(b) A local council
(c) A charity
(d) A political party
(e) A college

Answer

Here are some suggestions.

(a) To defend a country
(b) To provide services for local people (such as the elderly)
(c) To help others/protect the environment
(d) To gain power/enact legislation
(e) To provide education

More **general objectives for not-for-profit seeking organisations** include:

(a) Surplus maximisation (equivalent to profit maximisation in commercial organisations)
(b) Revenue maximisation (as for a commercial business)
(c) Usage maximisation (as in leisure centre swimming pool usage)
(d) Usage targeting (matching the capacity available, as in hospitals)
(e) Full/partial cost recovery (minimising subsidy)
(f) Budget maximisation (maximising what is offered)
(g) Producer satisfaction maximisation (satisfying the wants of staff and volunteers)
(h) Client satisfaction maximisation (the police generating the support of the public)

It is difficult to judge whether **non-quantitative objectives** have been met. For example, assessing whether a charity has improved the situation of those benefiting from its activities is difficult to research. Statistics related to product mix, financial resources, size of budgets, number of employees, number of volunteers, number of customers serviced and number and location of facilities are all useful for this task.

The primary objectives of commercial manufacturing and service organisations are likely to be fairly similar and centre on satisfying shareholders. The **range of objectives** of not-for-profit organisations is as **wide as the range of not-for-profit organisations**.

# 3 Achieving objectives in the public sector

FAST FORWARD

**Public sector organisations** have limited control over both the level of **funding** they receive and, to an extent, the objectives they can achieve.

## 3.1 The link between funding and achieving objectives

In the private sector, revenues and ultimately profits depend on customers being attracted and returning. In the **public sector**, however, **funding** tends to come direct from the government, **not from those using the public service** (pupils, patients and so on). Obtaining funds, or additional funds, can be a complex political process: there is **not necessarily a link between providing more service and obtaining more funds.** There are limits on the levels of taxation and government borrowing that are possible in a global economy.

### Case Study

*UK Police forces*

The October 2010 Spending Review by the UK Government was a key part of the Government's programme to tackle the huge budget deficit in the country.

One element of the Spending Review was the announcement of cuts to police funding, with funding set to reduce by 20% in real terms by 2014/2015.

The Treasury acknowledged that these funding cuts will require police forces to make 'challenging' savings, but claimed that by cutting out costs, and reducing bureaucracy 'hundreds of millions of pounds and hundreds of thousands of man hours' could be saved, such that the funding cuts 'should not lead to any reduction in the number of police officers, visible and available on the streets'.

However, the Police Federation and opposition politicians have both expressed serious concerns that the cuts will translate into fewer police officers, which in turn would 'undermine the fight against crime' and reduce 'the safety of our communities'.

Rob Garnham, Chairman of the Association of Police Authorities said: 'It is difficult to envisage how some loss of service can be avoided. ... There is a risk that the positive momentum of the last few years on crime reduction and [increased] public confidence will be interrupted, at a time when communities are likely to be looking more towards the police for help.'

The context of the cuts is also important. Although the UK had come out of recession by 2010, unemployment was rising and economic conditions were still tough, with talk of a 'double-dip' recession recurring throughout 2011. At the same time crime figures were showing an increase in robberies, burglaries and motor vehicle crime (theft or and from vehicles).

These increases are not unexpected, given the tough economic conditions. Yet the difficulty the police forces now face is how to tackle rising crime levels with lower funding of their own.

One of the key differences between commercial, private sector organisations and public sector organisations is in the link between achieving objectives and the funding received.

Indeed, what might appear to be poor performance against non-financial objectives can lead to higher levels of funding in the public sector. For example, if the level of crime in an area is rising, this might indicate a police force is being ineffective. However, it may also indicate that the police force needs additional funding to tackle the increase in crime.

The **level of service provided**, which effectively **determines the funding** that an organisation receives, is a **political** decision.

(a) The public sector has to provide services, whether or not they are efficient or economic.

(b) Services have to be provided to all customers. For instance, hospitals cannot turn away emergencies.

(c) Levels of local provision are often determined centrally by experts and formulae.

(d) Local decision making by, say, nominated members of local authorities, can lead to different services being offered in different parts of the country.

(e) Public sector units compete against each other for limited funds.

Public sector organisations therefore have to provide the **best service possible with the allocated funding**.

## 3.2 Planning

Planning in the public sector is inhibited by the political system. Governments change, government ministers change more frequently. New ministers wish to 'leave a mark', do something which produces change. **Changes in priorities and/or changes in funding formulae** can be **imposed with little or no notice**.

**Expenditure increases have to be balanced by appropriate expenditure cuts**. If a hard winter means that more money has to be spent on clearing roads of snow, something, quite possibly road maintenance and resurfacing, will have to be cut. This is because the **budget authorisation** is all important. Once it is taken, **clear authority** has been given to act within its **limits** and in the **way specified** by the detail of the budget. **Very little flexibility** is allowed in moving funds from one budget area to another.

Public sector organisations have **limited control** over both the **level of funding** they receive and, to an extent, the **objectives they can achieve**.

### 3.2.1 Budgeting in the public sector

In his March 2005 article in *Student Accountant* ('Beyond Budgeting'), Shane Johnson considered issues of budgeting in the public sector. (The emphasis in the extract below is BPP's)

'In the public sector, the **budget** process inevitably has considerable influence on organisational processes, and **represents the financial expression of policies resulting from politically motivated goals and objectives**. Yet the **reality** of life for many public sector **managers** is an **increased pressure to perform in a resource-constrained environment**, while also being subjected to growing **competition**. In essence, a public sector budget:

(a) Establishes the level of income and expenditure
(b) Authorises that expenditure, once agreed, out of the planned income
(c) Acts as a control on expenditure and income
(d) Communicates policies and plans
(e) Focuses attention on the future
(f) Motivates managers and staff.

While these issues may be common with the private sector, a number **of issues** arise which are **specific to the public sector**. For example, UK local authorities are prevented by law from borrowing funds for revenue purposes or budgeting for a deficit.'

The article suggests that the 'Beyond Budgeting' model might allow managers greater freedom and flexibility, but there would need to be a **considerable change of mindset**, or culture, in the public sector to achieve this flexible agenda, particularly if this flexibility entailed greater delegation to managers.

However, **public sector financial regulations** tend to be very rigid; for example they tend to prevent the transfer of funds from one budget head to another unless the transfer complies with a strict set of rules and regulations. Similarly, budgets in the public sector tend to concentrate on planning for one financial year ahead, which creates problem when trying to create budget systems that reflect longer-term objectives and go beyond the annual cycle.

The article concludes that one of the key challenges facing the public sector is whether it can adapt to the concept of **greater flexibility** which lies at the heard of 'Beyond Budgeting'. There is little doubt that public sector organisations are keen to improve their performance, and they are adopting initiatives such as key performance indicators and 'best value' plans to help achieve this. However, the lack of flexibility within the organisations is likely to constrain managers' ability to move 'Beyond Budgeting.'

Budgeting in the public sector is likely to take place in the context of **politically-motivated policies and objectives**, and within a complex legal and financial framework. Not only is this not conducive to the adoption of the 'Beyond Budgeting' model, but perhaps more generally it also re-iterates the organisational, managerial and cultural differences between public sector organisations and their private sector counterparts.

# 4 Performance measurement in not-for-profit organisations

FAST FORWARD

Not-for-profit organisations tend to have **multiple objectives** which are **difficult to define.** There are a range of other problems in measuring performance.

Commercial organisations generally have market competition and the profit motive to guide the process of managing resources economically, efficiently and effectively. However, not-for-profit organisations **cannot by definition be judged by profitability** and do not **generally have to be successful against competition,** so other methods of assessing performance have to be used.

As we have already said, a major problem with many non-for-profit, particularly government bodies, is that it is extremely **difficult to define their objectives** at all, let alone find one which can serve a yardstick function in the way that profit does for commercial bodies.

## Question — Objectives for not-for-profit organisations

One of the objectives of a local government body could be 'to provide adequate street lighting throughout the area'.

(a) How could the 'adequacy' of street lighting be measured?

(b) Assume that other objectives are to improve road safety in the area and to reduce crime. How much does 'adequate' street lighting contribute to each of these aims?

(c) What is an excessive amount of money to pay for adequately lit streets, improved road safety and reduced crime? How much is too little?

## Answer

Mull over these questions and discuss them in class or with colleagues if possible. It is possible to suggest answers, perhaps even in quantitative terms, but the point is that there are no **easy** answers, and no right or wrong answers.

Given the potential difficulty in defining the objectives of not-for-profit and public sector organisations precisely, you might feel there is little scope for measuring their performance. However, there is equally little scope to argue that such organisations should just be given whatever amount of money they say they need to pursue their aims, with no check on whether it is spent well or badly.

(a) Without information about what is being achieved (outputs) and what it is costing (inputs) it is impossible to make **efficient resource allocations**. These allocation decisions rely on a range of performance measures which, if unavailable, may lead managers to allocate resources based on subjective judgement, personal whim or in response to political pressure.

(b) Without performance measures managers will not know the **extent to which operations are contributing to effectiveness and efficiency;** when diagnostic interventions are necessary; how the performance of their organisation **compares** with similar units elsewhere; and how their performance has **changed** over time.

(c) **Government** may require performance information to decide how much to spend in the public sector and where, within the sector, it should be allocated. In particular they will be interested to know what results may be achieved as a consequence of a particular level of funding, or to decide whether or not a service could be delivered more effectively and efficiently in the private sector. Likewise **people who provide funds for** other kinds of non-profit seeking organisations are entitled to know whether their money is being put to good use.

Some kind of measure of '**value for money**' becomes particularly important in the context of **funding constraints** or limited funding which we referred to in the previous section.

## Question — Performance measures in a charity

What performance measures might be used by a famine relief charity?

## Answer

Some measures that might be used include:

- Income in donations, and changes in income over time
- Income by source – personal donations, corporate donations etc.
- Responses to campaign initiatives, such as television or newspaper advertisements, or appeals relating to specific crises
- Cost containment measures – such as management costs and other operating expenses. (This is particularly important as donors want to know that as much of their donation as possible is going to the famine relief, and charities are likely to be criticised if administration costs absorb a high proportion of income)
- Income from commercial activities (for example, charity shops)
- Number of volunteers attracted
- Changes in mortality and sickness rates in areas where relief has been provided.

You may have thought of other measures, but this list is an indicator of some of the measures which you could have suggested.

This question and answer are taken from an article on 'Not-for-profit organisation' by Robert Souster which was published in *Student Accountant* in October 2009. This article, and a companion article published in September 2009, provides some useful background information about objectives and management in not-for-profit organisations.

## 4.1 How can performance be measured?

FAST FORWARD

Performance is judged in terms of inputs and outputs and hence the **value for money criteria** of **economy, efficiency** and **effectiveness.**

As the performance of not-for-profit organisations cannot be properly assessed by using conventional accounting ratios (such as ROCE, ROI etc.) it is usually judged in terms of **inputs and outputs** instead, and this ties in with the 'value for money' criteria that are often used to assess non-profit seeking organisations. (We look at 'value for money' in more detail in Section 6).

(a) **Economy** (spending money frugally)
(b) **Efficiency** (getting out as much as possible for what goes in)
(c) **Effectiveness** (getting done, by means of the above, what was supposed to be done)

More formal definitions are as follows.

Key terms

**Effectiveness** is the relationship between an organisation's outputs and its objectives; the extent to which the organisation achieves its objectives.

**Efficiency** is the relationship between inputs and outputs; the 'output' of the organisation per unit of resource consumed.

**Economy** is the ability of the organisation to optimise its use of its productive resources; achieving the appropriate quantity and quality of inputs at the lowest cost possible.

We will look at these concepts in more depth in Section 6.

## 4.2 Problems with performance measurement of not-for-profit organisations

(a) **Multiple objectives**

As we have said, not-for profit organisations tend to have multiple objectives. Consequently, even if the different objectives can all be clearly identified it is impossible to say which the overriding objective is.

(b) **Measuring outputs**

Outputs can seldom be measured in a way that is generally agreed to be meaningful. (For example, are good exam results alone an adequate measure of the quality of teaching?) Equally, data collection can be problematic. For example, unreported crimes are not included in data used to measure the performance of a police force.

(c) **Lack of profit measure**

If an organisation is not expected to make a profit, or if it has no sales, indicators such as ROI and RI are meaningless.

(d) **Nature of service provided**

Many non-profit seeking organisations provide services for which it is difficult to define a cost unit. For example, what is the cost unit for a local fire service? This problem does exist for commercial service providers but problems of performance measurement are made simple because profit can be used.

(e) **Financial constraints**

Although every organisation operates under financial constraints, these are more pronounced in non-profit seeking organisations. For instance, a commercial organisation's borrowing power is effectively limited by managerial prudence and the willingness of lenders to lend, but a local authority's ability to raise finance (whether by borrowing or via local taxes) is subject to strict control by central government.

(f) **Political, social and legal considerations**

(i) Unlike commercial organisations, public sector organisations are subject to strong political influences. Local authorities, for example, have to carry out central government's policies as well as their own (possibly conflicting) policies.

(ii) The public may have higher expectations of public sector organisations than commercial organisations. A decision to close a local hospital in an effort to save costs, for example, is likely to be less acceptable to the public than the closure of a factory for the same reason.

(iii) The performance indicators of public sector organisations are subject to far more onerous legal requirements than those of private sector organisations. We consider this point in more detail in Section 5.

(iv) Whereas profit-seeking organisations are unlikely in the long term to continue services making a negative contribution, non-profit seeking organisations may be required to offer a range of services, even if some are uneconomic.

## 4.3 Possible solutions to these problems

### 4.3.1 Inputs

Performance can be judged in terms of inputs**.** This is very common in everyday life. If somebody tells you that their suit cost $750, you would generally conclude that it was an extremely well-designed and good quality suit, even if you did not think so when you first saw it. The drawback is that you might also conclude that the person wearing the suit had been cheated or was a fool, or you may happen to be of the opinion that no piece of clothing is worth $750. So it is with the inputs and outputs of a non-profit seeking organisation.

### 4.3.2 Judgement

A second possibility is to accept that performance measurement must to some extent be subjective**.** Judgements can be made by **experts** in that particular not-for-profit activity or by the **persons who fund the activity**.

### 4.3.3 Comparisons

We have said that most non-profit seeking organisations do not face competition but this does not mean that all are unique. Bodies like local governments, health services and so on can judge their performance **against each other** and **against the historical results of their predecessors**. And since they are not competing with each other, there is less of a problem with confidentiality and so **benchmarking** is easier.

### 4.3.4 Quantitative measures

**Unit cost measurements** like 'cost per patient day' or 'cost of borrowing one library book' can fairly easily be established to allow organisations to assess whether they are doing better or worse than their counterparts.

**Efficiency measurement of inputs and outputs** is illustrated in three different situations as follows.

(a) **Where input is fixed**

$$\frac{\text{Actual output}}{\text{Maximum output obtainable for a given input}}$$ 25/30 miles per gallon = 83.3% efficiency

(b) **Where output is fixed**

$$\frac{\text{Minimum input needed for a given output}}{\text{Actual input}}$$ 55/60 hours to erect scaffolding = 91.7% efficiency

(c) **Where input and output are both variable**

Actual output ÷ actual input
compared with
standard output ÷ standard input

$9,030/7,000 meals = $1.29 per meal

$9,600/7,500 meals = $1.28 per meal
Efficiency = 99.2%

As a further illustration, suppose that at a cost of $40,000 and 4,000 hours (inputs) in an average year two policemen travel 8,000 miles and are instrumental in 200 arrests (outputs). A large number of possibly meaningful measures can be derived from these few figures, as the table below shows.

| | *$40,000* | *4,000 hours* | *8,000 miles* | *200 arrests* |
|---|---|---|---|---|
| *Cost $40,000* | | $40,000/4,000 = $10 per hour | $40,000/8,000 = $5 per mile | $40,000/200 = $200 per arrest |
| *Time 4,000 hours* | 4,000/$40,000 = 6 minutes patrolling per $1 spent | | 4,000/8,000 = ½ hour to patrol 1 mile | 4,000/200 = 20 hours per arrest |
| *Miles 8,000* | 8,000/$40,000 = 0.2 of a mile per $1 | 8,000/4,000 = 2 miles patrolled per hour | | 8,000/200 = 40 miles per arrest |
| *Arrests 200* | 200/$40,000 = 1 arrest per $200 | 200/4,000 = 1 arrest every 20 hours | 200/8,000 = 1 arrest every 40 miles | |

These measures **do not necessarily identify cause and effect** (do teachers or equipment produce better exam results?) **or personal responsibility and accountability**. Actual performance needs to be compared as follows.

(a) With standards, if there are any
(b) With similar external activities
(c) With similar internal activities
(d) With targets
(e) With indices
(f) Over time, as trends

Non-profit seeking organisations are forced to use a **wide range** of indicators and can be considered early users of a **balanced scorecard** approach (covered in Chapter 13).

## 4.4 Not-for-profit organisations and profit-seeking bodies

If it has struck you when reading the previous sections that the main issue in the performance measurement of not-for-profit organisations is one of **quality,** you may be wondering whether the distinction between profit-seeking and not-for-profit in this context is worth making!

The answer, of course, is that increasingly it is not. The **commercial sector's new focus on customers and quality of service has much in common with the aims of non-profit seeking organisations**. Conversely **non-profit seeking organisations** (in particular government bodies) have increasingly been forced to **face up to elements of competition and market forces.**

The distinctions are thus becoming blurred. The problems of performance measurement in not-for-profit organisations are to a great extent the problems of performance measurement generally.

## Question



Can you think of some issues which would impact on the different performance indicators used by a public sector hospital (eg an NHS hospital in the UK) and a private sector hospital?

## Answer

- The private sector hospital would be focused on maximising **profit**, the NHS hospital on **cost efficiency.**
- Managers within a private sector hospital are likely to have far greater autonomy than those working in the NHS.
- A private sector hospital has far greater **freedom in selecting its patients** and the types of **treatment** offered. It can choose to specialise in the most profitable areas. An NHS hospital, unless it is a specialist centre, must treat all patients and offer a huge range of treatments.
- Private sector hospitals can **market** their services.

## Case Study

A recent review of information systems in public sector and private sector organisations (Kankanhalli & Kohli, 2009) observed some differences between the two sectors which we have already considered. The review also recorded how these affected attitudes to purchasing IT in the two sectors.

**Ownership**. The public sector was owned by its citizens whilst the private sector was owned by shareholders.

**Structures**. More likely to be centralised in the public sector whilst the private sector structure followed whatever suited the firm or strategy was adopted.

**Client relationship**. Government saw no need to build loyalty as it was monopolistic and there might be no specific client. Its client base was diverse. Private sector identified a client and sought to build loyalty.

**Goals**. The public sector sought to reach all citizens and be inclusive. The private sector rated profitability and shareholder return as most important.

**Means of evaluation**. The government sector rated social welfare highest whereas the private sector saw measures such as ROI as more important.

The report noted **some attitudes to purchasing IT** in each sector arising out of the differences listed.

**Public managers** were less likely to adopt new IT systems. They **were more risk averse** because they needed to satisfy so many different 'owners' and users. The **private sector** could justify investment if there was an **expectation of increasing market share and profit**.

**Public sector** organisations saw IT as a **cost-reduction exercise** that is doing more with the same number of employees. The **private sector** saw IT as a means of **increasing profitability**.

Because of the centralised structure and formal procedures for procurement, **there was far more complexity in making purchasing decisions in the public sector than the private sector**. This also meant a degree of rigidity in making decisions.

(Kankanhalli, A. & Kohli, R. Does public or private sector matter? An agenda for IS research in e-government. *Association for Information Systems 2009*)

## 4.5 Comparing the performance of profit-seeking and not-for-profit organisations

A valid comparison between such organisations may **require adjustments** to be made to data provided for analysis purposes. Here are some examples.

(a) If the not-for-profit organisation does not **charge for services**, a hypothetical amount may need to be included in profit calculations, possibly based on the number of customers who would be willing to pay.

(b) The not-for-profit organisation may have no debt (perhaps because it has been paid off by a governing body, a local authority and so on). Any **interest paid on debt** by the profit-seeking organisation may therefore need to be removed from profit calculations.

(c) Any **loss attributable to uneconomic sections/divisions/services** of the not-for-profit organisation (which it may be required to continue for social or legal purposes), may need to be removed for comparison purposes.

## 4.6 Using league tables

**League tables** are a readily-available data bank for users of public services ranking not-for-profit organisations on a range of measures such as mortality rates and completion rates for degree courses. They are compiled using benchmarks against comparative organisations and then ranked on the measures used.

### Question — League tables

What do you think might happen if a senior school (for pupils aged 11+) chooses to concentrate on its ranking in a league table for students achieving a set number of good passes (grades A to C in the UK) in their final exams?

### Answer

The school may succeed in getting students to pass the exams, but at the expense of other priorities. It is a criticism of league tables in the UK that where schools focus on this measure, they omit to help students who are not likely to meet the grades by making their priority the students who are likely to pass and boost this measure.

As the question above indicates, users of league tables need to be aware of their limitations and use them carefully.

If we continue the example of school league tables we can illustrate some of these limitations:

If the league tables are produced on the basis of academic results alone, they may reflect the **capability of the students** as much as the **quality of teaching** provided by the school. A school with academically gifted students is likely to show better results than a school with less talented students. Headline academic results, in themselves, do not provide a measure of the **value added** by the school, or the **effectiveness** of the education provided by the school. However, these ideas of 'value added' or 'effectiveness' are also much harder to quantify and measure.

Another issue is that each year, several organisations produce academic school league tables, as well as giving schools 'value-added' scores. However, each organisation has its own criteria and methodology for calculating which school is the 'best.' Therefore, the rankings are likely to differ from one league table to the next.

Finally, it is worth remembering that the primary focus on the league tables is on academic performance. However, the league table does not necessarily indicate that a school which ranks highly in the league tables will be the 'best' one for a specific child to go to. A pupil who is a gifted sportsperson but not particularly academic will not necessarily benefit from being at a school that is consistently at the top of the league table but which places little emphasis on sports and physical education.

Ultimately, the league tables can help parents who want to find out about the academic standing, but the parents have to use this information in conjunction with other research activities about the school.

## 4.7 Benchmarking

The principle of benchmarking is equally relevant to not-for-profit organisations as it is for profit-oriented ones: comparing operating performance and identifying the best practices can be beneficial to an organisation whatever its objectives.

Charities and public sector not-for-profit organisations are facing an increasing number of challenges. In particular, as public funding for a number of organisations is reduced (in the current economic downturn), the importance of funding raising programmes has increased as have pressures on internal cost management. Consequently, the organisations need to ensure all their services and processes are as **effective** and as **efficient** as possible. Benchmarking the performance of their services and processes against similar ones in other organisations can play a key role in improving efficiency and helping them achieve **value for money**.

However, organisations also need to be aware of the potential problems involved in benchmarking:

(a) It can be costly and time-consuming; an organisation needs to be sure the potential benefits of a benchmarking exercise justify the cost involved

(b) The activities or processes being benchmarked must be selected wisely, organisations should focus on those areas which use most resources or have the greatest impact on its critical success factors. However, it may prove difficult to compare performance in these activities or processes against other organisations.

(c) The processes being benchmarked must be similar enough to allow meaningful comparison

(d) It may be difficult to obtain comparable / relevant information from other organisations

(e) Benchmarking information must be interpreted carefully to ensure that different organisations record performance in a similar way and that comparisons are made on a like-for-like basis; equally external factors which may affect performance need to be accounted for.

## 4.8 Difficulties in deriving performance measures

We looked at the features of services in Chapter 3 earlier in the Text. The four facets of services – **simultaneity, heterogeneity, perishability** and **intangibility –** can make them difficult to measure quantitatively. These four facets are also characteristic of the activities in the majority of not-for-profit organisations, because they are service-providing organisations. This adds another level of complication to measuring the performance of not-for-profit organisations.

A hospital could report the *number* of operations it has carried out in a month, but this would not measure the quality of its procedures or patient care, not would it take account of the complexity of the operations being carried out. Often qualitative measures are used to capture aspects of service - such as quality and reliability. And it seems likely that some kind of qualitative measures will also be necessary to supplement quantitative measures of performance.

### Case Study

The National Health Service (NHS) has announced plans to introduce a 'patient rating system' to improve the quality of nursing care in England.

From April 2013, patients will be asked if they would recommend the hospital they were treated in to their friends and family, and the results will be made public.

However, these proposals highlight the potentially subjective nature of any such rating systems. In particular, what factors would determine whether a patient would 'recommend' a hospital to friends and family? The quality (and success) of any medical treatment received? The quality of the care the patient received from the staff looking after them? How quickly they were treated? Factors relating to the hospital itself (eg cleanliness, how crowded they were)?

# 5 Politics, performance measurement and undesirable service outcomes

FAST FORWARD

The combination of politics and the desire to measure public sector performance may result in **undesirable service outcomes.**

## 5.1 Performance measurement in the public sector

Performance measurement in the public sector has traditionally been perceived as presenting four **special difficulties.**

### 5.1.1 How to assess performance

With public sector services, there has **rarely been any market competition** and **no profit motive**. In the private sector, these two factors help to guide the process of fixing proper prices and managing resources economically, efficiently and effectively. Since most public sector organisations cannot be judged by their success against competition or by profitability, other methods of assessing performance have to be used.

### 5.1.2 Stakeholder expectations

**Different stakeholders hold different expectations** of public sector organisations. For example, parents, employers, the community at large and central government might require different things from the education sector. And even within groups of stakeholders, such as parents, there might be a mix of requirements. Priorities of all the groups might change over time. Schools have to reconcile the possibly conflicting demands made on them but to make explicit statements of objectives might show that they are favouring one group of stakeholder at the expense of another.

### 5.1.3 Influence of government

Given the role of government in public sector organisations, long-term organisational objectives are sometimes sacrificed for short-term political gains.

### 5.1.4 Defining performance measures

In the public sector, **performance measures are difficult to define**. Measures of output quantity and output quality themselves provide insufficient evidence of, for example, a local authority's success in serving the community.

### 5.1.5 Ways in which these problems could be managed/overcome

(a) Set up systems for regional benchmarking (making allowances for known regional differences).
(b) Change the way in which such organisations are controlled to restrict political interference.
(c) Carry out cost-benefit-analyses in an attempt to place a financial value on services being provided.
(d) Use independent agencies (of experts) to make objective decisions based upon their experience and information provided.

## 5.2 Performance indicators

During the 1980s, however, the increased availability of information technology led to a dramatic reduction in the cost of collecting data. This fuelled the practice of publishing information (**performance indicators**) about the performance of public sector bodies. This aimed to **overcome** the traditional **problems** of public sector performance measurement and enable various interested parties to **secure control** of public sector resources.

Whether within central government, local government or other public services (such as the NHS in the UK) public sector bodies are required to produce and publish key indicators on a variety of fronts.

## 5.3 Citizens' Charter

Many performance indicator schemes have been put in place, the most infamous of which is probably the Citizens' Charter in the UK. This was published in 1991 and **aims to hold public services to account** by publishing information about their activities and achievements.

(a) **Standards** are set and published in service **charters**.

(b) **Quality** is delivered by **privatising** or **contracting out** services.

(c) Services are monitored and compared by compiling **league tables** of performance and making them public.

(d) **Individuals** have **rights of redress** through complaints procedures.

The aim of the Charter is therefore to **turn the user into a consumer** operating in a public services marketplace, with **competing providers** to choose between and the **power to punish** them when performance falls below standard.

### 5.3.1 Parents' Charter

This contains a number of measures intended to make schools more sensitive to the demands of parents.

(a) Published **league tables** of public examinations results, truancy rates and destinations of pupils leaving school

(b) The right of **parents** to **express a preference** for the school their child should attend, offering parents some **sanction against poor performance**

### 5.3.2 Patients' Charter

(a) **Publication of performance data** including waiting times for outpatients' appointments and waiting times for ambulance services

(b) **Patients' rights**, includes guaranteed admission for inpatient treatment within a specified number of years of being placed on a waiting list

### 5.3.3 Clarity of objectives

The Citizens' Charter attempts to specify **consistent** and **unambiguous** quality of service standards as clearly and **succinctly** as possible in an attempt to overcome the traditional difficulty of measuring performance against unclear or multiple objectives.

(a) Quality of service standards can be specified in terms of problems like late trains in the same sort of way as in private sector airlines.

(b) The introduction of a national curriculum in schools has established a uniform standard of output for the whole country (although inputs in terms of students' abilities and prior education are uneven).

## 5.4 Examples of indicators

To assess **overall performance** of a public service (ie those areas/issues generally considered to be important), indicators can be usefully divided into three groups.

(a) **Financial indicators to measure efficiency**

(i) Cost per unit of activity (eg cost per arrest/bed-night in a hospital/pupil)

(ii) Variance analysis

(iii) Comparisons with benchmark information

(iv) Cost component as a proportion of total costs (eg administration costs as a proportion of total costs)

(v) Costs recovered as a proportion of costs incurred (eg payment received from householders requesting collection of bulky/unusual items of refuse)

(b) **Non-financial (quantifiable) indicators to measure effectiveness**

(i) Quality of service/output measures (eg exam results, crime rates)

(ii) Utilisation of resources (eg hospital bed occupancy ratios, average class sizes)

(iii) Flexibility/speed of response (eg hospital waiting lists)

(c) **Qualitative indicators to measure effectiveness**

(i) Workplace morale

(ii) Staff attitude to dealing with the public (eg can they provide the correct information in a helpful and professional manner)

(iii) Public confidence in the service being provided (eg will a pupil be well educated, a patient properly cared for)

We will be looking in more detail at various indicators later in this Study Text.

## 5.5 Undesirable service outcomes

The publication of league tables, such as those for schools, has been said to encourage **dubious comparisons**, however, and/or to lead to a **competitiveness which does not fit** with the nature of many of the services being provided.

For example, extra effort and expenditure on disruptive pupils may represent the **best way for a society as a whole** to deal with them, but a **school's best managerial strategy** is to exclude such pupils (and there has been a sharp rise recently in such exclusions) so as to improve performance for league table purposes.

Hospitals are under increasing pressure to **compete on price and delivery** in areas such as elective (in other words postponable) surgery such as hip and knee replacements. Although this **reduces waiting lists**, it may represent a **shift of resources from other, less measurable areas** such as emergency services. In attempting to reach a target of ensuring that no patient waits more than a certain number of years for an operation, patients awaiting serious surgery are said to have suffered longer waiting times as hospitals have concentrated on reducing the longer waiting times of those in need of relatively minor surgery. (This is an example of the problem of **measure fixation**, covered in Chapter 12.)

A recent debate on standards in higher education in the UK has focused on a number of criteria included in league tables of universities published by national newspapers. One issue is the number of students being awarded the top two classes of undergraduate degree which are 2:1 and 1st. Some commentators suggest this is grade inflation brought about by the publication of league tables ranking universities partly on the number of top degrees awarded. Another criterion is student satisfaction measured by responses in the National Student Survey. This also appears as a contributing factor in some league tables.

Case Study

'Eight British universities have been accused of putting undue pressure on students in an attempt to boost their position in crucial national league tables. Documents released under freedom of information show the universities were reported to the higher education funding body in the last two years over allegations they tried to persuade students to give their institutions high scores in the National Student Survey. The 22-question "student experience survey" is critical in determining universities' national rankings and their reputation with students and employers.'

(*The Guardian*, 26 April 2010)

### 5.6 Undesirable outcomes of reward systems

**What gets measured, gets done**

The management guru, Tom Peters, asserts that one of the best pieces of advice he has heard is that "What gets measured, gets done."

Although this adage is appropriate for both profit and not-for-profit organisations, it is perhaps particularly important in connection to performance measurement and reward systems in not-for-profit organisations.

In the UK, the government issues performance targets for government departments and public sector organisations and the level of resources allocated to the organisations is linked to how well they perform against the targets. In addition, individual providers of public services may also get specific rewards linked to their performance, either directly (the top performing hospitals gain 'earned autonomy' to authorise their own capital investments without having to gain approval from central government, for example) or indirectly (schools that perform well attract more students and hence more resources).

Not surprisingly, therefore, if the **targets focus on a particular aspect of performance**, that will be the aspect of performance the organisation will most want to try to achieve.

This is particularly important in public sector organisations which often have a number of different stakeholders (for example: service users, taxpayers and politicians) and therefore a number of potential different goals which may be in conflict. However, if one of these goals is prioritised as a key performance measure, this is the one the organisation is likely to focus on.

This is similar to some of the issues we identified with school league tables earlier. The key target indicator for schools in the UK is the percentage of students gaining at least five GCSE passes at grade C or above. But this could encourage teachers at a school to 'teach to the test' rather than providing a more rounded education for their pupils. Equally, it may encourage schools to adopt a selective admissions policy – in other word selecting students which it considers are academically more able and therefore more likely to improve its ranking.

## 6 Value for money

FAST FORWARD

Public sector organisations are now under considerable pressure to prove that they operate economically, efficiently and effectively, and are encouraged from many sources to draw up action plans to achieve **value for money** as part of the continuing process of good management.

Although much has been written about value for money (VFM), there is no great mystique about the concept. The term is common in everyday speech and so is the idea. If you have studied Paper F5, you should be familiar with the three 'E's of economy, efficiency and effectiveness.

Key term

**Value for money** means providing a service in a way which is economical, efficient and effective.

## Case Study

To drive the point home, think of a bottle of Fairy Liquid (washing-up liquid). If we believe the advertising, Fairy is good 'value for money' because it washes half as many plates again as any other washing up liquid. Bottle for bottle it may be more expensive than some other brands of washing-up liquid, but plate for plate it is cheaper. Not only this but Fairy gets plates 'squeaky' clean. To summarise, Fairy gives us VFM because it exhibits the following characteristics.

(a) **Economy** (more clean plates per pound)
(b) **Efficiency** (more clean plates per squirt)
(c) **Effectiveness** (gets plates as clean as they can be)

The assessment of economy, efficiency and effectiveness should be a part of the normal management process of any organisation, public or private.

(a) Management should carry out **performance reviews** as a regular feature of their control responsibilities.
(b) Independent assessments of management performance can be carried out by 'outsiders', perhaps an internal audit department, as **value for money audits (VFM audits).**

Value for money is important **whatever level of expenditure** is being considered. Negatively it may be seen as an approach to spreading costs in public expenditure fairly across services but positively it is necessary to ensure that the desired impact is achieved with the minimum use of resources.

### 6.1 Studying and measuring the three Es

Economy, efficiency and effectiveness can be studied and measured with reference to the following.

(a) **Inputs**

 (i) Money
 (ii) Resources – the labour, materials, time and so on consumed, and their cost

 For example, a VFM audit into state secondary education would look at the efficiency and economy of the use of resources for education (the use of schoolteachers, school buildings, equipment, cash) and whether the resources are being used for their purpose: what is the pupil/teacher ratio and are trained teachers being fully used to teach the subjects they have been trained for?

(b) **Outputs**, in other words the **results of an activity**, measurable as the services actually produced, and the quality of the services.

 In the case of a VFM audit of secondary education, outputs would be measured as the number of pupils taught and the number of subjects taught per pupil; how many examination papers are taken and what is the pass rate; what proportion of students go on to further education (eg at university).

(c) **Impacts**, which are the **effect that the outputs** of an activity or programme have in **terms of achieving policy objectives.**

Policy objectives might be to provide a minimum level of education to all children up to the age of 16, and to make education relevant for the children's future jobs and careers. This might be measured by the ratio of jobs vacant to unemployed school leavers. A VFM audit could assess to what extent this objective is being achieved.

As another example from education, suppose that there is a programme to build a new school in an area. The **inputs** would be the **costs of building** the school, and the resources used up; the **outputs** would be the **school building** itself; and the **impacts** would be the **effect that the new school has on education in the area** it serves.

## 6.2 VFM audits and objectives

In a VFM audit, the objectives of a particular programme or activity need to be specified and understood in order for the auditor to make a proper assessment of whether value for money has been achieved.

(a) In a **profit seeking organisation**, objectives can be expressed financially in terms of target profit or return. The organisation, and profit centres within it, can be judged to have operated **effectively** if they have **achieved a target profit** within a given period.

(b) In **non-profit seeking organisations**, effectiveness cannot be measured this way, because the organisation has non-financial objectives. The **effectiveness** of performance in such organisations could be measured in terms of whether **targeted non-financial objectives have been achieved**, but as we have seen there are several problems involved in trying to do this.

## 6.3 Example: assessing achievement of VFM

An example which has been cited is a decision by the government that hill farmers should be paid an allowance or subsidy. The allowances or subsidies could be paid economically and efficiently, but an auditor in a VFM audit would need to know why the allowance or subsidy was being paid to decide whether VFM had been achieved.

Suppose that the purpose of the subsidy was to encourage farmers to continue farming in hill areas so as to provide employment for the rural population. Farmers might use their allowance to buy labour–saving machinery, with the 'impact' that jobs were lost in hill farming. In such a situation a VFM audit would reveal that **VFM had not been achieved** because the objective of the program of allowances/subsidies **had not achieved the stated objective** and even had the opposite effect.

## Chapter Roundup

- **Corporate objectives** concern the firm as a whole. **Unit objectives** are specific to individual units of an organisation. These will differ depending on the organisation. We have given examples of objectives found in different types of organisation. You may have examples of your own.
- One possible definition of a **not-for-profit organisation** is that its first objective is to be involved in non-loss operations to cover its costs, profits only being made as a means to an end.
- The range of **objectives** of not-for-profit organisations is as wide as the range of non-profit seeking organisations.
- **Public sector organisations** have limited control over both the level of **funding** they receive and, to an extent, the objectives they can achieve.
- Not-for-profit organisations tend to have **multiple objectives** which are **difficult to define.** There are a range of other problems in measuring performance.
- Performance is judged in terms of inputs and outputs and hence the **value for money criteria** of **economy, efficiency** and **effectiveness.**
- The combination of politics and the desire to measure public sector performance may result in **undesirable service outcomes.**
- Public sector organisations are now under considerable pressure to prove that they operate economically, efficiently and effectively, and are encouraged from many sources to draw up action plans to achieve **value for money** as part of the continuing process of good management.

## Quick Quiz

1 Which one of the following groups are NOT stakeholders in not-for-profit organisations?

A Employees
B Volunteers
C Shareholders
D Funding providers

2 What general objectives of non-profit seeking organisations are being described in each of the following?

(a) Maximising what is offered
(b) Satisfying the wants of staff and volunteers
(c) Equivalent to profit maximisation
(d) Matching capacity available

3 *Match the definition to the term.*

| *Terms* | | *Definition* | |
|---|---|---|---|
| (a) | Economy | (1) | Ensuring outputs succeed in achieving objectives |
| (b) | Efficiency | (2) | Getting out as much as possible for what goes in |
| (c) | Effectiveness | (3) | Spending money frugally |

4 List three sources of funds for not-for-profit organisations.

5 Six problems of measuring performance in non-profit seeking organisations were described in this chapter. Which two are missing from the list below?

| | | | |
|---|---|---|---|
| (a) | Multiple objectives | (c) | Lack of profit measure |
| (b) | Measuring output | (d) | Nature of service provided |

# Answers to Quick Quiz

1 C One of the key distinctions between not-for-profit (NFP) organisations and commercial, private sector companies is that NFPs do not have shareholders, and consequently they do not have to earn profits for their shareholders.

2 (a) Budget maximisation
(b) Producer satisfaction maximisation
(c) Surplus maximisation
(d) Usage targeting

3 (a) (3); (b) (2); (c) (1)

4 Possible answers include:

Government funding (eg grants)
Donations (eg bequests from individuals, or corporate donations)
'Self'-funding (eg charity shops raise money for charities; universities charge fees to students)
Fundraising activities (eg sponsored events)

5 Financial constraints
Political/social/legal considerations

Now try the question below from the Question Bank

| Number | Level | Marks | Time |
|---|---|---|---|
| Q14 | Examination | 20 | 36 mins |

# Not-for-profit organisations – part 1



**Several papers in the ACCA Qualification may feature questions on not-for-profit organisations. Although many of the principles of management and organisation apply to most business models, not-for-profit organisations have numerous features that distinguish them from the profit maximising organisations often assumed in conventional economic theory.**

This article explains some of these features. The first part of the article broadly describes the generic characteristics of not-for-profit organisations. The second part of the article takes a specific and deeper look at charities, which are one of the more important types of not-for-profit organisations.

## What is a not-for-profit organisation?

It would be simplistic to assume that any organisation that does not pursue profit as an objective is a not-for-profit organisation. This is an incorrect assumption, as many such organisations do make a profit every year and overtly include this in their formal plans. Quite often, they will describe their profit as a 'surplus' rather than a profit, but as either term can be defined as an excess of income over expenditure, the difference may be considered rather semantic.

Not-for-profit organisations are distinguished from profit maximising organisations by three characteristics. First, most not-for-profit organisations do not have external shareholders providing risk capital for the business. Second, and building on the first point, they do not distribute dividends, so any profit (or surplus) that is generated is retained by the business as a further source of capital. Third, their objectives usually include some social, cultural, philanthropic, welfare or environmental dimension, which in their absence, would not be readily provided efficiently through the workings of the market system.

# Types of not-for-profit organisation

Not-for-profit organisations exist in both the public sector and the private sector. Most, but not all, public sector organisations do not have profit as their primary objective and were established in order to provide what economists refer to as public goods. These are mainly services that would not be available at the right price to those who need to use them (such as medical care, museums, art galleries and some forms of transportation), or could not be provided at all through the market (such as defence and regulation of markets and businesses). Private sector examples include most forms of charity and self-help organisations, such as housing associations that provide housing for low income and minority groups, sports associations (many football supporters' trusts are set up as industrial and provident societies), scientific research foundations and environmental groups.

# Corporate form

Not-for-profit organisations can be established as incorporated or unincorporated bodies. The common business forms include the following:

- in the public sector, they may be departments or agents of government
- some public sector bodies are established as private companies limited by guarantee, including the Financial Services Authority (the UK financial services regulator)
- in the private sector they may be established as cooperatives, industrial or provident societies (a specific type of mutual organisation, owned by its members), by trust, as limited companies or simply as clubs or associations.

A cooperative is a body owned by its members, and usually governed on the basis of 'one member, one vote'.

A trust is an entity specifically constituted to achieve certain objectives. The trustees are appointed by the founders to manage the funds and ensure compliance with the objectives of the trust. Many private foundations (charities that do not solicit funds from the general public) are set up as trusts.

# Formation, constitution, and objectives

Not-for-profit organisations are invariably set up with a purpose or set of purposes in mind, and the organisation will be expected to pursue such objectives beyond the lifetime of the founders. On establishment, the founders will decide on the type of organisation and put in place a constitution that will reflect their goals. The constitutional base of the organisation will be dictated by its legal form.

If it is a company, it will have a Memorandum and Articles of Association, with the contents of the latter entrenched to ensure that the objectives cannot be altered easily in the future. Not-for-profit organisations that are not companies most commonly have a set of Rules, which are broadly equivalent to Articles of Association.

As with any type of organisation, the objectives of not-for-profit organisations are laid down by the founders and their successors in management. Unlike profit maximisers, however, the broad strategic objectives of not-for-profit organisations will tend not to change over time.

The purposes of the latter are most often dictated by the underlying founding principles. Within these broad objectives, however, the focus of activity may change quite markedly. For example, during the 1990s the British Know-How Fund, which was established by the UK government to provide development aid, switched its focus away from the emerging central European nations in favour of African nations.

It is important to recognise that although not-for-profit organisations do not maximise profit as a primary objective, many are expected to be self-financing and, therefore, generate profit in order to survive and grow. Even if their activities rely to some extent on external grants or subventions, the providers of this finance invariably expect the organisation to be as financially self-reliant as possible.

As the performance of not-for-profit organisations cannot be properly assessed by conventional accounting ratios, such as ROCE, ROI, etc, it often has to be assessed with reference to other measures. Most not-for-profit organisations rely on measures that estimate the performance of the organisation in relation to:

- effectiveness – the extent to which the organisation achieves its objectives
- economy – the ability of the organisation to optimise the use of its productive resources (often assessed in relation to cost containment)
- efficiency – the 'output' of the organisation per unit of resource consumed.

Many service-orientated organisations use 'value for money' indicators that can be used to assess performance against objectives. Where the organisation has public accountability, performance measures can also be published to demonstrate that funds have been used in the most cost-effective manner.

It is important within an exam question to read the clues given by the examiner regarding what is important to the organisation and what are its guiding principles, and to use these when assessing the performance of the organisation.

# Management

The management structure of not-for-profit organisations resembles that of profit maximisers, though the terms used to describe certain bodies and officers may differ somewhat.

While limited companies have a board of directors comprising executive and non-executive directors, many not-for-profit organisations are managed by a Council or Board of Management whose role is to ensure adherence to the founding objectives. In recent times there has been some convergence between how companies and not-for-profit organisations are managed, including increasing reliance on non-executive officers (notably in respect of the scrutiny or oversight role) and the employment of 'career' executives to run the business on a daily basis.

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# Not-for-profit organisations - part 2 Charities



**The term 'charity' refers to the practice of benevolent giving. Charities are established for general or specific philanthropic purposes.**

They are one type of not-for-profit organisation, but with several additional distinguishing features:

- they exist entirely to benefit defined groups in society
- as their purposes are philanthropic, they can usually avail themselves of favourable tax treatment, and for this reason have to be registered with a regulator
- their activities are restricted or limited by a regulator
- they rely on the financial support of the public or businesses (or both) in order to achieve their objectives
- in order to be financially viable, they rely heavily on voluntary (unpaid) managers and workers.

# Charitable activities

In the UK, charities are regulated by the Charities Act 2006, which sets out in very broad terms what may be considered to be charitable activities, many of which would be considered as such in other jurisdictions within most other countries. These include:

- the prevention or relief of poverty
- the advancement of education
- the advancement of religion
- the advancement of health or the saving of lives
- the advancement of citizenship or community development the advancement of the arts, culture, heritage or science
- the advancement of amateur sport
- the advancement of human rights, conflict resolution or reconciliation or the promotion of religious or racial harmony or equality and diversity
- the advancement of environmental protection or improvement
- the relief of those in need, by reason of youth, age, ill-health, disability, financial hardship or other disadvantage
- the advancement of animal welfare
- the promotion of the efficiency of the armed forces of the Crown or of the police, fire and rescue services or ambulance services
- other purposes currently recognised as charitable and any new charitable purposes which are similar to another charitable purpose.

The activities of charities in England and Wales are regulated by the Charity Commission, itself a not-for-profit organisation, located in Liverpool. The precise definition of what constitutes charitable activities differs, of course, from country to country. However, most of the activities listed above would be considered as charitable, as they would seldom be associated with commercial organisations.

# Corporate form

Charities differ widely in respect of their size, objectives and activities. For example, Oxfam is a federal international organisation comprising 13 different bodies across all continents, while many thousands of charities are local organisations managed and staffed entirely by volunteers.

Unsurprisingly, most of the constituent organisations within Oxfam operate as limited companies, while local charities would find this form inappropriate and prefer to be established as associations.

A charity is not forbidden from engaging in commercial activities provided that these activities fully serve the objectives of the charity. For example, charities such as the British Heart Foundation, the British Red Cross, and Age Concern all raise funds by operating chains of retail shops. These shops are profitable businesses, but if a company is formed to operate the shops, the company would be expected to formally covenant its entire annual profits to the charity.

Charities with high value non-current assets, such as real estate, usually vest the ownership of such assets to independent guardian trustees, whose role is to ensure that the assets are deployed in a manner that reflects the objectives of the charity.

The guardian trustees are empowered to lease land, subject to the provisions of the lease satisfying requirements laid down by the Charity Commission.

## Formation, constitution and objectives

Charities are always formed with specific philanthropic purposes in mind. These purposes may be expanded or varied over time, provided the underlying purpose remains. For example, Oxfam was originally formed as the Oxford Committee for Famine Relief in 1942, and its original purpose was to relieve the famine in Greece brought about by the Allied blockade. Oxfam now provides famine relief on a worldwide basis.

The governing constitution of a charity is normally set down in its rules, which expand on the purposes of the business. Quite often, the constitution dictates what the organisation cannot do, as well as what it can do.

Charities plan and control their activities with reference to measures of effectiveness, economy and efficiency. They often publish their performance outcomes in order to convince the giving public that the good causes that they support ultimately benefit from charitable activities.

## Management

Most charities are managed by a Council, made up entirely of volunteers. These are broadly equivalent to non-executive directors in limited companies. It is the responsibility of the Council to chart the medium to long-term strategy of the charity and to ensure that objectives are met.

Objectives may change over time due to changes in the external environment in which the charity operates. Barnardos is a childrens' charity that was originally founded as Doctor Barnado's Homes, to provide for orphans who could not rely on family support.

The development of welfare services after World War II and the increasing willingness of families to adopt and foster children resulted in less reliance on the provision of residential homes for children but greater reliance on other support services. As a result, the Barnardos charity had to change the way in which it looked at maximising the welfare of orphaned children.

Local charities are dependent on the support of a more limited population and therefore have to consider whether their supporters will continue to provide the finance necessary to operate continuously. For example, a local charity supporting disabled sports could be profoundly affected by the development of facilities funded by central or local government.

Every charity is confronted by distinctive strategic and operational risks, of which the Council must take account in developing and implementing its plans. International aid charities are vulnerable to country risk and currency risk, so plans have to take account of local conditions in countries whose populations they serve. Many such countries may, of course, be inherently unstable politically.

Operational risk for charities arises from the high dependence on volunteer workers, including the extent to which they can rely on continued support, as well as problems of internal control. For example, many charities staff their shops with the help of unpaid retired people, but there is some debate as to whether future generations of retired people will be as willing to do this for nothing.

As many charities have to contain operating expenses in order to ensure that their objectives can be met, it is often difficult or impossible for them to employ full time or part time paid staff to replace volunteer workers.

Risks also arise from the social environment, particularly in times of recession, when members of the public may be less disposed to give to benefit others as their discretionary household income is reduced.

There is some evidence of ‘charity fatigue’ in the UK. This arises when the public feel pressurised by so many different competing charities that they feel ill-disposed to give anything to anyone at all.

**Test how much of this article, and Part 1 of the article, you have understood below.**

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# Check your understanding

Test your knowledge by answering these self-test questions – the questions are based on both this article and Part 1.

**Question 1**
What performance measures might be used by a famine relief charity?

**Question 2**
Why do individuals give to charities?

**Question 3**
XYZ Charity provides local community facilities for disabled persons participating in sports. Its management committee wishes to outsource the operation of its club premises and land to a specialist organisation. What conditions might be imposed by the governing council of XYZ Charity?

**Answers**

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