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Proposed Model of the Relationship between Internal Governance Mechanism and Sustainability of Social Enterprises

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Abstract

A proper governance system and legal structure under which social enterprises can be established and operated are currently not in place in Malaysia. This study aims to examine the direct relationship between internal governance mechanism and sustainability of social enterprises. The board structure and characteristics are the emphasis of the internal governance mechanisms in this research. Meanwhile, financial, non-financial and social or environmental sustainability performance are combined to determine the success of social enterprises which refer to social enterprise's ability to sustain and survive. Based on the proposed conceptual model, this study concludes that internal governance encompasses important mechanisms that can be controlled within the organisation that are crucial for the sustainability of social enterprises as an emerging sector in Malaysia.

Keywords: Internal Governance, Social Enterprise, Sustainability, Board Characteristics, Firm Performance and Survival

Introduction

The Malaysian government acknowledges the importance of social enterprise in delivering the government's function to provide social or environmental solutions. As such, a substantial amount of funds is allocated to accelerate the social enterprise ecosystem in Malaysia. A blueprint of the Malaysian Global Innovation and Creativity Centre¹ (MaGIC), the Malaysia Social Enterprise Blueprint 2015 – 2018 (MSEB 2015 – 2018), was also recently published to support this effort. By the year 2018, the Malaysian social enterprise sector is anticipated to be “self-sustaining, equitable, and people-centric in order to empower impact-driven entrepreneurs”.

¹ Malaysian Global Innovation and Creativity Centre (MaGIC) was launched in order “to catalyse the entrepreneurial ecosystem in Malaysia, bringing together the abundant resources from partners and communities alike, and to develop entrepreneurs of enduring, high growth start-ups that will make a positive impact at a regional or global scale” (www.mymagic.my).

Nevertheless, the emerging sector may have difficulties to sustain, survive, grow, and ensure the continuation of its activities. The blueprint underlines one of the challenges is the lack of proper internal governance to administer the social enterprise sector. Moreover, a national survey of 144 Malaysian organisations in the sector was conducted by MaGIC Social Entrepreneurship Unit² (MaGIC SE) in 2015. The results indicated that a majority of social enterprises were financially immature, underperforming, and unable to survive. The lack of proper internal governance and poor financial performance in social enterprises will impair their ability to continue to exist in the long term. Using the resource dependence theory (Pfeffer & Salancik, 1978), this study emphasises the importance of the board structure in social enterprises to access the critical resources that are essential for the survival and sustainability of the organisation in the long term. Accordingly, a study of social enterprises is timely and crucial to address these issues.

Social enterprise as an emerging sector in Malaysia

The social enterprise sector is now a focus of the Malaysian Government due to its potential to promote a sustainable and equitable society and economic growth (Malaysian Global Innovation and Creativity Centre (MaGIC), 2015). One approach to achieve an equitable society and economic growth is by improving the well-being of the bottom-class society. To that end, the Malaysian Government aims to uplift the quality of life of its citizens (*rakyat*) by providing business opportunities via social enterprise that comprises social-based entrepreneurial business activities. This scheme to boost the number of social enterprises has two main objectives in assisting the community. First is by resolving social or environmental problems and second, by earning extra income for a better quality of life. The importance of social enterprises in addressing social or environmental problems has been recognised by the Malaysian Government.

Internal Governance Mechanism

A proper internal governance structure to administer the social enterprise sector in Malaysia is essential. As the blueprint highlights the current lack of proper governance for social enterprises in Malaysia, the internal governance mechanisms for this emerging sector become the core focus of this study. This research examines the key features of the internal governance board structures that are adopted by various types of social enterprises in Malaysia. Subsequently, the ideal internal governance mechanism, particularly the internal governance board structure that is most suitable for the social enterprise sector in Malaysia, is proposed.

Notably, internal capability is a vital element that influences external resources to drive the organisation towards enhanced sustainability or survivability in delivering its services (Bloom & Chatterji 2009). Therefore, the internal governance mechanism plays a more important role compared to the external governance mechanism considering the nature of social enterprises which comprise both profit and social motives. Proper internal governance promotes the sustainability and success of social enterprises. Hence, this research selects the internal governance mechanism as a main driver that affects the sustainability of social enterprises.

² MAGIC Social Entrepreneurship (MaGIC SE) is a dedicated team within MaGIC that is responsible for fulfilling the mandate given by the Government to develop the social enterprise sector in Malaysia through its special allocation of RM20 million funding.

Firm governance is essential for an organisation as it is able to influence their performance and survival (Renders, Ann, & Sercu, 2010). Notably, the internal governance has a strong effect on the sustainability performance of social enterprises. Thus, this research examines the relationship of the internal governance mechanism (board structure), as critical resources and key success factors for the development, survival, and sustainability of social enterprises. Firm governance is essential for an organisation as it is able to influence its performance and survival (Renders, Ann, & Sercu, 2010).

Governance is clearly a key factor to the success of the social enterprise in both business and social terms. It is interesting to explore it due to its unique features. Governance plays an important role as one of the key success factors for social enterprises as business owners need to balance between the economic, social and multiple stakeholder objectives. With good governance, the risk of an organisation's potential failure will be reduced. On the other hand, poor governance would lead to unfavourable consequences on organisational performance and accountability (Brahimi et al. 2013).

Sustainability Performance

An organisation's sustainability can be defined as the ability of an organisation to survive so that it can continue to serve its constituency by giving full commitment to its clients, patrons, and the community in which it operates. In addition, the needy can place their trust in the commitment made by the organisation (Weerawardena, McDonald, & Mort, 2009). The essential aspect of firm sustainability is the integration of both financial performance and social or environmental performance dimensions (Aras & Crowther 2008; Arena, Azzone, & Bengo 2015; Bagnoli & Megali, 2011). Notably, monitoring the sustainability performance of social enterprises is a complex process because they have to maintain both profit and social missions at the same time (Abdul & Sarif, 2015; Jenner & Authors, 2016).

Measuring performance of a social enterprise is not an easy task, as it requires the consideration of a variety of objectives and involves various stakeholders, which contributes to conflicting interests (Kerlin, 2006). Social enterprises can be operated in various sectors or activities. This leads to certain barriers such as diversity in information needs among the interested parties, differing expectations from stakeholders, and also different ways in measuring performances of social enterprises. This barrier results in difficulties to define a unique framework that could be applied to social enterprises across different fields or contexts (Arena et al., 2015). The significant role of performance measurement is for monitoring business progress; monitoring the effect of strategies and plans; diagnosis; supporting decision making; and facilitation of motivation and communication (Jenatabadi, 2015). Academicians and the not-for-profit practitioners deem financial performance measures as more valuable compared to another type of performance such as learning and growth as financial performance helps the organisation to sustain the enterprise's overall performance (Gamble & Beer, 2015).

In the Malaysian context, as the social enterprise sector is still in its infancy, the consideration of the profit motive or the need to remain in an economically viable state is still relevant and important for the survivability of social enterprise. Strengthening resourcing and applying commercial strategies in social enterprise is necessary to facilitate sustainability, growth, and

achievement of both social and economic goals (Jenner & Authors, 2016). As a result, social enterprises have to maintain both profit and social missions at the same time. In this study, financial, non-financial and social or environmental performance are combined to determine the success of social enterprises which refer to a social enterprise's ability to sustain and survive.

Hence, as social enterprises have the purpose of a non-profit and for-profit at the same time, this research measures the sustainability of social enterprises based on financial (Beuren, Hein & Klann, 2008; Orlitzky, Schmidt & Rynes, 2003; van Essen, van Oosterhout & Carney, 2012), non-financial performance (Gainer & Padanyi, 2004; Grieco, Michelini & Iasevoli, 2014) and social or environmental performance dimensions using the proposed model by Ebrahim & Rangan (2014). Both financial and social or environmental performance dimensions are equally important; the financial performance dimension is a vital aspect of sustainability as it will lead to better performance in the social or environmental dimension, and vice versa.

Relationship between internal governance mechanism and sustainability

There are prior studies that explore the relationship between internal governance mechanism and firm performance (e.g Dalton, Daily, Johnson, & Ellstrand, (1999), Johl, Kaur, & Cooper (2015), Pearce & Zahra, (2012) and Mair, Mayer & Lutz, (2015)) as an indicator of a successful resource dependence strategy. Dalton et al. (1999) in their study using meta-analysis review found a positive relationship between board size and firm financial performance. Firms in highly regulated industries tend to have a higher proportion of stakeholder directors (Luoma & Goodstein, 1999) and that stakeholder directors are more likely to improve corporate social performance (Johnson & Greening, 1999). However, issues on boards of directors are common in the commercial sector, boards of directors are also crucial to the success of the social enterprise as they ensure accountability, legitimacy, and transparency in the operations of such organisations (Spear, Cornforth, & Aiken, 2009).

Recent studies, from the resource dependence theory perspective, Bendickson et al. (2015) found that large or small firms moderate the relationship between board member diversity and board member function in monitoring and provision of the resource. As compared to a large firm, small firms can enhance performance through an appropriate member composition in differing ways. Board composition is found positively associated with future measurements of corporate financial performance (Pearce & Zahra, 2012). Daily and Dalton (2015) examined the impact of governance (board structure) on financial performance in smaller corporations. They found no financial benefit for having outside directors in the small or entrepreneurial corporation as they actively seek the advice and counsel of their knowledgeable and available inside directors to acquire resources and expertise from the external operating environment. Regardless the size of the organisations, the person sitting on the boards plays an important function with strong power to reduce uncertainty, influencing a successful utilisation of resources provided which will lead to better performance. If a social enterprise has a formal internal governance structure, it will ensure a good strategic direction, governed in a fair and transparent manner in achieving its social and environmental mission and objectives and it may influence a better performance. From these, the following relationship is hypothesised:

H₁: There is a relationship between internal governance mechanisms and sustainability performance of social enterprise.

Proposed Model

The issue on how the managing board ultimately impacts social enterprise performance received little attention by scholars. Therefore, the current study has proposed the direct relationship between internal governance mechanisms and the sustainability of social enterprise.

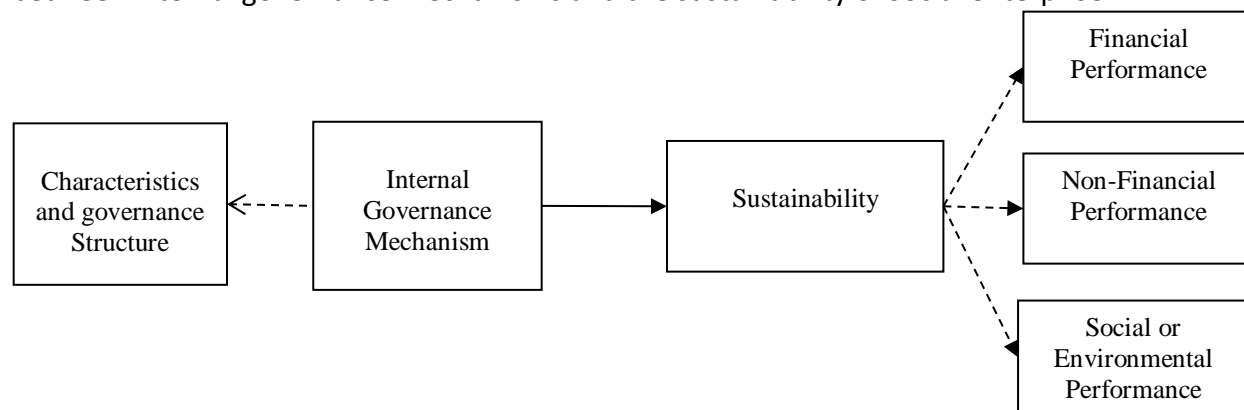


Figure 1. Proposed model of relationship between internal governance mechanism and sustainability.

Conclusion

Although the development of social enterprise in Malaysia is still in a nascent stage, it now becomes an important agenda to spearhead the growth of social enterprises to be at least at the same level with other Southeast Asian countries such as Thailand, Singapore, and Philippines. Social enterprises have both profit and social motives but they are most likely unable to sustain or survive in this new sector as the profit motives do not exist and are not the priority (Galvin & Iannotti, 2015). As the social enterprise in Malaysia is an emerging sector, baseline indicators such as the board characteristics of internal governance have to be established and prioritised in order to survive. The survival of social enterprises can be likened to an individual's need for food and water as part of basic survival in everyday life.

Similar to the commercial firms, social enterprises need to have a proper governance in order to operate and run their social or environmental activities and survive in the long term. This survivability demonstrates the sustainability of the social enterprise sector. These issues motivate the current study to bridge the practical or industry gap between the expectation of the government on social enterprises to deliver government's function in improving the citizen's quality of life and the reality of a lack of proper internal governance that is available for this new sector in Malaysia. Accordingly, a study of social enterprises is timely and crucial to address these issues. Hence, a study on board characteristics of social enterprises and sustainability performance of social enterprises is crucial to help this organisation to continuously deliver impactful activities to the society. This study proposed the relationship of internal governance mechanism (board characteristics) and sustainability performance of social enterprises.

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