



# The strategic importance of intellectual capital in the non-profit sector

IC in the non-profit sector

Eric Kong

*School of Commerce, Charles Sturt University, Wagga Wagga, Australia*

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## Abstract

**Purpose** – This paper aims to examine five key strategic management concepts: industrial organisation (I/O), resource-based view (RBV), knowledge-based view (KBV), balanced scorecard (BSC) and intellectual capital (IC) within the non-profit context and to determine which is most applicable in the non-profit sector.

**Design/methodology/approach** – This paper reviews the above concepts in the light of the unique non-profit environment.

**Findings** – The IC concept is more effective compared with other strategic management concepts within the non-profit context. IC is an important resource that non-profit organisations need to develop in order to gain sustained strategic advantage.

**Research limitations/implications** – This paper helps to build a nascent body of literature suggesting that the concept of IC is the most effective strategic management concept in NPOs. The increased awareness of the IC concept in the sector, as a result of this paper, is likely to generate further research from both non-profit practitioners and scholars.

**Originality/value** – Very little systematic research has reviewed the applicability of strategic management concepts within the non-profit context. The paper acts as the first attempt to fill this gap.

**Keywords** Intellectual capital, Non-profit organizations, Strategic management

**Paper type** Literature review

## Introduction

Non-profit organisations (NPOs) are today commonly operating in a highly competitive environment that is characterised by increasing demand of services from the community, growing competition for contracts with the public and for-profit sector (Ramia and Carney, 2003), declining volunteer support (Lyons, 2001) and a generally tighter government funding source (Craig *et al.*, 2004). The need for competent strategic management concepts that are able to fit in the unique non-profit environments has become widely accepted (Backman *et al.*, 2000; Salamon *et al.*, 1999; Stone *et al.*, 1999).

The field of strategic management has been dramatic in the last three decades (Hoskisson *et al.*, 1999; Wright *et al.*, 1994). Many strategic management concepts such as industrial organisation (I/O), resource-based view (RBV), knowledge-based view (KBV), balanced scorecard (BSC) and intellectual capital (IC) have emerged. However, unlike the other strategy concepts, IC stresses qualitative, non-financial indicators for future strategic prospects and may be harnessed to co-ordinate with the unique environment in which NPOs operate. IC contributes to NPOs' strategic positioning by providing enhanced understanding of the allocation of organisational resources. Simultaneously, IC enables NPOs to enhance their performance by providing meaningful information to organisational stakeholders. In these ways, IC aids the



organisations in their attempts to reconcile their social and commercial objectives. As will be demonstrated in this paper, IC is the most appropriate strategic management concept for NPOs.

This paper is divided into three main parts. First, it provides a brief outline of the four strategic management concepts, including industrial organisation (I/O), resource-based view (RBV), knowledge-based view (KBV) and balanced scorecard (BSC), within the non-profit context. It is argued that the concepts are inapplicable in the non-profit sector. Second, an overview of the emergence, the concept and the three component parts of IC is presented. Finally, the strategic importance of IC in NPOs is reviewed. This paper argues that IC is an alternative strategic management conceptual framework within the unique non-profit environment.

### **Industrial organisation (I/O)**

The industrial organisation (I/O) is one of the most popular strategic management concepts, and emphasises the external environmental determinants of organisational performance (Porter, 1985, 1996, 1998). The I/O school of strategy stresses choosing an appropriate industry and positioning an organisation within that industry according to a generic strategy of either low cost or product differentiation (Zack, 2005). However, the I/O school of strategy is inapplicable in the non-profit sector as it induces NPOs to demonstrate, using market logic, their differences from competitors in their field (Goold, 1997). They are urged to do a better job of positioning and differentiating their services in the sector (Chetkovich and Frumkin, 2003) so that they can convince their stakeholders, especially fund providers, that they deserve resources more than their competitors (Barman, 2002). Differentiation leads to the construction of a hierarchy of comparison between NPOs and their competitors according to certain measures or criteria such as cost and benefit calculus or bottom-line measurement, in which NPOs attempt to come out on the top of the hierarchy (Barman, 2002). However, the organisations often have goals that are amorphous and offer services that are intangible (Forbes, 1998). Accordingly, the success of NPOs cannot be measured by how closely the organisations keep to budgeted spending (Kaplan, 2001).

### **Resource-based view (RBV) and core competency**

A resource-based approach to strategic management focuses on the costly-to-copy attributes of an organisation as the fundamental drivers of performance and competitive advantage (Bontis, 2002; Peteraf, 1993; Wernerfelt, 1984). As a subset of RBV of a firm, the theory of core competence allows organisations to rethink, identify, and exploit what they can do to make growth possible in global competition (Hamel and Prahalad, 1994). The two theories stress the internal capabilities of firms. However, both theories predominantly focus on the internal aspects of organisations (Bontis, 1999; Roos *et al.*, 1997). Peppard and Rylander (2001) argue that RBV does not provide a holistic perspective for understanding how resources can be put into practice to create value for organisations, which has limited the theory as mostly a conceptual framework. The theory of core competence views that the “value of the talented people” is more valuable because it is part of an organisational system (Mouritsen, 1998, p. 468). Accordingly, the value of non-human aspects of an organisation, such as information technology, is often overlooked.

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The strategic management process in NPOs is more complex (Chetkovich and Frumkin, 2003) as a result of the special characteristics of the organisations such as the combination of paid staff and volunteers and accountability of multiple constituents. Thus the theories of RBV and core competence, which stress internal capabilities, may not be able to provide a balanced picture of how a NPO is performing.

### **Knowledge-based view (KBV)**

In many respects, the development of strategic management thinking at least to some extent has been influenced by the significance of the economic role of “knowledge”. Organisations that are able to effectively utilise knowledge, notably tacit knowledge, are more likely to coordinate and combine their traditional resources and capabilities in new and distinctive ways, providing more value for their customers than their competitors (Teece *et al.*, 1997). The perspective of utilising knowledge as the primary source of competitive advantage became known as the knowledge-based view (KBV), an extension of the RBV (Grant, 1997; Wiklund and Shepherd, 2003). However, the limitation of the KBV is that it conceives both tacit and explicit knowledge as an objectively definable commodity (Empson, 2001). KBV implies that knowledge is a static internal resource in organisations which can be controlled, exploited, and traded like most physical resources (Styhre, 2003). As a result, information systems are often developed attempting to capture, store, retrieve and transmit knowledge between units, departments, organisations, and between individuals (Styhre, 2003).

Although the fact that the knowledge-based perspective views knowledge as an asset is an important concept, the perception, to certain extent, becomes distorted as too much focus is on the development of information technology (Ipe, 2003), which limits the growth of visualising and understanding of intellectual aspects, particularly tacit knowledge, for value creation in organisations, including NPOs.

### **Balanced scorecard (BSC)**

The Balanced Scorecard™ (BSC) helps to bring forth intellectual resources in organisations (Petty and Guthrie, 2000). It includes a set of measures to monitor organisational performance across four linked perspectives:

- (1) financial;
- (2) customer;
- (3) internal process; and
- (4) learning and growth (Kaplan and Norton, 1992, 1996, 2000).

It is the cause-effect relationships among the four measures, both financial and non-financial, that distinguish BSC from other strategic management systems (Wall *et al.*, 2004). Kaplan (2001) claims that BSC enables NPOs to bridge the gap between mission and strategy statements and day-to-day operational actions by facilitating a process which NPOs can achieve strategic focus. However, there are a number of reasons to suggest that BSC offers an inferior framework for the non-profit context.

First, BSC proposes a strategy which is formulated and executed under the assumptions that presupposed existence of a stable target group of customers are always in place (Mouritsen *et al.*, 2005) and the maximisation of bottom-line profitability between two competing organisations always exists (Goold, 1997).

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However, both assumptions do not really exist in the non-profit context. NPOs are often accountable to multiple constituents. This means that the beneficiaries of the non-profit services are typically different from those who provide material support (Brown and Kalegaonkar, 2002; Lyons, 2001). For instance, government purchases services from NPOs and other group of people are the final users of services. Thus, NPOs do not have customers but only service recipients. Also, NPOs exist for the betterment of the society. Their mission is often perceived as a moral absolute rather than as an economic prerogative subject to a cost and benefit calculus (Guy and Hitchcock, 2000). A strategy that sacrifices mission for greater margin will eventually become untenable as it likely alienates stakeholders such as service recipients and the general public in the non-profit sector (Alexander, 2000). Accordingly, strategic management approaches that are based primarily on the notion of competitions and customers are generally unacceptable to the non-profit sector.

Second, there is a concern that the cause-and-effect relationships among the four BSC perspectives are logical rather than causal (Norreklit, 2000, 2003). It is always assumed in BSC that *learning and growth* drives efficient *internal process*, then that drives a high level of *customer* satisfaction, and that drives good *financial* outcomes (Norreklit, 2000). These logical fallacies could lead to an inaccurate anticipation of performance indicators (Norreklit, 2000, 2003). In the case of NPOs, it almost guarantees that the cause-and-effect relationships do not work in the organisations as the expectations and demands of various constituent groups associated with NPOs are often conflicting and even contradictory (Lawry, 1995).

Third, BSC is criticised for being fairly rigid because the four linked perspectives and the indicators within them are relatively limiting (Bontis *et al.*, 1999). For instance, the considerations on the external environment in BSC are only limited to customers (Petty and Guthrie, 2000). However, the issues in the non-profit sector are rendered complex. The possible external indicating factors for NPOs are likely to be broader than that in the *customer* perspective of BSC. The potential risk is that non-profit managers may be misled by focusing only on the four perspectives in BSC and may end up missing other equally important factors in their organisations (Bontis *et al.*, 1999).

Finally, there is no clear-cut human resource element focus in the four BSC perspectives. The importance of the innovativeness and talents of employees and volunteers in NPOs may be diminished significantly. The ability of NPOs to achieve their objectives depends almost entirely on the knowledge, skills and experience of their paid employees and volunteers (Hudson, 1999). Many NPOs, in fact, rely heavily on voluntary labour (Hudson, 1999). The lack of clear-cut human resource element focus in the four BSC perspectives may discourage talented individuals from joining the organisations because they may feel that their efforts in the organisations are not recognised under the BSC model.

Even Kaplan and Norton admit that applying BSC in NPOs is different to applying it in business organisations because NPOs strive to deliver vague mission outcomes, not superior financial performance (Kaplan, 2001; Kaplan and Norton, 2004). They claim that they have modified the BSC specifically for the unique non-profit environment (Kaplan and Norton, 2004). This paper, however, argues that the modified BSC does not resolve the problems discussed above. The modified BSC becomes even more confusing. The confusion starts with the financial perspective being replaced in

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the modified model by a fiduciary perspective, which reflects the objectives of other constituents such as donors and taxpayers.

Kaplan and Norton (2004) claim that both financial and customer stakeholders needed to be satisfied concurrently. Therefore, both customer and fiduciary perspectives are located on the same level, which, however, does not fit in the original cause-and-effect relationship principle. The two perspectives (fiduciary and customer) are not connected. As a result, there may be a misconception that service recipients are not important to donors and taxpayers or that the latter are not concerned with the needs of the service recipients. However, both donors and service recipients are, in fact, closely linked together and their needs and expectations from the two sides do not necessary have to be in the same direction. Therefore, meeting the needs of both the financial and customer stakeholders simultaneously is not just difficult – sometimes it is impossible. In short, even though the BSC model has witnessed a big step in strategic management development in terms of visualising the knowledge and skills in NPOs, the model itself is not compatible to the unique non-profit environment.

Although highly supportive of the notion that NPOs need to be managed strategically, this paper takes a step further by arguing that the organisations must place the social dimension at the centre of their strategy since the social dimension is often the *raison d'être* of NPOs' existence in society. This paper argues that, unlike the strategic management concepts mentioned, the concept of intellectual capital (IC) can be utilised as a competent strategic management conceptual framework in the non-profit sector.

### **The concept of intellectual capital (IC) and its components**

Stewart (1997) defines IC in terms of organisational resources relating to wealth creation through investment in knowledge, information, intellectual property, and experience. Following the work of a number of scholars in the field of IC, IC encompasses three primary interrelated non-financial components:

- (1) human capital (HC);
- (2) structural capital (SC); and
- (3) relational capital (RC) (Bontis, 1998; Roos *et al.*, 1997).

Human capital (HC) includes various human resource elements, including attitude, competencies, experience and skills, tacit knowledge and the innovativeness and talents of people (Choo and Bontis, 2002; Guerrero, 2003; Roos and Jacobsen, 1999). It represents the tacit knowledge embedded in the minds of people in organisations (Bontis, 1999; Bontis *et al.*, 2002). HC is important to organisations as a source of innovation and strategic renewal (Bontis, 2002; Bontis *et al.*, 2000; Webster, 2000). A higher level of HC is often associated with greater productivity and higher incomes or compensation (Wilson and Larson, 2002). It is therefore in the interests of human resource managers to recruit and develop the best and brightest employees as a means of achieving competitive advantage (Bontis *et al.*, 2002).

Structural capital (SC) refers to the learning and knowledge enacted in day-to-day activities. The pool of knowledge that remains in an organisation at the end of the day after individuals within the organisation have left represents the fundamental core of SC (Grasenick and Low, 2004; Roos *et al.*, 1997). SC becomes

the supportive infrastructure for HC. It includes all of the non-human storehouses of knowledge in organisations – such as databases, process manuals, strategies, routines, organisational culture, publications and copyrights – which creates value for organisations, thus adding to the organisations' material value (Bontis *et al.*, 2000; Ordóñez de Pablos, 2004).

Relational capital (RC) characterises an organisation's formal and informal relations with its external stakeholders and the perceptions that they hold about the organisation, as well as the exchange of knowledge between the organisation and its external stakeholders (Bontis, 1998; Fletcher *et al.*, 2003; Grasenick and Low, 2004). RC is important to an organisation because it acts as a multiplying element creating value for the organisation by connecting HC and SC with other external stakeholders (Ordóñez de Pablos, 2004).

The three IC components are inter-dependent (Subramaniam and Youndt, 2005; Youndt *et al.*, 2004). Through the combination, utilisation, interaction, alignment, and balancing of the three types of IC and as well as managing the knowledge flow between the three components, IC renders the best possible value to organisations. Although the IC perspective was first developed as a framework to analyse the contribution of intellectual resources in for-profit organisations, as argued in this paper, the concept of IC is equally relevant to NPOs (Kong and Thomson, 2006).

### **Importance of IC in the non-profit context**

IC is capable of adapting to the challenges posed by the non-profit environment in the knowledge economy because some of the theoretical roots of IC come from the internal focus associated with core competence theory (Mouritsen *et al.*, 2005). IC helps to shift NPOs' strategic focus to intellectual resources, including knowledge, skills and experience. This is important to NPOs because strategic activities and changes that are brought to the organisations will be mainly driven by internal initiatives by paid employees and volunteers rather than external forces such as government agencies. Therefore, resistance to those strategic activities and changes by volunteers and employees is likely to be lowered.

In profit-making organisations, profits serve as a simple common language for communication, delegation and co-ordination, and as a means to measure organisational success and benchmark performance (Sawhill and Williamson, 2001; Speckbacher, 2003). NPOs, however, have no uniformity of financial goals that can be applied as a means of communication to compare goods and services that they produce (Speckbacher, 2003). Accordingly, as discussed earlier, NPOs are vulnerable under for-profit strategic management techniques which stress cost saving and value for money. Mouritsen *et al.* (2005) emphasise that IC is related to questions about identity, such as "who you are, and what you want to be" and thus, IC is not merely an objective in relation to intellectual resources, but is an identity crafted around ability and knowledge of what an organisation can do (Mouritsen *et al.*, 2005; Roos *et al.*, 1997). As a result, the IC approach forces non-profit leaders to rethink their mission and their social *raison d'être*. IC becomes important to NPOs not only because it helps the organisations to avoid goal displacement and resource diffusion, but it assists them to refocus their objectives on the social dimensions, which are sometimes distorted by operating in commercial contract environments under the public sector reform movement.



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Most organisational resources have either decreasing or increasing returns through their lifetime (Peppard and Rylander, 2001). For instance, a tangible asset depreciates with usage and each single entity is usually limited to defined tasks (Webster, 2000). IC, on the other hand, does not decrease in value with usage. Peppard and Rylander (2001) argue that IC resources can be utilised simultaneously by many users in different locations at the same time and thereby, are non-competitive in an economic sense. This is because when IC is articulated and challenged, new knowledge may be developed. Thus, IC is often characterised by “increasing returns” (Peppard and Rylander, 2001, p. 515); that is, value generated increases per incremental unit of investment. The non-competitive characteristic of IC is important to NPOs because IC may encourage resource sharing rather than resource competition. Intensified competition encouraged by public sector reforms can be destructive to the non-profit sector as NPOs are competing with each other for resources rather than working together to solve social problems. The non-competitive characteristic of IC also encourages NPOs to take advantage of knowledge sharing in the knowledge economy.

Norreklit (2000) asserts that if a model is to be effective in an organisation, the model must be rooted in the language of the organisation’s people and communicated to all parts of the organisation. This draws another important point – if a model is to apply in NPOs, it must be kept simple and easy to use or disseminate through the whole organisation. Bontis *et al.* (1999) argue that IC is flexible and easy to understand because it represents the collection of intellectual resources and their flows. Accordingly, IC can serve as a simple conceptual framework for NPOs that requires relatively little interpretation. IC is important to NPOs because it helps to create changes in people’s behaviour and values. Roos (1998, p. 151) argues that although IC may superficially be concerned with sales growth and value creation, it has a deeper purpose:

The deeper purpose of an IC approach is to change people’s *behaviour*, not least through changing the corporate language. The concept of IC brings with it *a whole set of new values* about what is good and what is bad management, what is the right and the wrong things [*sic*] to do in corporations [emphasis added].

Values embedded in IC are useful for NPOs, particularly in today’s non-profit environment. As public sector reforms often carry with them values consistent with “value for money” and competition, causing threats to NPOs’ traditional qualities such as fulfilling social objectives. IC becomes a valid strategic management conceptual framework within the non-profit context in the knowledge economy.

In contrast, failing to account for IC may lead to a misallocation of intellectual resources and run the risk of making poorly informed decisions, which lead to weak strategic planning processes, high employee turnover, inadequate training and development, inexperienced top management teams, and inability to turn data into information in NPOs. In short, as Salamon (1996) argues, in the light of contemporary realities in the non-profit sector, NPOs urgently require a “new settlement” to assist them to re-examine their functions, their relationships with citizens, government, and business organisations, and the way they will operate in the years ahead. This paper argues that the concept of IC can be one of the bases for such a new settlement which enables NPOs to utilise their knowledge effectively in the competitive non-profit environment.

## Conclusion

The highly competitive non-profit environment has forced NPOs to change the way they manage and operate their activities. NPOs are now urged to utilise their organisational resources more effectively. As argued in this paper, a competent strategic management framework is urgently needed to be developed in NPOs. This paper examines five key strategic management concepts within the non-profit context and determines which one is most applicable in the non-profit sector. As compared to the other strategic management concepts, IC is a valid strategic management conceptual framework for NPOs. IC allows NPOs to pursue their social objectives and utilise their resources effectively, and simultaneously to sustain their cherished qualities. Further research involving specific non-profit sub-sectors and methodologies needs to be carried out to empirically test the findings of this paper.

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**Corresponding author**

Eric Kong can be contacted at: [ekong@csu.edu.au](mailto:ekong@csu.edu.au)