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The determinants of transparency in nonprofit organizations: An exploratory study ☆

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ABSTRACT

This study provides descriptive evidence regarding the nature of voluntary financial disclosure in the nonprofit sector. The ability of outside stakeholders to access organization-specific information concerning the operations of a nonprofit organization is important for donation decisions. Members of the U. S. Senate, donors, and other stakeholders have expressed concern about the lack of transparency in the nonprofit sector. This study identifies factors associated with greater transparency in the nonprofit sector. Based on our study, a nonprofit is more likely to allow us access to its audited financial statements if it is a larger organization, has more debt, a larger contribution ratio, an NTEE classification of Higher Education, or a higher compensation expense ratio.

1. Introduction

This study examines the opportunity for the public to access the financial and operational information of large U.S. nonprofit organizations. Open access is important for efficient capital flow and for well-informed donation decisions (U.S. Senate, 2004, 2005). U.S. nonprofit organizations represent approximately 5% of GDP and 10% of U.S. jobs. Aggregate gross receipts exceed 1.6 trillion (Wing, Pollack, & Blackwood, 2008).

Public availability to the audited financial information of nonprofits is important because the non-accessibility may result in the loss of public confidence. Recent high-profile cases (e.g., Red Cross), have drawn the ire of the U.S. Senate Finance Committee (U.S. Senate, 2004). At "Charity Oversight and Reform: Keeping Bad Things from Happening to Good Charities" hearing, U.S. Senator Max Baucus (ranking Finance Committee member) lamented:

> " . . . inflated salaries paid to trustees and charity executives, insider deals with insufficient transparency, charities engaging in abusive tax shelters, and charities serving as conduits to finance terrorist activities and operations. This proliferation of sloppy, unethical, and criminal behavior is unacceptable. It has led to a crisis in confidence. It has hurt fundraising by legitimate charities. And it overshadows the good work done by the majority of civic-minded groups. Like the recent corporate scandals, these events make Americans second-guess their faith in bedrock institutions."

This study examines nonprofits willingness to disclose by requesting audited financial statements from the 300 largest U.S. nonprofits. Toder (2006) and others have argued that nonprofits' audited financial statements should be available to the public. Requiring only Federal IRS Form 990 is fraught with dangers as 990 information is neither externally audited nor GAAP compliant. Furthermore, a completed Form 990 is sometimes so lengthy (over 1000 pages) that finding relevant information is difficult for even a knowledgeable reader. Consequently, the Independent Sector (2006) recommended Form 990 changes to Congress, including attaching audited GAAP financial statements to Form 990s of organizations with more than $1 million revenue.

We investigated possible associations with nonprofits' refusals to provide financial information.[3] Of organizations sent requests, 142 provided audited statements to us, 68 refused, and 51 did not respond. We mailed up to four request letters to organizations, sending the last as registered mail to ensure that the organization had received the request.

☆ Data availability: Due to nondisclosure arrangements, data are not available from the author, but may be obtained from sources identified in the text.

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[3] Similar research has subsequently been conducted in Australia. Flack (2006) surveyed 646 registered charities in the State of Queensland, Australia. With a response rate of 32.9%, he found that 59.3% publish an annual report and of those 63.6% provided copies. Health and Education charities were more likely to publish an annual report. In a similar fashion, Flack tested the determinants of voluntary disclosure and found that vulnerability (concentration of sources of revenue), reliance on donated revenue, and size are associated with voluntarily providing an annual report.

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To develop a nonprofit disclosure model, we consulted the for-profit, as well as not-for-profit, voluntary disclosure, and principal-agent literatures for variables to explore. Statistics were culled from National Center for Charitable Statistics' (NCCS) database (extracted from IRS Forms 990). Based on our analysis, a nonprofit is more likely to disclose its audited statements if it has more debt, a larger contribution ratio, a National Taxonomy of Exempt Entities (NTEE) classification of Higher Education, a higher compensation–expense ratio and/or is a larger organization. This study is important in providing descriptive models of disclosure behavior.

The remainder of this study consists of Section 2: background to tax-exempt disclosure issues; Section 3: importance of nonprofit financial statements; Section 4: related theory; Section 5: hypotheses and model; Section 6: description of sample; Section 7: analyses and empirical results; and Section 8: findings, interpretations, and limitations.

2. Background on tax-exempt disclosure issues

Beginning in 1999 the IRS requires nonprofit organizations to provide public accessibility to copies of their tax-exempt status (IRS Form 1023 or 1024) and their three most recent information returns (IRS Forms 990, 990 EZ, 990-BL or 1065). IRS guidelines encourage but do not require organizations to publish this information on their website or as part of a database of tax-exempt organizations, such as www.guidestar.org. Form 990 contains detailed income statement and balance sheet information, contribution solicitation information, program service accomplishments, and officer/director compensation.

Certain states similarly recommend, but do not require, nonprofit organizations adopt the provisions of Sarbanes–Oxley Act (SOX) to enhance institutional accountability and responsibility (McCarthy & Mattie, 2003). The North Carolina Center for Nonprofits (2003), for example, notes "….although SOX was aimed at the business community, attorney generals around the country are using it as a template for nonprofit reform and regulation.…To model best practices, nonprofits should proactively adopt … provisions of SOX."

The Senate Finance Committee proposed requiring CEOs to sign (under penalty of perjury) a declaration to implement processes and procedures ensuring tax returns' compliance with IRS code and to reasonably assure accuracy and completeness (U.S. Senate, 2004). One reason for this proposal was that the General Accounting Office found Form 990 provided information that was inaccurate and incomplete (U.S. Senate, 2004). Other studies have found that without common standards for filing Form 990, comparable organizations provide varying disclosures (Keating & Frumkin, 2003). For example, one study observed many nonprofit organizations apparently intentionally misclassify or aggregate various sensitive information items such as fundraising expenses (Krishnan, Yetman, & Yetman, 2006). The Senate recommended reforms to achieve greater transparency and to ensure exempt organizations' accurate, complete, timely, consistent, and informative reporting (U.S. Senate, 2004) including provision that organizations with gross receipts over $250,000 be independently audited and required to post on their websites federally required information. But, legislation to that end has languished, to the disadvantage of the American public.

3. Nonprofit financial statements

Financial Accounting Standard (SFAS) No. 117 and Statement of Financial Accounting Concepts No. 1 (FASB, 1978) recognize the primary purpose of nonprofits' financial statements is to supply information to satisfy interests of external users of financial statements in (a) an organization's ability to effectively and efficiently provide those services they promote and (b) how managers discharge their stewardship responsibilities (FASB, 1993b). Investors, creditors, and others may use reported earnings and financial statements to assess cash flow prospects; evaluate management's performance; estimate earning power; predict future earnings; assess risk; or confirm, change, or reject earlier predictions or assessments. Because investors' and creditors' cash flows are related to those of enterprises, financial reporting also should help investors, creditors, and others assess the amounts, timing, and uncertainty of enterprises' prospective net cash inflows.

4. Theory development

While the goal of for-profit institutions arguably is profit maximization, nonprofit organizations strive for other goals. However, efficiency and ownership issues do exist in nonprofits. For example, donors want funds to be used efficiently; and not on bigger bonuses and better offices for officers, or for non or low-value added conferences and travel. While not publicly traded, nonprofit organizations compete for resources, whether funding, labor or managerial talent; therefore, they too have economic incentives similar to publicly traded firms without the ownership structure.

Considering for-profit and not-for-profit entities' similarities, we draw on existing theory and previous not-for-profit empirical findings in developing our voluntary financial disclosure model. Several studies have examined for-profits' voluntary disclosure. For example, Bushman, Piotroski, and Smith (2004) and Verrecchia (1983) suggest information's availability is apparently a key determinant in the efficiency of resource allocation and economic growth and in the mitigation of information asymmetry. This observation can also apply to nonprofits. These authors developed a framework for analyzing corporate disclosure, defined as the availability of firm-specific information to those outside publicly traded firms. For example, many inter-firm differences exist in corporate reporting quality (disclosure intensity and timeliness, accounting methods, and audit quality), and in information dissemination, both private (analyst following, institutional holdings, and insider trading) and in general (media or Internet).

While nonprofits lack analyst following and institutional holdings, they have similar issues. For example, several external parties are interested in nonprofits' finances: banks are attentive to performance with debt; outside services such as ministrywatch.com monitor financial issues; and major contributors want to know how efficiently contributions are spent. Finally, while media coverage is probably not a motivator for nonprofits, disseminating financial information should be important. Again, while this study is exploratory, we have used these ideas to develop a model of nonprofit voluntary financial disclosure.

5. Hypotheses and model development

This study's objective is to develop and test a model of voluntary financial disclosure in the nonprofit sector. Based on the previous discussion, we present the following generic disclosure model

$$Response(1) = f(\text{nonprofit disclosure variables} + \text{control variables}) \tag{1}$$

5.1. Dependent measures

For our dependent measure, we used two formulations, *Response* ($n = 210$) and *Response*1 ($n = 261$). *Response* is a (0.1) dummy variable (1 if an organization responded to our request by providing either the hardcopy or electronic version of the financial statements, or the web link from which the financial statements could be downloaded, and 0 if an organization responded but declined either to provide the statements or to participate in the survey). Thus, *Response* excludes all non-responding organizations. A *Response* coded 1 indicates the organization provided its audited financial statements to us.

*Response*1 is the second formulation of our dependent measure, differing from *Response* by adding all non-response organizations to