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Financial disclosure management in the nonprofit sector: A framework for past and future research

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ABSTRACT

This paper provides a review and synthesis of past research regarding financial disclosure management by nongovernmental nonprofit organizations and suggests directions for future study. The primary purpose of this review is to summarize the evidence on financial disclosure management to help regulators and other stakeholders understand why, how, and to what extent nonprofits engage in this behavior. The paper begins by defining disclosure management in nonprofit organizations and exploring the motivations for why it might occur. Next is a survey of the nongovernmental nonprofit financial reporting environment: objectives, common practices, and the informational needs of users of nonprofit financial reports. Research exploring the motives, methods, and consequences of disclosure management is summarized. The evidence suggests that nongovernmental nonprofit managers have a variety of incentives to manage reported numbers and that they do in fact alter spending decisions, choose accounting methods, and design cost allocations to achieve certain performance benchmarks. Furthermore, this review sheds light on the consequences of disclosure management and what can or should be done to limit it.
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1. Introduction

In this paper we review the scholarly research on financial disclosure management in the nonprofit sector.[1] Recent financial scandals involving public charities, such as the National Capital Area United Way and the Red Cross, have shaken the public's confidence in public charities and have resulted in serious decreases in donations to those organizations (Dimsdale, 2009; Rucker, 2007). These scandals have also shed light on the unique financial reporting environment of nonprofit entities and how it creates incentives and opportunities for financial disclosure management, which in turn can lead to a misallocation of charitable donations and a failure to optimize philanthropic output. The primary purpose of this review is to summarize the evidence on financial disclosure management to help regulators and other stakeholders understand why, how, and to what extent nonprofits engage in this behavior. Furthermore, the review sheds light on the consequences of disclosure management and what can or should be done to limit it.

There is a large stream of research examining earnings management in the for-profit sector, where managers use judgment in financial reporting and in structuring transactions to alter financial reports either to mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers (Healy & Wahlen, 1999). However, nonprofit entities differ from profit entities in ways that can affect reporting incentives and constraints. The objective of nonprofit management is not the maximization of shareholder wealth as it is for the typical profit-seeking firm. Nonprofits serve a different set of stakeholders and measure economic performance somewhat differently. Nonetheless, research shows that nonprofits, like for-profit firms, have both motives and opportunities to misreport financial information in order to mislead stakeholders or influence contractual outcomes. Since nonprofit organizations do not focus on earnings or profits as such, we use the more general term "financial disclosure management" or simply "disclosure management" rather than "earnings management" to describe the opportunistic use of financial reporting and real-transaction management to affect stakeholders' perceptions of firm performance.

The nonprofit sector is an important and rapidly growing part of the United States economy. In 2008, the most recent year for which there is data, nonprofits that report to the Internal Revenue Service (IRS) accounted for approximately $1.9 trillion in revenue and $4.3 trillion in assets (Wing, Roeger, & Pollak, 2010).[2] Nonprofits enrich our lives through art and culture and provide many goods and services that the government might otherwise be called upon to fund. Charitable giving can be thought of as a form of voluntary wealth redistribution and is considered very much part of the American way of life. Most estimates place the percentage of American households that make monetary contributions each year at 70–80 percent, and the average American household contributes more than $1000 annually (Brooks, 2008). If nonprofit organizations manage their financial disclosures to mislead stakeholders, then allocation of resources to and within this sector of the economy may be suboptimal.

The remainder of the paper proceeds as follows. Section 2 discusses the theoretical underpinnings for the study of financial disclosure management: information asymmetry, the agency problem, and the nonprofit objective function. The nonprofit financial reporting environment and the role of charity watchdog groups as financial information intermediaries are discussed next, to show how the unique characteristics of the nonprofit environment create

[1] Accounting research on nonprofit entities focuses on either governmental or nongovernmental units.

Our review is limited in scope to nongovernmental units. While federal, state and local governments and their agencies are broadly considered to be part of the nonprofit sector, the financial, regulatory and reporting environments in which they operate set them apart as a separate field of research. In particular, governments and their agencies are created by a political process, are often funded by tax money (and often have the ability to increase revenues by raising taxes), do not typically conduct fundraising, seldom receive donations, and are subject to different forms of governance, regulation, and reporting requirements. They do not request tax exemption from the IRS, and they do not report to the IRS via Form 990.

[2] These numerical facts do not include small nonprofits with gross receipts less than $25,000 or religious congregations, which are exempt from reporting requirements.

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