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Career concerns and accounting performance measures in nonprofit organizations

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A B S T R A C T

Many in the nonprofit sector view accounting-based performance measures to be overly influential and counterproductive in the evaluation of charities and their leaders. The contention is that such measures are imperfect and often biased, leading to dysfunctional rationing of fundraising and administrative infrastructure. To examine these concerns and the broader question of nonprofit executive incentives, we develop a model of nonprofit executives who are concerned with influencing external perceptions. In doing so, we demonstrate that accounting-based performance measures alter executive incentives in critical ways. In particular, disclosure of the functional classification of nonprofits' expenses can reduce incentives to overinvest in fundraising and restore investments in programs; at the same time, it also comes with the potential downside of undermining key investments in long-term infrastructure.

Introduction

In his now-viral TED talk ("The Way We Think About Charity is Dead Wrong"), Dan Pallotta provided a voice to many in the nonprofit sector who view the reliance on accounting-based performance measures for non-governmental organizations (NGOs) to be detrimental to their overall effectiveness. The viewpoint, elaborated upon in books by Pallotta (2010), Stern (2013), and others, is that by developing an imperfect picture of how much of a nonprofit's resources are devoted to its mission, the functional classification of expenses has become a key focus of outsiders' evaluation of NGOs and their executives; this focus, in turn, incentivizes executives to cut key investments in fundraising and advertising. Despite the almost universal acceptance of this view and concomitant disdain for accounting performance measures in the nonprofit community (even spawning the "Overhead Myth" movement to discredit reliance on accounting measures), there has been little or no formal analysis of the viewpoint.

In this paper, we present a parsimonious model of nonprofit executives' incentives in order to examine the consequences of reliance on accounting-based performance measures. The model captures two key elements: (i) to the extent that nonprofit executives are driven by extrinsic motivation, such incentives are typically not due to explicit pay arrangements but rather an incentive to influence external perceptions; and (ii) the primary accounting performance measure that is critical and unique to nonprofits is the functional classification of expenses, which provides an assessment of the portion of expenses attributable to achieving an organization's mission, i.e., the program expenses.

Our setting provides a formal analysis of actions nonprofit executives are incentivized to undertake when at least part of their motivation is driven by a desire to boost market perceptions of their effectiveness. Consistent with intuition, we show that the more the market values the ability to generate revenues and/or the more executives can benefit from administrative perquisites, the more focus executives place on efforts to generate revenues. Similarly, the more the market values the ability to efficiently focus

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resources toward a mission and/or the less executives can benefit from perquisites, the more emphasis they place on using (rather than generating) resources effectively. Interestingly, we also show that the more efficient an organization is in using resources, the less incentive an executive has in trying to generate such resources. Among other things, this suggests that if left unchecked, the natural order of things may lead to inherently inefficient organizations being the ones generating the bulk of donations.

The model also presents a different view of observed executive pay-to-performance sensitivities. That is, though empirical observation of variation in nonprofit executive pay moving in concert with accounting metrics is often interpreted as evidence of contractual performance pay arrangements, implicit market forces may also explain such variability. In particular, despite the lack of explicit incentive pay, our model demonstrates how external demands for nonprofit executives will generate pay that varies predictably with accounting outcomes. This market-driven view of pay-to-performance sensitivity also offers additional empirical implications. For one, we show that the more the market places a premium on revenue-generating ability relative to the ability to devote resources to the mission, the more sensitive pay will be to revenue and the less sensitive it will be to the measure of program expenses. This means that in markets characterized by strong presence of for-profit entities, for whom revenue is at a premium (e.g., education; health care), the more (less) pay should appear sensitive to revenues (program expenses). Additionally, we show that the more precise the accounting cost allocation exercise, the less sensitive pay will be to revenue and the more sensitive it will be to program expenses. In other words, the greater the uncertainty about the functional allocation of expenses (driven by, say, the use of SOP 98-2 in allocating joint costs), the greater the pay sensitivity will be to revenue and the less weight the market will place on program expenses.

Returning to the fundamental criticism of how accounting estimates can distort incentives, our model of career concerns of nonprofit executives demonstrates that the incentive to influence external perceptions in itself can distort decisions away from what may be in the best interest of donors. In particular, in order to boost perceptions of revenue-generating abilities, a nonprofit executive may overinvest in fundraising efforts. This, in turn, can lead to a reduced focus on improving efforts to efficiently direct resources to the organization's mission. Interestingly, the functional classification of expenses stipulated by accounting rules can help mitigate each of these concerns.

By tracking expenditures that go into the revenue-generation process, the accounting measure helps sift out what revenues are attributable to executive ability and what are simply due to high fundraising spending. This undercuts the incentive for the executive to overinvest in fundraising as a means of trying to posture to a marketplace that values revenue generation. The attempt to separate program expenses as part of functional expense classification also gives the marketplace a second measure on which to evaluate executives – their efficiency at putting resources to use. The newfound emphasis on program expenses incentivizes executives to put more energy into cutting administrative bloat and effectively directing resources toward the mission.

However, this desire to cut administrative costs to signal greater efficiency to markets comes with a downside in that it also encourages executives to divert resources from potentially useful long-term infrastructure spending. In other words, since accounting does not provide a natural distinction between wasteful and useful administrative spending, it incentivizes executives to "trim the fat" even in cases where some administrative spending is critical. That is, an additional implication of our model is that it provides a theoretical justification for the so-called nonprofit starvation cycle (Gregory & Howard, 2009), where efforts to trim administrative costs undermine long-term viability.

Taken together, our results suggest a nuanced balance between viewing accounting measures with utter suspicion or with unadulterated faith is warranted. The functional classification of expenses shifts the executive's emphasis away from excessive fundraising while also simultaneously forcing him to focus on the use of resources. The latter entails a trade-off. When excessive administrative spending is the norm in the absence of functional classification, the tight discipline introduced by accounting metrics proves beneficial. On the other hand, cost cutting can be excessive when it discourages spending on valuable infrastructure. The paper's propositions succinctly capture these economic forces.

This paper lies at the nexus of the literatures on career concerns incentives and accounting performance measurement for NGOs. In terms of the first literature stream, the seminal analysis of career concerns incentives is Holmstrom (1982, 1999). This initial analysis of implicit career incentives was expanded by Dewatripont, Jewitt, and Tirole (1999a, 1999b) who generalize the model to examine, among other things, the allocation of effort across tasks, complementarities between skill and effort, and alternative information structures. The career concerns framework has also generated insights about managerial investment (Holmstrom & Ricart i Costa, 1986), information acquisition incentives (Milbourn, Shockley, & Thakor, 2001), team dynamics (Auriol, Friebel, & Pechlivanos, 2002), job design (Kaarboe & Olsen, 2006), disclosure regulation (Autrey, Dikolli, & Newman, 2007), and performance measure design (Arya, Frimor, & Mittendorf, 2010; Autrey, Dikolli, & Newman, 2010).

Theoretical inquiry of career concerns is motivated by circumstances wherein employees face limited explicit incentive compensation but rely on salaries determined by labor markets. Driven by both donor and regulatory restrictions, such limited incentive pay is commonplace among NGOs, making incentives to influence external perceptions all the more important to examine in nonprofits.

Surprisingly, there is a dearth of theoretical study of incentives among NGOs and none (to our knowledge) on the incentives of nonprofit executives to influence marketplace perceptions. That said, there has been substantial empirical study of NGO behavior and the role of accounting measures therein. In terms of executive pay incentives, Baber, Daniel, and Roberts (2002) and Sedatole, Swaney,