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Misreporting Fundraising: How Do Nonprofit Organizations Account for Telemarketing Campaigns?

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ABSTRACT: The purpose of this study is to examine the frequency, determinants, and implications of misreported fundraising activities. We compare state telemarketing campaign reports with the associated information from nonprofits' annual Form 990 filings to directly test nonprofits' revenue and expense recognition policies. Using a conservative approach that understates the extent to which nonprofit organizations violate the reporting rules, our study indicates that 74 percent of the regulatory filings from nonprofit organizations fail to properly report telemarketing expenses. Smaller nonprofits, less monitored firms, and those with less accounting sophistication are more likely to inappropriately report telemarketing costs as a component of net revenues rather than as expenses. Nonprofits that use external accounting services are more likely to properly classify the cost of their telemarketing campaigns as professional fundraising fees.

Keywords: *efficiency; nonprofit; fundraising; telemarketing.*

Data Availability: *All data are from public sources.*

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I. INTRODUCTION

Our paper examines nonprofits that hire professional solicitors to conduct telemarketing campaigns to determine under what conditions they appropriately report the associated expenses. Using annual IRS filings (Form 990s) and matching them to the state reports of individual telemarketing campaigns, we examine three potential methods of misreporting costs. First, we investigate whether nonprofits report the proceeds from telemarketing campaigns as contribution revenue, net of the associated fundraising expense. This accounting method violates current accounting standards (both SFAS No. 117 and IRS 990 reporting rules), which require that all gross revenue and related expense amounts be separately reported. For firms that separately report revenues and expenses from telemarketing campaigns, we then examine whether the telemarketing costs are properly classified as professional fundraising fees. Finally, we explore whether the costs are fully reported as fundraising expenses rather than allocated to the program or administrative functional categories. Using a conservative approach that understates the extent to which nonprofit organizations violate the reporting rules, we find that over 74 percent of the regulatory filings fail to properly report telemarketing expenses, by either netting them against contributions or failing to characterize them as professional fundraising expenses.

Fundraising campaigns that reach a large number of potential donors can be time-consuming and complex. For this reason, nonprofit organizations often hire professional solicitation firms that have access to mailing or telephone lists and employ a larger fundraising staff than the nonprofit could afford. One concern about this method of fundraising is that it can be expensive, with the professional solicitor retaining all or most of the proceeds collected on a nonprofit's behalf (Keating et al. 2003; Strom 2003; and Bartosiewicz 2004). In an attempt to increase monitoring of this fundraising technique and improve external governance of nonprofits, several state regulators issue annual reports to make potential donors aware of these high costs. The New York State "Pennies for Charity" report, for example, reveals that professional solicitors in that state retained \$0.73 of every dollar raised through telemarketing campaigns between 1994 and 2001 (Keating et al. 2003). A second concern is that the public is being misled about the true costs of fundraising on nonprofits' annual financial filings with the IRS (Urban Institute 2004; Krishnan et al. 2006). The possibility exists that nonprofits may intentionally hide the costs associated with this often-expensive fundraising technique in order to improve financial reports and mislead donors about organizational performance.

The reliability of nonprofit financial reports is important. Prior research documents that donors and grantors use financial information to inform contribution decisions (e.g., Weisbrod and Dominguez 1986; Tinkelman 1999; Greenlee and Brown 1999; Parsons 2003) and that boards rely on this information to make executive compensation decisions (Baber et al. 2002). Further, watchdog groups issue ratings based largely on Form 990 financial information. These ratings depend heavily on efficiency ratios—such as the ratio of program expense to total expense and the ratio of fundraising expense to total contributions—to evaluate spending efficiency.¹ Our analysis indicates that by misreporting telemarketing expenses the nonprofits in our sample could understate the fundraising ratio by as much as 15 percent. Thus, misreporting telemarketing expenses has the potential to affect decisions made by users of nonprofit financial information.

An Urban Institute (2004) study also questions the quality of amounts reported as fundraising expenses on Form 990 by documenting that only 41.6 percent of nonprofits

¹ Donor reliance on financial information to guide fundraising decisions may have increased in recent years due to the creation of Guidestar, an online service that provides free access to recent Form 990 filings.

that receive contributions report fundraising expenses. Further, there is evidence that some nonprofits misreport financial information to affect how program or fundraising costs are reported. Trussel (2003) finds that certain performance indicators, such as lower surplus margins or less deferred revenue, are positively related to the likelihood that a nonprofit will manipulate its program efficiency ratio. Jones and Roberts (2006) provide evidence that nonprofits use joint cost allocations to avoid reporting changes in the program ratio. Krishnan et al. (2006) show that some nonprofits inappropriately report zero fundraising expenses despite evidence on the Internet that they engage in activities that can arguably be considered fundraising. Their paper further finds that nonprofits are more likely to report zero fundraising costs when donations or managers' pay are sensitive to changes in reported program ratios or revenue.

Our study extends this research by providing direct evidence that many nonprofits under-report fundraising costs. We examine a group of nonprofits that undeniably engage in fundraising activities (i.e., telemarketing) and study whether these organizations comply with clear rules for reporting this type of activity. Using a conservative estimate of a nonprofit's telemarketing activity, we determine that 16 percent of our larger sample of nonprofit telemarketing firm-years report no fundraising expenses. An additional 20 percent appear to under-report fundraising costs. Telemarketing costs should be properly classified as professional fundraising fees, yet the majority fails to classify these costs appropriately.

We investigate the factors associated with the three potential forms of misreporting. Prior research (Krishnan et al. 2006) suggests that misreporting may be intentional. The findings in this paper suggest that misreporting is also strongly associated with weak monitoring and accounting knowledge. Specifically, we find that smaller nonprofits, those with less accounting sophistication (those that fail to use accrual accounting and outside accounting services), and firms with less outside monitoring (those that are unaudited or have lower leverage) are more likely to inappropriately report their telemarketing costs in net revenues. Even when a firm does recognize telemarketing cost as an expense, we still find that firms are likely to misclassify the expense. First, firms with relatively more officer compensation and those that use the services of professional accountants are more likely to properly classify the costs of telemarketing campaigns as professional fundraising fees. Second, we find that smaller firms, those with relatively less officer compensation, and nonprofits with lower leverage are more likely to allocate telemarketing expenses to non-fundraising expense categories.

This research is important for a number of reasons. Prior research has either implied or inferred that financial misreporting was intentional and designed to mislead financial statement users. Misreporting, however, either could be the result of managers deliberately trying to mislead potential donors, or could be a consequence of management without the requisite accounting knowledge and reporting experience. This paper is the first to specifically consider the effect of accounting sophistication on nonprofit reporting practices.² This distinction is important because as public use and scrutiny of nonprofit financial information increases, regulators search for ways to improve the quality of nonprofit financial reports. For instance, in the wake of the Sarbanes-Oxley Act of 2002 and several nonprofit scandals, the Senate Finance Committee held hearings and is considering additional regulation of nonprofit organizations. Moreover, several states have considered or passed legislation increasing the number of nonprofits required to have annual CPA audits. Our results support the expectation that monitoring, particularly the existence of an audit, is associated with

² Accounting sophistication could be knowledge of the accounting rules applicable to completing Form 990 or a system of internal controls that mitigates the likelihood of misreporting.

higher quality reporting. The results also indicate that educating Form 990 preparers and nonprofit financial staffs can play a role in improving reporting quality.

The remainder of the paper is organized as follows. Section II describes professional fundraising campaigns and the related accounting issues. Section III presents the research hypotheses and the methodology. Section IV describes the data. The results are summarized in Section V. Section VI concludes with a summary of the study's contributions.

II. PROFESSIONAL FUNDRAISING CAMPAIGNS

The Cost of Telemarketing Campaigns

Though many nonprofits hire professional telemarketing firms to organize and complete their fundraising efforts, the use of telemarketing firms is controversial among charity officials, regulators, watchdog agencies, and donors. As a result, 39 states require nonprofit organizations that engage in charitable solicitations to register with the state. Twenty-two of these states require professional fundraisers to file reports regarding their telemarketing activities, and at least ten make telemarketer reports available to donors via the state's website.

Despite a number of arguments justifying the high costs of professional campaigns (Suhrke 2002), regulators are concerned that donors are not fully aware of or are poorly informed about the cost of telemarketing campaigns. The State of Illinois pursued one case to the U.S. Supreme Court (*Madigan v. Telemarketing Associates, Inc.*, 2003), asserting that the telemarketer led donors to believe a significant percentage of the funds would directly benefit Vietnam veterans, when, in fact, 85 percent of the funds went to the telemarketer or to cover the nonprofit's administrative costs. The Supreme Court found, in this case, that there had been "particular representations made with intent to mislead" by the telemarketing firm. However, the Court refused to define high fundraising costs as fraudulent. Similarly, the IRS attempted to revoke the tax-exempt status of the United Cancer Council using the argument that high fundraising fees charged by a professional telemarketer amounted to private inurement. However, the U.S. Court of Appeals for the Seventh Circuit rejected that claim, stating that high fundraising fees do not equate to private inurement of an inside party (*International Journal of Not-for-Profit Law [IJNL]* 1999). The courts have consistently refused to rule that high fundraising fees are excessive or illegal.

The Potential to Misreport Telemarketing Costs

Our study focuses on a less transparent issue: the representations that nonprofits make about telemarketing campaigns on their Form 990. IRS reporting rules specify that nonprofits that use professional fundraisers must report the gross proceeds from these campaigns as contributions revenue and separately report the fees retained by the professional fundraisers as "professional fundraising fees." To the extent that these expenses are incurred for fundraising rather than for programmatic or administrative costs, they are to be reported in the fundraising functional expense category.

A nonprofit can misreport the costs of these campaigns in three ways. First, nonprofits can report the net proceeds collected as contributions revenue rather than showing gross revenue as contributions and the telemarketers' fees separately as fundraising expense. Such reporting does not affect earnings, but it does affect the reported program and fundraising efficiency ratios that donors and others use for decision-making.

As an example, assume that prior to recording activities related to a telemarketing campaign, a nonprofit collects \$100,000. From these revenues, the organization spends \$60,000 on programs, \$10,000 on general administration costs, and \$20,000 on fundraising. The remaining \$10,000 is saved for future years. During the year the organization engages

a professional fundraising firm to conduct a telemarketing campaign on its behalf. The professional fundraiser collects \$25,000, retains \$18,750 (75 percent) of the proceeds as a fundraising fee, and remits the remaining \$6,250 to the nonprofit organization. The nonprofit spends an additional \$6,250 on its programs. If the nonprofit includes only the net proceeds from the telemarketing campaign as contributions revenue, it reports a program (fundraising) efficiency ratio of 69 (19) percent.³ If it follows current accounting standards and IRS reporting rules and reports the gross proceeds as revenue and the retained fee as fundraising expense, it reports less impressive program and fundraising ratios of 58 and 31 percent, respectively.⁴

Given that a nonprofit is reporting telemarketing costs as an expense rather than a deduction from revenues, it can mislead users by reporting the amounts retained by the fundraiser somewhere other than in the professional fundraising fee category. This category is an explicit line in the statement of functional expenses in Form 990, yet nonprofits sometimes report these costs on other lines, particularly "other expenses." Although this has no overall affect on the total fundraising or program ratios, it does not highlight to board members, watchdog groups, state regulators, or other users of financial information that an organization uses a professional fundraising method that may be expensive, or even controversial.

A third technique that may make it difficult to identify telemarketing costs involves allocating some telemarketing costs to program activities. Using the previous example of the \$25,000 campaign that resulted in net proceeds of \$6,250, if the entire \$18,750 telemarketing fee is reported as fundraising expense, it generates a program ratio of 58 percent. If management decides to allocate 50 percent of the telemarketing fee to program costs, then the reported program ratio increases to 66 percent, while the fundraising ratio is decreased from 31 percent to a more attractive 24 percent.⁵

III. RESEARCH QUESTIONS AND DESIGN

Categorizing Reporting Practices

Using the techniques described above, we classify a nonprofit's accounting practices in three ways: (1) as a gross or net revenue reporter, (2) as a proper expense classifier or a misclassifier, (3) as a fundraising cost nonallocator or allocator. To be classified as a gross revenue reporter, a nonprofit must report contributions on Form 990 that equal or exceed our estimate of gross telemarketing receipts and also report some fundraising expenses. This approach, however, may inappropriately classify firms with other sources of contribution revenue as gross revenue reporters, thereby biasing against finding that nonprofits misreport revenues. We define net reporters as those that report telemarketing fees as contra-revenues rather than expenses, thus excluding them from our second and third tests.

For the second test, we examine gross reporters to determine whether they properly classify their telemarketing costs as professional fundraising fees. To be categorized as a

³ Program ratio with net proceeds recorded as revenues and spent on programs: $(60,000 + 6,250)/(90,000 + 6,250) = 69$ percent. Fundraising ratio (fundraising expenses/total contributions) with no expense related to professional fundraising campaign: $20,000/(100,000 + 6,250) = 19$ percent.

⁴ Program ratio with gross proceeds recorded as revenues, retained fee recorded as fundraising expense, and net proceeds spent on programs: $(60,000 + 6,250)/(90,000 + 25,000) = 58$ percent. Fundraising ratio with retained fee recorded as fundraising expense: $(20,000 + 18,750)/(100,000 + 25,000) = 31$ percent.

⁵ Program ratio with 50 percent of retained fee allocated to program expense: $(60,000 + 6,250 + 9,375)/(90,000 + 25,000) = 66$ percent. Fundraising ratio with 50 percent of retained fee allocated to fundraising expense: $(20,000 + 9,375)/(100,000 + 25,000) = 24$ percent.

proper expense classifier, the organization must report professional fundraising fees that equal or exceed the combined fees paid to all solicitors. Finally, we categorize nonprofits by whether they allocate telemarketing fees to non-fundraising activities. We compare our estimate of telemarketing fees to total fundraising expenses on Form 990. Nonprofits that reflect telemarketing costs as fundraising expense should report total fundraising expense on Form 990 that is higher than the combined fees paid to all solicitors.

Allocation, however, is not necessarily a form of misreporting. The AICPA's SOP 87-2 and 98-2 allow the allocation of fundraising costs when fundraising activities are incurred jointly with programmatic activities (see Roberts [2005] for complete discussion of the joint cost rules). This standard is applied under limited circumstances and is typically used to decide whether and how to allocate costs related to direct-mailing fundraising activities.⁶ In fact, only 23 percent of our sample indicates that they use the joint cost standards. However, we are concerned that managers who allocate a portion of telemarketing fees out of fundraising expense may do so without proper regard for the accounting rules.

In summary, the first test examines management's decision to report gross revenue and the related telemarketing expense. The second and third tests focus on the nonprofits that properly report gross revenues and examines how these nonprofits recognize the expenses associated with telemarketing campaigns.

Hypotheses and Regression Models

State reports of the activities of professional fundraisers aim to inform donors about fundraising costs and address the concern that donors are misled by reported efficiency ratios. However, professional telemarketers report the results of individual telemarketing campaigns while nonprofits are responsible for their Form 990 filings. There is no mechanism to ensure the information reported on these two documents is consistent. Similar to Greenlee and Gordon (1998), we use actual fundraising costs reported in state telemarketing reports to investigate the veracity of fundraising costs reported by nonprofits.⁷

We hypothesize that the pressure to report favorable efficiency ratios affects most nonprofits, but that circumstances such as financial distress may affect the motivation to misreport the fundraising costs associated with telemarketing campaigns. We also expect that certain forms of nonprofit accountability and governance, such as professionally staffed organizations or external monitoring, mitigate the likelihood of inappropriate financial reporting.

To determine if the occurrence of net reporting, expense misclassification, or allocation of the costs related to professional fundraising campaigns is systematically determined by accounting sophistication, governance measures designed to protect against misreporting, or incentives to misreport, we use the following logistic regression models and adjust the standard errors and associated z-statistics for the intrafirm correlations arising from the inclusion of multiple years of observations (Huber 1967; Rogers 1993).

⁶ If a professional telemarketer delivers program information on behalf of a nonprofit organization during a fundraising campaign, then joint cost allocation rules permit allocation of some portion of the cost to program expense. Though we are not certain of the frequency of this form of program activity, we recognize that it is permissible under GAAP in some cases.

⁷ Reporting for professional telemarketing campaigns occurs annually, even if the campaigns have a duration of greater than one year.

Revenue Recognition Test

$$\begin{aligned}
 P(\text{Net Reporting}) = & \beta_0 + \beta_1 \ln \text{ASSETS} + \beta_2 \ln \text{OFFSAL} + \beta_3 \text{ACCRUAL} \\
 & + \beta_4 \text{PROFACCT} + \beta_5 \text{RESTRICTED} + \beta_6 \text{501C3} \\
 & + \beta_7 \text{AUDIT} + \beta_8 \text{LEVERAGE} + \beta_9 \text{YIELD} \\
 & + \beta_{10} \text{SECTOR} + \varepsilon.
 \end{aligned} \tag{1}$$

We first calculate *REVDIFF* = Contributions on Form 990 – Telemarketing Gross Receipts. Contributions are measured using the amount reported in Part I line 1b (direct contributions) when this level of detail is available in the dataset. Otherwise, contributions are measured using Part I line 1e (total contributions). *Net Reporting* = 1 if either (a) *REVDIFF* < 0 or (b) fundraising expenses reported on the 990 = 0, and 0 otherwise.

Expense Classification Test

$$\begin{aligned}
 P(\text{Misclassifier}) = & \gamma_0 + \gamma_1 \ln \text{ASSETS} + \gamma_2 \ln \text{OFFSAL} + \gamma_3 \text{ACCRUAL} \\
 & + \gamma_4 \text{PROFACCT} + \gamma_5 \text{RESTRICTED} + \gamma_6 \text{501C3} + \gamma_7 \text{AUDIT} \\
 & + \gamma_8 \text{LEVERAGE} + \gamma_9 \text{YIELD} + \gamma_{10} \text{SECTOR} + \varepsilon.
 \end{aligned} \tag{2}$$

We calculate *FEEDIFF* = Professional Fundraising Fee on Form 990 – Telemarketing Fees. The professional fundraising fee is obtained from Part II line 30 of Form 990. *Misclassifier* = 1 if *FEEDIFF* < 0, and 0 otherwise, using a sample that is composed only of firms identified as gross reporters.

Expense Allocation Test

$$\begin{aligned}
 P(\text{Allocator}) = & \lambda_0 + \lambda_1 \ln \text{ASSETS} + \lambda_2 \ln \text{OFFSAL} + \lambda_3 \text{ACCRUAL} \\
 & + \lambda_4 \text{PROFACCT} + \lambda_5 \text{RESTRICTED} + \lambda_6 \text{501C3} + \lambda_7 \text{AUDIT} \\
 & + \lambda_8 \text{LEVERAGE} + \lambda_9 \text{YIELD} + \lambda_{10} \text{SECTOR} + \varepsilon.
 \end{aligned} \tag{3}$$

We calculate *FUNDEXPDIFF* = Fundraising Expense on Form 990 – Telemarketing Fees. Total fundraising expense is measured using Part I line 15 of Form 990. *Allocator* = 1 if *FUNDEXPDIFF* < 0, and 0 otherwise, using a sample that is composed only of firms identified as gross reporters.⁸

The independent variables are defined below.

Professionalism and Accounting Sophistication

According to Tinkelman (1999), larger organizations are more likely to have quality financial reports because they are more likely to have professional accounting expertise. Following Tinkelman, we use the natural logarithm of beginning total assets (*lnASSETS*) from Part IV line 59 column A as a proxy for organizational size. We predict negative coefficients for *lnASSETS* in all three tests.⁹

⁸ Because our measure of telemarketing gross receipts is inexact, we use alternative measures of *REVDIFF*, *FEEDIFF*, and *FUNDEXPDIFF* to test the sensitivity of our results. These measures are discussed in the additional testing section of the paper.

⁹ An alternative proxy for size is total revenues. However, we do not use total revenues to measure size as the number is understated if an organization reports its telemarketing revenues on a net basis.

In addition to organizational size, we use the natural logarithm of officers' salaries and wages (*lnOFFSAL*) from Part II line 25 of Form 990 to measure the degree to which an organization has professional managers. Tinkelman (1999) proposes that the existence of professional (versus voluntary) management may indicate a higher level of accounting sophistication and a greater ability to produce high-quality financial reports. Baber et al. (2002), however, find that changes in executive compensation are positively associated with changes in program ratios. Managers may have an incentive to conceal fundraising costs to improve efficiency ratios and increase compensation. Thus, we do not predict the sign on the coefficients for *lnOFFSAL* for any of the tests.

We include two measures that reflect management's knowledge of generally accepted accounting principles (GAAP). Although the IRS does not require nonprofits to use GAAP when completing Form 990, knowledge and use of GAAP indicate accounting sophistication. The first measure, *ACCRUAL*, equals 1 if an organization uses accrual accounting, and 0 otherwise. We predict the coefficients on *ACCRUAL* are < 0 for all three tests.

An organization that engages an external professional accountant to assist with its reporting function is more likely to use proper accounting in its Form 990. Similar to Krishnan et al. (2006), we use an indicator variable (*PROFACCT*) that equals 1 if accounting fees on Part II line 31 of Form 990 are > 0 , and 0 otherwise. We predict negative coefficients on *PROFACCT* for all three tests.

Donors may impose restrictions on the use of their charitable contributions. These limitations can direct the use of donated funds for a specific purpose or time period, or can require that the donation is permanently invested in order to serve as an ongoing source of investment income for the nonprofit. Nonprofits that receive restricted donations are likely to be more complex in terms of their range of operations and also more sophisticated in their accounting with a wider range of services offered than nonprofits with no restricted contributions. We include a dummy variable, *RESTRICTED*, that is equal to 1 if temporarily or permanently restricted net assets from Part IV lines 68 and 69 are > 0 , and 0 otherwise. We expect the coefficients on *RESTRICTED* are negative for all three tests.

External Monitoring

Desai and Yetman (2005) and Yetman and Yetman (2006) demonstrate that nonprofit organizations are less likely to misreport when they are monitored. One form of monitoring is the federal requirement that most nonprofits organized as non-church 501(c)(3) entities must file an annual Form 990 if they earn \$25,000 or more in revenues, and make that informational filing available to any interested party upon request. Availability of financial information means these nonprofits are subjected to greater scrutiny by the donor public and/or watchdog agencies. To meet the public disclosure requirement, some nonprofits post their annual 990 filings on their own websites. Additionally, GuideStar collects the financial information from informational tax filings and has compiled a large searchable database that makes this information available, via the Internet, in a single location for a variety of stakeholders (see <http://www.guidestar.org>). In contrast, current law does not require non-501(c)(3)s and private foundations to make their Form 990s publicly available.

To date, most nonprofit accounting research examines only 501(c)(3) organizations. Our study, however, includes many non-501(c)(3) organizations, such as police and fire support organizations. We use a dummy variable, *501C3*, that equals 1 if the organization is a 501(c)(3) organization, and 0 otherwise. We predict that 501(c)(3) organizations are less likely than non-501(c)(3) organizations to misreport fundraising expenses; thus, we expect negative coefficients on *501C3* for all three tests.

Another important form of monitoring is an audit by an independent accountant. Some states require organizations that are registered in the state or doing sufficient business therein (usually based on total revenues) to submit audited financial statements. In addition to state-mandated audits, nonprofit organizations that receive a pre-defined level of federal funds must undergo an audit in compliance with the Office of Management and Budget's Circular No. A-133. We use a dummy variable, *AUDIT*, that equals 1 if either (a) an organization meets the audit requirements of the state in which it is incorporated or in which it solicits funds or (b) an organization was subjected to an A-133 audit according to the Single Audit database maintained by the Census Bureau, and 0 otherwise.¹⁰ We expect the presence of an audit (whether state or federally mandated) to be negatively associated with the occurrence of net reporting and expense misclassification. As cost allocations are permitted under GAAP, we do not expect to find a significant coefficient associated with audits in the expense allocation test.

Financial Indicators

Ideally, we would like to test whether nonprofits misreport telemarketing activities to manage the program or fundraising ratios. However, we cannot directly examine these particular financial indicators because they are affected by misreporting the revenues and expenses associated with telemarketing revenues. Because we do not have the full population of telemarketing campaigns since not all states issue reports, we cannot determine the telemarketing fees retained by all professional fundraisers for a given organization. Thus, we cannot compute program or fundraising ratios "as if" the net (gross) reporter recorded (did not record) all telemarketing expenses.

We can, however, indirectly examine management's incentive to manage efficiency ratios by investigating whether organizations with poor financial health have greater incentive to use accounting techniques to improve their financial reports. Organizations experiencing financial distress or unfavorable results may be more likely to use net reporting, or misclassify or allocate fundraising costs than those that are more financially robust or efficient. Consistent with prior research (Krishnan et al. 2006) we include leverage to measure the financial health of nonprofit organizations. We compute *LEVERAGE* as beginning total liabilities divided by beginning total assets. Lower leverage (higher solvency) indicates a more financially robust organization, which may mitigate incentives for misreporting. However, high leverage may be associated with monitoring related to debt or unearned revenue provided by creditors or donors/members, respectively, relative to firms with lower leverage. Due to these two potentially offsetting effects, we do not predict a sign on the coefficients for *LEVERAGE* for the three tests.

The primary criticism of telemarketing is that it is too expensive, thus we predict that a manager may have an incentive to hide the cost of professional fundraising activities. We measure the cost of telemarketing activities as the combined net proceeds received by the nonprofit in a year, divided by the associated gross proceeds (*YIELD*). We expect negative coefficients on *YIELD*, suggesting that a nonprofit is more likely to misreport when the yield is low.

¹⁰ We do not have a complete list of all states in which each nonprofit telemarkets. It is possible that a nonprofit's telemarketing or other activities in a particular state may require it to complete an audit, but we are unable to detect the need for the audit. Additionally, nonprofits can voluntarily choose to complete an audit. In these two cases, our *AUDIT* variable would be coded as 0 when it should be coded as 1.

Sector

We control for nonprofit sector using the first digit of the National Taxonomy of Exempt Entities (NTEE) codes. The sectors examined separately in our analysis include arts, education, health, and human services. All other types of organizations are grouped as “other.”

IV. DATASETS

Telemarketing Campaign Data

To test our hypotheses, we use data from telemarketing reports available from state regulators and IRS Form 990 filings. Various states require professional fundraisers to file annual reports detailing the nonprofits for which they have generated donations, the gross proceeds collected on behalf of each organization, and the net proceeds remitted to the nonprofits. We collect these fundraising reports from the states’ websites, usually from the office of the state attorney general. We retrieve state fundraising reports for California starting in 1995 and for New York in 1996. In subsequent years, we access reports from Ohio, Massachusetts, Vermont, North Carolina, Indiana, and Connecticut. Our sample includes reports from both large and small states with a variety of oversight regulations.¹¹

Most reports are only available in Adobe Acrobat (*.pdf) format, so a conversion process is required to convert the data into a machine-readable form, often requiring manual data input. After minor data cleaning, combining the state reports yields data from eight states on 20,203 telemarketing campaigns undertaken by 635 professional fundraisers on behalf of 4,248 nonprofits.

The requirements for fundraising reports vary across states. Some of the reports filed include only information about campaigns conducted within the state. Others include information about nationwide fundraising proceeds. In some cases, it appears that national figures are provided even though state-specific data is requested. Sometimes, when a campaign conducted in one year is completed in a second, the gross receipts of a single campaign are reported to the state in two consecutive years. The result of this variation of reporting practice is that a single campaign may be reported simultaneously to more than one state or that a single campaign may be reported to a state in multiple years.

To eliminate duplicate campaigns, we compare every campaign by a given telemarketing firm for a given nonprofit organization. Because there is no campaign number or other similar identifier (such as an employer identification number [EIN]), the comparison requires that we first standardize the names of the nonprofit organizations and the telemarketing firms.¹² We then compare the campaigns reported for a nonprofit-telemarketer combination. If we find multiple campaigns with equal gross receipts (within \$10), we retain a single campaign with the highest net receipts reported in the earliest year. Eliminating these duplicate campaign reports results in a reduced sample of 16,977 unique fundraising campaigns. Table 1 summarizes our dataset (campaign-level sample) of telemarketing campaigns without duplicated gross receipts during the period 1995–2004.

We recognize that the due dates for interim reports differ from state to state, thus our next concern is to address the possibility that interim and final reports are filed for the same campaigns. Several state reports do not indicate which campaign results are interim, so gross proceeds from one campaign may be included in both interim and final reports.

¹¹ For more information about the range of oversight options across different states, see Fremont-Smith (2005).

¹² For example, one campaign report may use the nonprofit name “Society for the Prevention of Cruelty to Animals,” while another refers to the same organizations as “The S.P.C.A.” A telemarketer may be listed as “Samano, Phillip J. & Assoc. Inc.” in one report and “Phillip J. Samano and Associates, Inc.” in another.

TABLE 1
Telemarketing Campaigns by Year

Year	State Reports Included	Number of Campaigns	Number of Nonprofits	Number of Telemarketers	Average Gross Proceeds	Average to Nonprofit	Median Yield
1995	California	496	416	104	285,786	116,284	24.9
1996	California, New York	1,199	944	190	263,673	96,920	25.0
1997	California, New York, Ohio	1,233	964	215	288,966	117,974	25.0
1998	California, Massachusetts, New York, Ohio, Vermont	1,884	1,284	268	244,617	90,413	25.0
1999	California, Massachusetts, North Carolina, New York, Ohio, Vermont	2,124	1,444	269	246,647	89,905	28.7***
2000	California, Massachusetts, North Carolina, New York, Ohio, Vermont	1,762	1,175	264	353,197	168,199	25.5***
2001	California, Massachusetts, North Carolina, New York, Ohio, Vermont	2,134	1,434	294	332,575	162,957	30.0***
2002	California, Indiana, Massachusetts, North Carolina, New York, Ohio, Vermont	2,389	1,449	319	319,076	142,278	30.0
2003	Connecticut, Indiana, Massachusetts, North Carolina, New York, Ohio, Vermont	2,441	1,418	261	386,876	168,107	30.5
2004	Indiana, North Carolina, New York, Vermont	1,315	846	176	317,596	135,275	35.0***
All Campaigns	California, Connecticut, Indiana, Massachusetts, North Carolina, New York, Ohio, Vermont	16,977	4,248	635	309,551	132,703	29.0

*** Significant at the 0.01 level.
Rank sum compares yield for campaigns in a given year with yield from campaigns in the previous year.

Similarly, telemarketers may report state campaign figures to one state and national campaign figures to another state. To reduce the chances of double counting proceeds from a single campaign reported in different state reports, we retain only the largest telemarketing campaign completed by a given solicitor for a given nonprofit in any particular year in our dataset. This eliminates 3,551 campaigns, reducing our sample to 13,426 unique telemarketing campaigns known as the firm-fundraiser-year sample (see Table 2).¹³

The next step is to consolidate all of the campaigns on behalf of a given nonprofit in a single year so that we can compare the proceeds from these campaigns to Form 990. To do this, we sum all the campaigns in one year for a unique nonprofit organization from all telemarketing firms (using only the largest campaign reported by each fundraiser). After we total the highest gross receipts from each telemarketing firm associated with a particular nonprofit-year, we have a sample size of 11,375 firm-years (see Table 2). We then compare these firm-year telemarketing proceeds data to the financial reports filed by the nonprofit organizations.

Form 990 Financial Statement Data

For the financial data filed by the nonprofit organizations, we use two sources: the Core files of IRS Form 990s for the years 1994–2004 and the Digitized Data file of IRS Form 990s for the years 1998–2003. Both data sources are distributed to academic researchers by the National Center for Charitable Statistics (NCCS) at the Urban Institute.

The Core data files provide limited information from all tax-exempt organizations required to file a Form 990 or 990-EZ.¹⁴ The Core data is composed of two separate files each year for 501(c)(3) and non-501(c)(3) filers. Both Core files contain the same Form 990 variables, representing the major financial accounts, but exclude some of our variables of interest. In contrast, the NCCS Digitized Data file contains all numbered items from Form 990 and 990-EZ (though not the details from required attached schedules), and thus is more comprehensive than the Core files. However, it only covers 501(c)(3) filers and the later years of our sample.

We use the two data sources to develop two initial datasets. The base dataset employs financial information from both sources. In the early years, this dataset uses the Core data, and, when possible, switches to the Digitized Data file in the later years. As the Digitized Data file does not include non-501(c)(3) organizations, the Core data is used for those firms in the more recent years. The advantage of this “both sources” dataset is that it has the most firm-year observations, allowing us to develop the largest possible database—4,871 firm-years (see Table 2). Unfortunately, the inclusion of the Core data limits our ability to include some variables (*ACCRUAL*, *PROFACCT*, and *RESTRICTED*) due to missing data fields. Additionally, the Core data file includes total contributions, but does not separately include direct contributions (which is where telemarketing gross receipts should be reported) and indirect revenues. For this reason, we develop a second “digitized dataset” that uses only observations from the Digitized Data file. The extensive coding in the Digitized Data file allows the inclusion of numerous additional independent variables (*ACCRUAL*,

¹³ The possibility exists that a nonprofit organization could have multiple campaigns by a given fundraising firm in a single year, so using only the largest campaign will possibly understate donations raised by professional firms. This may reduce the likelihood that we properly identify net reporters, and biases us against finding significant results in our tests.

¹⁴ We use the IRS Core files instead of the Statistics of Income (SOI) files, because the SOI files contain primarily large organizations (assets greater than \$10 million). Many nonprofit organizations that use professional fundraisers are too small to be included in the IRS SOI files.

TABLE 2
Sample Selection

Sample	Level of Observation	Number of Campaigns	Number of Charities	Average Gross Receipts	Average Proceeds to Nonprofits
“Initial Sample” of Telemarketing Campaigns	Campaign	20,203	4,248	\$325,723	\$140,798
“Campaign Level Sample” with Duplicate Campaigns Removed across States and Years	Campaign	16,977	4,248	\$309,551	\$132,703
“Firm-Fundraiser-Year Sample” with Only the Largest Campaigns per Firm-Fundraiser-Year Retained	Firm-Fundraiser-Year	13,426	4,248	\$324,983	\$136,636
“Firm-Year Sample” with Largest Campaigns Summed for Each Firm (not yet matched to financial data)	Firm-Year	11,375	4,248	\$383,580	\$161,273
“Matched Firm-Year Sample” with Largest Campaigns Summed for Each Firm Matched to Financial Data (Core and Digitized Data files)	Firm-Year	4,871	1,625	\$582,543	\$253,404

PROFACCT, and *RESTRICTED*), as well as the more precise direct contributions measurement for comparison with telemarketing reports.

Combined Data

A major challenge is to match the telemarketing campaign data to Form 990 data, since the state campaign data reports identify nonprofits by name (and not by numeric identifier). We employ a multiple-round procedure that involves having research assistants trace the nonprofit name from the campaign reports into the IRS Business Master File, which is a database of organizations granted federal exemption by the IRS, or the GuideStar database of recent Form 990s, in order to identify the associated EIN.¹⁵ After the list of potential matches is developed, the authors review the work and then open and read a number of Form 990s to assure that the name and EIN matches identify the appropriate nonprofit.¹⁶

We are unable to find EINs for some organizations as the IRS Business Master File and GuideStar do not include filings for all tax-exempt organizations. An IRS (1994) study reveals that the Business Master File is missing a significant number of nonprofit organizations. In addition, if police and fire support organizations and public school booster clubs are considered part of their respective municipalities and benefit from municipal government tax exemptions, then they may opt not to file Form 990. In other instances, we find too many possible matches, particularly from federated organizations that have multiple chapters that are independently incorporated nonprofits. If we do not feel confident that we have identified the correct EIN for a nonprofit name, then we do not include the telemarketing observations for that nonprofit in our final datasets.

The next step is to match the data from the state fundraising reports to the datasets we develop using the Core and Digitized Data files. For the “both sources” dataset, we find financial information for 4,871 (43 percent) of the 11,375 observations in our firm-year sample. We find an EIN but are unable to find any financial information for an additional 1,462 (13 percent) of the firm-years. The major reason for these missing observations is that all churches and other nonprofits with less than \$25,000 in annual revenue are exempt from the annual Form 990 filing requirement (see Table 3). Additionally, we find 1,024 firm-year observations in which the combined campaigns had gross receipts of \$25,000 or more in revenues but for which we find no associated Form 990. This indicates that the use of net revenue reporting of telemarketing campaigns may allow nonprofits to avoid filing Form 990s.

The 4,871 firm-year observations with clearly identified EINs represent 8,796 campaigns with average net proceeds of \$171,904 and a median yield of 30 percent. The remaining 6,504 firm-year observations that are not matched to financial data are based on 8,181 campaigns, which generate \$90,554 on average, with a median yield of 26 percent.

Due to the high percentage of telemarketing data that we cannot match to Form 990s and the significant difference in median yield, we are concerned about the generalizability of our results to the broader telemarketing nonprofit population. To assess sample selection bias, we use the campaign sample ($n = 16,977$) and regress the campaign yield (net proceeds remitted to the nonprofit divided by gross proceeds raised on the nonprofit's behalf) on factors found to be relevant in Keating et al. (2003), such as campaign size, the solicitors'

¹⁵ The Core and Digitized Data files identify nonprofit organizations by EIN.

¹⁶ Selected state regulators presently require telemarketers to report the proceeds of telemarketing campaigns. However, there is no easy way for the public to relate this information to the applicable nonprofit as many nonprofit names are similar or related through a federation. The state charity office reports could encourage more public scrutiny if state reports included EINs and the exact name and address of each nonprofit, and ensured that the numbers reported were statewide rather than nationwide figures.

TABLE 3
Matching EINs to Both Sources Dataset

	Number of Firm- Years	Percentage of Firm- Years	Underlying Campaigns	Percentage of Campaigns	Average Net Proceeds to Charity
All Firm-Years	11,375	100%	16,977	100%	\$132,703
Unable to Match EIN to Financial Data because:					
No Form 990 data available	1,462	13%	1,870	11%	
Multiple EINs found	480	4%	1,162	7%	
No EIN found	4,562	40%	5,149	30%	
Total Unmatched	6,504	57%	8,181	48%	\$90,554
Financial Data Found	4,871	43%	8,796	52%	\$171,904

The “Both Sources” dataset includes financial information obtained from both the IRS Core files for 1994–2004 and the NCCS Digitized Data files from 1998–2003.

and nonprofits’ experience in telemarketing, and purported charity focus. Our primary variable of interest is whether a campaign can be matched to financial data. We find that this coefficient is insignificant, suggesting that the campaigns that successfully match to Form 990 data do not differ from the unmatched campaigns from a yield perspective after controlling for size, experience, and industry.

V. EMPIRICAL RESULTS

Descriptive Statistics

Using the “both sources” dataset, we have 4,871 firm-years available for analysis. Due to data limitations, we exclude 736 observations from Form 990EZ filers, which lack fundraising expense information, and an additional 61 observations with missing data. Due to problems of data accuracy arising from preparer errors and coding mistakes, we conduct outlier analysis, using the DBETA overall measure of influence, and drop 11 observations that are overly influential in one or both of the regressions. Our final sample is 4,063 firm-year observations representing 1,382 nonprofit organizations. Table 4 provides numerical derivation for the regressions based on the two different datasets.

The means and medians for the various samples are in Table 5. As shown in Panel A, gross reporters differ substantially from the net reporters.¹⁷ The net reporters represent 27 percent of the sample and are more likely to lack accounting sophistication or knowledge as measured by size, officers’ compensation, use of accrual accounting, and existence of restricted net assets. The net reporters’ median total assets equal \$255,000 as compared to \$3.5 million for gross reporters. Only 52 percent of the net reporters use accrual accounting versus 92 percent for gross reporters, while one-quarter of net reporters report either permanently or temporarily restricted net assets in contrast to gross reporters, 75 percent of which have restricted net assets. Net and gross reporters do not differ significantly in their reliance on external accountants; however net reporters are less likely to be audited than their gross reporting counterparts (56 percent to 96 percent, respectively, in the “digitized dataset”). Net reporters are less likely to be a 501(c)(3) organization (56 percent of net

¹⁷ During the sample period, 91 percent of sample organizations are consistently labeled as either gross or net reporters. Only 3 percent of the organizations have more than one change between reporting categories.

TABLE 4
Sample Selection

	Both Sources	Digitized Dataset
Panel A: Dependent Variable = <i>P(Net Reporter)</i>		
Total Firm-Years	4,871	2,648
Less: 990-EZ Filers ^a	(736)	(130)
Observations with Missing Variables	(61)	(38)
Outliers ^b	(11)	(12)
Final Regression Sample	4,063	2,468
Panel B: Dependent Variable = <i>P(Misclassifier)</i>^c Dependent Variable = <i>P(Allocator)</i>^c		
Firm-Years in Panel A Final Regression Sample	4,063	2,468
Less: Net Reporters	(1,109)	(585)
Final Regression Sample	2,954	1,883

^a The 990-EZ does not report fundraising expense, which makes all EZ filers appear to be net reporters in the revenue test (fundraising expense appears to equal zero). Additionally, fundraising expense is necessary for the allocator test.

^b Outliers are defined using the DBETA overall measure of influence.

^c The sample begins with firm-years that are labeled gross reporters.

reporters in the “both sources” dataset are 501(c)(3) organizations and 92 percent of gross reporters are 501(c)(3) organizations). Net and gross reporters do not consistently differ significantly in their reliance on debt and the amount retained by professional fundraisers.

Table 5, Panel B presents the means and medians for gross reporters that properly classify telemarketing costs as professional fundraising fees, and those that appear to misclassify their expenses on their Form 990s. Approximately 65 percent of the sample does not properly classify the costs of their telemarketing campaigns as professional fees. Expense misclassifiers are larger (\$3.5 million versus \$3.2 million in median total assets), but pay slightly less to their officers (\$96,000 as compared to \$109,000 in median pay). Misclassifiers use external accountants less often (66 percent compared with 81 percent for proper expense classifiers), but are more likely to use accrual accounting (93 percent versus 89 percent for proper expense classifiers), to have restricted net assets (79 percent versus 68 percent for proper expense classifiers) or to be 501(c)(3) organizations (93 percent compared to 88 percent for proper expense classifiers). There are no significant differences between expense misclassifiers and proper classifiers in the frequency of audits, but proper expense classifiers have significantly more leveraged debt than misclassifiers. Campaign yields tend to be lower for organizations that properly report professional fundraising fees (33 percent versus 38 percent for misclassifiers in the “both sources” dataset and 34 percent versus 40 percent in the “digitized dataset”).

Table 5, Panel C summarizes the means and medians for gross reporters that allocate fundraising expenses and those that do not. Of the 2,954 firm-years in this “both sources” sample (representing 980 nonprofits), 359 firm-years (12 percent) appear to allocate a portion of their telemarketing fees to non-fundraising categories. The allocators are significantly different from non-allocators on most attributes other than 501(c)(3) status. Allocators are smaller (allocator median total assets equal \$394,000 and non-allocator median total assets equal \$4.7 million) and pay their officers much less money (\$11,000 versus

TABLE 5
Descriptive Statistics

Panel A: Gross versus Net Revenue Reporters

	Both Sources		Digitized Dataset	
	Gross	Net	Gross	Net
<i>lnASSETS</i>	14.91 (15.06)	12.42*** (12.45)***	15.23 (15.43)	12.39*** (12.10)***
<i>Assets</i>	5,790,000 (3,500,000)	1,490,000*** (255,000)***	5,280,000 (3,600,000)	1,440,000*** (158,000)***
<i>lnOFFSAL</i>	8.96 (11.51)	4.37*** (0.00)***	9.44 (11.78)	4.14*** (0.00)***
<i>Officers' Salaries</i>	278,538 (100,000)	49,333*** (0.00)***	318,043 (131,148)	67,881*** (0.00)***
<i>ACCRUAL</i>			0.92 (1.00)	0.52*** (1.00)***
<i>PROFACCT</i>			0.71 (1.00)	0.72 (1.00)
<i>RESTRICTED</i>			0.75 (1.00)	0.25*** (0.00)***
<i>501C3</i>	0.92 (1.00)	0.56*** (1.00)***		
<i>AUDIT</i>	0.97 (1.00)	0.71*** (1.00)***	0.96 (1.00)	0.56*** (1.00)***
<i>LEVERAGE</i>	0.49 (0.19)	0.41 (0.02)***	0.54 (0.18)	0.49 (0.08)***
<i>YIELD</i>	36.22 (38.75)	33.72** (28.28)***	37.78 (41.08)	35.85 (29.74)***
<i>n</i>	2,954	1,109	1,883	585

Panel B: Proper Expense Classifiers versus Misclassifiers

	Both Sources		Digitized Dataset	
	Proper Classifier	Misclassifier	Proper Classifier	Misclassifier
<i>lnASSETS</i>	14.61 (14.97)	15.09*** (15.08)***	14.91 (15.40)	15.40*** (15.44)**
<i>Assets</i>	4,190,000 (3,163,000)	6,690,000*** (3,532,689)***	3,900,000 (3,697,000)	6,020,000** (3,598,000)**
<i>lnOFFSAL</i>	9.44 (11.60)	8.68*** (11.48)***	9.77 (11.84)	9.27** (11.75)*
<i>Officers' Salaries</i>	306,593 (108,879)	262,744** (96,322)***	338,314 (138,748)	307,205 (127,002)*
<i>ACCRUAL</i>			0.89 (1.00)	0.93*** (1.00)***
<i>PROFACCT</i>			0.81 (1.00)	0.66*** (1.00)***

(continued on next page)

TABLE 5 (continued)

	Both Sources		Digitized Dataset	
	Proper Classifier	Misclassifier	Proper Classifier	Misclassifier
<i>RESTRICTED</i>			0.68 (1.00)	0.79*** (1.00)***
<i>501C3</i>	0.88 (1.00)	0.93*** (1.00)***		
<i>AUDIT</i>	0.97 (1.00)	0.97 (1.00)	0.95 (1.00)	0.96 (1.00)
<i>LEVERAGE</i>	0.66 (0.18)	0.39** (0.19)	0.67 (0.18)	0.48 (0.18)
<i>YIELD</i>	32.65 (31.85)	38.23*** (43.18)***	33.54 (32.51)	40.05*** (45.38)***
n	1,064	1,890	656	1,227

Panel C: Non-Allocators versus Allocators

	Both Sources		Digitized Dataset	
	Non-Allocator	Allocator	Non-Allocator	Allocator
<i>lnASSETS</i>	15.17 (15.35)	13.07*** (12.88)***	15.50 (15.73)	12.83*** (12.63)**
<i>Assets</i>	6,440,000 (4,656,000)	1,070,000*** (394,000)***	5,820,000 (4,900,000)	4,170,000 (222,000)
<i>lnOFFSAL</i>	9.37 (11.77)	5.99*** (9.29)***	9.80 (11.94)	6.23*** (9.80)***
<i>Officers' Salaries</i>	307,388 (128,728)	69,997*** (10,817)***	345,615 (152,833)	69,454 (18,000)
<i>ACCRUAL</i>			0.93 (1.00)	0.79*** (1.00)***
<i>PROFACCT</i>			0.71 (1.00)	0.78** (1.00)**
<i>RESTRICTED</i>			0.79 (1.00)	0.40*** (0.00)***
<i>501C3</i>	0.92 (1.00)	0.89 (1.00)		
<i>AUDIT</i>	0.97 (1.00)	0.94*** (1.00)***	0.97 (1.00)	0.87*** (1.00)***
<i>LEVERAGE</i>	0.51 (0.19)	0.37** (0.18)**	0.57 (0.18)	0.33** (0.18)**
<i>YIELD</i>	36.62 (40.06)	33.35** (30.63)***	38.17 (42.51)	34.24* (30.00)***
n	2,595	359	1,695	188

*, **, *** Differences are significant at the 0.10, 0.05, and 0.01 levels, respectively.
Figures reported are means (medians). The significance tests for the means are t-tests and rank sum tests for medians.

\$129,000 in median pay). They also use accrual accounting less frequently (79 percent to 93 percent) and are less likely to report restricted net assets (40 percent compared to 79 percent). Allocators are less likely to be audited (94 percent compared to 97 percent).

Finally, allocators have smaller campaign yields (33 percent versus 37 percent in the “both sources” dataset).

Regression Results

The correlations among the independent variables are presented in Table 6. For the “both sources” full sample, the independent variables with the highest degrees of correlation are *lnASSETS* with *lnOFFSAL* and *501C3*, with correlations of 0.42 and 0.33, respectively. For the more limited sample used in the second regression, the correlations are generally much lower, although a high correlation of 0.43 remains between *lnASSETS* and *lnOFFSAL*.

In the “digitized dataset,” several variables have relatively high correlations, making it less likely that these variables will be significant in regression. The *RESTRICTED*, *ACCRUAL*, *lnASSETS*, *lnOFFSAL*, and *AUDIT* are all correlated with each other in the 0.39 to 0.67 range. The correlations are lower in the more limited sample used in the second regression with most of the correlations of the five variables in the 0.15 to 0.44 range. The correlation of *RESTRICTED* to *lnASSETS*, however, is 0.67.

The first model reported in Tables 7 through 9 provides the results for regressions that use Core and Digitized Data in the “both sources” dataset; the second model in each table reports the regression results for the “digitized dataset” only. Recall that we use both these datasets because some of the variables of interest are not included in the Core data files. However, the “digitized dataset” does not include non-501(c)(3) nonprofits or 1995–1997 Form 990 returns. We focus the analysis first on the larger sample from the “both sources” dataset before turning to the additional insights that can be gleaned from the richer data fields available in the more limited sample from the “digitized dataset.” To better understand the effects of each variable, we focus the discussion on the marginal effects rather than the coefficients.

Table 7 reports the results of logistic regression based on Equation (1), which examines the likelihood of a nonprofit reporting only the net proceeds received from a professional fundraiser as revenue rather than properly reporting the gross proceeds collected. When organizations report on a net basis, they presumably do not report the expense associated with the telemarketing campaign, thus understating reported fundraising expenses. A positive (negative) coefficient in this regression indicates that the organization is more (less) likely to misreport telemarketing activities by reporting only contributions received from the professional fundraiser (i.e., net proceeds).

We start by examining the larger “both sources” sample using the more limited variables available in that dataset. The pseudo R^2 for this model is 29 percent. The estimates on *lnASSETS* and *lnOFFSAL*, which examine the effects of size and professional management, are both negative and statistically significant. This indicates larger organizations and organizations that pay more in total executive salaries are less likely to be classified as misreporting telemarketing activities. A one-unit increase in the natural log of size or officer salaries translates into a 4.2 and 1.1 percentage point decrease, respectively, in the probability of misreporting revenues when other independent variables are held fixed at their means.

Similarly, the governance variables are associated with a reduced likelihood of revenue misreporting. Organizations registered as 501(c)(3) entities are associated with a 33.8 percentage point increase in the likelihood of proper revenue reporting compared with non-501(c)(3) entities. Being audited by a CPA firm is associated with a 34.3 percentage point increase in the chances of being classified as properly reporting telemarketing proceeds.

TABLE 6
Correlations among Independent Variables

Panel A: Independent Variables Used in Logistic Regressions with Both Sources Dataset (n = 4,063)									
	<u>lnASSETS</u>	<u>lnOFFSAL</u>	<u>501C3</u>	<u>AUDIT</u>	<u>LEVERAGE</u>	<u>YIELD</u>			
lnASSETS	1.00								
lnOFFSAL	0.42	1.00							
501C3	0.33	0.27	1.00						
AUDIT	0.25	0.27	0.30	1.00					
LEVERAGE	-0.14	0.02	0.02	-0.01	1.00				
YIELD	0.11	0.01	0.09	0.00	-0.03	1.00			
Panel B: Independent Variables Used in Logistic Regressions with Digitized Dataset (n = 2,468)									
	<u>lnASSETS</u>	<u>lnOFFSAL</u>	<u>ACCRUAL</u>	<u>PROFACCT</u>	<u>RESTRICTED</u>	<u>AUDIT</u>	<u>LEVERAGE</u>	<u>YIELD</u>	
lnASSETS	1.00								
lnOFFSAL	0.43	1.00							
ACCRUAL	0.48	0.40	1.00						
PROFACCT	0.02	0.10	-0.00	1.00					
RESTRICTED	0.67	0.39	0.48	-0.04	1.00				
AUDIT	0.44	0.39	0.54	0.01	0.41	1.00			
LEVERAGE	-0.15	0.03	0.02	-0.01	-0.08	0.01	1.00		
YIELD	0.10	0.01	0.04	-0.03	0.09	-0.00	-0.03	1.00	

TABLE 7
Logistic Regression of the Likelihood of Net Reporting Using Two Datasets

$$P(\text{Net Reporting}) = \beta_0 + \beta_1 \ln \text{ASSETS} + \beta_2 \ln \text{OFFSAL} + \beta_3 \text{ACCRUAL} + \beta_4 \text{PROFACCT} \\ + \beta_5 \text{RESTRICTED} + \beta_6 501\text{C3} + \beta_7 \text{AUDIT} + \beta_8 \text{LEVERAGE} \\ + \beta_9 \text{YIELD} + \beta_{10} \text{SECTOR} + \varepsilon$$

	Predicted Sign	Both Sources		Digitized Dataset	
		Coefficient ^a (Standard Error)	Marginal Effect ^b	Coefficient ^a (Standard Error)	Marginal Effect ^b
<i>lnASSETS</i>	—	−0.26*** (0.03)	−4.2%	−0.10** (0.05)	−1.4%
<i>lnOFFSAL</i>	?	−0.07*** (0.01)	−1.1%	−0.08*** (0.02)	−1.1%
<i>ACCRUAL</i>	—			−0.55** (0.23)	−8.7%
<i>PROFACCT</i>	—			0.05 (0.18)	1.0%
<i>RESTRICTED</i>	—			−0.99*** (0.21)	−15.1%
<i>501C3</i>	—	−1.65*** (0.23)	−33.8%		
<i>AUDIT</i>	—	−1.61*** (0.20)	−34.3%	−1.49*** (0.24)	−28.3%
<i>LEVERAGE</i>	?	−0.06*** (0.02)	−0.1%	−0.02* (0.01)	−0.3%
<i>YIELD</i>	—	0.00 (0.00)	0.0%	0.00 (0.00)	0.0%
Constant		5.35*** (0.47)		2.51*** (0.61)	
n		4,063		2,468	
Pseudo R ²		29%		31%	

*, **, *** Significant at the 0.10, 0.05, and 0.01 levels, respectively, two-tailed test.
^a The standard errors and associated z-statistics are adjusted for the intrafirm correlations arising from the inclusion of multiple years of observations (Huber 1967; Rogers 1993).
^b The marginal effect indicates the effect on the probability of net reporting of a one-unit change for continuous variables and a change from 0 to 1 for discrete variables when independent variables are evaluated at their means.
P(Net Reporting) = 1 if *REVDIFF* < 0 or if fundraising expense = 0, and 0 otherwise;
lnASSETS = natural logarithm of beginning assets;
lnOFFSAL = natural logarithm of officers' salaries and wages;
ACCRUAL = 1 if organization uses accrual accounting and 0 if it uses the cash basis;
PROFACCT = 1 if accounting fees > 0, and 0 otherwise;
RESTRICTED = 1 if permanent or temporarily restricted net assets > 0, and 0 otherwise;
501C3 = 1 if entity is organized as a 501(c)(3), and 0 otherwise;
AUDIT = 1 if entity meets the audit requirements of a state in which it operates or solicits funds or is subject to an A-133 audit, and 0 otherwise;
LEVERAGE = total beginning liabilities/total beginning assets; and
YIELD = combined net proceeds from telemarketing campaigns/combined gross proceeds from telemarketing campaigns.

The financial health indicator, however, explains relatively little of the variance in the revenue reporting decision. Highly leveraged organizations are less likely to be classified as misreporting their telemarketing revenues net of expenses. The coefficient on *LEVERAGE* is negative and statistically significant, and a one-unit change would alter the probability of net reporting by 0.1 percentage points. This may indicate that organizations with more debt are monitored by their creditors. The coefficient on the *YIELD* variable is insignificant, suggesting that nonprofits with lower telemarketing yields are not any more likely to be classified as a misreporter than their counterparts.

The “digitized dataset” allows a broader range of variables to be tested and compares telemarketing proceeds to direct contributions, but is limited to 501(c)(3) organizations and to more recent years. The logistic regression model has a pseudo R^2 of 31 percent. The coefficients of the common variables (*lnASSETS*, *lnOFFSAL*, *AUDIT*, *LEVERAGE*, and *YIELD*) are qualitatively similar. The marginal effect of a unit change decrease in *lnASSETS* and *AUDIT* are more modest at 1.4 and 28.3 percentage points, respectively, in the “digitized dataset” as compared to the “both sources” dataset. The statistical significance of the *LEVERAGE* variable is lower although a one-unit change in the variable is modestly higher in the “digitized dataset.”¹⁸

Two of the measures of accounting sophistication, *ACCRUAL* and *RESTRICTED*, are significant in the predicted direction. The use of accrual accounting is associated with an increase in the probability of properly reporting revenues of 8.7 percentage points. Nonprofits with some restricted net assets are 15.1 percentage points more likely to be classified as properly reporting gross revenues from telemarketing campaigns. These results are consistent with the hypothesis that accounting sophistication and knowledge are associated with the likelihood that an organization will misreport revenues and expenses associated with telemarketing campaigns.

Counter to our expectations, the *PROFACCT* variable is insignificant. Krishnan et al. (2006) suggest that *PROFACCT* may proxy for either the use of an outside accountant to assist with preparing Form 990s (or providing other accounting services) or the use of an independent auditor. We specifically control for the use of an independent auditor, include non-501(c)(3) organizations, and use different control variables, all of which may explain the difference in our result from that observed by Krishnan et al. (2006). These results could also differ due to sample variations; nonprofits that employ telemarketers may inherently differ from the large organizations used in their study.

To determine the possible effect that net misreporting has on reported ratios, we examine the organizations that are designated as net reporters because they have fundraising expense equal to zero. We calculate an estimate of the ratio of fundraising expenses to total expenses by increasing reported fundraising expenses (and thus total expenses) by the amount of the telemarketers’ fees. The median ratio of fundraising expense as a percentage of total expense increases from zero to 15.0 percent in the “both sources” dataset and to 11.7 percent in the “digitized dataset” (results untabulated). Based on our estimation of “corrected” fundraising expense, the difference in the ratios is substantial.

The second test examines the factors associated with classifying costs associated with telemarketing campaigns in an expense category other than professional fundraising fees.

¹⁸ We explore whether the negative association between *LEVERAGE* and net reporting is explained by bondholders and bankers either requiring audits or engaging in additional monitoring. In the “digitized dataset,” liabilities can be decomposed between bonds and other liabilities. The sample, however, has relatively few that have outstanding bonds, so that we are not able to effectively evaluate the role of credit relations in promoting better financial reporting practices.

The results of our examination using the logistic regression in Equation (2) are summarized in Table 8. The model has very low explanatory power, with a pseudo R^2 of only 2 percent using the “both sources” dataset and 4 percent using the “digitized dataset.” Very few of the independent variables are statistically significant in the predicted direction.

In the “both sources” dataset, only officers’ salaries and the 501(c)(3) status have a statistically significant relationship to misclassification. Nonprofit organizations that pay relatively higher salaries to their officers are more likely to properly classify their telemarketing costs. A one-unit increase in *lnOFFSAL* is associated with a 1-percentage point increase in the likelihood of proper classification. Nonprofits that are 501(c)(3)s are 18.7 percent more likely to misclassify, which is not consistent with better governance.

The results differ in the “digitized dataset” that focuses exclusively on 501(c)(3) organizations and recent years. The *lnOFFSAL* is not significant, while *PROFACCT* and *RESTRICTED* are. Robustness checks reveal that *lnOFFSAL* is negatively and significantly associated with expense misclassification in the absence of *PROFACCT* but not *RESTRICTED*, suggesting that the significance of *lnOFFSAL* in the both sources regression is due to an omitted correlated variable (*PROFACCT*). In the digitized sample, organizations that use external accountants to assist them with accounting and reporting are significantly less likely to misclassify professional fundraising fees. *PROFACCT*, which measures sophistication acquired from outside the organization, is associated with a 15.9 percentage decrease in the likelihood of misclassification.

An unexpected result is that nonprofits that have restricted net assets are 9.1 percentage points more likely to misclassify telemarketing costs. A possible explanation for this result is that those nonprofits that receive restricted donations (which, in turn, results in restricted assets) are concerned with revealing to their donors that they use an external professional fundraiser.

Overall, the results reported in Table 8 suggest that monitoring does not change the likelihood that telemarketing fees will be properly classified. Additionally, sophistication seems to play a relatively small role, with the use of external accountants being the most significant explanatory factor.

In the third test, the characteristics associated with the telemarketing cost allocation decision are assessed. The samples are limited to the nonprofits designated as gross reporters. Table 9 reports the results from estimating the logistic regression in Equation (3). The pseudo R^2 for the allocation decision is 13 percent using the “both sources” dataset and 19 percent for the “digitized dataset” sample. Both management sophistication variables, *lnASSETS* and *lnOFFSAL*, are negative and statistically significant, meaning that larger nonprofits and those with larger or better compensated professional staffs are less likely to report a portion of the telemarketing fees as program or administrative expenses instead of as fundraising expenses. For the “both sources” regression, a one-unit change in *lnASSETS* and *lnOFFSAL* alters the probability of allocating costs by 1.8 and 0.6 percentage points, respectively. A potential explanation for this result is that nonprofits that are relatively smaller in size or in terms of their officers’ payroll manage telemarketing costs to report more favorable fundraising (or program) ratios.

Governance and accounting sophistication variables perform quite differently in the allocation and revenue recognition decisions. In the “both sources” dataset, the 501(c)(3) organization variable is marginally significant, but in the opposite of the predicted direction. It increases the likelihood of allocation of telemarketing costs by only 3.5 percentage points as compared to a decrease of 33.8 percentage point effect in the gross revenue test. The audit variable is insignificant in both allocation regressions, whereas it has a substantial mitigating effect in the net reporting regression. This finding is not surprising given that

TABLE 8
Logistic Regression of Likelihood of Misclassification of Professional Fundraising Fee Using Two Datasets

$$P(\text{Misclassifier}) = \gamma_0 + \gamma_1 \ln \text{ASSETS} + \gamma_2 \ln \text{OFFSAL} + \gamma_3 \text{ACCRUAL} + \gamma_4 \text{PROFACCT} \\ + \gamma_5 \text{RESTRICTED} + \gamma_6 \text{501C3} + \gamma_7 \text{AUDIT} + \gamma_8 \text{LEVERAGE} \\ + \gamma_9 \text{YIELD} + \gamma_{10} \text{SECTOR} + \varepsilon$$

	Predicted Sign	Both Sources		Digitized Dataset	
		Coefficient ^a (Standard Error)	Marginal Effect ^b	Coefficient ^a (Standard Error)	Marginal Effect ^b
<i>lnASSETS</i>	—	0.05 (0.03)	1.1%	0.01 (0.04)	0.2%
<i>lnOFFSAL</i>	?	−0.04*** (0.01)	−1.0%	−0.03 (0.02)	−0.6%
<i>ACCRUAL</i>	—			0.25 (0.27)	5.8%
<i>PROFACCT</i>	—			−0.76*** (0.18)	−15.9%
<i>RESTRICTED</i>	—			0.40** (0.20)	9.1%
<i>501C3</i>	—	0.77*** (0.24)	18.7%		
<i>AUDIT</i>	—	−0.10 (0.25)	−2.3%	0.02 (0.35)	0.5%
<i>LEVERAGE</i>	?	−0.03 (0.02)	−0.1%	−0.00 (0.02)	−0.1%
<i>YIELD</i>	—	0.00 (0.00)	0.0%	0.00* (0.00)	0.0%
Constant		−0.28 (0.40)		0.65 (0.51)	
n		2,954		1,883	
Pseudo R ²		2%		4%	

*, **, *** Significant at the 0.10, 0.05, and 0.01 levels, respectively, two-tailed test.
^a The standard errors and associated z-statistics are adjusted for the intrafirm correlations arising from the inclusion of multiple years of observations (Huber 1967; Rogers 1993).
^b The marginal effect indicates the effect on the probability of net reporting of a one-unit change for continuous variables and a change from 0 to 1 for discrete variables when independent variables are evaluated at their means.
P(Misclassifier) = 1 if *FEEDIFF* < 0, and 0 otherwise;
lnASSETS = natural logarithm of beginning assets;
lnOFFSAL = natural logarithm of officers' salaries and wages;
ACCRUAL = 1 if organization uses accrual accounting, and 0 otherwise;
PROFACCT = 1 if accounting fees > 0, and 0 otherwise;
RESTRICTED = 1 if permanent or temporarily restricted net assets > 0, and 0 otherwise;
501C3 = 1 if entity is organized as a 501(c)(3), and 0 otherwise;
AUDIT = 1 if entity meets the audit requirements of a state in which it operates or solicits funds or is subject to an A-133 audit, and 0 otherwise;
LEVERAGE = total beginning liabilities/total beginning assets; and
YIELD = combined net proceeds from telemarketing campaigns/combined gross proceeds from telemarketing campaigns.

TABLE 9
Logistic Regression of Likelihood of Allocation of Fundraising Expense Using Two Datasets

$$P(Allocator) = \lambda_0 + \lambda_1 \ln ASSETS + \lambda_2 \ln OFFSAL + \lambda_3 ACCRUAL + \lambda_4 PROFACCT + \lambda_5 RESTRICTED + \lambda_6 501C3 + \lambda_7 AUDIT + \lambda_8 LEVERAGE + \lambda_9 YIELD + \lambda_{10} SECTOR + \varepsilon$$

	Predicted Sign	Both Sources		Digitized Dataset	
		Coefficient ^a (Standard Error)	Marginal Effect ^b	Coefficient ^a (Standard Error)	Marginal Effect ^b
<i>lnASSETS</i>	—	−0.23*** (0.04)	−1.8%	−0.28*** (0.06)	−1.3%
<i>lnOFFSAL</i>	?	−0.07*** (0.02)	−0.6%	−0.07*** (0.02)	−0.3%
<i>ACCRUAL</i>	—			0.43 (0.36)	1.7%
<i>PROFACCT</i>	—			0.37 (0.25)	1.6%
<i>RESTRICTED</i>	—			−0.55* (0.31)	−2.8%
<i>501C3</i>	—	0.55* (0.29)	3.5%		
<i>AUDIT</i>	—	0.02 (0.30)	0.1%	−0.01 (0.40)	−0.1%
<i>LEVERAGE</i>	?	−0.19*** (0.07)	−1.5%	−0.30*** (0.08)	−1.4%
<i>YIELD</i>	—	0.00 (0.00)	0.0%	0.00 (0.00)	0.0%
Constant		1.41*** (0.54)		2.09*** (0.74)	
n		2,954		1,883	
Pseudo R ²		13%		19%	

*, **, *** Significant at the 0.10, 0.05, and 0.01 levels, respectively, two-tailed test.

^a The standard errors and associated z-statistics are adjusted for the intrafirm correlations arising from the inclusion of multiple years of observations (Huber 1967; Rogers 1993).

^b The marginal effect indicates the effect on the probability of net reporting of a one-unit change for continuous variables and a change from 0 to 1 for discrete variables when independent variables are evaluated at their means.

P(Allocator) = 1 if *FUNDEXPDIF* < 0, and 0 otherwise;
lnASSETS = natural logarithm of beginning assets;
lnOFFSAL = natural logarithm of officers' salaries and wages;
ACCRUAL = 1 if organization uses accrual accounting, and 0 otherwise;
PROFACCT = 1 if accounting fees > 0, and 0 otherwise;
RESTRICTED = 1 if permanent or temporarily restricted net assets > 0, and 0 otherwise;
501C3 = 1 if entity is organized as a 501(c)(3), and 0 otherwise;
AUDIT = 1 if entity meets the audit requirements of a state in which it operates or solicits funds or is subject to an A-133 audit, and 0 otherwise;
LEVERAGE = total beginning liabilities/total beginning assets; and
YIELD = combined net proceeds from telemarketing campaigns/combined gross proceeds from telemarketing campaigns.

virtually all firm-years in the second test are audited. Similarly, we find that the accrual variable is insignificant. The firms that spend on outside accounting or auditing services do not display significantly different allocation behavior from their counterparts that do not use outside services. However, we should note that we find that firms that have restricted funds are less likely to allocate some telemarketing costs to non-fundraising activities, but the statistical significance is marginal (significant at 0.10). Overall, the results suggest that accounting sophistication and certain monitoring activities have a substantial effect on the likelihood that telemarketing expenses will be allocated to expense categories other than fundraising expense.

Additional Tests

We conduct supplemental tests to examine the robustness of our results. First, we recognize that the telemarketing proceeds may be drawn from a state report whose fiscal year does not overlap precisely with the Form 990 fiscal year. For example, a yearly state report may cover a calendar year while a nonprofit has a different fiscal year. Moreover, a fundraising campaign by a telemarketer may start on July 1 and end on June 30 of the following year. For nonprofits with a calendar fiscal year, revenues generated by telemarketing firms would be reported in two separate Form 990 filings. Additionally, if a campaign is conducted across multiple years, the partial results of the first year of the campaign may be reported to the state in one year, with the entire campaign (gross receipts from years one and two) reported to the state in the subsequent years. There may also be numerical variation due to differences in the cash and accrual methods used (especially if a campaign generates pledges receivable in one year that is collected in a subsequent year).

To decrease the likelihood that we improperly label a nonprofit organization as misreporting due to the mismatch between the campaign and fiscal years, we create two additional datasets. We sum Form 990 data for a three-year period, including the year of the campaign and the years immediately before and after. For a nonprofit to be labeled as a net reporter or an allocator, it would then need to have three-year Form 990 numbers that are smaller than a single year of campaign data. Combined three-year datasets are constructed using financial information from both the Core and Digitized Data files (“both sources three-year”) and from only the Digitized Data file in later years (“digitized data three-year”). We use these more conservative datasets to test the robustness of the regression results obtained using our first two datasets.

The results from regressions that use the “both sources three-year” dataset to examine net reporters are largely the same as those obtained from the single year “both sources” dataset and have a pseudo R^2 of 27 percent. The only difference is that *LEVERAGE* is not a significant predictor of either net reporting or the likelihood of allocating telemarketing expense out of fundraising expense. With the “digitized data three-year” dataset, we find largely similar results; however, *lnASSETS* and *LEVERAGE* are insignificant. The variables appear to be insignificant in the regression due to a low correlation with the dependent variable rather than a high degree of multicollinearity with other independent variables.

The three-year datasets also generate results for the allocator test that are qualitatively similar to the single year datasets. For the “both sources three-year” dataset, the 501(c)(3) variable is dropped from the regression because it is so highly correlated with the allocation decision. However, the other variables remain significant as in the single-year regression. With the “digitized dataset three-year,” the results are essentially the same with one notable exception: *PROFACCT* is significant, while *ACCRUAL* is not.

A potential explanation for the shift is the high degree of multicollinearity between *ACCRUAL*, *PROFACCT*, *AUDIT*, and *RESTRICTED* in the Digitized Data sample. We ran

a series of revenue recognition and allocator regressions employing combinations of these variables. PROFACCT is consistently insignificant in the revenue and allocation tests using the single year “digitized dataset,” suggesting that our result may differ from Krishnan et al. (2006) due to sample differences.¹⁹ Therefore, we conclude that the insignificance of PROFACCT in these two tests is not due to a lack of power and high multicollinearity.

Liquidity and operating margin are other measures of nonprofit financial distress (Tuckman and Chang 1991).²⁰ Neither of these additional financial distress variables is a significant predictor in any of the misreporting tests. The inclusion of the variables does not substantially change the results of the regression analyses.

We include dummy variables for each year during the sample period. Our results do not change when these year variables are included in the regression. Additionally, we run separate regressions for each year in the sample period. Although, we find the incidence of misreporting decreases during the sample period, our initial results are robust across years.

Yetman and Yetman (2006) indicate that states may vary in the degree to which they regulate nonprofits. Therefore, we include dummy variables for each state in our sample. Our results do not change when these variables are included in the analysis.

As previously mentioned, we use a very conservative estimate of total telemarketing revenues and expenses, which decreases the likelihood that we will improperly classify a nonprofit as a net reporter, a misclassifier, or an allocator. In order to protect against improperly classifying an organization as a gross reporter, we create alternate measures of *REVDIFF*. Instead of classifying an organization as a net reporter if *REVDIFF* < 0, we label an organization a net reporter if total telemarketing revenues from all telemarketing firms are less than 95 (or 90) percent of reported contributions on Form 990. These alternative measures adjust for any organizations that may be net reporters, but appear to be gross reporters because they have large contributions from sources other than telemarketing. We create similar alternative measures of *FEEDIFF* and *FUNDEXPDIFF*, where in order to be categorized as a misclassifier or an allocator, the total telemarketing fees must exceed 95 (or 90) percent of total reported professional fundraising fees or total fundraising expenses on Form 990. The results are robust to the definitions of *REVDIFF*, *FEEDIFF*, and *FUNDEXPDIFF*.

Because the telemarketing reports do not indicate the type of service the professional fundraiser provides, our concern is that a limited number of the professional fundraisers in our sample conduct special events, such as selling tickets to a performance (Keating et al. 2003) and do not merely provide telemarketing services. In these instances, the IRS requires revenue generated from special events to be treated differently than contribution revenue. Thus, it is possible that the organizations report all or part of the “telemarketing” collections as special event revenue in Part 1 line 9a (gross revenues from special events). In this case, we could incorrectly classify an organization as a net reporter. Further, although IRS guidelines require that the “telemarketing” fee be reported on the professional fundraising fee line, the instructions on Form 990 on how to handle special event revenue and their related costs are ambiguous. Thus, some Form 990 preparers may interpret “direct expenses of special events” to include the fundraiser’s fee. If this is the case, then the preparer will

¹⁹ We also conducted analysis of variance influence factors, a test which can only be run on an OLS specification. It did not indicate any multicollinearity problems.

²⁰ A number of organizations have zero liabilities, which results in a current ratio that is undefined. We invert the current ratio to avoid losing observations. Further, we deflate profit margin by total assets rather than total revenue because revenue may be misreported.

report the “telemarketing” fee on line 9b (direct expenses of special events). To address our concerns about possible special events services provided to nonprofit organizations, we create an alternative measure of *REVDIFF* to compare total telemarketing revenues to contributions plus special event revenue from Form 990. Similarly, we measure *FEEDIFF* to compare total telemarketing costs to professional fundraising fees plus direct costs of special events and *FUNDEXPDIFF* to compare total telemarketing costs to total fundraising expense plus direct costs of special events. Our results are robust to these alternative measures of *REVDIFF*, *FEEDIFF*, and *FUNDEXPDIFF*.

Finally, rules governing the allocation of joint costs changed in 1998 with the issuance of SOP 98-2. To determine whether the likelihood of allocating telemarketing expense out of fundraising expense differs as a result of SOP 98-2, we include a dummy variable, *SOP98-2*, in the regression (using “both sources”) that equals 1 if Form 990 is dated after 1998, and 0 otherwise. The coefficient on this variable is not significant and its inclusion does not affect the regression results.

VI. CONCLUSIONS

Prior research has supported a concern by regulators and donors that nonprofits have incentives to understate fundraising costs and may inappropriately allocate these costs to other activities. Additionally, a number of studies provide evidence that donors direct their charitable gifts to nonprofits that report higher program ratios and lower fundraising ratios. With more than 76 percent of the more than \$240 billion in annual contributions to nonprofits in the U.S. coming from individual donors (American Association of Fundraising Counsel [AAFRC] Trust for Philanthropy 2003), misreporting by nonprofits can potentially have a large effect on the distribution of donations among nonprofit organizations.

Our study provides empirical evidence of how frequently fundraising costs are misreported, and examines the methods used and the factors associated with these decisions. This study directly tests the veracity of nonprofits’ reporting practices by comparing federally mandated nonprofit financial reports to disclosures of revenues and costs of telemarketing campaigns filed by telemarketing solicitors in certain states. Additionally, it is the first paper to specifically consider the effect of accounting sophistication on nonprofit reporting practices.

We design our tests to produce conservative estimates of telemarketing revenue and expense by using only the single largest reported telemarketing campaigns conducted each year for a nonprofit by each of its telemarketing solicitors. These estimates of total annual telemarketing revenues and expenses are then compared to the nonprofit’s annual IRS informational filing. Because our design biases against incorrectly labeling a nonprofit a misreporter, we may not have fully detected net reporting, particularly by organizations with contributions raised without the assistance of professional solicitors. This is particularly a concern for the larger organizations in our sample as they are more likely to generate contributions from multiple sources. Thus, we may have underestimated the degree to which misreporting occurs.

Despite our conservative test design, we find that over 74 percent of the organizations in our sample fail to properly report telemarketing expenses. Twenty-seven percent of firm-years contain misreported revenues. Of the remaining 73 percent, a majority misclassify their reported costs in a category other than professional fundraising fees, and 9 percent engage in cost allocations, meaning that not all telemarketing costs are reported as fundraising expenses. Using an even more conservative design that compared a single year of campaign revenue and expenses to the sum of three years of firm-wide contributions and fundraising expenses, 14 percent of this sample is misreporting revenues. Of the remaining

sample, 53 percent report telemarketing expenses as other than professional fundraising fees and, at least, another 4 percent is allocating telemarketing costs to an expense category other than fundraising.

Our results provide strong evidence that nonprofits misreport telemarketing fees, which affects how program and fundraising ratios are reported. The effect on reported ratios of misreporting is substantial. We find that by misreporting telemarketing expenses the nonprofits in our sample could understate the fundraising ratio by as much as 15 percent.

Of the misreporting we detect, most occurs among small nonprofits that have limited accounting sophistication. Our findings suggest that nonprofits that have greater accounting sophistication and those likely to be subjected to greater external monitoring are less likely to be classified as a misreporting firm. We find that the factors associated with the more prevalent activity of misreporting revenue differ from those related to expense classification and allocation. Higher accounting sophistication and more external monitoring appear to play a greater role in moderating revenue misreporting. Only the use of professional outside accountants appears related to proper classification of telemarketing costs as professional fees. We interpret these results as suggesting that misreporting decisions may be driven either by incentives to improve reported results or a lack of familiarity with accounting. Prior research has implicitly or explicitly attributed misreporting to managerial incentives. Our study is the first to specifically consider accounting sophistication as a factor in misreporting.

SOP 98-2 requires nonprofit organizations to allocate costs incurred jointly for fundraising and program activities to several expense categories. However, the occurrence of expense allocation should be related to the joint activity, not systematically associated with organizational characteristics. Allocation of telemarketing costs to an expense category other than fundraising is less often associated with larger organizations and those that have relatively higher levels of debt. This finding implies that allocation may occur more often in small organizations in order to improve reported fundraising ratios, or is more prevalent in organizations that have less accounting sophistication or fewer monitoring mechanisms.

These findings can inform the current debates by state and federal regulators as they search for ways to improve the quality of nonprofit financial reports. In particular, we provide evidence to policy makers that, in addition to regulation and monitoring, educating Form 990 preparers can improve accounting quality.

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