Director Monitoring of Expense Misreporting in Nonprofit Organizations: The Effects of Expense Disclosure Transparency, Donor Evaluation Focus and Organization Performance*

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ABSTRACT

This study examines whether three factors—the transparency of expense disclosures, donor evaluation focus, and organization performance—influence how directors monitor management expense misreporting in nonprofit organizations. An experiment with 189 nonprofit directors finds that the enhanced transparency of expense disclosures increases director monitoring by reducing the tendency to accept management expense misreporting. Further, an organization's nonfinancial performance and the perceived fairness of donor evaluation focus interact to influence director monitoring practices. Specifically, when directors know an organization's nonfinancial performance is poor and understand that this performance will negatively influence the willingness of donors to contribute, directors monitor less if they think that donors are adopting a more balanced approach to organizational evaluation that focuses on both financial and nonfinancial performance; that is, there is a reverse fair process effect as this donor approach is perceived as being fairer than if donors focus solely on financial performance. However, monitoring is equally strong regardless of donor evaluation focus when directors know that an organization's nonfinancial performance is good and a donation is forthcoming.

Contrôle par les administrateurs des inexactitudes de l'information relative aux dépenses dans les OSBL : incidence de la transparence de l'information relative aux dépenses, de l'objet de l'évaluation des donateurs et de la performance de l'organisme

RÉSUMÉ

L'auteure se demande si trois facteurs — la transparence de l'information relative aux dépenses, l'objet de l'évaluation des donateurs et la performance de l'organisme — influent sur la façon dont les administrateurs contrôlent l'inexactitude de l'information relative aux dépenses produite par les gestionnaires, dans les organismes sans but lucratif (OSBL). Une expérience faisant intervenir 189 administrateurs d'OSBL révèle que la transparence accrue de l'information fournie au sujet des dépenses accroît le contrôle exercé par les administrateurs en réduisant la tendance à accepter les inexactitudes que contient l'information rela-

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tive aux dépenses produite par les gestionnaires. En outre, la performance non financière d'un organisme et la légitimité perçue de l'objet sur lequel porte l'évaluation des donateurs interagissent de telle sorte qu'elles influent sur les pratiques des administrateurs en matière de contrôle. Plus précisément, lorsque les administrateurs savent que la performance non financière d'un organisme laisse à désirer et comprennent que cette performance aura une incidence négative sur la propension des donateurs à verser des dons, ils exercent un contrôle moins sévère s'ils croient que les donateurs adoptent une approche plus équilibrée en ce qui a trait à l'évaluation de l'organisme en s'appuyant à la fois sur sa performance financière et non financière — en d'autres termes, lorsqu'il existe un effet de légitimation inversée du fait que ce mode d'évaluation qu'adoptent les donateurs est perçu comme étant plus légitime que s'ils ne s'intéressaient qu'à la performance financière. Toutefois, le contrôle est tout aussi rigoureux, peu importe l'objet de l'évaluation des donateurs, lorsque les administrateurs savent que la performance non financière de l'organisme est bonne et qu'un don est prévisible.

1. Introduction

In a fundraising context, larger donors have historically focused on the financial performance of nonprofit organizations to evaluate organizational efficiency.[1] These donors specifically focus on one indicator of financial performance—the ratio of reported program expenses to total expenses (i.e., the program ratio)—and tend to contribute to organizations that report a higher program ratio, as a high program ratio shows their donations are going directly into programs and services, rather than administrative and fundraising expenses (Yetman and Yetman 2013; Parsons 2007; Okten and Weisbrod 2000; Khumawala and Gordon 1997; Weisbrod and Dominguez 1986). Prior studies reveal that to increase opportunities for donations, managers in some nonprofit organizations have misreported fundraising and/or administrative expenses as program expenses in order to boost the program ratio (Keating, Parsons, and Roberts 2008; Jones and Roberts 2006; Krishnan, Yetman, and Yetman 2006; Baber, Roberts, and Visvanathan 2001).[2] However, the monitoring by boards of directors has been associated with less managerial expense misallocation (e.g., Yetman and Yetman 2012; Eldenburg and Vines 2004; Roberts 2005), and the primary purpose of this study is to advance the extant literature by closely examining director monitoring of management expense misreporting.

Expenses would normally be misallocated by managers in situations where there is a low program ratio. Managers have no need to misallocate expenses when the program ratio is high, given that these circumstances are conducive to higher levels of charitable giving (Baber et al. 2001; Krishnan et al. 2006; Keating et al. 2008). To investigate director monitoring of management expense misreporting, there must be a case that expenses are being misallocated by managers. Hence, this study is situated in a context where a nonprofit organization suffers from a *low* program ratio (i.e., poor financial performance) and managers misreport expenses to boost the ratio.

1. Baber et al. (2001) describe a type of donors, namely, rationally ignorant donors, who are generally small donors and lack incentive to seek out either financial or nonfinancial metrics. They make small contributions only when properly motivated and informed. This paper does not consider this type of donors because these donors donate without evaluating financial metrics and thus do not encourage managers to misallocate expenses to boost the program ratio.
2. Nonprofit organizations range from charities that are heavily dependent on donations to membership-based organizations that may rely less on donations. In this study, I focus specifically on nonprofit organizations that solicit donations as part of their funding.

When nonprofit organizations have a low program ratio, directors of these organizations understand that their fiduciary duty is to both monitor managers and work with them to raise funds (Greenlee, Fischer, Gordon, and Keating 2007; Gill 2005; O'Regan and Oster 2005). Under these circumstances, directors of nonprofits are found to compromise their monitoring to help managers impress donors. For example, the Board of Directors of Mothers Against Drunk Driving in Canada (MADD Canada) condoned the management practice of misreporting fundraising expenses to boost the program ratio from 19 percent to 84 percent in order to solicit donations (Donovan 2007).[3] As such, it is important to examine what factors might strengthen the monitoring of management expense misreporting by directors.

Contingency theory argues that director behaviors are conditional on the circumstances in which they monitor managers and suggests an integrative theoretical framework for analyzing such directors' behaviors that considers board attributes as well as environmental circumstances (Miller-Millesen 2003; Ostrower and Stone 2010). While prior empirical studies (e.g., Yetman and Yetman 2012; Ostrower and Stone 2010; Callen, Klein, and Tinkelman 2003) have documented how board attributes (e.g., size, independence and composition) influence director monitoring in nonprofit organizations, I am unaware of any that examine whether and how environmental circumstances influence monitoring. Hence, this study empirically investigates the impact of three environmental factors on director monitoring: two hotly debated institutional factors, *transparency of expense disclosures* and *donor evaluation focus*, as well as one organizational factor, *performance*.

Transparency of expense disclosures defines the *quality* of expense information that donors can obtain from financial reports of nonprofit organizations.[4] A lack of transparency regarding which expenses are included in or allocated to program expenses (i.e., the numerator of the program ratio) has long been a problem in financial reporting of nonprofit organizations (Jones and Roberts 2006). Unclear allocation disguises management actions and hinders donors and other stakeholders from understanding the program ratio. To enhance transparency, some regulators such as the Financial Accounting Standards Board in the United States (the FASB) require that nonprofit organizations disclose how they allocate joint costs among functional expense categories (i.e., charitable programs, administration and fundraising) (FASB 1993). However, other regulators, such as the Canadian Accounting Standards Board, believe that the transparent accounting treatment may not necessarily curb expense misreporting and thus do not make the disclosure mandatory (CPA Canada Handbook 2014). This paper intends to provide evidence to regulators by showing whether enhanced transparency can strengthen director monitoring of expense misreporting, as transparency can influence directors' perception of the risk that their lack of due diligence might be detected.

Donor evaluation focus can be defined as the approach taken by donors in deciding to make donations. Researchers have concluded that the fundamental factor driv-

3. On December 9, 2006, the *Toronto Star* revealed that approximately 19 cents of every dollar raised went to support MADD's programs, instead of the 84 cents claimed by the organization. It was found that the organization's fundraising activities were claimed to be educating the public about drunk driving; therefore, MADD allocated fundraising costs as program expenses. In 2007, after the *Toronto Start* reports and under pressure from volunteers, MADD's board of directors admitted that MADD was wrong and stopped this practice (Donovan 2007).

4. This study does not consider the possible involvement by directors in the choice of the transparency level of expense disclosures, an issue that future research could address. Rather, this study treats disclosure transparency as an exogenous factor that has already been decided to shed light on the effects of transparency on director oversight.

ing the misreporting of expenses is the managerial belief that donors focus solely on financial performance (generally measured by the program ratio) to make their charitable giving decisions and thus will be impressed with a high program ratio (Silverman and Beatty 2007; Krishnan et al. 2006). Following recent expense misreporting scandals, advocacy groups (e.g., Imagine Canada, GuideStar, BBB Wise Giving Alliance, and Charity Navigator) have called for donors—and donors themselves have expressed enthusiasm for the idea—to shift their evaluation focus from financial metrics only (i.e., *financial* evaluation focus) to a balance of financial and nonfinancial performance (i.e., *balanced* evaluation focus) (Perry 2013; Association of Fundraising Professionals 2008). When a shift to this balanced evaluation focus occurs, it has been found that nonprofit directors will believe that donors evaluate nonprofit organizations more fairly (Chen 2015).[5] Numerous studies find that perceived fairness has an impact on people's behaviors (e.g., Brockner and Wiesenfeld 1996; Libby 2001; Cohen, Webb, Sharp, and Pant 2007). Hence, this paper examines whether directors' knowledge of donor evaluation focus influences director monitoring of management expense misreporting.

Finally, I will also examine whether nonfinancial performance can moderate the effect of donor evaluation focus on director monitoring. As mentioned above, this study is situated in a context where nonprofit organizations suffer poor financial performance as defined by a *low* program ratio. In such a situation, a donor shift to a balanced evaluation focus—more specifically, a focus that includes nonfinancial metrics in the donor evaluation—does not guarantee that nonprofit organizations receive donations (Chen 2015). When organizations do not fulfill their missions or fail to achieve promised service goals, in general donors perceive this nonfinancial performance as poor. Furthermore, if a donor adopts a balanced evaluation focus, the overall assessment of an organization's performance can worsen when its nonfinancial performance is poor (O'Regan and Oster 2005).[6] When this approach is adopted by donors, an organization must have a good financial performance in order to improve the chances of receiving donations. Hence, whether directors prefer the balanced donor evaluation focus and consequently leverage their monitoring depends on an organization's nonfinancial performance.

This study takes advantage of the experimental method to hold constant the relatively poor financial performance of nonprofit organizations (i.e., low program ratio) and creates a context where management misreports expenses to boost the low program ratio. The experiment uses a $2 \times 2 \times 2$ fully-crossed design and manipulates the above three factors. One hundred and eighty-nine nonprofit directors participated in the experiment and the results indicate that enhanced transparency of expense disclosures strengthens director

5. Directors develop beliefs about donor evaluation processes in two main ways. First, nonprofit organizations actively reach out to donors to solicit donations. At fundraising events designed to cultivate the relationship between donors and nonprofit organizations, nonprofit organizations listen to donors' concerns and find out how donors make decisions (Sargeant 2008). Second, donors, especially larger donors, want to have an impact on nonprofit organizations and often communicate to nonprofit organizations the factors that most strongly affect their donation decisions (Sargeant 2008). For example, the United Way, an organization that distributes donations to charitable organizations on behalf of donors, lists its criteria of assessing a nonprofit organization in its online marketing materials.
6. Nonfinancial performance, such as service efforts and achievements, is voluntarily disclosed. It can be presented as measurable indices (e.g., the number of clients served, the percentage of satisfied clients, a comparison of service results to the organization's goals) but is more often reported as a qualitative description of service efforts and achievements in the organizations' annual reports (Parsons 2003). Currently, many Canadian nonprofit organizations report service performance in annual reports, mostly in qualitative but sometimes in quantitative terms (Salterio and Legresley 2011).

monitoring and makes directors less likely to allow management misreporting. Further, this study has found that an organization's nonfinancial performance moderates the effect of donor evaluation focus on director monitoring. Specifically, when the organization suffers poor nonfinancial performance and directors believe that donors will not make gifts, a reverse fair process effect occurs—directors monitor management misreporting relatively less if donors adopt a fairer balanced evaluation focus than if donors adopt a less fair financially focused evaluation. This is because directors have a greater dislike for an unfavorable donation outcome generated by a fairer evaluation than for one generated by a less fair evaluation. Thus, they are more likely to decrease their monitoring, trying to reverse the unfavorable donation outcome if donors adopt the fair balanced evaluation. However, when nonfinancial performance is good, director monitoring is equally strong no matter which evaluation focus donors adopt. Directors believe that regardless of donors' evaluation focus, good nonfinancial performance can overcome donors' hesitation to donate despite poor financial performance and thus there is no need to compromise monitoring to boost poor financial performance.

The results of this study have several implications. First, this paper responds to the call from contingency theory by demonstrating that the environmental circumstances in which directors exercise their monitoring do influence this behavior. Second, transparent expense disclosures in financial statements of nonprofit organizations enhance director monitoring of management. Therefore, one possible response for the accounting standard setters (e.g., the Canadian Accounting Standards Board) is to make the transparent expense disclosures mandatory rather than voluntary. Third, although a balanced donor evaluation focus is preferred in practice, there appear to be unintended consequences. When an organization suffers both poor financial and nonfinancial performance, management might be most likely to boost the program ratio to impress donors. However, this study finds that directors also decrease their oversight of expense misallocation in this situation. To counter this potential negative effect, advocacy groups and donors may need to consider how to signal an appropriate message regarding donor evaluation criteria to managers and directors of nonprofit organizations.

The literature review will now be introduced, followed by the hypothesis development and the experiment. Finally, the experimental results and a concluding discussion are provided.

2. Literature review and hypothesis development

Monitoring of board directors in nonprofit organizations

In nonprofit organizations, all funds raised or generated by organizations should, over time, be spent for charitable purposes. The nondistribution of earned profits or surplus allegedly leads to management shirking, as no market-competitive mechanisms exist in the nonprofit sector to monitor management's opportunistic behavior and to punish the organization's inefficiency (Rose-Ackerman 1996). Despite the potential for management shirking, government regulations for nonprofit organizations are not as effective as they should be in most countries because of limited staffing and financial resources that preclude systematic and effective oversight or enforcement. For example, in the United States, the audit rate of registered charities by the Internal Revenue Service was approximately 0.69 percent in 2012 (IRS 2012).[7] Similarly, only approximately 0.87 percent of registered charities are regularly audited by the Canada Revenue Agency (CRA; Canadian Tax Foundation 2012). In the absence of an effective regulatory system, the oversight from the

7. Based on the 2012 IRS report, 10,743 out of 1,537,465 nonprofit organizations were audited by the IRS. Thus, the audit rate was approximately 0.69 percent.

board of directors is an important mechanism for monitoring and disciplining nonprofit management.[8]

Directors of nonprofit organizations typically directly receive detailed knowledge of management practices that enables them to identify when expenses are misallocated on financial reports, and this knowledge comes from a number of sources. Directors approve the expense budget each year and constantly monitor whether organizations' expenses stay within the budget, so they are aware of ongoing expenditures (Gill 2005). Managers discuss the reporting of certain expense items and obtain opinions or approval from directors, especially from those directors who are financially literate (Donovan 2007; Mittoo 2007). In addition, directors meet annually to review financial statements and discuss whether appropriate accounting methods and policies are applied and whether certain items, especially expense items, are reasonably reported (Ahier 2007; Gill 2005). Based on the knowledge gained from these activities, once directors uncover management expense misallocation, they have to decide whether to implement monitoring. This paper examines whether and how their oversight of management expense misreporting is influenced by two institutional factors, *transparency of expense disclosures* and *donor evaluation focus*, and one organizational factor, *performance*.

Effect of transparency on director monitoring

In nonprofit organizations, directors are involved in the process of financial reporting by monitoring its quality. Prior research demonstrates that in for-profit organizations, reporting transparency reduces the tendency of those who prepare financial statement to misreport, as they perceive a higher risk of detection and subsequently reduced benefits from misreporting (Jo and Kim 2007). Similarly, if nonprofit organizations adopt a policy of transparent expense disclosures, directors are likely to believe that donors can easily identify which expenses (e.g., printing, salary, rent) are included in charitable program expenses (Yetman and Yetman 2013). With such information more readily available, donors can more easily question any unusual or suspicious expenses included in charitable program expenses. Hence, closer scrutiny by donors can increase the directors' perception that expense misallocation can be detected by donors (Buller, Strzyzewski, and Comstock 1991).

In addition, directors may be concerned about the potential harm to their own reputations if expense misallocation is detected, as directors of nonprofit organizations are expected to ensure that financial statements are free from misreporting (Hunton and Rose 2008). Thus, directors would not allow management to misallocate expenses to boost the low program ratio if expense disclosures are transparent. In contrast, if nonprofit organizations adopt opaque expense disclosures, it would be difficult for donors to obtain the necessary information to identify the misallocation (Khumawala and Gordon 1997; Okten and Weisbrod 2000). Directors tend to endorse expense misallocation because, by boosting the low program ratio, they can help the organization increase its chances of receiving donations that could not be obtained otherwise. Hence, I hypothesize:

8. Oversight from external auditors in nonprofit organizations is not as regular as director oversight. There is no general legal requirement that nonprofit organizations must have their financial statements audited (Sossin 2001). Many nonprofit organizations, especially small ones, choose not to be audited (Gill 2005). External audits are only mandatory for certain nonprofit organizations. For example, the Ontario Ministry of the Attorney General requires that all incorporated charities with annual revenues of more than \$100,000 be audited. The Canadian Revenue Agency recommends that charities should have their financial statements audited if their annual gross revenues from all sources are more than \$250,000. In Canada, 62 percent of charities reported annual revenues of less than \$100,000, and 80 percent reported revenues of less than \$250,000 (Gill 2005). In the United States, nonprofit organizations that receive more than \$300,000 in federal funding (i.e., grants from federal agencies) are required to have an audit performed in accordance with the Office of Management and Budget's Circular No. A-133 (Keating et al. 2008).

Hypothesis 1: *Directors of nonprofit organizations increase their monitoring by being less likely to permit management to misallocate expenses to enhance a low program ratio when expense reporting is transparent than when expense reporting is opaque.*

Interactive effect of nonfinancial performance and donor evaluation focus on director monitoring

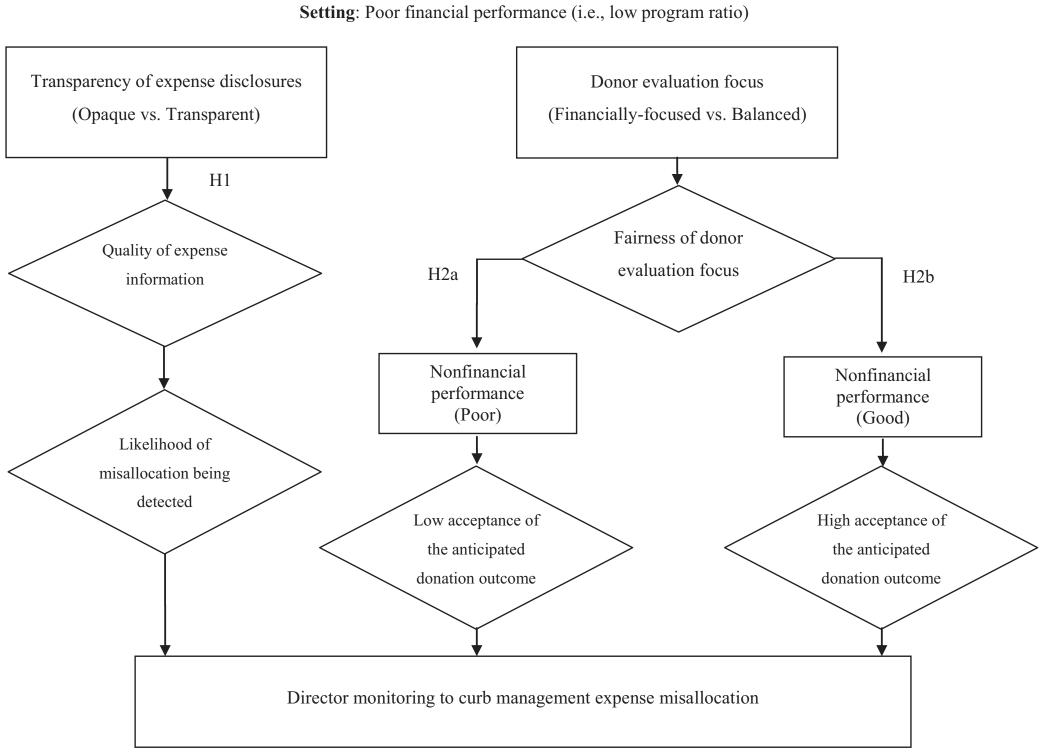
As previously mentioned, this study is situated in a context where nonprofit organizations suffer poor financial performance (i.e., a *low* program ratio) and managers misallocate expenses to boost the low program ratio. In such a situation, an organization's nonfinancial performance may moderate the effect of donor evaluation focus on director monitoring.

When an organization suffers poor nonfinancial performance, directors believe that donors will not donate given that poor financial and nonfinancial performance will affect the decision of all donors, whether or not they adopt a balanced or financially focused evaluation. Directors then consider the donor evaluation process as they make sense of this potential unfavorable donation outcome (Brockner et al. 2003; Cropanzano and Greenberg 1997; Brockner and Wiesenfeld 1996; Rutte and Messick 1995). Chen (2015) shows that directors perceive a balanced donor evaluation focus to be a fairer process than a financially focused evaluation. Although a fair process often leads to higher acceptance of an unfavorable outcome, prior research suggests that the setting examined here is one in which a fair evaluation process will actually make individuals *less* accepting of an unfavorable outcome. This is known as the "reverse fair process effect" (Cropanzano, Paddock, Rupp, Bagger, and Baldwin 2008; Brockner, De Cremer, Fishman, and Spiegel 2008; Holmvall and Bobocel 2008; Van den Bos 2003; Brockner 2002; Brockner and Wiesenfeld 1996).

Brockner, Wiesenfeld, and Diekmann (2009) review the fairness literature starting from the 1970s and identify conditions under which the reverse fair process effect occurs. This review found that when individuals perceive their performance to be at or above an acceptable level, they believe a favorable outcome should result (Van den Bos, Lind, Vermunt, and Wilke 1997; Brockner and Wiesenfeld 1996; Thibaut and Walker 1975). If the outcome is unfavorable and the process unfair, individuals can blame the process (Brockner et al. 2008; Van den Bos 2003; Brockner 2002; Brockner and Wiesenfeld 1996). If the outcome is unfavorable but the individual perceives the process to be fair, prior research indicates an extremely negative reaction will result with the individual becoming *less* accepting of the unfavorable evaluation outcome than if it had been generated by an unfair evaluation process (Brockner et al. 2009; Cropanzano et al. 2008; Van den Bos 2003; Brockner 2002). Unlike an unfair process, a fair process does not lead individuals to expect an unfavorable outcome and hence an unfavorable outcome resulting from a fair process shocks them and is less acceptable.

Directors genuinely support the charitable cause of their organization and *intrinsically* believe that the organization *deserves* donations despite its poor financial and nonfinancial performance, because the organization is engaged in socially positive activities (Gill 2005; O'Regan and Oster 2005; Silverman 2004; Murray 2001). Based on this belief, directors expect that a relatively fair balanced donor evaluation will increase the chance that donors contribute, as donors' attention to the organization's good deeds may alleviate the otherwise negative effect of the low program ratio on donors' decisions. However, directors also expect an unfavorable donation outcome in this setting as a result of poor nonfinancial and financial performance, and this expectation triggers the reverse fair process effect. Directors will have a stronger negative reaction to the

Figure 1 Conceptual framework underlying hypotheses



expected unfavorable outcome if the fairer balanced donor evaluation focus is used than if the less fair financially focused donor evaluation is utilized. This reaction will make directors more likely to allow management misreporting to boost the low program ratio (Van den Bos et al. 1997; Brockner and Wiesenfeld 1996; Thibaut and Walker 1975). Hence, I predict:

Hypothesis 2a: *Where a nonprofit suffers poor nonfinancial performance, directors decrease their monitoring when they perceive donors to have adopted a balanced evaluation focus than when they perceive donors to have adopted a financially focused evaluation.*

Good nonfinancial performance can mitigate the negative impression given by a low program ratio if donors adopt a balanced evaluation, but would not be considered by donors if they adopt a financially focused evaluation. Therefore, in a context of good nonfinancial performance, a balanced donor evaluation is more likely to bring a favorable donation outcome than a financially focused donor evaluation; that is, the fair balanced donor evaluation generates what directors expect a fair evaluation to generate, a more promising donation outcome. Thus, the balanced donor evaluation focus leads to directors' higher acceptance of the donation outcome and a lower tendency to allow managers to misallocate expenses to boost the low program ratio (Brockner and Wiesenfeld 1996; Cropanzano and Greenberg 1997; Brockner et al. 2003). This "fair process effect" is hypothesized:

TABLE 1
Manipulation of expense reporting transparency

Panel A: Opaque (less transparent) expense reporting manipulation*

Expenses	
Advertising and promotion	$400,000
Travel and vehicle	$100,000
Office supplies and expenses	$60,000
Occupation costs	$240,000
Training for staff and volunteers	$120,000
Salaries	$600,000
Professional and consulting fees	$100,000
Other expenses	$20,000
Total	**$1,640,000**

Panel B: More transparent expense reporting manipulation†

Expenses	Charitable programs	Fundraising	Administrative	Total
Advertising and promotion	$400,000			$400,000
Travel and vehicle	$2,000		$98,000	$100,000
Office supplies and expenses	$36,000		$24,000	$60,000
Occupation costs	$190,000		$50,000	$240,000
Training for staff and volunteers	$120,000			$120,000
Salaries	$560,000		$40,000	$600,000
Professional and consulting fees	$60,000		$40,000	$100,000
Other expenses	$9,600	$2,000	$8,400	$20,000
Total	**$1,377,600**	**$2,000**	**$260,400**	**$1,640,000**

Notes:

* In both transparent and opaque conditions, the management of the family center misallocated the $300,000 fundraising expenses to charitable program expenses and reported the enhanced program ratio, 84 percent, in the center's annual reports.

† Panel B is adapted from section 4470 of the CPA Canada handbook and the guidance of the CRA (2009): T3010B, Registered Charity Information Return, with accompanying forms and financial statements. Available at: http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/rtrn/smpls-fnncl-eng.html.

Hypothesis 2b: *Where a nonprofit has a good nonfinancial performance, directors increase their monitoring when they perceive donors to have adopted a balanced evaluation focus than when they perceive donors to have adopted a financially focused evaluation.*

I summarize the conceptual framework underlying the above hypotheses in Figure 1.

3. Research method

Experimental design

This study employs a full 2 (expense disclosure transparency: opaque versus transparent) × 2 (donor evaluation focus: financially focused versus balanced) × 2 (organization nonfinancial performance: worse versus better than benchmark) between-subjects experiment.

TABLE 2
Nonprofit director participant profile (N = 189)

		Frequency
Age	Under 25	0.53%
	26–40	11.11%
	41–50	21.69%
	51–60	33.87%
	61–70	22.75%
	over 70	10.05%
Gender	Percentage female	54.59%
Education	Secondary school	2.12%
	Postsecondary diploma	7.94%
	Bachelor's degree	34.39%
	Master's/PhD degree	43.38%
	Other (e.g., law, medicine)	12.17%
Accounting designation	Has an accounting designation (e.g., CA, CGA, CMA)	34.39%
Current profession	Accountant	63.30%
	Lawyer	8.26%
	Medical doctor	1.83%
	Engineer	5.50%
	Other (e.g., professor)	21.11%
Employment profile	Government department or agent	15.08%
	Large private company	6.70%
	Medium-sized private company	5.03%
	Small-sized private company	10.61%
	Nonprofit organization	29.05%
	Large public company	10.06%
	Medium-sized public company	1.12%
	Other organization	22.35%
Annual revenue of largest nonprofit organizations for which participants served as directors	<\$100,000	8.46%
	\$100,000–\$499,999	15.34%
	\$500,000–\$999,999	13.23%
	\$1,000,000–\$4,999,999	24.87%
	\$5,000,000–\$9,999,999	12.17%
	≥\$10,000,000	25.93%
Participant's responsibility on the board (Note: do not add to 100% as directors can select all that apply)	Finance	60.11%
	Audit	28.19%
	Fundraising	46.81%
	Governance	64.36%
	Human resources	38.30%
	Nominations	46.81%
	Planning	68.09%
	Bylaws and policy	53.72%
	Other	13.83%

The first variable, transparency of expense disclosures, is operationalized as either a one-dimensional expense-reporting format allowed by section 4470 of the CPA Canada handbook designated "opaque" or as the two-dimensional expense-reporting format suggested in section 4470 designated "transparent."[9] In the transparent expense-reporting format, nonprofit organizations disclose joint costs (e.g., expenses related to an event that has both fundraising and educational purposes) by nature (e.g., printing, salary, renting) as well as by function (i.e., program, fundraising and administrative expenses). Compared to the opaque format, where expenses are only categorized by nature, the transparent format explicitly discloses the detailed contents of charitable spending and provides useful complementary information for donors to understand the program ratio reported in annual reports. Table 1 illustrates the difference between opaque and transparent expense reporting manipulation as used in this experiment.

The second variable, donor evaluation focus, is manipulated at two levels: whether a potential large donor adopts a single financial evaluation metric (i.e., the program ratio) or a more balanced set of performance evaluation metrics including both the financial indicator (i.e., the program ratio) and the appropriate nonfinancial indicators of "service efforts and achievements."

The third manipulated variable, nonfinancial performance, also varies at two levels: relatively good or poor compared to the organization's service performance last year and its peer organizations' performance in the current year.

Participants

As directors with financial backgrounds are most likely to assume responsibility of overseeing financial reports, I solicited participants from the following groups: (i) members of the Chartered Professional Accountants of Ontario, as many CPA members sit on the boards of nonprofit organizations (Lindsay 1997; Markham 2004; Statistics Canada 2005); (ii) through directors of umbrella nonprofit organizations, such as the United Way Canada, Community Foundation and Imagine Canada; and (iii) directors in nonprofit organizations to which I have access through personal or institutional contacts. The contact persons in each group were asked to send an invitation to potential participants, with a follow-up email sent approximately one week later. In the end, 189 directors participated.[10] Table 2 presents the demographic information of the participating directors.

Among the 189 participating directors, 63.30 percent reported accounting as their profession, and 34.39 percent had an accounting designation. As for the specific tasks, the participating directors performed on the board, 60.11 percent were responsible for financial governance, 46.81 percent were responsible for fundraising, and 28.19 percent were responsible for audit-related issues.[11] In addition, 23.81 percent of participating directors were also auditors of other nonprofit organizations. As a result, the sample represents financially literate directors who are more likely to be involved in monitoring financial reporting (Iyer and Watkins 2008; Vermmer et al. 2006).

9. Organizations are free to adopt either transparent or opaque expense disclosures in Canada. From a practical standpoint, this creates an ideal context in which to manipulate transparency of expense disclosures. As such, I recruited director participants from Canada.
10. Initially, I collected 212 responses. Of those responding, nine claimed that they are not or have not been directors in nonprofit organizations and seven director participants did not finish the experimental questionnaire, which resulted in a final sample of 189 participating directors. Those who did not finish were evenly distributed across cells.
11. I did not ask participants to specify whether they sit on the audit committee of the board because many nonprofit organizations do not have an audit committee (Iyer and Watkins 2008; Vermmer, Raghunandan, and Forgione 2006). Instead, I asked participants to indicate their responsibilities on the board, allowing me to track whether my participant pool represents those directors who monitor financial reports. Given that directors who are not responsible for financial governance may also provide their opinions on whether to permit management expense misallocations, I would say that the participant pool of this study (i.e., 60.11 percent of director participants responsible for financial governance) is representative.

Experimental procedures

A pretest using 185 undergraduate accounting students indicated that the experimental instrument is understandable and appropriate. After validating the experimental instrument, potential participants were invited to take part in the study. Participants clicked on a Web link provided in the invitation email which directed them to the website where the experimental instrument was located. Once at this site, participants first read general information about the study, including the precautions taken to ensure anonymity (i.e., the ethics consent procedure), and then clicked a consent button to participate. The survey software randomly assigned participants to one of the eight experimental conditions and then took them through the online case. Participants then answered postexperimental and demographic questions. Randomization appears to be successful, as there are no significant demographic differences across experimental cells (all p's ≥ 0.104).

Experimental case

In this case, participants in all conditions learn that a family center has incurred \$400,000 of expenses in a special fundraising campaign.[12] Out of these expenses, \$100,000 is associated with education and volunteer recruitment in the special campaign and is allowed to be reported as charitable program expenses on the financial statements according to Canadian GAAP. As a result, the remaining \$300,000 of campaign expenses should be reported as fundraising expenses. However, if \$300,000 is reported as fundraising expenses, the center's program ratio would be 66 percent, 8 percentage points lower than the national average, and donors sensitive to the program ratio might not donate to the center in the future. Therefore, the center management has decided to allocate the \$300,000 fundraising expense to charitable program expenses, boosting the program ratio to 84 percent, 10 percentage points higher than the national average. Participating directors also have received information about the transparency of the center's expense report on financial statements (transparent versus opaque), donor evaluation focus (balanced versus financially focused) and the center's nonfinancial performance (relatively good versus poor relative to the benchmark). Participants are asked to decide whether management's proposed misallocation should be allowed at an upcoming board meeting. A postexperiment question asks participants whether they believe that management's proposed allocation is unethical; the mean score of the answer to this question on an 8-point scale from 1 "ethical" to 8 "unethical" is 6.88, which is significantly higher than the midpoint of the scale ($t = 18.26$; $p < 0.001$). Therefore, participating directors tend to believe the proposed allocation is a misallocation of expenses.

Independent variables

The three manipulated variables—the transparency of the organization's expense disclosures (*TR*), donor evaluation focus (*EF*), and the organization's nonfinancial performance (*NFP*)—are independent variables. The first variable, *TR*, is a dichotomous variable. In the transparent expense-reporting condition, participants are presented with the two-dimensional transparent format of expense reporting on financial statements (please refer to Table 1). In the opaque expense-reporting condition, participants are presented with the one-dimensional opaque expense-reporting format.

12. This study uses a suitably disguised family center as the experimental case because this type of organization does not provide services that normally invoke strong personal opinions. Furthermore, the broader human welfare sector represents 32.9 percent of nonprofit organizations, which is the largest group of nonprofit organizations in Canada (Statistics Canada 2005).

For the second independent variable, donor evaluation focuses (*EF*) in conditions where donors adopt a financially focused evaluation, participating directors are told that the target donor in the experimental case “focuses solely on the program ratio when making donation decisions.” However, in the condition where donors adopt a balanced evaluation focus, participating directors are informed that the target donor “focuses on both the program ratio and any voluntarily disclosed level of service efforts and achievements when making donation decisions.”

The third independent variable is the organization’s nonfinancial performance (*NFP*). When the organization’s nonfinancial performance is relatively good (poor), participants are told that “The number of parents and children who received services from the Center was 8 percent higher (lower) than last year and 5 percent higher (lower) than the average number of clients serviced by similarly sized family center.”

Dependent variable

The dependent variable is the likelihood that participants agree with management’s proposal to allocate fundraising expenses to charitable expenses to boost the program ratio (*LKDAgree*). It is measured on a 9-point scale from 1 “very unlikely” to 9 “very likely” in response to the question, “How likely are you to agree with management’s proposal to report all of the $400,000 in campaign expenses as ‘Charitable Programs’ expenses?”

Control variables

Four participants’ demographic characteristics are significantly or marginally significantly associated with the dependent variable: (i) the annual revenue of the nonprofit organization for which the participants serve as directors ($F_{(5,183)} = 2.07$, $p = 0.071$); (ii) the participant’s educational background ($F_{(4,184)} = 3.77$, $p = 0.006$); (iii) the participant’s experience with audit issues on the board ($F_{(1,186)} = 4.85$, $p = 0.029$); and (iv) the participant’s accounting designation ($F_{(1,187)} = 6.59$, $p = 0.011$). In addition, three relevant variables that potentially impact the director’s decision to allow management’s proposed expense misallocation are also significantly or marginally significantly associated with the dependent variable: (i) the participant’s general belief about the importance of service performance in obtaining donations ($F_{(1,186)} = 3.85$, p = 0.051); (ii) the participant’s judgment of the ethicality of management’s proposed misallocation ($F_{(1,187)} = 69.52$, $p < 0.001$); and (iii) the participant’s experience in dealing with expense allocation issues in a fundraising context ($F_{(1,184)} = 2.94$, $p = 0.088$). To reduce multicollinearity, I use the backward deletion process and ultimately include three out of the above seven variables as control variables (Schelchter and Forsythe 1985; Darlington 2010).[13] These include: (i) the participant’s judgment of the ethicality of management’s proposed misallocation (labeled *Ethical*), which is measured on an 8-point scale from 1 “ethical” to 8 “unethical,” (ii) the annual revenue (size) of the nonprofit organization (denoted *Size*); and (iii) the participant’s accounting designation (denoted *Accounting Designation*), which equals 1 if the participant has an accounting designation and 0 otherwise.[14]

13. The backward deletion process includes the following three steps: (i) predict the dependent variable *LKDAgree* from all identified potential covariates (note: omitting independent variables *TR*, *EF* and *NFP* at this stage); (ii) delete the least significant covariate from the regression, recompute the regression, delete the least significant covariate again; and (iii) repeat the previous two procedures until all the t values for all regressors are at least 1.42 or the F-values are at least 2 (Schelchter and Forsythe 1985; Darlington 2010).
14. Results of the hypothesis testing, including all seven identified potential covariates are similar to those from the hypothesis testing including the three covariate variables identified here, but all variance inflation factors (VIF), which quantify the severity of multicollinearity, are elevated (VIF for *TR* increases by 0.161, VIF for *EF* increases by 0.303, and VIF for $EF \times NFP$ increases by 0.274).

TABLE 3
Likelihood that directors agree with management proposed expense misallocation to boost the program ratio (*LKDAgree*)

Panel A: Descriptive statistics—LSMean of *LKDAgree* after controlling *Ethical, Size* and *Accounting Designation* (raw mean of *LKDAgree*)*

Transparency of expense disclosures	Donor evaluation focus	Organization's nonfinancial performance: Poor	Organization's nonfinancial performance: Good	Overall	
Opaque	Financially focused	Cell 1 2.60 (2.56) ($n^{‡‡}$=25)	Cell 2 2.24 (2.04) (n = 25)	μ_{11} = 2.51 (2.30) (n = 50)	μ_1 = 2.77 (2.76) (n = 98)
	Balanced	Cell 3 3.53 (3.65) (n = 23)	Cell 4 2.77 (2.84) (n = 25)	μ_{12} = 3.07 (3.23) (n = 48)	
Transparent	Financially focused	Cell 5 1.91 (1.57) (n = 23)	Cell 6 2.14 (1.91) (n = 22)	μ_{21} = 2.01 (1.73) (n = 45)	μ_2 = 2.23 (2.24) (n = 91)
	Balanced	Cell 7 3.09 (2.88) (n = 24)	Cell 8 1.70 (2.59) (n = 22)	μ_{22} = 2.52 (2.74) (n = 46)	

Panel B: Analysis of covariance (ANCOVA) of *LKDAgree*

Source	DF	Sum of squares	Mean square	*F*-value	$Pr > F^{§§}$
Transparency (*TR*)†	1	14.680	14.680	4.72	0.031
Evaluation focus (*EF*)‡	1	13.136	13.136	4.22	0.042
Nonfinancial performance (*NFP*)§	1	14.354	14.354	4.61	0.033
EF × *NFP*	1	11.591	11.591	3.72	0.055
TR × *NFP*	1	0.007	0.007	0	0.961
TR × *EF*	1	1.450	1.450	0.47	0.496
TR × *EF* × *NFP*	1	4.120	4.120	1.32	0.252
Ethical #	1	205.863	205.863	66.12	<.0001
Size **	5	35.284	7.057	2.27	0.050

(The table is continued on the next page.)

TABLE 3 (continued)

Panel B: Analysis of covariance (ANCOVA) of *LKDAgree*

Source	DF	Sum of squares	Mean square	*F*-value	$Pr > F$[§§]
Accounting Designation [††]	1	13.062	13.062	4.2	0.042
Error	174	541.733	3.113		
Total	188	893.238			

Panel C: Planned contrasts for tests of Hypothesis 1 to Hypotheses 2a & 2b

Contrasts	LSMean difference (SE)	*p*-value[§§]
Hypothesis 1: Transparent versus Opaque (mean of Cells 5, 6, 7, 8 versus mean of Cells 1, 2, 3, 4)	2.23 − 2.77 = −0.54 (0.27)	0.046
Hypothesis 2a: Poor nonfinancial performance:		
Balanced versus Financially focused (mean of Cells 3, 7 versus mean of Cells 1, 5)	3.12 − 2.16 = 0.96 (0.39)	0.016
Hypothesis 2b: Good nonfinancial performance:		
Balanced versus Financially focused (mean of Cells 4, 8 versus mean of Cells 2, 6)	2.58 − 2.16 = 0.42 (0.38)	0.276

Notes:

* Dependent variable is the likelihood that directors agree with management's proposed expense misallocation (*LKDAgree*), which is measured on a 9 point scale from 1 to 9, with 1 denoted "Very unlikely" and 9 "Very likely."

† *TR* = 0 when the expense disclosure is opaque; TR = 1 when the expense disclosure is transparent.

‡ *EF* = 0 when donors make donations based solely on the program ratio (i.e., financially focused); *EF* = 1 when donors make donations based on both the program ratio and the nonfinancial performance (i.e., balanced).

§ *NFP* = 0 when the organization's nonfinancial performance is worse than last year and its peer organizations' service performance; *NFP* = 1 when the organization's nonfinancial performance is better than last year and its peer organizations' nonfinancial performance.

\# *Ethical*: participant's perceived unethicality of allocating all fundraising expenses to charitable program expenses. It is measured on an 8-point scale with 1 denoted as "ethical" and 8 as "unethical."

** *Size*: the annual revenue of the nonprofit organizations for which the participant serves as a board member. *Size* = 1 if the annual revenue is less than $100,000, *Size* = 2 if the annual revenue is from $100,000 to $499,999, *Size* = 3 if the annual revenue is from $500,000 to $999,999, *Size* = 4 if the annual revenue is from $1,000,000 to $4,999,999, *Size* = 5 if the annual revenue is from $5,000,000 to $9,999,999, and *Size* = 6 if the annual revenue is larger than $10,000,000.

†† *Accounting Designation* = 1 if the participant has an accounting designation; otherwise *Accounting Designation* = 0.

‡‡ *n* refers to the number of participants.

§§ All *p*-values are two-tailed.

4. Results

Manipulation checks

The participants are asked to indicate on a 9-point scale (from −4 "strongly disagree" to +4 "strongly agree") whether they agree with each of three statements to check whether they attended to the experimental manipulations. To a greater extent, participants assigned to the transparent conditions agree that the organization's expense reporting "allows donors to determine that the $400,000 special campaign expenses were allocated completely to 'Charitable Programs' expenses" than those participants in the conditions where the organization's expense reporting is opaque (the mean score = 2.25 versus −0.99; $t = 7.55$, $p < 0.001$).[15] Participants assigned to the balanced evaluation conditions agree significantly less that the donor "makes donation decisions based solely on the program ratio" than participants assigned to the financially focused conditions (the mean score = −2.09 versus 2.49; $t = 13.54$, $p < 0.001$). Finally, participants in the conditions where nonfinancial performance improves agree significantly more that the organization "improved service quality this year than last year" than those in the conditions where nonfinancial performance declines (the mean score = 2.76 versus −2.81; $t = -20.62$, $p < 0.001$). Therefore, the manipulations of expense disclosures transparency, donor evaluation focus and organization's nonfinancial performance are all successful.

Descriptive results

Table 3, panel A documents the descriptive statistics for the dependent variable (*LKDAgree*), the likelihood that directors would agree with management's proposal to allocate fundraising expenses to boost the program ratio. The adjusted raw means of *LKDAgree* in eight cells range from 1.70 to 3.53, all of which are significantly less than the midpoint of the scale (i.e., the value of 5 on a 9-point scale with 1 "very unlikely and 9 "very likely") (all p-values ≤ 0.023).[16] This finding is qualitatively consistent with Yetman and Yetman (2012), indicating that financially literate directors tend to act on their monitoring role to prevent management expense misallocation.

Hypothesis testing

Hypothesis 1 predicts that directors would be less likely to allow management's proposed expense misallocation in the context of transparent expense reporting, as compared to opaque expense reporting. As indicated in Table 3, panel B, there is a significant main effect of transparency (*TR*) in the overall ANCOVA ($F_{(1,174)} = 4.72$, $p = 0.031$). The further planned comparison presented in Table 3, panel C indicates that, consistent with Hypothesis 1, transparency reduces the director's tendency to endorse management misallocation of fundraising expenses (the adjusted mean score of *LKDAgree* for Transparent versus Opaque = 2.23 versus 2.77; $t = -2.01$, p-value = 0.046) (Buckless and Ravenscroft 1990). These results provide support for Hypothesis 1.

15. In the pretest, I found that the participants struggled to answer the abstract manipulation check question "How transparent do you find the expense reporting?" because they think that defining transparency is ambiguous and completely depends on how much information an individual needs. To avoid ambiguity, rather than ask an abstract question, I have adopted a question concerning a concrete feature of transparency to check the manipulation of "transparency."
16. I also measured the likelihood that the participating directors believe other members of the board would agree with management's proposed expense misallocation. The mean scores in eight cells are all less than the midpoint of the scale (i.e., the value of 5 on a 9-point scale with 1 "very unlikely" and 9 "very likely"), but not all mean scores are statistically significantly less than the midpoint (all p-values ≤ 0.687).

Hypotheses 2a and 2b predict that the organization's nonfinancial performance moderates the effect of donor evaluation focus on director monitoring. Specifically, Hypothesis 2a predicts when an organization's nonfinancial performance is poor, the donor balanced evaluation focus decreases director monitoring to a lower level, compared to a financially focused donor evaluation. In contrast, Hypothesis 2b predicts when an organization's nonfinancial performance is good, the donor balanced evaluation focus strengthens director monitoring, compared to donor financially focused evaluation. The ANCOVA results in Table 3 (panel B) indicate a marginally significant interaction between donor evaluation focus and nonfinancial performance ($EF \times NFP$: $F_{(1,174)} = 3.72$, $p = 0.055$). Further planned contrasts in Table 3 (panel C) indicate a significant increase in director willingness to agree with management's misallocation in the balanced compared to the financially focused conditions when the organization has poor nonfinancial performance (the adjusted mean score of *LKDAgree* for balanced versus financially focused = 3.12 versus 2.16; $t = 2.45$, $p = 0.016$). Thus, Hypothesis 2a is supported. However, planned contrasts in Table 3 (panel C) show when the organization has relatively good nonfinancial performance, there is no difference in directors' willingness to permit management's proposed expense misallocation between the balanced and financially focused evaluation conditions (the adjusted mean score of *LKDAgree* for balanced versus financially focused: 2.58 versus 2.16; $t = 1.10$, $p = 0.276$) (Buckless and Ravenscroft 1990). So, Hypothesis 2b is not supported.

Further analysis

Further analysis has been conducted to enhance understanding of the above findings. For Hypothesis 1, it is argued that the increased risk that the expense misallocation might be detected would drive the positive effect of transparency on director monitoring. I measured the directors' perceived risk of detection using a 9-point scale with −4 "strongly disagree" to +4 "strongly agree" in response to the question, "Management's proposed reporting of expenses in the financial statements allows donors to determine that the $400,000 special campaign expenses were allocated completely to 'Charitable Programs' expenses." As expected, the mean scores of the risk of detection are significantly higher in the conditions where the organization's expense reporting is transparent than in the conditions where the organization's expense reporting is opaque (all p-values ≤ 0.015).

Second, the reverse fair process effect predicted in Hypothesis 2a and the fair process effect predicted in Hypothesis 2b are based on directors' perception of the procedural fairness of donor evaluation focus. I measure directors' assessment of the procedural fairness of donors' evaluation focus (labeled *PFair*) on a 9-point scale from −4 to 4, with −4 denoted "very unfair" and 4 "very fair" in response to the question "Do you consider this potential large donor's evaluation criteria for making a donation to be fair?" As expected, the mean scores are significantly higher in the conditions where donors adopt a balanced evaluation focus than in the conditions where donors adopt a financially focused evaluation (all p-values ≤ 0.01).

When developing Hypotheses 2a and 2b, I assume directors believe that the organization deserves donations regardless the organization's financial and nonfinancial performance. I measure the directors' assessment of the organization's deservingness for donations (labeled *Deserve*) on a 9-point scale with 1 "not at all" to 9 "to a large extent" in response to the question "Given the Center's performance this year, to what extent does the Center deserve the financial support of new donors?" The mean scores of *Deserve* in all eight experimental cells are significantly larger than 1 "not at all" (all p-values < 0.001), and also either statistically equal to (p-values > 0.861) or significantly larger than (p-values < 0.002) the midpoint of the scale. This indicates that, as expected in the hypothesis development section, directors believe that their organization deserves donations to some extent regardless of its financial and nonfinancial performance.[17]

The reverse fair process effect predicted in Hypothesis 2a is presumably caused by a director's belief that when the organization has a relatively poor nonfinancial performance, the balanced donor evaluation focus cannot guarantee a donation that the director might think that the organization deserves. The fair process effect hypothesized in Hypothesis 2b is also based on directors' perception of the likelihood that the organization will receives donations—specifically, compared to the financially focused donor evaluation, the balanced donor evaluation focus can improve the likelihood that an organization receives donations when nonfinancial performance is good. As such, I measured directors' assessment of the likelihood that the organization will receive donations (i.e., *LKDDonate*) on a 9-point scale with 1 "unlikely" to 9 "likely" in response to the question "Given the Center's performance this year, how likely is it that the Center will obtain a donation from this potential new large donor?"

For Hypothesis 2a, the mean scores of *LKDDonate* in the cells with poor nonfinancial performance are significantly or marginally significantly less than the midpoint of the scale (all p-values ≤ 0.067). Thus, as expected, when the organization has a relatively poor nonfinancial performance, directors anticipate that donors would not donate even if they adopt a fairer balanced evaluation. The fair donor evaluation process fails to generate the donation outcome that directors believe the organization should deserve. Therefore, as predicted in Hypothesis 2a, the reverse fair process effect occurs.[18]

For Hypothesis 2b, I found when the organization has relatively good service performance, directors do believe that the organization is more likely to receive donations if donors adopt a balanced evaluation than if donors adopt a financially focused evaluation (mean score of *LKDDonate* = 6.170 versus 5.021; $F_{(1,92)} = 2.93$, $p = 0.004$). Also, the mean scores of *LKDDonate* for those cells with improved nonfinancial performance are either statistically equal to (p-values > 0.861) or significantly larger than (p-values < 0.002) the midpoint of the scale. This means that directors believe good nonfinancial performance can overcome donors' hesitation to donate despite poor financial performance and they do *not* anticipate an unfavorable donation outcome. The fairness literature shows that only an *unfavorable* outcome can trigger people's sense-making process and the sense-making process is essential for the perceived procedural fairness of an evaluation process to influence people's decision-making and their subsequent behavior (See 2009; Brockner et al. 2009; Cropanzano and Greenberg 1997; Brockner and Wiesenfeld 1996; Rutte and Messick 1995). In case of this study, when directors do not anticipate an unfavorable donation outcome, they do not examine the procedural fairness of donor evaluation focus

17. Only the threshold judgment of "deserve or not" rather than the relative judgment on "deserve more or less" is relevant here because it is the directors' belief that the organization does not deserve an unfavorable donation outcome that sets the stage for directors to experience a dislike feeling when a fair evaluation process generates an unfavorable outcome.
18. To exclude a possible alternative explanation, that is, donation maximization rather than perceived procedural fairness contributing to the finding in the poor nonfinancial performance group, I have run a regression analysis for this group, using the likelihood that directors would agree with management proposed misallocation (*LKDAgree*) as the dependent variable and the director assessment of the likelihood of the organization obtaining donations (*LKDDonate*) and the director perceived procedural fairness of donor evaluation process (*PFair*) as the independent variables (Kachelmeier and Towry 2002; Franciosi, Kujal, Michelitsch, Smith, and Deng 1995). The regression results (not tabulated) indicate that *LKDDonate* (coefficient = 0.083; $t = 0.75$, $p = 0.456$) is not significantly associated with directors' tendency to allow management's expense misallocation, while *PFair* is marginally significantly associated with it (coefficient = 0.153; $t = 1.82$, $p = 0.072$). Therefore, the finding for Hypothesis 2a is not driven by the desire to obtain donations, but only by the influence of perceived fairness of the donor evaluation process.

to determine the reason behind a relatively favorable outcome. Therefore, the fair process effect predicted in Hypothesis 2b is not found.[19]

5. Discussion

Managers of nonprofit organizations may misallocate expenses to boost a low program ratio to facilitate the solicitation for donations by making the organization appear to be devoting more resources to charitable works than is actually the case (e.g., Keating et al. 2008; Krishnan et al. 2006). Although normative studies claim that the board of directors monitors management to prevent expense misreporting (Gill 2005; Fama and Jensen 1983), little research has been done to provide empirical evidence as to what directors do in the face of management expense misallocation and what factors could impact their monitoring (Brown and Guo 2010; Callen et al. 2003).

I conducted an experiment with 189 directors from nonprofit organizations, situated in a context where managers misallocate expenses to boost a low program ratio in order to impress donors. As predicted, the results from the experiment indicate that the transparency of organizations' expense disclosures increases director tendency to monitor and makes them less likely to accept management's expense misallocation as a means to increase the program ratio. Further analysis shows that directors' perception of a higher risk of detection by donors and other third parties under more transparent reporting underlies the positive effect of transparency on director oversight.

However, the results also indicate that, although the balanced donor evaluation focus is perceived to be procedurally fairer by directors, it actually decreases directors' monitoring of management expense misallocation as compared to the case in which directors know that donors will adopt a less fair financially focused evaluation. The negative effect of the balanced donor evaluation focus occurs only when the organization has relatively poor financial and nonfinancial performance.

Further analysis shows that despite an organization's poor financial and nonfinancial performance, directors actually believe donors should donate because of their commitment to the organization's "worthy" causes. Directors also believe that a fair evaluation process should generate a desirable evaluation outcome, that is, a positive donation decision from donors. When the outcome is not what directors expect, directors experience stronger negative feelings about the unfavorable outcome derived from a fair (i.e., balanced) evaluation process relative to an unfair (i.e., financially focused) evaluation process. These stronger negative feelings encourage directors to reduce their monitoring by agreeing with management expense misallocation in an attempt to reverse the unfavorable outcome. However, when the organization's nonfinancial performance is relatively good, directors do not anticipate an unfavorable donation outcome although the organization has a relatively low program ratio. Given that they do not anticipate an unfavorable outcome, directors do not need to compromise their monitoring to solicit donations. Therefore, director monitoring is equally strong regardless of donor evaluation focus when the organization has a relatively good nonfinancial performance.

This study contributes to the literature in two ways. First, prior accounting studies have documented that board attributes (e.g., size, independence and composition)

19. The ANCOVA in Table 3 panel B shows a significant main effect of nonfinancial performance on directors' tendency to allow management expense misallocation ($F_{(1,174)} = 4.61$, p-value = 0.033). The contrast tests (not tabulated) indicate that directors are less likely to allow management expense misallocation when the organization has relatively good service performance than when the organization has relatively poor service performance. This finding can be explained by directors' assessment of the likelihood of the organization obtaining donations: because directors believe that an organization with good service performance can obtain donations, it is not necessary to risk violating their fiduciary duties by allowing management misallocations on financial statements.

influence director monitoring in nonprofit organizations (Yetman and Yetman 2012; Roberts 2005; Eldenburg and Vines 2004; Callen et al. 2003).This study adds to the existing accounting literature by demonstrating that environmental factors, such as accounting disclosure requirements and external evaluation systems, can also impact how nonprofit directors exercise their monitoring. Second, whereas the fairness literature has repeatedly showed that procedural fairness benefits organizations, a burgeoning stream of studies specifies the boundary conditions of such effects. For example, some studies (e.g., Cropanzano et al. 2008; Brockner et al. 2008; Holmvall and Bobocel 2008; Van den Bos 2003; Brockner 2002) found when people see themselves as personally responsible for unfavorable outcomes, they actually prefer an unfair process over a fair process that generates the outcomes, as a fair process cannot enable them to attribute unfavorable outcomes to the process but only to themselves. This study adds evidence to this stream of studies by showing that nonprofit directors can also react negatively to a fair evaluation process when the outcome resulting from the fair evaluation is not as favorable as anticipated.

The findings from this study have practical implications. Transparent expense disclosures in financial statements of nonprofit organizations improve director monitoring of management. This finding has regulatory implication for the bodies that set accounting standards (e.g., the Canadian Accounting Standards Board). Probably, the transparent expense disclosures should be mandatory rather than voluntary. It is also particularly interesting that donors' adoption of a balanced evaluation of organization performance reduces director oversight of management expense misallocation when organizations suffer from poor service performance. If managers do not have a positive service performance to emphasize, they might well attempt to manipulate the program ratio as a means to make them and the organization look better. Yet under this condition, the monitoring by directors is at its lowest level. Recent research and professional reports all indicate that both donors and nonprofit organizations would prefer a balanced donor evaluation focus (Perry 2013; Association of Fundraising Professionals 2008; Silverman and Beatty 2007; Silvergleid 2003; Campbell 2002; Kaplan 2001). Ironically, donors' adoption of the financially focused evaluation can increase director oversight of management expense misallocation, although it is claimed that this approach can motivate managers to misallocate expenses in nonprofit organizations in the first place.

Further research is needed to determine how to obtain benefits from a balanced donor evaluation focus in light of the costs of reduced director monitoring. For example, does the prior experience of directors in for-profit and nonprofit organizations play a mitigating role? Does the reputation of directors also influence director monitoring? Are directors at a higher stage of moral development more likely to overcome the negative effect of the balanced donor evaluation focus than those directors at a lower stage of moral development? These research questions may identify situations where a balanced donor evaluation is more desirable than a financially focused evaluation in order to enhance the director oversight of management expense misallocation.

There are several limitations to my research. In particular, by law the disclosure of nonfinancial performance is not mandatory for nonprofit organizations in Canada, but many nonprofit organizations do report their nonfinancial performance on annual reports (Parsons 2003; Salterio and Legresley 2011). In addition, I construct a scenario in the experimental case where the indicators for the nonprofit organizations' nonfinancial performance can easily be measured and compared across peer organizations. However, in practice, it is often difficult and challenging to design a set of effectiveness measures that reflects the needs of all stakeholders, while facilitating comparability across nonprofit organizations (Herman and Renz 2008; Campbell 2002; Kaplan 2001). Nonetheless, this experiment captures the essential elements of the quality of nonfinancial performance by simplifying the measurements of nonfinancial performance. It is also important to note that not all experiment participants are directors with accounting expertise who might know whether management's proposed allocation of fundraising expenses to charitable expenses violates GAAP. However, not all nonprofit organizations have accountants sitting on their board, and 63.30 percent of the participants in this study were accountants. So, the sample can be said to well represent the pool of financially literate directors who may influence the whole board on the issues regarding the expense reporting of nonprofit organizations. Finally, this study does not address the issue of how managers respond to director oversight, which is critical, given that financial statements are the product of discussion and negotiation between management and directors. This research question is left to future study.

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