Community Social Capital and Financial Reporting Quality in Nonprofits

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Abstract

Based on the social norms and structural theories of social capital, our study provides evidence that the social capital of a nonprofit organization's headquarters area has a positive and statistically significant impact on its financial reporting quality. This evidence is consistent with the social capital theory view of community social capital, which argues that social capital encourages morally acceptable behavior, provides reputational capital, and has implications for organizations. Additionally, our study finds that community social capital is positively associated with the strength of nonprofits' governance and negatively associated with managerial opportunistic behavior, which in turn mediates the main relationship.

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1. Introduction

Social capital is defined as the social networks that foster norms-conducive behavior and constrain norm-deviant behavior in society (Fukuyama, 1997; Portes, 1998; Putnam, 2001a); it has been shown to impact societal (Brooks, 2005) and organizational behavior (Jha & Chen, 2015; Ferris et al., 2017; Gupta et al., 2018). The social capital of an entity's location is critical to the entity's disciplinary environment and its ability to produce high-quality financial reports. The seminal research on social capital characterizes community social capital as cohesive social networks that impose disciplinary measures (such as the risk of losing friendships or facing social isolation), thereby promoting norms conducive to societal behavior (Fukuyama, 1997; Portes, 1998; Putnam, 2001a; Lu et al., 2016; Hasan et al., 2017; Li-Kuehne, et al., 2024).

Although for-profit literature indicates that social capital positively impacts financial reporting quality (Jha & Chen, 2015) and governance (Ferris et al., 2017), this area has received less attention in literature on nonprofit organizations, hereafter denoted as NPOs. NPOs, driven by a mission for societal benefit rather than profit, may not face the same financial pressures as for-profit entities, potentially reducing incentives for financial manipulation. Additionally, the altruistic nature of NPO managers contrasts with the profit-oriented focus of their for-profit counterparts. For-profit managers often strive for grandiosity, increased personal recognition, and greater rewards, fostering traits such as CEO narcissism, hubris, and overconfidence (Aktas et al., 2016; Amernic & Craig, 2010; Buchholz et al., 2018; Tang et al., 2018). Since NPO managers presumably lack such characteristics, social capital disciplinary instruments may not be needed and, hence, are not relevant. Our study fills the void in NPO literature by exploring the impact of social capital on NPO financial reporting quality.

Consistent with social norms theory (Kohlberg, 1984) and the structural theorist view of social capital (Bourdieu, 1989; Lin, 1999; Payne et al., 2011), we argue that community social capital disciplines self-interested managers' and directors' behavior (e.g., Jha, 2019), and also provides reputational capital (Bhuyan et al., 2022) to them. We argue that since managers and board members in high community social capital NPOs are more disciplined and have higher reputational capital at stake, these managers and board members are more likely to provide truthful disclosures (Jha & Chen, 2015).[1] Therefore, we predict that NPOs in regions with high community social capital provide higher quality financial reports than NPOs in regions with low community social capital.

However, the notion that community social capital positively affects NPO financial reporting quality is not without controversy. Ambiguity arises because some prior studies rely on Bebchuk's managerial power (Bebchuk et al., 2002) and groupthink bias (Janis, 1982) perspectives of agency theory. Firstly, Bebchuk's managerial power perspective suggests that social connections within social capital provide NPO managers and directors with labor market insurance. Regions with high social capital offer robust labor market insurance and the assurance of job security, even in the face of termination, creating an environment where management is more prone to opportunistic behavior, including financial reporting manipulation.

Moreover, prior studies of groupthink bias suggest that teams with a more cohesive background are susceptible to lapses in judgment, compromised monitoring, and less sophisticated decision-making (Janis, 1982; Strindlund et al., 2022). Groupthink bias is the "dark side" of social capital. A large proportion of the workforce in NPOs comes from the local

[1] High social capital regions not only heighten the risk of reputation loss, but also include several disciplinary instruments such as guilt, social isolation, gossip, and condescending stares from the members in the society (Bourdieu, 1986, 1989; Bourdieu & Wacquant 1992; Lin, 1999; Payne et al., 2011; Javakhadze et al., 2016).

community, and these employees and volunteers play a crucial role in checking NPOs' behavior (Dell et al., 2022; Subedi & Farazmand, 2019). In regions with high social capital, groupthink bias causes these individuals to avoid engaging in constructive disagreements or to overestimate the abilities of their social network peers (i.e., NPO managers) (Chiappe et al., 2012; Ryngaert & Thomas, 2012).[2] More specifically, employees in high social capital regions are more likely to accept financial manipulation by managers (e.g., managers classifying fundraising and administrative expenses as charitable expenses) and more likely to overestimate the ability of NPO managers to supply truthful financial reports.

In summary, the social capital view predicts that community social capital fosters honest information sharing, leading to an overall improvement in financial reporting quality. Conversely, the managerial power and groupthink perspectives within agency theory suggest that community social capital may elevate the risk of financial misreporting. Consequently, the relationship between community social capital and NPO financial reporting quality becomes an empirical question that our study aims to investigate.

Our study collects community social capital data at the United States (US) county level from Rupasingha et al. (2006) and NPO data from Form 990 files in the US obtained from Amazon Web Services (AWS). AWS began collecting Form 990 information in 2013.[3] The primary proxy for NPO financial reporting quality (*FRQ*) is based on Krishnan and Yetman (2011) and

[2]In the literature on related party transactions, Ryngaert and Thomas (2012) suggest that employees may overestimate the abilities of their relatives when evaluating transactions, such as granting approvals for loans to their siblings.

[3] Form 990 underwent significant changes in the year 2008 and it took a few years for all NPOs to disclose data consistent with the changes of Form 990.

Yetman and Yetman (2012), who demonstrate that NPOs inflate charitable expenses by misallocating these expenses and understating fundraising expenses.[4]

Our study finds that an NPO's community social capital has a positive association with its financial reporting quality, confirming the social capital view of community social capital (*H1a*). This finding suggests that community social capital constrains NPO and self-interested insiders' behavior from manipulating financial numbers in Form 990 disclosures. Our results are invariant to different model specifications, controlling for various proxies for community social capital and financial reporting quality, self-selection bias, year fixed-effect, industry fixed-effect, firm fixed-effects, state fixed-effects, and controlling for county and principal officer characteristics, as well as utilizing the two-stage least square instrumental variable (2SLS IV) method.

We also provide evidence (*H2a*) that community social capital incentivizes NPOs to adopt strong governance mechanisms to monitor financial reports for possible errors, misstatements, and fraud.[5] More specifically, we find that NPOs which have high community social capital are more likely to adopt written policies (conflict of interest, whistleblower protections, and document retention), to provide copies of Form 990 to the board before filing the form with the IRS, and to have an audit committee. Overall, the evidence suggests governance mechanisms mediate the positive relationship between community social capital and financial reporting quality in that community social capital improves the strength of governance mechanisms and then, in turn, positively influences financial reporting quality. Our additional analyses find that the local crime rate in the local community moderates the relationship between community social

[4] The study also employs an alternative proxy for financial reporting quality, focusing on the misallocation of administrative expenses as charitable expenses. The construction of these two proxies for NPOs' financial reporting quality is discussed in the research design section 3.2.

[5] In line with social norms theory (Kohlberg, 1984) and structural theorist view of social capital (Bourdieu, 1989; Lin, 1999; Payne, et al., 2011), our study argues that managers and directors in high community social capital NPOs have fewer incentives to shirk, behave entrenched and resist the adoption of strong governance practices. NPOs in high community social capital, for example, are more likely to adopt a whistleblower protection policy.

capital and financial reporting quality. Increased crime rates weaken the positive association between social capital and financial reporting quality, and violent crime weakens the relationship more than non-violent crime. We also find that managerial opportunistic behavior in an NPO mediates the relationship between community social capital and financial reporting quality, in that social capital reduces managerial opportunistic behavior, which in turn increases financial reporting quality.

The paper is organized as follows: Section 2 discusses prior literature and proposes hypotheses to address our study's empirical questions. Section 3 defines the variables and develops the empirical model. Section 4 discusses the sample and presents the results. Section 5 provides a discussion of findings and contributions. Finally, Section 6 concludes with a summary and explanation of the results.

2. Literature Review and Hypothesis Development

Putnam (1993, 1995) popularized the concept of social capital by defining social capital as social networks, interactions, norms, and trust that facilitate coordination and cooperation for mutual benefit. Woolcock (1998) further simplified the definition of social capital as the benefits linked to norms and networks among relationships. The following sections discuss community social capital from the lens of social capital theory and agency theory. Afterward, we present the main hypothesis, which predicts that the relationship between community social capital and NPO financial reporting quality could be either negative or positive.

2.1 Social Capital as Social Norms and Social Networks

Some theorists view social capital from the perspective of social norms theory (Kohlberg, 1984) and relate social capital to norms, values, attitudes, and beliefs expected in a social group (Portes, 1998; Putnam, 1993). Consistent with this view, community social capital encourages

morally acceptable behavior in society and has implications for organizations headquartered in communities that set high ethical standards (Pastoriza et al., 2008; Jha & Cox, 2015; Jha, 2019; Li-Kuehne, et al., 2024). Jha and Cox (2015) find that firms in areas of high community social capital practice a higher level of socially responsible activities. Similarly, Jha and Chen (2015), Jha (2019) and Li-Kuehne et al. (2024) suggest that firms in high community social capital locations hold higher ethical standards.

Furthermore, some theorists view social capital from the perspective of structural theory (e.g., Bourdieu, 1986, 1989; Bourdieu & Wacquant, 1992; Lin, 1999; Payne et al., 2011), which argues that the large and dense networks in high social capital areas serve as proxies for managerial reputational capital (Javakhadze et al., 2016). These networks may proxy network participants' reputations because such network participants potentially have a significant number of relationships to lose in the event of a breach of public trust. In addition, information transfers quickly in these networks so this effect is increased in such situations. Similarly, Liu (2015) finds that familiar connections among actors in the bond underwriting process are essential in lowering borrowing costs, suggesting that relationships among network participants help reduce information asymmetry (Bo et al., 2021).

Overall, the predominant view that emerges from both the norms and networks view of social capital is that community social capital, captured by shared common beliefs (i.e., social norms) and dense associational networks in a community, encourages ethical behavior, facilitates quick information transfer, and provides reputational capital to the network participants (Woolcock, 1998; Hasan et al., 2017). In line with this view, we argue that network participants in high community social capital areas follow morally acceptable behavior because such behavior is encouraged and violations are disciplined.

2.2 Social Capital Theory View of Community Social Capital

Agency theory (Jensen & Meckling, 1976) argues that NPO managers may act opportunistically and have incentives to manipulate financial numbers. Incentives to misreport financial disclosures are ultimately tied to self-interested managerial motives for increasing compensation and maintaining job security. While for-profit corporations have the clear and measurable goal of profit maximization, NPOs' goals are challenging to define and measure. Such ambiguity can prompt some NPO board members to shirk their monitoring duties (Weisbrod, 1998). We provide two broad arguments relating to the norms and network aspects of community social capital, suggesting a positive relationship between community social capital.

First, consistent with social norms theory (Kohlberg, 1984), we argue that community social capital disciplines NPO self-interested managers' behaviors by encouraging them to practice honest dealings and imposing several disciplinary instruments for dishonest and self-interested dealings (Kandori, 1992; McMillan & Woodruff, 2000; Jha & Chen, 2015; Javakhadze et al., 2016; Gupta et al., 2018). These disciplinary instruments include guilt, social isolation, gossip, and condescending stares from local community members. Thus, managers in high social capital NPOs are less likely to manipulate financial numbers in Form 990. Consistent with this view of social norms, these disciplinary instruments also discourage board members from shirking their monitoring responsibilities, incentivizing them to implement strong governance practices and increase financial reporting quality.

Second, consistent with the network size view (i.e., structural theory) of social capital, we argue that large and dense networks in high social capital areas proxy managerial and board members' reputational capital (Bourdieu, 1986, 1989; Bourdieu & Wacquant, 1992; Lin, 1999; Payne et al., 2011). Prior studies in for-profit settings have established a positive association

between managerial reputation and financial reporting quality (Jha, 2019; Bhuyan et al., 2022) and between board reputation and financial reporting quality (Khoo et al., 2020). Javakhadze et al. (2016) and Kandori (1992) argue that extensive networks increase the stakes associated with reputational damage because individuals in large, dense networks risk harming numerous close relationships if they act dishonestly. This heightened risk of reputational loss acts as a strong deterrent against unethical behavior and mismanagement. Similarly, Powell (2003) notes that in social networks, the boundaries between formal business status and personal social status are often blurred. This integration means that individuals' reputations are closely tied to their social networks.[6] As a result, individuals in high social capital regions are likely to be more vigilant about their actions. Additionally, NPOs typically employ local community members, including both staff and volunteers (Dell et al., 2022). Consequently, managers and directors in NPOs have more reputational capital at stake, as their local social connections facilitate rapid word-of-mouth communication, which can lead to gossip and potential social isolation within the community. Since the costs of reputation loss are higher for managers and board members in high social capital NPOs, we expect that these managers are less likely to manipulate financial numbers in Form 990 disclosures, and board members are more likely to employ strong governance mechanisms.

Altogether, we argue that the norms and networks of community social capital provide external disciplinary instruments to managers and board members, reducing their opportunistic behavior and promoting more truthful financial disclosures in Form 990. Therefore, our study predicts a positive relationship between community social capital and NPO financial reporting quality.

[6] Fafchamps and Minten (1999) provide further evidence that the loss of the relationship with network participants serves as the self-disciplining role for network participants.

2.3 Agency Theory View of Community Social Capital

Alternatively, prior literature grounded in agency theory (Jensen and Meckling, 1976) argues that community social capital may negatively influence financial reporting quality. Building on agency theory, we present perspectives on managerial power and groupthink bias to support the negative relationship between community social capital and financial reporting quality in NPOs.[7]

First, Bebchuk's managerial power perspective within agency theory (Bebchuk et al., 2002) posits that social connections within social capital offer labor market insurance to insiders (Faleye et al., 2014; Liu, 2015). The robust labor market insurance present in regions with high social capital fosters a climate where management is more prone to opportunistic behavior. This is because the assurance of job security, even in the face of termination, diminishes the negative consequences of their actions (Bhuyan et al., 2022; He, 2015). One such opportunistic behavior involves the manipulation of financial reports, as these managers are less worried about the subsequent penalties following the revelation of financial misreporting (Griffin et al., 2021; He, 2015). In essence, we argue that social networks within communities rich in social capital provide labor market insurance to NPO managers, consequently leading to a decline in financial reporting quality.

Second, the agency view of social capital argues for the dark side of social capital, highlighting the prevalence of groupthink bias within cohesive social groups (Janis, 1982;

[7] Based on Agency theory (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983), it can be argued that NPO managers are agents whose interest is to maximize their salaries, career prospects, and job security. Whereas the other stakeholders of NPOs (e.g., IRS, donors, grant-makers, regulators, creditors, watchdog agencies, and media) are the principals who want NPOs to maximize spending on charitable purposes and to be truthful about their financial reporting in Form 990.

Strindlund et al., 2022).[8,9] We posit that community members, including employees in NPOs headquartered in high social capital regions, may be susceptible to groupthink bias. Given that the NPOs' workforce is typically comprised of individuals from the local community, including employees and volunteers, and these individuals play a significant role in overseeing the nonprofit's behavior (Dell et al., 2022; Subedi & Farazmand, 2019) [10] and participating in nonprofit strategy (Parker, 2018; Mihanovic & Rosan, 2014)[11], these organizations are more likely to experience groupthink bias induced by social capital.

We present several reasons outlining how groupthink contributes to poor financial reporting quality in NPOs. Employees within NPOs play a crucial governance role, overseeing managerial behavior and reporting financial misconduct (Rhode & Packel, 2009). However, in high social capital regions, individuals, due to groupthink bias, may avoid expressing dissenting opinions or engaging in constructive disagreements for the sake of maintaining group cohesion. This compromises the fiduciary duties of the local NPO community, including employees and directors, in monitoring managerial behavior.[12] Additionally, the overconfidence bias stemming from groupthink hampers judgment and leads individuals within cohesive groups to overestimate the capabilities of their social peers (Brookins et al., 2014; Chiappe et al., 2012). In conclusion, NPOs headquartered in high social capital regions face a unique disadvantage, where both the

[8] In their exploration of the negative aspects of social capital, Strindlund et al. (2022) suggest that groupthink bias within social capital contributes to an overestimation of the capabilities of social peers and leads to a non-rational escalation of commitment.
[9] Cohesive social groups typically consist of individuals with similar backgrounds, making such groups prone to lapses in judgment, compromised monitoring, and less sophisticated decision-making (Janis, 1982).
[10] Dell et al. (2022) suggest that nonprofits have oversight from the community participants.
[11] Parker (2018) suggests that NPO staff members are motivated by intrinsic factors to contribute to positive social change and are deeply concerned about the well-being of NPO stakeholders. Their involvement in various NPO programs and services reflects their commitment to the welfare of diverse stakeholders.
[12] Consistent with this view, Kuang and Lee (2017) suggest that well socially connected directors devote less time and effort in monitoring managers and thus, firms with such directors suffer from more corporate fraud.

monitoring of management and the assessment of managerial ability to provide accurate financial reports are compromised due to groupthink in high social capital regions.

Altogether, managerial power and groupthink perspectives of agency theory suggest that community social capital provides strong labor market insurance to the managers of NPOs and induces groupthink bias, ultimately contributing to poor financial reporting quality.

2.4. Hypothesis Development

We present two competing hypotheses to describe the effect of community social capital on the financial reporting quality of NPOs. On the one hand, the social capital view, as discussed in Section 2.2, predicts that community social capital facilitates truthful information sharing, ultimately increasing financial reporting quality. On the other hand, the managerial power and groupthink perspectives under agency theory, as discussed in Section 2.3, suggest that community social capital contributes to the risk of financial misreporting (i.e., poor financial reporting quality). We propose the following null hypothesis because the relationship between community social capital and the financial reporting quality of NPOs could go either direction.

$H1_{null}$: *There is no association between community social capital and NPO financial reporting quality.*

H1a: *Community social capital has a positive effect on NPO financial reporting quality. (The social capital view).*

H1b: *Community social capital has a negative effect on NPO financial reporting quality. (The agency theory view).*

2.5 Community Social Capital, NPO Governance and Financial Reporting Quality

If our results support the social capital theory view of community social capital in *H1a,* it implies that the norms and networks component of community social capital disciplines NPO self-interested manager behaviors and director shirking by encouraging NPOs to implement

strong governance practices.[13] However, if our results support the agency theory view in *H1b*, it implies that managers and directors in high social capital regions are less likely to implement strong governance practices due to managerial power and groupthink-induced bias resulting from high social capital. Depending on whether social capital theory or agency theory holds sway, community social capital either incentivizes NPOs to adopt strong governance practices or discourages such firms from adopting strong governance practices. Therefore, we propose the following hypothesis (*H2a*) in null form.

H2a: *Community social capital is not associated with the strength of NPO governance mechanisms over financial disclosures.*

We extend our *H2a* to financial reporting quality to predict that NPO governance mediates the relationship between NPO community social capital and financial reporting quality. In this scenario, community social capital strengthens (or weakens) the governance mechanisms over financial reports, thereby increasing (or decreasing) financial reporting quality. Thus, we propose the following hypothesis (*H2b*) in null form.

H2b: *The relationship between community social capital and NPO financial reporting quality is not mediated by NPO governance mechanisms over financial disclosures.*

3. Research Design

This section presents the research design of our study. First, we discuss how our study operationalizes the social capital of an NPO's headquarters area. Second, we present two proxies for NPO financial reporting quality. Third, we present three proxies of NPO governance mechanisms that managers and directors can implement to monitor the NPO financial reports for

[13] More specifically, community social capital provides disciplinary instruments and reputational capital so that managers are less likely to resist strong governance practices and directors are more likely to implement strong governance practices to monitor NPO financial reports for possible errors, misstatements, and fraud.

possible errors, misstatements, and fraud. Finally, we discuss the models for financial reporting quality.

3.1 Social Capital Measures

Our study relies on Rupasingha et al. (2006) to construct the social capital index at the county level. The dataset is available on the Northeast Regional Center for Rural Development (NERCRD) website.[14] The social capital index (*SC*) of NERCRD at the US county level is the first principal component of an analysis based on four factors, including the number of social organizations and associations in a county, voter turnout, census response rate, and the number of nonprofit organizations excluding those without an international approach (Jha & Chen, 2015; Li & Lu, 2022). Consistent with community social capital literature (Jha & Chen, 2015; Hoi et al., 2018; Li et al., 2018; Jha, 2019), our study interpolates and extrapolates the community social capital index to fill missing years. Since social capital in a particular community remains relatively stable over time, interpolation and extrapolation biases are not concerns in this setting.

In later robustness tests, our study also uses four alternative measures of community social capital. First, we use *SC_DUMMY* as an indicator variable equal to 1 if community social capital is above the median social capital index and 0 otherwise. This helps address the issues associated with the skewed distribution and outliers in the main measure of social capital. Second, some prior studies (e.g., McGuire et al., 2012) argue that county-level measures may misrepresent local community participants' associations with a firm as many employees connected with a firm are likely to reside in a Metropolitan Statistical Area (MSA). To calculate community social capital at an MSA level for a firm's headquarter location, we take the mean value of SC of all

[14] The full information about community social capital components can be found at https://aese.psu.edu/nercrd/community/social-capital-resources/social-capital-variables-for-2014/data-dictionary-social-capital-variables.

counties that belong to a particular MSA. We name this alternative measure *SC_ALT*. Third, we use the social capital index (*SC_PUTNAM*) constructed by Putnam (2001b). Fourth, following Bhandari and Bhuyan (2023) and Gupta et al. (2018), we also use Putnam Trust (*SC_TRUST*), which is the score based on the survey questions in Putnam (2001b): "Agree that most people can be trusted".[15]

3.2 Financial Reporting Quality Measures

Prior studies acknowledge the importance of NPO charitable expenses as essential information for users of Form 990 because it shows how much NPOs are actually spending on charitable activities (Tinkelman & Mankaney, 2007). NPO managers have incentives to increase charitable expenses to demonstrate that the contributions to the NPOs are spent on charitable purposes. Previous studies argue that NPO managers who report a higher charitable expenses ratio (charitable expenses divided by total expenses) receive higher salaries (Baber et al., 2002), attract more donations (Callen, 1994; Yetman & Yetman, 2013), and are less likely to lose tax-exempt status (Lagnando, 2004). In addition, charity watchdogs such as the Better Business Bureau Wise Giving Alliance, National Charities Information Bureau, Charity Navigator, the American Institute of Philanthropy, and various news sources such as Forbes use the charitable ratio as one means of rating nonprofits.

Prior NPO literature documents that NPO managers inflate charitable expenses by understating fundraising expenses and misallocating these expenses as charitable expenses (Krishnan et al., 2006; Keating et al., 2008; Krishnan & Yetman, 2011). Our study follows Yetman and Yetman (2012) to construct our main measures of NPO financial reporting quality, primarily based on NPOs' propensity to understate fundraising expenses. More specifically, our

[15] In later robustness tests, our main results are robust to these four alternative proxies of the community social capital measure.

main measure of NPO financial reporting quality is based on Yetman and Yetman's (2012) use of Wing et al. (2006) and Steinberg's (1986) theoretical link between fundraising expenses and donations. An error term for each observation is calculated so that an increasing error term value indicates higher financial reporting quality (*FRQ*). Observations that generate positive (negative) residuals in model (1) are those that indicate more (less) fundraising expenses than the model predicts. Thus, the error term from model (1) represents the increasing value of financial reporting quality (*FRQ*). The regression results are reported in Column (1) of Table A in the online appendix.

$$\textit{Fundraising Expenses}_{(i,t-1)} = \beta 0 + \beta 1\ \textit{Private Donations}_{i,t} + \beta 2\ \textit{Feeder Donations}_{i,t} + \beta 3\ \textit{Government Grants}_{i,t} + \text{Industry FE} + \text{Year FE} + \varepsilon_{i,t}\ , \quad (1)$$

where *Fundraising Expenses* represent the lagged values of total fundraising expenses reported by the NPO. *Private Donations* include contributions from individuals, corporations, and foundations, while *Feeder Donations* consist of contributions from federated fundraising organizations like the United Way. *Government Grants* include contributions from local, state, or federal agencies. Our study incorporates year and industry fixed effects to mitigate the impact of invariant year and industry characteristics.

We follow Yetman and Yetman (2012) and construct an alternative measure of NPO financial reporting quality. NPOs reporting administrative expenses tend to underreport these expenses and shift them to the charitable expense category. In line with this argument, Yetman and Yetman (2012) use Steinberg's (1986) theoretical link between administrative expenses and donations to propose a model that predicts lagged values of administrative expenses. An error term is calculated for each observation, where the increasing value of the error term represents

higher financial reporting quality (*FRQ_ALT*). The regression results are reported in Column (2) of Table A in the online appendix.

$$Administrative\ Expenses_{(i,t-1)} = \beta 0 + \beta 1\ Private\ Donations_{i,t} + \beta 2\ Feeder\ Donations_{i,t} + \beta 3\ Government\ Grants_{i,t} + \beta 4\ Total\ Expense_{i,t} + \beta 5\ Total\ Assets_{i,t} + \beta 6\ Total\ Assets_{i,t}^{\wedge 2} + \text{Industry FE} + \text{Year FE} + \varepsilon_{i,t}\ , \quad (2)$$

Administrative Expenses refer to the total administrative expenses reported by the NPO. Consistent with Yetman and Yetman (2012), this model includes *Private Donations*, *Feeder Donations*, *Government Grants, Total Expense*, *Total Assets*, and the square of *Total Assets.*

3.3. Governance Measures

Our study uses three measures of NPO governance mechanisms that managers and directors can implement to monitor NPO financial reports for possible errors, misstatements, and fraud. These three measures come from the revised IRS Form 990, which includes the new Part VI: Governance, Management, and Disclosure. The first measure captures whether NPOs have voluntarily adopted several written policies intended to mitigate opportunistic managerial behavior (Yetman & Yetman, 2012; Blackwood et al., 2014). Part VI, Section B, lines 12, 13, and 14 of the revised Form 990 provides information on whether NPOs adopt written policies regarding conflict of interest, whistleblower protections, and document retention/destruction. Yetman and Yetman (2012) and Blackwood et al. (2014) argue that NPOs adopting the above stated written policies provide better governance as they mitigate managerial incentives to act on their self-interest. The presence of each of these written policies is coded as one and zero otherwise. To capture a single comprehensive measure of written policy, we sum each of these three codes, so the aggregate value ranges from 0 to 3; an aggregate value of 3 (0) indicates the presence (absence) of all three policies. Our study names this first measure of NPO governance

as *WRITTEN_POLICY*, where the higher values indicate stronger NPO monitoring over financial reporting.

The second measure of NPO governance is whether the board was provided with copies of Form 990 for review before the form was filed with the IRS (Yetman & Yetman, 2012). Our study names this variable *BOARD_REVIEW*, which equals 1 if the NPO reported providing copies of Form 990 to the board before filing with the IRS, and 0 otherwise. The third and final measure of board characteristics is the presence of the audit committee (Yetman & Yetman, 2012; Blackwood et al., 2014). Our study names this variable *AUDIT_COM*, which equals 1 if the nonprofit reported having an audit committee, and 0 otherwise.

3.4 Financial Reporting Quality Model

This section presents the multivariate models used in our study to test the effect of community social capital on financial reporting quality. Numerous models have been developed over the years to explain NPO financial reporting quality. Our study uses the following model based on Yetman and Yetman (2012).

$$FRQ_{i,t} = Constant + \beta_1 SC_{i,t} + \gamma\ Firm\ Characteristics_{i,t} + Year\ Controls + Industry\ Controls + \varepsilon_{i,t}$$

$$\text{Year FE} + \varepsilon_{i,t}\ , \qquad (3)$$

where *FRQ* is our dependent variable and main proxy of financial reporting quality discussed in Section 3.2. The construction of the main independent variable of interest community social capital, *SC*, is explained in detail in Section 3.1. The model controls for NPO size (*SIZE*) and age (*AGE*) as larger and older NPOs generally have better information environments (Yetman & Yetman, 2012).[16] In addition, prior NPO literature documents that larger firms have more

[16] NPO size and age are also used as a proxy for reputational capital and prior studies argue that firms with high reputational capital are less likely to manipulate their financial numbers and thus provide higher disclosure quality (Weisbrod & Dominguez, 1986). In addition, Fernandez (2008) documents that younger NPOs are at greater risk of failure and thus have higher pressure to look financially better to the current and potential stakeholders.

resources (Ohlson, 1980; Bruderl & Schussler, 1990) which they can use to improve disclosure quality. Larger NPOs, for example, can hire many financial experts and CPAs in their accounting team, increasing the Form 990 disclosure quality. Similarly, NPOs that rely more on donations are expected to make more transparent disclosure. Therefore, the model controls for donation intensity, which is the ratio of total donations to total revenues (*DON_INTENSITY)*.

The model also controls for NPO growth (*DON_GROWTH*). Prior studies (e.g., Loebbecke et al., 1989) document that high-growth firms have greater opportunities and pressure to manage financial numbers (Yetman & Yetman, 2012). Prior studies (e.g., Mercer, 2004) argue that managers in distressed firms have greater incentives to manipulate financial disclosures; thus, our study controls for the current ratio, calculated as current assets divided by current liabilities (*CURRENT_RATIO*). NPOs with higher values of the current ratio are less distressed than NPOs with lower current ratio values. The model also controls for NPO financial performance (*ROA*) and total expenditures (*LNEXPENSE*) but does not predict any direction for these control variables. Unlike for-profit companies, nonprofit organizations do not have a profit maximization mission. We expect the relationship of *ROA* and *LNEXPENSE* with *FRQ* to be either positive or negative.

Finally, the model controls for the number of NPO board directors (*BOARD_SIZE*). A large board of directors can provide additional insights and eyes to monitor management. However, literature also documents potential increased communication and coordination problems as board size increases and the decreased ability of the board to control management, thereby leading to agency problems (Jensen, 1993; Yermack, 1996; Eisenberg et al.,1998). In addition, prior studies suggest that the effect of board size depends on various factors, such as diversity and the inclusion of professional and institutional investors among board members (Mwaungulu et al.,

2023). Due to these conflicting arguments, we expect that the relationship between *BOARD_SIZE* and *FRQ* could be either positive or negative. The regression model also includes year and industry fixed effects to minimize the impact of invariant year and industry characteristics. [17] In later robustness tests, we also control for county characteristics, principal officer characteristics, conduct firm fixed effects regression, and state fixed effects regression.

4. Sample and Analyses

4.1 Sample Formation, Distribution and Descriptive

Our research investigates the impact of the social capital of an NPO headquarters area on the NPO's Form 990 disclosure quality. In the context of our research, the quality of Form 990 represents NPO financial reporting quality. More specifically, as discussed in Section 3.2, we focus on NPOs' tendency to underreport fundraising and administrative expenses in Form 990 to assess the quality of Form 990. The higher (lower) the amount of these expenses compared to the donations, the higher (lower) the NPO financial reporting quality.

Exempt from issuing stock, nonprofits are not bound by the regulations stipulated in the Securities and Exchange Commission (SEC) Acts of 1933 or 1934 and the Sarbanes-Oxley Act (SOX) of 2002. Notably, Form 990 underwent significant changes in 2008, and it took several years for many nonprofits to adapt to these changes and establish a consistent disclosure format. For our analysis of nonprofit financial reporting quality and governance, we utilize US data sourced from Form 990 in a machine-readable format accessible through Amazon Web Services (AWS). While AWS offers access to machine-readable data for electronic 990 forms from 2013

[17] Our study separately examines the variance inflation factors (VIFs) on the independent variables in each of the major estimations to alleviate potential concerns about multicollinearity and find that all the variables have a VIF less than 2, suggesting that multicollinearity is not an issue the models.

onwards, our final sample commences from 2014 due to the limited number of nonprofit observations with required data in 2013.

The source of the National Taxonomy of Exempt Entities (NTEE) Code is the NCCS database.[18] Nonprofit firm-year observations that belong to the religion industry were eliminated, as many religious firms do not need to file Form 990.[19] The final sample size includes 202,132 observations for the period 2014-2018. Table 1 Panel A shows the sample distribution by year. 2014 has the least percentage of sample observations as this period coincides with the second year AWS started collecting NPO Form 990 information. The sample observations are fairly distributed for the period 2015-2018. The year 2018 has the largest number of observations, comprising 24.58 percent of the sample size.

Table 1 Panel B reports distributions of the sample observations by NTEE classifications, which use ten industry classifications for NPOs. The 'Human Services' industry has the largest number of observations overall. While the 'Mutual/Membership Benefit' industry comprises only 0.20 percent of the sample size and has the lowest number of observations in classified industries, the 'Unknown, Unclassified' industry has the lowest number of observations overall (0.09 percent of total sample observations).

< Insert Table 1 about here >

Table 2 Panel A presents the descriptive statistics of the variables used in the empirical analyses. Regarding our main proxy of financial reporting quality, the median value of *FRQ* is 0.075 and *FRQ_ALT* is -0.823, indicating that, on average, NPO observations have higher values of positive and negative error terms from Equation (1) and Equation (2), respectively. The

[18] https://nccs.urban.org/project/national-taxonomy-exempt-entities-ntee-codes

[19] More importantly, Subedi and Liu (2024) present evidence that local religiosity attracts NPOs, which in turn introduces a multicollinearity and other research design issue.

average return on assets (*ROA*) in our sample NPOs is only 0.1 percent. The mean of *BOARD_SIZE* is 13.468. The average *WRITTEN_POLICY* is 2.160, suggesting the sample NPOs, on average, adopt at least two of the three written policies regarding conflict of interest, whistleblower protections, and document retention/destruction. Similarly, on average, 40.10 percent of observations have their Form 990 reviewed by all governing body members before filing with the Internal Revenue Service (IRS). Around 35.90 percent of NPOs have an audit committee to review the financial reporting process. Table 2 Panel B presents a correlation matrix of a few selected main variables.

The summary statistics of our primary measure of community social capital (*SC*) are consistent with Hoi et al. (2018) and Li et al. (2018). The summary statistics of *FRQ* and *FRQ_ALT* closely follow Yetman and Yetman (2012) in terms of quartile distribution. The mean values are slightly different from Yetman and Yetman (2012). However, we note that our sample period differs from Yetman and Yetman (2012) as their study uses the 1998 to 2008 sample period, whereas the current study covers the sample period starting from 2014 to 2018.

The summary statistics of *SC_PUTNAM* and *SC_TRUST* also closely follow Gupta et al. (2018). Our descriptive statistics of county characteristics closely follow those of Bhandari and Bhuyan (2023). We note that some county variables in Bhandari and Bhuyan (2023) are natural log-transformed. For example, the current study's measure of *DENSITY* is the natural log-transformed in Bhandari and Bhuyan (2023), where the study names it POPSM. The anti-natural log values closely follow the summary statistics of our paper.

< Insert Table 2 about here >

4.2 Baseline Regression Results (Tests for the main hypothesis H1)

Table 3 presents our main regression results. We use Equation (3) and run the ordinary least squares (OLS) regression model with standard errors clustered at the firm level and adjusted for heteroscedasticity. The main independent variable of interest is community social capital (*SC*). The primary dependent variable is financial reporting quality (*FRQ*), which is derived from Model (1). Specifically, FRQ represents the error terms from Model (1), where lower values of the error terms indicate better financial reporting quality. According to prior NPO literature, NPO managers may inflate charitable expenses by understating fundraising expenses and misallocating fundraising expenses as charitable expenses. Consequently, the error terms capture variations in financial reporting quality (Yetman & Yetman, 2012). Lower values of the error terms indicate that the reported fundraising expenses are less than what the model predicts.

The OLS regression model in Column (1) includes controls for the variables from Equation (3) and year fixed effects. The table shows a coefficient of 0.2158 for *SC*, which is statistically significant at the 1% level (t-statistic = 8.8613; p-value < 0.01). The OLS regression model in Column (2) includes controls for the variables from Equation (3) and industry fixed effects. The table shows a coefficient of 0.2109 for SC, which is statistically significant at the 1% level (t-statistic = 8.6996; p-value < 0.01). Finally, the OLS regression model in Column (3) controls for both year and industry fixed effects, along with the control variables from Equation (3). The table documents a coefficient of 0.2106 for *SC*, which is significant at the 1% level (t-statistic = 8.6893; p-value < 0.01). In all three columns, we document a positive and statistically significant relationship between community social capital and financial reporting quality at a 1% level. Overall, the results shown in Table 3 confirm our main hypothesis (*H1a*) and suggest that community social capital is positively associated with NPO financial reporting quality. The

coefficients of the control variables are discussed in detail in section OA.1 of the online appendix.

< Insert Table 3 about here >

4.3 Robustness Tests and Endogeneity Tests

This section discusses additional tests to support the robustness of our baseline regression results. More specifically, we control for county and principal officer characteristics to mitigate correlated omitted variable bias, employ alternative measures to reduce measurement errors, utilize matching methodologies to address self-selection bias (Subedi, 2024), and conduct annual regressions to account for time series dependence in the error terms. We also incorporate firm and state fixed effects to control for firm and state time invariant omitted variables. Additionally, we consider interpolation and extrapolation biases to ensure the reliability of our estimates. All of these robustness tests are discussed in detail in sections OA.2 to OA.9 of the online appendix, with the corresponding tables also provided there.

We also employ two-stage least squares instrumental variable (2SLS IV) regressions to address endogeneity concerns stemming from measurement errors, omitted variable bias, and reverse causality. We use two instrumental variables: *IV1* and *IV2*. *IV1* is calculated as the log of one plus the distance of the nonprofit headquarters' zip codes from the Canadian border. *IV2* is calculated as the percentage of families with children in the county. The rationales and the validity of these instrumental variables are discussed in Section OA.8 of the online appendix.

Our first-stage results in Columns (1), (3), and (5) confirm that our instrumental variables (*IV1* and *IV2*) have the expected relationships with county-level community social capital (SC). Additionally, our instrumental variables are robust, with Cragg–Donald Wald F-statistics exceeding 10.

Columns (2), (4), and (6) present the results for the second-stage regression of the 2SLS model. In these columns, the dependent variable is *FRQ*, and the independent variable of interest is the predicted value of community social capital (*SC_Predicted*) from the first stages in Columns (1), (3), and (5), respectively. Firm controls include all nonprofit-specific control variables from Table 3. The coefficients on firm controls are not disclosed for the sake of brevity. However, the full table with all coefficients is available in Table O of the online appendix. The coefficients on *SC_Predicted* are positive and significant in all second stages, leading us to conclude that our main results are robust to the 2-SLS IV regressions.

< Insert Table 4 about here >

4.4 Community Social Capital, Governance and Financial Reporting Quality (Tests for H2a and H2b)

To test *H2a* and *H2b* we run structural equation modeling (SEM) and investigate the association between community social capital and NPO governance mechanisms over financial reporting. We report the results of the effect of community social capital on NPO governance mechanisms over financial reporting in Columns (1)-(3) of Table 5 Panel A. More specifically, this table presents the results of *p[SC, Mediating Vars]* from SEM conducted in Panel B. The dependent variables are *WRITTEN_POLICY*, *BOARD_REVIEW*, and *AUDIT_COM* in Columns (1), (2), and (3), respectively. We find that community social capital is positively and significantly associated with all three proxies of NPO governance mechanisms over financial reporting. This finding is consistent with the prediction of social capital theory. To assess the robustness of the results in Panel A, we additionally provide the standard OLS results with t-statistics in Table Q of the online appendix. While the coefficients in Panel A do not exactly match with those in Table Q of the online appendix, they exhibit a high degree of similarity.

Combining our main *H1a* results and *H2a* results, it appears that the positive effect of community social capital on NPO financial reporting quality is mediated via improvement in NPO governance mechanisms. To empirically test whether the economically significant mediation effect exists, we follow prior studies (e.g., Bhattacharya et al., 2012; Dhole et al., 2016; Landsman et al., 2012) and conduct a path analysis to test *H2b*. We present the results in Table 5 Panel B. The total effect of community social capital size (*SC*) to financial reporting quality (*FRQ*) is decomposed into the direct path (i.e., the portion attributable to the direct link between *SC* and *FRQ*) and mediated path (i.e., the portion mediated by NPO Governance Mechanisms). We find that out of the total effect from *SC* to *FRQ*, 9.82%, 5.82% and 8.54% are attributable to the mediated paths via *WRITTEN_POLICY, BOARD_REVIEW* and *AUDIT_COM*, respectively.[20] Thus, we conclude that community social capital incentivizes NPOs to adopt strong governance mechanisms to monitor financial reports, which in turn, positively influences financial reporting quality.

< Insert Table 5 about here >

4.5. Additional Analyses

We conducted three additional analyses, which include an examination of individual components of community social capital, the moderating effect of local crime rates, and the mediating effect via reduced managerial opportunistic behavior. Each of these is discussed in detail below.

4.5.1 Sub-Components Analysis

Rupsingha et al. (2006) measure of the social capital index is the first principal component of an analysis based on four components: number of social organizations and associations in a county (ASSN), voter turnout (PVOTE), census response rate (RESPN) and the number of

[20] The construction of all three governance mechanisms is explained in Section 3.3.

nonprofit organizations excluding those without an international approach (NCCS). We regress *FRQ* on each of the individual components of community social capital and find that ASSN and NCCS drive our main results. The results of this additional analysis are reported in Table R of the online appendix.

4.5.2 Moderation Effect of Local Crime Activities

Recent studies indicate that local crime rates have spillover effects on firms' financial reporting quality, with companies headquartered in regions with high crime rates exhibiting higher accounting fraud (Golden, 2021; Holzman et al., 2021). After establishing the positive impact of community social capital on financial reporting quality in NPOs, we conduct an additional analysis to explore the moderating effect of local crime rates on the relationship between community social capital and financial reporting quality.

Managers and board directors may be less concerned with social disciplinary norms and reputation in areas with high crime rates, which diminishes the positive effect of social capital as a disciplinary force. Overall, the positive effect of social capital on financial reporting quality should be greater in areas with low crime rates. Alternatively, social capital may mitigate agency concerns in high-crime areas and, therefore, have a greater impact there. Thus, the marginal positive effect of community social capital on financial reporting quality should be higher in areas with high crime rates. We therefore anticipate that the interaction term between community social capital and crime rates could be either positive or negative.

We present the results of this additional analysis in Column (1) of Table S in the online appendix. The interaction term between the crime rate and community social capital is negative and significant, suggesting that the positive relationship between community social capital and financial reporting quality weakens as the crime rate increases. This finding supports our

argument that managers and directors are less influenced by social disciplinary forces in areas with high crime rates. Consistent with this argument, we find in Columns (2) and (3) of Table S that the magnitude of the negative interaction term is greater with the violent crime rate. Overall, we find that the local crime rate weakens the positive relationship between community social capital and nonprofit financial reporting quality, and it weakens more as the level of violent crime increases compared to the increase in non-violent crime.

4.5.3 Mediation Effect Via Managerial Opportunistic Behavior

We also consider two measures of NPOs' managerial opportunism and test the meditation effect of managerial opportunism on the relationship between community social capital and financial reporting quality. The channel can be referred to as the "incentive channel," as community social capital incentivizes management to refrain from engaging in opportunistic behavior, thereby leading to improvements in financial reporting quality.

The first measure is related party transactions (*RPT*), which is an indicator variable equal to one if the NPO reports that its management has a business relationship with the NPO. Prior literature on publicly traded companies argues that managers can use RPTs to advance their personal interests, such as tunneling resources from the firms to related parties (Aharony et al., 2010; Jian & Wong, 2010; Kohlbeck & Mayhew, 2017). We rely on these studies to argue that RPTs can be used as a proxy for managerial entrenchment or opportunism.[21]

[21] We acknowledge a limitation of our RPT measure: not all RPTs are inherently opportunistic; however, many are found to be opportunistic on average (Kohlbeck & Mayhew, 2017). Additionally, RPTs may sometimes stem from weak governance (Balsam et al., 2017; Lo & Wong, 2016). Consequently, our incentive channel might be capturing effects related to governance rather than solely measuring opportunistic behavior. As more data on NPOs' managers become available in the future, subsequent research may explore this issue further to better differentiate between opportunistic behavior and governance-related effects.

Our second measure to capture managerial opportunistic behavior is whether the management engages in political campaign activities (Cespa & Cestone, 2007). For publicly traded companies, Shanor et al. (2021) document that political spending and lobbying activity is now the most common issue in shareholder proposals. Political lobbying activities in NPOs can be viewed as opportunistic, as they allow managers to curry favor with key stakeholders who may assist them in resisting oversight from donors and the board of directors. We measure management political campaign activities (*POL*) as an indicator variable equal to one if the organization engages in direct or indirect political campaign activities on behalf of or in opposition to candidates for public office.

We anticipate that community social capital should incentivize management to avoid opportunistic behavior, which, in turn, should positively influence financial reporting quality. To test this mediation effect via managerial opportunism, we conduct structural equation modeling and investigate the association between community social capital and managerial opportunism in financial reporting. We report the results of the effect of community social capital on managerial opportunism in Columns (1) and (2) of Table T, Panel A, in the online appendix. The dependent variables are *RPT* and *POL* in Columns (1) and (2), respectively. We find that community social capital is negatively and significantly associated with both proxies of managerial opportunism. This finding is consistent with the prediction of social capital theory that community social capital deters management from opportunistic behavior.

In Panel B of Table T, we find that the mediated effect through a reduction in managerial opportunism is also significant for both proxies of managerial opportunism. Combining the results in Panels A and B of Table T in the online appendix, we conclude that the positive effect of community social capital on NPO financial reporting quality is mediated by a reduction in

managerial opportunistic behavior. We caution readers that our measures of opportunistic managerial behavior are not well-established in the NPO literature and may have limitations. As more data on NPO managers becomes available in the future, subsequent research may explore this relationship using more accurate proxies.

5. Discussion and Contribution

In this section, we discuss why community social capital might affect NPOs differently than for-profit companies. We provide discussions on the dual role of community social capital, which can both enhance oversight and present opportunities for exploitation. We also explore the distinctions between NPOs and for-profit firms, emphasizing that, unlike for-profit entities, the effect of community social capital on NPO financial reporting is not yet clearly understood. Our findings contribute to clarifying whether community social capital has any effect on NPO financial reporting quality and, if so, whether the effect is positive or negative. Additionally, we outline the other contributions of this study.

Local Community Employees and Volunteers: The Dual Role of Social Capital

NPOs often employ local community members, including employees and volunteers, who play a crucial role in overseeing nonprofit activities (Dell et al., 2022; Parker, 2018; Subedi & Farazmand, 2019). This community involvement can improve oversight and accountability. However, it also introduces the risk that managers and directors might exploit these social ties, potentially compromising the NPO's mission of serving broader societal goals. This dual role of community social capital—enhancing oversight while also presenting opportunities for exploitation—highlights the complex dynamics at play.

Market Pressures in NPOs vs. For-Profit Firms

A key difference between NPOs and for-profit firms is the absence of market pressures that often drive financial manipulation in the latter. NPO managers do not face pressures related to earnings expectations, securing market financing, or maintaining CEO reputations (Huang et al., 2017; Goodell et al., 2020). This mission-driven focus on community benefit rather than profit generation generally aligns NPOs with ethical practices, reducing the likelihood of financial manipulation compared to their profit-centric counterparts (Felix et al., 2017; Weerawardena et al., 2010).

Managerial Characteristics in NPOs vs. For-Profit Firms

NPOs typically attract mission-driven managers who prioritize societal benefits over personal gain (Stater & Stater, 2019; Rawls et al., 1975; Rose-Ackerman, 1997). In contrast, for-profit firms often draw individuals motivated by personal recognition and rewards, which can lead to traits such as CEO narcissism and hubris (Aktas et al., 2016; Amernic & Craig, 2010; Buchholz et al., 2018; Tang et al., 2018). Consequently, community social capital might be more critical in disciplining managerial behavior in for-profit firms than in NPOs, where the alignment of personal and organizational goals often reduces the need for such disciplinary mechanisms.

NPOs' Characteristics and Positive Impact on Financial Reporting Quality

On the other hand, NPOs have unique characteristics that suggest community social capital could have a stronger positive impact on the financial reporting quality of NPOs compared to for-profit firms. Community social norms and networks can be more interwoven with NPOs than with for-profit organizations, as NPOs are more likely to engage with local employees and volunteers and rely on community donations. Consistent with this argument, Dell et al. (2022)

and Subedi and Farazmand (2019) suggest that NPOs have oversight from community participants and that counties with high levels of volunteerism attract more NPOs. This close interconnectedness with the community can elevate scrutiny and drive higher standards of financial reporting. Moreover, public trust is essential for NPOs to achieve their missions and maintain transparency (Azman et al., 2015; Becker, 2018; Carman, 2011; Saxton et al., 2012).[22] The reliance on donations and public trust necessitates high levels of accountability and transparency (Chapman et al., 2021; Farwell et al., 2019; Schultz et al., 2019), further reinforcing the positive impact of community social capital on NPO financial reporting quality.

Summary of the above Discussions

Overall, the relationship between community social capital and NPO financial reporting quality is nuanced due to the unique characteristics of NPOs. These include their mission-driven focus, the attraction of altruistic managers, a donor-driven balance sheet, and the deep interconnections with their local communities. Our study highlights that while community social capital can enhance NPO financial reporting quality by promoting stronger governance and accountability mechanisms, it also carries potential risks of managerial exploitation. Our findings underscore the importance of community social capital in fostering ethical behavior and governance within NPOs (Gupta et al., 2018; Hoi et al., 2018; Jha, 2019).

Other Contributions

Our study makes several other key contributions to the existing literature. First, we expand the understanding of how community social capital impacts organizational policies, specifically

[22] In cases of direct competition between nonprofits and for-profits, nonprofits leverage public trust to gain an advantage over for-profits (Laidler-Kylander et al., 2007; Yang & Northcott, 2021; James, 2003). Financial reporting quality plays a crucial role in maintaining and building trust and transparency in the nonprofit sector (Becker, 2018; Dell et al., 2022; Burks, 2018).

in NPO contexts, aligning with prior studies on for-profits by Cahan et al. (2021), Huang et al. (2021), de Villers et al. (2022), and Li and Lu (2022). Significantly, our paper addresses the call made by de Villiers et al. (2022), who highlighted the gap in exploring how social capital influences accounting. To the best of our knowledge, this study represents the first attempt to establish a direct link between an NPO's community social capital, its financial reporting quality, and governance. Several studies, such as Gregory (1999), Brooks (2005), Saxton and Benson (2005), Jha and Cox (2015), Jha and Chen (2015), Cui et al. (2017), Hasan et al. (2017), Gupta et al. (2018), and Jha (2019), bear close resemblance to our work and demonstrate the broader relevance of social capital in areas like ethical infrastructure, charitable giving, and socially responsible activities.

Second, our study extends the literature on NPO financial reporting quality by highlighting community social capital as a critical yet overlooked firm-level qualitative characteristic (Yetman & Yetman, 2012; Palmer, 2013; Dang & Owens, 2016; Garven et al., 2018). This study provides empirical evidence of its significant association with NPO financial reporting quality, thereby addressing a gap in understanding a firm-level qualitative characteristic: social capital. To ensure the robustness of the finding, we employed a comprehensive methodology that includes various robustness checks, alternative measures, and endogeneity tests.

Third, we contribute to NPO governance literature by demonstrating how community social capital motivates managers and directors to adopt robust governance mechanisms, which in turn enhance financial reporting quality (Abu Khadra & Delen, 2020; Harris et al., 2015; Harris et al., 2017; Hall & O'Dwyer, 2017). Additionally, our study addresses the call by Abu Khadra & Delen (2020) for more empirical evidence in NPO governance and, specifically, responds to

Engelberg et al.'s (2013) call to identify mechanisms through which social connections confer advantages to the firm. We highlight strong governance as one such mechanism.

Finally, our study holds implications for practitioners and policy makers, including auditors, regulators, donors, creditors, and other stakeholders of NPOs. NPOs headquartered in areas of high community social capital receive additional disciplinary forces from society, contributing to enhanced disclosure quality. Stakeholders, including auditors, regulators, donors, and creditors, may gather soft information about the trustworthiness and reputation of these NPOs. For instance, the IRS could consider community social capital as a factor in reducing the risk threshold for selecting an NPO for a return review.[23] Likewise, independent auditors can consider NPO community social capital as a factor that reduces audit risk.[24] This approach not only decreases government audit expenses, including IRS and local government audit costs for reviewing NPOs Form 990 but also lowers costs for individual NPOs, such as audit fees paid to independent auditors.[25]

[23] The IRS conducts two types of audits: a Field Audit and a Correspondence Audit (IRS, 2019). In a Field Audit, the IRS agent physically visits the organization's premises, while in a Correspondence Audit, the IRS requests the organization to send documents by mail.

[24] Prior studies in the audit literature define audit risk as the risk that an auditor expresses a clean opinion when the financial statements are materially misstated, and they establish that high audit risks lead to auditors charging higher audit fees (Davis et al., 1993). As audit risk increases, auditors are likely to exert greater effort in auditing clients' financial statements, thereby charging higher audit fees (Radhakrishnan, 1999; Subedi, 2024). In the case of an auditor with a nonprofit client headquartered in a high community social capital, the auditor, based on the findings of our study, may assess low audit risk and charge lower audit fees to the nonprofit client.

[25] While there is no general requirement for NPOs to undergo an independent audit, many choose to do so voluntarily to enhance their appeal for funding and donations (Yetman & Yetman, 2012). However, in the United States, NPOs spending more than $750,000 in federal funds annually are mandated to undergo an independent financial audit (National Council of Nonprofits, 2020). Similarly, when registering with the state for charitable fundraising purposes, many state and local governments request NPOs to provide audited financial statements (National Council of Nonprofits, 2020). In certain instances, banks may also stipulate an independent audit as a prerequisite for obtaining a loan. Yang et al. (2022) examine factors influencing auditors' likelihood to issue going concern modified audit opinions (GCOs) for Australian charities. The current study also contributes to this line of literature.

6. Conclusion

Social capital is critical to an entity's disciplinary environment and, thus, influences an entity's ability to disclose high-quality financial reports. While the moral hazards influence of social norms and networks has been explored in the for-profit sector (Jha & Chen, 2015), we fill a literature void by addressing the impact of community social capital on NPO financial reporting quality. Our study also contributes to the important stream of NPO governance literature. Further, our results have useful implications for practitioners, policy developers and other NPO stakeholders. We find that the disciplinary effects of community social capital are positively associated with financial reporting quality. In addition, our study documents a path where community social capital incentivizes NPOs to establish robust governance mechanisms, which contribute to enhancing NPO financial reporting quality. Our additional analyses reveal that the local crime rate moderates the relationship between community social capital and financial reporting quality, in that increased crime rates weaken the main relationship. Similarly, we find that managerial opportunistic behavior in an NPO mediates the main relationship, as social capital reduces managerial opportunistic behavior, leading to improved financial reporting quality.

Our results are bolstered by robustness and endogeneity analyses. First, our main results hold even after accounting for various county characteristics, principal officer characteristics, firm fixed effects, and state fixed effects. Second, the findings remain consistent when employing alternative measures for both community social capital and financial reporting quality. Third, in addressing potential biases related to functional form misspecification and self-selection, the results hold using an entropy-balanced sample. Fourth, to mitigate possible time-series dependence in the error terms, our main results are robust to Fama and MacBeth (1973) annual

regressions. Finally, 2SLS IV regressions were performed to address other endogeneity concerns, yielding results that support our main findings.

Our study is subject to limitations. First, the county level proxy for community social capital may not capture local social capital but rather some other characteristics. Although prior research in social capital extensively uses Rupsingha et al.'s (2006) county level social capital index, our study also uses two alternative measures of community social capital and finds similar results. The main results may also suffer from reverse causality bias in that one may argue that NPO financial reporting quality actually determines the social capital. However, community social capital preexists the sample firms used in our study, and thus the effect of social capital is fairly exogenous to reverse causality bias. In addition, we validate our main findings using alternative model specifications, entropy balancing and 2SLS IV regression. We also acknowledge that our sample consists of the US nonprofit firms, and the impact of corporate governance may vary in other countries due to different macroeconomic conditions and institutional settings (Huang et al., 2020).

Since the data is based on U.S. social capital, future studies could investigate and compare how social capital influences financial reporting quality in NPOs across different countries and institutional settings (Putnam, 2002). Comparative studies could also investigate variations in social capital, such as differences in civic engagement, volunteerism, and community trust, impact financial disclosure practices and governance mechanisms (Otero et al., 2024). Future research can further investigate the evolving role of artificial intelligence (AI) in shaping social capital and its implications for financial reporting quality in NPOs. While AI has the potential to enhance transparency and efficiency in financial reporting, it may also introduce new challenges

(Bhandari & Bhandari, 2024), such as algorithmic biases, reduced human oversight, and ethical dilemmas in financial disclosures.

Appendix

Appendix A: Variable Descriptions

FRQ	=	the error terms from the model (1) where the increasing value of the error terms indicates the increasing value of NPO financial reporting quality;
FRQ_ALT	=	the error terms from the model (2) where the increasing value of the error terms indicates the increasing value of NPO financial reporting quality;
SC	=	community social capital index of Northeast Regional Center for Rural Development (NRCRD) at the US county level;
SC_DUMMY	=	social capital dummy variable equals 1 if community social capital (SC) is above the median social capital index and 0 otherwise;
SC_ALT	=	social capital index of Northeast Regional Center for Rural Development (NRCRD) at the US Metropolitan Statistical Area (MSA) level;
SC_PUTNAM	=	Social Capital Index Constructed by Putnam (2001b);
SC_TRUST	=	A Putnam (2001b) score based on the survey question: "Agree that most people can be trusted";
SIZE	=	the natural logarithm of total assets at the end of the current year;
AGE	=	the number of years the organization has been a registered nonprofit organization;
ROA	=	return on assets calculated as the net income divided by the total assets at the end of the year;
LNEXPENSE	=	the natural logarithm of total expenditures at the end of the current year;
CURRENT_RATIO	=	current ratio calculated as the current assets divided by the current liabilities;
DON_INTENSITY	=	the ratio of total donations to total revenues;
DON_GROWTH	=	the average growth in the NPO's donations during the sample period;
BOARD_SIZE	=	number of voting governing directors in the nonprofit board;
WRITTEN_POLICY	=	a measure that ranges from 0 to 3 and indicates whether the NPO has voluntarily adopted three written policies (conflict of interest, whistleblower protections, and document retention/destruction). The presence of each of these written policies is coded as one and zero otherwise. In order to capture a single comprehensive measure of written policy, we add these numbers in that the aggregate value ranges from 0 to 3, where the aggregate value of 3 (0) indicates the presence (absence) of all three policies;

BOARD_REVIEW	=	1 if the NPO reports that it provided copies of the IRS 990 to the board before filing the form 990 with the IRS, and 0 otherwise;
AUDIT_COM	=	1 if the NPO reports having an audit committee, and 0 otherwise;
POPULATION	=	the natural log of the county's population;
AGE_COUNTY	=	the natural log of the median age of the county's population;
DENSITY	=	the natural log of the number of people per square mile in the county;
INCOME	=	the natural log of the per capita income in the county;
MALETOFEMALE	=	male-to-female ratio in the county;
WHITEPOP	=	the proportion of the white population to the total population in the county;
CRIME	=	the crime rate (in percentage) in the county;
VIOLENTCRIME	=	the violent crime rate (in percentage) in the county;
NONVIOLENTCRIME	=	the non-violent crime rate (in percentage) in the county;
GENDER	=	1 if the principal officer of the nonprofit is male, and 0 otherwise;
DOCTOR	=	1 if the principal officer of the nonprofit holds a doctoral degree, and 0 otherwise;
CPA	=	1 if the principal officer of the nonprofit is a certified public accountant (CPA), and 0 otherwise;
TOTCOMP	=	the natural log of the total compensation paid to the officers of the nonprofit;
RPT	=	1 if the NPO reports that its management has a business relationship with the NPO and 0 otherwise;
POL	=	1 if the NPO engages in direct or indirect political campaign activities on behalf of or in opposition to candidates for public office, and 0 otherwise;
IV1	=	the first instrumental variable for community social capital, which is calculated as the log of one plus the distance of the nonprofit headquarters' zip codes from the Canadian border;
IV2	=	the second instrumental variable for community social capital, which is calculated as the percentage of families with children in the county;

Tables

Table 1: Sample Distribution

Panel A: Sample Distribution by Year

Fyear	Freq.	Percent
2014	15567	7.70
2015	42372	20.96
2016	46180	22.85
2017	48319	23.90
2018	49694	24.58
Total=	202,132	100

Panel B: Sample Distribution by Industry

Industry	Freq.	Percent
Arts, Culture and Humanities	21263	10.52
Education	25216	12.48
Environment and Animals	8057	3.99
Health	32359	16.01
Human Services	89598	44.33
International, Foreign Affairs	1995	0.99
Mutual/Membership Benefit	409	0.20
Public, Societal Benefit	23057	11.41
Unknown, Unclassified	178	0.09
Total=	202,132	100

Notes: Table 1 Panel A presents sample distribution by year. Table 1 Panel B presents sample distribution by industry. The industry classification is based on the National Taxonomy of Exempt Entities (NTEE) Code Classification, where the first digit of the code identifies an industry. The religion industry is not included in this sample.

Table 2: Summary and Correlation Statistics

Panel A: Summary Statistics

Variable	Mean	SD	Q1	Median	Q3
FRQ	0.075	8.999	-2.085	-0.955	-0.717
FRQ_ALT	-0.823	14.739	-8.219	-2.747	2.774
SC	-0.212	0.898	-0.741	-0.307	0.160
SC_DUMMY	0.500	0.500	0.000	0.000	1.000
SC_ALT	-0.471	0.538	-0.884	-0.572	-0.103
SC_PUTNAM	-0.104	0.589	-0.365	-0.186	0.102
SC_TRUST	0.427	0.085	0.381	0.432	0.459
SIZE	14.393	2.053	13.068	14.226	15.586
AGE	3.379	0.755	2.944	3.466	3.850
ROA	0.009	0.304	-0.034	0.017	0.089
LNEXPENSE	14.253	1.849	12.916	13.976	15.355
CURRENT_RATIO	25.222	133.510	0.616	1.927	7.253
DON_INTENSITY	0.628	0.340	0.337	0.715	0.950
DON_GROWTH	0.300	1.579	-0.099	0.033	0.218
BOARD_SIZE	13.468	11.175	7.000	11.000	16.000
WRITTEN_POLICY	2.160	1.148	1.000	3.000	3.000
BOARD_REVIEW	0.401	0.490	0.000	0.000	1.000
AUDIT_COM	0.359	0.480	0.000	0.000	1.000
POPULATION	12.736	1.565	11.630	12.978	13.793
AGE_COUNTY	3.678	0.118	3.596	3.673	3.759
DENSITY	6.362	1.907	5.067	6.396	7.548
INCOME	10.938	0.377	10.701	10.896	11.135
MALETOFEMALE	0.966	0.048	0.938	0.961	0.987
WHITEPOP	71.572	18.793	58.446	73.542	87.538
CRIME	10.489	10.689	3.140	6.766	15.027
VIOLENTCRIME	0.687	0.846	0.123	0.388	0.928
NONVIOLENTCRIME	9.983	9.984	2.957	6.476	14.330
GENDER	0.579	0.494	0.000	1.000	1.000
DOCTOR	0.020	0.139	0.000	0.000	0.000
CPA	0.114	3.368	0.000	0.000	0.000
TOTCOMP	4.618	1.770	4.111	4.691	5.548
IV1	6.680	0.622	6.197	6.455	7.223
IV2	49.165	23.151	39.521	53.604	63.824

Panel B: Correlation Matrix

	Variable	*v1*	*v2*	*v3*	*v4*	*v5*	*v6*	*v7*
v1	FRQ	1						
v2	FRQ_ALT	0.1241***	1					
v3	SC	0.0220***	0.0119***	1				
v4	SIZE	0.1842***	0.1566***	0.0052	1			
v5	AGE	0.1019***	0.1269***	0.0197***	0.3512***	1		
v6	ROA	0.0089***	-0.0281***	0.0034	0.1442***	0.0067***	1	
v7	BOARD_SIZE	0.1471***	0.0843***	0.0018	0.2659***	0.2945***	0.0206***	1

Notes: Table 2 Panel A presents the basic descriptive statistics of the variables used in our study. We note that our main sample size for the financial reporting quality model consists of 202,132 observations (N=202,132). However, the sample size decreases when employing alternative measures of community social capital, controlling for county characteristics, controlling for officer characteristics, and using instrumental variable regression. Table 2 Panel B presents the Pearson correlation coefficients for a few selected main variables used in our study. The coefficients with *** are significant at the 1% level. The coefficients with ** are significant at the 5% level. The coefficients with * are significant at the 10% level. The other coefficients are not significant at the 10% level. The complete descriptions of the variables can be found in Appendix A.

Table 3: Community Social Capital and Financial Reporting Quality (Tests for H1)

Dependent Var= FRQ			
	(1)	**(2)**	**(3)**
Variable	**Coeff.**	**Coeff.**	**Coeff.**
SC	0.2158***	0.2109***	0.2106***
	(8.8613)	(8.6996)	(8.6893)
SIZE	0.6138***	0.5963***	0.5952***
	(39.1184)	(38.1759)	(38.1072)
AGE	0.2759***	0.2446***	0.2474***
	(9.8848)	(8.4737)	(8.5614)
ROA	-0.3966***	-0.3842***	-0.3824***
	(-7.8205)	(-7.5822)	(-7.5476)
LNEXPENSE	0.1630***	0.2417***	0.2451***
	(10.1420)	(13.7405)	(13.9075)
CURRENT_RATIO	0.0000	0.0001	0.0001
	(0.4967)	(1.3364)	(1.2970)
DON_INTENSITY	1.1106***	0.9565***	0.9622***
	(17.4715)	(15.3862)	(15.4700)
DON_GROWTH	-0.0619***	-0.0615***	-0.0616***
	(-7.7101)	(-7.6441)	(-7.6624)
BOARD_SIZE	0.0788***	0.0760***	0.0758***
	(27.2010)	(26.5884)	(26.5348)
Constant	-13.4425***	-14.3388***	-14.1398***
	(-45.9963)	(-48.0995)	(-46.8334)
Year FE	Yes	No	Yes
Industry FE	No	Yes	Yes
Adjusted-R^2	0.473	0.486	0.487
N	202,132	202,132	202,132

Notes: Table 3 presents ordinary least square (OLS) regression analyses of community social capital (*SC*) on the primary proxy for financial reporting quality (*FRQ*). The regression models in Columns (1), (2), and (3) control for year only, industry only, and both year and industry fixed effects, respectively. The year fixed effects control for the tax filing year of Form 990 and the industry fixed effects control for NTEE industry classification. The main independent variable of interest is *SC*. The standard errors are robust, clustered at the firm level, and the t-statistics are presented in parentheses under the coefficient estimates. ***, **, and * represent significance at the 1%, 5%, and 10% levels for two-tailed tests, respectively. The complete descriptions of the variables can be found in Appendix A of the main manuscript.

Table 4: Two Stage Least Squares Instrumental Variable (2SLS IV) Tests

	1st Stage	2nd Stage	1st Stage	2nd Stage	1st Stage	2nd Stage
Dependent Var=	SC	FRQ	SC	FRQ	SC	FRQ
	(1)	**(2)**	**(3)**	**(4)**	**(5)**	**(6)**
Variable	**Coeff.**	**Coeff.**		**Coeff.**		**Coeff.**
IV1	-0.1402***				-0.0419***	
	(-37.85)				(-12.69)	
IV2			0.0119***		0.0126***	
			(128.29)		(102.50)	
SC_Predicted		0.7535**		0.9261***		0.8985***
		(2.22)		(11.30)		(8.36)
Constant	0.4755***	-16.0191***	-1.0288***	-14.5006***	-0.8232***	-16.3152***
	(13.09)	(-36.77)	(-52.02)	(-44.85)	(-24.86)	(-36.94)
Firm Controls	Yes	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R^2	0.035		0.138		0.163	
Wald Chi^2 Statistic		2458.77***		3610.41***		2431.65***
Weak Instrument Test (Cragg-Donald F Statistic)	1432.61*** (P_value<0.000)		16458.00*** (P_value<0.000)		5405.29*** (P_value<0.000)	
N	107,642	107,642	168,454	168,454	100,081	100,081

Notes: Table 4 reports the results of the 2-SLS IV regressions. Columns (1), (3), and (5) present the results of the first-stage regression, where the dependent variable is *SC*, and the independent variables are the instrumental variables for community social capital. Columns (2), (4), and (6) present the results of the second-stage regression of the 2SLS model. In these columns, the dependent variable is *FRQ*, and the independent variable of interest is the predicted value of community social capital (*SC_Predicted*) from the first stages in Columns (1), (3), and (5), respectively. All regression models include year and industry fixed effects. The standard errors are robust, clustered at the firm level, and the t-statistics are presented in parentheses under the coefficient estimates. ***, **, and * represent significance at the 1%, 5%, and 10% levels for two-tailed tests, respectively. The complete descriptions of the variables can be found in Appendix A of the main manuscript.

Table 5: Community Social Capital, Nonprofit Governance & FRQ (Tests for H2a)

Panel A: Community Social Capital and Nonprofit Governance (Tests for H2a)

Dependent Var=	WRITTEN_POLICY	BOARD_REVIEW	AUDIT_COM
	(1)	**(2)**	**(3)**
Variable	**Coeff.**	**Coeff.**	**Coeff.**
SC	0.0432*	0.0247***	0.0189***
	(1.77)	(20.74)	(17.18)
SIZE	0.0285***	0.0278***	0.0472***
	(13.37)	(31.81)	(58.51)
AGE	-0.0603***	-0.0287***	-0.0203***
	(-17.71)	(-18.42)	(-14.07)
ROA	0.0134	-0.0207***	-0.0189***
	(1.56)	(-5.88)	(-6.53)
LNEXPENSE	0.2731***	0.0307***	0.0451***
	(121.47)	(32.89)	(51.01)
CURRENT_RATIO	-0.0004***	-0.0001***	-0.0002***
	(-19.09)	(-15.02)	(-33.01)
DON_INTENSITY	0.3403***	0.0371***	0.0717***
	(48.60)	(11.11)	(23.11)
DON_GROWTH	-0.0184***	-0.0027***	-0.0046***
	(-12.19)	(-4.00)	(-7.48)
BOARD_SIZE	0.0007***	0.0002**	0.0009***
	(2.78)	(2.14)	(10.33)
Year FE	Yes	Yes	Yes
Industry FE	Yes	Yes	Yes
N	202,132	202,132	202,132

Notes: Table 5 Panel A presents results of *p[SC, Mediating Vars]* from structural equation modeling (SEM) conducted in Panel B. This is considered as path #2 in the SEM, where the coefficients on *SC* are reflected as a mediated path *p[SC, Mediating Vars]*. The dependent variables are *WRITTEN_POLICY, BOARD_REVIEW*, and *AUDIT_COM* in Columns (1), (2), and (3), respectively. The main independent variable of interest is *SC*. The regression models include year and industry fixed effects. We note that SEM gives z statistics. It does not produce t-statistics and does not allow clustering. The system of equations used in the SEM command also does not produce Adjusted-R^2, and constants are not shown. All regression models include year and industry fixed effects. The standard errors are robust, and the z-statistics are presented in parentheses under the coefficient estimates. ***, **, and * represent significance at the 1%, 5%, and 10% levels, respectively.

Panel B: Community Social Capital, Nonprofit Governance & FRQ (Tests for H2b)

		Mediating Vars					
		WRITTEN_POLICY		BOARD_REVIEW		AUDIT_COM	
		Coefficient	P-value	Coefficient	P-value	Coefficient	P-value
Direct path							
p[SC, FRQ]	1	0.2259***	<0.001	0.2092***	<0.001	0.2036***	<0.001
percentage1		90.18%		94.62%		91.46%	
Mediated Path							
p[SC, Mediating Vars]	2	0.0432*	<0.100	0.0247***	<0.001	0.0189***	<0.001
p[Mediating Vars, FRQ]	3	0.5698***	<0.001	0.4820***	<0.001	1.0083***	<0.001
Total Mediated Path	4=2*3	0.0246***	<0.001	0.0129***	<0.001	0.0190***	<0.001
percentage2		9.82%		5.82%		8.54%	

Notes: Table 5 Panel B uses structural equation modeling (SEM) to test the mediating effect of the governance variables (*WRITTEN_POLICY*, *BOARD_REVIEW*, and *AUDIT_COM*) on community social capital and nonprofit financial reporting quality relationship. In order to test the mediation effect, we follow prior studies (e.g., Bhattacharya et al., 2012; Dhole et al., 2016; Landsman et al., 2012) and conduct a path analysis of the link between the community social capital (*SC*) and financial reporting quality (*FRQ*). We use *WRITTEN_POLICY*, *BOARD_REVIEW*, and *AUDIT_COM* as three proxies for nonprofit governance mechanisms as our study argues that community social capital incentivizes the nonprofit management and board to adopt good governance mechanisms to monitor financial reports for potential misstatements and frauds. Each of these three proxies of governance mechanisms is used as a mediating variable.

We construct path analysis using the following system of equations:

FRQ = f(SC, Governance, Controls)

Governance = f(SC, Controls)

The controls include all the control variables used in our main model in Table 3.

The standard errors are robust and the p-values are based on the z-statistics of the coefficient estimates. *, **, and *** denote significance at the 10%, 5%, and 1% levels. The complete descriptions of the variables can be found in Appendix A.

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