



**The Hauser Center**  
for Nonprofit Organizations

**Misreporting Fundraising: How do Nonprofit Organizations  
Account for Telemarketing Campaigns?**

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## **ABSTRACT**

The purpose of this study is to examine the frequency, determinants and implications of misreporting fundraising activities. We compare state telemarketing campaign reports with the associated information from nonprofits' annual Form 990 filings to directly test nonprofits' revenue and expense recognition policies. Our study indicates that smaller nonprofits, and those with less accounting sophistication, are more likely to inappropriately report telemarketing costs as a component of net revenues rather than as expenses. In addition, less monitored firms are more likely to report telemarketing campaign revenues net of expenses. Additionally, among those firms that do report telemarketing costs as expenses, we find that smaller firms, and those with relatively less officer compensation, are more likely to allocate telemarketing expenses to non-fundraising expense categories.

Key words: efficiency, nonprofit, fundraising, telemarketing

Data Availability: All data are from public sources.

# **MISREPORTING FUNDRAISING: HOW DO NONPROFIT ORGANIZATIONS ACCOUNT FOR TELEMARKETING CAMPAIGNS?**

## **I. INTRODUCTION**

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

Our paper examines nonprofits that hire professional solicitors to conduct telemarketing campaigns to determine under what conditions they appropriately report the associated expenses. Using annual IRS filings (Form 990s) and matching them to state reports of individual telemarketing campaigns, we test for two potential forms of

misreporting costs. First, we investigate whether nonprofits report the proceeds, net of the associated fundraising expense, as contribution revenue. This accounting method violates current accounting standards (both SFAS No. 117 and IRS 990 reporting rules) which require that all gross revenue and related expense amounts be separately reported.

Second, for the firms that report telemarketing costs, we explore whether the telemarketing costs are fully reported as fundraising expenses rather than allocated to the program or administrative categories.

The reliability of nonprofit financial reports is important. Prior research documents that donors and grantors use financial information to inform contribution decisions (e.g., Weisbrod and Dominguez 1986; Tinkelman 1999; Greenlee and Brown 1999, and Parsons 2003) and that boards rely on this information to make executive compensation decisions (Baber et al. 2002). Further, watchdog groups issue ratings based largely on Form 990 financial information. These ratings depend heavily on efficiency ratios – such as the ratio of program expense to total expense and the ratio of fundraising expense to total contributions – to evaluate spending efficiency.<sup>1</sup>

There is evidence that some nonprofits misreport, or even intentionally manage, financial information to impact how program or fundraising costs are reported. An Urban Institute study (2004) indicates that only 41.6 percent of the nonprofits that receive contributions report fundraising expenses. Trussel (2003) finds that certain performance indicators, such as lower surplus margins or less deferred revenue, are positively related to the likelihood that a nonprofit will manipulate its program efficiency ratio. Jones and Roberts (2006) suggest that nonprofits use joint cost allocations to avoid reporting changes in the program ratio. Krishnan et al. (2006) show that some nonprofits

inappropriately report zero fundraising expenses despite evidence on the internet that they engage in activities that can arguably be considered fundraising. Their paper further finds that nonprofits are more likely to report zero fundraising costs when donations or managers' pay are sensitive to changes in reported program ratios (or changes in revenue).

Our study extends this research and provides further evidence that many nonprofits underreport fundraising costs. Additionally, this paper is the first to specifically consider the impact of accounting sophistication on nonprofit reporting practices.<sup>2</sup> Our results, however, indicate misreporting of fundraising costs is at least partly due to lack of accounting sophistication and not necessarily due to an intent to mislead financial statement readers. These results can inform the current debates by states and federal regulators as they search for ways to improve the quality of nonprofit financial reports. We examine a group of nonprofits that undeniably engage in fundraising activities (i.e., telemarketing) and study whether these organizations comply with clear rules for reporting this type of activity. Using a conservative estimate of a nonprofit's telemarketing activity, we determine that 16 percent of our larger sample of telemarketing firm-years report no fundraising expenses. An additional 20 percent appear to underreport fundraising costs.

We investigate the factors associated with misreporting to determine whether nonprofit managers deliberately understate their fundraising expenses. We find that smaller nonprofits and those with less accounting sophistication are more likely to inappropriately report their telemarketing costs in net revenues. In addition, less monitored firms (those that are unaudited or have lower leverage) are more likely to

report telemarketing campaign revenues net of expenses. Even though this decision dramatically alters key financial ratios, we interpret these findings as evidence of a lack of accounting sophistication rather than an intent to mislead financial statement readers.

Among those firms that do report telemarketing costs as expenses, we find that smaller firms, those with relatively less officer compensation, and nonprofits with lower leverage are more likely to allocate telemarketing expenses to non-fundraising expense categories. This finding provides evidence that allocation may occur without a proper understanding of the allocation rules.

The remainder of the paper is organized as follows. Section two describes professional fundraising campaigns and the related accounting issues. Section three presents the research hypotheses and the methodology. Section four describes the data. The results are summarized in section five. Section six concludes with a summary of the study's contributions.

## **II. PROFESSIONAL FUNDRAISING CAMPAIGNS**

### **The Cost of Telemarketing Campaigns**

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

Despite a number of arguments justifying the high costs of professional campaigns (Suhrke 2002), regulators are concerned that donors are neither fully aware of nor correctly informed about the cost of telemarketing campaigns, particularly at the time of solicitation. The State of Illinois pursued one case to the U.S. Supreme Court (*Madigan v. Telemarketing Associates, Inc.*), asserting that the telemarketer led donors to believe a significant percentage of the funds would directly benefit Vietnam veterans, when in fact 85 percent of the funds went to the telemarketer or to cover the nonprofit's administrative costs. The Supreme Court found, in this case, that there had been "particular representations made with intent to mislead" by the telemarketing firm. However, the Court refused to define high fundraising costs as fraudulent.

### **The Potential to Misreport Telemarketing Costs**

Our study focuses on a less transparent issue: the representations that nonprofits make about telemarketing campaigns on their Form 990. IRS reporting rules specify that nonprofits that use professional fundraisers must report the gross proceeds from these campaigns as contributions revenue and separately report the fees retained by the professional fundraisers as fundraising expense. In fact, nonprofit organizations are to report the costs incurred from fundraising conducted by third-party fundraisers in the Form 990 statement of functional expenses on a separate line designated as "professional fundraising fees."

A nonprofit can conceal the costs of these campaigns in two ways. First, nonprofits can report the net proceeds collected as contributions revenue rather than showing gross revenue as contributions and the telemarketers' fees separately as fundraising expense. Such reporting does not impact earnings, but it does affect the

reported program and fundraising efficiency ratios that donors and others use for decision-making.

As an example, assume that prior to recording activities related to a telemarketing campaign, a nonprofit collects \$100,000. From these revenues, the organization spends \$60,000 on programs, \$10,000 on general administration costs, and \$20,000 on fundraising. The remaining \$10,000 is saved for future years. During the year the organization engages a professional fundraising firm to conduct a telemarketing campaign on its behalf. The professional fundraiser collects \$25,000, retains \$18,750 (75 percent) of the proceeds as a fundraising fee, and remits the remaining \$6,250 to the nonprofit organization. The nonprofit uses the entire amount received from the professional solicitor on its programs. If the nonprofit includes only the net proceeds from the telemarketing campaign as contributions revenue, it reports a program (fundraising) efficiency ratio of 69 (19) percent.<sup>3</sup> If it follows current accounting standards and IRS reporting rules and reports the gross proceeds as revenue and the retained fee as fundraising expense, it reports less impressive program and fundraising ratios of 58 and 31 percent, respectively.<sup>4</sup>

A second technique that conceals telemarketing costs involves properly reporting gross revenues collected by the professional fundraiser, but then allocating some telemarketing costs to program activities. Using the previous example, if the entire \$18,750 telemarketing fee is reported as fundraising expense, it generates a program ratio of 58 percent. If management decides to allocate 50 percent of the telemarketing fee to program costs, then the reported program ratio increases to 66 percent, while the fundraising ratio is decreased from 31 percent to a more attractive 24 percent.<sup>5</sup>

### III. RESEARCH QUESTIONS AND DESIGN

#### Categorizing Reporting Practices

Using the misreporting techniques described above, we classify a nonprofit's accounting practices in two ways: (1) as a gross or net revenue reporter and (2) as a fundraising cost allocator or nonallocator. To be classified as a gross revenue reporter, a nonprofit must report contributions on the Form 990 that equal or exceed our estimate of gross telemarketing receipts and also report some fundraising expenses. This approach, however, may inappropriately classify firms with other sources of contribution revenue as gross revenue reporters, thereby biasing against finding that nonprofits misreport revenues.

We then categorize nonprofits by whether they allocate telemarketing fees to non-fundraising activities. We define net reporters as those that report telemarketing fees as contra-revenues rather than expenses, thus excluding these organizations from the second test. Using the remaining population, we compare our estimate of telemarketing fees to total fundraising expenses on the Form 990. Nonprofits that reflect telemarketing costs as fundraising expense should report total fundraising expense on the Form 990 that is higher than the combined fees paid to all solicitors.<sup>6</sup>

Allocation, however, is not necessarily a form of misreporting. The AICPA's SOP 87-2 and 98-2 allow the allocation of fundraising costs when fundraising activities are incurred jointly with programmatic activities (see Roberts 2005 for complete discussion of the joint cost rules). This standard is applied under limited circumstances and is typically used to decide whether and how to allocate costs related to direct-mailing fundraising activities. In fact, only 23 percent of our sample indicates that they use the

joint cost standards. However, we are concerned that managers who allocate a portion of telemarketing fees out of fundraising expense may do so without proper regard for the rules.

In summary, the first test examines management's decision to report gross revenue and the related telemarketing expense. The second test focuses on the nonprofits that properly report gross revenues and examines how these nonprofits report the telemarketing fees associated with these revenues.

### **Hypotheses and Regression Models**

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

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

To determine if the occurrence of net reporting or allocation of the costs related to professional fundraising campaigns is systematically determined by, accounting sophistication, governance measures designed to protect against misreporting, or incentives to misreport, we use the following logistic regression models:

$$P(\text{Net Reporting}) = \beta_0 + \beta_1 \ln \text{ASSETS} + \beta_2 \ln \text{OFFSAL} + \beta_3 \text{ACCRUAL} + \beta_4 \text{PROFACCT} + \beta_5 \text{RESTRICTED} + \beta_6 501c3 + \beta_7 \text{AUDIT} + \beta_8 \text{LEVERAGE} + \beta_9 \text{YIELD} + \beta_{10} \text{SECTOR} + \varepsilon \quad (1)$$

We first calculate  $\text{REVDIFF} = \text{Contributions on Form 990} - \text{Telemarketing Gross Receipts}$ . Net Reporting is one if either (a)  $\text{REVDIFF} < 0$  or (b) fundraising expenses reported on the 990 = 0, and zero otherwise.

$$P(\text{Allocator}) = \lambda_0 + \lambda_1 \ln \text{ASSETS} + \lambda_2 \ln \text{OFFSAL} + \lambda_3 \text{ACCRUAL} + \lambda_4 \text{PROFACCT} + \lambda_5 \text{RESTRICTED} + \lambda_6 501c3 + \lambda_7 \text{AUDIT} + \lambda_8 \text{LEVERAGE} + \lambda_9 \text{YIELD} + \lambda_{10} \text{SECTOR} + \varepsilon \quad (2)$$

We calculate  $\text{COSTDIFF} = \text{Fundraising Expense on Form 990} - \text{Telemarketing Fees}$ . Allocator is one if  $\text{COSTDIFF} < 0$ , and zero otherwise, using a sample that is composed only of firms identified as gross reporters.

The independent variables are defined below.

#### *Professionalism and Accounting Sophistication*

According to Tinkelman (1999), larger organizations are more likely to have quality financial reports because they are more likely to have professional accounting expertise. Following Tinkelman, we use the natural logarithm of beginning total assets ( $\ln \text{ASSETS}$ ) as a proxy for organizational size. We predict negative coefficients for  $\ln \text{ASSETS}$ .<sup>8</sup>

In addition to organizational size, we use the natural logarithm of officers' salaries and wages ( $\ln \text{OFFSAL}$ ) from Part II, line 25 of Form 990 to measure the degree

to which an organization has professional managers. Tinkelman (1999) proposes that the existence of professional (versus voluntary) management may indicate a higher level of accounting sophistication and a greater ability to produce high-quality financial reports. Baber et al. (2002), however, find that changes in executive compensation are positively associated with changes in program ratios. Managers may have an incentive to conceal fundraising costs to improve efficiency ratios and increase compensation. Thus, we do not predict the sign on the coefficients for  $\ln\text{OFFSAL}$ .

We include two measures that reflect management's knowledge of generally accepted accounting principles (GAAP). Although the IRS does not require nonprofits to use GAAP when completing Form 990, knowledge and use of GAAP indicate accounting sophistication. The first measure,  $\text{ACCRUAL}$ , is one if an organization uses accrual accounting, and zero otherwise. We predict the coefficients on  $\text{ACCRUAL}$  are  $< 0$ .

An organization that engages an external professional accountant to assist with its reporting function is more likely to use proper accounting in its Form 990. Similar to Krishnan et al. (2006), we use an indicator variable ( $\text{PROFACCT}$ ) that is one if accounting fees on Part II, line 31 of Form 990 are  $> 0$ , and zero otherwise. We predict negative coefficients on  $\text{PROFACCT}$ .

Donors may impose restrictions on the use of their charitable contributions. These limitations can direct the use of donated funds for a specific purpose or time period, or can require that the donation is permanently invested in order to serve as an ongoing source of investment income for the nonprofit. Nonprofits that receive restricted donations are likely to be more complex in terms of their range of operations and also more sophisticated in their accounting with a wider range of services offered than

nonprofits with no restricted contributions. We include a dummy variable, RESTRICTED, that is equal to one if temporarily or permanently restricted net assets are  $> 0$ , and zero otherwise. We expect the coefficients on RESTRICTED are negative.

### *External Monitoring*

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

To date, most nonprofit accounting research examines only 501(c)3 organizations. Our study, however, includes many non-501(c)3 organizations, such as police and fire support organizations. We use a dummy variable, 501c3, that is one if the organization is a 501(c)3 organization, and zero otherwise. We predict that 501(c)3 organizations are less likely than non-501(c)3 organizations to misreport fundraising expenses; thus, we expect negative coefficients on 501c3.

Another important form of monitoring is an audit by an independent accountant. Some states require organizations that are registered in the state or doing sufficient business therein (usually based on total revenues) to submit audited financial statements. In addition to state-mandated audits, nonprofit organizations that receive a pre-defined level of federal funds must undergo an audit in compliance with the Office of Management and Budget's Circular No. A-133. We use a dummy variable, AUDIT, that is one if either (a) an organization meets the audit requirements of the state in which it is incorporated or in which it solicits funds or (b) we find, by searching the Single Audit Database maintained by the Census Bureau, that the organization was subject to an A-133 audit, and zero otherwise.<sup>9</sup> We expect the presence of an audit (whether state- or federally-mandated) to be negatively associated with the occurrence of net reporting or allocating fundraising costs.

#### *Financial Indicators*

Organizations with poor financial health have greater incentive to use accounting techniques that improve their financial reports. Thus, organizations experiencing financial distress or unfavorable results may be more likely to use net reporting or allocate fundraising costs than those that are more financially robust or efficient. Consistent with prior research (Krishnan et al. 2006) we include leverage to measure the financial health of nonprofit organizations. We compute LEVERAGE as beginning total liabilities divided by beginning total assets. Lower leverage (higher solvency) indicates a more financially robust organization, which may mitigate incentives for misreporting. However, high leverage may be associated with monitoring related to debt or unearned

revenue provided by creditors or donors/members, respectively, relative to firms with lower leverage. We do not predict a sign on the coefficients for LEVERAGE.<sup>10</sup>

The primary criticism of telemarketing is that it is too expensive, thus we predict that a manager's incentive to hide the cost of professional fundraising activities is positively related to the relative cost of those activities. We measure the cost of telemarketing activities as the combined net proceeds received by the nonprofit, divided by the combined gross proceeds raised on the nonprofit's behalf (YIELD). We expect negative coefficients on YIELD.

#### *Sector*

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

## **IV. DATASETS**

### **Telemarketing Campaign Data**

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

Our sample includes reports from both large and small states with a variety of oversight regulations.<sup>11</sup>

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

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

To eliminate duplicate campaigns, we compare every campaign by a given telemarketing firm for a given nonprofit organization. Because there is no campaign number or other similar identifier (such as an employer identification number), the comparison requires that we first standardize the names of the nonprofit organizations and the telemarketing firms.<sup>12</sup> We then compare the campaigns reported for a nonprofit-telemarketer combination. If we find multiple campaigns with equal gross receipts (within \$10), we retain a single campaign with the highest net receipts reported in the

earliest year. Eliminating these duplicate campaign reports results in a reduced sample of 16,977 unique fundraising campaigns. Table 1 summarizes our dataset (campaign-level sample) of telemarketing campaigns without duplicated gross receipts during the period 1995 to 2004.

Table 1 about here

We recognize that the due dates for interim reports differ from state to state, thus our next concern is to address the possibility that interim and final reports are filed for the same campaigns. Several state reports do not indicate which campaign results are interim, so gross proceeds from one campaign may be included in both interim and final reports. Similarly, telemarketers may report state campaign figures to one state and national campaign figures to another state. To reduce the chances of double counting proceeds from a single campaign reported in different state reports, we retain only the largest telemarketing campaign completed by a given solicitor for a given nonprofit in any particular year in our dataset. This eliminates 3,551 campaigns, reducing our sample to 13,426 unique telemarketing campaigns known as the firm-fundraiser-year sample (see Table 2).<sup>13</sup>

Table 2 about here

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

(see Table 2). We then compare these firm-year telemarketing proceeds data to the financial reports filed by the nonprofit organizations.

### **Form 990 Financial Statement Data**

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

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

We use the two data sources to develop two initial datasets. The base dataset employs financial information from both sources. In the early years, this dataset uses the Core data, and, when possible, switches to the Digitized Data file in the later years. As the Digitized Data file does not include non-501(c)3 organizations, the Core data is used for those firms in the more recent years. The advantage of this “both sources” dataset is that it has the most firm-year observations, allowing us to develop the largest possible database – 4,871 firm-years (see Table 2). Unfortunately, the inclusion of the Core data

limits our ability to include some variables (ACCRUAL, PROFACCT, and RESTRICTED) due to missing data fields. Additionally, the Core data file includes total contributions, but does not separately include direct contributions (which is where telemarketing gross receipts should be reported) and indirect revenues. For this reason, we develop a second “digitized dataset” that uses only observations from the Digitized Data file. The extensive coding in the Digitized Data file allows the inclusion of numerous additional independent variables (ACCRUAL, PROFACCT, and RESTRICTED), as well as the more precise direct contributions measurement for comparison with telemarketing reports.

### **Combined Data**

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

We are unable to find EINs for some organizations as the IRS Business Master File and Guidestar do not include filings for all tax-exempt organizations. An IRS study (1994) reveals that the Business Master File is missing a significant number of nonprofit organizations. In addition, if police and fire support organizations and public school

booster clubs are considered part of their respective municipalities and benefit from municipal government tax exemptions, they may opt not to file Form 990s. In other instances, we find too many possible matches, particularly from federated organizations that have multiple chapters that are independently incorporated nonprofits. If we do not feel confident that we have identified the correct EIN for a nonprofit name, we do not include the telemarketing observations for that nonprofit in our final datasets.

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

Table 3 about here

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

Due to the high percentage of telemarketing data that we cannot match to Form 990s and the significant difference in median yield, we are concerned about the generalizability of our results to the broader telemarketing nonprofit population. To assess sample selection bias, we use the campaign sample (N=16,977) and regress the campaign yield (net proceeds remitted to the nonprofit divided by gross proceeds raised on the nonprofit's behalf) on factors found to be relevant in Keating et al. (2003), such as campaign size, the solicitors' and nonprofits' experience in telemarketing, and purported charity focus. Our primary variable of interest is whether a campaign can be matched to financial data. We find that this coefficient is insignificant, suggesting that the campaigns that successfully match to the Form 990 data do not differ from the unmatched campaigns from a yield perspective after controlling for size, experience, and industry.

## **V. EMPIRICAL RESULTS**

### **Descriptive Statistics**

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

Table 4 about here

The univariate statistics for the various samples are in Table 5. As shown in Panel A, gross reporters differ substantially from the net reporters. Note that during the sample period, 91 percent of sample organizations are always labeled gross reporters or are always labeled net reporters. In fact, only three percent of the organizations have more than one change between reporting categories. In the “both sources” dataset, 27 percent of the firm-years in the sample are classified as net reporters. These observations represent substantially smaller firms and have median beginning total assets of \$255,000 as compared to approximately \$3.5 million for gross reporter observations. Similarly, total officers’ salaries for observations classified as net reporters are substantially lower. Net reporters have a summary campaign yield averaging 34 percent versus 36 percent for the gross reporters. They are much less likely to be 501(c)3 organizations (56 percent versus 92 percent) or to be audited (71 percent compared to 97 percent for gross reporters). There is not a significant difference between the leverage reported by gross and net reporters. Human service organizations represent 23 percent of the observations, yet are 26 percent of the net reporter firm-years and 35 percent of the allocator firm-years. Arts and educational organizations are 20 percent of the overall sample but only nine percent of the net reporter subsample and eight percent of the allocators. Forty percent of the observations in the “both sources” sample are classified as “other.” These firms, which are primarily non-501(c)3 and societal benefit organizations, represent 51 percent of the net reporter firm-years but only 33 percent of the allocator firm-years.

In the “digitized dataset,” the comparison of gross and net reporters on the common variables is qualitatively similar to the results from the “both sources” dataset. Only 52 percent of the net reporters use accrual accounting compared to 92 percent for

gross reporters. Unexpectedly, net and gross reporters do not differ significantly in their reliance on external accountants with 72 percent usage by net reporters and 71 percent by gross reporters. However, net reporters are much less likely to report either permanently or temporarily restricted net assets with only 25 percent noting restricted net assets versus 75 percent for gross reporters. Overall, 28 percent of the observations from the “digitized dataset” are of human service providers, 13 percent are associated with educational institutions, 15 percent are from the arts, and 24 percent are not classified. Human service providers, however, represent 45 percent of the net reporters and 42 percent of the allocators, respectively. Arts organizations tend to be nonallocating gross reporters and represent only six percent of the net reporters and three percent of the allocators.

Table 5 about here

Table 5, Panel B summarizes the univariate statistics for gross reporters that allocate fundraising expenses and those that do not. Of the 2,954 firm-years in this “both sources” sample (representing 980 nonprofits), 359 firm-years (12 percent) appear to allocate a portion of their telemarketing fees to non-fundraising categories. The allocators are significantly different from nonallocators on most attributes other than 501(c)3 status. Allocators are smaller (median beginning total assets of \$394,000) compared to nonallocators (median total assets of approximately \$466,000), have smaller campaign yields (33 percent versus 37 percent), and are less likely to be audited (94 percent compared to 97 percent).

In the more detailed “digitized dataset” the allocators exhibit significantly different attributes from nonallocators. Allocators less frequently use accrual accounting

(79 percent to 93 percent) and report restricted net assets (40 percent compared to 79 percent).

### **Regression Results**

The correlations among the independent variables are presented in Table 6. For the “both sources” full sample, the independent variables with the highest degrees of correlation are lnASSETS with lnOFFSAL and 501c3, with correlations of 0.42 and 0.33, respectively. For the more limited sample used in the second regression, the correlations are much lower with the highest correlation being 0.35 between lnASSETS and lnOFFSAL.

In the “digitized dataset,” several variables have relatively high correlations, making it less likely that these variables will be significant in regression. The RESTRICTED, ACCRUAL, lnASSETS, lnOFFSAL and AUDIT are all correlated with each other in the 0.39 to 0.67 range. The correlations are lower in the more limited sample used in the second regression with most of the correlations of the five variables in the 0.15 to 0.44 range. The correlation of RESTRICTED to lnASSETS, however, is 0.60.

Table 6 about here

The first model reported in Tables 7 and 8 provides the results for regressions that use Core and Digitized data in the “both sources” dataset; the second model in each table reports the regression results for the “digitized dataset” only. Recall that we use both these datasets because some of the variables of interest are not included in the Core data files. However, the “digitized dataset” does not include non-501(c)3 nonprofits or 1995-1997 Form 990 returns. We focus the analysis first on the larger sample from the “both sources” dataset before turning to the additional insights that can be gleaned from the

richer data fields available in the more limited sample from the “digitized dataset.” To better understand the effects of each variable, we focus the discussion on the marginal effects rather than the coefficients.

Table 7 about here

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

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

Similarly, the governance variables are associated with a reduced likelihood of revenue misreporting. Organizations registered as 501(c)3 entities are associated with a

33.8 percentage point increase in the likelihood of proper revenue reporting compared with non-501(c)3 entities. Being audited by a CPA firm increases the chances of properly reporting telemarketing proceeds by 34.2 percentage points.

The financial health indicator, however, explains relatively little of the variance in the revenue reporting decision. Highly leveraged organizations are less likely to misreport their telemarketing revenues net of expenses. The coefficient on LEVERAGE is negative and statistically significant, and a one-unit change would alter the probability of net reporting by 1.0 percentage point. This may indicate that organizations with more debt are monitored by their creditors. The coefficient on the YIELD variable is insignificant, suggesting that nonprofits with lower telemarketing yields are not any more likely to misreport than their counterparts.

The “digitized dataset” allows a broader range of variables to be tested but is limited to 501(c)3 organizations. The logistic regression model has a pseudo  $R^2$  of 31 percent. The coefficients of the common variables (lnASSETS, lnOFFSAL, AUDIT, LEVERAGE and YIELD) are qualitatively similar. The marginal effect of a unit change decrease in lnASSETS and AUDIT are more modest at 1.4 and 28.3 percentage points, respectively, in the “digitized dataset” as compared to the “both sources” dataset. The statistical significance of the LEVERAGE variable is marginal in the “digitized dataset.”<sup>17</sup>

Two of the measures of accounting sophistication, ACCRUAL and RESTRICTED, are significant in the predicted direction. Using accrual accounting increases the probability of properly reporting revenues by 8.7 percentage points. Nonprofits with some restricted net assets are 15.1 percentage points more likely to

properly report revenues from telemarketing campaigns. These results are consistent with the hypothesis that organizations that misreport revenues and expenses associated with telemarketing campaigns are more likely to do so because they lack professional management and accounting sophistication than from a motivation to hide poor organizational or telemarketing campaign performance.

Counter to our expectations, and contrary to the findings reporting by Krishnan, et al. (2006), the PROFACCT variable is insignificant. Krishnan, et al. (2006) suggest that PROFACCT may proxy for either the use of an outside accountant to assist with preparing Form 990s or the use of an independent auditor. We specifically control for the use of an independent auditor, and include non-501(c)3 organizations, which may explain the difference in our result.

Table 8 about here

In the second test, the characteristics associated with the telemarketing cost allocation decision are assessed. The samples are limited to the nonprofits designated as gross reporters. Table 8 reports the results from estimating the logistic regression in equation 2. The pseudo  $R^2$  for the allocation decision is 13 percent using the “both sources” dataset and 19 percent for the “digitized dataset” sample. Both management sophistication variables,  $\ln\text{ASSETS}$  and  $\ln\text{OFFSAL}$ , are negative and statistically significant, meaning that larger nonprofits and those with larger or better compensated professional staffs are less likely to report a portion of the telemarketing fees as non-fundraising expenses. For the “both sources” regression, a one-unit change in  $\ln\text{ASSETS}$  and  $\ln\text{OFFSAL}$  alters the probability of allocating costs by 1.8 and 0.6 percentage points, respectively. A potential explanation for this result is that nonprofits that are relatively

smaller in size or in terms of their officers' payroll manage telemarketing costs to report more favorable fundraising (or program) ratios.

Governance and accounting sophistication variables perform quite differently in the allocation and revenue recognition decisions. In the "both sources" dataset, the 501(c)3 organization variable is marginally significant in the predicted direction, but it reduces the likelihood of allocation of telemarketing costs by only 3.4 percentage points as compared to a 33.8 percentage point effect in the gross revenue test. The audit variable is insignificant in both allocation regressions, whereas it has a substantial mitigating effect in the net reporting regression. This finding is not surprising given that virtually all firm-years in the second test are audited. Similarly, we find that the accrual variable is insignificant in the "digitized dataset." The firms that spend on outside accounting or auditing services do not display significantly different allocation behavior from their counterparts that do not use outside services. However, it should be noted that we find that firms that have restricted funds are less likely to allocate some telemarketing costs to non-fundraising activities, but the statistical significance is marginal. Overall, the results suggest that accounting sophistication and certain monitoring activities have a substantial impact on the likelihood that telemarketing expenses will be allocated to expense categories other than fundraising expense.

### **Additional Tests**

We conduct supplemental tests to examine the robustness of our results. First, we recognize that the telemarketing proceeds may be drawn from a state report whose fiscal year does not overlap precisely with the Form 990 fiscal year. For example, a yearly state report may cover a calendar year while a nonprofit has a different fiscal year. Moreover,

a fundraising campaign by a telemarketer may start on July 1 and end on June 30 of the following year. For nonprofits with a calendar fiscal year, revenues generated by telemarketing firms would be reported in two separate Form 990 filings. Additionally, if a campaign is conducted across multiple years, the partial results of the first year of the campaign may be reported to the state in one year, with the entire campaign (gross receipts from years one and two) reported to the state in the subsequent years. There may also be numerical variation due to differences in the cash and accrual methods used (especially if a campaign generates pledges receivable in one year that is collected in a subsequent year).

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

The results from regressions that use the “both sources three-year” dataset to examine net reporters are largely the same as those obtained from the single year “both sources” dataset and have a pseudo  $R^2$  of 27 percent. The only difference is that LEVERAGE is not a significant predictor of either net reporting or the likelihood of

allocating telemarketing expense out of fundraising expense. With the “digitized data three-year” dataset, we find largely similar results; however, InASSETS and LEVERAGE are insignificant. The variables appear to be insignificant in the regression due to a low correlation with the dependent variable rather than a high degree of multicollinearity with other independent variables.

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

A potential explanation for the shift is the high degree of multicollinearity between ACCRUAL, PROFACCT, AUDIT, and RESTRICTED. We ran a series of revenue recognition and allocator regressions employing combinations of these variables. PROFACCT is consistently insignificant using the single year “digitized dataset,” suggesting that our result may differ from Krishnan, et al. (2006) due to sample differences.<sup>18</sup> Therefore, we conclude that the insignificance of PROFACCT is not due to a lack of power and high multicollinearity.

Liquidity and operating margin are other measures of nonprofit financial distress (Tuckman and Chang 1991).<sup>19</sup> Neither of these additional financial distress variables is a significant predictor of misreporting and the inclusion of the variables does not substantially change the results of the regression analyses.

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

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

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

## **VI. CONCLUSIONS**

Prior research has supported a concern by regulators and donors that nonprofits have incentives to understate fundraising costs and may inappropriately allocate these costs to other activities. Our results can inform the current debates by state and federal regulators as they search for ways to improve the quality of nonprofit financial reports. Our study provides empirical evidence of how frequently misreporting of a highly criticized and relatively expensive fundraising method occurs, and explains the determinants of misreporting. This study directly tests the veracity of nonprofits’

reporting practices by comparing federally mandated nonprofit financial reports to disclosures of revenues and costs of telemarketing campaigns filed by telemarketing solicitors in certain states. Additionally, it is the first paper to specifically consider the impact of accounting sophistication on nonprofit reporting practices.

We design our tests to produce conservative estimates of telemarketing revenue and expense by using only the single largest reported telemarketing campaigns conducted each year for a nonprofit by each of its telemarketing solicitors. These estimates of total annual telemarketing revenues and expenses are then compared to the nonprofit's annual IRS informational filing. Because we are careful to avoid incorrectly labeling a nonprofit a misreporter, we may not have detected net reporting by organizations with contributions from sources other than professional solicitors. This is particularly a concern for the large organizations in our sample because large nonprofits are more likely to generate contributions from multiple sources. Thus, we may have underestimated the degree to which misreporting occurs.

With our conservative tests, we find that 27 percent of firm-years appear to contain misreported revenues and an additional nine percent appear to fail to fully report all telemarketing costs as fundraising expenses. Since the time period associated with a reported campaign is imprecise, we also compare the campaign revenue and expenses to the sum of three years of firm-wide contributions and fundraising expenses. Our tests suggest that at least 14 percent of this sample is misreporting revenues and at least another four percent is allocating telemarketing costs to an expense category other than fundraising.

Of the misreporting we detect, most occurs among small nonprofits that have limited accounting sophistication. Our findings suggest that nonprofits that have greater accounting sophistication and those likely to be subjected to greater external monitoring are less likely to misreport. We find that the factors associated with the more prevalent activity of misreporting revenue differ from those related to expense allocation. Higher accounting sophistication and more external monitoring appear to play a greater role in moderating revenue misreporting, while size and accounting sophistication are associated with better reporting of both forms. We interpret these results as suggesting that a lack of familiarity with accounting dominates misreporting decisions instead of incentives to improve reported results.

Given the apparent lack of sophistication of non-501(c)3 firms, the IRS may want to consider extending the public Form 990 disclosure requirements to these nonprofits. Another policy issue relates to audits. In the wake of the Sarbanes-Oxley Act of 2002 and additional nonprofit scandals, the Senate Finance Committee held hearings and is considering additional regulation of nonprofit organizations. Numerous states have considered or passed legislation increasing the number of nonprofits required to have annual CPA audits. Our analyses suggest that audited nonprofits are much more likely to be better reporters, choosing to report revenues gross and less likely to allocate fundraising costs to programs or administrative costs. State regulations trigger audits once an organization reaches a certain size threshold, typically based on total revenues. Perhaps a much lower threshold triggered by gross telemarketing proceeds or gross proceeds from all externally conducted fundraising campaigns is more appropriate. Alternatively, a review or limited assurance procedures could be considered.

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**Table 1 – Telemarketing Campaigns by Year**

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

Note: Ranksum compares yield for campaigns in a given year with yield from campaigns in the previous year.

\*\*\* Significant at the 0.01 level

**Table 2 – Sample Selection**

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

**Table 3 – Matching EINs to Both Sources Dataset**

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

Note: The “both sources” dataset includes financial information obtained from both the IRS Core files for 1994-2004 and the NCCS Digitized Data files from 1998-2003.

**Table 4 – Sample Selection****Panel A: Dependent Variable = P (Net Reporter)**

	Both Sources	Digitized Dataset
Total Firm-Years	4,871	2,648
Less: 990-EZ Filers <sup>a</sup>	(736)	(130)
Observations with Missing Variables	(61)	(38)
Outliers <sup>b</sup>	(11)	(12)
Final Regression Sample	4,063	2,468

**Panel B: Dependent Variable = P (Allocator)<sup>c</sup>**

	Both Sources	Digitized Dataset
Firm-Years in Panel A Final Regression Sample	4,063	2,468
Less: Net Reporters	(1,109)	(585)
Final Regression Sample	2,954	1,883

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

<sup>b</sup> Outliers are defined using the DBETA overall measure of influence.

<sup>c</sup> The sample begins with firm-years that are labeled gross reporters.

**Table 5 – Descriptive Statistics**

**Panel A - Gross vs. Net Reporters**

	<u>Both Sources</u>			<u>Digitized Dataset</u>		
	Gross	Net		Gross	Net	
lnASSETS	14.91	12.42	***	15.23	12.39	***
lnOFFSAL	8.96	4.37	***	9.44	4.14	***
ACCRUAL				0.92	0.52	***
PROFACCT				0.71	0.72	
RESTRICTED				0.75	0.25	***
501c3	0.92	0.56	***			
AUDIT	0.97	0.71	***	0.96	0.56	***
LEVERAGE	0.49	0.41		0.54	0.49	
YIELD	36.22	33.72	**	37.78	35.85	
N	2,954	1,109		1,883	585	

**Panel B - Allocators vs. Nonallocators**

	<u>Both Sources</u>			<u>Digitized Dataset</u>		
	Non-Allocator	Allocator		Non-Allocator	Allocator	
lnASSETS	15.17	13.07	***	15.5	12.83	***
lnOFFSAL	9.36	5.99	***	9.8	6.23	***
ACCRUAL				0.93	0.79	***
PROFACCT				0.71	0.78	**
RESTRICTED				0.79	0.40	***
501c3	0.92	0.89				
AUDIT	0.97	0.94	***	0.97	0.87	***
LEVERAGE	0.56	0.37	**	0.57	0.33	**
YIELD	37.11	33.35	***	38.17	34.25	*
N	2,595	359		1,695	188	

\*\*\* Differences are significant at the 0.01 level

\*\* Differences are significant at the 0.05 level

\* Differences are significant at the 0.10 level

**Table 6 – Correlations Among Independent Variables**

**Panel A: Independent Variables Used in Logistic Regressions with Both Sources Dataset (N = 4,063)**

	lnASSETS	lnOFFSAL	501c3	AUDIT	LEVERAGE	YIELD
lnASSETS	1.00					
lnOFFSAL	0.42	1.00				
501c3	0.33	0.27	1.00			
AUDIT	0.25	0.27	0.30	1.00		
LEVERAGE	-0.14	0.02	0.02	-0.01	1.00	
YIELD	0.11	0.01	0.09	0.00	-0.03	1.00

**Panel B: Independent Variables Used in Logistic Regressions with Digitized Dataset (N = 2,954)**

	<u>lnASSETS</u>	<u>lnOFFSAL</u>	<u>ACCRUAL</u>	<u>PROFACCT</u>	<u>RESTRICTED</u>	<u>AUDIT</u>	<u>LEVERAGE</u>	<u>YIELD</u>
<u>lnASSETS</u>	1.00							
<u>lnOFFSAL</u>	0.43	1.00						
<u>ACCRUAL</u>	0.48	0.40	1.00					
<u>PROFACCT</u>	0.02	0.10	0.00	1.00				
<u>RESTRICTED</u>	0.67	0.39	0.48	-0.04	1.00			
<u>AUDIT</u>	0.44	0.39	0.54	0.01	0.41	1.00		
<u>LEVERAGE</u>	-0.15	-0.01	-0.02	-0.01	-0.08	0.01	1.00	
<u>YIELD</u>	0.10	0.01	0.04	-0.03	0.09	0.00	-0.03	1.00

**Table 7 – Logistic Regression of the Likelihood of Net Reporting Using Datasets**

$$P(\text{Net Reporting}) = \beta_0 + \beta_1 \ln \text{ASSETS} + \beta_2 \ln \text{OFFSAL} + \beta_3 \text{ACCRUAL} + \beta_4 \text{PROFACCT} + \beta_5 \text{RESTRICTED} + \beta_6 \text{501c3} + \beta_7 \text{AUDIT} + \beta_8 \text{LEVERAGE} + \beta_9 \text{YIELD} + \beta_{10} \text{SECTOR} + \varepsilon$$

	Predicted Sign	Both Sources			Digitized Dataset		
		Coefficient		Marginal Effect <sup>a</sup>	Coefficient		Marginal Effect <sup>a</sup>
lnASSETS	-	-0.26 ***		-4.2%	-0.10 **		-1.4%
lnOFFSAL	?	-0.07 ***		-1.1%	-0.08 ***		-1.1%
ACCRUAL	-				-0.55 **		-8.7%
PROFACCT	-				-0.05		0.8%
RESTRICTED	-				-0.99 ***		-15.1%
501c3	-	-1.65 ***		-33.8%			
AUDIT	-	-1.61 ***		-34.2%	-1.49 ***		-28.3%
LEVERAGE	?	-0.06 ***		-1.0%	-0.02 *		-0.3%
YIELD	-	0.00		0.0%	0.00		0.0%
Constant		5.35 ***			2.51 ***		
N		4,063			2468		
Pseudo R <sup>2</sup>		29%			31%		

<sup>a</sup> The marginal effect indicates the effect on the probability of net reporting of a one-unit change for continuous variables and a change from zero to one for discrete variables when independent variables are evaluated at their means.

\*\*\* Significant at the 0.01 level – two tailed test

\*\* Significant at the 0.05 level – two tailed test

\* Significant at the 0.10 level – two tailed test

P(Net Reporting) = one if REVDIFF < 0 or if fundraising expense = 0, zero otherwise,  
 lnASSETS = natural logarithm of beginning assets,  
 lnOFFSAL = natural logarithm of officers' salaries and wages,  
 ACCRUAL = one if organization uses accrual accounting and zero if it uses the cash basis,  
 PROFACCT = one if accounting fees > 0, zero otherwise,  
 RESTRICTED = one if permanent or temporarily restricted net assets > 0, zero otherwise,  
 501c3 = one if entity is organized as a 501(c)3, zero otherwise,  
 AUDIT = one if entity meets the audit requirements of a state in which it operates or solicits funds or is subject to an A-133 audit and zero otherwise,  
 LEVERAGE = total beginning liabilities / total beginning assets,  
 YIELD = combined net proceeds from telemarketing campaigns / combined gross proceeds from telemarketing campaigns.

**Table 8 – Logistic Regression of Likelihood of Allocation of Fundraising Expense Using Datasets**

$$P(\text{Allocator}) = \lambda_0 + \lambda_1 \ln \text{ASSETS} + \lambda_2 \ln \text{OFFSAL} + \lambda_3 \text{ACCRUAL} + \lambda_4 \text{PROFACCT} + \lambda_5 \text{RESTRICTED} + \lambda_6 501c3 + \lambda_7 \text{AUDIT} + \lambda_8 \text{LEVERAGE} + \lambda_9 \text{YIELD} + \lambda_{10} \text{SECTOR} + \varepsilon$$

	Predicted Sign	Both Sources		Digitized Dataset	
		Coefficient	Marginal Effect <sup>a</sup>	Coefficient	Marginal Effect <sup>a</sup>
lnASSETS	-	-0.23 ***	-1.8%	-0.28 ***	-1.3%
lnOFFSAL	?	-0.07 ***	-0.6%	-0.07 ***	-0.3%
ACCRUAL	-			0.43	1.7%
PROFACCT	-			0.37	1.6%
RESTRICTED	-			-0.55 *	-2.8%
501c3	-	0.55 *	3.4%		
AUDIT	-	0.01	0.1%	-0.01	-0.1%
LEVERAGE	?	-0.19 ***	-1.5%	-0.30 ***	-1.4%
YIELD	-	0.00	0.0%	0.00	0.0%
Constant		1.42 ***		2.09 ***	
N		2,954		1,883	
Pseudo R <sup>2</sup>		13%		19%	

<sup>a</sup> The marginal effect indicates the effect on the probability of net reporting of a one-unit change for continuous variables and a change from zero to one for discrete variables when independent variables are evaluated at their means.

\*\*\* Significant at the 0.01 level – two tailed test

\*\* Significant at the 0.05 level – two tailed test

\* Significant at the 0.10 level – two tailed test

- P(Allocator) = one if COSTDIFF < 0, zero otherwise,
- lnASSETS = natural logarithm of beginning assets,
- lnOFFSAL = natural logarithm of officers' salaries and wages,
- ACCRUAL = one if organization uses accrual accounting, zero otherwise,
- PROFACCT = one if accounting fees > 0, zero otherwise,
- RESTRICTED = one if permanent or temporarily restricted net assets > 0, zero otherwise,
- 501c3 = one if entity is organized as a 501(c)3, zero otherwise,
- AUDIT = one if entity meets the audit requirements of a state in which it operates or solicits funds or is subject to an A-133 audit, zero otherwise,
- LEVERAGE = total beginning liabilities / total beginning assets,
- YIELD = combined net proceeds from telemarketing campaigns / combined gross proceeds from telemarketing campaigns.

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- <sup>1</sup> Donor reliance on financial information to guide fundraising decisions may have increased in recent years due to the creation of Guidestar, an online service that provides free access to recent Form 990 filings.
- <sup>2</sup> Accounting sophistication could be knowledge of the accounting rules applicable to completing the Form 990 or a system of internal controls that mitigate the likelihood of misreporting.
- <sup>3</sup> Program ratio with net proceeds recorded as revenues and spent on programs:  $(60,000 + 6,250) / (90,000 + 6,250) = 69\%$ . Fundraising ratio (fundraising expenses/total contributions) with no expense related to professional fundraising campaign:  $20,000 / (100,000 + 6,250) = 19\%$ .
- <sup>4</sup> Program ratio with gross proceeds recorded as revenues, retained fee recorded as fundraising expense, and net proceeds spent on programs:  $(60,000 + 6,250) / (90,000 + 25,000) = 58\%$ . Fundraising ratio with retained fee recorded as fundraising expense:  $(20,000 + 18,750) / (100,000 + 25,000) = 31\%$ .
- <sup>5</sup> Program ratio with 50% of retained fee allocated to program expense:  $(60,000 + 6,250 + 9,375) / (90,000 + 25,000) = 66\%$ . Fundraising ratio with 50% of retained fee allocated to fundraising expense:  $(20,000 + 9,375) / (100,000 + 25,000) = 24\%$ .
- <sup>6</sup> We choose to compare the telemarketing fees from state reports to total fundraising expense instead of professional fundraising fees as a review of recent Form 990s revealed that the majority of nonprofits that appeared to be underreporting telemarketing fees were reporting them as an “other fundraising expense” rather than professional fundraising fees. We do not have a good explanation for this behavior as it does not affect fundraising ratios.
- <sup>7</sup> Reporting for professional telemarketing campaigns occurs annually, even if the campaigns have a duration of greater than one year.
- <sup>8</sup> An alternative proxy for size is total revenues. However, we do not use total revenues to measure size as the number is understated if an organization reports its telemarketing revenues on a net basis.
- <sup>9</sup> We do not have a complete list of all states in which each nonprofit telemarkets. It is possible that a nonprofit’s telemarketing or other activities in a particular state may require it to complete an audit, but we are unable to detect the need for the audit. Additionally, nonprofits can voluntarily choose to complete an audit. In these two cases, our AUDIT variable would be coded as zero when it should be coded as one.
- <sup>10</sup> We do not examine financial indicators, such as program or fundraising ratios, that are impacted by misreporting of revenues and expenses associated with telemarketing revenues.
- <sup>11</sup> For more information about the range of oversight options across different states, see Fremont-Smith (2005).
- <sup>12</sup> For example, one campaign report may use the nonprofit name Society for the Prevention of Cruelty to Animals, while another refers to the same organizations as The S.P.C.A. A telemarketer may be listed at Samano, Phillip J. & Assoc. Inc. in one report and Phillip J. Samano and Associates, Inc. in another.
- <sup>13</sup> The possibility exists that a nonprofit organization could have multiple campaigns by a given fundraising firm in a single year, so using only the largest campaign will possibly understate donations raised by professional firms. This may reduce the likelihood that we properly identify net reporters, and biases us against finding significant results in our tests.
- <sup>14</sup> We use the IRS Core files instead of the Statistics of Income (SOI) files, because the SOI files contain primarily large organizations (assets greater than \$10 million). Many nonprofit organizations that use professional fundraisers are too small to be included in the IRS SOI files.
- <sup>15</sup> The Core and Digitized Data files identify nonprofit organizations by EIN.
- <sup>16</sup> Selected state regulators presently require telemarketers to report the proceeds of telemarketing campaigns. However, there is no easy way for the public to relate this information to the applicable nonprofit as many nonprofit names are similar or related through a federation. The state charity office reports could encourage more public scrutiny if state reports included EINs and the exact name and address of each nonprofit, and ensured that the numbers reported were statewide rather than nationwide figures.
- <sup>17</sup> We explore whether the negative association between LEVERAGE and net reporting is explained by bondholders and bankers either requiring audits or engaging in additional monitoring. In the “digitized dataset,” liabilities can be decomposed between bonds and other liabilities. The sample, however, has relatively few that have outstanding bonds, so that we are not able to effectively evaluate the role of credit relations in promoting better financial reporting practices.
- <sup>18</sup> We also conducted analysis of variance influence factors, a test which can only be run on a OLS specification. It did not indicate any multicollinearity problems.

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<sup>19</sup> A number of organizations have zero liabilities which results in a current ratio that is undefined. We invert the current ratio to avoid losing observations. Further, we deflate profit margin by total assets rather than total revenue because revenue may be misreported.