

THE MONITORING ROLE OF BOARD DIRECTORS IN NOT-FOR-  
PROFIT ORGANIZATIONS' EXPENSE MISALLOCATION: EFFECTS  
OF DONORS' EVALUATION FOCUS AND TRANSPARENCY OF  
EXPENSE DISCLOSURES

by

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## **Abstract**

Directors in not-for-profit organizations are not only monitors who ensure that financial reports are free from misreporting but also often act as fundraisers. This paper examines the intensity of directors' monitoring when management misallocates expenses to solicit donations; especially whether the directors' oversight is influenced by the organization's expense disclosure transparency and the donors' evaluation focus. The results from two experiments indicate that directors play a monitoring role to not allow management's expense misallocation. Further, the enhanced transparency of expense disclosures increases directors' tendency not to endorse management's expense misallocation. However, the donors' adoption of a balanced evaluation process (i.e., considering both financial and nonfinancial performance metrics) reduces directors' monitoring compared to the donors' adoption of an expense-focused evaluation process (i.e., focusing solely on financial metrics). This effect of the donors' adoption of a balanced evaluation process occurs when directors anticipate donors will not donate to the not-for-profit organization, but not when directors anticipate donors will donate. This paper contributes to a richer understanding of directors' role in not-for-profit organizations' expense misallocations. Implications for nonprofit governance are discussed.

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Particularly, I would dedicate this thesis to my father. He did not have a chance to witness my journey to accomplish this doctoral degree. But he lives in my heart forever, inspiring me to overcome foreseeable and unforeseeable obstacles and giving me strength to persistently pursue my goal. Finally, I would thank my family members, who have always been there for me during this process. I am grateful to their endless patience and sacrifices.

## Table of Contents

Abstract .....	ii
Acknowledgements .....	iii
Chapter 1 Introduction .....	1
Chapter 2 Institutional Background .....	9
2.1 The Agency Problem and the Role of Directors in Not-for-profit Organizations ....	9
2.2 Disclosure Transparency of Expense Reporting in Not-for-Profit Organizations in Canada .....	12
2.2.1 Expense Reporting 1989 to January 2009 .....	13
2.2.2 Expense Reporting as of January 2009 .....	14
2.3 Donors' Performance Evaluation Focus .....	15
2.4 Summary .....	19
Chapter 3 Experiment 1: Fairness of Donors' Evaluation Process in Not-for-profit Organizations .....	21
3.1 Literature Review .....	21
3.2 Hypothesis Development .....	23
3.3 Research Method for Experiment 1 .....	28
3.3.1 Experimental Design .....	28
3.3.2 Participants .....	29
3.3.3 Procedures .....	30
3.3.4 Experimental Case .....	31
3.3.5 Independent Variables .....	32
3.3.6 Dependent Variable .....	33
3.4 Results of Experiment 1 .....	33
3.4.1 Manipulation Checks .....	33
3.4.2 Hypothesis Testing .....	34
3.4.3 Additional Analysis .....	35
3.5 Conclusion: Experiment 1 .....	38

Chapter 4 Experiment 2: Directors’ Monitoring of Management’s Expense Misallocation in Not-for-profit Organizations.....	39
4.1 Literature Review.....	39
4.1.1 Expense Misallocation in Not-for-profit Organizations.....	39
4.1.2 The Role of Directors in Expense Misallocation of Not-for-profit Organizations.....	41
4.1.3 Effect of Perceived Procedural Fairness in Business Settings.....	42
4.1.4 Effect of Transparency of Financial Reports.....	43
4.1.5 Summary of Findings from Literature Review.....	44
4.2 Hypothesis Development.....	44
4.2.1 Effect of Donors’ Evaluation Focus on Directors’ Oversight.....	44
4.2.2 Moderating Effect of Organizations’ Service Performance on Donors’ Evaluation Focus.....	47
4.2.3 Effect of Transparency on Directors’ Oversight.....	49
4.2.4 Interactive Effect of Transparency and Donors’ Evaluation Focus on Directors’ Oversight.....	50
4.3 Research Method for Experiment 2.....	54
4.3.1 Experimental Design.....	54
4.3.2 Participants and Procedures.....	55
4.3.3 Experimental Case.....	57
4.3.4 Independent Variables.....	59
4.3.5 Dependent Variable.....	60
4.3.6 Control Variables.....	60
4.4 Results of Experiment 2.....	63
4.4.1 Manipulation Checks.....	63
4.4.2 Hypothesis Testing.....	64
4.4.2.1 Test of H2: Effect of Donors’ Evaluation Focus on Directors’ Oversight.....	65
4.4.2.2 Test of H3: Moderating Effect of Service Performance.....	66
4.4.2.3 Test of H4: Effect of Transparency on Directors’ Oversight.....	66

4.4.2.4 Test of H5: Interaction between Donors' Evaluation Focus and Transparency .....	67
4.4.3 Additional Analysis .....	68
4.4.3.1 Fairness Boundary Condition and the Reverse Fair Process Effect in H2 and H3 .....	68
4.4.3.2 Potential Alternative Explanation for Findings of H2 and H3 .....	72
4.4.3.3 Risk of Detection and H4.....	74
4.4.3.4 Perceived Uncertainty and H5 .....	75
4.5 Conclusions: Experiment 2 .....	76
Chapter 5 Conclusions and Implications .....	78
References.....	105
Appendix A Instrument of Experiment 1.....	114
Appendix B Instrument of Experiment 2.....	124

## **List of Figures**

Figure 1 Expense Reporting Formats Allowed by Section 4470 of the CICA Handbook	86
Figure 2 Means of Directors' Perceived Procedural Fairness in Experiment 1.....	87
Figure 3 LSMeans of Directors' Tendency to Allow Management's Proposed Expense Misallocation in Experiment 2.....	88

## **List of Tables**

Table 1 Participant Profile for Experiment 1 (N = 93) .....	89
Table 2 Mean (Standard Deviation) of Procedural Fairness Assessment of Donors' Evaluation Process (PFair).....	91
Table 3 Procedural Fairness Assessment of Donors' Evaluation Process (PFair): For Group with Low Program Ratio .....	92
Table 4 Procedural Fairness Assessment of Donors' Evaluation Process (PFair): For Group with Declined Service Performance .....	93
Table 5 Participant Profile for Experiment 2 (N = 189).....	94
Table 6 Likelihood that Directors Agree with Management's Proposed Expense Allocation to Boost the Program Ratio (LKDAgree) .....	96
Table 7 Participant's Assessment of the Organization's Deservedness for Donations ....	99
Table 8 Participant's Assessment of the Organization's Deservedness for Donations: Good Service Performance vs. Poor Service Performance.....	100
Table 9 Participant's Assessment of the Likelihood that the Organization Obtains Donations .....	101
Table 10 Participant's Assessment of the Likelihood that the Organization Obtains Donations: Expense-focused vs. Balanced .....	102
Table 11 Participant's Assessment of the Detection Risk .....	103
Table 12 Participant's Perceived Uncertainty Feelings .....	104

# Chapter 1

## Introduction

This thesis investigates the extent to which directors of a not-for-profit organization play a monitoring role when management allocates fundraising expenses to boost the organization's program ratio to make the organization appear more favorable to donors. The program ratio, defined as the ratio of program spending to total spending, is a financial metric commonly used in practice to evaluate a not-for-profit organization (Baber et al. 2001). A higher program ratio indicates that the not-for-profit organization devotes more financial resources to charitable activities and fewer financial resources to administration and fundraising. Prior studies demonstrate that management of some not-for-profit organizations allocate fundraising expenses to boost the program ratio to aid in soliciting donations by making the organization appear to be devoting more resources to charity (e.g., Keating et al. 2008; Krishnan et al. 2006). Both the CICA Handbook and the guidance issued by the Canada Revenue Agency (the CRA) clearly specify that in the context of fundraising, all expenses related to soliciting donations must be reported as fundraising expenses.<sup>1</sup> Therefore, allocating fundraising expenses inappropriately to program expenses can be argued to constitute misreporting in financial statements (CRA 2009a; Keating et al. 2008; Krishnan et al. 2006).

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<sup>1</sup> Only limited expense types that occur in fundraising activities can be reported as charitable program expenses. These expenses must directly provide services or educate the public about the organization's charitable purpose (CRA 2009a). For example, the printing costs for educational materials distributed in fundraising events are one type of costs that are allowed as program expenses.

As a monitor on behalf of donors and other stakeholders, the board of directors has a fiduciary duty to ensure that financial statements are free from misreporting (O'Regan and Oster 2005; Miller 2002). However, directors often aid in fundraising activities to help ensure financial stability of the not-for-profit organization (Gill 2005). Due to their interest in securing sufficient funding to run charitable programs, directors may allow management to allocate expenses in a manner that aids in attracting more donations. For example, the Board of Directors of a Canadian not-for-profit organization, Mothers Against Drunk Driving (MADD Canada), approved management's practice of claiming fundraising expenses as program expenses to boost its program ratio from 19% to 84%.<sup>2</sup> The stated program ratio made the organization appear more attractive to donors and less likely to incur scrutiny from the Canada Revenue Agency.<sup>3</sup>

MADD Canada's expense misallocation scandal triggered, at least in part, action by the Canadian Accounting Standards Board (the AcSB). In January 2009, the AcSB put into effect a new CICA Handbook Section 4470 "Disclosure of allocated expenses by

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<sup>2</sup> On December 9, 2006, the *Toronto Star* revealed that about 19 cents of every dollar raised went to support the MADD's programs instead of the 84 cents claimed by the organization. The *Toronto Star* investigated and concluded that the organization's fundraising activities were claimed to also be educating the public about drunk driving; therefore, MADD allocated fundraising costs as program expenses. MADD's practice was originally identified by the CRA in a letter dated March 3, 2003, stating that MADD made "incorrect allocation of expenditures" and its charitable status would be revoked if it continued this practice. However, the head of MADD insisted that the regulator and the organization's board of directors gave him permission to allocate fundraising expenses in this manner. In the end, no penalty was assigned to MADD. In 2007, after the *Toronto Star* reports and under pressure from volunteers, MADD's board of directors admitted that MADD was wrong and stopped this practice (Donovan 2007).

<sup>3</sup> The CRA announced in 2004 that to keep their registered status, not-for-profit organizations must expend in each year on charitable programs an amount at least equal to its "disbursement quota" for the year, which is roughly 80% of last year's revenues donated by individuals and organizations issued tax-receipts in the year (Morrisey et al. 2006). The 80% rule, however, has not yet been firmly applied to punish or revoke a charity's registered status. Also, the disbursement quota is excessively complicated to calculate and may be abused by charities. Hence the Department of Finance Canada announced they would eliminate the 80% rule on and after March 4, 2010 (Bourgeois 2010). Even so, the CRA has issued guidance on "Fundraising by Registered Charities" indicating they will closely watch charitable spending, and may raise questions or concerns if not-for-profit organizations spend more than 35% of donations on fundraising (CRA 2009a).

not-for-profit organizations”, encouraging (although not requiring) Canadian not-for-profit organizations to disclose detailed allocation information if they allocate fundraising and administrative expenses to program expense (AcSB 2008).<sup>4</sup> The additional disclosure increases reporting transparency, which for purpose of this thesis is defined as the availability of organization-specific information to those outside the organization (Bhattacharya et al. 2003; Barth and Schipper 2008). Regulators believe that the enhanced expense reporting transparency causes directors to perceive additional scrutiny from the public and other external stakeholders and thus reduce a tendency to allow management’s expense misallocation. Even so, the more transparent expense reporting is not mandatory under current regulatory requirements.<sup>5</sup> Furthermore, transparency alone might not be sufficient to motivate nonprofit directors to curb management’s expense misallocation. Disclosure of expense allocation information has been required in the U.S. for nearly 20 years, but expense misreporting in U.S. not-for-profit organizations is still prevalent (Keating et al. 2008; Krishnan et al. 2006; Baber et al. 2002; Yetman 2001).<sup>6</sup>

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<sup>4</sup> The CICA is re-organizing the Handbook to adjust for the adoption of International Financial Reporting Standards (IFRS). This new section 4470 is currently included in Part III “Accounting Standards for Not-For-Profit Organizations”.

<sup>5</sup> Directors may involve the management’s decision on whether to choose more transparent expense disclosures. This study does not consider the possible involvement by directors in the choice of transparency level. Rather, in the setting of this study, the transparency level has already been chosen, and directors are not allowed to change it. The rationales behind this setting are 1) the expense reporting transparency belongs to accounting policies. Due to requirement for consistency of accounting policies, it is not easy to change the expense reporting transparency without valid explanations; 2) theoretically, treating the disclosure transparency as an exogenous factor can shed light on which type of expense disclosures, opaque or transparent, could be better to increase the intensity of directors’ oversight.

<sup>6</sup> In June 1993, the Financial Accounting Standards Board (FASB) issued the Statement of Financial Accounting Standard (SFAS) No. 117, *Financial Statements of Not-for Profit Organizations*, which required U.S. not-for-profit organizations to disclose how they allocate joint costs among functional expense categories (i.e., charitable programs, administration and fundraising).

Therefore, other factors also influence directors' oversight of management's expense allocation.

One such factor is posited to be directors' reaction to the fairness of the donors' evaluation criteria. In the context of soliciting donations, the organization is evaluated by donors. Prior studies show that donors primarily focus on financial metrics, especially the program ratio, to evaluate the not-for-profit organization's performance and to decide whether to donate (i.e., donors are expense-focused) (Parson 2007; Baber et al. 2001). Managers of not-for-profit organizations argue that a more balanced set of performance evaluation metrics, which include both financial metrics and appropriate nonfinancial indicators of "service efforts and achievements", more fairly represents the not-for-profit organization's performance (Association of Fundraising Professionals 2008; Silverman and Betty 2007; Campbell 2002; Kaplan 2001). This opinion is actually supported by donors, who are gradually adopting a *balanced* rather than *expense-focused* evaluation process when given the information to do so (Silverman and Betty 2007; Silvergleid 2003). Numerous studies find that people develop fairness assessments of performance evaluation processes (e.g., Dipboye and de Pontbriand 1981; Landy et al. 1980; Landy et al. 1978); hence, directors may form judgments about the fairness of the evaluation processes (i.e., expense-focused vs. balanced) that donors use to evaluate the directors' organization and determine whether donations will be given. Thus, such procedural fairness judgments may be another mechanism that influences directors' oversight of management's expense allocation.

Given that both institutional factors, the transparency of organizations' expense disclosures (transparent vs. opaque) and donors' evaluation focus (balanced vs. expense-focused), exist under the current regulatory system, an important research question arises: in the context of fundraising, which regime more effectively motivates directors in their monitoring role and thus curbs management's potential misallocation of fundraising expenses? To address the research question, I conduct two experiments. The results of Experiment 1 provide the foundation to answer the research question by validating the assumption that directors perceive a donor's balanced evaluation process to be procedurally fairer than an expense-focused evaluation process.

The results of Experiment 2 show that as expected by regulators, the transparency of expense disclosures increases directors' monitoring of management's expense misallocation by reducing directors' tendency to endorse an allocation of fundraising expenses to boost the program ratio. However, although the donors' balanced evaluation process is perceived to be procedurally fairer by directors, it results in decreased monitoring of management's expense allocation by directors compared to the expense-focused evaluation process when directors anticipate donors not donating to the organization. The negative effect of the donors' balanced evaluation process originates from directors' belief that the not-for-profit organization does not deserve an unfavorable donation decision from donors and that a fair evaluation process should generate a desirable evaluation outcome. Thus a negative donation decision from donors via their fair evaluation process (i.e., the balanced evaluation process) is more unacceptable for

directors than a negative donation decision via an unfair evaluation process (i.e., the expense-focused evaluation process).

This thesis contributes to the extant literature in the following ways. First, prior studies present empirical evidence of expense misallocation in not-for-profit organizations, and show that outside monitoring (i.e., auditing) is associated with less expense misreporting (Keating et al. 2008; Krishnan et al. 2006). Although outside monitoring by auditors is important, it is not as ongoing as director oversight. There is no general legal requirement that not-for-profit organizations must have their financial statements audited, nor is there any general requirement that not-for-profit organizations disclose their audited financial statements (Sossin 2001).<sup>7</sup> Many not-for-profit organizations, especially small ones, choose not to be audited (Gill 2005). Directors, however, review the financial statements on a regular basis, and may be in a better position to oversee management's expense allocation than auditors (Ahier 2007; Gill 2005). This study complements the literature about expense misallocation in not-for-profit organizations by showing whether and how the board of directors plays a role in reducing management's expense misallocation.

Second, economists argue, from the perspective of agency theory, that directors of not-for-profit organizations may not carry out the monitoring expected of them, as takeover threats are unlikely and there are no residual claimants to impose discipline on

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<sup>7</sup> External audits are only mandatory for certain not-for-profit organizations. For example, the Ontario Ministry of the Attorney General requires that all incorporated charities with an annual income of more than \$100,000 be audited. The CRA recommends that charities should have their financial statements audited if their annual gross income from all sources is more than \$250,000. In Canada, 62% of charities reported annual revenues of less than \$100,000, and 80% reported revenues less than \$250,000 (Gill 2005).

board members (Fama and Jensen 1983; Glaeser 2003). My research extends and complements the current literature by examining whether two institutional factors, donors' evaluation focus and expense reporting transparency, can affect directors' decisions to actively monitor management's expense allocation policies designed to make the organization appear more favorable in donors' eyes. Therefore, this study shows that weak director governance in not-for-profit organizations may not solely be due to economics as suggested by agency theory, but instead may be a subconscious decision resulting from directors' reactions to institutional factors.

Third, the existing research concerning directors in not-for-profit organizations focuses on normative factors guiding what directors "should" do to improve not-for-profit governance; for example, how to structure the committees of the board, how many times directors should meet, how many independent directors each committee should have, and so on. Empirical studies that examine what directors actually do in not-for-profit settings are rare (Brown and Guo 2010; Callen et al. 2003; Yetman and Yetman 2011). This thesis contributes to the extant research by *empirically* examining factors that impact directors' oversight of management's expense allocations. Regulators and practitioners should consider these factors when formulating standards of good practice for the board of directors in not-for-profit organizations.

This thesis proceeds as follows. Chapter 2 introduces the institutional background about why the research question addressed in this thesis is important. Chapter 3 presents the literature review, hypothesis development, experimental design and results to validate

the assumption of this study that procedural fairness concerns arise in directors' minds due to donors' evaluation focus. In Chapter 4, I review the literature and theory needed to develop hypotheses about my fundamental research question of whether donors' evaluation focus and expense reporting transparency interactively motivate directors to be more diligent in monitoring management's expense allocations. I then present the experimental design and the results. Finally, in Chapter 5, I summarize the results of the two experiments, and provide concluding remarks.

## Chapter 2

### Institutional Background

#### 2.1 The Agency Problem and the Role of Directors in Not-for-profit Organizations

Not-for-profit organizations in developed countries (e.g. the U.S., Canada, the UK, Australia) are an important economic force that addresses the needs and interests of citizens and touches virtually every aspect of people's life from service delivery such as health care, education, community development and housing to creative functions in arts and culture, sports, recreation, civic advocacy, and professional associations. They contribute a significant portion of GDP (e.g. 6.9% in the U.S. and 8.5% in Canada) and provide employment for a large segment of the workforce (e.g. nearly 8.6 million full-time equivalent workers in the U.S. and over 2 million in Canada) (Hall et al. 2005; Sokolowski and Salamon 1999).

One economic difference between not-for-profit organizations and for-profit organizations is that not-for-profit organizations operate under the non-distribution constraint; that is, no one has a legal claim to the organizations' surplus (Glaeser and Shleifer 2001). All funds raised or generated by the organizations must, over time, be spent for charitable purposes. Without strong profit incentives, managers of not-for-profit organizations are less likely to sacrifice service quality for profits. Hence, not-for-profit organizations are more trusted especially in markets where trust between service providers and consumers is important but customers are unable to judge service quality directly (Rose-Ackerman 1996). Therefore, not-for-profit organizations become the

primary organizational form of choice, or even the exclusive choice in some countries, to provide some services such as health care and education (Glaeser and Shleifer 2001).

However, it is also the characteristic of non-distribution of earned profits or surplus that allegedly leads to management shirking, as a market-competitive mechanism to monitor managers' opportunistic behavior and punish the organizations' inefficiency is absent in not-for-profit organizations (Rose-Ackerman 1996). Furthermore in most countries, government regulations for not-for-profit organizations are not as effective as they should be, due to limited resources in staff and funds. For example, only approximately 0.75% of registered charities are regularly audited by the Canada Revenue Agency (the CRA), the primary institution through which the Canadian federal government regulates not-for-profit organizations (Sossin 2001).<sup>8</sup> Similarly in the U.S., the audit rate of registered charities by the IRS fell from 0.64 % in 1996 to 0.43% in 2001 (GAO 2002). Without an effective regulatory system to monitor not-for-profit organizations, regular oversight from the board of directors is an important mechanism to monitor and discipline not-for-profit management.<sup>9</sup> Fama and Jensen (1983) argue that nonprofit boards, if composed of independent directors, should provide assurance against management's wrongdoings, as not-for-profit directors are devoted to the charitable cause of the not-for-profit organization and are also concerned about their reputations in

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<sup>8</sup> Federal and provincial governments regulate charities in Canada. The federal government is responsible for the registration and the tax-related issues of not-for-profit organizations through the CRA, while the provincial governments regulate the conduct of charities, especially providing the legal structures within which not-for-profit organizations may operate, protecting not-for-profit organizations against fraud, and enforcing charitable fiduciary relationships (Sossin 2001).

<sup>9</sup> Oversight from external auditors in not-for-profit organization is not as regular as director oversight. Please see footnote 7 for details.

other markets, hence are willing to contribute their wealth and time to the organization and should be motivated to take their monitoring role seriously.

Unfortunately, director oversight may not be strong in reality. Management wrongdoings and fraud occur in not-for-profit organizations (the Association of Certified Fraud Examiners 2008; Greenlee et al. 2007). For example, Chen et al. (2009) searched Canadian national and leading regional newspapers between 1998 and 2008 and identified 114 fraud cases in Canadian not-for-profit organizations reported by the media. They found that the most frequently reported perpetrators of frauds in not-for-profit organizations were managers, who committed 29.82% of total frauds in their sample. Similarly, Greenlee et al. (2007) find that more than 25% of the reported frauds in U. S. not-for-profit organizations were conducted by managers and the most costly frauds were also those perpetrated by managers.

Agency theory attributes weak director oversight to the fact that there can be no takeover threats from outside and there are no residual claimants to impose discipline on or to remove board members (Fama and Jensen 1983; Glaeser 2003). However, Miller's (2002) field study suggests that the weak director oversight results from directors' confusion about to whom they are responsible. Directors in not-for-profit organizations have multiple accountabilities to several stakeholders (e.g., donors, clients, managers, regulators etc.), who may have conflicting claims on and varying expectations for organizational resources. In addition, directors are not only monitors protecting the not-for-profit organization from management's wrongdoings, but like management, they also

often act as fundraisers, especially in (but certainly not limited to) small not-for-profit organizations (Gill 2005; O'Regan and Oster 2005). Directors have to balance their oversight role as monitors and their quasi-management role as fundraisers in carrying out their fiduciary duties in not-for-profit organizations.

This study focuses on the effects of two institutional factors on the directors' decisions to intervene in management's expense misreporting in financial statements. Specifically, I examine whether and how the transparency of expense reporting and the donors' evaluation process affect the directors' oversight when management misallocates fundraising expenses to boost the organization's program ratio to make the organization appear more favorable to donors. The reason I choose these two institutional factors to investigate is that regulations and standards surrounding them have recently changed and these factors are believed to play a crucial role in directors' willingness to monitor management in the context of fundraising (AcSB 2008; Silverman and Betty 2007; Silvergleid 2003).

## **2.2 Disclosure Transparency of Expense Reporting in Not-for-Profit Organizations in Canada**

Not-for-profit organizations' expense reporting is seen as a critical mechanism to demonstrate the organizations' accountability and to earn donors' trust (Krishnan et al. 2006). Expense reporting allows donors to evaluate whether funds are spent on charitable activities and it is hoped that they make better donation decisions. Not-for-profit

organizations' expenses reports appear in their financial statements.<sup>10</sup> Since January 1, 1989, not-for-profit organizations have been required to prepare financial statements in accordance with the CICA Handbook (CICA Handbook 4400s series).<sup>11</sup> Prior to 1989, there was no official pronouncement on not-for-profit accounting in Canada albeit organizations were encouraged to adopt the CICA Handbook standards as needed.

### **2.2.1 Expense Reporting 1989 to January 2009**

Before the new Section 4470 came into effect in January 2009, only Section 4431 in the CICA Handbook provided GAAP on how to report expenses in financial statements. Section 4431 required not-for-profit organizations to report expenses in the statement of operations, but allowed not-for-profit organizations discretion to choose the most informative presentation for their operations. The CICA Handbook Section 4431 illustrated two examples of how to report expenses, one classified expenses by nature (for example, salaries, purchased materials, mortgage interest) and the other by function (for example administrative, research, ancillary operations). See Panel A of Figure 1 for an example. No matter which presentation format was selected, allocation information such as the allocation basis and the amount allocated were not required even if organizations

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<sup>10</sup> Not-for-profit organizations' financial statements are currently not required to be available to the public, but the financial statements are accessible to the stakeholders of not-for-profit organizations. First, all not-for-profit organizations are required to submit a copy of their financial statements when they file the tax documents to the CRA. The CRA makes charities' annual tax filings after 2000 available on-line to the public and also may provide a copy of the charity's tax filings to any person upon request (Income Tax Act Section 241 (3.2) 1998). Second, not-for-profit organizations that receive government grants to conduct public fundraising campaigns and borrow money from fund lenders are frequently required to provide a copy of financial statements to the regulators, the related entities and the individual stakeholders. Third, not-for-profit organizations often publish their financial statements on their website or circulate them in hard copy (Salterio and Legresley 2011).

<sup>11</sup> The original section issued by the Accounting Standards Board in January 1989 is Section 4230 "Non-profit Organizations – Specific Items". In 1997, Section 4230 was replaced by Section 4400s series.

allocated fundraising or administrative expenses to the charitable expenses category. Not-for-profit organizations also rarely disclosed allocation information voluntarily (AcSB 2007). Therefore financial statement readers were not able to determine whether and how fundraising expenses were allocated to charitable program expenses.

### **2.2.2 Expense Reporting as of January 2009**

After the MADD Canada scandal (referred in the Chapter 1 Introduction), the AcSB issued an Exposure Draft in August 2007, which proposed a new Section 4470 “Disclosure of allocated expenses by not-for-profit organizations” in the CICA Handbook, with the purpose of promoting the transparent disclosure of expenses by function in the financial statements of not-for-profit organizations. Section 4470 encourages, but does not require, not-for-profit organizations to disclose allocation information, such as the allocation basis and the amount allocated among functions, if they allocate fundraising or administrative expenses into the charitable program expenses category. If not-for-profit organizations choose to disclose this information, allocation becomes more transparent since financial statement users can then determine whether and how fundraising expenses are allocated to charitable program expenses.

The AcSB received fifty-seven comment letters from CA firms and not-for-profit organizations about this proposed standard. Only three CA firms and one not-for-profit organization expressed negative comments on the proposed transparent expense reporting. These negative comments did not disagree with the proposed transparent expense reporting *per se*, but point out the difficulty in applying the proposed standard

under the ambiguous definitions of “administrative expenses”, “fundraising expenses” and “the allocation basis” described in the exposure draft. Therefore with the support of a majority of CAs and not-for-profit organizations who wrote the comment letters, this new Section 4470 was approved by the AcSB on May 26, 2008 and came into effect as of January 2009.

To be clear, Section 4470 only applies to those not-for-profit organizations that have already allocated or will allocate expenses among functions *and* also report their expenses by function in the financial statements. Alternatively, not-for-profit organizations can choose the extent of disclosure of allocation information by selecting to report expenses by nature instead of by function in the financial statements. Please refer to Figure 1 to see alternative expense reporting formats allowable by Section 4470. Therefore, under Section 4470, the transparent expense reporting is not mandatory, but voluntary management choice. The effect of this choice of expense transparency may affect the intensity of directors’ oversight of management expense allocation.

[Insert Figure 1 here]

### **2.3 Donors’ Performance Evaluation Focus**

The set of performance evaluation metrics donors focus on to make donation decisions is gradually changing. Ideally when evaluating accountability, donors should look at not only how much funding not-for-profit organizations directly put into charitable activities but also how efficiently not-for-profit organizations utilize the resources to provide services and accomplish their missions (Khumawala and Gordon

1997; Parson 2003). If desired, donors can easily obtain the ratio of charitable spending to total spending (i.e., the program ratio) from the organization's annual report or from filings required for tax purposes.<sup>12</sup> Current and potential donors likely expect the program ratio to be as high as possible. Their expectations are reflected by regulations issued by the CRA, which recommend that no charity spend more than 35 percent of donation revenues on fundraising; otherwise the CRA could revoke its registered charitable status (CRA 2009a). The CRA regulation suggests that not-for-profit organizations should spend at least 65 percent of donation revenues on charitable activities. In the U.S, the federal government requires not-for-profit organizations that participate in the Combined Federal Campaign to allocate more than 75 percent of total revenues into programs, while the industry watchdog, Better Business Bureau Wise Giving Alliance, dictates that the program ratio should be at least 60 percent (Roberts 2000).

Prior studies (e.g, Weisbrod and Dominguez 1986; Khumawala and Gordon 1997; Okten and Weisbrod 2000; Parson 2007) find that donors, especially large donors, primarily look at the program ratio as a main criterion of efficiency and tend to contribute to organizations reporting a higher program ratio. Part of reason is that the program ratio is easily accessible and very simple to compare across organizations. Donors' sole focus on the program ratio has also been blamed for driving not-for-profit organizations to misreport their expenses (Silverman and Beatty 2006; Krishnan et al. 2006). Meanwhile,

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<sup>12</sup> No matter whether the expense reporting is transparent or not, not-for-profit organizations generally disclose the ratio of charitable spending to total spending (i.e., the program ratio) in their annual reports. If not, donors can easily obtain the program ratio from the online tax filings on the CRA website, which is available to the public: <http://www.cra-arc.gc.ca/chrts-gvng/lstngs/menu-eng.html>.

managers of not-for-profit organizations themselves feel that donors' expectations for a high program ratio and correspondingly very low, even zero, spending on fundraising and administration is unrealistic, because they are competing for a rather limited pot of funds with other charitable groups, and so must invest in fundraising activities (Association of Fundraising Professionals 2008, Silverman and Beatty 2006). Hence, not-for-profit organizations and advocacy groups (e.g., Imagine Canada) call for donors to not only evaluate not-for-profit organizations' performance by looking at the program ratio, but also to consider not-for-profit organizations' nonfinancial performance, such as accomplishments in terms of services provided.

Following recent scandals involving expense misreporting in not-for-profit organizations, donors also realize that it is necessary to know more about service effectiveness in addition to financial indices (Silverman and Betty 2007; Silvergleid 2003). However, the availability of nonfinancial metrics is an issue. First, it is expensive to track service outcomes and organizations' fear of finding that something is not working also keeps not-for-profit organizations from committing their scarce resource to measuring effectiveness (Silverman and Betty 2007). Second, it is inherently difficult and practically challenging to design a set of effectiveness measures that reflect the needs of all stakeholders and are comparable across various not-for-profit organizations given the difficulty of quantifying human services and a vast variety of services provided by various not-for-profit organizations (Herman and Renz 2008; Campbell 2002; Kaplan 2001). Third, politically, some kinds of not-for-profit organizations, such as health

service providers, are reluctant to use output efficiency indices, as they are not congruent with the philosophy that caring for clients/patients, not saving costs, is the priority (Cutt et al. 1996). Despite the difficulty in obtaining nonfinancial indicators of service performance, prior research indicates donors show an interest in these indicators, and base their contributions to not-for-profit organizations, in part, on service effectiveness when effectiveness measures are available (Silverman and Betty 2007; Silvergleid 2003).<sup>13</sup>

Given donors' growing interest in appropriate nonfinancial metrics, the availability of service performance evaluation metrics is increasing. Researchers (e.g. Herman and Renz 2008; Speckbacher 2003; Kaplan 2001; Fine et al. 2000) have explored and developed various effectiveness measures such as program outcome scores, trying to create a balanced performance evaluation system. Third-party organizations (e.g. the American Institute of Philanthropy, the Better Business Bureau Wise Giving Alliance, Guide Star, and the Canadian Comprehensive Auditing Foundation) have actively responded to the increased demand for service effectiveness measures and provide effectiveness evaluation services to donors and other stakeholders (Silverman 2004; Murray 2001). Not-for-profit organizations themselves are also aware of this information demand trend among stakeholders and are beginning to take this trend into consideration

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<sup>13</sup> Service effectiveness metrics are voluntarily disclosed. They can be presented as measurable indices (e.g., the number of clients served, the percentage of satisfied clients, a comparison of service results to the organization's goals etc.), but more often are reported as a qualitative description of service efforts and achievements in the organizations' annual reports (Parson 2003). Currently, many Canadian not-for-profit organizations provide a report of service performance in annual reports, mostly in qualitative terms, but sometimes in quantitative terms as well (Salterio and Legresley 2011).

when conducting their activities (Balsler and McClusky 2005). Therefore, current changes in the not-for-profit environment facilitate the transition of donors' evaluation focus from an expense-focused evaluation process to a more balanced evaluation process. The tendency to adopt a balanced evaluation process reflects beliefs of donors and others that believe there is a need to evaluate not-for-profit organizations more fairly (Silverman 2004).

## **2.4 Summary**

When directors believe that management may have misallocated fundraising expenses to boost the program ratio, they must balance their role as monitors who ensure that financial reports are free from misreporting and their role as fundraisers for charitable programs. This balancing process may be affected by two factors: the transparency of the organization's expense disclosures and the donors' evaluation focus, which have undergone changes in the current regulatory and economic environment. In terms of expense reporting transparency, Section 4470 of the CICA Handbook encourages not-for-profit organizations to adopt a transparent expense reporting format (i.e., when disclosing allocation information by function), but also permits not-for-profit organizations to use an opaque expense reporting format (i.e., by disclosing expenses only by nature). In addition, there is a trend toward more donors considering nonfinancial as well as financial indicators like the program ratio in their donation decisions, especially if both financial and nonfinancial indicators are available. The coexistence of the newer and older forms of disclosure transparency and donor evaluation focus in the

current period motivates in part my research question: which combination of these two factors constitutes a more efficient institutional environment that motivates directors to oversee management expense allocation more diligently? While I recognize that enhancing director monitoring is not the sole or even main reason for these changes, it is important to understand the effect of such changes on directors' activities as directors are the first line of defense against unethical managers' behavior. Answers to the research question have implications for regulators as well as industry professionals in terms of how to improve director oversight of management expense allocation in not-for-profit organizations.

## **Chapter 3**

### **Experiment 1: Fairness of Donors' Evaluation Process in Not-for-profit Organizations**

The goal of Experiment 1 is to validate the assumption underlying the research question of this study; specifically, whether procedural fairness concerns arise in directors' minds due to donors' evaluation focus. I need to validate this assumption because prior studies (e.g., Leventhal 1980; Lind and Tyler 1988; Lind et al. 1990) do not lead readily to determining which type of donors' evaluation focus (expense-focused or balanced) is perceived to be procedurally fairer by directors in the context of fundraising.

#### **3.1 Literature Review**

Directors in for-profit organizations may see their main role as a monitor of the organizations' performance on behalf of shareholders. However, directors in not-for-profit organizations often volunteer to serve on the board out of a desire to make a difference through a charitable cause, and therefore pay equal, or maybe even more, attention to the organizations' social responsibilities, including the organizations' nonfinancial performance in accomplishing service program objectives. For example, O'Regan and Oster (2005) conducted a large-scale survey that indicates 90% of 3,000 director respondents gave mission fulfillment and program improvement as the primary reason for serving on the board of a not-for-profit organization. To advance a charitable cause, directors care about whether the organization can obtain sufficient donations and

what performance evaluation metrics donors adopt to decide whether and how much to donate (Callen et al. 2003).

In this research project, I consider two arch-types of donor. One donor type focuses solely on a financial metric, specifically the program ratio, to make donation decisions. This type of donor wants to make sure that as much of total funds donated as possible are spent on charitable programs, not on administrative or fundraising activities (Charity Intelligence Canada 2008; Roberts 2005; Voluntary Sector Initiative 2003). They view the program ratio as a “sufficient statistic” for evaluating achievements of charitable programs (Feltham and Xie 1994). I label these “expense-focused donors.”

The second donor type considers the program ratio (i.e., the indicator of financial performance) as well as nonfinancial indicators of “service efforts and achievements” (Silverman and Betty 2007; Campbell 2002; Kaplan 2001). They believe that while the portion of donations devoted to charitable programs as compared to administrative and fundraising activities is important, it is equally important to know more directly the impact of their donations in advancing the charitable cause. These are labeled “balanced donors”.<sup>14</sup>

Analytical and empirical studies (e.g., Feltham and Xie 1994; Banker et al. 2000) demonstrate that a single financial measure (e.g., earnings) is not usually considered a “sufficient statistic” for performance evaluation in a for-profit organization. A single

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<sup>14</sup> In addition to the two types of donors mentioned above, Baber et al. (2001) indicated a third type of donor, namely the rationally ignorant. These donors are usually small donors who lack incentives to seek out either financial or nonfinancial metrics. They make small contributions only when properly motivated and informed. This paper does not consider this third type of donors, because this type of donors donates without evaluating financial metrics.

financial measure, for example net income, only reflects the organization's short-run performance, ignores the organization's long-term strategy, fails to capture the organization's multidimensional performance, and is often subject to manipulation (Kaplan and Norton 2001a, 2001b). So, it is usually necessary to add nonfinancial measures to financial measures to overcome these shortcomings (Feltham and Xie 1994; Banker et al. 2000).

Similarly, directors in a not-for-profit organization, as advocates for the organization, may believe the expense-focused evaluation process is less representative and less accurately portrays the organization's performance than the balanced evaluation process. In a fundraising context, directors in a not-for-profit organization may think that they are evaluated by donors if they believe part of their responsibility is fundraising. Several studies (e.g., Burney et al. 2009; Lau and Moser 2008; Lau and Sholihin 2005) find that different performance evaluation processes focusing on financial and/or nonfinancial metrics can lead to different fairness perceptions of the evaluation process in the eyes of evaluatees. Thus, I expect that directors in not-for-profit organizations develop procedural fairness perceptions of donor's evaluation focus.

### **3.2 Hypothesis Development**

Both evaluatees and third-party observers form fairness judgments about an evaluation process through which a decision or an outcome is determined; this type of fairness judgment is defined as procedural fairness (Leventhal 1980, Skarlicki et al. 1998; Turillo et al. 2002). Directors can be evaluatees if they internalize that fundraising is their

main concern as a director of the organization. Directors can also be third-party observers if they think monitoring management is the more important function and fundraising is management's responsibility, not the directors' first priority. The psychology literature shows that third-party observers develop procedural fairness perceptions in the same way as evaluatees (Skarlicki et al. 1998; Turillo et al. 2002).

Leventhal (1980) identifies six rules that people use to judge the symbolic and informational characteristics that a procedurally fair evaluation process should have. People do not need to apply all of the six rules to assess procedural fairness of a decision-making process in a particular setting as normally the most salient rules or "norms" are applied (Ambrose and Arnaud 2005; Leventhal 1980). In the context of performance evaluation in not-for-profit organizations, two of the rules, namely "accuracy" and "representativeness" may be most relevant to assessments of fairness of donors' evaluation processes (Dipboye and de Pontbriand 1981; Landy et al. 1980; Landy et al. 1978).<sup>15</sup> Leventhal (1980) defines these two rules as:

- Accuracy. Procedures should be based on as much valid information and informed opinion as possible, with a minimum of error.
- Representativeness. Procedures must reflect the basic concerns, values and outlook of individuals and subgroups impacted by the evaluation outcome.

When acting as an advocate for a not-for-profit organization, directors may be concerned about the sufficiency of a single financial performance measure (i.e., the

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<sup>15</sup> The other four of Leventhal's rules (1980) are consistency, bias suppression, correctability and ethicality.

program ratio) to reflect the organization's performance both accurately and in a representative manner. For example, a high program ratio indicates that the organization spends a large portion of its revenues on charitable programs and a small portion on fundraising and administrative activities. A lack of investment in fundraising and administration, however, could lead to a funding shortage and a lack of support from professional staff in future periods, and eventually damage the organization's capability to deliver services efficiently and to run charitable programs effectively (Rose-Ackerman 1982; Kaplan 2001).<sup>16</sup>

Appropriate nonfinancial metrics of service effort and achievements complement the program ratio, concretely showing outcomes of charitable spending and linking the current financial performance to the organization's future goals (Kaplan 2001). Adding appropriate service performance metrics to the program ratio can relatively more comprehensively, hence more accurately, gauge the organization's actual performance. Therefore from the standpoint of directors, a balanced set of financial and nonfinancial metrics may be considered to be more accurate and representative than a financial metric alone, and thus procedurally fairer according to Leventhal's rules (1980) for judging procedural fairness.

The symbolic and informational characteristics identified by Leventhal's rules (1980) are considered to be normative in nature, and are labeled "non-instrumental" characteristics of an evaluation process in the literature. A series of studies (e.g., Lind et

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<sup>16</sup> Similar arguments have been made in the context of for-profit organizations about the potential negative effects on long-run performance of a short-term focus on profit (Van der Stede 2000; Banker et al 2000).

al. 1980; Schaubroeck et al. 1994) found that non-instrumental characteristics are relatively stable and tend to provide a predictable long-term outcome, hence people's procedural fairness perceptions are relatively unaffected by the concrete outcome associated with evaluatees' performance in a specific period (Brockner and Wiesenfeld 1996). Therefore, I predict:

*H1: Directors of not-for-profit organizations perceive the donors' balanced evaluation process to be procedurally fairer relative to the donors' expense-focused evaluation process, regardless of the organization's financial and nonfinancial performance.*

In addition to the non-instrumental dimension, an evaluation process has another dimension that may also influence procedural fairness perceptions; that is, the process' capacity to provide favorable evaluation outcomes (Lind and Tyler 1988; Lind et al. 1990). Lind et al. (1990) argue that procedural fairness judgments can also be affected by the outcome of the evaluation. If a procedure generates an unfavorable outcome, the procedure may be judged as unfair, even if the evaluation process meets Leventhal's normative rules (1980). These types of procedural fairness judgments depend on whether the outcome is perceived to be favorable or unfavorable to the individual, and are therefore labeled "instrumental" in the literature. The instrumental value of the evaluation process (i.e., capacity of the evaluation process to increase the likelihood of a favorable outcome) may induce procedural fairness perceptions over and above the non-instrumental value of the evaluation process (e.g., normative characteristics such as

accuracy and representativeness) (Greenberg and Folger 1983; Lind and Tyler 1988; Paese et al. 1988; Lind et al. 1990; Greenberg 1990).

In the context of this study, I argue that adding appropriate nonfinancial metrics about service efforts and achievements to the program ratio cannot guarantee that donors will make a favorable donation decision. For example, when service performance is relatively poor, provision of service performance information might offset the donors' favorable evaluation of an organization with a high program ratio, or make the donors' evaluation worse for an organization whose program ratio is relatively low. Hence, the balanced set of evaluation metrics, though more accurate and representative and therefore procedurally fair, cannot guarantee an increased likelihood of the organization obtaining donations, and thus may not be considered fairer due to the outcome being unfavorable than the expense-focused evaluation process.

Relatively good service performance, however, can mitigate the negative impression given by the poor program ratio, or strengthen the donors' positive evaluation brought about by a high program ratio. When the organization performs well according to the appropriate service metric, the instrumental value of the donors' balanced evaluation focus (i.e., fairness judgments based on the favorability of the outcome) could generate additive procedural fairness perceptions beyond fairness perceptions triggered by the non-instrumental value of the balanced evaluation process alone (i.e., more normative fairness judgments based on accuracy and representativeness rules). The donors' balanced evaluation process is perceived to be procedurally fairer than the expense-

focused evaluation process. Hence, the organization's service performance may moderate the directors' procedural fairness perceptions. I formalize the moderating effect as a set of alternative hypotheses:

*H1a<sub>alt</sub>: Directors of not-for-profit organizations perceive the donors' balanced evaluation process to be equally fair or less fair relative to the donors' expense-focused evaluation process, if the organization has relatively poor non-financial (i.e., service) performance.*

*H1b<sub>alt</sub>: Directors of not-for-profit organizations perceive the donors' balanced evaluation process to be procedurally fairer relative to the donors' expense-focused evaluation process, if the organization has relatively good non-financial (i.e., service) performance.*

### **3.3 Research Method for Experiment 1**

#### **3.3.1 Experimental Design**

The experimental design is 2 (evaluation process: balanced versus expense-focused) × 2 (service performance: improved versus declined) × 2 (program ratio: below average versus above average) minus 2 between-subjects.<sup>17</sup> The two cells that are deleted are

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<sup>17</sup> Financial performance as indicated by a high or low program ratio is also related to the probability of the organization obtaining donations and thus may influence the instrumental value of the donors' evaluation process and consequently directors' procedural fairness perceptions. To maintain internal validity, I also manipulate the third variable "the program ratio". The results of Experiment 1 show that the program ratio does not impact directors' procedural fairness perceptions of the donors' evaluation process ( $F_{(1,60)}=0.37, p=0.547$ ).

those where both service performance and the program ratio are above the benchmarks, since these two cells do not provide informative comparisons to test the hypotheses.<sup>18</sup>

Donors' evaluation focus is manipulated by informing participants whether a potential large donor adopts a single financial evaluation metric (i.e., the program ratio) or a more balanced set of performance evaluation metrics including both the financial indicator (i.e., the program ratio) and appropriate nonfinancial indicators of "service efforts and achievements". Service performance varies at two levels: relatively good or poor compared to last year's service performance and the service performance of peer organizations. Finally, the program ratio has two levels: above the national average (i.e., spending relatively more on direct charitable activities as a percentage of total expenses) vs. below the national average (i.e., spending relatively less on direct charitable activities as a percentage of total expenditures).

### **3.3.2 Participants**

I enlisted the help of contact persons in or associated with not-for-profit organizations to send an invitation email to individuals who are current or former board members of Canadian not-for-profit organizations. A total of 93 directors participated in this experiment.<sup>19</sup> Table 1 presents their demographic information. Participants are or have been directors of not-for-profit organizations with annual revenues ranging from

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<sup>18</sup> In addition, excluding these two cells reduces demand on my relatively limited pool of participants with experience as directors of not-for-profit organizations.

<sup>19</sup> I also asked the contact persons to request the contacted directors to send out the invitation to other individuals who those contacted directors knew were current or former nonprofit directors. As such, I cannot know the total number of directors who received the invitation. Therefore, I am not able to calculate the response rate.

less than \$100,000 to more than \$10,000,000. Among the 93 directors, 31.25% were accountants, and 23.60% had an accounting designation. As for what specific tasks the participating directors perform on the board, 64.51% of them were responsible for financial governance and audit-related issues and 45.16% were responsible for fundraising activities. Randomization appears to be successful as there are no significant demographic differences across experimental cells (all  $p$ 's  $\geq 0.124$ ).<sup>20</sup>

[Insert Table 1 here]

### **3.3.3 Procedures**

I first ran a pretest using 46 commerce students who had recently graduated with accounting as a concentration. The pretest results indicate that the experimental instrument is understandable and appropriate and the manipulations generate the effects I expect. After validating the experimental instrument via the pretest, I requested the contact persons to send an invitation to potential participants, with a follow-up email approximately one week later. To respond to the survey, participants clicked on the web-link provided in the invitation email and were automatically taken to the website where the experimental instrument was located. Participants first read general information about the study, including all precautions being taken to ensure their anonymity (i.e., ethics consent procedure), and clicked a consent button to participate in the study. Then they were randomly assigned by the survey software to one of the six experimental conditions. The software proceeded to take participants through the online case where participants,

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<sup>20</sup> All  $p$ -values in this paper are two-tailed, if not otherwise specified.

acting as a director in a not-for-profit organization, were asked to assess the procedural fairness of the evaluation focus of a potential large donor. Participants then answered post-experimental and demographic questions.

### **3.3.4 Experimental Case**

Canadian not-for-profit organizations provide a wide range of services (e.g. social services, arts and culture, housing, religious) to all kinds of people (e.g. the general public, children, young people, elderly people, ethnic groups etc.). To eliminate the possibility that personal opinions about the importance of certain charitable causes could influence participating directors' devotedness to the organization and their decisions, this study uses a suitably disguised family center as the experimental case. This type of organization was selected for two reasons: first a family center does not provide services that normally invoke strong personal opinions, and second, the broader human welfare sector represents 32.9% of not-for-profit organizations, which is the largest group of not-for-profit organizations in Canada (Statistics Canada 2005).

In the experimental case, all participants were instructed to assume the role of a director on the board of the family center. They were told that the family center needs to develop alternative funding sources to replace their government funding due to sudden government budget cuts. Participants also received information about the center's service performance and program ratio. Since procedural fairness judgments are formed based on comparing alternative evaluation processes (Kahneman et al. 1986), the participating directors were also explicitly reminded that the center's potential donors adopt either an

expense-focused evaluation process or a balanced evaluation process. Further the participants were informed that a targeted potential large donor in the case is of the expense-focused or the balanced type. Then the participants judged the procedural fairness of the large donor's evaluation process used to decide about a donation to the family center.

### 3.3.5 Independent Variables

Two manipulated variables, the donors' evaluation focus and the organization's service performance, are independent variables. Both of them are dichotomous variables. For the independent variable "donors' evaluation focus" (EF), in the conditions where donors adopt an expense-focused evaluation process, participating directors are told that the target donor in the experimental case "**focuses solely on the program ratio** when making donation decisions". However, in the conditions where donors adopt a balanced evaluation process, participating directors are informed that the target donor "**focuses on both the program ratio and any voluntarily disclosed level of service efforts and achievements** when making donation decisions".

The second independent variable, the organization's service performance (SP), also varies at two levels. When the organization's service performance is relatively good, participants are told that: "Overall, the Centre's programs experienced great success this year. The number of parents and children who received services from the Centre was 8% higher than last year and 5% higher than the average number of clients serviced by similarly sized family centers." When the organization's service performance is relatively

poor, however, participants are told that: “Overall, the Centre’s programs did *not* experience as much success this year as was hoped. The number of parents and children who received services from the Centre was 8% lower than last year and 5% lower than the average number of clients serviced by similarly sized family centers.”

### **3.3.6 Dependent Variable**

The dependent variable is participants’ perceived procedural fairness of the donor’s evaluation process (PFair). Procedural fairness is measured on a 9-point scale from -4 “Very unfair” to +4 “Very fair” in response to the statement “Do you consider this potential large donor’s evaluation criteria for making a donation to be fair?”

## **3.4 Results of Experiment 1**

### **3.4.1 Manipulation Checks**

Participating directors are asked to answer on a 9-point scale (from -4 “Strongly disagree” to +4 “Strongly agree”) whether they agree with each of three statements that are used to check if participants attend to the manipulations. Directors assigned to the group evaluated by balanced donors agree significantly less with the statement “The potential large donor makes donation decisions based **solely** on the program ratio” than directors assigned to the group evaluated by expense-focused donors (mean= -2.02 vs. 1.45;  $t = -7.20$ ,  $p < 0.0001$ ). Directors in the conditions where service performance improves agree significantly more with the statement “Overall, the Centre’s service performance is **excellent** this year” than those in the conditions where service performance declines (mean = 1.21 vs. -0.68;  $t = 5.43$ ,  $p < 0.0001$ ). Finally, directors

assigned to the conditions where the program ratio was below average agree with the statement “The Centre’s program ratio was **below** the national average this year” to a larger extent than those participants in the conditions where the program ratio was above average (mean = 2.14 vs. -1.61;  $t= 6.88$ ,  $p<0.0001$ ). Therefore, the manipulations of donors’ evaluation focus, the organization’s service performance and financial performance are all successful.

### **3.4.2 Hypothesis Testing**

Descriptive statistics for directors’ procedural fairness assessment of donor’s evaluation process (PFair) in each cell are presented in Table 2 and Figure 2. H1 predicts a main effect of donor’s evaluation focus (EF) on directors’ judgment of the procedural fairness of the donor’s evaluation process (PFair), while H1<sub>aalt</sub> and H1<sub>balt</sub> predict an interaction between donor’s evaluation focus (EF) and the organization’s service performance (SP). Since the design of Experiment 1 is not a fully-crossed factorial design, I conduct ANOVA for the group with the low program ratio and the group with declined service performance, separately.

From the ANOVA results for the group with the low program ratio presented in Panel A of Table 3, we can see that there is a significant main effect of donors’ evaluation focus (EF) on perceived procedural fairness ( $F_{(1, 61)}=10.31$ ,  $p=0.002$ ), but the interaction of donor’s evaluation focus and the organization’s service performance (EF\*SP) is not significant ( $F_{(1, 61)}=2.01$ ,  $p=0.162$ ). The planned contrasts for testing hypotheses in Table 3 Panel B indicate that regardless of the service performance being

relatively good or poor, the donor's balanced evaluation process is perceived to be significantly or marginally significantly fairer than the donor's expense-focused evaluation process (one-tailed p-values  $\leq 0.094$ ).

[Insert Table 2, Table 3 and Figure 2 here]

The ANOVA results for the group with declined service performance (Panel A of Table 4) show that there is a significant main effect of donors' evaluation focus (EF) on perceived procedural fairness ( $F_{(1, 60)}=8.82, p=0.004$ ), but the interaction of donor's evaluation focus and the organization's program ratio (EF\*PR) is not significant ( $F_{(1, 60)}=1.54, p=0.219$ ). The planned contrasts for testing hypotheses in Table 4 Panel B indicate that regardless of the program ratio being above or below the national average, the donor's balanced evaluation process is perceived to be significantly or marginally significantly fairer than the donor's expense-focused evaluation process (one-tailed p-values  $\leq 0.010$ ).

[Insert Table 4 here]

Hence regardless of the organization's financial performance (i.e., the program ratio) and non-financial performance (i.e., service performance), directors consider the donors' balanced evaluation procedurally fairer than the donors' expense-focused evaluation process. H1 is supported, while the alternative hypotheses H1<sub>alt</sub> and H1<sub>balt</sub> are not supported.

### **3.4.3 Additional Analysis**

To investigate why H1 alone is supported, I examine two dimensions (i.e., non-instrumental and instrumental) of donors' evaluation process that may induce procedural fairness perceptions. First, for the non-instrumental dimension, I measure representativeness and accuracy of the donor's evaluation process using a 9-point scale with 1 being "Not at all" and 9 being "To a large extent". The mean score on the representativeness scale for directors assigned to the balanced evaluation process condition (5.796) is significantly higher than that for directors in the expense-focused condition (4.863) ( $t=2.11$ ,  $p=0.037$ ). The balanced evaluation process is also perceived to be significantly more accurate than the expense-focused evaluation process (means = 5.563 vs. 3.932;  $t=3.85$ ,  $p=0.0002$ ). These results support my argument that directors perceive the balanced evaluation process to be more representative and more accurate than the expense-focused evaluation process.

Second, I examine the instrumental dimension of the donor's evaluation process (i.e., the directors' estimated likelihood of the organization being able to obtain donations (LKDDonate)). It is measured on a 9 point scale (from 1 "Very unlikely" to 9 "Very likely") in response to the statement "How likely is it that the Centre will obtain a substantial donation from this potential large donor given the Centre's performance?" I find that the donor's adoption of a balanced evaluation process, compared to the adoption of an expense-focused evaluation process, does not significantly decrease the perceived likelihood of the organization obtaining donations when the organization has relatively poor service performance (the mean score of LKDDonate for Balanced vs. Expense-

focused: 5.000 vs. 4.603;  $F_{(1, 60)} = 0.70$ ,  $p = 0.406$ ). Neither does a balanced evaluation process significantly increase the perceived likelihood of receiving donations compared to an expense-focused evaluation process, when the organization has a relatively good service performance (mean = 5.533 vs. 4.286;  $F_{(1, 27)} = 2.80$ ,  $p = 0.106$ ). These findings indicate that including the metrics of service performance in donor's donation decisions cannot significantly change directors' perceived likelihood of the organization obtaining donations. Although these findings are not consistent with the argument of the hypothesis development for  $H1_{alt}$  and  $H1b_{alt}$ , they are reasonable because in practice, service performance has been shown to be a less dominant factor in donor's donation decisions, in comparison to the program ratio (Weisbrod and Dominguez 1986; Khumawala and Gordon 1997; Okten and Weisbrod 2000; Parson 2007).

Next I consider perceived procedural fairness (PFair) as the dependent variable and test its association with the non-instrumental characteristics of the donor's evaluation focus (i.e., representativeness and accuracy) and the instrumental characteristics of the donor's evaluation focus (i.e., the likelihood of the organization obtaining donations). The regression results (not tabulated) indicate that accuracy (coefficient = 0.518;  $t = 4.01$ ,  $p = 0.0001$ ) is significantly positively associated with perceived procedural fairness, but representativeness (coefficient = 0.025;  $t = 0.19$ ,  $p = 0.846$ ) and the likelihood of obtaining donations (coefficient = 0.119;  $t = 1.27$ ,  $p = 0.206$ ) are not significantly associated with perceived procedural fairness. Therefore, only the non-instrumental value of donors' evaluation process, specifically accuracy, contributes to forming procedural fairness

perceptions, while the instrumental value (i.e., the likelihood of the organization obtaining donations) does not. These results shed light on why I find only the main effect of donor's evaluation focus on directors' procedural fairness perceptions.

### **3.5 Conclusion: Experiment 1**

In the context of directors assessing the procedural fairness of the donors' evaluation process, only the symbolic and informational characteristic of the donors' evaluation process (i.e., accuracy) contributes to forming procedural fairness perceptions. But the capacity of the donors' evaluation process to provide favorable evaluation outcomes does not impact directors' procedural fairness perceptions of the donor's evaluation focus. Therefore, no matter whether the likelihood of obtaining donations is relatively higher or lower due to the organization's financial and nonfinancial performance, directors consider the balanced evaluation process procedurally fairer than the expense-focused evaluation process. I assume these results will carry over to Experiment 2.

## Chapter 4

### Experiment 2: Directors' Monitoring of Management's Expense

#### Misallocation in Not-for-profit Organizations

Experiment 2 addresses directors' monitoring of management's expense allocation policies about fundraising expense in response to the different donors' evaluation focus as well as the relative transparency of the organization's expense disclosures. Specifically building on Experiment 1 that shows directors' fairness assessment arises due to donors' evaluation processes, Experiment 2 examines whether and how donors' evaluation process (expense-focused vs. balanced) and the organizations' expense disclosure transparency (transparent vs. opaque) impact directors' willingness to intervene when management misallocates fundraising expenses to artificially boost the program ratio to apparently make the organization look more favorable to donors.

#### 4.1 Literature Review

##### 4.1.1 Expense Misallocation in Not-for-profit Organizations

The belief that it is “easier” to solicit donations when the program ratio is high has been argued to be the motivation behind program-ratio-related expense misreporting in not-for-profit organizations (Baber et al. 2001; Krishna et al. 2006; Keating et al. 2008).<sup>21</sup> Donors, especially institutional and large individual donors, use the program ratio as an important performance evaluation criterion. Organizations with a higher program ratio

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<sup>21</sup> In addition, management compensation is also found to motivate expense misreporting (Baber et al. 2002; Krishnan et al. 2006; Keating et al. 2006), but I do not focus on this issue and leave it for future research.

are believed to be better managed and therefore will tend to attract more donations than organizations with a lower program ratio. Therefore, if management predicts that the program ratio will be below donors' expectations and that the program ratio will be the donors' evaluation metric, management may misallocate expenses to artificially increase the reported program ratio and increase the probability of receiving donations.<sup>22</sup>

Prior studies demonstrate several ways that not-for-profit organizations commit expense misreporting to increase the program ratio. Krishnan et al. (2006) find that not-for-profit organizations report zero fundraising costs to boost the program ratio, despite the ostensible fundraising activities disclosed on the organizations' websites. Keating et al. (2008) show that not-for-profit organizations enhance the program ratio by failing to properly report professional fundraising expenses; for example, netting professional fundraising costs against revenues, misclassifying them into other types of expenses (e.g. "other" category), and/or misallocating them into program expenses. Jones and Roberts (2006) report that in order to maintain the program ratio at a reasonably high level, some not-for-profit organizations manipulate the allocation of joint costs towards program expenses (e.g., report expenses related to an event that has both fundraising and educational purposes as program expenses).

In addition, prior studies find that not-for-profit management has little or no motivation to manage expense reporting when the organization is able to obtain donations

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<sup>22</sup> Not-for-profit organizations may manipulate expenses to make the program ratio higher but not too high. If the program ratio is too high, it is difficult to explain to nonprofit stakeholders the failure to sustain the high program ratio over time. In addition, extremely high program ratios may catch regulators' attention resulting in a greater tendency for them to scrutinize the organization (Krishnan et al. 2006; Jones and Roberts 2006).

relatively easily (Baber et al. 2001; Krishna et al. 2006; Keating et al. 2008).<sup>23</sup> Therefore Experiment 2 is situated in a context where directors are more likely to encounter management's expense misallocation and thus affect the intensity of monitoring they undertake; that is, when the organization's program ratio fails to meet donors' expectations expressed as the national average program ratio.<sup>24</sup>

#### **4.1.2 The Role of Directors in Expense Misallocation of Not-for-profit Organizations**

Directors of not-for-profit organizations typically have direct and detailed knowledge about expense items in financial statements and may be able to identify whether management is misallocating expenses. First, directors approve the budget each year and during the year constantly monitor whether organizations' expenses stay within the budget (Gill 2005). Second, management may discuss with directors how to report certain expense items to obtain opinions or approval from directors, especially those more financially literate directors (Mittoo 2007; Donovan 2007). Third, directors meet annually to review the financial statements and discuss whether appropriate accounting methods and policies were applied and certain items, especially expense items, were reasonably reported (Ahier 2007; Gill 2005).

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<sup>23</sup> Of course, donors' evaluation outcome involves two levels of donors' donation decisions: first, to donate or not; second, how much to donate. This paper focuses on the first level, because the threshold decision of making donations or not is influenced more by the performance of not-for-profit organizations, but the amount of donations is often determined by factors other than the performance of not-for-profit organizations, such as donors' wealth.

<sup>24</sup> The donors' expectation for the value of a program ratio could be shaped by regulations and professional common sense. The CRA may raise questions or concerns if not-for-profit organizations spend more than 35% of donations on fundraising (CRA 2009a). The CRA announced a requirement for the disbursement quota in 2004 (i.e., 80% of receipted incomes should be spent on charitable activities), but terminated this requirement in 2010 (see more details in footnote 3). The disbursement quota is approximately equal to the program ratio. The Canadian average disbursement ratio is 74%, which this study uses as a proxy for the national program ratio (CRA 2002). In the U.S., 80% is a purported norm about the program ratio from expectation of donors and funders (Gregory and Howard 2009).

Existing studies, however, provide very limited empirical evidence about whether board directors play a role in reducing management expense misallocation in financial statements once they have identified management's misallocation behavior. The only empirical research I am aware of is Yetman and Yetman (2011), which used tax filing data provided by U. S. not-for-profit organizations and showed that expense misreporting is reduced when directors are independent and financially literate. My study complements the current literature by empirically examining the extent to which directors of not-for-profit organizations monitor management's expense misallocation; more specifically how directors' perceptions of procedural fairness aroused by the donors' evaluation focus and directors' reactions to the transparency of organizations' expense disclosures influence directors' oversight of management expense allocation.

#### **4.1.3 Effect of Perceived Procedural Fairness in Business Settings**

According to the results of Experiment 1, procedural fairness concerns arise due to donors' evaluation focus. Perceived procedural fairness is demonstrated to mitigate people's negative behaviors in reaction to negative outcomes including reduced employee performance (Libby 1999, 2001) and employees' lack of commitment to their jobs (Burney et al. 2009; Lau and Moser 2008; Lau and Sholihin 2005). Perceived procedural fairness is also shown to reduce self-interested behavior such as division managers' price resistance in transfer price negotiation (Kachelmeier and Towry 2002), managers' intentions to commit earnings management (Cohen et al. 2007), taxpayers' noncompliance with tax regulations (Porcano 1984), and employees' decisions to steal

from the organization (Greenberg 1990, 1993). Turillo et al. (2002) even found that third party observers, who have no self-interest in a situation, tend to punish the party treating others unfairly and to help the unfairly treated party at their own cost. Therefore, directors' procedural fairness concerns may also affect directors' intervention into management's expense misreporting.

#### **4.1.4 Effect of Transparency of Financial Reports**

Prior research demonstrates that reporting transparency reduces information asymmetry between companies and investors, and thus lowers the cost of equity (e.g. Botosan 1997), the transactions costs of bonds (Edwards et al. 2007) and capital flight during economic crisis (Gelos and Wei 2003). These benefits of reporting transparency are achieved through transparent disclosure altering investors' perceptions of risk (Handa and Linn 1993). Reporting transparency is also considered a desired attribute of financial reports in not-for-profit organizations allowing them to gain trust and support from the public and is thus emphasized by regulators, such as the IRS and the CRA (CRA 2002; GAO 2005).

On the side of financial information providers, reporting transparency is believed to reduce opportunistic or fraudulent reporting behavior. This belief is supported by Hunton et al.'s research (2006), in which the more transparent reporting format for comprehensive income is found to lead to less earnings management. However, Hannan et al. (2006) report that under a precise information system (alternatively, more transparent because owners in this precise information system have a better idea of the

managers' private cost information), managers in a budgeting setting are less honest in reporting costs than those who are under a coarse (or less transparent) information system. Hence, it is an open question whether transparency can decrease financial statement preparers' desire to manipulate financial numbers. Directors in not-for-profit organizations are actively involved in the preparation of financial reports (Mittoo 2007; Donovan 2007) and have the motivation to present a desirable financial profile to donors as well as to maintain their reputation, including their reputation for being an effective monitor. Therefore, it is worth examining whether as expected by regulators, expense reporting transparency can actually reduce the directors' tendency to permit managers' expense misreporting.

#### **4.1.5 Summary of Findings from Literature Review**

Prior studies demonstrate that both perceived procedural fairness and transparency can impact decision making. Hence, this study complements current literature by providing empirical evidence regarding whether and how donors' evaluation focus and financial reporting transparency affect directors' monitoring of management's expense allocations in a fundraising context.

### **4.2 Hypothesis Development**

#### **4.2.1 Effect of Donors' Evaluation Focus on Directors' Oversight**

Experiment 2 is situated in a context where the organization's program ratio fails to meet donors' expectations and management anticipates that donors will not donate due to the low program ratio and thus, proposes to misallocate expenses to boost it. Like

management, directors may also anticipate an unfavorable donation outcome, because donors, both those who adopt an expense-focused evaluation process and those who adopt a balanced evaluation process, attend to the program ratio and the organization's program ratio is below donors' expectation.

Psychological studies find that people's negative response to an unfavorable outcome can be mitigated by the use of a fair decision-making process through which the outcome is derived (see a review by Brockner and Wiesenfeld 1996). Specifically, if people perceive decision-making procedures as unfair, they react more negatively to the unfavorable outcome; if decision-making procedures are perceived as fair, however, they exhibit a relatively less negative (in some cases even a mildly positive) reaction to the unfavorable outcome (e.g., acceptance). Such an effect of procedural fairness on people's acceptance of an unfavorable outcome is called the "fair process effect" (Folger et al. 1979). The fair process effect is found to impact individuals' acceptance of an unfavorable outcome that either was or will be received (Brockner and Wiesenfeld 1996; See 2009). Given that in the context of this study, an unfavorable donation outcome can be anticipated by directors, the fair process effect is likely to occur.

The underlying cognitive process involved in the fair process effect suggests that anticipating an unfavorable evaluation outcome initiates sense-making or information-seeking behavior (See 2009; Brockner et al. 2003; Cropanzano and Greenberg 1997; Brockner and Wiesenfeld 1996; Rutte and Messick 1995). People use procedural information to make sense of the predicted unfavorable outcome. For example,

information about the fairness of evaluation procedures influences people's attributions of responsibility for the unfavorable evaluation outcome. People tend to externalize the causes of unfavorable evaluation outcomes when evaluation procedures are believed to be unfair; that is, they tend to blame the party conducting the unfair evaluation for the unfavorable outcome. Therefore, unfair procedures are thought to exacerbate people's resentment toward the predicted unfavorable evaluation outcome and provoke negative reactions, such as rejection of the unfavorable outcome (Van den Bos et al. 1999).

In contrast, when procedures are considered to be fair, people cannot easily externalize (i.e., blame) the unfavorable evaluation outcome on the party making the decision. A series of studies demonstrates that fair procedures tend to make people more accepting of responsibility for the predicted unfavorable outcome and reduce their resentment toward the outcome, and thus they tend to be more accepting of the outcome (e.g., Brockner et al. 2003; Van den Bos et al. 1999; Lind and Tyler 1988).

As shown by the results of Experiment 1, directors perceive the donors' balanced evaluation process (i.e., focusing on both financial and nonfinancial indicators) to be procedurally fairer relative to the donors' expense-focused evaluation process (i.e., solely relying on an expense-focused indicator like the program ratio). Consequently, if donors adopt the expense-focused, and also relatively unfair, evaluation process, directors are likely to externalize the causes of the unfavorable outcome and blame donors, but not the organization's undesirable performance, for the unfavorable outcome. Thus directors resent the predicted unfavorable donation decision and consequently initiate defensive

behaviors (i.e., allow expense misallocation) to prevent the unfavorable outcome from occurring (Brebels et al. 2008; Folger et al. 1983). Such resentment, however, can be mitigated if donors use a fair evaluation process (i.e., a balanced evaluation focus), because directors may then believe the organization should take responsibility for the predicted unfavorable outcome. Therefore, it is expected that directors are less likely to allow management to allocate fundraising expenses to boost the program ratio when donors adopt a fairer, rather than a relatively unfair, evaluation process. This argument leads to the following hypothesis:

*H2: Given a low program ratio, directors of not-for-profit organizations are less likely to allow management to allocate fundraising expenses to enhance the program ratio when donors adopt a balanced evaluation process than when donors adopt an expense-focused evaluation process.*

#### **4.2.2 Moderating Effect of Organizations' Service Performance on Donors' Evaluation Focus**

An unfavorable outcome can be perceived as either an unfair outcome or a fair outcome (Brockner and Wiesenfeld 1996; Van den Bos et al. 1999).<sup>25</sup> Perceptions of outcome fairness are developed based on comparison. The reference point of comparison can be the outcome that relevant others such as coworkers receive or the outcome that

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<sup>25</sup> Outcome favorability is associated with, but conceptually different from, outcome fairness (Holmvall and Bobocel 2008; Brockner and Wiesenfeld 2005; Brockner et al. 2003; Brockner and Wiesenfeld 1996). Outcome favorability refers to whether outcomes are in favor of the individual's interests. Favorable outcomes are generally believed to be fair by individuals who benefit from or have personal interests in the outcomes.

individuals feel they “deserve” (Adam 1965; Van den Bos et al. 1998; Folger 1986). In the context of this study, directors may anticipate an unfavorable donation outcome due to the organization’s low program ratio, but meanwhile may also assess whether the not-for-profit organization “deserves” the unfavorable outcome based on their own evaluation of the organization’s financial (i.e., program ratio) and nonfinancial (i.e. service achievements) performance. The assessment of deservedness forms a reference point for directors to judge the fairness of the anticipated unfavorable outcome (i.e., outcome fairness) (Adam 1965; Van den Bos et al. 1998; Folger 1986). “Doing something good” is typically the main reason that directors voluntarily serve on not-for-profit boards (Gill 2005; O’Regan and Oster 2005). Service efforts and program achievements are what directors care most about, while financial performance measures like the program ratio are secondary. Therefore, I argue that compared to financial indicators, non-financial indicators of service achievements are likely to weigh heavily in directors’ assessment of the organization’s “deservedness” for donations.

From the director’s perspective, a low program ratio alone may not be a valid reason for a donor not to donate. If the organization achieved relatively high service performance, directors may think that the organization *deserves* donations despite its low program ratio, whereas the organization with a relatively low level of service performance does not deserve donations. Therefore, if the organization demonstrated good service performance, directors may believe the anticipated unfavorable donation

outcome is unfair. However, if the organization did not provide relatively good service, directors might think that the anticipated unfavorable donation outcome is fair.

Prior studies (e.g., Brockner and Wiesenfeld 1996) showed that the fair process effect is more significant when the outcome is unfair than when the outcome is fair, as feelings of uneasiness aroused by outcome unfairness cause people to be more likely to attend to procedural fairness to figure out why the unfavorable outcome is received or anticipated (Brockner and Wiesenfeld 1996; Greenberg 1993). Hence, the fair process effect triggered by the donors' adoption of a balanced evaluation process is stronger in the context where the organization's service performance is relatively good than the case where the organization's service performance is relatively poor. I predict:

*H3: Given a low program ratio, donors' use of a balanced evaluation process reduces not-for-profit directors' likelihood of allowing management to allocate fundraising expenses to boost the program ratio to a larger extent when organization's service performance is relatively good than when organization's service performance is relatively poor.*

#### **4.2.3 Effect of Transparency on Directors' Oversight**

Transparency is found to reduce the tendency of financial statement preparers to misreport (Hunton et al. 2006). The effect of transparency on preparers' behavior results from their belief that improved transparency facilitates users' detection of misreporting and a higher detection risk reduces benefits of misreporting (Hunton et al. 2006). In the context of not-for-profit organizations, release of extra information through the more

transparent disclosure of expense allocation information puts the organization under closer scrutiny. Directors may be concerned about harm to their reputation if expense misallocation is detected (Hunton and Rose 2008), because directors are expected to make sure that the financial statements are free from misreporting. Therefore, to avoid a higher risk of potential reputational harm, directors would tend not to allow management to allocate fundraising expenses to boost the program ratio when expense disclosure is transparent. I hypothesize:

*H4: Given a low program ratio, directors of not-for-profit organizations are less likely to allow management to allocate fundraising expenses to enhance the program ratio when expense reporting is transparent than when expense reporting is opaque.*

#### **4.2.4 Interactive Effect of Transparency and Donors' Evaluation Focus on Directors' Oversight**

Hunton et al. (2006) argue that transparency reduces management misreporting because transparency induces managers' perceptions of a higher detection risk and subsequently a lower benefit from misreporting. This argument implicitly indicates that managers' decisions under transparency are based on the probability of detection and hence are probabilistic; in other words, managers cannot say for sure what will happen. Psychological studies categorize this type of decision as a decision made under uncertainty (e.g., Kahneman et al. 1982; Van Dijk et al. 1997; Sniezek et al. 1990). The source of uncertainty can be environmental or self-imposed (Van den Bos 2001a, 2001b).

For example, employees may experience environmental uncertainty after being laid off because they do not know whether they will be able to find a new job (Thau et al. 2007). People's subjective belief that they lack knowledge about a decision at hand can provoke self-imposed uncertainty (See 2009).

Directors can only predict how donors interpret the additional disclosures through use of more transparent reporting. They cannot be certain whether donors will detect management's expense misallocation and if detected, whether they will be held accountable for their lack of monitoring diligence.<sup>26</sup> In contrast, under opaque expense reporting, directors can be more certain about donors' reactions to expense reports, because allocation information that could raise donors' concerns is not disclosed in a meaningful format. Even if donors do question expense reporting, directors can control the situation by selectively releasing additional expense information to donors. Hence, transparency may cause directors to feel more uncertain about consequences of their approval of management's misallocation, compared with opaqueness.

People utilize a different cognitive process to develop fairness perceptions when they feel certain, compared with when they feel uncertain (Lind 2001; Van den Bos et al. 1997; Lind et al. 2001). Van den Bos and Lind (2002) indicate that fairness information matters to people more in uncertain situations than in certain situations, as people use fairness judgments as a substitute for more cognitive information to manage their feelings of uncertainty and make them feel more confident or certain about their decisions.

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<sup>26</sup> However, the estimated probability of detection will be increased with such additional allocation information (Hunton et al. 2006; Nagin and Pogarsky 2001).

When people enter an uncertain situation, they start searching for information to form fairness judgments and resolve uncertainty. When people feel more certain about decisions at hand, however, they may not need to use fairness information as a substitute for more cognitive information to resolve uncertainty (Van den bos 2001a; See 2009). For example, when people are certain about whether an authority (e.g., a committee responsible for granting funds) can be trusted, they rely less on fairness to decide on their support for a public policy (Van den bos et al. 1998). Therefore, perceived procedural fairness tends to impact people's decisions less under certainty than under uncertainty. Alternatively speaking, the effect of procedural fairness on people's reactions (i.e., the fair process effect) is stronger under uncertainty than under certainty.

In the context of not-for-profit organizations, I argue that expense reporting transparency invokes directors' uncertain feelings about the potential consequences of their approval of management's expense misallocations, while expense reporting opaqueness allows directors to feel more certain about such consequences. According to the arguments above, the fair process effect predicted by H2 is stronger under transparency than under opaqueness. More specifically, the donor's fair evaluation process reduces the directors' tendency to allow management misallocation to a larger degree when expense reporting is transparent, relative to when expense reporting is opaque. Hence, I hypothesize a moderating effect of transparency on directors' willingness to allow management to allocate fundraising expenses to boost the program ratio. This hypothesis is stated formally below:

*H5: Given a low program ratio, donors' use of a balanced evaluation process reduces not-for-profit directors' likelihood of allowing management to allocate fundraising expenses to boost the program ratio to a larger extent when expense reporting is transparent than when expense reporting is opaque.*

There is tension in the above conjectures regarding the fair process effect in H2, H3 and H5 as a series of studies (e.g., Holmvall and Bobocel 2008; Van den Bos 2003; Brockner 2002; Van den Bos et al. 1999) showed that a boundary condition exists for the fair process effect. More specifically, if people believe that they *do not deserve* an unfavorable evaluation outcome in the first place, fair evaluation procedures do not mitigate, but may actually intensify, people's negative reactions to an unfavorable evaluation outcome (Holmvall and Bobocel 2008; Van den Bos 2003; Brockner 2002; Van den Bos et al. 1999).

These studies indicate that when people firmly believe that they do not deserve the anticipated unfavorable outcome regardless of their performance quality, they will not blame their low performance for the unfavorable evaluation outcome. They attribute the anticipated unfavorable outcome to evaluators' unfair evaluation process if evaluators adopt an unfair evaluation process. However, if evaluators adopt a fair evaluation process, people cannot attribute the unfavorable evaluation outcome to the fair evaluation procedures, because nothing is wrong with the evaluation process. Neither do they attribute the unfavorable evaluation outcome to their low performance. Frustration with

the inability to figure out why a fair evaluation process generates an undesirable outcome makes people more resentful to the unfavorable outcome, and thus they react more negatively to protest it. Such intensifying effect of procedural fairness on people's negative reactions to an unfavorable evaluation outcome is called the *reverse* fair process effect (Holmvall and Bobocel 2008; Van den Bos 2003; Brockner 2002; Van den Bos et al. 1999).

In the context of not-for-profit organizations, directors genuinely support the charitable cause of the organization for which they sit on the board. Hence from the start, directors may believe that the organization is doing something good and thus deserves donations regardless of the organization's financial and nonfinancial performance. Therefore, there is a possibility that I may find the reverse fair process effect rather than the fair process effect for H2, H3 and H5.

### **4.3 Research Method for Experiment 2**

#### **4.3.1 Experimental Design**

A full 2 (donor's evaluation focus: expense-focused vs. balanced) × 2 (organization's service performance: better than benchmark vs. worse than benchmark) × 2 (organization's expense disclosure: opaque vs. transparent) between-subjects experiment is used to test H2 to H5. The first two variables are manipulated as in Experiment 1. The third variable, the transparency of expense reporting, is operationalized as either a one-dimensional expense reporting format allowed by Section 4470 of the CICA Handbook designated "opaque" or as the two-dimensional expense reporting format suggested in the

new Section 4470 designated “transparent.” In the two-dimensional expense report, not-for-profit organizations disclose joint-costs (e.g. expenses related to an event that have both fundraising and educational purposes) by nature (e.g. printing, salary, renting) as well as by function (i.e., program, fundraising and administrative expenses). Compared to the one-dimensional format, the two-dimensional format explicitly discloses whether and how not-for-profit organizations allocate expenses among functions, reveals underlying spending activities of organizations, and therefore is more transparent. Figure 1 illustrates the difference between one-dimensional and two-dimensional expense reporting as used in this experiment.

#### **4.3.2 Participants and Procedures**

I recruited participants for Experiment 2 from the following groups: 1) members of the Institute of Chartered Accountants of Ontario (the ICAO), because many ICAO members sit on the boards of not-for-profit organizations (Lindsay 1997; Markham 2004; Statistics Canada 2005); 2) through directors of umbrella not-for-profit organizations, such as the United Way Canada, Community Foundation, and Imagine Canada; and 3) directors in not-for-profit organizations to which I have access through personal or institutional contacts. I requested the contact persons in each group to send an invitation to potential participants, with a follow-up email approximately one week later. In the end,

189 directors participated in Experiment 2.<sup>27</sup> Table 5 presents demographic information of participating directors.

[Insert Table 5 here]

Among the 189 participating directors, 63.30% report that their profession was accountant, and 34.39% had an accounting designation. Hence my sample represents financially literate directors that are more likely to be involved in monitoring financial reporting. As for what specific tasks the participating directors perform on the board, 60.11% of them were responsible for financial governance, 46.81% were responsible for fundraising and 28.19% were responsible for audit-related issues. In addition, 23.81% of participating directors were also auditors of other not-for-profit organizations.

On average, the organizations for which participants served as directors had 43.26% of annual revenues coming from donations. The participating directors had reasonable experience in fundraising; the mean score of fundraising experience is 6.95 on a scale with 1 anchored as “Never involved fundraising” and 10 as “Involved on numerous occasions”, which is significantly larger than the midpoint of the fundraising experience scale (i.e., the score of 5.5) ( $t=6.49$ ,  $p<0.0001$ ). In terms of how concerned they are about the effect of the program ratio on donations, the mean score is 5.52 on a scale with 1 denoted as “Not at all” and 9 as “To a large extent”, which is significantly larger than the midpoint of the scale (i.e., the score of 5) ( $t=2.85$ ,  $p=0.005$ ). Overall, it appears the

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<sup>27</sup> Initially, 196 directors participated in Experiment 2, but 7 directors did not finish the experimental questionnaire resulting in a final sample of 189 participating directors.

participating directors were generally capable of understanding and performing the experimental task regarding expense allocation in a fundraising context.

The procedures for Experiment 2 are the same as those in Experiment 1. I use an on-line questionnaire to solicit participants' responses. All participants are randomly assigned to one of eight experimental cells. Randomization appears to be successful as there are no significant demographic differences across experimental cells (all  $p$ 's  $\geq 0.104$ ).<sup>28</sup>

### **4.3.3 Experimental Case**

The experimental case used in Experiment 2 is similar to that of Experiment 1, but differs in the following aspects. First, since Experiment 2 is situated in a scenario where the organization's program ratio fails to meet donors' expectations (i.e., a low program ratio), participants in all eight conditions of Experiment 2 are told that prior to management's proposed expense misallocation the program ratio is below the benchmark, set at the national average program ratio. Second, the experimental case adds content regarding management expense misallocation. More specifically, all participants are instructed to assume the role of a director for a family center. They are told that the family center incurred \$400,000 of expenses in a special campaign, because the center needs to develop alternative funding sources to replace their governmental funding due to

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<sup>28</sup> Five demographic variables, however, are marginally significantly associated with the dependent variable. They are: 1) the annual revenue of the not-for-profit organization for which participants serve as directors; 2) participant's educational background; 3) participant's experience with audit issues on the board; 4) participant's accounting designation; and 5) participant's experience in dealing with expense allocation issues in the fundraising context. I choose two of them as control variables: the annual revenue of the not-for-profit organization for which participants serve as directors (i.e., SZ) and participant's accounting designation (i.e., DESGN). Please see Section 4.3.6 for the detailed selection process of control variables.

sudden government budget cuts. The expenses associated with education and volunteer recruitment in the special campaign are allowed to be reported as “Charitable Program Expenses” in the financial statements according to Canadian GAAP, while the remaining expenses should be reported as “Fundraising Expenses”. Due to a volunteer misinterpreting the task, the centre did not track the dollar amount or the staff hours spent on each event in this special campaign. Participating directors learn that management roughly estimates that \$100,000 should be reported as “Charitable Program Expenses”. However, if \$100,000 were reported as “Charitable Program Expenses”, the centre’s program ratio would be 8 percentage points lower than the national average. Hence, donors sensitive to the program ratio may not donate money to the centre due to the program ratio being below the national average. Therefore, the center’s management proposes to allocate all of the \$400,000 campaign expenses to “Charitable Program Expenses”. As such, the program ratio would be 10 percentage points higher than the national average, and thus the possibility of receiving donations from donors considering the program ratio would be higher.

Participants also receive information about donors’ evaluation process (balanced vs. expense-focused), the transparency of the center’s expense report in financial statements (transparent vs. opaque) and the center’s service performance (relatively good vs. poor relative to the benchmark). Finally participants are told that at an upcoming board meeting, they will be discussing whether to allow management’s proposed allocation. A post-experiment question asks participants whether they believe that management’s

proposed allocation is unethical; the mean score of the answer to this question on an 8-point scale with 1 “ethical” to 8 “unethical” is 6.88, which is significantly larger than the midpoint of the scale ( $t=18.26$ ;  $p<0.0001$ ). Therefore, no matter whether participating directors have enough accounting knowledge to judge whether management’s proposed expense allocation violates GAAP, results indicate they tended to believe the proposed allocation was a misallocation of expenses.

#### **4.3.4 Independent Variables**

Three manipulated variables, the donors’ evaluation focus (EF), the organization’s service performance (SP) and the transparency of the organization’s expense reporting (TR), are independent variables. The first two independent variables, the donors’ evaluation focus (EF) and the organization’s service performance (SP), are defined as in Experiment 1. The third variable “the transparency of expense reporting” (TR) is a dichotomous variable. In the transparent expense reporting conditions, participants are presented with the two-dimensional format of expense reporting in the financial statements, and also told that “The reporting proposed by management allows donors to readily determine that the \$400,000 is allocated completely to ‘Charitable Programs’ expense and not to ‘Fundraising’ expense”, while in the opaque expense reporting conditions, participants are presented with the one-dimensional expense reporting format and also informed that “The reporting proposed by management does not allow donors to readily determine that the \$400,000 is allocated completely to ‘Charitable Programs’ expense”.

#### **4.3.5 Dependent Variable**

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

#### **4.3.6 Control Variables**

According to experimental methodologists (Schluchter and Forsythe 1985; Darlington 2010), covariate variables in a randomized experiment should include variables that are independent of the experimental manipulation(s), but may have an effect on the dependent variable or those variables that are typically not fully dealt with through random assignment. I measure participants' demographic characteristics as well as relevant variables that potentially impact the directors' decision about whether or not to allow management's proposed expense misallocation. These include the participant's opinion about the importance of the directors' monitoring role versus fundraising role, their familiarity with Section 4470 of the CICA Handbook, and their ethical judgment about management allocating fundraising expenses to charitable expenses (see post-experiment questions in Appendix B).

I find that the participants' answers to four post-experimental questions (that is, participants' general belief about the importance of service performance in obtaining

donations, participants' general belief about the relative importance of service importance vs. program ratio in obtaining donations, participants' familiarity with Section 4470 of the CICA Handbook, and participants' ethical judgment on management's proposed misallocation) are significantly or marginally significantly different across eight experiment cells (all p-values  $\leq 0.066$ ).

In addition, I test the association of each post-experimental question as well as each demographic variable to the dependent variable (LKDAgree). I find that the following 6 variables are significantly or marginally significantly negatively associated with the dependent variable: 1) participant's general belief about the importance of service performance in obtaining donations ( $F_{(1, 186)} = 3.85$ ,  $p = 0.051$ ), 2) the annual revenue of the not-for-profit organization for which participants serve as directors ( $F_{(5, 183)} = 2.07$ ,  $p = 0.071$ ), 3) participant's educational background ( $F_{(4, 184)} = 3.77$ ,  $p = 0.006$ ), 4) participant's experience with audit issues on the board ( $F_{(1, 186)} = 4.85$ ,  $p = 0.029$ ), 5) participant's accounting designation ( $F_{(1, 187)} = 6.59$ ,  $p = 0.011$ ) and 6) participant's judgment of the ethicality of management's proposed misallocation ( $F_{(1, 187)} = 69.52$ ,  $p < 0.0001$ ). One variable, participant's experience in dealing with expense allocation issues in the fundraising context, is marginally significantly positively associated with the dependent variable ( $F_{(1, 184)} = 2.94$ ,  $p = 0.088$ ).

In total, I identified 9 variables that are either significantly different across eight experimental cells or significantly associated with the dependent variable. Theoretically, I should include all the identified variables as control variables for hypothesis testing

(Schluchter and Forsythe 1985). However, some of the identified potential covariate variables are causally related with each other or highly correlated. For example, familiarity with the CICA Handbook is determined by whether the participant has an accounting designation ( $F_{(1, 187)} = 29.29, p < 0.0001$ ). Therefore, including all these variables may cause multicollinearity. Further according to Schluchter and Forsythe (1985) and Darlington (2010), using too many covariates may lower the precision of the estimate of the treatment's effect. Therefore, following Schluchter and Forsythe (1985) and Darlington (2010), I use the backward deletion process to determine which covariates should be included in hypothesis testing. Three steps are needed:

- 1) Predict the dependent variable LKDAgree from all the above identified potential covariates (note: omitting independent variables EF, SP, and TR at this stage);
- 2) Delete the least significant covariate from the regression, re-compute the regression, again delete the least significant covariate;
- 3) Keep repeating the above two procedures until all the t values for all regressors are 1.42 or above, or F values are 2 or above.

In the end, I identified three variables that should be controlled for in hypothesis testing: 1) participant's judgment of unethicality of management's proposed misallocation (labeled ETHICAL), which is measured on an 8-point scale from 1 "Ethical" to 8 "Unethical"; 2) the annual revenue (size) of the not-for-profit organization (denoted SZ), which is classified into six categories: less than \$ 100,000, \$100,000 to \$499,999, \$500,000 to \$999,999, \$1,000,000 to \$4,999,999, \$5,000,000 to \$9,999,999,

and larger than \$10,000,000; and 3) the participant's accounting designation (denoted DESIG), which equals to 1 if the participant has an accounting designation and 0 otherwise.<sup>29</sup>

## 4.4 Results of Experiment 2

### 4.4.1 Manipulation Checks

Participants are asked to indicate on a 9-point scale (from -4 “Strongly disagree” to +4 “Strongly agree”) whether they agree with each of three statements that are used to check if participants attended to the experimental manipulations. Participants assigned to the group evaluated by balanced donors agree significantly less with the statement “The potential new large donor identified by the Executive Director makes donation decisions based **solely** on the program ratio” than participants assigned to the group evaluated by expense-focused donors (the mean score of Balanced vs. Expense-focused = -2.09 vs. 2.49;  $t=13.54$ ,  $p<0.0001$ ). Participants in the conditions where service performance improves agree significantly more with the statement “Overall, the Centre served **more clients with improved service quality** this year than last year” than those in the conditions where service performance declines (the mean score of Improved Service vs. Declined Service= 2.76 vs. -2.81;  $t= -20.62$ ,  $p<0.0001$ ). Finally, participants assigned to the conditions where the organization's expense disclosure is transparent agree with the statement “Management's proposed reporting of expenses in the financial statements

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<sup>29</sup> Results of the hypothesis testing including all 9 identified potential covariate variables are similar to those from the hypothesis testing including the 3 covariate variables identified here, but all VIFs are elevated (VIF for EF increases by 0.303, VIF for TR increases by 0.161, VIF for EF\*SP increases by 0.274, and VIF for EF\*TR increases by 0.565).

**allows donors to determine** that the \$400,000 special campaign expenses were allocated completely to ‘Charitable Programs’ expense” to a larger extent than those participants in the conditions where the organization’s expense reporting is opaque (the mean score of Transparent vs. Opaque = 2.25 vs. - 0.99;  $t = 7.55$ ,  $p < 0.0001$ ). Therefore, the manipulations of the donor’s evaluation focus, the organization’s service performance and the transparency of the organization’s expense disclosures are all successful.

Furthermore, I conducted an ANOVA using perceived procedural fairness (PFair) as the dependent variable and the three manipulated variables, the donor’s evaluation focus (EF), the organization’s service performance (SP) and the organization’s expense disclosure transparency (TR) as independent variables. The results (not tabulated) indicate that the main effect of the donor’s evaluation focus (EF) is significant ( $F_{(1, 181)} = 56.85$ ,  $p < 0.0001$ ), but the interaction between the donor’s evaluation focus and the organization’s service performance (EF\*SP) is not significant ( $F_{(1, 181)} = 0.03$ ,  $p = 0.870$ ). The further planned contrast tests show that no matter whether the organization’s service performance is relatively good or poor, directors consider the donors’ balanced evaluation process significantly procedurally fairer than the donors’ expense-focused evaluation process (all  $p$ -values  $\leq 0.010$ ). These results replicate the results of Experiment 1 and further confirm that the assumption validated in Experiment 1 about directors’ procedural fairness perceptions is still held in Experiment 2.

#### **4.4.2 Hypothesis Testing**

Descriptive statistics for the dependent variable (LKDAgree), the likelihood that directors would agree with management’s proposal to allocate fundraising expenses to boost the program ratio, are documented in Figure 3 and Table 6 Panel B. The raw means of LKDAgree in eight cells range from 1.70 to 3.53, all significantly less than the midpoint of the scale (i.e., the value of 5 on a 9-point scale with 1 “Very unlikely and 9 “Very likely) (all p-values  $\leq 0.023$ ).<sup>30</sup> This finding indicates that directors play a monitoring role to not allow management’s expense misallocation.

[Insert Figure 3 and Table 6 here]

#### 4.4.2.1 Test of H2: Effect of Donors’ Evaluation Focus on Directors’ Oversight

H2 predicts a main effect of donors’ evaluation focus (EF) on directors’ oversight of management expense misallocation; more specifically, directors are less likely to allow management to allocate fundraising expenses to charitable expenses when donors adopt a balanced (fair) evaluation process than when donors adopt an expense-focused (unfair) evaluation process. The ANCOVA results reported in Table 6 (Panel A) indicate a significant main effect of EF ( $F_{(1, 174)} = 4.22, p = 0.042$ ). However, the planned contrast for testing H2 reported in Table 6 (Panel C) indicates that the significant main effect of EF is in the opposite direction to what H2 predicts (the adjusted mean of LKDAgree for Balanced vs. Expense-focused = 2.79 vs. 2.19;  $t = 2.20, p = 0.029$ ). This finding demonstrates that, given a low program ratio, the donors’ adoption of a balanced (fair)

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<sup>30</sup> I also measured the likelihood that the participating directors believe other members of the board would agree with the management’s proposed expense misallocation. The mean scores of this likelihood in eight cells are all less than the midpoint of the scale (i.e., the value of 5 on a 9-point scale with 1 “Very unlikely and 9 “Very likely), but not all mean scores are statistically significantly less than the midpoint (all p-values  $\leq 0.687$ ).

evaluation process increases, rather than decreases, directors' tendency to allow management's proposed expense misallocation. Therefore, H2 is not supported.

#### 4.4.2.2 Test of H3: Moderating Effect of Service Performance

H3 predicts that the organization's service performance moderates the effect of donors' evaluation focus on directors' tendency to endorse management's proposed expense misallocation, with the fair process effect being stronger in the group with relatively good service performance than in the group with relatively poor service performance. Although the ANCOVA results in Table 6 (Panel A) indicate a marginally significant interaction between service performance and donors' evaluation focus (EF\*SP:  $F_{(1, 174)} = 3.72, p = 0.055$ ), the planned contrasts presented in Table 6 (Panel C) indicate that the interaction is not consistent with the prediction of H3.

Planned contrasts indicate there is no difference in directors' willingness to allow management's proposed expense misallocation between the balanced and expense-focused evaluation process conditions when the organization has relatively good service performance (the adjusted mean score of LKDAgree for Balanced vs. Expense-focused: 2.58 vs. 2.16;  $t = 1.10, p = 0.276$ ). Unexpectedly, I find a significant increase in directors' willingness to agree with management's misallocation of expenses in the balanced compared to the expense-focused condition when service performance is poor (the adjusted mean score of LKDAgree for Balanced vs. Expense-focused = 3.12 vs. 2.16;  $t = 2.45, p = 0.016$ ). Hence, H3 is not supported.

#### 4.4.2.3 Test of H4: Effect of Transparency on Directors' Oversight

H4 predicts directors will be less likely to allow management's proposed expense misallocation in the context of transparent expense reporting compared to opaque expense reporting. As indicated in Table 6 (Panel A), I find a significant main effect of transparency (TR) in the overall ANCOVA ( $F_{(1, 174)} = 4.72, p = 0.031$ ). The further planned comparison presented in Table 6 (Panel C) indicates, consistent with H4, transparency reduces the directors' tendency to endorse management's allocation of fundraising expenses to charitable expenses to boost the program ratio (the adjusted mean score of LKDAgree for Transparent vs. Opaque = 2.23 vs. 2.77;  $t = -2.01, p\text{-value} = 0.046$ ). These results provide support for H4.

#### 4.4.2.4 Test of H5: Interaction between Donors' Evaluation Focus and Transparency

Finally, H5 predicts a moderating effect of expense reporting transparency on donors' evaluation focus. The overall ANCOVA results presented in Table 6 (Panel A) indicate the interaction between donors' evaluation focus and transparency is not significant (EF\*TR:  $F_{(1, 174)} = 0.47, p = 0.496$ ). Further, the planned contrasts presented in Table 6 (Panel C) do not indicate a stronger effect of donors' balanced evaluation process as compared to donors' expensed focused evaluation process on directors' tendency to agree with management's proposed expense misallocation when expense reporting is transparent (the adjusted mean score of LKDAgree for Balanced vs. Expense-focused = 2.52 vs. 2.01;  $t = 1.47, p\text{-value} = 0.145$ ) or when expense reporting is opaque (the adjusted mean score of LKDAgree for Balanced vs. Expense-focused = 3.07 vs. 2.51;  $t = 1.32, p\text{-value} = 0.191$ ). Hence H5 is not supported.

#### 4.4.3 Additional Analysis

I conduct additional analysis to enhance my understanding of the above findings in Experiment 2.

##### 4.4.3.1 Fairness Boundary Condition and the Reverse Fair Process Effect in H2 and H3

H2 predicts a fair process effect; that is, directors are less likely to endorse management's proposed expense misallocation when donors adopt a balanced (relatively fair) evaluation process than when donors adopt an expense-focused (relatively unfair) evaluation process. Further, H3 predicts that a stronger fair process effect will be found in the context where the organization's service performance is relatively good than is the case where the organization's service performance is relatively poor. However inconsistent with predictions, the results of H2 indicate that the donors' adoption of a balanced (relatively fair) evaluation process significantly increases, not decreases, the directors' tendency to endorse management's proposed expense misallocation. Furthermore, the results for H3 demonstrate that such negative effect only occurs in the context of the organization's service performance being relatively poor, but not relatively good.

The results of H2 and H3 demonstrate that I do not find the fair process effect, as predicted by H2 and H3, but the reverse fair process. A series of studies found that if people believe that they *do not deserve* an unfavorable evaluation outcome in the first place, the reverse fair process effect, rather than the fair process effect, occurs (Holmvall and Bobocel 2008; Van den Bos 2003; Brockner 2002; Van den Bos et al. 1999). In light

of the possible boundary condition for the effect of procedural fairness, I examine directors' assessment of deservedness for donations (labeled *Deserve*), which is measured on a 9-point scale with 1 "not at all" to 9 "to a large extent" in response to the question "Given the Centre's performance this year, to what extent does the Centre deserve the financial support of new donors?".

The mean scores of *Deserve* in all eight experimental cells range from 4.78 to 7.36 (see Table 7). Comparing to the lower end-point of the scale (i.e., the value of 1 "not at all"), the mean scores on *Deserve* in all cells are significantly larger (all  $p$ -values  $< 0.0001$ ). This may indicate that directors believe the organization deserves donations to some extent. Alternately, the organization does *not deserve* the unfavorable outcome (i.e., no donations) no matter whether the organization's service performance is relatively good or poor. This assessment of deservedness may result from directors' genuine support for the charitable cause of the organization. Specifically, directors believe that the organization is doing something good and thus deserves donations. Furthermore, as Table 8 shows, the mean scores on *Deserve* in the cells with good service performance are significantly larger than the mean scores in the cells with poor service performance (all  $p$ -values  $< 0.002$ ).

[Insert Table 7 and Table 8 here]

According to the reverse fair process effect, if donors adopt an unfair evaluation process (i.e., expense-focused evaluation process), directors will attribute the unfavorable donation decision to that unfair process. This resolves the inconsistency between the

anticipated unfavorable outcome and their belief about the organization's deservedness for donations. However, if donors adopt a fair evaluation process (i.e., balanced evaluation process), directors expect that the fair evaluation process should generate a desirable donation outcome. If the anticipated outcome via the donors' fair evaluation process is then unfavorable, directors cannot figure out why a fair evaluation results in an undesirable outcome and thus feel more resentful to the unfavorable outcome. The empirical results are consistent with the boundary condition as I discussed at the end of the hypothesis development section; that is, the donor's adoption of a balanced (fair) evaluation process increases, rather than decreases, the directors' tendency to allow management's expense misallocation.

Further, in the hypothesis development of H2 and H3, I assume that directors *anticipate an unfavorable outcome* (i.e., less likely to obtain donations) due to the organization's low program ratio. This assumption is necessary to predict H2 and H3, because according to prior studies (e.g., Brockner and Wiesenfeld 1996), only an unfavorable outcome can trigger people's resentment toward the outcome and initiate a sense-making process. A series of studies (See 2009; Brockner et al. 2003; Cropanzano and Greenberg 1997; Brockner and Wiesenfeld 1996; Rutte and Messick 1995) indicated that the sense-making process triggered by the anticipated unfavorable outcome is essential for perceived procedural fairness to influence people's decision-making and their subsequent behavior. Although I believe my assumption about the anticipated

unfavorable outcome in the hypothesis development is reasonable, failure to support H2 and H3 indicate a need to test whether this assumption is supported by the data.

To perform this test, I examine the directors' assessment of the likelihood that the organization will receive donations (i.e., LKDDonate). This judgment is captured on a 9-point scale with 1 "unlikely" to 9 "likely" in response to the question "Given the Centre's performance this year, how likely is it that the Centre will obtain a substantial donation from this potential new large donor?" If the score of LKDDonate is less than the midpoint of the scale (i.e., a score of 5), directors anticipate an unfavorable donation outcome; otherwise not. As documented in Table 9, the mean scores of LKDDonate in all cells with poor service performance are significantly or marginally significantly less than the midpoint of the scale (all p-values  $\leq 0.067$ ). This result indicates that director participants believe the organization is unlikely to obtain donations and thus anticipate an unfavorable outcome when the organization has relatively poor service performance. However, the mean scores of LKDDonate for those cells with improved service performance are either statistically equal to (p-values  $> 0.861$ ) or significantly larger than (p-values  $< 0.002$ ) the midpoint of the scale. So I find that in the context of the organization's service performance being relatively good, director participants believe it is unlikely that donors will not donate; alternatively speaking, directors *do not* anticipate an unfavorable outcome. Hence, my assumption is only valid when the organization has a relatively poor service performance, but not when the organization has a relatively good service performance.

[Insert Table 9 here]

Although my assumption that directors anticipate an unfavorable donation outcome is not supported by the data for the group with the relatively good service performance, the finding makes some sense considering that directors weigh highly the organization's service performance when evaluating the organization's performance themselves (please see my detailed arguments about this point in Section 4.2.1). Prior studies (e.g., Camerer et al. 1989) find that people tend to be influenced by the "curse of knowledge"; that is, people are unable to ignore the additional information they possess in predicting the judgments of others. Hence, directors may not be able to totally disregard their own knowledge when assessing how likely donors will donate. They may project that donors also heavily weigh the organization's service performance and will donate as long as the organization's service performance is good. Therefore, directors *appear not to* anticipate an unfavorable outcome when the organization has relatively good service performance. This helps to explain why in tests of H3 the effect of the donors' evaluation focus is only significant in the group with relatively poor service performance, while in the group with relatively good service performance, the effect of donors' evaluation focus is not significant.

#### 4.4.3.2 Potential Alternative Explanation for Findings of H2 and H3

Kachelmeier and Towry (2002) and Franciosi et al. (1995) show that people's preference for fairness can be overpowered by wealth maximization. Since directors in not-for-profit organizations have responsibility for raising money and keeping the

organization's financial sustainability, directors' decisions to allow management's expense misallocation may be purely driven by the desire to obtain donations, but not by the influence of perceived fairness of donor's evaluation process. Hence, the less likely the organization is to obtain donations, the more likely directors are to endorse management expense misallocation to boost the program ratio and attract donations. As the donors' adoption of a balanced vs. expense-focused evaluation process may cause directors to perceive a different likelihood that the organization will obtain donations, the differential donation likelihood in the donors' balanced evaluation process vs. the donors' expense-focused evaluation process conditions could be an alternative explanation for the effect of donors' evaluation focus that I find for H2 and H3. Therefore, I examine the directors' assessment of the likelihood of the organization obtaining donations (i.e., LKDDonate).

As shown in Table 10, when the organization's service performance is poor, the mean scores of LKDDonate in the conditions where donors adopt a balanced evaluation process are not significantly different from those in the conditions where donors adopt an expense-focused evaluation process (all p-values  $\geq 0.820$ ). However, I find a significant effect of the donors' evaluation focus when the organization's service performance is relatively poor; more specifically, the directors' tendency to allow management expense misallocation is significantly higher when donors adopt a balanced evaluation process compared to when donors adopt an expense-focused evaluation process ( $p=0.016$ ).

In contrast, when the organization's service performance is good, the mean scores of LKDDonate in the conditions where donors adopt the balanced evaluation process are significantly or marginally significantly higher than those in the conditions where donors adopt the expense-focused evaluation process (all p-values <0.063), but I do not find directors' tendency to endorse management expense misallocation is significantly different between the expense-focused and balanced groups (p=0.276). Therefore, wealth maximization cannot explain the findings for the effect of donors' evaluation focus I find in H2 and H3.

[Insert Table 10 here]

#### 4.4.3.3 Risk of Detection and H4

Results support the prediction of H4; that is, the transparency of the organization's expense reporting reduces the directors' tendency to endorse management's proposed expense misallocation. In developing the hypothesis, I argued that the effect of transparency is due to the increased risk that the expense misallocation will be detected. I measure the directors' perceived detection risk using a 9-point scale with -4 "Strongly disagree" to +4 "Strongly agree" in response to the question "Management's proposed reporting of expenses in the financial statements allows donors to determine that the \$400,000 special campaign expenses were allocated completely to Charitable Programs expense". As shown in Table 11, the mean scores of the detection risk measure are significantly higher in the conditions where the organization's expense reporting is

transparent than those in the conditions where the organization's expense reporting is opaque (all p-values  $\leq 0.015$ ). Therefore, H4 is supported.

[Insert Table 11 here]

#### 4.4.3.4 Perceived Uncertainty and H5

To investigate the reason why the moderating effect of transparency on donors' evaluation focus predicted by H5 is not significant, I examine directors' perceived uncertainty about the consequences of endorsing management's expense misallocation, because I argued that uncertain feelings elicited by transparent expense reporting vs. opaque expense reporting drive the moderating effect of transparency. The directors' perceived uncertain feelings are measured by four 9-point scales (from 1 "Very uncertain" to 9 "Very certain") respectively in response to the following four questions:

*If, as management suggests, the Centre reported all of the \$400,000 in campaign expenses as "Charitable Programs" expense, how certain are you that*

- 1) the potential new large donor will question the total amount of "Charitable Programs" expense and the program ratio reported in the Centre's annual report?*
- 2) donors in general will question this allocation?*
- 3) auditors will question this allocation?*
- 4) the auditors will propose an adjustment to materially decrease the \$400,000 allocation of campaign expenses to "Charitable Programs" expense?*

The results presented in Table 12 indicate that directors do not perceive higher uncertain feelings under transparency, compared to under opaqueness (all p-values  $\geq 0.446$ ). This

contradicts the argument for developing H5, and may explain why H5 is not supported.

[Insert Table 12 here]

#### **4.5 Conclusions: Experiment 2**

Experiment 2 examines, when the organization's program ratio is below donors' expectations, whether and how the donors' evaluation process (expense-focused vs. balanced) and the organization's expense disclosure transparency (opaque vs. transparent) impact the directors' monitoring of management's expense misallocation. The results show that the transparency of expense disclosure increases directors' oversight of management's expenses in that directors are less likely to endorse an allocation of fundraising expenses to artificially increase the program ratio.

However, the effect of donors' evaluation focus appears to be contingent on directors' assessment of whether the organization can obtain donations from donors. Specifically, when the organization has relatively good service performance, directors anticipate that the organization can obtain donations from donors despite its low program ratio. The anticipated favorable donation outcome appears not to trigger directors' resentment toward the outcome. Thus there is no role for procedural fairness. This may explain why I do not find a significant effect of donors' evaluation focus on directors' oversight when the organization's service performance is good.

In contrast, when the organization has relatively poor service performance, directors may anticipate that donors will not donate (i.e., an unfavorable donation outcome), and meanwhile they firmly believe that the organization does not deserve an unfavorable

outcome despite its poor financial and nonfinancial performance. In their sense-making process, directors may attribute the anticipated unfavorable outcome to the unfair donors' evaluation process and thus resolve their question if donors adopt an expense-focused (relatively unfair) evaluation process. But when donors adopt a balanced (relatively fair) evaluation process, donors may find it difficult to blame the unfavorable outcome on the fair evaluation process and become more resentful to the donor's unfavorable decision, and thus react more negatively to protest it by endorsing a misallocation of fundraising expenses to boost the program ratio. Further analysis indicates that this finding is not driven by directors' desire to maximize donations, because when the organization has poor service performance, directors believe that the likelihood that donors will donate is not significantly different in the context of donors adopting a balanced evaluation process from in the context of donors using an expense-focused evaluation process.

## Chapter 5

### Conclusions and Implications

Management of not-for-profit organizations may misallocate fundraising expenses to boost the program ratio to aid in soliciting donations by making the organization appear to be devoting more resources to charity (e.g., Keating et al. 2008; Krishnan et al. 2006). Although normative studies claim that the board of directors provides assurance against management's expense misreporting (Greenlee et al. 2007; Gill 2005; Fama and Jensen 1983), little research shows empirical evidence about what directors really do in the face of management's expense misreporting (Brown and Guo 2010; Callen et al. 2003).

Studies (e.g., Gill 2005; O'Regan and Oster 2005; Miller 2002) suggest that directors in not-for-profit organizations are monitors protecting the not-for-profit organization from management wrongdoing, and that in many cases directors also act as fundraisers for the organization. Taking multiple responsibilities means that directors in not-for-profit organizations have to balance their oversight role as monitors and their quasi-management role as fundraisers if they know that management misallocates expenses to boost the program ratio to impress donors. The balancing process is particularly worth examining now because two factors that influence directors' decision in the context of fundraising are in the process of change. First, the AcSB suggests that not-for-profit organizations adopt a transparent format to disclose expense allocation information, although they are still permitted the use of an opaque format (the CICA Handbook 2009). Second, the donors' evaluation focus seems to be changing. Although donors tend to

focus on the organization's financial indicators to decide whether to donate to the organization, there is a trend towards donors considering financial as well as nonfinancial indicators of performance if both types of indicators are available (e.g, Weisbrod and Dominguez 1986; Khumawala and Gordon 1997; Okten and Weisbrod 2000; Parson 2007; Silverman and Betty 2007). The coexistence of the two institutional factors poses an important question: which regime should be promoted by regulators so that directors oversee management's expense misallocation more diligently? This study uses the advantage of the experimental method to create different regimes, allowing me to empirically examine whether and how the transparency of expense reporting and the donors' evaluation process could individually and also interactively affect the director oversight of management's proposed expense misallocation.

I conduct two experiments. Experiment 1 is used to validate the assumption underlying the research question of this study: procedural fairness concerns arise in directors' minds due to donors' evaluation focus. In addition, Experiment 1 demonstrates how two dimensions of donors' evaluation procedures (i.e., symbolic and informational characteristics, and the capacity of donors' evaluation procedures to generate a favorable donation outcome) play a role in the process that directors develop procedural fairness judgments in a fundraising context. The results of Experiment 1 show that only the symbolic and information characteristic of donors' evaluation process (i.e., accuracy) contributes to forming procedural fairness perceptions in the context of my study, and

directors perceive a balanced evaluation process to be procedurally fairer than an expense-focused evaluation process.

Experiment 2 directly addressed the fundamental research question of this study. It is situated in a context where the organization's program ratio is below donors' expectation and management proposes to misallocate fundraising expenses to boost the program ratio in order to impress donors and increase the chance of the organization obtaining donations. As such, directors need to balance their monitoring role with their concern for the organization continuing to exist and do good work when management proposes expense misallocation.

The results of Experiment 2 show that directors do tend to play a monitoring role by not allowing management's expense misallocation. Further as predicted, the transparency of expense disclosures increases directors' monitoring of management's expense allocations by reducing directors' tendency to endorse an allocation of fundraising expenses to boost the program ratio. Additional analysis shows that it is the directors' perceived higher risk of detection by donors and other third parties under more transparent reporting that is behind the positive effect of transparency on directors' oversight. This finding supports my theorizing about the effect of the expense reporting transparency.

The results of Experiment 2, however, indicate that although the balanced evaluation process is perceived to be procedurally fairer by directors, it decreases the directors' monitoring of management's expense allocation compared to the expense-focused

evaluation process. The negative effect of the donors' balanced evaluation process occurs when the organization's service performance is relatively poor, but not when the organization's service performance is relatively good. Further analysis shows that as directors genuinely support the not-for-profit organization's charitable cause, they expect donors to donate to the organization even when the organization's service performance is relatively poor. Meanwhile directors continue to believe that a fair evaluation process should generate a desirable evaluation outcome. So when the anticipated outcome is not what directors hope for and at the same time donors adopt a balanced (fair) evaluation process, directors feel frustrated with the inability to understand how the donors' fair evaluation process can lead to an undesirable outcome, and thus they feel more resentful toward the unfavorable donation decision and tend to allow management's expense misallocation in order to reverse the unfavorable outcome. However, when the organization's service is relatively good, directors anticipate a favorable donation outcome from donors. Anticipating a favorable outcome makes directors less likely to further examine procedural fairness to uncover the reasoning behind the favorable donation outcome. Therefore, I do not find a significant effect of donors' evaluation process when the organization has relatively good service performance.

My finding that the donors' adoption of the balanced evaluation process reduces the directors' oversight of management expense misallocation is particularly interesting in light of recent research and professional reports advocating a more comprehensive approach to evaluating not-for-profit organizations. The Association of Fundraising

Professionals (2008), Herman and Renz (2008), Silverman and Beatty (2006, 2007), Silvergleid (2003), Campbell (2002) and Kaplan (2001) all indicate that the balanced evaluation process is a fairer evaluation process that both donors and not-for-profit organizations would prefer. However, this study suggests that the balanced evaluation process can have a negative impact on directors' oversight of management's expense misallocation and may have unintended consequences if donors wish directors to focus on monitoring the not-for-profit management on their behalf. Ironically, although the donors' adoption of expense-focused evaluation process is claimed to motivate management to misallocate expenses in not-for-profit organizations, it is the expense-focused evaluation process that can increase directors' oversight of management's expense misallocation and reduce management's expense misallocation.

Further research is needed to examine how to mitigate the negative effect of donors' balanced evaluation process on directors' oversight of management expense misallocation. For example, does the prior experience a director has both in for-profit organizations and not-for-profit organizations play a mitigating role? Does the reputation of the director also influence the director's monitoring intensity? Do directors at a higher stage of moral development are more likely to overcome the negative effect of donors' balanced evaluation process than those directors at a lower stage of moral development? These research questions may identify situations where the donors' balanced evaluation process is more desirable than the donors' expense-focused evaluation process when it comes to enhance the directors' oversight of management's expense misallocation.

There are limitations to my research. First, I constructed a scenario where the nonfinancial indicators for the not-for-profit organization's service performance in the experimental case can be easily measured and compared across peer organizations. However, in reality, it is inherently difficult and practically challenging to design a set of effectiveness measures that reflect needs of all stakeholders and are comparable across various not-for-profit organizations (Herman and Renz 2008, Campbell 2002, Kaplan 2001). Nonetheless, it is possible to judge whether the organization's service performance is relatively good or poor based on subjective evaluations of whether the organization provides service performance that meets expectations. I believe my experiment captures the essential elements of the quality of service performance by simplifying the measurements of service performance. Second, not all of my participants are directors with accounting expertise who can know whether the management's proposed allocation of fundraising expenses to charitable expenses violates GAAP. But in reality, not all not-for-profit organizations have accountants sitting on their board. Further, 63.30% of my participants are accountants. So, I believe my sample well represents the pool of directors who can influence the whole board on the issues regarding expense reporting of not-for-profit organizations. Third, to probe what is affecting the participants' monitoring judgments, I should have included a follow-up questionnaire to ask participating directors some qualitative process questions. A future short interview with directors can be conducted to complement to this study. Finally, my study does not address how management responds to the directors' oversight. After all,

the financial statements are the product of discussion and negotiation between management and directors. I leave this research question to future study.

There are at least three implications to be drawn from my research. First, I provide empirical evidence demonstrating that directors in not-for-profit organizations monitor management's expense misallocation, and further, the intensity of the directors' oversight is affected by their reactions to the institutional environment. Second, as expected by the Canadian Accounting Standards Board (the AcSB), the transparency of expense disclosures in financial statements improves the directors' motivation to monitor management's expense misallocation. Therefore, one possible response is for the AcSB to make the more transparent expense reporting a mandatory disclosure rather than a voluntary disclosure. Third, although more donors are adopting a balanced evaluation process to decide whether to donate to a not-for-profit organization, there appear to be unidentified consequences from this shift as directors decrease oversight of expense misallocation in response to donors' adoption of the balanced evaluation process. Meanwhile, advocacy groups (e.g., Imagine Canada) should be cautioned of the possible negative effect of the donors' adoption of the balanced evaluation process on directors' oversight if they encourage donors to adopt the balanced evaluation process. Finally, like the donors' balanced evaluation process, the balanced scorecard that is widely used in for-profit organizations also has a similar structural feature (i.e., considering both financial and nonfinancial measures). The findings regarding the negative effect of the donors' balanced evaluation process may also have implications for for-profit

organizations. Specifically, management in for-profit organizations should be aware that the balanced scorecard may have a similar unintended effect on employees.

**Figure 1 Expense Reporting Formats Allowed by Section 4470 of the CICA Handbook**

**(Manipulation of Expense Reporting Transparency)**

**Panel A:** Opaque One-dimensional Format of Expense Reporting

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

**Panel B:** Transparent Two-dimensional Format of Expense Reporting

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

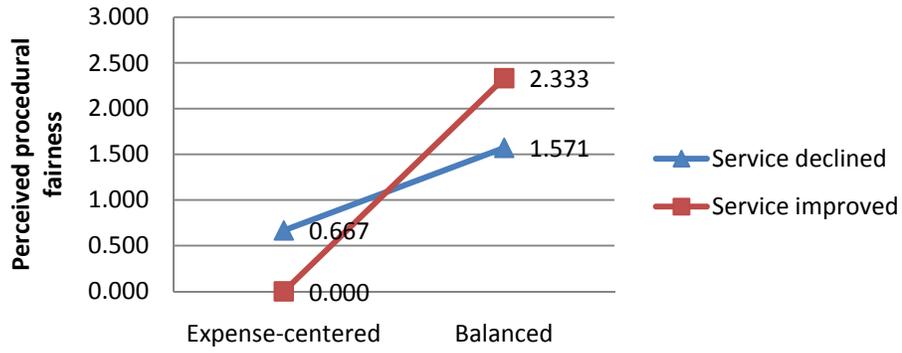
Note: Panel B is adapted from Section 4470 of the CICA Handbook and the guidance of the CRA (2009b): T3010B, Registered Charity Information Return, with accompanying forms and financial statements.

Available at: <http://www.cra-arc.gc.ca/chrts-gvng/chrts/prtng/rtrn/smpls-fnncl-eng.html>.

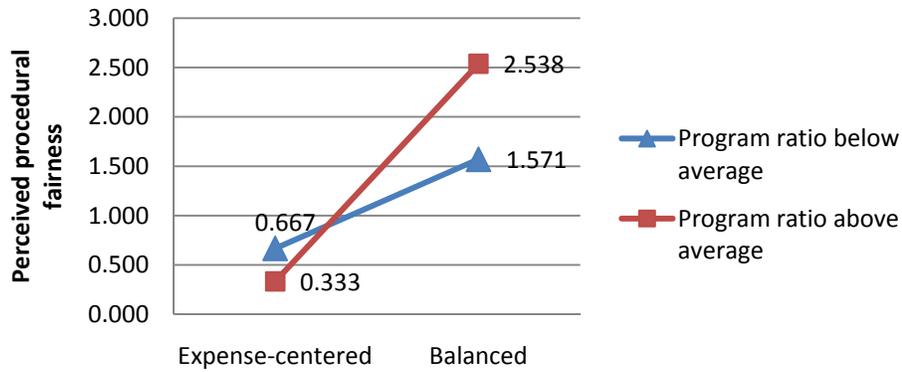
**Figure 2 Means of Directors' Perceived Procedural Fairness in Experiment 1**

(PFair)\*

**Panel A:** Group with low program ratio:



**Panel B:** Group with declined service performance:

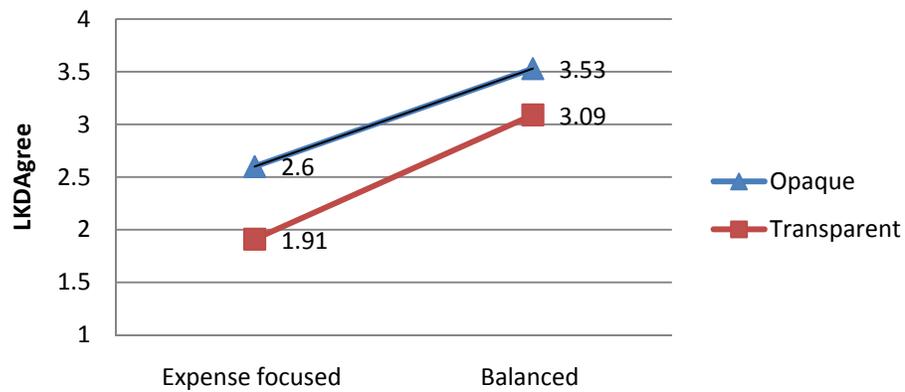


\*PFair is perceived procedural fairness of the donor's performance evaluation process, which is measured on a 9 point scale from -4 to 4, with -4 denoted "Very unfair" and 4 "Very fair".

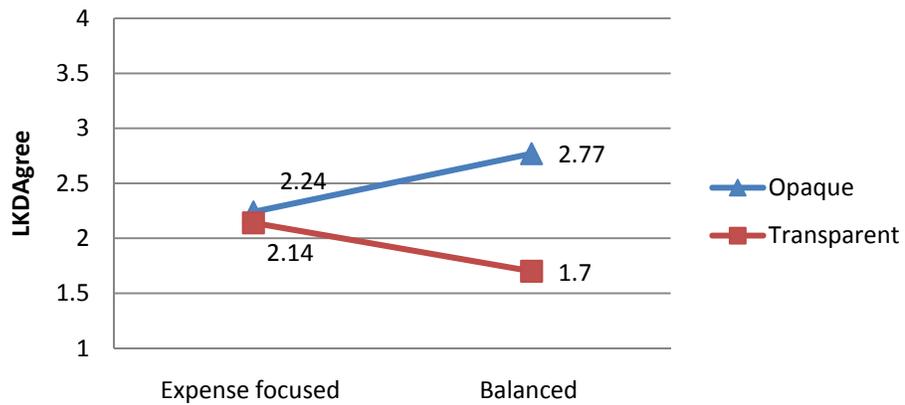
**Figure 3 LSMeans of Directors' Tendency to Allow Management's Proposed Expense Misallocation in Experiment 2**

(LKDAgree)\*

Service performance declined:



Service performance improved:



\*LKDAgree is directors' likelihood of agreeing with management's proposed expense allocation, which is measured on a 9 point scale from 1 to 9, with 1 denoted "Very unlikely" and 9 "Very likely".

**Table 1 Participant Profile for Experiment 1 (N = 93)**

		Frequency	
Age	26-40	7.53%	
	41-50	31.18%	
	51-60	43.01%	
	61-70	12.90%	
	over 70	5.38%	
Gender (% female)		31.11%	
Education	Secondary school	2.15%	
	Post-secondary diploma	11.83%	
	Bachelor's degree	38.71%	
	Master's/Ph.D. degree	34.41%	
	Other (e.g., law, medicine)	12.90%	
Accounting Designation		23.60%	
Current Profession	Accountant	31.25%	
	Lawyer	6.25%	
	Medical Doctor	3.13%	
	Engineer	17.19%	
	Other (e.g., professor)	42.19%	
Employment profile	Public company	7.69%	
	Large private company	7.69%	
	Medium size private company	9.89%	
	Small size private company	9.89%	
	Not-for-profit organization	23.08%	
	Government	27.47%	
Other organization	14.29%		
	Annual Revenue of Not-for-profit Organizations for which Participants Served as Directors (Note: If directors serve more than one organizations, this refers to the largest amount of annual revenues)	<\$ 100,000	12.35%
		\$100,000 to \$499,999	18.52%
		\$500,000 to \$999,999	12.35%
		\$1,000,000 to \$4,999,999	22.22%
		\$5,000,000 to \$9,999,999	9.88%
≥\$10,000,000		24.69%	

**Table 1 (Continued)**

		Frequency
Participant's Responsibility on the Board  (Note: The director could choose all that apply)	Financial Governance/Audit	64.52%
	Fundraising	45.16%
	Human Resources	41.94%
	Nominations	35.48%
	Planning	64.52%
	Bylaws and Policy	51.61%
	Other	18.28%

**Table 2 Mean (Standard Deviation) of Procedural Fairness Assessment of Donors’  
Evaluation Process (PFair)**

<b>Performance</b>		<b>Evaluation Focus</b>	
		Expense-focused	Balanced
Service declined:	Program ratio above average	$\mu_1^a=0.333$ (2.469) ( $n^b=15$ )	$\mu_2=2.538$ (1.613) ( $n=13$ )
	Program ratio below average	$\mu_3=0.667$ (1.952) ( $n=15$ )	$\mu_4=1.571$ (2.063) ( $n=21$ )
Service improved :	Program ratio below average	$\mu_5=0.000$ (2.287) ( $n=14$ )	$\mu_6=2.333$ (1.676) ( $n=15$ )

<sup>a</sup>  $\mu$  refers to the mean score of PFair.

<sup>b</sup>  $n$  refers to the number of participants.

Note: Dependent variable is perceived procedural fairness of donor’s performance evaluation process (PFair), which is measured on a 9 point scale from -4 to 4, with -4 denoted “Very unfair” and 4 “Very fair”.

**Table 3 Procedural Fairness Assessment of Donors' Evaluation Process (PFair):  
For Group with Low Program Ratio**

**Panel A:** Analysis of Variance (ANOVA) of Assessment of Procedural Fairness

Source	DF	Sum of Squares	Mean Square	F Value	Pr > F
EF <sup>a</sup>	1	41.545	41.545	10.31	0.002
SP <sup>b</sup>	1	0.036	0.036	0.01	0.925
EF*SP	1	8.086	8.086	2.01	0.162
Error	61	4.030	4.030		
	64	292.400			

<sup>a</sup> EF: Manipulation of donors' evaluation focus. EF=0 when donors make donations based solely on the program ratio (i.e., expense-focused donors); EF =1 when donors make donations based on both the program ratio and service performance (i.e., balance donors).

<sup>b</sup> SP: Manipulation of the organization's service performance. SP=0 when the organization's service performance is worse than last year and its peer organizations' service performance; SP=1 when the organization's service performance is better than last year and its peer organizations' service performance.

**Panel B:** Planned contrasts for tests of H1 and the alternative hypotheses H1<sub>alt</sub> and H1<sub>balt</sub>

		Contrasts	Mean difference (Standard error)	p- value*
Program ratio below average:	Service declined:	Expense-focused vs. Balanced	$\mu_3 - \mu_4 = -0.90$ (0.68)	<b>0.094</b>
	Service improved	Expense-focused vs. Balanced	$\mu_5 - \mu_6 = -2.33$ (0.75)	<b>0.001</b>

\*One-tailed p-value

**Table 4 Procedural Fairness Assessment of Donors' Evaluation Process (PFair):  
For Group with Declined Service Performance**

**Panel A:** Analysis of Variance (ANOVA) of Assessment of Procedural Fairness

<b>Source</b>	<b>DF</b>	<b>Sum of Squares</b>	<b>Mean Square</b>	<b>F Value</b>	<b>Pr &gt; F</b>
EF <sup>a</sup>	1	37.504	37.504	8.82	0.004
PR <sup>b</sup>	1	1.557	1.557	0.37	0.547
EF*PR	1	6.557	6.557	1.54	0.219
Error	60	255.040	4.251		
	63	296.484			

<sup>a</sup> EF: Manipulation of donors' evaluation focus. EF=0 when donors make donations based solely on the program ratio (i.e., expense-focused donors); EF =1 when donors make donations based on both the program ratio and service performance (i.e., balance donors).

<sup>b</sup> PR: Manipulation of the program ratio. PR=0 when the program ratio is lower than the national average; PR=1 when the program ratio is higher than the national average.

**Panel B:** Planned contrasts for tests of H1 and the alternative hypotheses H1<sub>alt</sub> and H1<sub>balt</sub>

		<b>Contrasts</b>	<b>Mean difference (Standard error)</b>	<b>p- value*</b>
Service declined:	Program ratio above average	Expense-focused vs. Balanced	$\mu_1 - \mu_2 = -2.21$ (0.78)	<b>0.003</b>
	Program ratio below average	Expense-focused vs. Balanced	$\mu_3 - \mu_4 = -0.90$ (0.70)	<b>0.010</b>

\*One-tailed p-value

**Table 5 Participant Profile for Experiment 2 (N = 189)**

		Frequency
Age	Under 25	0.53%
	26-40	11.11%
	41-50	21.69%
	51-60	33.86%
	61-70	22.75%
	over 70	10.05%
Gender (% female)		54.59%
Education	Secondary school	2.12%
	Post-secondary diploma	7.94%
	Bachelor's degree	34.39%
	Master's/Ph.D. degree	43.39%
	Other (e.g., law, medicine)	12.17%
Accounting Designation		34.39%
Current Profession	Accountant	63.30%
	Lawyer	8.26%
	Medical Doctor	1.83%
	Engineer	5.50%
	Other (e.g., professor)	21.10%
Employment profile	Government department or agent	15.08%
	Large private company	6.70%
	Medium size private company	5.03%
	Small size private company	10.61%
	Not-for-profit organization	29.05%
	Large public company	10.06%
	Medium size public company	1.12%
	Small size public company	0.00%
Other organization	22.35%	

**Table 5 (Continued)**

		Frequency
Annual Revenue of Not-for-profit Organizations for which Participants Served as Directors (Note: If directors serve more than one organizations, this refers to the largest amount of annual revenues)	<\$ 100,000	8.47%
	\$100,000 to \$499,999	15.34%
	\$500,000 to \$999,999	13.23%
	\$1,000,000 to \$4,999,999	24.87%
	\$5,000,000 to \$9,999,999	12.17%
	≥\$10,000,000	25.93%
Participant's Responsibility on the Board (Note: The director could choose all that apply)	Finance	60.11%
	Audit	28.19%
	Fundraising	46.81%
	Governance	64.36%
	Human Resources	38.30%
	Nominations	46.81%
	Planning	68.09%
	Bylaws and Policy	53.72%
Other	13.83%	

**Table 6 Likelihood that Directors Agree with Management’s Proposed Expense Allocation to Boost the Program Ratio (LKDAgree)**

**Panel A:** Analysis of Covariance (ANCOVA) of LKDAgree

<b>Source</b>	<b>DF</b>	<b>Sum of Squares</b>	<b>Mean Square</b>	<b>F Value</b>	<b>Pr &gt; F*</b>
EF <sup>a</sup>	1	13.136	13.136	4.22	0.042
SP <sup>b</sup>	1	14.354	14.354	4.61	0.033
TR <sup>c</sup>	1	14.680	14.680	4.72	0.031
SP*TR	1	0.007	0.007	0	0.961
EF*SP	1	11.591	11.591	3.72	0.055
EF*TR	1	1.450	1.450	0.47	0.496
EF*SP*TR	1	4.120	4.120	1.32	0.252
ETHICAL <sup>d</sup>	1	205.863	205.863	66.12	<.0001
SZ <sup>e</sup>	5	35.284	7.057	2.27	0.050
DESGN <sup>f</sup>	1	13.062	13.062	4.2	0.042
Error	174	541.733	3.113		
<b>Total</b>	<b>188</b>	<b>893.238</b>			

\* All p-values are two-tailed if not otherwise specified.

<sup>a</sup>EF: EF=0 when donors make donations based solely on the program ratio (i.e., expense-focused donors); EF =1 when donors make donations based on both the program ratio and the service performance (i.e., balanced donors).

<sup>b</sup>SP: SP=0 when the organization’s service performance is worse than last year and its peer organizations’ service performance; SP=1 when the organization’s service performance is better than last year and its peer organizations’ service performance.

<sup>c</sup>TR: TR=0 when the expense disclosure is opaque; TR=1 when the expense disclosure is transparent.

<sup>d</sup>ETHICAL: participant’s perceived unethicity of allocating all fundraising expenses to charitable program expenses. It is measured on an 8-point scale with 1 denoted as “ethical” and 8 as “unethical”.

<sup>e</sup>SZ: the annual revenue of the not-for-profit organizations for which the participant serves as a board member. SZ =1 if the annual revenue is less than \$ 100,000, SZ=2 if the annual revenue is from \$100,000 to \$499,999, SZ=3 if the annual revenue is from \$500,000 to \$999,999, SZ=4 if the annual revenue is from \$1,000,000 to \$4,999,999, SZ= 5 if the annual revenue is from \$5,000,000 to \$9,999,999, and SZ =6 if the annual revenue is larger than \$10,000,000.

<sup>f</sup>DESGN: DESGN =1 if the participant has an accounting designation; otherwise DESGN=0.

**Panel B:** Descriptive Statistics – LSMeans of LKDAgree after controlling ETHICAL, SZ and DESGN (Raw Mean of LKDAgree)

**Table 6 (Continued)**

Level of Transparency	Donor's Evaluation Focus	Organization's Service Performance		Overall	
		Service declined	Service improved		
Opaque:	Expense focused	Cell 1 2.60 (2.56) (n*=25)	Cell 2 2.24 (2.04) (n=25)	$\mu_{11}=2.51$ (2.30) (n=50)	$\mu_1=2.77$ (2.76) (n=98)
	Balanced	Cell 3 3.53 (3.65) (n=23)	Cell 4 2.77 (2.84) (n=25)	$\mu_{12}=3.07$ (3.23) (n=48)	
Transparent:	Expense focused	Cell 5 1.91 (1.57) (n=23)	Cell 6 2.14 (1.91) (n=22)	$\mu_{21}=2.01$ (1.73) (n=45)	$\mu_2=2.23$ (2.24) (n=91)
	Balanced	Cell 7 3.09 (2.88) (n=24)	Cell 8 1.70 (2.59) (n=22)	$\mu_{22}=2.52$ (2.74) (n=46)	

\*n refers to the number of participants.

Note:

1. In all cells, the program ratio is below the national average.

2. Dependent variable is directors' likelihood of agreeing with management's proposed expense allocation (LKDAgree), which is measured on a 9 point scale from 1 to 9, with 1 denoted "Very unlikely" and 9 "Very likely".

**Panel C: Planned contrasts for tests of H2 to H5**

Contrasts	LSMean difference (Standard error)	p-value
<b>H2:</b> Balanced vs. Expense-focused (mean of Cells 3, 4, 7, 8 vs. mean of Cells 1, 2, 5, 6)	2.79-2.19 = 0.60 (0.27)	<b>0.029</b>
<b>H3:</b> Good service: Balanced vs. Expense-focus (mean of Cells 4, 8 vs. mean of Cells 2, 6)	2.58-2.16 = 0.42 (0.38)	<b>0.276</b>
Poor service: Balanced vs. Expense-focus (mean of Cells 3, 7 vs. mean of Cells 1, 5)	3.12 -2.16= 0.96 (0.39)	<b>0.016</b>
<b>H4:</b> Transparent vs. Opaque (mean of Cells 5, 6, 7, 8 vs. mean of Cells 1, 2, 3, 4)	2.23 - 2.77= - 0.54 (0.27)	<b>0.046</b>

**Table 6 (Continued)**

**Panel C:** Planned contrasts for tests of H2 to H5

<b>Contrasts</b>	<b>LSMean difference (Standard error)</b>	<b>p-value</b>
<b>H5:</b> Opaque: Balanced vs. Expense-focused (mean of Cells 3, 4 vs. mean of Cells 1, 2)	3.07 – 2.51= 0.56 (0.43)	<b>0.191</b>
Transparent: Balanced vs. Expense-focused (mean of Cells 7, 8 vs. mean of Cells 5, 6)	2.52 – 2.01= 0.51 (0.34)	<b>0.145</b>

**Table 7 Participant’s Assessment of the Organization’s Deservedness for Donations**

**(Deserve)\***

Cells	Deserve (Mean)	t-test: $h_0 = 1$ (“not at all” deserve)		t-test: $h_0 = 5$ (the midpoint point of the scale with 1 “not at all” and 9 “to a large extent”)	
		t value	p value	t value	p value
<b>Cells with Good Service:</b>					
Cell 2 (Expense-focused, Good service, Opaque)	7.360	22.54	<.0001	8.36	<.0001
Cell 4 (Balanced, Good service, Opaque)	7.080	18.94	<.0001	6.48	<.0001
Cell 6 (Expense-focused, Good service, Transparent)	7.227	17.91	<.0001	6.41	<.0001
Cell 8 (Balanced, Good service, Transparent)	6.909	17.64	<.0001	5.70	<.0001
<b>Cells with Poor Service:</b>					
Cell 1 (Expense-focused, Poor service, Opaque)	5.080	8.39	<.0001	0.16	0.8707
Cell 3 (Balanced, Poor service, Opaque)	4.783	9.64	<.0001	-0.55	0.5852
Cell 5 (Expense-focused, Poor service, Transparent)	4.870	7.93	<.0001	-0.27	0.7918
Cell 7 (Balanced, Poor service, Transparent)	5.130	9.26	<.0001	0.29	0.7726

\* Deserve is measured on a 9-point scale with 1 “not at all” to 9 “to a large extent” in response to a question: “Given the Centre’s performance this year, to what extent does the Centre deserve the financial support of new donors?”

**Table 8 Participant's Assessment of the Organization's Deservedness for Donations:  
Good Service Performance vs. Poor Service Performance  
(Deserve)\***

<b>Cells: Poor Service vs. Good Service (Donors' Evaluation Focus &amp; Transparency held constant)</b>	<b>Deserve (Mean)</b>		<b>p-value</b>
	<b>Poor Service</b>	<b>Good Service</b>	
Expense-focused & Opaque (Cell 1 vs. Cell 2)	5.080	7.360	<0.0001
Balanced & Opaque (Cell 3 vs. Cell 4)	4.783	7.080	<0.0001
Expense-focused & Transparent (Cell 5 vs. Cell 6)	4.870	7.227	<0.0001
Balanced & Transparent (Cell 7 vs. Cell 8)	5.130	6.909	0.002

\* Deserve is measured on a 9-point scale with 1 "not at all" to 9 "to a large extent" in response to a question: "Given the Centre's performance this year, to what extent does the Centre deserve the financial support of new donors?"

**Table 9 Participant’s Assessment of the Likelihood that the Organization Obtains Donations**

(LKDDonate)\*

Cells	LKDDonate (Mean)	t-test: $h_0 = 5$ (the midpoint point of the scale with 1 “unlikely” and 9 “likely”)	
		t value	p value
<b>Cells with Good Service:</b>			
Cell 2 (Expense-focused, Good service, Opaque)	5.080	0.18	0.861
Cell 4 (Balanced, Good service, Opaque)	6.120	3.52	0.002
Cell 6 (Expense-focused, Good service, Transparent)	4.955	-0.1	0.924
Cell 8 (Balanced, Good service, Transparent)	6.227	3.81	0.001
<b>Cells with Poor Service:</b>			
Cell 1 (Expense-focused, Poor service, Opaque)	4.000	-2.13	0.044
Cell 3 (Balanced, Poor service, Opaque)	4.130	-2.75	0.012
Cell 5 (Expense-focused, Poor service, Transparent)	4.087	-1.93	0.067
Cell 7 (Balanced, Poor service, Transparent)	4.000	-2.66	0.014

\* LKDDonate is measured on a 9-point scale with 1 “unlikely” to 9 “likely” in response to the question “Given the Centre’s performance this year, how likely is it that the Centre will obtain a substantial donation from this potential new large donor?”

**Table 10 Participant’s Assessment of the Likelihood that the Organization Obtains Donations: Expense-focused vs. Balanced (LKDDonate)\***

<b>Cells: Expense-focused vs. Balanced (Service Performance &amp; Transparency held constant)</b>	<b>LKDDonate (Mean)</b>		<b>p-value</b>
	<b>Expense-focused</b>	<b>Balanced</b>	
<b>Cells: Good Service Performance</b>			
Good Service & Opaque (Cell 2 vs. Cell 4)	5.080	6.120	0.063
Good Service & Transparent (Cell 6 vs. Cell 8)	4.955	6.227	0.033
<b>Cells: Poor Service Performance</b>			
Poor Service & Opaque (Cell 1 vs. Cell 3)	4.000	4.130	0.820
Poor Service & Transparent (Cell 5 vs. Cell 7)	4.087	4.000	0.880

\* LKDDonate is measured on a 9-point scale with 1 “unlikely” to 9 “likely” in response to the question “Given the Centre’s performance this year, how likely is it that the Centre will obtain a substantial donation from this potential new large donor?”

**Table 11 Participant’s Assessment of the Detection Risk**

**Opaque vs. Transparent**

<b>Cells: Opaque vs. Transparent (Donors’ Evaluation Focus &amp; Service Performance held constant)</b>	<b>Detection Risk (Mean)</b>		<b>p-value</b>
	<b>Opaque</b>	<b>Transparent</b>	
Expense-focused & Poor Service (Cell 1 vs. Cell 5)	-0.840	2.826	< 0.0001
Expense-focused & Good Service (Cell 2 vs. Cell 6)	-1.160	1.636	0.0014
Balanced & Poor Service (Cell 3 vs. Cell 7)	0.217	2.333	0.0150
Balanced & Good Service (Cell 4 vs. Cell 8)	-2.080	2.182	<0.0001

Note: the perceived detection risk is measured on a 9-point scale with -4 “Strongly disagree” to + 4 “Strongly agree” in response to the question “Management’s proposed reporting of expenses in the financial statements allows donors to determine that the \$400,000 special campaign expenses were allocated completely to Charitable Programs expense”

**Table 12 Participant’s Perceived Uncertainty Feelings**

**Opaque vs. Transparent**

Perceived Uncertainty	Perceived Uncertainty (Mean)		t value	p-value
	Opaque	Transparent		
CertainND <sup>1</sup>	6.153	6.133	0.06	0.953
CertainD <sup>2</sup>	5.392	5.429	- 0.10	0.919
CertainA <sup>3</sup>	7.602	7.756	-0.57	0.567
CertainAj <sup>4</sup>	7.000	7.242	- 0.76	0.446

Note:

1. CertainND: participant’s certain feelings about the new donors’ response to his/her agreement of management’s proposed misallocation. It is measured on a 9 point scale (from 1 “Very uncertain” to 9 “Very certain”) in response to the question “If, as management suggests, the Centre reported all of the \$400,000 in campaign expenses as “Charitable Programs” expense, how certain are you that the potential new large donor will question the total amount of ‘Charitable Programs’ expense and the program ratio reported in the Centre’s annual report?”

2. CertainD: participant’s certain feelings about the response of donors in general to his/her agreement of management’s proposed misallocation. It is measured on a 9 point scale (from 1 “Very uncertain” to 9 “Very certain”) in response to the question “If, as management suggests, the Centre reported all of the \$400,000 in campaign expenses as ‘Charitable Programs’ expense, how certain are you that donors in general will question this allocation?”

3. CertainA: participant’s certain feelings about the auditors’ response to his/her agreement of management’s proposed misallocation. It is measured on a 9 point scale (from 1 “Very uncertain” to 9 “Very certain”) in response to the question “If, as management suggests, the Centre reported all of the \$400,000 in campaign expenses as ‘Charitable Programs’ expense, how certain are you that auditors will question this allocation?”

4. CertainAj: participant’s certain feelings about the auditors’ suggested audit adjustments. It is measured on a 9 point scale (from 1 “Very uncertain” to 9 “Very certain”) in response to the question “If, as management suggests, the Centre reported all of the \$400,000 in campaign expenses as ‘Charitable Programs’ expense, how certain are you that auditors will propose an adjustment to materially decrease the \$400,000 allocation of campaign expenses to ‘Charitable Programs’ expense?”

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## Appendix A

### Instrument of Experiment 1

**Please read the below case, in which you are asked to imagine yourself as a board member of a local nonprofit organization. The questions which follow the case will be based on your appraisal and understanding of the case.**

#### ABC Family Resource Centre

As a member of the Board of Directors (“director” hereafter) for the ABC Family Resource Centre (“the Centre” hereafter), you are preparing for an important Board meeting. At this meeting, the Board will be discussing how to implement the Centre’s new strategy. The 7-year-old Centre is dedicated to promoting family literacy — the Centre’s motto is “Literacy develops in families first”— and there are four key programs which the Centre provides:

- 1) **Books for Babies:** encourages and teaches parents of infants to read to their babies.
- 2) **Help Your Child Read & Write:** helps parents with children in elementary school to improve their children’s reading and writing.
- 3) **Learning Together:** assists parents with improving their reading and writing skills, while teaching parents how to help their preschool children become successful learners.
- 4) **Book Buddies:** teams elementary school children with their preschool siblings, relatives, or neighbors, and teaches these children how to read and learn from each other.

In addition to the above four established programs, the Centre initiated a new program this year, “Rhymes that Bind”, which is an oral-language development program promoting positive parenting. However, in the middle of the fiscal year, the provincial and municipal governments suddenly announced funding cuts to a number of social programs; these cuts affect many agencies in the social-service sector, including the ABC Centre. Historically, the Centre has had annual revenues estimated at \$1,600,000, approximately 50% of which came from provincial and municipal government funding. The Centre’s management estimates that, next year, the Centre’s funding from provincial and municipal governments will be reduced by at least 60%, and that this funding will continue to decrease in the following years. This reduction in government funding puts tremendous pressure on the Centre to find alternative funding sources to support its established and newly launched programs in the coming years.

Anticipating that provincial and municipal funding cuts might occur at any time, the Centre’s management had been developing a new funding strategy. After a recent

emergency Board meeting, the Board approved management's new funding strategy for the next five years. This new strategy focuses on diversifying funding sources, and replacing lost government funding with donations from charitable foundations and large individual donors.

Research shows these donors are of two main types in terms of how they make decisions to donate. The **first type** of donor focuses **solely** on the program ratio— calculated by dividing expenditures devoted to charitable programs by the total expenditures. These donors focus on the program ratio to ensure as much of the funds they donate as possible is spent on charitable activities, rather than on administrative or fundraising activities. They consider the program ratio to be a surrogate indicator of the Centre's service performance. So, the first type of donor tends to donate to a charity reporting a reasonably high program ratio relative to the national average, regardless of the level of service efforts and achievements voluntarily disclosed by the charity.

The **second type** of donor evaluates a charity based on **both** the program ratio and information voluntarily disclosed by the charity about its level of service efforts and achievements. They believe that both metrics together ensure that as much of the funds they donate as possible is spent on charitable activities and that charitable services are provided efficiently and effectively. So, the second type of donor tends to donate to a charity reporting a reasonably high program ratio as well as improvements in service performance.

The Executive Director has identified a new large donor. The Board was very happy to learn of this potential donor.

### **Manipulation of Donors' Evaluation Focus**

#### *Expense-focused:*

The executive director informed the board of directors that this donor **focuses solely on the program ratio** when making donation decisions.

#### *Balanced:*

The executive director informed the board of directors that this donor **focuses on both the program ratio and any voluntarily disclosed level of service efforts and achievements** when making donation decisions.

### **Manipulation of the Program Ratio**

#### *The program ratio above the average:*

The Centre's program ratio is 84% this year, which is above the national average of 74%. Donors who consider the program ratio in making their donation decisions would likely evaluate a program ratio above the national average as a **positive indicator** when deciding about a donation to the ABC Centre.

*The program ratio below the average:*

The Centre's program ratio is 66% this year, which is below the national average of 74%. Donors who consider the program ratio in making their donation decisions would likely evaluate a program ratio below the national average as a **negative indicator** when deciding about a donation to the ABC Centre.

**Manipulation of Service Performance:**

*Improved:*

Overall, the Centre's programs experienced great success this year. The number of parents and children who received services from the Centre was 8% higher than last year and 5% higher than the average number of clients serviced by similarly sized family centers. Donors who consider the level of service efforts and achievements in making their donation decision would likely consider this a **positive indicator** when considering making a donation to the ABC Centre.

*Declined:*

Overall, the Centre's programs did **not** experience as much success this year as was hoped. The number of parents and children who received services from the Centre was 8% lower than last year and 5% lower than the average number of clients serviced by similarly sized family centers. Donors who consider the level of service efforts and achievements in making their donation decision would likely consider this a **negative indicator** when considering making a donation to the ABC Centre.

**The Decision**

**You are preparing for a Board of Directors meeting, which was called to advise the Executive Director whether he should continue to use his scarce fundraising time to further pursue the new large donor or whether he should concentrate on prospecting elsewhere. There are no right or wrong answers to the following questions. Please answer based on your reaction to the case information.**

1. Given what you know about this potential large donor, how likely would you be to recommend that the executive director continue to invest scarce fundraising time in pursuing this donor?

1	2	3	4	5	6	7	8	9
-----	-----	-----	-----	-----	-----	-----	-----	-----
Very unlikely								Very likely

2. How likely is it that the Centre will obtain a substantial donation from this potential large donor given the Centre's performance?

1	2	3	4	5	6	7	8	9
-----	-----	-----	-----	-----	-----	-----	-----	-----
Very unlikely								Very likely

3. Do you consider this potential large donor's evaluation criteria for making a donation to be fair?

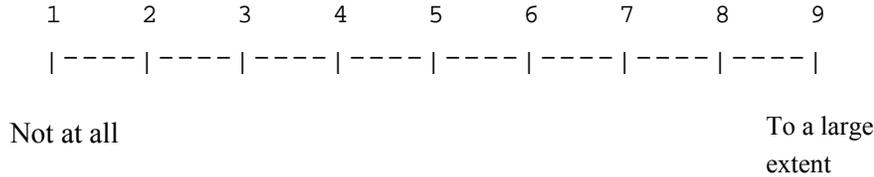
-4	-3	-2	-1	0	1	2	3	4
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Very Unfair								Very Fair

**If you wish, please explain or elaborate on your responses above**

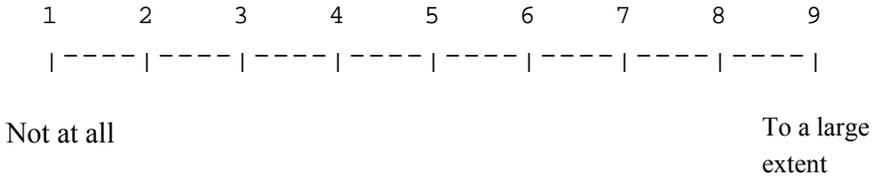
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**For the following questions, please choose the value on the scale which most accurately indicates your understanding or belief about the case.**

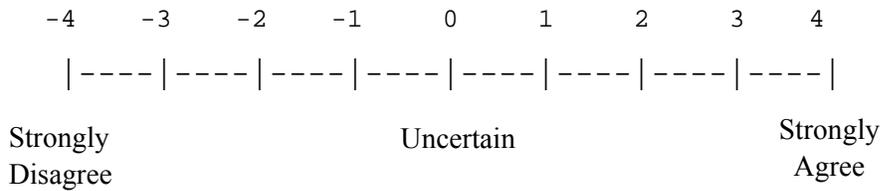
1. To what extent do you believe the evaluation criteria that the potential large donor uses for making a donation capture **efficiency of funds use and service quality** of the Centre?



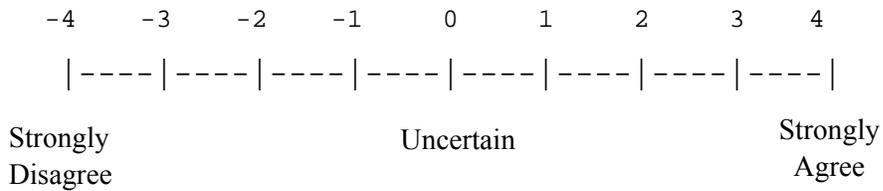
2. To what extent do you believe the evaluation criteria that the potential large donor uses for making a donation present an **accurate** evaluation process that considers as much valid information as possible?



3. The potential large donor makes donation decisions based **solely** on the program ratio.



4. Overall, the Centre's service performance is **excellent** this year.

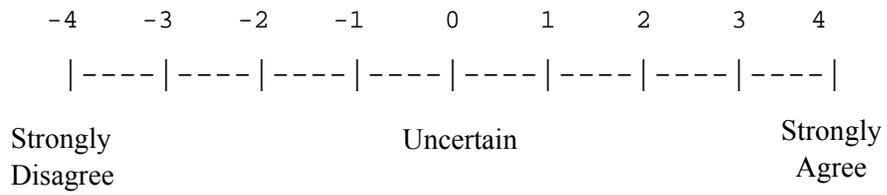


5. The Centre's program ratio was **below** the national average this year.





5. In general, I believe that service efforts and achievements are **more important** than financial performance when determining a non-profit organization's chance of obtaining donor funding.



## Final Demographic Questions

Please answer the following questions about yourself. Remember, this questionnaire is completely anonymous and researchers will not make any effort to personally identify you.

**Age** (choose one):

- Under 25 \_\_\_\_\_
- 26 - 40 \_\_\_\_\_
- 41 - 50 \_\_\_\_\_
- 51 - 60 \_\_\_\_\_
- 61 - 70 \_\_\_\_\_
- Over 70 \_\_\_\_\_

**Gender:** Male \_\_\_\_\_ Female \_\_\_\_\_

Your current, or most recent, employer is a (choose one):

- \_\_\_\_\_ public company
- \_\_\_\_\_ large private company
- \_\_\_\_\_ medium sized private company
- \_\_\_\_\_ small sized private company
- \_\_\_\_\_ non-profit organization
- \_\_\_\_\_ government
- \_\_\_\_\_ other organization (please specify \_\_\_\_\_)

Have you been a board director for not-for-profit organization(s)? Yes \_\_\_ No

What responsibilities have you had on Board(s) of not-for-profit organization(s)?

(Choose all that apply):

- Financial Governance/Audit \_\_\_\_\_
- Fundraising \_\_\_\_\_
- Human Resources \_\_\_\_\_
- Nominations \_\_\_\_\_
- Planning \_\_\_\_\_
- Bylaws and Policy \_\_\_\_\_
- Others \_\_\_\_\_ (specify \_\_\_\_\_)

What is the size (in terms of annual revenues) of the largest not-for-profit organization for which you have been a Board member?

- <\$ 100,000 \_\_\_\_\_
- \$100,000 to \$499,999 \_\_\_\_\_
- \$500,000 to \$999,999 \_\_\_\_\_

\$1,000,000 to \$4,999,999 \_\_\_\_\_  
\$5,000,000 to \$9,999,999 \_\_\_\_\_  
≥\$10,000,000 \_\_\_\_\_

What is the **highest educational level** you have completed? (Choose only the highest):

Secondary school \_\_\_\_\_  
Post-secondary diploma \_\_\_\_\_  
Bachelor's degree \_\_\_\_\_  
Master's/Ph.D. degree \_\_\_\_\_  
Other (e.g., law, medicine) \_\_\_\_\_ (specify \_\_\_\_\_)

Profession (if any):

Lawyer \_\_\_\_\_  
Medical Doctor \_\_\_\_\_  
Engineer \_\_\_\_\_  
Accountant \_\_\_\_\_  
CA (Canada) \_\_\_\_\_  
CMA (Canada) \_\_\_\_\_  
CGA (Canada) \_\_\_\_\_  
CPA(the U. S.) \_\_\_\_\_  
Other Designations \_\_\_\_\_ (specify \_\_\_\_\_)  
Other \_\_\_\_\_ (specify \_\_\_\_\_)

Approximate time taken to complete this questionnaire \_\_\_\_\_ minutes.

*Thank you very much for your help!*

## Appendix B

### Instrument of Experiment 2

**Please read the below case, in which you are the board member of a local not-for-profit organization. The questions which follow the case will be based on the case and draw on your experience as a not-for-profit board member.**

#### ABC Family Resource Centre

As a member of the Board of Directors (“director” hereafter) for the ABC Family Resource Centre (“the Centre” hereafter), you are preparing for an important Board meeting. At this meeting, the Board will be discussing management’s decision regarding how to report an extra \$400,000 in campaign expenses in the Centre’s financial statements. The 7-year-old Centre is dedicated to promoting family literacy—the Centre’s motto is “Literacy develops in families first”—and there are four key programs which the Centre provides:

- 1) *Books for Babies*: encourages and teaches parents of infants to read to their babies.
- 2) *Help Your Child Read & Write*: helps parents with children in elementary school to improve their children’s reading and writing.
- 3) *Learning Together*: assists parents with improving their reading and writing skills, while teaching parents how to help their preschool children become successful learners.
- 4) *Book Buddies*: teams elementary school children with their preschool siblings, relatives, or neighbors, and teaches these children how to read and learn from each other.

In addition to the above four established programs, the Centre initiated a new program this year, “Rhymes that Bind”, which is an oral-language development program promoting positive parenting. However, in the middle of the fiscal year, the provincial and municipal governments suddenly announced funding cuts to a number of social programs; these cuts affect many agencies in the social-service sector, including the ABC Centre. Historically, the Centre has had annual revenues estimated at \$1,600,000, approximately 50% of which came from provincial and municipal government funding. The Centre’s management estimates that, next year, the Centre’s funding from provincial and municipal governments will be reduced by at least 60%, and that this funding will continue to decrease in the following years. This reduction in government funding puts tremendous pressure on the Centre to find alternative funding sources to support its established and newly launched programs in the coming years.

Anticipating that provincial and municipal funding cuts might occur at any time, the Centre's management had been developing a new funding strategy. After an emergency Board meeting, the Board approved management's new funding strategy for the next five years. This new strategy focuses on diversifying funding sources, and replacing lost government funding with donations from charitable foundations and large individual donors.

Research shows that the targeted charitable foundations and large individual donors are of two main types. The first type of donor focuses **solely** on the program ratio (calculated by dividing expenses devoted to charitable programs by the total expenses) when deciding whether to make a donation. These donors focus on the program ratio to ensure as much of the funds they donate as possible is spent on charitable activities, rather than on administrative or fundraising activities. They consider the program ratio to be a good surrogate indicator of the Centre's service performance. So, the first type of donor tends to donate to a charity reporting a reasonably high program ratio relative to the national average, regardless of the disclosures about service efforts and achievements voluntarily made by the charity in its annual report.

The second type of donor evaluates a charity based on **both** the program ratio and information voluntarily disclosed by the charity about its level of service efforts and achievements in the annual report. They believe that both sets of metrics together ensure that as much of the funds they donate as possible is spent on charitable activities and that charitable services are provided efficiently and effectively. So, the second type of donor tends to donate to a charity reporting a reasonably high program ratio as well as reporting improvements in the organization's service performance and quality.

As a first step in implementing the new fundraising strategy, the Centre launched a special campaign to enhance public awareness of the Centre and reach potential donors. In total, \$400,000 was spent on a series of events: **community education, mailing out annual reports and related information and networking with charitable foundations**. Despite this spending on the campaign, the Centre managed to keep the budget balanced by reducing administrative expenses, thanks to an increased number of volunteers running daily operations this year.

In this special campaign, some expenses can be attributed to community education and volunteer recruitment. According to generally accepted accounting principles, these expenses are allowed to be reported as expenses devoted to charitable programs, i.e., "Charitable Programs" expense in the Centre's financial statements. The campaign expenses that are not allowable as "Charitable Programs" expense should be reported as "Fundraising" expense in the Centre's financial statements. Due to a volunteer misinterpreting how to track time and expenditures that related to community education and volunteer recruitment separate from fundraising during the campaign, the Centre did

not specifically track the dollar amount or the staff hours spent on each event type in this special campaign.

Even so, the Centre's management estimated that \$100,000 of the \$400,000 in campaign expenses were spent on community education and volunteer recruitment. If only \$100,000 out of the \$400,000 was reported as "Charitable Programs" expense in the Centre's financial statements, the Centre's program ratio (calculated as total "Charitable Programs" expense divided by "Total Expenses") would be 66% which is below the national average of 74% according to a recent study by the Canada Revenue Agency.

As a result of the campaign, the Executive Director has identified a potential new large donor. The Board was very happy to learn of this potential new donor.

### **Manipulation of Donors' Evaluation Focus**

#### *Expense-focused:*

The executive director informed the board of directors that this donor **focuses solely on the program ratio** when making donation decisions. Management predicts that this donor would likely evaluate a reported program ratio below the national average as a **negative indicator** when deciding about a donation to the ABC Centre.

#### *Balanced:*

The executive director informed the board of directors that this donor **focuses on both the program ratio and information disclosed about the number of clients served and the service quality provided by the organization** when making donation decisions. Management predicts that this donor would likely evaluate a reported program ratio below the national average and a reduction in clients served and service quality as **negative indicators** when deciding about a donation to the ABC Centre.

### **Manipulation of Service Performance**

#### *Improved:*

Overall, the Centre's programs experienced great success this year. The number of parents and children who received services from the Centre was 8% higher than last year and 5% higher than the average number of clients serviced by similarly sized family centers. Service quality was also judged by participants in the program for more than one year to be improving.

#### *Declined:*

Overall, the Centre's programs did **not** experience as much success this year as was

hoped. The number of parents and children who received services from the Centre was 8% lower than last year and 5% lower than the average number of clients serviced by similarly sized family centers. Service quality was also judged by participants in the program for more than one year to be declining.

Since a program ratio below the national average might be a negative sign to donors, the Centre’s management decided to report **all** of the \$400,000 spent on the special campaign as “Charitable Programs” expense in its financial statements. Management justifies this decision by claiming that all events in the special campaign were run by staff and volunteers who normally work directly on charitable programs. As such, the Centre’s program ratio will be reported as 84% which is well above the national average of 74%.

**Manipulation of Transparency**

*Opaque:*

As permitted by generally accepted accounting principles and consistent with last year, management reports expenses in aggregate by nature (e.g., rents, salaries, and travel expenses) but not by function (i.e., charitable program, fundraising and administrative) in the Centre’s financial statements. Below is the expense portion of the Centre’s Revenue and Expense Report proposed by management to be included in the Centre’s financial statements. The \$400,000 spent on the special campaign is reported as “Advertising and promotion” expenses in the Expense Report. Management also notes in the Centre’s annual report that 84% of expenses are spent on charitable programs this year (i.e., the program ratio is 84%). The reporting proposed by management does **not allow** donors to readily determine that the \$400,000 is allocated completely to “Charitable Programs” expense.

**Expenses**

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

*Transparent:*

As permitted by generally accepted accounting principles and consistent with last year, management labels each individual expense by nature (e.g., rents, salaries, and travel expenses) *and* by function (i.e., charitable program, fundraising and administrative) in the Centre’s financial statements. Below is the expense portion of the Centre’s Revenue and Expense Report proposed by management to be included in the Centre’s financial statements. The \$400,000 spent on the special campaign is reported as “Advertising and promotion” expenses and allocated to “Charitable Programs” expense in the Expense Report. Management also notes in the Centre’s annual report that 84% of expenses are spent on charitable programs this year (i.e., the program ratio is 84%). The reporting proposed by management **allows** donors to readily determine that the \$400,000 is allocated completely to “Charitable Programs” expense and not to “Fundraising” expense.

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

## The Decision

You are preparing for a Board of Directors meeting, which was called to review the Centre's year-end financial statements. During this meeting, you will discuss management's proposal to consider all of the \$400,000 in campaign expenses as "Charitable Programs" expense. This decision boosts the Centre's program ratio to 84%, which is 10 percentage points higher than the national average of 74% and, thus, makes it more likely that the Centre will attract donations. You note that the program ratio proposed by management is 18 percentage points higher than the 66% it would have been if \$100,000 (management's original estimate of campaign expenditures related to community education and volunteer recruitment) had been allocated to "Charitable Programs" expense. As a director, you are considering whether you will agree with this management proposal.

Please use your judgment to answer the following questions regarding the case.

1. How **likely** are you to **agree** with management's proposal to report all of the \$400,000 in campaign expenses as "Charitable Programs" expense?

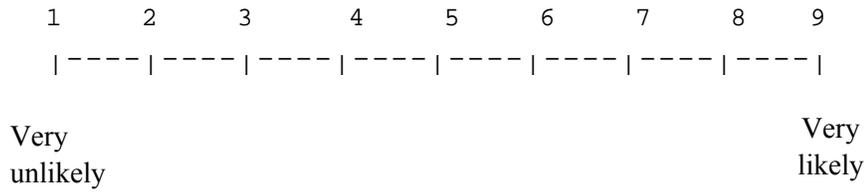
1	2	3	4	5	6	7	8	9
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Very unlikely								Very likely

2. How much of the \$400,000 in campaign expenses would **you recommend** management to report as "Charitable Programs" expense? ("k" represents 1,000)

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\$0	\$100k	\$200k	\$300k	\$400k		

Or enter an exact amount: \$ \_\_\_\_\_

3. In your opinion, how **likely** are other members of the Board to **agree** with management's proposal to report all of the \$400,000 in campaign expenses as "Charitable Programs" expense?



4. How much of the \$400,000 in campaign expenses do you believe **other members** of the Board would recommend management to report as “Charitable Programs” expense? (“k” represents 1,000)



Or enter an exact amount: \$\_\_\_\_\_

**If you wish, please explain or elaborate on your responses.**

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**Suppose that, in the end, the Centre reported the entire \$400,000 in campaign expenses as “Charitable Programs” expense. Please indicate your views about this action on the following scales by choosing the point on the scale that best describes your reaction to this decision.**

Reporting the entire \$400,000 in campaign expense as “Charitable Programs” expense is:

Just								Unjust
	1	2	3	4	5	6	7	8
Unfair								Fair
	1	2	3	4	5	6	7	8
Morally right								Not morally right
	1	2	3	4	5	6	7	8
Not Acceptable to my family								Acceptable to my family
	1	2	3	4	5	6	7	8
Culturally acceptable								Culturally unacceptable
	1	2	3	4	5	6	7	8
Traditionally unacceptable acceptable								Traditionally acceptable
	1	2	3	4	5	6	7	8
Produces the greatest utility								Produces the least utility
	1	2	3	4	5	6	7	8
Minimizes benefits while maximizes harm								Maximizes benefits while minimizes harm
	1	2	3	4	5	6	7	8
Does not violate an unwritten contract								Violates an unwritten contract
	1	2	3	4	5	6	7	8
Violates an unspoken promise								Does not violate an unspoken promise
	1	2	3	4	5	6	7	8

The action described above is:

Ethical								Unethical
	1	2	3	4	5	6	7	8





## Final Demographic Questions

Please answer the following questions about yourself. Remember, this questionnaire is completely anonymous and researchers will not make any effort to personally identify you.

**Age** (choose one):

- Under 25 \_\_\_\_\_
- 26 - 40 \_\_\_\_\_
- 41 - 50 \_\_\_\_\_
- 51 - 60 \_\_\_\_\_
- 61 - 70 \_\_\_\_\_
- Over 70 \_\_\_\_\_

**Gender:** Male \_\_\_\_\_ Female \_\_\_\_\_

Your current, or most recent, employer is a (choose one):

- \_\_\_\_\_ government department or agency
- \_\_\_\_\_ large private company
- \_\_\_\_\_ medium size private company
- \_\_\_\_\_ small size private company
- \_\_\_\_\_ not-for-profit organization
- \_\_\_\_\_ large public company
- \_\_\_\_\_ medium size public company
- \_\_\_\_\_ small size public company
- \_\_\_\_\_ other organization (please specify \_\_\_\_\_)

Are you currently, or have you been, a **board member** of not-for-profit organization(s)?

Yes \_\_\_\_\_ No \_\_\_\_\_

Are you currently, or have you been, an **auditor** of not-for-profit organization(s)?

Yes \_\_\_\_\_ No \_\_\_\_\_

Are you currently, or have you been, a **senior manager** of not-for-profit organization(s)?

Yes \_\_\_\_\_ No \_\_\_\_\_

What responsibilities have you had on Board(s) of not-for-profit organization(s)?  
(Choose all that apply):

- Finance \_\_\_\_\_
- Audit \_\_\_\_\_



\$5,000,000 to \$9,999,999 \_\_\_\_\_  
≥\$10,000,000 \_\_\_\_\_

What is the **highest educational level** you have completed? (Choose only the highest):

Secondary school \_\_\_\_\_  
Post-secondary diploma \_\_\_\_\_  
Bachelor's degree \_\_\_\_\_  
Master's/Ph.D. degree \_\_\_\_\_  
Other (e.g., law, medicine) \_\_\_\_\_ (specify \_\_\_\_\_)

Professional designation (if any):

Lawyer \_\_\_\_\_  
Medical Doctor \_\_\_\_\_  
Engineer \_\_\_\_\_  
Accountant \_\_\_\_\_  
CA (Canada) \_\_\_\_\_  
CMA (Canada) \_\_\_\_\_  
CGA (Canada) \_\_\_\_\_  
CPA(the U. S.) \_\_\_\_\_  
Other Designations \_\_\_\_\_ (specify \_\_\_\_\_)  
Other \_\_\_\_\_ (specify \_\_\_\_\_)

Approximate time taken to complete this questionnaire \_\_\_\_\_ minutes.

*Thank you very much for your help!*