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Citation

RANASINGHE, Tharindra; KHUMAWALA, S.; MISHRA, S.; and DHOLE, S.. Executive Compensation and Regulation Imposed Governance: Evidence from the California Non-Profit Integrity Act (2004). (2012). *Accounting and Finance Association of Australia and New Zealand (AFAANZ) 2012 Conference*. Available at: https://ink.library.smu.edu.sg/soa_research/1019

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Executive Compensation and Regulation Imposed Governance: Evidence from the California Non-Profit Integrity Act (2004)

1. Introduction

In the wake of the much publicized governance failures in the corporate sector, the U.S. Congress had enacted the Sarbanes-Oxley Act (hereafter, SOX) in 2002 in an attempt to restore investor and public confidence in corporations. The scandals, however, were not just restricted to the corporate sector. Indeed, as Bolton and Mehran (2006) document, the not-for-profit sector had its own fair share of scandals too. Some examples include fraud and excessive compensation at NAACP, United Way, and Adelphi University; private benefits paid to board members and friends of the Nature Conservancy; and allegations that the New Jersey Symphony Orchestra inflated instrument values to get a larger tax deduction.

The attorneys general of twenty separate states in the United States have reacted to these public sector scandals by launching 30 investigations into non-profit organizations across the country (Eaton and Akers, 2007). At the federal level the United States Senate Finance Committee held hearings on problems in the not-for-profit sector under the title, “Charity Oversight and Reform: Keeping Bad Things From Happening to Good Charities” on June 22nd, 2004. The regulatory attention – at both the state and federal levels in the not-for-profit sector was focused on the lack of good governance and issues relating to excessive executive compensation. The Commissioner of Internal Revenue Service, Mark W. Everson, testified at the Senate hearings;

“We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems... We are concerned that the governing boards of tax-exempt organizations are not, in all cases, exercising sufficient diligence as they set compensation for the leadership of the organizations. There have been numerous recent reports of executives of

both private foundations and public charities who are receiving unreasonably large compensation packages”¹(emphasis added).

In a regulatory response to the scandals plaguing non-profit organizations, the state of California passed the Non-Profit Integrity Act (SB1262) in 2004. This Act, which became effective January 1st, 2005, is regarded as a watershed moment in regulatory attempts to strengthen governance mechanisms in the not-for-profit sector. Closely modeled after SOX², the Act requires qualifying California charities to file audited financial statements with the Attorney General’s office and establish an audit committee. The Act also requires boards of directors of non-profit organizations to approve the compensations of key executives and ensure that the compensation paid is “*just and reasonable*.” Finally, the Act regulates the interaction between the charitable organization and commercial fundraisers. Many other states have subsequently attempted to follow the examples set by governance legislation in the corporate sector as well as California’s Act (Mead 2008).

The objective of this paper is to assess what impact California’s Non-profit Integrity Act (2004) (also referred to as “the Act” and “regulation” in the remainder of this paper) has had on the executive compensation costs of affected charitable organizations. Investigating the executive compensation effects of the Act is important not only in evaluating whether this legislation has achieved its intended objectives, but also in informing the broader policy debate on regulatory efforts to improve governance. Such investigations would be especially useful for policy makers of other states contemplating similar regulations.

¹Written Statement of Mark W. Everson, Commissioner of Internal Revenue, before the Committee on Finance, U.S. Senate: Hearing on Charitable Giving Problems and Best Practices. IR-2004-81, June 22, 2004. Available online at <http://www.irs.gov/pub/irs-news/ir-04-081.pdf>

² For instance Jackson (2006) terms the act as “*California “Sarbanes-Oxley clone” legislation*”.

The Act has evoked strong responses from legal experts and executives of affected organizations who feel that the requirements imposed by the Act are unwarranted. For example, Gilkeson (2007) argues against the necessity of the Act by pointing out that the benefits that would accrue to society as a result of this legislation would not justify the additional costs of compliance. Mulligan (2007) contends that the legislation will not bring about the desired improvements in governance in non-profit organizations because the Act takes a stockholder-based normative approach, which is inappropriate in a non-profit setting. Executives of non-profits in California have expressed concern that complying with the provisions of the Act will have serious financial consequences for these organizations. Conversely, proponents of the Act welcomed the new legislation as a step in the right direction towards creating transparency and restoring constituent confidence in the not-for-profit sector (Ljung 2005).

The effect of governance regulations on executive compensation in the not-for-profit sector is an important research area for the following reasons. First, due to the absence of an alienable residual claimant, agency conflicts in the not-for-profit sector are not identical to those of the for-profit sector, making a mechanical extension of the research findings for the for profit sector to the not-for-profit sector questionable. Many donors to charities donate without any expectation of return. They contribute to charities because they feel good doing so (Andreoni, 1990). Thus, strengthened governance mechanisms may not necessarily be relevant to them, in contrast to shareholders of corporations. On the other hand, proponents of regulation would argue that non-profits need more regulatory attention precisely for this reason. Therefore it is necessary to engage in studies that are focused on the not-for-profit sector only.

Additionally, the not-for-profit sector accounts for a large and rapidly growing segment of the US economy, meriting research attention on account of its sheer size. According to Wing

et al (2010) there were nearly 600,000 non-profits that collected more than \$25,000 in gross receipts and filed an informational return with the IRS in 2008 – a growth of 47 percent since 1998. Moreover, in that same year, they generated over \$1.9 trillion in revenue – about 13 percent of the US Gross Domestic Product (GDP).

Although there have been many arguments in the popular press and among practitioners on the relative merits or lack thereof in regulating non-profits, there is a clear paucity of scholarly research on this issue. With respect to California's Non-profit Integrity Act, Neely (2011)³ presents some initial evidence by examining some potential benefits (or lack of) brought about by the Act. Comparing the data in the year immediately before and after the passage of the Act, Neely (2011) concludes that the Act did not result in a discernable change in reporting practices or commercial fund raising activities of the affected organizations. While Neely's (2011) study is focused on uncovering whether the Act has resulted in desirable improvements in matters pertaining to disclosure quality, and commercial fund raising activities, this paper investigates whether the Act has generated desired benefits in terms of reigning in executive compensation packages that were allegedly "*unreasonably large*."

In assessing the efficacy of regulator enforced governance mechanisms in not-for-profits, the issue of executive compensation is important for the following reasons. First, excessive executive compensation in not-for-profits has long been a source of concern for many parties and the Act has specific provisions aimed at addressing this issue. Second, the effectiveness of any regulation can only be correctly assessed when *both* potential benefits and costs are evaluated. Governance regulations may indirectly affect executive compensation through imposing certain risks and restrictions on executives. Specifically, executives could demand higher compensation in response to the perceived higher risk imposed by the Act. Indeed, there is evidence that the

³ To our knowledge, Neely's is the only other study that examines the impact of the Act on aspects of performance of non-profits.

passage of SOX has led to increases in director compensation (Linck et al, 2009), and changes in the executive compensation mix (Cohen et al, 2008b). Hence, an investigation of executive compensation effects is an important component of any comprehensive cost-benefit assessment of regulation.⁴

Using a sample of 1,850 California non-profit firms which are impacted by the Act during a six year period surrounding the adoption of the Act, we analyze the pre to post-regulation changes in executive compensation in comparison to a control group of similar non-profits that are domiciled in the state of Ohio⁵ and hence were not subjected to the provisions of the Act.

This difference-in-differences approach enables us to minimize the concern that observed changes could be due to other omitted factors that are unrelated to the Act. We use two measures of executive compensation: ratio of officer compensation to total revenue (*Execompl*) and ratio of officer compensation to total salaries (*Execompl2*). Our results indicate that affected California non-profits experienced a greater increase in executive compensation from pre to post-regulation in comparison to the Ohio non-profits. The increase is significant both statistically and economically. For example, after adjusting for the contemporaneous change in control group, executive compensation of affected California non-profits has gone up by approximately 10 percent from pre to post Act periods. This finding should be of particular concern to regulators as the outcome of the Act in relation to executive compensation seems to be in stark contrast to its objectives.

⁴ In other words Neely's (2011) lack of evidence on the Act having significant changes in the behavior of not-for-profits may need not be viewed negatively on its own. If the Act did not impose significant costs either, the overall impact of the Act could be neutral. We also note however, that extant research on the impact of the Act is not exhaustive and there may be significant effects on aspects other than those that are investigated by Neely (2011) and us.

⁵ Our choice of Ohio as a control group is motivated by the similarity in the regulatory environment for non-profits to California. We explain our choice of Ohio in detail later in the paper.

While the difference-in-differences approach is useful in negating omitted correlated variables problems we cannot rule out the possibility that observed results are due to more dominant state (i.e. California) specific factors, other than the enactment of the Act. We address this potential concern by also employing California not-for-profit firms from exempt industries as an additional control group. Our results are robust to this alternative choice of control group. Even with the California control group, our conclusions about executive compensation costs increasing after the enactment of the Act remain unchanged.

Next, we investigate whether any changes in executive compensation highlighted above are more pronounced for organizations that are less likely to have voluntarily pre-adopted governance measures similar to those prescribed by the Act. In addition to highlighting the differential cost implications of regulations for different organizations, detection of such differences lend further confidence that our earlier findings are, in fact, caused by the Act. As prior research documents that larger not-for-profits are more likely to voluntarily adopt more stringent, SOX-like governance mechanisms (Ostrower and Bobowick 2006; Vermeer et al. 2006), we also investigate whether the observed executive compensation effect of the Act differs across smaller and larger not-for-profits. In line with prior research, we expect the executive compensation effect to be more pronounced for smaller of the affected not-for-profits. Our results confirm this expectation. The earlier recorded increase in compensation is entirely driven by the smaller than median (in terms of total assets) firms of our sample, indicating that the Act did not create an incremental impact on those firms that were more likely to have voluntarily pre-adopted its recommendations.

While it is a matter of concern that compensation costs of the affected charities in California appear to have increased after the Act, it is possible that the observed increase in

executive compensation was offset by savings in non-program related costs and/or was associated with a subsequent improvement in program-related efforts, as captured by the program ratio.⁶ If so, increases in compensation would be largely justified. We investigate this possibility by analyzing the changes in total non-program related expenses and program ratio, to determine the effectiveness of the organization. Our results suggest that the ratio of non-program expenses to total revenue appears to have increased after 2004, meaning that the organization did not become more effective. We also do not find any comparative improvements in program ratio. Collectively, these results indicate that the increases in executive compensation were not associated with savings in other costs or more effort in charitable activities.

Another alternative explanation of our finding of increases in executive compensation is that in pre-Act periods, organizations were able to opportunistically classify a portion of executive compensation as program expenses and the greater reporting discipline forced by the Act has prevented this from happening in post-Act periods. If the Act has prevented such opportunistic classification shifting, one could observe an increase in reported compensation expenses, but total expenses should remain unchanged. However, we find that pre to post-Act, changes in the excess of revenue over expenses (scaled by total revenue) is more negative for affected California organizations in comparison to control group, making this “elimination of classification shifting” argument less plausible.

Overall, our results indicate that not only did the Act’s provisions aimed at limiting “*excessive*” executive compensation not meet the desired objectives, but also the greater regulatory scrutiny and reporting burden introduced by the Act has, in fact, led to further

⁶ Charities that meet the established cutoffs for program expense as a percentage of total expense and fund raising costs as a percentage of contributions are more likely to receive favorable reviews by watchdog groups. NFP executives may have additional incentives to manage ratios. Baber, et al. (2002) show that increases in amounts committed to program activities that result from improving the program spending ratio correlate with changes in executive compensation.

increases in executive compensation. Our findings thus raise questions as to whether regulation enforced changes in governance can bring about desired results. Mead (2008) reports that at least four other states (CT, NH, WV, MA) have already passed SOX inspired not-for-profit reforms and at least six others (MI, MS, NY, OH, PA, VT) were considering doing so. In this respect, our study has important policy implications for states that have enacted similar legislation or are contemplating doing so.

The rest of the paper is organized as follows. Section 2 provides a brief institutional background of the Act; Section 3 develops the hypotheses; Section 4 describes the empirical methodology; Section 5 describes the data and presents the empirical results and Section 6 concludes.

2. Institutional Background

In the wake of the numerous scandals and governance failures⁷ in the not-for-profit sector and the euphoria surrounding the enactment of SOX, the state of California enacted the Non-Profit Integrity Act in 2004. The Act, which aims to strengthen governance measures involving non-profit organizations, was signed into law by Governor Schwarzenegger on September 29, 2004, and became effective on January 1, 2005. The Act broadly covers two areas: governance and commercial fundraising activities of non-profit organizations. The main provisions include:

1. Requirement to prepare publicly accessible annual financial statements audited by an independent public accountant (CPA).
2. Establishment of an audit committee that is responsible for making recommendations on hiring and firing of auditors, negotiating auditor compensation, approving non-audit

⁷ For example a 1999 series of *Chicago Tribune* articles reported that a major child sponsorship organization had continued to accept contributions for children who were dead. Examples of other fraudulent activities include Ponzi schemes (Harris 2002) as well as personal use of charitable assets (Whoriskey and Salmon 2003; Herbert 2006)

services by the auditor, and ensuring that financial affairs of the non-profit organization are in order.

3. Requirement to review the executive compensation of charitable organizations by their governing boards or authorized board committees to ensure that payment is “*just and reasonable*”.
4. Numerous provisions aimed at regulating commercial fundraising activities by not-for-profit organizations.

The Act applies to all charitable organizations, unincorporated associations, and trusts over which the State of California or the Attorney General has enforcement or supervisory powers. However, provisions 1 and 2 above apply only to those with gross revenues exceeding two million dollars. The two million dollar threshold excludes grants received from governmental entities, if the non-profit must provide an accounting of how it used the grant funds. Moreover, educational institutions, religious organizations, hospitals, licensed health care service plans, and cemeteries are exempt from the provisions of the Act.

The focus of this paper is on the executive compensation implications of the Act. The requirement 3 above is directly aimed at addressing concerns regarding “*excessively high*” executive compensations in the not-for-profit sector and ensuring that compensation is “*just and reasonable*”. Additionally, we think that even the other requirements have potential executive compensation implications as stringent monitoring and reporting requirements alter an executive’s risk exposures, creates additional administrative burden, and potentially limit his/her expropriation opportunities.

In the next section, we develop the hypotheses and expand on these issues.

3. Hypothesis Development

Following the highly publicized corporate scandals of the last decade and the subsequent enactment of SOX, there have been numerous empirical studies on the impact of governance regulation in the for-profit sector. Several of these document the benefits of SOX, suggesting that the governance in the corporate sector has improved following the enactment. For instance, Lobo and Zhou (2006) document an increase in accounting conservatism following SOX. Both Bartov and Cohen (2008) and Cohen et al (2008a) find the passage of SOX to have resulted in a reduction of earnings management through accruals. Cohen et al (2011) report that auditors consider SOX to have resulted in a substantial improvement in corporate governance environment.

While the above studies have documented some benefits of SOX, others argue that efficient governance practices emerge endogenously through value maximizing contracts between firm's stakeholders. According to this point of view, exogenously imposed governance mechanisms could be value destroying as they force the alteration of endogenously emerged efficient equilibriums. For example, Romano (2005) argues that SOX provisions that regulate certain aspects of executive compensation are inherently problematic as investors would have to increase another component of a manager's pay package to make up the loss in utility. Moreover, this is likely to be costlier as the now-restricted compensation option would not have been present if it was not relatively more efficient. In a related study, Cohen et al (2008b) report that the additional liability imposed by SOX on corporate executives has altered the compensation mix away from incentive compensation and towards fixed salary. Further, they find that SOX has reduced the level of risk taking by corporate executives on behalf of their

firms. In a recent paper, Larcker et al (2011) find that market reaction to recent events relating to corporate governance regulations are largely negative, implying that costs of regulation are seemingly greater than benefits when it comes to exogenously imposed corporate governance.

3.1 Governance and Executive Compensation in the Not-for-Profit Sector

The not-for-profit sector is, however, distinctively different from the corporate sector in the absence of residual claimants. The absence of intense monitoring by a residual-claimant as in the corporate sector, and the virtual immunity from ouster via takeovers may present non-profit-managers with a greater latitude to expropriate the firm's assets and engage in other forms of opportunistic behavior, thereby providing a rationale for greater regulatory oversight.

On the other hand Fama and Jensen (1983a, 1983b) argue that absence of alienable residual claims in the not-for-profit sector is a natural response to avoid the donor-residual claimant agency problems that could arise in such entities. In other words, when a part of an organization's net cash flow is from resources provided by donors, the presence of parties with a residual claim on net cash flows makes it difficult to assure donors that they are protected from expropriation by residual claimants. Fama and Jensen (1983a) note that in response to the unique nature of their agency conflicts, non-profits have adopted board structures with some noticeable differences from those of for-profit corporations. These include self-perpetuating boards, presence of major donors as board members, and general absence of internal agents as voting members of the board. If this latter view is true, regulatory imposition of governance rules on not-for-profits can be viewed as an unnecessary and costly intervention.

Accordingly, governance in the not-for-profit sector in general and attempts to regulate the same in particular are contentious areas that provide rich research opportunities. While a

number of studies explore issues related to governance in the not-for-profit sector and not-for-profit boards (for example, Bradshaw et al. 1992; Callen and Falk 1993; Olson 2000; Callen et al 2003; Vermeer et al. 2006) there is a clear dearth of research that explores how not-for-profits are affected by governance regulations. California's Non-profit Integrity Act presents the researcher with unique opportunities in this regard. Neely (2011) reports preliminary evidence that this Act did not have a significant impact in improving reporting practices and commercial fund raising activities of affected organizations.

However, despite the fact that the Act has incorporated specific provisions aimed at curbing excessive executive compensation, to our knowledge, no research has investigated the impact of the Act (or any other not-for-profit regulation for that matter) on this aspect till date. The importance of executive compensation related issues in the not-for-profit sector is evidenced through continuous concerns raised by regulators in recent times over possible executive compensation abuses. For example, issues relating to abuses in executive compensation have come up several times during the Senate hearings on June 22nd, 2004 and the staff discussion paper that was released subsequent to these hearings (commonly known as the "Grassley White Paper") presents a number of proposals aimed at curbing such abuses (United States Senate Finance Committee 2004).⁸ Therefore, whether and how the Act has altered executive compensation in affected California not-for-profits is an interesting research question that can potentially influence the policy debate.

We think that the executive compensation implications of the Act are many-fold. In a normative sense, if the executive compensation in non-profits is indeed excessive and compensation review requirements of the Act are effective, we should observe a relative

⁸ These proposals include annual, in advance approval of executive compensation by the board, public disclosure of compensation arrangements with justifications, and ensuring that compensation consultants are independent and hired by and report to the board.

decrease in executive compensation, following the enactment of the Act. On the other hand, a positive approach to the issue dictates the opposite to be true for at least two non-mutually exclusive reasons. First, if the endogenously emerged compensation schemes are efficient in terms of attracting and retaining managerial talent and minimizing agency conflicts, unwarranted regulatory scrutiny can potentially increase compensation costs as agents alter the composition of compensation packages to exclude elements that are viewed negatively by regulators and replace these with more costly alternatives (Romano 2005). Second, if stricter regulations and closer monitoring impose greater risks on the manager, this could lead to the manager demanding greater compensation in return. Thus, it is possible that compensation costs increase after the passage of the Act. Our (refutable) hypothesis is formally stated below.⁹

Hypothesis 1 (H1):

Executive compensation costs of affected California not-for-profits have decreased more from pre to post-Act periods in comparison to the control group.

3.2 Differential impact of the Act based on likelihood of voluntary adoption of governance measures

Next, we investigate whether any changes in executive compensation induced by the Act are more pronounced for organizations that are less likely to have voluntarily pre-adopted governance measures similar to those prescribed by the Act. This analysis invokes our interest in two aspects. First, it potentially sheds light on whether and how regulations of this nature can have differential impacts on different organizations; an issue that should be of interest to policy makers. Second, in the event that we do find the changes in executive compensation from pre to post-Act period to be more pronounced for firms that are less likely to have voluntarily pre-adopted similar governance measures, it acts as corroborative evidence that lends further

⁹ All hypotheses have been stated in the alternate form.

confidence to our assertion that findings of Hypothesis 1 are in fact driven by the Act. Prior research indicates that larger not-for-profit organizations are more likely to voluntarily adopt stronger governance mechanisms. For example, in analyzing the Urban Institute's *National Survey of Nonprofit Governance*, Ostrower and Bobowick (2006) report that larger organizations are more likely to have independent audit committees, more likely to make their financial statements available to the public, have a formal conflict of interest policy for board members, and have a process to protect whistleblowers. Moreover, Vermeer et al (2006) find that larger not-for-profit organizations are more likely to have audit committees with solely independent directors.

If larger organizations are more likely to have stricter governance mechanisms to start with, we would expect the impact of regulation on these organizations to be relatively lower. If this is true, any evidence observed in support of Hypothesis 1 should be stronger for smaller not-for-profit entities. Therefore we propose the following as our second hypothesis.

Hypothesis 2 (H2):

The change in executive compensation due to Non-profit Integrity Act is greater for smaller affected organizations.

We note however, that the Act is fully applicable to significantly large not-for-profit organizations (with annual gross revenues in excess of two million dollars). It is possible that size effects on the voluntary adoption of governance mechanisms are not that pronounced for this sub sample of organizations that are significantly large to begin with. While this would bias against us finding results in support of Hypothesis 2, we still consider this to be an important question as the rationale for the Act and its potential impact becomes questionable if a large

majority of the organizations that fall under its purview have already voluntarily adopted its recommendations.

We discuss our data and empirical methodology in the next section.

4. Empirical Methodology and Data

4.1 Empirical Methodology

We employ two measures of executive compensation:

- I. *Execomp1*: Ratio of officer compensation to total revenue
- II. *Execomp2*: Ratio of officer compensation to total salaries

Execomp1 captures the proportion of annual financial inflows that is been paid out to officers as compensation. *Execomp2* measures the executive's share of total compensation expense. Scaling by total revenue in *Execomp1* adjusts for changes in executive compensation due to changes in overall scale of operations. However, this measure does not capture potential effects of wage inflation being different to that of overall inflation in the economy. *Execomp2* adjusts for this possibility since the denominator too is a wage measure.

We analyze the pre to post-Act changes in executive compensation of affected California not-for-profits and compare these with changes in our control group (difference-in-differences estimations). The ideal control group for this purpose should be a group of non-profits that are similar to those in California and operate under similar pre-Act regulatory environment, but did not experience the effect of regulation (the Act) under consideration. We use non-profits of similar industries and size thresholds based in the state of Ohio as our control group. Our choice of Ohio not-for-profits as the control group is motivated by Fremont-Smith (2004) and Desai and Yetman (2005) who present comprehensive reviews of state regulations affecting non-profit

organizations. Desai and Yetman (2005) classify the 17 pieces of legislation documented in Fremont-Smith (2004) into a detection index (11 laws) and a prosecution index (6 laws). Ohio and California are similar in these aspects, differing only among 2 dimensions. Both states have the same filing requirements in the pre-Act period, with the exception that Ohio non-profits do not have to report to the Attorney General's office if they sell substantially all of their assets. California and Ohio are similar along the prosecution index also, with the exception that in Ohio there is no unique set of statutory laws that apply only to non-profit organizations.

Similar to prior studies that have focused on the implementation effects of reporting standards (Roberts 2005) and regulations (Neely 2011) in the not-for-profit sector we conduct our analysis by comparing the relevant descriptive statistics in univariate settings. Additionally, we also run multivariate tests with industry fixed effects to ensure that univariate results are not driven by differences and changes in industry composition. The general model of the multivariate tests is as follows:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Calif_i + \beta_3 Post_t * Calif_i + \beta_j Industry_i + \varepsilon_{it} \dots \dots (1)$$

where, for firm i , and year t :

y = the dependent variable of interest

$Post$ = an indicator variable taking the value of 1 for years after the Act (2005-2007) and zero otherwise (2002-2004)

$Calif$ = an indicator variable taking the value of 1 if the organization is based in California and affected by the Act, and zero otherwise

$Industry$ = dummy variables for industry controls. The National Taxonomy of Exempt Entities – Core Codes (NTEE-CC) divides the not-for-profit universe into 26 separate industries. The sample that we use for testing Hypotheses 1 and 2 covers all these

industries, except those that come under the scope of education, grant making, health care, religion and organizations classified as unknown.

Our dependent variables are the ratio of officer compensation to total revenue (*Execomp1*) and the ratio of officer compensation to total salaries (*Execomp2*). The interaction coefficient ($\widehat{\beta}_3$) captures the pre to post-Act change in variable of interest over and above that of control group and is our coefficient of interest. In testing Hypothesis 2, where the impact of the Act for large and small organizations is separated, we run equation (1) in a seemingly unrelated regression (SUR) (Zellner 1962) setting with dependent variables (*Execomp1* and *Execomp2*) separated by whether the total assets of the organization are above (*Large Firm*) or below (*Small Firm*) the sample median. We employ a SUR approach because it is more general than the simple OLS model and allows the error terms to be cross-correlated, a distinct possibility for our sample of small and large non-profits.

4.2 Data

We obtain the bulk of the financial data required for the empirical analysis from the National Center for Charitable Statistics (NCCS) core data files. The core data file, however, does not provide detailed breakdowns of many line items necessary for our analysis. In order to obtain those, we also use the NCCS digitized database, which runs from 1998-2003 and manually collect individual Form 990s for years after 2003. Our sample covers the period from 2002 to 2007. Table 1 highlights our sample selection criteria. We start with an initial sample of 201,661 firm-year observations (57,352 firms) from California and Ohio in the intersection of the core data, digitized database and the Form 990s. Next, we delete observations from organizations with gross annual receipts of less than two million dollars as some important provisions of the Act do not apply to them. This results in a loss of 175,625 firm-year

observations (50,347 firms). We also delete those observations from industries that are exempted from the requirements of the Act such as educational institutions, hospitals, and religious organizations. This leads to a further loss of 11,422 firm-year observations (2,909 firms). Finally, we delete the observations with missing values for key variables and truncate the sample at 1 percent and 99 percent to mitigate the effects of outliers. Our final sample consists of 8,514 firm-year observations (1,554 firms). The Treatment group of California firms consist of 6,329 firm-year observations (1,155 firms) while the control group of Ohio firms consist of 2,185 firm-year observations (399 firms). The higher number of observations from California is not surprising, given that it is a more populous state.¹⁰

Insert Table 1 here

Table 2 presents the industry distribution of our sample. As the Table shows, our sample covers a wide range of industries that are covered by the Act. There is a significant concentration of organizations in Human Services – Multipurpose and Other accounting for 42.0 percent, 41.7 percent, and 43.0 percent of full, California, and Ohio samples respectively. Arts, Culture, and Humanities also account for over 10 percent of observations across the groups. More importantly, we do not find substantial differences in industry distribution between California and Ohio samples.

Insert Table 2 here

Table 3 presents descriptive statistics for our sample. As the Act is fully enforced only on non-profits with over two million dollars in annual gross revenue (excluding grants), our sample consists of relatively large organizations. Mean (median) values of total assets and total annual revenue are 23.1 (6.1) and 12.8 (6.1) million dollars. Untabulated analysis indicate that

¹⁰ According to 2010 census of US Census Bureau total population of California and Ohio were 37,253,956 and 11,536,504 respectively. (<http://2010.census.gov/2010census/data/apportionment-pop-text.php>)

California and Ohio samples do not differ significantly in terms of assets even though California non-profits are larger in terms of revenue, total expenses, and non-program expenses. Mean (median) officer salaries for total, California, and Ohio samples are 0.80 (0.52), 0.79 (0.52), and 0.86 (0.49) million dollars respectively. The mean officer salaries are not significantly different between California and Ohio. In terms of variables used in empirical analysis, both California and Ohio non-profits expend around 3 percent of revenue on officer compensation (*Execompl*) on average. Also, on average, officer compensation amounts to about 12 percent of total salary bill (*Execompl2*) for both groups. The *Non-program expense ratio* is slightly lower for California, which appears to be getting translated to a slightly better *Program ratio*. Descriptive statistics indicate that California and Ohio groups are generally comparable in terms of financial indicators.

Insert Table 3 here

5. Empirical Results

5.1 Changes in Executive Compensation

Panel A of Table 4 reports univariate tests of Hypothesis 1, which investigates the changes in executive compensation costs of firms that are affected by the Act. In terms of *Execompl* (that is, executive compensation scaled by total revenue), we find that executive compensation costs have gone up from pre to post Act period for both California and Ohio organizations. More interestingly, difference-in-differences tests reveal that the increase in *Execompl* is significantly larger for affected California firms (z-statistic = 5.439, p-value < 0.01). This increase is economically significant as well. After controlling for contemporaneous change in control group, the proportion of revenue paid as executive compensation for California not-for-profits have gone up by 10 per cent (0.003/0.030), on average in the post-Act period.

Untabulated results indicate that this relative increase in executive compensation cost is not due to changes (i.e. decreases) in revenue which is used as the denominator in *Execompl*. In fact, untabulated analysis indicates that revenues have increased from pre to post-Act for both California and Ohio not-for-profits and the increase in California is greater than that of Ohio.

Inferences in terms of *Execompl2* (executive compensation scaled by total compensation) are very similar. While both California and Ohio witnessed increases in *Execompl2* from pre to post-Act periods, the increase in California is significantly greater than that of Ohio firms (z-statistic = 5.523, p-value<0.01). The executive compensation share of total compensation has increased by over 13 percent (0.014/0.105), on average from pre to post-Act periods for affected California not-for-profits after controlling for contemporaneous increase in Ohio control group.

Insert Table 4 here

Panel B of Table 4 reports multivariate results for Hypothesis 1. These are consistent with the inferences of univariate tests. The interaction coefficient $Post*Calif(\widehat{\beta}_3)$ is positive and significant in both *Execompl* (coefficient estimate=0.423; t-statistic=1.640) and *Execompl2* (coefficient estimate=1.382, t-statistic=1.690) models (p-value < 0.1 for both). Collectively, these results are consistent with the notion that increased risk and administrative burden brought about by the Act has resulted in higher executive compensation costs, contrary to regulator's objective of reducing the same. These results are not consistent with Hypothesis 1, which predicts that executive compensation has decreased in affected non-profits in California as a result of the Act.

In order to further substantiate that our empirical results above are indeed due to the Act, we use a second control group of non-profits drawn from organizations in California that are classified as religious, grant making, health and education that have gross receipts in excess of

USD 2mn. The advantage of using this control group is that these organizations are all drawn from California but are exempt from the requirements of the Act. Using this additional control sample conclusively eliminates any possibility that our results in Table 4 may have been driven by more dominant California-specific factors that are not related to the Act.¹¹

Table 5 presents descriptive statistics for this control sample. The Table reveals that the non-profits in the California control sample are much larger than those that constitute the test sample in terms of total assets – the mean (median) total assets for the control sample is 37.866 (8.503) million dollars; total revenue – the mean (median) total revenue for the control sample is 24.900 (7.699) million dollars; and total expenses – the mean (median) total expenses for the control sample is 19.307 (6.279) million dollars. Untabulated results suggest that these differences are all statistically significant, suggesting that the control sample consists of larger non-profits. The main variables of interest, *Execompl*, *Execompl2*, *Non-program expense ratio*, *Program ratio* and *Excess* are, however, very comparable to the test group. Specifically, the mean (median) values for *Execompl*, *Execompl2*, *Non-program expense ratio*, *Program ratio* and *Excess* are 0.030 (0.019), 0.094 (0.048), 0.114 (0.155), 0.822 (0.802), and 0.044 (0.030) respectively. There is no statistical difference in these variables between the test and control groups.

Insert Table 5 here

In Table 6, we present the results for Hypothesis 1 using the California control sample. Panel A presents the univariate results. The Table shows that the difference-in-differences for both *Execompl* (z-statistic = 7.418, p-value < 0.01) and *Execompl2* (z-statistic = 10.616, p-value

¹¹ Our Ohio control group is similar to treatment group in terms of industry composition, but differs in the State of domicile. In contrast, this second control group is domiciled in the same State, but consists of different industries.

< 0.01) are significantly positive, suggesting that executive compensation has appeared to have increased significantly in the affected California non-profits after the Act.

Insert Table 6 here

Panel B of Table 6 presents the results of the multivariate analysis. Notice that the interaction coefficient ($\widehat{\beta}_3$), which captures the effect of the Act on the executive compensation in affected California non-profits is positive and statistically significant for both *Execomp1* (coefficient=0.003, t-statistic=1.900) and *Execomp2* (coefficient=0.018, t-statistic=2.960) models. Taken together, these results suggest that executive compensation appears to have increased in affected California non-profits after the Act. This result is consistent with the results presented in Table 4, using the Ohio control group.

Our results indicate that contrary to regulator expectations, the Act has in fact resulted in an increase in executive compensation expenses for affected non-profits.

5.2 Differential Impact on Likelihood of Voluntary Adoption

In Hypothesis 2 we test whether the increase in executive compensation detected above is more pronounced for smaller non-profits as they are relatively less likely to have voluntarily pre-adopted the governance measures introduced by the Act (Ostrower and Bobowick 2006; Vermeer et al 2006). Table 7 presents the SUR results with dependent variables (*Execomp1* and *Execomp2*) separated by whether the total assets of the organization are above (*Large Firms*) or below (*Small Firms*) the sample median. Consistent with our prediction, we find that interaction coefficient ($\widehat{\beta}_3$), which captures the effect of the Act on the executive compensation in affected California non-profits, is positive and statistically significant for *Small Firms*, but not for *Large Firms*. The results are consistent for both *Execomp1* (for *Small Firms*; coefficient=0.007, t-statistic=2.430, for *Large Firms*; coefficient=-0.001, t-statistic=-0.720) and *Execomp2* (for *Small*

Firms; coefficient=0.016, t-statistic=2.110, for *Large Firms*; coefficient=-0.003, t-statistic=-0.420). These indicate that the increase in executive compensation brought about by the Act is primarily confined to relatively smaller non-profits. Further, we are able to comfortably reject the null hypothesis that the interaction coefficient is the same for both large non-profits and small non-profits (F -statistic=6.10 for *Execompl* and F -statistic=3.16 for *Execompl2*). To the extent that the findings of prior literature that size is a reasonable proxy for the voluntary adoption of more stringent governance measures applies to our setting, these results highlight that the costs of regulation (in terms of executive compensation) has differed on the likelihood of such voluntary adoptions. These results also add further confidence to our assertion that changes observed in Hypothesis 1 are in fact a result of the Act.

Insert Table 7 here

We next verify our results above by using the California control group. Table 8 reports these results. The Table shows that the interaction coefficient ($\widehat{\beta}_3$), which captures the effect of the Act on the executive compensation in affected California non-profits is positive and significant for both *Execompl* (coefficient=0.003, t-statistic=16.190) and *Execompl2* (coefficient=0.007, t-statistic=13.650) for the smaller firms. It is not significant for either *Execompl* or *Execompl2* for the larger firms. These results are consistent with the results in Table 7 and suggest that the Act has appeared to have failed to reduce executive compensation in smaller non-profits. It did not seem to have a significant impact on the larger non-profits, which are more likely to have already adopted stringent SOX-like governance mechanisms voluntarily.

Insert Table 8 here

We now explore some alternative explanations for observing greater increases in compensation costs for affected California non-profits.

5.3 Possible alternative explanations for the observed increase in executive compensation in affected non-profits

We interpreted our findings in tests of H1 as evidence of the Act increasing executive compensation expenses, in contrast to its intentions. However, it could be argued that the observed increase in reported executive compensation costs cannot be viewed in a negative light if it is due to one of the following reasons.

1. Increases in compensation were accompanied by overall reductions in non-program expenses (i.e. even though executive compensation has increased, the Act may have lead to greater savings in other non-program expenses).
2. Increases in compensation were accompanied by greater efforts towards charitable activities, as measured by a higher program ratio.
3. The observed increase in reported executive compensation cost is due to reduced managerial discretion in classification shifting of costs (Jones and Roberts 2006; Krishnan, et. al 2006) as a result of the better reporting discipline brought about by the Act (i.e. elimination of classification shifting in post-Act periods have created the “appearance” of higher executive compensation costs).

If any of the above are true, then higher executive compensation in post-Act periods cannot be viewed as evidence of regulation not meeting its intended objectives. Indeed, if explanations 1 and 2 above hold true, we should expect any post-Act increases in executive compensation to be accompanied by improvements in operating performance. For instance, measures such as non-program expenses to total revenue (*Non-program expense ratio*) should go down and ratio of program expenses to total expenses (*Program ratio*) should go up. In the

absence of such changes, the two above-mentioned justifications of the increased compensation will not be valid.

The third alternative explanation of elimination of opportunistic cost-shifting would result in stopping the shifting of reported costs across categories (that is, from administration expenses to program expenses), without altering the total cost structure. Hence, if this explanation holds, one should not observe a relative change (i.e. deterioration) in excess of revenue over expenses scaled by revenue (*Excess*) in post-Act periods. On the other hand, if *Excess* deteriorates in the post-Act period in comparison to control group, it becomes more likely that higher reported executive compensation cannot be attributed to reduced cost shifting activities and is probably caused by a true increase in executive compensation costs.

We explore these alternative explanations through the following Research Propositions.

RP1: Affected California not-for-profits have experienced a greater reduction in the ratio of non-program expenses to total revenue from to pre to post-Act periods when compared with the control group.

RP2: Affected California not-for-profits have experienced a greater increase in Program ratio from to pre to post-Act periods when compared with the control group.

RP3: The excess of revenue over expenses (Excess) of Affected California not-for-profits has improved from pre to post-Act periods when compared with the control group.

If we find the results consistent with these research propositions, it becomes possible that our earlier findings for H1 are not indicative of the Act being burdensome on the affected non-profits. On the other hand, if these propositions are not to be empirically supported, then we can

effectively rule out the alternative explanations outlined above and can be more confident that any observed increases in executive compensation expenses are in fact due to greater compensation costs associated with higher risk exposure and administrative burden.

Table 9 presents results for the tests of RP1-3 for our main sample. Panel A reports univariate results. As indicated in Table 9, we do not find any evidence of California not-for-profits improving either the *Non-program expense Ratio* or *Program Ratio* in post Act periods in comparison to sample group (*Research Propositions 1 and 2*). As a matter of fact, California non-profits indicate a relative deterioration of both measures (the deterioration in *Non-program expense Ratio* is statistically significant, whereas that in *Program Ratio* is not) from pre to post-Act periods.¹² These results tend to indicate that observed increases in executive compensation are unlikely to be off-set by savings or improvements in operating efficiency elsewhere.

If, as argued in the alternative explanation (3) above that the observed increases in executive compensation are due to reduced classification shifting activities, then we should not observe any pre to post-Act changes (i.e. decreases) in excess of revenue over expenses (*Excess*) for California non-profits in comparison to those of Ohio (*Research Proposition 3*). However, Panel A of Table 9 shows that California non-profits have in fact witnessed a relative decrease in *Excess* from pre to post Act periods when compared with the change in Ohio (t-statistic=-6.494, p-value<0.01). Hence, it is unlikely that observed increases in executive compensation are driven by improvements in reporting quality brought about by the Act. Indeed, the observed increases in executive compensation expenses appear to be real.

Insert Table 9 here

¹²The z-statistic and p-value for difference-of-differences in *Non-program expense Ratio* are 7.350 and <0.001 respectively. z-statistic and p-value for difference-of-differences in *Program Ratio* are -1.325 and 0.185 respectively.

Panel B of Table 9 reports results of multivariate tests for *Research Propositions 1-3* where industry effects are controlled for. These results are very similar those of the univariate tests. Specifically, the interaction coefficient ($\widehat{\beta}_3$) which captures the effect of the Act on the executive compensation in affected California non-profits, is positive and statistically significant for *Non-program expense Ratio* (coefficient=0.025 t-statistic=1.740), statistically insignificant for *Program Ratio* (coefficient=0.002 t-statistic=1.050), and negative and significant (coefficient= -2.157, t-statistic=-2.920) for *Excess*, suggesting that while there is no evidence of a decrease in administrative costs or an increase in program-related expenses, the Act appears to have reduced the excess of income over expenses in affected non-profits.

We next replicate the above results with the California control group. Table 10 presents these results. Panel A of Table 10 presents the univariate results. Consistent with Table 9, Panel A shows that the difference-in-differences in the *Non-program expense Ratio* is positive and significant (difference-in-differences=0.004, z-statistic=1.629), while that in the *Program Ratio* is statistically insignificant for the affected California non-profits. The difference-in-differences for the *Excess* of the affected organizations is, negative and statistically significant (difference-in-differences= -0.003, z-statistic=-2.723). The multivariate results in Panel B show that, the interaction coefficient ($\widehat{\beta}_3$), which captures the effect of the Act on the executive compensation in affected California non-profits, is not statistically significant for the *Non-program expense Ratio* and *Program Ratio*, but negative and statistically significant for *Excess* (coefficient= -0.017, t-statistic=-2.920), suggesting that while there is no evidence of a decrease in administrative costs or a relative increase in program-related expenses, the Act appears to have reduced the excess of income over expenses of affected non-profits.

Insert Table 10 here

Collectively, these results indicate that the Act has resulted in an increase in executive compensation costs and the increase is very much likely due to greater risk and administrative burden imposed on non-profit executives by the Act. This raises concerns over the efficacy of the Act in relation to its provisions aimed at curbing compensations that were supposedly “*excessive*”.

The next section concludes.

6. Conclusion

In this paper we assess whether and how California’s Non-profit Integrity Act (2004) impacted the executive compensation costs of affected charitable organizations. Given the general concerns aired by regulators over the potentially excessive executive compensation in non-profits and the specific requirement of the Act aimed at ensuring that executive compensations are “*just and reasonable*” it is clear that regulators had expected the Act to have a moderating effect on executive compensation. Our findings, however, indicate that the Act has resulted in an increase in executive compensation costs for affected California non-profits. Further analyses also reveal that these increases are primarily confined to relatively smaller organizations within the affected non-profits where there was a low likelihood of pre-Act voluntary adoption of governance measures. These results are robust to the use of either similar non-profits domiciled in the State of Ohio, or California non-profits from exempt industries as the control group.

As the apparent compensation increases could also be explained by overall declines in non-program costs, greater efforts towards charitable activities, and/or elimination of opportunistic cost shifting activities, we also check the impact of the Act on non-program costs,

program ratio and the excess of income over expenses. These additional tests indicate that the observed increases in executive compensation costs are not due to above alternative explanations.

When combined with Neely's (2011) failure to find that the Act has resulted in improvements in reporting quality or commercial fund raising activities, our findings raise concerns with respect to the efficacy of the Act. We believe our findings to have broader implications for informing policy debate on the relative merits of regulating non-profits governance as a number of other states have either adopted similar regulations or are contemplating to do so (Mead 2008). Moreover, our findings are also consistent with some concerns raised in the corporate sector that attempts to regulate executive compensation can lead to unintended consequences (Cohen et al 2008b, Romano 2005).

However, we would like to add the following caveats to our results. First, our findings – even when interpreted in conjunction with Neely (2011) – should not be interpreted as a comprehensive repudiation of the efficacy of the Act. Our study (as well as Neely, 2011) is focused on a specific facet that we believe to be of interest to researchers as well as practitioners and policy makers. However, in our opinion, the extant body of literature is not sufficient to make broad claims on the overall efficacy of the Act. Second, while our findings can have general implications for the debate on governance regulation in both not-for-profit and corporate sectors, we caution against over generalizations of these as specific institutional and environmental settings can either moderate or intensify these effects. We leave further investigation of these aspects to future researchers.

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Tables

Table 1: Sample Selection

Details	Full Sample		California		Ohio	
	Firms	Observations	Firms	Observations	Firms	Observations
Initial sample of 501 (c) (3) ^a organizations	57,352	201,661	42,473	147,268	14,879	54,393
<i>Less:</i>						
Gross receipts less than USD 2mn ^b	50,347	175,625	37,427	128,610	12,920	47,015
Industries that are exempt or could not be identified ^{c, d}	2,909	11,422	2,003	7,852	906	3,570
Missing values for key variables	2,493	5,479	1,850	4,002 ^e	643	1,477
Outliers	49	621	38	475 ^f	11	146
Final Sample	1,554	8,514	1,155	6,329 ^g	399	2,185

^a The IRS code section 501 (c) (3) provides for an exemption from federal income tax and allows donors to these organizations to deduct their donation on their federal income tax return. To qualify for 501 (c) (3) exemption, an organization must be organized to operate exclusively for one or more of the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and/or the prevention of cruelty to children or animals.

The initial sample is based on all 501 (c) (3) organizations that report to the Attorney General's office in California and Ohio respectively. The sample is based on all organizations for which there are data on the NCCS digitized database (1998-2003), the NCCS Core database (2002-2007) and individual Form 990s. Data from individual form 990s are necessary for defining gross receipts (see b, below). The sample covers the 6 year period from 2002 to 2007.

^b Government grants and contract income are removed from the calculation of gross receipts.

^c The Act does not apply to organizations that are classified as religious, grant making, health or education

^d We use a second control group of firms from California that belong to the exempt sectors defined in footnote c. For this control group, we also include these observations. Our second sample (the California sample) thus consists of observations drawn only from California. We do not include the Ohio firms in this sample.

^e Observations with missing values for the California sample: 6,443.

^f Outliers for the California sample: 919

^g The final California sample: 11,296 observations (2,063 firms).

Table 2: Industry Distribution (Percentage)

Industry ^h	Full Sample	California	Ohio
Arts, Culture, and Humanities	10.5	10.1	11.6
Environmental Quality, Protection, and Beautification	1.7	1.9	1.2
Animal-Related	1.2	1.6	0.0
Diseases, Disorders, Medical Disciplines	3.1	3.0	3.3
Mental Health, Crisis Intervention	9.4	9.1	10.3
Crime, Legal Related	2.9	3.1	2.2
Employment, Job related	5.5	5.4	5.7
Food, Agriculture, and Nutrition	2.2	2.2	2.2
Housing, Shelter	7.3	7.0	8.0
Public Safety, Disaster Preparedness, and Relief	0.2	0.2	0.2
Recreation, Sports, Leisure, Athletics	1.6	1.8	1.1
Youth Development	3.9	4.4	2.5
Human Services - Multipurpose and Other	42.0	41.7	43.0
International, Foreign Affairs, and National Security	2.2	2.7	0.5
Civil Rights, Social Action and Advocacy	0.5	0.7	0.0
Community Improvement, Capacity Building	3.8	2.6	7.2
Science and Technology, Research Institutes, Services	1.1	1.3	0.5
Social Science Research Institutes, Services	0.3	0.4	0.0
Public Society Benefit - Multipurpose and Other	0.7	0.8	0.6
	100.0	100.0	100.0

^h The National Taxonomy of Exempt Entities (NTEE) Core Codes divides the universe of non-profit organizations into 26 major groups. The Table above classifies the sample of 8,514 firm-year observations defined in Table 1, based on this NTEE classification.

Table 3: Descriptive Statisticsⁱ

Variable	Full Sample			California			Ohio		
	Mean	Median	S. D.	Mean	Median	S. D.	Mean	Median	S. D.
Total Assets	23.160	6.102	63.886	22.644	5.846	66.467	24.657	6.909	55.727
Total Revenue	12.836	6.099	22.130	13.638	6.163	24.152	10.513	5.907	14.544
Total Expenses	11.963	5.654	20.908	12.774	5.717	22.905	9.614	5.408	13.283
Program Expenses	9.690	4.637	5.293	10.474	4.688	6.101	7.403	4.435	9.453
Non-program Expenses	2.210	1.020	8.903	2.209	1.029	8.766	2.211	0.964	9.068
Total Salaries	1.436	0.226	5.601	1.533	0.229	5.766	1.442	0.216	5.097
Officer Salaries	0.803	0.516	0.985	0.785	0.518	0.949	0.864	0.486	1.102
Execomp1	0.032	0.022	0.048	0.032	0.022	0.045	0.032	0.022	0.055
Execomp2	0.117	0.065	0.166	0.116	0.064	0.162	0.124	0.067	0.178
Program ratio	0.785	0.812	0.112	0.814	0.810	0.113	0.783	0.825	0.110
Non-program expense ratio	0.169	0.161	1.392	0.162	0.167	1.217	0.210	0.163	1.179
Excess	0.041	0.018	0.239	0.042	0.017	0.171	0.044	0.017	0.289

ⁱ The sample is based on the sample of 8,514 observations (6,329 in California and 2,185 in Ohio) for the period 2002-2007, defined in Table 1. The variables are defined as follows: **Total Assets** = Total assets at the end of the year, line 59 on Form 990; **Total Revenue** = Total revenue, line item 12 on Form 990; **Total Expenses** = Total revenue, line item 17 on Form 990; **Program Expenses** = Total program-related expenses; **Non-Program Expenses** = Difference between total expenses and program-related expenses; **Total Salaries** = The total compensation expenses reported on Form 990; **Officer Salaries** = Total compensation paid to the top 5 executives, as reported on Form 990; **Execomp1** = The ratio of the total compensation paid to executives to the total revenue earned in the period; **Execomp2** = The ratio of the total compensation paid to executives to the total compensation paid during the year; **Program Ratio** = The ratio of program related expenses to total expenses; **Non-program expense ratio** = The ratio of non-program expenses to total revenue; **Excess** = Excess of income over expenses defined as the ratio of gross operating and non-operating income to gross revenue.

All figures, other than the ratios have been expressed in \$ mn.

Table 4: Analysis of Executive Compensation*Panel A: Univariate Analysis*

		California	Ohio
<u>Execomp1</u>			
Pre-Act	Mean	0.030	0.032
	Median	0.021	0.021
Post-Act	Mean	0.034	0.033
	Median	0.024	0.023
Pre to Post Difference		0.004*** (6.050)	0.001*** (2.369)
Difference-in-Differences		0.003*** (5.439)	
<u>Execomp2</u>			
Pre-Act	Mean	0.105	0.121
	Median	0.059	0.061
Post-Act	Mean	0.125	0.127
	Median	0.070	0.073
Pre to Post Difference		0.020*** (6.697)	0.006*** (3.366)
Difference-in-Differences		0.014*** (5.523)	

Panel B: Multivariate Analysis^j

Model:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Calif_i + \beta_3 Post_t * Calif_i + \beta_j Industry_i + \varepsilon_{it}$$

		<i>Execompl</i>		<i>Execompl2</i>	
		Coefficient	t-statistic	Coefficient	t-statistic
<i>Intercept</i>	$\widehat{\beta}_0$	1.626***	2.740	23.708**	2.580
<i>Post^k</i>	$\widehat{\beta}_1$	-0.015	-0.070	0.576	0.800
<i>Calif^l</i>	$\widehat{\beta}_2$	-0.368*	-1.740	-1.462***	-2.440
<i>Post*Calif</i>	$\widehat{\beta}_3$	0.423*	1.640	1.382*	1.690
<i>Industry Controls?</i>		Yes		Yes	
<i>Adj. R²</i>		2.49%		12.53%	
<i>N</i>		8,511		8,283	

^j ***, **, and * represent statistical significances at the 1%, 5% level or better and 10% level respectively.

The Table above reports tests based on the sample of 8,514 observations (6,329 in California and 2,185 in Ohio) for the period 2002-2007 (pre-Act: 2002-2004, post-Act: 2005-2007), defined in Table 1. Panel A above presents the univariate Wilcoxon signed rank test results for the equality of the dependent variables. Panel B presents results for the multivariate regressions (heteroscedasticity adjusted).

^k Post: A dummy variable that takes of value 1 for year on or after 2004; zero otherwise.

^l Calif: A dummy variable that takes a value 1 if the observation is from California; zero otherwise.

Table 5: Descriptive Statistics for the California control group

California ^m			
Variable	Mean	Median	S.D.
Total Assets	37.866	8.503	105.216
Total Revenue	24.900	7.699	50.231
Total Expenses	19.307	6.279	46.624
Program Expenses	16.790	5.086	5.239
Non-program Expenses	2.852	1.193	5.174
Total Salaries	2.425	0.890	14.171
Officer Compensation	0.360	0.178	1.442
Execomp1	0.030	0.019	0.050
Execomp2	0.094	0.048	0.165
Program ratio	0.822	0.802	0.046
Non-program expense Ratio	0.114	0.155	0.129
Excess	0.044	0.030	0.196

^m The Table above is based on a sample of 4,967 observations for the period of 2002 to 2007. The sample above is drawn from non-profit organizations in California that have gross receipts (excluding Government grants and contract income) of more than \$2mn and classified as religious, grant making, health or education.

The variables are defined as follows: **Total Assets** = Total assets at the end of the year, line 59 on Form 990; **Total Revenue** = Total revenue, line item 12 on Form 990; **Total Expenses** = Total revenue, line item 17 on Form 990; **Program Expenses** = Total program-related expenses; **Non-Program Expenses** = Difference between total expenses and program-related expenses; **Total Salaries** = The total compensation expenses reported on Form 990; **Officer Salaries** = Total compensation paid to the top 5 executives, as reported on Form 990; **Execomp1** = The ratio of the total compensation paid to executives to the total revenue earned in the period; **Execomp2** = The ratio of the total compensation paid to executives to the total compensation paid during the year; **Program Ratio** = The ratio of program related expenses to total expenses; **Non-program expense ratio** = The ratio of non-program expenses to total revenue; **Excess** = Excess of income over expenses defined as the ratio of gross operating and non-operating income to gross revenue.

All figures, other than the ratios, have been expressed in \$ mn.

Table 6: Analysis of Executive Compensation for the California control group*Panel A: Univariate Analysis*

		California (Treatment)	California (Exempt)
<u>Execomp1</u>			
Pre-Act	Mean	0.030	0.031
	Median	0.021	0.017
Post-Act	Mean	0.033	0.033
	Median	0.024	0.020
Pre to Post Difference		0.003*** (5.439)	0.002*** (3.429)
Difference-in-Differences			0.002*** (7.418)
<u>Execomp2</u>			
Pre-Act	Mean	0.098	0.096
	Median	0.054	0.043
Post-Act	Mean	0.123	0.100
	Median	0.067	0.051
Pre to Post Difference		0.025*** (5.997)	0.004*** (3.675)
Difference-in-Differences			0.022*** (10.616)

Panel B: Multivariate Analysis

Model:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Test_i + \beta_3 Post_t * Test_i + \beta_j Industry_i + \varepsilon_{it}$$

		<i>Execomp1</i>		<i>Execomp2</i>	
		Coefficient	t-statistic	Coefficient	t-statistic
<i>Intercept</i>	$\widehat{\beta}_0$	0.029*** ⁿ	28.160	0.097***	26.450
<i>Post</i> ^o	$\widehat{\beta}_1$	0.000	0.470	0.001	0.180
<i>Test</i> ^p	$\widehat{\beta}_2$	-0.016***	-2.960	0.125	1.360
<i>Post*Test</i>	$\widehat{\beta}_3$	0.003*	1.900	0.018***	2.960
<i>Industry Controls?</i>		Yes		Yes	
<i>Adj. R²</i>		1.28%		7.19%	
<i>N</i>		11,296		11,296	

ⁿ***, **, and * represent statistical significances at the 1%, 5% level or better and 10% level respectively.

The Table above reports tests based on the sample of 11,296 observations (6,329 in California treatment group and 4,967 in California exempt group) for the period 2002-2007 (pre-Act: 2002-2004, post-Act: 2005-2007). Panel A above presents the univariate Wilcoxon signed rank test results for the equality of the dependent variables. Panel B presents results for the multivariate regressions (heteroscedasticity adjusted).

^o Post: A dummy variable that takes of value 1 for year on or after 2004, zero otherwise.

^pTest: A dummy variable that takes a value 1 if the organization is not classified as religious, grant making, health or education; zero otherwise.

Table 7: Analysis of Executive Compensation – Small vs. Large Firms

Model:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Calif_i + \beta_3 Post_t * Calif_i + \beta_j Industry_i + \varepsilon_{it}$$

		<i>Execompl</i>				<i>Execompl2</i>			
		Small Firms		Large Firms		Small Firms		Large Firms	
		Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
<i>Intercept</i> ^q	$\widehat{\beta}_0$	0.000	0.020	0.000	1.070	0.000	0.020	0.002	1.300
<i>Post</i>	$\widehat{\beta}_1$	0.001	0.730	0.005***	3.880	0.003	0.490	0.025***	3.790
<i>Calif</i>	$\widehat{\beta}_2$	-0.006***	-3.200	0.005***	3.880	-0.008	-1.630	-0.002	-0.420
<i>Post*Calif</i>	$\widehat{\beta}_3$	0.007***	2.430	-0.001	-0.720	0.016**	2.110	-0.003	-0.420
<i>Industry Controls?</i>		Yes		Yes		Yes		Yes	
<i>Adj. R²</i>			23.08%				30.26%		
<i>F - Statistic</i>			6.10				3.16		
<i>N</i>			8,511				8,283		

^q The regression results above are based on the sample of 501 (c) (3) organizations defined in Table 1. The sample covers the 6 year period from 2002 to 2007 and consists of 8,514 observations. The variables are as defined in Tables 2, 3 and 5.

Table 8: Analysis of Executive Compensation – Small vs. Large Firms for the California sample

Model:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Test_i + \beta_3 Post_t * Test_i + \beta_j Industry_i + \varepsilon_{it}$$

		<i>Execompl</i>				<i>Execompl2</i>			
		Small Firms		Large Firms		Small Firms		Large Firms	
		Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
<i>Intercept</i>	$\widehat{\beta}_0$	0.005*** ^r	9.500	0.003***	9.110	0.014***	9.450	0.010	7.710
<i>Post</i>	$\widehat{\beta}_1$	0.034***	28.860	0.020***	29.820	0.091***	25.600	0.073	26.250
<i>Test</i>	$\widehat{\beta}_2$	0.009	0.460	0.040***	8.440	0.061	1.050	0.202	10.520
<i>Post*Test</i>	$\widehat{\beta}_3$	0.003***	16.190	-0.002	- 0.640	0.007***	13.650	-0.005	-1.320
<i>Industry Controls?</i>		Yes		Yes		Yes		Yes	
<i>Adj. R²</i>			15.64%				19.49%		
<i>F - Statistic</i>			36.89				9.18		
<i>N</i>			11,296				11,296		

^r ***, **, and * represent statistical significances at the 1%, 5% level or better and 10% level respectively. The t-statistics reported in the Table have been adjusted for heteroscedasticity.

Table 9: Analysis of Non-program expense Ratio, Program Ratio, and Excess of income over expenses

Panel A: Univariate Analysis

		California	Ohio
<u>Non-program expense Ratio</u>			
Pre-Act	Mean	0.153	0.208
	Median	0.164	0.161
Post-Act	Mean	0.169	0.212
	Median	0.175	0.164
Pre to Post Difference		0.016*** (3.034)	0.004 (1.459)
Difference-in-Differences		0.012*** (7.350)	
<u>Program Ratio</u>			
Pre-Act	Mean	0.822	0.742
	Median	0.813	0.822
Post-Act	Mean	0.810	0.790
	Median	0.807	0.846
Pre to Post Difference		-0.012 (0.679)	0.048 (0.976)
Difference-in-Differences		-0.060 (-1.325)	
<u>Excess</u>			
Pre-Act	Mean	0.034	0.023
	Median	0.014	0.013
Post-Act	Mean	0.059	0.070
	Median	0.026	0.027
Pre to Post Difference		0.025*** (6.873)	0.047*** (4.903)
Difference-in-Differences		-0.022*** (-6.494)	

Panel B: Multivariate Analysis

Model:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Calif_i + \beta_3 Post_t * Calif_i + \beta_j Industry_i + \varepsilon_{it}$$

		<i>Non-program expense Ratio</i>		<i>Program Ratio</i>		<i>Excess</i>	
		Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
<i>Intercept</i> ^s	$\widehat{\beta}_0$	0.719***	2.890	0.012	0.970	15.897***	3.930
<i>Post</i>	$\widehat{\beta}_1$	-0.051***	-0.140	0.002	1.160	4.669***	3.580
<i>Calif</i>	$\widehat{\beta}_2$	-0.055***	-2.920	0.013***	5.640	1.478	1.180
<i>Post*Calif</i>	$\widehat{\beta}_3$	0.025*	1.740	0.002	1.050	-2.157***	-2.920
<i>Industry Controls?</i>	Yes			Yes		Yes	
<i>Adj. R²</i>	6.37%			15.36%		2.42%	
<i>N</i>	8,514			8,514		8,511	

^sThe tests are based on the sample of 501 (c) (3) organizations defined in Table 1. The sample covers the 6 year period from 2002 to 2007 and consists of 8,514 observations (6,329 for California and 2,185 for Ohio). In the Table above, “Before” (“After”) refers to the years before (after) 2004. Variables are defined as in the Table 4.

Table 10: Analysis of Non-program expense Ratio, Program Ratio, and Excess of income over expenses for California control group

Panel A: Univariate Analysis

		California (Treatment)	California (Control)
<u>Non-program Expense Ratio</u>			
Pre-Act	Mean	0.153	0.109
	Median	0.164	0.152
Post-Act	Mean	0.169	0.121
	Median	0.175	0.157
Pre to Post Difference		0.016*** (3.034)	0.012*** (2.859)
Difference-in-Differences		0.004* (1.629)	
<u>Program Ratio</u>			
Pre-Act	Mean	0.821	0.814
	Median	0.813	0.836
Post-Act	Mean	0.819	0.826
	Median	0.807	0.838
Pre to Post Difference		-0.002 (0.505)	0.012 (0.962)
Difference-in-Differences		-0.015 (-0.525)	
<u>Excess</u>			
Pre-Act	Mean	0.031	0.034
	Median	0.013	0.025
Post-Act	Mean	0.052	0.058
	Median	0.023	0.036
Pre to Post Difference		0.021*** (4.621)	0.024*** (3.313)
Difference-in-Differences		-0.003*** (-2.723)	

Panel B: Multivariate Analysis^t

Model:

$$y_{it} = \beta_0 + \beta_1 Post_t + \beta_2 Test_i + \beta_3 Post_t * Calif_i + \beta_j Industry_i + \varepsilon_{it}$$

		<i>Non-program expense Ratio</i>		<i>Program Ratio</i>		<i>Excess</i>	
		Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
<i>Intercept</i>	$\widehat{\beta}_0$	0.935***	187.85	0.019***	18.830	0.039***	3.930
<i>Post</i>	$\widehat{\beta}_1$	-0.026***	-3.960	0.003***	2.640	0.022***	3.580
<i>Test</i>	$\widehat{\beta}_2$	-0.096***	-2.470	0.025	1.220	0.135***	1.180
<i>Post*Test</i>	$\widehat{\beta}_3$	0.000	0.040	-0.003	-1.210	-0.017**	-2.920
<i>Industry Controls?</i>		Yes		Yes		Yes	
<i>Adj. R²</i>		3.55%		12.84%		1.37%	
<i>N</i>		10,974		10,974		11,296	

^t The tests are based on the sample of 501 (c) (3) organizations defined in Table 1. The sample covers the 6 year period from 2002 to 2007 and consists of 11,296 observations (6,329 in California treatment group and 4,967 in California exempt group) for the period 2002-2007 (pre-Act: 2002-2004, post-Act: 2005-2007).. Variables are defined as in the Tables 4 and 6.