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"CORPORATE" GOVERNANCE IN NONPROFIT ORGANIZATIONS: A NON-TECHNICAL REVIEW OF THE ECONOMIC LITERATURE

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ABSTRACT

The economics based theoretical and empirical literature on the governance of nonprofit organizations is brought together and integrated in a way easily accessible for non-economists. This literature is scattered around in academic journals covering economics, health economics, management, accounting, and the more nonprofit geared scientific publications.

After defining corporate governance, the most appropriate microeconomic framework to study governance problems is presented in a non-technical way: the principal-agent theory. Most of the economic literature deals with the role and influence of the board, and its relation to the organization's management and performance. This is also reflected in the paper's structure. With respect to the board, its functioning, composition, and committee structure are discussed, followed by a review of the literature on incentive based remuneration schemes, disclosure of financial information, and the use of debt to mitigate agency problems between the board and management. In a following section the available literature dealing with donors and subsidizing authorities in governance relations is presented. The paper's conclusion contains a number of practical implications of the scholarly obtained results to date, as well as some suggestions for further theoretical and empirical research.

INTRODUCTION

"Corporate governance" is a widely used concept, covering a growing range of definitions going from the strictly organizational level to the societal level.¹ It originated in the theories on the functioning of profit organizations: "Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (Shleifer, Vishny 1997: 737). This definition can easily be extended in order to include all institutional forms without leaving the organizational level: "corporate governance [is] the design of institutions that induce or force management to internalize the welfare of stakeholders" (Tirole 2001: 4), or, more specifically, "[corporate] governance is the system by which organizations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance" (Anheier 2005: 230). "Corporate" in "corporate governance" refers to any form of organization, and not anymore exclusively to profit organizations. The present paper deals with corporate governance defined in this way, but confined to nonprofit organizations, characterized (in the eyes of an economist) by the fact that their founders are not entitled to (a part of) the organization's profits, a condition traditionally called the non distribution constraint (Hansmann 1987: 28).²

The present paper aims at bringing together and integrate as much as possible the economics based theoretical and empirical literature on the governance of nonprofit organizations in a way easily accessible for non-economists and useful for practitioners. As can be inferred from this paper's list of references, this literature is scattered around in general academic journals covering, a.o., economics, health economics, management, accounting, finance, and the more nonprofit geared scientific publications. Compared to the huge amount of theoretical work on profit governance, "[less] is known about governance arrangements in nonprofit corporations" (Dyl et al. 2000: 335), or "the economics-based literature has been fairly silent on nonprofit governance" (Eldenburg et al. 2000: 5). A reason might be the fact that "[nonprofit] organizations have governance problems that resemble the problems in for-profit firms, but are often far more extreme" (Glaeser 2003: 39). By now, the situation has slightly improved, especially due to a number of empirical papers devoted to nonprofit governance. This might be the reason why the above quotation of Eldenburg et al. is not found anymore in the published version of their paper (Eldenburg et al. 2004).

In the next section, the microeconomic underpinnings of the economic literature on nonprofit governance are presented in a conceptual way. In the subsequent sections, their applications to nonprofit governance issues are exposed.

1. THE ECONOMIST'S FRAMEWORK FOR GOVERNANCE RESEARCH

The appropriate theoretical (microeconomic) framework within which most of the salient aspects of corporate governance can be analyzed is the *principal-agent* theory. A principal-agent relationship can be defined as "a contract under which one or more persons (the

¹ See for instance the four volumes (about 2,300 pages) needed by Keasey et al. (eds.) (1999) in their attempt to cover the field of corporate governance as exhaustively as possible.

² A plea for a broader approach, extending the governance analysis outside the confines of the nonprofit organization, can be found in Stone and Ostrower (2007: 419). They indicate that the literature on public governance can be integrated into the more traditional governance literature described here, though there is still a "wide gap between research traditions focused on public governance and those attending to nonprofit governance" (ibid.: 433).

principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal" (Jensen, Meckling 1976: 308). Part of the principal's problem can be solved by designing appropriate incentive schemes, including some amount of monitoring (at a cost called *monitoring cost*). The agent can commit herself by incurring *bonding costs*, in an attempt to convince the principal she will do her utmost to accommodate to his goals. The eventual difference between the optimal organizational performance from the point of view of the principal and the eventual performance is called the *residual loss*. The sum of monitoring costs, bonding costs, and the residual loss is the *agency cost*.

In general, principal-agent relationships are affected by two categories of problems, each resulting from informational asymmetries between the principal and the agent. Before signing the contract, the potential agent can conceal some relevant but negative information about herself, leading to an *adverse selection* problem. After having signed the contract, the agent can misbehave as long as her behavior is unobservable (*moral hazard*).

Principal-agent relationships abound within society: between shareholders and managers in profit organizations, managers and subordinates in any kind of hierarchical organizations, patients and physicians, students (and/or their parents) and teachers, firms and their advertising agencies, donors and donation recipients, governments and subsidized organizations, needy people and relief organizations,... Without any doubt various relationships in nonprofit organizations can also be analyzed within this framework (Brody 1996: 462; Herman, Heimovics 1991; Hewitt, Brown 2000; Miller-Millesen 2003; Steinberg 1990), though this runs counter the "stewardship" ideal one might cherish. A closer analysis however reveals that this opposition between stewardship theory and principal-agent theory is more virtual than real, as a stewardship relationship can be defined as a principal-agent relationship in which the objectives of both principal and agent are identical (Caers et al. 2006: 29). In this interpretation a stewardship relationship is just a limiting case of the general principal-agent relationship, sometimes, rightly or wrongly, believed to be reality by some principals, as illustrated by Miller (2002) on a small sample of 12, mostly local, US nonprofit organizations from New York and Connecticut: "the board members generally do not believe that their chief executives will behave opportunistically" (Miller 2002.: 437).

Referring to the aforementioned definitions of corporate governance, it is clear that the relationships between organizational stakeholders and (members of) the organization can be characterized as principal-agent relationships. Every stakeholder can act as a principal in a principal-agent theory of (nonprofit) organizations. As there is no reason to expect them all to have identical objectives, and, for that matter, identical perceptions of effectiveness (Herman, Renz 2004: 699), a comprehensive principal-agent approach would imply a "multiple principals" framework. At the moment of writing, such a nonprofit theory has not been developed yet, though considering the board as the principal (in line with mainstream theorizing on profit organizations) in a way brings the objectives of a number of stakeholders together³, assuming away possible differences in objectives between its principals, even if we consider the founders of the organization to be the only ones to reckon with. Therefore, the

³ A few studies concentrate on the ultimate owner of the organization instead of on the board this owner constitutes. Farsi and Filippini (2004) for instance find no significant efficiency differences between public nonprofit organizations and private nonprofit organizations (panel data on 36 Swiss nursing homes in the Ticino canton, 1993-2004), whereas Knox et al. (2006) find efficiency differences between private secular nonprofit organizations and religious nonprofit organizations (about 150 Texan nursing homes in each of the years 1994, 1998, 1999), the secular ones being more efficient (Knox et al. 2006: 658).

board is mostly described as a monolithic body⁴, having clear goals and objectives, which are the benchmarks of organizational behavior, assumed to be steered by the agent (manager).

Possible differences in objectives between nonprofit boards and nonprofit managers can be measured either indirectly⁵ or directly. The paper by Du Bois et al. (2006) is an example of the last group of methods. Their sample consists of 503 primary school managers, 187 secondary school managers, and 171 board chairpersons of nonprofit schools in Flanders (2005). In this sample a stewardship attitude by managers is certainly not present: ideology appears to be more important for board chairpersons, whereas objectives such as staff satisfaction and pupil satisfaction seem more important for the managers. This implies that at least in their setting agency problems are bound to exist.

Also in cases in which there is no difference in objectives between board and management, differences in ideology, religion, or perceptions on optimal strategies may arise. Theoretically, these are no agency conflicts, but they are clearly relevant when discussing governance issues in nonprofit organizations.

Concluding, it goes beyond any doubt that the board has been the major point of interest in the economic thinking on nonprofit governance⁶ (managers being the agents mostly considered), contrary to specific stakeholders such as donors and lenders, to which scant research efforts are devoted in the microeconomic analysis of nonprofit governance, or beneficiaries, volunteers, or staff members, who are almost ignored.

2. THE BOARD AS ORGANIZATIONAL PRINCIPAL

2.1. Functioning of the board

Before looking at the relationship of the board (principal) and its agent(s), the literature on the functioning of the board itself deserves some attention, as its (lack of) effectiveness affects its impact on the agent's freedom of movement. Apart from this functioning, empirical work reviewed by Ostrower and Stone (2006: 617-618) indicates that the balance of power between board and management is affected by three groups of variables ("b" indicating that higher values of the variable under consideration imply more board influence, and "m" more managerial power):

- individual variables
 - gender of board members: more female board members seem to make the board less influential;
 - prestige/wealth of board members (b);
 - managerial tenure (m);
 - managerial credentials (m).
- organizational variables

⁴ Du Bois et al. (2005) discover a link between board composition and organizational objectives, based on a sample of 170 chairpersons of nonprofit Flemish primary and secondary schools, collated in 2005. Apart from their gender, board members are grouped into members with an educational background, a legal background, a financial background, or a religious background. Using an ordered probit methodology, it is shown that board composition matters in terms of organizational objectives, at least as expressed by the chairperson. To give just one example, the data show that the presence of more men in the board decreases the importance attached to ideology as a key objective of the school. Enacting regulations on board composition, such as e.g. on gender representativity, might therefore have unexpected, but not necessarily unwanted or negative, side effects on the organizational objectives effectively pursued.

⁵ The seminal paper is here Steinberg (1986). For an extension, see Brooks and Ondrich (2007). These methods are designed to measure organizational objectives by looking at fundraising policies, and deriving from that the balance of power between board and manager.

⁶ An interesting exception is Speckbacher (2008), who proposes the primary stakeholder to be considered as the relevant principal.

- age (m);
- size (m);
- complexity and degree of bureaucratization (m).
- environmental variables
 - complexity of interorganizational ties, making power more fragmented;
 - organizational financial dependence on board members (b);
 - stability (m);
 - governmental funding (m).

Coming back to the board's functioning, it can be observed that there is still no real economic theory on this issue (Ostrower, Stone 2006: 612), contrary to the existence of numerous practitioner oriented handbooks on the topic. They mostly depart from "a "heroic" model of the role of the non profit board" (Herman, Heimovics 1990: 168), although this might also be considered just to be a normative stance.

To gauge the nonprofit board's functioning⁷, Gill et al. (2005) designed and validated (on a sample of 312 respondents, of which 31 executive directors, from 32 Canadian nonprofit organizations) what they call the Governance Self-Assessment Checklist, consisting of 144 items grouped into twelve subscales (see Table 1).

Table 1 - Subscales of Governance Self-Assessment Checklist for nonprofit boards

	Subscale description
1	Board effectiveness quick check (15 items)
2	Board structure (13 items)
3	Board culture (16 items)
4	Mission and planning (13 items)
5	Financial stewardship (10 items)
6	Human resources stewardship (9 items)
7	Performance monitoring (9 items)
8	Community representation (8 items)
9	Risk management (13 items)
10	Board development (10 items)
11	Board management (11 items)
12	Decision-making (17 items)

Source: Gill et al. (2005: 277-278, 282)

An early study to assess the nonprofit board's functioning has been published by Middleton (1987), who reviews the available (essentially US based) empirical results at that time. She concludes that "many board members and managers alike contend that boards often function poorly" (ibid.: 141). A more cynical view has been expressed by Brody (1996: 487): "[the]

⁷ At the individual board member level, Preston and Brown (2004: 222) present a literature review from which they derive a list of performance indicators: attendance during meetings, input during meetings, organizational knowledge, follow-up of relevant topics, volunteering for operational tasks.

most important task of the nonprofit board is to ensure its own continuation." More recent empirical work however allows us at least to shade these observations, though the measurement of organizational performance is not free of validity problems, and most samples are rather small.

Thirty-nine volunteer managed nonprofit organizations in a Boston suburb (1992) constituted the sample of Smith and Shen (1996). Reputation, measured by the number of nominations by leaders of other organizations, is seen to be positively affected by the mere presence of a board (ibid.: 279). In the aforementioned paper by Gill et al. (2005), for each organization in the sample two external observers familiar with the organization were asked to rate the organization on ten effectiveness items. Also internal effectiveness ratings were collected. Most of the subscale values of the Governance Self-Assessment Checklist (see Table 1) are significantly related to these ratings (ibid.: 284). Brown (2005), on a sample of 100 nonprofit, mostly human service, organizations, finds significantly positive correlations between organizational performance as perceived by executives and board members, and board performance as perceived by respectively board members and executives (ibid.: 331).

In a certain way contrary to the previous results, Herman and Renz (2004), on a 1999 sample of maximally 44 United Way funded organizations in the US (health and welfare organizations, organizations helping developmentally disabled people), do not find a relationship between the application of "good" practices by the board and organizational effectiveness as measured by the number of people involved in the organization.

Though the empirical results obtained up to now are fragmentary and do not allow us to formulate general conclusions, warranting further systematic research, it appears that boards perceived to function well can be expected on average to impact on organizational outcome by mitigating agency problems between board and management. It should be borne in mind that "well functioning" is essentially a multidimensional concept, containing both formal and informal components.

2.2. Governance structure: composition of the board and committees

One of the first empirical papers delving into the impact of board composition on the behavior of nonprofit organizations is published by Dyl et al. (2000). Their sample consists of 54 nonprofit medical research charities in the US (1991), and focuses on managerial representation on the board, which appears to be positively related to higher executive salaries and more attention to fundraising (departing from the assumed principal's objectives), but not to management expenses or organizational wealth (conforming to the principal's objectives).

Callen et al. (2003) composed a sample of 108 large New York nonprofit organizations in 1995 and 1996. They characterize board composition by using five categories of members: staff (median value: 2 per cent of board size), major donors, persons with professional skills (the largest group: 37 per cent median value), well-known individuals, and the inevitable "others" (Callen et al. 2003: 501), and also present information on the existence and composition of all kinds of committees. The most frequently observed committees are the finance and nomination committees (in more than 70 per cent of the organizations surveyed), the least frequently observed the audit committee (in 35 per cent of the cases, though this number amounts to about 80 per cent in the post Sarbanes-Oxley sample (2004) of 128 of the largest US nonprofit organizations of Vermeer et al. (2006)). Also, the composition of the existing committees does not reflect board composition, but seems, logically, adapted to the committees' competences: the median share of professionally skilled members of the audit committees is almost two thirds of the committee's size, whereas this share is lower than one third for the nomination committee, to give just a few examples (Callen et al. 2003: 502). The governance structure in place and the composition of the governance bodies are clearly shown

to affect organizational behavior: more donors on the board go together with less administrative expenses and more core activities, larger boards are positively associated with (relative) fundraising expenses. The effect of the committees as such is not assessed, but donor membership of these committees is. Their presence in finance committees is positively related to the organization's administrative efficiency (ibid.: 515-516).

The link between governance structure and performance is also assessed by Alexander and Lee (2006). They concentrate on the board configuration, looking at the impact of having a "corporate model" board, characterized by a limited number of paid specialized board members, by including in the board a substantial share of actively participating inside directors, by managers being directly accountable to the board, by finite terms for the board members, and by a focus on strategic issues (ibid.: 737). Their data pertain to nonprofit hospitals (three samples of each around 1,000 observations in the period 1985-1993), and reveal only a positive link between the presence of "corporate model" boards and the level of (adjusted) admissions, but not with efficiency, market share, occupancy, or cash flow (ibid.: 747). De Andrés-Alonso et al. (2006) concentrate on the relationship between board characteristics (size, relative number of outsiders, rotation of board members, presence of an executive committee, minimum number of board meeting per year, organization's founder being a board member) and efficiency on a sample of 41 Spanish nongovernmental development organizations (1995-2001). There seems to be no relationship with technical efficiency (measured as the share of administrative costs in total costs), but smaller sizes, larger shares of outsiders, and lower meeting frequencies positively affect what is called allocative efficiency (direct project expenses divided by donations and subsidies) (De Andrés-Alonso et al.: 600).

Another study with New York data, in a sample of more than 3,100 board members of 403 nonprofit contractors of New York city (data collected in 1999), is performed by O'Regan and Oster (2005). Contrary to earlier work, they go into a little bit more detail as to the members' professional skills (financial, other business, education, law, social services) (O'Regan, Oster 2005: 213). Interestingly, the unit of analysis is the board member, and not the board itself or the organization. The behavioral patterns they discern are complex (ibid.: 221). To give one example, they find that the presence of voting executives in the board is inversely correlated with the number of donating board members, but positively with the average amount donated (ibid.: 220).

Taken together, the available research on the behavioral impact of board and committees composition does not lead to very coherent insights yet, making detailed generalizations methodologically impossible. Nevertheless, it points to the conclusion that the composition of the board, and the governance structure in general, may not be neutral as to its effect on the functioning of the organization,⁸ but the complex patterns involved have not been unraveled yet, suggesting fruitful directions for further research. However, the presence of managers and donors in the board and its committees seems to have potential effects on governance effectiveness, the first ones exacerbating agency problems, the last ones mitigating them.

2.3. Performance based remuneration schemes

To find incentive mechanisms to discipline managers as a means to attain organizational objectives is, theoretically, not such a difficult task in profit organizations, as is proved by the lavish academic literature on the matter. For nonprofit organizations, this is different (Steinberg 1990): "[the] core governance problems of [nonprofit organizations] arise from their management having generally poor incentives and being shielded from the most potent

⁸ See Jackson, Donovan (1999: 18 sqq.) for an example of a practitioner oriented version of this statement.

disciplining devices in for-profit firms, like hostile takeovers, proxy fights, or even independent directors" (Bolton, Mehran 2006: 296). Profits are certainly not an appropriate criterion to use performance based remuneration schemes, as they divert managerial efforts and attention from the organizational objectives to wealth creation (Preyra, Pink 2001: 511), apart from their potential negative effect on subsidies or donations received.

Finding relevant, objective, measurable and verifiable performance criteria to serve as a basis for the calculation of the managerial remuneration is not easy, but there is some empirical support to argue that this is not impossible, at least to a limited extent. However, these results were obtained only in cross-sectional settings, whereas only a time series approach would allow firm conclusions as to the link between performance (changes) and remuneration (changes). Baber et al. (2002), in a study on 331 US charities in a four year period at the end of the nineties, establish a very significantly positive relationship between the relative change in managerial compensation and the relative change in *program* spending (all expenses minus administrative expenses and fundraising expenses). Despite its significance, the relationship is also weak, as a one per cent increase in program spending goes together with a .07 per cent increase in managerial compensation (ibid.: 687, n6). Hallock's paper (Hallock 2002) is comparable in its set-up. His sample contains 9,776 US nonprofit organizations (1992-1996), and performance is measured by a number of variables: size, program expenses relative to total expenses, and financial revenues. After controlling for industry (being significant on its own) and the organization, the only statistically relevant but albeit very small correlation is found between managerial compensation and size (a result also obtained by Jobome in his UK sample of the 100 largest charities in terms of their 2000-2001 income (2006: 347)), which seems to be a very questionable performance variable, as it might also proxy for organizational complexity, in which case it is natural to expect higher managerial wages in larger organizations, irrespective of possible incentive effects. O'Connell (2005), in a sample of 133 nonprofit liberal arts colleges in the US (1995-1996), cross-sectionally finds a positive relationship between the colleges' reputations (as perceived by administrators of other colleges) and the chief executive's salary. Finally, also Carroll et al. (2005), in a panel study with 38,880 observations (US, 1992-1996), find that "asset size is a major determinant of total executive compensation" (Carroll et al. 2005: 27), followed by performance, which in their case is a revenue based metric (ibid.).

These results are not very convincing as to the possibility of finding effective incentive mechanisms as a basis for managerial remuneration in nonprofit organizations (see also the recent review by Jobome (2006: 335-338)), even if there might be organizations considering the implementation of pay-for-performance systems, such as the two organizations in the Austrian sample of nine organizations (2004) in the exploratory study by Brandl and Gütter (2007), which were as far as having established a project group and a change management program for the matter (Brandl, Gütter 2007: 184-185). The correlations found are implicit at best (because of the cross-sectional designs), and do not allow any conclusion as to causality. Also, the choice of the performance variables, uniform throughout the samples used, need not reflect real organizational objectives, which need not be identical, even not for comparable organizations. On top of that, when designing incentive based payment systems, there should be no ambiguity with respect to the organizational objectives, as well as to their measurement. If these conditions are not met, performance based remuneration systems will force managers to pursue the objectives implied in this system, departing from the real organizational goals, institutionalizing or sometimes even creating in a certain way principal-agent differences. Therefore, it is no surprise to conclude that optimal remuneration schemes in nonprofit organizations are hardly explored (Brandl, Gütter 2007: 178; Brickley, Van Horn 2002: 228; Preyra, Pink 2001: 511), and to observe that bonuses are much smaller relative to the base

managerial pay in nonprofit organizations when compared to profit organizations. Roomkin and Weisbrod (1999: 772), in a 1992 sample of US hospitals, document these percentages to be respectively less than 18 per cent and more than 40 per cent (excluding options).

Finally, one should carefully consider possible derived effects of introducing performance based payment systems in nonprofit organizations, as illustrated by Frey (1997) in an analytic model in which the fact to be remunerated in terms of performance results in a decrease of altruistic motivation not compensated by the positive effect on performance induced by the incentive scheme introduced.

2.4. The role of accounting information

Accounting information and financial statements can be used by the organization's principal(s) to monitor the financial performance of the organization, external auditing reducing uncertainty about the validity of the accounting figures (Jegers 2002). Therefore, accounting and auditing can be seen as monitoring costs in the organization's relationship with its board.

It goes without saying that other sorts of reporting should be produced to describe the nonfinancial performance of the organization (Falk 1992: 490), which is, without any doubt, far more important than its financial performance (Hyndman 1990: 304; Parsons 2003: 106), though the latter constrains in a way the former. In that respect it is interesting to note that in a recent sample of 341 US museums (both public and nonprofit), 76 annual reports contained no financial data whatsoever (Christensen and Mohr, 2003), let alone a financial statement.

Referring to the discussion above on managerial remuneration schemes, the possible impact of accounting figures on these schemes depends on the question "whether charities explicitly use accounting measures for setting executive compensation" (Baber et al. 2002: 691). If not, there is no point in manipulating whatever accounting figure in order to optimize, from the manager's point of view, the accounting signal disclosed. The paper closest to relevance in this context is written by Robbins et al. (1993), who study accounting choices in 298 US hospitals (public, private nonprofit, and proprietary). The choice of the inventory valuation method (LIFO/FIFO) and the depreciation method used are combined in a binary choice variable with two categories: income-increasing choices (84% of the sample) and income-decreasing choices (16% of the sample). Unfortunately, separate results for nonprofit organizations are not given. In the whole sample, there seems to be a positive relation between the existence of management compensation plans and income-increasing choices, but this might be due to the presence of proprietary hospitals in the sample.

2.5. The role of debt

Already in the first economic writings on governance in profit organizations there was an important role for debt as it was assumed to (partly) contain agency problems between shareholders and management, though it also acknowledged that debt generates an additional agency conflict between shareholders (now acting as agents) and debtholders (the principals), which on its turn can be mitigated by imposing protective covenants, most of which will be expressed in accounting and auditing terms.

A comparable reasoning applies for nonprofit organizations. Lenders to nonprofit organizations know that these have specific objectives not expressed in financial terms, but as long as the organization is expected to be able to pay interests and capital repayments when due, there is no reason to be financially worried (see also Christensen, Mohr 1995: 324). Also here agency problems between board and management could be addressed by imposing the organization to borrow (making the lenders some kind of intermediate principals), in order to have management forced not to divert earnings into discretionary expenses. Estimating

potential agency costs in an organization by dividing compensations, salaries and wages by total assets, Jegers and Verschueren (2006) and Verschueren and Jegers (2004), in a multivariate setting on samples of respectively 22,766 Californian nonprofit organizations and 7,294 US cultural nonprofit organizations for 1999, find a positive correlation between these potential costs and the presence of debt, which is at least not contradicting an agency explanation of debt. Also here, the debtholders can protect themselves by imposing the borrowing organization to produce and have audited accounting information.

3. DONORS AND SUBSIDIZING AUTHORITIES AS ORGANIZATIONAL PRINCIPALS

In the economic thinking on nonprofit governance donors only play an indirect role as, possibly, members of the board (see also above). The only substantial exception is the literature on the impact of accounting information on donors and donations.

Disclosing financial information and auditing are clearly bonding costs in the organization's (principal-agent) relationship with (potential) donors, though "[there] is limited empirical research examining the impact of *accounting* data on charitable giving decisions" (Parsons 2003: 104), and it appears there is no research at all on the role of auditing, although audited financial statements are mentioned in the papers by Gordon and Khumawala (1999: 42) and Hyndman (1990), and Tate (2007: 58) establishes in her sample (15,955 US nonprofit organizations for the period 1997-2002 receiving at least 300,000 USD in federal funds per year) that organizations audited by a Big Five audit firm more heavily rely on donations.

Accounting choices⁹ might also matter in the relationships with principals such as subsidizing authorities and donors. Reported wealth, for instance, can be assumed to impact on the government's and donors' willingness to provide subsidies and gifts (Chase, Coffman 1994): higher levels of wealth are considered to be either a reason to reduce payments ("political cost") or a signal of financial viability entailing more subsidies and gifts, which are then expected not to be wasted. Apparently, the civil servants concerned and the public are assumed not to be able to correctly assess the disclosed data. On top of that, managers are supposed to be concerned with their personal reputation, therefore trying to select accounting methods indicating maximal financial performance (return on endowments in this case). In a sample of 137 private colleges and universities in the US (data pertaining to 1989) (ibid.), the choice between fair market value reporting of the endowments and their reporting at cost is considered. The results show that the institutions choosing the fair market value method are more endowed (supporting the financial viability reasoning) and realize higher returns on their endowments (not contradicting the reputation argument).

Christensen and Mohr (1995) frame their accounting choice study on US museums also in a principal-agent context (1989 data on 106 museums, of which 84 are nonprofit). The choice here is whether or not to report the value of the museum's collection as part of its assets. There seems to be statistical support for political cost reasoning: the more federal government support is obtained, the less this kind of reporting is observed. The results of Eldenburg and Vines (2004) can also be understood in a similar way. Based on a sample of 98 nonprofit hospitals located in Florida (1989–1991), they observe that hospitals with higher cash levels are more prone to report a larger share of their uncompensated care as charity care, and not as bad debt, signaling to the (fiscal) authorities that their tax-exempt status is fully justified. As labeling uncompensated care as charity care implies foregoing any cash collection (e.g.

⁹ In most countries, accounting regulations allow in some circumstances for different methods to calculate financial data. The choice between these methods is typically made by management.

through Medicare or Medicaid), hospitals with lower cash levels have to trade off the expected cost of losing their nonprofit status with the expected cost of illiquidity.

The examples so far relate to what is called financial accounting, i.e. accounting pertaining to the overall organization. Besides this kind of reporting, accounting is also concerned with calculating revenues and costs related to distinct activities of the organization. This is the field of cost accounting. Mostly, research concentrates on distinguishing in terms of costs and revenues program activities and profit activities (with its implied tax consequences), administrative activities, and fundraising activities. The most subtle aspect is the allocation of common costs (technically called indirect costs, or overhead costs) to these categories. Bowman (2006), applying a quasi-experimental design on about 1,200 Chicago based organizations (1999-2001), documents the impact of reported allocation rules on donations, though his results also imply other factors to be much more influential (Bowman 2006: 303-304).

If organizations develop both subsidized and non-subsidized activities, it is rather difficult for the authorities to have a clear picture of the relevant costs. Cost accounting reduces this information asymmetry, especially in cases where cost accounting regulations are enacted to guide the allocation of the indirect costs. Sometimes these regulations are very strict and sometimes they give the organizations some leniency, in which case organizations could be inclined to allocate as much as possible (and allowed if they want to comply) indirect costs to the subsidized activities. If the nonsubsidized activities are taxed, some trade-off has to be made between higher subsidies and lower taxes payable. Furthermore, if the nonsubsidized activity is developed on a profit market, overhead allocation techniques potentially distort competition on this market (Weisbrod 1988: 116).

Both the papers by Cordes and Weisbrod (1998: 208) (on 1,476 US nonprofit organizations from the arts, education, health, and human services industries (data on 1992)) and Yetman (2001: 308-309) (on 703 US nonprofit organizations for 1995-1997 from the education, health, and charity industries) document cost shifting behavior towards taxable activities. A number of organizations seem to be too zealous when shifting costs: three out of five organizations reporting taxable unrelated business income in the US in 1991 (32,690 observations) managed to report losses, which when aggregated exceeded the aggregated profits (Cordes, Weisbrod 1998: 201, referring to work by Riley). One can only hope that applying creative allocation rules is the explanation for this situation, and not engaging in unprofitable "profit" activities.

Finally, note cost shifting away from nonprofit activities to profit activities reduces the reported cost of the former, which then appear to have been performed more efficiently.

When considering potential donors, organizations have an incentive to guide indirect cost allocations in a way signaling high activity levels (Trussel 2003), especially when total program costs (direct program costs plus allocated indirect program costs) are disclosed together with the total administrative costs and the total fundraising costs. Krishnan et al. (2004) present empirical evidence of this: comparing the data of 719 hospital-year observations (Californian nonprofit hospitals, 1994–1998) in two databases that should contain the same data, they find that on average program expenses reported in the publicly available database exceeded the same expenses reported in the other database with USD 13.9 million (Krishnan et al. 2004: 15). Furthermore, of the 95 hospitals reporting no fundraising expenses at all, at least 19 appear to have publicly documented fundraising activities (ibid.: 22; for a comparable result in which, in two samples, about fifty per cent of respectively more than 16,000 New York contribution receiving organizations and more than 16,000 US contribution receiving organizations (1992-1994) report fundraising expenses lower than one

per cent of contributions, see Tinkelman (2006: 449)), apparently shifting the fundraising costs maximally to program costs and/or administration costs. In their subsequent paper (Krishnan et al. 2006) they also find that the probability of not reporting any fundraising cost increases with the intensity of the relationship between donations and the share of program costs in total costs. The same conclusion is reached when looking at the relationship between managerial remuneration and the share of program costs.

Jones and Roberts (2006) do not look at program activity share increasing manipulations, but at manipulations to dampen program activity share variability. In their sample of 708 organization-year observations of US nonprofit organizations (1992-2000), they indeed see such behavior.

Clearly, auditing cost accounting data (which is usually not included in the auditor's task) will contribute to their reliability when disclosed (Tate 2007: 51), reducing information asymmetries between donors and the organization.

4. WHAT ABOUT VOLUNTEERS?

Although the academic economic and managerial literatures on volunteers abound, it is surprising to observe that they hardly pertain to topics dealing with the functioning of nonprofit organizations within agency or governance frameworks (Sampson 2006: 364). The mere existence of these literatures makes it improbable that the organizational impact of volunteers would be comparable to the impact of professionals, as also implied by Liao-Troth and Dunn (1999: 346,347). Furthermore, in a principal-agent reasoning it seems unwarranted not to make a distinction between voluntary principals and voluntary agents. An empirical justification for this distinction is found in Hustinx (2005: 635-640), who discerns in her sample of volunteers working for the Flemish Red Cross five styles of volunteering, one of which to a great extent corresponds to the group of voluntary board members, also called "a unique group of volunteers" by Preston and Brown (2004: 222), who also observe that boards in numerous nonprofit organizations almost exclusively consist of volunteers (ibid.: 221). In the same vein, Handy (1995) explicitly models the decision of a volunteer to join a board, taking into consideration wealth and reputation effects. But all these scholarly efforts do not preclude the fact that "almost no research has been conducted on how or the extent to which board volunteering affects the achievements of the organization" (Herman 2005: 78).

CONCLUSION

In this paper the economic research on governance of nonprofit organizations is brought together and integrated in a non-technical way. This leads to conclusions for practice and research, but these are up to now only partial and provisional.

Practitioners will have understood that the way in which the board functions can impact on organizational outcome and relative strength with respect to management, though much research will be needed to explore the mechanisms through which this happens. Nevertheless, it can already be inferred that the presence of managers and donors in the board and its committees seems to have potential effects on governance effectiveness, the first ones exacerbating agency problems, the last ones mitigating them.

As to the possibility of finding effective incentive mechanisms as a basis for managerial remuneration in nonprofit organizations, not much of a practically useful result has been reached, the only promising empirical research being performed with cross-sectional samples. One can even wonder whether this is conceivable, given the cumulative difficulties of unequivocally defining an organization's objectives, and verifiably measuring organizational performance. Therefore, it is no surprise to conclude that optimal remuneration schemes in nonprofit organizations are hardly explored (Brandl, Gütter 2007: 178; Brickley, Van Horn

2002: 228; Preyra, Pink 2001: 511), and to observe that bonuses are much smaller relative to the base managerial pay in nonprofit organizations when compared to profit organizations.

Finally, financial disclosure and auditing have a place in a nonprofit governance structure, especially with respect to external funders such as donors and subsidizing authorities. Attention must be paid to the possibility of manipulating accounting figures in order to affect donor generosity of subsidy increases, without implying that this attention should be geared towards misleading the users of the information disclosed.

Looking at the research achievements, it is fair to say that no such thing as a coherent (economic) theory on nonprofit governance has emerged yet. Nevertheless, there is already a challenging body of research insights, scattered around in multiple publication outlets. Most of the important board related aspects of nonprofit governance have been studied theoretically and/or empirically (almost exclusively with US data), not always leading to consistent results as to optimal governance structures and optimal governance mechanisms to steer organizational behavior. This can partly be understood by the fact that, all over the world, nonprofit organizations, profit organizations alike, have to function in differing institutional contexts, which, on top of that, are not always static. Compared to the abundant amount of research on profit governance, there is ample room for path-breaking theoretical and empirical research left. I only mention a few possible venues: looking explicitly at specific stakeholders almost ignored up to now, such as the beneficiaries and volunteers of the organization, modeling the interaction between different stakeholders as to governance mechanisms, analyzing the specific role(s) of volunteers in governance, incorporating legal and institutional contingencies when looking for optimal governance structures and designing concomitant comparative research, focusing on producing, influencing, or manipulating the information produced by agents on behalf of their principals, studying the selection and use of performance measures to contain organizational behavior, all of these lines of research preferably imbedded in a comprehensive economic theory on nonprofit governance, and empirically tested in numerous countries and contexts. Given its importance, the nonprofit sector deserves all possible academic efforts to turn these potential research contributions dreamt of into scientific reality.

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