

Quality of financial disclosures of nonprofit organizations that report zero fundraising expense

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ABSTRACT

Krishnan, Yetman, and Yetman (2006) provide evidence that many U.S. nonprofit organizations (NPOs) that report zero fundraising expense understate fundraising expense to appear more efficient and, therefore, that the financial disclosures of such NPOs are less reliable. Whether the donor market perceived the reliability of financial disclosures of NPOs that reported zero fundraising expense to be less than the reliability of financial disclosures of NPOs that reported some fundraising expense is tested using a model of organization-level donations. The evidence is provided for a full sample of NPOs and for industry-specific samples: arts, education, health, philanthropy, and human services for 2000 and 2001.

Results suggest that the donor market did not perceive the financial disclosures of arts, health, human services, and philanthropy NPOs that reported zero fundraising expense to be less reliable than the financial disclosures of such NPOs that reported positive fundraising expense. Similar results are found for the full sample of NPOs, in which many types of NPOs are included. Only for education NPOs is there evidence that the donor market perceived the financial disclosures of the NPOs that reported zero fundraising expense to be less reliable than the financial disclosures of the NPOs that reported positive fundraising expense.

Key words: Nonprofits, donations, fundraising, financial disclosures

INTRODUCTION

A continuing topic of interest among researchers and nonprofit organization (NPO) managers is identification of NPO organizational characteristics, such as efficiency, fundraising, type of mission, and wealth that affect levels of donations to NPOs. Some characteristics that have been identified in the literature, such as efficiency, are communicated by NPOs to the market for donations via financial disclosures. Many studies on U.S., Canadian, and UK data (e.g., Posnett and Sandler, 1989, Callen, 1994, Tinkelman 1998, Marudas, 2004) test the relation between organization-level donations and an accounting measure of NPO inefficiency, called “price” of giving¹. These studies generally find a significant negative relation between donations and price, strongly suggesting that at this ratio, calculated from NPO financial disclosures is relevant to the donor market.

Krishnan, Yetman, and Yetman (2006), testing data from 1982 to 2001, provide evidence that many U.S. NPOs that report zero fundraising expense are understating the amount of fundraising expense they actually incur, in order to appear less inefficient². Accounting theory suggests that the donor market will react more to financial disclosures that are reliable. If the donor market considers zero fundraising expense to be implausible, and therefore, considers the financial disclosures of the NPOs that report zero fundraising expenses to be less reliable than the financial disclosures of NPOs that report some fundraising expense, then it should react less or not at all to the financial disclosures of NPOs that report zero fundraising expense. On the other hand, if donors consider zero fundraising not to be implausible or are unaware of when NPOs report zero fundraising expense, then their reaction to the financial disclosures of NPOs that report zero fundraising expense would not be significantly different than that for NPOs reporting some fundraising expense.

Only one prior study, Tinkelman (1999) examines this issue. Tinkelman (1999) tests the relation between “price of giving”, a measure of inefficiency calculated from NPO financial disclosures and donations in a large data set of NPOs filing with New York State in 1992-94. The sample is divided into one subsample of NPOs reporting zero fundraising expense or zero administrative expense and another subsample of NPOs reporting some fundraising expense and some administrative expense. Results suggest that price has a significant negative effect on donations in both subsamples, although the effect of price on donations to the NPOs reporting zero fundraising or administrative expense is significantly less than the effect of price on donations to the NPOs in the other subsample. However, industry-specific samples are not tested and hospitals and educational institutions are excluded from the sample because “they were subject to somewhat different accounting requirements prescribed in specialized audit guides and because New York has special filing rules for colleges” (p. 141). Furthermore, because the zero reporting subsample contains NPOs that report zero fundraising expense or zero administrative expense, the paper tests the potential reduced reliability of the financial disclosures from both of these effects, not just from the effect of reporting zero fundraising expense.

¹ Price of giving (“price”) is defined as $(\text{program expenses} + \text{fundraising expenses} + \text{administrative expenses}) / (\text{program expenses})$. It is the reciprocal of the efficiency measure called program spending ratio, which is reported by nonprofit “watchdog” agencies such as the Philanthropic Advisory Service of the Better Business Bureau, Guidestar, and the American Institute of Philanthropy.

² An NPO that misreports some fundraising expense as program expense would decrease the numerator and increase the denominator in the price of giving, thereby decreasing the price of giving, a measure of inefficiency.

Thus, the purpose of this paper is to provide empirical evidence on whether the donor market perceives the reliability of financial disclosures of NPOs that report zero fundraising expense to be lower than the financial disclosures of NPOs that report some fundraising expense. This evidence will be provided not only for a full sample of NPOs, but also for industry-specific samples: arts, education, health, philanthropy, and human services (as defined by the National Taxonomy of Exempt Entities).

The results of this paper should be interesting to regulators and watchdog agencies, who would have empirical evidence on whether the donor market considered the financial disclosures of NPOs reporting zero fundraising expense to be less reliable. If the donor market did not react less to the financial disclosures of such NPOs, it may have been because the donor market was unaware of when NPOs reported zero fundraising. If so, regulators and watchdog agencies may want to publicize these instances more broadly. On the other hand, it may have been that donors were aware of NPOs that reported zero fundraising expense, but believed that such NPOs, in fact, did not incur fundraising expenses. Managers of NPOs who are legitimately reporting zero fundraising expense, because, for example, volunteers such as board members conduct all fundraising activities for the NPO, may be interested to know whether the donor market perceives the financial disclosures of their NPOs as less reliable.

EMPIRICAL SPECIFICATIONS

Accounting theory suggests that the extent to which users of financial information will rely on such information is increasing in its perceived reliability. The principal source of financial information on NPOs is the IRS Form 990. NPOs with revenues of \$25,000 or more are required by law to file this form annually and to make it readily available to the public. It is from this information, that the efficiency ratios and other ratios are calculated and published by various information intermediaries such as Guidestar and Charity Navigator. If, as reported by Krishnan, Yetman and Yetman (2006), many of the NPOs reporting zero fundraising expense on their Forms 990 are underreporting the actual fundraising expenses they have incurred, then the reliability of financial disclosures of such NPOs is lower. However, it is an empirical issue as to whether the donor market considers the financial disclosures (via the Form 990) of NPOs reporting zero fundraising as less reliable. It may be that the donor market is aware of the extent of reporting of zero fundraising expense but perceives it to be legitimate or it may be that the donor market would perceive such reporting to be inappropriate, but it is not aware of the extent of such reporting, and, therefore, it continues to rely on the financial disclosures of such NPOs. Therefore, the hypothesis to be tested, in alternative form, is H1: The donor market perceives the financial disclosures of NPOs that report zero fundraising expense to be less reliable than the financial disclosures of NPOs that report some fundraising expense.

The perceived reliability of NPO financial disclosures by the donor market is proxied by the strength of the relation between donations and the inefficiency measure “price of giving” (PRICE), defined as $(\text{program expenses} + \text{fundraising expenses} + \text{administrative expenses}) / \text{program expenses}$. The effect of this measure of inefficiency, calculated directly from information in the NPOs’ Forms 990, on donations is tested extensively in the accounting, economics, and public administration literatures (e.g., Weisbrod and Dominguez, 1986; Posnett and Sandler, 1989; Tinkelman, 1998 and 1999; Marudas, 2004; Marudas and Jacobs, 2006). Also, see Jacobs and Marudas (2009) for a comprehensive recent review of this literature.

Testing is performed on a subsample (hereafter “zero FR”) consisting only of NPOs that report zero fundraising expense in their 990s (and positive amounts of administrative and program expenses) and a subsample (hereafter “positive FR”) consisting only of NPOs that report some fundraising expense (and positive amounts of fundraising and program expenses). Finding that the relation between PRICE and donations in the zero FR subsample is significantly weaker than the relation between PRICE and donations in the positive FR subsample is considered evidence in support of the hypothesis. Testing is performed on these subsamples from a full sample of NPOs of various types and then industry-specific samples consisting only of one type of NPO; e.g., arts, education, health. This is done because prior studies find significant differences in the strength of the relation between donations and PRICE across industry-specific samples of NPOs (e.g., Tinkelman, 1999; Marudas 2004; Marudas and Jacobs, 2004; Tinkelman and Mankaney, 2007).

The following model of donations, based on Marudas (2004), is tested. The model includes numerous control variables.

$$\ln\text{DON}_{i,t} = b_0 + b_1\ln\text{PRICE}_{i,t-1} + b_2\ln\text{FR}_{i,t-1} + b_3\ln\text{GOV}_{i,t-1} + b_4\ln\text{PREV}_{i,t-1} + b_5\ln\text{AGE}_{i,t} + b_6\ln\text{WEALTH}_{i,t} + b_7\ln\text{TOTASS}_{i,t} + u_{i,t}$$

where i indicates NPO, t indicates year, DON is direct donations, PRICE is total expenses / program expenses, FR is fundraising expense, GOV is government support, PREV is program service revenue, AGE is years since the organization was founded, WEALTH is “years of available assets” at the beginning of the year, specified as (total net assets – permanently restricted net assets) / (total expenses – fundraising expenses), TOTASS is total assets at the beginning of the year, and u is error.

DATA

All data are from the Statistics of Income database developed by the National Center for Charitable Statistics for 2000 and 2001. This database includes all U.S. NPOs with total assets of at least \$10,000,000 and an asset-weighted random sample of smaller NPOs. Since the model requires lagged values of certain variables, only NPOs with data in two successive years can be used. There are 14,089 such observations. From this number, following Tinkelman (1999), the following observations are deleted because of implausible values of one or more variables:

- 3,400 observations with zero or negative donations³
- 4 observations with negative fundraising expenses
- 833 observations with zero total assets
- 1 observation with negative administrative expenses
- 395 observations with zero administrative expenses and zero fundraising expenses⁴

³ Although zero donations are not always implausible, it cannot be determined when such values were plausible and when they were not. Therefore, following Tinkelman (1999), all of the zero donation observations are deleted for consistency.

⁴ These observations are deleted because reporting both zero administrative expenses and zero fundraising expenses is another potential signal to the donor market that an NPO’s financial disclosures are manipulated. Since the purpose of this paper is to test whether reporting zero fundraising is a signal to the donor market of financial manipulation, if these observations were not deleted, the paper would be testing two potential signals – zero fundraising and zero fundraising and zero administration, the latter of which is arguably a stronger signal of financial manipulation (since PRICE would be 1 and the program spending ratio a perfect 100%).

104 observations with zero program expenses⁵
 4 observations with negative program service revenue
 20 observations with negative total revenue
 273 observations with negative net assets⁶
 355 observations without data on when the NPO first filed an IRS Form 990 (the year used to calculate the age of the NPO).

This leaves 8,700 usable observations of which 3,033 have zero fundraising (“zero FR sample”) expenses and the remaining 5,667 have positive fundraising expenses (“positive FR sample”).

Prior studies find significant differences in parameter estimates across specific industry types of NPOs (e.g., Posnett and Sandler, 1989; Tinkelman, 1999; Marudas, 2004). Therefore, each of the two subsamples to be tested, zero FR and positive FR, was separated into the following five industry-specific samples, based on the National Tax Exempt Entities classification scheme, which are large enough to test separately.

	<u>Zero FR subsample</u>	<u>Positive FR subsample</u>
Arts	128 observations	593 observations
Education	349 observations	1,780 observations
Health	1,248 observations	747 observations
Human services	472 observations	826 observations
Philanthropy	91 observations	380 observations

Since the log of zero is undefined, following the prior research, a nominal amount (\$1) is added to every zero value of GOV and PREV. Descriptive statistics for the data for each sample are as indicated in Table 1 (Appendix).

Because of significant heteroscedasticity in all years, White’s (1980) consistent variance-covariance matrix estimator is used to develop confidence intervals. Multi-collinearity, measured by condition indices, is moderate based on the method of Hair et al. (1995). Cook’s distance test indicates only two influential outliers, both in the positive FR philanthropy subsample, which is deleted. Durbin-Watson *d* statistics indicate no significant autocorrelation.

RESULTS

The results, for all variables in the model, from testing the zero FR and positive FR subsamples for the full sample of NPOs in the data set are as indicated in Table 2 (Appendix). The coefficient estimate on PRICE for the positive FR subsample is significantly negative as expected (-0.13). Interestingly, the coefficient estimate for PRICE for the zero FR subsample is larger and significantly negative (-0.26), although the difference between the two coefficients is not statistically significant at the 10% level or better. This evidence does not support the hypothesis that the financial disclosures of NPOs reporting zero fundraising are perceived by the donor market to be less reliable than the financial disclosures of NPOs reporting positive fundraising expense. The results for the other variables are not discussed, since they are not relevant for the purpose of this paper, and the results for the other variables for the arts,

⁵ Price is infinite for NPOs with zero program expenses.

⁶ Observations with negative net assets necessarily have negative wealth. These observations are deleted because the log of a negative number is undefined, and the hypothesized relation between wealth and donations is unlikely to be monotonic from positive to negative values of wealth, precluding simply adding a constant to make these negative values positive.

education, health, human services, and philanthropy samples are available from the authors upon request.

As indicated in Table 3 (Appendix), for the arts sample, the coefficient estimate on PRICE is not significant in either subsample (and there is no statistically significant difference between the two at the 10% level or better). This evidence also does not support the hypothesis. The finding of no significant relation between PRICE and donations for arts organizations may seem unusual. However, it is consistent with results reported in Tinkelman (1999) and Marudas (2004). One possible explanation offered is that donors to arts organizations are more likely, than donors to other types of NPOs, to be consumers of the services of the arts organization to which they donate, thereby providing these donors with an alternative set of information on how their donations are used (Tinkelman, 1999)

For the education sample, the coefficient on PRICE for the zero FR subsample is not significant, whereas for the positive FR sample it is large (-0.60) and significant, and there is a statistically significant difference between the two coefficients at better than the 1% level. This evidence supports the hypothesis for the education sample.

For the health sample, the coefficient estimate on PRICE for the zero FR subsample is large (-0.65) and significant and for the positive FR subsample it is small (-0.07) but also significant. However, the estimate for the zero FR subsample is significantly greater in magnitude (at the 10% level) than the estimate for the positive FR subsample. This evidence not only does not support the hypothesis, it actually supports the notion that the reliability of the financial disclosures of health NPOs that report zero fundraising expense is greater than the reliability of the health NPOs that report positive fundraising expense. It is interesting to note (from the Data section) that the portion of all health NPOs in the data set that reported zero fundraising expense is very high, 63%. For no other sample does the portion exceed 50%. It may be that many NPOs in the health sample, such as hospitals, indeed do not incur fundraising expenses and, therefore, that their reporting zero fundraising expense is legitimate and that the donor market understands this.

For the human services sample, the coefficient estimate on PRICE for the zero FR subsample is large (-0.54) but not significant, whereas for the positive FR subsample it is small (-0.08) and significant. However, interestingly, the difference is not statistically significant at the 10% level or better. This is because, while the coefficient on PRICE for the zero FR subsample is not significant, it is barely not significant (with $p=0.14$), and the coefficient for the positive subsample, although significant, is very small. Therefore, technically, this evidence also does not support the hypothesis.

Finally, for the philanthropy sample, the coefficient estimate on PRICE for the zero FR subsample is very large (-2.73) and significant, whereas for the positive FR subsample it is not significant and, naturally, there is a significant difference between the two (at better than the 1% level). This evidence not only does not support the hypothesis, but actually supports the notion that the reliability of financial disclosures for the philanthropy NPOs that report zero fundraising expense is more reliable than the financial disclosures of the philanthropy NPOs that report positive fundraising expense.

SUMMARY AND CONCLUSIONS

This study provides substantial evidence that the donor market, at least in 2001, did not perceive the financial disclosures of arts, health, human services, and philanthropy NPOs that

reported zero fundraising expense to be less reliable than the financial disclosures of NPOs that reported positive fundraising expense. Similar results were obtained from testing the full sample of NPOs, in which many types of NPOs are included. Only for education NPOs is there evidence supporting the hypothesis that the donor market perceived the financial disclosures of the NPOs in the sample that reported zero fundraising expense to be less reliable than the financial disclosures of the NPOs in the sample that reported positive fundraising expense. Overall, these results are somewhat surprising, in light of evidence suggesting that many of the U.S. NPOs that report zero fundraising expenses inappropriately underreport actual fundraising expenses incurred (Krishnan, Yetman, and Yetman, 2006). The results strongly suggest that the financial disclosures of NPOs, other than education NPOs, which reported zero fundraising expense were considered by the donor market to be no less reliable than the financial disclosures of NPOs that reported positive fundraising expense. If indeed, many of the NPOs reporting zero fundraising expense were significantly understating actual fundraising expenses they incurred, then it may be that the donor market was not aware of when such NPOs reported zero fundraising expense. This could have occurred because the donor market was aware only of the program spending ratio (reciprocal of PRICE used in this paper), which masks whether an NPO has reported zero fundraising expense.

The principal limitation of this study is that the results are consistent with the following three states, but there is no way to distinguish among them without further research. These states are: 1) the donor market is not aware of when NPOs report zero fundraising expense, and if it were, would consider the financial disclosures of such NPOs to be less reliable, 2) the donor market is aware of when NPOs report zero fundraising expense but believes that zero fundraising expense does not significantly understate actual fundraising expense incurred by such NPOs, 3) the donor market is aware of NPOs that report zero fundraising expense and penalizes them by systematically giving fewer donations to them relative to NPOs that report positive fundraising expense, but among NPOs that report zero fundraising expense, the donor market provides more donations to NPOs that appear more efficient. Future studies could employ a survey methodology to examine the extent to which donors are aware of when NPOs report zero fundraising.

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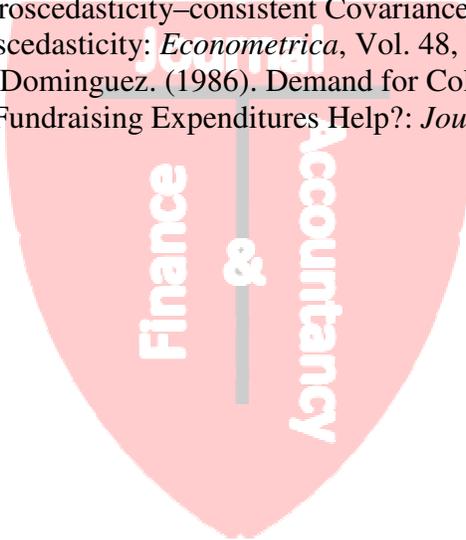


TABLE 1
DESCRIPTIVE STATISTICS

Descriptive statistics (mean and standard deviation) of the data from the National Center for Charitable Statistics. All variables are in thousands of dollars, except PRICE, ADMIN, AGE, and Y. Data are from 2000, except for donations, which are from 2001.

N=5,667	POSITIVE FUNDRAISING SUBSAMPLE	
	<u>Mean</u>	<u>Standard deviation</u>
DON	\$8,853	\$38,789
PRICE	1.37	1.29
FR	\$941	\$3,659
GOV	\$3,586	\$26,627
PREV	\$25,101	\$100,581
AGE	36	19
WEALTH	5.47	14.85
TOTASS	\$112,605	\$568,192
N=3,033	ZERO FUNDRAISING SUBSAMPLE	
	<u>Mean</u>	<u>Standard deviation</u>
DON	\$1,884	\$18,908
PRICE	1.27	0.56
GOV	\$1,898	\$13,052
PREV	\$52,215	\$312,299
AGE	33	19
WEALTH	4.12	20.78
TOTASS	\$26,658	\$105,935

DON is donations (in thousands of dollars)

PRICE is price (the reciprocal of “program spending”) which is total expenses / program expenses

ADMIN is administrative expenses / total expenses

FR is fundraising expense (in thousands of dollars)

GOV is governmental financial support (in thousands of dollars)

PREV is program revenue (in thousands of dollars)

AGE is years since first filing a tax form

WEALTH is net assets / (total expenses - fundraising expenses), considered to be a measure of wealth

TOTASS is total assets at the beginning of the year (in thousands of dollars)

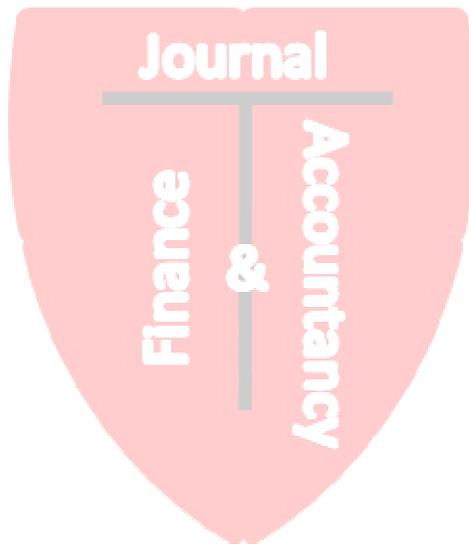


TABLE 2
 CROSS-SECTIONAL RESULTS – FULL SAMPLE
 Regression coefficients from testing the following model in levels form.

$$\ln \text{DON}_{i,t} = b_0 + b_1 \ln \text{PRICE}_{i,t-1} + b_2 \ln \text{FR}_{i,t-1} + b_3 \ln \text{GOV}_{i,t-1} + b_4 \ln \text{PREV}_{i,t-1} + b_5 \ln \text{AGE}_{i,t} + b_6 \ln \text{WEALTH}_{i,t} + b_7 \ln \text{TOTASS}_{i,t} + u_{i,t}$$

	ZERO FR	POSITIVE FR
INTERCEPT	9.09***	2.69***
t stat.	31.4	17.4
PRICE	-0.26*	-0.13***
t stat.	-1.7	-7.6
FR		0.54***
t stat.		47.1
GOV	0.03***	0.01***
t stat.	4.7	5.7
PREV	-0.08***	-0.07***
t stat.	-7.1	-22.4
AGE	0.12*	-0.05**
t stat.	1.9	-2.3
WEALTH	0.33***	0.01
t stat.	10.2	1.0
TOTASS	0.21***	0.35***
t stat.	10.3	27.2
ADJ. R SQ.	0.09	0.61

***, **, and *, significant at the 1%, 5%, and 10% levels (two-tailed), respectively.

DON is donations (in dollars)

PRICE is total expenses / program expenses, which is the reciprocal of the “program spending” ratio

FR is fundraising expenses (in dollars)

GOV is governmental financial support (in dollars)

PREV is program service revenue (in dollars)

AGE is years since the organization first filed a tax form

WEALTH is (net assets / (total expenses – fundraising expenses))

TOTASS is total assets at the beginning of the year (in dollars)

TABLE 3
COMPARATIVE RESULTS

Comparative results for the coefficient estimate on PRICE in the zero fundraising subsample and the positive fundraising subsample from testing the following model in levels form for the full, arts, education, health, human services, and philanthropy samples.

$$\ln\text{DON}_{i,t} = b_0 + b_1\ln\text{PRICE}_{i,t-1} + b_2\ln\text{FR}_{i,t-1} + b_3\ln\text{GOV}_{i,t-1} + b_4\ln\text{PREV}_{i,t-1} + b_5\ln\text{AGE}_{i,t} + b_6\ln\text{WEALTH}_{i,t} + b_7\ln\text{TOTASS}_{i,t} + u_{i,t}$$

	PRICE	
	ZERO FR	POSITIVE FR
FULL	-0.26*	-0.13***
ARTS	0.11	0.03
EDUCATION	<u>0.01</u>	<u>-0.60***</u>
HEALTH	<u>-0.65*</u>	<u>-0.07*</u>
HUMAN SERVICES	-0.54	-0.08*
PHILANTHROPY	<u>-2.73**</u>	<u>0.01</u>

***, **, and *, significant at the 1%, 5%, and 10% levels (two-tailed), respectively.

Figures underlines indicate a statistically significant difference between the coefficients for each subsample at the 10% level or better.

DON is donations (in dollars)

PRICE is total expenses / program expenses, which is the reciprocal of the “program spending” ratio

FR is fundraising expenses (in dollars)

GOV is governmental financial support (in dollars)

PREV is program service revenue (in dollars)

AGE is years since the organization first filed a tax form

WEALTH is (net assets / (total expenses – fundraising expenses))

TOTASS is total assets at the beginning of the year (in dollars)