AUDIT AVOIDANCE BY NOT-FOR-PROFIT ORGANIZATIONS

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ABSTRACT

JENNA M. MEINTS: Audit Avoidance by Not-for-Profit Organizations
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Financial audits are an increasingly popular nonprofit governance mechanism with state governments. By 2008 nineteen states required that their not-for-profit organizations (NPOs) obtain financial statement audits based on the NPOs' reported levels of gross revenues. This study provides evidence that an unexpectedly large number of NPOs just avoid reporting revenues that would require state-mandated audits. Audit avoidance is most pronounced in Illinois, Massachusetts, and New York; the only states that freely disclose NPOs' audited financial statements online. These findings suggest that state-mandated financial audits and public disclosure of audit results can be costly for NPOs. Results of logistic regressions suggest that NPOs with low or no management compensation are more likely to engage in audit avoidance behavior. I find no evidence that the strength of general state enforcement is associated with audit avoidance. These results have implications for recent and ongoing efforts to improve non-profit governance and accountability via specific public policies.

To my Mother,
whose unconditional encouragement and love
have moved me to places I thought that I could never reach.

And to Beth,
who has put up with me, pushed me, and supported me
through every word written, and every moment unwritten, during this journey.

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1. Introduction

According to the National Center for Charitable Statistics (NCCS; 2011) there were approximately 1,046,719 registered public charities in the United States as of November 2010. In 2008 charities held over $2.6 billion in assets, received over $1.4 trillion in revenues, and expended over $1.3 trillion in charitable funds. Individuals, corporations, and foundations donated more than $303 billion to charitable causes in 2009 (Wing et al., 2010). The considerable economic footprint of charities combined with highly publicized governance failures, involving such well-known institutions as the Red Cross, the United Way, and the Nature Conservancy, underscore the need for better governance and accountability in the NPO sector (e.g., Mead, 2007).[1] This study investigates whether not-for-profit organizations (NPOs) manipulate their accounting to avoid state laws that require financial audits.

States, which are arguably the most capable regulators of NPOs within their borders, have taken steps toward stronger governance of the NPO sector through the passage of legislation that mandates audited financial disclosures from NPOs. As of 2008, nineteen states required that certain charities obtain financial audits, depending on their reported levels of "gross revenues." For all of these states, gross revenues are net of rental expenses, the cost basis of securities sold, the cost basis of other assets sold, special events costs, and the cost of goods

[1] Throughout this study, "not-for-profit organization" (NPO) means any 501(c) 3 tax-exempt public charity that has a charitable social services purpose. Hospitals, educational institutions, foundations, and other 501(c)3 tax-exempt organizations that are subject to different legal rules from most 501(c)3 social services charities are excluded from this group.

sold.[2] For example, the Massachusetts Attorney General Office required audited financial statements from MA charities with gross revenues of at least $100,000 from roughly 1979 through 1998, $250,000 during 1998-2004, and $500,000 since January 1, 2005. Several other states are considering passing or have already drafted legislation to pass their own audited financial disclosure requirements. Other states have revised their financial disclosure practices in recent years.[3] Wide variation in these practices across states provides a naturally powerful setting in which to investigate the consequences of state regulation.

Although mandating audited financial disclosures from NPOs is a relatively recent and ongoing trend among states, whether those disclosures assist states in governing NPOs is not clear. It is uncertain whether this form of regulation is cost-effective and whether NPOs change their reporting behavior in response to audited disclosure requirements. This study provides relevant empirical evidence on the cost effectiveness and financial reporting impact of mandated financial audits.

My findings suggest that NPOs manipulate revenues downward to avoid engaging auditors. In pooled, cross-sectional analyses of 580,423 NPO-year observations, spanning 1989-2008, there is a significant and unexpectedly large number of NPOs that just avoid crossing the revenue thresholds that would trigger financial audits. Using Burgstahler and Dichev (1997) smoothness analyses, I find there are significantly more NPOs than expected landing in the 5% bin immediately to the left of the standardized audit threshold.

[2] In general, state charitable oversight bodies examine line 12 of IRS Form 990 (prior to the 2008 revision), which reports total revenue net of rental expenses, the cost basis of securities sold, the cost basis of other assets sold, special events expenses, and the cost of goods sold.

[3] A few examples, not all-inclusive: Effective in 2010, Washington instated its first audit requirement. Illinois and West Virginia also updated their audit requirements in 2010. Connecticut and Maryland updated their audit requirements in 2009.

In general, I find that more NPOs just avoid their audit thresholds than those that just cross them in each of the twenty years 1989-2008. Audit avoidance behavior is acutely evident in Illinois, Massachusetts, and New York. These three states have the highest unexpected proportions of NPOs reporting revenues just below their audit thresholds. They are also the only states that provide online, public access to multiple years' worth of their NPOs' audited financial statements. This evidence suggests that NPOs are the most reluctant to trigger audit requirements when their audited financial statements will be disclosed to the public. The result is consistent with the argument in Neely (2011), that financial audits induce costs that are greater than the associated benefits for NPOs.

Previous literature has shown that some managers extract rents from their NPOs through excessive compensation (see, e.g., Core et al., 2006). This compensation could come in many forms, such as salary, extra expense accounts, financial benefits, or non-pecuniary benefits. NPOs explicitly disclose executive compensation (salary) on IRS Form 990. On the one hand, it could be argued that managers that are paid a higher salary are less likely to extract rents through other means. If so, there would be little incentive for highly paid NPO managers to manipulate revenues downward to avoid engaging an auditor because they have nothing to hide. On the other hand, managers paid a low or no salary might have greater incentives to extract rents through means other than salary, and thus would have a greater incentive to avoid an audit.

Relying on logistic regressions that model the probability of the event that an NPO just avoids an audit threshold on total executive compensation, I find a negative correlation between the probability of an NPO just avoiding an audit threshold and executive compensation. This finding suggests that the lower the explicit executive compensation, the more likely NPO managers are to engage in audit avoidance behavior.

Recent research in the securities markets suggests that enforcement matters to the effectiveness of regulation (see, e.g., Coffee, 2007, and Jackson and Roe, 2009). In logistic regressions that model the probability of the event that an NPO just avoids an audit threshold on several proxies for state enforcement environments, I find no evidence that the strength of a state's enforcement environment is related to whether NPOs avoid their audit thresholds. This finding suggests that existing state enforcement regimes have been inadequately crafted and/or implemented to have a significant effect on accounting manipulation.

Finally, I investigate the method by which NPOs achieve downward revenue manipulation around audit thresholds. For my sample, NPOs that continually avoid audits report unusually high rental expenses and unusually high cost bases of securities sold in years during which they just avoid audit thresholds. These costs directly reduce the amount of gross revenues that contribute toward audit thresholds.

In addition to contributing empirical evidence to the ongoing debate about NPO regulation and required financial disclosures, this study is one of the first to examine audit thresholds across states. It is also the first study to examine how revenue manipulation occurs, and it does so with a larger panel of time-series data than examined previously. With respect to legal resources, this study provides the most detailed known resource on state-by-state laws addressing NPO audit requirements. Finally, this study introduces several new measures of state enforcement environments.

The paper proceeds as follows. In Section 2, I provide background on the role of the state in NPO regulation, discuss incentives that affect NPOs' financial management, and develop the empirical hypotheses. Section 3 describes the data employed in this study. Section 4 presents the main empirical results. I provide evidence from several robustness tests in section 5. Section 6

describes and investigates empirically how audit avoidance can be achieved through accounting manipulation. Section 7 contains a summary and conclusion.

2. Background and Related Literature

2.1. The State

Public donors are often far removed from the actual operations of the organizations to which they donate. These NPO principals have little ability to monitor agent behaviors. The inability of principals to detect and monitor malfeasance in NPOs heightens the importance of state regulation and enforcement to the non-profit sector. In fact, Easley and O'Hara (1983) argue that NPOs exist where state-imposed constraints on NPOs produce a "better" outcome than could be achieved with a for-profit firm. The relatively large role of the state in governing not-for-profit organizations makes the not-for-profit sector a naturally powerful setting in which to investigate the effects of regulation.

Hugh Jones, President of the National Association of State Charity Officials, described the role of the state in an address to the Subcommittee on Federal Workforce, Postal Service, and the District of Columbia of the United States House of Representatives Oversight and Government Reform Committee on April 30, 2008.

> It is state charity officials who serve as the primary regulators over public charities and are the parties most likely to pursue breaches of the fiduciary duties of loyalty, care and good faith that our state and common laws impose upon the directors, officers and trustees of charitable assets. Typical regulatory and enforcement actions include, but are not limited to, administering state registration and reporting requirements; correcting inaccurate and misleading financial reports; redressing fraudulent and deceptive charitable solicitations; enforcing charitable trusts and bequests; recovering diverted charitable assets; imposing fines and penalties for violations of state law; and, overseeing corporate mergers, conversions and asset sales.

Although Jones described typical duties of a state, each state has a different scope of power over charitable regulation and enforcement. For example, New York has its own Charitable Bureau within the Attorney General Office that employs twenty full-time attorneys. The Bureau receives designated funding to carry out its duties, including charitable registration, reporting, and oversight. This stands in stark contrast to the majority of states that receive no funding for charitable oversight, do not have a separate legal Charities division, and employ one or no full-time attorneys to focus exclusively on the nonprofit sector. There is little uniformity in charitable laws and oversight across states.

As of 2008, nineteen states required certain charities to obtain financial audits. In various years, each state established slightly different thresholds at which NPO financial disclosures become necessary. Appendix A details these state audit requirements. The research design of this study exploits the cross-state variation in audit requirements.

2.2. Incentives

2.2.1. Cost-benefit analysis

Recent research suggests that the costs of undergoing a financial audit outweigh the benefits for NPOs; especially in the case of small NPOs. In 2005, The Urban Institute surveyed a national sample of 5,115 NPOs about their governance practices and perceptions (see Ostrower and Bobowick, 2006). Responses indicated that one-third of NPOs had not undergone a financial audit within the past two years. This percentage jumped to 57% for NPOs with contributions less than $100,000. Among all NPOs that did not have an audit during the previous two years, 62% said it would be somewhat or very difficult to comply with a law requiring them to have one.

These responses suggest that many NPOs perceived significant costs associated with financial audits.

If a substantial number of NPOs perceived that the benefits outweighed the costs of publicly disclosing their financial information, then one would expect high percentages of NPOs to publicly disclose their audit results. However, the findings of Ostrower and Bobowick (2006) offer evidence that many NPOs perceive financial audits as costly and burdensome. In fact, approximately one-quarter of NPOs that did undergo audits chose not to publicly disclose audit results.

Neely (2011) studied changes in NPOs' financial reporting behaviors with respect to California's Nonprofit Integrity Act (NIA) of 2004. Among other regulations, the NIA mandated that NPOs based in California with gross revenues of at least $2,000,000 must undergo financial audits. California enacted the NIA with the purposes of increasing financial transparency, mitigating fundraising abuses, and strengthening governance of NPOs. Neely (2011) examined the financial reports of a sample of 1,077 California NPOs that were subject to the NIA. Comparing pre-NIA and post-NIA IRS Forms 990 of NPOs that were subject to the NIA audit requirement, Neely (2011) found that there was little improvement in NPOs' financial reporting quality, variable improvements in contributions received, and a significant increase in accounting fees. Neely (2011) also found that the change in accounting fees was greater for smaller organizations compared to larger organizations. These findings are consistent with the argument that the costs of increased financial transparency may outweigh the benefits for NPOs.

Similar to the Urban Institute study's survey responses, the findings in Neely (2011) imply that the costs of (mandated) audited financial statements may outweigh the benefits. These costs may be especially burdensome for small NPOs, which constitute the majority of NPOs with

revenues near their respective audit thresholds. This leads to my first hypothesis (stated in the alternative):

$H1_a$. There will be an unexpectedly large number of NPOs that report revenues just below the state audit threshold for an audit.

2.2.2. Public disclosure

To examine whether NPOs perceive potential benefits from increased public disclosure of their financials, Ostrower and Bobowick (2006) surveyed how many audited NPOs chose to publicly disclose their audited financial statements. Of all audited NPOs, 24% chose not to publicly disclose their audit results. This percentage jumped to 34% of NPOs with contributions less than $100,000.

Of all NPOs that had websites at the time of the study, less than 11% of them made their IRS Forms 990 available to the public by posting the Form on their web site or by including a link to another website that posted it, such as GuideStar. This percentage dropped to 7% of NPOs with contributions less than $100,000. Taken together, the facts that up to 34% of all NPOs and up to 93% of small NPOs chose not to disclose their financial statements speaks not only to possibly limited benefits of public financial disclosures, but to the existence of significant costs associated with public financial disclosures.

If there is indeed a significant cost to public financial disclosure, then the presence or absence of a financial audit becomes all the more important for an NPO when a state publicly discloses that NPO's financial information. For example, Illinois, Massachusetts, and New York each manage a free, online, multiyear, publicly accessible database of its NPOs' IRS Forms 990 and audited financial statements. These are the only states that electronically provide full audited

financial statements to the public. At any time, any person can access the internet, click a few links on one of these Attorney General Office's websites, and immediately have access to several years' worth of any NPO's audited financial statements and opinions. To an NPO nearing an audit threshold in one of these states, reporting revenues above the threshold not only invites the state to review its operations, it invites every person with internet access to scrutinize its financial details.[4]

Public scrutiny of NPOs' financials has increased exponentially in the past decade. There are now numerous watchdog agencies that gather NPOs' financial information and then rate and/or rank the financial health of those NPOs for public donors. Some of these watchdog agencies include Charity Navigator, the American Institute of Philanthropy, the Better Business Bureau Wise Giving Alliance, the Economic Research Institute, and Guidestar. Even if an NPO manages its resources prudently and conscientiously, there is always the possibility that the NPO looks "inefficient" in comparison to others operating in different environments. It is also possible that influential donors will disagree with some of an NPO's management choices. Those donors may attempt to interfere and alter NPO operations. These possibilities can be distressing to even the most prudently managed of NPOs. The preceding discussion leads to my second hypothesis:

$H2_a$. There will be a larger unexpected proportion of NPOs that just avoid their audit thresholds in Illinois, Massachusetts, and New York, compared to all other states.

2.2.3. Management compensation

Previous literature has shown that managers extract rents from their NPOs through excessive compensation and other perquisites (see, e.g., Core et al., 2006). If this is the case, then

[4] Research has shown that donors use NPO financial information that is publicly available online (e.g., Gordon et al., 2009).

managers will have an incentive to manipulate revenues downward to avoid engaging an auditor, which would draw greater scrutiny. All else equal, if explicit executive compensation is low, then managers may feel justified in making decisions that are personally beneficial to them. In contrast, managers with high compensation would be less likely to succumb to a natural instinct to compensate themselves using the resources of the NPO, and therefore would have less incentive to engage in audit avoidance behavior. Formally, I hypothesize that:

$H3_a$. Organizations that pay lower explicit compensation are more likely to report revenues just below audit thresholds than NPOs whose managers have high explicit compensation.

2.3. Enforcement

Recent literature argues that not only are detection and monitoring mechanisms important for governance, but enforcement of these mechanisms matters, too (see, e.g., Coffee, 2007, and Jackson and Roe, 2009). Here, the strength of a state's enforcement may differentially affect whether NPOs perceive that they can avoid audit thresholds. Strong enforcement environments may cause NPO managers to be more apprehensive about misreporting revenues. Conversely, relatively weak enforcement environments may provide the opportunity for NPOs to understate revenues to avoid the audit threshold and any resulting negative consequences that may come from disclosing financial information to the state.

With respect to not-for-profit organizations, Desai and Yetman (2007) construct state-by-state empirical indices of detection and prosecution (enforcement) environments.[5] Desai and Yetman's Prosecution (Enforcement) index captures the number of legal assistance mechanisms in state laws that provide specific prosecutorial/enforcement powers over NPOs. Examples of the six enforcement mechanisms included in this index are the existence of Cy-près authority,

[5] Desai and Yetman (2007) operationalize information collected and documented by Marion Fremont-Smith (2004) in *Governing Nonprofit Organizations*.

limitations on reincorporating as a for-profit corporation, and of limitations on the liquidation of not-for-profit assets. Desai and Yetman (2007) find evidence that the enforcement environment of a state is weakly associated with lower insider compensation at private foundations, but not associated with lower insider compensation at public charities.

The Desai and Yetman (2007) study is the only recent examination of the association between state enforcement strength and NPOs' behaviors. Given the paucity of research on this association, the issue of the impact of enforcement on NPO reporting is an open empirical question. For example, Catharine Wells was the Director of the Division of Public Charities for the Commonwealth of Massachusetts from 1979 to 1984. In prepared remarks for a 2006 conference on nonprofit accountability, Wells commented as follows:

> As an ex-regulator, I can be forgiven for bristling at the frequent suggestion that state regulation is inevitably inadequate. Certainly, there are some states that devote only a few resources to this important job, but there [are] other states that have active and effective offices. In Massachusetts, from 1979 to 1984, the Division had six lawyers including one lawyer who was also a C.P.A. In addition, there were eight administrative staff members assigned to the Division. This may seem small compared to the tens of thousands registered charities, but the Division was able to set priorities that resulted in significant levels of accountability. While the Division registered about 10,000 charities, many of these had only nominal funding. State law required an audited financial statement from each charity with income in excess of $100,000 and the Division was active in enforcing this requirement. **We examined all audited statements for irregularities** and had a regularized system for follow-up. In the course of a year, the Division contacted hundreds of organizations seeking explanations and, in some case, changes in their practices. In appropriate cases, we filed law suits.

This commentary implies that Massachusetts has a strong enforcement environment with respect to NPOs' audited financial statements. Notably, Wells explicitly acknowledges the enforcement tools applied to **audited** statements. It is unclear, however, whether Massachusetts expends any enforcement resources on NPOs that are not required to have audits. If not, then even the strongest of overall enforcement environments would not affect whether NPOs

manipulate their accounting to stay just below an audit threshold. The following hypothesis addresses this issue:

> **$H4_a$**. The general strength of the state enforcement environment significantly reduces the probability that an NPO reports revenues below the state audit threshold.

3. Sample Selection and Data Description

3.1. Sample Selection

I began sample selection with skeleton information on state audit thresholds from the National Council on Nonprofits 50 state survey (2009), which provided state-by-state audit requirements current through June 2009. I manually fact-checked, updated, and expanded this information from state-provided legislation, LexisNexis legal resources, contacts with respective Attorney Generals offices and Secretaries of State offices, as well as publications from nonprofit law expert Marion Fremont-Smith (2004, 2007).

Financial information is drawn from the publicly available IRS Forms 990 that 501(c)3 public charities are required to file each year with the Internal Revenue Service. The National Center of Charitable Statistics (NCCS), which is part of The Urban Institute, compiles this financial information into several datasets. This study uses data from NCCS Core files for years 1989 through 2008. There are approximately 3,855,497 NPO-year observations in this set of files, although many of those data are duplicate observations.

The sample was restricted to NPO-year observations from 19 states with an audit requirement in state law that was effective 2008 or earlier. This restriction reduced the sample size by 1,872,704 to 1,982,793 NPO-years.

State laws limit the scope of NPOs affected by each audit requirement. After taking all legal restrictions into account, the testable sample was 928,761 NPO-years. I removed

observations that were missing any of employer identifier number (EIN), name, state, or IRS Form 990 filing date, and I excluded observations with "foundation" anywhere in their names. I also excluded observations of NPOs that were required by federal law to undergo audits because they received certain federal grant monies. The sample was restricted to those years between 1989 and 2008 for which there was an empirically testable audit requirement in effect per state law. The final sample consisted of 580,423 NPO-years covering 94,437 unique organizations. Appendix B summarizes the impact of sample selection criteria on sample size.

3.2. Data Description

Table 1 contains sample descriptive statistics. As seen in Panel A, most financial variables are non-normally distributed and skewed to the right (e.g., skewness for total revenue is 49.7 and for contributions is 95). Looking at annual median values, most NPOs are small with median total revenues of $174,079 and median contributions of $50,229. Overall, NPOs receive an average of approximately $4.64 in revenues for each $1 that they have in total assets. They have net reserves (FUNDBAL) of $674,914 and total assets of $1,271,159.

On average, NPOs receive a very small amount of revenues from investment income. They do not expend much on fundraising. Mean total executive officer compensation is $25,667, which is a small portion of the mean total compensation paid to other NPO employees ($352,410). Most NPOs do not compensate their officers, and most NPOs pay out very little compensation at all.[6] These statistics capture the essential, volunteer-driven nature of NPOs.

Panels B, C, and D of Table 1 describe the state, year, and NTEE distributions of the sample. In Panel B, Pennsylvania and New York comprise over 33% of sample NPO-years,

[6] Officers received positive and non-zero compensation in approximately one-third of the sample's NPO-years. Mean compensation, winsorized at the 1% and 99% levels, for this subsample was $82,785, while median compensation was $53,000.

while Rhode Island is at the other extreme with just 0.50% of NPO-years. In Panel C it can be seen that there are more NPO observations per year in more recent years. Whereas there are 10,216 NPO records for 1989, the sample has upward of 55,000 NPO records in each of its most recent data years, 2007 and 2008.

In Panel D of Table 1, the two most represented NTEE categories are those for Arts, Culture, and Humanities (A); and Human Services (P). Combined, these comprise approximately 45% of sample NPO-years. Although not tabulated, the ten most represented NTEECC's ranging from 3.77% to 1.96% of sample NPO-years are child day cares (NTEECC = P33; N = 21,881), baseball and softball (N63; 18,423), fire prevention (M24; 18,317), theater (A65; 15,968), senior citizens' housing and retirement communities (L22; 14,930), housing development, construction, and management (L20; 14,870), animal protection and welfare (D20; 13,466), historical societies and historic preservation (A82; 13,247), human services for specific populations (P81; 12,833), and general human services (P20; 11,367).[7, 8]

4. Methodology and Results

4.1. Audit Avoidance

Hypothesis 1 states that there will be an unexpectedly large number of NPOs that report revenues just below their state audit thresholds. To test this hypothesis, I calculated Burgstahler and Dichev (BD; 1997) smoothness statistics and Bennett and Bradbury (BB; 2010) smoothness

[7] The complete NTEECC distribution is available upon request.

[8] Recent research has suggested that the behavior of NPOs may differ across NTEE categories. Although not directly related to the research question in this study, I examined audit avoidance for each NTEE category included in this study. Four categories had unexpectedly large numbers of charities just avoiding audits: A - Arts, Culture, and Humanities, N - Recreation and Sports, I - Crime and Legal-Related, and D - Animal-Related. Complete audit avoidance statistics by NTEE category are available upon request.

test statistics. In essence, BD and BB statistics are both standardized unexpected bin scores.[9] BD's expected bin count is an average of two adjacent bins from the overall distribution, while that of BB is an average of four adjacent bin counts. Where BD statistics may capture too little of the overall bin distribution to estimate accurate bin count expectations, BB statistics supplement BD findings.

The cross-sectional, pooled sample of 580,423 NPO-years, spanning 1989-2008, was split into bins and analyzed for three separate bin intervals. Bins had interval widths 10%, 5%, and 1% of the respective state-year audit threshold. All bin widths yielded similar statistical significance. For brevity, I report 5% bin widths for BD tests and 1% bin widths for BB tests. Bin counts, BD statistics, and BB statistics are presented in Table 2 and illustrated in Figure 1.

Based on twenty bins with interval widths of 5% of the relevant state audit threshold, 143,360 NPO-years landed in the bins from 50% below the threshold to 50% above the threshold. As seen in Figure 1, there is an almost monotonic decrease in the number of NPOs that land in each bin, moving from the smallest revenue bin (left/negative: N10) to the largest revenue bin (right/positive: P10). This is not surprising because most NPOs are small, local, and/or grassroots organizations. These NPOs receive revenues below the levels at which audit requirements take effect.

However, the trend of decreasing bin counts across the distribution is not completely monotonic. Comparing the count of bin N02 (N = 7,225) to the count of bin N01 (N = 7,219) in Table 2, there is a difference of only six NPO-years between bins. This is a very small difference compared to the adjacent differences between bins N03 and N02 (7,638 – 7,225 = 413) and

[9] Based on the range of revenues observed in this sample, I estimated the standard deviation for BB test statistics from the unexpected bin counts in bins N20 to P20 instead of bins N25 to P25. There is no known change in interpretation from the original BB test statistic with a standard deviation estimated over 50 bins to this modified BB test statistic with a standard deviation estimated over 40 bins.

between bins N01 and P01 (7,219 – 5,665 = 1,554). In fact, this unexpectedly high count in bin N01 produced a BD smoothness statistic of 7.82.[10] As seen in Figure 1, Bin N01 is the only bin that is not smaller than the bin to its left. This finding indicates that there is an unexpectedly large jump in the bin distribution at bin N01, consistent with manipulation of reported revenues downward to avoid engaging auditors.

Table 2 reports that more NPOs just avoid their audit thresholds than those that just cross them in seventeen of nineteen states. The two states that did not report a higher N01 bin count than P01 bin count were Arkansas (46 to 48) and New Hampshire (23 to 24). These were two of the smallest states by NPO-year observations included in the sample. The differences in bin counts were small: 1 NPO for New Hampshire and 2 NPOs for Arkansas.

4.2. Public Disclosure Avoidance

Hypothesis 2 states that there will be a disproportionately larger number of NPOs just avoiding their audit thresholds in Illinois, Massachusetts, and New York. Each of these states provides the public with free, online access to multiple years' worth of its NPOs' financial records. In Table 2, fourteen of nineteen states produce an abnormally small decrease in the number of NPOs from bin N02 to N01. However, Illinois, Massachusetts, and New York actually report unexpected increases in the number of NPOs from bin N02 to bin N01.

In Illinois, 538 NPOs land in bin N02, 550 in bin N01, and 414 in bin P01. The BD statistic for bin N01 is 2.72 ($p < .01$). In Massachusetts, 711 NPOs land in bin N02, 813 in bin N01, and 456 in bin P01. The BD statistic for bin N01 is 7.15 ($p < .01$). In New York, 1,541

[10] In untabulated results, the BD statistic for N01 was 6.97 for 10% interval widths. Out of 400,519 NPO-years for 20 bins from 100% below to 100% above the respective state-year audit threshold, 15,445 NPO-years landed in bin N02, 13,310 NPO-years in bin N01, and 12,310 NPO-years in bin P01. The BD statistic for N01 was 4.98 for 1% interval widths. Out of 25,470 NPO-years for twenty bins from 10% below to 10% above the respective state-year audit threshold, 1,467 NPO-years landed in bin N02, 1,542 NPO-years in bin N01, and 1,167 NPO-years in bin P01.

NPOs land in bin N02, 1,609 in bin N01, and 1,245 in bin P01. The BD statistic for bin N01 is 4.65 ($p < .01$). Figure 2 provides a graphical summary of these findings.

Table 3 further explores the impact of public disclosure on NPO audit avoidance. Table 3 reports, by state from highest percentage to lowest percentage, the percentage of NPO-year observations that land in bin N01 (just avoids an audit) out of all NPO-years with gross revenues between 50% below and 50% above the respective state-year audit threshold.

For example, 30,197 NPO-years had gross revenues between 50% above and 50% below New York's respective state-year audit threshold. Of these 30,197 NPO-year observations, 1,609 NPO-years landed in bin N01. The percentage of NPO-year observations that just avoided an audit in NY was therefore 5.328% (1,609 / 30,197). For Massachusetts, 6.147% (813 / 13,225) just avoided audits, while 5.097% (550 / 10,790) just avoided audits in Illinois.

Compared to all other individual states, Massachusetts produced the highest percentage of NPO-years that reported revenues just below the relevant yearly audit threshold. New York produced a higher percentage than all other states that did not publicly disclose audit results online. Illinois produced a higher percentage than all other non-disclosing states except New Jersey. Combined, the percentage of NPO-years within 50% above and 50% below a respective state-year audit threshold that just avoided audits was 5.482% for the three states that publicly disclosed audit results online. The combined percentage of avoidance for states without public disclosure was 4.687%. These percentages were significantly different $\chi^2 = 33.2341$.

These results indicate that NPOs in Illinois, Massachusetts, and New York were the most likely to report revenues just below the audit threshold. This three-state pattern of avoidance directly relates to public disclosure of audit results in those three states. No other state publicly discloses audit results online. This evidence suggests that public disclosure of NPOs' financial

information deters NPOs from triggering an audit even more than the presence of a legal audit requirement alone.

4.3. Management Compensation

Hypothesis 3 states that organizations that pay relatively lower explicit compensation are more likely to report revenues just below their respective state-year audit thresholds. I ran a logistic regression on the entire sample of cross-sectional, pooled NPO-years relating compensation to the probability that an NPO just missed the audit threshold and landed in bin N01.

E1: $Pr\ (N01 = 1) = \alpha + \beta_1 * ASSETS_{it} + \beta_2 * CONTCH_{it} + \beta_3 * ROA_{it} + \beta_4 * PROSECUTE + \beta_5 * COMPENS_{it} + \varepsilon$

E1 was clustered by EIN (Employer Identification Number; a.k.a., organization). State, year, and NTEE category fixed effects were included. ASSETS is the total assets of an NPO at the end of its fiscal year. It is included to control for NPO resources, as compensation may be endogenous to NPO size, which, in turn may be associated with NPOs that report revenues well beyond relevant state audit thresholds. CONTCH is the annual change in contributions from the previous fiscal year. It is included to control for unexpected increases in revenues. ROA is calculated as total revenue divided by lagged total assets. It is included to control for the management resource efficiency. PROSECUTE is equal to Desai and Yetman's (2007) Prosecution value for each state. It is meant to control for state enforcement environment.[11] COMPENS is the total amount of compensation paid to all executive officers in an NPO.[12]

[11] PROSECUTE does not behave exactly as state fixed effect. Multiple states had the same values for state enforcement environment. State fixed effects were included in the model in addition to PROSECUTE to capture the idiosyncrasies between states that identical PROSECUTE values would not capture.

Results from these regressions are presented in Table 4. Only the full model (6) of E1 is discussed here.

The coefficient of interest for Hypothesis 3 is β_5 for COMPENS. In a multivariate model where the event is coded 1 if an NPO just avoids its audit threshold (Model 6), this coefficient is slightly less than zero and highly significant (β_5 = -0.00000178; $p < .0001$). This result, though small in magnitude, is consistent with H3. As total executive compensation increases $1, the log odds of an NPO just avoiding an audit threshold decreases .00000178. The odds ratio of this result is slightly less than 1. As total executive compensation decreases (increases), an NPO is slightly more (less) likely to avoid an audit.

To explore management compensation further, I conducted a Wilcoxon-Mann-Whitney test to assess whether there was a significant difference between compensation for NPOs in bin N01 (just avoid) and in bin P01 (just cross). For the variable COMPENS, there were 7,292 NPO-years in bin P01 with mean total officer compensation of $17,524 (mean rank = 6,705). There were 5,725 NPO-years in bin N01 with mean total officer compensation of $14,662 (mean rank of 6,364).[13]

NPOs in bin N01 have lower compensation than those in bin P01. These compensation levels are significantly different ($p < .001$). The negative correlation between executive compensation and the probability that an NPO avoids an audit (falls in bin N01) combined with the finding that NPOs just avoiding audits have lower explicit compensation than non-avoiders is consistent with officers avoiding audits to extract rents from their NPOs when explicit compensation is low. This implies that audit avoidance is undertaken in management self-interest, especially if rents can be extracted through non-pecuniary benefits.

[12] The effects of scaling by assets or fund balance are negligible.
[13] All means reported in this study are winsorized at the 0.5% and 99.5% levels, unless otherwise specified.

4.4. State Enforcement

Hypothesis 4 states that the general strength of the state enforcement environment will be significantly associated with the probability that an NPO just avoids the state-year audit threshold. I conducted my analysis of the possible relation between the strength of state enforcement and audit avoidance in the same manner as that for compensation. With respect to Equation 1, β_4 on PROSECUTE is the coefficient of interest.

Results from these logistic regressions also are presented in Table 4. If the general strength of state enforcement affects whether an NPO just avoids or just crosses its audit threshold, then one would expect the PROSECUTE coefficients for bin N01 to be significant, in either direction. β_4 is positive and insignificant in all models. I conducted a Wilcoxon-Mann-Whitney test of the differences in enforcement between bin N01 and bin P01. This analysis also produced insignificant mean rank differences between the general strength of enforcement for bin N01 and that for bin P01. Overall, these results suggest that the strength of a state's enforcement is not associated with the probability that an NPO reports revenues that just miss or just cross its audit threshold.

5. Robustness Tests

5.1. Exclude States

To ensure that certain states were not driving the avoidance finding, I conducted cross-sectional pooled analyses on the full sample excluding certain states. The first reduced sample excluded Illinois, Massachusetts, and New York. These states had the most acute avoidance statistics (see Figure 2). For 77,960 NPO-years from the sixteen remaining states in twenty 5% bin intervals, the Burgstahler and Dichev (1997) test statistic was significant (BD for bin N01 =

2.17; $p < .05$).[14] This significant result suggests that the three states with acute over-avoidance did not drive the overall avoidance finding.

The second reduced states sample excluded New York (N = 119,728) and Pennsylvania (N = 78,492). These states comprised over 33% of the original sample's 580,423 NPO-year observations. For 92,333 NPO-years from the seventeen remaining states in twenty 5% bin intervals, the BD test statistic for bin N01 was significant (6.55; $p < .001$).[15] This significant result suggests that the two disproportionately high observation states did not drive the overall avoidance finding.

5.2. NPO Distribution in Unaudited Years

5.2.1. Years not subject to audit requirements within the audited states

If the unexpected jump in NPOs landing in bin N01 relates to NPOs avoiding their audit thresholds, then there should be no such jump in revenue distributions for years without an audit requirement. For example, California's audit requirement ($2,000,000 revenues) went into effect on January 1, 2005. As evidenced in this study, there is avoidance of the $2,000,000 threshold after 2004 (audit-relevant years). In years prior to 2005, there was no audit requirement in effect for California.

If the distributional jump in bin N01 seen after 2004 (audit-relevant years) was driven by NPOs seeking to avoid crossing the audit threshold, then there should be no such jump around $2,000,000 prior to 2005 (years without audit). Stated differently, if the distributional jump around $2,000,000 is simply a function of the most likely size of California NPOs (i.e., mode

[14] For 13,027 NPO-years from the sixteen remaining states in twenty 1% bin intervals, the Bennett and Bradbury (2010) test statistic was significant (BB for bin N01 = 2.02; $p < .05$).

[15] For 15,749 NPO-years from the seventeen remaining states in twenty 1% bin intervals, the Bennett and Bradbury (2010) test statistic was significant (BB for bin N01 = 2.79; $p < .05$).

revenues of $1,900,000-$1,999,999), then there should be a jump in that 5% portion of the revenue distribution in each and every year – regardless of whether an audit requirement was in effect.

I created a new data set to test the audit-relevance of the distributional jump. This sample is focused on each state's most recent audit requirement. Instead of including audit-relevant years, it included only non-relevant NPO-years – those in which the audit requirement was not in effect. Bins were constructed identically to the primary sample's bins. For example, the set of non-relevant NPO-years for California were those NPOs within ten bins below and ten bins above the $2,000,000 revenue point for years prior to 2005. This dataset included 579,599 (non-relevant) NPO-years across the nineteen states with audit requirements tested in this study.

For 111,681 of these NPO-years in 5% bin intervals from ten bins below to ten bins above the standardized audit threshold, the Burgstahler and Dichev (1997) test statistic was not significant for the bin with revenues just to the left of the standardized threshold value. For the overall distribution of nineteen states in non-audit years, there is no jump in the distribution of NPOs with revenues identical to those in audit-relevant years. This result suggests that the distributional jump in bin N01 is unique to the existence of a relevant audit requirement.

5.2.2. *Years in states not subject to audit requirements*

Following the logic of Section 5.2.1, if the unexpected jump in NPOs that land in bin N01 relates to NPOs avoiding their audit thresholds, then there should be no such jump in revenue distributions during the same years subject to the original audit requirement in another state that has no audit requirement. For example, California's audit requirement ($2,000,000 revenues) went into effect on January 1, 2005. There is an unexpectedly large jump in the

number of NPOs that land in bin N01 during NPO-years after 2004. If this jump in the distribution relates to the audit threshold at $2,000,000, then there should be no such jump in the distribution of NPOs around $2,000,000 after 2004 in any state that does not have an audit requirement.

I created another dataset to test the audit-relevance of the distributional jump across states with an audit requirement and states without an audit requirement. I constructed this ("unaudited") dataset in the same manner as the original dataset, except that I included observations for all originally excluded states and excluded observations for all originally included states. In other words, this unaudited dataset includes observations only from states that had no legal audit requirements in effect by 2008. It covers 31 states, spans 1989-2008, and consists of 811,823 NPO-years.

I created pseudo-thresholds for each state that had an audit requirement by imposing the original state's audit requirements on this new dataset in two ways. First, I imposed each of the nineteen original state's audit threshold on the cross-section of all NPO-years from states without audit requirements. For example, I tested California's audit threshold on pooled, cross-sectional NPO-years from the 31 unaudited states for NPOs with gross revenues from 50% below to 50% above $2,000,000 for years after 2004. When bins were set up for these unaudited observations identical to those that were set up for the California observations, there was no jump in observations in bin N01. None of the nineteen pseudo-thresholds produced a jump in bin N01. There also was no pattern across states of abnormally small decreases in NPO-years between bin N02 and bin N01.

In my second analysis of this unaudited dataset, I applied the pseudo-thresholds for Illinois, Massachusetts, and New York to the new dataset on an individual state-state basis.

These three states publicly disclosed the audit results of their NPOs, and they had the most acute audit avoidance. Illinois' audit threshold was imposed first on Alaska (no audit requirement), second on Alabama, third on Arizona, and so on. Instead of testing Illinois' audit threshold on one cross-section of unaudited states as before, this time I tested Illinois' audit threshold 31 separate times on 31 individual states that did not have audit requirements. I conducted the same analyses for Massachusetts and New York, for a total of 93 pseudo-threshold tests. [16]

For each of Illinois, Massachusetts, and New York, none of the 31 pseudo-thresholds produced a significantly large number of observations landing in bin N01. Combined with the results of the cross-sectional pseudo-threshold tests, this finding indicates that the distributional jump in bin N01 seen in the original sample is unique to the existence of a relevant audit requirement.

5.3. State Enforcement Environment

Main state enforcement analyses were conducted utilizing Desai and Yetman's (2007) Prosecution (enforcement) index. To ensure that measure choice did not influence the relation between state enforcement and avoidance, I created and analyzed six supplemental general state enforcement proxies. Descriptive statistics for these proxies are in Appendix D.

As shown in Table 5, logistic regressions were re-run on Models 4 and 6 replacing PROSECUTE with each respective state enforcement measure. There is no evidence of a relation between any of the six supplemental general state enforcement proxies and whether an NPO just avoids its audit threshold.

[16] Tabulated results from this section are available by request.

5.4. Federal Enforcement Environment

Tax-exempt organizations are subject to a dual regulation regime (see e.g., Fremont-Smith, 2004). They are regulated by both state and federal governments. This dual regulation leads to the possibility that federal enforcement crowds out or otherwise interacts with the effects of state enforcement. If this federal enforcement effect does exist, then it may be the reason that state enforcement does not have a significant relation to whether an NPO just avoids a GAAP audit threshold. To control for this possibility, a measure of federal enforcement environment was created. It equals the percentage of tax-exempt organizations' tax returns that the IRS chooses to examine by year.

This federal enforcement measure is based on annual information in Table 13 of the Internal Revenue Service's Data Books for years 2006, 2007, 2008, and 2009. Table 13 reports the number of tax-exempt organizations' tax returns examined in the previous fiscal year. The federal enforcement measure for each year of 2005, 2006, 2007, and 2008 was calculated as "Tax-exempt organizations and related taxable returns examined in Fiscal Year 200X, total" divided by "Tax-exempt organization returns processed in Calendar Year 200X-1."

To investigate whether federal enforcement is related to NPOs avoiding the threshold beyond which a GAAP audit is triggered, I ran logistic regressions where the modeled event is the probability that an NPO just avoids a GAAP audit. Models included state enforcement and federal enforcement (IRS_ENFORCE) as independent variables, as well as NTEE and year fixed effects. I clustered standard errors by state. In all models, neither state enforcement nor federal enforcement was significant.[17] These results suggest that when one considers NPOs' dual

[17] In expanded models, the interactions of state enforcement proxies and federal enforcement were also insignificant.

regulation regime, no form of enforcement relates to whether an NPO just avoids a GAAP audit.[18]

6. Methods of Accounting Manipulation

This study provides evidence that a disproportionate number of NPOs report revenues that allow them to just avoid audits. To do so, NPOs must manage their accounting in a way that minimizes revenues during avoidance years. Per IRS Form 990, total revenue is net of rental expenses, the cost basis of securities sold, the cost basis of other assets sold, special events costs, and the cost of goods sold. Any increase in one of these costs directly reduces total revenue.

In a normal organizational lifecycle, an NPO experiences revenue growth and fluctuations over time. This implies that it would be unusual for an NPO to report the same level of revenues over multiple years. Arguably, NPOs that report revenues falling in bin N01 for more than one year (repeat avoiders) are the most likely to have managed their revenues in order to continually avoid an audit.[19]

6.1. Rental Expenses

There are 220 NPO-years in bin N01 that have sufficient data to calculate the average annual percentage change in rental expenses. 157 of these NPO-years represent 157 unique NPOs, each of which landed in bin N01 only once during the sample period. The other 63 NPO-year observations in bin N01 belong to 29 unique NPOs. These NPOs landed in bin N01 during

[18] The results are similar when tests were based on one-year-lagged values of the state enforcement variables and of federal enforcement. Unlike the implicit perfect foresight assumption in the main tests, these tests exploit the assumption that managers predict that state and federal enforcement efforts follow a random walk.

[19] There was insufficient data to test the cost basis of other assets sold for repeat avoiders (N = 6).

two, three, or four years of the sample period. I split these 220 bin N01 observations into two groups: NPOs that avoided an audit once and NPOs that repeatedly avoided an audit.

Panel A of Table 6 reports my findings. For NPOs that avoided an audit in only one year of the sample, the average annual percentage change in rental expenses was -23.41% (N = 157).[20] For NPOs that repeatedly avoided an audit during the sample period, the average annual percentage change in rental expenses was 27.35% (N = 63).

I then created two non-avoider control groups. The first non-avoider group consisted of all NPO-years landing in bins 5-25% below the audit threshold (small; N02, N03, N04, N05). The second non-avoider group consisted of all NPO-years landing in bins 5-25% above the audit threshold (large; P02, P03, P04, P05). For large non-avoiders, the average annual percentage change in rental expenses was -9.61% (N = 703). For small non-avoiders, that percentage change was -11.16% (N = 911).

NPOs that repeatedly avoided an audit had an average annual percentage change in rental expenses in the year of avoidance that was significantly higher than that of all other groups.[21] This implies that only those NPOs that repeatedly avoided their audit thresholds reported increases in rental expenses, which decreased the amount of revenues contributing toward the audit threshold. In sum, the subset of NPOs in bin N01 that were the most likely to manipulate their accounting in order to avoid an audit indeed appeared to inflate their rental expenses.

[20] I winsorize means for rental expenses and special event expenses at 2.5% and 97.5% levels.

[21] For Sections 6.1 and 6.2 two sample t-tests assuming unequal variances indicated that there were significant differences at $p < .05$ between the mean for repeated avoiders and all other means.

6.2. Cost Basis of Securities Sold

Following the same procedure as that for rental expenses, I examined a group of 331 NPO-years in bin N01 that had sufficient data to calculate the average annual percentage change in rental expenses. My one-time avoidance subsample consisted of 271 unique NPOs. My repeat avoidance subsample consisted of 60 NPO-years for 29 unique NPOs.

The average annual percentage change in the cost basis of securities sold for repeat avoiders was 26.97%. The percentage change was only 3.52% for one-time avoiders.[22] For large non-avoiders, the average annual percentage change in the cost basis of securities sold was -20.51% (N = 1,106). For small non-avoiders, the percentage change was –9.26% (N = 1,401).

NPOs that repeatedly avoided an audit had an average annual percentage change in the cost basis of securities sold in the year of avoidance that was significantly higher than that of all other groups. Like the findings for rental expenses, these percentages imply that repeat avoiders inflate their cost basis of securities sold to report lower revenues.

6.3. Special Event Expenses

Following the same procedure as before, I examined a group of 1,689 NPO-years in bin N01 that had sufficient data to calculate the average annual percentage change in rental expenses. My one-time avoidance subsample included 1,458 unique NPOs. My repeat avoidance subsample consisted of 231 NPO-years for 97 unique NPOs. The average annual percentage change in special event expenses for repeat avoiders was 1.62%. This percentage change was 0.41% for one-time avoiders, 4.83% for large non-avoiders (N = 4,973), and 5.83% for small non-avoiders (N = 7,640).

[22] I winsorize means for the cost basis of securities sold and the cost of goods sold at 5% and 95% levels.

These percentage changes are not significantly different ($p > .05$). There is no evidence that repeat avoiders inflate special event expenses any more than other NPOs. This finding is not surprising, as special event expenses are incurred with much less frequency than NPOs' everyday expenses and costs. Thus, special event expenses are more transparent to outsiders and riskier for the NPO to manipulate.

6.4. Cost of Goods Sold

Following the same procedure as that for rental expenses, I examined a group of 821 NPO-years in bin N01 that had sufficient data to calculate the average annual percentage change in the cost of goods sold. My one-time avoidance subsample consisted of 713 unique NPOs. My repeat avoidance subsample consisted of 108 NPO-years for 45 unique NPOs.

The average annual percentage change in the cost of goods sold for repeat avoiders was 0.44%. The percentage change was -1.89% for one-time avoiders. For large non-avoiders, the average annual percentage change in the cost of goods sold was 6.10% ($N = 3,474$). For small non-avoiders, that percentage change was 2.69% ($N = 2,310$). These percentage changes are not significantly different ($p > .05$). There is no evidence that repeat avoiders inflate cost of goods sold any more than other NPOs. Compared to rental expenses, the cost basis of securities sold, and special event expenses, the cost of goods sold is the only expense that relates directly to an NPO's main operations. Therefore, outsiders may scrutinize the cost of goods sold more than expenses associated with auxiliary accounts. The cost of goods sold relays information about management of central operations.

7. Conclusion

Regulation is the backbone of financial accountability and its effects can have significant impacts on the economy. The importance of the state in charitable administration, monitoring, and enforcement combined with the wide variation in these practices across states provides a naturally powerful setting in which to investigate the consequences of regulation. This study utilizes smoothness analyses and logistic regressions to examine whether not-for-profit organizations manipulate their accounting to circumvent state laws that require financial audits.

My main findings are as follows: First, some NPOs appear to manipulate revenues downward to avoid engaging auditors. In pooled, cross-sectional analyses of 580,423 NPO-year observations spanning 1989-2008, there is a significant and unexpectedly large number of NPOs that just avoid crossing the revenue threshold past which they would need to obtain financial audits. Second, this avoidance result is especially evident in Illinois, Massachusetts, and New York. These three states are the only states that provide publicly accessible, online, multiyear databases of NPOs' IRS Forms 990 and financial audits. This finding suggests that an NPO is the most likely to avoid an audit when the state under whose jurisdiction the NPO resides freely discloses the NPO's financial information to the public. Third, evidence from logistic regressions suggests that an NPO's management is more likely to avoid an audit when explicit executive compensation is low. Fourth, logistic regressions employing seven different measures of general state enforcement environments produce no evidence that the strength of a state's general enforcement environment is related to whether NPOs just avoid their audit thresholds. Finally, this study provided evidence that NPOs inflate rental expenses and the cost basis of securities sold to continually avoid reporting revenues that cross audit thresholds.

Appendix A: Not-for-profit sector audit requirements in effect by 2008

State	Accounting Measure	Amount	Most recent threshold, included[1]	Other threshold(s), included	Other threshold(s), excluded
Arkansas	mod[2] gross revenues	$500,000	2001		1998/1992: $100K/$25K (AR grants)
California	gross revenues	$2,000,000	January 1, 2005		
Connecticut	mod gross revenues	$200,000	October 1, 2005	June 1, 2000: $100K	July 1, 2009: $500K
Georgia	gross revenues	$1,000,000	2000[4]		
Illinois	gross revenues	$150,000	1997[4]		January 1, 2010: $300K
Kansas[3]	contributions	$500,000	July 1, 2005	1993[4]: $100K	
Maryland[3]	contributions	$200,000	2004[4]		June 1, 2009: $500K
Massachusetts	gross revenues	$500,000	January 1, 2005	1998[4]: $250K; 1979[4]: $100K	
Minnesota	gross revenues	$750,000	July 31, 2008	July 1, 1997: $350K; [4]Earlier: $100K	
Mississippi	contributions	$500,000	July 1, 2008	July 1, 1997: $100K; [4]Earlier: $50K	
New Hampshire[3]	gross revenues	$1,000,000	September 30, 2004		
New Jersey	gross revenues	$250,000	July 8, 2006	Since at least 2003[4]: $100K	
New Mexico	gross revenues	$500,000	1999[4]		
New York[3]	gross revenues	$250,000	2002	1977: $150K	
Pennsylvania[3]	contributions	$300,000	December 26, 2006	June 22, 2001: $125K; 1990: $100K	
Rhode Island	gross revenues	$500,000	July 2, 2004		
Tennessee[3]	gross revenues	$500,000	July 1, 2007	April 18, 2001: $300K; 1997: $250K	1976: $10K
West Virginia	mod contributions	$100,000	June 7, 2002	1995: $50K	June 12, 2010: $200K
Wisconsin	contributions	$400,000	April 22, 2008	1991[4]: $100K	
OMB Circular A-133[5]	federal grants	$500,000	December 31, 2003	1996: $300K; 1984: $100K	

This appendix presents state-by-state audit requirements in effect by 2008 and tested in this study. Note 1: Included = Included in study design. Excluded = Excluded because data not available at time of study. Note 2: Mod = Modified, per state law. Note 3: Confirmed threshold information with respective Attorney General Office and/or Secretary of State Office. Note 4: Best estimate based on available sources. Note 5: Office of Management and Budget Circular A-133: *Audits of States, Local Governments, and Non-Profit Organizations*.

Appendix B: Sample Selection

	N lost	N retained
All state-years: 1989 - 2008		3,855,497
Restrict to states with empirically testable state law audit requirements STATE = AR, CA, CT, GA, IL, KS, MD, MA, MN, MS, NH, NJ, NM, NY, PA, RI, TN, WV, WI	(1,872,704)	1,982,793
Exclude trusts and unknown organizational forms ORGCD = 1, 3, 4, 5	(71,804)	1,910,989
Restrict to NPOs that receive substantial proportion of incomes from public/government/work related to charitable missions FNDNCD = 15, 16	(301,615)	1,609,374
Restrict to certain NTEE major groupings NTEE1 = A, C, D, F, G, H, I, J, K, L, M, N, O, P, U, V	(597,112)	1,012,262
Restrict to certain NTEECC's NTEECC not A - Z 01-05, 11, 12, 19. Not N61.	(83,501)	928,761
Restrict to NPOs not missing necessary IRS Form 990 data	(24,300)	904,461
Delete organizations that contain "foundation" anywhere in name	(37,942)	866,519
Restrict to years in which an audit requirement was in effect per state law	(235,023)	631,496
Delete organizations that were required to undergo an audit based on the amount of federal grant money received (per federal law)	(10,365)	621,131
Delete organizations from MA that were required to undergo an audit because total assets were at least $5 million (per state law)	(40,708)	580,423

This Appendix presents the step-by-step criteria that were used to select the sample in this study.

N lost = NPO-year observations excluded from final sample.
NTEE = National Taxonomy of Exempt Entities
NTEECC = National Taxonomy of Exempt Entities Core Codes
Variable names/codes listed, per NCCS methodology.
Final sample size is 580,423 NPO-years.

Appendix C: Variable descriptions

Variable	Description
TOTREV	Total Revenue
CONT	Contributions
GRANTS	Grants
FUNDBAL	Fund Balance
ASSETS	Total Assets, End of Year
INVINC	Investment Income
SOLICIT	Fundraising Expenses
EXPS	Total Expenses
COMPENS	Total Officer Compensation
OTHSAL	Total Non-Officer Compensation
ROA	Return on Assets: Total revenue / Lagged Total Assets

This Appendix presents descriptions of the main financial variables used in this study. Data for all variables presented here comes from the National Center for Charitable Statistics.

Appendix D: General state enforcement measures

Panel A: Proxy descriptions

Variable	Description	Source
STLOCENFEMPLOY_CAP	State and local law enforcement employees per 100,000 residents (monitoring, detection, law enforcement)	BJS 2004 Census, Appendix Table 1
STENFEMPLOY_CAP	State law enforcement employees per 100,000 residents (monitoring, detection, law enforcement)	BJS 2004 Census, Table 6
JUDEMPLOY_CAP	Judicial and legal employees per 10,000 residents (prosecution, courts, and public defense)	BJS Justice Expenditure and Employment Extracts for 2007, Table 8
JUDEXPEND_CAP	Judicial and legal expenditures per 10,000 residents (prosecution, courts, and public defense)	BJS Justice Expenditure and Employment Extracts for 2007, Table 8
DHHS_FRAUD	Number of state enforcement actions taken against health and human services organizations that were listed in an OIG online news feed between April 1, 2010 and March 30, 2011	OIG State Enforcement online news feed
CIVIL_FRAUD	Number of civil monetary penalty settlements for false and fraudulent claims that were listed in an OIG online news feed between March 3, 2003 and February 7, 2011	OIG Enforcement Actions online news feed
IRS_ENFORCE	% of tax-exempt organizations' tax returns examined, by year	IRS Data Books 2006-2009: Table 13

Panel B: Correlations

	STLOCENFEMPLOY_CAP	STENFEMPLOY_CAP	JUDEMPLOY_CAP	JUDEXPEND_CAP	DHHS_FRAUD	CIVIL_FRAUD	IRS_ENFORCE
STLOCENFEMPLOY_CAP		-0.12124	0.46815	0.28937	0.69383	0.26379	-0.00404
STENFEMPLOY_CAP	-0.10747		0.50823	0.04066	0.21599	0.04597	*-0.0028*
JUDEMPLOY_CAP	0.51163	0.51531		0.62523	0.77026	0.4463	-0.0098
JUDEXPEND_CAP	0.30098	0.0477	0.4097		0.68632	0.64699	-0.0092
DHHS_FRAUD	0.81783	0.03131	0.56407	0.48455		0.47556	-0.00697
CIVIL_FRAUD	0.35598	0.09312	0.17938	0.74591	0.45556		-0.00819
IRS_ENFORCE	-0.00662	*-0.00351*	-0.00889	-0.00998	-0.00857	-0.00801	

Appendix D, Panel A describes the six supplemental state enforcement proxies and the federal enforcement proxy. BJS = Bureau of Justice Statistics. OIG = U.S. Department of Health and Human Services Office of the Inspector General. **Appendix D, Panel B** Pearson (Spearman) correlations are reported below (above) the diagonal. Most correlations are based on 616,751 NPO-years. Federal enforcement-state enforcement correlations are based on 241,904 NPO-years. All correlations are significant at $p < .05$, except for that between IRS_ENFORCE and STENFEMPLOY_CAP (in italics). It is insignificant.

Table 1: Descriptive statistics

Panel A: Measures of central tendency

Variable	N	Mean	SD	25%	Median	75%
TOTREV	580,423	$1,001,296	$1,527,501	$63,592	$174,079	$623,328
CONT	580,423	$362,725	$977,171	$6,901	$50,229	$218,444
GRANTS	109,039	$28,963	$71,508	$0	$0	$15,000
FUNDBAL	580,423	$674,914	$704,246	$18,408	$88,595	$432,320
ASSETS	580,423	$1,271,159	$920,151	$36,904	$162,878	$811,554
INVINC	580,423	$13,974	$22,414	$11	$717	$5,180
SOLICIT	580,423	$14,089	$87,114	$0	$0	$823
EXPS	580,423	$951,577	$1,514,331	$57,507	$161,620	$587,970
COMPENS	580,423	$25,667	$85,552,510	$0	$0	$33,300
OTHSAL	485,210	$352,410	$57,825,011	$0	$2,770	$152,390
ROA	546,843	4.64	47,215	0	2	4
State-specific governance indices[1]						
PROSECUTE	580,423	4.91	0.55	3		6
DETECT	580,423	7.96	1.08	4		11
COMBINED	580,423	12.87	1.41	8		16

This table contains descriptive statistics for the variables in this study. Variables are defined in Appendix C. Robust means are presented; all financial variables are winsorized at the 1% and 99% levels. Note 1: These state-specific governance indices were used with permission from the authors of "Constraining Managers without Owners: Governance of the Not-for-Profit Enterprise" by Mihir Desai and Robert Yetman (DY; 2007). Desai and Yetman reported descriptive statistics for their indices in Table 3 of the DY paper for all states in the United States. DY reported means of 11.47 for the combined index, 6.75 for the Detection index, and 4.71 for the Prosecution index. The statistics for the sample studied here differ from DY's statistics because these cover only nineteen of all of the states. These nineteen states all had an aggressive detection mechanism in place with respect to audit requirements. Therefore, these states have slightly higher index ratings than the full sample of states, which includes states without that detection measure.

(Table 1 continued)

Panel B: State distribution

STATE	N	%
AR	6,528	1.12%
CA	49,234	8.48%
CT	15,881	2.74%
GA	15,121	2.61%
IL	39,698	6.84%
KS	17,035	2.93%
MA	53,984	9.30%
MD	11,258	1.94%
MN	40,871	7.04%
MS	9,523	1.64%
NH	4,088	0.70%
NJ	43,256	7.45%
NM	7,375	1.27%
NY	119,728	20.63%
PA	78,492	13.52%
RI	2,895	0.50%
TN	19,328	3.33%
WI	36,833	6.35%
WV	9,295	1.60%
TOTAL	580,423	100.00%

Panel C: Year distribution

YEAR	N	% of final
1987	98	0.02%
1988	863	0.15%
1989	10,218	1.76%
1990	13,730	2.37%
1991	14,591	2.51%
1992	15,823	2.73%
1993	16,525	2.85%
1994	17,357	2.99%
1995	18,472	3.18%
1996	19,708	3.40%
1997	25,180	4.34%
1998	26,198	4.51%
1999^	7,244	1.25%
2000	28,124	4.85%
2001	30,919	5.33%
2002	34,110	5.88%
2003	36,158	6.23%
2004	38,534	6.64%
2005	52,458	9.04%
2006	52,157	8.99%
2007	59,028	10.17%
2008	56,196	9.68%
2009	6,732	1.16%
TOTAL	580,423	100.00%

Table 1, Panel B (Panel C) presents the state (year) distribution of the total sample of state-years. N represents how many NPO-year observations were included in this study. % of final = Percentage of final sample that came from each state (year). For example, 6.35% of the final sample came from Wisconsin. The Core files sometimes contain return information for years other than the main year listed. The 1989 and 1990 Core files contained some returns for 1987 and 1988. The 2008 Core file included some IRS Form 990 information for 2009. These observations were retained in cross-sectional, pooled analyses. They were excluded whenever year became a factor in the analyses. All time-sensitive analyses spanned the years corresponding to the NCCS Core files: 1989-2008. ^Note that the NCCS does not have data for 1999. These 1999 observations were culled from other years' files, such as 1998 and 2000.

(Table 1 continued)

Panel D: NTEE distribution

NTEE		Frequency	Percentage
A	Arts, Culture, and Humanities	121,073	20.86%
C	Environmental Quality, Protection, and Beautification	16,701	2.88%
D	Animal-Related	16,223	2.80%
F	Mental Health, Crisis Intervention	29,866	5.15%
G	Diseases, Disorders, Medical Disciplines	20,356	3.51%
H	Medical Research	3,477	0.60%
I	Crime, Legal Related	16,009	2.76%
J	Employment, Job Related	12,607	2.17%
K	Food, Agriculture, and Nutrition	10,540	1.82%
L	Housing, Shelter	53,178	9.16%
M	Public Safety	21,910	3.77%
N	Recreation, Sports, Leisure, Athletics	83,947	14.46%
O	Youth Development	26,281	4.53%
P	Human Services - Multipurpose and Other	142,387	24.53%
U	Science and Technology Research Institutes, Services	3,692	0.64%
V	Social Science Research Institutes, Services	2,176	0.37%
		580,423	100.00%

Table 1, Panel D presents the NTEE (National Taxonomy of Exempt Entities) classifications of organizations within the total sample.

Table 2: Bin counts of NPO-years, by state

	AR	CA	CT	GA	IL	KS	MA	MD	MN	MS	NH	NJ	NM	NY	PA	RI	TN	WI	WV
N10	146	683	400	264	1,018	460	1,266	266	978	261	54	141	149	2,722	2,134	57	464	927	225
N09	124	551	373	257	938	464	1,064	247	891	250	52	158	141	2,587	1,804	62	420	864	230
N08	88	538	405	227	836	414	1,049	233	800	205	53	113	140	2,214	1,715	46	406	816	218
N07	79	530	293	294	800	347	893	210	705	189	41	129	125	2,063	1,581	45	337	749	252
N06	88	417	304	177	714	352	884	192	672	200	45	131	125	1,891	1,498	37	320	719	178
N05	71	366	295	157	644	294	816	184	609	205	34	108	95	1,824	1,389	42	292	648	187
N04	62	369	262	163	587	300	715	167	579	189	36	92	99	1,597	1,171	35	302	595	185
N03	55	286	249	125	605	243	716	159	544	149	33	96	103	1,586	1,159	39	248	581	173
N02	50	276	233	124	538	225	711	143	498	153	26	101	83	1,541	1,074	21	263	554	158
N01	46	251	226	114	**550**	238	**813**	131	475	147	23	98	68	**1,609**	1,043	32	218	530	149
P01	48	227	189	108	414	186	456	109	362	127	24	50	59	1,245	940	30	216	467	114
P02	49	208	158	96	433	206	487	137	361	108	22	64	75	1,180	889	35	210	464	114
P03	55	194	157	78	404	169	480	106	351	118	21	61	72	1,184	873	23	187	407	103
P04	56	164	162	87	388	179	424	108	342	118	21	54	59	1,147	832	27	160	393	101
P05	36	184	149	74	356	162	428	105	283	109	25	44	43	1,097	758	19	168	392	92
P06	45	145	111	71	328	188	422	100	295	119	20	56	60	1,009	719	18	153	372	95
P07	37	135	123	77	314	155	434	104	306	106	22	63	43	999	705	18	141	379	92
P08	37	137	131	59	330	127	398	92	296	71	14	50	57	892	671	19	139	334	110
P09	33	134	136	55	306	132	395	84	287	89	21	52	51	932	610	23	119	301	103
P10	37	115	125	52	287	125	374	74	263	75	9	30	53	878	663	24	135	315	72
TOTAL	1,242	5,910	4,481	2,659	10,790	4,966	13,225	2,951	9,897	2,988	596	1,691	1,700	30,197	22,228	652	4,898	10,807	2,951

This table presents bin counts per state. Vertical labels are bin labels. N10 is the tenth bin to the left of the threshold, based on bin intervals with width 5% of the respective state threshold. For example, the required audit threshold for California is $2,000,000 in revenue. The CA law that required audits of NPOs with revenues of at least $2 million went into effect on January 1, 2005. Bin N10 contains the number of NPOs that reported revenue between $1,000,000 and $1,099,999 for any year ending after January 1, 2005. As of the end of the 2008 NCCS Core files, 683 NPOs landed in bin N10. Bin N01 falls just to the left of the required audit threshold. These NPOs just avoided the requirement to file an audit. Bin P01 falls just to the right of (and includes) the audit threshold. These NPOs reported revenues that should have triggered financial audits per state law.

Table 3: Public Disclosure

Panel A: Smoothness statistics for NPO-years that just avoid audits

	BD	BB
MA*	**7.1543**	-2.7796
NY*	**4.6524**	-2.5404
IL*	**2.7222**	-1.8212
NJ	1.9989	-1.3171
KS	1.8144	-1.1625
MN	1.7671	-1.3709
RI	1.0008	-0.1529
PA	0.9448	-0.7509
WV	0.9120	-0.5308
CT	0.8517	-0.7409
WI	0.7192	-0.8134
MS	0.4911	-0.7818
MD	0.3698	0.6532
CA	-0.0265	-0.0697
GA	-0.1571	-0.0270
NM	-0.3033	1.0753
NH	-0.3452	0.9869
AR	-0.3669	0.5209
TN	-1.2088	1.0931

Panel B: Percentage of NPO-years that just avoid audits

State	% Just Avoid
MA	**6.147%**
NJ	*5.795%*
NY	**5.328%**
IL	**5.097%**
WV	5.049%
CT	5.044%
MS	4.920%
RI	4.908%
WI	4.904%
MN	4.799%
KS	4.793%
PA	4.692%
TN	4.451%
MD	4.439%
GA	4.287%
CA	4.247%
NM	4.000%
NH	3.859%
AR	3.704%

	% Just Avoid
Three states with public disclosure	***5.482%***
States without public disclosure	***4.687%***

Panel A of Table 3 reports the Burgstahler and Dichev (BD; 1997) smoothness statistics and Bennett and Bradbury (2010) smoothness statistics for bin N01 in each state, from BD's highest significance to BD's lowest significance. For both statistics, an absolute value greater than or equal to 2 is significant at $p < .05$. *Indicates significance at $p < .01$.

Panel B of Table 3 reports, by state from highest percentage to lowest percentage, the percentage of NPO-years that land in bin N01, given that the NPO-year reports gross revenues between 50% below and 50% above the state-year audit threshold. For example, 30,197 NPOs reported gross revenues between 50% above and 50% below New York's respective state-year audit threshold. Of these 30,197 NPO-year observations, 1,609 NPO-years landed in bin N01. The percentage of NPO-year observations that landed in the 'just avoid' bin was 1,609 / 30,197 = 5.328%. Combined for the three states that publicly disclose audit results (IL, MA, and NY), the percentage of NPO-year observations within 50% above and 50% below the respective state-year audit threshold that lands in bin N01 is 5.482%. for the sixteen states that have audit requirements but that do not publicly disclose the results of those audits combined that probability is 4.687%. These percentages were significantly different: $\chi^2 = 33.2341$.

Table 4: Regression Analyses

Pr(N01=1)

Variable	1	2	3	4	5	6
ASSETS	**-0.2140**					**-0.2040**
	114.4081					92.5548
	<.0001					<.0001
CONTCH		**-0.1066**				**-0.0187**
		44.9046				14.2447
		<.0001				0.0002
ROA			*-0.0152*			**-0.7240**
			3.0848			5.8569
			0.0790			0.0155
COMPENS				*0.0000*		**-1.7800**
				0.3533		26.3020
				0.5523		<.0001
PROSECUTE					*41,200*	*-1.8100*
					0.6191	4.8693
					0.4314	0.6097

Table 4 presents results for the following logistic regression:

$$E1:\ Pr(N01=1)=\alpha+\beta_1*ASSETS+\beta_2*CONTCH+\beta_3*ROA+\beta_4*PROSECUTE+\beta_5*COMPENS+\varepsilon$$

Table 4 lists the coefficient estimate, Wald Chi-Square statistic, and p-value for each variable. Coefficient estimates should be multiplied by 10^{-6}. Standard errors are clustered by EIN (organization). For coefficients with p-values under $p < .05$, coefficients are in bold. Insignificant ($p > .05$) coefficients are italicized. Year, state, and NTEE fixed effects are included in the models, but these effects are excluded from this table for brevity. 7,219. NPO-years landed in bin N01 (just avoided audit). Note that the regressions for only PROSECUTE are clustered by state without modeled state fixed effects. Appendix C provides variable defintions.

Table 5: Regression analyses of supplemental enforcement proxies

	Pr(N01=1)	
	4	**6**
STLOCENFEMPLOY_CAP	-0.0008	0.0006
	0.6191	0.2607
	0.4314	0.6097
STENFEMPLOY_CAP	0.00196	-0.0014
	0.6191	0.2607
	0.4314	0.6097
JUDEMPLOY_CAP	0.0206	-0.0146
	0.6191	0.2607
	0.4314	0.6097
JUDEXPEND_CAP	0.00589	-0.0036
	0.6191	0.1974
	0.4314	0.6568
DHHS_FRAUD	0.0275	-0.0195
	0.6191	0.2607
	0.4314	0.6097
CIVIL_FRAUD	0.2724	0.0359
	1.5676	0.0252
	0.2105	0.8738

Table 5 presents results of logistic regressions of E1, models 4 and 6, re-run 12 separate times with each state enforcement proxy listed here. These proxies substituted for PROSECUTE in the original E1:

$$E1: \ Pr(N01=1)=\alpha+\beta_1*ASSETS+\beta_2*CONTCH+\beta_3*ROA+\beta_4*PROSECUTE+\beta_5*COMPENS+\varepsilon$$

Coefficient estimates are followed by Wald Chi-Square statistics. In model 4, standard errors are clustered by state. There are year and NTEE fixed effects. In model 6, standard errors are clustered by EIN. There are year, state, and NTEE fixed effects. For coefficients with p-values under $p < .05$, coefficients are in bold. Financial variables are described in Appendix C.

Table 6:
Accounting Manipulation

Panel A: Rental Expenses

	N	Mean
Repeat avoiders	63	0.2735
One-time avoiders	157	-0.2341
Non-avoiders, large	703	-0.0961
Non-avoiders, small	911	-0.1116

Panel B: Cost Basis of Securities Sold

	N	Mean
Repeat avoiders	60	0.2697
One-time avoiders	271	0.0353
Non-avoiders, large	1,106	-0.2051
Non-avoiders, small	1,401	-0.0926

Panel C: Special Event Costs

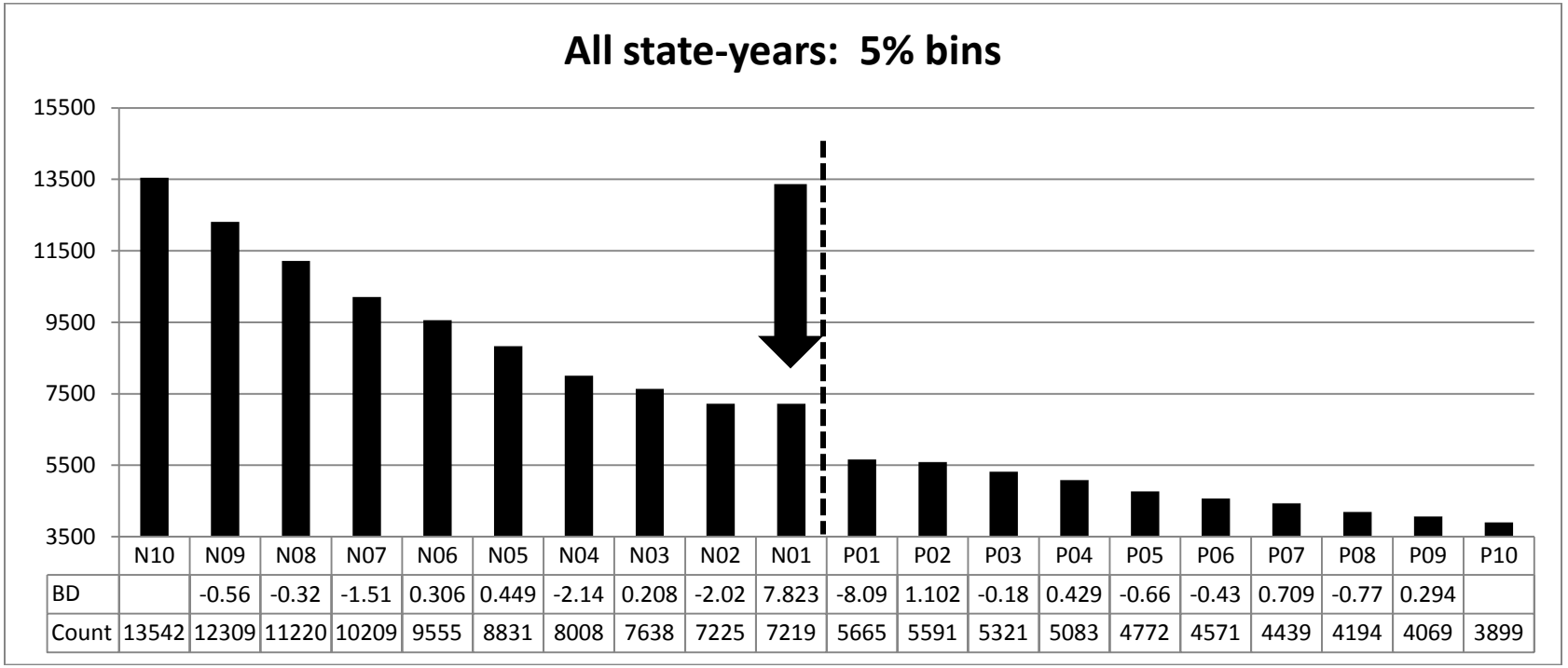
	N	Mean
Repeat avoiders	231	0.0162
One-time avoiders	1,458	0.0041
Non-avoiders, large	4,973	0.0483
Non-avoiders, small	7,640	0.0583

Panel D: Cost of Goods Sold

	N	Mean
Repeat avoiders	108	-0.0218
One-time avoiders	713	-0.1364
Non-avoiders, large	3,474	-0.0456
Non-avoiders, small	2,310	-0.0702

Table 6 presents the average annual percentage change in four different pre-threshold costs for four groups. The first group contains all NPO-years in bin N01 for which an NPO repeatedly landed in bin N01. This repeat avoiders group is the most likely to manipulate their accounting to continually avoid an audit. The second group, one-time avoiders, contains all NPO-years in bin N01 for which the NPO landed in bin N01 only once during the sample period. The third group, large non-avoiders, contains all NPO-years in bins P02, P03, P04, and P05. The fourth group contains all NPO-years in bins N02, N03, N04, and N05. For rental expenses and special event expenses, means are winsorized at the 2.5% and 97.5% levels. For the cost basis of securities sold and the cost of goods sold, means are winsorized at the 5% and 95% levels. Comparing the repeat avoiders group to all other groups in the same Panel, the means are significantly different ($p<.05$) for rental expenses and the cost basis of securities sold.

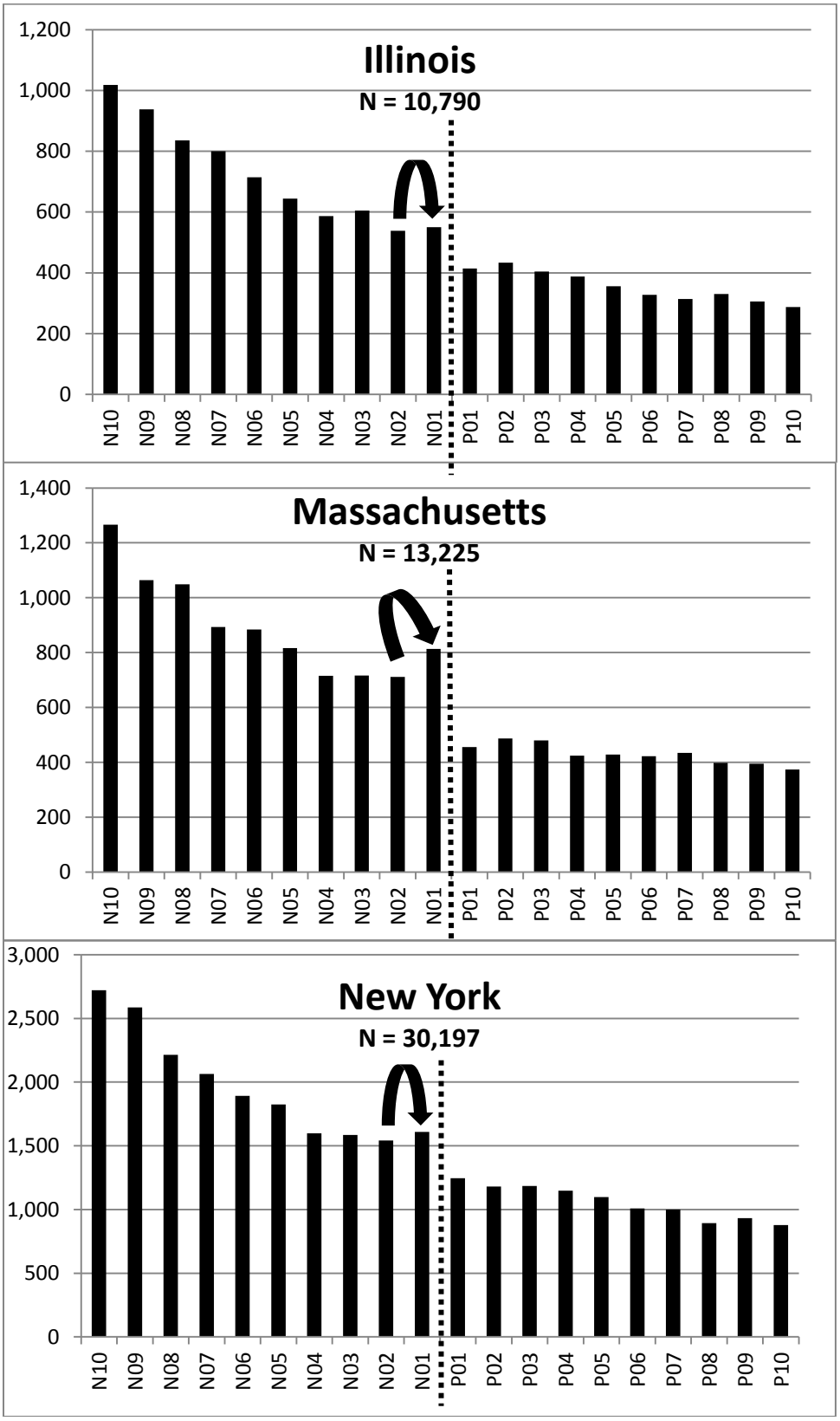
Figure 1. Distribution of all state-years, 5% bins



	N10	N09	N08	N07	N06	N05	N04	N03	N02	N01	P01	P02	P03	P04	P05	P06	P07	P08	P09	P10
BD		-0.56	-0.32	-1.51	0.306	0.449	-2.14	0.208	-2.02	7.823	-8.09	1.102	-0.18	0.429	-0.66	-0.43	0.709	-0.77	0.294	
Count	13542	12309	11220	10209	9555	8831	8008	7638	7225	7219	5665	5591	5321	5083	4772	4571	4439	4194	4069	3899

Figure 1 illustrates the cross-sectional, pooled distribution of NPO-years. Bin intervals are 5% of the respective state-year audit threshold. The arrow points to Bin N01, in which NPOs just avoid an audit. The dashed line to the right of the arrow between N01 and P01 indicates the standardized audit threshold. BD = Burgstahler and Dichev (1997) smoothness statistics, for which a value greater than or equal to the absolute value of 2 is considered statistically significant with $p < 0.05$. Count = the number of NPOs landing in each bin. Count is plotted on the vertical axis.

Figure 2. Unexpectedly large bin N01: Top three states



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