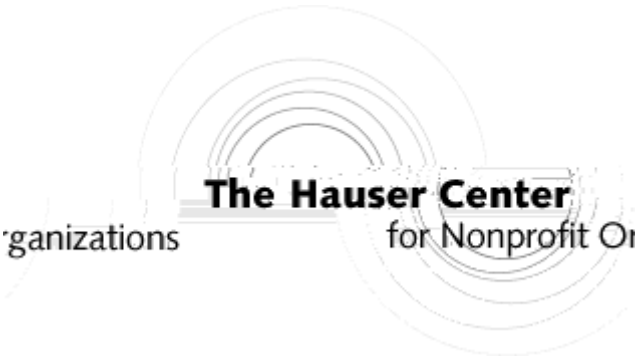

Is it Time to Address Selective Disclosure for Nonprofit Organizations?

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Abstract

Over the past two decades, there have been several highly publicized nonprofit scandals that have eroded the public's confidence in the sector (Aviv 2004). Significant changes in nonprofit regulation have been implemented to address these concerns that have expanded the financial information available to the public. Interestingly, the calls for more nonprofit accountability have not focused on an important concern, that of selective disclosure. This is a practice under which an

I. Introduction

Over the past two decades, there have been several highly publicized nonprofit scandals[1] that have eroded the public's confidence in the sector (Aviv 2004). Significant changes in nonprofit regulation have been implemented to address these concerns with more legislation currently under consideration by the Senate Finance Committee. Two important changes have expanded the financial information available to the public: In 1999, IRS regulations required that 501(c)3 charities (except private foundations) [illegible]

substantial risks to the nonprofit sector by facilitating fraud and harming the public's trust. The paper describes the existing nonprofit reporting requirements and potential shortcomings. It will examine two alternative disclosure environments, the Freedom of Information Act (FOIA) in the federal government and corporate securities regulation, particularly Regulation Fair Di

Single Audit Act (about 36,000 for FY 2004, the last full year of filings) are required to make their audits available for public inspection. Compliance with this regulation appears to be low (Khumwala and Neeley 2005).[4]

The public as well as major donors rely on material information beyond the Form 990 and the audited financial statements to make their giving decisions. To assess the range of material information consistently sought by potential donors, I conducted an internet search for "common grant applications" used by associations of funders in May 2005 and identified sixteen.[5]

Place Table 1 Here

As Table 1 indicates, donors require a substantial number

III. Recent Cases Highlight the Issues with Selective Disclosure

A. New Era Philanthropy

The potential ramifications of selective disclosure are, perhaps, best highlighted by the fraud perpetrated by the Foundation for New Era Philanthropy.[6] This organization derived its name from offering a new approach to fundraising, with a heavy emphasis on matching grants from "anonymous benefactors." In the early 1990s, hundreds of individuals as well as religious, educational, cultural, and charitable organizations invested funds with New Era, believing that these funds would be doubled in six months by guaranteed monies that the founder, Jack Bennett, had secured from several very

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disclosed, because there was “a substantial likelihood that a reasonable investor would consider it important in making his or her investment decision.” The SEC addressed the selective disclosure issue by pursuing a negligence case. It ultimately found the Authority and then-chairman James J. Kerasiotes negligent in not disclosing the projected cost overruns in bond documents. But, the SEC did not impose fines and other penalties on the Authority or Kerasiotes (SEC 2003).

C. The State of Maryland

In April 2006, the State of Maryland undertook an actuarial valuation to determine for the first time the extent of its unfunded other post-employment benefits (OPEB), which

them, and we got the triple-A rating…. They reaffirmed our triple-A rating, so I mean what more can we say?" (Ackerman 2006).

These cases demonstrate the potential for fraud and financial gain by certain "inside" parties from the current selective disclosure regime. In the nonprofit arena, both donors and nonprofits could benefit from a more open and transparent fundraising process. The question remains how to shift from the current regulatory environment to one that is based on fair and ample disclosure of material information.

IV. Freedom of Information Act

In 1966, Congress addressed the issue of disclosure by the federal government by passing the Freedom of Information Act, which mandated that the records of US federal agencies are available to the public with some limited exceptions, such as national security.[8] The Act's intent was to "ensure an informed citizenry, vital to the functioning of a democratic society, needed to check against corruption, and to hold the governors accountable to the governed." Initially, the federal agencies were opposed to the bill due to the high cost and risk of disclosure. The exceptions were modified. When the bill passed the House (307 to 0), only one agency, Health, Education & Welfare, still recommended a veto (Nati

as well as ensuring the public's access to electronic governmental communications. Post 9/11, several national security measures have narrowed the scope of FOIA.

After forty years, the FOIA is viewed by many an as important element of a

V. Corporate Securities Regulation

A. Pre-Regulation Fair Disclosure

In the private sector, several acts and regulations promulgated by the Securities and Exchange Commission (SEC) govern disclosure by publicly traded corporations. The 1933 Securities Act mandated regular disclosures of financial and other significant information by firms wishing to sell securities to the public in order to address concerns over deceit, misrepresentations, and other fraud in the sale of securities. To obtain the right to issue securities in the United States, a firm is required to register with the SEC by providing extensive documentation, including a description of the company's properties, business and management, a description of the security for sale, and audited financial statements. These documents are submitted electronically to the SEC's EDGAR system and become available to the public. Most firms must then make annual and quarterly filings to be allowed to have their securities traded on the secondary market.[10]

B. Regulation Fair Disclosure

In the late 1990s, SEC Commissioner Arthur Leavitt became concerned that the SEC was not fulfilling its mission to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation. One of his particular concerns was the practice of selective disclosure by publicly traded firms. Individual investors echoed his concerns, stating in comment letters to the SEC that they viewed selective disclosure as the equivalent of insider trading. The recipients of the nonpublic information could and were using the information for financial gain, disadvantaging other people. Such an unlevel playing field can reduce market participation, making markets less liquid and

[10] Domestic issuers with fewer than 300 shareholders can "go dark" and avoid many of the ongoing public disclosure requirements.

efficient. Selective disclosure can create pressure on research analysts to issue favorable reports and ratings to gain access to this information.

In 2000, the Commission adopted Regulation Fair Disclosure (Reg FD), which was designed to address selective disclosure, defined in this contex

number of solo forecasts fell from 50 to 70 percent overall and only 27 percent of the new information was released. Agrawal, Chadha, and Chen (2005) examine the most post-Reg FD data and find that earnings forecasts by sell-side analysts are less accurate and more dispersed. The results are more pronounced for forecasts immediately following Reg RD than more recently. Mohanram and Sunder (2004) found evidence that analysts from large brokerage houses had greater forecast accuracy pre-FD, but experienced a decline post Reg FD.

An issuer failing to comply with Reg FD, it is subject to an SEC enforcement action. The comments prior to adoption of Reg FD suggested significant concern that there would be a high level of litigation with firms inadvertently engaging in actions that would trigger an SEC action (Walker 2001). There have, however, been relatively few cases. In November 2002, the SEC announced the settlement of its first three cases and a report of investigation.[14] Several other cases have been settled, but one recent case was taken to court, but the allegations were dismissed.[15]

In sum, Regulation FD has had a significant effect in corporate information practices. It appears it has changed corporate information disclosure practices and seems to have reduced information asymmetries with a relatively low number of enforcement actions.

VI. Key Elements to Address Selective Disclosure

To create an environment with fair and ample disclosure, a set of legal and financial systems need to be put in place, and the ultimate structure could take on several potential forms. Several possible approaches have already been put forward: Herzlinger (1996)

[14] The settled cases involved Raytheon Company and Franklyn A. Caine, Secure Computing Corporation and John McNulty; and Siebel Systems, Inc. The report of investigation involves Motorola.
[15] The defendants were Siebel Systems, Inc., Kenneth A. Goldman, and Mark D. Hanson. The litigation involved a private meeting with an institutional investor and an invitation-only dinner hosted by an investment firm.

Table 1), including organization-wide and program budgets, the board list, a written description of programs, and pending support for individual programs. A management discussion and analysis (MD&A) describing the financial performance of the organization as a whole could be required.[16]

Finally, the mandatory disclosures in the central repository would need to include a form that can be filed when material events or decisions have been made. This document is known as Form 8-K in the corporate setting, and is used when a senior leadership change is announced, a merger is announced, etc. The frequency with which corporations file 8-Ks varies considerably based on the complexity and rate of change in the organization and their interpretation of fully complying with Reg FD. A set of guidelines would need to be drafted to delineate for nonprofits when a Form 8-K-type filing was required.

D. Voluntary Disclosures

The survey of affiliated grantmakers suggests a number of items that a nonprofit might want to voluntarily include in an annual filing or report, such as an organization chart, staff qualifications, and prior sources of funding. With the consent of donors, a nonprofit might be able to reduce or replace its detailed and individualized grant reporting with an annual or quarterly report on program performance, a shift that might significantly reduce the cost associated with restricted grant administration and facilitate the development of consistent program performance measures.[17]

E. Offering Documents

[16] MD&As are required in the annual 10-K filings of publicly traded firms and are required for state and local governments issuing comprehensive annual financial reports (CAFRs). Both Herzlinger (2001) and Keating and Frumkin (2003) recommended this document be made mandatory for audited nonprofit organizations.

[17] Note: If Regulation Fair Disclosure standard were imposed on nonprofits, then they might be forced to disclose the restricted grant reports publicly in a Form

A final group of documents that might facilitate a timely and fair disclosure environment could be used to encourage fundraising through an offering-type process. A nonprofit would assemble an offering package that describes a program or set of programs for which it desired funding. It would outline the use of the funds and outline the program reporting that it would agree to provide. This document would help ensure that the material information about the proposed program was available publicly and that many donors had an opportunity to support the program. The nonprofit could benefit by reducing the uncertainty surrounding grant funding, eliminating the need to complete multiple grant applications and report separately on a number of grants. The donors could benefit from having access to a broader range of applications and would not be subject to as much direct pressure from nonprofits to fund particular projects.

E. Oversight and Monitoring

One drawback of a Reg-FD-type regulation might be that nonprofits would be granted more discretion to aggregate, analyze, and interpret organizational activities, finances, and outcomes. Donors accustomed to being able to conduct their own form of due diligence and obtain information in a particular form that meets their needs may find the more aggregated or limited information to be less helpful in decision-making. They may feel that there are inherent information asymmetries and become more concerned about the reliability of the data.

These concerns can be mitigated by ensuring compliance through third-party oversight and monitoring. In the for-profit world, these concerns are addressed through a combination of monitors: corporate board members, external auditors, legal counsel, and the Securities and Exchange Commission as well as adequate legislation, regulations and

funding to support dissemination of disclosure documents, inspections and, most importantly, enforcement actions.

VII. Conclusions

Presently, nonprofit organizations operate in an environment dominated by selective disclosure. This paper has outlined several risks associated with selective disclosure and argued for fair disclosure requirements to mitigate these risks. A more compelling argument that is not as developed in this paper is that of efficiency gains. If both nonprofits and funders knew that material information provided by the nonprofit to donors would be available to all donors then some of the present funding-related uncertainty would be reduced, lowering the transaction costs associated with funding and potentially reducing the need for donors to be so restrictive in their grant-giving.

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Table 1

Common Grant Application Form Requirements	Percentage (N=16)
1. PROPOSAL BODY	
Cover Letter Required	**81%**
Proposal Text Guidelines Provided	**100%**
2. BUDGETS	
Guidelines or Form for Current Agency Operating Budget Provided	**100%**
Additional Requirements for Agency Operating Budget	**44%**
Program Budget Form or Guidelines Provided	**100%**
List of Pending Support for Program	**75%**