

# INFORMATION DISCLOSURE BY CHARITY ORGANIZATIONS

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## Abstract

*This study is an empirical investigation on the extent of disclosure of information by charity organizations in Malaysia. It also reports the association between organizational-specific attributes and the extent of disclosure. Using content analysis, a total of 88 items of information listed in disclosure index were applied to 65 annual returns for the year 2009 of charity organizations. The study revealed a very low level of disclosure of information, with a mean score of only 23.98. The findings also found that the existence of an independent audit is highly significant and positively related to the extent of disclosure. Similarly, the organizational-specific attributes such as organizational size and financial performance are also found to be significant. Other variables such as age, board size and board composition are insignificant in explaining the extent of disclosure. This study has contributed to the academic literature, showing that the existence of external governance mechanism brings the potential for better disclosure and transparency. This disclosure is at least sufficiently meets the requirement of the Registry. This study could assist in better understanding of how to improve the extent of disclosure for the charity organizations.*

*Keywords: information, annual returns, content analysis, disclosure index, charity*

## 1.0 Introduction

Malaysia has quite substantial number of registered non-profit organizations (NPOs). As at April 2011, it is estimated that 64,136 organizations have registered with the Registry of Society (ROS).<sup>1</sup> Despite the enormous size and its importance, there is limited empirical research examining the disclosure of information and performance of the charity organizations.

There is a broad acceptance that the NPOs, specifically the charity organizations need to improve their accountability and transparency. The lack of transparency and information asymmetry that exists between NPOs and donors can be minimized through more transparent information disclosure [1]. Disclosure of information in the

non-profit sector is necessary to ensure that resources are better utilized, so that donors and volunteers would continue their support and involvement. Previous studies have taken up few measures on the effects of financial performance, often captured by the efficiency ratios and the amount of donations [2-6].

One of the ways to enhance accountability and transparency is by establishing governance mechanism over the NPOs. Some corporate governance Act in the developed country such as in the USA also has implications over the NPOs. The American Competitiveness and Corporate Accountability Act, popularly known as the Sarbanes-Oxley Act or SOX, passed in 2002, has most provisions that apply to publicly held companies, has targeted similar regulation toward the non-profit organizations (Panel on the Non-Profit Sector).

Recently, South East Asia countries such as Singapore and Thailand through their Charity Councils have been actively reviewing and

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<sup>1</sup> <http://www.ros.gov.my>

improving their non-profits regulatory framework. The Charity Council of Singapore has embarked on the Code of Governance for Charities and Institutions of a Public Character or IPCs, introduced in November 2007. Later, the Charities Accounting Standards (CAS) issued on 24 June 2011 set out the financial reporting framework, which applies to charities when they prepare their financial statements for financial periods beginning on or after 1 July 2011. This latest initiative is the major effort by the Singapore Accounting Standards Council to improve governance and enhance public confidence in the charity sector. However, Malaysia, as one of the South East Asia countries where the levels of transparency and governance controls is not prescribed by law. Hence, proactive action should be taken to improve the situation because accountability, transparency and good governance are the keys to enhance the relationships between the NPOs, donors and volunteers.

## 2.0 Financial Reporting Environment of Charity Organizations in Malaysia

The primary objective of financial reporting is to provide information that is useful for resource providers in making rational decisions about the allocation of scarce resources to business and NPOs [7, para. 35]. From social perspective, accountability implies a willingness to endure public scrutiny and a duty to report not only to the minimum requirement of the law [8]. The annual report produced by most organizations is one measure to fulfil their accountability duty to their stakeholders and to the society at large. Reporting is a means of accountability tailored to meet the stakeholders' information needs, as highlighted in the Malaysian Accounting Standards Board [9, para. 7] states that:

*“Financial statements are a structured representation of the financial position and financial performance of an entity. The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions. Financial statements also show the results of management’s stewardship of the resources entrusted to it.”*

The main statutes dealing with establishment and regulation of NPOs in Malaysia are the Societies

Act 1966 (Act 335) & Regulations and the Income Tax Act (ITA) 1967 issued by the Inland Revenue Department (IRD). Some NPOs may register under specific Acts (e.g. the Sports Commission Act or the University and University Colleges Act 1971). The ROS's primary function is only concerned with the registration, control and monitoring of registered societies throughout Malaysia so that they do not adversely affect the security, peace, public order, welfare or morality in Malaysia. The ROS requires the registered societies to submit Form 9 within 60 days after holding its Annual General Meeting (AGM).<sup>2</sup> In dealing with the accountability and accounting, the registered societies are required to submit the accounts of the last financial year together with a balance sheet showing the financial position at the close of the last financial year of the society. The accounts can either be audited by the societies' internal auditor or an external auditor.

Based on the above reporting environment of charity organizations, the only primary source of information for stakeholders to make decision is the annual return furnished to the ROS every year. However, the annual returns are limited to the members of the organizations and are not publicly available for reviews. Thus, the current forms of disclosure are very minimal based on the reporting requirements of the regulator. Furthermore, the presentation of the account is not tailored to the stakeholders' needs of information. For this reason, the aim of this study is to examine the extent of disclosure by charity organizations. This study also investigates the association between organizational-specific attributes and the extent of disclosure in the sample.

Most of the non-profits disclosure studies have been conducted in the USA and other developed countries, such as the UK. To date, studies on non-profits disclosure conducted for developing countries have been very scant. This study is intended to fill this gap by looking at NPOs in Malaysia, as an emerging country.

The remainder of this study is organized as follows. Section 3 reviews the literature and the hypotheses development. Section 4 outlines the data collection and research design. Section 5 summarizes the findings and finally, Section 6 concludes the study.

<sup>2</sup> Section 14(1) of the Societies Act 1966 (Act 335) & Regulations

### 3.0 Review of Literature and Hypotheses Development

Disclosure of information by NPOs is crucial for several reasons. First, information can be used by stakeholders to evaluate the effectiveness and efficiency of a charity organization. Second, the disclosures can potentially improve donors' perceptions. The donations increase if donors gain assurances of effectiveness are disclosed in the report. In fact, a considerable literature has developed that examines the disclosure levels and the donations (donations as a proxy of financial performance).

#### 3.1 Financial Performance

There have been quite a number of previous studies that found a positive relationship between information disclosure and financial performance [2, 4-6, 10]. These studies used the extent of voluntary disclosures based on annual reports that are hypothesized to impact the charity donation decisions. A charity organization depends on contributed income such as donations from donors and grants from foundations. This shows that disclosure of financial information in the financial statements is very important since it can influence a potential donor's decision to donate. Previous studies provide evidence that financial reports play a role in donation decision [4, 11, 12]. Through financial reports issued by the charity organizations, donors can obtain necessary information for them to assess and evaluate the performance efficiency of the organization. Therefore, it is hypothesized that:

*H<sub>1</sub>: Financial performance of charity organization is positively associated with its extent of information disclosure.*

#### 3.2 Board Size

Governance structure, particularly board governance is another important variable that links to information disclosure. Board size has been extensively used as a proxy to measure board governance. A number of studies (see for example, [13] and [14] provide empirical evidence that support the positive association between board size and information disclosure. [15]'s study proposes that as more members are added to the board, there are better levels of monitoring. Larger size of the board of trustees may also be important because of the increased in the levels of fundraising and improved performance. However, opposing evidence was also found in studies

relating performance to board size [13, 16] and disclosures to board size [17]. Further empirical investigation is therefore needed. Given the strong theory to support a positive relationship, it is hypothesized that:

*H<sub>2</sub>: Charity organizations with large board size disclose information to a greater extent than those with small board size.*

#### 3.3 The Presence of Institutional Donors on Board

The presence of institutional donors who provide charity organizations with large amount of resources may be interested in the organizational efficiency. They will have more power and access to the information to monitor the organizational efficiency because they demand detailed information beyond the financial information such as detailed strategic plans, budget and information on each project that they financed. Nevertheless, some studies proved that having the corporate members on board do not help to guarantee the efficiency of the non-profit organizations [12]. Since studies on board composition consider the relationship between the presence of institutional donors and organizational efficiency, this leads this study to the development of the following hypothesis related to the presence of institutional donors and the disclosure of information:

*H<sub>3</sub>: The presence of institutional donors on board will be positively related to the extent of information disclosure by charity organizations.*

#### 3.4 The existence of an independent audit

The functions of an audit include ensuring the quality of financial accounting and control systems. Given the function of an independent audit within the non-profit context, [18] and [19] argued that the existence of the external audit may improve internal control and thus regarded it as an effective monitoring device for improving disclosure quality. They found that the presence of an independent audit is significantly related to the adoption of SOX disclosure measures. Similarly, [20] provides support that the presence of an independent audit minimizes reporting problems and acts as a tool for more reliable financial reporting that enhances disclosure quality. This leads to the following hypothesis:

**H<sub>4</sub>:** *The existence of an independent audit is positively associated with the extent of information disclosure.*

### 3.5 Control Variables

A large number of studies on disclosure attempted to correlate the extent of disclosure with specific control variables attributes of the NPOs. The most frequently examined attributes have been the organizational size and age of the organization. In this study, the organizational attributes, i.e. the organizational age and size were considered as control variables.

## 4.0 Data Collection and Research Design

### 4.1 Extent of Disclosure

Most previous studies on the extent of information disclosure have developed indices to examine the extent of information disclosure with organizational-specific attributes [21, 22]. In this study, the extent of disclosure (TDISC) was measured through content analysis using charity disclosure index, developed by the researcher.<sup>3</sup> The index consists of 88 items. Analysis of reliability based on Cronbach alpha was carried out to check the internal consistency of this index. Cronbach alpha of 0.89, surpasses 0.80 to 0.90 indicates the consistency of the index is very good [23]. The index was then checked against the charity organizations annual returns for the year 2009 using content analysis. For each item disclosed, a value of “1” is assigned, and “0” is assigned for the non-disclosure item.

### 4.2 Measurement for the Independent and Control Variables

Data on all except one of the independent variables were collected from the annual returns of the participating organizations. Data on financial performance (FINP) is measured by natural log of total donations and natural log of board members represents the board size (BSIZE). Further, a binary scheme was used to denote the presence of institutional donors on board (INDB) and the existence of an independent audit (INDAUD). These dummy variables were coded “1” to indicate existence and “0” to indicate non-existence. Organizational size (ORGSIZE) is

measured by the log of total assets and organizational age (AGE) is measured by the number of inception years.

### 4.3 Regressions Model

The model estimated for regressions in this study is:

$$\text{TDISC} = \beta_0 + \beta_1 \text{FINP} + \beta_2 \text{BSIZE} + \beta_3 \text{INDB} + \beta_4 \text{INDAUD} + \beta_5 \text{AGE} + \beta_6 \text{ORGSIZE} + \varepsilon$$

where,

**TDISC** = Overall Extent of Disclosure

**FINP** = Financial Performance

**BSIZE** = Board Size

**INDB** = Institutional Donors on Board

**INDAUD** = Independent Audit

**AGE** = Age of Organization

**ORGSIZE** = Organizational Size

$\varepsilon$  = Error term,  $\beta_0$  = the intercept

## 5.0 Findings

Table 1 shows the distribution of overall extent of disclosure. The average disclosure was 23.98, with a range of 10 to 39. This result is consistent with the literature that charity organizations have great flexibility in their disclosure [11]. In addition, the relative low disclosure implies that charity organizations in Malaysia may disclose information outside of their annual returns.

**Table 1: Descriptive Statistics of Continuous Variables (n=65)**

	Mean	Std. Dev.	Min.	Max.
<b>Dependent Variable:</b>				
TDISC	29.38	6.630	10	39
<b>Independent and Control Variables:</b>				
FINP	11.07	1.520	8	15
BSIZE	2.58	0.492	2	4
AGE	3.11	0.792	1	4
ORGSIZE	13.46	2.121	7	18

### 5.1 Results of Multiple Regressions

Multiple regressions were estimated using the organizational-specific attributes as independent variables. The possible existence of multicollinearity was tested in this study. The computation of Variance Inflation Factor (VIF) observed for all independent variables were below 2.0. Thus, these results support the lack of presence of multicollinearity in the research model. The tests of normality, given the results of

<sup>3</sup> The sources of information items in the development of the index involve the review of literature, interviews and confirmed by surveys. It is available upon request from the author.

the Kolmogorov-Smirnov statistic on the dependent variable suggest symmetrical distribution<sup>4</sup>, thus no violation of the normality assumption. Table 2 presents the Adjusted R<sup>2</sup> (coefficient of determination), F-ratio, beta coefficients and t-statistics for the model and summarizes the multiple regression results of dependent variable (the extent of disclosure) on the organizational-specific attributes.

**Table 2: Multiple Regression Results**

Variables	Coefficient	Std Error	Beta t-values	Sig.
Constant	25.185		1.288	0.203
FINP	0.414	0.518	0.888	0.001*
NFINP	-2.419	3.075	-0.786	0.435
BSIZE	-2.463	1.748	1.409	0.164
INDB	2.237	1.638	1.365	0.178
INDAUD	6.726	1.855	3.626	0.000*
AGE	0.637	1.186	0.537	0.593
ORGSIZE	0.496	0.400	1.239	0.002*

\* significant at 1% level

Three variables entered in the equation were significant at the 0.01 level in the regression model. These variables are: financial performance, existence of independent audit and organizational size. In addition, the directions of the signs of all significant coefficients are in agreement with the hypotheses. In contrast, board size, institutional donors on board and organizational age are insignificant. Results of Adjusted R<sup>2</sup> indicate that only 31.5% of these variables are explained. This means, there could be other variables that could explain the extent of disclosure.

The most significant variable is the external governance variable, the existence of an independent audit (INDAUD) with a p-value of 0.000. This provides support for Hypothesis 4 (H<sub>4</sub>) that organizations which carried on an independent audit are likely to have a higher extent of disclosures. In addition, large organizations tend to have more disclosure (p < 0.01) is supported. This result supports numerous previous empirical studies that large organizations

disclose more information because they may have more funding than smaller organizations.

## 6.0 Conclusions

In recent years, the regulatory and oversight bodies of NPOs have promulgated non-profits governance in order to enhance accountability and transparency. In Asia, fraud and financial crisis in NPOs have provided more evidence on the governance and transparency issues. There has been little research relating to disclosure and specific governance attributes in emerging countries. This study uses Malaysian data to analyze whether the organizations disclosed more information when they performed well, have an independent audit and are large in size.

There are several important implications of this study. These results provide empirical evidence to attentive Malaysian regulators to improve NPOs transparency by imposing the establishment of an independent audit. It is essential to have a higher accountability to stakeholders via such external governance mechanisms. One limitation in this study worth nothing is even though the main focus of this study is on the extent of disclosures; such may not imply quality disclosures due to different instrument used to measure the disclosure. And, although the study found the expected relationship between financial performance and governance variable, the findings show that there may be other factors that influence the charity organizations disclosure of information.

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<sup>4</sup> The value of Kolmogorov-Smirnov statistic has a significant value of 0.2.

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