

Governance and Unrelated Business Profitability in Nonprofits

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ABSTRACT

The purpose of this study is to analyze the relationship between governance measures in nonprofits and unrelated business income reported for nonprofits. As nonprofits face difficulties raising funds, these organizations may turn to additional sources of revenue, including unrelated business activity. Income that is earned outside of the exempt purposes of the nonprofit is taxable. However, agency theory suggests that nonprofits should engage in profitable unrelated business activity in order to maximize the services provided. This study addresses if governance in a nonprofit helps reduce agency costs through evaluating its relationship with the unrelated business income reported on a Form 990-T. This quantitative study was evaluated through Pearson's correlation, Spearman's correlation, and multiple regression using public data from 2016 and 2017 tax returns. The findings suggest limited evidence of a positive relationship between governance and unrelated business income. Though the effects were weak, the combined results provide evidence of a positive relationship between governance and profitability in the unrelated business activities of nonprofit organizations.

Keywords: Governance, Profitability, Nonprofits, Unrelated business activity

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INTRODUCTION

Nonprofit organizations may face difficulties raising funds in order to meet their exempt purpose. In 2017, the Tax Cuts and Jobs Act (TCJA) reduced the incentives behind charitable giving by both encouraging the standard deduction and decreasing the tax rate (Tax Policy Center, n.d.). As evidence, individual donor contributions in 2018 decreased by 3.4 percent (inflation adjusted) (Giving USA [GUSA], 2019). In fact, contributions from individuals made up less than 70 percent of total contributions given; considering at least the last 50 years, this year marked the first time the individual-to-total contributions percentage was lower than 70 percent (GUSA, 2019).

When organizations receive less than expected from donors, these nonprofits may turn to outside sources for revenue, and this activity may be unrelated to their exempt purpose. For instance, the United States Government may decrease nonprofit funding due to fiscal constraints, which requires social nonprofits to engage in commercialized activities (Ecer, Magro, & Sarpca, 2017). Nonprofits in the United States are able to engage in unrelated business activity to earn revenue, but this activity is taxed like a business (IRS, 2017). This activity also must have a profit motive (IRS, 2013), which suggests that nonprofits should report positive unrelated business taxable income. Donors desire nonprofits to maximize services to beneficiaries (Hofmann & McSwain, 2013). Therefore, a deficit from unrelated activities would decrease the nonprofit's ability to succeed financially and carry out its exempt purpose (Yetman, 2001). Therefore, one would expect a positive relationship between stronger monitoring through internal governance and capital providers and unrelated business profitability.

To measure for profitability, this study uses the profit margin reported on the nonprofit's Form 990-T. First the study uses an independent variable to measure internal governance through an index. This index is calculated as a score considering governance disclosures on the Form 990 related to board independence, nonprofit audit and tax decisions, and nonprofit policies. Second, three different variables are used to measure external governance from different capital providers; these providers include the government, bondholders, and donors. Third, control variables are included in the study: firm size, firm age, location, financial condition, industry, growth, religious affiliation, year, and Charity Navigator rating. The study uses Pearson's correlation, Spearman's correlation, and multiple regression. Similar to Yetman and Yetman (2003), this study also focuses on four industries: 1) arts, cultures, and humanities; (2) education; (3) health; and (4) human services organizations.

Overall, the results are mixed. When evaluating the relationship between the governance index and the profit margin of the nonprofit, a Pearson's correlation of $r = .120$ ($p = .016$) indicated a significant positive, but weak relationship between these two variables, which would allow the null hypothesis to be rejected. Since the data was not normal, the Spearman's correlation was used to analyze the relationship. This correlation suggested that a significant relationship did not exist ($r_s = .051$, $p = .305$). After transforming the profit margin variable according to Templeton's (2011) two-step process, Pearson's correlation indicated a statistically significant relationship between government grants and profitability ($r = .111$; $p = .027$). Spearman's correlation did not find a significant relationship ($r_s = .076$, $p = .127$). Under multiple regression, results of the regression model comparing governance and profitability were not significant ($R^2 = .06$, $F(16,382) = 1.526$, $p = .087$). However, a further stepwise analysis indicated that the best model included both government grants and the governance index ($R^2 = .018$, $F(2,396) = 3.601$, $p = .028$). In this model, the relationship between government grants and

profitability was significant ($p = 0.026$). No significant relationships were found with the variables for municipal bonds and restricted net assets with profitability.

This study contributes to the literature by considering the presence of governance in the profitability reported for unrelated business activity. This study extends profitability research to nonprofit organizations. The data used for this study incorporated more available IRS data as more information was available after the Pension Protection Act of 2006 (Hofmann, 2007; H.R. Res. 4, 2006; Omer & Yetman, 2007) with increased governance data available after the 2008 major revision of the Form 990 (IRS, 2008).

This paper will first include a literature review and hypotheses development. The next section will discuss the methodology, data collection, analysis, and results. Finally, the study will discuss future research opportunities and limitations as well as a conclusion.

LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Agency Theory and Nonprofits

Managers of a nonprofit are agents of two principals; they are the agents of the donors as well as the beneficiaries (Hofmann & McSwain, 2013). The existence of two principals increases information asymmetry, which magnifies agency issues in nonprofit organizations (Kitching, 2009). The nonprofit manager may not always act in the interest of the donors and/or beneficiaries (Hofmann & McSwain, 2013). Unlike the profit maximization goal within for-profit entities (Hanlon & Heitzman, 2010), the nonprofit organization desires to raise revenue in order to use that revenue for exempt-related expenses or maximize services provided (Hofmann & McSwain, 2013). The principals would expect to maximize services (Hofmann & McSwain, 2013).

Nonprofits may engage in activities outside their exempt purpose in order to supplement revenue (Ecer et al., 2017; Knoll, 2007; McArdle & Chene, 2017). To be unrelated, these activities are conducted on a regular basis and are not substantially related to the exempt purpose as indicated when the organization became tax exempt (IRS, 2019). While unrelated activity provides funding for nonprofit organizations, this activity does not significantly relate to the purpose of the organization (IRS, 2019). Because of the objective to maximize services, unrelated business activity should have a profit motive, which is a requirement under IRS examination (IRS, 2013). A deficit from unrelated activities would damage both the financial results for the organization and the ability to carry out the mission (Yetman, 2001).

Governance and Profitability from Unrelated Business Activities

Monitoring costs are designed to reduce the number of diverging activities from the agent and decrease residual loss from agency issues (Jensen & Meckling, 1976). This study focuses on the monitoring costs associated with additional governance. To date, the relationship between governance and performance for unrelated business activities for nonprofit organizations has not been researched. Therefore, one must consider for-profit studies in order to predict the relationship between governance and performance. Overall, research has suggested that governance and firm performance has a positive relationship (Abdalkrim, 2019; Bauer, Eichholtz, & Kok, 2010; Bebchuk, Cohen, & Ferrell, 2009; Bhagat & Bolton, 2008, 2013; Brown & Caylor, 2009; Gompers, Ishii, & Metrick, 2003; Shaukat & Trojanowski, 2018).

Considering nonprofits, a deficit from unrelated activities would impede the organization's ability to carry out its mission (Yetman, 2001). Therefore, one would expect a positive relationship between governance and the profitability of the unrelated business activity as reported on the Form 990-T.

HYPOTHESIS DEVELOPMENT

Dependent Variable

Unrelated business activities should be profitable as a deficit would not only lower the financial results reported for the organization but also decrease the ability to carry out the organization's exempt purpose (Yetman, 2001). Otherwise, the nonprofit entity should not engage in the activity, as it would decrease the service maximization of the nonprofit.

In this study, profitability is defined as unrelated business income as measured in US dollars. As this income only includes the activity outside of the exempt purpose of the entity (IRS, 2017), the measure for this study will focus on the unrelated activity operating performance as opposed to total firm value. Following the studies by Bauer et al. (2010), Brown and Caylor (2009), and Gompers et al. (2003), this study will measure performance from the unrelated activity through the profit margin, which is the unrelated business income divided by unrelated business revenue. This ratio would be continuous in nature.

Independent Variables

Firstly, this study considers internal governance in the nonprofit. With stronger internal governance, the nonprofit should be prevented from engaging in unrelated business activity that did not increase the profit in order to increase the services available to the beneficiaries as desired by the donors (Hofmann & McSwain, 2013).

Similar to Newton (2015), a governance index was used based on information provided on the Form 990. This index included information related to the nonprofit's board independence (Harris, Petrovits, & Yetman, 2015, 2017; Newton, 2015), audit and tax decisions (Harris et al., 2017; Neuman, Omer, & Thompson, 2015; Newton, 2015) and governing policies (Harris et al., 2015, 2017; Newton, 2015; Yetman & Yetman, 2012), as shown on Table 1. Based in agency theory, one would expect that one would expect that a company with stronger oversight would present more profitable financial results from activities that are unrelated to the purpose of the nonprofit organization. However, due to the lack of prior research in nonprofit organizations, the researcher defers to the null hypothesis.

Hypothesis 1: Internal governance measures have no statistically significant relationship to unrelated business income (UBI) as reported on the Form 990-T.

Table 1: Governance Index

Governance Index (Average of 3 Sections)

Board Independence (Ratio of Points/Potential Points)

INDEPENDENCE	Ratio of independent board members
OUT MGT	Outsourced management
INS BUS REL	Inside business relationship
MEMBERS	Oversight from members or stockholders

Audit and Tax Decisions (Ratio of Points/Potential Points)

AUDIT	Audited or review/compilation
AUDIT COMM	Presence of audit committee
990 TAX	Tax preparer - 990
990-T TAX	Tax preparer – 990-T
WEBSITE	Availability of tax returns

Nonprofit Policies (Ratio of Points/Potential Points)

990 REVIEW	Form 990 review policy
CEO COMP	CEO compensation policy
NON-CEO COMP	Non-CEO compensation policy
WHISTLE	Whistleblower policy
CONF INT	Conflict of interest policy
DOC RENT	Document retention policy

Secondly, this study considers governance from external capital providers and the relationship to profitability reported on the Form 990-T. Additional oversight from capital providers could impact the nonprofit's decisions to provide profitable services when engaging in unrelated business activity. To reduce agency costs, several stakeholders can monitor various executive actions (Nikolova, 2014). First, additional monitoring of nonprofits is required when nonprofits receive government grants and contracts (Boris, De Leon, Roeger, & Nikolova, 2010), which can require reporting similar to Sarbanes-Oxley for public companies (Ostrower, 2007). In addition, nonprofits may receive funding from municipal bonds, and the investors in these bonds would suggest greater oversight over the nonprofit (Yetman & Yetman, 2012). Finally, additional oversight could come from donors that are placing restrictions on donated funds; these restrictions also cause management to take donors' expectations into account (Shon, Hamidullah, & McDougale, 2019). Based on the additional oversight required for these capital providers, the researcher hypothesizes the following:

Hypotheses 2: There is no relationship between the level of funding from capital providers and unrelated business income (UBI).

Hypothesis 2a: Capital provided from governments has no relationship to UBI.

Hypothesis 2b: Capital raised through bond issues has no relationship to UBI.

Hypothesis 2c: The level of restricted donations has no relationship to UBI.

Governance should increase unrelated business profitability. In for-profit organizations, governance is associated with increased firm performance (Abdalkrim, 2019; Bauer et al., 2010; Bebchuk et al., 2009; Bhagat & Bolton, 2008, 2013; Brown & Caylor, 2009; Gompers et al.,

2003; Shaukat & Trojanowski, 2018). Specifically, the research suggested that internal governance should increase firm performance (Brown & Caylor, 2009; Shaukat & Trojanowski, 2018). The presence of governmental grants tends to increase accountability (Ostrower, 2007) and provide additional focus to the nonprofit's mission (Lu & Zhao, 2019). Long-term debt through municipal bonds requires greater oversight (Yetman & Yetman, 2012). Having restricted donations also limits the ability of the nonprofit to act against donors' expectations (Shon et al., 2019), which suggests that these nonprofits would have limited ability to engage in unprofitable, unrelated activities.

Prior research in the nonprofit sector had not considered the relationship between governance and unrelated business activity. No other study to the researcher's knowledge had evaluated the relationship between governance and the unrelated business income from unrelated business activities. This study filled that gap by considering how internal or external governance mechanisms related to the net income reported on the Form 990-T.

METHODOLOGY

The purpose of this study is to evaluate whether increased governance measures in nonprofits are associated with higher unrelated business income for unrelated business activities. The goal is accomplished through descriptive statistics, Pearson's correlation, Spearman's correlation, and multiple regression.

In order to determine the needed sample size, the effect size f^2 was set 0.10, which is slightly below medium, and the study conducted the research with a $\alpha = 0.05$ significance criterion with an 80% probability of detecting the R-squared when it occurs (Hair, Black, Babin, & Anderson, 2015) with 4 predictor variables and 9 control variables, which is a total of 13 independent variables. Based on G*Power software (Version 3.1.9.4), which was developed by Faul, Erdfelder, Lang, & Buchner (2007), the required sample size was 125 returns. This study used a sample of 400 returns, which met the requirements (Faul et. al, 2007). As much information must be compiled from the Forms 990 and 990-T, a sample is needed to analyze the hypotheses.

Sample and Data Collection

The population for this study includes nonprofits that filed both a Form 990 and Form 990-T in the tax years 2016-2017. The sample frame includes nonprofits with returns available through the IRS Annual Extract (IRS, n.d.-a). The complete Forms 990 and 990-T are available on the Tax-Exempt Organization Search website beginning with the 2016 tax year (IRS, n.d.-b). Due to the availability of this data in 2016, the study will only include returns from the tax years 2016-2017. Through this search, one can access the returns actually filed (IRS, n.d.-c), allowing for reliable data.

The researcher collected the data from the IRS website, Nonprofit Explorer, and Charity Navigator primarily. The sample was selected through a random, stratified sample that included 100 returns from each industry: (1) arts, cultures, and humanities; (2) education; (3) health; and (4) human services organizations.

If return information was missing for both years, the next nonprofit was selected according to a random number function within Excel. The final data set is both cross-sectional and time-series data. Missing tax returns were possible because a nonprofit may select that they

filed a Form 990-T on the Form 990 (according to the IRS Annual Extracts) but did not actually file in the current year.

Model

Complete Empirical Model

This section discusses the procedures for each hypothesis and discusses the model for this study. Data analysis was completed in SPSS. An increase in internal and external governance measures is expected to increase the profit margin reported on the Form 990-T for unrelated business activity.

This study overall uses ordinary least squares regression. With regression analysis, the independent variables are used to predict one dependent variable (Hair et al., 2015). To calculate the unrelated trade or business income, this study will consider any income items reported in Form 990-T, Column A. Both Hypothesis 1 and Hypotheses 2 consist of continuous independent variables and one continuous dependent variable. A Pearson's correlation and Spearman's correlation will be used for each separate hypothesis. As noted by Laerd Statistics (2015), both the null and alternative hypothesis in this test are noted below.

$H_0: \rho = 0$; the population correlation coefficient is equal to zero.

$H_A: \rho \neq 0$; the population correlation coefficient is not equal to zero.

After correlation analysis, the full model will be tested through ordinary least squares regression for Hypotheses 1 and 2 with the following regression equation.

$$\text{PROFIT}_i = \alpha + \beta_1 \text{GOV INDEX}_i + \beta_2 \text{GOV GRANTS}_i + \beta_3 \text{MUNI BONDS}_i + \beta_4 \text{RESTR ASSETS}_i + \beta_5 \text{AGE}_i + \beta_6 \text{ECON COND}_i + \beta_7 \text{LOCATION}_i + \beta_8 \text{SIZE}_i + \beta_9 \text{GROWTH}_i + \beta_{10} \text{INDUSTRY}_i + \beta_{11} \text{RELIGION}_i + \beta_{12} \text{YEAR}_i + \beta_{13} \text{RATED}_i + \epsilon_i$$

Data Analysis

One extreme outlier was removed, changing the sample to 399 returns. In the sample, the governance index had a mean (median) of 0.688 (0.729). This measure suggests the level of internal governance within a nonprofit based on answers to questions about board independence, audit and tax decisions, and policies. If a nonprofit had no governance measures in place, the index would equal zero while a score of one would indicate the highest level of governance possible. The data was not normally distributed but could be transformed through Templeton's (2011) two-step process.

For the capital provider variables, the percentage of revenue from government grants had a sample mean (median) of 7.35% (0.00%) and the percentage of assets with donor restrictions reported a sample mean (median) of 18.07% (1.75%). These two variables were not normally distributed and were skewed with high kurtosis. However, this was expected due to the number of nonprofits report that zero government grants or zero restricted assets.

Meanwhile, the sample mean (median) for the percentage of revenue from municipal bonds was 0.02% (0.00%). In the sample, 13 nonprofits indicated any revenue from municipal bonds with only one nonprofit reporting greater than 1% of revenue from municipal bonds.

Therefore, the variable for municipal bond revenues is not normally distributed. Table 2 notes the descriptive statistics for the sample.

Table 2: Descriptive Statistics

Variable	n	M	SD	Min. Value	Median	Max. Value	Skewness	Kurtosis
Avoidance	399	0.296	0.457	0	0	1	0.899	-1.199
Governance Index	399	0.688	0.161	0.104	0.729	0.938	-1.353	1.441
Government Grants	399	7.35%	0.175	0.00%	0.00%	96.33%	3.108	9.658
Municipal Bonds	399	0.02%	0.005	0.00%	0.00%	9.32%	19.973	398.936
Restricted Assets	399	18.07%	0.359	-284.70%	1.75%	353.82%	1.292	30.902

To analyze the relationship between the governance index and profitability, Pearson's correlation was employed. While the data is not normally distributed, the Pearson's correlation test is somewhat robust with normality deviations (Laerd Statistics, 2015). In this correlation analysis, a small positive correlation between the governance index and profit margin existed ($r = .120$, $p = .016$) with significant results. Spearman's correlation was also utilized as the data was not normal, but the results were not statistically significant ($r_s = .051$, $p = .305$). Based on these findings, there is some support that increased internal governance has a positive relationship with the profitability of unrelated business activity in nonprofits.

To analyze the relationship between the reliance on government grants and profitability, the profit margin variable was transformed using Templeton's (2011) two-step process. After this transformation, Pearson's correlation indicates a significant relationship ($r = .111$; $p = .027$), but Spearman's correlation did not ($r_s = .076$, $p = .127$). Based on these findings, there is some support that increased funding from government grants has a relationship with the profitability of unrelated business activity in nonprofits.

For the reliance on municipal bonds, neither Pearson's correlation ($r = -.041$, $p = .418$) nor Spearman's correlation ($r_s = -.030$, $p = .556$) indicated a statistically significant relationship, even after transforming the profit margin variable. Similar results were found for the percentage of restricted assets with no significant relationship under Pearson's correlation ($r = .037$, $p = .466$) or Spearman's correlation ($r_s = .025$, $p = .623$) after transforming the profit margin.

The entire model was assessed through multiple regression for governance and profit margin. The profit margin was transformed through Templeton's (2011) two-step process in order to meet the normality assumption for linear regression. Overall, there was independence of residuals, as assessed by a Durbin-Watson statistic of 1.562. Linearity and homoscedasticity were indicated through analysis of a scatterplot comparing the studentized residual by the standardized predicted value. In addition, the tolerance for the independent variables were greater than 0.1, and the VIF values were less than 3. These results indicate that a collinearity problem does not exist in this regression. Eight outliers that were either influential or leveraging in nature were considered. These outliers are a part of the data provided, and exclusion decreased the model fit. Therefore, these data points were left in the regression. Due to the transformation process, the data was normally distributed.

R^2 for the overall model was 6.0% with an adjusted 2.1%, which is weak. In this regression, the independent variables did not significantly predict the profitability from unrelated business activity in nonprofit organizations considering a p-value of 0.05 ($F(16,382) = 1.526$, $p = .087$). The results are presented in Table 3.

Table 3: Multiple Regression Results for Profit Margin

Profit Margin	B	95% CI for B		SE B	β	p	R^2	ΔR^2
		LL	UL					
Model						0.087	0.061	0.021
Constant	-0.374	-1.259	0.512	0.457		0.407		
Governance Index	0.166	-0.681	1.013	0.431	0.026	0.701		
Government Grants	0.751	0.142	1.361	0.317	0.127	0.016		
Municipal Bonds	-6.256	-28.181	15.668	11.151	0.028	0.575		
Restricted Assets	0.117	-0.188	0.423	0.155	0.041	0.451		
Age	0.001	-0.003	0.004	0.002	0.025	0.686		
Economic Condition	0	0	0	0	0.062	0.252		
Location	-0.962	-4.684	2.761	1.893	0.026	0.612		
Size	-0.003	-0.141	0.136	0.071	0.003	0.973		
Growth	0.002	-0.019	0.022	0.017	0.007	0.883		
Industry								
Arts	-0.144	-0.461	0.173	0.161	-0.063	0.373		
Health	0.399	0.079	0.719	0.163	0.167	0.015		
Human Services	-0.044	-0.368	0.279	0.164	0.019	0.788		
Religion								
Christian	0.043	-0.344	0.431	0.197	0.011	0.826		

Other	-0.631	-1.815	0.553	0.602	0.053	0.295
Tax Year						
2017	0.121	-0.089	0.331	0.107	0.057	0.258
Rated						
Rated by Charity	0.189	-0.165	0.544	0.18	0.058	0.294
Navigator						

Note: Model = "Enter" method in SPSS. B = unstandardized regression coefficient; CI = confidence interval; LL = lower limit; UL = upper limit; SE B = standard error of the coefficient; β = standardized coefficient, R^2 = coefficient of determination; R^2 = adjusted R^2 .

The following variables were excluded from the analysis: Industry-Education, Religion-None, Tax year-2016, and Rated-Not Rated.

A stepwise analysis was followed in order to determine a recommended model. The order was based on the statistical significance of the ability for the predictor variable to explain the transformed profit margin variable. In this analysis, the first independent variable included is the one with the greatest contribution (Hair et al., 2015). In the stepwise analysis, the order for each model is as follows: government grants, governance index, restricted assets, and municipal bonds. The results from this analysis are shown in Table 4.

Table 4: Stepwise Analysis Results

Profit margin model summary								
Model	R	R^2	Adjusted R^2	SE	F	df1	df2	p
1 ^a	0.111	0.012	0.010	1.032	4.928	1	397	0.027
2 ^b	0.134	0.018	0.013	1.030	3.601	2	396	0.028
3 ^c	0.135	0.018	0.011	1.032	2.438	3	395	0.064
4 ^d	0.141	0.020	0.010	1.032	1.986	4	394	0.096

a. Predictors: (Constant), Government grants

b. Predictors: (Constant), Government grants, Governance index

c. Predictors: (Constant), Government grants, Governance index, Restricted assets

d. Predictors: (Constant), Government grants, Governance index, Restricted assets, Municipal bonds

According to Table 3, the model with statistical significance with the best fit was Model 2, which included both government grants and the governance index. The results for the Model 2 regression can be found in Table 5. Therefore, some support exists suggesting that the relationship between government grants and profit margin is significant.

Table 5: Model 2 Results

	B	95% CI for B		SE B	β	p	R ²	ΔR^2
		LL	UL					
Model						0.028	0.018	0.013
Constant	-0.475	-0.924	-0.027	0.228		0.038		
Government Grants	0.659	0.079	1.238	0.295	0.111	0.026		
Governance Index	0.482	-0.149	1.113	0.321	0.075	0.134		

RESULTS

Overall, a multiple regression was performed to analyze the relationship between internal and external governance measures and the profitability from unrelated business activities reported on the Form 990-T. The results are shown in Table 3, 4, and 5. For Hypotheses 1 and 2a, some support indicated that a positive relationship existed between governance and profitability in nonprofits through Pearson's correlation. Through stepwise analysis, the relationship between government grants and profitability was again highlighted. However, no support was shown for Hypotheses 2b and 2c. In addition, the complete regression model was not statistically significant.

DISCUSSION OF RESULTS

From the results, a positive association was found between the level of governance in nonprofit organizations and unrelated business profitability. A weak, positive relationship was found between internal governance and the profit margin ($r = .120$, $p = .016$). In addition, support was provided for the relationship between government grants and the transformed profit margin through Pearson's correlation ($r = .111$; $p = .027$). Though the effect sizes for these two relationships are weak, these relationships collectively indicate that stronger governance has a positive relationship with profitability. Overall, these findings are consistent with for-profit studies that suggest a positive relationship between governance and firm performance (Abdalkrim, 2019; Bauer et al., 2010; Bebchuk et al., 2009; Bhagat & Bolton, 2008, 2013; Brown & Caylor, 2009; Gompers et al., 2003; Shaukat & Trojanowski, 2018).

A deficit from unrelated activity would require resources to be used for a purpose outside of the nonprofit's mission. This is contrary to donor goals when considering agency theory; donors desire to maximize services (Hofmann & McSwain, 2013). If resources are used instead for unprofitable, unrelated activities, the number of exempt services may be decreased. Government funding may improve this issue; for example, Lu & Zhao (2019) indicated that nonprofits with governmental funding tend to become more mission focused as well as increase spending on related programs as compared to other nonprofits (Lu & Zhao, 2019). While the relationships are weak, the results collectively indicate that firms who have stronger governance have less misallocation of expenses and report higher profitability. The results suggest that the goal of the 2008 IRS revision was directionally correct.

As nonprofits face greater government scrutiny with the acceptance of grants, nonprofits may be more likely to report unrelated income properly. Therefore, one would expect that increased reliance on government grants to be related to increased profitability from unrelated

business activities. The government may serve as a watchdog to ensure that income is properly reported.

Meanwhile, the study also provided evidence related to the percentage of municipal bond revenue and the prevalence of restricted assets. While both municipal bond revenue and restricted assets are indicative of additional oversight (Harris et al., 2017; Shon et al., 2019), the study indicated that this type of oversight is not associated with increased profitability for unrelated business activities. In the sample, only 13 nonprofits reported any municipal bond revenue, and only one return indicated a significant amount of income at 9.32%. Therefore, nonprofits may not use municipal bonds as a large enough revenue source to provide significant power to bondholders. Restricted assets also did not significantly relate to profitability. This result was unexpected as additional oversight from donors should incentivize nonprofit managers to engage in more profitable unrelated business activities as this would maximize the services of the nonprofit. Donors with restrictions may be more concerned with their specific donations as opposed to the unrelated business activities of the nonprofit.

LIMITATIONS AND FUTURE RESEARCH

This study includes several limitations. The distribution of both independent and dependent variables is non-normal. While nonparametric tests were used to evaluate the data, the researcher accepted some violations of normality when using regression analysis. Since the sample size included 399 returns, the data does tend to be more trustworthy in spite of normality issues (Williams, Grajales, & Kurkiewicz, 2013). Nevertheless, the results could be considered biased. In addition, the study only used the returns from the 2016-2017 tax years due to availability on the IRS website. Using data from different years may be beneficial for a future study. The researcher also assumed that all information reported on the Form 990 was accurate for governance as well as that the board possessed the sophistication to carry out its duties as suggested on the Form 990. Finally, the study is not seeking to determine causation but is only a correlation study.

Future research may consider differences in the tax law with the Tax Cuts and Jobs Act and economic conditions. The components of the governance index could be considered separately, which may lead to a stronger correlation that found with the index.

CONCLUSION

Limited evidence suggested a positive relationship between the governance index and profitability as well as a positive relationship between government grant reliance and profitability. The results are directionally correct with the expected relationship between governance and the profitability reported for unrelated business activity. The implications indicate that agency costs may be reduced through increased levels of governance in the nonprofit setting. Donors may consider the level of governance in a nonprofit organization before providing funds to the nonprofit to ensure the funds are used for service maximization. Additional studies should consider the relationships at a more detailed level.

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