FEASIBILITY STUDY ON ESTABLISHING A CERTIFICATION SYSTEM FOR NONPROFIT ORGANIZATIONS IN THE CZECH REPUBLIC

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CERTIFICATION AS A VIABLE QUALITY ASSURANCE MECHANISM IN TRANSITION ECONOMIES: Evidence, Theory, and Open Questions

by

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1. INTRODUCTION

Where there is a problem, one often finds the belief that a law or regulation can, and ought to, take care of it (*Muris, 2002; Roland and Verdier, 2003*). Even under the best of circumstances, however, this is a dubious belief. Third-party enforcement through the state is expensive and tends to be ineffective especially when the quality of goods and services is observable but not, or not easily, verifiable in court (*Akerlof, 1970; Tirole, 1988*). Every student, for example, knows when a professor takes his responsibilities lightly. Typically, however, a student will not be able to enforce good teaching, or dissertation supervision, in court. Things get worse when the quality of goods and services is not even observable, or only at prohibitively high cost (*Darby and Karni, 1973*). How, for example, would one go about proving in court that one's donation to a nonprofit (e. g., for the recent tsunami disaster relief efforts, or for flood victims in the Czech Republic) was not used the way it was intended? Below, following the economics literature, we sometimes call such services credence goods.

Drawing on the notion that consumers often have choices, and can vote with their feet if they are displeased with a good or service, economists since Adam Smith have made the case for reputation as an effective disciplining device in many of the situations where third-party enforcement fails, or works poorly (e. g., *Heal, 1976; Klein and Leffler, 1981; Ortmann 1999, 2001*). Unfortunately, reputational enforcement has its drawbacks too: it can only work if supported by fairly strong information flows (*Tullock, 1985; Frank, 1988,* especially chapter 3). So while it may be easy to ascertain, even for individual consumers, the reputation of local taxi enterprises (e. g., AAA), it is much more difficult to ascertain the quality of firms that provide educational, health, or other (social) services such as disaster relief efforts. There are many such situations of asymmetric information where quality assurance through third-party enforcement or reputation is all but impossible. What, then, can be done?

We propose that properly designed systems of certification have tremendous potential especially in situations where both the state and the market are likely to fail in their enforcement function. Throughout we use donative nonprofits (nonprofits which finance themselves significantly out of donations and hence

have to raise, either on their own or by way of some fundraising firms, funds from public or state entities) as a running example. We call the problem of asymmetric information in the context of donative nonprofits *the fundraising problem*. This problem is closely related to the problem of whether charities manage their funds wisely and efficiently, a problem occasionally called the credibility problem (e. g., *Gibelman and Gelman 2004*) for reasons we will have to say more about below. Since the credibility problem is closely related to the fundraising problem (e. g., *Ortmann and Schlesinger 2003*), below we often talk, somewhat simplifying, about the fundraising problem.[1] We note that most of our arguments apply also to commercial nonprofits (nonprofits which finance themselves for the most part from selling their products to everyone willing to pay for them) and, more generally, even to for-profits that provide experience or credence goods.

We choose donative nonprofits as our running example because this manuscript is meant to inform the discussion about a certification system for donative nonprofits in the Czech Republic that will draw on the experiences of similar initiatives in Europe, Canada, and the U.S.A. Theoretical reflection seems warranted since the extant systems display remarkable diversity. This diversity is, maybe, not all that surprising given that these systems evolved at different times and in different places, and that an optimal system for all these circumstances is unlikely to exist. Of particular importance is that none of the extant systems has evolved in a transition economy, for reasons that we can only speculate about.[2] There are also prominent examples of such projects that faltered over the last few years. Given that significant sums are involved in the design and implementation of certification systems, theoretical reflection about the promises and pitfalls of such systems seems very much in order.

The remainder of the paper is structured as follows: In section 2 we describe U.S. attempts to solve the fundraising problem as well as some European success stories of certification solutions to the fundraising problem. We also pay attention to a failed attempt at such a solution – "we learn from failure, not from success!" (*Stoker, 1897*) after all – before summarizing other extant quality assurance systems. In section 3 we sketch out the stylized facts, or commonalities, that emerge from our review. In section 4 we examine what economic theory has to say about the stylized facts that we identified and about the fundraising problem, and where the extant theory is deficient. Section 5 concludes with a list of design and implementation issues.

[1] Roughly speaking, the credibility problem is concerned with nonprofits doing what they say they will, and whether they do so wisely and efficiently. All nonprofits face this problem, whether they raise funds or not. In a sense, the credibility problem addresses the issue of whether indeed nonprofits deliver the quid-pro-quo that is implied by the tax and regulatory breaks bestowed upon all nonprofits. The fundraising problem identifies the credibility problem with respect to a specific, and arguably particularly important revenue source that – because of its atomistic composition – tends to be most severely exposed to the asymmetric information problem.

[2] It is our reading that throughout the nineties consumer protection was not a high priority. This may have been a response to more pressing demands on scarce enforcement resources, lack of effective consumer protection laws, and the fact that there was no strong demand for high quality and services to start with.

2. THE FUNDRAISING PROBLEM: Some (Attempted) Solutions

The nonprofit sector (also called the third sector, or civil sector) finances itself partially out of donations which, unlike funds from state agencies, are contributions from citizens and grant-making agencies that may or may not be dedicated to a specific purpose. According to Salamon et al. (1999) donations accounted in 1995 on average for less than 10 % of nonprofit revenues in Western countries. The percentage is more than twice as high in areas such as environmental protection, culture, or various forms of international help. While these percentages may appear relatively insignificant, the absolute numbers are not: giving in the U.S.A., for example, amounted to $240 billion in 2003 (*Giving USA, 2004*). Donations sometimes come unsolicited (such as when Bill Gates gives away some of his wealth for purposes close to his heart) but typically donations are solicited through fundraising activities of the nonprofits themselves, or organizations that specialize in fundraising.

Fundraising brings up a number of interesting issues. For example, do those competing for funds honor truth in advertising, or do they dramatize their mission to increase the willingness of potential donors to give? What is an appropriate fundraising ratio anyway? That is, how much should it cost to raise a dollar or Euro to fund some project that benefits the public? One percent? Ten percent? Twenty-five? Fifty?

And once funds have been raised, are they indeed spent for the purpose for which they were raised? This question addresses the wide-spread perception among donors that nonprofits, whether donative or commercial, are rather incompetent at spending money wisely and efficiently (e. g., *Bradley, Jansen, and Silverman 2003; Light 2004, 2004a; Gibelman and Gelman 2004*).

A prominent case that highlighted the fundraising problem was the Red Cross's Liberty Fund, set up as a special account to aid the victims of the September 11 attacks on the World Trade Center and the Pentagon. The Red Cross tried to divert some of these funds to upgrade its telecommunications system and to build up its

blood reserves. While these activities may have been sensible things to do, they were not what donors had in mind when they poured almost 1 billion dollar money into the fund.[3]

Another case illustrative of these issues, albeit from a different perspective, was the decision of various branches of Medecins Sans Frontiers (MSF) to ask the public, less than 10 days after the disaster hit, not to send any more money for its tsunami relief efforts. The organization felt that it had collected enough money to finance the emergency aid mission in which it specializes. Curiously, the organization was criticized by numerous other organizations for this announcement; apparently some of these critics suggested that MSF should have done what the Red Cross did and was taken to task for. Less prominent but more pervasive (and harder to detect) are various forms of gift exchange, internal cross-subsidization, or mission drift (e. g., *Ortmann & Squire 2000*).

Two curious facts suggest that these, or similar problems ("tunneling"), also afflict the nonprofit sector in the Czech Republic. Of the organizations comprising the Czech nonprofit sector, 88 % are associations with no legal requirements mandating their accountability or disclosure of information.[4] More closely followed organizations such as foundations and foundation funds comprise only 2 %, and public benefit organizations only 1.5 % of the sector (*Brhlikova, 2004*). Nevertheless, even the disclosure of legally required information is lacking: in 2002, for example, only 32.9 % of foundations and foundation funds supplied their annual reports to their respective courts as required by law (*CVNS, 2004*), a dismal record that is bound to induce lack of accountability and transparency.

Examples like the Red Cross's Liberty Fund, or the apparent lack of understanding of the importance of accountability and transparency displayed by the reporting behavior of Czech foundations or foundation funds, are likely to generate negative reputational spillover effects which can affect dramatically the trustworthiness, and ultimately viability, of the third sector as a whole (*Ortmann and Schlesinger, 2003; Gibelman and Gelman, 2004; Light, 2004, 2004a; Panel on the Nonprofit Sector, 2005; Senate Finance Committee staff, 2004*)[5]. What can be done? And what has been done elsewhere?

[3] Light (2004 a, p. 1) argues that "the controversies surrounding the disbursement of the September 11 relief funds and subsequent nationally-visible scandals surrounding the Nature Conservancy and several private foundations appear to have left a durable imprint that has yet to fade." Light (2004) backs up this statement with numerous survey data.

[4] The number may be an overestimate, as the associations do not provide information about their termination. It is therefore not possible to obtain an exact number of working organizations.

[5] In response to the controversies surrounding the disbursement of the September 11 relief funds, etc., the Finance Committee of the Senate of the U.S.A. issued in the summer of 2004 a white paper on various changes it might consider as a means to reduce abuse and fraud in the nonprofit sector; it also invited the Independent Sector (www.independentsector.org) to comment on that draft. The Independent Sector, jolted into action by the white paper, then convened the Panel on the Nonprofit Sector (www.nonprofitpanel.org) in a clear attempt to influence the outcome of the Finance Committee's deliberations. Nunez (2001) suggests in which direction this influence is likely to go; more on the issue of self-regulation below.

2.a THE U.S. SOLUTION(S)

2.a.1 IRS form 990, GuideStar, and related services

Not surprisingly, given the prominent and relatively long-lasting role the third sector has played there, the U.S.A. has dealt with the fundraising problem, and related problems of misrepresentation and fraud, for decades (e. g., *Ortmann and Schlesinger, 2003*, pp. 82–85; see also *Stamler, 2004* a, b). Initially, guided by a belief in the efficacy of laws and regulations, the U.S.A. tried to solve this problem using third-party enforcement. Specifically, the Internal Revenue Service (IRS), in conjunction with the General Attorney offices of the states, was charged with enforcing the non-distribution and reasonable compensation constraints, together with other regulations pertaining to nonprofits.

A typical nonprofit organization in the U.S.A. with revenues above $25,000 is legally required to fill out IRS Form 990 which requires nonprofits to divulge – and to divulge to the members of the public – information such as revenues, assets and expenditures for program activities, administration and fundraising, as well as information on board members, directors, and key employees, including their salaries.[6]

Several shortcomings of this solution have been identified over time: In the past the returned forms were essentially stored away in some drawer – rarely to see the light again – because the IRS simply did not have the resources to check even a small fraction of the forms received. This fact, in turn, reduced nonprofits' incentive to report properly (*Froelich, Knoepfle, and Pollak, 2000*, pp. 245–6; *Senate Finance Committee staff, 2004*, pp. 8–9, pp. 18–19). But even those who do fill out the form have been critical of the guidance provided, especially if they are professionally trained (*Froelich, et al. 2000*, pp. 245; *Senate Finance Committee staff, 2004*, pp. 8–9).

In an attempt to improve the accountability and transparency of the nonprofit sector, new legislation and its interpretations in 1999 required most organizations in the sector to make their Form 990 easily accessible. Internet-based services such as GuideStar (*www.guidestar.org*), the National Center for Charitable Statistics (*nccsdataweb.urban.org*), or the cyber-accountability network (*www.cyb-acc.org*), have used those opportunities to provide guidance on how to fill out Form 990, to change nonprofits' incentives to report properly, and to persuade charitable and

[6] The minimum revenue cut-off point means that about 70% of nonprofits do not have to fill out Form 990.

nonprofit organizations that completing Form 990 correctly and carefully might in fact be a strategy that is likely to have significant payoffs (e. g. *www.crcmn.org/ /npresources/truthtips.pdf*).

GuideStar in particular is a tremendous success story by some measures. For one it has become the public disclosure vehicle of IRS data. Founded in 1994, it currently maintains database records for more than one million U.S. organizations and has extracted from the annual filings with the IRS extensive financial and descriptive records time series for the 300,000 largest nonprofits. Yet GuideStar is much more than a derivative of IRS Form 990: It supplements these data with voluntary answers to its own questionnaire which is currently filled out by about 10 percent of nonprofits. This number, however, is misleading[7], as the participants comprise more than 20 percent of the filing charities (which account for 99 percent of all charitable activity), and because participation is skewed toward larger, fundraising-type charities, roughly 50 percent of the economic and fundraising activity of all U.S. charities.

GuideStar's basic services are free to everyone that registers; at present it has more than 250,000 registered users of which the majority is nonprofits. Additional GuideStar PLUS information services such as "Analyst Reports" (each report includes peer group comparisons) or "Compensation Reports" are available for a fee. The company (a nonprofit whose own Form 990 is available on the GuideStar site) currently has a budget of $6 million, one third of which is covered by fees for services and two thirds by donations. The company's goal is to finance about 70–80 % of its costs through its GuideStar PLUS services within a couple of years. It recently launched www.guidestar.uk.org, a similarly constructed charity information website in the United Kingdom whose first three years of existence has been funded by the Treasury through a grant of almost $5 million. A pilot project in South Africa is well on its way, as is an exploration project in Germany. These various initiatives are coordinated by GuideStar International which was formed in October 2004 and is conceptualized as a collaborative effort in "sharing technology, data, best practices, and international fund-raising" (*www.guidestar.org/about/press/ /041004_gs_intl.jsp*).

It will be interesting to follow these developments closely, for at least two reasons. In the United Kingdom, information similar to that obtained from the 990 Form seems readily available; but in South Africa, Germany and the Czech Republic the equivalent of a 990 Form does not exist, or at least is not publicly available. Plus, it is not clear whether the tremendous funds that GuideStar has been able to attract in

[7] We thank Buzz Schmidt, chairman emeritus of GuideStar, and now chairman of GuideStar International, for setting us straight.

the U.S. and the U.K. will be forthcoming elsewhere. In short, the economic viability of the project has yet to be proven. It may have to rely to a significant extent on private and public donations well beyond the take-off phase.

There can be little doubt that the GuideStar model does bring significant benefits to its various stakeholders that might justify such donations, even in a steady state equilibrium. It is a tremendous source of information for donors, grant makers, government regulators, policy makers, and various professionals (including academic researchers, who interestingly account for only a rather small slice of the currently 5 million annual visits to the GuideStar website in the U.S.A.). It is also a tremendous source of information for not-for-profits who want to compare themselves to their competitors (e. g., through the peer group comparison service).

By ratcheting up the scope of the questionnaire GuideStar could, and apparently intends to (although we have heard differing opinions on this issue), increasingly take on characteristics of a certification agency.[8] Indeed, to the extent that GuideStar will not be able to work in countries such as South Africa, Germany, and the Czech Republic with a ready-made set of data similar to those provided by IRS Form 990, it will have to devise a system of voluntary submission of data. It will be interesting to see what kind of system of carrots and sticks will be devised. It will also be interesting to see how GuideStar-like systems such as the Dutch "donateursvereniging" (*www.geefwijzer.nl*) will solve the same problem, and how these systems will affect certification agencies, to be discussed presently.

In our view, the key problem with the GuideStar model is its exclusive reliance on information provided by the organizations themselves, leaving significant leeway for those that try to bend the rules. Mission drift, for example, cannot be captured in any reasonable manner by way of GuideStar data, nor can untruthfulness in communication, use of restricted funds for operational purposes, inadequate documentation or misuse of expense reporting, improper allocation of fundraising and overhead expenses, or similar recurring compliance issues. While GuideStar, and the many initiatives it has spawned, is likely to lead to increased transparency and accountability of the sector through increased accessibility and quality of the information reported in Form 990, it is for the time being unlikely to allow consumers to really sort out the good guys from the bad guys (even if the consumer is savvy enough to read the "Analyst Reports" that GuideStar provides and that are probably one's best bet to identify truly deviant behavior). So, what does allow for this?

[8] It would be interesting to assess empirically how those that supplied additional information to GuideStar have fared in terms of their revenues relative to those that did not. Our conjecture is that so far it has not made a difference because the additional questions are too vague and can be answered falsely with impunity.

2.a.2 "Standards for Excellence" and related certification systems

Concerns about the efficacy of IRS enforcement motivated the Maryland Association for Nonprofit Organizations (*www.marylandnonprofits.org*, from here on Maryland Nonprofits) to launch in 1997 a certification program that checks the quality of nonprofits in the state against Standards for Excellence.[9] If the organization passes the certification check it is awarded the Standards for Excellence seal (*www.standardsforexcellenceinstitute.org*). In light of the fact that the program is now in the process of being implemented in other states[10], the program is considered a success in high places (e. g. *Senate Finance Committee, 2004*, p. 18), despite a relatively low and slowly increasing participation rate of organizations in Maryland: As of January 2005, only 53 organizations out of more than 1400 potential candidates (i. e. members of Maryland Nonprofits) had the seal.[11]

It is of particular interest in the present context that Maryland Nonprofits and its associate organizations does not restrict its program in other than a geographical manner, i. e. all organizations that are recognized as nonprofit by the IRS and reside in the corresponding state can, in principle, be certified. This prevents the certifier from imposing standards that would be too 'industry' specific. As we will see, other certification agencies – in particular those in Europe, to be discussed below – have chosen a different model.

Another distinguishing characteristic of Maryland Nonprofits is its goal to offer "a full range of services designed to help all nonprofits more effectively serve the community." The idea is to fix through consulting and training sessions what might be broken. The certificate therefore resembles more a diploma for passing the required consulting and training units. Clearly, this produces a situation where conflicts of interest are likely to happen.

Yet another distinguishing characteristic is the fact that on-site meetings may occur as part of the review process but don't have to, giving the investigative process considerably less depth and thus decreasing the probability that organizations which misrepresent their true nature are detected.

Another organization that has recently started certification in the U.S.A. is the Better Business Bureau's (BBB) Wise Giving Alliance, an organization that resulted from the 2001 merger of 2 nonprofits (the National Charities Information Bureau, the Council of Better Business Bureaus Foundation, and its Philanthropic Advisory Service); it is affiliated with the Council of Better Business Bureaus. Its main purpose until recently was the provision of information on organizations that

[9] The Standards of Excellence consist of guiding principles, or core values, such as honesty, integrity, fairness, respect, trust, compassion, and responsibility that are applied to eight areas of concern (Mission and Program, Governing Body, Conflict of Interest, Human Resources, Financial and Legal, Openness, Fundraising, Public Affairs and Public Policy) and that are further developed in 55 specific standards.

[10] After several organizations from other states showed their interest in replicating the Maryland Standards for Excellence program in their areas, Maryland Nonprofits established an umbrella organization, Standards for Excellence Institute, whose job it is to sell the program to other states and to coordinate the various efforts. As of January 2005, the program operates in 7 states – some already administering certification, others only offering training and consulting services – but it is expected be launched in 30 more states in the near future.

[11] As of February 2005 GuideStar counts 1993 participants out of 25,125 (990-filing and non-filing) Maryland charities in its database that provide additional information. Recall though that the information is not independently verified and, in any case, is a fraction of what certification agencies (to be discussed in more detail below) typically ask for.

solicit nationally or have national programs. In early 2003, the BBB Wise Giving Alliance launched a certification program which differs from that of the Maryland Association of Nonprofit Organizations in that it focuses on national charities only. Another important difference is that the fee organizations have to pay is not charged for the evaluation but for the possibility to use the seal. All organizations are evaluated in the same manner (and for free), but only those that pay the fee are awarded the seal and can use it on their website and publications. As of January 2005, 51 organizations have the seal.

Notably, the ECFA (Evangelical Council for Financial Accountability, www.ecfa.org), is a Christian organization that has provided certification for 25 years and currently has more than 1100 members (nonprofits); the certificate being membership in the organization. Membership requires signing the Statement of Faith, i. e. the organizations must be evangelical, which alone significantly restricts potential membership. The other requirements are summarized in 6 points concerning the management, financial management, disclosure and fundraising practices (the fundraising practices are further developed in 11 points). The standards are formulated in a rather broad manner, although each standard is provided with an extensive commentary, including practical guidelines. ECFA performs on-site checks of approximately 10 percent of its members each year; it receives no subsidies, and 100 percent of its costs are covered by membership fees. The requirement for eligibility is similar to that for Maryland Nonprofits – the restriction being not geographical but ideological. No other restriction applies – any type of nonprofit organization may apply. In the way it is organized, however, ECFA resembles the way European certification agencies such as CBF, DZI, or ZEWO operate (about which more below).[12]

It is curious why there were no earlier attempts in the U.S.A. to start secular certification programs. Most likely it is the result of the belief, widespread until fairly recently, that issues of accountability and transparency are to be solved by the state.[13] Form 990 and organizations using that form as their major input (at least for now) clearly are such attempts but, as we have seen, they do have their problems. The recent emergence of Maryland Nonprofits and the BBB Wise Giving Alliance certification programs, as well as the earlier emergence of ECFA, strikes us an indicator of these problems. Given their relatively recent emergence and state of flux, or peculiar market niche, it seems too early to draw conclusions about these models' viability.

[12] Wilke (2005), available in draft only after a second draft of our paper had been circulating, has an extensive and very useful discussion of the three organizations reviewed in this section; it is unfortunately written in German.

[13] Commenting on the preceding statement, Wilke (2005) suggests an alternative explanation: that the high degree of organization of nonprofits (in networks such as Independent Sector etc.), and their lobbies, tend to favor stricter attempts at self-regulation over independent certification in times of crisis. This is a persuasive argument: one just has to look at the composition of the Panel on Nonprofit Sector that currently tries to address the concerns of the Senate Finance Committee to see that there must be some truth to that proposition.

2.b SEEMINGLY SUCCESSFUL EUROPEAN SOLUTIONS: Examples from Germany, the Netherlands, Switzerland, and Austria

Contrary to the U.S., third sector certification systems have a long tradition in several European countries (e. g. Switzerland, about 70 years, Norway and Sweden, about 60 years, France, 15 years, Germany and the Netherlands, about 10 years). Guet (2002), in close cooperation with the International Committee of Fundraising Organizations (IFCO), has described eight such systems within Europe (and two Christian monitoring agencies in the U.S.A. – the already briefly discussed ECFA – and Canada). Due to space constraints we focus below on the certification agencies in the Netherlands, Germany, Switzerland, Austria (all this section), and England (in the next).[14] In contrast to Maryland Nonprofits, most of these systems focus on fundraising organizations that work on the national level. While there are many differences in the scope and mode of operation and funding of the certification agencies reviewed in Guet (2002) and below – something not really surprising given the evolutionary trial-and-error ways in which they have grown, and the different fiscal and legal environments in which they operate – two polar models emerge. One is the model pursued by the Dutch and German certification agencies, Centraal Bureau Fondsenwerving (CBF) and Deutsches Zentralinstitut fuer soziale Fragen (DZI), respectively. The other model is pursued by the Austrian certification agency. The Swiss model is a hybrid of sorts of these two polar models, albeit arguably closer to the Dutch-German model. At first glance, the organizational difference between the Dutch and German model on the one hand and the Austrian on the other is the decision to conduct the detailed evaluation of participant organizations in-house (the former) or to have it done by outside examiners ("Wirtschaftspruefer", the latter).

While CBF and DZI started their certification activities in 1995 and 1992, respectively, DZI was established in 1893 (focusing initially on the documentation and critical commentary of social work in general and of charity activities in particular) and CBF was established in 1925 (focusing initially on coordination at the local level of the fundraising activities of national charities). The Swiss certification system (ZEWO) started certification in 1940, having been established in 1934. Interestingly, until 2001 ZEWO was more akin to a self-regulatory collective. The credibility problem that that organizational form brought about – to be discussed more generally below in section 3 – led to a radical reorganization that was, initially, probably too much oriented toward consumer protection. The current organizational form gives the target organizations significant input in the process of determining the standards but restricts their involvement in the evaluation process proper.

[14] Our discussion draws on Bekkers (2003), Guet (2002), information generously supplied the organizations that we discuss, as well as lengthy interviews two of the present authors (AO, AK) had with the chief executive officers of the Central Bureau of Fundraising (CBF) in Amsterdam and the Deutsche Zentralinstitut fuer Soziale Fragen (DZI) in Berlin, a long telephone conversation that AO had with the chief executive of ZEWO, numerous conversations that two of the present authors (AO, KS) had at the ICFO meeting in Vienna in May 2004, and generous comments by Bekkers and Wilke on earlier versions of this manuscript.

All three certification agencies have reached a general level of acceptance (about 30 percent name recognition in the total population, with the percentage being higher in that part of the population that indeed gives), and with the reputation of the ZEWO seal so strong that "some cantons do only allow/approve collections by organizations which have the ZEWO seal of approval; other cantons do ask the opinion of ZEWO before allowing a collection." (*Guet, 2002*, p. 27). Along similar lines, in Germany the Federal Ministry on Economic Cooperation and Development and the Foreign Office have simplified their application procedures for those charities which have been awarded the DZI seal of approval (*Wilke, 2003*).

CBF and DZI focus on national and supra-regional fundraising institutions, respectively. Until recently, DZI restricted its certification activities to those organizations pursuing humanitarian and social goals; since January 2004 it has started to certify all exempt public benefit organizations (political parties excluded). CBF covers very much the same ground. Both organizations presently have awarded their seal of approval to about 200 organizations. In contrast, ZEWO currently has awarded its seal of approval to about 475 foundations and public benefit associations, reflecting possibly its longer history.

All three organizations provide various degrees information about entities that have not been certified (yet). All three organizations approve the seal for a fixed period of time (DZI, yearly; CBF and ZEWO, every 5 years), with an intense initial screening process at the beginning. Interestingly, and importantly, although an audited financial statement is required, all three certification agencies require more information than just the financial statements. These additional information requests seem to have two functions: revelation of the additional information per se (which also allows cross-checking for the plausibility of other information) as well as the applicant's willingness to divulge those bits of information. If a charity is less than forthcoming with the required information, it is taken as a signal of its lack of trustworthiness. In other words, the certification agencies believe that it is their job to assess trustworthiness but not to induce it, "feststellen, nicht herstellen" as the DZI CEO put it. This strategy is, for good reasons that we shall argue below, in marked contrast to that of the Maryland Nonprofits approach. All organizations require accuracy of information, honest fundraising practices (truth in advertising!), and a prohibition against pressure being exerted on potential donors.

All three institutions charge for the certification process. Pricing varies. While ZEWO, CBF, and DZI charge for every evaluation, the fee depends on the costs of the evaluation or on the volume of fundraising income. For example, the initial fees charged by DZI and CBF are currently 1,500 € and 3,630 € respectively; subsequent

evaluations (each year) are 500–7,000 € and 250–5,000 €, respectively, depending on the size of the organization that is evaluated. The ZEWO initial fee is 2,260–4,500 €, annual fees are 320–7,000 € (with the average being about 600 €), and the re-certification fee (every 5 years) amounts to 1,200–2,260 €. The annual fees are computed as .25 per mill of revenues. The low average reflects the skewed distribution of organization size with few firms being large and many being small. It is important to understand that these out-of-pocket expenses are, however, only part of the total costs of acquiring, and maintaining, the seal of approval. Since the questionnaires that have to be filled out go significantly beyond what audited financial statements require, there is a substantial cost connected to the provision of that information. Exactly what these costs are, we have not been able to discern; they seem to vary widely (from less than a week to several weeks of manpower).

Interestingly, CBF (about 40 percent) and DZI (about 30 percent) are not fully financed from fees paid by the monitored charities.[15] In contrast, all other certification agencies discussed in Guet (2002) are (almost) completely self-financed from fees paid by the monitored institutions or from contributions. This is also the case for ZEWO, which finances about 99 % of its operations from fees. That said, as we will see below when discussing the Austrian case, the depth of investigation and therefore the detection probability of "bad apples" differs dramatically across CBF and DZI on the one hand and other organizations on the other: The depth of investigation is a, if not the, key cost-component of the certification activities, and any assessment of a certification procedure has to trade off these costs with the welfare benefits of an increased detection probability. In addition, less than complete reliance on fees is, in the view of the ZEWO CEO, likely to increase an agency's independence. It would, for example, make it easier to have re-certification every three years rather than every five years.

The three organizations just reviewed pursue, to varying degrees, other activities. DZI, for example, understands itself also as a depository of information about issues involving social work, broadly constructed. Following its original mission, it answers bibliographic queries and also produces a journal. Importantly, it also keeps track of a significant number of organizations that are candidates for the seal but that have either not applied or have been turned down. In effect, DZI answers per year about 300–400 press queries, many of which are not concerned with those companies that do have the seal of approval. In the wake of the tsunami relief efforts, it handled more than 200 queries. Both CFB and ZEWO also, albeit to a lesser degree, engage in information and publishing activities. Both, for example, publish an annual almanac that features those charities that were awarded the seal of approval.

[15] To be more precise: For 2005, DZI has a budget of 1.050,000 € from which about 430,000 € is its own income in the form of certification fees (300,000 €), library/publishing (95,000 €), etc. DZI's donor advice and seal-of-approval departments (roughly comparable to CBF as a whole) has a budget of 670,000 €, with 330,000 € its own income and 340,000 € subsidies from the federal government.

DZI (about 20 full-time equivalent employees, of which about 13 work for the donor advice and seal-of-approval departments) and CBF (about 15 full-time equivalent employees) are of about equal size, with ZEWO currently having about 5 full-time equivalent employees but planning to enlarge in the near future. The smaller number of employees at ZEWO is a function of the way the evaluation is organized. Like the Austrian certification agency to be discussed presently, ZEWO relies heavily (albeit not as extremely) on external examiners. The number of full-time employees is a bit misleading because of the different tasks that the certification agencies undertake. The certification branch of DZI, for example, consists of five what could be called "field investigators" and three assistants, with the CEO and his deputy signing off on every report. Of course, support and administrative staff do also work for the donor advice and certification process, summing to about two-thirds of DZI's manpower.

The Austrian model differs radically from that of its Dutch and German counterparts. Specifically, the Austrian Institute for Fundraising (Österreichische Institut für Spendenwesen – ÖIS; founded in 1996) defines as its major function, similar to DZI, provision of information about the sector. The ÖIS is a division of the Austrian Foundation for Development Aid Research (Österreichische Forschungsstiftung fuer Entwicklungshilfe). Interestingly, although the ÖIS was involved in the development of the standards for the seal of approval, the seal of approval itself (awarded since November 2001) is administered by the Chamber of Accountants (Kammer der Wirtschaftstreuhaender).[16] In effect, the whole certification operation at the Kammer exists of one person who spends, supported by a secretary, part of her/his time on coordinating the activities connected with this job. How does s/he do it? By reliance on external accountants that are paid in full by the applicants.

The obvious advantage of this solution is the ability to rather quickly expand the number of certified firms. In the Austrian case, this means that almost 50 firms were certified during 2001, while during 2002 almost 100 firms[17] (including most of the initial almost 50) made the grade – out of 600 organizations that qualify in principle.

The obvious disadvantage of the Austrian solution is the problem of quality assurance and comparability of the interpretation of the standards. The standards by their very nature are, to quite an extent, "soft" and open to subjective interpretation. As the reliance on external accountants increases, the standards are more likely to be interpreted less uniformly. Plus, a few in-house accountants who investigate a couple hundred organizations on a regular basis are more likely to develop a "feel" for compliance issues, since they will have more similar organizations to

[16] It is our understanding that this was the result of a compromise of sorts. The Austrian Foundation for Development Aid Research was originally interested in building a DZI-like organization but could not get support from partners that later signed a three-year cooperation agreement that was then implemented by the Kammer of Wirtschaftstreuhaender ("accountants").

[17] Interestingly, and maybe not surprisingly, these firms command about 25 percent of the funds that are raised by the 500 organizations that are not yet certified. To what extent this reflects some sort of selection bias, or to what extent it reflects already a payoff of the increased trustworthiness that the seal of approval bestows is an open question an answer to which would be highly desirable.

investigate than their counterparts under the Austrian scheme who are likely to investigate only a handful, and quite possibly, rather diverse organizations. Lastly, the incentives of external accountants may be very different from those of in-house accountants.

The theoretical problem is to what extent the Austrian solution might increase the probability of the certification procedure becoming a less effective separating device of good and bad types, and to what extent therefore the probability of a bad type leading to reputational spillover effects might increase. The devil is clearly in the details here but the trade-off seems to warrant more investigation. On the basis of its relatively short track record, the Austrian model seems viable but it is, perhaps, too early to issue a final verdict.[18] Hence the title of this section.

2.c SOME FAILURES WORTH KEEPING IN MIND: Examples from Europe

While there are a number of success stories such as CBF, DZI, and ZEWO, there are also a couple of interesting failures: projects that have not managed to become serious competitors to existing institutions. We concentrate here on two, one in Germany and one in England.

The English case is remarkable for a variety of reasons. The Accrediting Bureau for Fundraising Organizations (ABFO), an initiative supported by the well-known and well-established Consumers' Association, developed standards for organizations that raise funds from the public for charitable and public interest purposes in early 1996, and in late 1996 arranged a series of trials with five volunteer fundraising bodies to validate the application of the standards. An internal report in January 1997 called these trials "successful in meeting the objectives" and standards were found to be effective in examining the workings of the organizations visited. The trial organizations themselves were reported as seeing accreditation as "a useful, positive 'health check'". The trial organizations also saw considerable advantages in going through some such health check.

Yet almost three years later, only two organizations had been accredited and in what looked like an act of desperation, ABFO considered accreditation of the Royal National Lifeboat Institute, possibly against its will (although the wisdom of such a confrontational approach to the sector was doubted by some). In an internal memo in March 2000, ABFO's meager progress was attributed to two main obstacles:

[18] Here, too, it would be desirable to have hard facts about the impact that the seal of approval had on the revenue generation of those that were awarded the seal of approval.

"the basic resistance of the entire charity sector to external scrutiny" and "the lack of an effective lobby, which believes fervently that charities should be susceptible to scrutiny, and in particular that fund-raising charities should be accredited."

That effective body could, and probably should have been, the Charity Commission (which, interestingly, now seems to accept the GuideStar U.K. initiative, and which seems to have been pushed into reforming itself through this new threat; see the April 1 2004 announcement of its own online database launch of charity accounts and governing documents). The Charity Commission, however, never adopted the concept of a certification scheme. And the support of the Consumers' Association ultimately did not carry ABFO through; it essentially went into a state of hibernation in 2002 without ever realizing ideas that were fairly close to those that GuideStar U.K. has been implementing thanks to a huge grant by HM Treasury Invest to Save Budget (*www.guidestar.uk.org/support.htm*).

From a distance it is, of course, difficult to assess what actually led to the non-acceptance of a proposition that in other countries thrived. The evidence that we have seen and discussed suggests strongly that the failure to bring key players from the sector on board, for whatever reason it was, seems to have been the kiss of death (at least for now) of the English patient.

In Germany, DZI has over the years experienced various competitors, the most prominent ones being the Deutsche Spendeninstitut Krefeld and the Deutsche Spendenrat. The Deutsche Spendeninstitut Krefeld modeled itself to some extent after GuideStar but, after 6 years of existence, had to shut down when it was not able to secure the donations or state funding necessary to finance its continued existence. A major part of the problem seems to have been the lack of the kind of information that is publicly available in the U.S.A. and U.K. Another problem seems to have been the questionable transparency of the whole enterprise, including its profit- and software-making divisions.

The fact that of all the countries discussed in Guet (2002) one, and only one, certification agency has managed to establish itself, is an interesting fact that suggests at first glance that there may be economies of scale (and scope) to be captured. Here, too, it seems too early to hand down a final verdict. More empirical research seems in order.

2.d RELATED SYSTEMS OF QUALITY ASSURANCE

The problem of quality assurance is one that does not just pertain to the fundraising problem, or to nonprofits. In essence, every industry that produces experience or credence goods faces the resultant asymmetric information problem, as Adam Smith observed astutely (*Ortmann, 1999*). Not surprisingly then, we do find other quality assurance systems which we shall therefore briefly discuss.[19]

2.d.1 ISO 9000, ISO 14000

ISO stands for the International Organization for Standardization. ISO has developed several sets of standards, the best-known being the ISO 9000 system and the ISO 14000 system. ISO 9000 is a set of standards for management of quality, while ISO 14000 guides the management of environmental issues. Because the basic modus operandi is similar, we focus on the ISO 9000.

The so-called ISO 9000 family consists of a number of standards guiding quality management. ISO 9001 is the only member of the family to issue a standard "against which a third party certification can be carried" (*www.isoeasy.org*), i. e. a seal of approval can be issued. It applies to manufacturing as well as to service industries. ISO itself neither issues, nor approves, certificates; the organization only develops the standards. Certificates are issued by certification agencies existing throughout the world. Some countries, such as the Czech Republic, require that these certification agencies be accredited by a national accreditation body (which in the Czech Republic is a nonprofit organization).

The general aim of ISO 9001 standards is to assure product quality ('product' being used as a generic term for both goods and services). The purpose of product quality is customer satisfaction and compliance with applicable regulations. The system attempts to achieve these goals by controlling the whole process of production in the company, under the assumption that quality production will lead to quality products. Strictly speaking, ISO certification thus guarantees processes aimed at customer satisfaction rather than products, but this distinction is academic in that a poor product invariably identifies problems with the process that produced it.

The process of ISO 9001 certification is more complicated than the processes described in section 2.b. This is partially due to the fact that obtaining the certificate usually requires significant changes in the operation of the company as well as the introduction of new policies, while the certification of nonprofits

[19] Wilke (2005) points out that the RAL Institute (www.ral.de) in Germany started, because of the large number of seal-of-approval systems, a certification system for certifiers. As of the end of year 2004, 172 certifiers were themselves RAL-certified. Wilke (2005) also discusses a study prepared by the Institut fuer Ökologische Wirtschaftsforschung that lists three criteria that a seal-of-approval system ought to fulfill to have credibility: the independence of the issuing agency from applicants, the objectivity of the criteria/the degree to which the criteria go beyond legal or regulatory requirements, and the transparent development of the criteria/the thoroughness with which the evaluations are conducted. According to Wilke, world-wide only about 20 certification systems for charities fulfill these criteria.

mostly assesses the current situation. The typical ISO certification process consists of the following: demand/inquiry, informative interview, written application/filling out of questionnaires, examination of the application, approval of the application, contract, establishment of an auditing committee, pre-certification audit, result and corrections if applicable, certification audit, result and corrections if applicable, certificate proposal, issue of certificate, audits. The seal is valid for 3 years; audits are carried out regularly depending on the certifying company, but usually occur twice a year. The costs of ISO certification seem to be (significantly) higher than those incurred by certification of CBF, DZI, and ZEWO, for example, though we have not been able to ascertain the costs more precisely.

Importantly, over the past couple of years there have been instances of NPOs acquiring the ISO certification, namely the Business Education Council of Niagara, Canada (*Moffatt, 2002*) and Medair, an international humanitarian aid organization with headquarters in Switzerland (*Verboom, 2002*). The case of Medair is particularly interesting here since Medair is certified by both the ISO 9001 and ZEWO. Clearly, at least the decision makers at Medair must have thought that there is value added in both certificates. It would be desirable to understand the relative advantages of these two systems better.

2.d.2 Accreditation of institutions providing higher education in the U.S.A.

While most nations control the quality of education through governmental agencies, in the U.S.A. the monitoring has traditionally been performed by private, nonprofit institutions: At least since 1952, the federal government has relied on a system of accreditation to assess the quality of education (and authorize the distribution of federal and state funds).

Accreditation is provided on 3 levels – accrediting organizations that provide "institutional" accreditation which evaluates colleges or universities operating on the regional level (the U.S.A. is split geographically into 6 regions for that purpose) and operating on the national level; and specialized accrediting organizations providing accreditation of individual programs (e. g. distance learning programs).[20]

Independent of these distinctions, accreditation requirements are similar: the stress is on quality (of the provided education, but also of management), and its further improvement. In an attempt to monitor the monitors, both the U.S. Department of Education and the Council for Higher Education Accreditation (CHEA), an independent nongovernmental institution in existence since 1997[21], oversee the

[20] It is necessary to emphasize that the U.S. accreditation system is not prohibitive, i. e. institutions without accreditation are allowed to provide education. However they cannot access federal funds, which tends to be the major source of income of nonprofits and for-profits alike.

[21] Similar institutions existed for more than 40 years before 1997.

quality of the various accreditation organizations. Currently 58 organizations are recognized by CHEA, 56 by USDE, and 36 by both.

The process of accreditation of educational institutions is very similar to the process of ISO certification; it is time-consuming and requires extensive preparation of materials by the organization. After submission of a written application with all the required documents (a thoroughly detailed description of all the provided programs and employed faculty), and self-assessment of the institution, on-site visits organized by the accreditor follow. These on-site visits are typically performed by experts in the field, i. e. they are peer reviews[22] (*www.ed.gov/admins/finaid/ /accred, www.chea.org*).

The performance of the U.S. system of accreditation of institutions of higher learning is not undisputed. Ortmann (1997, 2001), for example, has proposed that the astonishing emergence of a rather successful – by various measures – for-profit post-secondary education sector in the U.S.A. can only be explained by the inefficiency of traditional colleges and universities. This, of course, was something that accreditation was meant to prevent.

Maybe not surprisingly, many educational institutions have sought ISO certification. A simple google search with the keywords "iso higher education" yields currently more than one million hits, many of them illustrating the (attempted) application of ISO to educational institutions. We are not aware of persuasive studies that document the success of ISO certification to educational institutions.

2.d.3 Self-regulation? Codes of conduct?

Yet another form of quality assurance is self-regulation, i. e. the voluntary acceptance of a code of conduct by the members of a club. This code is usually created by an 'umbrella' organization, an organization providing services to operating institutions in a certain field, or by a group of organizations with a similar purpose. Signing of the Code means the organization is voluntarily willing to follow the rules and regulations listed there.

Examples of this type of regulation abound (*Wyatt, 2004*). As regards the fundraising industry we can mention the German Deutsche Spendenrat (*www.spendenrat.de*) or the Czech Donors' Forum (*www.donorsforum.cz*). The main problem with codes of conduct is their reliance on self-reporting, i. e. the organizations are trusted to follow the regulations without any follow-up checks, leaving significant space for abuses and provision of false information. We believe that the rather meager

[22] Despite the fact that the review is performed by peers, the process cannot be considered self-regulatory. The regulatory body is a distinct, private entity that only co-operates with experts in the field.

success that both organizations had in their respective countries is a result of the structural problems that affect these self-regulated systems. Nunez (2001) provides an insightful model of self-regulation and shows that self-regulatory organizations typically have little incentive to monitor quality and to reduce fraud, at least without public parallel regulation.[23] [24]

Recall that, until 2001, ZEWO was more akin to a self-regulatory collective. As mentioned, the structural problem ("credibility problem") that this organizational form brought about prompted a radical reorganization towards consumer protection which significantly reduced the influence of the fundraising organizations, seemingly to the benefit of society at large. The trick is to find the right balance of independence and involvement, of reasonably disinterested investigation and informed standards.

[23] In some respects, Nunez (2001) explains well the bargaining game that has taken place over the past year, and continues to take place, between the Senate Finance Committee in the U.S. and the nonprofit sector there.

[24] In essence, they are prone to violate one or more of the three criteria identified by the the Institut fuer Ökologische Wirtschaftsforschung (see footnote 19 above): the independence of the issuing agency from applicants, the objectivity of the criteria/the degree to which the criteria go beyond legal or regulatory requirements, and the transparent development of the criteria/the thoroughness with which the evaluations are conducted.

3. DISCUSSION OF VARIOUS SYSTEMS

Below we identify the commonalities and main differences between the systems described above in section 2 along two dimensions: first, internally or externally developed and imposed standards (where the label "external" captures the independence of the issuing agency from applicants), and second, self-reported data or data produced through "investigators". In the following table we classify the systems described in section 2 in accordance with these two dimensions.

Of course, the two dimensions that we choose are ideal types; one almost never finds them in such purity. For example, even investigators of certification agencies such as CBF or DZI rely to some extent on self-reported data.[25] The key difference is that investigators can force applicants in principle to divulge data that otherwise they might have chosen not to reveal. This changes the nature of the information revelation game significantly.

		Standards set	
		Internally	*Externally*
Information provision	*Self-reported*	Codes of conduct (Deutsche Spendenrat, Donors Forum)	IRS Form 990, GuideStar
	Investigated	U.S.A. accreditation (?)	Certification systems, ISO

A system based on self-reported data has one important advantage: even though there are some internal costs related to the reporting of the data, it is cheap. Unfortunately, the value of data provided by self-reports is likely to be of inferior quality even in the best of circumstances (i. e. in situations where a club might

[25] In the extreme one could argue that all data are ultimately self-reported. But surely there is a difference, both in scope and in quality, between data reported from Form 990 (especially if there are no tangible consequences attached to misrepresentation), and the kind of data generated by the kind of structured data generation process that CBF or DZI use.

understand the importance of truthful and complete reporting). A system based on self-reports also requires significant interest and knowledge of consumers (i. e. will they read the provided information, and will they understand it?), as well as sufficient information flows (i. e. consumers will relate to each other their insights about the organizational realities of the firms that they look into). If these conditions, which are clearly necessary conditions but not sufficient ones, are not met, the system leaves significant room for abuse and misrepresentation (e. g. the problems with IRS Form 990 reporting described in section 2.a).

A system based on data produced through "investigators" has corresponding disadvantages and advantages. The acquisition of the data is likely to be more expensive – possibly significantly more expensive – but the value of these data is likely to be higher. The question is whether these expenses are an investment worth its money. In section 4 we discuss economic models of quality signaling which suggest that the answer can be both yes and no. The challenge of a proper design is to avoid the 'no' answer. It turns out that the answer hinges importantly on the costs it takes to detect "bad apples" (the detection probability) and the social welfare (in the form of savings in transaction and information costs, and other welfare improvements that are prompted by such a system).

As to our distinction of standards, our intuition suggests that standards set internally are likely to be less binding than standards set externally. The rules imposed by the IRS, for example, seem more binding than those imposed by codes of conduct that a club-like set of organizations might report. The problem is that in order to get firms to submit to externally set standards one has to force organizations legally or convince persuasively that indeed there are gains to be had for those that are competent and intend to play by the rules. As we have documented, although we believe that there are persuasive arguments for a certification system, it is sometimes not easy to persuade enough organizations to take the risk. If the system is designed without the participation of key players in the target market,[26] then the standards may overlook important industry characteristics. Even if the certifier manages to avoid this design problem and create the standards carefully and correctly, the target organizations may still feel the rules are imposed on them (similar to legislation but without the enforcing powers) and may resist participating. The case of the English certification is arguably an example of a failure of this type.

The main advantage of a self-regulated system that determines its own standards then is the involvement of the target organizations. Unfortunately, this may also be the major disadvantage, in that the involvement may lead to an inability to overcome

[26] All stakeholders' groups shall be involved: target organizations, donors, and government representatives.

opportunistic and shortsighted behavior. Lack of transparency and accountability are almost guaranteed in situations where tightly-knit groups of people interact. The self-assessment of such a group of peers is not likely to be as detached as that of external evaluators. Again, the ZEWO decision of 2001 seems to illustrate the problem.

The optimal design of a quality assurance system must avoid the threats identified above; the evidence reviewed above seems to suggest that independent investigators may be a key component of any promising problem. That said, while external standards are important, it is equally important to make sure that a critical mass of target organizations will buy into the basic idea, its design and implementation.

4. THE ECONOMICS OF CERTIFICATION

4.a COMMONALITIES

Even though, as we have documented, there are many variants of certification models, there are some interesting commonalities:

First, candidates for a seal of approval voluntarily provide information that often goes well beyond the legal (accounting) requirements. How much more is arguably the key design and implementation parameter of a certification agency, for it is likely to limit the coverage the certification agency can provide. Closely related is the issue of how likely a certification agency is to catch a bad apple, which can spoil the reputation of the seal of approval (and the good apples).

Second, candidates for a seal of approval not only send a signal, but send a costly signal, through out-of pocket expenses (e. g., the examination fee that they have to pay) as well as the costs it takes to collect the requested information. None of these costs of course matters substantially in the GuideStar model, so we would expect systematically lower signaling and separating effects in that context unless GuideStar injects more information gathering components into its data collection efforts. But any such attempt would increase the costs of doing business significantly.

Third, most of the systems that we considered above focus on organizations raising funds nationally, rather than locally. The national focus may result from the fact that the payoffs from certification are higher on the national level (where building a reputation is probably much more expensive); on the local level building one's reputation may be less expensive and hence become a viable alternative. But even here, as the system franchised by Maryland Nonprofits suggests, certification could be of some value.

Fourth, all current certification providers use essentially one disclosure rule: the seal of approval. They do, for example, not rank certified organizations, nor do they provide full disclosure of their findings, although they can, of course, adjust their

specific disclosure rule (or, in other words: the toughness of their standards) in many ways. Indeed, very little additional information is made public. In most cases the organizations are assured that the materials they provide to the certifier are confidential and will not be made public.

Fifth, organizations such as CBF and DZI have managed to build their reputations quite quickly. Bekkers (2003), for example, reports that the recognition rate of the CBF seal of approval almost doubled over the two-year span from 2001 to 2003 and was known by one third of the population at large in 2003 and by half of that part of the population that gives. Intuition suggests that these recognition figures translate into higher giving to those that are certified, although direct evidence does not seem to exist. Indirect evidence, however, exists in the form of the number of applications and the fact that firms that initially refused to sign on, often do later.

Sixth, all certification providers are nonprofits, with CBF and DZI being funded significantly, albeit decreasingly, with state money in various guises. To the extent that these certification agencies do provide a public service, public subsidies seem not unwarranted. In fact, in light of the influence that large fundraising might otherwise have, public subsidies seem warranted. And, in light of ever-increasing demands on government resources, the question of self-sustainability, however, is not likely to go away any time soon.

4.b WHY? WHAT THEORY SAYS...

Why would a company pay out-of-pocket and significant personnel expenses to be certified? Unless the company is irrational, it has to have the expectation that there will be a payoff that makes the investment worthwhile.

It turns out that economists have thought about such mechanisms for a while. In the language of economics, the willingness to provide the requested information – at substantial out-of-pocket and personnel expense – is a costly signal of one's "type". The signal induces a "separating" equilibrium in which participating players reveal themselves as "good" types, while those that do not participate are revealed as "bad" types. Interestingly, the good types do not have much of a choice. Once a critical mass of participating firms has been reached, consumers will view those

trustworthy firms that might not want to go through the certification process for one reason or another as not trustworthy. Hence, the trustworthy types have little choice but to get the seal (unless they are able to acquire a reputation of their own, which is unlikely to be a less costly strategy). The situation is similar, for example, to the incentives of those who are thinking about acquiring an advanced degree. The pain of getting such a degree is rather high for those who are not well-equipped to attend a particularly demanding program but might want to misrepresent themselves to potential employers.

So again, then, why would a company pay out-of-pocket and significant personnel expenses to be certified? The key to the answer lies, to our mind, in the demand shifts that are prompted by a successful separating equilibrium. Succinctly, the demand curve shifts out on the good types while it shifts in on the bad types. This shift may be budget neutral in the sense that the total volume of giving remains the same, but it doesn't have to be. In fact, within limits a nonprofit sector that is trusted will on average be able, ceteris paribus, to collect more funds that one whose reputation is shot. The evidence in Bekkers (2003) is suggestive of such a mechanism.

Several rather technical papers have been written on the topic of certification (although the certifiers are sometimes called different names, such as intermediary). In the present context the following papers are of particular interest to us: Biglaiser (1993), Biglaiser & Friedman (1994), and Lizzeri (1999).

Biglaiser (1993) shows that an intermediary indeed has the potential to increase the welfare of society in situations with asymmetric information. He considers an ongoing market in which buyers buy one unit of an experience good and sellers sell one unit of the experience good. The good has either a high or low quality, and this quality realization is pre-determined but unobservable. Thus, the moral hazard problem of sellers is assumed away. The intermediary increases the welfare of society by increasing the speed with which the market functions. This is possible because, as the only agent in the market, the intermediary buys more than one unit of the good, and therefore gains experience faster. The intermediary does not cheat, because the short term gains from selling low quality goods for a high price are outweighed by the 'infinitely' repeated profits accruing to the intermediary who stays in the market for a long period (forever) and who maintains his reputation.

Shortcomings of Biglaiser's model were addressed in a follow-up paper by Biglaiser & Friedman (1994). Here the authors address the role of an intermediary in situations where the sellers choose the quality of the goods they sell. It is shown

that the intermediary is able to mitigate this problem as well, and again increases the welfare of society.

While the models by Biglaiser and Biglaiser & Friedman incorporate considerations of reputation and highlight the information advantage of the intermediary over other buyers, they neglect a feature that is of importance in the present context: the decision process of the intermediary. Lizzeri (1999) focuses exactly on this aspect using a different modeling approach: he analyzes the asymmetric information problem in a one-shot game with two uninformed buyers, one informed seller, and one or more intermediaries. The intermediary provides the seller with an opportunity to reveal his quality, if the seller chooses to do so; the intermediary, through the choice of a disclosure rule (such as full disclosure, or disclosure of grades, or no disclosure) and a fee charged for certification, reveals some of the information to the buyers. Lizzeri assumes that the intermediary can assess the quality of the seller at no cost, and that the buyers appreciate the quality revealed to them through the intermediary. Technically, Lizzeri solves for sequential equilibria for various specifications of this game.

While the model is rather abstract and assumes away several important considerations (such as reputation as an alternative means of information transmission, cheating of the intermediary, or imperfect detection of quality), it elucidates some important issues concerning certification.

Assuming that the intermediary chooses to fully disclose the information he obtains, Lizzeri identifies a separating equilibrium with 'good' sellers asking for certification, and 'bad' sellers not asking for certification, rationalizing the kind of certification systems that we seem to be able to observe in Germany, the Netherlands, or Switzerland. In contrast, in those cases where the certifier chooses no disclosure, an undesired pooling equilibrium emerges in which all the sellers ask for certification, the intermediary awards it to all, and in so doing captures all the surplus but deflates the value of the certificate to zero. Unfortunately, a profit maximizing intermediary always chooses the second equilibrium, ensuring himself maximum possible profits. Lizzeri analyzes other possible extensions of the game: he examines, for example, a scenario with several intermediaries, and shows that competition among intermediaries shifts the power to consumers who end up completely informed.

As mentioned, the model presented by Lizzeri (1999) is rather abstract, but to the extent that it highlights in a stark manner certain features of theoretical equilibria (some of which we seem to see implemented in real life), it helps us understand

better the workings of these institutions. Particularly, it points out a significant threat related to certification: as we observe no disclosure being used by most agencies considered, we have to keep in mind that their temptation to shift to the pooling equilibrium by certifying most of the organization in the market is rather high. The problem is due to the profit-maximizing status of the agency in the model, which highlights the need to carefully monitor the enforcement of the non-distribution constraint in the certification agency we attempt to build. The nonprofit status of the certification agencies discussed in section 2.b. seems an effective means of counteracting that temptation.[27]

According to the model by Lizzeri it might seem optimal to build two competing agencies and in this way force them to behave optimally. However, before drawing such a conclusion, it is first necessary to examine whether the market is sufficient to allow the existence of more than one certification organization, since in most cases even the one organization needs to be subsidized by the state; and subsidizing two organizations is likely to be more expensive than monitoring one organization carefully.

[27] In personal communication, Wilke stressed the importance of this point and argued that this problem might ultimately undue the Maryland Nonprofits model. We are sympathetic to that concern. Wilke also pointed out that the kind of complementary donor advisory services that DZI provides, as long as they are paid either by the government, or by a public that values the provision of non-seal information (including warnings), can have a similar salutatory effect. We agree with that argument, too.

5. DISCUSSION AND CONCLUSION: Toward the Design and Implementation of Certification Systems in Transition Economies

Michael (2004) argues that the time has come to walk the talk: it is time to get away from public exhortations and other forms of moral appeals and to start thinking hard about the design of incentive-compatible and effective anti-corruption measures. We are very sympathetic to these sentiments.

When it comes to consumer protection, we encounter sound but incomplete economic theory. We also encounter systems in other countries that work reasonably well. But reasonably well does not mean optimal. More importantly, these systems are in place in places where both legal enforcement and reputation have some bite.

In this article we have discussed a form of enforcement that relies much less, or not at all, on the state, and that relies on the market only indirectly: Certification agencies force their members to reveal their (good) type through costly signals that can be "engineered" to induce a separating equilibrium. We have discussed the viability of this system of enforcement in environments where state and market have failed to deliver a satisfying degree of quality assurance, and have also discussed related information systems and systems of quality assurance.

Important questions – indeed questions that should be answered by any real-life version of a certification system – are yet not answered in a completely satisfactory manner. We enumerate these questions below to remind the reader of the complexities of the design and implementation problem:

- What exactly is the trade-off between the scope, and hence cost, of certification and the welfare benefits that can be captured this way?

- How strong is the demand shift, for individual organizations as well as the whole sector, that trustworthiness buys? Does it always pay off?

- → How strong a demand shift will "bad types", which got certified by mistake, generate?
- → What industries, or industry segments, are certifiable?
- → What is the critical mass of key members of targeted industries that one needs to get on board to launch a certification agency with a reasonable degree of confidence?
- → How independent should the certification agency be a) in the setting of standards and b) in the certification process proper?
- → To what extent should such an agency be financed from public funds?
- → What other tasks should a certification agency undertake?
- → How crucial is it that certification be done "in-house" (i. e. how much is to be gained by in-house "investigators")?
- → How important are industry-specific assessment instruments?
- → Who monitors the monitor?
- → Can self-regulation ever be a viable alternative to certification?

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CERTIFICATION AS A VIABLE QUALITY ASSURANCE MECHANISM: Theory and Suggestive Evidence

by

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1. INTRODUCTION

Worldwide, and even within some countries, the fundraising industry is a multi-billion dollar business (*Giving USA, 2004; Salamon et al., 1999*). Its basic function is to persuade potential donors to give generously to nonprofits to finance their operations. This may happen directly when the nonprofit's fundraising operation is in-house, or indirectly when the fundraising operation is a foundation that mediates the process of giving by collecting funds and distributing them to appropriate nonprofits. In the following, we do not concern ourselves with the specifics of the channels through which donations flow from donors to the entities that spend them. Rather, we are interested in understanding the problem of asymmetric information, or principal-agent problem, between donors and the charities that are the recipients of their generosity. Below we refer to this problem as the *fundraising problem*: Donors often know little about the entities that they have decided to give money to (e. g. the recent tsunami relief efforts), thus opening the door for potential abuses.[1]

Numerous well-documented scandals (e. g. *Ortmann and Schlesinger, 2003; Wyatt, 2004; Panel on the Nonprofit Sector, 2005; Bullain and Marschall, 2005*) continue to emphasize the importance of the problem that has found starkly diverging institutional solutions in different countries. In the U.S.A., for example, the interested parties have relied mostly on Form 990 which the Internal Revenue Service requires all nonprofits (including foundations) above a given revenue hurdle to fill out. This public document has become the key input in a new decentralized monitoring system called GuideStar that allows interested parties to search through millions of IRS 990 forms, and to do so (in return for a modest fee) in a highly structured search environment. The problem with this system is that all the data are self-reported and, in addition, not well-standardized (*Froelich, Knoepfle, and Pollak, 2000*), leaving considerable room for abuses. In contrast, especially in Europe the interested parties have relied on various forms of certification systems whose common denominator is that fundraising entities submit voluntarily, and for a fee, to the investigations of an independent agency that will issue a seal of approval assuring donors that the applicant has met some standard of quality.

[1] Some argue that the severity of the problem depends on the donor's size, the argument being that a large donor surely will give large amounts only if she can control the outcome. There is something to that argument in that in principle a donor could send her own "investigators" to evaluate whether the charity spent the donation in line with its promises. But this we typically see rarely, suggesting that it is costly, and/or that there are economies of scale in assessing charities.

The extant certification systems all exist, albeit in a surprising variety (e. g. *Guet, 2002; Ortmann, Svitkova, and Krnacova, 2005*), in countries such as Germany, the Netherlands, Switzerland, Sweden, Austria, and the U.S.A./Canada. Notably, such systems do not presently exist in transition and developing countries. This may be for the simple reason that the nonprofit sector is not developed enough to warrant quality assurance mechanisms. Some have argued that the typically weaker enforcement of laws and regulations makes certification not a viable solution in such environments. However, below we show that it is exactly the twin conditions of an embryonic nonprofit sector in a society where laws and regulations are weakly enforced that allow certification systems to have the most beneficial impact. Be that as it may, in light of the existing, starkly diverging realizations that we find in Europe, and in light of the fact that some attempts to start certification mechanisms (such as the English one; see *Ortmann, Svitkova, and Krnacova, 2005*) have been prominent failures and, lastly, in light of the growing importance of the nonprofit sector in transition and developing countries (*Salamon et al., 1999; Brhlikova, 2004; Svitkova, 2004*), pondering the incentive properties of certification mechanisms under those circumstances seems worthwhile. Indeed, our interest in the topic was triggered by the question of whether, and if, what kind of certification system would be viable in the transition economy that we live in.

We note that, even though here we use the fundraising problem as our running example, our theoretical considerations below apply to all problems of asymmetric information of a similar make: To the extent that commercial nonprofits, or even for-profits, produce experience and credence products (goods or services), they face, at least in principle, the same kind of problems that donative nonprofits face.

It is important to note that despite the fact that the listed facts describe the fundraising problem, it is straightforward to extend the consideration to other industries (both for- and nonprofit) facing the asymmetric information problem (typically markets with experience and credence goods, such as provision of social services or child care, education).

The literature that is most closely related to our work is theoretical research on intermediaries whose task is to mitigate the asymmetric information problem in product (*Peyrache and Quesada, 2004, 2002; Lizzeri, 1999; Biglaiser, 1993; Biglaiser and Friedman, 1994*) or labor markets (*Spence, 1973*). None of these papers, however, captures the specific features of the fundraising industry, namely the nonprofit status of the certification agency itself or the specific welfare consequences of trustworthiness of the individual nonprofits and the nonprofit sector as a whole. In fact, some of these models (e. g. *Lizzeri, 1999; Peyrache*

and Quesada, 2002) lead to rather counterintuitive results that are empirically difficult to verify, such as the certification agency capturing all surplus. Some of these papers suggest that competition may be beneficial but nowhere – at least in Europe – do we see competing certification agencies.

The second section of the manuscript details the stylized facts about the certification systems that we can observe. The third section lists assumptions for the model based on the observed facts and describes the setup and timing of the basic and extended games. The fourth section provides results, while the fifth lists future extensions, policy implications and concludes.

2. STYLIZED FACTS

The aim of this study is to build a model that allows us to study the fundraising problem and the viability of a particular solution to this problem, certification. Towards that goal we first enumerate the stylized facts that a more institutionally oriented companion study of such certification systems has produced (*Ortmann, Svitkova, and Krnacova, 2005*; see also *Guet, 2002*).[2] Since our basic model is a signaling game, we often use game-theoretic terminology even in the description of the stylized facts.

F1. [Game, players, their actions, and their objectives]

As mentioned, we focus on the fundraising problem and hence the strategic interaction of three types of "players": fundraising organizations (charities), donors, and certifiers. Fundraising organizations raise funds, or donations, for various charitable purposes. Their aim is to collect as many donations as possible. Toward that end they typically make promises about how they will spend the funds raised. Donors are the providers of donations. Their motivations can be rather diverse.[3] For present purposes, a relevant fact is that a significant portion of donors seems to care about what happens with their funds and hence about the quality of charities (*Bekkers, 2003*). The certifier provides a seal of approval, or certificate, that guarantees that fundraising organizations that ask for it do in fact meet some minimal quality requirement.[4] A certifier, too, may be motivated by various objectives. Interestingly, all certifiers of charitable organizations that we observe (*Guet, 2002*) are nonprofit organizations.[5]

F2. [Quality of charities]

The charities (fundraising organizations) differ in their quality (representing administrative costs, quality of project management, and, hence and most importantly, the fraction of donations that reaches those in need).

[2] The facts enumerated in this section provide the 'suggestive evidence' that certification may help to solve the fundraising problem. We call it suggestive as it is based on a small set of real-life cases that have some commonalities but also differ in important aspects such as whether they farm out the substance of their evaluations or do them in-house, or the kind of charities that they admit as candidates, or their reliance on public subsidies.

[3] A number of studies suggest that donors differ in their motives to give (Andreoni, 1990; Glazer and Konrad, 1996; Harbaugh, 1998a, 1998b); it is, however, not the aim of the current paper to analyze these motives further.

[4] It is important to realize that a certifier is different from an auditor, the main difference being the extent of requirements on the charity's operation. Certifiers do check the financial operations of charities, but they also check many other aspects such as governance or management. More details in Ortmann, Svitkova, and Krnacova (2005).

[5] However, this is true only for certifiers of charitable organizations. Other seal-of-approval systems (e. g., ISO) typically have profit maximizing certifiers.

F3. [Observability of quality of charities]

The quality of charities is typically not observed by donors.[6] The fundraising problem arises because typically donors do not observe the 'quality', or type, of the charity, i. e. they do not have enough information (if any) to assess whether the charity keeps its promises.

F4. [Donors that care about quality will redirect towards certified charities, and adjust upward, their donations]

Donors appreciate quality – if there is a certificate, donors that care about quality shift their giving to the certified charities only (because their quality is on average higher than that of the noncertified charities). Also, donors increase their giving to certified charities, and they do so increasingly with higher quality. Thus, aggregate giving also increases (*Bekkers, 2003*).

F5. [Certification is a costly signal; the two components of the cost]

The certifier provides a seal of approval, or certificate, that guarantees that fundraising organizations that obtain it do in fact meet some minimal quality requirement. This certificate is a costly signal because compliance with the minimal quality standard is more expensive for bad types than for good types. Specifically, charities asking for certification incur external and internal costs:[7] As regards the former, charities have to pay fees (initial fees, annual fees, recertification fees) set by the certifier. These fees typically vary with the size of the evaluated fundraising organization. As regards the latter, charities have to incur some costs related to the process of certification within the organization. These are mostly administrative costs (wages, preparation of documents), and are likely to be higher if the organization tries to misrepresent its type, to appear better.

F6. [Cost of detection technology]

While the signal may be costly, the certifier is not necessarily able to judge organizations without mistake. Detection is costly. The certifier chooses among detection technologies that produce different probabilities of detection (e. g., the Dutch-German model on the one hand and the Austrian model on the other hand; see *Ortmann, Svitkova, and Krnacova, 2005*). Detection technologies differ in their costs, and these costs increase with the quality

[6] Empirically, in every country there are some large charities that have established reputations on their own and do not seem to need the certifier, especially initially, to guarantee that they meet some minimal quality requirement. Interestingly, experience has shown that many of these large charities do end up asking for certification (Ortmann, Svitkova, and Krnacova, 2005). The reason for this will be become clear in the discussion of our model.

[7] This is true for all cases considered in Ortmann, Svitkova, and Krnacova, 2005: Austria, Germany, Netherlands, and Switzerland. Certification is free in Sweden (the system is supported by state subsidies); the charities must pay the costs of investigation only in case of special inquiry. Nevertheless, the internal costs apply to all cases.

of the detection the certifier wants to attain; it is not possible, however, to obtain a detection technology with no mistakes at all – the costs of such a technology are prohibitive.

F7. [Disclosure rules]

The certifier announces only whether the organization has obtained a certificate or not – he does not disclose additional information about the quality of the certified organizations, nor does he rank the organizations.[8]

[8] We note that other disclosure rules have been observed in other industries. For example, JD Power ranks brands of cars according to their quality (Peyrache and Quesada, 2002). We conjecture that the easier comparability of output in the car industry might drive that result. The easier comparability of output is likely to induce a differentiated demand response. Because of more difficult comparability of the output of fundraisers, such a differentiated demand response seems not possible.

3. MODEL: ASSUMPTIONS AND TIMING

We now map the stylized facts into assumptions that lay the foundations for our model.

A1. [Game, players, their actions, and their objectives]

The game is sequential and involves three types of players: charities, donors and a certifier. The timing of the game is described below. We assume that charities and donors are of measure 1. The certifier is a single player. Charities maximize donations obtained from donors that care about what happens to their funds (quality). The certifier provides a seal of approval (a "certificate" that guarantees some minimal quality requirement, or "standard" which is denotes *s* below) and may have one of the following optimization functions: maximization of profit, maximization of standards ('Money to Africa'), and maximization of detection probability. The last two objectives are our measure, for now, of maximization of welfare. (As we will see, they lead to different results.)

A2. [Quality of charities]

The quality of the charity (fundraising organization) is represented by *t*; we assume *t* is distributed according to a uniform distribution on the unit interval, F(t) ~ U[0,1]. Higher *t* represents higher quality, which can be interpreted, for example, as a higher fraction of donations reaching their purpose. Quality is fixed for now.[9]

A3. [Observability of quality of charities]

Donors do not observe *t*, the quality of individual charities. They observe only the cumulative distribution function, *F(t)*.

[9] We realize that a certification mechanism may well affect, and hopefully does affect, the distribution of types. But the evidence in the organization and management literature suggests that organizations, and their corporate cultures, are rather difficult to build or turn around. In addition, a model endogenizing the distribution of types would have to look much more complex (and probably use other tools). Hence, for now, we stick to our assumption.

A4. [Donors that care about quality will redirect towards certified charities, and adjust upward, their donations]

Donors that care about quality give *t* to a charity of quality *t*.[10] If certification is not available, these donors give to all organizations according to the quality of the average organization, *E[t]*; if certification is available, these donors adjust their giving accordingly. Specifically, all their giving flows to certified charities only and increases to *E[t | t > s]*.[11] The expected donation of a certified charity is therefore *E[t | t > s] / (1 - s)* and the expected donation of a noncertified charity is *0*. This giving function reaches its maximum at the maximum standard (when the total giving is *1*), with total giving going to the "best" charity. In order to rule out this implausible scenario (which is brought about by our assumption of a continuum of charities), we restrict our standards to be strictly less than *1*. This threshold is called *e* below. Note that in our setup, the difference between giving to a certified charity and a non-certified charity is the lowest (but still positive) at a standard of zero, i. e. donors appreciate identification of the "worst" charity (or the small number of charities that would remain without certification) and give nothing to them while giving some positive amount to the certified ones.[12]

A5. [Certification is a costly signal; the two components of cost]

The certifier provides a seal of approval, certifying that a charity that was awarded it has met a standard, *s*.

Two types of costs are related to certification:

The external costs (the fee for, or price of, certification) are denoted *P*. For the sake of simplicity, we assume that large organizations are aggregates of several small ones. Thus, we assume that all fundraising organizations have the same size and hence face the same *P*.[13]

The internal costs are assumed to take two forms:

A5i. $c(t)$, $c'(t) < 0$, a decreasing function of *t*. This form of the cost function is used for our basic model that will help us fix the basic ideas of certification.

A5ii. $c(t,s)$, $c_t(t, s) < 0$, $c_s(t, s) > 0$, is a function of both quality, *t*, and standards, *s*. We assume that $c(t, s)$ is decreasing in quality and increasing in

[10] Other donors may give for other reasons (such as the act of giving itself). These donors do not care about certification. In our model they make possible the continued existence of organizations of inferior quality. However, we do not need to consider these donors in our analysis because certification (as they do not learn about it) does not affect their giving in any respect.

[11] The aggregate and individual giving is equal as we assume donors in measure 1. The differences occur in the number of donors attracted by individual foundations.

[12] If we were to assume that donors keep giving to the noncertified charities as well, we would avoid the problematic result observed in Lizzeri (1999) or Peyrache and Quesada (2002) where the certifier collects all the surplus from the market without providing any additional information. However, this giving function is reasonable, keeping in mind the group of uninformed donors who give to the noncertified charities no matter what happens with certification.

[13] Indeed, several of the companies that we have studied in Ortmann, Svitkova, and Krnacova (2005) charge as an annual fee a per mill of revenues (e. g., Swiss certifier ZEWO). All certifiers studied in more detail in Ortmann, Svitkova, and Krnacova (2005) have similar schemes.

standards: if the standards are low the costs of preparing for certification are also low, independent of the quality of the organization; in contrast, if the standards are high then preparing for certification is costly, and indeed it is especially costly for those fundraising organizations which do not meet the standard and which therefore might have to misrepresent themselves.[14]

A6. [Costs of detection technology]

While the signal is costly, the certifier is not necessarily able to judge organizations without mistake. Detection is costly because detection technology is not for free; its costs are denoted $c_{CF}(p_{min})$, where the subscript denotes certifier and p_{min} denotes the minimum detection probability, this occurs at type $t = s$. A certifier can (and will have to because of whatever budget constraint he faces) choose the detection technology; we assume that it is uniquely defined by his choice of p_{min}.

We assume that costs increase, at an increasing rate, in the minimum detection probability: it is very costly to implement very good detection technologies. In fact, perfect detection is not possible, $½ \leq p_{min} < 1$. (The minimum detection probability must be at least ½, i. e. probability of a correct identification must be higher than probability of a false identification.)

Below we assume that the probability of detection for types $t > s$, $p = p(t, s, p_{min})$, is a linear function of the distance between t and s, $|t - s|$, perfect detection ($p(t, s, p_{min}) = 1$) is reached at point e; above e charities are assumed to be of the good type (e represents a threshold above which charities are considered good and their specific quality is no longer of concern. Below e is assumed to be .95.) The probability of detection for types $t < s$ is also an increasing linear function of the distance between t and s, $|t - s|$, although in fact any increasing function will do, as we shall see presently.

A7. [Disclosure rules]

The certifier announces only whether the organization has obtained a certificate or not – he does not disclose additional information about the quality of the certified organizations, nor does he rank the organizations.

[14] Throughout this study we work with costs that are linear both in t and s; however, it should be possible to consider functions that are convex in both, t, s, with negative cross-derivative (representing opposite effects of t and s – the negative impact of t on costs may be mitigated by increasing s). The robustness of our results to different specifications of our cost functions, or demand shifts induced by certificates, are obviously important topics for future research.

A.8. [What donors observe]

Donors observe the standard and certificates only. Specifically, they observe neither the internal nor the external costs of certification. Donors, for now, believe that the certifier is committed to being honest or, alternatively, values his reputation.[15]

A9. [Commitment of the certifier]

We assume that the certifier is honest and does not misrepresent the standard or quality of the certified organizations.

We proceed with the formalization of the full game which will then be solved for several specifications.

The timing of the game is as follows:

1. The charity learns its type, t.

2. The certifier sets standards, s, fee, P, and the minimum probability of detection (detection technology), p_{min}.

3. The charity observes the conditions of certification, s, P, and p_{min}; based on this information it infers its probability of detection $p(t, s, p_{min})$, computes its internal costs $c(t, s)$, and decides whether to ask for certification or not (in order to maximize expected "profits" = expected donations less costs of certification).

4. The certifier examines the charities that ask for certification and awards certificates to those that pass his standards (making mistakes with probability $1 - p(t, s, p_{min})$).

5. Donors make a decision based on s (as communicated by the certifier) and whether a charity is certified or not.

We solve the game by backward induction. Our aim is to determine a pure-strategy sequential equilibrium separating good and bad types (types above and below a given standard).

[15] An alternative assumption may be that the donors are able to observe the conditions of certification themselves – they may control the work of the certifier. However, we think this assumption is very unrealistic.

We solve a simplified basic game and the full game. For the full game we solve variants of the game for two cost configurations and three objective functions of the certifier. For the basic game, we identify the optimal decision of the charity: we solve the basic game G_B (and its simplified version G_B^-) to fix ideas. In the basic game, and its simplified version as well, we omit the decision problem of the certifier; the certifier in these games is simply a mechanistic provider of the certificate that does not incur any costs. (The simplified game furthermore omits the probability of detection and employs a simplified cost function.) For the full game G_F we add the choice of the certifier (using different optimization functions).

4. MODEL: RESULTS

4.1 SIMPLIFIED BASIC GAME, G_B^-

We first solve the simplified basic game, G_B^-. This game is a signaling game similar to the one in Spence (1973). We assume that the internal costs are a function of type *t* only, *c(t)* (A5i), and that the costs of detection are – in contrast to A6 used below – prohibitively high, thus the certifier does not evaluate at all. His role is mechanical – he is the provider of a certificate, i. e. he gives the charities a tool to separate themselves.[16]

The decision of a charity to apply for a certificate has to satisfy the incentive compatibility constraints (ICC) so that charities of quality above (below) standard are better off (not) asking for certification:

$$d_C - P - c(t) < d_{NC} \qquad \text{for } t < s;$$

$$d_{NC} < d_C - P - c(t) \qquad \text{for } t > s.$$

Where d_C is the expected donation to a certified charity, $E[t \mid t > s] / n_C$, n_C is the fraction ("number") of charities with a certificate, in this case $1 - s$; d_{NC} is the expected donation to a non-certified charity (by A4 we assume that the expected donation to a non-certified charity is *0)*, *P* is the fee paid for certification (external costs), and *c(t)* are the internal costs of charity of quality *t*.

We consider only solutions where separation occurs at the standard, *s,* specified by the certifier (assuming A9). In other words, the certifier behaves honestly in order to preserve his reputation, or is otherwise committed; therefore the separating equilibrium and standard coincide.

If a separating equilibrium exists, there must exist a standard s^* satisfying both IC constraints with equality:

$$d_C - P - c(s^*) = d_{NC} \Leftrightarrow c(s^*) + P = d_C - d_{NC}.$$

[16] As a matter of fact, this is an important distinction to the Spence model. There, educational institutions somehow exist: the Spence model is silent on the issue of their existence, but assumes that they could force different types to internalize the different costs of an education (which of course the bad types won't do because it is too costly for them). Likewise, in our simplified model the certifier somehow exists and manages to force them to internalize these costs of being certified (which of course the bad types won't do because it is too costly for them).

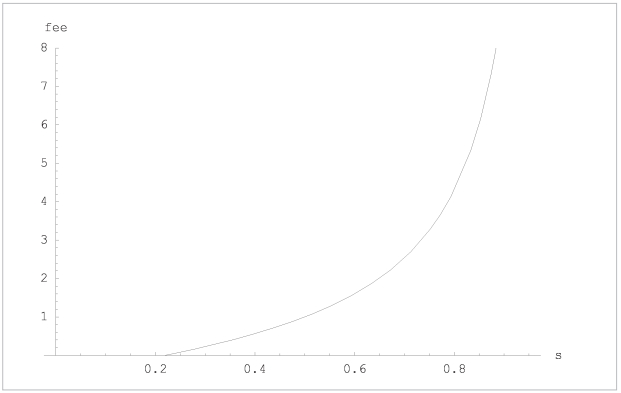
From the rearranged condition we see that for the type at the separating equilibrium, s^*, internal and external costs are equal to the additional donations it can expect, i. e. what the charity pays for certification is covered by the expected increase in donations induced by certification. The expected profit of the type at the separating equilibrium, s^*, is therefore 0 (types above s^* are left with a surplus, as their costs are lower).

The difference in donations is known: with our giving function, as defined by A4, (and no mistakes in detection), the difference in donations is $(1 + s) / (2 - 2s)$, an increasing function of standards. The solution of $c(s^*) + P = (1 + s) / (2 - 2s)$ depends on $c(s^*)$, the shape of the cost function. Assuming linear costs, $c(t) = 1 - t$, we get the separating fee as an increasing function of standards, as depicted in Figure 1.[17]

Charging a higher fee, P, leads to separation at higher standard. Note that even charging no fee at all induces separation at $s = .2$. This is intuitive: for types below this threshold, the payoffs from certification are too low to entice them to participate. In terms of the rearranged condition, even with P = 0, $c(s^*) > d_C - d_{NC}$.

In the separating equilibria identified by the rearranged conditions, types with $t > s^*$ (which from here on we shall call "good types") come to ask for certification, pay the separating fee, $P^* = c(s^*) - (1 + s^*) / (2 - 2s^*)$, incur $c(t)$, obtain the certificate, and then receive donation d_C. Types with $t < s^*$ (which from here on we shall call "bad types") do not apply and do not receive donations. Thus, in order to induce a higher standard (and possibly to increase the welfare of society), the certifier has to increase the fee, P.

Figure 1: Separating fee, P, as a function of standards s (for c(t) = 1 - t).



[17] All computations and figures in this paper were done in Mathematica v. 4.1.

Assuming that the internal costs, $c(t)$, are a function of type only, rules out a pooling equilibrium at $s = 0$, as the internal costs reach their maximum at this point and thus prevent the low types from participating.

Similar solutions exist for the family of cost functions that are decreasing in t and are convex ($c'(t) < 0$, $c''(t) > 0$), such as $c(t) = 1 / t$, or $c(t) = (1 - t) / t$. The identified solutions all determine a one-to-one relationship between an optimal standard and the fee that needs to be charged to reach this standard.

Given a particular cost function, and assuming that the certifier is honest (A9), the certifier announces a standard at which he wants to induce separation and the fee that corresponds to this standard. Note that in this simplified basic game (which we have introduced to fix ideas), the certifier can select any such standard/fee combination he chooses: they all lead to separation. Also, he does not need to evaluate the charities himself; he is sure that only charities above s^* ask for certification as the internal costs $c(t)$ together with the fee P^* ban the bad charities from applying. However, as in Spence (1973), no guidance is given by the simplified basic game as to which of these combinations would be optimal in some yet to be defined sense.

4.2 BASIC GAME, G_B

We now start to address the drawbacks of the simplified basic game by solving the basic game G_B. Specifically, we now assume that the internal costs are a function of both type, t, and standard, s (A5ii). We also assume that the certifier does evaluate charities and in this evaluation makes mistakes (A6).

Specifically, we assume an internal cost function, $c(t, s) = (1 - t)s$; i. e. we assume that costs decrease in type and increase in standards. The decrease in type captures our intuition that it will be less costly for better types to provide the required certification materials, and therefore also more costly for worse types to misrepresent themselves. The increase in standards captures our intuition that the (internal) costs of compliance with standards depends on the chosen standard: if the standard is close to zero, almost everyone will be able to fulfill it. But as standards are tightened, costs of compliance will increase albeit less so for the better types. This is reflected in the cross-derivative which is negative for the cost function that we have chosen. Again, there exists a family of internal cost functions for which costs decrease in type and increase in standards that lead to similar qualitative results such as $c(t, s) = (1 - t)s^2$, or $c(t, s) = (1 - t)s / t$.)

As in the simplified basic game, we assume for now that the certifier behaves honestly (A9), and that the separating equilibrium therefore occurs at the announced standard, *s.* The ICCs of charities then look as follows:

$$(1 - p(s, t, p_{min})) d_C + p(s, t, p_{min}) d_{NC} - P - c(t,s) < d_{NC} \quad \text{for } t < s;$$

$$d_{NC} < p(s, t, p_{min}) d_C + (1 - p(s, t, p_{min})) d_{NC} - P - c(t,s) \quad \text{for } t > s$$

$$\Leftrightarrow$$

$$(1 - p(s, t, p_{min})) d_C < P + c(t,s) \quad \text{for } t < s \quad \text{ICC for the bad types;}$$

$$p(s, t, p_{min}) d_C > P + c(t,s) \quad \text{for } t > s \quad \text{ICC for the good types.}$$

To recall, $p(t, s, p_{min})$ is the probability of detection of an organization of type t (A6), and the expected donation to non-certified charities is 0 (and therefore does not appear in the rearranged conditions) (A4).

We note that, strictly speaking, $d_C = d_C(s, p_{min}, e)$ and $d_{NC} = d_{NC}(s, p_{min}, e)$ where e represents the threshold above which charities are assumed to be of the good type (A6); to simplify notation we omit the arguments.

It is important to remember, however, that expected donations are functions of detection probability: if mistakes are not possible, the number of charities with certificate is $1 - s$, i. e. all charities above the threshold have the certificate. If mistakes are possible, the number of charities with certificate is lower (and the expected donation therefore higher). Some charities are wrongly assessed to be of a quality below the standard and hence do not obtain the certificate; this number depends on the detection probability, i. e. the frequency of mistakes.

This can be seen from the original ICCs: the good types receive donations with probability $p(s, t, p_{min})$, i. e. they are assessed correctly, while they receive nothing with probability $1 - p(s, t, p_{min})$, i. e. they are assessed incorrectly. Because $1 - p(s, t, p_{min}) > 0$, and since both internal costs, $c(t,s)$, and external costs, P, are bounded away from zero, some good types have, ex ante, the incentive to apply even though ex post they may fall through the cracks. This can also be seen from the re-arranged ICC which demonstrates that the expected revenue is greater than the costs. In contrast, the bad types receive donations only in the case of mistakes (induced by the imperfect detection technology) but the expected value of these donations is swamped by the internal costs, $c(t, s)$, and external costs, P, both of

which are bounded away from zero. Because the expected value of these donations is swamped by the costs, the bad types will not apply in the first place.[18]

As one can see from the re-arranged ICCs, (contrary to the simplified game) it is not possible to find a fee that would satisfy both conditions with equality except for the limit case where the probability of detection is *.5*. A probability of detection, $p = p(s, t, p_{min}) > .5$, shifts the constraints apart for the good types and the bad types.[19] Note that in separating equilibrium we are interested in what happens at the separating point $t = s$, where the detection probability is $p(s, t, p_{min}) = p_{min}$. Thus from now on we talk about detection probability p_{min} only.

A separating equilibrium arises if both constraints hold. In fact, with the exception of $p_{min} = .5$, there will be many separating equilibria with two boundary cases defined by one of the constraints being satisfied with equality. (Note that for $p_{min} > ½$, if one of the constraints holds with equality, the other is satisfied with strong inequality. Note also that the ICCs are satisfied for all fees between the two boundary cases, i. e. the problem has infinity of solutions.)

Below, we describe the two boundary solutions only;[20] as before for the simplified game, we solve for the optimal fee that must be charged to induce separation at *s* (see Figure 1). We denote the two boundary solutions as the upper boundary fee (labeled P_H, it arises when the constraint for the good types binds) and the lower boundary fee (labeled P_L, it arises when the constraint for the bad types binds). As the names suggest, the lower boundary fee is always below the upper one (for all $p_{min} > ½$). This results from the fact that the expected donations to the good types are always above those expected by the bad types, as explained above.

The lower boundary fee, P_L, is a function of technology, p_{min}, and standards, *s*. As Figure 2 demonstrates, the equilibrium exists for all p_{min} and standards *s.* However, analogous to what we saw in Figure 1, some (p_{min}, *s*) pairs induce separation without charging any fee – this is the flat part in Figure 2. For those (p_{min}, *s*) pairs that induce separation without charging any fee, charities separate into good types and bad types simply on the basis of their internal costs.

The lower boundary fee increases in *s*: the higher the standards the certifier wants to induce, the higher a fee he must set to restrict bad types from applying for certification. The fee decreases in quality of detection technology, p_{min}; the effect, however, is small (but increasing in *s*). This results from the fact that the incentive constraint of the bad types binds: increasing the detection probability decreases their expected payoffs (and lowers the probability that they will be awarded the

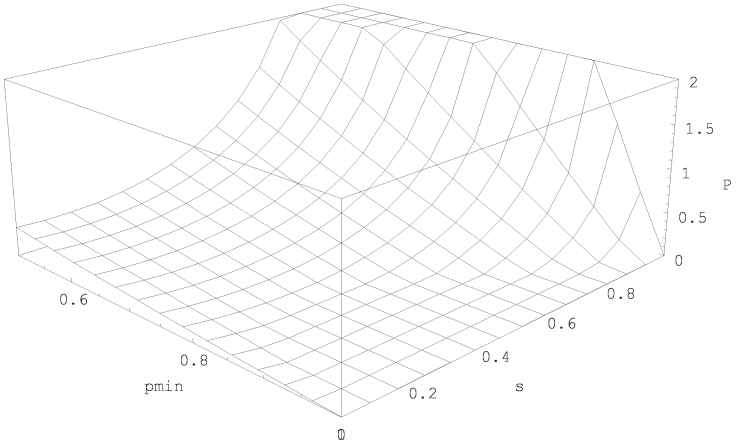
[18] This assumes that an applicant will have to pay the fee, *P*. (They will have to pay the internal costs anyway.) Indeed, as the example of German certification agency DZI demonstrates, unsuccessful applicants do have to pay the application fee. This affects nearly one third of the applicants, with these costs becoming sunk for about one fifth of the applicants. Qualitatively, this fact strengthens the incentives of applicants to reveal their type. If unsuccessful applicants would not have to pay the application fee, the argument in the text would be affected only quantitatively but not qualitatively, as long as the internal costs would swamp the expected value of getting donations that one does not deserve.

[19] The gap between the ICCs is due to the detection done by the certifier. If the certifier were able to assess the charities perfectly, he would award the certificate only to charities that are good, i. e. these would get the certificate with certainty, while the bad charities would not be able to obtain it at all. Thus, the gap would be maximum, *1*.

[20] It is sufficient to describe the boundary solutions for two reasons: first, they define all solutions in between, and second, we will see later (solving the full game, G_F) that the certifier always chooses a boundary solution.

certificate by mistake). Consequently, the fee needed to induce separation can be lower.

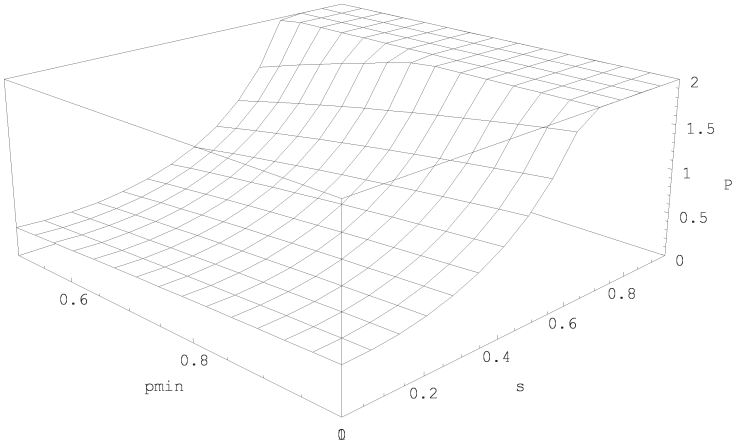
Figure 2: Lower boundary fee



The upper boundary fee, P_H, is also a function of technology, p_{min}, and standards, s. As Figure 3 demonstrates, the equilibrium exists for all p_{min} and standards s. However, in contrast to what we saw in Figures 1 and 2, it is always necessary to charge a fee – there is no flat part in Figure 3.

The upper boundary fee also increases in s: the higher the standards the certifier wants to induce, the higher a fee he must set to restrict bad types from applying for certification. In contrast to the lower boundary fee case, the fee increases in quality of detection technology, p_{min}; but the effect again is small (and also increasing in s). This results from the fact that now the incentive constraint of the good types binds: increasing the detection probability increases their expected payoffs (and lowers the probability that they will not be awarded the certificate by mistake). Consequently, the fee needed to induce separation must be higher.

Figure 3: Upper boundary fee



Note that the identified solutions also include a pooling equilibrium: setting $s = 0$ effectively means that the certifier pools all charities and that he awards the certificate without additional restrictions. The internal costs at this point are zero. The certifier realizes that there is no need to evaluate the charities asking for certification as, in the end, the certificate shall be awarded to all. In order to maintain this equilibrium he must charge a fee below (or equal to) *E[t]*, the expected donation of a certified charity. This is observed in Figure 3 at the point where $p_{min} = 1$, i. e. where the certifier is assumed to evaluate all charities correctly as being above standard and to give them the certificate.[21]

4.3 FULL GAME, G_F

In this section we solve the full game, G_F, by adding to the basic game, G_B, various assumptions about the objective function that the certifier might have; all assumptions of the basic game are maintained in what follows in this section. Guided by an objective function, the certifier now chooses among the separating equilibria identified in section 4.2. As before, he does so by choosing simultaneously the technology, p_{min}, the standard, s, and the fee, P (that lies within the boundaries – lower and upper boundary fee). He also considers the pooling equilibrium where all charities have the certificate.

[21] In Figure 2 we see the problem from the bad types' perspective: with perfect detection they do not have any chance to obtain the certificate, thus the maximum fee the certifier may charge is *0*.

We consider two types of certifiers: A profit maximizing certifier (4.3.A below), and a nonprofit certifier, for which we analyze two specifications: a certifier maximizing the welfare of society defined either as the maximum amount of donations reaching those in need, referred to as 'Money to Africa' (4.3 B),[22] or as maximum detection probability, referred to as 'Tech detect' (4.3 C). These three cases are all analyzed for two parametrizations of the certifier's cost function $c_{CF}(p_{min})$, high and low.[23] Needless to say, all our results below depend on the particular functional specification; the robustness of our results is subject to further research.

In addition, we assume that the certifier will not set standards above a threshold *e*, a minimum number of charities that he will identify as 'good' in the market. As noted above, perfect detection ($p(t, s, p_{min}) = 1$) is reached at point *e*; above *e* charities are assumed to be of the good type. Below *e* is assumed to be .95.

A) PROFIT MAXIMIZATION

The certifier maximizes:

$$\text{Max}_{P,s,p\text{min}} (1 - s)P^* - c_{CF}(p_{min})$$

where *P** is the fee inducing the separating equilibrium identified in section 4.2, and hence the first term denotes the certifier's income from certification, and the second term denotes his costs of technology.

While the certifier maximizes this function simultaneously, we analyze his optimal choice sequentially.

We start with the determination of the optimal fee: Clearly, the charged fee increases profit ceteris paribus, therefore the optimal fee of a profit maximizing certifier is the upper boundary fee P_H (arising from the good types' constraint, as depicted in Figure 3). This ensures the highest possible profit for all the (s, p_{min}) pairs. (This is the highest possible fee ensuring separation at *s*; fees above would shift the separating point *s* further up, violating A9 [commitment of the certifier to being honest].)

The impact of standards is two-fold: first, an increase in standards decreases participation in certification and thus lowers the certifier's income from fees; second, an increase in standards increases the maximum possible fee that may be charged (Figure 3). The optimal choice of *s* depends on the interplay of these

[22] Results in this case are similar to results we obtain if the certifier maximizes standards; given our assumptions, the certifier that maximizes standards will thus uno actu maximize giving to 'Money to Africa'.

[23] We assume the cost function $c_{CF}(p_{min}) = a\ (.25/(p_{min} - 1)^2 - 1)$. This functional form meets the requirements from A6: costs are infinite for perfect detection, $p_{min} = 1$, and 0 for no detection, $p_{min} = ½$. Costs are high with a = ½, and low with a = .1.

two effects. For the functional specification we have chosen, the negative effect of decreasing participation ultimately overpowers the positive effect of increasing the fee. The optimal standard – computed from the first-order conditions of the certifier's profit maximization problem – is therefore slightly below the maximum possible standard, .95, at .87 for high costs and .88 for low costs. The optimal standard does not directly depend on the cost function, but is affected indirectly through the optimal choice of detection technology.

The impact of detection technology on profits is both direct and indirect. It is direct through the costs of technology. It is indirect through its effect on the fee that may be charged for certification: increasing detection probability increases the fee that may be charged (recall Figure 3). The optimal investment is again computed from the first-order conditions of the certifier's profit maximization problem. For the high cost case, the costs are prohibitive, resulting in zero investment in detection technology, i. e. $p_{min} = ½$. The case with low costs and optimal standard .88 (as identified above) leads to detection technology with $p_{min} = .61$.

The case with high costs, however, still assigns the certifier a role; but as the certifier does not invest in detection technology the induced separation of bad guys from good guys is noisy, with bad guys not applying but with a high number of good guys falling through the cracks.

The profit maximizing certifier also needs to take into account the pooling equilibrium with all charities obtaining the certificate, implying that the minimum quality is zero ($s = 0$). Donors now expect charities with a certificate not to be of zero quality; therefore they give *E[t]* (as in the case without certification). Nonetheless, the (few) charities of zero quality will in any event apply for certification since the costs of certification to them will be counteracted by the donations they will receive. *E[t]* is also the maximum fee that can be (and thus is) charged by a profit maximizing certifier resulting in profit *E[t];* thus the profit of the certifier is ½ (A2).

Since the profit ensured by the optimal choice identified above is .56, the certifier prefers the separating equilibrium to the pooling equilibrium. Interestingly, and importantly, this result differs from that of Lizzeri (1999). This result is due to the different giving behavior of donors, which in turn is due to their appreciation of quality and a demand shift benefiting certified organizations only. The profit can be high in the separating equilibrium because, in line with the higher standards, higher fees can be charged for certification, which ensures sufficient profits to the certifier even if participation is low. However, it is necessary to keep the pooling

equilibrium in mind, as it may become the most profitable one if the behavior of donors changes ever so slightly.

B) NONPROFIT CERTIFIER – 'MONEY TO AFRICA' MAXIMIZATION

The certifier maximizes welfare:

$$Max_{P,s,pmin}\ E[t / t > s]\ (1 + s) / 2 - (1 - s)P^* - c_{CF}(p_{min}).$$

Since the results for 'Money to Africa' maximization are qualitatively similar to maximization of standards only, we analyze this latter case (which turns out to be more easily trackable[24]). Hence,

$$Max_{P,s,pmin}\ s - (1 - s)P^* - c_{CF}(p_{min}).$$

In the first equation we model welfare as the amount of funds reaching the target group (assuming that type, *t*, represents the fraction of funds reaching its goal), while in the second we model welfare as maximum standard. In both cases we subtract costs related to certification (fees paid by charities and the costs of technology incurred by the certifier).

We follow the logic of our preceding analysis and first identify the optimal fee. The impact of the fee on welfare is negative ceteris paribus: an increase in the fee increases the costs of certification having a negative impact on the welfare. A welfare maximizing certifier, therefore, chooses the lowest possible fee inducing separation, which is the lower boundary fee, P_L.

The impact of standards is again two-fold: first, an increase in standards has two direct positive effects, an increase in welfare and a decrease in participation (i. e. decrease in losses due to fees paid); second, an increase in standards has an indirect negative effect through an increase in the maximum fee that can be charged. Nevertheless, the positive effects prevail and it is always optimal to set the standards as high as possible – in our case it means reaching the threshold $s = e = .95$. (Of course, our earlier caveat about the validity of this claim maintains.)

[24] We are on 'the safe side' as the importance of standards in this case is lower than it is in the case of 'Money to Africa' maximization.

The impact of detection technology is two-fold as well: a direct negative effect due to costs of technology incurred by the certifier; and an indirect positive effect through the impact on the fee that can be charged for certification. The lower boundary fee charged in the latter case is decreasing in detection probability (Figure 2).

The positive effect of detection probability is stronger in this case than in the case of profit maximization, as now the detection probability not only decreases the maximum fee that may be charged but also decreases the expected donations of the certified charities (this was an argument against p_{min} in the profit maximizing case). The optimal detection technology is *.64* for the low costs; for the high cost case, the costs are – again – prohibitive, resulting in zero investment in detection technology, i. e. $p_{min} = ½$.

A welfare maximizing certifier will never choose the pooling equilibrium, as the welfare in this case is 0 and he is able to ensure positive welfare by setting nearly any other standard.

Analyzing the behavior of any welfare maximizing certifier (both those maximizing standards and detection probability) opens space for an additional consideration: keeping a balanced budget, we need to make sure that the certifier covers his costs, at least after subsidies (which for now we do not consider). (We may further require that the certifier spends all his revenue on related businesses.) We analyze welfare maximizing certifiers who always choose the lower boundary fee, P_L. Thus, below we use P_L only. The constraint looks as follows:

$$c_{CF}(p_{min}) = (1 - s)\, P_L \Leftrightarrow P_L = c_{CF}(p_{min}) / (1 - s).$$

Interestingly, a standards maximizing certifier is always able to cover his costs; he needs to charge a high fee to induce high standards, therefore the income is sufficient to cover the corresponding costs of technology. In the optimal case identified above, the certifier even makes a profit (.28). Implementing the constraint requiring zero profit in the end would, therefore, force the certifier to invest more in technology (which would increase the detection and shift the equilibrium from the maximum welfare case).

C) NONPROFIT CERTIFIER – 'TECH DETECT' MAXIMIZATION

The certifier maximizes:

$$Max_{P,s,pmin}\ b\ p_{min} - (1 - s)P^* - c_{CF}(p_{min}),$$

where *b* is the parameter representing how much the society cares for correct detection. (Below we assume *b = 1*.) The other parts of the welfare function are as in B.

The certification fee has, similar to the case above, a negative impact on welfare only; thus a welfare-maximizing certifier chooses the lower boundary fee, P_L (Figure 2).

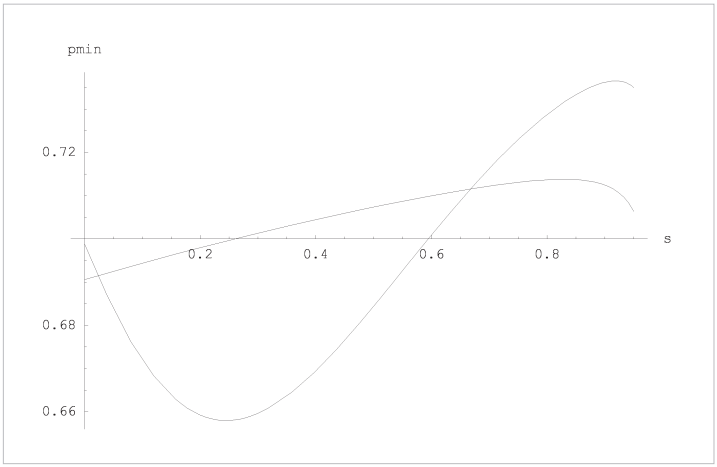
The impact of standards is two-fold (as in the previous cases): first, increasing standards has a direct positive impact through decreasing participation (decreasing losses due to the fees paid); second, increasing standards has an indirect negative impact through increasing the optimal fee (increasing losses due to fees). The first-order condition on optimal standards is similar to that of the standards maximization case, except for the missing direct influence of standards, which was very important in the standards maximization case – its pretermission leads to a significantly different result – the negative impact prevails, and the resulting optimal standard is very low: in the low cost case .26, and in the high cost case .2.

The effect of detection probability is also similar to the case of standards maximization (positive effect on welfare due to a decrease in the optimal fee, negative effect due to costs), but in addition, we now have the direct positive impact on welfare, pushing the investment higher for all the choices of standard. Thus, the optimal investment is the highest (as expected) from all the considered cases. It is still not possible to sustain investment in detection for the high costs, i. e. $p_{min} = ½$. The optimal detection for the low costs is $p_{min} = .7$.

A technology maximizing certifier does not even consider the pooling equilibrium with $s = 0$ as in that case technology plays no role; it becomes redundant.

Again, we need to take into account that the certifier needs to cover his costs; in this case the budget constraint binds as the certifier choosing the optimal solution identified above incurs losses (-.1). The certifier covering costs chooses the maximum possible detection he can afford (according to the condition described in section 4.3.B); in Figure 4, both welfare-maximizing detection (optimal detection identified from the FOC, the curve that oscillates less) and the maximum possible detection that the certifier can afford (cost-covering detection) as a function of standards are shown.

Figure 4: Optimal detection and cost-covering detection



The cost-covering detection follows the behavior of revenues, as these determine how much can be invested; it reaches its minimum at *s = .26*. This standard is also the welfare maximizing standard (as losses due to the certification fee play an important role in determining welfare): to maintain this standard but to cover his budget the certifier would have to decrease his investment in detection technology to $p_{min} = .66$ (from the original optimal $p_{min} = .7$). Such a decrease, however, might not lead to a separating equilibrium. Thus, the technology maximizing certifier solves the optimization problem keeping in mind the binding constraint (p_{min} defined by the budget restriction). The solution under this constraint is similar to the original one: standard is .245, the investment in technology is .66. The welfare decreases from .45 to .43, and profit is zero.

D) NUMERICAL SUMMARY OF RESULTS

Table 1: Numerical results

	Profit maximization	Money to Africa	Tech detect
P	P_H 5.29	P_L 6.97	P_L .1
s	.88	.95 (max)	.26
$\mathbf{p_{min}}$	.61	.64	.7

Table 1 summarizes the results explained in sections (4.3.A-C): We see that the profit maximizing certifier does not set the highest possible standard although he sets the standard quite high. This behavior is profitable for him due to the demand shift of consumers who give all the donations to certified charities only, and the certifier is consequently able to charge a high fee, ensuring himself high profit. He still invests something in technology; he does so because technology has a positive effect on the size of the fee he may charge. This result is in stark contrast to some of the results in Lizzeri (1999).

The certifier who maximizes 'Money to Africa' cares strongly about the standard. Since maximization of standards, in our model, also means maximization of the fraction of donations reaching Africa, the certifier sets the standard as high as possible – at threshold *e*. To induce separation at this point, he needs to charge a correspondingly high fee which – despite the fact that he chooses the lowest possible fee – is still higher than that from the profit maximizing case. The certifier invests in detection, as detection decreases the fee he must charge to induce separation (Figure 2).

The certifier who maximizes 'Tech detect' cares about the quality of his detection technology, but also about the costs of detection technology on welfare. Thus, he minimizes the costs of certification by setting the standard very low. This implies that he needs to charge a rather low price to induce separation. Investment in detection helps to decrease the fee even further and, moreover, increases the welfare directly; thus the investment is the highest from all the considered cases.

5. CONCLUSION:
Future work and policy implications

We have built a model which illustrates how, and under what conditions, an independent certifier might mitigate the principal-agent problem in fundraising, or the *fundraising problem*. In contrast to previous literature, we studied both for- and non-profit organizational forms of the certifier. Our results (in particular, those assuming the 'Money to Africa' welfare function) seem to rationalize the stylized facts of certification systems that we have identified.

Specifically, certification agencies that deal with variants of the fundraising problem that we observe in various West-European countries and the U.S.A. and Canada (and that we have discussed in more detail in *Ortmann, Svitkova, and Krnacova, 2005*) are all nonprofits, impose relatively high standards on applicants, and indeed certify only a fraction of the (potential) applicants.

It is the nature of modeling to abstract. The model introduced in this paper, too, is a simplification of real-world institutions. But, by enumerating explicitly the stylized facts on which we draw, and by enumerating the assumptions on which we build our model (and how these assumptions are related to the stylized facts), we make our modeling efforts transparent and open to critique. In fact, we welcome a critique of our reading of the stylized facts that we identified and the assumptions that we use.

Some avenues that we could take in future work are self-evident:

First, although relatively simple, our model is not analytically trackable. It would be desirable to build a model that could be tracked analytically (although that may come at the cost of having to simplify the model even further).

Second, given that we were not able to solve the model analytically – it is too complicated for that – we had in various places (e. g. the cost functions, or the detection technology) to make do with functional specifications that are constrained only by our intuition of what appropriate functional specifications are. Since trusting

intuition is something that economists are hesitant to do, testing the robustness of these specifications is desirable.

Third, there is very little work out there (the notable exception being *Bekkers, 2003*) that would allow us to calibrate our model and hence rationalize our choice of particular functional specifications. For example, the Austrian model of certification on the one hand and the Dutch and German models of certification on the other hand, differ in a key aspect: the former relies heavily on external "investigators" (using, however, its quality assessment instrument) while the latter use internal investigators. This difference is very likely to affect the interplay of detection probability and welfare effects of bad types being, mistakenly, certified as good types. Unfortunately, we have no inkling about this relationship (although we suspect that the Austrian model is tempting fate).

Fourth, we have assumed (A9) that the certifier is honest and does not misrepresent the standard or the quality of the certified organizations (for, say, for-profit maximizing reasons). This is, quite likely, a heroic assumption, especially in transition and developing countries where concepts of accountability and transparency, or reputational enforcement, often seem rather alien. A certifier, in other words, might have an incentive to cheat (as self-regulatory systems are prone to do; e. g. *Nunez, 2001, 2002*) and it is important to understand what exactly these incentives are and how they could be undermined.

Fifth, and relatedly, there is the question of whether one should force the certification agency to make ends meet, or whether it should be supported by state subsidies. This, too, ought to be modeled and, in fact, we have made first steps towards a better understanding within the strictures of our model already.

What are the policy implications of our model so far?

Clearly, certification systems are viable quality assurance mechanisms in transition and developing countries. But getting the particular realization of such a system right is an endeavor that takes reflection. Our results suggest that a certification agency ought to be a non-profit itself[25] and that such an organization has to be both accountable and transparent. Our results so far also suggest that, to the extent that they allow for the choice of a better detection technology, public subsidies for a certification system might be desirable.

[25] Of course, we understand well that nonprofits are often afflicted with their own sets of incentive problems.

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LIST OF VARIABLES:

t — type (quality) of charity/fundraiser, distributed according to F(t) ~ U[0 ,1]

s — standards – choice of the certifier, requirement on charities to obtain certification

$P^*(s, p_{min})$ — optimal fee – fee ensuring separation (given standards and detection probability)

P — external costs of certification – fee charged by the certifier for the service

p_{min} — minimum detection probability at standard (t = s)

$p(t, s, p_{min})$ — the probability of detection of an organization of type *t*

c(t) — internal costs of certification; here function of *t* only – this type is used only in the simplified version of the basic game, G_B^-; the usually assumed form is (1 - t)

c(t, s) — internal costs of certification; function of *t* and *s* – used throughout the game; the usually assumed form is (1 - t)s

$c_{CF}(p_{min})$ — costs of detection probability – function of the minimum detection probability p_{min} that applies in case $t = s$ (organization is exactly of the quality as the required standards); the assumed form is $a\,(p_{min})^2$, alternative assumed form is with costs going to infinity

a — cost parameter (from c_{CF} from above), we assume values, high – 1, medium – ½, or low – .1

d_C — expected donation of a certified organization

d_{NC} — expected donation of a noncertified organization

b — parameter expressing donors' valuation of either standards (case B) or detection probability (case C)

w — weight of welfare in certifier's optimization function [(1 - w) is the weight of profit]

RESOURCE SECTION

CONTENTS

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1. INTRODUCTION

This section is meant to provide easy access to selected resources relevant to the Prague workshop on certification May 23–24, 2005.

There are many regulations and standards available (see *Ortmann, Svitkova & Krnacova 2005*, and also *www.independentsector.org*, specifically the *Who's Doing What* section at *www.independentsector.org/issues/accountability/standards2.html*, which compiles almost 100 standards, codes, and principles of nonprofit and charitable organizations, external review organizations, membership organizations, etc.)

Here we present two:

The Standards of the Evangelical Council for Financial Accountability (ECFA)

The ECFA, together with the BBB Wise Giving Alliance (BBB WGA), are widely considered the leading certifier organizations in the USA (e. g. *Wilke 2005*). While the certification activities of the BBB WGA are of recent date, the ECFA has been in the certification business for more than twenty years, and very successfully so. We reprint here only the ECFA's Seven Standards of Responsible Stewardship but note that each of these standards comes with an extensive commentary; these are available on request, unfortunately only in English, in electronic form.

Seal Regulations of the Centraal Bureau Fondsenwerving (CBF)

The CBF (also discussed in *Ortmann, Svitkova, & Krnacova 2005*; see also *Bekkers 2003* which documents the impact of these regulations) strikes us the template of an organization that could be implemented in the Czech Republic, or, more generally, in other transition economies. We are grateful that the CBF has given us permission to reprint an informal translation of its guidelines in this booklet. The seal regulations included in this booklet include articles 1 to 4 (out of 18) of the contract; the standards themselves are in Article 4. The standards are currently being extended for consideration of quality of product but this extension is not available yet.

Adriana Krnacova, Andreas Ortmann, Katarina Svitkova (Prague, April 2005)

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2. CFA'S SEVEN STANDARDS OF RESPONSIBLE STEWARDSHIP

Standard # 1 – Doctrinal Statement

Every member organization shall subscribe to a written statement of faith clearly affirming its commitment to the evangelical Christian faith and shall conduct its financial and other operations in a manner which reflects those generally accepted Biblical truths and practices.

Standard # 2 – Board of Directors and Audit Committee

Every member organization shall be governed by a responsible board of not less than five individuals, a majority of whom shall be independent, which shall meet at least semi-annually to establish policy and review its accomplishments. The board or a committee consisting of a majority of independent members shall review the annual audit and maintain direct communication between the board and the independent certified public accountants.

Standard # 3 – Audited Financial Statements

Every member organization shall obtain an annual audit performed by an independent certified public accounting firm in accordance with auditing standards generally accepted in the United States of America (GAAS) with financial statements prepared in accordance with accounting principles generally accepted in the United States of America (GAAP).

Standard # 4 – Use of Resources

Every member organization shall exercise management and financial controls necessary to provide reasonable assurance that all resources are used (nationally and internationally) in conformity with applicable federal and state laws and regulations to accomplish the exempt purposes for which they are intended.

Standard # 5 – Financial Disclosure

Every member organization shall provide a copy of its current audited financial statements upon written request and provide other disclosures as the law may require. An organization must provide a report, on request, including financial information, on the specified project for which it is soliciting gifts.

Standard # 6 – Conflicts of Interest

Every member organization shall avoid conflicts of interest. Transaction with related parties may be undertaken only if all of the following are observed: 1) a material transaction is fully disclosed in the audited financial statements of the organization; 2) the related party is excluded from the discussion and approval of such transaction; 3) a competitive bid or comparable valuation exist; and 4) the organization's board has acted upon and demonstrated that the transaction is in the best interest of the member organization.

Standard # 7 – Fund-Raising

Every member organization shall comply with each of the ECFA Standards for Fund-Raising:

7.1 **Truthfulness in Communication:** All representations of fact, description of financial condition of the organization, or narrative about events must be current, complete, and accurate. References to past activities or events must be appropriately dated. There must be no material omissions or exaggerations of fact or use of misleading photographs or any other communications which would tend to create a false impression or misunderstanding.

7.2 **Communication and Donor Expectations:** Fund-raising appeals must not create unrealistic donor expectations of what a donor's gift will actually accomplish within the limits of the organization's ministry.

7.3 **Communication and Donor Intent:** All statements made by the organization in its fund-raising appeals about the use of the gift must be honored by the organization. The donor's intent is related both to what was communicated in the appeal and to any donor instructions accompanying the gift. The organization should be aware that communications made in fund-raising appeals may create a legally binding restriction.

7.4 **Projects Unrelated to a Ministry's Primary Purpose:** An organization raising or receiving funds for programs that are not part of its present or prospective ministry, but are proper in accordance with its exempt purpose, must either treat them as restricted funds and channel them trough an organization that can carry out the donor's intent, or return the funds to the donor.

7.5 **Incentives and Premiums:** Organizations making fund-raising appeals which, in exchange for a contribution, offer premiums or incentives (the value of which is not insubstantial, but which is significant in relation to the amount of the donation) must advise the donor of the fair market value of the premium or incentive and that the value is not deductible for tax purposes.

7.6 **Financial Advice:** The representative of the organization, when dealing with persons regarding commitments on major estate assets, must seek to guide and advice donors so they have adequately considered the broad interests of the family and the various ministries they are currently supporting before they make a final decision. Donors should be encouraged to use the services of their attorneys, accountants, or other professional advisors.

7.7 **Percentage Compensation for Fund-Raisers:** Compensation of outside fund-raising consultants or an organization's own employees based directly or indirectly on a percentage of charitable contributions raised is not allowed.

7.8 **Tax-Deductible Gifts for a Named Recipient's Personal Benefit:** Tax-deductible gifts may not be used to pass money or benefits to any named individual for personal use.

7.9 **Conflict of Interest on Royalties:** An officer, director, or other principal of the organization must not receive royalties for any product that is used for fund-raising or promotional purposes by his/her own organization.

7.10 **Acknowledgment of Gifts-in-Kind:** Property or gifts-in-kind received by an organization should be acknowledged describing the property or gift accurately *without* a statement of the gift's market value. It is the responsibility of the donor to determine the fair market value of the

property for tax purposes. The organization should inform the donor of IRS reporting requirements for all gifts in excess of $500.

7.11 **Acting in the Interest of the Donor:** An organization must make every effort to avoid accepting a gift from entering into a contract with a prospective donor which would knowingly place a hardship on the donor, or place the donor's future well-being in jeopardy.

3. **CBF SEAL REGULATIONS** – UNOFFICIAL VERSION

ARTICLES 1 through **4**

ARTICLE 1

DEFINITIONS

CBF

Centraal Bureau Fondsenwerving

CBF Seal

A Seal of approval issued by the CBF

Fundraising institution

A foundation or association established under Dutch law with full legal capacity which appeals to the generosity of the public by means of fundraising in order to achieve charitable, cultural, scientific or other objectives which serve the common good. Fundraising is understood to mean that the funds so acquired have been donated voluntarily, form no or no equal compensation for goods or services rendered and that no rights for care or aid can be derived from them.

Beneficiary of games of chance

A foundation or association established under Dutch law with full legal capacity which receives funds from a games of chance licensee, as meant in the law

concerning games of chance, in order to achieve charitable, cultural, scientific or other objectives which serve the common good and which is not a Fundraising institution at the same time (see article 17). Within the frame of these Regulations a games of chance beneficiary which appeals to the generosity of the public by means of fundraising is considered to be a fundraising institution.

Applicant

A fundraising institution which has filed a written application for recognition as Seal-holder with the CBF.

Criteria for the CBF Seal

The conditions mentioned in article 4 of these Regulations, which have to be met in order to qualify for recognition as Seal-holder.

Seal certificate

The written statement issued by the CBF that the criteria for the CBF Seal and the other conditions for recognition as Seal-holder are met.

Seal agreement

The agreement made by the CBF and the Seal-holder, which entitles the Seal-holder to use the CBF Seal.

Seal-holder

A fundraising institution which is entitled to use the CBF Seal.

ARTICLE 2

The CBF Seal

a. The CBF Seal, as registered in the Benelux Register of Trade Marks, nr 675846, includes a graphic image (logo) with an accompanying Seal certificate.

b. The Seal-holder is entitled to use the CBF Seal logo as such on written and audio-visual materials in compliance with the Seal agreement. This right is granted for the duration of the seal agreement for a period of no longer than five years subject to extension.

c. When the agreement ends every right to use the CBF Seal lapses. In that event the Seal-holder is to return the Seal certificate to the CBF.

d. The use of the graphic image accompanying the CBF Seal is subject to instructions of the CBF as laid down in enclosure 9* of these Regulations (* not included in this text).

e. The Seal-holder is not entitled to use the CBF Seal as its own trade mark or as a part of it.

ARTICLE 3

Conditions for awarding the CBF Seal

a. Fundraising institutions which have been active in the Netherlands as such for at least three years are eligible for award of the CBF Seal.

b. To be awarded the CBF Seal, Applicants have to meet the criteria for the CBF Seal and commit themselves to the CBF to keep meeting these, as well as the other conditions included in the agreement, by signing the Seal agreement.

c. The fundraising institution is to refrain from using a name and a logo which, separately or in combination, at first sight lead to confusion among the general public with a name and/or a logo of longer existing institutions.

d. By presenting the CBF with an application for the CBF Seal, the Applicant accepts the procedure that applies to the assessment of the application as described in these Regulations.

ARTICLE 4

Criteria for the CBF Seal

The governing board of the CBF has decided to allow a transitional regulation to be in force regarding the following criteria for the CBF Seal printed in italics. As of July 2005 the criteria for the CBF Seal printed in italics will also be applied in assessments and checks.

Paragraph 1 – The governing board of the fundraising institution

The governing board determines policy, establishes the financial guidelines and holds the final responsibility for the daily management. The governing board is to be arranged in a manner which warrants an independent performance of duties by the governing board and its individual members. The following provisions are to be observed in this respect.

Paragraph 1.a *– The governing board of the fundraising institution without a supervisory body*

a. The governing board consists of at least five natural persons.

b. In order to make decisions more than half of the number of board members has to be present at the meeting in person. Each board member has one vote.

c. A board member is only authorized to represent the institution together with one or more other board members.

d. Close family or other comparable relations between members of the governing board are not allowed.

e. The members of the governing board receive no remuneration as such, direct or indirect. A reasonable compensation for costs incurred by them on behalf of the institution and services rendered by them is not considered as remuneration. These compensations are shown and specified in the annual accounts.

f. The members of the governing board resign periodically. Appointments and any re-appointments are tenable for a maximum period of five years.

g. The members of the governing board of the fundraising institution are not to be board member, founder, shareholder, supervisor or employee of:

- an entity to which the fundraising institution directly or indirectly, wholy or partly yields the funds raised by it;

- an entity with which the fundraising institution structurally conducts legal acts which are valuable in money.

An entity as meant in this paragraph is equated with a legal person or entity which is – directly or indirectly – connected to the fundraising institution according to its statutes.

h. What is stated in subsection g does not apply with respect to an entity, or an entity – directly or indirectly – connected to it according to its statutes, to which the fundraising institution yields funds (receiving entity) in accordance with the objective stated in its statutes on the understanding that:

- the influence of a receiving entity on the appointment and nomination for appointment of the governing board of the fundraising institution is allowed to a limit of one third of the number of board members;

- no more than one third of the number of board members consists of the persons mentioned under subsection g of this paragraph.

The board members mentioned here are – with the exception of representation by participation in acts of the governing board – not allowed to represent the fundraising institution.

i. What is stated in subsections g and h does not apply if and so far as consolidation, regarding the fundraising institution and the entity mentioned above, as meant in article 650.108 of the 'Richtlijn Verslaggeving Fondsenwervende Instellingen' (official accounting guideline), takes place.

j. The criteria mentioned above under subsections a through i are to be expressed in the statutes of the fundraising institution.

Paragraph 1.b *– The governing board of the institution with a supervisory body*

a. There is a division of competences between the governing board and the supervisory body concerning the establishment of general policy and the financial guidelines.

b. The governing board governs the fundraising institution and has the final responsibility for the (daily) management and the execution of its programmes and activities.

c. The governing board is to consist of at least two natural persons.

d. Each board member has one vote.

e. A board member is only allowed to represent the fundraising institution together with one or more other board members.

f. Close family or comparable relations between members of the governing board are not allowed.

g. The members of the governing board resign periodically. Appointments and any re-appointments are tenable for a maximum period of five years.

h. The members of the governing board of a fundraising institution are not allowed to be board member, founder, shareholder, supervisor or employee of:

   – an entity to which the fundraising institution directly or indirectly, wholy or partly yields the funds raised by it;

   – an entity with which the fundraising institution structurally conducts legal acts which are valuable in money.

   An entity as meant in this paragraph is equated with a legal person or entity which is – directly or indirectly – connected to the fundraising institution according to its statutes.

i. What is stated in subsection h does not apply with respect to an entity, or an entity – directly or indirectly – connected to it according to its statutes, to

which the fundraising institution yields funds (receiving entity) according to the objective stated in its statutes on the understanding that:

- the influence of a receiving entity on the appointment and nomination for appointment of the governing board of the fundraising institution is allowed to a limit of one third of the number of board members;

- no more than one third of the number of board members is allowed to consist of the persons mentioned under subsection h of this paragraph.

The board members mentioned here are – with the exception of representation by participation in acts of the governing board – not allowed to represent the fundraising institution.

j. What is stated in subsections h and i does not apply if and so far as consolidation, regarding the fundraising institution and the entity mentioned above, as meant in article 650.108 of the 'Richtlijn Verslaggeving Fondsenwervende Instellingen' (official accounting guideline), takes place.

k. The supervisory body is to consist of at least three natural persons.

l. In order to make decisions more than half of the number of members of the supervisory body has to be present at the meeting in person. Each member of the supervisory body has one vote.

m. Close family or comparable relations within the supervisory body and between members of the supervisory body and members of the governing board are not allowed.

n. The members of the supervisory body receive no remuneration as such, direct or indirect. A reasonable compensation for costs incurred by them on behalf of the fundraising institution and services rendered by them is not considered as remuneration. These compensations are shown and specified in the annual accounts.

o. The members of the supervisory body resign periodically. Appointments and any re-appointments are tenable for a maximum period of five years.

p. The members of the supervisory body of a fundraising institution are not allowed to be board member or employee of the fundraising institution.

Furthermore members of the supervisory body of a fundraising institution are not allowed to be board member, founder, shareholder, supervisor or employee:

– of an entity to which the fundraising institution directly or indirectly, wholy or partly yields the funds raised by it;

– of an entity with which the fundraising institution structurally conducts legal acts which are valuable in money.

An entity as mentioned in this subsection is equated with a legal person or entity which is – directly or indirectly – connected to the fundraising institution according to its statutes.

q. Subsection p does not apply with respect to an entity, or an entity – directly or indirectly – connected to it, to which the fundraising institution yields funds (receiving entity) in accordance with the objective stated in its statutes on the understanding that influence of a receiving entity on the appointment and nomination for appointment of members of the supervisory body is allowed to a limit of one third of the number of members of the supervisory body of the fundraising institution. In addition to this no more than one third of the supervisory body of the fundraising institution consists of members belonging to a receiving entity.

r. Subsections p and q do not apply if and so far as consolidation, regarding the fundraising institution and the entity referred to, as meant in article 650.108 of the 'Richtlijn Verslaggeving Fondsenwervende Instellingen' (official accounting guideline), takes place.

s. The criteria mentioned above under subsections a through r are to be expressed in the statutes of the fundraising institution.

Paragraph 1.c *– Conflict of interests*

The governing board and, if applicable, the supervisory body, guards against a conflict of interests between the fundraising institution and members of its governing board and/or its employees and/or, if applicable, the members of the supervisory body, the members of an advisory body and the members of a scientific council. In this respect each board member, member of a supervisory body, member of an advisory body and member of a scientific council is to issue

a statement as included in Enclosure 12* and give it to the CBF (* not included in this text).

a. In the event of a conflict of interests regarding a board member or supervisor, the member in question is to report this to the governing board or the supervisory body of which he or she is a member. Furthermore the member in question is to abstain from deliberations and decision-making in this matter. The presence of the member in question does not count when determining whether the quorum required for decision-making is met.

b. If a conflict of interests arises between the fundraising institution and one or more of its board members, the institution can only be represented if and so far as the statutes of the fundraising institution provide for this. The authority to represent the institution is not to be granted to those who are parties in the conflict of interests.

c. If the fundraising institution has a supervisory body, the statutes are to grant the authority to represent the institution to the supervisory body in the event of a conflict of interests between the institution and one or more of its board members. If a conflict of interests arises regarding forementioned body or one or more of its members, the first sentence of subsection b of this paragraph applies correspondingly. If the fundraising institution has the legal form of an association, the general meeting can appoint a representative at all times, in divergence of the contents of this subsection.

d. A conflict of interests as meant in the opening of this paragraph occurs among other instances if legal acts, which are valuable in money, are performed between i) the fundraising institution and the persons mentioned in the opening of this paragraph; ii) persons who have a close family or other relation with the persons mentioned in the opening of this paragraph; iii) legal persons of which the persons mentioned above under i and ii are board member, supervisor or stockholder.

e. The criteria mentioned above under the letters a through d are to be expressed in the statutes of the fundraising institution.

Paragraph 2 – Policy

a. With respect to the continuity of the activities, the governing board is to draw up a multi-year policy plan for a period of at least three years with

accompanying multi-year financial estimate. *The multi-year policy plan contains measurable objectives and the prioritization of these objectives. In order to draw up the multi-year policy plan a situation analysis is made. In this respect opportunities and threats, among other things, are considered.*

b. The multi-year policy plan and the activities of the fundraising institution are to be in accordance with the objective stated in its statutes.

c. *The governing board is to familiarize the employees of the fundraising institution with the outlines of the multi-year policy plan.*

d. Before the end of the fiscal year the governing board, or the supervisory body as meant in paragraph 1.B of this article, draws up an *annual policy plan and* budget for the following year, in which the policy and the financial guidelines *(will be: the objectives, programmes, activities and intended results)* are clearly described.

e. The governing board, or the supervisory body as meant in paragraph 1.b of this article, regularly and demonstrably inspects (*and evaluates)* the implementation of policy (the realization of the objectives, the programmes and the activities of the fundraising institution). *Where necessary the implementation of policy is adjusted.*

f. *The governing board, or the supervisory body as meant in paragraph 1.b of this article, establishes that the fundraising institution is adequately organized and equipped to implement the policy.*

Paragraph 3 – Fundraising, propaganda and public information (and communication)

a. *The fundraising institution is to structure external communications in such a way that the information supply offers a clear insight into the objectives of the organization and their realization and that the information is easily accessible. Furthermore the information from different perspectives (fundraising, public information and communication) is to be consistent.*

b. In fundraising, propaganda and public information the identity, the objective, the programmes and the financial needs of the fundraising institution are to be clearly described.

c. In the activities and expressions *(will be: external communications)* mentioned above the fundraising institution is to refrain from deception and comparison with other fundraising institutions.

d. The fundraising activities of the institution are directed at acquiring voluntary contributions and are not allowed to be intimidating.

e. On request the fundraising institution is to provide information regarding the issues mentioned above to all at all times.

f. The fundraising institution is to have a procedure for the reception and consideration of complaints. The fundraising institution makes regulations pertaining to this available to every interested party on request. The complaints received and their consideration are to be recorded in a register.

g. The fundraising institution is to see to a balanced division of the costs for fundraising and the costs for the realization of the objective. The costs for fundraising of the fundraising institution over a period of three consecutive years, expressed as a percentage of the revenues from its own fundraising in any one year, do not amount to an average of more than 25 % of the revenues from its own fundraising. The calculation of the percentage mentioned in the last sentence is applicable as from the third year of the existence of the fundraising institution.

h. With regard to a fundraising institution which submits a request as meant in article 3 of these Regulations in the fourth financial year after its foundation, in contravention to what is stated under letter g of this paragraph, the costs for fundraising in the third financial year after its foundation are not allowed to amount to more than 25 % of the revenues from its own fundraising. Furthermore the adopted budget for the financial year in which the request is made, should show that the costs for fundraising in that year will not amount to more than 25 % of the revenues from its own fundraising. If the CBF Seal is granted, the fundraising institution mentioned here is to comply with what is stated under i below in the fifth financial year after its foundation and with what is stated under g of this paragraph in the sixth financial year after its foundation.

i. With regard to a fundraising institution which submits a request as meant in article 3 of these Regulations in the fifth financial year after its foundation, in contravention to what is stated under g of this paragraph, the costs

for fundraising expressed as a percentage of the revenues from its own fundraising in the third and fourth year of its existence are not to amount to more than an average of 25 % of the revenues from its own fundraising in those years. Furthermore the adopted budget for the financial year in which the request is made, should show that the costs for fundraising in that year will not amount to more than 25 % of the revenues from its own fundraising. If the CBF Seal is granted, the fundraising institution mentioned here is to comply with what is stated under g of this paragraph in the sixth financial year after its foundation.

j. Where a financial year is mentioned, the complete financial year is meant.

Paragraph 4 – Expenditure of Funds

a. *The responsibilities regarding the expenditure of funds (including financing and the transfer of funds) are to be described clearly.*

b. The expenditure of funds is to be in accordance with the budget. Expenditures which deviate from the budget are to be sanctioned by a board decision to that effect.

c. Funds that have been given restrictions regarding their expenditure due to the nature of a project or due to third parties, are to be employed for the objective within a period of three years. Deviations from this are sanctioned by a board decision to that effect.

d. *With respect to the expenditure of funds the opportunities and threats for each expenditure category are to be assessed in advance each year.*

e. *The progress of expenditures for the objective is to be monitored and reported demonstrably.*

f. *The expenditures for the objective are to be evaluated and reported demonstrably on project, programme and organizational level.*

g. *The results of the progress check and the evaluation are to be considered when drafting a new policy cycle (multi-year policy plan and financial estimate, budget and accompanying activity plan).*

h. *The fundraising institution is to see to a balanced division between the overhead costs and the expenditures for the realization of the objective. The fundraising institution sets a standard for the level of its overhead costs.*

i. Any surplus after liquidation and settlement of the fundraising institution is to be spent in pursuance of its statutes in accordance with its objective, or is to be transferred to another institution which is recognized by the Inspector of Registration Duty and Inheritance Tax as an institution for the common good.

   In the event of a legal merger or split-up of the fundraising institution it must be evident from its statutes that the funds the fundraising institution gives in the merger or split-up as well as the profits emanating from them, can only be spent in deviation of the regulations applicable before the merger or split-up with permission from the court.

Paragraph 5 – Reporting

a. The annual report is to be drawn up in accordance with the 'Richtlijn Verslaggeving Fondsenwervende Instellingen' (official accounting guideline), *taking into account that the elements policy, communication, safeguarding the quality of the organization and expenditure of funds in relation to the objectives are clearly expressed in the governing board's report.* Any modifications in the 'Richtlijn' mentioned above have no legal effect on these CBF Regulations until after and so far as decided on to that effect by the governing board of the CBF after recommendation by the Board of Experts. Otherwise article 5 of these Regulations applies correspondingly.

b. The annual accounts are to be accompanied by an approving auditor's report.

c. The annual report as described in the 'Richtlijn Verslaggeving Fondsenwervende Instellingen' is public and is to be made available to interested persons within nine months after the end of the financial year, if so desired upon payment for the costs of reproduction.

Paragraph 6 – Additional requirements regarding the collection of usable clothing

a. The annual accounts are to include a survey movement of goods in accordance with "Enclosure D* Model commentary on the result sales and/or used goods" (* not included in this text).

b. The accountant is to state explicitly that the survey movement of goods is reported correctly and comprehensively.

c. If the collection of used clothing is contracted out, the contractee's accountant is to declare that the statement of the number of kilogrammes collected, which has been certified by the accountant, has been verified and that in his judgement the movement of goods has been reported correctly and comprehensively (see enclosure 11 (not included in this text)).

d. The progressive average net price realized per sold kilogram over the last three years is to constitute at least 25 % of the progressive average market price per kilogram over the last three years. In order to determine the market price per kilogram the starting point is the average gross price realized per kilogram used clothing of the fundraising institutions which collect the used clothing themselves by means of a picking up and bringing in system. The annual CBF publication "Statements clothes collections" includes an overview of the gross price realized, the costs and the net price realized over the past five years.

(Articles 5 through 17 are not included in this text)

QUESTIONNAIRE FOR THE CBF SEAL APPLICATION

(To be used as of July 2005)

Questions concerning the subject of policy

1. Who are actively involved in the process of formulating, determining and testing the objectives?

2. What information is used to determine the objectives?

3. In what way have the objectives been made measurable (for example by means of performance-indicators)?

4. Which preconditions (including opportunities and threats) for achieving the objectives have been included in the multi-year policy plan?

5. How are the objectives prioritized and what are the feasability terms for the objectives?

6. In what way are the objectives safeguarded to be in accordance with the objectives stated in the statutes?

7. How does it become apparent that the employees are informed of the objectives and of changes in them?

8. In what way are the goals, results, activities and means for the next financial year established and what safeguards are there that they are in line with the multi-year policy plans and the financial estimate?

9. How is the implementation of policy supervised and how often is a report made to the governing board?

10. In what way are the results of the implementation of policy evaluated and is the outcome included in the next policy-making cycle?

11. How does the institution establish whether the organizational structure (organization, tasks and responsibilities) and the administrative organization (procedures, financial guidelines and authorities) are adequately arranged to realize the objectives and how often and in what way is this evaluated?

12. In what way does the institution make sure that the employees have the right qualifications for the performance of their tasks?

Questions concerning the section on fundraising, public information and communication

13. How does it become clear that the external communications give a good insight into the objectives and their realization?

14. How are the different perspectives (fundraising, public information and communication) geared to one another?

15. How does it become clear that the communication objectives (distinguished into fundraising and expenditures for the objectives) are clearly described?

16. How does the institution make sure that the communication objectives and activities are in line with the objectives?

17. How does it become clear that the institution communicates its objectives and results to interested parties in an accessible way (frequency, actuality and obtainable through different media)?

18. In what way does the institution pay attention to (not) realized results and (not) realized objectives in its external communications?

19. Does the fundraising institution use a code of conduct (or comparable instrument) in which the basic principles for external communication are described and is indicated in this instrument that the organization is to refrain from misleading information, comparison with other fundraising institutions and intimidating behaviour?

20. How does it become clear whether the fundraising institution supervises observance of the code of conduct (or comparable instrument) and enforces observance if necessary?

21. How has the institution seen to it that the information mentioned above is obtainable to all at all times?

22. How is the complaint procedure set up and is this procedure available to every interested party?

23. How are incoming complaints handled, are these complaints evaluated and which terms are observed for this and how is made sure that repetition of complaints is prevented?

24. What is the policy (standards, attribution, and suchlike) of the fundraising institution concerning the costs for fundraising and is this in accordance with the requirements?

25. How does the institution periodically establish that the policy regarding the costs for fundraising is met and is action taken if necessary?

Questions concerning the section on expenditure of funds

Can the answers to the following questions concerning expenditures for the objective and organizational overhead costs be found in the expenditure (activity) plan:

A – Regarding expenditures for the objective

Decisionmaking

26. Who makes the decisions concerning expenditures, financing and the transfer of funds?

27. Which (documented) procedures are followed regarding decisions?

28. Who drafts and lays down these procedures?

29. How has the institution established that these decisions are made with sufficient expertise?

30. In what way are expenditures, financing and the transfer of funds tested on quality, feasibility (including insight into opportunities and threats) and relevance in light of the objective?

31. In what way are other organizations which are involved in the expenditures, financing and the transfer of funds tested on reliability, quality and continuity?

32. How are the results of the tests mentioned above determined and are measures taken to prevent noted deviations in the future if necessary?

33. Which (possibly standardized) conditions are used for the allocation (internally or externally) of funds?

34. In what way are decisions concerning expenditures, financing or the transfer of funds recorded and made known to parties involved?

Progress control

35. How, by whom and with what frequency does progress control (regarding the content) of the activities and the results achieved take place and how is insight given into the opportunities and threats signaled during their execution?

36. To whom is the progress of an activity reported?

37. How is the (internal) control of activities and the allocation of funds arranged and how and to whom is account of this given?

38. Which sanctions are imposed on non-observance of (internal and external) conditions?

Evaluation

39. How and by whom is the final result (including financial accounting) of the expenditures, financing and the transfer of funds assessed?

40. How and to whom is the final result of the expenditures, financing and the transfer of funds reported?

41. How have the activities and the results achieved as a whole contributed to the realization of the objectives?

42. How and with what frequency is the governing board informed about the realization of the objectives?

43. In what way has the institution seen to it that the results can lead to modifications in policy?

44. How and with what frequency are the criteria for assessment of the expenditures, financing and/or the transfer of funds evaluated and adjusted if necessary?

B – Regarding the organizational overhead costs

45. Has the fundraising institution set a standard for the level of the organizational overhead costs?

46. What is this standard based on?

47. What deliberances played a role in the establishment of the standard?

48. In what way and with what frequency does the institution check whether the standard is reached and to what action does deviation of the standard lead?

49. In what way does the institution give information about the standards used and the extent to which it does or does not succeed in reaching them?

Questions concerning the section on reporting

50. Is the institution in any way organizationally interwoven with other legal persons?

51. Is the institution part of an international association?

52. What is the institution's legal connection with the international association?

53. Is a consolidated balance sheet and statement of revenue and expenditure of the international association included in the annual report?

54. In what way is attention given to safeguarding the quality of the organization and the expenditures in the governing board's report?

55. How does the institution give insight into the extent to which the objectives for the financial year were achieved and what the causes are of any deviations?

56. Was an unqualified auditor's report obtained for the past financial years?

57. Is indicated in the report that the 'Richtlijn Verslaggeving Fondsenwervende Instellingen' (official accounting guideline) was used in the annual accounts?

58. In what way are the annual accounts available to interested parties?