

An Empirical Analysis of the Determinants of Financial Reporting Quality in Japanese Nonprofit Organizations: Focusing on Governance

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ABSTRACT

Nonprofit organizations play an important role in Japan. Yet, very few empirical studies, to our knowledge, have examined the financial reporting quality and governance of Japanese nonprofit organizations empirically. Addressing this research gap, we developed and tested hypotheses on financial reporting quality and governance. First, in terms of their characteristics, Japanese nonprofit organizations can be categorized by the type of competent authority system under which they function. In Japan's nonprofit sector, competent authorities provide guidance and supervision to correct reckless management. External audits are only mandated for certain nonprofit organizations. Second, governance might suppress earnings management within accounting standards in these organizations. Furthermore, earnings management may be reduced by decreasing pressure and incentives within and outside the organization. It is suggested that governing bodies and accounting standards should be unified. Legal supervision by governing bodies and audits might be ineffective. Finally, we propose future directions for the governance of Japanese nonprofit organizations.

Keywords: Governance, Nonprofit Organizations, Japan, Financial Reporting Quality, Structural Equation Modelling

ARTICLE INFO

Article History:

Received: 6 September 2025

Accepted: 8 October 2025

Available online: 31 December 2025

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INTRODUCTION

Nonprofit organizations, such as social welfare organizations, volunteer groups, NPOs, and residents' groups, complement government and market failures (Committee to Discuss Social Welfare Organizations, 2014). This relationship exemplifies their important role in Japan. Indeed, social welfare systems and markets have developed rapidly and flexibly in response to emerging needs arising from changes in socioeconomic conditions that cannot be adequately addressed by systems or market principles alone. Therefore, nonprofit organizations are assets created by mature societies, and their continual development is indispensable.

This study focused on the financial reporting quality of nonprofit organizations in Japan, where the proportion of services provided by nonprofit organizations is increasing. Unlike for-profit firms, nonprofit organizations are not subject to market checks, allowing room for fraud, the existence of which distorts the allocation of resources in society. As the proportion of services provided by nonprofit organizations increases, fraud becomes a serious phenomenon worthy of empirical investigation.

To date, fraud and discretionary behaviour have been analysed through the perspective of theories developed within European and American contexts. We shifted this focus to Japan. If our findings are consistent with established theories, it would bring us closer to confirming the universality of these theories (Nakashima & Yoshida, 2025). However, conflicting findings do not necessarily disprove theory but suggest idiosyncrasy in the case of Japan.

We especially focused on social welfare organizations, which have an overarching role as providers of welfare services in Japan. Their role in society is especially outsized in the context of a large, rapidly ageing Japanese population.

Despite the large corpus of literature on the governance of nonprofits (Baba, 2013a; Baba, 2013b; Fujioka & Inoue, 2023; Hotta, 2022; Nagahata, 2014; Natsuyoshi, 2021; Togo, 2023; Yoshida & Yokoyama, 2022) and empirical studies on for-profit organizations (e.g. Nakashima, 2019b) in Japan, to the best of our knowledge, empirical analyses on nonprofits

remains scant. Most studies in this area were either descriptive or theoretical. Fujioka and Inoue (2023), for example, surveyed university educational supporters, while Natsuyoshi (2021) analysed data on Japanese public-interest corporations and foundations. Neither focused on the relationship between governance and financial reporting quality, particularly regarding the determinants of financial reporting. Our aim was to address this gap in the literature.

In summary, we examined the relationship between financial reporting quality and governance, posing the following questions:

RQ1:What are the characteristics of financial reporting quality and governance of nonprofit organizations in Japan compared with those in other countries?

RQ2:Which governance factors are most effective for nonprofit organizations in Japan?

RQ3:What are the future directions for governance of nonprofit organizations in Japan?

This study contributes to existing literature on the governance of nonprofit organizations in Japan. No studies have focused on the relationship between governance and financial reporting quality in Japanese nonprofit organizations. Our findings should inform researchers and practitioners about effective governance factors related to the financial reporting quality of Japanese nonprofit organizations.

The remaining of this paper is organized as follows: Section 2 explains the characteristics of the quality of financial reporting and governance of nonprofit organizations in Japan compared with that of nonprofit organizations in other countries, and develops the hypotheses; Section 3 presents the methodology; Section 4 shows the results of hypotheses testing; Section 5 discusses the results; and Section 6 concludes.

LITERATURE AND HYPOTHESES

Financial Reporting Quality of Japanese Nonprofit Organizations

In research on for-profit firms, “financial reporting quality” is often referred to as “quality of earnings.” Financial analyses of for-profit firms focus on their earnings, which are often manipulated through discretionary management. The measure of earnings quality allows for a more comprehensive analysis of the financial conditions of for-profit firms. Among its indicators, Dechow et al. (2010) specifically identify earnings persistence, abnormal accruals, earnings smoothness, asymmetric timeliness and timely loss recognition, and target beating. Dichev et al. (2013) and Nakashima (2019a) respectively surveyed the earnings quality reported by chief executive officers of U.S. and Japanese for-profit firms.

In Japan, nonprofit organizations generally do not account for “earnings” in their operations. Instead, maintaining persistent net balances over the term is considered a requirement for stable operations. We defined financial reporting quality as “financial reporting of persistent, smooth, and positive net balances over the term,” and employed (1) persistent net balances over the term, (2) smooth net balances over the term, and (3) positive net balances over the term as indices for evaluating the financial reporting of nonprofit organizations.

Earnings management encourages financial reports that lack persistence and smoothness, and are thus of poor quality. While Nakashima (2019b) found that governance and internal controls were positively associated with earnings management, the Agency Theory suggests that sound governance and internal controls should mitigate earnings management. Krismiaji et al. (2016) concluded that board governance was positively associated with the relevance and faithful representation of accounting information in for-profit firms in Indonesia.

We assumed that these findings can also be applied to nonprofit organizations in Japan, where reform of social welfare organization system had tremendously improved governance and internal controls in social welfare organizations (Ministry of Health, Labour and Welfare, n.d., 1). Accordingly,

H₁: Governance and internal controls are negatively associated with the management of net balances over the term (equivalent to net income in private companies).

Governance of Japanese Nonprofit Organizations

Given our objective, we must provide an operational definition of “governance.” We followed the Charity Commission’s (2005) definition, which states that governance involves “the systems and processes concerned with ensuring the overall direction, effectiveness, supervision and accountability of an organization.” The governance of nonprofit organizations in Japan exhibits various characteristics: 1) a theoretical framework guiding practices, 2) governing bodies, 3) governance led by administrative organizations, and 4) limited external audits.

Theoretical Frameworks Guiding Practices

Several theories have been proposed to explain the mechanisms underlying governance in nonprofit organizations. A review of the Japanese literature highlighted three prominent theories: the Agency Theory (Murata, 2021; Natsuyoshi, 2021; Togo, 2023; Yoshida & Yokoyama, 2022), Stakeholder Theory (Hotta, 2022; Murata, 2021; Togo, 2023; Yoshida & Yokoyama, 2022), and Stewardship Theory (Hotta, 2022; Togo, 2023).

We noted that, according to Hambrick and Mason (1984), managerial background characteristics partially predicted organizational outcomes, strategic choices, and performance levels. For this reason, we also introduced the Upper Echelons Theory, which posits that managerial background characteristics partially predict organizational outcomes. Executives pursue discretionary activities when there is pressure from top management or incentives. Nakashima (2019b) hypothesized that pressure and incentives are positively associated with earnings management. This is also true for nonprofit organizations. To avoid this situation, Osano (2001) proposed appointing independent external directors, whereas Nagahata (2014) recommended introducing external directors to improve the board’s supervisory function. Accordingly,

H₂: Pressure and incentives are positively associated with the management of net balances over the term.

Governing Body

Nonprofit organizations in Japan differ from those in other countries. They are categorized based on the competent authority system under which they operate. However, there is a lack of widespread recognition among stakeholders and the general public regarding their unified sectoral organization (Ushiro & Sakamoto, 2017). Table 1 presents an overview of nonprofit organizations in Japan.

Table 1: Nonprofit Organizations in Japan

Type of nonprofit organization	Relevant laws and regulations
Public interest incorporated associations and foundations	Act on General Incorporated Associations and General Incorporated Foundations (Act No. 48 of June 2, 2006) Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundations (Act No. 49 of June 2, 2006)
General incorporated associations and foundations	Act on General Incorporated Associations and General Incorporated Foundations (Act No. 48 of June 2, 2006)
Corporations engaged in specified nonprofit activities	Act on Promotion of Specified Nonprofit Activities (Act No. 7 of March 25, 1998)
Social welfare organizations	Social Welfare Act (Act No. 45 of March 29, 1951)
Incorporated educational institutions	Private Schools Act (Act No. 270 of December 15, 1949)
Medical corporations	Medical Care Act (Act No. 205 of July 30, 1948)

Note: This table was prepared by the authors on page 8 of the Japanese Institute of Certified Public Accountants (2013).

If multiple governing bodies oversee nonprofit organizations, these governing bodies are likely to establish various accounting standards. Krismiaji et al. (2016) found that the relevance and faithful representation of accounting information increased after the adoption of International Financial Reporting Standards. Nakashima (2019b) hypothesized that accounting standards limit managers' earnings management decisions. Both studies suggested that accounting standards negatively influenced discretionary activities. However, at the time of Enomoto's (2019b) survey, Article 14 of the Act on Authorization of Public Interest Incorporated Associations and Public Interest Incorporated Foundations stated the following:

When public interest corporations operate their business for public interest purposes, they shall not obtain revenue that exceeds the amount compensating the reasonable cost required for the operation of said business for public interest purposes.

This is known as the “principle of balanced income and expenditure.” Given this principle, managers of social welfare organizations must manage net balances to avoid surpluses when adopting amended accounting standards. However, as Anthony (1984) stated, income above zero (or loss below zero) is not a measure of performance concerning service goals. Nevertheless, this positive or negative value conveys important information about an entity’s financial activities. A negative value indicates that the entity has not maintained equity. If this persists, the entity will face bankruptcy. As a result, social welfare organizations maintained a minimum net balance to ensure survival (Enomoto, 2019a). Accordingly,

H₃: Accounting standards are positively associated with the management of net balances to maintain minimum net balances over the term.

Governance Led by Administrative Organizations

The division of roles among the general meeting (the highest decision-making body in a nominal sense), the board of directors (with actual decision-making authority), and the secretariat (which manages activities) is unclear in Japanese nonprofits (Baba, 2013b). Often, representative directors engage in arbitrary management practices, the roles of the board of directors and secretariat are not differentiated, and directors directly intervene in activities, resulting in governance practices that deviate from legal standards (Baba, 2013b). Nevertheless, competent authorities do provide guidance and supervision to correct reckless management behaviour (Baba, 2013b).

This discussion suggests that the enforcement of laws by administrative organizations is effective in diminishing earnings management. Osano (2001) also suggested that law enforcement may suppress arbitrary managerial activities, while Nakashima (2019b) hypothesized that law enforcement was negatively associated with earnings management. This is also true for nonprofit organizations. Accordingly,

H₄: Law enforcement is negatively associated with the management of net balances over the term.

Limited External Audit

Krismiaji et al. (2016) stated that board governance, which includes the auditing committee, is positively associated with the relevance and faithful representation of accounting information. However, social welfare organizations in Japan do not have audit committees; they have internal auditors (Article 45-18 of the Social Welfare Act) and, in limited cases, external auditors (Article 45-19 of the Social Welfare Act). The Stakeholder Theory further suggests that an organization is obligated toward a group of stakeholders, including auditors. Effective auditors should reduce discretionary activities. This is also true for nonprofit organizations. Following Nakashima (2019b), we hypothesized that,

H₅: The presence of an auditor is negatively associated with the management of net balances over the term.

METHODOLOGY

Data and Sample

To test our hypotheses, we used structural equation modelling, following Enomoto (2019c), whose variables were derived from the “Survey on the Quality of Financial Reporting of Social Welfare Organizations” administered to the managers of Japanese social welfare organizations (Enomoto, 2019b), and from the financial statements of the organizations that participated in the survey obtained from the “Electronic Disclosure System of Financial Statements of Social Welfare Organizations” maintained by the Welfare and Medical Service Agency. A survey questionnaire was developed based on Nakashima (2019a) and pretested with a convenience sample of 16 managers of social welfare facilities in Wakayama Prefecture, Japan. It was then distributed to 585 social welfare organizations with external auditors. By 8 December 2019, 90 responses were received (response rate, 15.4%). Some participants did not complete the survey, so 62 complete responses were included in the analysis.

All respondents were managers of Japanese social welfare organizations offering welfare services to older persons, persons with disabilities, and children. Figure 1 illustrates the services offered by these organizations. There was no significant bias in the types of services offered.

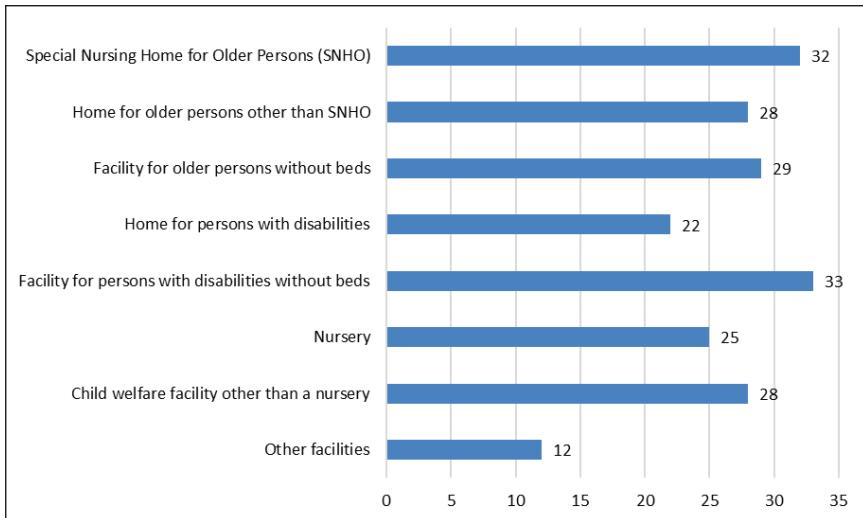


Figure 1: Services Offered by the Social Welfare Organizations

Note: This figure was prepared by the authors based on responses to Q1.2 of the survey.

This figure follows Nakashima (2019b).

Variable Definitions

We examined several variables based on Enomoto (2019c). The independent variables were as follows: 1) Pressure/Incentive (PI), derived from the averages of the responses to Q8.5(1)-(10) of the questionnaire (motivation to be involved in accounting fraud), ranging from one to five; 2) Financial Performance (FP), that is, the income from service activities at the end of the year divided by total assets, ranging from $-\infty$ to $+\infty$; 3) Accounting Standards (AS), that is, the average of the responses to Q4(2), Q7.1, and Q7.2 of the questionnaire (factors affecting net balances over the term), ranging from one to five; 4) Auditor (AU), that is, the average of the responses to Q4(9) and Q4(12) of the questionnaire (internal and external auditors), ranging from one to five; 5) Governance/Internal Control (GI), that is, the average of the responses to Q4(5) and Q4(6) of the questionnaire (internal controls and board), ranging from one to five; and

6) Law Enforcement (LE), that is, the average of the responses to Q4(13) and Q4(14) of the questionnaire (guidance and inspection by competent authorities and the amendment of laws), ranging from one to five.

The three dependent variables were 1) Balance Management 1 (BM1), derived from the response to Q5.1 of the questionnaire (discretion permitted for the financial reporting of social welfare organizations), ranging from one to five; 2) Balance Management 2 (BM2), derived from the response to Q8.1 of the questionnaire (percentage of organizations that use discretion for net balances for the term when disclosing financial performance within accounting standards), ranging from zero to a hundred; 3) Balance Management 3 (BM3), derived from the response to Q4(7) (choice of accounting policies of the organization when there are multiple options), ranging from one to five. As management of net balances over the term encourages financial reports of poor quality, these three variables were the proxies for lower reporting quality. In addition, these three variables were measured by single questions. However, the questions were simple and easy to understand. Therefore, there was little possibility of measurement error.

We included one mediating variable, Decision Usefulness (DU), which was derived from the averages of the responses to Q3(1)-(7) of the questionnaire (the use of data on net balances over the term), ranging from one to five.

Analytical Model

To test our hypotheses, we used structural equation modelling following Enomoto (2019c). We adapted Nakashima's (2019b) model and focused on the factors that determined discretionary activities in the financial reporting of nonprofit organizations. We did not adopt the analytical models applied to nonprofit organizations outside Japan because, as mentioned earlier, it sought the results of the analysis using Japanese theories. Following Enomoto (2019c), the following regression models were used for analysis:

Regression Model 1

$$BM_{i,t} = \beta_0 + \beta_1 FP_{i,t} + \beta_2 AS_{i,t} + \beta_3 AU_{i,t} + \beta_4 GI_{i,t} + \beta_5 LE_{i,t} + \beta_6 PI_{i,t} + \beta_7 DU_{i,t} + \varepsilon_{i,t}$$

Regression Model 2

$$BM2_{i,t} = \beta_0 + \beta_1 FP_{i,t} + \beta_2 AS_{i,t} + \beta_3 AU_{i,t} + \beta_4 GI_{i,t} + \beta_5 LE_{i,t} + \beta_6 PI_{i,t} + \beta_7 DU_{i,t} + \varepsilon_{i,t}$$

Regression Model 3

$$BM3_{i,t} = \beta_0 + \beta_1 FP_{i,t} + \beta_2 AS_{i,t} + \beta_3 AU_{i,t} + \beta_4 GI_{i,t} + \beta_5 LE_{i,t} + \beta_6 PI_{i,t} + \beta_7 DU_{i,t} + \varepsilon_{i,t}$$

Enomoto's (2019c) model, using path analysis, is shown in Figure 2.

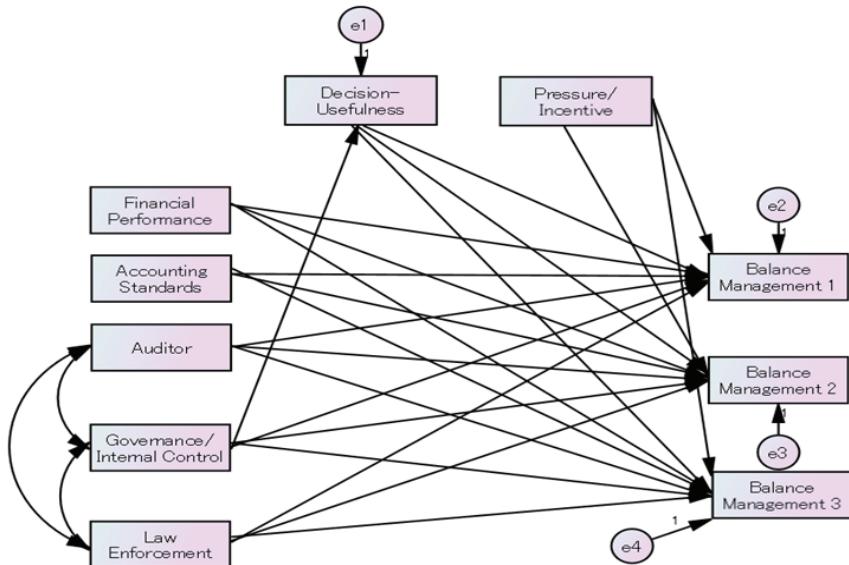


Figure 2: Analytical Model

Note: This figure was adapted from Nakashima's (2019b) model and modified by changing the concept from for-profit to nonprofit. Variable Definitions: Decision-Usefulness: Averages of Q3(1)-(7); Pressure/Incentive: Average of Q8.5(1)-(10); Financial Performance: Income from service activities at the end of the year/total assets; Accounting Standards: (Q4(2)+Q7.1+Q7.2)/3; Auditor: (Q4(9)+Q4(12))/2; Governance/Internal Control: (Q4(5)+Q4(6))/2; Law Enforcement: (Q4(13)+Q4(14))/2; Balance Management 1: Q5.1 discretion permitted for the financial reporting of social welfare organizations; Balance Management 2: Q8.1 percentage of organizations that use discretion for net balances for the term when disclosing financial performance within accounting standards; Balance Management 3: Q4(7), choice of accounting policies of the organization when there are multiple options.

RESULTS

Descriptive Statistics

Table 2 shows the descriptive statistics for the financial data and respondents' social welfare organizations, and Figure 3 shows the correlations for each variable.

Table 2: Descriptive Statistics of the Social Welfare Organizations (N=62)

Variables	Mean	Median	Std. Dev.	1st Quartile	3rd Quartile	Min.	Max.
Decision-Usefulness	3.486	3.429	0.672	3.107	3.857	1.714	5.000
Pressure/Incentive	2.218	2.200	0.686	1.875	2.700	1.000	4.000
Financial Performance	0.605	0.543	0.358	0.421	0.686	0.194	2.747
Accounting Standards	2.743	2.696	0.516	2.354	3.101	1.619	4.167
Auditor	3.000	3.000	1.004	2.000	4.000	1.000	5.000
Governance/Internal Control	3.161	3.000	0.819	2.500	4.000	2.000	5.000
Law Enforcement	3.315	3.000	0.811	2.875	4.000	2.000	5.000
Balance Management 1	3.032	3.000	0.701	3.000	3.000	1.000	5.000
Balance Management 2	43.661	40.000	27.315	20.000	60.000	0.000	100.000
Balance Management 3	2.887	3.000	1.042	2.000	4.000	1.000	5.000

Note: This table was prepared based on Nakashima (2019b). We modified the concept from for-profit to nonprofit. Variable Definitions: Decision-Usefulness: Averages of Q3(1)-(7); Pressure/Incentive: Average of Q8.5(1)-(10); Financial Performance: Income from service activities at the end of the year/total assets; Accounting Standards: (Q4(2)+Q7.1+Q7.2)/3; Auditor: (Q4(9)+Q4(12))/2; Governance/Internal Control: (Q4(5)+Q4(6))/2; Law Enforcement: (Q4(13)+Q4(14))/2; Balance Management 1: Q5.1 discretion permitted for the financial reporting of social welfare organizations; Balance Management 2: Q8.1 percentage of organizations that use discretion for net balances for the term when disclosing financial performance within accounting standards; Balance Management 3: Q4(7), choice of accounting policies of the organization when there are multiple options.

Table 3: Correlation of Variables

Correlations: Correlations above (below) the diagonal are Pearson (Spearman) correlations. The bottom number for each variable indicates the two-tailed p -value, and ** denote significance at the 5% and 1% levels, respectively. This table was constructed according to Nakashima (2019a). While the table constructed by Nakashima (2019b) was for for-profit firms, it was adapted for nonprofit organizations. The definitions of these variables are similar to those listed in Table 2.

Model Fit

The goodness-of-fit index (GFI) of Enomoto's (2019c) model was 0.819. The higher the GFI, the better the model fit. The normed fit index (NFI) and comparative fit index (CFI) of the model were 0.685 and 0.713, respectively. A model is considered to have a good fit when the NFI and CFI values are close to 1. The root mean square error of the approximation (RMSEA) for the model was 0.218. A lower RMSEA value is considered better.

Enomoto (2019c) prioritised the comparability between for-profit firms and nonprofit organizations. Therefore, the model must be similar to that of Nakashima (2019b), resulting in relatively poor model fit.

Model Results

Table 4 and Figure 3 present the results of Enomoto's (2019c) analysis.

Table 4: Model Estimates

			Estimate	P	
Decision-Usefulness	<---	Governance / Internal Control	0.368	***	***
Balance Management 1	<---	Decision-Usefulness	-0.187	0.184	
Balance Management 2	<---	Decision-Usefulness	8.518	0.09	*
Balance Management 3	<---	Decision-Usefulness	0.313	0.041	**
Balance Management 1	<---	Financial Performance	0.059	0.802	
Balance Management 2	<---	Financial Performance	22.896	0.007	**
Balance Management 3	<---	Financial Performance	-0.087	0.736	
Balance Management 1	<---	Accounting Standards	0.164	0.318	
Balance Management 2	<---	Accounting Standards	7.741	0.185	
Balance Management 3	<---	Accounting Standards	0.61	***	***
Balance Management 1	<---	Auditor	0.172	0.207	
Balance Management 2	<---	Auditor	-1.766	0.717	
Balance Management 3	<---	Auditor	0.14	0.347	
Balance Management 1	<---	Governance / Internal Control	0.065	0.655	
Balance Management 2	<---	Governance / Internal Control	-9.406	0.069	*
Balance Management 3	<---	Governance / Internal Control	0.171	0.279	
Balance Management 1	<---	Law Enforcement	-0.019	0.906	

Balance Management 2	<--- Law Enforcement	-8.679	0.136
Balance Management 3	<--- Law Enforcement	0.162	0.364
Balance Management 2	<--- Pressure / Incentive	14.603	*** ***
Balance Management 1	<--- Pressure / Incentive	-0.138	0.264
Balance Management 3	<--- Pressure / Incentive	-0.037	0.784

Note: This table illustrates the results of structural equation modelling based on Nakashima's (2019b) model. This table was constructed by modifying the concept from for-profit to nonprofit.

The definitions of the variables are similar to those shown in Figure 2.

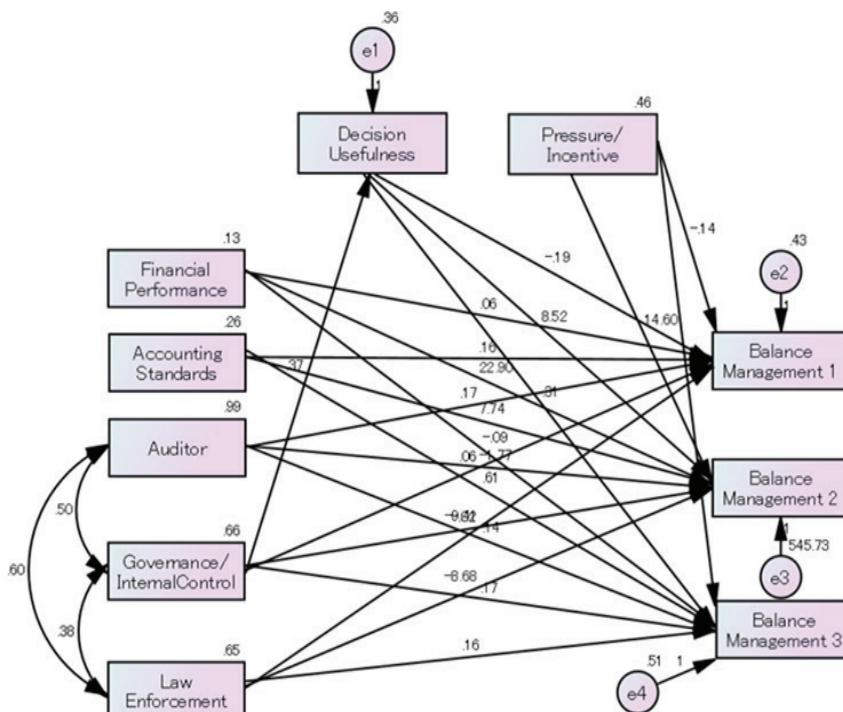


Figure 3: Model Estimation

Note: This figure illustrates the results of structural equation modelling based on Nakashima's (2019b) model. This figure was constructed by modifying the concept from for-profit to nonprofit. The definitions of the variables are similar to those shown in Figure 2.

Hypotheses Testing

Testing of H1

Governance and internal controls were negatively associated with the management of net balances over the term. This suggested a negative causal relationship of governance and internal controls with the management of net balances over the term. According to Enomoto (2019c), the estimated causal relationship from Governance/Internal Control (GI) to Balance Management 2 (BM2) was negative (-9.406), which was statistically significant at the 10% level (0.069). Although the significance level was 10%, governance and internal controls might have suppressed earnings management within accounting standards in nonprofit organizations. Therefore, H1 was supported.

Testing of H2

Pressure/Incentive was positively associated with the management of net balances over the term. This suggested a positive causal relationship between pressure/incentives and the management of net balances over the term. According to Enomoto (2019c), the estimated causal relationship from Pressure/Incentive (PI) to Balance Management 2 (BM2) was positive (14.603) and statistically significant at the 0.1% level (**). Therefore, H2 was supported, suggesting that earnings management within accounting standards may be mitigated by reducing pressure and incentives within and outside an organization.

Testing of H3

Accounting standards promoted managers' decisions regarding the maintenance of minimum net balances over the term. This finding suggested a positive causal relationship between accounting standards and the management of net balances over the term. According to Enomoto (2019c), the estimated causal relationship from Accounting Standards (AS) to Balance Management 3 (BM3) was positive (0.61) and statistically significant at the 0.1% level (**). Therefore, H3 was supported. This finding implied that accounting standards, depending on their content, may encourage broader choice of accounting policies. In the presence of multiple governing bodies with different accounting standards, organizations are likely to select and adopt those that facilitate easier earnings management. Therefore, the governing bodies and accounting standards should be unified.

Testing of H4

Law enforcement was negatively associated with the management of net balances over the term, suggesting a negative causal relationship between law enforcement and the management of net balances over the term. According to Enomoto (2019c), the estimated causal relationship from Law Enforcement (LE) to Balance Management 1 (BM1) was negative (-0.019), and that from Law Enforcement (LE) to Balance Management 2 (BM2) was also negative (-8.679). However, both results were not significant. Limited sample size (n=62) and poor model fit might have contributed to this result. Therefore, H4 was not supported. It might have indicated that legal supervision by governing bodies was ineffective.

Testing of H5

Auditor was negatively associated with the management of net balances over the term, suggesting a negative causal relationship between auditor and the management of net balances over the term. According to Enomoto (2019c), the estimated causal relationship from Auditor (AU) to Balance Management 2 (BM2) was negative (-1,766). However, this result was not significant. Limited sample size (n=62) and poor model fit might have contributed to this result. Therefore, H5 was not supported. It might have indicated that auditors were ineffective. Consequently, introducing external audits to all nonprofit organizations may not be beneficial.

DISCUSSION

This study examined the financial reporting quality and governance of nonprofit organizations in Japan, clarifying the relationship between financial reporting quality and governance of nonprofit organizations in Japan.

First, it explored the characteristics of financial reporting quality in Japanese nonprofit organizations. Second, it elucidated the governance characteristics of these nonprofit organizations.

The Stakeholder Theory remains a popular lens of analyses among scholars because of the characteristics of Japanese nonprofit organizations. These entities differed from those in other countries in several ways, one

of which was their classification based on the type of competent authority that provides guidance and supervision to correct reckless management behaviour. Despite their importance, both stakeholders and the general public failed to fully recognize the unified sectoral organization of nonprofits (Ushiro & Sakamoto, 2017).

Finally, we established that external audits were mandated only for a limited number of nonprofit organizations.

Hypotheses testing revealed that governance, reduced pressure and incentives for management, unified governing bodies and accounting standards might have mitigated earnings management. However, legal supervision and auditors seemed to be ineffective at mitigating earnings management.

CONCLUSION AND RECOMMENDATION FOR FUTURE RESEARCH

Given the factors we found that were effective or ineffective in mitigating the earnings management of nonprofit organizations in Japan, we propose the following future directions for the governance of Japanese nonprofit organizations as key implications of the study.

First, the introduction of external directors is beneficial. Our hypothesis testing showed that appointing external directors was a good choice, as Osano (2001) and Nagahata (2014) suggested as well. Currently, incorporated educational institutions require external directors (Article 31, paragraph (4), item (2) of the Private Schools Act), but no such provisions exist for other types of nonprofit organizations. In the for-profit sector, public companies must appoint external directors (Article 327-2 of the Companies Act (Act No. July 86 26, 2005)), and nonprofit organizations also require external oversight. As pressure and incentives are positively associated with the management of net balances over the term, earnings management can be mitigated by reducing both internal and external pressures and incentives. Introducing external directors would lessen the pressure from the board on earnings management, making their appointment a critical future direction.

Second, the centralization of the governing bodies is recommended. As previously noted, Japanese nonprofit organizations are categorized under a competent authority, with little recognition among stakeholders and the general public regarding their unified sectoral organizations (Ushiro & Sakamoto, 2017). Given the choice of multiple governing bodies with different accounting standards, organizations will likely choose standards that facilitated earnings management. Centralizing these governing bodies is essential to close this loophole. The governance reform of public-interest corporations was an attempt to address this. It abolished the previous system permitting the establishment of public-interest corporations by competent government agencies. However, given that various types of nonprofit organizations still exist (Table 1), they should be merged into a single organization with a centralized governing body.

Third, rigorous enforcement of laws by governing bodies is crucial. Our findings suggested that law enforcement was not negatively associated with the management of net balances over the term, indicating that legal supervision by regulatory agencies may be ineffective. Counteracting this effect requires improvements to the quality of law enforcement officials in the governing bodies as well as effective law enforcement.

Fourth, enhancing audits in nonprofit organizations is essential. Our findings indicated that auditors were not negatively associated with the management of net balances over the term, suggesting that audits of nonprofit organizations may be ineffective. Before implementing external audits across nonprofit organizations, it may be necessary to enhance the effectiveness of internal and external audits.

While acknowledging these contributions, we must also mention some limitations of the study. Regarding the survey questionnaire by Enomoto (2019c), there were some limitations. First, as the response rate was 15.4%, there might be non-response bias. Second, the sample size (n=62) was relatively small. Third, the survey was self-recording format, therefore, there might be erroneous responses. Fourth, the respondents were limited to social welfare organizations with external auditors. In addition, the model showed relatively poor fit. Balance management variables were derived from single questions, therefore, there might be potential measurement errors. These limitations must be addressed in future research.

ACKNOWLEDGEMENTS

We thank Nguyen To Tam for the valuable discussions and comments at the Academic Paper Session of the 2024 Annual Conference of the Asia-Pacific Management Accounting Association.

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