Welcome to the Nonprofit Quarterly’s special issue on the proposed shifts in the federal regulatory environment for public charities. This publication is designed primarily to inform nonprofits of all sizes and stripes about activity taking place on the national stage, and as always, we have also tried to provide you with analyses, with a sense of context, and avenues for action. Some of this action should be taken at the organizational governance level (see “Is Accountability the Same as Regulation?” on page 2). Some action should be taken to support advocacy at a national legislative level (see “Ragging the Puck: Not a Viable Strategy for the Whole Game” on page 14). The analyses we have provided are intended to help you think critically about the proposals in play and your choices for involvement.

To assist in context-setting, this issue includes two maps (an EZ version and a more complicated version) depicting the complex regulatory environment we live in. The complex map is designed to be posted. We have left space for your own additions. We have also tried to provide a historical and political context in “How Did We Get Here: The Regulatory Framework 2005” by Jon Pratt on page 18.

We do want to acknowledge the many partners that we have had in producing this issue of NPQ. Our funding partners included Carnegie Corporation of New York, the Philanthropic Collaborative, Rockefeller Brothers Fund, and the Surdna Foundation. These foundations contributed quickly to this effort, enabling us to get this material to you in real time, and we are grateful for their faith in us to do so.

Ruth McCambridge and Jon Pratt were the co-editors of this issue, aided by Andrew Crosby. Our intellectual partners and editorial contributors include Angela Bies at Texas A&M University; Woods Bowman at DePaul University; Rick Cohen with the National Committee for Responsive Philanthropy; Julie Floch at Eisner LLP; Scott Harshbarger, former Attorney General of Massachusetts and former President of Common Cause; Bill Josephson, formerly with the New York State Attorney General’s Charities Bureau; and Bob Ottenhoff at GuideStar. Our readers, who contributed comments and helped fine-tune our analysis (but bear no responsibility for any shortcomings) included Audrey Alvarado at National Council of Nonprofit Associations, Elizabeth Boris at the Urban Institute, Rick Cohen, Terry Knowles at the New Hampshire Attorney General’s office; Bob Ottenhoff, Jonathan Spack at Third Sector New England, and Tim Walter at the Association of Small Nonprofit Associations, Elizabeth Boris at the Urban Institute, Rick Cohen, Terry Walter at the Association of Small Nonprofits (note: not all readers contributed to all articles).

The pull-out map included in this issue is the work of Jon Pratt, brilliantly rendered by designer and illustrator Gregg Dinderman. Finally, as a member of our editorial advisory board Rick Cohen deserves a special vote of thanks in that this issue was originally his idea.

We hope you enjoy this special issue, and if you are not yet a regular subscriber, subscribe today!
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Is Accountability the Same as Regulation? *Not Exactly*

by Ruth McCambridge

The regulatory configuration surrounding public charities is multidimensional, and its effects vary from one organization to the next. As the simplified map on the next page shows, the basic structure of that environment includes:

- A nonprofit board’s own practices for ensuring that the organization is properly accountable to its stakeholders.

- The standards promulgated by a self-regulating professional group; these may be used to accredit the whole organization or various parts for a particular type of work.

- The voluntary ethics and accountability standards programs promulgated by organizations such as state associations of nonprofits, the Better Business Bureau, or the Evangelical Council for Financial Accountability.

- The various requirements (be they rigorous, modest, or whimsical) attached to grants and contracts by intermediary funding organizations, foundations, or government agencies.

- State charitable registration requirements implemented by the charities divisions of state attorneys general. Resources for monitoring and enforcement among these offices vary widely, and 12 states have no registration.

- The filing and annual reporting requirements of the IRS and the federal government.

- The increased scrutiny of the public made possible by the National Center for Charitable Statistics, GuideStar, charity watchdog organizations, and the press.

Again, this is a simplified map. We have included a pull-out map in this issue as well describing in greater detail what the nonprofit regulatory landscape looks like.

For many nonprofits with modest funding and multiple programs and funding sources, the number and variation of external accountability requirements can seem overwhelming. We believe accountability requirements need to be restructured so they are reasonable, cohesive, and size-sensitive.

This special supplement to *NPQ* urges nonprofits to get involved in educating Congress and state officials to encourage cohesion and reasonableness in the public regulatory environment. Disclosure and reporting requirements do not need to be further complicated to ensure quality reporting and enforcement—they need to be streamlined and fine-tuned; funding needs to be made available for transparency and enforcement; and a few laws and regulations around a few classes of organizations, primarily in philanthropy, need serious strengthening.

**Setting the Stage**

Regulation is important, but it does not equal accountability. In fact, it almost always misses one of the most important elements of accountability: our responsibility to the cause we are established to benefit.

When we at *NPQ* think about the word accountability, the first thing that comes to mind is not external regulation by the IRS or...
anyone else. Our first thought is about the integrity of the governance system for each individual nonprofit. This internal system has to be the primary mechanism that adjusts and readjusts the organization’s direction and strategies to ensure that it is operating in the best interests of those it is designed to benefit.

We operate in trust to them, but the people whose needs we are meeting have no legal “standing.” In other words, they cannot require accountability of us—although donors can. The first line of defense to keep nonprofits “of use” to their primary beneficiaries is the commitment of the board to provide optimal value. This critical day-to-day accountability is influenced by who is on the board, to whom board members feel responsible, and how well the board bases its decision-making in sound transparency and consultation processes with its constituency. The nonprofit and foundation regulatory environment does not mandate that we engage with our communities. We must require that of ourselves.

The Regulatory Environment Is Heating Up

“[F]ar too many charities have broken the understood covenant between the taxpayers and nonprofits—that charities are to benefit the public good, not fill the pockets of private individuals. Too many well-meaning charities have fallen prey to the charlatans’ pitch about easy money. Some charities are blinded by their own mission and the need for additional dollars. These charities are willing to sign onto deals that provide dollars to promoters and insiders but only pennies to the charity. It is the taxpayers who are the losers.”

Opening Statement of Sen. Chuck Grassley
Senate Finance Committee Hearing on Charitable Giving; June 22, 2004

The Senate Finance Committee is well on its way to legislating the further regulation of the nonprofit sector, posed as an effort to hold nonprofits more consistently accountable. Senators and congressmen are anxious to add that they know that the large majority of nonprofits out there are acting within reasonable legal limits, but . . . those few bad apples cause this drive for better regulatory controls.

On the East Coast, and particularly in Washington, repeated media stories have exposed stolen funds (United Way of the National Capital Area), questionable real estate deals (the Nature Conservancy), and eye-popping private foundation trustee fees (Boston Globe series). The IRS raised a series of alarms about nonprofits being used as accommodations to abusive tax shelters, and questioned the actual value of vehicle donations to charities that taxpayers were claiming as tax deductions. Senator Grassley’s and Baucus’s sponsorship of legislation with tax advantages to land trusts such as the Nature Conservancy, just before the Washington Post ran its exposé on the Nature Conservancy’s land...
deals, could not have helped build confidence in the current regulatory framework.

Those in Washington, DC that are most concerned with the nonprofit sector are abuzz about the goings-on at the Senate Finance Committee—a typical “inside the beltway” drama with many acts and actors—but how important is it to you?

The truth is that a revision of the “controls” (which in this conversation are largely comprised of financial and reporting disclosure mechanisms) is unquestionably needed for everyone’s sake, particularly in light of the fact that there is increased public access to the information contained in those reports. Still, such tinkering with the controls is insufficient as a response either to the core accountability problem among nonprofits or to the problems that have emerged as the corporate scandals of the sector.

**Why is the Regulatory Environment Heating Up?**

Probably the single most powerful thing that has been done over the past decade to enhance public charities’ accountability is the establishment of GuideStar. According to Steve Miller, IRS Chief of Exempt Organizations, GuideStar’s online provision of Forms 990 has “changed the face of philanthropy.” The federal government has not been the pivotal player here—philanthropy has, paying most of the freight for the development of a mechanism that provides public access to public information. The development of a data repository to hold and provide access to 990 reports has opened a can of worms. We now not only know what any particular nonprofit chooses to report on their 990, but we also know, through a massive research effort conducted by the Urban Institute and the Center on Philanthropy at Indiana University, that these reports aren’t very reliable. This realization has sparked efforts to get the report format and related requirements revised. It has also, along with all of the activity around corporate governance and Sarbanes-Oxley, called audit activities among nonprofits into question.

**Is the Regulatory Environment Inadequate?**

Some of the conversations around tightening up oversight of nonprofits might lead you to believe that we are currently operating in something of a wild west scenario. This, of course, could not be further from the truth for many nonprofits who are faced with a dizzying array of regulators and people who demand documented accountability. Many nonprofits have federal or state contracts with high regulatory requirements, or are connected to professional associations that accredit all or parts of what they do. Foundations and United Ways have their own, often somewhat unique, sets of accountability requirements.

**Who/What/Where is the Problem?**

Accountability is always a mix of self and external controls. It is critical to find the right balance of the two. There are many highly regulated situations where the culture is to beat the regulations or to drift to the lowest allowable compliance level.

On the other hand, to have no regulations or monitoring where other people’s money is being used in trust is absurd. There are simply too many entrepreneurial souls out there looking for the right niche for their next scam. We also need the exercise of discussing what our ethical guidelines should be and agreeing upon a set of basic steps that ensure that these are adhered to.

Can reforming audits and the Form 990 do the trick? Not without a whole raft of other activities. Some of these must be aspirational—self-generated at the individual organizational level and association level—but some must, inevitably, be connected to enhanced reporting, monitoring and enforcement mechanisms.

**Let’s Talk!**

E-mail us, referring to this article, at: feedback@nonprofitquarterly.org.
Making the Best Use of IRS Form 990

by Robert G. Ottenhoff

GUIDE STAR responds to more than one hundred phone calls and e-mails every day, a significant number of which are from the employees of nonprofit organizations. They are all engaged in the difficult task of trying to make their organizations more transparent and accountable. This is a remarkable development—one that underscores the transformation taking place in the delicate relationship between nonprofits and our funders, whether they be foundations, government agencies, or individuals.

Three big trends are driving this demand for information.

First is the increasing demand for transparency and accountability. We’re hearing it from sources like the Senate Finance Committee, but we’re also noticing it in requests for more openness from government, schools, and religious institutions.

Secondly, donors are seeking more information on which to make decisions. Corporate and private foundations, and government agencies are now starting to undertake more due diligence—better data makes better decisions.

Finally, philanthropy’s demographics are changing. Traditionally, philanthropy was considered something reserved for the wealthy, or something we only began to think about when we were putting together our wills or bequests.

Over the last decade, however, we’ve seen the rise of a new type of donor: more proactive individuals who have the resources to contribute while they are still alive and want to be engaged with the charities they support. Not content with merely giving to worthy causes, these new donors view their charitable gifts as philanthropic investments. They monitor the results of their donations just as they monitor the results of their financial investments.

GuideStar receives a lot of calls about organizations’ IRS Form 990. Initially, many of the 990 calls had an indignant air to them: “How dare you take my 990 and post it to a public Web site for all to read?” Now the tide has turned. Today, the nonprofits’ calls have an air of urgency: “What’s taking you so long to post my 990? My donors want to see it before we get our next grant.” Some organizations are responding to these new demands by trying to post more data—such as information on boards and senior management—on GuideStar. Others include summaries of the year’s accomplishments and a look ahead at goals for the coming year.

Other callers want to know why an organization doesn’t have a 990 posted. Slowly, the public is recognizing the fact that many nonprofits—including organizations with annual incomes of $25,000 or less, most faith-based organizations, and subsidiary organizations, to name only a few—are not required to file a 990. This creates a gaping hole in providing nonprofit data.

Robert G. Ottenhoff is president and CEO of GuideStar. To find out more about GuideStar services, go to www.guidestar.org.
Despite the growing public importance of the 990, we still find a significant number of errors in returns:

“Details available on request.” More than one 990 on our site uses this phrase in place of the information required. Don’t. The 990 is a form submitted to the federal government under penalty of perjury, not a résumé. In IRS-speak, not providing the required data constitutes “failing to provide a complete and accurate return,” and an organization can be fined for it.

Altering the form. On other 990s, the preparers have crossed out a line here and inserted something else; one form on our site shows the word “Interest” struck out in Part II, line 41, and “Insurance” written in its place. Bad idea, especially since the preparer could have indicated insurance costs just two lines later, in line 43, “Other.”

Failing to provide a description of your organization’s exempt purpose in Part III. This is a common—and completely unnecessary—error. Not only could the organization be fined for failing to provide a complete return, but it is also missing a prime opportunity to tell the world about its mission.

Including private information in public portions of the 990. We’ve found bank account numbers, aid recipients’ Social Security numbers and addresses, and other confidential information in charities’ 990s. Although the identity of contributors to public charities (reported on Schedule B) is confidential, the rest of the 990 isn’t. Don’t worry if you’ve made a mistake in the past, Guidestar can mask improperly reported, sensitive information on Form 990, for a small fee.

All of this leads me to a few conclusions:

We need to be more realistic about the strengths and weaknesses of Form 990. Making it available publicly on the Internet has had an enormous positive impact on the effectiveness and efficiency of the sector. But the document is hard for many to complete. The guidelines are open to interpretation and are not consistently followed; mistakes are easy to make; and the information is not always timely. Many people are working to improve this situation, but it will take years to complete.

The imperfections of the 990 also mean one should be careful about making judgments from it. GuideStar recommends that evaluators look at multiple years before drawing a conclusion. Better yet, we urge organizations and founda-

For all of its weaknesses, the 990 is the only document that hundreds of thousands of exempt organizations file each year. This makes it the only common denominator we have for assessing the work of those organizations.
RELATIONSHIPS WITH AUDITORS HAVE been a central issue in corporate scandals such as Enron and WorldCom. It was addressed by the Sarbanes-Oxley reform for public companies and has rightly been a nonprofit sector concern.

The Senate Finance Committee proposals have focused on whether audits should be mandated for nonprofits (and if so, at what threshold level) whether rotation of auditors should be required, and what other accountability and reporting measures should be established. Before either embracing or rejecting these proposals, it is critical to understand what an audit does and does not provide. This article addresses what boards (and management) should expect from the audit process, as well as ways to evaluate whether the best services are being provided.

How are financial statement audits related to accountability? What does an audit really tell the reader of financial statements? Simply stated, an audit tells the reader whether the financial information that management has reported to the auditors properly portrays the financial health of the organization as of a given date (typically its year-end, although audits should also report substantial subsequent events). So, assuming an “unqualified” audit opinion, the reader can take some comfort that financial information presented by management can be relied upon.

The audit opinion itself does not address the systems or procedures at an organization that helped to create these figures, nor does it provide any form of assurance on these systems or procedures. No one outside the organization and its board should rely on an organization’s financial statement audit opinion to gauge the efficiency and effectiveness of an organization’s internal reporting mechanisms.

During the audit, the auditor may discover weaknesses or areas of potential problems in an organization’s internal controls, but this is not specifically communicated in the audit opinion on the financial statements. In fact, this information—which should be communicated by the auditor to the board as a by-product of the audit process, in the form of a “management letter”—is generally private information for the board of the organization and not for public consumption.

Nonprofit Quarterly editors recently had the opportunity to interview Julie Floch, CPA, Director of Not-for-Profit Services at Eisner LLP, and Bill Josephson, former Assistant Attorney
General in charge of the Charities Bureau of New York Attorney General Eliot Spitzer’s Law Department, about their views on organizational governance concerns and the audit process. Anyone who knows these two knows that they often agree to disagree, but there were many points on which they concurred, mainly on the importance of the nonprofit sector and the absolute requirement for stronger assumption of responsibility and accountability by nonprofits, their boards, and the auditors who serve them.

First, to set the stage: Bill Josephson is an imposing figure. He seems to enjoy scaring the bejeezus out of people (albeit for their own good) by asking them questions that test their understanding of their own fiduciary responsibilities. Julie Floch is a diminutive figure, but not exactly a retiring personality. In our session with them they went toe-to-toe primarily about the fascinating topic (in their opinion) of the appropriateness of the audit process, the stance of boards and management with regard to this process, and other governance concerns.

Both believe, as stated previously, that there are critical governance and reporting issues that are not reflected in an audit report, including potential or real problems in the checks and balances of the financial systems. And sometimes, those problems conceal improper practices, fraud, or even insolvency. Thus the outside reader of the financial statements, while perhaps able to rely on the year-end financial information shown, is unable to gauge what is “really going on” at the organization from the financial statements alone.

As Floch observes, “An unqualified opinion by an auditor does not indicate the quality of management’s reporting processes underlying the financial information shown. For example, an auditor can begin the audit fieldwork and recommend many substantial adjustments to the financial statements in order for them to be fairly stated in conformity with generally accepted accounting principles. If management
agrees, it adjusts the financial statements. The adjusted financial statements are then released into the marketplace with an unqualified auditor’s opinion—because the information presented is now fairly stated in conformity with generally accepted accounting principles. By contrast, another organization presents its financial statements to the auditors, and the auditors test the information presented, and find that they have no adjustments to recommend because they believe the information as presented is fairly stated in conformity with generally accepted accounting principles as is. This audit also goes out into the marketplace with an unqualified opinion. And yet, we would all agree that in the first case the organization is probably operating with poor and inaccurate information. And yet, we would all agree that in the first case the organization is probably operating with poor and inaccurate information, perhaps leading it to make dangerous fiscal decisions, while the second organization’s financial systems are more reliable.”

“The public looking at these two sets of financial information has no way of knowing what the audit fieldwork processes were behind either opinion. There is no tool that communicates to the public (although as mentioned before, there should be a management letter presented internally) that on this internal control level the organization is not functioning as it should. The audit report merely signifies that the auditor believes that the financial information in the financial statements at that point in time is fairly stated, regardless of the processes used to get to those figures.” Josephson is critical of this and believes “too many auditors do not properly assess the organization’s ability to continue to operate.” He believes that auditors’ concerns about the organization’s ability to continue as a “going concern,” if it exists, should be communicated in the audit opinion well before insolvency is imminent.

Josephson and Floch agreed that the audit’s usefulness to management and the board is severely curtailed if it is not accompanied by a detailed management letter and a meeting with the appropriate board oversight committee (preferably the audit committee, but if not, then the board of directors itself) to discuss the audit process and audit findings (including the processes that were needed to adjust the financial statements). While the auditor can communicate these management letter findings either orally or in writing, both stressed that the board should insist that the communication be in writing. Josephson said that he has seen many instances where there were no management letters provided to organizations where the internal controls were clearly lacking, and he believes that to be the result of poor training and expertise of some auditors who work in the nonprofit field and others who may not accord to their nonprofit work the same standards and practices they accord to their for-profit work. He believes these auditors should be held accountable for the resulting failures of these organizations. Even if an organization would prefer not to receive a written management letter, Floch believes it is in the auditors’ best interests to provide one. She told us that one management executive said to her after she had delivered to his organization a lengthy management letter,

Recommended Resources from Josephson and Floch

Audit Committees: information sheets on audit committees produced by the National Council of Nonprofit Associations to provide guidance on the role of the audit committee:

Josephson and Floch also recommend two resources, which they were active in producing, available from the New York Attorney General’s Web site:
Financial Controls: Internal Control and Financial Accountability reflects some of the spirit of the discussion reflected in the article:
www.oag.state.ny.us/charities/internal_controls.pdf

Board Responsibilities: Right From The Start is a guide for board members:
www.oag.state.ny.us/charities/not_for_profit_booklet.pdf
detailing problems with the internal control structure and reporting processes, “You know what I do with your management letter? I take it politely, put it on the floor, jump all over it, and throw it out.” As one of the comments in the management letter addressed the lack of attention paid to the organization by the board, Floch says she resigned this particular engagement the day after the incident occurred, realizing there was no hope of improvement there.

Both Josephson and Floch agree, therefore, that boards should not be satisfied with an unqualified audit opinion, without a full and complete understanding of the management letter comments as well. The organization may still have quite serious and unaddressed problems that could eventually position them on the front page of the Chronicle of Philanthropy, even if the financial information is fairly stated at a point in time.

Josephson said that the New York Attorney General’s Charities Bureau had prepared changes to its regulations under which auditors for filers would separately alert the Bureau to the issuance of qualified opinions and also provide the Bureau on a confidential basis with copies of management letters. He also talked about the importance of having a nonprofit site (similar to the Securities and Exchange Commissions for publicly held companies) for reportable events. Thus contributors, grantors, and regulators would have early warning of substantial issues.

Long story short: boards or their audit committees must involve themselves in the audit process and take responsibility for managing it. To do otherwise would be foolhardy.

On Auditor Rotation

Neither Josephson nor Floch came down on the side of regulated rotation of audit firms—Josephson because he considers the feasibility of regular rotation of audit firms to be dependent on the size and importance of the organization, geographic location, numbers of available qualified auditors, and the extent to which the organization raises money from the public. Floch agreed with this, and in addition had concerns about the impact on the pricing structure that rotation could cause, as new engagements are initially more costly. Auditors’ fees usually allow for an investment in the first year’s engagement, but might be structured differently if the period of engagement were finite.

The core issue addressed by the rotation of audit firms is whether a long-term relationship with the firm leads to a lack of independence. In the public sector, the SEC requires a rotation of audit partners (not audit firms) every five years, in the belief that this promotes a clearer line between auditor and client. The SEC also has strict rules limiting other work that auditors can do for their audit clients, to keep the audit relationship from having potential conflicts of interest. This has started to be the norm in other “non-public” engagements as well, as both the American Institute of Certified Public Accountants and the GAO have issued guidance restricting the other types of work that auditors can do for their audit clients. There are those in the marketplace who believe that rotation of auditors can lead to a “fresh look,” though neither Josephson nor Floch believes that this fresh look should necessarily be legislated.

Josephson has an example of what he considers to be a clear conflict of interest in an auditor/client relationship, which he believes might not be all that uncommon in organizations that operate too informally. “This foundation had a lawyer-chairman-director who made a personal investment in an entity that was going south. In order to shore up his personal investment, he had the foundation make an investment in this entity as well—clearly improper behavior on his part, but his accountant, who knew the trouble with his personal investment, was also the auditor for the foundation. Was it the duty of the auditor to report to the board the inappropriateness of that transaction? Absolutely. Independence is very important in these matters.”

He also spoke of instances when even “big four” firm auditors who had audit relationships with two interrelated organizations seemed to have no understanding that they owed an equal (even special) fiduciary duty to each, even if one had a degree of (or even total) control over the other.

Both Floch and Josephson were adamant about understanding the competence of the audit firm, the audit team (including the partner), and the value of the services provided—both economically and in terms of whether the audit firm is a “fit” for the organization. They believe that this relationship should
also be examined on a periodic basis to make sure that the board (not management) is still satisfied with the services provided.

Both called attention to the availability of professional peer reviews and, with respect to auditors who also audit public companies, information from the new Public Companies Accounting Oversight Board.

**On Audit Committees**
The board (or its audit committee) should have full responsibility for management of the audit process, including hiring the auditor; approving the fee structure and services to be performed; approving the audit approach; discussing the audit fieldwork results with the auditors; and reviewing all auditor-proposed adjustments resulting from the audit process, among other functions. The audit committee should approve the financial statements and review the management letter. Josephson believes strongly that organizations should establish fully functioning separate audit committees to manage this process. He believes that the audit committee should be separate from the finance committee, as “the danger is that if you are really functioning properly in your finance committee role and overseeing the company’s financial reporting over the course of the year, you’ve lost some of your objectivity.” For some organizations, particularly those with small boards, an audit committee might not be practical because of the possible overlap between those on the finance committee and an audit committee—in such cases the entire board should act as the audit committee.

**Recommendations to Boards**
Understand that the board of the organization (not management) is the audit client, and that it needs to take responsibility for ensuring that the audit process is adequate and appropriate.

- Check the references of your auditors. Read the peer review reports of the auditors. Evaluate their knowledge and expertise in the nonprofit field. Choose one who agrees to issue a management letter that addresses both the appropriateness of the organization’s current practices and recommends corrections and improvements in the financial systems. Make sure the auditor has the expertise to assist with the preparation of the tax filings (if required), and is prepared to address them in a timely manner as well. Make sure that the fee is fair and consistent with the marketplace.

- Insist upon a written management letter to the board and immediately create a plan to implement its recommendations. Remember that a significant amount of time may have elapsed from the end of the fiscal year to receipt of the management letter, so it is important to address its concerns expeditiously.

- Auditing standards require that management makes some dozen or more written representations to the auditors—more in unusual situations. If your auditor is not doing this, consider retaining another auditor.

- Don’t use your auditor or auditing firm for other organizational or personal functions; make sure you are comfortable that independence is present, and that conflicts of interest do not exist.

- If an audit is not required, or undertaken, make sure that the board (or its committee) understands the processes for developing financial information that is reliable.

- Understand the internal controls that are in place at the organization, and make sure that regular updates about these controls are provided to the board by the CEO and CFO.

- Implement a conflict of interest policy for both management and the board, so that outside relationships do not influence the decision-making processes for the organization.

- Remember that under Sarbanes-Oxley, all organizations must have written whistleblower and record retention policies.

- Monitor carefully the progress of the various proposals made in Congress and by the various state charities regulators, for example that the board chairs, CEOs, and CFOs certify the adequacy of internal controls and the accuracy and completeness of IRS and state filings.

And finally, understand what assurances the audit process can and cannot provide. If you have the right auditor and the right board (okay, we know this is a tall order), the results from the audit process should go far beyond merely the audit opinion on the financial statements.

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**Let’s Talk!**
E-mail us, referring to this article, at: feedback@nonprofitquarterly.org.
Establishment

- Incorporate (state)
  - Articles of Incorporation (file with state)
  - Code of Regulations / Bylaws (state requirements)
- Obtain Employer Identification Number: Form SS-4 (federal)
- Obtain state taxpayer identification number (state)
- File for exempt status (federal)
  - Form 1023, Application for Recognition of Exemption
    - Provide EIN; attach Articles of Incorporation and Bylaws;
      file form 2848 or 8821, Power of Attorney and Declaration of
      Representative
- Make 501(h) election: Form 5768, election to make expenditures to
  influence legislation (federal)
- File PS Form 3624, application to mail at nonprofit standard mail rates
  (federal)
- File Form 8734, Support schedule for advance ruling period (five years
  after advance-ruling determination) (federal)
- Lobbying registration
  - File LD-1 under Lobbying Disclosure Act of 1995 (federal); state/local
    registration
- File for property tax exemption (state)
- Register trademark or service mark (federal and state)
- Charitable solicitation registration (state and local)

Annual Filings

- Form 990, Return of Organization Exempt From Income Tax, and
  required schedules (federal)
- Form 990-T, Exempt Organization Business Income Tax Return (if
  taxable unrelated business income) (federal)
- Employment tax returns
  - IRS Form 941, Employers Quarterly Federal Tax Return (federal)
  - IRS Form W-2, Wage and Federal Tax Statements (federal)
  - IRS Form W-3, Transmittal of Income and Federal Tax Statements
    (federal)
  - state, local returns (state)
- Lobbying reports
  - File LD-2 Lobbying Report (semi-annually) (federal)
  - state reports (state)
- Charitable solicitation reports (state)

Ongoing Compliance

- Audit: many states require audit for nonprofits which receive contribu-
  tions over a specified amount or have organizational revenue over
  a specified amount. These financial thresholds vary from $250,000 to
  $2 million pending on the state. In addition, some states require an
  audit if a nonprofit hires a paid fundraiser or if it receives $25,000 or
  more in direct or pass-through federal funding during a single fiscal
  year. (federal or state)
- Intermediate Sanctions (excess benefit contributions)—Form 4720,
  Return of Certain Excise Taxes on Charities and Other Persons Under
  Chapters 41 and 42 of the Internal Revenue Code (federal)
- Charitable Contribution Reporting
  - Substantiation and Disclosure (federal)
    - Written acknowledgement for any single contribution of
      $250 or more; written disclosure to donor who receives goods
      or services in exchange for single payment in excess of $75
  - Non-cash Contributions (federal)
    - Form 8282, Donee Information Return (dispositions of certain
      charitable deduction property made within 2 years after the
      donor contributed the property)
- File statements of continued corporate existence (frequency depends
  on the state) (state)
- Employees
  - I-9, US Department of Immigration and Naturalization form
  - Form W-4, Income tax withholding forms (federal)
  - State income tax withholding forms (state)
  - worker’s compensation coverage (state)
  - unemployment compensation coverage (state)
- File for copyright protection (federal)
- Update state on changes in Articles of Incorporation, statutory agent,
  address, etc. (state)

Significant Events Requiring Special Filing

- End lobbying activities (federal and state)
- End charitable solicitations (state)
- Merger (federal and state)
- Change in form (federal and state)
- Change in sources of support (federal)
- Change in activity (federal and state)
- Move geographic state of incorporation (federal and state)
- Dissolution (federal and state)

* This schematic covers 501(c)(3) organizations, excluding private foundations and
  churches. Furthermore, not all items are applicable to all organizations: some are manda-
  tory while others are voluntary. To understand those that apply to your organization you
  should seek legal advice. For a similar approach to regulations from an IRS point of view

Nonprofits’ Interaction with Federal and State Governments

Editors’ Note: this schematic from the National Council of Nonprofit Associations (NCNA) lays out many of the interactions with state and federal gov-
ernment that nonprofits encounter at different times in their existence. Along with the map insert in this edition we think readers cannot help but be
impressed by the number and complexity of regulatory and reporting requirements nonprofits must fulfill in addition to their missions.
Ragging the Puck: Not a Viable Strategy for the Whole Game

by Scott Harshbarger

Although [nonprofit scandals] don’t rise to the level of severity of the corporate scandals in terms of pure dollars and victim impact . . . they do strike a highly sensitive moral nerve.

The public’s understanding of recent corporate scandals continues to expand and deepen as the press covers the trials of CEOs and CFOs alleged to be malfeasant. The scandals, of course, seem to appear weekly and include such public dramas as the Enron, Adelphia, and WorldCom accounting frauds; Marsh McLennan and AIG’s broker fees; Putnam Investments’ mutual fund traders; the New York Stock Exchange’s excessive CEO compensation; and the Disney and Hewlett-Packard board shake-ups. These high profile examples are the poster children for the widespread need for increased corporate accountability, reasonable financial and internal controls, and enhanced transparency and disclosure—and major changes in the roles of regulators and boards.

Public outrage about such goings-on resulted in the passage of a major federal law called Sarbanes-Oxley, as well as inspiring aggressive SEC enforcement and oversight and a new activism by state and federal prosecutors, the media, and institutional investors. Wise boards and executives are also scrambling to ensure that they develop standards of governance that aggressively meet the new requirements. These are all excellent steps in the right direction.

Scott Harshbarger leads the Governance Practice at Boston’s Murphy, Hesse, Toomey and Lehane, and was the Massachusetts Attorney General (1991-99) and President of Common Cause (1999-2002).

In the nonprofit sector, Senator Charles Grassley (R-Iowa) is currently leading the U.S. Senate Finance Committee in considering legislation that would create billions of dollars in tax breaks for charitable giving. In exchange, however, the Finance Committee wants to see increased accountability measures for the charitable groups that would benefit under these changes. But there’s no need for Sarbanes-Oxley regulation in the nonprofit sector, is there? Sadly, the reputation of the nonprofit sector is somewhat tarnished these days.

The closest thing the nonprofit sector has had to the Enron and WorldCom spectacles in terms of producing national public outrage were the United Way and Nature Conservancy scandals—just due to the groups’ national prominence. Although they don’t rise to the level of severity of the corporate scandals in terms of pure dollars and victim impact—lost jobs, pensions, 401(k)s—they do strike a highly sensitive moral nerve based on the public’s enhanced expectations for nonprofits and their leaders to act well and honorably.

An increasing number of local stories are bolstering national news stories. In Massachusetts, for instance, these include a series by the Boston Globe Spotlight Team that exposed self-dealing and perks at numerous private family foundations, including the spending of millions of dollars on private jets, excessive salaries, and lavish travel. A century-old community hospital, beset by the many changes in the healthcare
market, made large, unsecured loans to some of its doctors, and had to close. When Boston University recently sought to hire a successor to President John Silber, many people were shocked at the amount of compensation offered to the successful candidate, who resigned a day before beginning his new job.

What can the nonprofit sector learn from the experience of for-profits in this brave new world of accountability? I argue that for-profits have
So, will the nonprofit sector and its leadership follow the for-profit leaders in its response to the call for more accountability? Will it rally to resist mandatory change by circling the wagons, raising the rhetorical flags, prophesying doom, and trying to run out the clock?

Donohue, meanwhile, serves on four corporate boards of directors, including Qwest Communications International, a company that is the subject of an investigation by the SEC, a major federal criminal investigation, and several lawsuits by investors. Qwest is, to make matters worse (at least in terms of perception), a big financial supporter of the Chamber of Commerce. Donohue and the Chamber are lobbying vigorously to defeat proposed SEC regulations that would empower shareholders and tighten accountability standards, arguing—with straight faces—that in the face of a massive breakdown in self-regulation and C-suite-level ethics, self-policing measures are sufficient! They are also lobbying state legislatures to restrict the powers of attorneys general, and have made major campaign contributions to candidates challenging some judges up for election.

So, will the nonprofit sector and its leadership follow the for-profit leaders in its response to the call for more accountability? Will it rally to resist mandatory change by circling the wagons, raising the rhetorical flags, prophesying doom, and trying to run out the clock? Or will it seize the moment to help order the regulatory and accountability landscape?

While many of the media scandals that have emerged in the nonprofit sector involve illegalities, the real crisis is one of ethics. Far too many of the more common “corrupt” practices that destroy the integrity and erode the reputation of organizations and the sector as a whole, are legal—or at least not illegal. Everyone in the sector sees it—boards that are not rigorous about their stewardship responsibilities; those that are internally conflicted over long spans of time or who practice self-dealing behind a veneer of charity; foundations that exist solely to shelter wealth for the rich; and last, but not least the national and multinational entities that ought be treated almost exactly as Fortune 500 companies in terms of expectations about audits, boards, counsel, controls, compliance, financial integrity, and fundraising checks and balances. Unfortunately, too many of these larger entities believe their status entitles them to immunity and to act with impunity behind closed doors, whether or not they self-deal, because they are doing work with care and compassion! And some of them have been known to lobby hard within the past decade to retain that latitude.

Too often and too consistently, the nonprofit sector’s leadership has resisted review in the same terms and to the same extent as corporate America. Much of the “leadership” that has had the time and drive to lobby on the regulatory environment at all has or is well aligned with a particular set of vested interests. I admit I am a skeptic on this, but that is a result of my 35 years of professional experience. While I believe in the importance and mission of our sector, and while I have observed a host of exceptional leaders and governance models, I have great fears that the sector, given the choice, will do exactly what it has done historically, and in fact exactly what the leaders of corporate America are doing now: ragging the puck* with task forces and studies proposing more standards and more voluntary action, while at the same time talking only to fellow “insiders” and true believers. Assertions that regulation will divert time and money from our core missions, and that we should not all be tainted by a few bad apples, prevent us from considering the benefits of meeting the challenge to participate actively in the evolution of a carefully crafted, well tended, well bounded, well refereed, and sun-drenched playing field—and one that need not be “one size fits all,” form over substance, or unduly costly.

As Attorney General of Massachusetts, I

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“Ragging the puck” is a hockey term that describes deliberately holding on, circling back, passing back, or otherwise retaining possession of the puck to keep your opponent from scoring.
developed model enforcement and education programs through strong partnerships and working relationships with all sizes and shapes of nonprofit organizations. I initially faced significant resistance, but fortunately I had the benefit of using an expert advisory panel of sector leaders and advisors to guide my office in developing a wide array of policies in diverse areas. As a result, my office was able to fairly and aggressively enforce the law against the small percentage of criminals, con artists, frauds, and corrupt entities whose actions tainted the integrity of the majority.

I am confident that this kind of public/private work toward strong and reasonable accountability systems can be done at a local level. What we are missing is the kind of positive, proactive advocacy from the sector—at the national level as well—that will help achieve the best balance of imposed and voluntary accountability measures. We must all value, not fear, the principles of democracy—accountability, transparency, disclosure, checks and balances, integrity, openness, robust debate, public and private-sector partnerships, and, above all, civic engagement by all of us, including an educated, active constituency.

We must all value, not fear, the principles of democracy.

Let’s Talk!

Let’s move this topic forward! Any ideas or arguments you’d like to share with the authors and editors? Send us an e-mail, referring to this article, at: feedback@nonprofitquarterly.org.
How Did We Get Here:  
*The Regulatory Framework 2005*

by Jon Pratt

Due to a growing complexity in the ways that organizations are structured . . . and due to opportunistic misuse of tax exempt organizations to further business or personal ends, nonprofits need government to provide structural integrity . . .

_The Senate Finance Committee’s push for increased control over nonprofit organizations and foundations needs to be seen against a backdrop of the increasing regulation of the finances of organizations of all kinds, as well as government’s love/hate relationship with First Amendment rights of speech and association as they apply to nonprofits._

Expanding the regulatory frame surrounding nonprofits is the next chapter in the ongoing evolution of the structural definitions of the nonprofit sector. Due to a growing complexity in the ways that organizations are structured and affiliated and due to opportunistic misuse of tax exempt organizations to further business or personal ends, nonprofits need government to provide structural integrity—a reliable degree of certainty regarding corporate formation, ownership of property, tax treatment and contract enforcement. But to balance this increased regulation, they struggle to maintain their autonomy and range of movement in the face of various government accountability reforms.

_“Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances.”_  
—First Amendment to the U.S. Constitution

The end of the Cold War has brought with it a worldwide consensus that successful democracy with market economies will have a robust set of nonprofit, or non-governmental, organizations that provide opportunities for citizens to do things together that they cannot do alone. The growth of organizations in more than 200 countries confirms that there is an almost universal interest in forming associations that are larger than friends and family relationships but smaller than the state—yet there is no consensus about how free these organizations should be.

Governments generally have an affinity for organizations that promote civic peace—whether it is earthquake relief, performing arts or health and education—but have less patience with organizations that seek to influence the workings of government, let alone aspire to rule the state. The ability of associations of plain citizens to serve as an intelligent check on the abuses of democratic power assumes a substantial degree of freedom—often not particularly appreciated by those in power.

_Jon Pratt_ is contributing editor to the *Nonprofit Quarterly* and executive director of the Minnesota Council of Nonprofits.

A LARGE CROWD OF ABOLITIONISTS GATHERED OUTSIDE THE BOSTON COURT HOUSE DURING A CASE INVOLVING A FUGITIVE SLAVE. TWICE IN 1851 ABOLITIONISTS IN BOSTON AND NEW YORK IGNORED THE 1850 FUGITIVE SLAVE ACT AND ATTEMPTED TO RESCUE ESCAPED SLAVES.
Neither Alexis de Tocqueville in *Democracy in America* nor the authors of the *Federalist Papers* felt that these expanding voluntary associations were a completely positive development for democracy, or that associations should have unrestricted freedom to exist. Tocqueville understood that forbidding some types of associations and allowing others would confuse people and inhibit the use of associations, but could be justified by the need for order:

> “However, I certainly do not think that a nation is always in a position to allow its citizens an absolute right of political association, and I even doubt whether there has ever been at any time a nation in which it was wise not to put any limits on the freedom of association.”

Tocqueville admits that there would be a cost to restricting the right of association:

> “To save a man’s life, I can understand cutting off his arm. But I don’t want anyone to tell me that he will be as dexterous without it.”

In *Federalist 10*, Madison sought strategies to counteract the inevitable development of factions and special interests dividing the attention and the loyalties of the public. Nevertheless, the First Amendment rights to peaceably assemble, speak, and petition the government were seen as necessary checks to protect the young democracy against authoritarian regimes.

Periodically in U.S. history, particular types of associations have been defined as threats to the Republic requiring active suppression—including abolitionists, the Palmer raids of 1919-21, anti-racketeering investigations of labor unions, infiltration of the Civil Rights and anti-Vietnam War movements, and indictments of Muslim charities after September 11th. Members of Congress have expressed special concerns about the concentrations of power held by large private foundations controlled by wealthy families, and in the 1969 Tax Reform Act enacted an excise tax and special restrictions on the use of private foundation funds.

The ongoing tension between the economic regulation of nonprofits and the First Amendment rights of people in organizations still exists, but is now largely overshadowed by the sheer amount of economic activity and the location of federal regulatory structure of nonprofits. Because a defining feature of charitable organizations is their freedom from the corporate income tax and their ability to receive tax deductible contributions, charitable organizations are commonly seen as creatures of tax policy (as opposed to expressions of speech and association). Academic explanations for the existence of nonprofit organizations mirror this focus on the economic aspects of organizations, citing “market failure” as a primary cause—when the marketplace fails to provide certain types of goods or services, the last resort is to form an association to provide this good or service.

The fact that the IRS was designated as the primary federal regulatory agency for nonprofits adds to this economic focus, despite the fact that nonprofit corporations generate a sliver of revenue for the federal government (a mismatch for the expertise and attention of the IRS). (In Great Britain, by contrast, oversight of charitable organizations is by the Charity Commission, not the Department of Inland Revenue.) The primary federal report required of nonprofit organizations, IRS Form 990 (Return of Organization Exempt From Income Tax), is termed an “information return,” not a tax return, and has evolved to be both a primary enforcement vehicle and awkward public disclosure and education tool.

The tax exemption (from the corporate income, state sales, and local property taxes) and eligibility for tax deductible gifts, conveys a significant economic benefit to the recipient organizations, and is a major explanation for why charitable organizations in the U.S. comprise a larger segment of the economy than in other developed countries. The power to tax (or not to tax) is well understood to include the power to regulate, so that the Internal Revenue Code has set aside the best financial incentives reserved for organizations that accept the greatest restrictions (including restrictions on speech, such as lobbying and electioneering).

In addition to enforcing tax laws and collecting revenue, state and federal governments focus on the economic aspects of nonprofits as part of their interest in protecting consumers and preventing theft and fraud; and the state attorneys general have broad powers at equity to preserve charitable trusts and assets. When specific problems or well publicized abuses occur, new laws and regulations are proposed, yet legislatures
unfamiliar with nonprofit organizations can be prone to overreaching and over-regulating—sometimes triggering constitutional challenges.

The growth in the number and size of U.S. nonprofit organizations—now 1.4 million organizations with $190 billion in charitable contributions and $700 billion in total revenue—threatens to overwhelm its regulatory framework. With this growth, the federal and state regulation of charitable organizations has seen a parallel increase in regulation.

The structural beginnings of the nonprofit sector are usually traced back to England’s Statute of Uses in 1601, the full name of which is “An Acte to redress the Mis-employment of Landes, Goodes, and Stockes of Money heretofore given to Charitable Uses.” Parliament passed this law to codify what already existed in common law, and legislatures have been adding provisions ever since. In the U.S., the adoption of the federal income tax, and the desire for a charitable deduction, propelled the formalization of tax exempt organizations—incorporated and chartered by state government, and made exempt first by the federal government.

The modern dimensions of the nonprofit sector have been shaped by five changes to the Internal Revenue Code governing exempt organizations:

The 1950 Tax Reform Act subjected otherwise tax exempt organizations to the regular corporate tax rate for Unrelated Business Income Tax. Concerns about unfair competition from nonprofit organizations owning for-profit enterprises, including New York University’s macaroni company, prompted Congress to carve out economic activities by nonprofits that would no longer be exempt (and reported on IRS Form 990T).

The 1969 Tax Reform Act defined private foundations as a new subset of charitable organizations, with greater restrictions, out of concerns that large foundations were unaccountable; some were benefiting their donors, and could sway elections and public debate. The 1969 law included an excise tax on their investment earnings, set out “prohibited transactions” with insiders, severely regulated grants to individuals, restricted grants for voter registration to grantees organizations active in five states, and prohibited expenditures or grants specifically for lobbying.

The 1976 Tax Reform Act clarified lobbying by charitable organizations, defining specifically allowable amounts for grassroots and direct lobbying, and creating a special option allowing organizations come under a safe harbor with definite sums that could be spent on lobbying, (beginning with 20% of the first $500,000 in expenditures).

The 1996 Intermediate Sanctions legislation prohibited excess benefits from being granted to individuals in control of tax-exempt organizations. Previously the IRS’s only penalty for violations was total revocation of exempt status, and despite publicized abuses, organizations were rarely punished. The new Intermediate Sanctions included fines against board members and nonprofit managers for excessive compensation violations.

In the American Jobs Creation Act of 2004, Congress voted to limit the deduction for vehicles contributed to charity in response to evidence that the value of these contributions to the charities was substantially less than what taxpayers were taking as deductions, projected to save $3.4 billion.

Simultaneous with increased federal legislation, out of a desire to prevent fraudulent charities victimizing innocent donors, 38 state legislatures adopted systems requiring charities to register their fundraising activities and file reports on their financial activity. As a result the regulatory framework that specifically governs nonprofits is divided equally between state and federal, with miscellaneous city and county regulations, in addition to the full range of employment, land use, environmental, postal and credit regulations that govern every employer, property owner, mailer, and financial entity in the United States.

The tension between government regulation and organizational speech has played out through a series of Supreme Court cases establishing a moving boundary between permissible regulation and protected speech. Four notable cases help set the limits of government authority over organizations:

At the height of the Civil Rights Movement’s struggle for voting rights in the South, Alabama ordered the NAACP to disclose the names of all its members in the state. In NAACP v. Alabama (1958), the Supreme Court found that the state of Alabama violated the First and Fourteenth Amendment rights of NAACP members because
“freedom to engage in association for the advancement of beliefs and ideas is an inseparable aspect of the ‘liberty’ assured by the Due Process Clause of the Fourteenth Amendment, which embraces freedom of speech, and that it was “immaterial whether the beliefs sought to be advanced by association pertain to political, economic, religious or cultural matters, and state action which may have the effect of curtailing the freedom to associate is subject to the closest scrutiny.”

In suburban Chicago, the village of Schaumburg adopted a municipal ordinance requiring 75% of an organization’s revenues be expended for “charitable purposes” as a condition for a solicitation permit—a condition an environmental group with a door-to-door canvass could not meet. In Village of Schaumburg v. Citizens for a Better Environment (1980), the Supreme Court nullified the ordinance (and 30 similar state laws around the country that restricted charitable organizations to specific efficiency percentages) and rejected the argument that soliciting contributions was purely commercial speech, citing previous cases on canvassing by religious and charitable organizations. While the municipality had an interest in protecting its citizens from fraud, its remedy was an overly broad prophylactic measure. Instead, the court’s opinion suggested that making information about organizations’ publicly available was a preferred route. The court’s dicta on public education spurred regulators and watch-dog groups to explore ways to better educate donors to get information about fundraising and administrative costs.

A practical method of mass access to charities’ financial information was not available until the maturing of the Internet in the mid-1990s. The National Center for Charitable Statistics, part of the Urban Institute, raised funds to contract with the IRS to scan images of charitable organizations’ IRS Form 990s. NCCS used the information for sector research and Guidestar posted the images on its Web site.

When government is a major source of nonprofit revenue, the sticking point is conditions attached to government subsidies, grants and contracts, such as the ban on abortion counseling by organizations receiving federal family planning funds. In Rust v. Sullivan (1991), in a 5-4 decision the Supreme Court rejected a First Amendment challenge, holding that the restrictions did not violate the speech rights of the recipient organizations, their staffs or their patients, since congress just chose to fund one activity instead of another, and the regulations ensured that appropriated funds were not used for activities, including speech, that were outside the federal program’s scope. In the case of the tax exemption itself, federal restrictions on charitable organizations’ speech have been upheld for the restriction of the amount of organizational resources they can expend for lobbying (Regan v. Taxation with Representation [1983]), despite the fact that veterans’ organizations are free from this restriction.

In 1991 the Attorney General of Illinois sued Telemarketing Associates, a professional fundraiser, alleging fraud and deceptive trade practices, since prospective donors were told a majority of donated funds would benefit Vietnam veterans—though only 15% of contributions went to the named charity, VietNow. The lower courts in Illinois supported Telemarketing Associates request to dismiss the charges on the same grounds as the Schaumburg decision, that charitable solicitation is highly protected speech. The Supreme Court reversed in Illinois ex rel. Madigan v. Telemarketing Associates (2003), ruling that fraudulent charitable speech is not protected, and that a narrowly tailored fraud action was an appropriate remedy since the burden of proof for all of the elements of fraud, including intent, would be ample protection for speech by charitable organizations. Telemarketing Associates strengthens the hand of regulators, while affirming that charitable speech must be carefully protected by using only narrowly tailored remedies to address a compelling state interest.

The Telemarketing Associates case created a rare split between charity regulators and nonprofit leaders, who feared that letting the fraud prosecution go forward was tantamount to reversing the Schaumburg decision. An unusual collection of Amicus briefs were filed in favor of dismissal, including Independent Sector, The American Cancer Society, the Points of Light Foundation, Conservative Legal Defense and Education Fund, American Target Advertising, Inc., Gun Owners Foundation, and English First. Independent Sector’s brief argued that the remedy could not be narrow: “The Illinois Attorney General’s fraud suit would violate the First
Amendment because it would force charities and their fundraisers either to keep their fundraising costs below whatever level the Attorney General deems ‘excessive’ or to speak the words compelled by the Attorney General.”

This tension and worry about which regulations would shrink the freedoms of associations carries over to the consideration of the current proposals. Most of the two dozen changes proposed in the 2004 Senate Finance Committee staff paper involve IRS procedures, mandated disclosures, changes in penalties and fees, etc. One proposed condition for 501(c)(3) status to be granted and/or continued is the requirement that boards have between three and 15 members. While Congress can set explicit conditions for tax preferences—down to what day forms must be filed—restricting the number of people on the decision-making body seems particularly intrusive and inappropriate. Since many organizations require broad participation and representation, taking away the option of setting their own size limits their choices of expression and decision-making—surely if freedom to associate with others allows one to choose one’s associates, groups should be able to decide how many to associate.

With the continued growth of nonprofit financial activity, media reports of abuses and additional pressures on lawmakers from contentious social issues and the permanent war on terrorism, where discussion regarding legitimate versus illegitimate controls is likely to continue to grow. It is in the interest of nonprofits to do three things:

• educate the public about their role as vehicles of free association and speech in our democracy;
• resist government controls that are aimed at limiting these rights; and
• proactively ensure reasonable government controls are in place to assure the public that their contributions and organizations are protected from fraud, theft, and insider transactions.

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Opportunities Lost: Missing the Point in the Nonprofit Accountability Conversation

by Rick Cohen

While the nonprofit leadership organizations addressing the issue of nonprofit accountability are clearly serious and sincere, many of us do not hold out much hope that the recommendations that emerge from major industry groupings or the legislation that follows will assuage the problems highlighted in recent public media scandals. Why?

First, transparency and enforcement cost money—and in the context of the current federal budget, serious questions have to be resolved about where it will come from. Even accountability-friendly nonprofits have every right to balk at supporting imposed fees and penalties when the foundation excise tax has ended up in the general treasury. Besides, a lot of enforcement occurs at the state level, and no plans are in the works to ensure the various offices of the attorneys general are consistently staffed or funded.

Rick Cohen is the executive director of the National Committee for Responsive Philanthropy (www.ncrp.org).
Second, the Independent Sector (IS) panel seems to have chosen as its first phase targets “low-hanging fruit” issues that would generate consensus among panel members. How will they handle the next phase, where the real challenges to the governance of foundations reside and where more disagreement exists? And will there be anyone interested and listening on Capitol Hill by the time the second phase emerges?

**Oversight, Enforcement, and Transparency Costs Plenty**

Governmental oversight of the nonprofit sector is going to go nowhere without capital infusions giving agencies such as the tax-exempt division of the IRS the wherewithal to carry out even the most basic functions of examining and investigating the voluminous submissions of 990PFs and 990s—never mind any more proactive measures. Despite breast-beating to the contrary, the foundation sector and its nonprofit leadership allies have never—until quite recently—voiced support for a specific linkage of the excise tax, generating well over a half billion dollars a year, to support governmental oversight and enforcement functions. Although they will defensively say that they publicly favored increasing the budget of the IRS tax-exempt division, you won’t find that as a core tenet in the message of the foundation sector’s lobbyists or their annual lobbying pilgrimage to Capitol Hill.

In fact, among the headers of the Council on Foundations’ 2005 “Foundations on the Hill” lobbying day is a listing of legislative issues accompanied by working papers and issue briefs addressing the priority legislative items for organized philanthropy (www.foundationsonthehill.org/issuепapers.htm). Keyed to pending legislation, the second topic on the list is the full repeal of the excise tax on private foundations. Originally designed to provide a dedicated resource for IRS oversight and enforcement actions, the tax was delinked from this function (or never adequately linked in the first place) many years ago, making foundations the unique nonprofit institution that is taxed to contribute to the federal treasury.

Until recently, only one national nonprofit leadership group (the National Committee for Responsive Philanthropy, NCRP) has called for the rededication of the foundation excise tax to this function, even laying out a strategy for reducing and consolidating the excise tax— parceling out the proceeds to IRS, state attorneys general, and nonprofit research and watchdog organizations. In the wake of the Senate Finance Committee brouhaha, the National Council of Nonprofit Associations (NCNA) belatedly endorsed NCRP’s longstanding call to link the excise tax to its original statutory purpose, and now one of the working groups convened by Independent Sector has recommended to IS’s nonprofit panel some targeted use of the excise tax.

**The Excise Tax: How Much are We Talking About?**

Even during the gloomy stock market days of 2002 and 2003, the excise tax was a $500 million per year revenue generator. In late 2003, NCRP estimated that a reduction and consolidation of the excise tax to a flat 1% would free up $140 million for new grantmaking and still leave more than $350 million to bulk up IRS oversight, to funnel desperately needed resources to state attorneys general, and to fund nonprofit data collection functions currently supported by philanthropic giving at nonprofits such as GuideStar and the National Center for Charitable Statistics. With the revived stock market of late 2004 and 2005, those figures significantly understate what the foundation excise tax could deliver for nonprofit oversight and enforcement plus needed research and data collection.

These recommendations for using the excise tax or finding other resources, such as 501(c)(3) or 990 filing fees, come a little late in the day to promise much. At the same time the IS working group recommendations were published, President Bush’s Fiscal Year 2006 budget emerged, taking the nation along the path of an almost total disappearance of resources for discretionary expenditures within a decade, not counting the costs of the war in Iraq, other potential military engagements, expenditures to fight terrorism, and the Social Security “fix.”

President Bush’s budget does propose more resources for the IRS, but there is little to suggest that it will be devoted to appropriate oversight. The precedent of Fiscal Year 2005 is frightening: the IRS’s new efforts against tax cheats did not focus on corporations or the wealthy, but befeefed up efforts aimed at low-income taxpayers filing for the Earned Income Tax Credit (EITC). With the drumbeat of major players blaming small
Many observers believe that the IRS is and should continue to be primarily a tax collection agency, not an instrument for effective enforcement of nonprofit accountability. The nonprofit accountability activism of attorneys general in New York, California, Minnesota, Massachusetts, and Illinois, as well as in other states, makes the case for some people that nonprofit accountability oversight and enforcement, like politics, is local—or state-level—rather than federal.

In the “CARE Act” portion of the omnibus S.6 introduced in the 109th Congress by Republicans Santorum, McConnell, Frist, and Hutchinson, the longstanding pleas of state charity officials are addressed with language authorizing the IRS to share information with the attorneys general about proposed enforcement actions by the Service against 501(c)(3)s. There is little question that the Independent Sector process will come out in favor of electronic filing of 990s and 990PFs, alleviating state agencies of having to dedicate staff slots to data input clerks.

But the Independent Sector’s working group endorsement of using the foundation excise tax for oversight did not include state charity officials among the potential beneficiaries. There might be a number of reasons for the apparent diffidence toward state attorneys general:

Some political wits suggest that “AG” stands not only for attorney general, but also for “aspiring governor.” Innuendo abounds that the high-profile charity enforcement activities of AGs such as New York’s Eliot Spitzer and others may be inspired as much by politics as probity.

All told, only about a third of the states possess active charity offices in their AG’s offices or elsewhere that do more than simply address charitable solicitations. Putting the emphasis on the enforcement activism of the state AGs leads to an inconsistent set of state government capacities and even inclinations for dealing with nonprofit accountability issues.

Despite ostensibly supportive statements from nonprofit leadership groups at convenings of the National Association of State Charity Officials (NASCO), the sector has taken a pretty strident stance against most examples of the AG’s activism. While effective in getting movement on the questionable “nonprofitness” of some nonprofit hospitals and insurers in Minnesota, AG Hatch has taken his share of lumps not only for his hospital interventions, but for his critique of the profit-like aspects of the nonprofit Minnesota Public Radio (MPR) controversy. The grumbling about Spitzer’s briefly floated Sarbanes-Oxley type accountability legislation was not limited to New York State, as nonprofits elsewhere fretted that their homegrown AGs might emulate New York’s.

Ultimately, it may be true that assigning the IRS increased oversight and enforcement functions is a non-starter, that the IRS is first and foremost a tax collection agency, not an entity to sniff out and correct nonprofit and foundation nonprofits or the proliferation of nonprofits for the accountability problem in the sector, it is hard to imagine that a pumped-up IRS will aim its tax-exempt enforcement resources at the well-endowed miscreants highlighted in the press.

Facing not only the fast-shrinking pot of federal discretionary revenues, but also the challenge of proposing to the Senate Appropriations Committee the dedication of a general tax revenue like the foundation excise tax to a specific purpose like nonprofit oversight, the Senate Finance Committee proposed a variety of alternatives for financing oversight, as well as a bevy of fees and charges to pay for IRS oversight functions.

Politically speaking, fees and charges are simpler to enact and bypass the Appropriations Committee scrum, but they pose two significant problems. First, unlike the excise tax, a motley array of fees and penalties add to the complexity of nonprofit tax compliance and perhaps place the burden on smaller nonprofits that might have less discretionary capital to direct toward fees and charges. Second, once a revenue like a fee or charge (or any new revenue raiser, for that matter) is on the table there is no guarantee that it will be used to pay for functions that benefit the nonprofit sector. Witness the car donation “fix,” whose purported $2 billion in tax savings was used to help offset the Bush Administration’s $146 billion corporate tax cut in 2004.
accountability dilemmas. But with such wide variability among the capabilities of states’ charity officers, it is difficult to bolster state oversight functions without first building the state oversight infrastructure.

Sources of Anti-Regulatory Pushback
To some nonprofits and foundations, the panoply of IRS agents, state charity officials, and federal agency contract monitors is enough regulatory oversight to squeeze the life out of anyone. This sentiment is hardly limited to the archconservative side of the political spectrum, but some conservatives are beginning to drive the bus.

It should not come as a surprise that in the conservative policy swing enveloping this nation during the past several years, the drumbeat against regulation in the nonprofit sector has had a right-wing tint. Conservative commentators such as Leslie Lenkowsky have fretted that bolstered regulations might kill the goose that laid the golden charitable egg, and even conservative intellectuals such as columnist George Will have taken aim at efforts to tighten up scrutiny of car donations. Oddly enough, their comments don’t sound all that different from some of the sentiments, stated with less animus toward government, by some nonprofit sector leaders aiming to protect their discretionary ability to pay handsome fees to foundation board members and to allow board members and insiders to benefit from ostensibly below-market business services rendered to their nonprofits and foundations.

Foundation leaders know that their industry is tremendously flexible and minimally regulated, allowing for the achievement of great good through philanthropic grantmaking, but permitting a variety of questionable behaviors, self-indulgent expenditures, and even hefty fees for sitting on nonprofit boards, not to mention the clearly objectionable self-enrichment schemes of some of foundation people who clearly embarrass their peers. Overall, foundations seem to have little appetite for regulatory reform, searching instead for self-regulatory mechanisms, relying on the Council on Foundations’ stewardship standards to ward off the threat of more muscular government oversight.

Similarly, the Independent Sector panel’s first phase panel recommendations generally modify the edges of nonprofit accountability with modestly increased excise penalties on inappropriate self-enrichment and tougher sanctions for nonprofits that repeatedly flout registration and filing laws. Joined by commentary from the National Council of Nonprofit Associations (NCNA), the IS panel clearly favors stronger self-regulation by the sector and investment in educating nonprofit board members about their fiduciary duties rather than adding significant brawn to government regulations. If the government did ante up with capacity-building funds, as IS and NCNA advocate and the Senate Finance Committee white paper intimated, one might wonder which national nonprofit organizations would be jostling at the head of the line to help with the expenditures.

The anti-regulatory drums beat loudest from the Philanthropy Roundtable, a foundation association leaning to the conservative side of the spectrum as a counterweight to the mainstream Council on Foundations. Emerging from the Roundtable’s criticisms of the Senate Finance Committee’s “white paper” recommendations in 2004 is a new organization, the Alliance for Charitable Reform, led ostensibly by well-known tax lobbyist Sandra Swirski of Venn Strategies. Like the Council on Foundations’ recruitment of Akin Gump to carry the foundation sector’s legislative package on Capitol Hill, replete with major Republican (former Congressman Bill Paxon) and Democratic (Clinton friend Vernon Jordan) leadership, Venn provides bipartisan lobbying muscle for the Roundtable’s fight against regulation, with well known Democratic operatives on staff such as former Kerry and Lieberman associate Anne Urban.

The Alliance has reportedly garnered support beyond the Roundtable’s conservative foundation supporters with its “concern … about the threat of potential legislation to every foundation’s integrity and freedom to operate.” Among the foundation players behind this new coalition are Heather Higgins of the Randolph Foundation, a former co-anchor of a television show with Newt Gingrich, and Daniel Peters of the Ruth and Lovett Peters Foundation, formerly an executive at Procter & Gamble.

Randolph, for example, funds a litany of con-
servative think tanks and policy advocates, including the vibrantly anti-regulation Competitive Enterprise Institute, which regularly advocates in favor of the notion “that consumers are best helped not by government regulation but by being allowed to make their own choices in a free marketplace,”14 language pretty similar to the sentiments of the Philanthropy Roundtable and the Alliance for Charitable Reform when they inveigh against the Senate Finance Committee rumblings.

Foundations, for their part, escape the Independent Sector panel lens with little scrutiny. They get chided for parking money in donor-advised funds (DAFs) at community foundations, though the panel seems to overlook parking spaces other than DAFs favored by foundations reluctant to meet their immediate payout requirements. But the panel clearly decided, before day one, that the issue of foundation payout would not be discussed at all. The issue of foundation trustee fees, probably the most common high-visibility issue in foundation accountability in the press during the past two years, is relegated to the panel’s second phase, suggesting for some misplaced priorities. Ranking right behind trustee fees would be the ability of foundations to use the legal, accounting, and investment firms owned by or associated with their trustees, but that’s perhaps lurking in phase II as well, along with attention to inappropriate foundation expenditures such as Bombardier jets for trustees and Jaguar roadsters for CEOs.15

What is Immediately Ahead?
Maybe we will all be surprised to see the milque-toast quality of the phase I issues and recommendations supplanted by tough-minded outrage and concomitant policy recommendations in phase II of the Independent Sector process. That would be great. But Congress is moving right along. The Senate Finance Committee already has a bill on the docket, the latest resurrection from the dead of the CARE Act, with the longstanding policy target of Independent Sector and many other national organizations of the non-itemizer charitable tax deduction. In Senator Rick Santorum’s new CARE Act (part of S.6), there are provisions for some improvements in charity oversight, including, most important, the ability of IRS and state charity officers to share information about ongoing investigations of nonprofit wrongdoers. The Committee is probably working up another batch of recommendations aimed at Type III supporting organizations, increased disclosure (and hopefully minimum payout requirements) for DAFs, and tightened regulations on charitable donations of land and easements in the wake of the Nature Conservancy and other scandals.

But where will attention be by the time the hopefully tough-minded phase II Independent Sector recommendations emerge? If CARE moves, which is doubtful, if the S.6-related nonprofit oversight improvements get spun out and adopted, if the Committee moves on some other issues, how much appetite will be left for more attention to the nonprofit issues that are other than low-hanging fruit? As the federal budget lurches ever deeper into deficits, as government spending for critical social needs falls off the radar screen, as the two parties duel over ways to debilitate the Social Security system, it is difficult to imagine that phase II will generate much Congressional traction.

Some nonprofit and foundation leaders will breathe a huge sigh of relief, having outlasted the scandals of 2003 and 2004 at the price of tighter restrictions on car donations, an IRS tax-exempt division slapped awake by Senate Finance Committee hearings, and probably some new regulations concerning penalties for nonprofits that inexplicably forget to file their 990s for years running.

Endnotes
1. Foundations on the Hill is also sponsored by the Forum of Regional Associations of Grantmakers.
2. The Web site also includes links for the Council’s and the Forum’s comments on the Senate Finance Committee white paper and a summary of presentations made at the Committee’s July 2004 nonprofit roundtable meeting, although not the testimony presented at the Committee’s official June 2004 hearings.
3. NCRP called for a distribution of the $350 million or more among several targets: 20% to beef up the IRS’s tax-exempt division, 40% to a fund controlled by the IRS commissioner to distribute to state charity offices, 15% for nonprofit research, 15% for nonprofit data collection (like the data collection that the IRS does on...
other economic sectors), and the remainder available for IRS special enforcement projects. Cf. Rick Cohen and Jeff Krehely, “Paying to Mind the Store,” Responsive Philanthropy (Spring 2004).

4. In 2005, the Administration requested a 68.5% increase in its EITC enforcement budget, though EITC represented only 2.8% of the uncollected tax gap (cf. www.americanprogress.org/site/pp.asp?c=biJRJ8OV F&b+4157), and the FY2006 budget request keeps the focus squarely on EITC tax cheats (estimated at one-fourth of EITC filers), as opposed to finding the much larger number of EITC-eligible families who fail to file for this resource.

5. Since the Clinton Administration, the public sector has supported reducing and consolidating (but not eliminating) the foundation excise tax to enhance tax simplification, contrary to a regime of multiple fees and penalties.


7. AG Christine Gregoire was elected governor in Washington in 2004; AG Claire McCaskill lost to the son of Republican Majority Whip Roy Blunt for governor in Missouri; former attorney general Jerry Kilgore is running for the statehouse in Virginia; current attorney general Eliot Spitzer is clearly aiming for the New York governor’s mansion; Minnesota’s Mike Hatch has run in the past and could well do so again; Florida’s Charlie Crist is rumored to be a potential Republican successor to term-limited Jeb Bush, etc.

8. In a well-publicized speech in 2002, the Minneapolis Foundation’s Emmett Carson criticized Hatch’s review of MPR’s for-profit catalogue business, Greenspring Co., and the Allina Health System’s conglomeration of hospitals, clinics, and nursing homes for finding neither entity engaged in any illegal activities and thereby obscuring rather than clarifying the applicability of nonprofit accountability laws (cf. cnpl.georgetown.edu/doc_pool/Neilsen0107Carson.pdf).

9. Spitzer’s bill calling for nonprofit CEO/CFO/Treasurer verification of annual reports, designation of executive committees and audit committees, controls on self-dealing by audit committee members, etc. never made it out of legislative committee. In late 2004, Spitzer’s office decided not to introduce even a modified bill, but to publicize the AG’s newfound support for “educating directors and officers of not-for-profit corporations rather than imposing new laws” (www.legislativegazette.com/read_more.php?story=325).


12. Venn’s 2004/2005 client list includes the philanthropy Roundtable, the Association of Small Foundations, and the National Committee on Planned Giving, in addition to corporate clients such Metropolitan Life, BellSouth, Eli Lilly, and the drug industry’s Pharmaceutical Research and Manufacturers Association of America (PhRMA). The foundation sector seems to have been partial to Akin Gump, with former Congressman Bill Paxon recruited for a quarter million dollars by the so-called Foundation Executives Group, a collection of some 20 large foundations united to fight the changes in foundation payout calculations in the Charitable Giving Act of 2003 (H.R.7), and more recently recruited by the Council on Foundations in 2004 to carry the sector’s Capitol Hill agenda (the Council also retains other out-of-house lobbyists in addition to its own in-house government relations staff). The Foundation Executives also retained Clark Consulting Federal Policy Group, whose midyear 2004 report counted $160,000 in fees for H.R.7 lobbying. Clark’s relatively recent 2004 client list includes the likes of the Financial Services Roundtable, representing the banking sector, the American Council of Life Insurers, Anheuser Busch, Amareda Hess, General Electric, the Edison Electric Institute, General Motors, and Akin Gump, among others.


A Survey of Proposals for the Further Federal Regulation of Nonprofits

by the editors

The June 22nd hearing featured mystery witnesses testifying under the pseudonyms “Mr. House” and “Mr. Car” (as if these were protected mafia witnesses) with their voices and appearances obscured. “Mr. Car” testified about vehicle donation scams, and soon thereafter the Finance Committee drafted legislation to reduce vehicle donation deductions to the sale amount realized by the charity (not the “Blue Book” value). The very quick action changing deductions for vehicles, starting January 1, 2005, is projected to save $3.5 billion for the treasury. It shows the Senate Finance Committee is ready to get Congress to act on charitable reform—at least when it increases revenue.

Also at the June 22nd hearing, IRS Commissioner Mark Everson testified that:

“We need go no further than our daily newspapers to learn that some charities and private foundations have their own governance problems. Specifically, we have seen business contracts with related parties, unreasonably high executive compensation, and loans to executives. We at the IRS also have seen an apparent increase in the use of tax-exempt organizations as parties to abusive transactions. All these reflect potential issues of ethics, internal oversight, and conflicts of interest.”

What is of Concern?

While there are a large number of proposals under consideration, momentum for change appears to be gathering around a few in particular. These few issues have been highlighted in
recent media covered scandals, some of which have occurred in DC right under federal lawmakers’ noses.

In other words, this is not a wide-open policy dialogue but one that has been informed by a number of “focusing events” or events that focus the attention of the public and policy makers at the same time. In this case, lawmakers seem to have been moved by the coverage of the Nature Conservancy, United Way of America, United Way of the the National Capital Area, and a number of press exposés on perks, and trustee fees at private foundations. The Senate Finance Committee is concerned about perks, and about donors getting away with tax savings through loopholes that allow benefit to come back to them, and the Ways and Means committee chair is suspicious of hospitals and credit unions which he thinks may be avoiding taxes on their profits.

There is also a generous portion of moral indignation that foundations, required to give away at least 5% of their assets to charities each year are counting high administrative costs within payout rates. This is a longstanding issue that was given power by a number of press accounts of excesses at foundations over the past year. However, the Committee is not dealing with a comparable situation in the enormous sums being warehoused in university endowments. These institutions also receive a tremendous amount of public-sector cash support each year. This speaks to the fact that attention is largely focused on particular types of nonprofits and is partially driven by press coverage.

The Need to Distinguish

Amazingly, current, accurate information about the size and activities of the nonprofit sector is not available—unlike virtually every other industry in the U.S.—although electronic filing should help this. Among the numbers being used in this debate, however, is the one commonly used to define the size of the sector at 1.4 million ostensibly charitable organizations. As we shall see, this number can be misleading.

Since the 1970s, researchers and industry groups have advanced this concept of “the nonprofit sector,” in which a disparate group of organizations (from food pantries to Harvard University) can be seen to be occupying a common section of the economy, sharing a set of tax exemptions and presumably Tocquevillian social capital-building relationships. Including the small with the large is a proven strategy in government relations, especially when demonstrating the negative effects and costs of government regulation. A single descriptive sentence can mention food pantries and small neighborhood organizations in the same breath with very big numbers: 1.4 million organizations, 10.9 million employees, and $2 trillion in assets.

But is this a reasonable approach for designing regulatory policy?

Granted, approximately 11,500 private colleges, universities, nonprofit hospitals and nursing homes share federal nonprofit tax status with human services organizations, nonprofit theatres, and neighborhood groups. But, they operate more like their for-profit counterparts in the same field than their smaller tax-exempt cousins. In other words, they run very much like businesses and probably merit a different brand of regulatory attention.

Then we have houses of worship and religious organizations. If you exclude these, since they are not under review right now and most of them are not required to report to the IRS, the total falls to approximately 800,000 federally tax-exempt organizations. Of these, approximately 550,000 have annual budgets of $25,000 or less and are not required to report to the IRS. We don’t discount these small organizations but know that some portion of them may be inactive or defunct. This leaves around 300,000 organizations—an important, hard working and perfectly respectable sized industry deserving of our pride.

Nonprofits would be better served to agree on definitions and some reasonable distinctions. A more cohesive course will be to understand the charitable section of the economy in two parts—very large fee-driven organizations such as hospitals, colleges, and nursing homes—and the rest.

To puff up the number of charitable organizations and their financial impact to somehow inflate the importance of the sector is a dangerous strategy. You might win people’s attention and respect as a really big industry, but risk broad brush tax and regulatory action. Besides, the lack of a commonly agreed-upon number of charitable organizations looks fishy. The widely varying statistics are confusing for policy makers.
The Groups Putting Forward Recommendations

A variety of individuals and groups are now weighing in on the Finance Committee recommendations, with five national nonprofits making the most visible responses. These are: the Panel on the Nonprofit Sector convened by Independent Sector (IS), the National Council of Nonprofit Associations (NCNA), the Council on Foundations (COF), the National Committee for Responsive Philanthropy (NCRP), and the newly minted Alliance for Charitable Reform (ACR).

Clearly these are not the only advisors from which comments will be taken. The Senate Finance Committee also requested recommendations from the Joint Committee on Taxation, which obliged with an extensive list of recommendations.

The following sections describe only some of many active proposals and positions under discussion. For more information, detailed opinion, and ways to get involved, visit the links to these organizations and to the Senate Finance Committee Web site on the next page.

Independent Sector received an invitational letter from Senate Finance Committee Chair Charles Grassley and ranking Democrat Max Baucus (after a bit of entrepreneurial prodding by IS) to convene a distinguished panel to consider these recommendations. IS is based in Washington, D.C. and has a regular membership of approximately 500 primarily larger nonprofits (some of which have many smaller member groups or affiliates) and foundations. IS convened the National Panel and created expert working groups involving more than 100 people. The IS panel released its interim report on March 1st. This first report covered primarily issues on financial reporting and transparency, and government oversight. A second round of consideration on the remainder of issues in question is in progress, and a final report is due later this spring.

The National Council of Nonprofit Associations, a network of 39 state associations and their 22,000 mostly small- and medium-sized nonprofit members, participated on the panel but also independently issued its own analysis and legislative recommendations.

The National Association of State Charity Officials (NASCO), an association of state charity regulators, weighed in on proposals that would affect the sharing of investigative information between the IRS and state charity regulators.

The National Committee for Responsive Philanthropy, which acts as an active and vocal advocate and watchdog on issues of philanthropy; the Council of Foundations, which is the largest and most mainstream group for foundations; and the new Alliance for Charitable Reform have concentrated their comments primarily, but not exclusively, on issues related to philanthropy.

The Alliance for Charitable Reform is a newly-formed coalition headed by Sandra Swirski, a veteran Washington tax lobbyist. The group is “concerned about the threat of potential legislation to every foundation’s integrity and freedom to operate,” and is a creation of the Philanthropy Roundtable, an association of foundations more politically conservative than the Council on Foundations. This group could carry a lot of weight on the Republican side of the aisle. They can be expected to oppose increased regulations or restrictions on private foundation trustee fees and increased minimum payout.

As with the progress of any legislation through Congress, there are huge unknowns about how this will proceed, the level of interest in the House Ways and Means Committee, and the views of members of the Senate Finance Committee other than Grassley and Baucus.

The recommendations below are drawn from the white paper produced by Senate Finance Committee staff and from the recommendations put forward by the IS-convened panel on the Nonprofit Sector, NCNA, NCRP, COF, ACR, and NASCO, but do not constitute an exhaustive list. We have selected what we believe to be most relevant to the day-to-day life of nonprofits.

As a backdrop to all this, some groups have been quietly and effectively working on these matters on an administrative level for several years, and their influence should not be understated. The National Center for Charitable Statistics (NCCS), now a program of the Urban Institute, was instrumental in helping to create the Form 990 as a joint federal-state reporting tool in the 1980s and has been suggesting revisions and refinements for the past 15 years based on its research and input from the stakeholders in the sector.

The Senate Finance Committee met on April 5
Proposals and Positions
Financial Reporting and Transparency

Forms 990

- Revise the Form 990 and set standards for its completion to ensure more uniformity of interpretation and greater scope. Require tax-exempt organizations to file electronically. NCNA and NCRP are in favor of the first measure. The IS panel favored reform of Form 990 but deferred a detailed recommendation for its second report. Electronic filing is agreed upon by IS, NCRP, COF, and NASCO. NCNA supports this measure with the caveat that it not impose undue hardship on small nonprofits and that support is provided where necessary. Some categories of tax-exempt organizations will likely be required to file electronically in 2006.

- Enhance disclosure of insider transactions and self-dealing on Form 990. NCNA supports this proposal. The IS panel supports an indication on Form 990 of whether an organization has a conflict of interest policy, but deferred a detailed recommendation until its second report.

- Require the Form 990 to be signed by the CEO or equivalent. The IS panel supports this proposal. NCNA supports this proposal only in conjunction with better standards and revisions to the form that lead to greater clarity regarding how the form is to be filled out.

- Require that audits be attached, where available. Absent an audit, require all charities with annual budgets of more than $250,000 to attach a financial statement reviewed by a CPA. The IS panel supports requiring organizations that conduct audits to attach audited statements to the Form 990.

- Institute a penalty for extended delay (extension of more than four months) in filing the Form 990. The IS panel deferred an opinion until its second report. NCNA opposes, expressing concern that audit firms often hold up report filing for less lucrative nonprofits.

- Conduct a five-year review of each charity’s tax-exempt status. This may be paid through sliding scale filing fees levied against the organizations. NCNA recommends a non-onerous five-year review for organizations that do not meet the $25,000 annual revenue requirement for filing the Form 990. The IS panel deferred an opinion until its second report, but called for an annual notification form for all organizations currently not required to file a Form 990 return.

- Require charities to disclose performance

Links

Senate Finance Committee site: http://finance.senate.gov/
Independent Sector: www.independentsector.org/
Panel on the Nonprofit Sector: www.nonprofitpanel.org/
National Council of Nonprofit Associations (NCNA): www.ncna.org/
National Association of State Charity Officials (NASCO): www.nasconet.org/
Alliance for Charitable Reform (ACF): www.acreform.com/
National Committee For Responsive Philanthropy (NCRP): www.ncrp.org/

More Information

The full Senate Finance Committee “Staff Discussion Draft” is available at:
Written testimonies submitted to the June 22, 2004 hearing can be accessed at:
http://finance.senate.gov/sitepages/hearing062204.htm
Video streaming of the June 22, 2004, and April 5, 2005, Senate Hearings can be accessed at:
http://finance.senate.gov/hearings/other/hearing062204.ram and /hearing040505.ram
goals in the Form 990. The IS panel deferred an opinion until the second report. NCNA opposes this measure because it “extends the uses of the form beyond its capabilities.”

Audits
• Establish a consistent budget threshold at which audits will be required. The IS panel recommends a threshold of $2 million. NCNA recommends a threshold of $500,000.
• Establish an alternative to audits for smaller organizations. The IS panel supports an accountant’s compilation and review for organizations with budgets between $500,000 and $2 million.
• Require boards of organizations above a certain budget size to establish audit committees. Opposed as a requirement by the IS panel and NCNA.
• Require boards to rotate auditors. Opposed by the IS panel and NCNA.

Funding and Coordination of Government Oversight and Enforcement
• Redeploy the foundation excise tax to fund enforcement, transparency efforts, and education. NCNA and COF support NCRP’s longstanding position in favor of dedication of the excise tax for oversight. The IS panel urged an overall increase in resources for IRS, and said it would be strongly supportive of efforts by Congress to earmark funds from penalties, fees, and excise taxes for oversight.
• Coordinate federal and state enforcement (including information sharing) and provide states the authority to pursue violations of federal laws. IS, NCRP, NASCO, COF, and NCNA all support such measures. See links for specifics.
• Establish stricter oversight procedures for acquisitions and conversions of nonprofits. The IS panel deferred this to its second report. NCNA strongly supports.

General Governance Concerns
• Increase taxes and penalties for self-dealing. The IS panel supports increased tax penalties for self-dealing and clearer standards for when the penalties should be imposed. The panel also urged clearer authority for abatement in cases where no excess benefit was received and the foundation was not harmed. It will make more specific recommendations in its second report. The language that the IS panel uses in its recommendation on this issue is unclear. The panel appears to support a tax as penalty for self-dealing, but is vague about the level at which this should be set or how much latitude should be afforded to the secretary to abate such a penalty.
• Standardize board duties, size, and behavior. The IS panel deferred recommendations for legislative and regulatory action to its second report, but made a set of recommendations to groups in the sector regarding the advisability of formal conflict of interest policies and audit committees. NCNA opposes legislative action.

Foundation Governance Concerns
• Limit or restrict the compensation of private foundation trustees. NCRP has advocated and recommends a limitation of $8,000/year compensation for private foundation trustees, but took no position on executive compensation. The IS panel deferred this opinion until the second report. COF recommends waiting for more study on this issue.
• Require increased reporting when administrative expenses (any expense above a grant to charity) amount to more than 10% of total expenses for non-operating foundations. Administrative expenses above 35% of total expenses would be disallowed as part of the payout requirement. IS deferred this to the second report. COF opposes legislative action at this time, recommending additional study by the field, possibly including the development of a set of definitions and standards that could then be adopted into law. NCNA supports.
• Further regulate and make transparent donor advised funds. The IS panel calls for better definition of donor advised funds, prohibition of asset parking or “round tripping,” and disclosure of aggregate financial information. The panel urges minimum activity rules but opposes a specific payout level for individual funds.
• Eliminate Type III supporting organizations as an area in which too much abuse has occurred. The IS panel opposes eliminating Type III supporting organizations across the board, citing a number of instances in which they are in active and legitimate use (see examples in report). NCNA opposes on a similar basis.

Establish stricter oversight procedures for acquisitions and conversions of nonprofits. The IS panel deferred this to its second report. NCNA strongly supports.
While the Nonprofit Quarterly has been an observer in all these activities, it would like to select a few issues on which to comment:

1. Transparency and enforcement measures should be funded using the foundation excise tax, not through fees and penalties. We recommend that full funding be set aside on a permanent basis for organizations like NCCS and GuideStar, among others, to allow reasonable public access to information about tax-exempt charities; that the IRS exempt organizations division staffing and budget be at least doubled so it can manage its workload; and that some funding be made available as a supplement to existing state charity regulators and an incentive to beefing up operations in states with little or no effective oversight activity. This is, after all, the front line where many charity violations will actually be prosecuted.

2. The Forms 990 should require disclosure of insider transactions and self-dealing. Increased penalties and taxes should be levied for these activities.

3. States should be encouraged to align their reporting forms as closely as possible with IRS Forms 990, and among them agree on a single common report.

4. The threshold for audits should be set at the level recommended by NCNA: $500,000. Audits should be required to be attached to Forms 990.

5. Donor advised funds at community foundations and other public charities should be made to observe the same transparency and cumulative payout requirements as foundations.

6. Administrative costs should not be included in the calculation of the 5% payout rate for private non-operating foundations. This will promote greater efficiency and necessary fiscal conservatism among this group of nonprofits not generally subject to standards of programmatic spending by outside contributors. Incentives in the form of a reduced levy of excise tax should be provided to foundations that significantly exceed the 5% floor.

7. Deductions for non-cash gifts should be based on the actual value of public benefit.
Benefits of Open Deliberation

As Congress considers legislation, it is in the interest of nonprofits across the country to follow the process and to weigh in on what should be done. Official committees and national organizations have their roles, but this does not replace the input from an open and frank deliberation across the breadth of nonprofit activity areas, organization sizes, and constituencies.

The Senate Finance Committee can be expected to take the Independent Sector panel’s recommendations fairly seriously, since the finance committee’s ranking members requested that IS convene sector opinion. The panel is, indeed, an ambitious effort, involving an enormous number of people on a wide swath of issues; it has managed to coalesce a good deal of knowledge, expertise, and dialogue on a set of critical regulatory issues—and for that we should all be grateful. But to be realistic, because the IS panel involves so many people and mixes nonprofits with their funders (which may lead to self-censorship) there is the risk that the lowest common denominator will be proposed in situations where disagreement exists. The fact that the panel has yet to deal with many of the toughest issues may mean that it simply cannot break past defending currently comfortable arrangements.

“Who’s in the room?” is always an important question. In the *Chronicle of Philanthropy* (“A Lukewarm Effort to Curb Abuses by Nonprofit Groups” 3/31/05), Pablo Eisenberg criticized the makeup of the main panel noting that foundations were overrepresented with 14 of the 24 panel members representing grantmaking institutions. It also overrepresents larger nonprofits like the American Heart Association, United Way of America, and the American Cancer Society. These groups are representative of IS’s membership but are not reflective of the size composition or geographic composition of the larger nonprofit sector.

While the panel has created a special working group on small organizations to reflect the views of smaller groups and raise size sensitivity concerns, the makeup of the panel has likely had its most substantive effect in what, when, and how issues related to philanthropy were taken up and addressed.

Private Foundation Issues

Public critiques of the Interim Report’s recommendations center on the panel’s slowness on or avoidance of divisive issues, many of which have to do with requirements for greater foundation accountability. These issues—required minimum payout, administrative spending, and private foundation trustee fees, among other things—are long-standing concerns and have been the topic of a number of public controversies over the past few years. These revelations and scandals not only affect the foundation community but also diminish public trust and reduce the grant dollars remaining for public benefit.

Whether or not these issues are reasonably addressed by sector spokespeople will reckon in the credibility of the nonprofit sector’s response to this regulatory push. “Ragging the Puck” (see story on page 16) so that no one else can take a shot is not in the best interest of the sector or the public. This is, by the way, not the only set of institutions that need to be scrutinized for payout. Universities also need to be looked at for their own payout rates, which are estimated by one insider to be 4.5%.

This situation argues for two responses:

- Independent advocacy on issues where the panel is acting slowly or not addressing an issue directly, and
- Careful consideration by IS of its own conflicts of interest. At the very least, it may wish to refrain from taking positions on some issues, like foundation payout and trustee fees, allowing those whose interests are clearly stated and publicly declared to fight it out.

Funding the Reforms

Finally, those of us who have done lobbying on any number of issues know that one of the pivotal issues in any campaign for reform is how to finance it. We need to ask similar questions regarding the financing of any new regulations. The most detailed work we have seen on this so far has been from NCRP. Specific recommendations for funding levels, staffing patterns, and revenue sources should be a major point of consideration in the IS panel’s next phase of work.
Can the Charitable Sector Regulate Itself?

by Woods Bowman and Angela Bies

This article will reflect on the extent of self-regulation in the sector and consider its strengths and weaknesses in light of the issues under discussion. We will discuss umbrella organizations (e.g., Girl Scouts, YMCA) that have internal standards to protect their “brand,” accreditation in various subsectors (e.g., health, education), and the beginnings of sector-wide accreditation. We will also touch on general codes of conduct, but we do not have space to consider research on board governance, best practices, or requirements imposed by the extensive web of foundations, federated giving campaigns, and government agencies that provide resources to the sector.

What’s the Problem?

After passing Sarbanes-Oxley in response to corporate scandals, Congress naturally turned its attention to the charitable sector, because it has had its share of scandal—albeit on a much smaller scale than Enron and WorldCom. Such names as United Way of America, Covenant House, Adelphi University, Bishop Trust, New Era Foundation, the Nature Conservancy, and PipeVine come to mind.

One can appreciate that the public—and Congress—might be skeptical of nonprofit organizations’ ability to govern themselves in the public interest. The charitable sector lacks the formal accountability mechanisms that, in theory, discipline bad actors in other sectors. Elections hold government officials accountable; in publicly traded corporations, shareholders have the power to elect managers. Although in practice CEOs virtually handpick their boards, shareholders have the power to sue directors for corporate malfeasance in so-called derivative suits.

There is no formal mechanism comparable to elections that gives the general public or any other nongovernmental stakeholder a say in selecting board members or disciplining boards that stray from their mission. If a charity missteps, the public must rely on their state attorney general to seek redress in court on its behalf. A donor can sue only in limited cases, such as when a charity violates the terms of a gift agreement.

Laws require governments to open their meetings and share information with the public, but there are no laws requiring charities—even those performing quasi-governmental functions—to do the same. The World Trade Center Memorial Foundation, which has the power to “own, construct, operate, and maintain” a memorial on the former World Trade Center site, is not required to open its meetings or its files. This lack of transparency in furtherance of a public purpose does nothing to bolster the public’s confidence in the charitable sector.

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Transparency

The standard access route to nonprofits' financial information is the publicly available IRS Form 990. Donors who want to do due diligence on a nonprofit can obtain free access to Form 990 data through Philanthropic Research, Inc., better known as GuideStar.

By its own estimate, GuideStar’s searchable, Web-enabled database contains more than one million nonprofits. “Each organization in the database has a GuideStar report. Each page of the report looks at one aspect of the organization: basic information, mission and programs, goals and results, finances, and leadership” (GuideStar Web site). The Web site also offers donors tips on how to use the information.

The law, however, does not require public charities with less than $25,000 in gross receipts or those engaged solely in religious activities to file. Some charities simply neglect to file. Only one in three charities actually files Form 990. The number of nonreporting charities is currently double the number of reporting charities. Closing these reporting gaps, although a worthwhile effort, would hugely expand the volume of paper flowing into an already understaffed IRS.4 And if GuideStar, which is privately funded, were unable to afford the cost of posting this new information to the Web, its usefulness would be greatly diminished.

In addition to the problem of nonfilers is the problem of accuracy. Karen Froelich at North Dakota State and other researchers who have compared Form 990 data with audited financial statements find that gross figures like total revenues and total expenses are reported accurately, but much of the other data is subject to error.5

Data on administrative and fundraising expenses are particularly suspicious. Three out of five filers implausibly report zero fundraising expenses. Researchers at the Urban Institute and Indiana University discovered that functional expense reporting was a low priority for charities, large and small.6

Proposed solutions, which include requiring the signature of the CEO or an equivalent to attest to the accuracy of report information under penalty of perjury, may cause people to take Form 900 more seriously, but it is unlikely to produce a sea change in the quality of reporting. It is quite a stretch to imagine busy federal prosecutors actually filing criminal charges for a violation.

Meanwhile, the charitable sector is experimenting with alternative models for increasing transparency. A popular method is to publish ratings that compare charities. Twenty-three organizations and five magazines publish comparative data on charities, but the vast majority do minimal evaluation, and none cover more than a few hundred.7 On page 6, Bob Ottenhoff of GuideStar raises other concerns about these “watchdogs.”

Jordan Silvergleid of The Advisory Board, an association of health care systems and medical centers, questions whether donors care about ratings. Using advanced statistical techniques, he was unable to detect a relationship between American Institute of Philanthropy ratings of various organizations and the amount of donations they receive.8 In Minnesota, donations to regional charities apparently respond to whether they meet the standards of the Minnesota Charities Review Council, but his sample is too small for this result to be convincing.

Seeking a new paradigm, the Greater Kansas City Community Foundation recently developed DonorEdge, a file on nearly 600 charities with data on both financial and non-financial performance metrics, verified through site visits. Donors with funds managed by the foundation have access to DonorEdge through a password-protected portal on its Web site. The William and Flora Hewlett Foundation is funding an expansion of DonorEdge to seven additional cities.

In short, the charitable sector has few formal and reliable mechanisms that provide transparency. It will cost a great deal to establish even those systems that would standardize the quality of information available from the forms 990, but that would be a very good start. Much of transparency remains, for the time being, in the hands of nonprofits themselves. This is sure to change.

Self-Regulation is Spotty

At the Independent Sector Panel’s request, Harvey Dale of the National Center on Philanthropy and the Law at NYU is heading a study of “self-regulatory, certification and accreditation systems in place among charities and other fields in the United States and other countries.” As we go to press, this study is still in progress,
so we will attempt a brief survey of the prior state of knowledge on the subject.

Dennis Young and other researchers at the Mandel Center on Nonprofit Organizations at Case Western Reserve University studied national umbrella organizations with regional or local affiliates in human services, health, education, religion, and the arts. They surveyed 829 candidates, but just over 200 responded, so it is hard to say precisely how many umbrella organizations exist or how much of the sector’s activity they control. Many national groups that responded to the survey are quite small—30 percent had budgets of $1 million or less in 1996 dollars.

Most umbrella groups act like trade associations, providing service to their members but exerting no control. Only one in three umbrella associations regulates the activities of its affiliates to some degree.

There are two basic types of associations: federal and corporate. Federal associations, which are three times more numerous, provide leadership and direction to their affiliates or actually share authority over operations and programs with them. The typical federal association sets policies governing the quality of affiliate services without necessarily establishing operating standards, while the typical corporate association does both.

In corporate associations, local offices are subordinate to the national organization. The typical corporate association also monitors services delivered by its affiliates, audits their finances, and files a consolidated Form 990, while the typical federal association does none of these things. In corporate associations, the national body is more likely to have the authority to suspend affiliate operations—giving teeth to self-regulation.

While hierarchical self-regulation has potential to improve the performance of association members, who will guard the guardians? Many innocent local organizations could be damaged by the missteps of their national organization, much like the local United Ways that saw their contributions decline in the wake of the Aramony scandal that rocked United Way of America.

Codes of conduct have multiplied rapidly in recent years. Independent Sector provides hyperlinks to over 100 on its Web site, including several overseas examples. They are organized into groups—public charities, foundations, individuals in professional practice, online giving, gifts-in-kind, marketing, and relationships between nonprofits and corporations. The Web site also includes hyperlinks to several donor bills of rights.

Within the public charity category alone, there are four codes used by national external review organizations and one used by a state organization (Charities Review Council of Minnesota). There are another three national and nine state codes for membership organizations, organizations having affiliates, and accrediting bodies for members. Finally, 25 codes were developed by organizations for internal use, and 26 are used by subsectors.

The Independent Sector Web site has the most comprehensive list available, but it contains a fraction of at least 200 organizations that we have found set standards in specific subsectors.

About 60 percent issue voluntary standards without verifying compliance, while 40 percent verify compliance. At least 90 percent of subsector accrediting processes include standards on program quality. At least 70 percent include standards on professional credentialing and program outcomes, ethics, and public disclosure. Other popular standards cover governance and financial management. The latter looms larger in the education field than in health care.

The Standards for Excellence program, developed by the Maryland Association of Nonprofit Organizations, does not focus on a specific subsector. It obtained foundation support in 1998 to establish an institute to replicate the program in other states. Participating nonprofits must apply, agree to abide by the standards, submit to evaluation by the institute’s local replication partner, and pay a fee. Accredited nonprofits are authorized to use the institute’s seal. The institute can withdraw authorization to use the seal if a nonprofit fails to live up to the Standards for Excellence. However, it is perplexing and disappointing that after more than six years only 44 charities in Maryland have chosen to be accredited—mostly small local groups or chapters of national organizations.11 Nationwide, only a few hundred are accredited through this program.

A handful of large international charities are accredited through a program established under the auspices of InterAction, an association of international charities. An outside party, Social

Most umbrella groups act like trade associations, providing service to their members but exerting no control. Only one in three umbrella associations regulates the activities of its affiliates to some degree.
Scholars frequently remark on the variety of activity and organizations in the nonprofit sector, so it should not be surprising that it will take many different tools to do an effective job of policing it.

Accountability International, conducted site inspections of their operations, including their international sites. But, the charities paid fees averaging $50,000, which almost surely will seriously hinder widespread adoption of this model.11

Eighty percent of subsector accrediting bodies are membership organizations and must be concerned with member services and support. A member who fails to meet minimum standards creates a dilemma for the accrediting body: don’t eject and lose credibility with the public, or eject and lose membership dues. Accrediting bodies typically work with an offender to bring it up to snuff.

As with many professional self regulatory systems, there is much room for conflicts of interest in the process of holding peers accountable. Even when outsiders are responsible for conducting surveys and awarding accreditation, the nonprofits being evaluated pay the bill.

Some public involvement may be necessary for a successful, creditable program. For example, the Dutch government accredits organizations that conduct mass solicitations. Participation is voluntary, but half of the nation’s fundraising charities are accredited, and René Bekkers of Utrecht University reports that donors who know about the accreditation system have more trust in charities and donate more to charitable causes in general.13

Conclusions
Increased transparency will give donors new tools for making informed judgments to reward “good” organizations and withhold support from the others. Educational and health care organizations, which generate most of their income by selling services, will be largely unaffected by new transparency rules. Accreditation neatly supplements transparency because over half of the accrediting bodies are in the field of education and one-quarter in health care.

Scholars frequently remark on the variety of activity and organizations in the nonprofit sector, so it should not be surprising that it will take many different tools to do an effective job of policing it.

Endnotes
1. Some states permit “relator” actions, in which citizens can bring suit in the attorney general’s name, but the attorney general must give approval and usually maintains a high degree of control. They are very rare. See Marion Fremont-Smith, Governing Nonprofit Organizations (Cambridge, MA: Belknap, 2004).
3. This proposal continues to ignore the 272,000 religious congregations that do not currently file with the IRS voluntarily, but gifts to congregations probably come from their own members, so omitting congregations is not a serious gap in sector transparency.
5. This project resulted in a series of five reports, which are available at the cost study’s Web site, www.coststudy.org.
8. This section is based on “Structure and Accountability: A Study of National Nonprofit Associations,” by Dennis Young, Neil Bania, and Daryne Bailey, Nonprofit Management and Leadership 6(4) summer 1994. They used Gale’s Encyclopedia of Associations to find candidates.
A proliferation of standards raises a question of consistency. Differences are easiest to see in standards established for financial ratios. Below, we compare the three most popular financial ratios used by The American Institute of Philanthropy, Wise Giving Alliance of the Better Business Bureau, Charity Navigator, and Ministry Watch, the Minnesota Charities Review Council and GuideStar. Of these, only the first four organizations rate charities.

All six organizations consider the cost of fundraising to be important. (The Charity Review Council views such costs as being encompassed adequately by the program ratio standard and related guidance.) On this subject there is a serious disagreement over how to calculate the relevant metric. There is a big difference, conceptually and numerically, between relating fundraising expenses to money raised and relating it to total expenses or total revenue. Such a difference can cause confusion among donors.

All six organizations also consider reserves to be important. All but one believe that charities with too much wealth do not need additional resources, and discourage donors from giving to them. Each organization measures reserves differently, and some of them use different terms to describe the concept of wealth. Some metrics do not make proper allowance for legally restricted wealth or illiquid wealth, such as buildings. Some say reserves should be no more than three years of expenses, while others say no more than two years.

Charity Navigator takes the opposite view—they believe that wealth indicates stability, and stability is a good thing. To receive Charity Navigator’s top five-star rating, a charity must have reserves at least equal to one year’s expenses, and it does not penalize charities for having too much wealth. One can only wonder what donors are to make of such a difference between competent authorities.

The following ratios are the most popular among the American Institute of Philanthropy (AIP), BBB Wise Giving Alliance (BBB), Charity Navigator (CN), Charities Review Council of Minnesota (CRC), and Ministry Watch (MW). GuideStar (GS) makes no recommendations for maximum or minimum values for financial ratios, while Charity Navigator (CN) and Ministry Watch (MW) combine results from several financial ratios into a single formula as the basis for their rating.

**Program Expense Ratio**
All use it. All except MW calculate it by dividing program expenses by total expenses. MW uses total revenue in the denominator. Recommendations: AIP ≥ 60%, BBB ≥ 65%, CRC ≥ 70%, and CN ≥ 75% for its five-star rating.

**Fundraising Ratio**
All except CRC use it. AIP and BBB calculate it by dividing fundraising expenses by related contributions. Recommendations: AIP and BBB ≤ 35%.

- GS calculates it by dividing fundraising expenses by total expenses.
- CN calculates it both ways. Recommendation: CN ≤ 10% for its five-star rating.
- MW calculates it by dividing fundraising expenses by total revenue.

**Reserve Ratio**
All use it. AIP defines a reserve as “currently available funds” including all invested funds, BBB defines it as unrestricted net assets, CRC defines it as unrestricted net assets “available for current use,” CN defines it as “working capital,” including all invested funds, GS defines it as unrestricted and temporarily restricted net assets minus equity in land, buildings, and equipment. MW relates current assets to expenses without identifying current assets as a reserve. Recommendations: AIP and BBB ≤ 3 years of expenses, CRC ≤ 2 years operating expenses, CN > 1 year. Notice that the CN standard is in the opposite direction of all other standards.

Independent Sector’s standards do not assign minimum or maximum values to these financial ratios, but speak to devoting a “reasonable” percentage of budget to programs, maintaining “reasonable” fundraising costs, and not accumulating operating funds “excessively.”

GuideStar cautions that ratios are useful for “comparing organizations of similar size and age, that are located in the same area or similar locales, and that have similar missions and programs” or for “tracking an individual nonprofit’s progress over time” (from GuideStar’s Web site).
While a variety of measures at the federal level are still being mulled over in the Senate Finance Committee, activity in the states, where our regulation is closer to home, has already increased in many cases.

**The Job**

Terry Knowles has been the Registrar of Charitable Trusts with the New Hampshire Attorney General’s Office since 1981. In describing the role of her office she says, “The Attorney General has held the common law authority to regulate charities and to protect charitable assets for over four hundred years. Elizabeth the First authored a document known as the ‘Statute of Charitable Uses’ in 1601, and that document formed the basis for nonprofit law in the United States. While the Attorney General’s authority to regulate charities was generally accepted, in 1943 New Hampshire became the first state in the country to codify into law the Attorney General’s common law jurisdiction over the supervision of charitable trusts.” Since that time nearly every state has adopted some form of legislation regulating charitable organizations and professional fundraising activities.

What does the “supervision of charitable trusts” mean exactly? According to Knowles, the New Hampshire Attorney General supervises and regulates charities doing business in the state; licenses professional fundraisers; regulates games of chance including Las Vegas and Monte Carlo fundraisers; oversees the filing of community benefits plans by healthcare charitable trusts; monitors all legislation that has any relationship to the nonprofit sector; and reviews reports from every town and city in the state of New Hampshire that holds charitable trust funds—234 in all. The Unit has also been assigned the responsibility to monitor charitable gift annuities issued by nonprofit organizations. Finally, the New Hampshire Attorney General is a necessary party to any legal action involving a charitable interest.

“Because the Charitable Trusts Unit consists of five people, we have to triage everything that
"[T]he sector has just exploded in the past 20 years. In addition, the issues relating to the nonprofit sector have become very, very complex."

Terry Knowles
New Hampshire AG’s Office

comes through the door each day.” Says Knowles. “Our first priority focuses on the investigation and prosecution of the increasing incidents of fraud, theft, and embezzlement in the nonprofit sector. Of equal importance, however, is the need for strategic board member recruitment and training. As our time allows, we go into the field and present workshops to nonprofit organizations designed to familiarize boards of directors members with their responsibilities.” Many state charity offices, faced with this kind of workload are understaffed and overwhelmed. One way of meeting these regulatory challenges and dealing with the lack of resources was the creation of a National Organization of State Charity Officials (NASCO) in 1979. Since NASCO’s inception, its members have met annually with those of the National Association of Attorneys General to talk about cases and trends. NASCO also invites members of the nonprofit sector to attend a portion of the conference and present their points of view on a variety of topics. NASCO has formed strategic partnerships with some private sector entities and is currently partnering with GuideStar on a Commerce Department grant project designed to streamline the annual financial filing and registration processes required by most states.

How the Environment is Changing: Public Attitudes

Most of those we talked to said that these responsibilities have been fairly constant. But Bill Josephson, who was with New York’s Office of the Attorney General until August 2004, comments that the environment has changed—and one of those changes has been in the realm of public scrutiny. “My hunch is that our relationship with the sector is not any different today than it was before, but that journalists, whistleblowers, complainants, and the regulators themselves are more present and that September 11th was sort of a catalyst. When an icon like the Red Cross is held up to light and found wanting, all of a sudden a lot of people become concerned about whether or not their faith in the sector was well justified.”

Mark Pacella, from the Pennsylvania Attorney General’s office, agrees. “I don’t mean to put this off on simply those organizations engaged in September 11th relief, because it’s certainly much broader than that. However, I do think it really did trigger a lot of awareness in people who started to think, ‘Well, what about our local organizations?’ We’ve certainly experienced an increase in those kinds of inquiries.”

More generally of course, there has been increasing public attention paid to the need for clearer ethical principles in the governance of organizations.

Increased Complexity in the Midst of Scarce Resources

The infrastructure for monitoring the nonprofit sector is not robust relative to the size, diversity, and growing complexity of the field. “The fact is that staffing and resources to regulate charities are woefully inadequate,” comments Knowles, of New Hampshire. “There’s no other way to put it. We have laws out there on the books, both at the federal and the state levels, but it’s a real challenge keeping up with the sector’s growth,” she explains. “When I started with this office we had approximately 1,100 charities registered here. We’re now approaching 7,000—and we’re one of the smaller states. You have states like California, which has 89,000 registered charities, and Massachusetts, with over 20,000 nonprofits, so the sector has just exploded in the past 20 years. In addition, the issues relating to the nonprofit sector have become very, very complex. For example, three United States Supreme Court decisions from the 1980s concerning the regulation of professional fundraisers rendered many state laws in this area unconstitutional. State legislatures had to scramble to enact new laws in order to comply with the pronouncements of the Court and many of those laws, in turn, became the subject of legal challenge… There are all sorts of nuances now relating to how charities invest their money, how they carry out their board responsibilities, what level of compensation should or should not be paid to chief executive officers, what constitutes a conflict of interest, and, above all, what is the role of the Attorney General in regulating char-
itable activity. . . It is very different from the way it used to be.”

Pacella again concurs, commenting, “A good example of this would be in our health care sector where you have nonprofit charitable community hospitals or health care systems that undergo mergers, affiliations, divisions, perhaps conversions or sales to for-profit acquirers. State regulators are finding themselves in the throes of those transactions, reviewing to ensure that the public’s interests are being safeguarded, that state laws are being complied with, etc. Given this growing complexity, being able to continue to address the enforcement needs of the sector within the parameters of existing resources has always been a challenge and doesn’t look to be getting any easier.”

Jamie Katz of the Massachusetts Attorney General’s Office takes this one step further: “We clearly deal first and foremost with inappropriate governance and spending, and improper use of charitable assets, as well as the weak financial systems often found in those situations. Another set of issues revolve around fraudulent solicitation, and solicitations that involve either charities or fundraisers making misrepresentations. In some cases, there are campaigns between for-profit fundraisers and charities that are a sham. On top of these more traditional problems, over the last 10 or 15 years charities have behaved differently. They have set up relationships with for-profits that were never there before. They have compensated management and trustees in ways that were not used before, and have modeled their behavior on for-profits or fundraised in ways they had not done before. Some of that is necessary and appropriate and has really helped charities perform their missions better and has strengthened their financial base. But there’s no question that we’re seeing relationships with for-profit entities that are wholly inappropriate. We’re seeing diversions of charitable assets and the emergence of systems and structures that do not protect charitable assets. We are confronting some combination of weak management and abuse in far too many cases. What’s hard is that there are 22,000 public charities in Massachusetts, many with increasingly complicated issues. We strive not only to deal with the governance issues, but also to register them, get them in compliance, and handle all the probate, trust, and fundraising matters.”

Katz says that this has led his office to a kind of leveraging strategy. “We are pursuing enforcement cases that have more general applicability. It’s kind of like the trip you take on the interstate when you pass the state trooper who’s got a couple of cars pulled over to write tickets. You tend to slow down if you know there’s some enforcement in that area. And that’s a good analogy for us. We don’t have to reach every excess compensation case that exists. We’ll never do that. But if we reach enough of them that people are a little concerned and think two or three times before they decide to overreach, we probably will have a pretty positive effect on those kinds of abuses.”

Streamlining for Greater Transparency
The attorneys general are working not only with the challenges of the growing size and complexity of the sector, but also with problems of disconnection between state and federal reporting and monitoring mechanisms.

“We’ve found from time to time when we are investigating a charity that we’re actually running on a parallel track with the IRS in their investigation,” says Knowles, “but under federal law they can’t tell us anything they are doing or indeed whether or not they are looking at a particular charity. And you find the charities under review become frustrated because they are dealing with two government agencies that can’t talk to each other—that’s a big problem. In my opinion we are wasting our very scarce regulatory resources. If that barrier were removed we’d be in a position to be more effective in the investigations that we do carry out.”

Bill Josephson anticipates that these barriers may soon be diminished. “IRS state cooperation provisions that are now in HR1528 as passed by the Senate create a window of opportunity around cooperation. Enactment is really critical because, as you know, until they are enacted we really can’t work jointly with the IRS. The IRS can’t speak to the AG offices. If we get the IRS cooperation provision then obviously the next step is to get resources to the IRS, as the Senate Finance Committee Staff has proposed.”

Josephson also thinks the sector will become more transparent if registration and filing systems are made consistent and simpler for nonprofits to manage. “Electronic filing and national and state registry are critically impor-
many attorneys general offices already try to help in this regard. Besides taking on the high-profile cases that may educate, “we do a lot of education,” says Katz. “We have materials up on our Web site, we sponsor a conference every year or two, we speak at a lot of meetings, and we have packages of material we send out to new charities. We will continue focusing on education, but we also need the trade associations and groups of charities to understand and advocate themselves for more accountability and better oversight. We will also offer legislation late this year, which we hope will pass and help set some standards. Certainly a lot of our time is spent putting out fires and dealing with problems that arise quickly, but by sponsoring legislation, by doing the education, we are trying to articulate what we think are the appropriate standards. We’re trying to help charities’ leaders prepare better to lead their charities.” Belinda Johns adds, “Education for donors and nonprofits will become more important, and for that reason we are beefing up our Web site to provide more information to both of those constituencies.”

For Knowles it boils down to prevention. “The more board training I do the better off I am, because if these organizations are governed properly I’m not going to be looking over the shoulders of the board members,” she says, “and that is a positive step. On the other hand, my message is not always warmly received—especially when I lecture on liability and risk management. It is often difficult for public-spirited citizens to recognize the culture of board membership has changed from the time-honored ‘pillar of the community’ model to a new era of responsibility, public accountability, and increased liability. At the conclusion of my training sessions invariably someone will say, ‘But we are only volunteers. Do we really have to do all of this?’ And the answer today is, of course, ‘Yes.’”

Josephson feels that the increased scrutiny nonprofits are feeling should be seen as an opportunity. “A big challenge is the acceptance of self-regulation and self-accreditation. It’s amazing to me that so much of the sector does not yet perceive that. It ought to perceive that going in that direction is preferable to further regulation from any outside authority.”

Self-Regulation

Josephson feels that the increased scrutiny nonprofits are feeling should be seen as an opportunity. “A big challenge is the acceptance of self-regulation and self-accreditation. It’s important for ease of filing . . . to cut down the processing time so that the public and journalists can have access to more timely information, and to enable the states and the IRS to work together more efficiently. As it is now, the 990s, when we finally have them, are almost two years old.”

Belinda Johns, with the Attorney General’s Office in California, points out some of the benefits of such a system for nonprofits and particularly those that function in multiple states. “Our goal is single point filing; that is, a single site where nonprofits can comply with the filing requirements of all states in which they operate. But in addition to that, as electronic filing becomes more available, it will be easier for nonprofits to comply in multiple states because accounting software packages will include the secondary reporting forms required by each state. What charities have to do differently in the various states is primarily related to solicitation. The nonprofit corporation laws in each state are fairly similar—it’s only when solicitation comes into play that the laws tend to vary more.”

Pacella thinks that making all filings electronic and creating links between systems will help in transparency and regulation. “I think this technology can dramatically improve the accuracy and timeliness and the usability of the data in a meaningful way. There’s a tremendous amount of information submitted on paper and it is a great benefit to regulators to have this information. But in large part, because of the volume that comes in and the resources that are in place now, that information is oftentimes simply on file. It is available, but the only way it gets looked at is if other circumstances draw our attention to it. Electronic filing, electronic data, for instance, holds the promise of changing all of that. Moreover, if organizations are going to have their financial realities open to public inspection, which I don’t think anybody says is a bad thing, it really is important that the information that is made publicly available be accurate and timely. And we have certainly not reached that plateau yet based on the experience of regulators and the amount of errors and omissions that we see in filings.”

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