

# Watchdog Wanted: Making the Case for Internal Oversight of the Nonprofit Sector

By Scott Harshbarger and Steven Netishen

**T**HE U.S. NONPROFIT SECTOR IS AT A crossroads. It has lost the public's trust in its ability to carry out its mission. This ebbing trust stems largely from the sector's fundamental lack of accountability, where existing mechanisms have been ineffective at routing out real and perceived corruption, fraud, governance and ethics problems and in ensuring that nonprofits fulfill their mission to those they serve.

To date, we have relied largely on external forces to check nonprofits' behavior; and certainly, nonprofits cannot ensure accountability on their own. But now, after years of nonprofit scandals and abuse, task forces, and reports, the time has come for the sector to willingly adopt more effective *internal* controls. With existing models to draw on, the sector must turn inward and begin to incorporate the principles of existing external watchdogs. To that end, this article is a call to action, where the key to success is to combine internally adopted mechanisms with the pressure of external oversight. In what follows, we propose new mechanisms, including the adoption of enforceable sanctions for unethical nonprofit behavior, developing joint partnerships between existing agencies, and the establishment of a new position of inspector general to oversee nonprofit adherence to

regulation. If the sector willingly adopts this combined approach to internal and external oversight, it can begin to restore discipline and accountability and reaffirm its compact to ensure the public good.

According to the *2008 Report on Charitable Confidence*, only 25 percent of Americans believe that charitable organizations do a "very good" job of helping people, which is a decrease from 34 percent in 2003. In the latest Ethics Resource Center report, *National Nonprofit Ethics Survey: An Inside View of Nonprofit Sector Ethics*, survey respondents reported observing more financial fraud than their counterparts in business, and 42 percent of respondents characterized their organizations as "weak" or "weak leaning" ethical cultures, compared with about 38 percent in the 2000, 2003, and 2005 surveys. The significant decline in the public's and insiders' confidence in the nonprofit sector has been driven by scandals such as the Red Cross's massive mishandling of its response to Hurricane Katrina, the embezzlement of nearly \$1 million from the Association of Community Organizations for Reform Now (ACORN), the Smithsonian Institution's highly publicized management and governance crisis, and other high-visibility incidents. Nonprofit sector leaders tend to shrug off such scandals as the bad acts of an

isolated few that have only marginal impact on the sector as a whole. The mere existence of these scandals, however, should be deeply troubling to the nonprofit sector because scandals, whatever their size and shape, have had a broad and lasting impact on the levels of public trust and, thus, on levels of charitable giving. The connection between confidence and giving is that basic. Now is the time for action. The nonprofit sector must acknowledge its scandals and shortcomings; institute mechanisms to expose, discipline, and guard against illegal and unethical behavior; and challenge itself to take deep and wide-reaching action to restore the public trust.

## Existing External Models

Strides have been made to create new, and improve on existing, governance mechanisms to monitor the nonprofit sector. Externally, there are multiple avenues to guide and check the nonprofit sector. Below we explore some of the existing mechanisms to ensure nonprofit accountability.

**The Internal Revenue Service.** In exchange for charitable missions, nonprofit organizations and foundations receive the benefit of tax-exempt status under federal and state tax codes. Considering the approximately \$300

billion donated to the nonprofit sector annually, this is a windfall of sorts from the public till. Because of the financial advantage of tax-exempt status and the filing processes required to receive it, the IRS, therefore, is perhaps the sector's most vital watchdog.

The IRS's filing and auditing system provides an annual opportunity to review a nonprofit's financials and ensure compliance with the requirements of tax exemption. The IRS's primary enforcement mechanism is the right to impose potentially substantial civil penalties for late or incomplete filings as well as, of course, the threat of losing tax-exempt status altogether.<sup>1</sup> In 2008 the IRS expanded its filing requirements to compel many small organizations with less than \$25,000 in gross receipts to submit an abbreviated return.<sup>2</sup> In 2007 the IRS issued a revised Form 990 to help improve transparency and compliance. The new form included major changes, such as the addition of a governance section and schedules relating to executive compensation, related organizations, and foreign activities, among others. The agency also provides educational support in the form of tutorials, published guidance, and other platforms to further counsel the sector.

**The federal government.** The federal government also uses its legislative and budgetary powers to impose oversight on the nonprofit sector. Quite successfully, the government has linked the granting of federal funds to regulatory compliance, such as by requiring proper accreditation before public universities can receive federal funds and, similarly, before nonprofit hospitals can be eligible for Medicare reimbursement. Further, Congress uses its legislative authority to institute meaningful investigation of the sector. Senator Chuck Grassley of Iowa, the senior Republican member of the Senate Committee on Finance, has aggressively monitored the nonprofit sector, including by spear-

heading investigations into executive compensation and spending abuses.

**State attorneys general.** At the state level, much of the governmental watchdog responsibility falls heavily on the public charities division of the attorney general's office. The attorney general's role is to protect the public interest by overseeing the use of charitable funds and the fundraising process, investigating specific complaints lodged against nonprofit organizations, and enforcing the laws and regulations affecting the sector. Attorneys general carry out their mission by imposing civil and criminal penalties, although the practices and resources of the attorneys general diverge greatly from state to state.

**The media.** The nonprofit sector has also relied on the media to be its watchdog and to highlight instances of bad behavior. But the nonprofit sector's reliance on the media has serious shortcomings. The media can be effective in exposing corruption and illegal and unethical behavior by those charged with safeguarding the public trust. But what happens after an article has been published and public outrage dissipates over time?

### Internal Controls Needed

While all of these external mechanisms help to provide oversight to the sector, they are limited in their ability to cause real and lasting change through oversight, enforcement, and sanctions. But the nonprofit sector remains resistant to adopting internal mechanisms that have teeth rather than merely offering aspirational and voluntary guidelines that organizations can choose to follow or disregard.

At root, the nonprofit sector has exhibited a fundamental "Not in my backyard" resistance to policing itself. In spite of its expertise, leadership, and clear identification of its internal challenges, the nonprofit sector has yet to truly stand up on the watchdog issue.

Ironically, nonprofits continually support and demand watchdogs to oversee other sectors; consider Common Cause, inspectors general of agencies, independent state and federal ethics commissions and congressional panels, and major federal and state oversight and watchdogs of every kind for the private and corporate sector. But nonprofits haven't been champions of the same principles on their home turf.

Some argue that the complexity and diversity of the nonprofit sector renders substantive, sector-wide reform impossible, not to mention the costs and concerns about unintended consequences. Thus, our recommendations for meaningful implementation that extend beyond education, technical assistance, and other aspirational changes, and toward greater enforcement and sanction-driven oversight, will likely be and have been hard fought. Nonetheless, the nonprofit sector must move beyond voluntary internal controls and accept that with the benefits of the tax code come the burdens of accountability and good governance. Enforcement and sanction capacities should be used to ensure that all nonprofits responsibly fulfill their charitable missions. If encouraged and implemented directly by the nonprofit sector itself, such substantive reinforcements could bolster its reputation in these difficult economic times, when the public is even more likely to require that its donations have been put to good use.

Accordingly, an internal nonprofit sector watchdog could be the guardian of the public trust that the sector so desperately needs. And some strides have been made to devise a uniform and standardized list of "best practices." In October 2007, for example, the Panel on the Nonprofit Sector, made up of 24 nonprofit and philanthropic leaders from a range of organizations, published *Principles for*

*Good Governance and Ethical Practice.* The report presented 33 principles of “sound practice,” covering legal compliance and public disclosure, effective governance, strong financial oversight and responsible fundraising. Directed to nonprofit organizations of every size and scope, these guidelines are truly thoroughgoing and broad based. They provide a checklist by which any nonprofit organization can measure its own behavior.

These efforts represent a start, but much more is needed. Significant challenges remain in areas such as training and education as well as in exposing and preventing fraud, abuse, criminality, and unethical conduct. Moreover, existing external “watchdogs” are incapable of correcting these shortcomings for a number of reasons, including a lack of nonprofit resources and expertise. Further, the sector-wide best practices that have been implemented remain largely voluntary and thus lack meaningful enforcement to ensure adherence.

### Combining Internal and External Oversight: Five Recommendations

The reality is that the nonprofit sector must do better. Below are some proposed next steps that build on the positive aspects of the current structure but also move toward more aggressive oversight, nonprofit self-determination, and consequences for lack of compliance.

**1. Agreed-upon, enforceable principles.** The nonprofit sector must extend its best-practice approach to become a valuable educational and technical assistance dissemination model for all in the nonprofit sector, regardless of organizational size, scope, and function. The sector must use its best practices as the foundation for internal oversight, enforcement, and sanctions. And of course, nonprofit leaders need to build a consensus on enforcement and sanctions.

Moreover, these agreed-upon principles

must be enforceable and subject to sanctions by regulators, creditors, associations and others. Further, enforcement must be designed to apply uniformly to major institutions and foundations based on size, scope, function, and revenue. While national associations may legitimately argue that they are regulated enough and internal regulation will likely be politically motivated, we must also acknowledge that the resources for external enforcement have been limited, and evidence of meaningful self-regulation and sanctions is almost nonexistent.

**2. Resources and joint partnerships.** To have any credibility, a proposal must include a commitment to actively provide adequate resources for regulation and enforcement of existing state and federal laws. The best models are joint federal and state task forces, federally funded state programs (like the Medicaid Fraud & Abuse program), or federal grantmaking programs (such as Community Oriented Policing Services) that ensure cooperation and coordination in enforcement as well as uniformity and consistency in terms of the sectors regulated. Hence, the development of a partnership between the Department of Justice, the IRS, state attorneys general, and a state charitable regulator partnership could achieve these objectives. A task force of these groups, together with a nonprofit advisory committee, could be convened to help identify and outline the possible structure, jurisdiction, funding, and power needed to ensure coordination of such a regulatory system.

**3. Education and assistance.** Another crucial element is education and technical assistance in the areas of governance, ethics, and transparency, enabled by adequate funding. While for years the nonprofit sector has talked about education and training, no one has come forward to actually fund a program focused on building capacity for internal

controls and good organizational management. The dearth of funding for education and infrastructure development in these critical areas is plainly obvious and particularly worrisome. Without sufficient funding, the nonprofit sector can never support self-regulation, and internal regulation and initiatives for greater accountability become largely hollow and rhetorical.

**4. Independent regulatory systems.** Each of the major accreditation organizations and associations should have an independent regulatory system that, in addition to its membership and educational functions, includes effective and efficient enforcement mechanisms for sanctioning those who violate these principles. Similarly, major grantmaking organizations should condition grants based on compliance with governance principles and subject them to audits. Sanctions for any organizations that do not implement governance standards appropriate to their size, shape, and function should be part of any enforcement structure.

**5. Inspector general models.** Evidence indicates that independent inspectors general are useful (if sometimes unpopular) in governmental agencies, correctional departments, and private corporation or public-sector agencies. So surely they are appropriate for nonprofit sectors and activities. Inspectors general should be funded by major private associations to contribute to education, technical assistance, and compliance budgets of associations, foundations, and grantmaking organizations. As is the case with the federal sentencing guidelines, establishing this kind of compliance mechanism would be viewed as a safe harbor for organizations that face external regulators, prosecutors, and self-regulatory sanctioning.

### Making Accountability a Reality

Today's approach to nonprofit accountability and regulation is clearly insuffi-

cient. The current external regulatory mechanisms and internal, nonbinding best-practice principles are insufficient to address the far-reaching problems of the nonprofit sector. To respond to these shortcomings, the sector must create a multilevel structure that includes support for external enforcement for crimes, fraud, and fiduciary abuses at all levels; strengthened accreditation and association models; the sanctioning requirements of grantmakers; a presumptive Sarbanes-Oxley-type approach for institutions and foundations of major size and revenue (realizing that there is no one-size-fits-all strategy or program, but there are foundational governance principles that should be adopted sector-wide); the establishment of core principles and methods of self-regulation with teeth at all other levels; and the introduction of the notion of joint federal-state oversight, plus the independent inspector general concept of self-regu-

lation.

This strategy of joint internal and external oversight can create an oversight structure with true power to ensure accountability. It is based on the belief that prevention is the best and cheapest form of protection and that a credible, sector-specific enforcement regime can establish a framework and a minimum ethic as a floor within which autonomy and pluralism can thrive. Such a structure encourages the nonprofit sector to affirm its strength, its belief in integrity, and its potential for doing well by doing good. It affords the nonprofit sector the ability to thrive and invite scrutiny and accountability and allows it to be the first to solve the problems and to implement a remedy. By taking the lead and effectively incorporating its own enforcement and sanctioning watchdog regime, the nonprofit sector stands to benefit in terms of reputation and operational efficiency.

## ENDNOTES

1. For a list of recent revocations of tax-exempt status, see the Internal Revenue Service page on recent revocations of 501(c)3 organizations ([www.irs.gov/charities/charitable/article/0,,id=141466,00.html](http://www.irs.gov/charities/charitable/article/0,,id=141466,00.html)).
2. See the IRS's filing requirements for small organizations ([www.irs.gov/charities/article/0,,id=169250,00.html](http://www.irs.gov/charities/article/0,,id=169250,00.html)).

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