

Standards for Excellence Institute



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July 15, 2004

Senate Committee on Finance
Attn: Charitable Governance Roundtable
Rm SD-203
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Senator Grassley, Senator Baucus and Senate Finance Committee Members:

On behalf of the Standards for Excellence Institute, we appreciate this opportunity to comment in response to the Staff Discussion Draft on the subject of Charity Oversight and Reform. The Standards for Excellence Institute is a national initiative to promote the highest standards of ethics and accountability in nonprofit governance, management and accountability, built on programs originated in Maryland and replicated in Georgia, Louisiana, North Carolina, Ohio, Pennsylvania and Illinois. The Institute serves as the catalyst and organizer for the Standards for Excellence program, an ethics and accountability initiative based on the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector* ("Standards for Excellence").

Based on our experience developing the Standards for Excellence Program and providing training and technical assistance to a diverse group of nonprofit organizations operating at the national, state and community level, we submit the comments below on many of the specific recommendations contained in the discussion paper. These expand on the more general comments regarding nonprofit regulations and best management practices submitted in our June 22, 2004 letter to the Senate Finance Committee, a copy of which is attached with this communication.

Many of the recommendations in the discussion paper call for improved and increased reporting and disclosure by nonprofits, more stringent standards for the conduct of nonprofit boards and managers, and improved enforcement by federal and state authorities. The response from the nonprofit sector will likely

Standards for Excellence Institute

420 W. Second Street, Suite 201 Baltimore, MD 21230 410.727.1726 FAX: 410.727.1914

www.standardsforexcellenceinstitute.org

focus on which of these recommendations should be made into law, which should be reserved for systems of self-regulation, and which may require more thought and discussion. We have submitted our own reaction on these issues.

However, in our view it is equally if not more important to highlight the recommendations that go beyond simply increasing or expanding regulatory and enforcement efforts. These include funding proposed for the development and promulgation within the nonprofit sector of best practice standards, for the implementation of accreditation programs, and for expanding the availability of training and technical assistance to board members and managers of nonprofit organizations.

Many of the highly publicized cases that have caused increased concern with nonprofit management and integrity, and most of the questions that arise in day-to-day operation of nonprofit organizations across the country, arise from matters that are already covered by laws and regulations.

If we move forward today with the adoption of enhanced legal standards, the creation of new accreditation programs and the promulgation of voluntary codes of best management practices, we will then find that we continue to face the following facts. First, tens of millions of well-intended individuals are involved in the management and operation of the nations' charities; and second, for the most part, their compliance with current legal requirements and standards of 'best practice' is essentially self-enforced.

Our research has shown that most of these board members and managers recognize there is a gap between effective governance and management standards, and the level of performance they are able to achieve day-to-day in their organizations. Real progress toward broadly enhancing the compliance and performance of nonprofits across the nation will require examining and eliminating the obstacles or conditions that prevent these organizations from closing that gap.

Our experience with the Standards for Excellence has demonstrated that 'setting the bar' is only the first step. Developing and distributing supportive educational materials, providing 'clinics' and other training opportunities in a variety of formats, and making staff available to provide hands-on assistance, are essential supports to enable nonprofits to achieve higher levels of performance.

Therefore we particularly endorse the recommendations to make federal resources available for these critical components of any compliance or improvement program.

A. Exempt Status Reforms

1. Five-year review of tax-exempt status by the IRS

Much of the information specified for the new five-year review appears to be available annually from review of the Form 990: e.g. current articles of incorporation and by-laws, whereas any change in these is already reportable on the 990. Also, for most

organizations, any information that would be contained in financial statements should already be contained in the annual 990.

Other information, such as conflict of interest policies, management policies regarding best practices, and a narrative about the organization's practices, would create new previously undefined areas of reporting.

Without very clear and specific guidelines for reporting management and organization practices, the value of such information to either the IRS or the public in evaluating charities may be very limited. The absence of clear definitions of 'program' vs. 'administrative' costs in current 990 reporting is one of the problems that limits the usefulness of that data in evaluating or comparing organizations' reports. We suggest that any new reporting requirements be preceded by development of reasonably precise and objective standards for what is to be reported.

For many organizations, particularly those exempt from annual 990 reporting based on budget size, a report with all of the information suggested for the five-year report would be a significant burden. However, a regular five-year requirement for the submission of *some type of basic report* by those organizations otherwise exempt from 990 filing would be desirable simply to identify those still in operation and those that have effectively ceased to exist.

A more cost effective alternative to lengthy five-year reporting may be simply expanding the 990 to include such information as specified accreditations and board activities. Enhanced review of the 990, triggered for example by reported insider activity, may be more cost effective for the IRS and less burdensome for filers.

Items 2 – 5 - no comments.

B. Insider and Disqualified Person Reforms

1. Apply private foundation self-dealing rules to all charities

We would not support applying the prohibition on disqualified person transactions to all charities and social welfare organizations. The rule is appropriate for private foundations, where the majority of board members may be selected based on a family or business relationship. Operating charities and social welfare organizations are not created for the management of a trust or endowment. They should, and most do, have more diverse boards.

Particularly in rural areas, where an organization would logically seek board participation from the limited number of business, professional and community leaders, a prohibition

on fair and good faith business transactions with all board members would create serious hardships for its effective operation.

Existing intermediate sanctions already impose severe penalties for any excess benefit transactions. Concerns with board or management self-dealing can be addressed by regulating the size and composition of nonprofit boards and closely monitoring internal business dealings. For example, our *Standards for Excellence* require that boards contain at least five unrelated individuals. Potential conflicts of interest must be disclosed, and approved by a majority of disinterested directors. Further, consideration could be given to providing that no such transaction may be allowed unless approved by the votes of at least five disinterested directors.

2. Expanded definition of disqualified person

We endorse this change.

Items 3 –5 – no comments

C. Grants and Expense Reforms

No Comments on this section.

D. Federal – State Coordination

1. Standards and review of conversions

We support both the development of more specific and stringent standards for conversion and greater IRS involvement in pre-conversion review.

2. Provide States authority to enforce federal actions

Stronger enforcement of existing federal standards is important to retain public confidence in the charitable sector, and we endorse this recommendation. But not all state charity officials are adequately equipped to enforce even existing state laws, and additional resources will be required to make this grant of broader enforcement authority productive.

State officials could also be helped by allowing the IRS to share information that would assist in the administration and enforcement of state laws regulating charities. We endorse this change, as long as disclosure of confidential information is restricted to those officials charged with administration of those laws, and confidentiality protections are otherwise maintained by IRS and state officials.

E. Improve Quality and Scope of Forms 990 and Financial Statements

1. Required signature by Chief Executive Officer

Endorse.

2. Penalties for filing failures

We feel strongly that the increased penalties for failures regarding required information, particularly those “for each failure”, are too severe for smaller organizations. Many of these organizations, often for cost considerations, prepare the 990 without outside professional assistance.

The 990 is a complex form that not every executive understands, and for which detailed standards for information do not exist. Also, there are widely different degrees of ‘errors or omissions’ that should be recognized in assessing penalties. Failure to file Schedule A is a major mistake – failure to check the “403b” box is minor. A missed check mark may be an inadvertent preparation error.

3. Penalties for failure to file timely 990

No Comments

4. Electronic Filing

We strongly recommend that electronic filing not be mandated for smaller organizations at this time. As noted above, many of these groups ‘self-prepare’ the Form 990, often to save administrative expense, and some very small groups still lack even basic computing capability. Currently, the cost to use an outside preparer or service just to provide electronic signature and filing would be an undue burden.

5. Standards for Filing

As noted above and in our June 22 letter the lack of clear definitions and standards for the preparation of the 990 has led to major concerns with the accuracy and comparability of the data. Promulgation of standards by the IRS is extremely important. We are concerned that the time frame suggested, less than 18 months, may not permit adequate opportunity for input, review and comment by the nonprofit community.

Because the charitable and educational sector is very diverse, the standards must recognize and accommodate, in specific but varying ways, these differences in types of organizations. Development of such standards will require extensive consultation with representatives of various nonprofit ‘subsectors’. We urge that this recommendation allow sufficient time, and require such consultation.

6. Independent audits or reviews

We have several questions and concerns with this recommendation.

Is the independent auditor of the 990 required to be different than the person performing an organization's annual audit? How does this new 'independent' review for compliance with 990 filing standards relate to organization and executive liability for errors or omissions in the filing? For organizations below \$250,000, engaging an auditor to review the 990, which contains all of the organization's relevant financial information, seems duplicative of the proposed 'review' of financial statements for such organizations by a CPA. It is not clear if this review requirement is also being considered for the 990EZ.

Many smaller organizations that rely solely on government funding forego an outside audit and are audited by their funding source. We suggest that any new audit or financial review requirement specifically allow such a government audit as an alternative form of compliance. Any additional auditing requirement imposes a new cost burden, particularly for smaller organizations.

There are circumstances in which the requirement for a change of auditor every five years may not be practical or even wise policy. In rural areas it may be impractical or unduly expensive to hire a different auditor – there may not be another locally available. Also, if an organization undergoes changes in financial managers, possibly from unforeseen circumstances, or is undergoing major organizational shifts in the fifth year of the 'cycle', it would often be unadvisable to also change the auditor in the same fiscal period.

We do agree that in the absence of such extenuating circumstances it is advisable practice to make a periodic change in the outside auditor. Our concern is that any legal requirement should allow flexibility in the type of circumstances mentioned above.

7. Enhanced disclosure of related organization and insider transactions

We endorse these changes.

8. Disclosure of performance goals, activities, and expenses in Form 990 and financial statements

We agree that charities should be able to articulate how they measure success and should have systems in place for program evaluation. Our *Standards for Excellence* require this. However, we have serious reservations with making a statement describing an organization's goals and performance a requirement on the Form 990. Without extensive guidelines and standards we doubt that this would be a significant aid to the public or potential donors, and it has potential for unintended negative consequences.

As discussed above, one of the major concerns with the present 990 is the lack of standards with respect to presentation and characterization of basic financial data. Even for the reporting of such apparently 'objective' data, the process of setting standards will not be easy, and 'one size does not fit all'.

Statements of goals and performance will by their nature be more subjective and necessarily require greater latitude in presentation. Organizations with more ambitious or difficult missions, or more diligent and conscientious management, will be less likely to prepare glowing reports of success, and more likely to set meaningful, more challenging goals. Public distribution of this information, and 'apples to oranges' comparisons to other organizations, may well have a detrimental effect on the goal-setting process.

An alternative approach may be to require disclosing on the 990 a means for donors to contact the organization and obtain information about the organization's goals and performance. This would allow organizations flexibility in how to organize and disclose the information. Except for the information regarding board meetings, the other disclosures recommended in this Item are already reportable on the Form 990.

9. Disclose investments of public charities

Already reportable on the Form 990

F. PUBLIC AVAILABILITY OF DOCUMENTS

1. Disclosure of financial statements

We support the required disclosure of annual audited financial statements and of financial documents required to be made public under state charity regulations, in addition to the Form 990. A requirement to disclose 'financial statements' should be clear as to which documents it includes. We believe that the intent here is limited to annual statements, and not to quarterly or other periodic documents prepared for internal management purposes.

2. Web-site disclosure

We support this recommendation, subject to clarification of which financial statements are included, as noted above.

Items 3, 4 and 5 – no comments at this time

G. ENCOURAGE STRONG GOVERNANCE AND BEST PRACTICES FOR EXEMPT ORGANIZATIONS

1. Board duties

This description of board duties combines elements of existing state and federal legal requirements with elements of governance best practice standards.¹ It is our experience that there is, in general, widespread agreement within the nonprofit community that the Boards of Directors ought to follow most² of the listed policies and practices. While it would be possible to require organizations to self-report, on the 990 or otherwise, that they are practicing sound governance process, it would likely be difficult if not impossible to enforce substantive compliance as a matter of law. A number of the requirements involve subjective judgments, such as the evaluation of whether a nonprofit is "being properly managed," that would render formal legal enforcement difficult or impractical. These practices are, we believe, more appropriate to promote through an aggressive system of industry self-regulation, such as our *Standards for Excellence* program.

2. Board composition

Our *Standards for Excellence* call for at least five unrelated directors. We endorse the concept of minimum standards, and suggest that the Form 1023 be revised to require disclosure of relationships. The Form 990 might be used to report the number and identity of independent directors. We do suggest that the standard for the proportion of independent directors of charities should be considerably higher than one-fifth, and two-thirds would not be unreasonable.

We do not agree with the maximum number of fifteen directors. This is below the number of individuals on many effective boards, and in many cases far below the number required for effective oversight of large institutions or for effective representation of large or diverse memberships.

3. Board/Officer removal

We endorse this recommendation.

¹ These closely resemble provisions of the *Standards for Excellence* code.

² We would take issue with the idea that a Board of Directors should be involved in annual approval of compensation for all management personnel. Rather, we advocate in our *Standards for Excellence* that Board engage in periodic reviews (e.g. every 3-5 years) of an organization's overall salary structure.

4. Government encouragement of best practices

In view of the major role that nonprofit charitable and educational organizations play in the delivery of government programs and services, there is a strong governmental interest, beyond compliance with basic legal standards, in their accountability and effectiveness. Correspondingly, since a large portion of nonprofit revenues are derived from governmental sources, nonprofits will likely respond quickly to incentives in the grant and contract process.

We endorse the concept underlying this recommendation, but we must note that many competent and well-managed organizations will for various reasons, many resource related, not obtain certification under rigorous ‘best practice’ standards programs. ‘Best Practice’ codes are in fact ‘stretch goals’ and penalizing smaller organizations, or organizations that are well-managed but unable to devote time and effort to undergo rigorous review to document this, raises fairness concerns. The IRS would also need to ensure that standards of different programs are truly comparable.

5. Accreditation

We support the authorization of funds (\$10 million) for the IRS to support accreditation efforts, based on our understanding that these apply to programs that certify conformance with ‘best practice’ standards. The continued refinement, operation and extension of the Standards for Excellence and similar programs in the states, and of both general and subsector-focused programs at the national level, will require more resources than are foreseeably available from member or philanthropic support.

Time, effort and resources will also be necessary to foster collaboration and research- and experience-sharing among the many efforts and programs that now exist in the nonprofit community. As indicated above, this is an area of logical partnership between government and the nonprofit sector. The investments proposed here and elsewhere in the white paper are miniscule by comparison to spending for support of private business development, or in efforts to make government-run programs more efficient. Nonprofit organizations deliver government programs and services, supplement government programs and services, and provide programs and services to citizens where government efforts are limited or non-existent.

However we do not equate this type of accreditation, or the best standards on which it is based, with the legal requirements for operation and management of charities. ‘Best Practice’ certification should remain voluntary and self-regulatory. While it may be considered as a positive factor when charitable status is questioned or reviewed, as discussed above, most nonprofit organizations will probably not obtain this type of certification. We do not believe it is an appropriate requirement for the granting of charitable status.

5. Establish prudent investor rules

No comments

H. FUNDING OF EXEMPT ORGANIZATIONS AND FOR STATE ENFORCEMENT AND EDUCATION

We strongly support the resources proposed in this initiative for training, accreditation, oversight and review.

The clear preference of nonprofit organizations is that funding for enhanced state oversight, and for capacity building, training and technical assistance within the sector itself, not place an additional burden on individual organizations. Much of the existing investment in management training and assistance within the sector is funded by the dues and other fees paid by nonprofits to state and national organizations. Any new fee structure must bear in mind this existing burden and the limited ability of organizations often in need of the most extensive assistance.

As discussed above, the development of enhanced legal requirements, and of best practice standards and accreditation programs, will not achieve the desired results without a corresponding effort to provide training and technical guidance. Resources must be available to demonstrate and explain the why and how of good management and accountability practices.

I. TAX COURT EQUITY AUTHORITIES, PRIVATE RELATOR AND VALUATION

No comments on this section.

CONCLUSION

The quality of governance, management and operations of nonprofit organizations is of vital interest to the people and communities nonprofits serve. Operating in accordance with best practices standards is important to assure the long-term viability of nonprofit organizations and to enhance their ability to serve the community, as well as to assure maintenance of public trust in the nonprofit sector. Yet achieving high standards is difficult for many nonprofits because of limited resources and other practical constraints. A balanced approach, including appropriate laws and regulations, vigorous law enforcement, and industry sponsored self-regulation and education, is necessary to promote higher levels of performance in nonprofit board and program activities.

