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A Framework for Analyzing Nonprofit Governance and Accountability Policies and Strategies

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Abstract

This paper presents a framework for analyzing the sprawling topic of nonprofit governance and accountability. It distinguishes various accountability-generating mechanisms and actors, including the unit-level governing board; government policies aimed at shaping the behavior of governing boards; and a broader, "natural demand" for accountability, generated by an organization's many stakeholders. The aims of these accountability mechanisms and actors also vary, and include the prevention of theft and fraud; the efficient use of resources; the choice of socially valuable goals; and the effective performance of an organization in service of those goals.

Our upcoming symposium comes at a moment of considerable public attention to the subject of nonprofit governance and accountability. Recent news stories have reported on foundations that lavish money on their trustees and advisors rather than the charitable causes they were founded to support; on the excessive compensation of nonprofit CEOs; on corrupt fundraising schemes; and on outright embezzlement. Analyzing news accounts systematically, as Marion Fremont-Smith and Andras Kosaras did for the years 1995-2002, confirms the dispiriting impressions of a casual reader. They document 104 criminal cases against trustees and staff at a range of nonprofit organizations, and half as many cases of breach of fiduciary duty.[1]

Even if these cases amount to no more than the sector's few bad apples, the public appears to be concerned about nonprofit governance and accountability on other grounds. In a 2003 survey conducted by the Brookings Institution, only 18 percent of respondents felt that nonprofit organizations spend their money wisely.[2] Sharing that sentiment, former U.S. Senator Bill Bradley, with colleagues from the McKinsey consulting firm, estimated in a *Harvard Business Review* article that the nonprofit sector wastes $100 billion annually because of inefficiencies in fundraising, administration, and program delivery.[3] That figure, they emphasize, is conservative; it does not try to account for programs that, although efficient, are simply ineffective, or focused on worthy but less than urgent social problems. However imperfect, their estimate reflects (and feeds) a widespread concern that even scrupulous nonprofits can be inefficient in their operations,

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[1] Marion R. Fremont-Smith and Andras Kosaras, "Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002," *The Exempt Organization Tax Review*, October 2003 – Vol. 42, No. 1.

[2] Paul C. Light, "Trust in Charitable Organizations" in *The Brookings Institution Policy Brief: Reform Watch #7*, December 2003.

[3] Bill Bradley, Paul Jansen, and Les Silverman, "The Nonprofit Sector's $100 Billion Opportunity," *Harvard Business Review,* May 2003.

ineffective in pursuit of their current mission, unwise with respect to their choice of goals, or some combination of all three.

These problems of corruption, efficiency, effectiveness, and prioritization of public problems have heightened the public's interest in nonprofit governance and accountability systems. Although a consensus has formed that these systems are apparently broken, a coherent reform agenda has yet to emerge. In her paper, "The Search for Greater Accountability of Nonprofit Organizations: Recent Legal Developments and Proposals for Change," Marion Fremont-Smith summarizes the welter of often conflicting policy and legal proposals offered in recent years. The key purpose of our conference is to see whether we can construct some kind of shared analytic perspective that would allow us to make sense of these proposals, and to help us all reach a more considered judgment of which of these proposals could reasonably be relied on to improve the performance of the nonprofit sector.

A Policy Analytic Framework for Examining Social Level Governance and Accountability Systems for the Nonprofit Sector

In the power point presentation entitled "On the Social Level Governance of Charitable and Nonprofit Organizations," we present a rough outline of a schema that might prove useful as we take up the sprawling subject of nonprofit governance and accountability. What makes this work potentially useful is that it presents a policy analytic framework that: 1) specifies the purposes that society should have in mind as it considers any important alteration of the existing systems that govern the performance of the nonprofit sector at the social level; 2) offers a description of the social processes by which nonprofit organizations are now governed and called to account; and 3) begins the

process of describing different kinds of interventions that could be made by government and other actors that would importantly alter the existing system that governs and demands accountability from the voluntary sector. There are perhaps three key points made in this paper that might be important to bear in mind throughout the conference.

The Crucial Distinction Between Social Level Governance and Firm Level Governance

One is a crucially important distinction between what we would call the social level system of governance and accountability for the nonprofit sector on one hand, and the firm level structures and processes of organizational governance on the other. We use the term "governance" somewhat carelessly to focus both on the public policies that might be adopted by a government to encourage or guarantee the effective performance of the nonprofit sector as a whole, and on the choices made by individual nonprofit organizations about the firm level structures and processes they will rely on to manage their firm level decision-making.

The confusion is a natural one because there are some crucially important links between these two ideas. For example, one important feature of a social level governance system could be explicit government regulation of the structures and processes of firm level governance. Indeed, among the social level governance proposals being made for the nonprofit sector are those that resemble the Sarbanes-Oxley law for the for-profit sector, and that required all public corporations to adopt some very specific structures for firm level governance including the inclusion of "outside directors," the establishment of "audit committees," etc. While the direct regulation of firm level governance is one possible form that social level governance could take, there are many other targets that

social level governance could aim at. For example, social level governance could impose obligations on nonprofit organizations to make financial and performance reports that would allow stakeholders who had an interest in their performance to be more knowledgeable about that performance, and better able to call them to account. Such a policy would certainly change the social level governance system of nonprofit organizations, but not by changing the structures and processes of firm level governance per se.

It is equally possible that a society could establish a social level governance system that placed all its hopes for improving the performance of nonprofit organizations in the firm level governance of those organizations. This is actually pretty close to the legal system we now have. In the current system, the law requires nonprofit organizations to identify themselves, state their purposes, and name the officers who can act for the organization. It allows many different kinds of firm level governance structures and processes ranging from small, centralized, self-perpetuating boards to large, federated structures where all members of the organization have rights to elect officers. Once the mission of the organization is set, and the structures and processes of governance are in place, the state then takes a very limited role in ensuring that the governors of the organization live up to the fiduciary duties of loyalty and care. Whether the governors turn out to be sufficiently zealous in the pursuit of their duties to ensure that there is no stealing, no operational efficiencies, high degrees of mission effectiveness, and constant surveillance of whether the existing mission represents the highest possible use of the organization's assets, is then pretty much left to the Board itself. This is an image of social level governance that has essentially rooted all its hopes in the performance of the

nonprofit sector in the quality of the firm level governance of the organization – not only its formal structures and procedures, but also in the actual way it performs.

Given the close functional relationship between the ideas of social level governance and firm level governance in shaping the overall performance of the voluntary sector, it is natural to get them confused. But if we fail to make this distinction, we will miss both the opportunities we have to shape the performance of the nonprofit sector through means other than efforts to influence structures, formal procedures, and actual practices of nonprofit boards and governors, and at the same time, the degree to which virtually all social level governance systems will be dependent on the quality of the boards and governors that operate at the firm level, and cannot be easily commanded to do their work better without blunting the initiative and freedom of the organizations within the sector.

Two Normative Frameworks for Assessing Social Level Governance Proposals

The second key idea is that all proposals for altering the social level governance of the nonprofit sector have to be evaluated against some explicit normative standard; and further, that we tend to rely on two distinct normative frameworks when evaluating particular reform proposals. The first normative framework could be called a "social utilitarian framework." This is the framework implicitly evoked at the beginning of this paper when we pointed to the "problems in the social performance of the nonprofit sector." We enumerated four different threats to the efficiency and effectiveness of nonprofit organizations in particular, and the sector as a whole more generally. Those social utilitarian concerns included: diversion of assets to private benefit, waste of

resources in organizational operations, ineffectiveness of organizational methods in achieving desired social results, and imperfect judgment in fitting missions to important social problems.

It is surely true that these are among the important presenting symptoms that animate public policy debate above the governance of the nonprofit sector. It is also true that these are materially important. And it is the sort of things that economists and professional managers can worry a great deal about.

But one doesn't have to be involved in the conversation about the (social level) governance of the nonprofit sector very long to hear in the background of the conversation a different set of normative concerns that could be called a "rights-based" framework for assessing governance proposals. What is central to this normative framework are many questions that focus on "right relationships" between non-profit organizations and other actors in society.

A crucial issue here, of course, is the degree to which it would be appropriate for society, acting through government, to condition the rights of individuals in the society to combine together to form a nonprofit organization. If we think that individuals ought to have this right as a matter of principle, it would be unjust to condition that right on specific ideas that we hoped might improve performance. And a great deal of respect for the rights of individuals to define and act on purposes they judge to be publicly valuable is at least one of the important reasons for us to exercise restraint when we begin thinking about how we might alter the social level governance system to improve the social performance of the voluntary sector. Indeed, this becomes particularly important when we begin to raise issues about the quality of the judgment that goes into the definition of

the mission of a nonprofit organization. Who, after all, is in a position to judge whether society needs more symphony orchestras, more treatment for AIDS, or stronger advocacy for the rights of women?

Less crucial, but still important issues that can be seen through a lens that focuses on right relationships as good or bad in themselves as opposed to good or bad in their consequences, are those that would focus on the right relationship between donors and nonprofit organizations, between clients and nonprofit organizations, and between staff and nonprofit organizations. One can reasonably say, for example, that a donor has some rights to shape the purposes, and inspect the performance of an organization to which he makes a contribution; or, that a nonprofit organization has a duty to tell the truth and not engage in deceptive advertising when soliciting donations.

Of course, when thinking about the right kind of relationships to try to set up between nonprofit entrepreneurs and the society, or between established nonprofit organizations and their various stakeholders, one could focus on the instrumental value of particular relationships in encouraging improved social performance. One could say, for example, that if we gave clients of nonprofit organizations a more powerful relationship to a nonprofit organization – one in which they could demand and get information from them, or serve on their board, or make choices about which organization to favor with their clientelism – then we might predict that the nonprofit organization would get better at serving their clients interests, and that that might constitute an improvement in organizational performance. Or, we could say that requiring the disclosure of information about performance might help create a kind of efficient capital market for nonprofit organizations.

But the important claim here is that we might have a normative basis for deciding whether an organizational stakeholder is entitled to something or not regardless of its impact on performance. The idea of a fiduciary relationship, after all, is a legal and moral concept as well as an economic one. And when one diverts assets from an organization's purposes to one's own pocket, one doesn't only diminish the economic performance of the organization, one commits a crime or a breach of civil duties that exposes one to moral judgment. Similarly, the questions of whether a nonprofit organization has a duty to donors, or to beneficiaries, or to some idea of society as a whole can be seen either through an economic lens that focuses on incentive effects on performance, or through a legal or moral lens that makes the interests of some stakeholders more deserving, and more strongly backed by the society than those of others.

A Three Tiered Behavioral System for Examining the Governance and Accountability of the Nonprofit Sector

The third key idea is that the actual social system that governs the behavior of nonprofit organizations, and does so at least in part by calling nonprofit organizations to account for their use of the assets they control, is a very wide behavioral system that is only imperfectly under the control of government. We see the system as consisting of three tiers:

(1) *natural demand for accountability*, which is generated by the various stakeholders of a given nonprofit and exists somewhat independently of governmental action (though governmental action can to some degree shape the natural demand for accountability);

(2) *government policy*, in which the government, acting in several capacities, works to improve the governance and accountability of nonprofit organizations, and of the sector as a whole; and

(3) *firm-level governance*, where individual nonprofit organizations make their own governing and accountability arrangements.

The conception of a three tiered system of accountability for nonprofit organizations deserves some explication.

<u>Natural demand for accountability</u>

Analysts often overlook the very form of accountability that nonprofit leaders experience most vividly: the natural demand for accountability. Natural demand is generated both by stakeholders known to the leaders of a nonprofit and by the impersonal forces of public opinion.

Every nonprofit organization is populated by and surrounded by stakeholders who want the organization's leaders to recognize and honor their claims. The employees, donors, clients or constituents, allied nonprofit organizations, government funding agencies, even commercial vendors of a given nonprofit all routinely seek to hold the organization's leaders accountable. Nonprofit leaders are technically free to reject many of these claims because they are not backed by the force of law. For moral, ethical, or practical reasons, however, most leaders are reluctant to do so lightly. Legally, for example, a charitable gift may be just that – a gift that the organization can use, as its leaders see fit, for any legitimate, mission-related purpose. Practically, however, donations often come with implicit or explicit expectations that nonprofit leaders feel

obligated to honor. That feeling of obligation is partly a response to natural demand for accountability.

An impersonal, ambient demand for accountability also influences nonprofit leaders. For example, frequent media reports on financial malfeasance, self-serving behavior, or questionable priorities (like those we summarized in opening this paper), can sensitize nonprofit leaders to society's expectations for right and lawful behavior. Seeking to avoid the fate of publicly criticized organizations, or to distinguish their organizations from them, nonprofit leaders may take extra measures to demonstrate their commitment to sound management, ethical behavior, and good performance. Even when their immediate stakeholders are indifferent to these concerns, nonprofit leaders may defer to the natural demand of public opinion, as both reflected in and shaped by media coverage.

As we will discuss in reviewing governance at the firm level, the strategic management of a nonprofit organization very much involves identifying, evaluating, and responding to this varied natural demand for accountability. It therefore needs to figure in any comprehensive framework of nonprofit governance and accountability. In focusing attention on the social systems that generate demands from various social actors for nonprofit accountability on one hand, and feelings of accountability held by those who govern, lead, and manage nonprofit organizations on the other, we are following the advice of Alnoor Ebrahim whose paper (entitled) "Placing the Normative Logics of Accountability in a Thick Perspective") calls for a more empirically grounded look at the complex social and power relations at play in accountability relationships and their implications for reform efforts.

Government Policy

The natural demand for accountability that comes from organizational stakeholders who have interests in demanding accountability from particular organizations exists apart from any explicit action by government to create a system of governance and accountability for the voluntary sector. But government adds to the social level of governance and accountability partly by influencing the natural demand for accountability, and partly by asserting its own independent role as an actor that can demand accountability from nonprofit organizations.

Mark Moore, in his analytic sketch (entitled "The Simple Analytics of Accountability) offers one highly stylized way of characterizing the complex system of accountability that works on nonprofit organizations, and the ways in which the natural demand for accountability might be importantly related to governmental policy.

More concretely, it seems to us that government acts in three different capacities to promote nonprofit governance and accountability.

1. *Government empowers stakeholders to demand accountability.*

Rather than specify absolute standards for nonprofit governance and accountability and enforce them universally, government sometimes chooses to equip stakeholders to hold nonprofits accountable. It facilitates natural demand in two ways.

First, it requires that nonprofit leaders disclose certain information about the organization's purposes, officers, and finances. Anyone seeking this information can turn to the public records of state and federal regulators, including attorneys general and the

Internal Revenue Service. Alternatively, they can rely on intermediaries that collect and sometimes analyze these public records. Guidestar, for example, runs a web site where the IRS filings of nonprofits are available to the public. In addition, some consumer-service organizations, such as the Better Business Bureau or Charity Navigator, analyze these public filings using their own standards of good governance and stewardship and then make their findings available to the public. By mandating disclosure of this information, government enables individual stakeholders to make at least some limited judgments about an organization's performance. As Elizabeth Keating discusses in her paper, "Is It Time to Address Selective Disclosure by Nonprofit Organizations?" current disclosure requirements are uneven in ways that may inhibit the ability of stakeholders to judge a nonprofit's performance. They allow nonprofits to provide some stakeholders with specially designed reports while withholding materially relevant documents, such as the audit, from others. However incomplete and uneven, the mere fact that such information is publicly available may constitute a form of the ambient natural demand for accountability noted above.

Second, government policy gives some stakeholders the opportunity to press their claims in the courts by determining who will have standing to sue a nonprofit organization; which nonprofit officers can be named in such a suit; on what grounds the suit may be made; and what kind of damages a court can award. Government policy currently reflects a reluctance to empower the stakeholders of nonprofits in this way. For example, many states do not allow members of a broad class of intended beneficiaries to sue a nonprofit organization. (So while everyone is an intended beneficiary of the foundation whose mission is to "advance the welfare of mankind," not everyone is

entitled to sue the foundation for failing to deliver on that mission.) Some states also limit the damages that can be awarded in litigation against nonprofits. Similarly, Congress has opted to limit the personal liability of members of nonprofit boards of directors, in large part to balance society's interest in advancing accountability with its interest in encouraging citizens to engage in voluntary action.

Even if it were to mandate the disclosure of much more detailed information or extend legal standing to many more stakeholders, government would still be relying on, rather than displacing, natural demand. It would still be for individual stakeholders to decide whether to examine a nonprofit's public filings, what conclusions to draw from such information, or whether to sue a nonprofit, if allowed. Where it is not satisfied with this reliance on stakeholder action, government policy can take a more active approach in fostering accountability.

2. Government regulates the governance of nonprofit firms to encourage accountability.

In addition to assisting natural demand by empowering stakeholders, government policy can promote accountability by regulating the internal governance arrangements of nonprofits organizations.

In this approach, government in effect identifies "best practices" for effective governance and imposes them on all nonprofit organizations. For example, some analysts have argued and policy makers have considered regulating, among other things, how many members can serve on a board; whether or how much they can be paid for board service; when they are deemed to have conflicts of interest; what kind of audits and financial reports they must review; and even how specific they must be in articulating

the organization's primary goals (as well specifying the metrics to be used for tracking progress toward them). In her paper, Catherine Wells, relying on her experience in regulating nonprofit organizations, points to the practical difficulties of trying to regulate the governance structures and processes of nonprofit organizations too closely. In his paper, "Charity Oversight: An Alternative Approach", Marcus Owens addresses the question of institutional design, exploring what kind of regulatory agency would be best suited to promote nonprofit accountability.

Particularly compared to these proposals, government policies to date suggest a reluctance to improve accountability through direct regulation of nonprofits' internal governance arrangements. All nonprofit organizations are required to designate officers to answer for the organization should government authorities or stakeholders (with legal standing) seek to hold it to account. Beyond that, the law enjoins board members to honor their "duties of loyalty and care," broad principles for fiduciary decision making. While they demand careful consideration of the organization's interests and obligations in overseeing its affairs, the law outlining these fiduciary duties leaves organizations to devise their own governance arrangements. Only in exceptional cases is government more exacting about nonprofits' internal governance arrangements. For example, whereas most nonprofits can devise their own procedures for the election of officers, the nominating and election procedures of political parties and of labor unions are highly specific. But as suggested by some of the recent proposals considered by the U.S. Senate (described in Marion Fremont-Smith's paper), government may be increasingly more inclined to promote accountability by regulating the internal governance arrangements of nonprofit organizations.

3. Government uses regulation to govern nonprofit organizations.

A third approach to social-level governance often goes unremarked in analyses of nonprofit governance and accountability: Government sometimes uses regulation to govern nonprofit organizations directly.

Through regulation, government can effectively substitute its judgments for those of individual boards of directors. For example, before they became the objects of regulation, many choices affecting worker safety, employment discrimination, and environmental protection were settled at the organizational level by managers, governors, and stakeholders. In regulating these issues, government assumed for itself prerogatives otherwise reserved for boards. In fact, the legislative and rule-making processes operate at the social level much as governing processes do at the firm level. They decide how managers should conduct the organization's affairs; establish procedures for oversight; and devise penalties for violations.

Where regulations reflect widely shared social norms, boards are unlikely to notice, much less object to, the transfer of governing power from their organizations to the government. (For example, very few boards probably experience child-labor laws as intrusive or constraining.) In contrast are regulations that reflect emerging norms or contested values, such as those requiring employers to extend health benefits to the unmarried partners of their employees. These regulations reveal how government regulation can effectively displace firm level governance, and why it therefore belongs in a governance and accountability framework.

As a class, nonprofit organizations are lightly regulated.   To qualify for tax-exempt status, a prospective nonprofit organization must meet certain requirements demonstrating its public purpose. But once such status is granted, nonprofits enjoy considerable latitude in determining how they will operate. Most regulations that do address organizational behavior apply to nonprofit and for-profit organizations alike. And when regulations are more narrowly targeted to a sub-class of organizations, it is often by industry. (Most regulations on the operation of hospitals, for example, do not distinguish between nonprofit and for-profit organizations.) Most of the nonprofit-specific regulations either enacted or now contemplated focus on structuring their governing arrangements, not on bypassing those arrangements to impose policies developed by the government. The exceptions – such as laws regulating how much of its assets a foundation must distribute to charity each year – are few. But the option remains.

Firm-level governance

Our accounts of natural demand and social-level governance suggest that governance at the firm-level is best understood as a matter of *strategic choice*.

This approach contrasts with two more prevalent conceptions of firm-level governance and accountability. In the first, nonprofit boards are seen as the *prime movers* of accountability. Boards in this view are not necessarily indifferent to the natural demand of stakeholders, or to the legal mandates of social-level governance, but neither one is their primary motivator. They act instead out of a moral zeal for ethical behavior and for the organization's mission. Efforts to improve firm-level accountability

consequently focus on educational and socialization approaches that can equip a motivated board to perform better. Robert Clark's paper, "Moral Systems in the Regulation of Nonprofits: How Value Commitments Matter," explores the social and organizational processes that assist in the development of extra-legal norms about accountability, and argues that the importance of these values-based approaches may significantly underestimated.

A second prevalent conception envisions boards as *accountability agents* that generate only as much accountability as government demands of them. Improving firm-level accountability in this view therefore entails improving social-level governance. Government must prescribe the governing processes it believes will produce proper accountability. Boards will generate accountability by following.

In a *strategic-choice* account, boards must make a series of governance and accountability decisions, even with respect to the seemingly non-negotiable demands of social-level governance. They must decide whether to comply with the requirements of the law and, if they do comply, whether to do so in a perfunctory manner aimed at avoiding legal problems or in a morally committed way aimed at promoting the diligence and prudence that the law envisions. Organizations can also choose whether to challenge social-level governance. Rather than a set of immutable givens, the mandates of social-level governance actually pose choices for leaders at the firm level Alone or with allies, they can press government policy makers to change the rules they are subject to. In responding to the natural demand of its stakeholders, a firm faces even greater strategic choice. As we described earlier, all organizations are made up of and surrounded by a variety of stakeholders who want the organization to recognize and honor their varied

claims, many of which lack the force of law. The leaders of each organization must therefore make their own moral, ethical, and practical calculations to decide which claims to honor. In doing so, they effectively develop an accountability strategy: They decide to whom, for what, and how they will be accountable.

In making those decisions, the strategic-choice board operates neither like a prime mover nor an accountability agent. A prime mover starts with a blank page and, motivated by its moral zeal, develops its own accountability strategy. In contrast, a strategic-choice board starts with a list of the real and consequential demands of its stakeholders. Yet it cannot simply comply with all of these demands the way that an accountability agent can with the legal mandates of social-level governance. The demands of stakeholders are too numerous, varied, and even conflicting. To get an accountability strategy, a board must evaluate, order, and harmonize those demands. Dutch Leonard's paper, "Should Mission Statements Be Promises?" explores an interesting nexus between this strategic-choice account and public scrutiny or government regulation. He poses the possibility that nonprofits could be free to decide *for what* and *to whom* they are accountable but that, once made, their decisions on these matters might be treated as promises subject to some form of review -- by the public, by beneficiaries, and/or by government oversight or enforcement.

Summary

The issue of how best to improve the governance and accountability of the nonprofit sector is an urgent one, but it is also one that is not likely to go away. This suggests that we might have some time to try to get our thinking and analysis straight before we have to make the important policy decisions that are now pressing themselves on us. It's a good thing, because it is not at all clear to us that we have a well-considered idea to offer. We are not even sure we know how to analyze the issue very well.

The papers presented as the basis for discussion in this conference may go some of the way in improving the quality of our judgment about this issue. But the point of this conference is not simply to ratify these particular papers. It is to see how the ideas in them can be improved, and made to fit together, and lead to a better judgment about what can be done to improve governance and accountability. For that purpose, we need a great deal of discussion stimulated by, but not dominated by these papers. We will also hope that those who participate in the conference will be motivated to write their own ideas about the best way to think about the problem, or the best solution to it. What we hope will happen is that this conference will help to create the intellectual and social capital that can be exploited to produce an excellent edited volume on how best to think about, and how best to structure, the social level governance and accountability of the voluntary sector.

For purposes of discussion, we have divided the conference into four sessions that fit imperfectly over the papers that have been written. In the first, we will take stock of recent policy and legal developments to gain a sense of the many issues at hand. In the second, we will take up the question of who is empowered to set a nonprofit

organization's purposes, and subject to what constraints. In the third, we will turn to the question of who is authorized to hold a nonprofit to account for its performance in pursuit of those purposes. Finally, we will attempt a wrap-up that offers some synthesis and identifies key themes and questions that emerged during our discussions, and that might guide our future work.