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Malfeasance in the Charitable Sector: Determinants of “Soft” Corruption at Nonprofit Organizations

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The economics and pathologies of corrupt organizations have been extensively scrutinized beginning with seminal work by Banfield (1975), Rose-Ackerman (1975), and Sherman (1980). Initially, attention was focused on the general topic of organizational corruption, but more recent work has addressed malfeasance at specific types of institution (e.g., educational establishments). In addition to descriptive work, some scholars have addressed the means by which—through either increased oversight or transformed managerial arrangements—corruption can be addressed.

More recent work on corruption, its causes and consequences, can be found in Jain (2001) and Aidt (2003). Organizational malfeasance has been examined by Vardi and Wiener (1996), Luo (2004), Baucus and Beck-Dudley (2005), and Pinto, Leana, and Pil (2008), while corrupt practices in the corporate sector were detailed by Baucus (1994), and Anand, Ashforth, and Joshi (2004). In addition, governmental corruption was analyzed by Banfield (1975) and Rose-Ackerman (2005). Baucus and Near (1991) and Steinber



and salaries rather than risk the commission of an actual crime (e.g., America's Worst Charities [<http://www.tampabay.com/topics/specials/worst-charities>], annual report by the Tampa Bay Times). In this context, the commission of actual criminal activity seems both unnecessary and potentially self-harming. This circumstance will be referred to as "soft corruption": practices that are unethical but not prosecutable—the characteristics of rogue, not unlawful, charities, those that collect donations but give little or nothing to any cause. It has been argued that high fund-raising expenses can represent a charity that is innovative, with a strong vision and significant accomplishments. The criteria that will be used to define "soft corruption" are a failure on seven financial measures that overall indicate the performance of an organization.

This approach is not without controversy. While the National Charities Information Bureau and the American Institute of Philanthropy both set minimum threshold levels for program expenses—a minimum of 50% at the NCIB and 60% at AIP—these standards have been questioned by others who evaluate charitable performance. Weber (1994) argues that fundraising efficiency is best utilized when comparing the performance of like organizations. Conversely, Hager, Pollak, and Rooney (2001) note that controlling for group-specific characteristics explain only a minor part of the differences in fund-raising efficiency. McLean and Coffman (2004) in "Why Ratios Are Not the Last Word" assert that program expenses should only be used in the context of



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REGULATORY CONSTRAINTS ON MALFEASANCE AT NONPROFITS

The regulatory environment within which charitable organizations operate includes multiple levels of oversight, but (in practice) ineffective disclosure requirements. Charitable nonprofits must maintain their 501(c)(3) standing with the Internal Revenue Service in order to solicit tax-deductible contributions. When charities are determined to be wholly corrupt organizations, legal action is taken by states' attorneys general under fraud statutes. At the national level, The Federal Trade Commission (FTC) can file civil actions against sham charities when it concludes they are little more than money-churning entities for their managers (In May 2015, for example, the FTC accused four cancer charities of collecting nearly \$185 million in donations and channeling little, if any, of the money to appropriate causes). Some individual states impose disclosure requirements on nonprofits, mandating that organizations that reach a threshold size (which varies by state) release audited financials. The Urban Institute's Center on Nonprofits and Philanthropy provides a complete breakdown of the differing requirements by state (Lott, Boris, Goldman, Johns, Gaddy, & Farrell, [2016](#)). Requiring release of Form 990 would duplicate current federal law.

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unwarranted) expansion of federal authority over an area that is now regulated by the states. Neely ([2011](#)) examines the impact of Sarbanes-Oxley-style enforcement at the state level, detailing California's Nonprofit Integrity Act of 2004. Ebrahim ([2011](#)) notes that various forms of nonprofit accountability exist, and none of them are appropriate for all organizations.

Nongovernmental Oversight

The most obvious form of oversight at charities is the presence of an independent voting board (IVB) that provides general guidance on the scope and aims of the organization and monitors the entity's financial integrity (see Miller, [2002](#), [2007](#) for a critical evaluation). In the context of nonprofit management, an IVB refers to individuals who did not receive compensation from the nonprofit as an officer or employee and did not conduct any transaction with the organization that must be reported on IRS Schedule L, Transactions with Interested Persons. Hodge and Piccolo ([2011](#)) provide details on effective board management and the financial stability of a nonprofit. Yetman and Yetman ([2012](#)) examine how the level of effectiveness of a nonprofit's board affects the accuracy of its expense reporting. Boozang ([2007](#)) argues that nonprofit boards may be excessively concerned with compliance and lose focus on the effectiveness of a charity's activities. Conducting an independent audit provides another level of

accountability, especially if the results of the audit are included on the nonprofits' 990 form. For example, Prakash and Williams ([2011](#)) argue that additional regulatory requirements to different nonprofits. Williams ([2011](#)) makes into account the relationship at nonprofit organizations. In addition, provide information as a complement to which provide evaluation and dated. Nonprofit Navigator does not meet disclosure (board).



seven financial criteria, including having excessive fundraising and management expenses. Currently, Charity Navigator ranks approximately 8,200 nonprofits.

Although these rating bodies provide another level of oversight, it is still up to donors to make the effort to investigate before giving. As argued earlier, the lack of a feedback loop that informs donors about how (and how well) their donations are utilized is missing. Thus, the charitable sector remains a “donor beware” environment.

COMPARISONS OF HARD AND SOFT CORRUPTION

The term “hard corruption” will be used to refer to organizations that have committed outright fraud that ultimately led to a criminal prosecution. It is widely recognized that not-for-profits might “adjust” their Form 990s so as to enhance their attractiveness to potential donors (note that Froelich, Knoepfle, and Pollak (2000) found no systematic manipulation of figures on Form 990s for those nonprofits that conduct an independent audit). Yet, hard corruption involves the deliberate misuse, for personal gain, of donations intended for a philanthropic cause. The illustrations below are meant to differentiate this form of criminal behavior from cases of “soft” corruption.

Not all instances of hard corruption at nonprofit organizations are widely publicized.

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individuals. The indictment charged the Wingos both with siphoning off donated funds and with paying (criminally) excessive salaries. Ultimately, both Wesley and Andrew Wingo received seven-year prison terms (Linda Wingo received a suspended five-year sentence).

The charitable sector is capable of innovation when it comes to crafting new corrupt practices. The Foundation for New Era Philanthropy, founded by John Bennett, Jr., promised nonprofits a simple means of doubling their contributions. The charity deposited a large sum of money with New Era—after a period of time the money was matched by an anonymous donor with similar interests and returned. In reality, New Era was simply a Ponzi scheme, with new deposits being used to match old deposits (for a description of the structure of Ponzi Schemes, see Jory & Perry, [2011](#)). When Bennett could no longer cover the inevitable shortfalls, he turned to borrowing money, eventually accumulating \$50 million in unpayable loans. After being exposed in the press in 1995, Bennett was charged with 82 counts of bank/wire fraud and money laundering and sentenced to 12 years in prison in 1998. At the time of his indictment, he finally confessed that no anonymous donors ever existed.

The United States Navy Veterans Association (USNVA) was a wholly corrupt organization started and managed by John Donald Cody (aka “Bobby Thompson”). The USNVA collected nearly \$100 million over a ten-year period ostensibly to assist veterans.

Although Cody was eventually convicted, he was never imprisoned and Cody fled the state in 2013 and eventually fled to prison.

Other examples of corruption in the nonprofit sector include the Case Western Reserve University Hospital and the University of California, Berkeley. These latter examples are discussed in more detail below.

Example of corruption in the nonprofit sector: Tampa Bay Water. The Tampa Bay Water Authority, America’s largest water utility (92%) give



are frequently in the 80–90% range, indicating that these organizations are simply “mills” for generating contributions, with little or no interest in pursuing their supposed philanthropic interest. Causes “supported” by these charities are predictable—focusing on those that will elicit a strong response from potential donors: Firefighters and police (14), treating or preventing cancer (10), children’s causes (8), and support for veterans (5). The prevalence of these organizations in the philanthropic sector reflects the ease by which sham nonprofits can be formed and successfully operated within the existing legal framework. It then falls upon donors to seek out further information on charities before giving. It should be noted that New York’s Attorney General issues a generalized report (“Pennies for Charities”) that describes charitable solicitation practices that result in a high proportion of donations to fundraising, rather than the identified cause of nonprofits.

As noted above, Charity Navigator (CN) also provides assessments of nonprofits. Evaluations of each charity include a financial, transparency and overall ranking. Poor performance in one criteria (e.g., financials) can be somewhat offset by better performance in the other (transparency), and charities receive an overall ranking (0–4 stars) that reflects CN’s assessment. Nonprofits receiving “0 star” rankings generally represent entities with both poor transparency and fundraising or compensation costs that consume most of what is donated to the organization. The effectiveness of charity

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Conversely, the work presented here will label as “soft corrupt” those organizations that achieve a zero-star financial rating from Charity Navigator—a score that represents poor performance on seven financial indicators. Trussel’s approach eliminates the need to accept self-reported financials. The only limitation to his methodology is there is no means to differentiate between those nonprofits that are actually misrepresenting their financials from those that simply appear to be.

A test of the determinants of soft corruption will be presented here. An empirical model using cross-sectional data on 450 charitable organizations (drawn from the over 8,000 nonprofits evaluated by Charity Navigator using a random number generator) will examine the relative importance of the presumed underpinnings of malfeasance. All charities that receive a zero-star ranking for financials will be included in the sample. The financial ranking is comprised of seven specific criteria that measure both whether donations are put to good use (e.g., Fundraising Expense Ratio) and the viability of the organization (Working Capital Ratio). Additional factors include administrative expenses (percentage), program expenses (percentage), fundraising efficiency, program expense growth, and liabilities to asset ratio.

Although there might be some disagreement about how one would define “soft” corruption, those charities receiving a zero-star financial ranking donate little or nothing to their prescribed causes. Neither the overall ranking nor the accountability and

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charities, high fundraising outlays are a necessary part of establishing the reputation of a new organization. It will not be argued here that “excessive” fundraising expenses are the only indicator of a poorly run organization, but simply part of what is utilized to evaluate performance. Perhaps the most significant drawback to using CN’s designation is the “black box” nature of the rankings. The seven criteria that are utilized to establish a financial ranking are available, and a diligent individual could extract a ranking from those measures, but the precise rubric used to establish a rating is still somewhat of an unknown (see <https://www.charitynavigator.org/index.cfm?bay=content.view&cpid=48> for a description of the procedures used by Charity Navigator).

An additional limitation of the Charity Navigator dataset is that much of the data is self-reported, suggesting that charities that are poor performers might exaggerate financials (e.g., program expenses/total expenses) to improve their ranking within CN’s rubric. This is an inherent imperfection in the procedure used to label zero-star charities. This would suggest, however, that these organizations are even worse than reported, still placing them in the category of soft corruption. In addition, CN utilized seven criteria to establish a financial ranking, not just the figure spent on programs. The concern here, in the end, might be with one-star charities that have misreported their financials, and should have been dropped into the zero-star category, a fruitful topic for

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nonprofits in this category earned the lowest financial ranking. For charities in the Health subsector, 1.5% of all organizations are zero-ranked. This variation across categories will be incorporated into the estimation.

TABLE 1 Zero-Star (financial) Charities, Number and as a Proportion of Total by Category



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Variables

Corruption in the nonprofit sector can be partly attributed to agency problems. Smaller donors expect neither a return nor donor-specific accountability, enabling charitable organizations to misuse funds without immediate consequences. Hence, one of the primary determinants of potential malfeasance is the degree of oversight under which the organization operates, and whether the details of that oversight are released to the public. Those organizations that maintain an independent voting board and release the names of those board members (`indboardi`) are less likely to violate donors' intentions (consistent with cited work by Boozang, [2007](#); Hodge & Piccolo, [2011](#); Miller, [2002](#)). Nonprofits that accept government grants (`govti`) assume an additional level of oversight and are thus more likely to be subject to oversight. Charitable organizations that are audited (`auditi`) are, in most cases, subject to more oversight (see Britton, [2007](#)). The requirements for independent audits of malfeasance are more stringent than those by Neely [\(2007\)](#), which are more affecting. [\[http://www.irs.gov/charities-nonprofits/and-Enforcement-Philanthropy\]](#) and Philanthropy states that operating organizations have no such requirements and are used to potential malfeasance. [\[http://www.irs.gov/charities-nonprofits/and-Enforcement-Philanthropy\]](#) states that operating organizations have no such requirements and are used to potential malfeasance.



(1)

where: $\text{rank}_i = 1$ for 0-star (financial) charities, 0 otherwise

age_i = Age of the nonprofit

$\text{indboard}_i = 1$ for charities with named independent boards, 0 otherwise

$\text{audit}_i = 1$ for organizations that release an annual audit, 0 otherwise

$\text{govt}_i = 1$ for nonprofits with partial government funding, 0 otherwise

state_i = Reporting requirement, 0 for none, 1 for legal requirement

expend_i = Annual level of giving

$\text{categ}_{i,j}$ = Category of giving; $j = 1, 5$

As Equation (1) utilizes a binary dependent variable, it will be estimated using both logit and probit models, although it is anticipated that there will be little difference in the results (logit models provide elasticities, which might be of interest to some researchers). Missing data, particularly on the age of the nonprofit, eliminated 40 observations, resulting in a total of 410 observations in the final estimations.

Results

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produced approximately 1% board and relative signs soft into the the presence t models (z-grants ould not be l funding,

where no such accountability exists. The other form of oversight, state reporting requirements widely regarded as an important check on misbehavior by nonprofits, does not test as significant (rejected by the model, with a z-score of 0.27 in both models). The two variables that were incorporated to reflect the “stature” of the organizations, age, and magnitude of expenditures, were also rejected in both instances. This is a somewhat surprising result, as seasoned charitable organizations would be expected to have developed a reputation and would not want to alienate long-time donors.

TABLE 2 Results of Estimation, Probit Regression

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TABLE 3 Results of Estimation, Logit Regression

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Two of the four binary variables included in the model were significant: Those representing Health and Human Services causes. In both the probit and logit estimations, charities that pursued health causes were significantly more likely (at the 5% level) to have a greater likelihood of being significant at the 1% level. Research and Religion explained by a tenfold increase in board (already



CONCLUSION

Trust in charities is fragile. Scandals are rare, but being seldom caught in the act, neither promises of reform nor

being an appropriate example). Once trust is broken in the charitable sector, however, the damage can be permanent and systemic. A contributor to a nonprofit who discovers that a donation was misused or appropriated is not only unlikely to donate to that organization again, but may foreswear charitable contributions altogether (see Light, 2008, p. 2). As the philanthropic sector plays a positive and significant role in a wide range of social programs in the U.S. economy, the damage from scandals in the nonprofit sector may be considerable.

The empirical work presented here indicates that two forms of oversight—maintaining an independent voting board and contracting for an independent audit—are the best means of avoiding organizational malfeasance at nonprofits. Governmental oversight, whether through reporting requirements or through the oversight inherent in the federal grant process, does not test as significant. This indicates that most concerns could be addressed by requiring both an independent board and an annual audit for all nonprofits with 501(c)(3) status. This is not to say this requirement would be a panacea for the problem of soft corruption—Aramony managed to manipulate the United Way Board during the 1992 scandal at the organization—but simply that this form of malfeasance would be less common with this form of oversight in place.

This article has also highlighted the unique circumstances that surround nonprofits, particularly when compared to the corporate sector. Most donors receive nothing—either in the form of a receipt or a statement of financials—resulting in an agency that is not audited, or pocketing funds. The lack of audits and the presence of soft corruption are of



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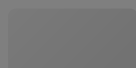


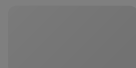
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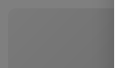
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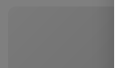
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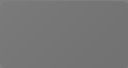






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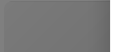
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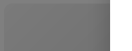
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