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

Mark Steven LeClair 

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## Abstract

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The causes and effects of organizational corruption have been widely examined in the literature. This article draws a distinction between “hard” corruption, which refers to the commission of illegal acts, and “soft” corruption, which refers to the abuse of power for personal gain. The article examines the determinants of “soft” corruption at nonprofit organizations and discusses the implications for the sector. The article argues that “soft” corruption is a significant problem for the nonprofit sector and that it is often overlooked. The article discusses the causes of “soft” corruption and offers suggestions for how to prevent it. The article concludes by discussing the implications for the sector and the need for further research.

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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 Steinberg (2010) focus on corporate governance and its relationship to ethical lapses.

Nonprofits are deemed to fulfill a special role in the economy. Given the goals of the charitable sector, it might be assumed that self-interested individuals would choose careers elsewhere, but malfeasance at nonprofits is surprisingly common. Works by Fremont (2001), and Holfrete (2009), all examined corruption. Essentially, Heynem (2009) educational institutions des an have been the nonprofit organizations rise (2009) tions (using

## Corruption or Simply Misbehavior

## In this article

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 other financial variables, and provide a side-by-side comparison of two hypothetical charities—one that would be deemed more effective based on financials, but less impactful based on outcomes. Charity watchdogs such as Charity Navigator and CharityWatch also caution against uncritical use of financial ratios. Batts ([2013](#)) argues that the

and should not be the only evaluation: is the charity argues that outcome

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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.

The problem with these forms of oversight is that, until malfeasance reaches some threshold, a nonprofit can continue to operate. The four cancer charities closed by the FTC (noted above) had operated and received donations for years. Disclosure requirements for nonprofits are inconsistent and often incomplete. They often come under scrutiny from the courts, and some argue that they are not sufficient to ensure that nonprofits are releasing accurate financial data. Some states have enacted laws that require nonprofits to release financial data (e.g., [California’s SB 8](#)) might be more effective. However, these laws could be more effective if they required nonprofits to release 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.

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, particularly if the results of the audit are included on the nonprofits' 990 form. For many small nonprofits, the cost of an independent audit may be prohibitive. Prakash and Gugerty ([2010](#)) argue that nonprofits that voluntarily agree to additional regulatory controls can utilize their participation in such programs as a means to differentiate themselves from other nonprofits. Finally, Williams ([2007](#)) makes into account the relationship at the nonprofit level. In addition, the provide information as a comprehensive evaluation of which provide Nonprofit Navigator is dated. Nonprofit Navigator does not meet the disclosure requirements (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 990 s so as to enhance their attractiveness to potential donors (note that Froelich, Knoepfle, and Pollak ([2000](#)) found no systematic manipulation of figures on Form 990 s 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. CharityWatch, however, provides a list of the most egregious examples of illegal activity on the part of nonprofits (CharityWatch Hall of Shame [<https://www.charitywatch.org/charitywatch-articles/charitywatch-hall-of-shame/63>]).

The scandal surrounding the 1992, is perhaps the most well-known example of hard corruption. The organization was charged with misappropriation of funds and was found to have siphoned off millions of dollars to have a private jet, a private office, and a private car. The organization, Aramony, was sent to prison for 9 months. In 1999, the Federal Bureau of Investigation (FBI) filed charges against the organization. The organization, Angel Food Ministries, was found to have sold the food to for-profit companies.

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 the organization claimed over 60,000 members, it actually was run entirely by Cody out of a duplex in Florida, and no evidence exists that the organization ever assisted any veterans. In 2010, questions were raised about the “charity” and Cody fled the state and eventually was sentenced to 12 years in prison in 2013.

Other major charities that have been exposed include the Children's Hospital, which was found to be a scam (see [this](#)), and the Children's Hospital, which was found to be a scam (see [this](#)).

Example: The Tampa Bay Times published a list of the Worst Charities in America's (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 oversight by organizations such as CharityWatch and Charity Navigator has been examined by authors such as Cnaan, Jones, Dickin, and Salomon ([2011](#)), who question the usefulness of ratings services when they are used by few donors. Additionally, Rao ([1998](#)) argues that political leanings may tamper with the accuracy of consumer ratings of organ

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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 transparency ratings are appropriate, as this would create a problem with bi-causality, as some of the factors that will be used as explanatory variables (e.g., whether the organization conducts an independent audit) partially establish both a charity’s transparency and its financial health.

Although the base of charitable organizations includes hospitals, schools, and universities, the findings of this section suggest that not fully reported expenses reported by either significant or exaggerated.

A significant portion of the total assets (low

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 future research.

Previous work on nonprofit corruption has focused on hard corruption; those organizations where civil or criminal wrongdoing was committed and announced in the press. Unethical behavior by nonprofit organizations is certainly not new, and has been exposed in a variety of ways. Malfeasance by nonprofits is nearly always a result of a few bad apples, and not a systemic problem. The prevalence of corruption in the nonprofit sector is relatively low, but it is far more common in the for-profit sector. In this article



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 one that carries potential legal peril for misconduct. Likewise, charitable organizations that conduct and release the results of an independent audit (`auditi`) are, in most instances, voluntarily imposing an added external control (follows work by Britton, [2007](#); Froelich, et al., [2000](#) on disclosure). State-specific disclosure requirements are also a factor in the degree of malfeasance. For example, the work by Neely et al. (2007) on the effect of regulations affecting the Nonprofit Sector ([https://www.nps.gov/Regulation-and-Enforcement/Nonprofits](#)) states that states that have no ceilings that are used as a variable (a potential

One of the potential “truisms” of misbehavior in the nonprofit sector is the idea that it is confined to smaller, less visible, organizations. The annual expenditures ( $\text{expend}_i$ ), labeled “total functional expenses” in the vernacular of Charity Navigator, will be used as a measure of size. One might also assume that this form of malfeasance is more likely in upstart, rather than established, charities. Hence, the age ( $\text{age}_i$ ) of the institution will be incorporated into the sample. Finally, it is possible that malfeasance is more common in certain subsectors (different giving categories) of the nonprofit universe. Binary variables ( $\text{categ}_{i,j}$ ) will be used to determine if significant variation is present in the sample across categories of giving. As utilization of binary variables is confined to  $n - 1$  cases (to avoid overspecification), preliminary testing was employed to determine within which subsectors malfeasance was more likely. Binary variables were included for “Animals,” “Health,” “Human Services,” and “Religion.”

Prior work on nonprofit corruption (e.g., Greenlee et al., [2007](#)) has focused on the magnitude of corruption and its determinants, attributing the scale of malfeasance to the compensation, tenure, and gender of perpetrators. It is unclear whether these influences would impact the decision to engage in soft corruption. In addition, as this form of misbehavior is frequently characterized by excess salaries, bi-causality is an issue. Hence, these additional factors will be omitted from the estimation. As noted above, Trussel ([2003](#)) used accounting variables to predict which nonprofits were likely to be misrepresenting their finances. In this estimation, however, the zero-ranked charities achieved that distinction as a result of financial variables. Utilization in an estimation would make the explanatory variables a function of the dependent variable (bicausality). For an additional evaluation of which numbers matter in evaluating the strength

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

age<sub>i</sub> = Age of the nonprofit

indboard<sub>*i*</sub> = 1 for charities with named independent boards, 0 otherwise

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

govt<sub>i</sub> = 1 for nonprofits with partial government funding, 0 otherwise

state<sub>i</sub> = Reporting requirement, 0 for none, 1 for legal requirement

$\text{expend}_i$  = Annual level of giving

cat<sub>g<sub>i</sub>, j</sub> = 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

The results are provided in Tables 2 and 3. Both the probit and logit models produced approximately the same degree of explanatory power (pseudo-R<sup>2</sup> of approximately 38%). The

level in the board and the public indicate soft corruption is important into the model the presence of gover scores of represer difficult

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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 heath causes were significantly more likely (at the 5% level) to receive a zero ranking. Similarly, in both estimations there was a greater likelihood that human services organizations would be zero-ranked (significant at the 1% level). Conversely, there was no difference between nonprofits in the Research and

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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.



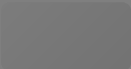

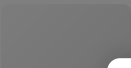
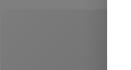
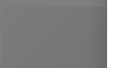
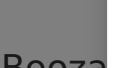
The empirical work presented here indicates that two forms of oversight—maintaining an independent voting board and contracting for an independent audit—are the best means of avoiding organizational malfeasance at nonprofits. Governmental oversight, whether through reporting requirements or through the 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 informational or monetary—from organizations to which they donate, resulting in an agency problem. This enables managers of charities to misdirect, misuse, or pocket (through excess salaries) donations with few consequences. Independent audits and the presence of a board of directors are essential to the prevention of soft corruption.



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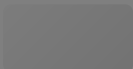
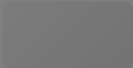
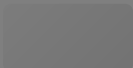



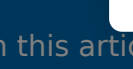
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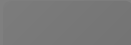
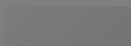
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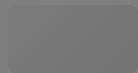


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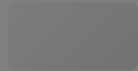
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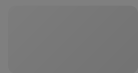
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