

## Regulating and Monitoring Nonprofits: Balancing Compliance and Best Practices

Nonprofits, like all businesses, have quite a bit of flexibility concerning the internal organization of their structures and processes. However, that flexibility is constrained by a myriad of agencies, governmental and otherwise; statutes; and individuals that regulate their activities and to whom they are accountable. The following discussion will shed light on some of those bodies and regulations that oversee, sanction, guide, or place specific expectations on nonprofits. It is incumbent upon the board of directors to be aware of these entities as part of its own primary duty of organizational oversight.

### Federal Government

For the most part, the federal government does not meddle in the nitty-gritty structure of a nonprofit. It does not stipulate how board meetings must be run or which committees a board must have. But it does pay a great deal of attention to private inurement, demanding that those affiliated with a tax-exempt organization do not reap undue financial benefit from this relationship. And it expects the organization to adhere to its mission, a purpose that originally helped classify it as tax-exempt.

The **Congress**, by enacting federal laws, and the **judicial branch**, as interpreter of the laws, expect tax-exempt organizations (with a few exceptions) to follow the criminal and civil statutes that apply to all entities and individuals. These include regulations on public health, national security, and employment-related issues, such as taxes and anti-discrimination policies.

Statutory law (developed by legislature) is only one component of the legal landscape that controls a nonprofit organization's operations. Another major component is case law, developed through judicial rulings both at the federal and state level when real-world cases are tested in court against the significant statutory law and case law precedents.

**The Internal Revenue Service (IRS)** is the primary federal entity that regulates tax-exempt organizations. The IRS has the power to recognize, deny, or revoke an organization's tax-exempt status, and it expects the organization to function within basic guidelines to maintain its preferential tax status. Nearly all tax-exempt organizations must report to the IRS annually. Most organizations file Form 990, an annual information return that allows the IRS to monitor, among other activities, how the organization raises and spends its funds. This document — as well as 1023 and 1024, applications for the tax-exempt status — are public documents and must be available to anyone who asks to see them. The IRS particularly watches the following issues:

- *Compensation*: The IRS pays attention to whether (and how much) board members and officers are compensated, as well as to whether the chief executive's and other key employees' total compensation packages remain within reasonable limits. In case of impropriety, the IRS can impose "intermediate sanctions," which are serious excise taxes, on board members and the individual managers involved.
- *Private Inurement*: The IRS examines an organization to determine if it provides unjustified private inurement (financial benefit greater than services rendered in return) to insiders, such as board or staff members. While owners and shareholders of for-profit corporations can share the profits, the beneficiary of a surplus in a nonprofit organization must be the organization itself — not an individual.
- *Unrelated Business Income*: The IRS looks at a nonprofit's business activities. Nonprofit organizations must not compete unfairly with for-profits and, if they engage in business activities unrelated to their mission, they must pay appropriate taxes or risk losing their tax-exempt status.
- *Lobbying*: Charities are limited in their freedom to lobby and influence legislation. Participation in political campaigns for or against a candidate results in the automatic loss of tax-exempt status for charities.
- *Governance*: Though the federal government expects a tax-exempt organization to be governed by a board, federal laws do not state how this board makes decisions and which processes it follows. There is nothing in the Internal Revenue Code that gives the IRS unequivocal oversight of corporate governance. However, as expressed in guidance materials on its Web site, the IRS believes that good corporate governance is necessary to ensure that the organization lives up to its responsibilities as a tax-exempt organization. The new Form 990, with its focus on governance policies and practices, is a clear indication of this heightened interest.

The IRS therefore is engaged in "regulation" by demanding public disclosure. There is no empirical evidence, however, that an organization that follows what the IRS considers to be good governance practices is any more likely to be well run or more faithful to its mission than an organization that has adopted alternative practices. However, to avoid a perception that they are non-compliant, many organizations have made or are likely to make changes to their operations, or to adopt new governance policies in light of the implied "mandate" from Form 990.

The Senate Finance Committee, during recent years, has been particularly interested in developing legislation affecting the charitable sector. The non-partisan **House-Senate Joint Committee on Taxation** has also been viewing proposals designed to increase regulation and accountability of the nonprofit sector. It makes sense for all nonprofit organizations to follow the activities in both committees and be familiar with the issues that particularly draw the legislators' attention.

Nonprofit organizations that receive federal funds are also monitored and investigated by other government agencies, such as the **Government Accounting Office** (the congressional watchdog).

The U.S. Postal Service offers qualified nonprofit organizations a discounted rate called "Nonprofit Standard (A)" for certain mailings. The complete regulations are found at <http://pe.usps.com/text/pub417/welcome.htm>. They include the following key points:

- The rules for determining qualification for special rates for a nonprofit organization are very different from the IRS tax-exemption rules.
- Special rules restrict "advertisements," which include promoting products and services.

- Special rules regulate mailings done jointly with commercial businesses.
- Periodicals must be sent at standard periodical rates unless they qualify as “periodical look-alikes.”

## State Regulation

States regulate corporations. Any incorporated nonprofit organization must follow specific state laws. These laws form a structural and operational framework for organizations that want to benefit from the protection provided by **incorporation**. Several states have adapted the Model Nonprofit Corporation Act

([www.abanet.org/rpmt/meetings\\_cle/2008/jointfall/Joint08/ExemptOrgCharitablePlanOrganGroup/BlackLetter.pdf](http://www.abanet.org/rpmt/meetings_cle/2008/jointfall/Joint08/ExemptOrgCharitablePlanOrganGroup/BlackLetter.pdf)). This act declares the necessity for the organization to have a board;

defines qualifications and standards of behavior for board members; and clarifies the minimum accepted structural elements for the board, including the size of the board, which officer positions should be in place, and how often the board must meet. Every corporation must file its **articles of incorporation**, which explain its respective authority levels and structure, with the state (usually the office of the Secretary of State). This document should not be extremely detailed as any amendments result in a new filing and administrative expenses.

All states also have **sunshine laws**, see <http://www.rcfp.org/ogg/index.php>. These open meeting requirements define where board meetings can be held, how notices are announced to the public, and how the minutes of the meetings will be posted for the public. The sunshine laws generally apply to organizations that receive public funding or government contracts.

Most states require any nonprofit conducting business or fundraising within the state to **register** with the state. This also applies to organizations that are incorporated in one state but have activities or an office in another state. Annual filings allow the **Secretary of State** or the **Department of Justice** to monitor fundraising or other business activity in the state and serve as a tool for donors wishing to verify that a fundraising individual or event is associated with a legitimate organization.

**Attorneys General (AG)** have broad powers to sue and determine the fate of a nonprofit or its board that does not abide by laws or general ethical standards created for nonprofits. They have the duty to protect the public’s interest in the charitable assets of a tax-exempt nonprofit. Complaints against a nonprofit should be directed to the office of the Attorney General but, unfortunately, most of these offices are short on funds and, by necessity, are obligated to triage their involvement. This usually means the AG will not act except in serious ethical or criminal type activities. Internal squabbles rarely get the AG’s attention.

The **National Association of State Charity Officials (NASCO)** is an association of state offices charged with oversight of charitable organizations and charitable solicitation in the United States. The requirements and procedures for forming charitable organizations differ from state to state, as do the registration and filing requirements for organizations that conduct charitable activities or solicit charitable contributions.

The **state charity offices** handle the state-specific oversight of charitable organizations [www.nasconet.org/agencies](http://www.nasconet.org/agencies). They are either connected to the Attorney General or the Secretary of the State office.

Any state agencies that provide funding or contracts to nonprofits tend to demand detailed reporting on how the funds have been expended. Some agencies require a power to appoint one or more board members as added internal monitors. These agencies also often dictate that the nonprofit must conduct an independent audit. A few states — California being the first with its Nonprofit Integrity Act of 2004 [www.ag.ca.gov/charities/publications/nonprofit\\_integrity\\_act\\_nov04.pdf](http://www.ag.ca.gov/charities/publications/nonprofit_integrity_act_nov04.pdf) — have also passed laws defining the thresholds at which an organization must have audits and audit committees.

## Local Statutes

Counties and municipalities also may have special regulations and registration requirements that apply to nonprofits. Solicitation is one area that is often regulated. Naturally, health-care or other public health organizations need to register with local authorities that regulate industry-specific activities. This applies also to day-care centers (see “industry-specific regulators”, below), homeless centers, educational institutions, and many other organizations that in any way address safety issues. In addition, a nonprofit may require a liquor license if it sells alcohol at its events. Auctions and gaming activities are covered by specific laws — usually also at the state level. The nonprofit may seek the assistance of its city hall or chamber of commerce to determine which permissions are needed if theirs is not an outright clear case.

State and federal laws are not the only laws to which nonprofit organizations are subject. Government authorities of jurisdictions smaller than a state, such as counties and municipalities, can and do implement laws that may be stricter than their superior governments’ laws. Such government authorities may require soliciting organizations and their paid contractors to register within the jurisdiction. This is in addition to registering with state and federal jurisdictions. Any soliciting organizations, wherever incorporated or located, that present charitable solicitations to residents of these intrastate jurisdictions may be subject to legal action by that jurisdiction’s government authority if they don’t adhere to the local law and its associated regulations.

## Other Regulatory Bodies

Numerous standard-setting organizations, particularly in the accounting industry, require nonprofit organizations to follow specific rules and guidelines. Each nonprofit should be familiar with the following organizations:

- **American Institute of Certified Public Accountants (AICPA):** The AICPA is the professional association for CPAs, and its members must meet specific professional standards. It also issues *statements of position*, which provide guidance on general or industry-specific financial accounting and reporting issues.
- **Financial Accounting Standards Board (FASB):** Since 1973, the FASB has been the designated organization for establishing standards of financial accounting and reporting, the so-called generally accepted accounting principles (GAAP). It issues statements of financial accounting standards (SFASs) that are officially recognized as authoritative by the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA).

## Industry-specific regulators

Many subsectors have industry-specific accreditation bodies that establish operating standards that must be followed in order for the nonprofit to maintain its certification. For example, hospitals and other health-care providers are subject to review by the Joint Commission on Accreditation of Healthcare Organizations (JCAHO). Zoos are subject to review by the American Association of Zoos and Aquariums. Museums can be accredited by the American Association of Museums, day care centers by the National Association for Education of Young Children, and rehab centers by the Commission on Accreditation of Rehabilitation Facilities. Although many accreditations are “voluntary,” they promulgate high standards and contribute to the professional reputations of the accredited organizations.

## Media calling

Don't forget the influence of media. Bad news sells. Unfortunately, scandals about a chief executive's lavish lifestyle on the organization's dime are more fascinating than stories about a local charity's success in attracting an army of volunteers to clean a park. Media do not have any regulatory power over nonprofits but they can have an enormous impact on the public's opinion — even influencing the IRS or the Senate Finance Committee to step up its interest in an organization's affairs. Systematically cultivating good relations with the media makes sense. Treat the media with respect. Respond quickly to inquiries. Be honest and provide solid explanations for your actions. And share good news; don't wait for the reporter to come knocking on the door.

## Nonprofits' Own Watchdogs

The sector's own watchdog agencies have created numerous standards for good behavior. Coalitions of organizations, state associations for nonprofits, and even state attorneys general have published ethical guidelines. Umbrella organizations spell out specific standards before a chapter is allowed to use the logo, name, and brand of the national organization. Some watchdogs provide seals of excellence for organizations that meet specific standards or rate organizations according to specific thresholds. Practices that draw attention include percentage of expenses directed to programs, cost of fundraising, audits, minimum size of the board, or existence of conflict-of-interest policies.

As the Maryland Association of Nonprofit Organizations states, nonprofits reap clear benefits from meeting public expectations. Their accountability is recognized. They manage to safeguard against improper behavior. They can measure good behavior. They develop a framework for self-improvement and proactively start solving problems. And donors feel more comfortable contributing to organizations that embrace good practices.

Here are a few examples of respected standards for nonprofits.

- **Panel on the Nonprofit Sector: *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations***

[www.nonprofitpanel.org/Report/principles/Principles\\_Guide.pdf](http://www.nonprofitpanel.org/Report/principles/Principles_Guide.pdf)

This guide, released in October 2007, outlines 33 recommendations to help charitable organizations improve their governance practices. These practices cover four main areas: legal compliance and public disclosure, effective governance, strong financial oversight, and responsible fundraising. Adherence to the principles is totally voluntary but those who commit to follow the principles can sign up — and show public support — at the Independent Sector Web site.

- **BoardSource and Independent Sector: The Sarbanes-Oxley Act and Implications for Nonprofit Organizations**  
[www.boardsource.org/dl.asp?document\\_id=558](http://www.boardsource.org/dl.asp?document_id=558)  
 After the SOX Act was adopted, the nonprofit sector was in “turmoil,” worrying about the possibility of similar laws being drafted to control nonprofits directly. The SOX Act created a noticeable wave of self reflection in nonprofit organizations and pushed the community to create internal recommendations for good accountability before an all-encompassing set of laws would make the case. This white paper was created as a response to this “movement” and continues to attract wide attention today.
- **Maryland Association of Nonprofit Organizations: *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector***  
[www.standardsforexcellence.org/sfxcert.html](http://www.standardsforexcellence.org/sfxcert.html)  
 These standards were created as a voluntary certification program for Maryland nonprofits. A positive review of all aspects of its programs and operations allows the organization to earn a Seal of Excellence. The Maryland Association of Nonprofit Organizations (MANO) provides assistance for nonprofits to work on needed aspects of their operations or governance to allow them to meet the expected benchmarks set by the standards. Eight Guiding Principles are covered: mission and program, governing body, conflict of interest, human resources, financial and legal, openness, fundraising, and public affairs and public policy. Fifty-five more specific Standards of Excellence define the principles. Numerous states have adapted the MANO standards.
- **The BBB Wise Giving Alliance: *Standards for Charitable Accountability***  
[www.bbb.org/us/Charity-Standards/](http://www.bbb.org/us/Charity-Standards/)  
 The accountability standards of the BBB Wise Giving Alliance, an initiative of the Better Business Bureau, became effective March 3, 2003. These standards apply to 501(c)(3) charitable organizations (excluding private foundations) and other organizations that solicit funds from individuals. There are 20 different standards grouped under governance, effectiveness, and finances. Organizations that want to earn the seal of approval are expected to comply with guidelines on how they govern their organization, spend their money, represent themselves truthfully in their documents, and willingly disclose basic information to the public. A lengthy implementation guide outlines the details of expectations.
- **Charity Navigator**  
[www.charitynavigator.org/index.cfm?bay=content.view&cpid=484#16](http://www.charitynavigator.org/index.cfm?bay=content.view&cpid=484#16)  
 Created in 2001 to help donors make wise decisions, Charity Navigator now rates nonprofits. It accepts organizations that are charities, solicit funds from individuals, and represent diversity in terms of mission, size, and location. Charities are rated for their organizational efficiency and capacity based on information provided in their Form 990s. To rate efficiency, Charity Navigator looks at fundraising efficiency, fundraising expenses, program expenses, and administration expenses. To rate capacity, it looks at primary revenue growth, program expenses growth, and working capital ratio. An overall rating (“qualitative designation”) is then given to the nonprofit according to a specific table.

## Self-regulation

Ultimately, nonprofit organizations must exercise self-regulation. Good practices and sensible policies protect and steer the staff and the board as they fulfill the mission of the organization. These guidelines serve as references for appropriate action, for ethical decision making, and for dealing with potential or actual conflicts. They can paraphrase a law, explain a procedure, clarify a principle, or express a desired goal. They are the protocol to follow, and, when properly used,

help to diminish embarrassing or potentially harmful situations, improper behavior, and ineffective decision making.

Organizations must pay attention to internal controls and checks and balances by segregating duties. Internal controls exist to eliminate vulnerability, suspicion, errors, mismanagement, and fraud within the organization — they act as deterrents and detection mechanisms. This kind of proactive thinking recognizes internal controls as good business practices, effective administrative processes, and as simply smart management and governance. Besides defining the parameters and authority levels within which staff and board members operate, internal controls call for a team effort and integration of all processes and procedures. They can result in operating efficiency by eliminating unnecessary, ineffective or duplicate steps during task implementation. Internal controls help advance accountability by focusing on productivity and cost-effective outcomes to guide decision making.

Continual demand for accountability should also awaken nonprofits to look at their auditing procedures. Organizations receiving federal funding must conduct an audit; they don't have a choice. As mentioned above, several states, with the lead coming from California, have been investigating requirements for larger organizations to conduct an audit on an annual basis. Even without statutory requirements, independent audits send a message that ethical standards and accountability are concerns taken seriously in the organization.

Only through transparency can an organization proactively answer questions and alleviate concerns in the minds of the public and individual constituents. Functioning in the open is the surest way to prove that an organization has nothing to hide and that it follows procedures leading to efficiency. Web sites are the logical place to share information and explain the mission, vision, and values of the organization and should feature the Form 990, audited financials, and annual reports for the public to see.

One of the clauses in the SOX Act that applies to all organizations, including nonprofits, relates to the treatment of whistleblowers—individuals who expose alleged illegal or unethical activities within the organization. No retaliation is allowed. To ensure that there are no repercussions for these individuals, every nonprofit should draft a policy outlining the process of reporting and handling of these claims. Please, see a sample policy below.

#### **EXHIBIT: SAMPLE WHISTLEBLOWER POLICY**

##### **XYZ WHISTLEBLOWER POLICY**

The whistleblower policy is intended to provide a mechanism for the reporting of illegal activity or the misuse of XYZ assets while protecting from retaliation the employees who make such reports.

##### **Questionable Conduct**

This policy is designed to address situations in which an employee suspects another employee has engaged in illegal acts or questionable conduct involving XYZ's assets. This conduct might include outright theft (of equipment or cash), fraudulent expense reports, misstatements of any accounts to any manager or to XYZ's auditors, or even an employee's conflict of interest that results in financial harm to XYZ. XYZ encourages staff to report such questionable conduct and has established a system that allows them to do so anonymously.

##### **Making a Report**

If an employee suspects illegal conduct or conduct involving misuse of XYZ assets or in violation of the law, he or she may report it, anonymously if the employee wishes, and will be protected against any form of harassment, intimidation, discrimination, or retaliation for making such a report in good faith.

Employees can make a report to any of the following XYZ executives at any time: chief executive, chief financial officer, or the head of human resources. XYZ will promptly conduct an investigation into matters reported, keeping the informant's identity as confidential as possible consistent with our obligation to conduct a full and fair investigation.

Alternatively, employees can make a report by calling either the board chair or the chair of the audit committee. Their names and phone numbers are posted on XYZ's intranet.

### **No Retaliation**

An employee who has made a report of suspicious conduct and who subsequently believes he or she has been subjected to retaliation of any kind by any XYZ employee is directed to immediately report it to the chief executive, the chief financial officer, or the head of human resources as appropriate.

Reports of retaliation will be investigated promptly in a manner intended to protect confidentiality as much as practicable, consistent with a full and fair investigation. The party conducting the investigation will notify the employee of the results of the investigation.

XYZ strongly disapproves of and will not tolerate any form of retaliation against employees who report concerns in good faith regarding XYZ's operations. Any employee who engages in such retaliation will be subject to discipline up to and including termination.

### **XYZ Reporting Procedures**

The "whistleblower" procedure is intended to describe the process through which concerns about the possible misuse of XYZ assets are handled pursuant to XYZ's whistleblower policy.

1. An employee makes a report of suspected misuse of XYZ assets by reporting in person to an XYZ executive, or reporting anonymously to the board chair or the audit committee chair.
2. The report is promptly reviewed by the chief executive, as well as the chief financial officer, to determine whether the report constitutes a complaint or a non-complaint, unless one of them is allegedly involved in the misconduct, in which case the report should be reviewed by only one of them. (If both of them are alleged to be involved, the report should go directly to the board chair or the audit committee chair.)
  - A *complaint* means any report involving (i) questionable accounting, auditing, financial reporting, or internal controls; (ii) suspected fraud, theft, or improper use of company assets; (iii) a violation of XYZ's conflict-of-interest policy that results in a financial harm to XYZ; or (iv) a claim of retaliation against any employee making a good-faith report regarding any of the preceding matters.
  - A *non-complaint* means a report of any other matter not involving a misuse of XYZ's assets.
3. If the report is deemed to be a complaint, it will be promptly investigated and forwarded to the audit committee chair. If the report is deemed to be a non-complaint, it will be referred to the appropriate executive or manager for follow-up. Some non-complaints may involve serious matters and may require prompt investigation, but may nevertheless not involve misuse of XYZ's assets.

4. Each complaint is fully investigated, and as far as possible handled so as to protect the privacy of the employee making the complaint. A written report of the outcome of each investigation is prepared and delivered to the audit committee chair.
5. The audit committee chair decides whether the report involves a matter that is material. If it is deemed material, it is reviewed by the full committee, which may forward it for disposition to the board or may direct senior management to take actions to resolve the situation. If the report is deemed nonmaterial, it is not reviewed by the committee but is instead addressed by the chief financial officer, as appropriate.

Excerpted from *The Nonprofit Policy Sampler, Second Edition* by Barbara Lawrence and Outi Flynn, a publication of BoardSource. For more information about BoardSource, call 800-883-6262 or visit [www.boardsource.org](http://www.boardsource.org). BoardSource © 2006.

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### **It all starts in the boardroom...**

Naturally, the board must recognize and faithfully exercise its fiduciary duty in oversight. The board is the guardian of organizational reputation. Reputation is one of the key assets an organization has. Donors — at least educated donors — are reluctant to give to an organization that seems to have something to hide or that does not follow procedures leading to efficiency. Wasting funds or directing them to inappropriate causes are valid reasons for supporters to go elsewhere — as well as for watchdogs to question the organization's tax-exempt status. No nonprofit should act in a way to alert negatively its main benefactors or endanger its preferential tax status.

Unfortunately, good intentions are not always sufficient. A few bad apples can quickly ruin a full bushel. In the nonprofit arena, a scandal affects the entire sector and has an impact on the reputation of all nonprofits. Whether regulation comes from official bodies, sector-related authorities, or internal policies of individual organizations, it is important that nonprofit leaders understand the legal and ethical parameters that define these boundaries.

### **Additional resources**

- "Governance in Form 990," a BoardSource White Paper.  
[http://www.boardsource.org/dl.asp?document\\_id=681](http://www.boardsource.org/dl.asp?document_id=681)
- The IRS Web site. <http://www.irs.gov/charities/index.html?navmenu=menu1>
- Legal Information for U.S. Business Organizations by Free Management Library.  
<http://www.managementhelp.org/legal/legal.htm>
- *The Nonprofit Legal Landscape* by Ober Kaler attorneys at law, BoardSource, 2005.  
[http://www.boardsource.org/Bookstore.asp?category\\_id=0&Item=162](http://www.boardsource.org/Bookstore.asp?category_id=0&Item=162)
- "The Sarbanes-Oxley Act and Implications for Nonprofit Organizations," a BoardSource and Independent Sector White Paper.  
[http://www.boardsource.org/dl.asp?document\\_id=558](http://www.boardsource.org/dl.asp?document_id=558)