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FINANCIAL ACCOUNTABILITY IN CHARITABLE  
ORGANIZATIONS: MANDATING AN AUDIT COMMITTEE  
FUNCTION

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INTRODUCTION

Charitable organizations have long enjoyed special benefits because the public has bestowed a special trust on them. This special trust is in danger of eroding due to abuse by some nonprofit executives and board members.<sup>1</sup> One noted example of such abuse is the United Way scandal, in which the former president of United Way of America, William Aramony, was convicted of stealing over six hundred thousand dollars from the organization.<sup>2</sup> As a result of the United Way scandal and others like it,<sup>3</sup> the nonprofit sector has been under increasing pressure to find a way to hold charitable organizations and their boards accountable to the public.<sup>4</sup>

Resolving the board accountability problem is daunting. Any proposed solutions must weigh possible negative consequences to charities in serving their missions, or in relation to any one of their stakeholders, including donors, board members, corporations, the

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1. See Eileen M. Evans & William D. Evans, Jr., "No Good Deed Goes Unpunished": *Personal Liability of Trustees and Administrators of Private Colleges and Universities*, 33 TORT & INS. L.J. 1107, 1107-08 (1998).

2. Karen W. Arenson, *Former United Way Chief Guilty in Theft of More Than \$600,000*, N.Y. TIMES, Apr. 4, 1995, at A1.

3. See *infra* Part IV.A.

4. In order to retain the public's trust, charity managers must perform their duties at a higher level than that required by the law. Failure to maintain the public trust could have negative consequences for charities, including decreased donations and decreased ability to govern themselves. See Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1414-15 (1998).

government, and beneficiaries. In addition, proposed reforms must address the need for public accountability without interfering with the independence that charities require to carry out their missions.<sup>5</sup>

Philosophical and practical considerations have rendered identifying a one-size-fits-all solution elusive. How should proposed reforms be mandated? Should reforms be left to the charitable community or should they be legislated? If legislation is the answer, should the federal government tackle the problem or should the state governments handle the task?

Once these questions are answered, new questions concerning enforcement of reforms emerge. Who is best equipped to enforce reforms? Who should have standing to bring actions against charities? Should an oversight agency similar to the SEC be created to monitor charitable organizations?

Other significant policy considerations underlie the debate. If reforms are too costly, the already overtaxed resources of public charities will be further stretched. The cost of reforms would come at the expense of the beneficiaries of public charities. In addition, imposing burdensome and costly procedures designed for poorly managed charities at the expense of well-run charities seems fundamentally unfair, as well as inefficient.<sup>6</sup>

This Note focuses on tax-exempt organizations authorized by section 501(c)(3) of the Internal Revenue Code.<sup>7</sup> Section 501(c)(3) organizations are those organized and operated exclusively for “religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition, . . . or for the prevention of cruelty to children or animals. . . .”<sup>8</sup> Although the code section makes no mention of the term, section 501(c)(3) organizations are generally referred to simply as “charities.”<sup>9</sup> Other code sections cover tax-exempt organizations

5. See Evelyn Brody, *Accountability and Public Trust*, in THE STATE OF AMERICA'S NONPROFIT SECTOR (forthcoming 2002) (manuscript on file with author).

6. See Harvey J. Goldschmid, *The Fiduciary Duties of Nonprofit Directors and Officers: Paradoxes, Problems, and Proposed Reforms*, 23 J. CORP. L. 631, 637 (1998) (“Harsh new fiduciary requirements, or uncontrolled exposure to litigation . . . would almost certainly have counterproductive effects.”)

7. I.R.C. § 501(c)(3) (2000).

8. *Id.*

9. See Robert C. DeGaudenzi, *Tax-Exempt Public Charities: Increasing Accountability and Compliance*, 36 CATH. LAW. 203, 203 (1995).

such as labor or trade unions, credit unions, lobbying organizations, and other mutual benefit corporations.<sup>10</sup>

Part I of this Note discusses the basic features distinguishing nonprofit organizations from for-profit organizations. Part II summarizes the legal framework currently in place to address the accountability of charitable organizations to the public. Part III recommends that charitable boards be encouraged to appoint an audit committee function to address the need for improved charitable board accountability. Part IV illustrates how implementing an audit committee in several cases could have prevented, or at least detected at an early stage, inside and employee fraud.

#### I. DISTINGUISHING NONPROFIT ORGANIZATIONS FROM FOR-PROFIT ORGANIZATIONS

Charitable organizations share some similarities with for-profit organizations;<sup>11</sup> however, several important features distinguish the charitable organization from the business corporation. Features distinct to charitable organizations include the nondistribution constraint, the volunteer nature of charitable boards, and the tax exemptions granted by the states and the federal government. The law reflects the different social policies inherent in governing charitable organizations versus business corporations.

The nondistribution constraint<sup>12</sup> is the most significant factor distinguishing charitable corporations from business corporations.<sup>13</sup> Other benefits, such as tax exemptions, flow from and are justified by adherence to the nondistribution restriction. Simply stated, the nondistribution constraint forbids charitable corporations from distributing net income (or profit) to any private shareholder or

10. See James J. Fishman, *The Development of Nonprofit Corporation Law and an Agenda for Reform*, 34 EMORY L.J. 617, 657–67 (1985), for a detailed classification of the various types of nonprofit corporations.

11. Like business corporations, nonprofit organizational size can range from a local “mom-and-pop” size soup kitchen to a complex multinational organization offering a substantial menu of services. See David W. Barrett, Note, *A Call for More Lenient Director Liability Standards for Small, Charitable Nonprofit Corporations*, 71 IND. L.J. 967, 969 (1996).

12. See Henry B. Hansmann, *Reforming Nonprofit Corporation Law*, 129 U. PA. L. REV. 497, 501–02 (1981); see also Geoffrey A. Manne, *Agency Costs and the Oversight of Charitable Organizations*, 1999 WIS. L. REV. 227, 258.

13. For simplicity, this discussion assumes that the organization is a nonprofit corporation (rather than a charitable trust). Most American charities are corporations.

individual.<sup>14</sup> Charitable resources are expended (or saved and invested for future expenditure) for the beneficiaries of charities, rather than distributed to owners or stockholders.

Nonprofit boards generally follow the corporate model of organization;<sup>15</sup> even so, significant practical differences result between the operation of nonprofit boards and for-profit boards. First, nonprofit boards are typically composed of volunteer directors who are generally unpaid.<sup>16</sup> Charities often recruit nonprofit board members for their fundraising ability or prestige in the community rather than for their ability to lead the organization.<sup>17</sup> Second, nonprofit directors may lack the corporate or legal expertise that their for-profit counterparts often possess.<sup>18</sup> Because charitable board members are generally not compensated and may lack expertise, they have little incentive to actively oversee the activities of the charitable organizations they serve.

Congress and the state legislatures have enacted various laws reflecting a policy that encourages charitable donations and ensures the public that such donations will be spent in furtherance of the charitable mission. The federal government provides a tax incentive encouraging individuals and corporations to contribute to charitable organizations by allowing taxpayers to deduct charitable contributions from adjusted gross income for purposes of calculating income tax.<sup>19</sup> In addition, qualifying charitable organizations are exempt from paying federal income tax,<sup>20</sup> and most states also provide tax exemptions from income, property, or state sales taxes.<sup>21</sup> By providing for tax incentives and tax exemptions, legislatures recognize the public benefits derived from charities and, through tax policy,

14. I.R.C. § 501(c)(3) (2000). The code explicitly states that “no part of the net earnings . . . [of the organization may inure] to the benefit of any private shareholder or individual.” *Id.*

15. See Fishman, *supra* note 10, at 619–40. Fishman discusses the twentieth-century change in preference in the organizational form of nonprofit organizations from the trust form to the corporate form. The charitable corporation evolved in large part due to testators’ fears that the English common law of trusts did not survive the American Revolution.

16. Tax-exempt entities may not distribute profits to directors or employees, although reasonable compensation can be paid. See Darryll K. Jones, *The Scintilla of Individual Profit: In Search of Private Inurement and Excess Benefit*, 19 VA. TAX REV. 575, 576 (2000).

17. See Thomas H. Boyd, *A Call to Reform the Duties of Directors Under State Not-For-Profit Corporation Statutes*, 72 IOWA L. REV. 725, 728 (1987); Fishman, *supra* note 10, at 674.

18. Fishman, *supra* note 10, at 675.

19. I.R.C. § 170(a) (2000).

20. I.R.C. § 501(a) (2000).

21. See, e.g., 35 ILL. COMP. STAT. 5/205 (2000).

encourage public support of charitable missions.<sup>22</sup> Tax policy also dictates, to a large extent, the manner in which charitable organizations are regulated.

## II. CURRENT STANDARDS OF BOARD GOVERNANCE AND REGULATION OF CHARITABLE ORGANIZATIONS

### A. *Obligations of Directors and Officers*

The charitable community<sup>23</sup> has long grappled with the issue of how to hold board members to a higher level of responsibility without adversely affecting board recruitment efforts.<sup>24</sup> Effective board leadership is crucial because charities are, for the most part, self-regulated.<sup>25</sup> One of the barriers to effective board leadership in the charitable sector is the lack of incentives for board members to properly monitor the organization; comparatively, these incentives are often present in the business sector.<sup>26</sup> For example, charitable board members are not subject to the threat of derivative suits from shareholders or the oversight of agencies such as the SEC.<sup>27</sup>

Like directors of business corporations and trustees of private trusts, the courts hold directors of nonprofit organizations and trustees of charitable trusts to the fiduciary duties of loyalty and due care.<sup>28</sup> The duty of loyalty imposes an obligation on directors or trustees of nonprofit organizations to set aside personal concerns and make decisions that are in the best interests of the organization.<sup>29</sup> In other words, the duty of loyalty forbids the director from profiting at the expense of the organization or engaging in self-dealing.

The duty of due care has been relaxed from earlier notions that imposed a strict trust standard and required the highest degree of

22. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578, 581 (1924).

23. "Far from homogeneous, the nonprofit sector comprises a complex web of participants." Brody, *supra* note 5, at 3. Business, government, and the public at large have all formed relationships with nonprofit organizations on some level. *See id.*

24. *See* Goldschmid, *supra* note 6, at 637.

25. *See* Fishman, *supra* note 10, at 677.

26. Peter Frumkin & Alice Andre-Clark, *Nonprofit Compensation and the Market*, 21 U. HAW. L. REV. 425, 461–62 (1999).

27. *See* Fishman, *supra* note 10, at 675.

28. Brody, *supra* note 4, at 1406.

29. The ABA Model Nonprofit Corporation Act adopts the following language: "A director shall discharge his or her duties . . . in a manner the director reasonably believes to be in the best interest of the corporation." REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1987).

honor and integrity from directors of business corporations.<sup>30</sup> Some have argued that the strict trust standard should be adopted for directors of charitable organizations because the beneficiaries of charitable organizations, unlike stockholders, do not have the power to voice concerns.<sup>31</sup> Nevertheless, most courts have relaxed the standard of care for directors of nonprofit organizations, and instead they have applied the more lenient standard used for corporate directors.<sup>32</sup> For example, the Model Nonprofit Corporation Act requires a director to exercise the care of an ordinarily prudent person in a like position under similar circumstances.<sup>33</sup> Expectations regarding director activity are minimal—nonprofit directors are expected to attend board meetings, review material submitted to the board, and request any other information needed to carry out their responsibilities as directors.<sup>34</sup> Noticeably absent from the Model Act are any expectations that directors ensure that management is engaging in sound practices.

The shift towards less stringent standards of care for directors exhibits sensitivity to practical factors, namely that nonprofit directors are typically volunteers and are not paid for their services.<sup>35</sup> Stricter standards of liability could also impact the efforts of charitable organizations to recruit directors.<sup>36</sup> Finally, board members bring different contributions to the charitable organization; while business experience is important, of equal importance to many charities is the board member's ability to bring prestige, donations, or contacts to the organization.<sup>37</sup>

30. See Evans & Evans, *supra* note 1, at 1115.

31. *Id.* at 1117.

32. See, e.g., *La. World Exposition v. Fed. Ins. Co.*, 864 F.2d 1147, 1152 (5th Cir. 1989) (on petition for rehearing) (upholding the same standard for nonprofit directors as was adopted by the Model Nonprofit Corporation Act).

33. REVISED MODEL NONPROFIT CORP. ACT § 8.30 (1987).

34. REVISED MODEL NONPROFIT CORP. ACT § 8.30 cmt. 2.

35. See Jones, *supra* note 16.

36. See Evans & Evans, *supra* note 1, at 1117.

37. See Fishman, *supra* note 10, at 674.

*B. Public Disclosure of Form 990: IRS and Public Oversight of Charitable Organizations*

1. Form 990: Congressional Policy

Congress has an interest in charitable organizations maintaining credibility with the public. In an effort to quell public concern surrounding several highly noted cases of misuse of funds by charity executives, Congress enacted legislation requiring that any organization required to file a Form 990 (the annual information return filed with the IRS) must make Form 990 available to the public.<sup>38</sup> Organizations that fail to provide for public inspection of Form 990 are subject to IRS penalties.<sup>39</sup>

Form 990 collects financial information, including details such as the organization's five highest-paid employees, five highest-paid contractors, and fundraising expenses.<sup>40</sup> In addition, the return requires the organization to disclose any transactions that involved board members.<sup>41</sup> The information is useful to the IRS in flagging possible tax violations such as excess-benefit transactions<sup>42</sup> or cases where revocation of tax-exempt status should be considered.<sup>43</sup>

The Staff of the Joint Committee on Taxation<sup>44</sup> asserted in a 2000 report that increased public disclosure would facilitate oversight of

38. Churches and exempt organizations with less than twenty-five thousand dollars in gross receipts need not file. I.R.C. § 6104 (2000). At the time section 6104 was enacted, Form 990 was available from the IRS; however, access to the information was difficult to obtain. The new law requires that filing charities make Form 990 directly accessible to the public. § 6104(d)(1)(A). Prior to the new disclosure requirements, one commentator noted that during congressional hearings, the public disclosure requirements in place were not serving their purpose, in part, because some public charities were failing to provide the information. See DeGaudenzi, *supra* note 9, at 221.

39. I.R.C. § 6652(c)(1) (2000).

40. I.R.S. Form 990, OMB No. 1545-0047 (2001).

41. See I.R.S. Form 990 Sched. A, OMB No. 1545-0047 (2001).

42. I.R.C. § 4958 imposes a 25 percent tax on officers, directors, and trustees of tax-exempt organizations (and a ten percent tax on approving managers of tax-exempt organizations) where those insiders are the beneficiaries of an excess benefit transaction. The sanction is an intermediate step available before revoking a charitable organization's tax-exempt status. See also Nancy G. Itnyre, *A Proposed Solution to a Problem Created by Worker Reclassification*, 77 U. DET. MERCY L. REV. 273, 292-98 (2000).

43. See generally Peter Swords, *The Form 990 as an Accountability Tool for 501(c)(3) Nonprofits*, 51 TAX LAW. 571 (1998).

44. The Joint Committee on Taxation was established by Congress and consists of ten members: five members from the Senate Finance Committee and five members from the House Committee on Ways and Means. The Committee is authorized to conduct studies and investigations on the administration of tax laws by the Internal Revenue Service. Pursuant to section 3802 of the IRS Reform Act, the staff of the Joint Committee on Taxation performed a

tax-exempt organizations, increase compliance with tax and other laws, and encourage charitable giving by holding tax-exempt organizations accountable to the public.<sup>45</sup> The committee staff also suggested that public disclosure is especially appropriate where the activities of tax-exempt organizations relieve government resources.<sup>46</sup> The committee's rationale is that since government operations (which are paid for with public funds) are open to public inspection, the operations of charities, which provide services that might otherwise be required of the government, should also be open to public inspection.<sup>47</sup>

Whether Form 990 disclosure has impacted public accountability is debatable.<sup>48</sup> The format of Form 990 is structured to enable the IRS to flag tax code violations, not to evaluate the organization as a whole.<sup>49</sup> Merely setting out financial information and disclosing it to the public is inadequate for public oversight purposes and may even cause confusion or misunderstanding among members of the public.<sup>50</sup> Further, the public is not in the legal or practical position to oversee the activities of charitable organizations.<sup>51</sup> Perhaps the public's true power is demonstrated when people close their checkbooks in reaction to cases where charity executives or boards have grossly abused their trust.

Public disclosure under Form 990 may deter some charity executives from misusing organization funds or engaging in self-dealing

study to aid in determining whether greater disclosure of information by charities would serve the public interest. See STAFF OF THE JOINT COMMITTEE ON TAXATION, U.S. CONG., GENERAL EXPLANATION OF THE JOINT COMMITTEE ON TAXATION, U.S. CONGRESS: HISTORY AND ROLE OF THE JOINT COMMITTEE IN THE LEGISLATIVE PROCESS (2000), available at <http://www.house.gov/jct/tablist.html>.

45. STAFF THE OF JOINT COMMITTEE ON TAXATION, U.S. Cong., Doc. No. JCS-1-00, STUDY OF PRESENT-LAW TAXPAYER CONFIDENTIALITY AND DISCLOSURE PROVISIONS AS REQUIRED BY SECTION 3802 OF THE INTERNAL REVENUE SERVICE RESTRUCTURING AND REFORM ACT OF 1998, VOLUME II: STUDY OF DISCLOSURE PROVISIONS RELATING TO TAX-EXEMPT ORGANIZATIONS 80 (2000), available at <http://www.house.gov/jct/pubs00.html> (web page provides link to PDF document).

46. *Id.* at 63 n.140.

47. *Id.*

48. Compare Deborah A. DeMott, *Self-Dealing Transactions in Nonprofit Corporations*, 59 BROOK. L. REV. 131, 144 (1993) (arguing that public disclosure requirements do not operate as a deterrent), with STAFF OF THE JOINT COMMITTEE ON TAXATION, *supra* note 45, at 80 (opining that public disclosure will increase compliance with federal tax laws).

49. See generally Swords, *supra* note 43.

50. See Brody, *supra* note 5, at 34.

51. See generally Rob Atkinson, *Unsettled Standing: Who (Else) Should Enforce the Duties of Charitable Fiduciaries?*, 23 J. CORP. L. 655 (1998).

transactions; however, the more likely result is that the information will never find its way onto Form 990.<sup>52</sup> Nearly 25 percent of charities receiving more than \$5 million in contributions reported that they spent nothing on fundraising, indicating that many charities are “simply not complying with IRS rules.”<sup>53</sup> Even where reported information might tend to expose misappropriation of charitable funds, the odds of detection by the public or the IRS are slim.<sup>54</sup>

In 1998, 10,353 out of 644,496 tax-exempt organization returns were examined by revenue agents of the IRS—less than 2 percent of all tax-exempt returns.<sup>55</sup> Of the returns examined, more than half were taxable returns such as payroll tax reports (Forms 940, 941, 942, and 943) and unrelated business income reports (Form 990-T).<sup>56</sup> In other words, less than 1 percent of Forms 990 or 990EZ (filed by small organizations) were examined.<sup>57</sup>

52. See Swords, *supra* note 43, at 578.

53. The findings of the study conducted by the Urban Institute’s Center on Nonprofits and Philanthropy sampled computerized returns for the tax years 1997–1998. The *Chronicle of Philanthropy* also examined returns from states that require professional fundraisers to disclose their clients. The Chronicle noted that in many cases fundraising consultants reported that they had received payments from charities, but the same charities reported no fundraising expenses on their federal returns. *Charities’ Zero-Sum Filing Game*, CHRON. PHILANTHROPY, May 18, 2000, at 21.

54. See IRS DATA BOOK, PUB. NO. 55B, at tbl. 20 (1998). The IRS Data Book is a statistical publication providing detailed information including revenues generated, returns filed, and returns examined.

55. See *id.*

56. See *id.* at tbl. 21.

57. See *id.* at tbls. 20–21.

TABLE 1: FROM IRS DATA BOOK TABLES 20 AND 21

Tax-exempt organization returns by type	
<b>Form 990 and 990EZ</b>	<b>4,145</b>
Forms 990PF, 5227, 1041A, and 1120	350
Form 990C	88
Form 990POL	107
Forms 8038, 8038G, 8038GC, 8038T, and 8328	126
<b>Total non-taxable returns</b>	<b><u>4,816</u></b>
Forms 940, 941, 942, and 943	2,845
Form 990-T	1,717
Form 4720	50
Forms 1040 and 1120 adjusted	925
<b>Related taxable returns</b>	<b>5,537</b>
Total tax-exempt organization returns examined by revenue agents in Fiscal Year 1998	<b>10,353</b>

## 2. Should the IRS Take On the Role of Policing Charities?

The appropriate charity policing roles of the states, the federal government,<sup>58</sup> and the public are often debated. Currently, the states, through their attorneys general, have the primary burden for policing charities.<sup>59</sup> The public is poorly situated to handle such a role due to legal and practical considerations.<sup>60</sup> In more recent years, Congress has granted the IRS a larger role in overseeing tax-exempt organizations.<sup>61</sup>

58. The constitutional issues surrounding charitable organizations and the right to association and the possible negative effects of an overly involved federal government are beyond the scope of this Note.

59. See Evelyn Brody, *Institutional Dissonance in the Nonprofit Sector*, 41 VILL. L. REV. 433, 481 (1996).

60. See Atkinson, *supra* note 51.

61. See generally Brody, *supra* note 4, at 1439 ("We have been moving to a system of federalizing oversight of charities.").

The IRS is not the appropriate agency to regulate charities; its role should continue to be limited to collecting revenue. Not only is policing charities outside the scope of the IRS's traditional area of responsibility,<sup>62</sup> but also taking on this new role would require substantial additional resources. Consistent with its tax collection role, where the IRS does examine exempt organization returns, resources are more heavily invested in examining taxable versus nontaxable returns filed by charities.<sup>63</sup> The IRS's role in policing charitable organizations should continue to be that of collecting tax revenues. Assigning to the IRS a larger role in policing charities would be costly to taxpayers and would not be as effective as requiring boards, which have a greater ability to know their organizations intimately, to exercise greater care by implementing audit committees.

This is not to say that the IRS cannot be helpful to the cause, but it should do so within its sphere of competence such as in the enforcement of intermediate sanctions.<sup>64</sup> Congress recently gave the IRS the authority to impose a 25 percent tax directly on charity executives, officers, and managers who profit by engaging in excess benefit transactions.<sup>65</sup> This is an example of an appropriate role for the IRS and falls within the traditional scope of IRS oversight. These intermediate sanctions can help in the battle to hold charity executives accountable by providing a disincentive for executives and others within charitable organizations to engage in unethical activities for financial gain.<sup>66</sup> In addition, intermediate sanctions provide the IRS with the broad authority to punish the bad actor, where previously the IRS was limited only to denying tax-exempt status, which hurt the entire organization and beneficiaries.<sup>67</sup>

62. "The Internal Revenue Service (IRS) is responsible for determining, assessing, and collecting internal revenue in the United States." *U.S. Department of Treasury, Duties & Functions: Internal Revenue Service*, at <http://www.treas.gov/education/duties/bureaus/irs.html> (last visited April 30, 2002).

63. See IRS DATA BOOK, *supra* note 54, at tbl. 21.

64. Intermediate sanctions are an alternative to the severe sanction of revoking an organization's tax-exempt status. The Taxpayer Bill of Rights 2 authorizes the IRS to impose monetary penalties on directors and officers who receive an economic benefit that is higher than the actual value received by the organization. See I.R.C. § 4958 (2000).

65. See *id.*

66. See generally Douglas M. Mancino, *New 'Intermediate Sanctions' May Cause Public Charities to Change the Way They Do Business*, 85 J. TAX'N 368 (1996).

67. See Alice A. Noble et al., *Charitable Hospital Accountability: A Review and Analysis of Legal and Policy Initiatives*, 26 J.L. MED. & ETHICS 116, 119 (1998).

### C. Standing

#### 1. Public Disclosure Requirements Have Limited Use

Even if the public, in reviewing Form 990, were able to catch more instances of executive or employee fraud, the issue of who has standing to sue a nonprofit organization still impedes enforcement. Currently, in most states, the only parties who have standing to sue for breaches of fiduciary duty by a nonprofit director are the attorney general or a director.<sup>68</sup> Generally, directors do not sue public charities,<sup>69</sup> in practice, if any suit is brought against a charity fiduciary, it is the state's attorney general who brings it.<sup>70</sup> Any monetary settlement or award is generally payable to the charity.

Current standing doctrine frustrates the purpose of making Form 990 available to public inspection. Congress intended public disclosure of Form 990 as a means of holding charities accountable to the public.<sup>71</sup> Although the public has access to information, without the ability to bring a case in court, they cannot, in the legal sense, truly hold charities accountable for their actions.

Expanding the current standing doctrine<sup>72</sup> to allow the public to bring actions against nonprofit fiduciaries would come at great cost to charitable organizations and their beneficiaries. Fiduciaries are often entitled to indemnification from the charity for their legal expenses, and charitable dollars spent on unnecessary litigation would reduce the amount available to further the charitable mission of the organization.<sup>73</sup> Although granting standing to the public might result in exposing a larger number of dishonest charity executives, the burden of litigation would be unfair to the many well-managed organizations.

68. See Fishman, *supra* note 10, at 669–70.

69. See *id.* at 669; see also Manne, *supra* note 12, at 249–50.

70. “Standing limitations for nonprofit entities are grounded largely in the outdated notion of the state as *parens patriae*, and thus, for much of the nation's history, have relegated enforcement to the exclusive province of the state.” Manne, *supra* note 12, at 241.

71. See STAFF OF THE JOINT COMMITTEE ON TAXATION, *supra* note 45, at 128.

72. For an excellent discussion of possible candidates for expanded standing see Atkinson, *supra* note 51.

73. See Fishman, *supra* note 10, at 670.

## 2. *Are the Attorneys General Effectively Policing Nonprofit Organizations?*

The state attorney general is the chief guardian of the public's interest in charitable organizations.<sup>74</sup> Although one might expect that the attorney general would closely regulate charities, especially because they lack shareholders to provide oversight, this is not the case.<sup>75</sup> The only obligation most states impose on charities is filing an annual report attesting to the charity's continuing existence and providing names and addresses of directors.<sup>76</sup> Often, state actions against charities result from media attention<sup>77</sup> or from complaints by board members or employees.<sup>78</sup> The attorney general can filter out frivolous or nuisance suits, thereby avoiding unnecessary costs to charitable organizations.<sup>79</sup>

Political and social reasons explain the limited role that attorneys general play in regulating charities. For the most part, attorneys general become involved only when self-dealing conduct is alleged.<sup>80</sup> They understandably do not want to take on the role of managing "at-risk" charities.<sup>81</sup> In addition, attorneys general have limited resources, and regulation of charities necessarily takes a back seat to maintaining public security and punishing violent crime.<sup>82</sup>

The lack of policing by state attorneys general has led some to suggest that the federal government should step in and subject charities to closer scrutiny.<sup>83</sup> The federal government's role in policing charities should be limited, however; a limited role, such as imposing intermediate sanctions, is appropriate. These sanctions impose stiff monetary penalties on directors and employees who engage in self-dealing transactions or receive excess compensation for

74. Nina J. Crimm, *Why All Is Not Quiet on the "Home Front" for Charitable Organizations*, 29 N.M. L. REV. 1, 24 (1999).

75. See Brody, *supra* note 5, at 12.

76. See Brody, *supra* note 59, at 481.

77. The activities of William Aramony, former president of United Way of America, and others involved in the scandal were brought to the attorney general's attention as a result of media investigations.

78. See Brody, *supra* note 59, at 481.

79. See Atkinson, *supra* note 51, at 684-85.

80. See Brody, *supra* note 59, at 499.

81. See *id.*

82. See Atkinson, *supra* note 51, at 683.

83. Regina L. Herzlinger, *Can Trust in Government and Nonprofits Be Restored?*, HARV. BUS. REV., Mar.-Apr. 1996, at 103.

their services without interfering with the overall management of charitable organizations.<sup>84</sup>

### III. AUDIT COMMITTEES: A LOW-COST (AND OFTEN NO-COST) SOLUTION TO GOVERNING NONPROFIT ORGANIZATIONS

Requiring all charities to have an audit committee function is the best way to prevent executive misconduct and hold charity boards accountable for overseeing the organization. The board has the authority and obligation to oversee and regulate the activities of the charitable organization and is in a better position than the federal or state governments to know the intimate details of the particular organization. Indeed, the board may appoint appropriate committees to ensure that the fiscal policies of the charity are sound, and that fraud and embezzlement are prevented, or, at least, detected.<sup>85</sup> The need for boards to be accountable and held responsible for upholding their duties is vital to improving the public's perception of charities. Implementing audit committees would represent a large step towards regaining and maintaining the public's trust in charitable organizations.<sup>86</sup>

Because nonprofit board members have various reasons for serving on the board,<sup>87</sup> one way to ensure that the board provides financial oversight is to identify specific board members who are willing to accept the responsibility associated with serving on an audit committee. Boards are composed of volunteers, and the structure of the charitable board has come about through tradition.<sup>88</sup> Rather than bifurcating the board, as some have suggested, into a board of advisors and a board of managers,<sup>89</sup> appointment of an audit committee<sup>90</sup> would ensure that the board is overseeing the financial man-

84. See generally Swords, *supra* note 43.

85. See Brody, *supra* note 4, at 1415–17 (discussing the different organizational forms of charities).

86. *Id.* at 1414.

87. Board members are often unclear about their role in the organization. Some board members may try to micromanage the organization where such management is not needed or wanted. Others perceive their mission in terms of fundraising, while still others “use their appointment to add a notch on their social-climbing belt.” Regina L. Herzlinger, *Effective Oversight: A Guide for Nonprofit Directors*, HARV. BUS. REV., July–Aug. 1994, at 52.

88. See generally Fishman, *supra* note 10.

89. *Id.* at 679–83.

90. The “audit committee” could be the finance committee or an independent committee that reports to the board and performs the functions of a traditional audit committee. I am advocating that all boards have an “audit committee function”; whether a traditional audit

agement of the organization without disrupting the board's traditional structure and effectiveness.

Bifurcating the board could remove some of the appeal of board membership and make it more difficult for charities to recruit board members.<sup>91</sup> In larger organizations, board members often join in order to network and mingle with leaders in the community. Some of those leaders may add prestige to the organization, though they may not actively participate in managing the organization. Other members may lend assistance to the organization by giving or obtaining large contributions, and may not be highly involved in governing. Conversely, other members may be solely interested in fulfilling the role of managing the organization.

Maintaining current board structures, but providing for an audit committee function, could both encourage voluntarism and facilitate board recruitment, while providing the needed oversight. Adopting this structure also acknowledges that volunteers have different reasons for becoming involved with charities and will allow board members to continue to network with each other. Finally, if boards take the self-help step of requiring competent and accountable audit committees, the need for government regulation of charitable organizations will diminish.

Some organizations do not appoint a separate audit committee; rather, the finance committee assumes the role of the audit committee. The important factor is that the organization has identified individual board members who have accepted primary responsibility for financial oversight of the organization;<sup>92</sup> a finance committee can easily fulfill this role. Financial oversight includes hiring independent auditors and recommending financial policies to the board, particularly those policies related to risk management of employees and board members.<sup>93</sup>

Not only is establishing an audit committee perhaps the best way for a board to control the financial operations of an organization, it is also the least expensive. Organizations could hire consultants or

committee is appointed or the board uses some other means to accomplish this oversight is a formality.

91. See Herzlinger, *supra* note 83.

92. See ERNST & YOUNG LLP, AUDIT COMMITTEES: IMPLEMENTING THE NEW RULES, at app. B (2000) (highlighting some of the basic responsibilities of for-profit corporation audit committees).

93. See *id.* at 9–11.

audit firms to perform operational audits; however, this cost may be prohibitive for many organizations. In addition, audit committees can more easily adjust the scope or frequency of their review based on the needs of the organization. The prevention or early detection of employee theft, both in fiscal terms and in terms of a damaged public image, can also be avoided.

A. *Who Should Guard the Guardians?*

At this point, we are brought full circle to the issue of who should police charities. This Note has advocated that boards should be the main source of oversight; however, some group must oversee the boards to assure donors and the public that their charitable dollars are being properly managed. Many options to improve charity governance exist, including increased oversight of charitable boards by the federal government, state governments, donors, accrediting bodies, and insurance companies.

The federal government could require that certain standards for financial accountability be met, including that the organization maintains an audit committee function as part of its regular board activities. Provisions for failure to comply could range from monetary penalties to revocation of tax-exempt status. Several problems would arise, however, if the federal government became overly involved in policing charity boards. First, charities are closely tied to the right of freedom of association,<sup>94</sup> and federal involvement in this area could negatively impact this right.<sup>95</sup> Furthermore, the federal government is not currently in the position to assess the quality of the individual audit committee functions of charities. To do so would require significant resources and increased budget dollars devoted to this area. For these reasons, the federal government should continue in its current limited role of granting tax-exempt status to new

94. See *Boys Scouts of Am. v. Dale*, 530 U.S. 640, 648 (2000) (discussing that the right to freely associate is crucial in preventing others from imposing their views on groups who hold different points of view).

95. The Joint Committee on Taxation was called upon to investigate allegations, which the Committee determined were unfounded, of IRS bias in handling determination letter requests where the organizations represented views opposed to those of the Clinton administration. STAFF OF THE JOINT COMMITTEE ON TAXATION, U.S. Cong., Doc. No. JCS-3-00, REPORT OF INVESTIGATION OF ALLEGATIONS RELATING TO INTERNAL REVENUE SERVICE HANDLING OF TAX-EXEMPT ORGANIZATION MATTERS 4-11 (2000), available at <http://www.house.gov/jct/pubs00.html> (web page provides link to PDF document).

charities, investigating areas where tax-exempt status should be questioned, and managing other federal tax issues.

The states could also enact legislation requiring that charities establish audit committees. Laws are powerful; however, the means required to enforce them are costly to taxpayers. In order to properly assess whether charities have competent audit committees, states would have to expend funds to hire additional staff. Generally, the states prefer to stay out of the business of charities unless problems arise and it is appropriate for the state attorney general to intervene.<sup>96</sup>

Perhaps donors are the best choice for encouraging, or even insisting, that charitable boards take ownership of their board responsibilities. Donors have the power to withhold their contributions if they believe an organization is not being managed properly. Such donors include rank-and-file public donors, foundations, and even the federal, state, and local governments in their capacity as “donors.”

Foundations and the government generally are sources of the larger donations on which charities are highly dependent. Government funding often takes the form of contracts rather than donations.<sup>97</sup> Program funding already depends on factors including the financial health of the organization.<sup>98</sup> These funding sources hold a position of power over charities, and could require proof of a well-functioning audit committee as a prerequisite for monetary awards. While this would place a larger burden on foundation and government resources during the grant application phase, it would benefit them in the long run because these groups would have reassurance that monies given to charities will be used for their designated purpose.

Members of the public generally are not large donors, and cannot individually insist that board duties are fulfilled. However, accrediting bodies such as the National Charities Information Bureau (NCIB) can provide the public with information about the soundness and structure of charitable boards.<sup>99</sup> This would give the public the

96. See Brody, *supra* note 5, at 12.

97. See Brody, *supra* note 59, at 445 (noting that government contracts have become the largest funding source for charities).

98. Applications to foundations typically require financial data, explanations for deficits, and so on. Governmental agencies at the federal, state, and local level often require very strict financial accountability because these entities are accountable to their taxpayers.

99. The NCIB evaluates charities based on certain standards and provides information to the public as to whether a charity has met those standards. The NCIB's number one standard is board governance; all other standards, it states, relate back to this most important standard.

ability to assess where its contributions are most likely to be used to further the mission of their chosen organization.<sup>100</sup>

Organizations such as the National Charities Information Bureau evaluate and provide valuable information to the public as to whether individual charities have met certain minimum standards established by the organization.<sup>101</sup> The NCIB's primary emphasis is on board governance, and the NCIB recognizes fiscal guidance that includes responsibility for investment management decisions, internal accounting controls, and budget decisions as an indication of sound board governance.

Organizations that evaluate charities, as well as accrediting bodies, already lead the way in providing nonprofits with incentives to conform to at least minimum standards. Most charities do not want to be listed as not meeting the minimum standards. Accrediting bodies have a special power in that charities wishing to attain the benefits of accreditation will have the incentive to institute an audit committee function.

Insurance companies, which provide directors & officers liability insurance, are another possible group that could push boards to adopt an audit committee function. Monetary incentives, in the form of discounted premiums, could be offered for charities whose boards exhibit sound financial management practices. The higher premiums would then be paid by those charities that are truly creating the risk of misuse or theft of organization funds.

### *B. The Audit Committee Function*

The primary purpose of the audit committee is to provide financial oversight for the organization.<sup>102</sup> The SEC has recently adopted regulations requiring for-profit corporations to establish audit committees that adhere to defined standards.<sup>103</sup> Though an exact replication of the SEC regulations might be too restrictive, the

The NCIB has merged with the Better Business Bureau's Philanthropic Advisory Service. *See generally* <http://www.give.org>, last visited (April 28, 2002).

100. *See generally id.*

101. *See generally id.*

102. *See generally* H. Felix Kloman, *The Audit Committee and Its Expanding Role in Risk Management*, COMMUNITY RISK MGMT. & INS., (Nonprofit Risk Mgmt. Ctr., Wash. D.C.), at [http://www.nonprofitrisk.org/nwsltr/archive/nl200\\_5.htm](http://www.nonprofitrisk.org/nwsltr/archive/nl200_5.htm) (Summer 2000).

103. *See generally* NAT'L ASS'N OF CORPORATE DIRS., REPORT OF THE NACD BLUE RIBBON COMMISSION ON AUDIT COMMITTEES (2000).

existence of a model operating in the for-profit community means that a requirement pressuring charities to adopt an audit committee function would not cause charities to navigate an uncharted course.

Charities and others might argue that recruiting board members is already difficult, and that requiring an audit committee function could create additional difficulties in board recruitment efforts. Rather than requiring immediate change, bodies such as accrediting boards and insurance companies could provide time for nonprofits to phase in an audit committee function.<sup>104</sup> This would give charities time to recruit and train audit committee members, and to define exactly what the purpose of the audit committee function should be for their particular organization.

Larger charities may encounter less difficulty. They can adopt policies that facilitate recruiting board members for the audit committee function. Larger, prestigious charities often base board membership on the board member's ability to meet established fundraising goals. Where such charities have difficulty engaging current board members to serve on audit committees, fundraising standards could be relaxed in order to attract financially literate (but politically unconnected) audit committee members.

Smaller charities may also be able to recruit financially literate members to fulfill this function through local CPA societies, public accounting firms, banks, and other financial institutions.<sup>105</sup> Many CPA societies have a public interest section geared at helping small nonprofit organizations recruit board members.<sup>106</sup> Public accounting firms and banks also encourage their employees to serve on charitable boards to increase their visibility within the community.

### *C. Expertise and Characteristics of Audit Committee Members*

Several characteristics of its members could improve the effectiveness of an audit committee. First, audit committee members

104. Nonprofits will certainly need time to adjust to these new requirements and it may take time, through trial and error, to determine what works best for the organization. In addition, those performing the audit committee function will need time to establish their own guidelines and modes of operation.

105. Organizations such as the state CPA societies encourage their membership to become involved with charities through programs such as CPA's for the Public Interest.

106. For example, the Illinois CPA Society has a "CPAs for the Public Interest" program aimed at helping charities improve the management of their organizations. See <http://www.cpaspi.org> (last visited April 28, 2002).

should exhibit independence in performing their duties to enhance the credibility of the committee.<sup>107</sup> Boards can establish policies that promote the independence of audit committee members. Forbidding employees from serving on the committee,<sup>108</sup> prohibiting members from having business dealings with the organization in their capacity as a board member, and nepotism policies are examples of ways that the board can provide for independence for audit committee members.

Additionally, an audit committee composed of some financially literate members is important because they already understand the importance of sound financial practices.<sup>109</sup> Those bodies establishing minimum standards for charities should encourage nonprofits to recruit at least one member who has an accounting or financial background.<sup>110</sup> Members who are not financially literate should be provided with the opportunity to become financially literate within a reasonable amount of time. The board can determine the required degree of financial literacy.

#### *D. Functions of the Audit Committee*

Audit committees hire the independent auditors (where an independent audit is required), which establishes a reporting relationship between the committee and independent auditors.<sup>111</sup> Doing so helps ensure that outside auditors are loyal to the audit committee and not to management. In working with the audit team, the audit committee takes part in assessing the quality, not just the acceptability, of current financial reporting practices.<sup>112</sup> This ensures committee involvement in establishing accounting policies concerning estimates, judgments, uncertainties, and unusual transactions.<sup>113</sup>

The audit committee's most vital function in preventing employee misuse of funds is review of the internal accounting system.

107. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, SAS NO. 90, AUDIT COMMITTEE COMMUNICATIONS (1999) (amending SAS NO. 61, COMMUNICATION WITH AUDIT COMMITTEES, and SAS NO. 71, INTERIM FINANCIAL INFORMATION).

108. See NYSE Rule 303.01 (1999).

109. See ERNST & YOUNG LLP, *supra* note 92, at 6.

110. The NYSE model requires that at least one member of the audit committee have an accounting or financial management background, and that each member be financially literate. NYSE Rule 303.01 (1999).

111. ERNST & YOUNG LLP, AUDIT COMMITTEES 25 (1992).

112. See ERNST & YOUNG LLP, *supra* note 92, at 9–10.

113. *Id.* at 10.

The method in which this review is accomplished will vary with the organization; however, all charities, large and small, can help prevent negative publicity and organizational upset by establishing basic policies designed to detect and prevent employee fraud.

Among the controls that the audit committee should put in place are that duties of financial staff are properly segregated, and that executive expenses are reviewed for appropriateness on a regular basis.<sup>114</sup> In addition, the audit committee should review and ensure that financial staff and executives do not have complete and unchecked access to organization bank accounts and other assets.<sup>115</sup> While there is not a one-size-fits-all checklist, audit committees should ensure that they are operating within these standard guidelines, and add additional guidelines as necessary.<sup>116</sup>

The functions described are generally accepted as good business practice and do not introduce any new or controversial procedures. Many well-run organizations, nonprofit and for-profit, already have procedures such as these in place. As the case studies will show, misuse of funds can be prevented if someone in the organization ensures that, at a minimum, simple and routine internal control procedures are in place. When employee fraud does occur, it can be detected earlier and dealt with internally, which certainly is preferable to learning about misfeasance or fraud from external sources.

#### IV. WHO IS MINDING THE TILL? HOW AUDIT COMMITTEES COULD HAVE HELPED

##### A. *Case Studies of Large and Small Charity Financial Scandals*

###### 1. The United Way Scandal

Perhaps the most infamous case of executive theft in recent history is that of former United Way of America president, William Aramony. Aramony was convicted and sentenced to a seven-year prison term for numerous violations of federal laws for defrauding the

114. HARRY R. REIDER, *THE COMPLETE GUIDE TO OPERATIONAL AUDITING* 54–56 (1994).

115. *Id.*

116. Randy Dillon, *Lessons from the United Way*, *MGMT. ISSUES*, Oct. 1992, at 1, 3–4.

United Way of America of over six hundred thousand dollars.<sup>117</sup> Aramony used the money to pay for “vacations, luxury apartments and other benefits for himself and his teen-age girlfriend.”<sup>118</sup> Two former financial executives of the charity were also found guilty of diverting charitable funds.<sup>119</sup> The thefts occurred from the mid-1980s to the early 1990s<sup>120</sup> and went undetected by the board of United Way of America until the media started making inquiries.<sup>121</sup>

In addition to hiding the thefts, Aramony also convinced the United Way board or executive committee to approve the creation of several spin-off corporations, even though the information he gave was insufficient and the rationale he gave for creating the spin-offs unsound.<sup>122</sup> Once the spin-off activities were incorporated, the board essentially lost control.<sup>123</sup> The spin-off boards, recruited by Aramony, were composed of a group of Aramony’s friends, which hired the children of United Way officers at substantial salaries, including Aramony’s son, who was hired as the first president of one of the spin-offs.<sup>124</sup>

The United Way board, which included leading figures from the corporate world,<sup>125</sup> could have easily detected (and possibly prevented) Aramony’s activities if they had ensured that an audit committee function, operating under standard guidelines, was in place. A report prepared by an investigative firm and a law firm to examine the allegations against Aramony concluded that internal control procedures present in most organizations were not in place at United Way, and that decisions made by management were not brought before the proper board committees.<sup>126</sup> The report noted that there was no travel and expense policy, that officers made unsubstantiated payments to individuals, and that the chief financial officer filed no expense reports supporting reimbursed expenses for

117. *United States v. Aramony*, 88 F.3d 1369, 1372–73 (4th Cir. 1996).

118. *See* Arenson, *supra* note 2.

119. *Aramony*, 88 F.3d at 1372–73.

120. *Id.* at 1373.

121. Charles E. Shepard, *Perks, Privileges and Power in a Nonprofit World*, WASH. POST, Feb. 16, 1992, § 1, at A1.

122. Goldschmid, *supra* note 6, at 634.

123. *Id.*

124. *See* DeMott, *supra* note 48, at 133.

125. *See* Brody, *supra* note 59, at 455.

126. *See* Dillon, *supra* note 116, at 1, 3.

an entire year.<sup>127</sup> The cost of the board's failure to provide oversight was significant in terms of lost donations and damage to United Way's public image.<sup>128</sup>

## 2. \$7.9 Million Embezzled by American Cancer Society Executive

Daniel Wiant, chief administrative officer of the Ohio division of the American Cancer Society, recently pled guilty to embezzling \$7.9 million from the charity.<sup>129</sup> Wiant, who had been imprisoned in Hawaii in the 1980s for fraud,<sup>130</sup> began stealing from Cancer Society bank accounts in April 1997.<sup>131</sup> The organization did not discover that any money was missing until May 2000, after the FBI alerted the organization that Wiant had transferred \$6.9 million to an Austrian bank account.<sup>132</sup> Prior to the large transfer, Wiant wrote checks totaling \$650,000 to personal bank accounts he had set up. The amounts were expensed as consulting fees.<sup>133</sup>

The response from one organization executive was, "We would have found out, but having the FBI find out this way made it easier, in that the funds were frozen."<sup>134</sup> Another spokesperson for the American Cancer Society stated that the organization was "astounded" by the embezzlement, and that financial procedures were already in place to prevent embezzlement of funds.<sup>135</sup> In response to the embezzlement, the organization expanded its procedure for background checks on employees<sup>136</sup> and also engaged PricewaterhouseCoopers, a "Big Five" accounting and audit firm, to conduct a fraud audit and review the organization's internal controls.<sup>137</sup>

One can only question the adequacy of the financial procedures and policies that would permit a single person within an organization

127. *Id.* at 3.

128. *See* Arenson, *supra* note 2.

129. *Ex-Charity Exec Admits Embezzling \$7.9 Million*, CHI. TRIB., Aug. 26, 2000, News, at 4 [hereinafter *Ex-Charity Exec*].

130. Matthew Sinclair, *Cancer Society Executive Accused of Stealing \$7M*, NONPROFIT TIMES, July 2000, at 4.

131. *Ex-Charity Exec*, *supra* note 129.

132. *Id.*

133. *Id.*

134. Sinclair, *supra* note 130.

135. *Cancer Society Officer Accused of Stealing*, CHRON. PHILANTHROPY, June 15, 2000, at 50.

136. Sinclair, *supra* note 130.

137. *Id.*

to transfer nearly \$7 million without someone else in the organization reviewing the transaction or being aware that such a large transaction had been made. Again, had an audit committee function been in place, basic internal accounting controls requiring additional approval for large transactions would have been functioning, and the bank would not have made the transfer. Although public outrage may not have reached the same levels as in the United Way case, the public embarrassment and the costs of a fraud audit and internal control review by a "Big Five" accounting firm could have been avoided had the board taken the simple step of ensuring that the organization had sufficient internal control policies in place.

### 3. Small-Time Scandal: Illinois Federation of Families

Much less impressive in scale than the United Way or American Cancer Society scandals, but comparatively far more devastating is the pending case of theft that occurred at the Illinois Federation of Families. In this case, an employee embezzled about forty-nine thousand dollars, or one-sixth of the organization's annual budget.<sup>138</sup> The employee, a part-time bookkeeper for the charity, allegedly wrote checks to himself from the organization's account using rubber stamps to forge the signature of authorized signers.<sup>139</sup> As a result of the alleged embezzlement, the charity was forced to cut three of its six staff members.<sup>140</sup>

The embezzlement occurred between January 1999 and April 2000, when the activity was detected.<sup>141</sup> Court documents show that during this time there were sixty-nine questionable transactions, most of which were checks made out to the employee.<sup>142</sup> The assistant attorney general stated, "One of the problems with a bookkeeper is they get all the bills and they get all the past due notices.<sup>143</sup> He just threw them away."<sup>144</sup>

This situation shows that even boards of small organizations need an audit committee function in order to prevent and detect

138. Jon Yates, *State Says Man Bilked Local Charity*, CHI. TRIB., September 15, 2000, § Trib West, at 1.

139. *Id.*

140. *Id.*

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.*

employee theft. In the Illinois Federation case, one of the most fundamental internal control procedures, segregation of duties, was not in place.<sup>145</sup> An audit committee operating under basic guidelines would have reviewed internal control policies and found that duties relating to cash were not adequately separated. While smaller organizations often have difficulty in segregating duties due to limited resources, a simple control requiring that someone other than the bookkeeper open mail, and reviews of monthly bank statements and checks accompanying the bank statements could have caught the bookkeeper's theft before having to cut half of the organization's staff. The restriction of the bookkeeper's access to the check-signing stamp, and the requirement that someone else in the organization sign checks is another common method of segregating duties that could have prevented the thefts.

*B. Appropriate Board Oversight Could Have Prevented These Scandals*

These real-life examples of theft and scandal that occurred in the charitable sector provide an opportunity to again bolster the claim that the board is best positioned to provide oversight and prevent such scandals from occurring. In each case, the board failed to ensure that its organization had adopted sufficient internal control policies. While management should take part of the blame, it is the board, and not management, that has a fiduciary duty and duty of due care to ensure that appropriate risk management and fiscal policies are in place.<sup>146</sup> Many cases of embezzlement and fraud are not so easily detected, but when boards do not ensure that public donations and charitable assets are protected by even the most fundamental and standard financial controls,<sup>147</sup> there can be no question that these boards have failed to provide sufficient oversight of the executive and the organization.<sup>148</sup>

145. See JO ANN HANKIN ET AL., FINANCIAL MANAGEMENT FOR NONPROFIT ORGANIZATIONS 551 (1998); see also Reider, *supra* note 114, at 56.

146. See generally Kloman, *supra* note 102.

147. See REIDER, *supra* note 114, at 55–56. Factors affecting the reliability of financial data include the functioning of the board of directors, particularly the audit committee. Internal controls can be categorized as procedures that address segregation of duties, proper authorization of transactions, and independent checks on performance and accountability.

148. Goldschmid notes that the quality of nonprofit corporate governance could be improved by developing guidelines for internal audit procedures. See Goldschmid, *supra* note 6, at 650.

## CONCLUSION

The charitable sector must recognize and address the need to hold boards accountable. Public policy and trust has allowed charities to largely regulate themselves, and enables charities to pursue a variety of missions at the lowest possible cost. If the charitable community is to maintain the public's trust, then change is necessary to demonstrate that charitable organizations are worthy of this trust without the need for increased government regulation.

Oversight by an audit committee should be standard practice in any nonprofit organization. Audit committees have been an institution in the corporate world for some time, and well-run charitable organizations already use audit or financial oversight committees. Industry-wide adoption of audit committees is the lowest-cost, most effective way to prevent, or at least detect, executive and employee theft or misuse of funds, and, in the long run, maintain and improve the public trust in charitable organizations.