Ethical Dilemma of Nonprofits in the Agency Theory Framework

Shyam B. Bhandari
Bradley University

The so-called nonprofit organizations include governments and Internal Revenue Services' Code 501 (c) organizations. Nonprofits play a very significant role in our society. They provide very essential public goods and humanistic services and employ millions of our nation's workforce. Nonprofits pursue profit no less than for-profits; they just refer to it as "increase in fund balances." Nonprofits differ from for-profit organizations in at least two significant dimensions: They do not pay tax and they do not have principal (i.e. owner-stockholders) in the agency theory framework, typical of a for-profit business. Because of these differences, nonprofits are relatively less effective, less efficient and less ethical in fulfilling their goals and mission. This higher propensity of unethical behavior by nonprofits can be attributed to the "agent without principal" paradigm. Other factors are typically passive board of trustees, indifferent benefactors and reluctant beneficiaries. Furthermore, humanistic image and a weak regulatory environment spare them from thorough scrutiny. This paper cites examples of questionable, illegal and unethical practices by nonprofits. Remedial measures have been suggested to monitor and to mitigate such practices.

INTRODUCTION

Ethical conduct is expected of all organizations whether they are for-profit or not-for-profit (hereafter nonprofits). Nonprofits which include governments, government agencies and Internal Revenue Services' (IRS) Code 501 (c) organizations provide very essential public goods, humanistic services, generate a significant part of our gross domestic product (GDP), and employ millions of our nation's workforce. Regulatory agencies, media, public interest groups and whistle blowers actively hound for-profit businesses for their unethical, illegal and criminal acts. Names like AIG, Baring Bank, Bernie Madoff, E.F.Hutton, ENRON, Ivan Boesky, Pfizer, Martha Stewart, Mike Milken etc. are well known in this context. United Way, Orange County are a few examples of nonprofits cited for their unethical acts.

The purpose of this paper is to recognize the yeoman service nonprofits perform in our society. At the same time we discuss the reasons for their higher propensity to indulge in unethical acts. The primary reason is the absence of owners (stockholders) as principals in the agency theory framework and passive board of directors/ trustee.

The paper is organized as follows: After critically examining terms: profit, "increase in the fund balances," nonprofits, tax-exempt status and ethics we introduced the basics of agency theory. Next, we discuss various reasons behind inefficiency, ineffective and unethical conduct by the nonprofits namely, agent without principal paradigm, passive board of director, indifferent benefactors, reluctant beneficiaries, humanistic image as shield and weak regulatory environment. This is followed by various remedial measures to ensure ethical behavior by nonprofits. The paper ends with summary and conclusions.

PROFIT VERSUS "INCREASE IN THE FUND BALANCE"

Profit, however defined is the goal of all economic entities – individuals as well as organizations. The phrase "profit is a dirty word" might be the reason for naming governmental and charitable organizations as nonprofits. Thus, the term profit is always associated with business organizations and not with government, charitable and educational organizations. Profit is simply revenue (or sales) minus a variety of expenses, namely production costs, management costs, marketing costs and financing costs. For-profit businesses pay tax on this difference but nonprofits do not. In other words, the so-called nonprofit organizations measure their 'profit' no differently, but refer to it as "increase in the fund balance". This difference in nomenclature is cosmetic not real. All organizations, for-profit or nonprofit are in pursuit of profit. According to Gardner Jr. (1987 p.6),

> "The United States seems suddenly to be burgeoning with efforts to develop business-oriented managers for the not-for-profit human service sector. Social workers and psychologists hurry back to school to get M.B.A. …As this happens; the lines between profit and not-for-profit get more and more blurred. Not-for-profits are developing profit making subsidiaries and multicorporate structure to play the competition game…"

Gardner Jr. (1987, p7) then quotes Wyndhan Blanton as follows:

> "…there is no such thing as a non-profit…(agency)….All…(agencies)…must turn a profit, in the sense that each must complete the financial reporting period with an excess of revenue over expenditures…No organization can endure with deficit. All…(agencies)…without exception, must complete their financial performance over time with a surplus – or go down the drain."

This surplus or increase in fund balance is no guarantee that the nonprofit is operating effectively, efficiently or ethically. As will be discussed later, nonprofits are able to avoid scrutiny of their operations due to the, absence of the manager-stockholder or agent-principal paradigm, typical of for-profit businesses and due to their humanistic image. Incidentally, most nonprofits therefore under perform on all three accounts.

NONPROFITS BETTER BE CALLED TAX-EXEMPT BUSINESSES

The real difference between "profit" and "increase in fund balances" lies in the fact that business profit is taxed whereas nonprofit's "increase in fund balance" is not taxed by federal and almost all state and local governments. The term nonprofit is therefore a misnomer. A more appropriate term is tax-exempt organizations or better tax-exempt businesses. Organizations should be called nonprofits only if tax-exempt status is clearly defined and strictly enforced.

Section 501(c) of publication 557 of IRS lists various types of nonprofit organizations. Most of these and government organizations receive their revenue from taxes, donations, grants and fees whereas a business receives their revenue from sale of merchandise or a service. In recent years, nonprofit have become very creative in their fund raising activities. Many of these use the sale of merchandise and services to generate revenue, which often is in violation of their tax-exempt status. This is not only illegal but also unethical. The IRS has been quite aware of this abuse and has been aggressively pursuing such violators but with limited success.

ETHICS, ETHICAL BEHAVIOR AND NONPROFITS

The term ethics has many meanings. The Webster dictionary defines ethics as the "study of standards of conduct and moral judgment". According to Taylor (1975, p.1) ethics is "inquiry into the nature and grounds of morality where term morality is taken to mean moral judgment, standards and rule of conduct". According to the American Heritage Dictionary (1996) ethics is the "rules or standards governing the conduct of members of a profession". According to Ferrell et al (2002, p.7):

> Business ethics comprises principals and standards that guide behavior in the world of business. Whether a specific required behavior is right or wrong, ethical or unethical is often determined by the stakeholders such as investors, customers, interest groups, employees, legal system and the community…

Ferrell et al (2002, p.8) has described the evolution of development of business ethics in North America in five distinct stages - before 1960s, 1970's, 1980's, 1990's and post 1990s. Most of their examples of ethical and unethical conducts pertained to for-profit business. However, Farrell et al (2002, p.14) cited Ethics Resource Center's 2000 National Business Ethics Survey as follows: to the question "Have you observed misconduct in the workplace? " Thirty one percent, of the employees at for-profit answered yes where as twenty-nine employees at nonprofit answered yes and a whooping thirty-eight percent employees in the government sector answered yes. Thus, unethical behavior by nonprofit organizations including government organizations is lot more likely than that for-profit business.

The section 501 (c) of publication 557 of the IRS lists more than twenty categories of nonprofit organizations. The four largest number of nonprofits are in 501 (c) (3), 501 (c) (4), 501 (c) (8), and 501 (c) (19), categories which include religious, educational, charitable, scientific, literary, social welfare, labor, employees, war veterans etc. Examples of ethical and unethical conducts abound in all these nonprofits. As has already been stated, nonprofit organizations play a very significant role in our society. They not only provide essential goods and services but also according to *The Nonprofit Reporter, Inc*. generate a substantial part of our gross domestic product (GDP) - almost ten percent including earned income, investment income, contracts etc., and employ nine percent of our nation's workforce. Herlinger (1996, p.2) however makes very insightful observation as follows:

> "When governmental and nonprofit organizations are good, they are very good. And good they must be, because we entrust them with society's most important function - educating our minds, uplifting our souls and protecting our health and society. Our collective perception of their value is evident in the monumental resources we devote to these institutions: Revenue of nonprofits alone has grown from less than \$200 billion in 1978 to \$1.1 trillion in 1993. But when governmental and nonprofit organizations are bad they are horrid".

In 1991 Peter Drucker was cited in December 19, issue of the Wall Street Journal for his eloquent support of nonprofit organizations which is stated in Seitz and Ellison text (2005, p.762) as follows:

> "America needs a new social priority: To triple the product of nonprofits and double the share of gross national income – now just under 3 per cent – they collect as donation. Otherwise, the country could face social polarization in just a few years… Drucker cites the success that nonprofits have had as an efficient means of achieving social goals. In fact, he asserts, "virtually every success that the U.S. has achieved in solving social problems has been because of nonprofits."

In reviewing the underlying mission of nonprofits, the general intent is 'to serve a public purpose'. In this context, Professor Drucker's praise of nonprofits is on the mark. According to The 2009 Statistical Abstract, in 2006 charitable donations amounted to 295 billion of which 223 billion was from individuals. Out of this, allocation to religion, education, health and human services were 96.8, 41.0, 20.2 and 29.6 billion dollars respectively. This large influx of money allows nonprofits to play a very significant role in serving the public at large. For example, religious organizations satisfy spiritual, moral and cultural needs of members; hospitals serve the sick and educational institutions conduct basic and applied research and educate our masses. The list of goods and services provided by federal, state and local governments - from defending our country to waste management, is too long to enumerate.

Ethical behavior of for-profits are under constant scrutiny from all the stakeholders and regulatory agencies like Securities and Exchange Commission (SEC), Internal revenue Service (IRS), Federal deposit Insurance corporation (FDIC), Federal Drug Agencies (FDA) etc. For-profit businesses involved in unethical practices eventually get exposed, receives wide negative publicity in the media, ensue litigation and ends up with huge penalties. The unethical, illegal, or criminal acts associated with names like Arthur Anderson, AIG, Baring Bank, Bernie Madoff, E.F.Hutton, ENRON, Ivan Boesky, Pfizer, Martha Stewart, Mike Milken etc. are well known. This list of infamous executives and firms is linked to for-profit businesses. But what about nonprofits? The nonprofits are not immune from unethical conduct. In fact, nonprofits could be considered more susceptible to unethical behavior than for-profits. This is because of the absence of the agent-principal dichotomy of agency theory framework in nonprofit organizations.

AGENCY THEORY AND AGENCY PROBLEM

The classical model of a firm assumes a single owner-manager operates the firm to maximize profits. This model also assumes that firms are small and the owner-managers' self-interested behavior insures, through invisible hands informational, operational and allocational efficiencies in a market economy. In this model the owner (principal) is the manager (agent); therefore there is no agency relationships and no agency problems. However, this classical model precludes specialization of productive activities, division of labor and delegation of decision-making authority.

The evolution of large organizations (for-profit and nonprofit) as a consequence of industrial revolution necessitated the delegating of decision-making authority from one person to another person or group. The relationship between these two sets of individuals can be described in terms of principal-agent relationships. Agency theory addresses various aspects of this relationship and its consequences. Eisenhardt (1989) reviewed various aspects of agency theory. According to her, agency theory is a controversial theory. It is concerned with resolving problems that can occur in agency relationships. She cites three problems. 1) The conflict in the goals of principals and agents due to self-interested behavior. 2) The cost associated with principals to verify what the agents are doing due to informational asymmetry, and 3) risk sharing. The extent of these problems within nonprofits is not self-evident because principals are not clearly identifiable. Jensen and Meckling (1976), Fama and Jensen (1983) and Fama (1980) have done extensive work in this area. Agency theory further developed into a modern contractual view of firm. According to Jensen and Meckling (1976), organizations are defined as "legal fictions which serve as a nexus for set of contracting relationship among individuals" the stakeholders. Therefore, instead of a dichotomy of self-interested behavior of agent-principal, we have a nexus of self-interested behavior of stakeholders. The potentially conflicting goals of these stakeholders add more complexity to the agency problem and agency cost.

AGENTS WITHOUT PRINCIPALS

Although both for-profits and nonprofits have a multiplicity of stakeholders, the agent-principal dichotomy is well-defined for-profit organizations than in comparison to nonprofits. Since nonprofits have no owner (shareholders), principals do not even exist. The obvious implication is that self-interested behavior of the agent-manager is more pronounced. This means that nonprofits have a higher propensity for unethical behavior. In a corporate form of for-profit business, managers are the agents and stockholders are the principals. If managers behave unethically, the board of directors, as representatives of the stockholders and regulatory agencies will take action. In other words, there are check-and–balances in place. Nonprofits differ in that they have agents but no principal. An educational institution, for example, has the following stakeholders: students, faculty, administration, alumni, board of trustees, or donors. Identifying the principal is difficult. This dilemma exists for almost all nonprofits. Thus, in an organization with no owner cum principal, the agency problem is not only unique but complex.

The absence of a clearly defined principal-owner for nonprofits is the root cause of a number of problems. According to Herzlinger (1996), nonprofits and governmental organizations' problems fall in four categories: ineffectiveness, inefficiency, private inurement and excessive risk. Briefly, nonprofits are ineffective if they do not fulfill the mission and accomplish the goals of the organization fully. Inefficient nonprofits are those, which spend too much on fund raising and administration, and not enough income is dedicated to service their clients. Private inurement is when nonprofits spend too much on the managers' personal benefit instead of the organization's charitable purpose, i.e. President of the United Way in 1995. Absence of principal also makes it easier for managers to assume excessive risk, i.e. Orange County's treasurer in 1995. Most of the times, these problems are due to unethical conduct of agent (manager) and absence of owner (stockholders).

If a nonprofit departs significantly from its mission, it must be considered as an unethical act. Consider the case of hospitals in the USA. According to Martinez (2009, p.A4) "more than half of the 5482 hospitals in the US are nonprofits that do not pay federal, state and local taxes. Some provide less in charity than the value of their tax breaks. The tax benefits and charity care provided, according to study of 27 nonprofit hospital systems in Chicago area are $479 million and $176 million respectively. Similarly, a news item in Phoenix News Times' January 28, 1995 issue reported that Arizona Chapter of The American Cancer Society used 95% of the donation for paying salaries and other overhead costs. A number of religious charities in the US diverted donated money to terrorist organizations in the Middle East, Afghanistan and Pakistan. A survey in February 2008 of 1000 adults by Ellison Research and reported in American Institute of Philanthropy's *Charity Rating Guide and Watchdog Report*, Americans believe that a typical Charity spends 36.3% of donation on overhead when they thought that 22.4% is reasonable. If blatant wasteful expenditures are considered as unethical act most of the government earmarks will qualify. There is a long list of apparently unethical expenditures in the so-called "pork barrel spending" and the "golden fleece awards". Other reasons for a higher propensity of unethical conduct of managers of nonprofits include passive board of trustees, indifferent benefactors, reluctant beneficiaries, humanistic shield, and weak regulatory environment.

PASSIVE BOARD OF TRUSTEE

In a for-profit organization, the board of trustees (or directors) represents the owner-principals, known as shareholders. The board is elected by and acts to safeguard the interest of these shareholders. In the absence of shareholders as principals in nonprofits, the board consists of eminent citizens and successful public figures regardless of their skill, expertise and qualification. For example, a hospital has rarely doctors on their board. This type of board never goes beyond rubber-stamping the managements' proposal. The board members of nonprofits are often ignorant about their appropriate role and are intimidated by the talent and professional expertise of nonprofit employees (Herlinger, 1996). Additionally, the board of nonprofits meets rarely and that too for a very short time. Finally, all too often an executive committee and a few handpicked board members behave like a closed club and make all the decisions. Other members of the board are perceived to be either disinterested or a threat to inner group. The passive board and no principals make the nonprofit a unique organization from the agency theory perspective and highly vulnerable from an ethical point of view.

INDIFFERENT BENEFACTORS AND RELUCTANT BENEFICIARIES

Donors and beneficiaries are two other stakeholders whose inactive posture plays a very important role in creating an environment conducive to unethical behavior of nonprofits. Donor-benefactors account for the majority of the revenue of charitable nonprofits. A true measure of inefficiency of nonprofit's operation is administrative (overhead) costs to spending on charitable purpose rather than overhead to donated revenue. For example, if a charity raised $200 in revenue of which $100 was administrative (overhead) expense and $100 was spent on charitable purpose, then the first measure is 100% where as the second measure is only 50%. The second measure understates inefficiency of this nonprofit.

The donors rarely care to inquire about the above-mentioned measures before or after donating their money. The irony is that when a donor invests in a for-profit firm they are very curious about the rate of return on their investment. Those same individuals who then donate to a charity, however, are a rarely concerned with how their money is used. This indifference emboldens managers of nonprofits to indulge in indiscreet behavior. Beneficiaries of nonprofits, especially charities are at the receiving end of their monies. Since they are receiving free or subsidized service, they are reluctant to react and report unethical acts of nonprofits.

HUMANISTIC IMAGE SHIELDS NONPROFITS

While there are a few exceptions (United Way's President, Orange County Treasurer and government earmarks) unethical and illegal activities among nonprofits are virtually immune from publicity and disclosure by stakeholders, media and regulatory agencies. The humanistic or altruistic image shields them from criticism. This is partly because of the following reasons. 1) Most of nonprofits are small both in size and operation 2) their stakeholders are limited in number; 3) regulatory agencies are understaffed. 4) The humanistic image and community service mission of most of the nonprofits. Finally 5) neither the supplier of funds (donors and taxpayers) nor the customers (recipients of services) have power, authority and control on operations of the nonprofits.

WEAK AND INEFFECTIVE REGULATORY ENVIRONMENT

The Financial Accounting Standard Board (FASB) and the Government Accounting Standard Board (GASB) sets the accounting standards for nonprofits and state and local governments respectively. The Office of Management and Budget through its Circulars play a role in identifying possible mis-appropriation of funds allocated to nonprofits. Ultimately, however, the IRS determines which nonprofit can retain tax-exempt status.

According to 2002 U.S. Census, there are 87,848 local governments and over 1.3 million public charity nonprofits. Most of these nonprofits are small. According to Coe (2007, p.2), "only 4 percent of 1.3 million charities have budget of over $10 million… Most states require that local units, regardless of size, engage a CPA to conduct an independent financial audit …Not subject to such a mandate small nonprofits often avoid audit." It is hard to determine how aggressively the aforementioned regulatory agencies go after unethical and illegal financial activities of more than two million nonprofits. In general, it is assumed that they are rarely audited, unless there is blatant misappropriation.

REMEDIAL MEASURES

Ethical conduct is a universal virtue for individuals and organization alike. Nonprofit organization whether governments or charities have the utmost responsibility in this regard. Because governments provide public goods and services and because charities have a humanistic mission, they must set the example and be the role model for our communities. What can be done to ensure ethical conduct by the nonprofits? Before we propose remedial measures from agency theory perspective, the solution proposed by Herzlinger (1996, p.7) is worth mentioning:

> "The U.S. Congress, the SEC, and the Department of the Treasury have made recent, laudable efforts to shed more light on governmental and nonprofit organizations, but their attempts stop short of lifting the veil of secrecy. I would like to propose a potentially powerful remedy that I call DADS: Increase the *disclosure, analysis,* and *dissemination* of information on the performance of nonprofits and governmental organizations and apply *sanctions* against those that do not comply with these requirements…"

We, however, hypothesized that the root cause of higher propensity of unethical conduct by nonprofits is due to the lack of identifiable principals. The solution, in addition to Herzingler's 'DADS' quoted above lies in defining and empowering one or more stakeholders as principals. These surrogate principals would play the similar role as owner-stockholders do in case of for-profit organization.

Which of the many stakeholders can best play the role of the principals? The obvious choices are benefactors (donors, granters or fund providers), government revenue departments (tax collecting agencies) and a new regulatory agency similar to the SEC. This new agency can act as a watchdog to delineate taxable and tax-exempt activities of nonprofits.

Benefactors as Principals

The benefactors are the true suppliers of residual capital just like stockholders in the case of for-profit corporations. The mission and the goals of the nonprofits drive the amount and frequency of benefactor's donation, or their ad-hoc grants. No other stakeholder is as concerned with the success of the nonprofits mission as the benefactors. A proactive and dedicated group of benefactors is most suited to assume the role of principal.

There are several reasons that benefactors (donors) are less likely to play the role of principal. Most of the benefactors provide funds to the nonprofits out of emotional, sentimental, religious, moral, popularity, or self-esteem reasons and not out of self-interest or profit motives. Thus benefactors rarely request to study or analyze annual reports, monitor or evaluate administrators' benefits and salaries, or elect or appoint the board of directors with skills and expertise necessary for effective and efficient operation of nonprofits. The nonprofits fundraising staff persistently appeal to potential donor's emotions and puts them on a guilt trip to extricate funds. Thus, the charitable spirit of the benefactors of nonprofits is not compatible with the wealth maximization goals of corporate shareholders.

Other factors which may work against the benefactors, as playing the role of principal, are that the net assets (or fund balance) of nonprofits have no market which can measure the success and failure of the nonprofits in terms of price fluctuation. A market mechanism can bring about a reallocation of the benefactors' portfolio of charitable contributions to achieve pareto-optimality; otherwise, it is just a zero-sum game. Benefactors also have a minimal role to play in the election or appointment of the board of directors (or the trustees). Major donors are typically employed elsewhere and therefore spare little time overseeing the functioning of nonprofits.

Revenue Departments as Principals

The tax-exempt status of nonprofits deprives the governments Revenue Departments of a substantial amount of revenue. This foregone revenue otherwise can be used for providing goods and services to the clients of nonprofits. The tax collecting agencies are therefore equally suited to perform the role of principals. Federal, State and local Government's revenue departments are also in a better position to assess whether nonprofits are providing sufficient mission-driven services to justify exemption from taxes.

In view of the overburdened IRS, potential conflict of interest and complicated constitutional and political issues, neither the legislature nor the IRS might be acceptable to perform the role of principal. Both the First and the Tenth Amendment have and can be invoked to question the granting of authority to impose sanctions against noncompliant nonprofits.

A New Agency

A third alternative is for federal, state and local governments to explore the possibility of creating a new agency, which would perform multiple roles similar to the Securities and Exchange Commission (SEC), perform for the for-profit organizations. This agency can be empowered to act as both regulator and enforcer of tax-exempt status of nonprofits.

Summary and Conclusion

Profit is the goal of all economic entities – individuals as well as organizations. The so-called nonprofit organizations, which include governments and IRS's Code 501 (c) organizations, refer to it as "increase in the fund balance". Nonprofits play a very significant role in our society. They generate a substantial part of our gross domestic product (GDP), provide very essential public goods and humanistic services and employ millions of our nation's workforce. Nonprofits differ from for-profit in at least two significant dimensions: They do not pay tax and they do not have principal (i.e. owner-stockholders) in the agency theory framework, typical of a for-profit business. Because of these differences, nonprofits are relatively less effective, less efficient and less ethical in fulfilling their goals and mission. While business ethics must be a primary focus of every nonprofit business, nonprofits frequently violate tax-exempt status and indulge in other unethical practices in the light of "agent without principal" paradigm. This higher propensity of unethical and illegal behavior by nonprofits is attributed to the agent without principal paradigm, typically passive board of trustees, indifferent benefactors, reluctant beneficiaries, humanistic image and a weak regulatory environment. This paper cites examples of a variety of unethical if not illegal practices by nonprofits. Remedial measures suggested for monitoring and mitigating such practices by nonprofits are identifying and empowering surrogate principal and a new agency, which parallels the SEC.

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