

Public Scrutiny of Foundations and Charities: *The Robert Wood Johnson Foundation Response*



Robert Wood Johnson
Foundation

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Editors' Introduction

American foundations are a unique national resource, serving as stewards of private resources used in the public interest. Responsible primarily to their own boards of directors—as contrasted with, say, the electorate or shareholders—foundations are, in the words of Alan Pifer, former president of the Carnegie Corporation of New York, “the least constrained of all institutions in our society.”² Unlike most other institutions, foundations have a dual public and private nature. They are private corporations whose endowments come from wealthy individuals and corporations. Under the Internal Revenue Code, the income on foundations’ investments is largely tax-exempt.

Given foundations’ lack of public accountability and the importance of the tax exemption to their very existence—not to mention their reputation for being secretive—it is not surprising that the federal government scrutinizes foundations to make sure that they use their resources legally and, at least arguably, for purposes that benefit the public. Nor is it surprising—in light of the recent highly publicized corporate and nonprofit organization scandals—that Congress would single out foundations for special attention at this time.

In this chapter, Susan Krutt, a communications associate at the Robert Wood Johnson Foundation, and David Morse, the Foundation’s vice president for communications, provide an overview of congressional scrutiny of foundations and charitable organizations and the sector’s response. They place the recent Senate hearings in the context of past congressional examinations of foundations, analyze the underlying issues, and explain how philanthropy is trying to address concerns about its lack of accountability. The authors conclude by discussing the approaches adopted by the Robert Wood Johnson Foundation to make its own work more transparent, especially through its evaluation and communications strategies.

1. The authors express their appreciation to Katherine Hatton, Carol Kroch, and James Ingram for their insightful review of this chapter.

2. Pifer, A. *Speaking Out: Reflections on 30 Years of Foundation Work*. Washington, D.C.: Council on Foundations, 2001.

Ouch! For charities that see themselves as beneficent social problem solvers and integral to a national spirit of generosity, the spate of headlines in some of America's leading newspapers hurt, and hurt badly: "CEO's Rewards at Nonprofit," "Costly Furnishings Come at Charities' Expense," "Philanthropist's Millions Enrich Family Retainers," "Wealthiest Nonprofits Favored by Foundations," "Nonprofit on Trial for Its Excess," "IRS Chief Says Nonprofits Are Vulnerable to Abuses." Beginning with a series of stories in the *San Jose Mercury News* in the spring of 2003, America's philanthropies, unaccustomed to and uncomfortable being in the public spotlight except to be appreciated for their benevolence, have increasingly found their *bona fides* questioned, both individually and collectively as a sector, with an intensity not felt for more than thirty years. The stories were more reminiscent of investigations uncovering recent scandals and abuses in large for-profit corporations like Enron, Tyco, and WorldCom than of the typical reporting of "good works" performed by America's nonprofit sector.

The headlines captured the attention of policy-makers, most notably state attorneys general across the country as well as members of Congress with oversight of the federal tax laws that regulate charitable activities. Congress's focus was less on foundations *per se* than on apparent abuses and complex tax scams festering throughout the larger charitable sector, including gross overvaluations of gifts of property, such as conservation easements and cars, to sometimes complacent and complicit charities.

For example, during a break in a standing-room-only hearing room in June 2004, Senate Finance Committee members and hearing attendees watched as an opaque screen was pulled out onto the floor in preparation for testimony from two anonymous witnesses. Known only as "Mr. Car" and "Mr. House," they proceeded to speak from behind the screen, through a voice-modifying device, blowing the whistle on complex schemes led by organizations that were stealing millions of dollars from Americans who thought they had made legitimate charitable gifts.

As the mechanized voices echoed through the room, members of the audience raised eyebrows and exchanged whispers. This, after all, was high drama for a hearing on the nation's charities—the sector that has been considered, since the days of De Tocqueville, the cornerstone of America's altruistic and voluntary spirit.

Indeed, Mr. Car and Mr. House got their names because they blew the whistle on nonprofit organizations that used the guise of charity to rip people off. Mr. Car had witnessed the brokering of donated cars to charitable groups, and Mr. House's testimony exposed an organization that helped low-income Americans afford down payments on home purchases. According to Mr. Car, donors assumed they were contributing the full value of their vehicles but ultimately the charities received less than 10 percent of that amount. The executives Mr. House described issued contracts to related groups that lined their own pockets with the proceeds.

Mr. Car and Mr. House disclosed two, but by no means the only two, cases of charitable malfeasance, and members of the Finance Committee seemed prepared to recommend a sweeping set of legislative reforms to increase and enforce compliance with regulations, restore public trust and accountability, and instill strong governance measures across America's charitable sector.

By the end of the summer of 2004, charities wondered whether they were about to be taken to the woodshed simply because a few bad actors had tarnished their otherwise virtuous sector, or whether the entire charitable enterprise had gone seriously astray. There was genuine cause for concern; although there have always been exceptions, foundations and other charities have generally served the public good and stayed well within the boundaries of legal, ethical, and accountable practice. In the past decade, however, there has been a notable upswing in public attention to, and regulatory scrutiny of, mismanagement and malfeasance among America's nonprofit organizations. The upshot? An erosion of the public trust that is vested in charities and that is the rationale for their tax exemption and the corollary tax deduction for charitable donations.

Senate Finance Committee Chairman Chuck Grassley opened the June 2004 hearing by describing that trust relationship: "Today the Finance Committee considers a very serious matter: ensuring that charities keep their trust with the American people. We will hear testimony today that is troubling, very troubling, suggesting that far too many charities have broken the understood covenant between the taxpayer and the nonprofits. That covenant is that charities are to benefit the public good, not fill the pockets of private individuals."¹

Foundations—a relatively small but influential segment of the nonprofit world—were not exempt from the critique or the purported cure. Finance Committee members questioned foundations' grantmaking and accounting practices, executive compensation levels, and trustee governance practices, and called for foundation-specific reforms at the hearing. On the heels of the Senate hearing, the Internal Revenue Service announced that it would investigate executive compensation packages at nearly two thousand charities and audit about four hundred foundations as part of a sweeping effort to heighten accountability and weed out bad practices.²

Other proposed oversight measures also would shake up philanthropies. The Senate Finance Committee considered a proposal to have the IRS review organizations' tax-exempt status every five years and have groups with \$250,000 or more in gross receipts submit independent audits of financial statements, and held a second hearing, in April 2005, to reassess the need for legislative and regulatory action to promote integrity among nonprofits. Some state regulators reached even further. On January 1, 2005, California's Nonprofit Integrity Act went into effect requiring all charities to have their boards review and approve "just and reasonable" executive compensation, groups with gross revenues over \$2 million to have independent audits, and commercial fundraisers to register new solicitation campaigns with the attorney general.³ And in Minnesota, legislators introduced a bill in February 2005 requiring any nonprofit receiving state funds and paying employees salaries that exceed the governor's compensation (\$120,303) to supply the attorney general with a list of salaries for its three highest-paid staff members. A related measure would make charities in this category list compensation totals for their three highest-paid directors, officers, or employees on all fundraising materials.⁴

These days, regulators are tracking foundation practices more vigorously as well, and they are quick to punish abusive or unethical practices. In 2004, in a suit brought by the Texas attorney general, a jury ordered three leaders of the Carl B. and Florence E. King Foundation to repay, in total, more than \$20 million to the foundation that they received in salaries, benefit packages, and other perks.⁵

In California, the president of the James Irvine Foundation and his wife repaid the foundation more than \$30,000 for a parting gift that was found to be illegal and to rectify a self-dealing charge stemming from the wife's occasional use of Irvine's facilities to operate her consulting firm.⁶

The Nonprofit Sector

The organizations discussed in this chapter are all part of the “third” or “independent” nonprofit sector of the economy—that is, the sector that is neither government nor business. Discussion of the nonprofit sector can be confusing, in part because of the bewildering complexity of the nonprofit sector itself and in part because of the tendency of commentators to conflate the terms *nonprofit* and *tax exempt* with *charity*. While all charities are nonprofits, not all nonprofits are charities. In fact, the Internal Revenue Code lists twenty-eight categories of nonprofit organizations that are exempt from federal income taxes, including social welfare organizations, trade associations, fraternal organizations, social clubs, and veterans' organizations, among others. However, only one category of nonprofit organization—those organized exclusively for religious, charitable (including health), scientific, literary, or educational purposes—are charities entitled to receive tax deductible contributions. (Charities are sometimes referred to as 501(c)(3)'s after the section of the Internal Revenue Code that defines them.) This chapter is concerned with charities and to a lesser extent social welfare organizations, but not the rest of the nonprofit sector.

Most charities solicit funds from and/or provide charitable or educational services to the general public. This group includes churches, hospitals, colleges and universities, museums, and publicly supported voluntary organizations, such as the United Way, Red Cross, American Heart Association, and American Cancer Society. These organizations are widely known and for the most part admired in their communities.

There is a smaller, less visible class of charitable organizations known generally as *foundations*, which generally do not provide services directly to the public, but instead carry out their charitable missions primarily by making grants to other charities. Foundations, as the term is used here, include private foundations and community foundations. Private foundations can be funded by a small group of individuals or can be corporate foundations that are funded by and carry out the charitable activities of a particular company. On the other hand, community foundations manage multiple funds contributed by multiple donors. Both private and community foundations solicit funds and make grants, and most are classified as public charities by the IRS.

Because private foundations operate largely outside the public eye, they are less known to the general public than are other charities. A 2003 survey of the public and policy-makers conducted by Wirthlin Worldwide found that when asked to name a foundation, more than half of survey respondents did not know of any or did not respond, and 12 percent named a publicly supported charity like the United Way or the Red Cross.⁷ However, because foundation grants are an important source of funds to other charities, foundations are widely known within the nonprofit sector. This chapter focuses to a significant extent on the particular role and concerns of grantmaking foundations and their relationship to government, to the public, and to those charities that are the recipients of grants and provide charitable services to the public.

For definitions of the technical or legal terms used in this chapter, see the glossary at the end of the chapter.

Regulatory Action and Philanthropic Reaction

These are but recent episodes in a drama that has been playing out, with occasional intermissions, for nearly a century. At the 1916 Walsh Commission hearings, which investigated whether foundations held too much influence over the nation's economic, educational, and social spheres, some critics berated the philanthropic pioneers Andrew Carnegie and John D. Rockefeller for designating what the appropriate "objects of philanthropy" should be. Liberal populists, labor leaders, and others believed this was something the American people, through public institutions, should decide for themselves.⁸

Over the last forty to fifty years—while the foundation world as we know it has taken shape—several periods of legislative inquiry have shaken the stability of the nonprofit sector. Across most all of these inquiries, certain themes recur: distrust of foundations as private, influential, but unaccountable pools of wealth; tension over the allocation of funds directly supporting charitable works versus internal administrative costs; and the appropriate role of foundations and their philanthropic benefactors in public policy-making. Indeed, the pattern of legislative and regulatory review has been cyclical, driven by familiar critiques of charitable organizations' behavior. Two widely held premises have driven the debates over the role of philanthropy in general and foundations in particular: the expectation that philanthropists should marshal private wealth to benefit the public good, and the tax exemptions and deductions that derive from that expectation.

The 1960s and the Tax Reform Act of 1969

The social upheaval of the 1960s presented the backdrop for several grantmakers to participate in political and civil rights debates. Some foundations—most notably the Ford Foundation, the nation's largest at that time—were deeply engaged in fostering social movements, tackling root causes as well as symptoms of urban poverty and racial inequality. When Ford gave Cleveland's Congress on Racial Equality and the Southern Regional Council grant funds to stage voter registration drives, several political leaders cried foul, charging that a tax-exempt foundation should not be allowed to use private funds to sway elections. In addition to the activism of some foundations, the 1960s saw an increase in the sheer number of foundations. New philanthropies were registered at the rate of 1,200 a year; some disregarded their core public benefit obligation by serving as little more than tax shelters for the affluent. Representative Wright Patman, a populist Democrat from Texas, viewed these as untaxed silos of private wealth, often established in perpetuity. In 1961, Patman opened an eight-year probe of foundations. Although the Treasury Department's 1965 *Report on Private Foundations* concluded that most foundations served a beneficial social purpose and did not abuse the tax system, it also reinforced several of Patman's concerns: some foundations were used for improper private gain, had inappropriate business holdings, or stockpiled money rather than granting it to charitable recipients.

Foundations were on the defensive, and it was unclear how hard Congress would crack down on the field. New regulation could have been stifling: Senator Albert Gore Sr., concerned about perpetuity, wanted to forbid any foundation to operate for more than twenty-five years. Although Patman's legacy, the Tax Reform Act of 1969, stripped away some of the more drastic proposals such as Gore's, it included landmark provisions regulating private foundation practices. It created a legal distinction between public charities—often educational institutions, churches, hospitals, and United Way-type organizations so classified because of their activities or because they receive a substantial amount of support from the general public and government—and private foundations, which do not meet the activity or public support test. Most foundations are classified as private foundations under the Act, although some, such as community foundations, have sufficient public support to be considered public charities.

The Tax Reform Act imposed a series of regulatory restrictions on private foundations that do not apply to public charities. Among them were:

- Setting a minimum payout level that required a private foundation to spend a minimum of 6 percent of its assets or all net investment income each year, whichever was greater. In 1981, Congress reduced this level to 5 percent and eliminated the alternate calculation.
- Levying a 4 percent net excise tax—later dropped to 2 percent—on net investment income, including capital gains. The tax falls to 1 percent if certain requirements are met.
- Prohibiting lobbying, except for “self-defense” lobbying on legislative matters that affect the foundation's legal or tax status. Lobbying also does not include broad discussion of social issues and nonpartisan analysis, study, and research—work that permits foundations to support or do significant public policy work.
- Placing strict conditions on voter registration grants, supplementing the existing prohibitions on all charities against intervention in political campaigns.
- Barring foundations from holding more than 20 percent of a business enterprise, including stock in a corporation or interest in a partnership.
- Instituting a ban on self-dealing, generally defined as direct or indirect financial transactions between a foundation and its trustees, officers, donors, and their family members. An exception permits a foundation to pay “reasonable compensation” for personal services provided to it.
- Prohibiting excessively risky investments.
- Expanding the tax return that foundations must make available for public inspection.
- Enforcing all of these prohibitions through a series of excise taxes, so that revocation of the foundation's tax-exempt status is no longer the only penalty available to regulators.⁹

The 1969 Tax Reform Act remains the most sweeping act of legislation to affect the nonprofit and philanthropic sectors. Its effects continue to guide foundations' behavior in powerful ways to the present day.

The 1970s

With the Tax Reform Act in place, private foundations entered the 1970s knowing that they could no longer fly unseen under the radar of government regulators. A new commission established in 1970 and chaired by John Gardner, former president of the Carnegie Corporation of New York, explored

how grantmakers could rebuild public trust in their work and prevent future punitive regulation. The Commission on Private Philanthropy and Public Needs, more commonly called the Filer Commission after its chairman, John H. Filer, the chief executive officer of Aetna, followed soon thereafter. Beginning in 1973, it undertook the task of analyzing both the role of philanthropy in America and the universe of charitable, or “voluntary,” organizations that receive foundation funds. Two years later, Commission members outlined their vision for how charities and “the practice of private giving” could be improved.

Although it did not lead to new legislation, the Filer Commission spurred several critical developments within philanthropy. For the first time, grantors and grantees came to think of themselves as part of the same overarching, independent sector. Philanthropists and grantees acknowledged their shared strengths, together with their governance and accountability hurdles. A subgroup of grantees involved in the commission went on to form the National Committee for Responsive Philanthropy, or NCRP, the first watchdog group to monitor the policies and principles of grantmaking foundations.

Within five years, the legacy of the Filer Commission produced Independent Sector, a central membership and advocacy group for America’s voluntary sector. Independent Sector joined NCRP, the Council on Foundations (philanthropy’s national trade association), the Foundation Center (the leading data repository on foundations), other national organizations in a broader effort to define and promote the value of foundations and other charities in society, and, if necessary, to be the advocates for the sector’s interests and its tax exemption.

Philanthropies and other charities in the independent sector were beginning to build an infrastructure to promote stronger understanding among policy-makers and the public of their distinct role and impact. While those who had gone through the battles of the 1960s hoped that such efforts would prevent further regulatory upheaval, sector leaders had learned that they had better be prepared for future inquiries into their operations.

The 1980s and 1990s

Regulatory attention to private foundations decreased somewhat in the 1980s and 1990s. In the early eighties, the IRS completed an “examination study” of private foundations and cited high overall compliance with federal requirements, prompting fewer audits of funders. Testifying before the Senate Finance Committee in 2004, IRS Commissioner Mark Everson pointed to this long-standing compliance as a chief reason that regulatory audits of tax-exempt groups had been relatively infrequent.¹⁰ During the 1990s, grantmakers primarily rallied around preserving and defending the advocacy responsibilities and rights of their nonprofit grantees, which came under assault by some in Congress. In 1995, Oklahoma Republican Representative Ernest Istook and two other congressmen introduced an amendment that would have limited the ability of nonprofits that received federal grants or contracts to use privately raised funds to educate Congress, influence policy, or otherwise speak out on legislation.

Istook amendment supporters framed the issue as one of federally supported nonprofits misusing tax-exempt public dollars—an injustice to taxpayers that had to be stopped. A diverse set of funders and charities rallied around the proposition that advocacy is fundamental to nonprofits' role in American democracy, and that the use of private funds for advocacy should be safeguarded, not chilled. The Istook amendment failed, but it served up a strong reminder to nonprofit leaders who may have forgotten the precariousness of their regulatory standing.

An Accountability Crisis? Is Transparency the Solution?

Since 2001, policy-makers have been consumed with governance and accountability scandals that cut a wide swath across major American institutions: corporations, government, even the church. The most notorious offenders are corporate giants whose leaders placed their own interests ahead of shareholders, employees, and customers. This has shaken public trust in institutions throughout society; by extension, it is not surprising to see private foundations and public charities—those organizations charged with fostering public good with private means—called to account as well. Paul Light, a professor of public service at New York University and nonresident senior fellow at the Brookings Institution, verifies this trend. His research indicates that confidence in America's charities nosedived after September 11th, when many Americans disapproved of the way charitable organizations such as the Red Cross managed the allocation of donations raised in response to the terrorist attacks. Confidence levels still stand 10 to 15 percent lower than they did in the summer of 2001.¹¹ And, speaking in April 2005 to the Council on Foundations, IRS Commissioner Everson said, “We see the twin cancers of technical manipulation and outright abuse that became evident in the profit-making sectors in the 1990s now migrating to too many pockets of the tax-exempt community.”¹²

For their part, public charities and private foundations have sometimes offered inviting targets. The press has taken several high-profile offenders to task. The *Washington Post* ran an in-depth series on financial irregularities and conflicts of interest concerning loans and land deals at the Nature Conservancy, a \$3-billion-plus environmental charity. Experts who deciphered the organization's tax returns and financial records called them “confounding” and akin to penetrating a “brick wall.”¹³ Elsewhere, the *Boston Globe* exposed the Paul & Virginia Cabot Charitable Trust, which reported 2002 assets of \$5 million and made an average of \$400,000 in yearly grants from 1998 to 2002 but paid trustee Paul Cabot Jr. more than \$1.4 million. Cabot also used the trust's funds to cover mortgage payments on two homes, plus yacht and golf club bills.¹⁴ Cabot was forced to repay more than \$4 million to the family foundation under a deal struck with Massachusetts attorney general Thomas Reilly.

Public suspicion has been fueled by the attitude of many foundations. Until recently, many managed their affairs in ways that reinforced public perceptions of them as elite and opaque. They communicated little, if any, more than was legally required, failed to explain their mission or funding priorities, and neglected to seek objective appraisals of their grantmaking results. The field is moving away from this insular stance but foundations have considerable work to do to inform outside stakeholders of their missions and persuade them of their effectiveness and integrity.

This remoteness and mysteriousness may partly explain the erosion of public trust. In March 2004, the Philanthropic Initiative, a consulting group, held a forum on “Trust and Transparency: Philanthropy as Private Action in Public Space.” Though participants felt that poor governance and accountability performance accounted in part for the loss of trust in philanthropy, they rated foundations’ lack of transparency as the key contributing factor.¹⁵

Transparency has suffered on both sides of the information exchange equation. Most grantmakers perform poorly when it comes to sharing information about their objectives and their results. In 2003, for example, only 7 percent of the largest 20,000 foundations issued annual reports.¹⁶ Moreover, until recently, there was little media attention to or public demand for news about philanthropy. What coverage there is tends to highlight alleged scandal or malfeasance, reinforcing the public’s distrust of foundations. Although the spike in reported abuses might seem alarming, it still represents a minute proportion relative to the universe of foundations. Dorothy Ridings, who was then president and chief executive officer of the Council of Foundations, calls these offenders “a very tiny slice of foundation activity ... a very visible, awful slice.”¹⁷

Congress reacted to the spate of turn-of-the-twenty-first-century corporate governance and accounting scandals by passing the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley mandates all publicly traded companies to include independent audit committees within their boards, have chief corporate officers certify financial statements, cut out insider loans, and strengthen whistle-blower protections. Although Congress has not formalized Sarbanes-Oxley–like mandates for charities, it seems to be getting close, or at least is encouraging the nonprofit sector to adopt some of the principles of transparency.

Why the Attention Now?

During the summer of 2003, Congress reviewed foundation payout levels and administrative budgets as it debated the Charitable Giving Act, H.R. 7. The booming stock market of the 1990s grew the asset bases of American foundations considerably, spurring rises in overall grantmaking and increasing the prominence of foundations and their donors. Critics argued that foundations weren’t giving away enough—that the annual minimum payout standard of 5 percent of assets was too low or that administrative expenses of grantmaking should be excluded from the payout equation. Watchdogs such as the National Committee for Responsive Philanthropy and the National Network of Grantmakers said foundations placed too high a premium on increasing and preserving their assets instead of spending more grant dollars to meet society’s urgent needs *today*, sparking a vigorous debate about perpetuity and the present and future value of social investments.¹⁸ Yet again, philanthropy was in a hot seat not experienced since the days of Wright Patman and the Tax Reform Act of 1969.

Although government has always overseen the nonprofit sector of which foundations are a part, there may be some reasons that regulators and legislators now appear to be focusing more intensively on this area. It is partly explained by the fact that the sector is growing ever larger, more complex, and more diverse, and the range of organizational forms, transactions, and practices that regulators must consider expands accordingly. In 1987, there were 1.3 million organizations in the entire nonprofit sector; a decade later, it encompassed 1.6 million, representing a 5 percent annual rate of increase.¹⁹ Roughly half are tax-exempt 501(c)(3) public charities that file with the IRS.²⁰

The ranks of foundations have ballooned in tandem with the overall growth of the nonprofit sector. From 1975 to 2002, the number of grantmaking foundations roughly tripled, from 22,000 to 65,000. A statistic that may better signal their influence—and why regulators are apt to look more closely these days—is that their collective assets soared from \$30 billion in 1975 to \$435 billion now.²¹

In many areas, the lines among nonprofit, government, and business are blurring, particularly in fields such as health care and education, where charities frequently provide services also provided by government and commercial organizations. Hybrid organizations are more prevalent: some charities have formed for-profit ventures in one area that can be used to underwrite charitable services; other public charities provide services that look much like and compete with those provided by for-profit entities. These factors contribute, to varying degrees, to the shifting regulatory landscape that America's charities must navigate.

Regulating philanthropies has grown more complicated as well. Foundations used to be relatively uniform in type and operations, but now there are more diverse organizational forms within the field. Along with traditional grantmaking models, today there are venture philanthropies that partner so closely with nonprofits that it can get tough to tell where the funder's work ends and the grantee's begins. In health care, where many nonprofit hospitals and health plans had converted to for-profit status, a new breed of health philanthropy arose—the health care conversion foundation. Established with the proceeds from conversions, these foundations grew from 81 in 1997, with combined assets of \$9.3 billion, to more than 170 in 2005 with \$18.3 billion in assets.²²

Donor-advised funds have also emerged as bold new players in philanthropy. Such funds have long been part of community foundations, but in the 1990s, many donor-advised funds were set up by commercial investment entities. Fidelity Investments led the way with its Charitable Gift Fund, and other banks and mutual funds companies have followed suit, attracting billions of investors' dollars that also flow to charitable causes. These new commercial donor-advised funds often compete with donor-advised funds operated by nonprofit community foundations and can be used by donors to avoid some of the inconvenience and restrictions of a private foundation. Policy-makers are looking closely at whether or how to further regulate donor-advised funds.

Although this boom, even with the 2000–2003 downturn in assets, suggests that foundations are thriving as never before, it is precisely this rise in numbers, influence, and complexity, coupled with reductions in government spending for social services, that leaves them vulnerable to claims that they are “unaccountable.”

At present, it is unclear how this current spate of legislative and regulatory review of charitable practices will shake out. Although some new requirements may be adopted, policy-makers may decide that others are inappropriate or unnecessary. What is certain, however, is that leaders at foundations and charities of all sizes, from coast to coast, are feeling the heat of the spotlight from government and the media, and boardrooms are abuzz with talk about strengthening accountability and performance standards.

Philanthropy Responds

This current threat of regulation and legislation has prompted wide-ranging reactions among foundation and other nonprofit leaders. Some view any increase in government oversight as harmful and too intrusive, and believe the sector can regulate itself when it comes to public accountability.²³ Others claim it's high time for the government to put some enforcement muscle behind public expectations and that imposing Sarbanes-Oxley-like requirements would be the best way to ensure that charities can demonstrate that they are honest, accountable stewards of the public's trust. Most leaders, not surprisingly, hold views that fall somewhere in the middle. They recognize that nonprofits must do more to show that they merit tax exemption and public support because they fulfill critical missions, perform valuable services, and adhere to high standards of performance and accountability. They believe that more effective regulation can support this goal.

The Council on Foundations, Independent Sector, the National Council of Nonprofit Associations, the National Committee for Responsive Philanthropy, and a host of other coordinating organizations have issued a call for all tax-exempt groups to demonstrate greater transparency, stronger accountability, and more rigorous governance. Though they have always encouraged nonprofits to pursue strong, ethical governance, they now frame these attributes as essential for the survival of charitable organizations in a hostile regulatory environment. The challenge for many of these organizations, such as the Council on Foundations and Independent Sector, is that their membership represents but a fraction of the 60,000-plus foundations and one-million-plus nonprofit organizations in the United States, and that they have little power, other than the power of persuasion, over their members' adherence to higher standards of accountability.

In 2004, the Council on Foundations launched "Building Strong and Ethical Foundations: Doing It Right," a nationwide governance and stewardship campaign. It calls upon foundations not only to comply with government regulations but also to uphold standards that may exceed legal requirements. It also is releasing a new publication called *Principles of Ethical Practice* for members and the field. Other national groups working to improve accountability and performance standards include the Better Business Bureau Wise Giving Alliance, GuideStar, and the Standards for Excellence Institute. GuideStar in particular has led the push for online reporting of charitable records, which vastly improves the accessibility of financial reports for donors and others. In partnership with the National Center for Charitable Statistics, GuideStar operates a free database that allows users to access IRS tax returns for more than a million charities, including foundations.²⁴

Evidence suggests that this sectorwide push for demonstrated accountability may be taking hold. The Center for Effective Philanthropy, which surveyed the 250 largest philanthropies in 2004, found that foundation boards across the country were revisiting and fortifying governance practices. Two-thirds have discussed governance in the wake of recent corporate scandals and media attention to foundation operations, and 34 percent have approved changes.²⁵ Many of these changes involve foundations posting information on their Web sites—their tax returns, conflict of interest policies, codes of ethics, administrative expense ratios, even executive compensation schedules. This is meaningful progress.

Regional nonprofit and donor associations also are propelling improvements in governance and transparency. The Forum of Regional Associations of Grantmakers joined with PriceWaterhouseCoopers

and the Charles Stewart Mott Foundation to publish no-nonsense guides to help funders submit more accurate and consistent tax returns to the IRS. They hope not just to drive up compliance rates but also to motivate grantmakers to use these forms as information tools that provide clear, usable data to the public and the press.²⁶

Improving the quality of data reporting is no small feat. The Internal Revenue Service claims that paper filings of IRS Forms 990 and 990-PF show error rates of roughly 35 percent, including faulty, missing, or inconsistent data.²⁷ The Form 990-PF, which private foundations are required to file, lacks uniform standards and common definitions for reporting expenses. For instance, it does not allow funders to segregate those “administrative” expenses—such as staff-provided assistance to grantees, evaluations of grant programs, Web sites, and the production of an annual report—that promote effective and transparent philanthropy. Independent Sector’s president, Diana Aviv, testified at the Finance Committee hearings that the existing forms “fall woefully short of providing a clear, useful tool for the public, for regulators, and for nonprofit practitioners.”²⁸

Regulators, meanwhile, are too poorly coordinated and underresourced to monitor charities’ compliance effectively. Reviewing 990s for inaccuracies and other red flags has largely been beyond the reach of national and state regulators. The IRS Exempt Organizations division has lacked adequate staff and funding to police nonprofits. At the state level, oversight is even spottier. To further complicate matters, the tax code precludes state and IRS regulators from sharing information and collaborating on charity investigations. Although there was some momentum within the field to improve 990s prior to the Senate hearings, Independent Sector, foundation groups, and IRS officials are pressing ahead now with greater urgency to make them clearer, more transparent, and easier to file.

In September 2004, the Senate Finance Committee summoned Independent Sector to convene an independent national panel to recommend to Congress steps to “strengthen good governance, ethical conduct, and effective practice of public charities and private foundations.” Paul Brest, president of the William and Flora Hewlett Foundation, and Cass Wheeler, CEO of the American Heart Association, lead this group of twenty-four charity and foundation executives, which looks like a fast-track version of the Filer Commission, which played such an important role in revamping the sector’s practices in the 1970s. In June 2005, the Panel on the Nonprofit Sector issued its final recommendations to Congress to fortify accountability, transparency, and governance outcomes across America’s nonprofit sector. While watchdog groups such as NCRP faulted the panel for recommending little more than stepped-up self-regulation, several key panel recommendations may hold promise for shoring up oversight of and confidence in nonprofits and foundations. Most notably, the report calls on Congress to allocate more resources to effective tax enforcement for and tracking of nonprofit groups and to appropriate federal dollars that help states do the same. It urges charities to disclose executive and trustee compensation levels and to keep those levels “reasonable,” form clear conflict-of-interest and travel expense policies, be independently audited if annual revenues top \$1 million or have a financial review performed by an independent accountant if they take in more than \$250,000 but under \$1 million, and require that at least one-third of all governing board members be independent. To improve foundation reporting, the panel calls for 990-PFs to draw bright, clear lines between grantmaking expenditures, program-related activities, administrative costs, and investments.²⁹

The Senate Finance Committee is taking the more than one hundred suggestions of the panel under consideration as it weighs whether enhanced self-regulation by nonprofits and foundations will be sufficient to restore public confidence or if more legislative or regulatory guidance is needed.

The Robert Wood Johnson Foundation: How One Foundation Tackles the Accountability Challenge

In 1972, at the time the Robert Wood Johnson Foundation emerged as the nation's second-largest foundation, its sheer wealth made compliance with the 1969 Tax Reform Act a top priority. Foundation staff members immediately scrambled to develop policies and programs to get its first year's mandated payout—approximately \$45 million—out the door. Executives soon sold off some Johnson & Johnson stock to meet the 20 percent ownership ceiling. At that time, they also worried about real or perceived governance conflicts; after all, Johnson & Johnson executives occupied half of the board seats. Gustav Lienhard, then the Foundation's president, delineated clear boundaries between Foundation and Johnson & Johnson operations, making it clear to the Foundation's staff, Johnson & Johnson, and external audiences that it was not the philanthropic wing of the corporation. The Foundation's leadership recognized that transparency and public accountability needed to be core operating principles in order to gain the trust of health leaders and public policy-makers required to carry out its mission.

Though that initial urgency has dissipated over the years, Foundation leaders have continued to inculcate the founding board's belief that accountable management and effective governance demand persistent, deliberate effort. Trustees and executives regularly probe whether the Foundation is sufficiently rigorous in meeting performance and accountability benchmarks, and insist on a process of ongoing improvement. Such efforts help the institution to understand how well it is fulfilling its mission and demonstrating accountability to various stakeholders.

Board Governance

From the Robert Wood Johnson Foundation's earliest days, the board has met its fiduciary obligation, overseeing the Foundation's funds, policies, and practices entrusted to it for the benefit of the public. The Foundation's leadership is attentive to board composition; although it made sense in 1972 for Johnson & Johnson executives, who could channel Robert Wood Johnson's charitable interests, to occupy half of all board seats, today the proportion of those with ties to the company is about one-quarter. More important, trustees bring the financial management expertise, health and health care leadership, and policy perspectives needed to shape the Foundation's direction.³⁰

One of the board's long-standing priorities has been to monitor the Foundation's performance in meeting its grantmaking objectives and responding to immediate and long-term issues in health and health care. Since 1992, one of the four annual board meetings has focused on assessing the Foundation's performance and accountability.

The Foundation's leaders have adopted data-driven tools to capture how well it serves the needs of various stakeholders. According to the Center for Effective Philanthropy, which published a case study on performance assessment at the Robert Wood Johnson Foundation, trustees and staff invest in assessment mechanisms that return a balanced, if imperfect, picture of the Foundation's

performance and how well it addresses essential questions such as, What are we trying to accomplish? What are the results? How can we adjust goals to enhance impact?²³¹

Administrative Cost Structure

For the past decade, the Foundation's administrative expenses, including compensation of staff, have typically fluctuated between 9 and 12 percent of its total costs of grantmaking. Because of the limitations of the IRS Form 990-PF that private foundations must file, most nongrant payments must be reported under the broad category of "operating and administrative expenses." Thus, the costs of certain major programs that are funded under contracts—such as the Covering Kids & Families campaign, a nationwide effort to promote the enrollment of eligible low-income children in governmental health insurance programs; the Center for Studying Health System Change, which tracks trends in the delivery and cost of health services and informs decision makers about them; and a broad-based national education campaign to improve end-of-life care in America—are considered by the IRS as operating and administrative expenses. Even though they are reported as "operating and administrative expenses," contractual arrangements such as these are viewed by Foundation board members and staff as efficient means of improving health and health care.

That said, the Foundation is working to cut back on administrative expenses by closely managing travel costs, trimming the use of consultants, and streamlining processes across departments. Given its breadth of operations and its commitment to providing technical assistance to grantees, however, it is unlikely that the Foundation will find itself on the lower end of the administrative cost scale anytime soon.

Evaluation and Communications: Assessing and Reporting Successes, Failures, and Lessons Learned

The Robert Wood Johnson Foundation has been evaluating grants and programs for almost as long as it has funded them. National initiatives, as a general rule, are evaluated by outside experts, ranging from leading academicians to staff members of research firms to experienced health care practitioners. Evaluators are given wide latitude to select state-of-the-art methods and to come to independent conclusions about impact. Two rationales motivate the Foundation's work in this area: evaluation informs key decisions to improve health and health care for Americans, and it helps the Foundation shape future programs.

In addition to formal program evaluations, the Foundation assesses impact through three other approaches: (1) the annual *Robert Wood Johnson Foundation Anthology*, which synthesizes findings from the Foundation's grantmaking areas, (2) Grants Results Reports, which summarize findings from specific grants and national programs, and (3) a performance appraisal system, which tracks the Foundation's progress in meeting its short-, medium-, and long-term objectives.

The Foundation also seeks to get a fuller, clearer picture of the impact and the quality of its work by asking internal and external audiences a fundamental question: How are we doing? Answers to that core question come through a variety of channels, primarily from its annual "scorecard." In addition

to containing case studies and performance measures designed to show progress, or lack thereof, toward reaching the objectives established by the Foundation, the scorecard also asks key constituents for their assessment of whether the Foundation is focusing its programs on the right issues and whether it is effective. It asks grantees, potential grantees, and applicants whose proposals were turned down how fair and responsive the staff is to applicants and grantees and whether policy-makers, opinion leaders, and journalists know about the Foundation and find its work useful. It also asks staff members what they think of the Foundation as a place to work. Each July, the Foundation's trustees use the scorecard to assess organizational performance and to set goals for the institution.

In 2004, the Foundation complemented its own survey by asking the Center for Effective Philanthropy to conduct an in-depth analysis of its performance and responsiveness through the eyes of its grantees. The Center for Effective Philanthropy compared responses from 200 of the Foundation's grantees with those of more than 3,500 grantees of twenty-nine other foundations. The Foundation rated relatively poorly in customer satisfaction, fairness and responsiveness, clarity of funding priorities, and grantee selection criteria. In a commentary e-mailed to national program directors, the Foundation's president and CEO, Risa Lavizzo-Mourey, called the findings "sobering, to put it mildly."

The results from the Center for Effective Philanthropy survey have driven an intense examination of the Foundation's internal grantmaking and administrative processes. In 2004, the Foundation initiated a top-to-bottom review of its grantmaking practices to remedy many of the problems that had been identified, align them more closely with the expectations of the field, and be clearer in communicating about program objectives. These are essential steps in the Foundation's continuing quest to be a more effective and accountable philanthropy.

The Foundation not only evaluates its programs, its grantmaking, and its staff's performance; it also places high priority on communicating with the field, policy-makers, and the public. It publicizes not just the glowing successes but also the disappointments and everything in between, sharing lessons from each outcome. Outcomes and results are shared through the *Anthology, Advances* (the Foundation's quarterly newsletter), the *Annual Report*, special reports, a new Web-based research center, and Grants Results Reports. At present, there are approximately 1,400 reports on projects and more than sixty reports on national programs posted on the Grants Results Reporting section of the Foundation's Web site.

The Foundation has learned that evaluation and communications work hand in hand in fostering greater transparency and driving social change. Over time, the Foundation has placed a high priority on strategic communications. Communications are an integral part of the Foundation's grantmaking approaches, and communications strategies sometimes form the crux of grant programs that foster Foundation goals, such as promoting access to health care (the Covering Kids campaign) or reducing harm caused by substance use (the Campaign for Tobacco-Free Kids). In 2004, communications grants made up roughly 19 percent of the funds awarded by the Foundation. The Foundation also helps grantees build their outreach capacity so that they may communicate the results of their work effectively to key audiences.³²

In addition to advancing the Foundation’s grantmaking practice and performance, the way in which it combines evaluation and communications also provides tangible evidence of the Foundation’s commitment to be accountable and transparent. It informs the efforts of those working in health, health care, and social change, and in a wider sense provides a base of evidence for policy-makers, the media, and the public increasingly seeking proof that public charities and foundations add value to society.

Closing the Performance and Perception Gap

Private foundations are unique: they command tremendous financial resources intended for the public good, yet they typically are unconstrained by the accountability systems that drive government, the financial bottom line of commercial enterprises, and the need for funds or the competition for service recipients that increasingly motivates other types of charitable organizations. Peter Karoff, a consultant, calls American philanthropy “the largest pool of private capital available in the world that is free from the constraints of governments or the marketplace.”³³

Foundations and other charitable organizations seem to be at a crossroads. All signs suggest that the accountability bar has been raised; it is now their responsibility to figure out how to clear it. In 2003 and 2004, Congress teetered at the edge of passing new laws to force charities to adhere to more stringent governance and accountability standards. California and Massachusetts already have enacted tougher reporting requirements, and other states and the federal government may follow their lead. The potential is there for such measures to constrain the way nonprofits do their work; for small charities in particular, they can pose backbreaking compliance burdens. Clearly, if foundations and other charities fail to strengthen their governance practices and their accountability, they face the unpalatable prospect of government imposing them from outside.

Regardless of how policy-makers ultimately address this dilemma, the move toward stronger standards of ethics, accountability, transparency, and governance will have beneficial long-term outcomes for foundations. Philanthropy is likely to grow at a fast pace; researchers predict that the economy will be infused with \$41 trillion in new wealth over the next fifty years, coming primarily from the estates of aging baby boomers.³⁴ This influx holds great promise for expanding Americans’ philanthropic giving and enhancing the impact of the foundation sector. If this growth is marked by sustained emphasis on accountability, foundations should emerge as stronger organizations that enjoy public support for their role as stewards of private wealth for public good.

Glossary

Form 990: The annual tax return that tax-exempt organizations with gross revenue of more than \$25,000 must file with the IRS. The Form 990 also is generally filed with the appropriate state offices. This return includes information about the organization’s assets, income, operating expenses, contributions, paid staff and salaries, names and addresses of persons to contact, and program areas.

Form 990-PF: The annual information return that must be filed with the IRS by private foundations and nonexempt charitable trusts that are treated as private foundations by the IRS.

Foundation: A nongovernmental charitable nonprofit corporation or trust with funds and a program managed by its trustees or directors, established to further social, educational, religious, or charitable activities, often by making grants. A private foundation receives its funds from, and often is controlled by, an individual, family, corporation, or other group consisting of a limited number of members. In contrast, a community foundation receives its funds from multiple donors and is classified by the IRS as a public charity.

Independent sector: The portion of the economy that includes all 501(c)(3) charitable and 501(c)(4) social welfare tax-exempt organizations as defined by the IRS, including all religious institutions (such as churches and synagogues). The independent sector is also referred to as the “voluntary sector,” the “nonprofit sector,” and the “third sector.”

Nonprofit: A term describing a charitable trust or a nonprofit corporation that has no shareholders or other owners and that does not distribute dividends or other earnings. A nonprofit organization’s income is used to support its operations. Nonprofit organizations that are included in the definition of the independent sector are nonprofit, tax-exempt organizations that are included in sections 501(c)(3) and 501(c)(4) of the code.

Payout requirement: The Internal Revenue Code requirement that all private foundations, including corporate foundations, pay out annually in grants and related expenditures the equivalent of 5 percent of the value of their investment assets.

Public charity: The largest category of 501(c)(3) organizations, which serve broad purposes, including assisting the poor and the underprivileged; advancing religion, education, health, science, art, and culture; and protecting the environment, among other purposes. A charity qualifies as a public charity by virtue of its activities or broad public support. Churches, educational institutions, and hospitals are considered public charities based on their activities. Other public charities, such as United Way-type organizations or museums, qualify by receiving a substantial part of their income, directly or indirectly, from the general public or from government sources. The public support must be fairly broad and not limited to a few individuals or families. Charities that do not meet the activity or public support tests are known as private foundations under Section 509(a) of the Internal Revenue Code.

Section 501(c)(3): The Internal Revenue Code section that defines tax-exempt organizations organized and operated exclusively for religious, charitable, scientific, literary, educational, or similar purposes. Contributions to 501(c)(3) organizations are deductible as charitable donations for federal income tax purposes. These organizations make up a large part of the independent sector.

Section 501(c)(4): The Internal Revenue Code section that defines tax-exempt organizations organized to operate as civic leagues, social welfare organizations, and local associations of employees. Contributions to 501(c)(4) organizations are not deductible as charitable donations for federal income tax purposes. Section 501(c)(4) organizations are considered part of the independent sector.

Tax-exempt: A classification under Section 501(c) of the Internal Revenue Code for qualified nonprofit organizations that excludes their income from federal income tax. There are twenty-eight categories of tax-exempt entities; 501(c)(3) and 501(c)(4) organizations are two of them. Although private foundations, including company foundations, are tax-exempt, they must pay a 1 or 2 percent excise tax on net investment income.

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