

## Independent Charities, Independent Regulators: The Future of Not-for-Profit Regulation

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EXECUTIVE SUMMARY

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At a National Press Club forum held 15 days before the federal elections of 7 September 2013, Liberal MP Kevin Andrews pledged that a Coalition government would abolish the Australian Charities and Not-for-Profits Commission (ACNC), a new regulatory body for the not-for-profit (NFP) sector that the Gillard government established in late 2012. When it was announced after the election that Andrews would be Minister for Social Affairs in the Abbott government, the commissioner of the ACNC, Susan Pascoe, quickly reassured the press and the public that the ACNC ‘is very much alive and implementing its statutory obligations,’ and would continue to do so until an Act of Parliament formally abolished the commission.<sup>1</sup> By late October, NFP-sector observers were already beginning to speculate that ‘the ACNC is likely to survive due to the complexity in unwinding the legislation connected with it.’<sup>2</sup>

Abolishing the ACNC should not be allowed to fall by the wayside. Even with an annual budget close to \$15 million, it is unlikely that the ACNC will make significant progress on any of the three objectives it was created to address: improving public trust in the NFP sector; reducing the burden of red tape that charities now face; and policing fraud and wrongdoing in the sector. The commission’s record during its first year has only confirmed this scepticism.

Other countries that have established their own charities commissions have realised that these commissions are not an effective way to regulate the NFP sector. The New Zealand Charities Commission (NZCC) was abolished only six months before the ACNC was launched because the Key government did not think the commission was providing value for money. In Britain, the Charities Commission for England and Wales has come under fire in the past couple of years and is the subject of a parliamentary inquiry into whether it is ‘fit for purpose’ at all.

Two recent developments in NFP regulation in Australia offer strong encouragement to the idea that the sector can have adequate oversight without a federal regulator. The first is the growth of independent charity watchdogs such as Charity Navigator, GiveWell and GuideStar. These groups conduct research into charities’ activities and finances, and then award each charity a rating based on this data. These ratings are collected into an online database and made available to the public, free of charge. Each evaluator has a different method for calculating these ratings, but all of them emphasise transparency, credibility and efficiency. Many of them are also beginning to offer more advanced services that government regulators are not well suited to provide, such as systems for measuring a charity’s social impact.

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The second development is the increasing importance of wealthy and ultra-wealthy donors in Australia's donation market. Howard-era reforms made it easier for high-net-worth philanthropists to conduct their giving on a large and long-term scale through personal foundations. Rather than relying on charity watchdogs, most high-wealth philanthropists now evaluate charities themselves, both before and after making donations. These private means of imposing oversight have proven to be at least as effective as government regulation at no cost to the taxpayer. The Coalition should welcome these two developments, not discourage them by continuing the failed charity-commission model of NFP regulation.

## The growth of not-for-profit regulation in Australia

The most consequential change in the 200-year history of NFP-government relations in Australia came only in the late 1990s. The bellwether was the abolition of the Commonwealth Employment Service (CES) in 1997. Private businesses and not-for-profit groups were then invited to bid to provide job-placement services on the government's behalf, fulfilling the old CES' duties on a contract basis.<sup>3</sup>

This contract-for-services model of funding was a departure from precedent. Until then, most government funding of not-for-profits was in the form of grants or direct subsidies, which usually did not impose any added restrictions beyond those already governing the grant recipient's sector (health, child care, aged care, etc.). This had been the norm as far back as the early 19th century, when Governor Macquarie first extended government funding to the Benevolent Society in NSW.

Within a few years of the abolition of the CES, the purchase-of-services model went from being a rarely used alternative to grants and direct subsidies to being the predominant form for NFPs, especially for welfare programs. The number of charities receiving government funds doubled from around 10,000 in 1995 to 20,000 five years later.<sup>4</sup>

With greater involvement came greater interference. Government agencies wrote certain supervisory powers into their service contracts, sometimes even mandating the appointment of a government representative to a charity's board of directors (27% of programs used this particular provision in 2007).<sup>5</sup> Almost all contracts required some form of performance reporting, which led charities to place a greater emphasis on quantifiable results and diligent recordkeeping. In 2008, when a survey conducted by the Australian Council of Social Services (ACOSS) asked charities whether such government contract requirements 'adversely affected service delivery,' a third said yes.<sup>6</sup>

In the 1995 Industry Commission report on charities in Australia, the term 'red tape' does not appear once. In the 2010 Productivity Commission report on the same subject, the burden of red tape is a constant theme. Clearly what began in 1997 as a small change to the way government funds NFPs had within 15 years produced a significant increase in the amount of government interference in the sector.

To solve this new problem of overregulation, which government had so recently created, the Gillard government proposed and, in late 2012, enacted a new national regulator, the Australian Charities and Not-for-Profits Commission (ACNC), which it hoped would both consolidate and improve government regulation of the sector. The establishment of the ACNC marked an expansion of government involvement in the NFP sector that, far from incremental, amounted to a giant leap. Australia has never before had a federal regulatory body devoted entirely to not-for-profits, much less one with expansive punitive powers and an annual budget nearing \$15 million. But this is not a leap into the unknown. Past experience and international comparisons provide a clear guide to the results we can expect from the ACNC. The soundest expectation is that the body will fail to achieve any of the three objectives for which it was founded.

### Objective #1: Reduce red tape

The legislation creating the ACNC lists as one of the body's main purposes 'the reduction of unnecessary regulatory obligations on the Australian not-for-profit sector.'<sup>7</sup> The prominence of red tape among the problems listed in the 2010 Productivity Commission report, compared with the silence on red tape in the 1995 Industry Commission report, suggests that bureaucratic reporting requirements are a real problem and not just a constant carp. The paperwork burden imposed on

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charities by government really has increased. (The term 'charities' will be used interchangeably with 'not-for-profit organisations' in this report when discussing the ACNC because at the moment, its regulatory powers apply only to NFPs that also qualify for charitable status. Other NFPs are expected to be added to the ACNC's purview at some point.)

One of the largest and most unnecessary sources of this red-tape burden is duplication. Depending on its size and activities, a charity can be required to provide the same information to different government agencies, in different formats, and at different points in the calendar year. Much of this duplication is the result of a lack of coordination between the federal and state levels. State governments control a large share of spending on health, social services, education and other relevant sectors, as well as certain licences and permits such as the licence required to conduct public fundraising. At the federal level are other grants and contracts with their own reporting requirements, as well as, of course, the Australian Taxation Office (ATO) and Australian Securities and Investments Commission (ASIC).

To date, the ACNC has reached agreements to eliminate duplicative reporting with the governments of South Australia and the ACT only.<sup>8</sup> Neither NSW nor Victoria, which between them have the lion's share of Australian charities, has agreed to accept the ACNC's Annual Information Statement (AIS) as a substitute for existing reporting requirements. Without the cooperation of the state governments, there is little chance that the ACNC will put a serious dent in the current paperwork burden.

In 2013, the ACNC had an opportunity to demonstrate its good faith as an enemy of red tape, and it did not escape the sector's notice when the ACNC allowed this opportunity to pass. The occasion for this lapse was the launch of the AIS form, which asks charities to provide information about their purpose, activities and employees; from 2014, the form will include a section on finances. ACNC Commissioner Susan Pascoe has said the AIS is the first step towards a 'report once, use often' policy that will allow government agencies to obtain information about charities from the ACNC's clearinghouse rather than from the charities themselves.<sup>9</sup>

For many NFPs, their first look at the AIS convinced them that it would be nothing more than an additional layer of reporting on top of existing requirements. The executive director of Catholic Education Melbourne, Stephen Elder, complained that it provided 'no additional transparency to the way Catholic education reports to government, only duplication of existing regulation.' He estimated the new requirements would cost his organisation 45 working days of 'unnecessary pen pushing' to complete.<sup>10</sup> The national director of UnitingCare Australia, the charitable arm of the Uniting Church, calculated that sector-wide compliance would take 43,125 work hours, based on the ACNC's own recommendation for how much time should be spent completing the AIS.

Much of the information requested in the AIS had already been submitted by charities to other government bodies, which led UnitingCare's director to ask why the ACNC had not obtained that information from those agencies that already had it, thus demonstrating rather than just proclaiming its commitment to the 'report once, use often' principle. UnitingCare summarised this objection in its highly critical report released in August 2013:

It is our experience that the ACNC has created an initial additional layer of reporting which could have been avoided. Much of the information required in the AIS and future financial reports has already been provided to government, often several times in different formats, to evidence operation and financial compliance ... *A significant opportunity for the ACNC to reduce red tape from the beginning of its operations has been missed.*<sup>11</sup> [emphasis added]

The report also complained that the ACNC had not taken compliance costs sufficiently into account, and therefore, had failed to strike ‘the appropriate balance of regulation and compliance.’ This is no surprise, since the Regulation Impact Statement (RIS) prepared in 2011 by Treasury after plans for the ACNC were announced did not even attempt to factor compliance costs into its evaluation of the proposed agency.

The [NFP] sector is extremely diverse and a generalised number would be unhelpful and particularly misleading. *Given informational gaps, it is impossible to estimate current compliance costs faced by the sector and changes in compliance costs that would arise due to the implementation of options considered in this regulator impact statement.*<sup>12</sup> [emphasis in the original]

When you don’t know how much trouble a regulation will be, it is hard to tell whether it will end up being more trouble than it’s worth. The ultimate conclusion of the UnitingCare report was cautiously worded but unmistakable in its message:

The Minister is required to do a review of the ACNC after five years, and if the ACNC has not delivered on its objectives then the Government could seek to abolish it.

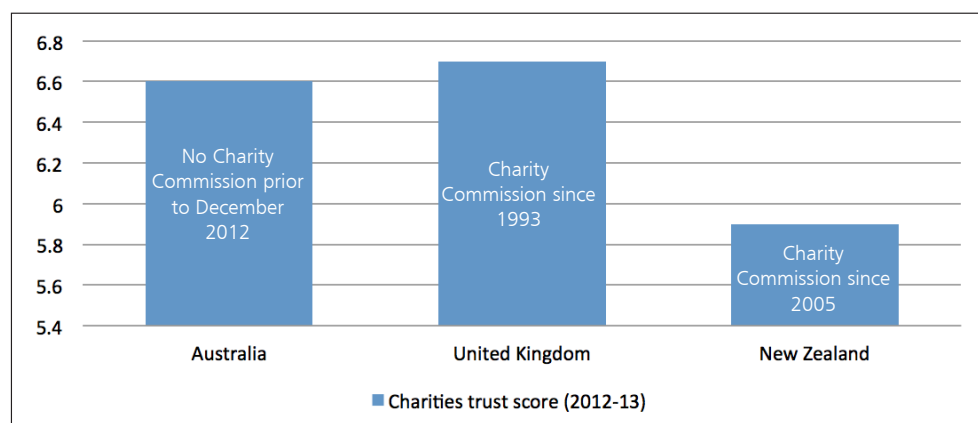
## Objective #2: Increase public trust in the NFP sector

In 2013, ACNC Assistant Commissioner David Locke visited various groups and conferences to deliver a presentation designed to familiarise his audiences with the ACNC. When the commission’s goals are listed at the beginning of this presentation, the first one cited is always, ‘Maintain, protect, and enhance public trust and confidence in the Australian not-for-profit sector.’ It is also the first goal listed among the ‘Objects of this Act’ in the law that created the ACNC.

Given its prominence among the rationales behind the ACNC, the connection between increased regulation and increased public trust is surprisingly difficult to substantiate. The Australian public’s trust in the NFP sector is already strong by international standards, as is clear from the high national levels of volunteering and charitable giving. In 2013, Australia ranked as the Most Generous Country in the Charities Aid Foundation’s World Giving Index, hardly an indication of a crisis of trust.<sup>13</sup> More importantly, even if there was significant room for improvement in Australians’ trust in the NFP sector, evidence suggests that the presence of a national charity regulator has no effect on trust levels.

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**Figure 1: No effect on trust scores**



**Source:** ChantLink, ‘Public Trust and Confidence in Australian Charities.’

**Even in countries with charity commissions, it is usually a whistleblower or a media story that alerts the commission to an instance of fraud worth investigating.**

In a 2013 survey prepared for the ACNC by the research firm ChantLink, Australians rated charities the third most trustworthy of the nation's institutions, behind doctors and the police and ahead of the High Court, the news media, and the ATO. The mean score given to charities (6.6) was more than 50% higher than that given to federal Parliament (4.2). It was also nearly identical to the trust score given to charities by respondents in England and Wales (6.7), where a national charities commission has existed for more than 10 years, and much higher than the score recorded in New Zealand (5.9), which at the time of the survey still had the charities commission it established in 2005.<sup>14</sup>

Charities commissions, then, do not necessarily lead to higher levels of trust. This may be because most members of the public simply do not know whether their country has a national charity regulator. In England and Wales, only 55% of respondents indicated knowledge of their charity commission.<sup>15</sup> In Australia, a focus group conducted as a follow-up to the trust survey recorded the following answers when participants were asked whether charities in Australia were regulated:

If you are a not for profit, then you're not taxed, so there would be a government body looking into them, hopefully.

I imagine they have to follow certain rules; that the government would have rules they need to follow to get tax exemptions.

Haven't they got guidelines to be setup as a charity? I'm sure that the government has got ways.<sup>16</sup>

The presence or absence of a national charity regulator seems to be something the average citizen is content to ignore. Whether charities are regulated through tax filings or annual information statements, by several agencies or just one, these details are unlikely to filter down into the national consciousness, where any effect on trust levels would occur. In the minds of most citizens, the answer to the question of how charities are regulated in their country will continue to be, as the focus group respondent said, 'I'm sure that the government has got ways.'

### **Objective #3: Police fraud and wrongdoing**

The purpose of any regulation is to reduce the incidence of some form of wrongdoing, or to pre-emptively deter potential wrongdoers. In the case of the ACNC, the questions to ask are: What sorts of wrongdoing exist in the not-for-profit sector? How prevalent are they? Is a national regulator the type of enforcer best suited to the specific problems the sector faces?

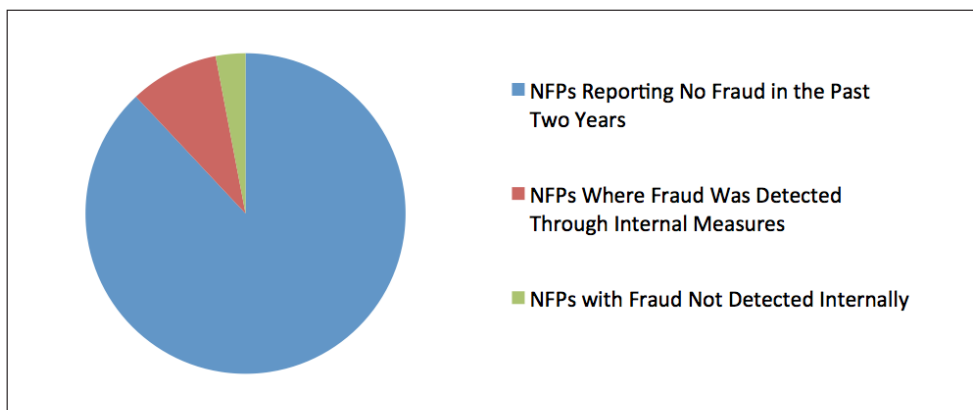
The broad category of 'fraud' encompasses most of the serious forms of wrongdoing that can take place in the NFP sector, from embezzlement to brand fraud to outright scams. The accounting and consulting firm BDO Australia has conducted a Not-for-Profit Fraud Survey every two years since 2006. The survey results show that fraud is a minor and declining problem for NFPs in Australia, and that the types of fraud that occur most frequently are not well suited to regulation by a national commission.

Only 12% of charities surveyed in 2012 had experienced fraud in the previous two years, down from 19% in 2006, a decline that obviously predated the ACNC. By far the most common type of fraud was cash theft, which accounted for 40% of incidents. Cash theft can be as mundane as a volunteer pocketing money from the cash box after a lamington sale, and of all types of fraud it involves some of the smallest average dollar amounts.<sup>17</sup>

In most cases (61%), the fraud was discovered by the charity itself, through either internal controls or an employee tip. External audits were responsible for detection in a mere 4% of cases. This makes sense. Fraud is usually perpetrated by a single



**Figure 2: Fraud: A minor and decreasing problem**



**Source:** BDO Not-for-Profit Fraud Survey 2012.

employee acting alone, so the guilty party's co-workers are almost always the people best positioned, most equipped, and most motivated to detect and eliminate fraud. It is telling that even in countries with established charity commissions, such as the United Kingdom and pre-2012 New Zealand, it is still usually a whistleblower or a media story that alerts the commission to an instance of fraud worth investigating.<sup>18</sup> Charities commissions, by their nature, are better at punishing fraud than detecting it.

Regulators also face the problem of charities' reluctance to cooperate with outside investigations. A surprising 57% of charities that detect fraud do not report it to the police, usually due to worries that a police report would harm the organisation's reputation.<sup>19</sup> Charities are even more protective of their reputation than business firms are, for obvious reasons. A business that suffers a highly publicised incident of white-collar crime still has its products to fall back on. Consumers who distrust the company may well continue to purchase its wares as long as the price and quality are right. A charity, on the other hand, has little to offer apart from its ability to credibly assure donors that their money will go to doing good, which makes blows to a charity's reputation truly catastrophic.

Given the difficulties of policing fraud, some nations' charities commissions adopt a different model in their approach to wrongdoing. Under this model, the commission's primary role is consultative, advising charities on best practices and how to stay within the law, on the logic that a large proportion of the violations that occur in the NFP sector are the result of ignorance rather than ill will. This approach addresses forms of illegality other than fraud—for example, cases where an organisation obtains tax exemptions even though its activities do not fit the legal requirements for charitable status. The ACNC is designed to incorporate both the enforcement model and the 'centre of excellence' model into its mission.

Unfortunately, attempting to act as both enforcer and consultant tends to work poorly in practice. The Charity Commission for England and Wales was also designed to fulfil both roles, but according to a report from the Centre for Policy Studies, the commission is focusing almost entirely on investigation and enforcement, to the exclusion of its advisory responsibilities. The primary reason is that the commission only gives advice when charities solicit it, and charities are reluctant to attract the commission's attention if there is a danger that it will lead to further aggressive investigation. The CPS report gives this analogy: 'If a member of the public wished to seek advice about the legality of an activity, he would go to a lawyer rather than to the police.' The Prime Minister's Strategy Unit review of 2002 also found that 'the blurring of boundaries between the Commission's advisory and regulatory roles continues to cause confusion.'<sup>20</sup>

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At the ACNC, this same 'blurring of boundaries' has already produced confusion to a significant, even crippling, extent. In late October 2013, *The Australian* reported that the commission's director of compliance had quit in July after only months on the job, and 8 of the 10 investigators in the compliance unit had also quit in the previous 10 months. One of the departed investigators, a former inspector with Victoria Police, told the paper, 'If the government knew what's going on in there, they'd find better ways to spend their \$53 million because it's an absolute waste of time.' An independent review of the ACNC conducted in June discovered 'uncertainty, confusion, and anxiety' among staff due to ineffective management.<sup>21</sup>

At the heart of this staff exodus was a fundamental difference of approach between the investigators, who were mostly law-enforcement veterans, and their managers, who were more likely to be civil servants and bureaucrats. The investigators felt frustrated at their superiors' reluctance to aggressively pursue reported cases of wrongdoing; their managers responded that a collaborative approach had always been their intention. According to an ACNC report released in September 2013, the commission had received 245 complaints since its inception, of which only 56 were found to be worthy of investigation. (There are approximately 60,000 registered charities in Australia.) Investigators into those cases found their efforts stymied and even 'blocked,' as one put it. Observing the situation from the outside, the head of the NFP-sector peak body Community Council for Australia said, 'It was perhaps not the right call to originally hire from the ranks of former police officers.'<sup>22</sup>

In the days after *The Australian* article was published, Deputy Commissioner Murray Baird responded to the ex-investigators' allegations by saying that 'the ACNC does not investigate criminal activity, as these matters are for the police.' This statement sums up the final reason why the ACNC is unlikely to be an effective regulator of the NFP sector. Before the ACNC was founded, law enforcement agencies had already established a solid record of pursuing charity scams and frauds.<sup>23</sup> If law enforcement will continue to fill that role even after the ACNC's entrance onto the scene, then it becomes less and less clear what role the ACNC has to play in the regulation of the NFP sector.

### **Declining confidence in charity commissions abroad**

The launch of the ACNC came at an inopportune time for national charities commissions in the English-speaking world. International comparisons were one of the motivations behind the commission's founding, with the United Kingdom, Canada, New Zealand and Ireland all cited in the explanatory materials attached to the 2012 ACNC bill as countries that had outpaced Australia in NFP regulation. But at least two of those countries had by 2012 already begun to doubt the value of their charities commission, and one of them has scrapped it entirely as a waste of taxpayer money.

In June 2012, the Key government abolished the New Zealand Charities Commission and handed its responsibilities to the Department of Internal Affairs. In seven years, only 30 charities had been removed from the charities register after investigation by the commission, and only three were removed for serious fraud or wrongdoing. The rest were deregistered due to questions over whether their missions truly fit the legal definition of 'charitable.' These were usually subtle and academic disputes over the precise meanings of legal terms, and among the groups deregistered in this way were such venerable organisations as the New Zealand National Council of Women (NZNCW); a district branch of the Rotary Club; and Business Mentors NZ, the country's largest not-for-profit mentoring group.<sup>24</sup> (The NZNCW regained its charitable status in 2013 after a judicial appeal.) The Key government calculated that it could save \$2 million over four years by abolishing the New Zealand Charities Commission (NZCC), with little risk that regulation of



the sector would decline in quality, so it prudently abolished a body that simply was not providing value for money.<sup>25</sup>

In the United Kingdom, the flashpoint for doubts about the Charity Commission for England and Wales was the Cup Trust scandal of 2013. The charity in question was in fact a tax-avoidance scheme that brought in £176 million over two years and distributed only £55,000, and despite several red flags, the commission continued to certify Cup Trust's charitable status.<sup>26</sup> This scandal amplified the impact of earlier allegations by a former caseworker. This ex-employee reported that the commission relied entirely on Her Majesty's Revenue & Customs to alert it to financial wrongdoing by charities and would only investigate a charity if the HMRC or a member of the public requested it. 'All of this means that the detection rate is very, very low,' he concluded.<sup>27</sup> Capping this series of blows to the commission's reputation was the revelation that the commissioner, William Shawcross, was being paid £50,000 per year for two days' work per week.<sup>28</sup>

An investigation by Parliament's Public Accounts Committee (PAC) led to a report in June 2013, which found that 'the Charity Commission's approach to regulation and enforcement lacks rigour.' The PAC also warned that it would immediately launch a 'thorough investigation of the Charity Commission and whether it is fit for purpose.'<sup>29</sup> If this report is as negative as its predecessor, the commission could see its duties handed over to other departments.

### **Charity watchdogs: An independent form of NFP regulation**

The decline in the reputation of national charities commissions has coincided with another development in the world of NFP regulation: the growth of independent charity watchdogs such as GiveWell, GuideStar and Charity Navigator. These groups perform many of the same functions as government charity regulators but with less intrusion, and they also provide donors and charities with additional services that government regulators do not—and in some cases cannot or should not—provide.

As far back as the 1970s, local civic groups have offered 'seals of excellence' or 'seals of approval' to charities that meet certain criteria for financial and operational soundness. Charities could then advertise this accreditation in their fundraising materials, and the boost in donations that came with these seals was often significant enough that the charities themselves were willing to pay as much as \$15,000 to cover the cost of the original audit.<sup>30</sup> However, cost and other logistical limitations prevented these 'seal' programs from operating on more than a local scale. Most were confined to single metropolitan areas and rated only dozens or hundreds of charities. This changed with the advent of the Internet.

More than a dozen online charity evaluators are operating in the United States, the United Kingdom and elsewhere, with each site covering thousands or even millions of charities in up to 35 countries. Each charity evaluator has a different approach, but the general model is the same. The evaluator obtains information about charities from publicly available government documents (such as IRS forms in the United States), from the charity's own website, or by asking the charity to voluntarily submit information. The evaluator then posts some or all of this information on its own website, usually with its own evaluation of the charity attached in the form of a letter grade or a star rating.

The proliferation of these national and international evaluators has led to a diversification of ranking systems as each watchdog site tries to set itself apart from its competitors. Philanthropedia, for example, incorporates into its rankings the opinions of 'foundation professionals, academics, researchers, non-profit senior staff, policy makers, and other professionals.' These opinions are weighted based on the expert's credibility and experience. Charity Navigator uses a simpler algorithm for ranking charities, focusing primarily on publicly available financial records, but

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this simplicity allows it to apply its rating system to more charities. GiveWell does not offer a searchable database, only an annual list of three Top Charities chosen for their effectiveness, transparency and financial health. In 2012, GiveWell removed the charity VillageReach from its list after ranking it #1 for three years, not because the group had become less worthy but because ‘it has now received over \$2 million due to GiveWell’s recommendation [and] we do not believe that VillageReach has short-term funding needs.’

Donors have responded enthusiastically to these new resources. In 2007, Charity Navigator reported 5 million users, and in 2008 GuideStar had 8 million. Interest tends to spike in the wake of large disasters, when donors are eager to give but worried about falling victim to opportunistic scammers. In 2004, when charity evaluator sites were still quite a recent development, Charity Navigator saw its daily hit count increase tenfold to 50,000 visitors per day in the week after the Asian tsunami of 26 December.<sup>31</sup>

### **Independent watchdogs versus charities commissions**

The organisations behind these sites are mostly not-for-profits themselves, and their ability to subsist on donations—or, in the case of GuideStar, donations plus user fees for access to premium data analyses—suggests a real demand for the services they provide. These services include some that government charities commissions were also meant to provide, namely searchable databases of charities that offer basic information about the goals and characteristics of charities, as well as ‘black lists’ of known scammers and frauds. Comparisons of records on shared goals show charity evaluators as better able to meet these goals than their government counterparts, for several reasons.

The first is competition. Like all not-for-profits, these evaluator sites depend a great deal on their reputation, and the desire to avoid embarrassing scandals keeps them vigilant. During its Cup Trust scandal, the Charity Commission for England and Wales was subjected to parliamentary investigation that, so far, has not forced any changes to the commission’s operations. If it had been an independent charity evaluator, it would have been forced to reform its practices quickly or else see its users and donors flock to alternative sites.

An example of how this competition works in practice came in 2011 when Greg Mortensen, author of the bestselling and award-winning book *Three Cups of Tea*, was found to have fabricated much of the information in his book and in the promotional materials for his charity, the Central Asia Institute (CAI). At the time the scandal broke, Charity Navigator rated CAI four stars. Their president quickly announced that the site would make adjustments to its rating system, and when the new system was finalised, CAI was retroactively awarded zero stars.<sup>32</sup> On the other hand, the American Institute of Philanthropy (AIP), which runs the site Charity Watch, was able to point to a 2010 report in which it had flagged CAI as a risk after AIP’s requests for financial documents were first ignored and then refused.<sup>33</sup> GiveWell said that it, too, had long been alarmed by CAI’s reluctance to provide information when asked. The history of GiveWell’s scepticism was described in the online article, ‘Why we had the right bottom line on the Central Asia Institute.’<sup>34</sup>

Competition has also led to sector-wide improvements in the way charities are evaluated. In the early stages of online charity evaluation, so much emphasis was placed on overhead ratios (the percentage of a charity’s budget devoted to administrative and fundraising costs) that it had produced what the *Stanford Social Innovation Review* termed a ‘Nonprofit Starvation Cycle.’<sup>35</sup> Pressure from donors would force a non-profit either to misreport its overhead budget or to cut overhead spending to dangerously low levels; the result would be weaker charities and continuing unrealistic expectations from donors. In June 2013, the heads of GuideStar, Charity Navigator, and the Better Business Bureau’s Wise Giving

Alliance penned a widely publicised open letter calling overhead ‘a poor measure of a charity’s performance’ and asked donors to ‘pay attention to other factors of nonprofit performance: transparency, governance, leadership, and results.’<sup>36</sup> This letter, and the accompanying ‘Overhead Myth’ publicity campaign, allowed these organisations to change their ranking algorithms without alienating donors.

The second advantage of independent charity evaluators is the broad array of penalties they can inflict when charities fail to meet their standards. Government regulators usually have only one or two punishments in their regulatory arsenal. The ACNC, for example, is empowered to revoke a group’s charitable status and, in extreme cases, suspend its board members. The absence of intermediate levels of punishment can lead to minor offenses going entirely unpenalised. In the United States, revocation of tax-exempt status was for many years the only punishment the IRS could inflict upon a charity engaged in wrongdoing, and ‘because this draconian penalty was its lone option, the IRS rarely sanction[ed] wayward organizations except in the most egregious cases,’ according to one legal scholar.<sup>37</sup>

But if government regulators are like a ‘pass/fail’ grading system, independent watchdogs are more like letter grades. This allows them to be sensitive to offenses that are not serious enough to warrant decertification but are still of interest to potential donors—administrative inefficiency, for example, or abnormally high CEO compensation. These can be flagged on a charity’s profile page or factored into a small reduction in its star rating.

The third and perhaps most important advantage of these sites is they allow charities to preserve their independence. When GiveWell and Charity Watch request information from charities, compliance is entirely voluntary. Usually the incentive of having a positive rating on these sites (or fear of having a suspicious-looking ‘question mark’ rating) is enough to persuade charities to be transparent, but small organisations are not forced to comply with red tape that would overtax their resources. Bare-bones watchdogs like Charity Navigator rely entirely on publicly available information (usually tax forms or annual corporate filings), which imposes no additional reporting burden at all. Yet Charity Navigator is still able to identify and highlight ‘10 Charities Overpaying Their For-Profit Fundraisers,’ ‘10 Highly Paid CEOs at Low-Rated Charities,’ and ‘10 Consistently Low Rated Charities,’ based entirely on public financial records.

### **Evaluating effectiveness: The next frontier in charity evaluation**

The three advantages listed above explain why independent charity regulators outperform government regulators in areas where their missions overlap. But independent watchdogs have also started to provide a new service that no government regulator should ever attempt to offer: rating charities by effectiveness.

Surveys show that the most important concern for the average potential donor is whether a charity’s efforts ‘make a positive difference.’<sup>38</sup> This ranks higher than whether a charity is transparent or how much it spends on administrative overhead. Unfortunately, not-for-profit organisations cannot produce annual balance sheets quantifying their accomplishments the way for-profit businesses can. The difficulty of measuring social impact has long been one of the thorniest issues facing the NFP sector’s donors and investors. Until recently, most dismissed the idea of a reliable effectiveness metric as a pipe dream.

This pessimism has diminished in the past decade, partly due to the influx of venture capitalists and former financial-sector workers into the philanthropy market. Martin Brookes, a former Goldman Sachs employee and founder of New Philanthropy Capital (NPC), explained his reason for developing his own method for scoring charity success: ‘When you come into this world from Goldman, you realize how screwed up it is as a market.’ The two co-founders of GiveWell also made their fortunes as hedge-fund analysts, which may be why they give

**In the United States, nearly 75% of charities have invested more money in results measurement in the last five years.**

**Most large charities already prepare financial reports.**

high marks to charities that (as the GiveWell site puts it) make ‘straightforward, evidence-backed value propositions such as “\$X delivers Y bednets, which saves Z lives.”’ NPC and GiveWell are only two of the many organisations now attempting to develop systems for quantifying philanthropic effectiveness, an effort that frequently receives the active cooperation of charities themselves. In the United States, nearly 75% of charities have invested more money in results measurement in the last five years.<sup>39</sup>

One of the challenges facing these would-be quantifiers is the risk that their schemes will have a flattening effect on a charity’s activities. When any system of measurement is introduced, there is a danger that it will inadvertently produce a situation where only what gets measured gets done at all. For example, if an employment agency is rewarded based on the number of job applicants it places, it may decide to focus its efforts only on easy cases and neglect the disabled, the long-term jobless, and other more difficult clients.

This danger can be avoided if multiple systems of impact measurement are allowed to flourish, making it less crucial for charities to tailor their efforts to any one axis of achievement. This diversity is especially important in these early years when impact measurement is still in its infancy and its methods are still being refined. The shortcomings of the system known as RM (Relentless Monetisation) may well be improved by lifting lessons from SROI (Social Return on Investment), or vice versa. Even as these methods evolve and become more stable, hard-nosed donors may still choose to put their trust in GiveWell’s number-crunchers while more visionary donors opt for Philanthropedia’s holistic approach. In a delicate field like social impact measurement, diversity will always be valuable—and diversity is exactly what would be sacrificed if a government charity commission were to impose one system of measurement on all charities regardless of their differences.

Thankfully, most national charity commissions seem to realise that measuring charity effectiveness is not an appropriate goal for a government regulator. The chief executive of the English Charity Commission flatly stated in 2013: ‘We don’t say anything about how well a charity operates, so if you’re wanting to give to a charity you need to find ways of ensuring yourself, beyond the regulator, that this is a good charity.’ The ACNC, too, has restricted itself to the modest goal of certifying that the organisations listed in its national register (1) truly qualify as charities under the law, and (2) are not scams or frauds. But if independent charity evaluators like GuideStar and Philanthropedia can reliably provide this information for any given charity, in addition to the effectiveness ratings that donors consider far more valuable, then the government register will have been rendered obsolete.

### **The prospects for independent charity evaluators in Australia**

In January 2013, the Australian charity database Givewell Australia (no relation to the American-based evaluator GiveWell) announced that it would be ceasing operations after 13 years. In the press release announcing its closure, Givewell explained: ‘We anticipate that the sort of data that Givewell provides will ultimately become available through the Australian Charities and Not-for-Profits Commission.’<sup>40</sup>

Even before Givewell closed, there were no websites like GuideStar or Charity Navigator operating in Australia, and there are none operating currently. This is not so surprising, since larger charity markets like the United States and Great Britain have seen their own charity-evaluator networks evolve only in the last five or ten years. But GuideStar recently began expanding its operations into new countries, with partner sites now operating in Belgium, India and (as of 2010) Israel. Seventy per cent of Australians give to charity, compared with 40% of Belgians and 51% of Israelis. With a market that size, it is likely that Australia will be a target of further expansion by GuideStar or a similar site.

There are some policy changes that should be anticipated for the entry of charity evaluators into the Australian market. The first is the abolition of the ACNC. The demise of Givewell Australia proves that concerns about the ACNC crowding out competitors are well founded. It may well be true that the particular information formerly offered by Givewell will soon be supplied by the ACNC's online register, but as we have seen, by their very nature independent charity evaluators often provide *more* information than government regulators. It would be a great loss to the donors of Australia if the ACNC were to crowd out competing sites with an inferior service funded by the taxpayer.

One disadvantage that charity evaluators will face when expanding into Australia is the relative dearth of publicly available government filings. In the United States, for example, the annual tax form that NFPs must file with the IRS (Form 990) is available to the public, which gives charity watchdogs access to detailed information about charities' finances. This is not the case in Australia, where the disclosure requirements for NFPs vary according to their organisational structure. However, it would not be necessary to legislate changes to the public availability of charities' annual reports to allow evaluators to do their work. Since most large charities already prepare financial reports—either to satisfy government reporting requirements or for review by the organisation's stakeholders—independent watchdogs could request that charities voluntarily make available to them those documents that cannot be obtained from ASIC or an information broker. Many large charities, like Red Cross Australia, already post their annual financial reports on their websites.<sup>41</sup>

The overall transparency of the NFP sector is likely to increase in the next few years in any case. Generally, transparency tends to improve when very wealthy donors become a prominent feature of a country's charitable sector. Donors of large sums conduct far more research than middle-income households before making their charitable donations, and they also have more clout when requesting information from charities. This raises what may be the most significant development in Australian philanthropy in the past decade: the increasing importance of high net worth donors.

### The rise of high-wealth donors: An overdue boon

Relative to other countries, Australia's donation market has long featured fewer high-wealth donors and more small household givers. In the United States, for example, the average charitable donation for those with incomes more than US\$200,000 in 2007 was \$21,246.<sup>42</sup> In Australia, in 2009–10, the equivalent average for those making AU\$200,000 or more was \$3,793.<sup>43</sup> This has begun to change, partly due to the mining boom. 'There's no question we are now starting to see what I would call mega-gifts on that North American scale,' says Louise Walsh of Philanthropy Australia. Philanthropy expert Gina Anderson agrees:

It's really now filtering through after the big boom ... We are also seeing the phenomenon of giving while you're living. Up until around 2000, most philanthropic foundations and trusts were set up through wills and bequests, when people died.

The rise in high-wealth philanthropy began in 2001 when the Howard government passed a law to allow prescribed private funds (PPFs), later renamed private ancillary funds (PAFs). Before PPFs were created, a family or corporate fund could qualify for tax deductibility only if it solicited and received funds from the public. This requirement, with its attendant publicity and added workload, discouraged many who otherwise would have been eager to deposit a large sum into an account, take a single tax deduction on that deposit, and then conduct their charitable giving in the more planned and long-term way that such a fund allows. Under the rules

**'We are now starting to see what I would call mega-gifts on that North American scale.'**



**Established foundations are offering courses on giving wisely.**

governing PAFs, six- and seven-figure donors are free to do this, provided the fund has one trustee from outside the family or company, and provided its subsequent gifts go to charities that qualify for deductible gift recipient (DGR) status. Response to this new option was very positive, and by June 2012, there were more than 1,000 PAFs with total assets of more than \$2.2 billion. This is in addition to the approximately 2,000 foundations and trusts incorporated under the old system.

It is significant that PAFs are a 'pull' rather than a 'push' policy—they offer enticements to give, not punishments for not giving. A survey of PAF stakeholders conducted in 2012 revealed that many remember the era of extremely high death duties in the state of Victoria. As one respondent described it, 'Probate duties were horrendous and the options for people were to give it to tax or set up a ... foundation.'<sup>44</sup> Although these death duties did lead to a higher-than-average number of charitable foundations being set up in the state, the motivations were entirely negative. When observers complain that Australia has long lacked a 'culture of giving'<sup>45</sup> among those with the most resources, the prevalence of negative rather than positive motivations may be one underlying cause.

### **Wealthy donors demand oversight**

Considering the size of the sums involved, it is not surprising that wealthy donors are exceptionally zealous about ensuring that their money is given wisely. They take great care in every stage of the giving process, from selecting a charity to following up on the results achieved by multi-year commitments. With the entry of more and more high-net-worth donors into the giving market since 2001, many resources have evolved to serve their appetite for advice, expertise and investigation.

The first is informal networks. The 2012 PAF stakeholder survey featured many references to casual advice-giving:

There's a sort of camaraderie amongst those people that have got PAFs to help each other out.

The couple of functions that I've gone to I've found very, very interesting. You're meeting likeminded people.

Our trustee, if they get a call from someone that's thinking about that, they'll quite often send their names over and I'll have a chat with that person. So there's a really good network or informal network that exists.

I initially just started by talking to anyone else from other corporate foundations that would talk to me ... They came in and shared their experiences, were just really fantastic and helped us a lot to get a picture.

In addition to these informal circles, respondents also mentioned professional associations, trade and academic publications, 'organisations where grantmakers can get together and swap notes,' and other more formal sources of up-to-date information. Some of the more established foundations are offering courses on giving wisely, and Philanthropy Australia hosts seminars and conferences for both grantmakers and grantseekers.<sup>46</sup> In 2013, course titles included 'Assessing Social Impact for Grant-Makers,' 'Governance of Ancillary Funds for Auditors,' and 'Impact Investing 101.'<sup>47</sup>

Equally important has been the change in attitude among financial advisers. Most people with significant wealth delegate the management of that wealth to a financial planner. Until recently, these professionals rarely raised the topic of philanthropy with their clients, either because they did not feel equipped to give



good advice on the subject or because they did not consider it to fall within their professional responsibilities. This is beginning to change. In 2002, a survey by the Australian Centre for Philanthropy and Nonprofit Studies found that only 14% of financial advisers were willing to provide philanthropy strategies to clients who requested it. By 2005—only four years after PAFs came into being—that figure had risen to 50%.<sup>48</sup> In May 2012, the private investment management firm Harper Bernays created the position of ‘Philanthropic Adviser’ and appointed an NFP-sector veteran to serve in that role assisting clients to determine how best to include charitable giving in their financial plans.

Like independent charity watchdogs, wealthy philanthropists and PAF trustees put significant effort into verifying the financial and operational soundness of charities. Donors with business experience may ask to review a charity’s books themselves; others will hire a professional to review them. Many use the clout that comes with deep pockets to thoroughly investigate potential grant recipients. One survey respondent paraphrased her process this way:

I need further information. Who else is supporting you? How many people? What are your running costs? How many volunteers? Basic information resources that the organisation can provide us with.<sup>49</sup>

Wealthy donors have also been enthusiastic participants in the drive to measure the effectiveness of charitable programs. It is common for large donations, especially those that span multiple years, to include funding for a professional evaluation of the social impact of the programs funded by the donation. Social Ventures Australia claimed in February 2012 that out of 49 Social Return On Investment (SROI) reports prepared by them in the previous year and a half, the majority had been funded by ‘investors’ (i.e. donors) with the cooperation of the charities being evaluated.<sup>50</sup> SROI is the most popular social-impact measurement in Australia, but others, like Social Accounting & Audit (SSA), are also in use.

None of this oversight is motivated by government requirements. Wealthy donors confer among themselves about best practices, ensure charities’ financial probity, and try to measure programs’ social impact because these safeguards are in their interests. Like household donors who give small amounts, wealthy philanthropists do not like to see their money wasted. Unlike household donors, wealthy philanthropists have the time, resources and influence to implement oversight on their own behalf.

### **An especially bad time for overregulation**

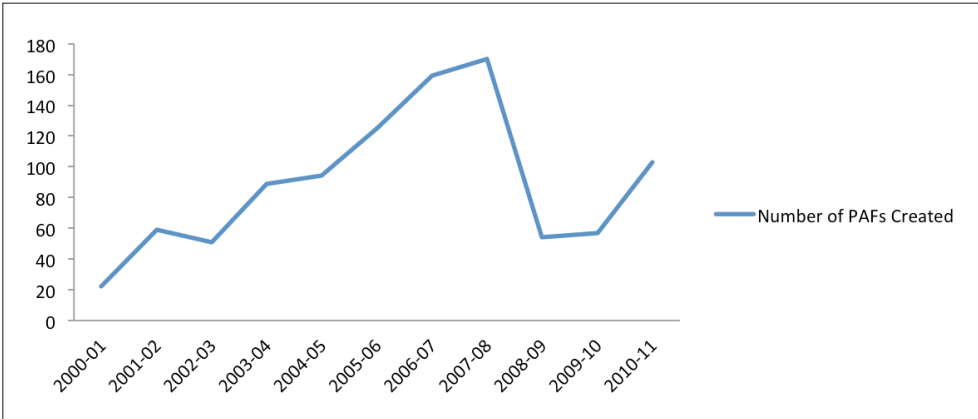
Australia’s wealthy and ultra-wealthy have lagged behind their peers in other countries in their charitable giving. In the United States, families with a net worth of \$1 million or more were responsible for 50% of all charitable donations in 2002. In Australia in 2010, the ‘mid-point’ in donations by income level was \$70,000: half of all tax-deductible dollars given to charity were donated by people making less than \$70,000 per year, half by those making more. The growth in the amount donated to charity by the affluent has not kept pace with the even greater growth in their incomes over the past decade.<sup>51</sup> Gifts from the very wealthy are where Australia’s donation market has the most room to grow.

Now that Australia’s rich are beginning to get more involved in the charitable sector, it would be counterproductive to discourage their efforts by adding to their regulatory burden. The removal of unnecessary regulations was what kickstarted the growth in high-wealth giving in the first place, with the easing of regulation surrounding private funds and foundations. It will take time for this initial enthusiasm for PAFs to develop into a stable ‘culture of giving,’ which makes the current moment a bad time to make charitable giving more difficult or complicated.

**Wealthy philanthropists have proven to be sensitive, even skittish, about proposed changes to the regulations governing their donations.**

**Overregulation  
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first place.**

**Figure 3: Number of PAFs Created**



**Source:** The Australian Centre for Philanthropy and Nonprofit Studies, ACPNS Current Issues Information Sheet 2013.

In the past, wealthy philanthropists have proven to be sensitive, even skittish, about proposed changes to the regulations governing their donations. In the first few years after the PAF law was passed, the number of new funds created each year rose steadily. This positive trend was dramatically reversed between 2008 and 2009, with the number of new funds dropping by 70%.<sup>52</sup> This sharp decline coincided with Labor government proposals to alter the law governing these funds, which if passed would have made trustees' contact details available to the public and increased to 15% the share of the fund required to be distributed annually.<sup>53</sup> Once these proposed changes were scrapped and the regulatory uncertainty ended, the number of new PAFs founded each year resumed its steady increase.

A similar bout of regulatory uncertainty has followed the introduction of the ACNC. Under the law creating the commission, the ACNC Charity Register would have publicly displayed the contact details of PAF donors, robbing philanthropists of their anonymity and potentially subjecting them to unwanted solicitations from grant-seeking charities. In 2013, the rules were amended to allow PAF donors to request that their details be kept private. However, they are required to submit a formal request (Form AE: Private ancillary funds—Information on register) to the ACNC; if this form is not filed, the default is still public disclosure.<sup>54</sup> Even after this amendment was announced, many PAF trustees were unaware that their details would soon be listed on a public database. The ACNC itself was so worried about the lack of publicity surrounding this rule that it extended the deadline for submitting the privacy-request form from November 2013 to March 2014.<sup>55</sup>

High-wealth giving in Australia is only beginning to grow to its full capacity, and overregulation should not be allowed to nip this growth in the bud. In the last decade, economic prosperity and the mining boom have produced many large fortunes. High-profile donors like Graham Tuckwell and Andrew Forrest are setting a virtuous example for their peers by donating seven- and eight-figure gifts. After a brief hiccup in 2009, philanthropists are once again embracing PAFs as a way to structure their giving in a more strategic and long-term way. With adequate oversight already in place—PAFs are still required to file audited financial statements with the ATO, even after the creation of the ACNC—the federal government should step back and allow these positive trends to develop.

## Conclusion

The problem facing the NFP sector in Australia is one of too much regulation, not too little. Public trust in the sector is high, fraud is steadily declining, and even before the ACNC was introduced there were more than enough oversight mechanisms in place, from sector-wide regulators like the ATO to sector-specific ones like ACARA, ACECQA, and ACSAA (governing schools, child care, and aged care facilities, respectively). In the case of charitable NFPs, the challenge is to pare this regulatory burden while still reassuring donors they can give their time and money confidently. The ACNC is unlikely to provide an effective solution to this dilemma.

Fortunately, it is now possible to provide adequate oversight for the NFP sector by non-government means. Donors of large amounts have found that it is in their own interests to guard against fraud and inefficiency in the charities to which they donate. Household givers who once lacked the means to conduct oversight on their own are now using online charity evaluators, and as these independent watchdogs continue to grow popular and the technology they use continues to advance, their value will continue to increase.

Non-government regulation is not just a matter of saving taxpayer money. It is crucial to preserving one of civil society's greatest resources: its independence. When the Australian government first began contracting out services to NFPs, it was expressly because these groups were closer to their clients, more zealous in their missions, and more willing to experiment with innovative solutions than their government counterparts. All these advantages have been undermined by increasing government interference in the past 20 years. If a solution to this problem is not found, then overregulation may destroy the very virtues that brought charitable organisations into the government's orbit in the first place.

Most people think of charity regulation as a trade-off: Red tape is a significant burden with many costs and disadvantages, but we must put up with it to ensure the charity sector is well governed. The success of independent charity watchdogs and wealthy-donor-imposed oversight demonstrates that it may be possible to have a well-regulated charity sector without imposing any additional mandatory reporting requirements.

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