

**The California Nonprofit Integrity Act: An Examination of  
the Implementation of Corporate Governance**

**DRAFT**

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## **Introduction**

Corporate governance in nonprofit organizations has taken on a new and heightened public visibility in recent years, as the benefits of the Sarbanes-Oxley Act have been noted in the private sector and as nonprofits have suffered their own public failures of accountability. Instances of failures of effectiveness in carrying out their missions, failures of accountability for financial resources and reporting, and failures to adequately screen volunteers have increased pressure on lawmakers to better regulate the nation's 1.3 million charities (Woods, 2005). Several states have already passed legislation requiring better accountability for financial reporting and professional fundraising, the most comprehensive of those laws passed in California and New York (Ford, 2005). This paper examines the implementation of the corporate governance portions of the California Nonprofit Integrity Act in relation to the literature on audit committee effectiveness in the for-profit sector.

## **Background:**

In the same manner that financial scandals in the for-profit sector led to the American Competitiveness and Corporate Accountability Act of 2002 (commonly known as the Sarbanes-Oxley Act), an increasing number of corporate governance failures in tax-exempt organizations are causing lawmakers to extend many of the corporate governance features of that Act to the nonprofit sector. The Red Cross, in particular, has been hard hit by scandal at both the national and local level. Mishandling of funds donated for fire victims near San Diego in 2001 led to the ouster of the executive director and the entire Board of the local Red Cross chapter (Vigil, 2004). More questions arose

regarding the Red Cross's handling of donations to the victims of the September 11<sup>th</sup> terrorist attacks (Red Cross, 2001). And more recently, the Senate Finance Committee opened an inquiry into the governance of the organization and its compensation policies in the wake of the Hurricane Katrina disaster (Strom, 2005), partially in response to a growing list of arrests for wire fraud at a Red Cross call center in Bakersfield, California (Malnic, 2005). However, the misconduct has not been limited to the Red Cross. In the wake of the September 11<sup>th</sup> irregularities at Washington, D.C.-area charities, a study by the Center for Public Service at the Brookings Institution found that "the percentage of people who say they have no confidence in such organizations has doubled since July 2001, to 16 percent," (Salmon, 2002). Such a decline demonstrates the loss of public trust in organizations' abilities to manage effectively and illustrates the fragile nature of the relationship between the American public and the nonprofit organizations they support.

Governance failures at nonprofits, many of which have led to the public disclosure of the salaries and compensation packages available to executives, have led to increased scrutiny by the Internal Revenue Service. Following evidence that some charities were funding terrorist organizations, the IRS began to focus on compensation abuses at nonprofit organizations ("A Warning to Nonprofits:.."). The IRS Commissioner last year requested an additional \$490 million to expand nonprofit enforcement and audits (Woods, 2004).

Finally, the Senate Finance Committee has held hearings into abuses in nonprofit organizations, with an eye toward applying the reforms of Sarbanes-Oxley to nonprofit organizations (Woods, 2004). Although Congress has yet to act on these hearings,

several states have already enacted such legislation, the most comprehensive being the California Nonprofit Integrity Act of 2004 and the New York Not-For-Profit Corporation Law (National Council of Nonprofit Associations, 2005).

### **Effects of the Sarbanes-Oxley Act**

The Sarbanes-Oxley Act (SOX) contained many provisions designed to prevent fraud and strengthen the integrity of the financial reporting processes, as well as enhancing the corporate governance functions of publicly traded companies. Although most of the provisions of the Act do not specifically apply to nonprofit entities, there has been significant application of the Act by the Boards of nonprofit organizations. The Listening Post Project of Johns Hopkins University recently reported that “57% of the boards in their survey reported having an audit committee, with another 14% considering creation of such a committee,” (Salamon, 2005). In addition, of those organizations with audit committees, “99% of these committees were independent,” (Salamon, 2005).

SOX also requires that the Chief Executive Officer and the Chief Financial Officer of the organization certify the fairness of the financial statements for publicly traded companies. Although no state laws currently have included such a provision for nonprofits, it signifies the critical nature of the financial reporting process and the importance of review of the financial reports by the CEO/director of the nonprofit organization (Guidestar, 2005).

The two areas of compliance in which SOX does not distinguish between publicly traded organizations and nonprofit organizations is in document destruction policies and in whistleblower protection. The Listening Post Project reported that “84% of

organizations reported having a records-retention policy,” and only “30% reported having whistleblower protections in place. (Salamon, 2005).

### **Importance of the Nonprofit Sector**

Of the three million tax-exempt organizations in the United States today, 1.8 million are charities (Woods, 2004), 88,000 in California alone (McDonald, 2004). Independent Sector, a group which includes tax-exempt organizations under Sections 501(c)3 and 501(c)4 of the Internal Revenue Code, reports in its Nonprofit Almanac for 1997 (the last year revenue data was available), that nonprofit organizations accounted for \$664.8 billion in total revenues. In 1998, the Almanac also states that these nonprofits employed 10.9 million paid employees, including full- and part-time. By 2010, the number of employees is expected to grow to 15 million (McDonald, 2004). Clearly, these organizations have a significant economic impact. In California alone, nonprofit “organizations collect approximately \$70 billion in revenue and oversee total assets exceeding \$225 billion,” (McDonald, 2004).

These organizations are also important in terms of social function. Under the Internal Revenue Code definitions, these organizations encompass charitable, social welfare, and religious activities, functions which often are not widely duplicated in the private sector. In addition, the populations served by these organizations are often under-privileged or otherwise under-resourced, making it unlikely that the for-profit sector or governmental agencies would serve to replace these functions.

### **The California Nonprofit Integrity Act of 2004**

The California Nonprofit Integrity Act of 2004 focuses primarily on the audit committee function of corporate governance and on regulation of commercial fundraising

activities. Although the area of commercial fundraising is an important issue, this paper is restricted to the corporate governance issues under the control of the board.

### **Framework and Hypotheses:**

The for-profit sector has seen an increased emphasis on audit committees as a result of spectacular business failures, including Enron, Tyco, and Worldcom. The NACD's Blue Ribbon Commission recently updated its report on Audit Committees to include developments in this area, including changes in requirements and responsibilities due to recent reforms (BRC, 2004). These changes are the result of legislative concerns over composition of audit committees as well as heightened expectations by the investing public regarding audit committee responsibilities, i.e. an extension of the expectations gap from the audit report to the audit committee.

The responsibilities of the audit committee are generally framed in the literature in three broad elements of oversight: financial reporting processes, risk assessment and internal control management, and the audit function, both internal and external (BRC, 2004). This broad framework is further specified in a taxonomy on audit committee effectiveness as "four dimensions of audit committee effectiveness: composition, authority, resources, and diligence," (de Zoort et al, 2002).

This taxonomy defines composition of the audit committee as including expertise, independence, integrity, and objectivity. Integrity and objectivity are difficult to measure, particularly in the nonprofit, i.e. largely volunteer, sector. However, two well-established tenets of audit committee membership include independence and financial literacy (BRC, 2004), and SOX contains provisions to address both of these concerns. Section 301 requires members of the audit committee to be independent, and Section 407

requires that publicly traded companies disclose whether at least one member of the audit committee is a financial expert and if there is no designated financial expert, the registrant must explain why ([www.aicpa.org/sarbanes/index.asp](http://www.aicpa.org/sarbanes/index.asp)). Previous research has indicated the importance of independence even prior to enactment of SOX; Beasley et al (2000) found that companies which suffered frauds had less independent audit committees and less independent boards than companies which had no fraud. Scarbrough et al (1998) found that audit committee members were more likely to have better interaction with internal auditors if they were wholly independent. We hypothesize that boards will be largely independent as nonprofit entities seek to widen their sphere of influence outward into the community and will attempt to place unrelated community members on the board, and thus, the audit committee. However, we hypothesize that because of the affiliated nature of the organizations in the sample, the boards may not be wholly independent. We also hypothesize that audit committees will not contain a financial expert as the pool of such volunteer experts may be thinned by demand created by the Nonprofit Integrity Act, and because the Act does not require such an expert.

De Zoort's taxonomy next defines authority as responsibilities and influence, as derived from the Board of Directors and applicable statutes. In this case, the responsibilities and influence derived from the Board of Directors should come in the form of a charter, and the applicable statutes should include both the applicable sections of the Sarbanes-Oxley Act as well as the California Nonprofit Integrity Act. We hypothesize that audit committees in the sample will have a charter, and will have reviewed both the Sarbanes-Oxley Act and the California Nonprofit Integrity Act.

Resources include an adequate number of members, generally defined in the literature as a minimum of three, with a less well-defined upper bound. Resources also include access to management, external auditors and internal auditors (de Zoort, et al, 2002). We hypothesize that audit committees will have access to management, as they are volunteer members and nonprofits are dependent on volunteer goodwill in their communities. We also hypothesize that the audit committee will have free access to both external and internal auditors.

And finally, diligence is specified in the taxonomy as incentive, motivation, and perseverance, which are noted in the literature as an essential component of audit committee effectiveness. These characteristics are proxied in the literature by both the number of audit committee meetings (de Zoort et al, 2002) and by the time spent in such meetings (Collier and Gregory, 1998). We hypothesize that the audit committees will have met at least once in the past year. However, since the California Nonprofit Integrity Act, which specifies the creation of such committees, has been in effect only a year at the time of the survey, we expect the number of meetings to be four or less, i.e. one per quarter.

### **Data and Results:**

The data for the study was obtained by means of an electronic survey (see Appendix A) of approximately 80 nonprofit corporations affiliated with the California State University System (CSU), including campus foundations, student organizations, and housing corporations. Although the organizations are affiliated with the CSU, each is an independently incorporated organization with 501(c)3 status under the Internal Revenue Code, and each has a Board of Directors.



**Appendix A**

**SURVEY**

1. What is the maximum authorized size of your organization's Board of Directors?  
\_\_\_\_\_ members
2. What is the current size of your organization's Board of Directors?  
\_\_\_\_\_ members
3. Do you have a designated audit committee?  
Yes \_\_\_\_\_ No \_\_\_\_\_

If Yes:

- a. What is the size of the audit committee? \_\_\_\_\_ members  
How many members are external to the organization?  
\_\_\_\_\_ members
- b. Do the audit committee members have all necessary access to management? (I.e. regular meetings, availability for questions)  
Yes \_\_\_\_\_ No \_\_\_\_\_
- c. Does your committee have a designated financial expert? (I.e. either a CPA or a non-CPA financial expert)  
Yes \_\_\_\_\_ No \_\_\_\_\_
- d. Are the members of your audit committee independent? (I.e. not compensated or engaged in any financial transactions with your organization)  
Yes \_\_\_\_\_ No \_\_\_\_\_
- e. How do you establish the objectivity and integrity of the members of your organization's audit committee? What is your screening process, if any?  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_
- f. Do members of the audit committee have access to internal audit reports, if any? (I.e. CSU System audit report)  
Yes \_\_\_\_\_ No \_\_\_\_\_

g. Do members of the audit committee have access to external auditors?  
Yes \_\_\_\_\_ No \_\_\_\_\_

If yes, how many times did the audit committee meet with the external auditors, not including Board meetings?

Never met \_\_\_\_\_ 1 time \_\_\_\_\_ 2-3 times \_\_\_\_\_  
4 or more times \_\_\_\_\_

h. Does the audit committee have a charter of responsibilities from the Board of Directors?

Yes \_\_\_\_\_ No \_\_\_\_\_

i. Has the audit committee reviewed applicable state and federal law to determine their responsibilities?

Sarbanes-Oxley Act Yes \_\_\_\_\_ No \_\_\_\_\_

California Nonprofit Integrity Act Yes \_\_\_\_\_ No \_\_\_\_\_

j. How often does the audit committee meet?

Monthly \_\_\_\_\_ Quarterly \_\_\_\_\_ Bi-annually \_\_\_\_\_

Annually \_\_\_\_\_ Other (specify) \_\_\_\_\_

k. How long are the meetings of the audit committee?

< 1 hour \_\_\_\_\_ 1-2 hours \_\_\_\_\_ 2-3 hours \_\_\_\_\_

> 3 hours \_\_\_\_\_

If no audit committee exists:

a. Is your Board in discussion regarding creation of an audit committee?

4. Does your organization have a formal document destruction (or records retention) policy? Yes \_\_\_\_\_ No \_\_\_\_\_

Is the records retention policy documented? Yes \_\_\_\_\_ No \_\_\_\_\_

Is the policy communicated clearly to all employees? Yes \_\_\_\_\_ No \_\_\_\_\_

Does it cover electronic communication, e.g. e-mail? Yes \_\_\_\_\_ No \_\_\_\_\_

5. Does your organization have a formal policy protecting whistleblowers?

Yes \_\_\_\_\_ No \_\_\_\_\_

Is it documented? Yes \_\_\_\_\_ No \_\_\_\_\_

Is it communicated clearly to all employees? Yes \_\_\_\_\_ No \_\_\_\_\_

6. Has the audit committee (or finance committee) specifically discussed the control environment of your organization, i.e. the adequacy of internal controls?  
Yes \_\_\_\_\_ No \_\_\_\_\_ Don't know \_\_\_\_\_
7. Has the audit committee (or finance committee if no audit committee exists) specifically discussed risk assessment in your organization?  
Yes \_\_\_\_\_ No \_\_\_\_\_ Don't know \_\_\_\_\_
8. Does your organization have a Code of Ethics for employees?  
Yes \_\_\_\_\_ No \_\_\_\_\_
- Is it documented? Yes \_\_\_\_\_ No \_\_\_\_\_
- Is it communicated clearly to all employees Yes \_\_\_\_\_ No \_\_\_\_\_
9. Is your external auditor one of the Big Four accounting firms?  
(Deloitte & Touche, KPMG, PriceWaterhouseCoopers, or Ernst & Young)  
Yes \_\_\_\_\_ No \_\_\_\_\_
10. Do you have a policy of rotating the external audit firm on a regular basis?  
Yes \_\_\_\_\_ No \_\_\_\_\_
- If yes, how frequently do you rotate audit firms?  
Every \_\_\_\_\_ years

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