

California Adopts the "Nonprofit Integrity Act of 2004"

Ever since enactment of the federal Sarbanes-Oxley legislation in 2002, which addressed corporate governance and accountability issues in publicly-traded corporations, exempt organizations and their advisors have watched carefully to see if states would follow suit with comparable legislation applicable to charitable organizations. California, Massachusetts and New York were among the first states where such legislation was either introduced or circulated for discussion.

On September 30, 2004, Governor Arnold Schwarzenegger signed S.B. 1262, the "Nonprofit Integrity Act of 2004" (the "Act"). The Act, which becomes effective on January 1, 2005, seeks to improve corporate governance, accountability and transparency in the California nonprofit sector in much the same manner as the recently enacted Sarbanes-Oxley legislation affects the for-profit community. In furtherance of this goal, the Act imposes a number of significant new requirements affecting both the operations of charitable organizations and the commercial fundraisers with whom they do business. Among the Act's major provisions are the following new requirements:

Preparation of Audited Financial Statements by Organizations Grossing \$2,000,000 Annually

Certain charitable organizations (including corporations, unincorporated associations, trustees and other legal entities holding property for charitable purposes) doing business or holding property in California for charitable purposes must now prepare audited financial statements in accordance with "generally accepted accounting principles" ("GAAP") in any year in which the organization receives or accrues gross revenue of \$2,000,000 or more. (Grant and service contract revenue from governmental entities is not counted as long as the governmental entity requires an accounting of the funds received.) The statements must be audited by an independent certified public accountant and made available to the California Attorney General and the public within nine months of the close of the applicable fiscal year in the same manner prescribed for IRS Form 990. If the firm conducting the audit also performs nonaudit services, the firm and its auditors are required to adhere to the standards for auditor independence set forth by the federal government. Under the Act, the Attorney General may prescribe standards for auditor independence different from those of the federal government.

Exemption for Certain Entities

Any charity organized and operated primarily as a religious organization, educational institution, hospital or licensed health care service plan is exempted from the audited financial statement requirement.

Formation of an Audit Committee

All charitable corporations that are required to prepare audited financial statements must have an audit committee appointed by the board of directors. The audit committee must be responsible for overseeing the corporation's relationship with the outside auditors and ensuring that auditor independence is maintained. The audit committee may include persons who are not members of the board of directors, but the members of the committee may not include any members of the staff, including the president/CEO and the treasurer/CFO. If the corporation has a finance committee, its

members may serve on the audit committee, although the chair of the audit committee may not be a member of the finance committee and members of the finance committee must comprise less than one-half the membership of the audit committee. Members of the audit committee may not receive additional compensation for their service and may not have a material financial interest in any entity doing business with the corporation. If the corporation subject to this requirement is under the control of another corporation, the audit committee may be part of the board of directors of the controlling corporation.

Board Approval of CEO and CFO Compensation

Under the Act, the board of directors (or authorized committee) of a charitable corporation or unincorporated association, or the trustees of a charitable trust, must approve the compensation and benefits of both the president/CEO and treasurer/CFO to assure that the compensation and benefits are just and reasonable. This approval must occur upon the officer's initial hiring, as well as at the time of any renewal or extension of the officer's term of employment. Approval is also required upon any modification of compensation, unless modifications are being offered to substantially all employees. Note that all charitable organizations are subject to this requirement; no entities are exempt.

Charitable Fundraising

In response to a spate of recent fundraising scandals in California, the Act prescribes detailed rules governing the conduct of commercial fundraisers and their relationships with charitable organizations. Under prior law, commercial fundraisers were required to register annually with the Attorney General and to file annual financial reports. Commercial fundraisers must now also retain certain records for a minimum of ten years and must enter into written contracts with charitable organizations for all solicitation campaigns. Such contracts must contain specific provisions ensuring proper treatment of the charitable proceeds and disclosing the full extent of the financial arrangement between the charity and the fundraiser. In order to curb perceived abuses of celebrity participation in charitable fundraising, fundraiser contracts must set forth the maximum dollar amount of payments in cash or in kind made to secure any person's attendance at, or endorsement of, a charity fundraising event.

Government Enforcement

Existing law grants the Attorney General broad powers of enforcement over charitable organizations and commercial fundraisers in the state, including the right to assess civil penalties for violations of the Act, with harsher civil penalties for offenses involving the defrauding of a charity or an individual. The Attorney General may also revoke the registration of charitable entities or commercial fundraisers operating in violation of the Act.

