Not Much to Cheer About

California Legislature Passes Ineffective Accountability Bill

By Pete Manzo

NCRP, its board of directors and its members firmly believe that legislation mandating standards of behavior and transparency, coupled with effective enforcement, is necessary to ensure that foundations and other nonprofit organizations be held accountable.

Unfortunately, advocates for increased accountability will not find much to cheer in the Nonprofit Integrity Act (Senate Bill 1262), recently passed by the California Legislature and signed into law by Gov. Arnold Schwarzenegger.

SB 1262 has two major prongs—a section dealing with governance aims to tighten the role of the board and outside auditors, while another section, much longer and involved, imposes significant new rules and disclosure requirements for the use of paid fundraising counsel by nonprofits. Since simply trying to summarize those fundraising provisions would exhaust the space we have for this report, and since they also are in many respects less objectionable, we'll focus here solely on the governance provisions.

At first blush, SB 1262's oversight provisions seem like pretty standard stuff. The bill applies to public benefit nonprofits, referred to in the bill as "Reporting Nonprofits," that are required to register and file periodic reports with the Attorney General's Office.[1] According to the bill, Reporting Nonprofits with gross revenues of more than $2 million, not including revenues from government grants or contracts, must

- ensure that the board of directors reviews and approves the compensation, including benefits, of the corporation's president or chief executive officer, and its treasurer or chief financial officer, to ensure it is "just and reasonable";
- have an annual audit done by an independent CPA, using generally accepted accounting principles;
- make the audit available to the public in the same manner as IRS Form 990, no later than nine months following the end of the prior fiscal year;
- have an audit committee that
  - > is appointed by the board of directors from members of the board or the public,
  - > is separate from the finance committee,
  - > is chaired by someone not on the finance committee, with a majority of members also not from the finance committee,
  - > excludes members of the staff, including the president or CEO, and the treasurer or CFO,
  - > is composed of members not receiving any compensation from the corporation, other than perhaps as members of the Board of Directors, and with no material financial interest in any entity doing business with the corporation, and
  - > is responsible for retaining, supervising and reviewing the auditor and approving the audit.

Who could be against things like independent audits, overseen by independent audit committees approved by boards, and making audits available to the public? In the details, though, the bill's oversight provisions dictate how boards should meet their fiduciary duties in ways that certainly will be difficult for many nonprofits to match. It is hard enough to find volunteers, even among boards members, to serve on finance committees, and the new provisions mean other board members not on the finance committee, or outsiders, have to be recruited to make up the majority of the audit committee, thereby likely sapping more energy from the staff and board that might be better used in other ways. The bill's oversight provisions also force boards of directors to get involved in reviewing the compensation and, therefore, inevitably the performance of the chief financial officer. In all likelihood, these mandates affecting boards will not detectably improve the effectiveness of their financial oversight.

More important is what the bill does **not** include:

- Although hospitals, universities and pri-

vate schools account for the lion's share of total revenue, they are not covered by the bill.
- The bill does nothing to increase the enforcement capabilities of the attorney general (AG). While it significantly increases reporting to the AG's Registrar of Charitable Trusts section, comprising 12 attorneys who valiantly try to protect the public's interest in the honest and effective operations of more than 90,000 public benefit nonprofits in the state, it makes no provision to increase or even maintain this level of staffing. (As of this writing, the AG's office has announced that it may be forced to lay off staff attorneys with less than 3 years' experience, although this may be posturing in labor negotiations.)
- The bill does not require public disclosure of transactions between nonprofits and directors or officers, which are easily hidden in 990 filings and audits.
- The bill's governance requirements do not apply to organizations with budgets of less than $2 million and, oddly, also exclude audited government grant and contract funding from the calculation of the $2 million gross revenue audit trigger. In a rare move, the bill's sponsor amended his bill to move the threshold up from $500,000 to $2 million during hearings, in response to testimony by nonprofit representatives. (Some witnesses advocated an even higher threshold of $5 million, citing a shortage of CPAs qualified to perform nonprofit audits.) This move conflicts with the recommendations of many nonprofit management experts that all nonprofits with gross revenues of more than $300,000 to 500,000 have independent audits.
- The bill offers no positive inducements for nonprofits to invest in improving their oversight systems (more on this below), a fault common to other regulatory efforts.

It's hard not to conclude that SB 1262 is a remarkable missed opportunity to increase philanthropic accountability in the nation's most populous state. At its birth, however, this effort to boost accountability seemed to have everything in its favor:

- several prominent local and national scandals that made nonprofit accountability a high-profile issue;
- local and national nonprofit leaders beginning to embrace the need for reform;
- a senior state senator sponsoring the bill who has strong ties to the nonprofit environmental community and is serving his last legislative term, adding a sentimental legacy factor to the deliberations;
- the public commitment of an elected attorney general who previously was a former president pro tempore of the state Senate;
- a track record of good working relations between the Attorney General's Office and a committee of expert nonprofit lawyers from the state bar that in prior years had worked closely with the AG to revise the state's laws governing unincorporated associations; and

- an advisory committee of nonprofit and foundation representatives, and accountants and lawyers specializing in serving nonprofits sponsored by the California Association of Nonprofits (CAN).

Certainly this mix could have produced a much better bill, one more likely to actually improve the ethical behavior of nonprofits.

So what went wrong? Perhaps not so incredibly, the small-gauge politics of the legislative process. The attorney general announced that his office was pushing an accountability bill last November, without consulting with the advisory committee led by the California Association of Nonprofits or the state bar's section of exempt-organization lawyers. In fact, some close to the negotiations believe that the announcement came before the bill's provisions had been drafted and without input from the office's section overseeing nonprofits, though an attorney from the Attorney General's Office denied this in a meeting with the state bar's exempt-organization lawyers. However the bill came to be proposed, once the first draft was introduced, nonprofit advocates were put in the uncomfortable position of seeking numerous amendments (SB 1262 has been amended nine times, with more than 50 changes to its provisions), while maintaining their support for increased accountability. After weeks of negotiations, the AG's office finally requested that CAN and others support the bill. Some nonprofit advocates pondered lending their support, in hopes of preserving influence with the AG in future negotiations. Others were sufficiently relieved by the removal of so many of the bill's burdensome original provisions that they withdrew their opposition, fearful that those provisions might return next year in new legislation if the AG didn't get at least some of what he wanted this session. In the end, CAN's Nonprofit Policy Council, the nonprofit lawyers groups and many others remained opposed to the bill.

As the bill sat on Gov. Schwarzenegger's desk, CAN's Nonprofit Policy Council and others urged him to veto it on the grounds that it would not be effective in preventing fraud or mismanagement and that its requirements were too intrusive; the *San Jose Mercury News*, which has been at the forefront of covering philanthropic scandals and demanding reform, also urged a veto in a recent editorial.[2] Now that the bill has been signed into law, nonprofit advocates hope they will be able to improve upon its provisions with future legislation, but given that the most powerful nonprofits are out of the bill's reach, nonprofit advocates may well be unable to do so.

Sadly the passage of the proposal, coupled with the official opposition to the bill by leading California nonprofit advocates, will not likely boost the public's already tenuous confidence in the nonprofit sector. And now that the bill has become law, chances of improving on its provisions are slim.

One final note about the shortcomings of SB 1262 and the debate surrounding it: From this author's point of view, the lack of a "carrot" for improving oversight systems is a glaring fault of accountability proposals like SB 1262, the bill proposed and later abandoned by New York Attorney General Elliot Spitzer, and some of the measures raised in the U.S. Senate Finance Committee's white paper. Assuring the public that nonprofits manage their resources faithfully and well is critical. Unfortunately, regulatory efforts almost always add burdens to many small and midsized nonprofits where they are weakest—in their infrastructure and in staff capabilities. These kinds of "overhead," or indirect costs, are precisely the ones that government and private funders do not want to support. One solution might be if government funders offered either bonus points on competitive bids or even bonus contract amounts for demonstrated or planned improvements in oversight. The cause of better governance, and better grantmaking, may well go further if legislators and funders would explore positive incentives to help nonprofits improve their accountability, rather than rely only on threats of enforcement. At the same time, as NCRP has forcefully argued, the government's enforcement capabilities must be increased if those threats are to be effective.

Notes

1. Reporting Nonprofits are public benefit organizations exempt from income tax under IRS Section 501(c)(3), not including religious organizations—which report to no state authorities—or hospitals and universities and private schools, which report to different state departments regulating health services and education.
2. "Bill to rein in nonprofits just saddles them with hassles; Schwarzenegger should veto it," Sept. 13, 2004 (http://www.mercurynews.com/mld/mercurynews/news/opinion/9650583.htm).