

The Nonprofit Integrity Act of 2004:

SWEEPING NEW RULES IMPACT EVERY CHARITABLE ORGANIZATION OPERATING IN CALIFORNIA

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On January 1, 2005, a sweeping new law comes into effect that impacts almost every charitable organization that operates or has assets in California. The Nonprofit Integrity Act, signed by Governor Schwarzenegger in September, imposes new rules in five areas: (1) Accounting standards, (2) Registration with the Registry of Charitable Trusts, (3) Audit requirements (Sarbanes-Oxley for nonprofits), (4) Compensation of key executives, and (5) Fundraising. The Act also imposes new rules on commercial fundraiser and fundraising counsel, which will not be addressed here except as they relate to the rules imposed on charitable organizations.

This article provides an overview of the Nonprofit Integrity Act, including the requirements of the Act in each of the above areas and which nonprofits they apply to. Every nonprofit that does any business in California is strongly encouraged to be familiar with and heed these rules. Failure to do so may result in scrutiny and, in the worst case, take over by the California Attorney General.

1. ACCOUNTING STANDARDS

This may be the easiest of the Act's new requirements to implement but is also probably the one that is most likely to be violated. The new requirement is that the financial records of any organization that seeks charitable contributions (including grants, donations, etc.) must be maintained on the basis of generally accepted accounting principles or "GAAP." In its essence, this means that effected organizations must maintain a chart of accounts and use standard double-entry accounting to record all of their transactions.

Too many nonprofits, and perhaps most small ones, utilize Quicken to maintain their financial accounting records. Quicken IS NOT an accounting program and should not be used by any nonprofit. Even QuickBooks is insufficient if the organization has the program's audit trail feature turned off.

Board members, who have fiduciary duty with regard to the charity's affairs and finances, may have to take it upon themselves to insist and insure that their charities follow these new rules. If a charity is unfamiliar with these

requirements it must seek the assistance of an accountant familiar and experienced with the GAAP rules *that apply to nonprofits* (which often are different than those that apply to commercial businesses) or, at the very least, consult a book on the subject.

2. REGISTRATION WITH THE REGISTRY OF CHARITABLE TRUSTS

With some exceptions (educational institutions, religious organizations, hospitals and cemeteries), all organizations that hold charitable assets in the state of California are required to register and file annual statements with the Registry of Charitable Trusts, a branch of the Office of the Attorney General. This requirement applies regardless of the organization's form, whether it be a nonprofit corporation, charitable trust or unincorporated association.

Prior to enactment of the new law, charities were required to register within six months of receipt of any property or other charitable assets. The only change effective January 1, 2005 is that they must now register within 30 days of first receipt of assets. It is very simple to avoid violating this rule. Any new charitable organization should register with the Registry immediately after it is incorporated. That is what this office is now doing for all of its start-up clients.

3. AUDIT REQUIREMENTS

The Nonprofit Integrity Act imposes a new audit requirement on all nonprofits holding assets or doing business in California that are required to register with the Registry (i.e., all but educational institutions, religious organizations, hospitals and cemeteries). This new requirement is effective for fiscal years ending June 30, 2005 or later. Audited financial statements required under the Act must be completed no later than nine months after the entity's fiscal year end. This is earlier than the extended tax filing deadline.

The audit requirement has several components:

- A minimum threshold.
- An exclusion for certain government grants;
- Auditor independence;

- Public disclosure of audits; and
- Requirements for an audit committee.

Effective June 30, 2005, all covered charitable entities that have \$2 million or more in gross revenue in any fiscal year are required to have prepared an audit conducted by a certified public accountant. Excluded from gross revenue for purposes of determining whether an organization has crossed the \$2 million threshold are *grants* (but not fees for services) the organization receives from government agencies if that government agency requires an accounting of how the organization uses those funds.

CPA firms that audit nonprofits that also perform other services for a given nonprofit must follow the standards for auditor independence specified in the "Yellow Book," a manual for auditor independence published by Comptroller of the Currency of the United States.

All audited financial statements prepared by any nonprofit that are required to register with the Registry (regardless whether an audit is required under the Act) must be made available for (1) inspection by the Attorney General and (2) any member of the general public upon request. This means the audit must be made available to the public at the charity's principal, regional and district offices during normal business hours, or by posting it to a freely available website will satisfy this requirement. (The audit letter need not be included with the public disclosure.) Audited financial statements must be available for no less than three years.

Audit Committee

Nonprofit corporations (but not other types of entities) subject to the audit requirement must have an audit committee. The Act specifies who may and may not serve on the audit

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committee and it specifies minimum duties of the audit committee. The corporation's governing body (e.g., board of directors) must appoint the audit committee. Interestingly, the audit committee may consist of just one person and its members need not be directors of the corporation.

The corporation's president/chief executive officer, treasurer/chief financial officer, any paid staff, and anyone who does business or has any financial interest in any entity that does business with the nonprofit may not be on the audit committee. If the nonprofit corporation has a finance committee its members must comprise less than 50% of the audit committee and the chair of the audit committee may not be a member of the finance committee.

The Act specifies five duties of the audit committee:

- Recommend to the board of directors the retention and termination of the independent auditor;
- May negotiate the compensation of the auditor on behalf of the board;
- Confer with the auditor to satisfy the committee members that the financial affairs of the charitable organization are in order;
- Review and determine whether to accept the audit; and
- Approve performance of any non-audit services to be provided by the auditing firm.

4. COMPENSATION OF KEY EXECUTIVES

The Act requires the governing board or an authorized committee of the board to review and approve the compensation of a charity's chief executive officer (e.g., president or executive director) and chief financial officer. Approvals are required when the (1) employee is hired or (2) when the employee's employment agreement or terms of employment are renewed, extended or modified (unless the modification applies to substantially all employees). These requirements will be met if the organization complies with safe harbor guidelines the IRS has issued with regard to its Excessive Benefit Transaction rules (4958 of the Internal Revenue Code and regulations thereunder). For a thorough discussion of these rules download our article at <http://lfnp.com/articles/EBT.pdf>.

Note that any committee delegated with this responsibility must consist exclusively of governing board members and may not include any person whose compensation the committee is to review, anyone related to such persons by blood or marriage, or any person who may have a direct or indirect financial interest in such person's compensation or employment.

5. FUNDRAISING

By far the most detailed provisions of the new law – and perhaps the most onerous – have to do with fundraising by and for charitable organizations. The Nonprofit Integrity Act outlines new requirements for charitable organizations that work with commercial fundraisers or fundraising counsel. A "**commercial fundraiser**" is any individual or entity that: (1) is paid to solicit funds, assets or property in California for charitable purposes; (2) receives or controls such items; or (3) engages for pay another person to do so. A "**fundraising counsel**" is any person or entity that is paid to manage, advise, counsel, consult, or prepare material for the solicitation in California of funds, assets, or property for charitable purposes, but who does not solicit, receive or control funds, and who does not engage or pay someone else to do so. Attorneys, employees and trustees of a charitable organization are *not* fundraising counsel, and employees of charities are not commercial fundraisers.

The Act establishes rules with regard to:

- Control over fundraisers by charities;
- Rules for the engagement of commercial fundraisers and fundraising counsel, and
- Specific prohibitions with regard to commercial fundraisers and fundraising counsel.

The Act also gives charities substantial requirements and rights with regard to fundraisers and fundraising counsel they engage. For example:

- Neither a charity, on the one hand, nor a fundraising counsel or commercial fundraiser, on the other, may enter into a fundraising contract with the other unless it has registered with the Attorney General or agrees to do so prior to the start of any solicitation.
- A contract with a fundraiser or fundraising counsel is voidable by the charity if the fundraiser or fundraising counsel has not registered with the Attorney General prior to the start of the solicitation.
- All work performed by commercial fundraisers and fundraising counsel must be undertaken pursuant to a written contract signed by the fundraiser or fundraising counsel's authorized officer and an official of the charity authorized by its governing body to do so.
- The charity may cancel any such contract within 10 days for any reason without liability.
- A charity may cancel any such contract upon 30 days written notice. (It must pay for the services provided per the

contract's terms during that 30 day period.)

- After the 10-day period, the charity may cancel the contract without liability if the commercial fundraiser or fundraising counsel has made any material representations, harms the charity's reputation or is found to have been convicted of a crime arising from charitable solicitations.
- Commercial fundraisers may not control or retain funds they collect on behalf of the charitable organization.

Note that if a charity cancels any fundraising contract under the Act it is required to mail a copy of the cancellation notice to the Registry of Charitable Trusts.

Contracts with Commercial Fundraisers

A charitable organization that engages the services of a commercial fundraiser must "establish and exercise control" over the fundraising activities conducted for their benefit. For every solicitation campaign or event produced by a commercial fundraiser, there must be a written contract between the fundraiser and the charitable organization. The commercial fundraiser or fundraising counsel must file a notice with the Registry of Charitable Trusts at least 10 days before the start of any solicitation campaign or event (or no later than the start of a campaign to raise funds for victims of disasters or emergencies).

The contract between charity and a commercial fundraising must include provisions that set forth all of the rights and responsibilities listed immediately above, plus the following:

- The charitable purpose for which the solicitation campaign or event is being conducted;
- The respective obligations of the commercial fundraiser and charity;
- The effective date and termination date of the contract, and the date the solicitation will start in the state;
- The requirement that all contributions received by the commercial fundraiser must, within five working days of receipt, either be deposited in a bank account controlled by the charitable organization or delivered in person to the charitable organization;
- The charitable organization controls and approves the content and frequency of any solicitation.
- The maximum amount the commercial fundraiser plans to pay individuals or entities to secure any person's attendance at, or approval, sponsorship or endorsement of, a fundraising event (e.g., amounts paid to celebrities to endorse or attend a fundraising event);
- The amount of the fee to be to the com-

mercial fundraiser. If the fee is a set amount (fixed fee), the contract must provide a good faith estimate the percent of total contributions the fee will comprise as well as the assumptions upon which that good faith estimate is based. If the commercial fundraiser will be paid a percentage fee, the contract must state the percent of total contributions the charitable organization will retain. If the solicitation involves the sale of goods or services, or sale of admission to an event, the contract must state the percentage of the purchase price the charitable organization will retain. The percentages to be retained by the charity stated in the contract must take into account not only the commercial fundraiser's fee but also any additional fundraising costs the charity must pay; and

- Any other information required by regulations adopted by the Attorney General.

The Act also imposes a number of requirements on commercial fundraisers. Those of particular relevance to charitable organizations specify that:

- A commercial fundraiser is required to disclose what percentage of total fundraising their expenses account for immediately when asked verbally and within 5 working days when queried in writing.
- A commercial fundraiser must maintain specified campaign records for each solicitation and retain them for 10 years following the end of each solicitation. They must be made available for inspection upon demand by the Attorney General.
- Commercial fundraisers must file an annual financial report of funds solicited on behalf of each tax-exempt organization or for each charitable purpose with the Attorney General.
- A person may not act as a commercial fundraiser, or an officer, director or owner of a controlling interest in a commercial fundraising entity, if he or she has been convicted in state or federal court of a crime, punishable as a misdemeanor or felony, arising from the conduct of charitable solicitation.

Contracts with Fundraising Counsel

A contract between a charity and a fundraising counsel must include provisions with regard to

the charitable organization's rights to cancel the contract as listed above, as well as provisions that set forth the following:

- The charitable purpose for which the solicitation campaign or event is being conducted;
- The respective obligations of the commercial fundraiser and charity;
- The effective date and termination date of the contract, and the date the solicitation will start in the state;
- That the fundraising counsel will neither solicit, review nor control donated items or employ any other person to do so;
- That the charity exercises control and approval over the content and frequency of solicitations; and
- The compensation to be paid the fundraising counsel.

12 Prohibitions

The Act prohibits the following twelve acts and practices with regard to the planning, conduct, or execution of any solicitation or charitable sales promotion. The prohibitions apply to, "regardless of injury":

1. Operating in violation of this Act or order of the Attorney General, or after registration is no long valid.
2. Engaging in fraud or using any unfair or deceptive act or practice that creates a likelihood of confusion or misunderstanding.
3. Using any name or any other representation that misleads a reasonable person as to the identity of the charitable beneficiary.
4. Misrepresenting or misleading anyone to believe that the beneficiary of a solicitation or sales promotion is a charitable organization when it is not.
5. Misrepresenting or misleading anyone to believe that another person sponsors, endorses, or approves a charitable solicitation or sales promotion when that person has not given consent in writing to the use of the person's name.
6. Misrepresenting or misleading anyone to believe that goods or services have endorsement, sponsorship, approval, characteristics, ingredients, uses, qualities, or benefits that they do not have,

or that any person has any endorsement, sponsorship, approval, status, or affiliation that the person does not have.

7. Exploiting registration required by law to imply endorsement or approval by the Attorney General.
8. Representing that a charitable organization will receive more than the amount reasonably estimated.
9. Distributing or offering to distribute – in connection with charitable solicitations by commercial fundraisers for police, fire, and other public safety personnel – membership cards or stickers, emblems, plates, or other items that could be used for display on a motor vehicle and that suggest affiliation with or endorsement by any public safety personnel or group.
10. Soliciting for advertising related to a charitable purpose to appear in a for-profit publication without making, at the time of solicitation, these disclosures: (a) the publication is for-profit, (b) the name of the solicitor and the fact that the solicitor is a professional solicitor, and (c) the publication is not affiliated with any charitable organization.
11. Representing that any part of contributions solicited by a given charity will be given to another charity unless the other charity has agreed in writing prior to the solicitation to the use of its name.
12. Representing that tickets to events will be donated for use by another unless certain requirements are met to prevent abuse.

CONCLUSION

The Nonprofit Integrity Act of 2004 imposes a variety of new duties on nonprofits operating in California. In practice, this means new obligations for board members of those organizations. Fortunately, the Act is relatively clear about what nonprofits must do to comply and its provisions generally are not difficult to enact. Reasonable diligence in doing so should thus ameliorate most, if not all, board member and staff concerns about the Act.