GOVERNANCE LEGISLATION IN THE NONPROFIT SECTOR: WHAT CANADIANS CAN LEARN FROM CALIFORNIA'S NONPROFIT INTEGRITY ACT

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Governance is a hot topic in the nonprofit sector, with largely volunteer-based boards of directors struggling to fulfil their governance responsibilities, as well as serve as major fundraising resources. Indeed, board members are often recruited for their fundraising prowess, with little expectation that they will actively monitor the nonprofit organization. The fact that nonprofit organizations lack residual claimants in the form of owners, coupled with lack of oversight by the board, creates a control weakness that can be exploited by staff to procure unwarranted benefits. Such benefits, when in the form of excessive compensation, can create a public relations nightmare for the nonprofit organization. Compensation scandals have affected several prominent U.S. nonprofits including the United Way of America and the Smithsonian. Given recent Canadian legislative interest in the activities of nonprofits, it seems like a good idea to examine the results of a major American state's legislative activity in the same area.

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The *Sarbanes Oxley Act* (SOX) of 2002 created a plethora of regulation for publicly traded companies in the U.S. While U.S. nonprofits were generally exempt from SOX requirements, the nonprofit sector examined their own governance practices, with governance provisions similar to SOX requirements being touted as best practices for the nonprofit sector. Ostrower & Bobowick (2006) surveyed nonprofits on their adoption of key SOX provisions and found that 20% of responding nonprofits had an audit committee, while 67% had been externally audited within the last two years of the study. These findings were sensitive to the size of the nonprofit. The majority of organizations greater than $40 million in annual expenditures reported having an audit committee and 97% having had an external audit within the last two years. In sharp contrast, comparable figures of smaller organizations (less than $100 thousand in expenditures) reveal that only 15% of smaller organizations reported having an audit committee, and only 43% were externally audited within the last two years of the study.

California (a state with a population that exceeds Canada's entire population by nearly 5 million people) responded to the perceived governance weakness in the U.S. nonprofit sector with the *Nonprofit Integrity Act* of 2004 ("NIA"). The NIA requires charitable organizations to file audited financial statements with the Attorney General's Office and to establish an audit committee. In addition, the board of directors of a nonprofit organization must review the compensation paid to the Chief Executive Officer and the Chief Financial Officer to ensure it is just and reasonable. Finally, the NIA prohibits unfair and/or deceptive solicitation practices, and requires a written contract between professional fundraisers and charities for each solicitation campaign or event.

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Charitable organizations were expected to comply with the NIA effective January 1, 2005. Organizations below $2 million in gross revenues are exempt from the requirements of the NIA. In addition, educational institutions, hospitals, cemeteries, and religious organizations are exempt from filing reports with the Attorney General and therefore are not subject to the mandatory audit and audit committee requirements. The NIA represents the most significant piece of recent state governance legislation affecting nonprofit organizations in the United States.

In an attempt to ascertain the impact of the NIA on affected Californian nonprofits, Neely (2011) collected data on 1,077 organizations that were required to comply with the NIA. These organizations were relatively large nonprofits reporting average 2005 revenue of $13 million. Neely's study quantified the cost and benefits to organizations one year after implementing the NIA's provisions. The study focused on three benefits, which were improvements in financial reporting, increases in donor contributions, and limits on executive compensation. The analysis was performed by comparing 2003-levels of these three factors (the year before the NIA was enacted) with 2005-levels (the first year after the NIA) of the organizations studied.

Overall, there were no detected financial reporting improvements or contributions flowing into the organizations that could be attributed to the introduction of the NIA. Financial reporting improvements were measured by the number of organizations that had correctly reported fundraising expenses, activity from professional fundraisers, and executive compensation. Executive compensation *increased* the year after the implementation of the NIA. However, this increase was less than the increase reported by a control group representing the population of U.S. nonprofits. The NIA appeared to accrue significant costs to nonprofit organizations in the year following the implementation of the legislation. Notably, the median accounting fees for affected nonprofits rose by approximately 15% the year after the NIA took effect.

While Neely (2011) examined only the first year after the adoption of the NIA, the results of the study suggest that the legislation had little measurable impact on financial reporting, donors did not respond by giving more to Californian charities, and executive compensation was not curtailed under the new legislation. It is possible that the NIA benefited nonprofit organizations in other ways, namely in the prevention of misconduct that is unobservable (and therefore not measurable). It is also possible that the real benefits of the NIA did not accrue to organizations until several years after the enactment of the NIA. However, given the real costs incurred to enact provisions of the NIA, caution should be exercised by governments interested in crafting similar legislation that is aimed at strengthening governance over the nonprofit sector.

References

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