

Date of Hearing: April 23, 2019

ASSEMBLY COMMITTEE ON PRIVACY AND CONSUMER PROTECTION

Ed Chau, Chair

AB 1181 (Limón) – As Introduced February 21, 2019

SUBJECT: Charitable organizations

SUMMARY: This bill would require financial records of solicitations for charitable purposes to be maintained according to specific standards, and would prohibit charitable organizations from reporting its noncash contributions in a way that is misleading or likely to cause confusion. Specifically, **this bill would:**

- 1) Require the financial records of a soliciting organization to be maintained on the basis of generally accepted accounting principles as established by the Financial Accounting Standards Board.
- 2) Provide that if a noncash contribution received by a charitable organization is restricted by the donor so that it cannot be used in the United States, the contribution shall be valued using the fair value of the end recipient market.
- 3) Prohibit, in the planning, conduct, or execution of any solicitation or charitable sales promotion, the reporting of noncash contributions in its audited financial statements, [or] reports filed with the AG, or solicitation materials, in a way that is misleading or likely to cause confusion.
- 4) Define “end recipient market” to mean the market in the country where the receiving charitable organization is located.
- 5) Define “fair value” to mean the price that the receiving charitable organization would receive if it sold the noncash contribution.
- 6) Correct an incorrect cross-reference, and make other various technical, non-substantive changes.

EXISTING LAW:

- 1) Establishes the Charitable Purposes Act (Act), which generally governs all charitable corporations, unincorporated associations, trustees, commercial fundraisers for charitable purposes, fundraising counsel for charitable purposes, commercial coventurers, and other legal entities holding or soliciting property for charitable purposes and requires these entities to file a registration statement, articles of incorporation, and an annual financial report with the AG. Existing law provides the AG with primary enforcement and supervisory powers over these entities, and requires that the AG maintain a register of charitable organizations subject to the Act. (Gov. Code Sec. 12580 et seq.)
- 2) Requires every charitable corporation, unincorporated association, and trustee subject to the Act to file with the AG an initial registration form, under oath, as specified, within 30 days after the entity initially receives property, except as specified. Existing law also generally

requires that these entities file with the AG periodic written reports, as specified. (Gov. Code Secs. 12585, 12586.)

- 3) Requires every charitable corporation, unincorporated association, and trustee that receives or accrues revenue of at least \$2,000,000, as specified, to prepare annual financial statements using generally accepted accounting principles that are audited by an independent certified public accountant with generally accepted auditing standards. Requires a charity to make its annual audited financial statements available to the public in the same manner that is prescribed for IRS Form 990, as specified. (Gov. Code Sec. 12586(e)(1).)
- 4) Prohibits, in the planning, conduct, or execution of any solicitation or charitable sales promotion, among other things, using any unfair or deceptive acts or practices or engaging in any fraudulent conduct that creates a likelihood of confusion or misunderstanding. (Gov. Code Sec. 12599.6(f)(2).)
- 5) Prohibits a person from knowingly submitting for filing on behalf of any charitable organization any statement, report, financial statement, attachment, or other information to be filed with the AG that contains information, a statement, or an omission that is false or misleading. (Gov. Code Sec. 12599.6(g).)
- 6) Authorizes the AG to bring a civil action for violation of the Act, as specified, at any time within 10 years after the cause of action accrued. Also authorizes the AG, notwithstanding the limited application of the Act to certain entities, to bring a civil action against a person who aids or abets a violation of that Act, specified laws relating to involuntary trusts, or the Nonprofit Public Benefit Corporations' article providing standards of conduct for directors and management, at any time within 10 years after the cause of action accrued. (Gov. Code Sec. 12596(b)-(c).)
- 7) Provides that the primary responsibility for supervising charitable trusts in California, for ensuring compliance with trusts and articles of incorporation, and for protection of assets held by charitable trusts and public benefit corporations, resides in the AG. The AG has broad powers under common law and California statutory law to carry out these charitable trust enforcement responsibilities. These powers include, but are not limited to, charitable trust enforcement actions under specified laws, including the Charitable Purposes Act. (Gov. Code Sec. 12598(a).)
- 8) Requires the financial records of a soliciting organization to be maintained on the basis of generally accepted accounting principles as defined by the American Institute of Certified Public Accountants, the Governmental Accounting Standards Board, or the Financial Accounting Standards Board. (Bus. & Prof. Code Sec. 17510.5.)

FISCAL EFFECT: Unknown

COMMENTS:

- 1) **Purpose of this bill:** This bill seeks to increase transparency in nonprofit finances by prohibiting charitable organizations from reporting noncash contributions in a way that is misleading or likely to cause confusion. This bill is sponsored by the Office of the Attorney General.

- 2) **Author’s statement:** According to the author, “AB 1181 addresses reported practices by some charities that grossly inflate the value of their publicly reported revenue and program expense, especially with respect to in-kind donations of pharmaceutical drugs. Overvaluation of the gifts-in-kind leads to an inflated total revenue for the charity which makes the charity appear more successful and efficient to the public and potential donors. An inflated revenue, in turn, can serve as a basis to hide excessive fundraising and administrative costs because these expenses would now appear smaller in comparison to the inflated total revenue. Inflated reports may also increase the charity’s ranking by charity watchdogs. This type of accounting practice is manipulative, misleading, and inconsistent with state law that safeguards transparency, fair reporting, and ensure a level playing field for honest charities that report accurate data to the Attorney General’s Registry of Charitable Trusts.”
- 3) **Addresses longstanding concerns with overvaluation of gift-in-kind donations:** Under California law, the AG oversees registered charities to ensure that funds received are properly managed and devoted to charitable programs. The office derives its authority from the Charitable Purposes Act, which was originally enacted in 1959. This law generally requires every person or entity that holds or solicits property for charitable purposes in California to file specified documents and information, including annual financial statements, with the AG. These reports are in turn used by the AG to investigate and litigate cases of charity fraud and mismanagement by trustees and directors of charities. This bill seeks to address longstanding concerns with charities overvaluing gift-in-kind donations, a type of charitable donation where goods and services are given instead of cash to buy needed goods or services.

As far back as 2012, Forbes reported on a multi-state effort to crack down on nonprofits who greatly exaggerate the value of donated goods to make themselves look more successful than they actually are.

In theory, there’s nothing wrong with gift-in-kind itself. A donation to a worthy charity is a donation to a worthy charity. The problem comes largely with the valuation. Cash is easily valued at, well, the amount of cash. But freed of the precision that cash provides, some charities value donated goods at many times the market price. The overvaluation makes a charity seem larger and more popular than it is, and also increases--artificially--financial efficiency ratios that many donors look at. (Barrett, *Charity Regulators (Finally) Eye Overvaluation Of Donated Goods*, Forbes (Nov. 8, 2012).)

In 2018, drug, tech, and financial services companies topped the list of corporate donors. (O’Leary et al, *Drug, Tech, and Financial-Services Companies Top List of Corporate Donors*, Chronicle of Philanthropy, (Sept. 5, 2018).) Many pharmaceutical companies make product donations a common feature of their corporate social responsibility efforts. In response to the crisis in Syria, for example, several major multinational pharmaceutical companies have donated medicines and cash to emergency relief organizations, including the International Committee of the Red Cross, International Health Partners and Project Hope. (Gray et al, *Pharmaceutical companies donating medicines in crisis situations*, Devex (Feb. 29, 2016).) The AG, sponsor of this bill, writes:

Pharmaceutical donations to charities are particularly susceptible to overvaluation abuse because their value on the international market can be pennies on the dollar compared to

their market value in the United States (U.S.). Thus, charities benefit from reporting pharmaceutical gift-in-kind donations at the higher U.S. market value even when such drugs will not be used for charitable programs in the U.S. Reporting the inflated value of the drugs through the use of U.S. prices is especially misleading when drug companies make the donations with the restriction that the donated drugs not be used in the U.S. Because of their intent to prohibit the use of the drugs in the U.S., the drug companies typically make donations of drugs to charities that provide international assistance, with the expectation that the donated drugs will be distributed to end recipient individuals or charitable groups located in other countries. In those circumstances, the charity should not be valuing their pharmaceutical gifts-in-kind using U.S. prices.

In a recent case investigated by [the California] [Department of Justice] DOJ, for example, a charitable organization created two subsidiary companies that purchased pharmaceutical drugs from a European wholesaler for less than \$225,000. These subsidiaries then donated the drugs to the parent charity. The parent charity reported the total value of these pharmaceutical donations as being over \$34.9 million using U.S. drug prices, rather than the actual purchase price paid by its subsidiaries. The parent charity also inaccurately claimed, in its financial reporting and on its website, that 99 [%] of all contributions it received provided direct aid. [Our] investigation found the parent charity's representation was the result of deceptive reporting of gift-in-kind donations, and that the charity had engaged in a misleading reporting scheme to purposefully increase the amount of its gift-in-kind donations to mislead the public. Ultimately, due to DOJ's investigation, this charity agreed to pay a large settlement and to stop its misleading representations.

By prohibiting charitable organizations from reporting gift-in-kind donations in a way that is misleading or likely to cause confusion, and requiring gift-in-kind donations conditioned on distribution outside the U.S. to reflect the fair market value in the market where the recipient charity is located, AB 1181 should arguably increase transparency for Californians, who often look to the value of a charity's donations when deciding the charity to which they wish to contribute. These requirements are also consistent with existing law which already prohibits using any unfair or deceptive practices or engaging in any fraudulent conduct that creates a likelihood of confusion or misunderstanding. The Act also expressly prohibits a person from knowingly filing a report or financial statement with the AG that contains information or an omission that is false or misleading. This bill would merely clarify that these same standards apply to in-kind donations.

- 4) **Generally accepted accounting principles:** The Charitable Purposes Act currently requires the financial records of a soliciting organization to be maintained on the basis of generally accepted accounting principles as defined by the American Institute of Certified Public Accountants, the Governmental Accounting Standards Board, or the Financial Accounting Standards Board. This bill would instead require financial records to be maintained only according to principles established by the Financial Accounting Standards Board.

The California Society of CPAs (CalCPA), representing the Certified Public Accountant profession, opposes this bill unless amended. CalCPA shares the goal of safeguarding Californians by ensuring charitable organizations do not mislead donors, and also recognizes that there are charitable organizations overstating the valuations of noncash contributions to

inflate the efficiency in the use of donor funds in their programs. CalCPA argues, however, that:

The language of AB 1181 would undermine uniform national accounting and valuation standards by essentially allowing California to set its own accounting standards and procedures that significantly deviate from those that are accepted and universally utilized throughout the United States. [...] Charities would need to maintain two separate financial and accounting records: one that is non-GAAP [generally accepted accounting principles] for California purposes and one that complies with GAAP for federal and other state's purposes. Two sets of financial and accounting records would create consumer confusion and significantly increase the complexity and cost of preparing and maintaining records for charitable organizations. [...]

GAAP refers to a uniform set of accounting principles, standards, and procedures that determine how businesses, governments, and nonprofits present financial information. [...] GAAP is not a single standard, rather it is a combination of authoritative standards and the accepted guidance in applying those standards to record and report accounting information. [...]

A CPA that prepares a charitable organization's financial statement in accordance with GAAP would need to look to more than just FASB standards. By removing the reference to the [American Institute of Certified Public Accountants] AICPA and [Governmental Accounting Standards Board] GASB in Section 17510.5 (a) of the Business and Professions Code, AB 1181 undermines GAAP by expressly removing the reference to two entities that are core to the formation and application of GAAP. This makes it unclear as to whether AICPA guidance and GASB can be used when preparing a financial statement for a charitable organization. In effect, this would prevent charitable organizations from across the country from being able to present financial statements in accordance with GAAP.

CalCPA, therefore requests that the author either: (1) allow for the completion of a process being undertaken by the Financial Accounting Standards Board (FASB), whereby they are reviewing how GAAP can be adjusted to address for concerns related to the valuation of gift-in-kind donations; or, (2) require a charity who has received a noncash contribution that is restricted to delivery outside the U.S. to indicate that condition on the organization's annual renewal form and disclose it on its website, as well as on all forms of solicitations for financial support.

The author and sponsor, who have been working with CalCPA to address their concerns, respond that GAAP, according to DOJ experts, is actually not defined by AICPA, GASB, or FASB, and that arguing such is a "misstatement of the way things really are today—that, in fact, FASB establishes the codification (the authority) and AICPA helps the accounting community understand and apply the codifications. In other words, AICPA provides guidance interpreting FASB ASCs (Accounting Standards Codification) but it is not a coequal source of "defining" GAAP. DOJ believes that this is a technical amendment to correct an outdated statute, and that this bill does not hamper AICPA from continuing to play an important role in providing guidance to the nonprofit sector."

Accordingly, to address CalCPA's concerns regarding overseas valuation of gifts-in-kind, the author offers the following amendment, which would allow more flexibility for charities in valuating noncash contributions distributed abroad, where the donation's value in the recipient market is unknown.

Author's amendment:

Page 2, line 12, strike "If" and insert: "*Notwithstanding subdivision (a),*"

Page 2, line 15, after "recipient market" insert: "*or a reasonable estimate thereof if the end recipient market value cannot be ascertained following a reasonable inquiry. If the end recipient market is unknown when the noncash contribution is received, the charitable organization shall value the contribution using only those markets in which the contribution is reasonably likely to be distributed or used, taking all facts and circumstances into consideration, and which are consistent with any restrictions, including donor restrictions, and with its mission and charitable purpose*"

Page 3, line 3, strike "receiving charitable organization is located" and insert "*noncash contribution is to be ultimately distributed*"

Staff notes that this bill does not seemingly address gifts-in-kind that end up being distributed abroad, despite not having that condition assigned to them. As this bill moves through the legislative process, the author and sponsor may also want to consider if requiring valuation based on end recipient markets should be required for all gifts-in-kind.

In opposition to this bill, the Nonprofit Alliance, a Washington D.C.-based association, writes:

Every charity is required by the IRS, in accordance with general accepted accounting principles (GAAP), to value its gifts in kind (GIK) using "the same accounting method on the return (including the Form 990 and all schedules) to report revenue and expenses that it regularly uses to keep its books and records" (Form 990 instructions, 2018).

The variation for a California filing, proposed in AB 1181, would require charities to devote considerable resources to research and recalculate their audited financial statements to comply with a single state's reversioning of a fair market value definition. Resources that would otherwise be spent on impactful delivery of life-saving missions will instead be used to research wholesale market values for products in the various countries any one organization may serve. This includes GIK that has been delivered to an organization's U.S. location but not yet distributed to an end recipient market at the end of a charity's fiscal year and, in some cases such as natural disaster recovery, without precise knowledge on where the goods will be needed and shipped.

The unnecessarily burdensome requirements set forth by your proposed reinterpretation of accounting standards for California filing are exponentially threatening to a charity's resources when we consider the precedent AB 1181 could set.

In response, the AG, sponsor of this bill, writes:

By using U.S. prices, these charities artificially inflate both their revenue and program expenses [...] These charities also report in the solicitation materials and on their websites that they are significantly more efficient than other charities that do not inflate their gift in kind, noncash donations.

The accounting abuses described above are not new. In 2011, Forbes reported that U.S. based nonprofits were donating mebendazole and albendazole, highly effective deworming pills, that could be bought on world markets in Europe, China and India for 2 cents each. But instead of showing the value of each pill as 2 cents, the pills were valued on some nonprofits' financial statements using U.S. prices as \$16.25 per pill—81,000% above that world market price.

Other charities are being hurt by this deceptive practice. Patrick Moynihan, president of The Haitian Project, a nonprofit organization that supports a private, tuition-free school in Haiti, told the *Globe*, “They are gaming the industry, because those of us who are not gaming cannot beat those ratios. Food for the Poor is very likely taking donations from compassionate, well-intentioned individuals of modest means in order to help corporations dispose of their trash.”

There is also the question whether the gift in kind ever reaches the end recipient. In 2012, Breast Cancer Society purportedly gave vaccines to Ghana, Africa but the administrator denied ever receiving the vaccines from the charity. A news reporter also noted that Food for the Hungry claimed it spent \$83 million in 2010 for disaster relief, but the IRS found that the charity overvalued the medicine it gave away to “mislead the public in order to raise more funds.”

In sum, the Attorney General seeks to protect donors and promote a level playing field amongst charities. If charities want to accept gift in kind donations, these donations should be valued fairly using only those markets in which the contributions are likely to be distributed, and by considering any donor restrictions and the mission and charitable purpose of the charity accepting the donations. (Citations omitted.)

REGISTERED SUPPORT / OPPOSITION:

Support

Office of the Attorney General (sponsor)

Opposition

CalCPA (unless amended)
The Nonprofit Alliance

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