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MEMORANDUM

By e-mail to Assemblymember.Limon@assembly.ca.gov.

To: The Honorable Monique Limón

From: Charles M. Watkins

Date: March 21, 2019

Re: A.B. 1181

Assemblymember Limón,

I am writing to respectfully request that you withdraw AB 1181. The bill proposes to arbitrarily create a unique version of "generally accepted accounting principles" ("GAAP"). This would defeat GAAP's primary purpose: to ensure that financial reporting is transparent and consistent from one organization to another.

Specifically, AB 1181 would create a special valuation rule for charities soliciting contributions in California and that receive and use restricted gifts-in-kind ("GIK")—typically, pharmaceuticals and medical supplies, food, and clothing—outside the United States. These charities would be required to value the GIK based on its fair market value in the country where it is finally distributed, instead of based on the fair market value in the United States, where the charity would otherwise have had to purchase the GIK.

My experience

I have worked with exempt organizations' legal, tax, and accounting issues since 1981. From 1981 through 1985, I worked in the Office of the Chef Counsel for the IRS, in what was then the Employee Plans and Exempt Organizations Division (now the Tax Exempt/Government Entities Division).

Since 1986, I have worked here at Webster, Chamberlain & Bean, advising charities on fundraising contract and compliance matters, overseeing our firm's management of charitable solicitation fundraising registrations for charities and fundraising counsel, communicating with state charity regulators, and participating in efforts to improve pending legislation and administrative initiatives (including efforts with respect to legislation in California in 2004 and 2014).

In 2007 and 2008, I collaborated with the IRS team that was revising Form 990, providing detailed comments on the initial draft of Schedule G, *Supplemental Information About Fundraising or Gaming Activities*, and at the IRS' specific request, reviewing and editing the instructions for Schedule G.

During my time in private practice, I have represented several charities that were being investigated by the Internal Revenue Service or a state attorney general on account of alleged overvaluations of GIK. In all cases, the investigating agency concluded that the charity had not improperly overvalued the GIK.

Background

As you are undoubtedly aware, the California Attorney General recently litigated a claim of overvaluation against three large charities—Food for the Poor, MAP International, and Catholic Medical Mission Board—that receive significant GIK in the United States, and directly or indirectly distribute it, to accomplish their charitable purposes, in Africa, Asia, and other Third World countries. As required by GAAP, in reporting their income and expenses, these charities valued the contributions and distributions at the wholesale fair market value in the United States, where they would have had to purchase the GIK had it not been donated to them. This valuation method was approved by each charity's independent certified public accounting firm, which audited their financial statements and prepared the Forms 990 that each charity submitted to the Internal Revenue Service. By signing the Form 990, each charity's officer and paid return preparer states:

> Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete.

Litigation by the Attorney General

As required by the Supervision of Trustees and Fundraisers for Charitable Purposes Act, Govt. Code, §12580 *et seq.*, all three charities submitted both their audited financial

statements and Forms 990 to the Attorney General's Registry of Charitable Trusts. For reasons unknown, the Attorney General's office investigated the charities and charged them with filing false statements with the Registry, and making false statements to the public. Copies of the Cease and Desist Order against, and the Appeal and Request for a Hearing by, each of the three charities are linked from this web page: https://oag.ca.gov/charities/public-notice.

It is my understanding that the Justice Department's administrative law judge who heard the cases has indicated that he intends to rule that, by valuing their GIK at its wholesale fair market value in the US, the charities acted in accordance with GAAP, and did not make any false or misleading statements to the Attorney General or the public. However, no written opinion has yet been issued.

In the course of the litigation, the Attorney General was apparently unable to find a certified public accountant who is familiar with the application of GAAP to valuing GIK to testify in support of his position. From the lawyer representing one of the charities, I understand that the "expert" CPA who testified in support of the Attorney General's position admitted to no significant experience in valuing GIK.

A.B. 1181

Faced with this impending loss, I understand that the Attorney General's office drafted, and asked you to introduce, A.B. 1181. A.B. 1181 has three operative provisions:

Source of GAAP

When preparing their financial statements and Forms 990, charities and their accountants and auditors are subject to applicable authoritative statements by FASB, GASB and the AICPA.

First, A.B.1181 would amend Cal. Bus. & Prof. Code §17510.5(a). Subsection (a) presently recognizes the several organizations whose statements are part of GAAP:

> The financial records of a soliciting organization shall 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.

The proposed amendment would arbitrarily limit the "source" of GAAP to the Financial Accounting Standards Board, and ignore the integral contributions of the American Institute of Certified Public Accountants and the Governmental Accounting Standards Board, supplementing the general principles established by FASB in this area, to GAAP. From this I infer that the Attorney General believes that had the ALJ not taken into account the statements of the AICPA and/or the GASB that address the valuation of GIK, the ALJ would have ruled in his favor.

I'm sure that the California Society of CPAs or the AICPA can provide you with a more detailed explanation of how the statements by the GASB and the AICPA are an integral part of GAAP.

Measuring "fair value": U.S. vs. market where distributed

The central issue in the administrative litigation is which market is most appropriate for measuring the value of donated GIK—the market in the United States, where the GIK was donated (or would have had to be purchased), or the market in the country where the GIK is used. According to the Cease and Desist Orders issued to each of the three charities, by using the U.S. market valuation instead of the valuation in the market in the countries where the GIK was distributed, they made materially false statements on their Forms 990, in their submissions to the Registry of Charitable Trusts, and to the public in solicitations for contributions. In the last case, the allegation is that, by including overvalued GIK in their program service expense, the charities misrepresented the percentage of their expenses spent for their charitable programs. These allegations have been rejected by the ALJ, based on his conclusion that the U.S. market is the relevant market.

A.B. 1181 proposes to remedy this perceived problem by adding new subsections 17510(c) and (d), which state:

> (c) 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.
>
> (d) For the purposes of this section:
>
> (1) "End recipient market" means the market in the country where the receiving charitable organization is located.

> (2) "Fair value" means the price that the receiving charitable organization would receive if it sold the noncash contribution.

These proposed new subsections raise several important questions. First, if GAAP is established by FASB, and the Attorney General believes FASB's Accounting Standards Codification supports its position, why is it necessary to create an arbitrary rule in subsection (c)? If the Accounting Standards Codification does not support the Attorney General's position, then, contrary to §17510.5(a), the Attorney General is proposing to require charities to use a standard other than GAAP to value GIK.

Second, the rule fails to address how a charity should value GIK when, as of the close of its fiscal year, it has received GIK, but not yet decided to which country (or countries) it should be sent. The Cease and Desist Orders describe a scenario in which the GIK is shipped directly from the manufacturer to a foreign charity designated by the U.S. charity as the final recipient, when the receipt of the contribution and the expense attributable to the distribution would presumably be recorded as of the same day. However, the orders omit a different, commonplace scenario. On many occasions, the U.S. charity takes possession of the GIK at its warehouse in the U.S., pending a decision about the country or countries to which the GIK will be shipped. In that case, as of the end of its fiscal year, the U.S. charity may not know the country for which in-country values must be reported to California.

A related problem is that if A.B.1181 is enacted, charities subject to the new rule might be obligated to spend substantial sums—reducing the amounts available for their charitable programs—to research and obtain wholesale market values for the same product in multiple countries to which a product was shipped, including many where there may be no "fair value" because there is no commercial market for the product.

Third, the proposed valuation requirement is vague, in that it does not provide charities with sufficient notice about how they can comply with the law. Presently, apart from the proposed §17510.5(c), for purposes of both its audited financial statements and its IRS Form 990, and in accordance with GAAP, a charity is required to value GIK at its wholesale value in the United States. The 2018 instructions for Form 990 state:

> Unless instructed otherwise, the organization should generally use 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.

A charity cannot complete Form 990 in one manner for the IRS, and differently for California. In fact, the Attorney General demands that the Form 990 that charities submit to the Registry of Charitable Trusts be "identical" to the Form 990 submitted to the IRS. Thus, it appears that proposed §17510.5(c) would place charities subject to the rule in the impossible position of being unable to satisfy both the IRS and the Attorney General.

Thus, we respectfully request that you ask the Attorney General for a description of what changes in financial reporting on Form 990 and in audited financial statements would be expected if A.B. 1181 is enacted, and how those changes would avoid being misleading or causing confusion (see below).

Finally, the premise of the proposed change is the perceived importance of a charity's program service expense percentage as a measure of whether it is a "good" charity. It seems that the Attorney General would be pleased if a charity could properly report that 90% of its expenses were sent for program services, without regard to the whether its programs were actually accomplishing anything worthwhile. The three most reputable resources for information about charities, Guidestar, the BBB Wise Giving Alliance, and Charity Navigator, have all rejected the premise that a charity's program service expense percentage is a useful measure of the effectiveness of its work. "The percent of charity expenses that go to administrative and fundraising costs—commonly referred to as "overhead"—is a poor measure of a charity's performance." http://s5770.pcdn.co/wp-content/uploads/2014/10/GS_OverheadMyth_Ltr_ONLINE.pdf; *see generally*, http://overheadmyth.com/.

Prohibited actions

The third operative provision of A.B. 1181 adds new paragraph (13) to Govt. Code §12599.6, which would prohibit a charity registered with the Registry of Charitable Trusts from—

> Reporting noncash contributions in its audited financial statements, reports filed with the Attorney General, or solicitation materials, in a way that is misleading or likely to cause confusion.

This provision simply begs the question. Why (apart from proposed §17510.5(c)) is it "misleading" to report in accordance with GAAP? And for a charity to report one value using GAAP (apart from proposed §17510.5(c)) on Form 990, and a second value (taking proposed §17510.5(c) into account) on other reports to the Attorney General and in

solicitation materials seems fairly "likely to cause confusion" among donors and prospective donors.

Conclusion

For the reasons discussed above, I respectfully request that you withdraw your support for A.B. 1181.

* * * *

Delegate Limón, that concludes my comments on A.B. 1181. Thank you for your time and attention to this matter. I would be pleased to discuss this matter with your or your staff at your convenience.

cc: Tania Ibanez, Deputy Attorney General
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