

# External Governance of Non-Profit Organization

## —Reflections on the Auditing Guidance of Public Welfare Foundation

Wei Xia

College of Public Administration, Jinan University, Guangzhou, China

Email: vvieo57894@163.com

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### Abstract

Nowadays, the society is increasingly concerned about the operation of the public welfare foundation. For third-party supervision as an important tool of external governance, the audit of the foundation should be targeted to reflect the implementation process and results of the fiduciary responsibility of the public welfare fund so as to meet the community's open and transparent demand for charitable information, reshaping the credibility of charitable organizations. Improving the traditional audit model tailored, and auditing the foundation in whether it is responsible for its public fiduciary responsibility, from the donors' point of view, the evaluation of the operation of the public welfare fund may be better able to meet the social's need for charity accountability.

### Keywords

Nonprofit Organization, Governance, Audit Supervision

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## 1. Raise the Problem

Since the beginning of this century, civil nonprofit organizations, including the foundation, have been thriving to become the “third sector” to save “government failure” and “market failure”, and its responsibilities undertaken are broadly related to all aspects of social life. China's charity has been in rapid development. However, because of the frequent outbreak of the domestic charity scandal, the credibility of our charity has been in heavy blow. At present, the confidence crisis of the charity is one of the key reasons Chinese non-profit organizations face the difficulty of fund-raising, because people do not know where their donations go and whether it is really used for the commonweal. We should fully realize that only reshaping of charitable organizations credibility and letting ordinary

people clearly see the flow of money can lead the whole society to participate in public welfare actively. How can public service institutions build credibility? Leveraging from the intermediary organizations that are generally trusted is undoubtedly the best shortcut. As the third independent party of donors and public institutions, accounting firms and other intermediaries play a more objective and impartial role for identifying statements.

Compared with other non-profit organizations, the foundation's information disclosure and audit mechanism construction is in the leading position, implementing certified public accountant auditing and auditing results announcement system earlier than others [1]. It can convey to the public the signal of open, transparent and effective operation through the audit of the foundation, and then take advantage of the external governance effect of audit, to attract more charity donations and to optimize the allocation of resources. The foundation's information disclosure already reaches the leading level compared to other forms of charitable organizations. And the foundation has also become one of the first batch of nonprofit organizations to implement the CPA audit and audit results publicity system [2], which can theoretically regain social trust, but why is it still be questioned? As a charitable and humanitarian relief organization that exists to meet the needs of society, does the general risk-oriented audit model which is applicable to the enterprise be also suitable for the foundation?

## **2. Why Does Question Exist—Information Supply Can Not Meet the Demand**

As the State Audit Commission Auditor General Jiayi Liusaid: "Audit is an indispensable part of the national political system, which is an 'immune system' designed to maintain the health of society and national economy." Therefore, it can be argued that the audit of nonprofit organizations is the institutional supply of the economy and society's immune system.

As public welfare fund which is taken as an organization exists to meet the need of society, its requirement for "immune system" must have its own particularity. And due to its charitable nature, compared with corporate legal person, because it doesn't generate profits, the managers do not have the pressure to create profits to return investors as they do in the profit organizations, so that their financial statements and audit requirements are different from those of firms. As donors would expect their donation to generate certain social significance, the audit requirement of the foundation is to supervise and evaluate its public responsibility entrusted by the donors, the public, even the whole country. So the audit objective isn't simply a reasonable guarantee of the fairness and legitimacy of the financial report but an assurance of the donation used under the will of donors and building public's confidence in charity.

Because its different property rights and principal-agent relationships compared to governments and enterprises, nonprofit organizations must have a unique governance mechanism that adapts to them. In other words, the special

audit needs of the foundation derive from its special commitment to public interest. Because its fiduciary responsibility is different from those of the enterprise and government, it is not only accountable for the public resource providers but the relevant stakeholders including its clients. Moreover, it aims at maximizing the public welfare, organizes and provides the public service at home even abroad. Under the fiduciary duty theory, when the principal-agent relationship is established, as a trustee, the nonprofit organization shall fulfill the obligations entrusted by the client in accordance with his wishes of the client in an effective manner. As there is bound to be information asymmetry between the principal and the trustee, as a result of that, the client is not directly involved in the daily management of non-profit organizations. In order to supervise the management of the property of the non-profit organization, the client must understand the operation status of the non-profit organization, and evaluate the performance of the trustee based on the information obtained and decide whether to continue to provide resources. Therefore, according to the fiduciary duty theory, the audit conclusion of the nonprofit organization can not only be involved in authenticity and fairness of the financial information, but also pay attention to whether the organizations' behavior fulfills the charitable mission and social responsibility according to the wishes of the client and its entrusted economic responsibility.

This public fiduciary responsibility of the foundation refers to the institutions that are entrusted with management power and have the right to use public resources shall take the responsibility for reporting to the public about the management of these resources and the process of planning, control and finance. As the funds raised by nonprofit organizations are characterized by gratuitousness, it determines that the funds should aim at fulfilling public fiduciary duties actively. With the establishment of the principal-agent relationship, the corresponding responsibility also needs to be clear to ensure that the agent could meet the expectations of the clients and the whole society. The audit report, as the only visible physical result in the whole audit process, should also provide reasonable assurance for the risk of fiduciary duty.

The current audit of the foundation is mainly based on the idea of risk-oriented idea, however, due to the possible existence of self-interest and moral hazard, risk-oriented audit is likely to be unable to meet the public's expectations towards the foundation. The supply of audit information as the additional disclosure of charitable information disclosure cannot be completely docked with the needs of many stakeholders to understand the donation of information. Meantime external audit should have been able to donate the positive effect of charitable donations, it's not prominent too.

### 3. Literature Review

Some scholars have conducted research on the audit guidance of the public welfare foundation.

Kai Wang [3] believed that auditing non-profit organizations such as public

foundations which highlight the public welfare and social function should apply donor-wish risk oriented audit, that is, aiming at achieving the donor wish based on the modern risk-oriented audit. Therefore, the audit opinion can not only reasonably guarantee whether there is major misstatement in the financial report but whether the donation is used under the will of donors.

Ruiying Zhu [4] argued that although the audit of the performance of disaster relief funds and fees are based on the basis of legitimate use on the review of emergency relief funds and materials, in addition, focusing on the review and supervision of the economics, efficiency, effectiveness, openness and transparency of the management and use of emergency relief funds and materials is necessary, too. Cuili Shao [5] also mentioned similar ideas, and built the relationship between audit and public management theory.

Zexia Wang [6] identified that the management is a high risk area for fraud. Thus the audit of accounting statements could focus on identifying and determining the risk of management fraud and take this as the entry point of the audit.

Bin Zhao [7] claimed that the audit should be linked to the theory of public crisis management, based on the whole process of tracking audit, oriented to crisis response, and improve the audit system of disaster relief funds, making it more responsive to the external audit environment under the conditions of public crisis.

Bo Cheng, Ting Xiong and Jing Wang [8] introduced the definition of property rights of nonprofit organizations, audit orientation and logical deduction, building an audit guide map of dual-oriented, three trial, internal and external co-governance, aiming at better guiding non-profit organization audit, and enhancing its social credibility.

At present, the domestic research on the governance of charitable foundation is not a few, providing a directional guidance and clarifying the ideas for the empirical research of charitable foundation. In addition, the theoretical research results on the information disclosure of the foundation are also abundant. In contrast, relevant research about improving information disclosure and enhance its credibility from external audit of charitable foundation is not too much.

#### **4. The Fiduciary Responsibility of Public Welfare Fund and Its Audit Model**

The Ministry of Finance and Ministry of Civil Affairs jointly issued “The Notice about How to Further Strengthening and Improving the CPA Audit System of the Foundation”, in December 26, 2011, demanding the foundation to accept the audit of certified public accountants legally. The various types of foundations registered in the civil affairs department in China will be audited by the accounting firm from January 1, 2012. The necessity and importance of the audit system for a non-profit organization management and the fulfillment of the fiduciary duty is far greater than that of an enterprise.

The quality of nonprofit organizations governance depends largely on whether the mission of public welfare can be done efficiently, and the social trust of the nonprofit organization depends entirely on the system in which the fiduciary duties are fulfilled and the actual situation of the fiduciary duties being conveyed to the public. Only by effectively carrying out the fiduciary responsibility and transmitting the relevant information to the stakeholders can the social trust of nonprofit organization be recognized, maintained and improved, so that the nonprofit organization can proceed smoothly.

Therefore, the audit supervision of non-profit organizations not only needs to justify the fairness and legitimacy of their financial statements. Furthermore, it needs to achieve the special audit purposes ignored by general risk-oriented audit, alleviate the confidence crisis caused by information asymmetry. In addition to ensure that the financial report is fair and real, but also must ensure that donations is used in accordance with the wishes of the donor and its declared public mission, supervise the foundation's trustee responsibility entrusted by the public.

Therefore, I believe that, as an important tool for the external governance of the foundation, the traditional financial statements risk audit guidance cannot fully meet the non-profit organizations' need to play the social functions and achieve the special needs of public mission. It can not reflect the specific implemental circumstances of the public fiduciary responsibility of the foundation in details, quality and timeliness. Auditing of nonprofit organizations should have specific targets. The risk-oriented audit model should take root in the soil of public welfare, cater to the special needs of the public sector, and fulfill the fiduciary duty-oriented audit to investigate whether it operates in accordance with its declared public mission. This new model can be more convincing to meet the citizens' needs of an open and transparent charitable information. It must be useful for reshaping the credibility of charitable organizations, and pushing our country's public welfare undertakings to a new climax.

The foundation's external independent audits are purchased directly for the organization and configured for the market price, so it has a certain private property. But compared to personal items, its audit report has the characteristics of obvious public goods such as non-exclusivity and non-competitiveness, moreover, potential donors do not need to pay an additional fee when obtaining an independent audit report, and a person using an independent audit report does not affect others using the same report. On this basis, combined with the nonprofit organization's non-profitability and social welfare, it is more appropriate to define the audit information disclosure as public goods.

Public goods cannot be traded on the market as ordinary private products, so the barrier to achieve a balanced production of public goods is that consumers can not correctly display their own consumer preferences [9]. For the foundation, the consumer is the donor, but also the client. It can include the public, members and so on. We can treat them as the contractor. While the manage-

ment layer is taken as an agent system, they have not the pressure of generating profits to return investors as profit organizations do. At the same time, there is a steady stream of funds for its injection from the government and society. Therefore, the phenomenon of illegal operations, embezzlement of public property, and seeking personal gains by the name of the public interest is rampant. Organizational behavior deviates from the fulfillment of the fiduciary duty, which seriously damages the trust of the client.

In such a case, the audit institution shall be able to effectively constrain the conduct of the management, to audit whether donation is made best use of and used in accordance with the wishes of the donor and its declared use of the mission, to obtain a reasonable guarantee about whether the organization conduct follows its fiduciary responsibility, reduces the risk of organizational operations deviating from fiduciary duties to an acceptably low level. Risk-oriented audit of fiduciary duties specifically means that, when auditing such an organization whose main mission is to fulfill social responsibility as public welfare foundations, whether its organizational behavior fully delivers the risk-oriented fiduciary duties. In addition to a reasonable assurance for its legitimacy and fairness of public welfare fund's financial report, it still needs to pay extra attention to whether the donation resources are used for specific purpose or usage, and whether achieved the desired results and efficiency.

### **5. A Preliminary Study of the Foundation's Fiduciary Duties Risk-Oriented Audit Model**

Traditional risk-oriented audits implement risk assessment procedures, identify and assess the risk of material misstatement of financial statements. However, the owner of the property of a nonprofit organization is the public. Donors, recipients and beneficiaries, these three are not the full owners of nonprofit property rights, so it is obviously not appropriate to take them as an audit client. The nonprofit organizations aim to achieve commonweal mission without shareholders, directors and those who are related with organizational interests, and won't generate profits like a profit organization. If you copy the audit model of profit-oriented organization completely, audit is difficult to function. When auditing nonprofit organizations, in addition to implementing risk assessment procedures, design and implement further audit procedures to respond to the risk of misstatement, correct the misstatement of the audited entity, and publish the appropriate audit opinion. It is also necessary to add non-profit organization internal control and project efficiency into the scope of the audit, thereby enabling nonprofit organizations to improve performance and social credibility, to avoid the lack of responsibility and resource abuse, and to promote a healthy and harmonious development of nonprofit organizations.

The public nature of the foundation determines its fiduciary duty in a special sense. Foundation has a different purpose and social mission different from other audited units. As a public interest agent which is mainly reflected in the im-

plementation of social functions, the audit ideas, methods and priorities should also be different. The audit of the foundation should reflect the implementation process and results of the fiduciary duties of the public welfare foundation. The main differences between the risk-oriented audit model of public fiduciary responsibility and the risk-oriented model of traditional enterprise audit are summarized as follows (Table 1).

- Key Link—An extension of risk-oriented audit model

At present, due to human resource and other aspects of restrictions, the financial and public welfare activities of the foundation can't be real-time supervised, thus audit and inspection can only be done after the activities. And the annual report which only shows the direct income and total expenditure cannot clearly reflect the problem "where the money come from and where the money go", which leaves a "clean edge ball" space. Auditing for charitable organizations must fill this gap, and strive to reflect the dynamic use of funds in details and to assess the operation of the activities comprehensively.

① The use of financial resources from various sources of income must meet the qualifying conditions for resource use and the way donation used must be in accordance with the wishes of the donor.

② Pay attention to the relevant internal control of the use of the donation in the audited units. Not only do we need to focus on the operation of internal control, but also to consider whether a particular control could (alone or together with other controls) and how to prevent, discover and correct the misappropriation of donated money and in that way.

**Table 1.** The main differences between two models.

	Traditional risk-oriented audit [10]	Risk-oriented audit of public fiduciary responsibility
Audit objectives	To confirm the fairness of the financial statements and to reduce the residual risk to an acceptable level	Reflecting the results of the fulfillment of the fiduciary duties of the Public Welfare Foundation
Risk factors	Risk of material misstatement	Risk of material misstatement, and deviating from fiduciary responsibility
Audit risk model	Audit Risk = Substantial Misjudgment Risk × Check Risk	Audit risk = (the risk of material misstatement + the risk of deviating from the fiduciary duty to fulfill) × check risk
Audit object and focus	Focusing on risk management, control and governance processes	Mainly concern about the management system, business processes, project performance and other organizational internal risk factors
Audit procedures	Integrated use of inspection, observation, inquiry, external confirmations, recalculation, re-execution and analysis	A variety of ways to obtain audit evidence from outside the audited foundation, such as observations, external confirmations, field research, etc.
Audit path [11]	Afterwards-audit	Pay more attention to pre-audit and intermediate audit

Chart source: Author self made.

③ Whether the public welfare funds expose the amount of donation; whether the use of the donation is kept tracking down; whether the progress of donation use is made public in time; whether the public is concerned about the whereabouts of the money; whether the social media keep reporting the large-scale public welfare activities.

④ Whether the implementation of the project has followed the mission of public welfare, does the use of charitable resources is efficient. What's more, we need to draw in and construct the foundation financial analysis and evaluation indicators, to analyze and evaluate the efficiency and effectiveness of foundation resources, and to provide effective information for decision-making and oversight for resource donors, government and foundation management, struggle for the better control and scientific plan of the effectiveness of the foundation.

⑤ Prepare the results questionnaire and results summary table:

Visit the donated units and individuals to check whether the aid provided is working, whether the amount of funds or the quantity of items, specifications, brand and quality is consistent with the plan. If there is anything inconsistent with the plan, check whether there is permission from the authority's approval, whether the recipient received the receipt from the foundation, whether there is any sign of fraudulent claims or unfair distribution, and whether the material received can resolve the emergency, easy to use and so on.

Summarize the information into a table, discuss the project results with the relevant person who are in charge of the foundation, and evaluate whether the project is completed as expected and whether it achieve the social functions and public mission.

⑥ Before issuing the audit report, to confirm the final outcome of the foundation activities, we should resort to the survey or interviews with the recipients done by the mainstream media to check whether the donation is used properly, how the goods and materials is used and whether the amount and flow accord with the original plan and budget. If there is any deviation, we should see whether the donation is approved by relevant directors, whether the change of the distribution is reasonable, and etc.

## **6. Conclusion and Discussion**

The nature of the nonprofit organizations decides that it is under no pressure to make profits. Moreover, with its peculiar system background, purpose and mission, the management does not have to worry their organization will be acquired or merged. However, there is still the possibility of pursuing selfishness, or manipulating or whitewashing the cost of business activities. Only by relying on effective non-profit organization governance mechanism can we prevent the integrity crisis, improve the efficiency, guide the healthy development of non-profit organizations, and lead it back to its nature.

As the civil audit of the foundation has just started, not only the modern risk-oriented audit model is unable to meet the current audit needs, but the pub-

lic fiduciary duties cannot be fully reflected. Apart from reasonably guaranteeing there is no major misstatement risk in the financial statement, the audit for the non-profit organizations shall examine the risk of diverging from the fiduciary duties and make a reasonable assurance.

At present, in-depth and systematic research about audit accountability on the non-profit organization is relatively weak in the theoretical circles. To enhance the information disclosure of the non-profit organizations through accountability, audit still lacks of sufficient theoretical guidance. Audit to evaluate the operation of the public welfare fund from the donor's perspective, may be more able to meet the social needs of charitable accountability, yet it has to be refined and practiced.

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