Are We OK?

New, post-Enron ethical standards for corporations are prompting orchestras to scrutinize their own governance practices.

The Legal Aid Society of New York, America’s oldest law firm serving poor clients, was also once the country’s largest and most respected. Its 880 lawyers handled more than 200,000 criminal cases a year through a contract with the City of New York, and Legal Aid also ran a small-scale, privately funded effort to handle civil cases on behalf of the poor. But in the summer of 2003, Legal Aid’s distinguished reputation began to unravel with an anonymous tip alleging financial improprieties.

Legal Aid's recent history clearly flanks "the front-page local-news-paper test," Peter Shira’s term for operations so lax that they attract unwanted media attention—while, of course, deterring from the organization’s effectiveness. Shira, senior vice president of the nonprofit service organization Independent Sector, hopes that stories like Legal Aid’s will be a wake-up call for governing boards of nonprofits everywhere to strive for better fiscal oversight and better governance overall.

Over the last three years, ethics and accounting scandals at companies like Enron, Arthur Anderson, Adelphia, and WorldCom have created the climate for better fiscal oversight and better governance overall. Over the last three years, ethics and accounting scandals at companies like Enron, Arthur Anderson, Adelphia, and WorldCom have created the climate for better fiscal oversight and better governance overall.

While orchestras and other nonprofits are required to comply with only a few of the provisions of Sarbanes-Oxley, service organizations such as BoardSource and Independent Sector are actively suggesting that nonprofits voluntarily adopt some of the principles and best practices outlined in the Act. If they don’t, says Edward Able, a board member of Independent Sector and president and CEO of the American Association of Museums, such measures may eventually no longer be optional; the Senate Finance Committee is already exploring new regulatory legislation specifically for nonprofits. “We hope we can stave it off if we build some of the principles of Sarbanes-Oxley into best practices at nonprofits,” says Able. “We’re working with the committee, and trying to convince them that with the diversity of nonprofits, it’s impossible to do a one-size-fits-all [bill].”

In their report, “The Sarbanes-Oxley Act and Implications for Non-profits” (available free online at www.independentsector.org under the “Accountability” menu), Independent Sector and BoardSource lay out the areas of concern. These include insider transactions, conflicts of interest, audit procedures, certified financial statements, and financial disclosure, in addition to the two elements of Sarbanes-Oxley with which nonprofits are required to comply: whistle-blower protection and document destruction.

The groups have condensed their recommendations into a two-page checklist, “Learning from Sarbanes-Oxley” (see “In Brief,” page 38). But Independent Sector’s recommendations go beyond adapting the Sarbanes-Oxley Act to the size-fits-all [bill]. In their report, “The Sarbanes-Oxley Act and Implications for Non-profits” (available free online at www.independentsector.org under the “Accountability” menu), Independent Sector and BoardSource lay out the areas of concern. These include insider transactions, conflicts of interest, audit procedures, certified financial statements, and financial disclosure, in addition to the two elements of Sarbanes-Oxley with which nonprofits are required to comply: whistle-blower protection and document destruction.

The code’s suggestions read like com-
What the law says, and what orchestras should do

Two provisions of the Sarbanes-Oxley Act of 2002 apply to all companies, both for-profit and nonprofit:

- **Whistle-Blower Protection.** Companies must protect whistle-blowers, take their complaints seriously, and protect them from retaliation. This includes developing a formal process to deal with employee complaints.

- **Document Destruction.** Companies cannot alter, cover up, falsify, or destroy documents to prevent their use in a federal investigation or bankruptcy proceeding. Companies should develop a clear policy on document retention and periodic document destruction. If an official investigation is underway (or even suspected), managers must stop any document-erasing immediately.

Orchestras should familiarize themselves with Sarbanes-Oxley provisions. Similar requirements exist in piecemeal in various states, and the IRS may soon require nonprofits to tighten their operations in these areas. Independent Sector and BoardSource recommend that all nonprofit orchestras take certain specific actions with regard to the remaining Sarbanes-Oxley provisions:

- **Audit Committees.** Orchestras that undergo full audits should establish an independent audit committee, separate from the finance committee. No member of the audit committee can receive compensation from the company—in other words, no managers, not even the CFO, should be on this committee. Even smaller orchestras, which may not be required to have an annual audit, should have their financial statements professionally compiled and reviewed. For all orchestras, financial literacy training should be part of the orientation of new board members.

- **Audit Firms.** Orchestras that undergo full audits should rotate firms (or at least lead and reviewing partners), every five years. In addition, audit firms should provide a single orchestra with both audit and non-audit services (other than tax preparation).

- **Certification of Financial Statements.** The CEO and CFO must both fully understand the financial statements and make sure they are accurate and complete. Ditto for forms 990, which should also be promptly filed.

- **Conflicts of Interest and Insider Transactions.** Orchestras should avoid real or apparent conflicts of interest, including personal loans to trustees or executives. All orchestras should have a clear conflict-of-interest policy that is fully disclosed and strictly enforced.

- **Disclosure.** Orchestras should provide their donors and the public with an accurate picture of their financial condition. By long-established law, nonprofit organizations must make their forms 990 available to anyone who requests them; audited financial statements should also be easily accessible for review.

Adapted from publications of Independent Sector and BoardSource: The Sarbanes-Oxley Act and Implications for Nonprofit Organizations and Learning from Sarbanes-Oxley: A Checklist for Nonprofits and Foundations.
“We live in a more complex world, and with nonprofits under more scrutiny, what might have passed muster a few years ago no longer will,” says Peter Shiras.

The response to Sarbanes-Oxley and the new scrutiny of nonprofits has acted as a call to boards and organizations to evaluate their governance procedures on a broad scale. “We live in a more complex world, and with nonprofits under more scrutiny, what might have passed muster a few years ago no longer will,” says Independent Sector’s Peter Shiras. Their challenge, he says, is manifold: “a combination of boards developing a higher degree of diligence, knowing what their responsibilities are; educating themselves in best practices; [and] being sure they have procedures in place for financial oversight, conflict of interest, evaluating the CEO, and setting the practice for executive compensation. That’s the procedure part. “The other half of the battle,” Shiras continues, “is making sure there’s a culture within the board that encourages what you might call constructive criticism and constructive debate. It’s about setting the tone at the top, so that board members feel that there are no stupid questions, discussion is encouraged, and being sure ethical values permeate what the board and the organization do.” Independent Sector’s model Code of Ethics suggests standards in categories such as governance, legal compliance, responsible stewardship, and openness and disclosure. “We hope our member organizations will adopt it for their own circumstances,” Shiras says.

Several orchestras have recently undertaken the process of evaluating their governance practices in response to Sarbanes-Oxley. The Spokane Symphony has adopted an ethics policy, and tentative approval has been given to new board policies in reference to an audit committee and conflict of interest. The Nashvile Symphony, meanwhile, spent the last two years completely revising and updating its by-laws which, according to President and CEO Alan Valentine, "hadn't been looked at for a long time.” In the intervening years, he adds, “the orchestra has grown very rapidly, expanding its annual budget from $6 million in 1998 to $11 million in 2004. The Nashville Symphony is also building a concert hall, scheduled to open in 2006. It has undertaken a major capital campaign, has assets of $200 million (up from $6 million in 1998), and has doubled its staff to 60. A new look at governance seemed necessary in the face of such dramatic organizational change.

While Nashville’s effort was not undertaken in response to Sarbanes-Oxley, Valentine says, “The Enron stuff was happening at that time, and we thought it had to have tighter oversight and controls—to beat Congress to the punch.” Among the changes to the Nashville Symphony by-laws were the formation of an audit committee of five members, all of whom are directors and not employees of the orchestra. “It adds another layer of oversight, and provides a forum for auditors to talk with the board without paid management in the room,” Valentine says.

Nashville also addressed broader areas of governance. It put more power in the hands of its executive committee, enabling the board to operate more efficiently, and built in mechanisms to keep the CEO in balance. The nominating committee became the “governance” committee, with responsibility for overseeing the operations of the board. The current board chair does not serve on that committee, and while Valentine sits on the committee as the orchestra’s president, he does not vote on nominating matters. “It’s a way to prevent the board from becoming a clique of people who are too close to each other, and to keep the CEO from loading the board with people who will do whatever he wants,” Valentine says.

Self-Examination For the Baton Rouge Symphony, the trigger for self-examination was a voluntary certification initiative offered by the Louisiana Association for Nonprofit Organizations. Titled “Louisiana Standards for Excellence,” the program invited...
Louisiana groups to complete a 28-page application, detailing their compliance to specific standards in a broad range of categories: mission and program, governing body, conflict of interest, human resources, financial and legal, openness, fund raising, and public affairs and public policy. The process of evaluating the orchestra’s compliance and establishing proper policies took several months, but was worth it, says J.L. Nave, the orchestra’s executive director. “It’s easy to let things slide—there’s the season coming up, the budget is due, the staff is overworked—but that doesn’t mean we should neglect the internal health of the organization,” he says. “It was a great body, conflict of interest, human resources, financial and legal, openness, fund raising, and public affairs and public policy. The process of evaluating the orchestra’s compliance and establishing proper policies took several months, but was worth it, says J.L. Nave, the orchestra’s executive director. “It’s easy to let things slide—there’s the season coming up, the budget is due, the staff is overworked—but that doesn’t mean we should neglect the internal health of the organization,” he says. “It was a great process—a little difficult, but it made us stronger.” Some of the changes include a more specific and effective conflict-of-interest policy, a confidentiality policy, and the formation of a new committee for government affairs and advocacy. The Dallas Symphony Orchestra has also complied with the spirit of the Sarbanes-Oxley Act. According to Fred Bronstein, the DSO’s president, the orchestra now has a standing Audit and Ethics Committee, charged with engaging the independent auditors and approving their work. A new conflict-of-interest policy is in place, the product of a task force of the Audit and Ethics Committee chaired by Dr. Richard O. Mason, professor of ethics and public policy at Southern Methodist University. The orchestra requires a Conflict of Interest Disclosure Statement to be completed by all members of the DSO’s board of governors, executive board, foundation, advisory governors, counsel to the chairman, and all staff; and education in what constitutes conflict of interest is planned for the board and staff. The DSO has also contracted with an outside company to provide “whistle-blower” services, allowing any complaint regarding accounting or auditing matters to be filed confidentially and anonymously. Orchestrans have gone through the process of scrutinizing their own ethics, governance, and accountability so that it is not enough to have the policies—they must pay attention to them. This also speaks to the essential nature of boards, which are ultimately responsible for the actions of the organization. “Very often boards don’t even have discussions,” says Peter Shira. “Attendance is bad; policies are in place but they are not followed, or even are consciously set aside, because it is said that they are burdensome. It’s not enough to say, ‘we have all those things.’ They have to be followed. Is there a culture in which issues are brought forward and dealt with?”

The Sarbanes-Oxley provisions make it impossible for corporate board members and executives to claim ignorance. (For example, they require a company’s CEO and CFO to sign off on all financial statements, including Form 990 tax returns.) By voluntarily adopting standards comparable to those of the Sarbanes-Oxley Act, nonprofit leaders accept the same responsibility. However, this means that board members really do need to understand what’s going on in the organization. One Independent Sector recommendation, “Provide financial literacy training to all board members,” is a case in point. “It’s hard to get boards to pay attention to finances, especially if times are good,” says Abe. “A lot of people on our boards are not financial people. They are not accustomed to reading balance sheets and understanding what they mean.”

Lowell Noteboom strongly recommends having “at least a core of individuals on the board who have the expertise and experience to allow them to be informed monitors of the organization’s finances. Then, for everyone else on board, 60 to 70 percent of whom don’t have the facility to fully understand a financial statement and are embarrassed to ask about it, the organization has a duty not only to give those board members the traditional financial reports, but to provide them with a straightforward narrative summary of what’s in it. This is not a question of catching nefarious activity—the finance committee and the outside auditor would catch that—but the accurate information has to be reported so that they can exercise judgment in the context of the orchestra’s finances, and make wise choices.”

Training, adherence to stated policies, and an open environment for asking questions make for a healthier operation. McAuliffe offers a final example: “The board is supposed to approve the budget. That can be saying, ‘Yes.’ Or, it can be an informed response, like ‘I am comfortable with that revenue projection,’ or ‘I don’t see how we can possibly do that with that little expense.’ The budget should be presented so that it is meaningful, and people can ask good questions.”

“That’s governance.”

Heidi Waleson is a New York-based freelance writer and opera critic of The Wall Street Journal. A frequent contributor to SYMPHONY, she last wrote on teaching artists in the September-October issue.

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