

by Heidi Waleson

# Are

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. The call prompted an internal investigation by Legal Aid executives and board members, who soon uncovered an unsuspected degree of financial mismanagement, even negligence, over several years.

The agency, which had run a deficit every year since 1996, was staring down a projected \$20 million shortfall for FY 2004, and was saved only by an \$11 million emergency bailout from the city. But

# We OK?

What's our financial position? When did we last change auditors? What constitutes conflict of interest? Do our trustees understand the financial statements? What documents should we save? Are employees free to air complaints?



the most shocking element of the story was that Legal Aid's very high-profile board members—respected lawyers and business people—apparently had no idea what was going on until mid-2003. Board chair Patricia M. Hynes, a lawyer at the firm of Milberg, Weiss, Bershad & Schulman, told *The New York Times* last July that the board had never had a discussion about deficits, and had relied on oral reports from management, seeing detailed financial reports only at the end of each year. According to the *Times*, Legal Aid's "financial officers had been neglecting their duties for years, operating without supervision or accountability to anyone at the society or on its board of directors, which had assumed a passive role, focusing mainly on fund raising."

Legal Aid's recent history clearly flunks "the front-page local-newspaper test," Peter Shiras's term for operations so lax that they attract unwanted media attention—while, of course, detracting from the organization's effectiveness. Shiras, 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 new federal legislation covering similar territory in the for-profit sector. The American Competitiveness and Corporate Accountability Act, or Sarbanes-Oxley Act, signed into law two years ago, now requires publicly traded companies to conform to new standards covering governance, financial transactions, audit procedures, conflicts of interest, and other matters of ethics.

When a for-profit stumbles on ethical matters, "the shareholders will feel the negative impact," says Lowell Noteboom; when a nonprofit does the same, "it's the whole community that loses."



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 Nonprofits" (available free online at [www.independentsector.org](http://www.independentsector.org) under the "Accountability" menu), Independent Sector and BoardSource lay out the areas of concern. These include insider transac-

tions, 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: whistleblower 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 requirements. The group has also posted a model Code of Ethics at [www.independentsector.org](http://www.independentsector.org), designed specifically to help nonprofits stay on the straight and narrow.

The code's suggestions read like com-



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mon sense. Concerning audit procedures, for example, Independent Sector recommends an annual external financial audit and the creation of a separate audit committee of the board, which selects the outside auditor. The committee should be free of conflicts of interest and should include at least one "financial expert." Independent Sector also suggests that the auditor (or the lead partner in the organization's audit firm) be rotated at least every five years, and that the organization not use the same firm for any non-audit services except tax form preparation.

#### Business Models

The Sarbanes-Oxley provisions on audit procedures grew out of the Enron scandal, in which the corporation and the audit firm were so incestuously intertwined that the corporation's financial malfeasance was obscured in its audited statements. "The

opportunity for misbehavior is much smaller" among nonprofit orchestras, according to Jack McAuliffe, vice president and chief operating officer of the American Symphony Orchestra League, because their primary purpose is giving concerts, not making money. Still, examples like Legal Aid demonstrate how dangerous a laissez-faire attitude can be.

"The real value of this is for ignorance lapses," says McAuliffe. In some orchestras, he points out, "instead of a separate audit committee, often you have a group of people on board who get together and go over the audit. They trust the CFO, and think that person is doing a thorough

job. But there's room for abuse." That casual attitude may also lead organizations to retain the same outside auditor for many years. "It is much easier," McAuliffe concedes. "If you change every five years, you have to spend a lot of time bringing someone up to speed. But the person who has been there a long time might not look as aggressively, and won't ask the questions that sound dumb on the surface." In a post-Sarbanes-Oxley scrutiny of its own governance and financial practices, the League has just changed auditors after seven years with a single firm. Also planned is an online guide to ethics for orchestras, forthcoming

this fall at the League's web site, [www.symphony.org](http://www.symphony.org).

"Orchestras are very ethical. Good staffs and good responsible board members are playing by the rules most or all of the time," says Lowell Noteboom, a lawyer and League board vice-chairman who also chairs the Saint Paul Chamber Orchestra's board. "However, when I ask in governance seminars, 'Do you have a formal ethics policy?' I get kind of a glazed stare." Noteboom points out that orchestras need to become aware of standards—and not just voluntary ones, since a number of states have passed legislation applying some Sarbanes-Oxley-like rules to nonprofits.

Orchestras of varying budget sizes have recognized some of these issues and acted on them. Kay Walvoord, executive director of the Holland Symphony Orchestra in Michigan, says that with an annual budget of \$140,000, her orchestra isn't required by state law even to have an external audit. However, the HSO has just completed its first one. After the League's National Conference last June in Pittsburgh, at which Sarbanes-Oxley was discussed, Walvoord went to her board chair with her concerns. "Even though the orchestra is under the radar screen as far as state requirements go, my board chair said 'Absolutely—in my corporate life we have weekly meetings dealing with ramifications of Sarbanes-Oxley.'"

Walvoord says that the orchestra's first audit produced recommendations for improvements to financial policy. "The more we can tighten up those systems, the better we look" to corporate donors, she says. "Arts organizations have appeared flaky in governance and financial practices. The more we can match appropriately what the corporate world understands, the better risks we'll seem to be."

Noteboom concurs. "The donor community relies on the board and the integrity of the financial and governance process as the premise on which they are willing to give money." He adds that when a for-profit stumbles on ethical matters, "the shareholders will feel the negative impact"; when a nonprofit does the same, "it's the whole community" that loses.

#### Setting the Tone

Insider transactions and conflicts of interest can also lead to problems if handled too informally. Much of the press scrutiny of nonprofits in recent years has centered on compensation for executives and directors. Of 279 articles about nonprofit accountability published between March 2003 and

July 2004, as compiled by Independent Sector, 60 cite compensation, and 61 refer to conflicts of interest.

The Independent Sector checklist recommends that organizations comply fully with all laws regarding compensation and benefits, and establish a conflict-of-interest policy and a "regular and rigorous means of

## Sarbanes-Oxley in Brief

### 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-purging immediately.

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

- **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 orches-

tras, 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 not 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*.

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enforcing it.” This can help clarify the relationships among trustees, their outside affiliations, and the nonprofit. For example, individuals often provide services and resources to the nonprofit organizations they serve as board members; legal and insurance services are common instances. “Let’s say there’s a board member who is a printer, who is bidding on a program-book contract,” McAuliffe posits. “Is there an official procedure for that?” Nonprofits, he adds, must have clear policies for handling such transactions.

In such a case, the board member may provide the service at cost, as his gift to the organization. This is nothing like the kind of cushy, enriching insider deals that Sarbanes-Oxley is meant to prevent, and there’s no doubt that rigorous self-dealing legislation patterned after rules designed for the for-profit world could be catastrophic for nonprofits. Able says, “There are board members who give money directly from their foundations or corporations to the nonprofit. We put them on the board because they have connections to resources. If you apply Sarbanes-Oxley to that, they would be prevented from doing that.”

## Eye on Ethics Rules

As Congress considers changes to the rules governing nonprofit and philanthropic groups, stay on top of the most recent developments by visiting the Government Affairs page of [www.symphony.org](http://www.symphony.org). Click on **Government Affairs** under Services in the left-hand menu to access Government Affairs Updates, useful links, and more.

“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.



Sector’s Peter Shiras. Their challenge, he says, is manifold: “a combination of boards developing a higher degree of diligence in 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 adapt 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 Nashville Symphony, meanwhile, spent the last two years completely revising and rewriting 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 40. 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 we 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 to 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 oversight balanced. 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

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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 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.

Orchestras that have gone through the process of scrutinizing their own ethics, governance, and accountability stress 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 Shiras. "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 stan-

dards 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," Able says. "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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