

ARTS Law Memo

Standards Mania

A lot of well-meaning people want us to run your organization better. They include U.S. Sen. Charles E. Grassley (R-Iowa); charity watchdog groups such as the Better Business Bureau; umbrella associations like Independent Sector, the Donors Forum of Chicago and the United Way; private foundations; Missouri Attorney General Jay Nixon; the Internal Revenue Service; and government funding agencies.

All are full of sage advice. Some have issued voluntary accountability standards. Others are using Web sites, new regulations or “the stick” to ensure that we earn the public’s trust by operating ethically, efficiently and with transparency.

The recent proliferation of standards can make even the most focused nonprofit executive dizzy. The goal of this issue of *Arts Law Memo* is to help you establish compliance priorities that make sense for your organization.

AGE OF ACCOUNTABILITY

During the last few years, several high-profile scandals and misjudgments by a few large organizations, including the Red Cross and The Nature Conservancy, have undermined the public’s confidence in the nonprofit sector and motivated the government to adopt or consider enacting new regulations.

According to a survey published in October 2005, nearly one-third of Americans have little or no confidence in charities, and two-thirds believe that charities waste a great deal or fair amount of money.

“Rebuilding Public Confidence in Charitable Organizations,” conducted by New York University’s Robert F. Wagner Graduate School of Public Service, found that even the sector’s most confident supporters have come to expect some level of poor performance and waste. Forty-six percent of respondents said leaders of charitable organizations are paid too much.

In 2004, U.S. Senate Finance Chairman Charles Grassley held hearings that focused on the most blatant abuses, including

car donation scams, shady tax shelters and excessive executive compensation. His staff prepared a discussion draft of comprehensive reforms that would protect charities from “bad actors” and tighten their accountability to donors.

Proposed reforms include five-year reviews of an organization’s tax-exempt status by the IRS and a new form for organizations not required to file IRS Form 990 returns.

Other suggestions include restricting the size of governing boards and expanded penalties under intermediate sanctions, which allow the IRS to impose excise taxes rather than revoking the organization’s exempt status when persons benefit from transactions with a nonprofit organization.

In response, the Independent Sector convened a blue ribbon group of nonprofit leaders called the Panel on the Nonprofit Sector. It released a report containing more than 120 recommendations to strengthen the transparency, governance and accountability of the sector.

The recommendations are less sweeping than those proposed by Grassley and are designed to consider smaller charities. Of the 3 million tax-exempt organizations in the United States, 79 percent operate on annual budgets under \$100,000. Only 6 percent of 501(c)(3) organizations have budgets larger than \$10 million.

INTERNAL REVENUE SERVICE

To ensure greater accountability and transparency, the IRS has been reworking its forms. In 2004, the service made significant changes in the application for tax-exempt status. The revised and longer Form 1023 is intended, in part, to capture information about potentially abusive transactions. For example, the revised form asks several questions about compensation arrangements and asks whether applicants have adopted a conflict of interest policy.

As described in the March issue of *Arts Law Memo*, the IRS also revised Form 990, the annual information return filed by tax-exempt organizations with annual receipts

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VLAA helps artists and arts organizations solve and avoid legal and accounting problems by:

- Making referrals to lawyers and accountants;
- Mediating arts-related disputes;
- Publishing *Arts Law Memo* and concise how-to guides;
- Sponsoring seminars and public forums;
- Arranging for guest speakers;
- Maintaining a reference library;
- Operating an arts space clearinghouse;
- Supplying model contracts and other arts law and business materials;
- Facilitating meetings;
- Conducting and disseminating research;
- Contributing articles to publications;
- Collaborating on arts advocacy initiatives; and
- Providing access to the national volunteer lawyers for the arts network.



This issue was written by VLAA Executive Director Sue Greenberg.

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of more than \$25,000. The changes have been described as incremental. A more comprehensive overhaul of the form is underway.

SARBANES-OXLEY ACT

When it comes to increased government oversight, tax-exempt organizations are not alone. In the wake of the Enron scandal and other cases of corporate misconduct, Washington has taken steps to reform the system of financial accountability with the goal of protecting investors and employees.

Two specific areas of the Sarbanes-Oxley Act of 2002 (SOX) apply to all corporations — including nonprofit organizations: whistle-blower protection and record retention/destruction.

The whistle-blower protection provision requires all nonprofit organizations to provide a safe and confidential method for employees to express concerns about questionable processes or to report criminal, fraudulent or unethical acts without fear of retaliation.

The record retention provision makes it a crime to alter, conceal, falsify or destroy any document to prevent its use in an official proceeding.

While it is unlikely that a nonprofit arts organization will be involved in a fraud investigation, the required policy record retention/destruction policy requirement should be seen as an opportunity to examine your organization's procedures — to consider what kinds of documents are critical to your work and to keep them as long as necessary, but no longer.

For more information about SOX, see the February issue of *Arts Law Memo*, which is posted on our Web site, www.vlaa.org. Sample policies also are posted on our site.

STATE PLAYERS

At the state level, New York and California led the accountability wave by seeking to duplicate and or extend SOX provisions to nonprofit organizations. More than 15 states, but not Missouri or Illinois, have adopted or introduced legislation, typically requiring all but the smallest organizations to submit audits.

While neither Missouri nor Illinois are considering new legislation, both

states have responded to the public's increased appetite for information. Missouri Attorney General Jay Nixon introduced a "Check a Charity" page on his Web site (www.ago.mo.gov/checkcharity.index.htm) last year.

His listings include the organization's mission statement, contact information, percentage of expenses spent on administrative and fund-raising, figures on program expenses and total revenue for the year being reported.

The Illinois attorney general provides similar information online. (www.ag.state.il.us/charities/index.htm).

GRANTMAKER PRIORITIES

Public and private grantmakers maintain the public trust primarily by continually seeking to improve the effectiveness of their grantmaking.

To be responsible stewards of their resources, most private foundations grantmakers require grantees to submit evaluation plans. To align values with action, most government grantmakers promote diversity and inclusiveness. To raise the bar, both private and public grantmakers encourage grantees to adopt best practices.

For example, in response to grantmaker requests for financial data, many organizations now include board giving as a separate line item in their annual budget. This highly recommended approach underscores that board member contributions are a fundamental part of the organization's overall fund-raising plans for the coming year and allows progress to be monitored during board meetings. The size of the gift may vary, but the stated goal should be 100 percent participation.

Being able to report "every board member is a donor this year" creates a strong impression; conversely, poor participation may jeopardize funding. A sample board giving policy is posted on our Web site (www.vlaa.org).

WATCHDOG GROUPS

Charity watchdog organizations serve the admirable purpose of helping donors make responsible philanthropic choices.

Thanks to the Internet, your 990

forms are being scrutinized by donors, researchers and the media. GuideStar's database (www.guidestar.org) offers financial information on more than 1.5 million tax-exempt organizations. More than 20,000 people visit the site every day.

The Better Business Bureau's Wise Giving Alliance (WGA) goes a step beyond disseminating financial reports by asking tax-exempt organizations to comply with high standards of conduct. Adopted in 2003, WGA's 20 Standards for Charity Accountability (www.give.org) set a baseline for ethical governance, responsible fund-raising and transparency of financial operations.

The WGA uses the standards to produce reports on nationally soliciting charitable organizations. About one-third of the local Better Business Bureaus, including the Better Business Bureau that serves eastern Missouri and Southern Illinois, report on regional charities.

In 2005, the Alliance responded to more than 2.2 million requests for reports on national charities; BBBs provided 96,648 reports on local organizations.

Adherence to the Standards for Charity Accountability is voluntary. But the consequences of not responding to a request for information or failing to meet all 20 standards can damage an organization's reputation.

Some organizations report that the Better Business Bureau is overly aggressive when gathering the information needed to generate its reports. Nonprofit executives say they have been treated like the unscrupulous roofing contractors, careless moving companies or inept auto mechanics who are typically the subject of Better Business Bureau investigations.

More importantly, they question the one-size fits all criteria, which has been criticized as overly simplistic and too focused on financial measures.

Then there is the nagging sense that the standards have no connection to your real work. Do any of the standards help you produce a world premiere play? A more moving concert? A ground-

breaking exhibit? An award-winning film or literary magazine?

MIXED MESSAGES

Among the other organizations that have issued standards are the Donors Forum of Chicago (www.donorsforum.org), the United Way of Greater St. Louis (www.stlunitedway.org) and Independent Sector (www.independentsector.org). The various standards are similar in scope but vary enough to overwhelm even the most careful reader.

For example, all of the documents address audits. But a growing organization that is wondering whether or not its year-end financial reports should be audited by a certified public accountant will discover that the Illinois Arts Council requires applicants with total revenue in excess of \$150,000 to supply an audit, the Better Business Bureau and Independent Sector standards say \$250,000 and the Missouri Arts Council's threshold is \$500,000.

Some of the standards are not sensible, such as Independent Sector's transparency guidelines, which say your conflict of interest policy should be posted on your Web site. Posting an internal document seems like overkill.

Other standards seem rather arbitrary. For example, the U.S. Senate Finance Committee proposes limiting board size to 15 members. However, several academic researchers have determined that structural arrangements, such as the size of the board and the number of board committees, are not significant indicators of board effectiveness.

HELP NEEDED

If all this helpful advice is contributing to your frustration and fatigue, you are not alone. According to "Daring to Lead," a new study of 2,000 nonprofit executives conducted by CompassPoint Nonprofit Services, two-thirds of the respondents felt that grantmakers had only a weak or modest understanding of what a nonprofit executive director's job entails.

The same could be said about those promulgating standards and encouraging best practices, who have not done enough to assist organizations in meeting their criteria.

Where to Begin?

Adopt the two policies required by Sarbanes-Oxley: whistleblower protection and records retention/destruction.

Adopt a conflict of interest policy.

Take what the IRS says seriously. Your chief executive officer should review Form 990 to ensure that it is accurate and complete. Comply with the regulations related to acknowledging charitable donations, payroll and lobbying. For more information, visit www.irs.gov.

Remember to file your annual report with the Secretary of State. Illinois organizations also must file with the Attorney General.

Get your financial house in order. Operate in accordance with an annual budget that has been approved by the board of directors. Prepare financial statements on a timely basis. To ensure that transactions are properly authorized, recorded and reported, make sure you have an internal control system.

Know when your organization needs an audit and budget accordingly. Prepare a written description of the audit committee's responsibilities. A sample, provided courtesy of Nonprofit Risk Management Center, is posted on VLAA's Web site, www.vlaa.org.

Make sure your board of directors understands its legal duties and can fulfill its fiduciary responsibilities. Use VLAA's forthcoming *Guide to Financial Oversight* as an opportunity for board education.

Spend donations and grants on their intended purpose.

Be aware of the values and priorities of your key funders.

If you receive a questionnaire from the Better Business Bureau, discuss what action should be taken with your board of directors. Make sure everyone understands the public relations implications of declining to respond or responding without being in compliance with all 20 standards.

Remain current with promising nonprofit practices and developments in the law.

Tell us how we can help you. Call 314/863-6930 or send an e-mail to vlaa@stlrac.org.

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