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NO. 1999-4397-3

# INDEPENDENT STATE AUDITOR'S
# REPORT ON CERTAIN ACTIVITIES
# OF THE NATIONAL MUSIC FOUNDATION, INC.

**OFFICIAL AUDIT REPORT**

**OCTOBER 5, 1999**

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The National Music Foundation, Inc., (NMF) is a private, nonprofit corporation originally incorporated in the state of Florida in 1987. The NMF, which registered as a foreign corporation doing business in Massachusetts on July 23, 1993, is exempt from income taxes under Section 501c(3) of the Internal Revenue Code.

According to NMF documents, the organization's main purpose is to build the National Music Center on a 62-acre tract of land in Lenox, Massachusetts. The NMF has adopted the following twofold mission statement:

- To educate the public about American music in order to preserve our nation's musical heritage and
- To provide for the retirement of professionals from the fields of music and recording, with provision made for those who cannot afford to retire on their own.

NMF officials planned to develop the Lenox campus to include a residence for active and retired musicians, a music library, a performing arts center, and a museum. The NMF also hoped to provide scholarship and mentor programs for music students as well as a venue for musicians to perform for the public through concerts and fundraising benefits.

Prior to the start of our audit, the Office of the State Auditor received correspondence that expressed concerns about both the use of $2.5 million in state grant funds as well as whether all stipulations of the grant were being met. Some of the correspondence we received included detailed investigative information gathered by the Town of Lenox's Chief of Police. We considered this information in planning and conducting our additional audit work.

Our audit questions a number of aspects of the NMF's administration of its governmental grant funds. Our audit disclosed that the NMF was not in compliance with a number of provisions of its grant agreements. Most importantly, the NMF was far behind in meeting its grant-imposed fundraising goal requirement of raising $5 million over the next three years. Additionally, when the NMF reported to the funding sources on its fundraising revenue progress, we determined that it overstated these revenues by over 600%, having reportedly raised $475,156 when our analysis indicates that it raised only $67,063.

Our audit also noted that NMF management engaged in questionable, ineffective, and inefficient management practices, especially considering the NMF's receipt of minimal and declining private contributions. NMF allowed employees to live in houses at the Lenox property for either minimal or no rent; went over budget in paying a fundraising consultant; paid a potentially excessive salary to the President/CEO; and rented what was claimed to be a satellite office space in New York City that had no apparent business purpose, We also question the oversight and guidance provided by the NMF's 19-member Board of Directors, since most members do not attend meetings and the actual governance is provided by five members who comprise the Executive Committee.

Lastly, the NMF has entered into a Purchase and Sale agreement to sell the Lenox property to another not-for-profit organization which, if finalized, could result in a gain of over $3 million on this sale. Our analysis indicates that this gain is attributable to the $3,660,000 of taxpayer-funded grants that the NMF has received. Due to the NMF's demonstrated failure to accomplish its mission objectives and its noncompliance with contractual agreements, we recommend that the NMF repay the $3,660,000 of government grants provided as well as

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## INTRODUCTION

Background

The National Music Foundation, Inc., (NMF) is a private, nonprofit corporation originally incorporated in the state of Florida in 1987. The NMF registered as a foreign corporation doing business in Massachusetts on July 23, 1993. The NMF is exempt from income taxes under Section 501c(3) of the Internal Revenue Code.

According to NMF documents, the organization planned to build a National Music Center on a 62-acre tract of land in Lenox, Massachusetts. The NMF has adopted the following twofold mission statement:

- To educate the public about American music in order to preserve our nation's musical heritage and
- To provide for the retirement of professionals from the fields of music and recording, with provision made for those who cannot afford to retire on their own.

NMF officials planned to develop the Lenox campus to include a residence for active and retired musicians, a music library, a performing arts center, and a museum. The NMF also hoped to provide scholarship and mentor programs for music students as well as a venue for musicians to perform for the public through concerts and fundraising benefits.

During the period of our audit, the NMF reported its fiscal operations according to the following functional expense groupings:

Educational Awareness: To provide a national program called the American Music Initiative, which would offer resources to teachers using American music in the classroom, and to provide other educational programs, including workshops and classes on American music.

Membership Events: To provide venues for musicians, songwriters, and other industry personalities that might not be available under normal supply-and-demand economics. Related activities include benefit concerts and special appearances.

Public Service: To provide formal and informal education to the general public, including dissemination of relevant information related to musicians, songwriters, and other industry personalities, their special needs, and the practices and trends in the music industry.

Facilities Operation: To finance occupancy costs associated with the maintenance of the facilities and grounds at the National Music Center.

Supporting Services (Management and General and Fundraising): To provide for the costs associated with the overall administration of the NMF and the costs associated with fundraising activities.

During the period of our audit, the NMF received its funding from a variety of sources, as indicated in the table below:

National Music Foundation, Inc.
Summary of Revenue

| | Fiscal Year Ended June 30, | | |
|---|---|---|---|
| Revenue Source | 1997 | 1998 | 1999* |
| Contributions | $157,226 | $ 63,533 | $194,211 |
| Pledge Income | - | 1,654,685 | 269,945 |
| State Capital Grant | - | 2,500,000 | - |
| Other State and Local Grants | 430,000 | 147,000 | 9,728 |
| State Deferred Payment Grant | 500,000 | 85,000 | - |
| Education Awareness | 66,000 | 63,800 | 125 |
| Performance Events | 34,616 | 136,060 | 215,594 |
| Rental Income | 14,000 | 20,980 | 16,570 |
| Membership Dues | 12,519 | 7,735 | 6,989 |
| Merchandise Sales | - | - | 12,759 |
| Investment Income | - | 14,327 | 34,439 |
| Refunds | - | - | 21,952 |
| Insurance Reimbursement | - | - | 76,678 |
| Other Income | 13,878 | 8,761 | 4,262 |
| Total Revenue | $1,228,239 | $4,701,881 | $863,252 |

*Unaudited amounts from NMF accounting records

## Audit Scope, Objectives, and Methodology

Since locating in Massachusetts, the NMF has received a number of grants to assist in developing the property. In 1998, the NMF was awarded a $2.5 million grant from the Commonwealth of Massachusetts from money appropriated by the state Legislature for regional exhibition, civic, and convention facilities. These funds were to be used for infrastructure improvements to the buildings and site. These funds could also be used to allow the NMF to reimburse itself for certain expenses (up to $750,000) previously incurred in connection with repairs and improvements at the Lenox site and repay any secured debt for financing improvements to the NMC that had matured as of the date of the first grant disbursement. The amount spent for this latter purpose was $376,397.

The Office of the State Auditor received correspondence expressing concerns about both the use of the $2.5 million in state grant funds as well as whether other stipulations of the grant were being met. Some of the correspondence we received included detailed investigative information gathered by the Town of Lenox's Chief of Police. We considered this information in planning and conducting our additional audit work.

We initiated an audit of the NMF to examine various fiscal and administrative controls over state grant funds, including the NMF's adherence to the various grant requirements. Our audit was conducted in accordance with applicable generally accepted government auditing standards for performance audits issued by the Comptroller General of the United States and included such audit procedures as we considered necessary to meet our audit objectives. Our specific objectives were to:

- Determine whether the NMF had implemented effective management controls, including processes for planning, organizing, directing, and controlling grant program operations, and policies and procedures to ensure that grant fund resources are safeguarded and efficiently used.
- Assess the NMF's business practices and its compliance with applicable laws, rules, and regulations; its own internal practices and procedures; and the various fiscal and administrative requirements of its state grants.

In order to achieve our objectives, we assessed the system of management controls established and implemented by the NMF over its operations. The purpose of this assessment was to obtain an understanding of management's performance, the control environment, and the flow of transactions through the NMF's accounting system. This assessment was used in planning and performing our audit tests. We then examined billings, invoices, and other pertinent financial records to determine whether expenses incurred under its state grants were reasonable, allowable, allocable, properly authorized and recorded, and in compliance with applicable laws, rules, and regulations. Our special-scope review was not made for the purpose of forming an opinion on the NMF's general-purpose financial statements. Additionally, we did not conduct a review of the construction manager's cost records as a basis for billing work.

Subsequent to the completion of our audit fieldwork, the NMF entered into a Purchase and Sale agreement on July 16, 1999 to sell the Lenox property to another organization. Since the NMF received substantial funding from the Commonwealth, through the Executive Office for Administration and Finance (EOAF) and other state, local, and federal funding sources, we communicated with EOAF during our audit and will refer this report to EOAF for review and action prior to the consummation of the sale.

## AUDIT RESULTS

1. Noncompliance with Terms of $2.5 Million Executive Office for Administration and Finance (EOAF) State Grant

Our audit disclosed that the National Music Foundation, Inc., (NMF) was not in compliance with several terms and conditions of its grant agreement with the Commonwealth of Massachusetts through EOAF, as follows:

a. Noncompliance with Donor Funding Requirements. Grant provision 2.1 states:

> Prior to disbursement of any grant funds obligated under this Agreement, the Grantee shall furnish to EOAF documentation from private individuals or organizations with substantial liquid assets for cash donation commitments totaling at least *TWO MILLION DOLLARS [$2,000,000]*. It is understood that the amount of funds EOAF will disburse to the Grantee shall be equal to the amount of private cash commitments received by the Grantee relative to the Center.

To fulfill this grant provision, the NMF obtained commitments from two individuals for $1 million each, to be paid over five years. One of the individuals has made two of the five pledged payments as required. However, the commitment and payment from the other individual was unfulfilled. As it turned out, the individual had made a $25,000 partial payment on a $200,000 installment pledge that was returned for insufficient funds and he then announced that he would not be fulfilling his commitment. On March 29, 1999, the NMF received a $175,000 wire transfer from an anonymous donor to pay off the balance of the first installment that the original donor had not fulfilled. The NMF President/Chief Executive Officer (CEO) informed us on August 11, 1999 that the anonymous donor would not pay the remaining $800,000 owed by the original donor.

b. Unallowable Charges for Administrative Expenses of $75,000: The grant agreement does not allow the NMF to be paid for administrative costs. Specifically, Provision 2.4 of the grant states:

> The Grantee understands that all non-construction related costs including, but not limited to organizational, planning, management and operation costs, in connection with program activities at the Center, whether previously incurred or expected to occur during the term of this Agreement, are ineligible for state reimbursement. Eligible construction costs include, but are not limited to, design, legal and accounting, construction management (e.g., clerk of the works), equipment, fixtures, furnishings.

On March 25, 1999, the NMF's President/CEO filed a spending plan that explained how the NMF would spend the remaining $500,000 balance of the $2.5 million grant. In this spending plan was a line for "Administrative expenses associated with grant of $75,000." According to the NMF's disbursements ledger, the NMF paid itself the $75,000 administrative cost on July 23, 1999, contrary to the grant terms cited above.

c. Lack of Sufficient Budget Documents: Section 2.5[a] of the grant agreement provided that EOAF was not obligated to disburse money to the NMF until receiving:

> A description of the proposed improvements and a budget breakdown showing the elements which will be funded with the state grant. . . .

The NMF did submit a budget document and did receive the grant money, but we have the following concerns with this budget document:

- The budget was prepared after the grant was awarded. Usually a budget request for funds is used as a basis for determining how much of a grant will be given.
- The budget that was submitted was vague and meaningless. The first two items showed estimated cost as "To Be Determined," and the last item did not list a cost because it was "Awaiting energy survey." Examples of vague items included the category description of "Re-paving NMC Theatre parking lot," Repair of internal roadways and parking lots," and "Repair/replace/upgrade light fixtures, HVAC, insulation, windows."
- The submitted budget contained one unallowable item under the category "Administration and contingency $194,550." Since this item is not an infrastructure cost, it should not have been allowable in accordance with the grant provisions.

d. Failure to Keep Property Insured: Section 2.6 [i] of the grant agreement required the NMF to keep the property insured. This section of the grant agreement states:

> The Grantee shall [a] keep the Center property insured against fire and other hazards in amounts covering such risks, but in no event in an amount less than the full insurable value of said property and cost of improvement thereto;

However, the NMF did not maintain insurance for all of the center properties. Therefore, when a fire broke out on October 22, 1998 after a contractor was doing work on the premises, the NMF could not collect from its insurance company. Fortunately, the contractor agreed to submit a claim under his insurance policy, and the NMF was able to obtain some compensation of $76,678 for the loss incurred.

Effective March 12, 1999, the NMF raised its insurance coverage to cover the other buildings that were previously uninsured.

e. A Required "Memorandum of Understanding" Was Not Executed: Section 2.6 [j] of the grant agreement required the NMF to execute a grant agreement with the Town of Lenox for use of the NMF premises. This section of the agreement states:

> The Grantee shall at any time prior to fulfillment of its obligations under this Agreement, execute a Memorandum of Understanding [MOU] with the Board of Selectmen, Town of Lenox allowing the use of the Center for town government-sponsored activities, subject to terms and conditions mutually agreed to by the parties to the MOU.

We inquired about the status of this agreement during a meeting with NMF officials on April 8, 1999. The President/CEO stated that this agreement was "all set." When we asked for a copy of it, the CEO's Assistant stated that it was drafted, but was sent to the town for approval. We then inquired about the status of the agreement with town officials, who told us that it was just a draft agreement and still needed much further refinement before they would consider signing it. When we made a follow-up visit to the NMF on August 11, 1999, the town still had not signed the agreement.

Recommendation: In the future, EOAF should ensure that all recipients of state grant funds adhere to the terms and conditions of their grant agreements with the Commonwealth before disbursing any grant funds.

2. Noncompliance with Grant Agreement over the Receipt and Deposit of State Grant Funds

We noted that the NMF's receipt and deposit of state grant funds was questionable. Specifically, we noted that EOAF advanced the NMF most of the $2.5 million grant ($2 million on April 23, 1998 and the remaining $500,000 on April 9, 1999); the NMF did not explore options on how to invest the EOAF grant funds; the NMF deposited the grant funds in a brokerage account rather than in a bank, contrary to the grant agreement; and the NMF earned $49,133 of interest income on the EOAF grant funds, which should be returned to the Commonwealth, as discussed below.

a. <u>The NMF Was Advanced $2.5 Million in State Grant Funds</u>: An advance payment of grant funds is unusual based on our observations of past experiences with grants, since most funding agencies will disburse the grant funds at various stages throughout a plan or project or upon completion (e.g., one-third of the money at the start of the grant, one-third at about the halfway point of the grant either in terms of time or items completed, and the final payment after satisfaction of other conditions). When we asked EOAF staff why so much of the money was advanced, they stated that it was due to their unfamiliarity in dealing with non-for-profit entities such as the NMF, since most of the organizations they deal with are municipalities.

b. <u>Deposit of Funds in Brokerage Account Rather Than Bank Account</u>: The NMF received $2 million of the $2.5 million grant and deposited it into a brokerage account on April 23, 1998. This account consisted primarily of Federal National Mortgage Association Discount Notes (Freddie Mac Notes) coming due in one month, with the balance deposited in a money market account through the brokerage firm. Section 2.2 of the grant agreement states:

> Grant funds received from EOAF pursuant to this Agreement shall be deposited in an interest-bearing bank account and kept separate and distinct from all other accounts associated with the Center.

We noted that, although the money was separated from other accounts associated with the NMC, it was not deposited in a separate interest-bearing bank account, contrary to this agreement. The NMF's President/CEO stated that a brokerage account was used because it would provide better liquidity than a bank and would still keep the funds relatively safe. However, these investments were neither collateralized nor insured, which could have resulted in a loss to the Commonwealth. If a Massachusetts bank was used, the money would be insured in full.

Moreover, we calculated that the NMF earned just under 5% on the funds it improperly deposited in the brokerage account. As of August 31, 1999, the NMF had earned interest income totaling $49,133. Based on a sample review of some similar no-load mutual funds, we determined that the NMF could have earned approximately 8% on this money while investing in similar investments and at the same time keeping the state grant fund investment relatively liquid and readily available. Moreover, this higher interest rate would have generated additional interest income.

c. Disposition of $49,133 of Interest Income. Since it was provided most of the grant money prior to its expenditure, the NMF was able to generate interest income totaling $49,133 through August 1999. The grant provisions do not delineate what is to be done with this interest income, and it is still in the possession of the NMF. Since we believe that the NMF should not have been advanced this much money, the interest earned should be returned to the Commonwealth.

Recommendation: In the future, the NMF should develop a formal cash management process for the handling of grant funds. Moreover, the interest income totaling $49,133 as of August 31, 1999, which was generated from the grant funds while in possession of the NMF, should be returned to the Commonwealth. Additionally, EOAF should require a budget and plan outlining the need for final installments and closer monitoring of the use of these types of grant funds before making subsequent installments. Specifically, EOAF should:

- Limit the initial disbursement of grant funds to what would be needed for immediate cash needs after ensuring that other matching fund requirements and grant conditions are met;
- Require entities to adopt policies that will provide for the safety of grant funds on hand as well as maximize income-generating potential by considering the alternative investment vehicles available; and
- Monitor organizations that receive grant funds to ensure that they are deposited as required by the grant agreement.

3. Inaccurate and Misleading Financial Reporting Resulted in an Overstatement of Revenues by over 600%, or $408,093

As a condition of receiving its $2.5 million state grant, the NMF was to raise an additional $5 million from private donations over the next three years. The NMF did submit a fundraising plan that showed how it was going to raise the required funds for the three years ending June 30, 2001. On March 18, 1999, the NMF filed a status report with EOAF indicating that it had raised $475,156 to date in accordance with the fundraising plan. However, our analysis indicates that the amount of revenue raised was only approximately $67,063—an overstatement of over 600%, or $408,093.

Section 2.5 of the grant agreement provides for following with respect to fundraising:

> Notwithstanding anything to the contrary provided herein, EOAF shall not be obligated to disburse any portion of the state grant awarded under this Agreement until the following documents have been submitted by the Grantee to the satisfaction of EOAF:
>
> [b] a fund raising plan designed to raise at least *SEVEN MILLION FIVE HUNDRED THOUSAND DOLLARS [$7,500,000]* in private donations over the next three [3] years for the purpose of financing the necessary improvements and operations of the Center, including the *TWO MILLION FIVE HUNDRED THOUSAND DOLLARS [$2,500,000]* referred to in item 2.1 above;

As of March 18, 1999, the NMF reported to EOAF that it had generated $475,156 of income. However, we reviewed the NMF's records and determined this amount was overstated by $408,093 because of the following reasons:

- It included ineligible income prior to the fiscal year that the fundraising plan applied to, resulting in an overstatement of $172,937.

- The income was reported on a gross income basis and did not disclose the related expenses to generate the net income, resulting in an overstatement of net income of $235,156.

A summary chart reflecting our analysis follows:

National Music Foundation, Inc.
Analysis of Fundraising Income-Expense

| | Per NMF Report January 1, 1998 to March 18, 1999 | Less: Prior Period Revenue January 1, 1998 to July 1, 1998 | Less: Expenses Not Reported by NMF | Adjusted NMF Report July 1, 1998 to March 18, 1999 |
|---|---|---|---|---|
| Contributions-Individual | $ 7,266 | $ 55 | - | $ 7,211 |
| Contributions-Corp. and Foundation | 43,784 | 10,500 | $94,173 | (60,889) |
| Founders Club | 21,000 | 9,000 | 504 | 11,496 |
| Rental Income | 26,500 | 16,480 | - | 10,020 |
| BSO DARTS Program | 85,067 | 21,267 | 30,903 | 32,897 |
| Membership | 11,882 | 6,095 | - | 5,787 |
| Concession | 12,543 | 348 | 6,710 | 5,485 |
| Merchandise | 555 | 245 | - | 310 |
| Recording | 2,000 | - | - | 2,000 |
| Special Events: | | | | |
| Florida Golf | 23,713 | - | 15,149 | 8,564 |
| Music Inn Tribute | 16,320 | - | 15,960 | 360 |
| New York Dinner | 113,837 | - | 71,757 | 42,080 |
| Berkshire Music Festival (Ads and Sponsorship) | 43,412 | 41,962 | - | 1,450 |
| Royalties | 996 | 704 | - | 292 |
| Equipment Donation | 66,281 | 66,281 | - | - |
| Total | $475,156 | $172,937 | $235,156 | $67,063 |

The above analysis identified $67,063 net revenue from fundraising for the period July 1, 1998 through March 18, 1999, which annualized through June 30, 1999 would result in $94,679 net revenue. However, according to the NMF's proposed fundraising plan for the year ended June 30, 1999, the NMF was supposed to raise $650,000 from contributions and events. Clearly, the NMF's estimated net revenue from fundraising of $94,679 is far below the annual $650,000 that it agreed to raise.

NMF officials stated that EOAF allowed them to report income amounts from the prior period. Additionally, they stated that they believed that they should be reporting gross revenues rather than net revenues. We might agree with reporting the gross revenues if the associated expenses were relatively insignificant, but, as shown in our analysis, the annualized expenses were not only material, but significantly reduce the NMF's gross revenue. The point of a fundraising plan is not to report the amount of contributions raised, but to show how much money is available, net of expenses.

Recommendation: The NMF should report fundraising on a basis that would enable EOAF to make a fair assessment of whether the NMF was meeting its fundraising obligations under the terms and conditions of the grant agreement.

4. Questionable, Ineffective, and Inefficient Management Practices Utilized by the NMF

Sound business practices advocate that an organization employ management practices that ensure that organizational goals and objectives are met in the most economical and efficient manner; assets are properly safeguarded; and transactions are properly authorized, reported, and recorded. However, the NMF's administrative staff, and in particular its President/CEO, did not exercise overall sound business judgment in their management of the NMF. For example, although the organization was experiencing fundraising problems (contributions declined from $462,498 in 1996 to $63,533 in 1998) and operating deficit problems (the NMF has incurred more than $1.9 million in cumulative operating deficits prior to receipt of state grant funds since fiscal year 1994), the President/CEO lived on the property in a portion of a large mansion (Springlawn) for $12,000 per year; stopped paying rent to the NMF during fiscal year 1998; allowed her administrative assistant and the assistant's husband to live in a house on the property rent free; hired a consultant for $50,000 (plus approximately $7,000 for out-of-pocket expenses) to help the NMF develop a fundraising strategy and allowed this consultant to go over budget; rented what was claimed to be "office" space in New York City for $15,600 annually; and paid herself a high salary level ($200,585) for the NMF's President/CEO in light of funding available and guidance provided to not-for-profit organizations operating in the Commonwealth. As a result, the Commonwealth and the other funding sources were not assured that the NMF's assets were properly safeguarded, that expenditures from the NMF's state-funded grants were provided in the most effective and efficient manner, or that the NMF was achieving its mission and fulfilling the conditions of the grant agreements.

We analyzed contributions from third parties for the three fiscal years ended June 30, 1998 and noted that the level of contributions continually declined, as indicated in the table below:

| | Fiscal Year | | |
|---|---|---|---|
| | 1996 | 1997 | 1998 |
| Contributions | $462,498 | $157,226 | $63,533 |

NMF staff also prepared an analysis of revenues and expenses for the six fiscal years 1994 through 1999. This analysis indicated recurring deficits prior to receipt of state grant funds, as follows:

National Music Foundation
Analysis of Deficits
Fiscal Years 1994 through 1999

| Fiscal Year | Deficit |
|---|---|
| 1994 | $ 157,547 |
| 1995 | 6,482 |
| 1996 | 118,634 |
| 1997 | 694,916 |
| 1998 | 575,493 |
| 1999* | 437,440 |
| | $1,990,512 |

*Unaudited according to the analysis prepared by NMF officials.

Despite the substantial reduction in contributions and continued deficits, the NMF's management processed transactions and conducted business activities that were neither prudent nor in the best interest of the NMF. As stated in other audit results in this report, the NMF expended funds on questionable and unnecessary items and was not in compliance with various provisions of the grant agreement. It also did not establish an adequate system of internal control over many aspects of its operations in order to ensure that the NMF’s assets, which were funded in large part by the Commonwealth and its agencies, were being safeguarded against loss, theft, or misuse. In addition to these activities, we also noted the following questionable actions taken by NMF management, particularly given the organization's distressed financial condition:

a. The President/CEO and Her Husband Reside on the Property: At our entrance conference, we were told that the President/CEO and her husband live in a small portion of the house at 40 Kemble Street, for which they pay $12,000 per year rent. We were told that the NMF receives a benefit from these individuals residing there because they provide security to watch over the property. However, this premise is questionable because:

- The "house" referred to by the President/CEO is known as "Springlawn" and is described in a grant application as "a 19,000 square foot mansion, one of Lenox's "Great Estates." According to insurance company records, the replacement cost value of Springlawn is $1.5 million. Although the President/CEO and her husband only occupy a relatively "small portion" of the premises, they have use of the entire mansion as evidenced by the fact that few events were held at Springlawn during the year (according to a schedule we were provided, only three events were to be held at Springlawn during the spring and summer of 1999).
- The President/CEO stopped paying rent to the NMF, but rather allowed the rent to accumulate as an account receivable, which was then offset against the amount the President/CEO is owed for deferred compensation. This is noted in the NMF's audit report under Related Party Transactions, as follows:

  > As of June 30, 1998, the President of the Foundation is owed $354,715 for accumulated and unpaid salary of $365,928, which has been deferred, less $11,213 for unpaid rent.

  As of June 30, 1999, the NMF's unaudited accounting records indicated that the amount of unpaid salary has increased to $434,471. By not paying the rent, the President/CEO had a negative impact on cash flow for the NMF, since this was money that the organization could use immediately, and the deferred compensation would not be paid until some later date.

- Having the President/ CEO and her husband live on the premises does not add significantly to the security level on the property. In fact, the NMF had a security system installed in Springlawn in December 1998 with a cost of $5,152, which was charged against EOAF grant funds. Additionally, due to the physical placement of Springlawn on the property, very little of the NMF grounds can actually be seen from Springlawn, which is located at the far northeast corner of the NMF campus. Additionally, trees around Springlawn block vision of the property to the point that we were unable to see Springlawn from most sections of the campus when we were touring various buildings there.

b. The Executive Assistant to the President/CEO Resides in Another House on the NMF Property: Although NMF officials did not inform us, our analysis of invoices revealed a living arrangement whereby the NMF's Executive Assistant and her husband live in what is known as the "Victorian House," and there was no evidence that the NMF was charging them any rent for living there. According to the NMF physical property cost records, the NMF spent $23,115 for renovations to this house, which is valued at $108,000 for replacement cost insurance purposes.

c. Fundraising Consultant: On August 21, 1998, the NMF accepted a proposal from a firm that, according to the firm, specializes in doing fundraising for arts and cultural institutions. According to the proposal, the firm was to:

> Conduct a Fundraising Assessment and develop a Strategic Campaign Plan for a national campaign to raise an estimated $50,000,000 to fund the initial phases of the master facilities plan for the Lenox, Massachusetts headquarters of the National Music Foundation, Inc., its projected national and local programming as well as the annual operations of the organization.

The firm was to be paid $50,000 for these services plus an estimated $7,000 for out-of-pocket expenses such as air travel, food, lodging, telephones, copying, etc. According to the proposal, the work was to be completed by December 30, 1998, including the presentation of a report and a fundraising plan. As of August 11, 1999, the NMF's President/CEO told us that she received a "preliminary verbal report" from the fundraising consultant and "expected a final report from the fundraising organization in about another month." However, according to NMF accounting records, the NMF expended $137,756 through June 1999 on the capital campaign consultant, and the NMF expected to receive at least two more bills. This exceeded the original contract budget, and the NMF still did not have a final report from the consultant. Moreover, there was no evidence that the NMF awarded the consultant contract through an open, competitive process.

d. Potentially Excessive Salary Level for the NMF's President/CEO: The salary level of the NMF's President/CEO appears to be excessive in light of the amount of contributions made to the organization, the ongoing deficits from NMF operations, and guidelines published by the Commonwealth's Division of Purchased Services (DPS). While it is up to the NMF's board to set the compensation level of the President/CEO, it appears that the Commonwealth is helping to fund, at least in part, the salary level of the President/CEO since the NMF paid itself for administrative costs to administer the EOAF grant. It was further noted that the NMF could make a substantial profit from the sale of the Lenox property, which was improved with taxpayer funds, and that this profit could then be used to pay the accumulated unpaid salaries of the President/CEO and her husband.

DPS guidelines provide guidance on what the Commonwealth considers an allowable cost for the President/CEO of a nonprofit organization. These regulations are provided in 808 Code of Massachusetts Regulations (CMR) 1.05, Unallowable Costs, as follows:

> 24) Salaries of Officers and Managers. Salaries of officers and managers to the extent they exceed the rate paid to state managers in job group M-XII, step seven.

For fiscal year 1998 (July 1, 1997 through June 30, 1998), this annual rate was $100,142, or $100,443 below the $200,585 paid to the President/CEO of the NMF in fiscal year 1998.

e. Rental of New York "Office": According to the NMF's annual audit report, the NMF rents space in New York City, (150 West 55th Street, just south of Central Park), for a satellite "office" on a month-to-month basis for $1,300 per month, which annualizes to $15,600 (See Appendix, page 26). Sources indicated that the first floor of this building has some commercial space, but that the rest of the building consists of apartments, and that a relative of the NMF President/CEO occupies Apartment 5C. We were informed that the $1,300 is in reality a monthly maintenance fee and that the President/CEO and her spouse often use this "apartment" when their niece is in California. By classifying this transaction as rent for office space, it appears that the President/CEO deliberately concealed the true use of the funds. Given the NMF's limited resources and the true nature of the "office," we question the need for this transaction.

Recommendation: The NMF's Board of Directors should take a number of steps to remedy the management practices that have allowed the deficiencies noted throughout this report to occur. Additionally, the Commonwealth's oversight agencies need to recognize the examples of unallowable and questionable costs disclosed in our report in determining the amount of funds to be recovered from the NMF.

5. Insufficient Board Participation

Our audit revealed that the NMF is governed by a relatively few number of individuals. Although the NMF's letterhead reflects 19 individuals on its Board of Directors, leaving the impression that the NMF has the support and involvement of all these individuals, it in actuality was run by four board members plus the President/CEO, who comprise the executive committee.

According to guidelines published by the state's Office of the Attorney General, members of a nonprofit organization's Board of Directors are responsible for governing the charity as it carries out its mission. The law imposes upon directors two primary duties: the duty of care (act with such care as an ordinarily prudent person would employ in their position) and the duty of loyalty (act in good faith and in a manner that they reasonably believe is in the best interest of their charitable organization). It is the board's job to oversee the President/CEO and to ensure that the charity is faithfully carrying out its purpose without extravagance or waste. The published guidelines also encourage the board to be vigorous and responsive to the mission of the charity. Steps should be taken to ensure that the board's process of selecting new members ensures diversity of viewpoints and rotation of board members and officers. The nominating process, which invites openness, variety and change, is important to achieving the goal of the charity in carrying out its purpose. The board should avoid becoming labeled as a closed club for "insiders only." Members should be chosen who have an interest in the charity's mission, represent diverse viewpoints, and have a willingness to learn and have an opportunity to review board members.

This means that:

- The nominating process should reach out for candidates, and actively recruit individuals whose commitment, skills, life experience, background, perspective or other characteristics will serve the charity and its needs.

- A larger candidate pool may result if non-board members as well as board members are included on the nominating committee.

- Board members should be reviewed periodically to confirm that they remain interested in and suitable for the board. Rotation off the board, assignments to off-board committees, and designation as emeritus member are other ways to achieve a vigorous board.

We question the oversight provided by the NMF's board for the following reasons:

- NMF officials are quick to point out that the NMF is composed of 19 well-known individuals with strong backgrounds and connections to the music industry. However, only seven members of the board attend the annual meeting.

- Only the five members of the board who comprise the Executive Committee are directly involved in governing the NMF. This is because the NMF approved the following motion at a May 17, 1993 meeting:

  To amend the NMF Bylaws to state the Executive Committee is the primary governing body of the Foundation, with the Board of Directors serving in an advisory capacity.

- The President/CEO is also a member of the Board of Directors and the Executive Committee. As the Massachusetts Attorney General's Charitable Organization guidelines suggest, the board should be overseeing the NMF's President/CEO. If the President/CEO is a member of the board, an additional layer of oversight is lost.

An appropriate segregation of NMF staff from the board is essential to ensure that the board can meet its oversight responsibilities in an independent and objective manner. Also, in order to meet its oversight responsibilities, the NMF should consider expanding the involvement of the governing body of the organization.

Recommendation: The NMF should consider amending its bylaws to transfer the governing body authority back to the Board of Directors. The NMF should then seek to expand the commitment and involvement levels of the board of directors to ensure that a wide range of viewpoints and experience is considered in the governing of the NMF. Finally, the board should consider not allowing the President/CEO to be a board member.

6. Outstanding NMF Debts

The NMF needs to take steps to ensure that sufficient funds are on hand to pay its debts when they come due. The NMF had debts totaling $1,358,771 as of June 30, 1999, as outlined in the following chart:

National Music Foundation, Inc.
Analysis of Debts Coming Due
As of June 30, 1999

| Description | Due Date | Amount | Comments |
|---|---|---|---|
| Mortgage Note | June 2000 | $ 200,000 | First annual payment. Final payment due June 9, 2013. Total due $1,600,990 plus 6% interest. |
| Mortgage Note | August 1999 | 718,300 | |
| Due Officers | Not Specified | 440,471 | Amount taken from unaudited NMF accounting records as of June 30, 1999. |
| | | $1,358,771 | |

The mortgage notes arose from the 1993 purchase of real estate in Lenox for the National Music Center. The terms of the mortgage gave the NMF periods of time when no payments were due. However, substantial funds will soon be needed to satisfy these debts.

The amounts reported in the above chart under the category "Due Officers" primarily arose from the President/CEO's not receiving her entire contract salary ($200,585 for the fiscal year ended June 30, 1998). A small portion ($6,000) of the "Due Officers" balance resulted from the Program Director not receiving his entire contract salary.

As of June 30, 1999, NMF accounting records reflected that the NMF had only $94,724 in unrestricted cash available to meet the above obligations

Based on the NMF's current fiscal condition, there is a strong likelihood that the NMF will not be able to pay its debts.

Recommendation: NMF officials should review their fundraising strategies to determine whether fundraising revenues will support having the cash available to pay these debts or whether it will be necessary to try to arrange to defer payment of these obligations.

7. Grant Funds Totaling More Than $3.6 Million Plus Interest of $280,785 Should Be Reimbursed to the Commonwealth and Other Funding Agencies

The NMF signed a Purchase and Sale agreement on July 16, 1999 expressing its intent to sell the NMF property for $5.1 million to another not-for-profit organization. This sale would result in a gain of $3 million to the NMF, since it bought the property for $2.1 million in 1993. However, this gain was substantially generated for the NMF at the expense of the Commonwealth's taxpayers, since state, federal and local entities have invested over $3.6 million in the NMF property and the NMF has little other funds to invest in property improvements, as evidenced by its declining private contributions and ongoing deficits (see Audit Result No. 4). Additionally, the Commonwealth should recoup grant funds from the NMF because the NMF was supposed to raise an additional $5 million in private donations over the next three years (see Audit Result No. 3), but is well behind that goal; the NMF failed to accomplish its mission objective; the infrastructure improvements to the property were financed in large measure with government funds; and the NMF was in noncompliance with the grant agreement.

Grants totaling $3,660,000 were given to the NMF, as follows:

National Music Foundation, Inc.
Table of Grants Provided

| Funding Source | Amount |
|---|---|
| Department of Housing and Community Development (pass-through of federal HUD funds) | $ 585,000 |
| Mass. Turnpike Authority | 240,000 |
| Department of Economic Development | 50,000 |
| Massachusetts Port Authority | 285,000 |
| Executive Office for Administration and Finance | 2,500,000 |
| Total Grants | $3,660,000 |

On March 24, 1998, a $2.5 million grant agreement was entered into between EOAF and the NMF to provide for infrastructure improvements to the NMF site. One of the grant stipulations provides that the Commonwealth may require the return of the grant funds in the event of a sale of the property. Specifically, Section 5.6 of the agreement states:

> The Grantee shall not, at any time following satisfactory completion of the center, elect to convey or otherwise dispose of the Center property for any other use without prior written consent from EOAF. In the event the Grantee elects to convey or otherwise dispose of the Center property and request such prior written consent from EOAF, EOAF shall, to the extent permitted by state law, seek the return of the grant funds awarded to the Grantee under this Agreement if in its judgement to do so would be in the best interest of the Commonwealth.

In accordance with this Section, EOAF and the NMF entered into an agreement dated April 26, 1999 and recorded at the Berkshire Registry of Deeds on May 3, 1999 (more than one year after the award of the grant funds) that restricted the sale or conveyance of the NMF campus without prior written consent from EOAF.

Another funding source was a $585,000 grant from the federal Department of Housing and Urban Development (HUD) Small Cities Ready Resource Deferred Payment Loan (a Community Development Block Grant [CDBG]) obtained by the Town of Lenox through the state's Department of Housing and Community Development (DHCD). This grant provided administrative funds of $104,250 to the Town of Lenox, leaving $480,750 to rehabilitate and repair buildings at the NMF site. This agreement became effective October 3, 1996 and provided for forgiveness of the loan at 20% per year and also provided for an additional payment to the Town of Lenox in the event of a sale or transfer of title to the premises. Specific provisions of the agreement require:

> In the event the Grantees sell or transfer title to the said premises; or in the event that the property ceases to be used for non-profit purposes within five (5) years from the date of the aforesaid agreement the Grantees agree to pay to the Town of Lenox an additional sum to be determined and hereinafter set forth.
>
> a. "Anniversary date" shall be defined as the date one year from the signing of this Agreement and from year to year thereafter until October 3, 2001.
>
> b. "Obligation" under this section shall be defined as $400,750
>
> c. Following the expiration of each anniversary date, commencing October 3, 1997, the obligation of the Grantee under this section shall be reduced at the following rate:
>
> d. After the first anniversary 20% shall be reduced. After each of the next four (4) anniversaries an additional 20% shall be reduced from the repayment obligation.

An $80,000 amendment to the above loan was entered into on November 21, 1997 and provided similar terms, with the exception of using the new date for the anniversary terms (i.e., November 21, 1998 being the first anniversary date).

Based on the above provisions, we calculate that the NMF foundation officially owes the following amounts to the Town of Lenox:

National Music Foundation, Inc.
Analysis of Grant Loan Balances
As of June 30, 1999

| Description | Agreement Date October 3, 1996 | Amendment Date November 21, 1997 | Total |
|---|---|---|---|
| Grant Loan | $400,750 | $ 80,000 | $480,750 |
| Forgiveness 1997 | (80,150) | - | (80,150) |

| | | | |
|---|---|---|---|
| Forgiveness 1998 | (80,150) | (16,000) | (96,150) |
| Total Outstanding | $240,450 | $ 64,000 | $304,450 |

However, for reasons previously explained, an arrangement should be made to have the NMF repay the entire amount of the grant, plus lost interest, to the Town of Lenox.

As noted earlier, the NMF has entered into a Purchase and Sale agreement to sell the Lenox property. One of the provisions of the agreement is that the above "Ready Resource Grant" be allowed to be transferred to the new buyer and that "neither the seller nor buyer shall be liable for repayment of any portion of the Grant." Section 7 of the Purchase and Sale agreement states:

> The parties agree that it shall be a mutual and reciprocal condition of the closing of this transaction that the Town of Lenox and its funding source for a so-called "Ready Resource" grant, in the original amount of $480,750 (the "Grant"), agree that the Buyer may purchase the Premises subject to the Grant, that the Grant shall continue to liquidate itself at the rate of twenty (20%) percent per year, that the Town shall subordinate its mortgage securing the Grant to any financing proposed by Buyer and that neither Seller nor Buyer shall be liable for repayment of any portion of the Grant.

Therefore, provisions of the Purchase and Sale agreement appear to be in conflict with the provisions of the $480,750 grant agreement, which requires repayment.

Recent media attention have focused on determining whether the new organization purchasing the property would be required to comply with the balance of the NMF's grant matching requirements. However, this ignores the immediate fact that the NMF, if the sale is approved, will realize a $3 million gain generated as a result of taxpayer-funded improvements.

The majority of improvements made at the NMF site were taxpayer-funded because the NMF was barely meeting its operating expenses with outside funding. For example, in fiscal year 1998 (July 1, 1997 to June 30, 1998) the President/CEO was to be paid $200,585 and her husband, the Programming Manager, was to be paid $48,000. However, $104,908 of these salary payments were deferred because the NMF did not have sufficient cash to pay them. Minutes of the Executive Committee meeting of November 21, 1997 noted that there was only $900 of cash available in the NMF checking account (after a transfer of $2,000 from the Scholarship Fund) and that there were $62,000 in invoices to be paid. These examples demonstrate that the NMF did not have resources available, other than government-funded grants, to make significant investments in the Lenox property and that the NMF's potential $3 million gain from the sale of its property was generated, in large part, from government funds.

Another reason that EOAF should recover grant funds is that the NMF was to raise additional private donations in addition to the $2.5 million EOAF grant. According to grant provision 2.5 (b), the NMF was to raise an additional $5 million in private donations over the next three years. In compliance with this provision, the NMF submitted a fundraising plan showing that it would raise a total of $7.5 million (including the EOAF grant) over the three fiscal years ended June 2001. However, as of June 1999, the NMF was well behind in its fundraising efforts. As noted elsewhere in this report, the NMF still had not received a report and fundraising plan from its consultant. Additionally, based on the unaudited financial summary that the NMF provided us with, the NMF was operating at a deficit of $437,440 before considering grant funds.

Lastly, the NMF's President/CEO informed us that, as far as she is concerned, the NMF has done remarkably well in fundraising. In a meeting with her on August 11, 1999, she stated that the Commonwealth has provided grants of $3.6 million and that the NMF has raised $4.2 million, which she believes shows that they are well along on their fundraising goals required by the $2.5 million EOAF grant. When we asked the President/CEO for an analysis of how she determined that the NMF raised $4.2 million, we were provided with an analysis that was primarily based on the NMF's annual audit reports. This analysis did show that the NMF received $4.2 million in revenues, as the President/CEO stated. However, this was only one step of the total analysis. We strongly disagree with the contention of the President/CEO regarding her fundraising efforts and responsibilities for the following reasons:

- The EOAF grant required a plan delineating how the NMF was going to raise funds during fiscal years 1999 through 2001. The analysis prepared by the NMF included years prior to the state grant requirements, since its analysis covered the period of fiscal years 1994 to 1999.
- The $4.2 million cited by the President/CEO is gross revenues only and does not include the fact that there is $6.3 million or expenses relating to those same periods, resulting in a net deficit of just under $2 million.

The NMF's demonstrated failure to accomplish its mission objectives, abuse and misuse of funds, and noncompliance with its contract agreements, coupled with the fact that the NMF property was improved largely with government funds, justify that all proceeds should be proportionally divided by state, federal, and local funding sources, and, at a minimum, these agencies should be fully reimbursed $3,940,785 for the principal grant amounts plus interest for the lost use of the funds, as shown below:

| Funding Source | Grant Amount | Potential Interest Lost | Total Funds To Be Repaid |
|---|---|---|---|
| Department of Housing and Community Development | $ 585,000 | $ 60,932 | $ 645,932 |
| Massachusetts Turnpike Authority | 240,000 | 30,855 | 270,855 |
| Department of Economic Development | 50,000 | 6,531 | 56,531 |
| Massachusetts Port Authority | 285,000 | 36,988 | 321,988 |
| Executive Office for Administration and Finance | 2,500,000 | 145,479 | 2,645,479 |
| Total | $3,660,000 | $280,785 | $3,940,785 |

Recommendation: In order to protect the Commonwealth's interests, EOAF, on behalf of itself and the other funding agencies, should review this matter and consider seeking repayment of the grant funds totaling $3,660,000 from the NMF as a result of its sale of the property, as well as $280,785 of lost potential interest income. Pending resolution of this matter, the Office of the Attorney General, working with the Executive Office for Administration and Finance, should place a lien on the property or take other necessary action to protect the Commonwealth's interest. Additionally, this review will need to determine whether any action needs to be taken to address Section #7 of the Purchase and Sale agreement allowing for the transfer of this grant to the new buyer, with which we would disagree.