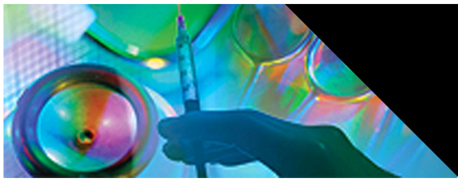

JONES DAY COMMENTARIES

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Sarbanes-Oxley Reforms: Implications for Nonprofit Health Care Industry

The recent prosecutions of HealthSouth executives under the Sarbanes-Oxley Act[1] have highlighted just some of the sweeping impact the Act is expected to have on corporate governance and accounting reform. Conceived in response to corporate collapses resulting from accounting irregularities and perceived failures of ethics and controls in publicly traded companies, the Act was designed in large part to protect the interests of investors and enhance corporate oversight and accountability of publicly traded companies. The Act provides direction to the Securities and Exchange Commission ("SEC") to promulgate rules and regulations to increase accounting and auditor regulation through the imposition of new duties on public companies and their executives, directors, auditors, and attorneys.

Although the Act applies only to publicly traded companies, it is widely anticipated that the emergence of corporate practices in response to the Act will have effects in the nonprofit sector of the health care industry. Traditionally, nonprofit health care organizations are held to even higher standards of conduct than public companies, due to their charitable nature, affiliation with religious movements and other public benefit interests, and their special status as tax-exempt entities. Government regulators and state Attorneys General are likely to cite public policy reasons for incorporating the new corporate responsibility standards into their oversight of nonprofit health care organizations, since the interests of charitable donors, tax-exempt bond holders, and the communities served by nonprofits are analogous to those of public company shareholders protected by the Act.[2] We therefore recommend that nonprofit health care organizations and their counsel review their own governance documents and policies and carefully consider the Act's corporate responsibility standards and accounting reforms.

Perhaps of greatest significance to the nonprofit health care industry will be the Act's pronouncements (and the subsequent rules thus far promulgated by the SEC) regarding financial disclosure obligations, audit committee composition and duties, and accounting and auditor practice standards. This commentary describes those aspects of the Act and discusses their likely application to nonprofit health care organizations.

Financial Disclosure Obligations

The Act requires the principal executive and financial officers of a public company to certify, in annual and quarterly reports required under the Securities and Exchange Act of 1934, that they have reviewed the report and that, to their

1 The Public Company Accounting Reform & Investor Protection Act of 2002, most commonly known as the Sarbanes-Oxley Act (the "Act").

2 This is an especially sensitive area for state Attorneys General (who oversee the charitable assets of the nonprofit organizations located in the jurisdictions they serve) in light of the many corporate governance and accounting controversies that have surfaced in the nonprofit health care industry in recent years (*e.g.*, Allegheny Health, Education and Research Foundation, Allina Health System, Baptist Foundation of Arizona, Intercoastal Health System, among others).

knowledge, it contains no material misstatements or omissions. In addition, principals are require to certify that the financial information fairly presents the financial condition and results of operations, together with certifications as to various internal controls and with respect to disclosures made to the audit committee and contained in the report. Further, periodic reports must disclose material correcting adjustments, material off-balance sheet transactions, and relationships that may materially affect a company's financial condition or results of operations.

It would be advisable for nonprofit health care organizations to take steps to implement measures ensuring the integrity and reliability of their financial statements, including an internal certification procedure and appropriate disclosures in any financial information made available to government agencies and outsiders. Financial integrity and stability of nonprofit health care organizations is of fundamental concern to state Attorneys General, who seek to ensure that charitable donors contributing to such organizations are able to make educated decisions based on reliable information. In addition, some financial disclosure obligations of the type contemplated by the Act will apply to health care organizations that issue tax-exempt bonds, since the disclosure of information to bondholders is already subject to regulation by the SEC. It would not be unreasonable to expect that the Act's standards would, in some form, be extended to the existing disclosure obligations in the tax-exempt bond context.

Compliance with at least some of the disclosure standards is advisable in light of the increased level of scrutiny nonprofit health care organizations are subject to as a result of the recent corporate governance scandals that have plagued the industry — the AHERF and Allina Health System controversies, among others. Generally speaking, those organizations faced charges of fraud, inadequate financial controls, conflicts of interest, improper raiding of charitable endowments, and corporate waste. Ultimately, those organizations (and their executive officers) faced significant public censure, fines, and, in some cases, criminal penalties. Nonprofits could avoid a similar plight by proactively holding their principal executive and financial officers to the Act's higher standards (particularly with respect to conflicts of interest and financial arrangements with management), with the goal of preventing misuse of their charitable assets. Other action steps might be to implement policies to inventory all restricted donations and periodically affirm that the restrictions are being complied with, take steps to ensure that restricted funds have not been misapplied to other activities, and review off-balance-sheet transactions to ensure that legal and accounting rules have been observed.

Audit Committee Composition and Duties

The Act provides that a public company's audit committee be composed entirely of independent directors. The Act's stated criteria for an independent director are that the director (a) may not accept any consulting, advisory, or other compensatory fee from the company (other than in the director's capacity as a member of the board or the audit or other board committee) and (b) may not be an affiliated person of the company or a subsidiary.[3] Companies are required to disclose whether or not the audit committee has at least one member who is a "financial expert," defined in terms of thorough education and experience as a public accountant or principal financial or accounting officer or controller or similar position, with sufficient accounting expertise. The SEC has proposed rules implementing this provision, which set forth myriad factors that the board is required to consider in determining whether someone is a financial expert with respect to a particular company. A public company's audit committee should include a charter under which it is directly responsible for the appointment, compensation, and oversight of the audit accounting firm (which shall report directly to the audit committee). In addition, the audit committee must have procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, and audit matters, and for confidential anonymous submissions by employees of concerns regarding questionable accounting or auditing.

The Act also requires a company to disclose whether it has adopted a code of ethics that applies to the company's principal officers, and if not, why not. Elements of a code of ethics as proposed by the SEC include policies on the avoidance of conflicts of interest, prompt internal reporting of

3 Governance proposals from the New York Stock Exchange also restrict the amount of business that the primary employer of an independent director may have with the company on whose board he or she sits.

violations to an identified individual, and accountability for failure to adhere to the code.

Since a functioning and independent audit committee is a critical component of corporate governance for nonprofit health care organizations, such organizations should consider the relevance of many of the above-described standards for their institutions. For example, an organization whose audit functions are performed by a finance committee should consider creating a separate audit committee with powers and duties in line with the Act's requirements. Further, nonprofit organizations should implement and continually update their corporate compliance programs with respect to business conduct and ethics, to meet the evolving needs of their organization. It is also important to recognize that the requirements set forth in the Act with respect to the composition and duties of an audit committee are in many respects consistent with the basic duties of care and loyalty to which directors of nonprofit organizations are already subject. Thus, a nonprofit health care organization would be well advised to consider the Act's provisions as a guideline with general application to the board of directors as a whole, and to consider ways to promote a culture of ethical decision-making and discourse rather than consensus. Suggested action steps for nonprofit organizations might be to simplify their corporate structure to streamline reporting relationships, periodically conduct corporate governance education, and review and enforce conflict of interest policies.

Accounting and Auditor Practice Standards

The Act creates the Public Company Accounting Oversight Board, a private entity subject to the SEC's regulation and oversight. The purpose of the Oversight Board is to oversee the auditing of public companies and to establish auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports. The Act requires registered public accounting firms providing audit services to timely report to the audit committee: (1) all critical accounting policies, (2) alternative treatments of financial information discussed with management, ramifications, and preferred treatment, and (3) other material written communications with management. The Act makes it unlawful for an officer or director of a company fraudulently to influence, coerce, manipulate, or mislead any independent or certified public accountant in the performance of an audit of financial statements for the purpose of making the financial statements materially misleading. Further, an accounting firm that is providing audit services to a company may not contemporaneously with the audit provide certain non-audit services to the issuer, such as bookkeeping or other services related to the accounting records or financial statements of the issuer.

Nonprofit health care organizations, particularly providers, already face a host of accounting challenges that must be overcome and managed within a complicated regulatory scheme. As discussed above, the integrity and reliability of financial statements and accounting procedures is of particular importance to nonprofit health care organizations in light of their charitable missions and scrutiny by state Attorneys General, as well as federal regulatory bodies, such as the Department of Health and Human Services' Office of Inspector General. Since health care organizations must rely heavily on estimates in preparing financial statements, an auditor's role is critical in assessing the validity and appropriateness of the estimates, considering the sometimes significant disconnect between a health care provider's billed charges and actual reimbursement. Thus, nonprofit health care organizations and their auditors should review the Oversight Board's standards relating to the preparation of audit reports and implement changes to their policies as may be necessary. In addition, nonprofit organizations should consider taking an inventory of non-audit services performed by auditors and transferring responsibility for some or all of those services to other sources.

The reader should also note that although we have generally recommended in this commentary that nonprofit health care organizations implement policies consistent with certain provisions of the Act, we recognize that the corporate governance challenges facing nonprofit health care organizations are different from those facing public companies. Where for-profit boards are concerned primarily with returning value to shareholders fairly immediately, nonprofit boards must serve the interests of their mission and local communities, with an eye to the long-term protection of their charitable assets. Finally, health care providers face particular challenges with respect to accounting, considering the complex and ever-changing governmental and third-party reimbursement systems, where actual payment received differs from billed charges, and payments are frequently subject to retroactive adjustments and government audits.

In sum, although we recognize that compliance with the Act by nonprofits is neither required nor feasible, we do consider the Act to be a very useful source of guidance for nonprofit health care organizations in this climate of close scrutiny and oversight. The emergence of "best practices" for governance developed in response to the Act will probably become standards against which nonprofit organizations will be judged in the future.

The foregoing is a very generalized discussion of some of the key provisions of the Act having significance in the nonprofit health care industry. Many of the Act's provisions are subject to future rulemaking and may require further clarification through future legislation. We will continue to monitor the SEC rules and regulations proposed to implement the Act, as well as the application of the Act by government regulators and state Attorneys General to nonprofit health care organizations.

Further Information

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