


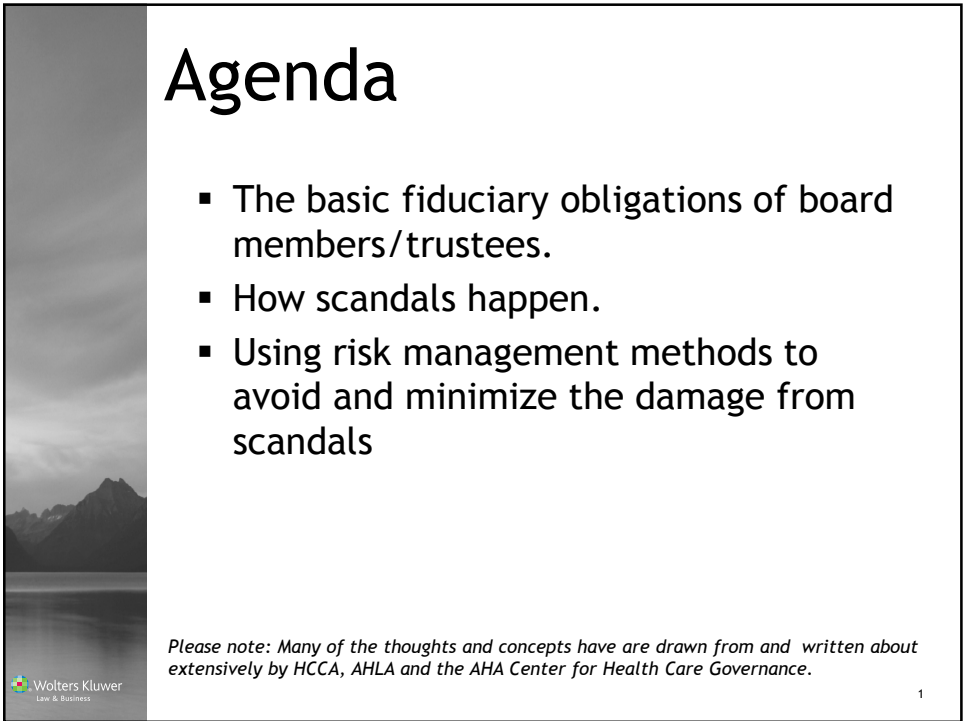
**Fiduciary Duty,  
Corporate Scandals, SOX  
and the Non-For-Profit**

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# Agenda

- The basic fiduciary obligations of board members/trustees.
- How scandals happen.
- Using risk management methods to avoid and minimize the damage from scandals

*Please note: Many of the thoughts and concepts have are drawn from and written about extensively by HCCA, AHLA and the AHA Center for Health Care Governance.*

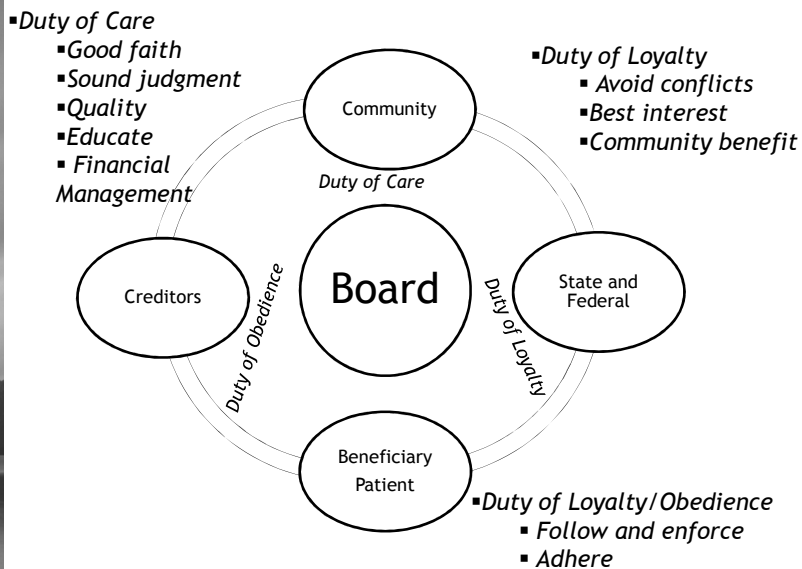
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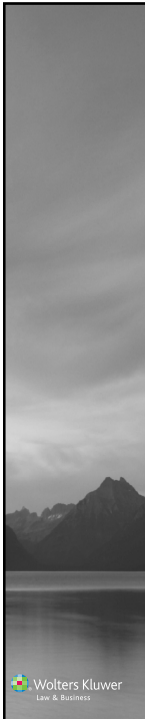
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# What is a Fiduciary

- Latin meaning "trust"
- "a person who stands in a special relation of trust, confidence or responsibility in his or her obligation to another" (Webster)

## The board has three core obligations





## Fiduciary Duty - Compliance & Ethics Programs

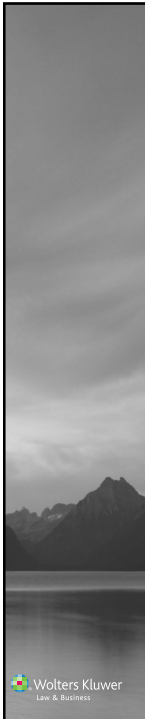
- Starts with Sentencing Guidelines
- Caremark Case (Del. Chancery)
- Director's fiduciary obligations include:
  - 1) A good faith effort to assure adequate compliance and ethics program exist; and
  - 2) That information regarding compliance with laws is brought to board's attention on a regular and timely basis



## Fiduciary Duty - Compliance & Ethics Programs

### Stone vs. Ritter (Del. Supreme Court)

- Director liability will be imposed if:
  - “The director failed to implement any reporting or information system controls [compliance & ethics program],” or
  - “Having implemented such a system or controls, consciously failed to monitor or oversee its operation.”



## Fiduciary Duty - Compliance & Ethics Programs

### Implications for Directors\*

- Need thorough understanding of compliance & ethics program
- Ask questions to identify and assess risks

\* Adapted from “Courts Link Good Faith Oversight with Directors Personal Liability”, Donovan & Corcoran, NACD-Directors Monthly, December 2007



## Fiduciary Duty - Compliance & Ethics Programs

### Implications for Directors\* (cont)

- Make its own assessment of effectiveness of compliance & ethics program
- Utilize outside expertise, if necessary, to conduct assessment
- Ensure proper remediation of risks
- Director liability tied to failure to act rather than bad decisions!!

## Fiduciary Duty: The scope is getting broader!



## Poor Governance= Opportunity for Scandal

- Enron, Caremark, Imclone, Tyco, Healthsouth, HCA
- Pfizer, Merck,
- Mortgage industry
- Investment schemes
- Micro scandals (Purchasing, Medical Directors, DME, SNF)



## Scandals:

- Overlooked or ignored risks
- Inadequate controls/validations of facts
- Bad/conflicted advice
- Investigation not done or poorly handled
- Inadequate disclosure or compounding cover up
- Compensation models



## Sarbanes-Oxley

### Congressional Response-sweeping reform legislation

- Increased oversight - Public Company Accounting Oversight Board
- Auditor independence/accountability
- Corporate responsibility
- Expanded financial disclosures

# Public Company Accounting Oversight Board (PCAOB)

## Composition

- Non-profit corporation, funded by SEC registrants and public accounting firms
- Members appointed by SEC. 2 must be CPAs, 3 cannot be (or have been) CPAs.
- Members must be “prominent, financially literate, individuals of integrity and reputation.”

## Duties

- Adopt, revise or repeal: Auditing standards, Quality control standards; Ethics standards for registered audit firms
- Mandated rules
  - 2<sup>nd</sup> partner review
  - Internal control reports
  - Inspection of registered audit firms
  - Work paper retention

# Auditor Independence / Accountability

## *Section 201: Services Outside the Scope of Practice of Auditors*

- *Prohibits registered audit firms from providing certain services to public companies*
  - *Bookkeeping*
  - *IT system design*
  - *Appraisal/valuations*
  - *Actuarial services*
  - *Management*
  - *Internal audit*
  - *HR*
  - *Legal*
  - *Broker dealer/investment*
  - *Expert*
- *Other Services PCAOB determines improper*

## Auditor Independence / Accountability

### Section 202: Pre-Approval Requirements

- Requires audit committee to be directly responsible for oversight of auditors.
- Audit committee must pre-approve all audit and permissible non-audit services.
  - De minimis exception for aggregate services less than 5% of fees
- Policy disclosures
- Fee disclosures

## Auditor Independence / Accountability

### Section 203: *Audit Partner Rotation*

- *Limits audit partners to providing audit services to 5 or 7 consecutive years, depending on role*
- *Audit partner includes*
  - Lead audit partner
  - Concurring partner
  - Client service partner
  - Partners who provide 10 or more hours of service
  - Lead audit partners for significant subsidiary (20%)

# Auditor Independence / Accountability

## Section 204: Auditor Reports to Audit Committee

- Auditors required to disclose to audit committee
  - All critical accounting policies and procedures
  - All alternative accounting/disclosure
  - Treatments of material financial information
  - Discussed with management
  - Other material written communications

# Auditor Independence / Accountability

## Section 205: Conforming Amendments Section 206: Conflicts of Interest

- Cooling off period for audit team members becoming employed by issuer in certain capacities.
  - Board Member
  - CFO, COO
  - Chief Accounting Officer
  - Director Internal Audit
  - Treasurer
  - President/CEO
  - General Counsel
  - Controller
  - Director financial reporting

# Corporate Responsibility

## Section 301: Public Company Audit Committees

- Relationships with auditors
  - Appointment, compensation, oversight, dispute resolution
  - Audit committee independence
  - Hotline/complaint mechanism
  - Authority to hire advisors

# Corporate Responsibility

## Section 302: Corporate Responsibility for Financial Reports

- Certification by CEO/CFO that s/he has:
  - Reviewed reports
  - Report is accurate, no material misstatements or omissions
  - Report fairly presents financial condition
  - Internal controls are in place
  - Significant control deficiencies disclosed to auditors and Audit Committee
  - Significant changes in internal controls



# Corporate Responsibility

## Section 303: Improper Influence on Conduct of Auditors

- Unlawful “to fraudulently influence, coerce, manipulate or mislead” an auditor
- Prohibitions include
  - Bribery/financial incentives
  - False/misleading legal analysis
  - Threatening auditor (blackmail, firing, removal, physical threats)
  - Deviation from GAAS



# Corporate Responsibility

## Section 304: Forfeiture of Bonuses and Profits

- Forfeiture of bonus/incentive compensation for chief executive(s)/ financial officer(s) “if an issuer is required to prepare an accounting restatement due to material noncompliance of the issuer, as a result of misconduct, with any financial reporting requirements under securities laws.”



# Corporate Responsibility

## Section 307: Rules of Professional Responsibility for Attorneys (cont.)

- Qualified Legal Compliance Committee
  - Independent members of board
  - Written P&Ps for review of allegations of impropriety
  - Established by board with authority to investigate, recommend changes and report to chief legal counsel, CEO and board; and if issuer fails to implement an appropriate response, report to SEC



# Expanded Financial Disclosure

## Section 404: Management Assessment of Internal Controls

- Requires issuer to create and maintain adequate internal controls for financial reporting
- Annually assess/report on control effectiveness
- Report must include:
  - Acknowledgement of managements accountability
  - Assessment of effectiveness
  - Auditors evaluation of management's assessment

## Expanded Financial Disclosure

### Section 404: Management Assessment of Internal Controls (cont.)

- Distinguishing financial statement audit from internal control assessment
  - Financial Statement Audit - express opinion on fairness of financial statements in accordance with GAAS
  - Internal Control Assessment - express opinion on whether issuer's internal controls are effective in ensuring accurate financial reporting

## Expanded Financial Disclosure

### Section 407: Disclosure of Audit Committee Financial Expert

- Issuer must identify and disclose independent financial expert, or explain why it does not have such an expert
- Expert is one who:
  - 1) Understands GAAP
  - 2) Can apply GAAP
  - 3) Has experience preparing/auditing financial statements similar to those of issuer,
  - 4) Understands internal controls; and
  - 5) Understands role of audit committee



## Application to Non-for-Profits

- NFPs 2<sup>nd</sup> largest source of all financial restatements from 1971-2000\* representing 9.3% of all restatements
- Clear direction toward disclosure
  - 990
  - Quality measures
- Bond Ratings
- Fraud, waste and abuse
- Future of NFP status
- Good discipline and governance



## Application to Non-for-Profits

### What are Not-for-Profits Doing?

- Adding/Enhancing audit committees
  - Creating audit committees
  - Adding financial experts
  - Greater independence

## Application to Non-for-Profits

### What are Not-for-Profits Doing? (cont.)

- Modifying audit committee charter
  - Authority to hire advisors
  - Greater direct oversight of auditors
  - Expanded meetings/more detailed review
  - Increased use of executive sessions with auditors/compliance/legal counsel

## Application to Non-for-Profits

### What are Not-for-Profits Doing? (cont.)

- Enhanced conflict of interest mgmt.
  - Modifying policies
  - Greater disclosure
  - Thorough review of conflicts
  - Elimination/limitation of loans to management

## Application to Non-for-Profits

### What are Not-for-Profits Doing? (cont.)

- Adoption of SOX like standards/policies and procedures
  - Non-audit services by auditors
  - Forfeiture of bonus/incentive compensation for misstatements/omissions
  - Improper influence on auditors
  - Frequent use of certifications by financial officers/key management

## Application to Non-for-Profits

### What are Not-for-Profits Doing? (cont.)

- Adoption of SOX like standards / policies and procedures (cont.)
  - Greater discipline in interim closing processes
  - Prompt/complete disclosure
  - Attorney reporting obligations
  - Improving internal controls
  - Expansion of ethics/compliance programs to address financial misconduct