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REGULATION

Sarbanes-Oxley Is Strong Medicine For Health Care Organizations

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ALTHOUGH THE SARBANES-OXLEY Act of 2002 has swiftly become a part of Corporate America's lexicon, even the most experienced attorneys may not realize that this legislation was first applied to the health care industry.

Later this year, the former CEO and chairman of HealthSouth, the nation's largest provider of outpatient surgery, diagnostic imaging and rehabilitation services, is expected to be tried in an Alabama federal court for his role in a $2.7 billion accounting fraud at the Birmingham-based health care company—holding the distinction of being the first chief executive of a major company to be charged criminally with violating Sarbanes-Oxley. This test case will have long-term implications for corporate governance standards and accounting reform, not only for publicly traded health care organizations like HealthSouth but for the private and nonprofit sector as well.

The Sarbanes-Oxley Act also may have a significant direct impact on health care organizations relative to changes in the U.S. Sentencing Guidelines. Amendments to the sentencing guidelines (in response to the Act), which took effect Nov. 1, 2004, will place greater responsibility on boards of directors of hospitals and health care organizations and senior management for the oversight of compliance and ethics programs. Failure of the health care provider to establish such programs, self-report and accept responsibility for its own conduct will

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How new sentencing guideline amendments will impact health care senior management

- **Directors and high-level personnel** shall be required to establish, exercise reasonable oversight and take an active leadership role for the content and operation of compliance and ethics programs.
- **Such governing authority will be** responsible for (i) identifying and assessing areas of risk, (ii) training high-level officials (on an ongoing basis), and (iii) providing compliance officers with sufficient authority to carry out their responsibilities.
- **Specific individual(s) within** the organization shall be assigned day-to-day operational responsibility for the compliance and ethics program and be given adequate resources to carry out the associated duties, with high-level personnel assigned ultimate responsibility for the program's effectiveness.
- **Small organizations** (fewer than 200 employees) shall demonstrate the same degree of commitment to ethical conduct and compliance with the law as large organizations, albeit with less formality and fewer resources than would be expected of large organizations, and will be eligible for compliance program credit.
- **The organization will be precluded** from mitigation of its sentence if it fails to self-report criminal misconduct in a timely manner and if management-level officials tolerated or were involved in illegal activities.
- **Failure to adhere to industry** regulations and standards weighs against an organization's eligibility for compliance credit under the guidelines.
- **Although the failure to prevent or** detect the instant offense will not necessarily mean that the program is not generally effective in preventing and detecting criminal conduct, recurrence of similar misconduct creates the rebuttable presumption that the organization failed to take reasonable steps to meet the requirements of the guidelines.
- **The guidelines mandate large fines** for organizations that have ineffective programs to prevent and detect criminal conduct.

severely undermine the provider's eligibility for compliance credit under these changes.

Going forward, the new sentencing guidelines amendments, many generated in direct response to Sarbanes-Oxley, will significantly impact compliance officers and senior management in a number of ways (see box).

PHYSICIAN HEAL THYSELF

The new sentencing guidelines make it clear that oversight of financial controls is not limited to public companies such as HealthSouth. The much-publicized collapse of the Allegheny Health Education and Research Foundation in the late 1990s, the criminal charges of misappropriation and corporate waste that followed, and the more recent allegations of executive abuses at Health MidWest and Allina Health System demonstrate that not-for-profits are just as susceptible to—and every bit as much in need of—financial scrutiny. Going forward, nonprofits could avoid a similar fate by proactively holding their principal executive and financial officers to Sarbanes-Oxley's higher standards. This could be accomplished by:

- **Implementing measures to ensure** the integrity and reliability of the provider's financial statements, including appropriate internal controls for financial information released to government agencies and outsiders.
- **Creating an audit committee composed** entirely of independent directors, with at least one member who is a "financial expert."
- **Having the audit committee pass** a resolution whereby it is directly responsible for the appointment, compensation and oversight of the outside auditor (which will report directly to the audit committee).
- **Having the audit committee install** procedures for the receipt and response to complaints regarding accounting and audit matters, including a mechanism for anonymous employee submissions.
- **Adopting a code of ethics** that applies to the organization's principal officers and executives.
- **Streamlining corporate lines** of reporting, conducting periodic corporate governance training and enforcing conflict-of-interest policies.
- **Restricting the accounting firm** providing audit services from contemporaneously performing non-audit services for the provider, such as bookkeeping or actuarial services relating to the provider's accounting records or financial statements. The appointment of a competent, independent auditor is critical, particularly in the health care industry, where the deviation between the provider's billed charges and actual reimbursement can result in retroactive adjustments and government audits.

Amendments to the sentencing guidelines took effect on Nov. 1

Many nonprofit organizations have, in fact, already implemented mechanisms that comport with Sarbanes-Oxley's requirements. For example, a number of health care providers have adopted an independent audit committee, consisting of board members who are not executives or otherwise employees of the organization. Indeed, the composition and responsibilities of an audit committee are in many regards consistent with the fundamental duties of care and fidelity to which directors of nonprofit organizations are already subject.

Additionally, the chief financial officer of a nonprofit health care provider such as a hospital is presently required to certify the organization's Medicare cost reports, essentially requiring the CFO to verify personally the accuracy and completeness of the provider's financial statements and the reliability of its internal financial controls.

Many states, in line with Sarbanes-Oxley, also prohibit loans by any nonprofit to its officers or directors, or to any corporation, firm, association or other entity in which one or more of its employees are officers or directors, or hold a substantial financial interest.

STATE REGULATORS FOLLOW SUIT

Government regulators and state attorneys generally are likely to cite public policy considerations as a basis for adopting the Sarbanes-Oxley standards into their oversight of nonprofit health care providers, insofar as the interests of charitable donors, tax-exempt bondholders and the communities served by not-for-profit organizations are akin to those of public company shareholders protected by the Act. In New York, for example, Attorney General Eliot Spitzer last year proposed a still-pending bill patterned after the federal governance reforms enacted under Sarbanes-Oxley that would amend the state's Not-for-Profit Corporation Law to protect the public against financial fraud and misconduct.

Additionally, just recently, Mr. Spitzer initiated a national probe into brokerage fees paid by insurance carriers for the sale of employee benefits such as life, disability and health insurance that is also certain to propel new governance and accounting reforms.

In sum, although non-compliance with Sarbanes-Oxley may not have direct ramifications for private or nonprofit health care organizations, because the new sentencing guidelines and state laws are adopting many of the Act's requirements, such providers would be wise to adopt governance practices, to the extent feasible, that comply with Sarbanes-Oxley standards. The fallout from the HealthSouth and more recent insurance brokerage firm scandals should cause any health care organization to reevaluate its accounting and governance practices. NU

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