



AUDIT COMMITTEE INSTITUTE

Corporate Governance Reforms: Implications for Not-for-Profit Healthcare

Audit Committee Roundtable Highlights—Spring 2004

KPMG



KPMG's Audit Committee Institute

Communicating with Audit Committees Since 1999

KPMG's Audit Committee Institute (ACI) has been communicating with audit committees since our formation in 1999. Our programs have allowed us to meet personally with thousands of directors and officers. ACI's initiatives include semiannual roundtables, publication of *Audit Committee Quarterly*, conference and board presentations, a toll-free hotline, periodic distribution of time-sensitive information, and our Web site, www.kpmg.com/aci.

ACI's Web site, which hosts audit committee tools and information, has been highly rated by directors and officers. The site's resources include additional information on topics discussed in *Audit Committee Quarterly*, published articles from ACI, regulatory and technical content, audit committee "hot topics," and additional resources.

ACI can be reached toll-free at 877-KPMG-ACI (877-576-4224) or via e-mail at auditcommittee@kpmg.com.

KPMG's Audit Committee Insights

Register for KPMG's *Audit Committee Insights*

KPMG LLP (U.S.) recently launched a biweekly electronic publication to help audit committee members, executives, and others stay up to date on the ever-increasing volume of news, opinions, research, and trends related to corporate governance and the role of the audit committee. KPMG's *Audit Committee Insights* contains relevant articles selected from hundreds of sources on such topics as financial reporting, audit committee surveys, shareholder issues, and items in the news. It also features articles offering KPMG's commentary, perspectives, and insights on key issues leveraging the knowledge gained through KPMG's Audit Committee Institute. Registration for this complementary electronic publication is available at www.kpmginsights.com.

Introduction

The laws of the marketplace are often as compelling as the laws of the land. While the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley or S-O) does not *legally* apply to the not-for-profit sector, this landmark legislation—which is dramatically reshaping corporate governance in the public sector—is affecting the way many not-for-profit healthcare organizations are approaching their own financial reporting practices. Indeed, the move to strengthen internal controls and financial reporting in the public sector has put significant pressure on not-for-profits to follow suit—voluntarily. Whether to reassure bond markets or donors, improve performance, or address the likelihood of similar regulations being adopted for their industry, not-for-profit healthcare organizations are responding to the new “Sarbanes-Oxley standard” in a variety of ways—from adopting full-blown governance and compliance programs that largely mirror Sarbanes-Oxley to taking a wait-and-see approach. The challenge is determining which elements of Sarbanes-Oxley or other corporate accountability reforms—if any—make the most sense for the organization, given its goals, resources, and risks.

To help directors and C-level executives of not-for-profit healthcare organizations examine the implications of Sarbanes-Oxley and the changing corporate governance environment, KPMG’s Audit Committee Institute (ACI) hosted the roundtable discussion “Corporate Governance Reforms: Implications for Not-for-Profit Healthcare” in the spring of 2004. The forum—ACI’s first roundtable for the not-for-profit healthcare sector—facilitated a dynamic exchange of knowledge and experiences among panelists and participants. ACI’s roundtable discussion was led by a panel of distinguished professionals who offered a range of perspectives and insights on corporate governance in the not-for-profit healthcare sector. This publication highlights key issues discussed as well as insights into governance and compliance approaches that are being considered—and implemented—by leading not-for-profit healthcare organizations.

Mounting Pressure to Act

By most accounts from the private sector, the financial and organizational resources required to comply with Sarbanes-Oxley are significant—and the challenges formidable. So why would an organization go through the often costly, time-consuming, complex, and disruptive process of implementing a Sarbanes-Oxley-like assessment of corporate governance and financial reporting practices on a *voluntary basis*? As reflected in the ACI's wide-ranging roundtable discussion, an array of internal and external pressures are driving not-for-profit healthcare providers to actively consider—and adopt—provisions of Sarbanes-Oxley.

Key external pressure points include:

- Mounting legislative and regulatory momentum to extend Sarbanes-Oxley-like requirements to the not-for-profit sector. (Currently, there are legislative proposals of this nature in a dozen states, and recent congressional committee hearings have focused on corporate governance among not-for-profits.)
- Perceptions of the capital markets—i.e., institutional investors, donors, lenders, and insurers—that can impact the availability and cost of capital.
- Independent auditors, who generally view Sarbanes-Oxley as both a leading practice and a critical element in managing their own client- and professional-practice risks.
- A move by the ratings industry to develop a system for rating the quality and effectiveness of an organization's corporate governance practices.

Not-for-profit healthcare providers also can face a formidable array of pressures from within the organization, such as:

- Board members who may also serve as directors or executives of publicly traded companies and, as a result, have direct experience with Sarbanes-Oxley as a leading practice.
- The desire to achieve efficiencies, manage risk, and improve performance through more effective internal controls and financial reporting practices.
- A spirit of responsibility and stewardship among directors and management in carrying out the organization's mission.

These pressure points—and others—will affect not-for-profit healthcare organizations differently, depending on their goals, resources, mission, and risk profile. Clearly, however, the increased scrutiny and heightened expectations that are driving corporate governance reform in the private sector are compelling many not-for-profit healthcare organizations to closely examine—and move forward in adopting—key provisions of Sarbanes-Oxley.

Participant Views

ON CONSIDERING SARBANES-OXLEY

- "Smaller organizations that don't have the resources and expertise could actually be negatively impacted by an attempt to implement Sarbanes-Oxley."
- "Ensuring transparency, credibility, and disclosure is critical to ensuring access to the capital markets."
- "Duties of obedience and care have been reawakened—often carried over from other boards."

The Sarbanes-Oxley Standard

Sarbanes-Oxley comprises an array of provisions designed to strengthen internal controls, financial reporting, and audit committee oversight of the financial reporting process and its key participants, including management and internal and external auditors. To this end, S-O requires that, among other things, public companies:

- Disclose whether the audit committee has an “audit committee financial expert”—and if not, why not.
- Disclose whether the company has a code of ethics that applies to its principal executive officer and senior financial officers—and if not, why not.
- Establish policies to help ensure the external auditor’s independence.
- Establish “whistleblower” procedures to receive, retain, and address complaints about accounting, internal controls, or auditing matters.

Some of the most challenging requirements of Sarbanes-Oxley, however, reside in sections 302 and 404, which pertain to the certification by the CEO and CFO of the company’s financial statements and the documentation of, assessment of, and reporting on the company’s internal control over financial reporting.

Sections 302 and 404

Section 302 requires a company’s CEO and CFO to issue a statement certifying the accuracy of the company’s periodic financial statements. Section 404 requires that the annual report of a publicly traded company contain a statement of management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting. Management is further required to assess the effectiveness of the company’s internal control structure and procedures for financial reporting.

From the perspective of the not-for-profit healthcare industry, some of the critical financial reporting areas and processes potentially affected by an S-O-like compliance initiative include:

- The tone at the top
- The internal control environment
- All major financial statement categories
- The revenue cycle
- Procurement
- Capital assets
- Risk management

Participant Views

ON UNDERTAKING AN S-O INITIATIVE IN THE NOT-FOR-PROFIT HEALTHCARE INDUSTRY

- “If you decide to adopt [elements of] Sarbanes-Oxley, don’t go halfway. Approach it as though it were a regulatory mandate.”
- “Under section 302 you’re personally certifying the organization’s financial statements. You have to get it right.”

Participant Views

ON INDEPENDENCE

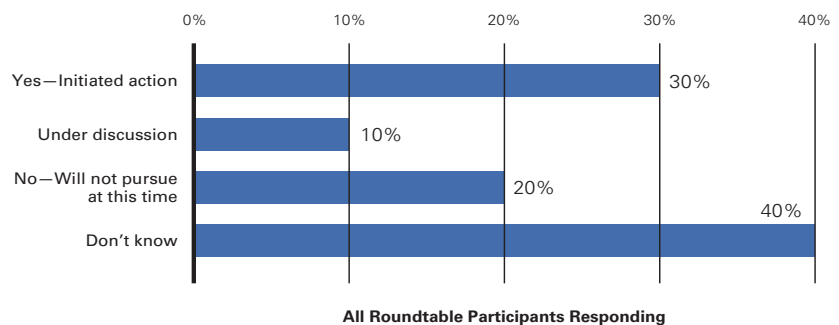
“The most significant long-term impact of Sarbanes-Oxley could be establishing true conflict-of-interest standards throughout this industry.”

ACI’s Dynamic Roundtable Format

ACI’s Audit Committee Roundtables are structured to encourage participation and feedback from the audience and a panel consisting of audit committee members, attorneys, and others supporting the audit committee process. During each roundtable, a moderator introduces various topics, with panel members and attendees providing much of the detailed discussion content. This approach results in an interactive format, with the moderator, panel, and audience collectively driving the direction of the discussion.

Additional audit committee responsibilities in a Sarbanes-Oxley-based environment include assuming “direct responsibility” for the appointment, compensation, and oversight of the external auditor as well as considering the external auditor’s independence and approving any nonaudit services it provides. These changes in the relationship with the external auditor have also made many audit committees reassess their reporting relationship with the organization’s internal audit department.

Does your organization require a principal executive officer to affirm that he or she has reviewed and certified any annual report?



Source: KPMG’s Audit Committee Institute, Spring 2004 Not-for-Profit Healthcare Roundtable

Approximately 40 percent of participants surveyed during the roundtable discussion said their healthcare organizations either require—or are considering requiring—their principal executives to affirm that they have reviewed and certified the annual financial statements. The balance of respondents said their organizations have no plans to pursue a financial statement certification requirement or didn’t know if such a requirement exists.

Voluntary “Compliance”: Key Considerations

Adopting—or even *considering*—a voluntary Sarbanes-Oxley-like compliance initiative presents formidable challenges:

- Which provisions of S-O make the most sense for the organization?
- Does the organization have the resources to achieve and sustain an expanded financial reporting initiative?
- How do the organization’s current financial reporting practices compare to S-O requirements?
- Will board members have sufficient time to devote to their expanded responsibilities?
- Will the benefits outweigh the costs?

In contemplating these and other issues and determining the most effective approach, leading not-for-profit healthcare organizations and their boards are weighing a variety of potential risks and rewards.

Weighing the Pros and Cons

In addition to the financial costs and organizational resources required by an S-O-like initiative, an assessment of internal controls and financial reporting processes might also pose major risks, such as:

- Damage to the organization’s credibility, due to heightened stakeholder expectations, if it fails to meet its compliance objectives.
- Overextending the organization’s resources, which could result in reduced emphasis on other organizational issues or, if financial costs are significant, a potential downgrading of the organization’s bond rating.

These risks can be compounded by a variety of factors, including: increasingly complex balance sheets in the healthcare industry; expanding regulatory requirements and oversight; inability or unwillingness among volunteer board members to devote sufficient time to the oversight process; and other major regulatory requirements, such as information security requirements under the Health Insurance Portability and Accountability Act (HIPAA).

The voluntary nature of the “compliance” process notwithstanding, many not-for-profit healthcare observers believe it is vital for organizations that adopt provisions of S-O to treat them as though they were regulatory requirements. A “half-baked” approach can quickly—and critically—undermine the credibility of the effort as well as the internal controls and financial reporting processes the provisions are designed to strengthen.

The potential benefits of creating an improved and sustainable process and sound corporate governance environment can be significant. Such benefits may include:

- Greater confidence in the organization and, as a result, increased support from donors, lenders, and other stakeholders
- Improved access to the capital markets and reduced cost of capital
- Enhanced process efficiencies and business performance value

In addition, taking a proactive approach to governance and financial reporting also may offer significant competitive advantages, particularly if S-O-based requirements are ultimately mandated for the not-for-profit healthcare sector.

Clearly, one size doesn’t fit all; however, many observers view the voluntary adoption of key provisions of Sarbanes-Oxley as a leading practice in the not-for-profit healthcare sector.

Participant Views

ON POTENTIAL RISKS AND REWARDS

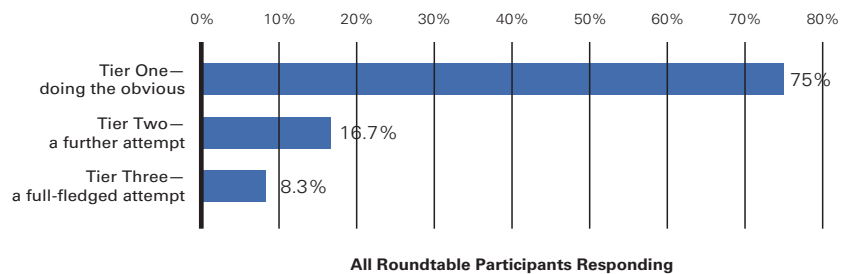
- “You can’t go into this process half-baked. The organization must be fully committed to carrying it out—whatever the extent or depth of the initiative.”
- “Increased confidence of the bond markets and reduced cost of capital are compelling rewards.”
- “Not all organizations will get out of this process what they put into it.”
- “You can move the organization toward greater controls maturity without going through the cost and burden of the Sarbanes-Oxley process.”

Who's Doing What: Reactions to Sarbanes-Oxley

Not-for-profit healthcare providers are responding to Sarbanes-Oxley and other corporate governance reforms in a variety of ways: some are investing significant resources toward implementing "full-blown" S-O programs, others are adopting provisions of S-O on an ad hoc basis, and many have taken a wait-and-see approach or have decided to take no action until forced to do so by law. Categorizing the status of their efforts within one of three general "tiers" of progress, roundtable participants indicated the following:

- Three quarters of respondents said they are taking fundamental steps (Tier One) to strengthen their internal controls and financial reporting processes, including:
 - Forming an audit committee
 - Requiring the audit committee to preapprove all nonaudit services provided by the external auditor
 - Increasing communications with internal and external auditors on such topics as financial reporting and other risks and areas of significant management judgments and estimates

Where does your organization fall?



Source: KPMG's Audit Committee Institute, Spring 2004 Not-for-Profit Healthcare Roundtable

- Approximately 16 percent of respondents said their organizations have also taken the additional steps (Tier Two) of:
 - Requiring financial statement certification by the CEO and/or CFO of operating units
 - Adopting a policy for the rotation of the external auditor's lead partner
 - Expanding auditor communications to include alternative accounting treatments, preferred methods of accounting, and key business risks
 - Extending audit committee oversight to internal audit
- Under 10 percent of roundtable participants said their organizations have undertaken a full-fledged S-O initiative (Tier Three) comprising all of the above actions as well as the following:
 - Formulating policies regarding the audit committee's and management's relationships with the external auditor
 - Designating an "audit committee financial expert"
 - Documenting and assessing internal controls, similar to the requirements of S-O section 404 (in some limited cases the external auditor is also being asked to report on management's assessment of internal controls)

Assessment of Internal Controls: Approaches and Key Factors

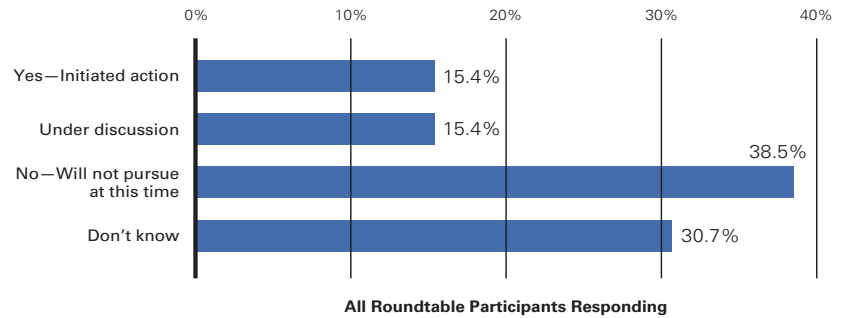
Some leading healthcare organizations are implementing a prioritized review of internal controls by focusing first on the areas of highest risk. In documenting, assessing, and reporting on an organization's internal control structure, several factors should be considered that might impact the approach on a strategic level:

- Additional financial and organizational resources will likely be needed, including a larger internal audit function with expanded capabilities as its role and responsibilities expand beyond a traditional focus on operations.
- Many of the implementation challenges and “bugs” will likely be resolved—or at least mitigated—by public companies over the next 6 to 12 months.

A number of “tactical” issues might also present healthcare organizations with potential challenges as they assess internal controls:

- Significant estimates—specifically the allowance for doubtful accounts and contractual allowances—may need to be reevaluated.
- Inventory of managed care contracts may need to be updated.
- Decentralized healthcare systems may require additional mitigating controls for multiple locations or departments.
- Integrated delivery systems may have multiple information systems that must be documented and tested.
- Physicians with remote access may present additional access and security controls issues.
- Additional training may be required to help ensure that all parties have sufficient understanding of their roles and responsibilities as well as the organization's overall compliance objectives.
- Controls that are currently “oral” and not documented must be identified, documented, and incorporated into the assessment process.
- Decentralized policies and procedures may need to be identified, integrated into the overall process, and updated regularly.

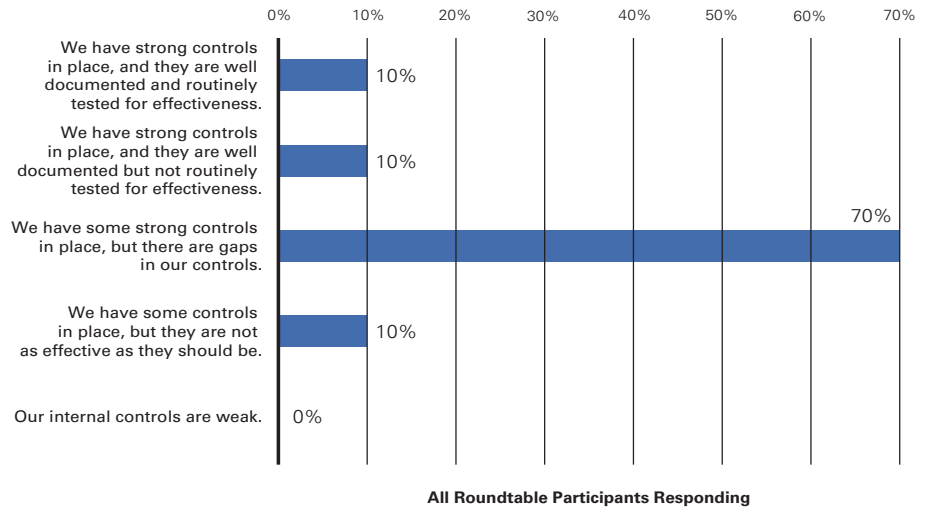
Does your organization mandate that the annual report contain an internal control report that: states that it is the responsibility of management to establish and maintain an adequate internal control structure and procedures for financial reporting; contains a self-assessment, as of the end of the organization’s fiscal year, of the effectiveness of the internal control structure and procedures?



Source: KPMG’s Audit Committee Institute, Spring 2004 Not-for-Profit Healthcare Roundtable

Approximately 30 percent of roundtable participants said their organizations either require, or are considering requiring, annual financial statements to contain an internal control report that states management’s responsibility for maintaining internal controls and contains management’s assessment of the effectiveness of the internal control structure and procedures. Thirty-eight percent said their organizations had no plans to pursue making this a requirement; and 30 percent didn’t know if their annual financial statements included such information.

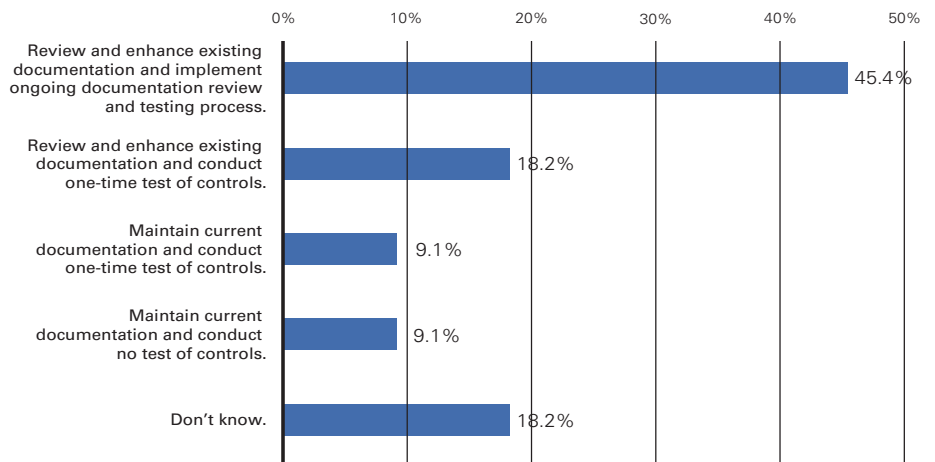
Which of these statements best describes the current status of your documentation of internal control over financial reporting?



Source: KPMG's Audit Committee Institute, Spring 2004 Not-for-Profit Healthcare Roundtable

Only 10 percent of roundtable participants believe their healthcare organizations have "strong controls in place" that are well documented and routinely tested for effectiveness, although another 10 percent said they have strong controls in place that are not routinely tested. The majority of participants (70 percent) said they believe they have some strong internal controls in place, although gaps still exist. The remaining 10 percent thought that their organizations' internal controls "are not as effective as they should be."

What are your next steps regarding documentation of internal control over financial reporting?



All Roundtable Participants Responding

Source: KPMG's Audit Committee Institute, Spring 2004 Not-for-Profit Healthcare Roundtable

More than half of those surveyed said their “next step” would be to review and enhance existing documentation and either conduct a one-time test of controls or maintain ongoing documentation reviews and testing. Approximately 20 percent said they would maintain their current documentation and conduct either a one-time test or no tests. Another 18 percent weren’t sure what their organization’s next steps would be.

In contemplating their approach to governance and financial reporting, organizations also should consider the following factors that may impact the success of their implementation efforts:

- Strength of the organization’s leadership and the “tone at the top”
- Effectiveness of the management team
- Level of “buy-in” and involvement across the enterprise
- Reasonableness of the implementation time frame

Conclusion

Confidence in a not-for-profit healthcare organization's financial reporting practices and corporate governance standards—as with any for-profit enterprise—is essential to success; and access to cost-effective capital and continued support from donors and stakeholders requires sound internal controls, effective oversight, and clear accountability—all key elements of Sarbanes-Oxley compliance.

While one size doesn't fit all, many of the participants at our roundtables believe the provisions of Sarbanes-Oxley represent fundamentally sound business practices and offer not-for-profit healthcare organizations valuable opportunities to enhance the integrity of their financial reporting processes.

In contemplating or adopting Sarbanes-Oxley-like practices, organizations and their boards should keep the following points in mind:

- Implementing all of the key provisions of the public company corporate accountability reforms will likely be a complex, costly, time-consuming process, requiring significant resources and knowledge.
- Adopting the provisions of Sarbanes-Oxley, particularly sections 302 and 404, may result in senior management taking on additional personal accountability and an increased perception of accountability for the accuracy of financial reporting results and the effectiveness of the financial reporting process.
- Launching a Sarbanes-Oxley-like initiative raises the bar substantially; failure to achieve this self-imposed standard could undermine the organization's credibility.
- Leading not-for-profit healthcare organizations are approaching their assessment of internal controls in a prioritized manner by focusing on the areas of greatest risk first.
- Many of the internal control implementation-related "bugs" will likely be resolved by the public sector over the coming months (as organizations approach their reporting deadlines).
- Sarbanes-Oxley-like regulations may ultimately be mandated for the not-for-profit sector.

The near-term costs associated with assessing internal controls and strengthening the financial reporting process are likely to be significant. However, by carefully weighing the pros and cons of voluntary compliance and implementing approaches that are commensurate with their resources and risks, not-for-profit healthcare organizations can realize long-term benefits from their efforts. Strong internal controls, sound financial reporting processes, and effective corporate governance practices are all essential to helping ensure the confidence of stakeholders and access to the capital and resources that are vital to carrying out the organization's mission.

Participant Views

ON THE ROUNDTABLE'S VALUE

Participants at ACI's Spring 2004 Not-for-Profit Healthcare Roundtable rated the forum as "very useful" or "extremely useful" in helping them address the issues impacting the effectiveness of their audit committee activities.

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We would like to acknowledge the valuable insight and contributions of Edward Giniat (eginiat@kpmg.com) and Daniel R. Curran (dcurran@kpmg.com) of KPMG's Healthcare practice in the United States in helping to coordinate the industry-specific roundtable and in compiling this publication.

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