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Ethical Breaches – Lessons for Canadian Charities

Introduction

The news of late has been all but dominated by stories of gross ethical breaches on the part of those governing corporate bodies (ENRON, WorldCom, to name but two), and on the part of Ministers of the Canadian government. Lessons are there to be learned by charitable boards. The purpose of this piece is to re-examine corporate governance in the charitable context. What positive steps can charitable boards and management take to ensure ethical actions are taken by them? What is the state of the law specifically with respect to the role of corporate auditors?

Non-Profit Corporate Governance

What is the role of the charitable board of governors? As outlined in greater detail in a previous article (refer to "The Duties and Liabilities of the Directors of Non-Profit Corporations", the role of the charity board member is multi-faceted. First, the board member, in executing his or her duties must exercise the care, diligence and skill that can be reasonably expected of a person with their own knowledge and experience. Second, there exists a fiduciary duty, that is, a duty to act loyally, honestly and in good faith with the best interests of the corporation. Certainly, ethical and responsible corporate governance exists and is enforced in the charitable and non-profit context. In fact, when the board member serves on a charitable board, his or her duties may be elevated to the status of a trustee, the very highest standard possible.

Avoidance of Conflicts of Interest

Corporate boards have the imperative to not only avoid conflicts of interest, but also to avoid the *appearance* of conflicts. In addition to serving without recompense, charitable directors, in exercising their fiduciary duties, should avoid any situation in which his or her personal interests conflict with those of the charity. This directive means that, not only should charitable board members recuse themselves from voting on matters in which they have a financial interest, or even a potential future conflict, but that they should also avoid having their business partners (lawyers, financial advisors, accountants) or family members benefit financially.

The Role of the Independent Auditor

For weeks on end, the ENRON debacle and then the WorldCom scandal dominated the financial headlines. More than any other lesson to be learned, these cases demonstrated that the role of an external, independent auditor is vitally important to protecting shareholders and trustees. Particularly in multi-level educational institutions and in large hospitals, accounting practices are nearly unintelligible to some trustees. As ENRON proved, monitoring of corporate behaviour leaves much to be desired, but audit oversight of charities is even more nebulous.

Common problems include excessive executive pay, higher fundraising costs than are self-evident, unreasonable expenses, board member conflict of interest. Another problem is the reality that a company's executives usually appoint auditors. A corporation's board of trustees does not appoint auditors. The result is that the auditors, who should be fully independent, become somewhat beholden to management. Accounting firms frequently sell consulting services to audit clients. In fact, in clear conflict of interest situations, auditors are hired to senior management positions or as internal auditors. It is little wonder that audit quality suffers.

A Canadian Obstacle to Shareholders

The Supreme Court of Canada decision of Hercules Managements Ltd. v. Ernst & Young (1997) 146 DLR (4th) 577 (S.C.C.), sets up a considerable barrier for shareholders wishing to hold a corporation's auditors responsible for accounting and auditing errors, or, in law, for cases of "negligent misrepresentation". The decision of the highest court in the land recognizes that there may be a duty of care between a company's auditors and company shareholders, but that the duty is negated by "policy considerations".

The Court held that the key consideration was that there would be, "socially undesirable consequences" if accounting firms were held liable to any given number of shareholders over an indefinite period of time, for their negligence in the preparation and presentation of financial statements.

The legal profession is divided on the value and wisdom of the decision. Many believe that it only succeeds in protecting irresponsible auditors from their negligence. They argue that if one can hold management responsible for a bad financial statement, then there is no reason why the auditor/accounting firm should not be liable also. After all, if the shareholders own the corporation, and the auditors are working for the corporation, then the auditors are the agents of the shareholders. Why should the agents not be held responsible for their work?

This analysis conceded, Hercules does allow the corporation that hired the auditors to sue on behalf of the shareholders. However, there is a less than satisfactory arrangement when management of the corporation (who truly hire the auditors) has pressured the auditors to report results in a certain fashion. The independence of the auditor is brought into question.

Other members of the legal profession support the decision, arguing that if it only becomes a search for which party has the “deepest pockets” and large accounting firms are always sued, that the corporate reporting system would break down.

Conclusion

These issues of corporate governance do have a place in the thinking of persons working within the charitable and non-profit sectors. The independence of the auditors must be respected. Board members who are simply relying entirely on auditor reports may wish to make more detailed examinations of the reports presented to them, at least enquiring of management about how the financial reports were prepared. What is the full relationship of the auditor to the organization? If one is not interested in diligently pursuing these issues, one may have to re-examine one’s utility to the charity. Liability issues are a real concern for those not concerned about standard of care and fiduciary duty to the charity. Simply being aware of these issues can make both management and board trustees in the charitable context better professionals.

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