Feature

Getting Fit: Is Your Department in Shape to Fight Fraud?

By Michael Fabrizius, CIA, CPA

Executive Summary

A recent update to our internal audit professional standards requires that fraud strategies be explicitly incorporated into our risk assessments, controls monitoring, and audit testing. Various factors are outlined to consider in better preparing healthcare internal audit departments for both a more vigorous and proactive role in fighting fraud and becoming compliant with the standards. Both the internal audit department and its organization will benefit by an increased capability in fraud prevention, detection, and investigative proficiency.

Introduction

The Institute of Internal Auditor's (The IIA) International Professional Practices Framework (IPPF) is the authoritative guidance on the internal audit profession, presenting mandatory and strongly recommended Standards and other guidance for the practice of internal auditing. In 2009 The IIA released an updated framework to address the changes that have taken place in the global internal audit profession since its last update in 2002.[1]

One of the principal changes was to incorporate mandatory standards regarding fraud that requires internal auditors to:

- Have sufficient knowledge to evaluate the risk of fraud and the manner by which it is managed by the organization, and to exercise due professional care (Standard 1200: Proficiency and Due Professional Care and Standard 1220: Due Professional Care).
- Include in periodic reports to senior management and the board, significant risk exposures and control issues, including fraud risks (Standard 2060: Reporting to Senior Management and the Board).
- Evaluate the potential for the occurrence of fraud and how the organization manages fraud risk (Standard 2120: Risk Management).
- Consider the probability of fraud when developing engagement objectives (Standard 2210: Engagement Objectives).

Other factors have recently come together to bring fraud to the forefront for healthcare internal audit departments. Tremendous pressure has been placed on healthcare management by the general economic crisis, healthcare reform, and the unique conditions in the industry. These include diminished reimbursement, reduced access to capital, and increased labor and supply costs. Many organizations are reacting by reducing costs and implementing layoffs. Not only will engagement levels of affected personnel be reduced, but the structure and effectiveness of previously designed controls may be inadvertently impaired or disabled. Maintaining internal controls to prevent fraud in this new environment poses a particular challenge.

As part of its *2009 Internal Audit Capabilities and Needs Survey*, Protiviti asked chief audit executives about their need for improvement in various audit process skills, along with their level of competency in those skills. The top identified areas that needed improvement included fraud-monitoring, fraud-detection/investigation, fraud-auditing, and fraud risk management/prevention.

The updates to our professional standards, the healthcare economic environment, and a possible internal audit capability deficiency require immediate self assessment. Internal audit departments should perform a self examination to determine what they might need to do to appropriately take on their newly expanded role in regard to fraud. The IIA Standards provide logical categories to shape this exercise.

Proficiency and Due Professional Care

The Standards indicate that internal auditors are required to possess the necessary knowledge, skills, and other competencies to conduct their engagements appropriately. This includes sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization.

The Standards require the internal auditor to exercise due professional care, which is the application of the care and skill expected of a reasonably competent internal auditor. The qualities of attention, knowledge, intelligence, and judgment provide the basis for the professional conduct of any internal audit. However, the Standards do acknowledge that there is no expectation of infallibility.

Knowledge

The potential range of knowledge, skills, and competencies to effectively carry out a department's professional responsibilities regarding fraud could potentially be considerable. However, the Standards indicate that "most internal auditors are not expected to have knowledge equivalent to that of a person whose primary responsibility is

[1] *The International Professional Practices Framework*, January 2009, The Institute of Internal Auditors

detecting and investigating fraud." But it seems clear that certain basic elements should be considered by every internal audit department. Where circumstances such as department size limit maintaining those capabilities internally, consideration will need to be given to obtaining them externally on an "as-needed" basis.

Among the basic elements that should be evaluated are knowledge of fraud schemes, investigative techniques, interviewing, data analytics, laws and regulations, and organizational relationships. Where gaps are identified, strategies should be actively deployed to increase competency.

An internal audit department needs to be increasingly aware of fraud schemes so that they can be readily recognized. It can be difficult to imagine the myriad of possible schemes that can be perpetrated against your organization. Following the media accounts of fraud and networking with other healthcare internal audit professionals can provide critical knowledge of common and recurring fraud schemes.

Investigative Techniques

Improper investigative techniques can jeopardize a fraud investigation. Knowledge is necessary regarding lawfully obtaining evidence that might be needed in a legal proceeding, which can vary from typical audit evidence. Workpapers and supporting documents should be appropriately secured and retained, including evidence (with chain of custody implications). Training events by relevant professional associations can provide needed education.

Analytics

Data analytics can be very important when an investigation needs to look at the entire population to determine clear patterns and magnitude, whereas an audit might use sampling and extrapolation. Data analytics expertise is increasingly common for auditors in the conduct of operational and financial audits. Proficiency occurs with repeated application of the tools, following training.

Legal

Laws and regulations can dictate the conduct of an investigation. Evidence gathering, interviewing, securing privilege, and labor laws can all come into play in an investigation. Some working knowledge is necessary, but more importantly, access to good advice should be readily available. Formal training should be taken advantage of and legal resources should be identified for access as needed.

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Relationships

The success of any internal audit department is in-part dependent on its working relationships with other departments in the organization. Departments such as legal, human resources, and security can become important partners of the internal audit department. Collaboration with these groups is often necessary to conduct thorough risk assessments; coordination is similarly required in many investigations. Organizational relationships that include adequate communication and mutual support will be a well developed competency of internal audit departments that successfully carry out their professional responsibilities.

Expertise

Having externally recognized fraud experts in an internal audit department can be achieved through members of the staff obtaining a specialty certification. For example, the Certified Fraud Examiner (CFE) credential indicates expertise in fraud prevention, detection, and deterrence.[2] CFEs are trained to identify the warning signs and red flags of fraud and fraud risk. Encouraging and supporting pursuit of this certification by staff members would appear to go a long way in acquiring the necessary proficiency for the department.

Limitations

Lastly, a good internal audit department always knows its limitations. There will be situations where certain types of allegations of fraud will make it preferable to hire outside experts rather than conducting an in-house investigation. Factors that will influence this decision include possible senior management involvement, need for specialized investigative skills, and the perceived credibility or independence of external experts from the perspective of stakeholders such as external auditors, litigators and regulators. Be prepared to recognize the signs that suggest this course of action.

Reporting to Senior Management and the Board

Similar to any internal audit activity, a responsibility exists to provide periodic reports regarding significant fraud risks, observations, fraud incidents, investigation results, and management's corrective actions to senior management and the board. However, variations from typical reporting practices will be necessary when there are issues or allegations related to a senior executive or any matters of organizational significance.

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The most serious matters will require very quick reporting escalation. Where there are allegations of fraud or lack of integrity on that part of senior management, maintaining the credibility of the internal audit function in supporting the audit committee's governance and oversight responsibilities requires incredible judgment on the part of internal audit leadership.

The success of internal audit in these situations will likely depend on its organizational status and working relationships with senior management and the audit committee. Changes in reporting structure and the cultivation of better relationships may be required.

It is best to assess and identify any opportunities for improvement in these areas now, well in advance of any matter that provides a test of their effectiveness.

[2] Certified Fraud Examiner, Association of Certified Fraud Examiners

Risk Management

The Standard for risk management requires internal audit to evaluate the potential for the occurrence of fraud and how the organization manages fraud risk. Fraud risk is defined by the Standards as the probability that fraud will occur and the potential consequences to the organization when it occurs.

The essential foundation in determining fraud risk is an understanding of the fundamentals of the entire organization and its industry. The identification of potential fraud schemes will consider the potential opportunities within the organization and the schemes that have occurred within the organization and the industry.

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The audit team needs to be well grounded in fraud schemes. While each fraud has unique elements, they tend to fall into defined categories and have shared characteristics. Common examples include disbursement fraud, expense reimbursement fraud, skimming, payroll fraud, diversion, and financial reporting fraud. Examples reported in the media would indicate that healthcare seems vulnerable to the full gamut of fraud schemes.

The process to determine organizational fraud risk and how it is managed should be structured to include members of the organization with awareness of vulnerabilities and knowledge of past schemes. Participants should include anyone with insight into these issues, such as security, legal, human resources, operational management and external auditors.

The risk assessment should inventory the possible schemes, identify the preventive and detective controls and monitoring, and score the likelihood and impact of each fraud risk. The highest composite scores will provide a prioritized roadmap for identifying engagements to test the operating effectiveness of internal controls to prevent and detect fraud.

Engagement Objectives

Individual engagements are now required to consider the probability of fraud when the engagement objectives are developed. The engagement risk assessment needs to consider the specific fraud schemes that are relevant and possible in the area being audited. Audit testing of the existence and operating effectiveness of controls will need to evaluate the identified fraud risks.

Sensitivity now needs to be heightened to identify red flags of fraud and their implications. Professional skepticism will have to be increased to adequately question performance and results, answers, and explanations that are typically encountered in the conduct of an audit.

Finally, internal auditors need to be able to determine when an internal audit should become a fraud investigation. When there may be a basis for prosecution or a lawsuit, a serious violation of organization policy, or any matter that could be subject to challenge and a contentious dispute or regulatory scrutiny, be prepared to consider shifting to investigation mode

When audit evidence strongly indicates the possibility of fraud, legal counsel should be consulted on the next steps to take. Pursuing an investigation without proper guidance can jeopardize the organization's reputation and may expose it to lawsuits, even from parties involved in the fraud.

Other Factors

A successful organizational fraud prevention and detection program will include many other components besides the capability of the internal audit department. It is generally recognized that these components will encompass a fraud policy; a fraud hotline; fraud awareness and training within the organization; and fraud investigation governance and protocols. A well prepared internal audit department can be an essential element in consulting on the design of these components as well as monitoring and evaluating their performance.

Conclusion

The risk of fraud is present in every healthcare organization. Internal audit needs to have robust capabilities on many dimensions to meet these new and increased expectations for fraud prevention, detection, and investigative proficiency. No time should be wasted in performing a departmental capability assessment and remediating any weaknesses in the team's skill set. **NP**

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