

Performing the First Internal Audit: Do You Know Where Your Risks Are?

By Renee Jaenicke

In June 2004, Catholic Healthcare West (CHW) acquired two new facilities along the California Central Coast. Internal audits had not been performed previously at either of these facilities. CHAN Healthcare Auditors has a contract to perform audit services at all CHW's facilities. This article describes how the author determined the potential risks, the effectiveness of internal controls and educated the management and staff on the value of internal audit.

Arroyo Grande Community Hospital and French Hospital Medical Center were owned by two different organizations in the three years before their acquisition in June 2004. Upon completion of the acquisition, the Chief Financial Officer (CFO) requested the healthcare audit organization perform a General Controls Review of financial operations at the two new facilities to serve as an initial baseline and to prioritize areas that might require improvement. These facilities had not experienced any internal audits during their two previous ownerships. Therefore, the first audit project required establishing the purpose of an internal audit group and also educating staff how their daily activities contribute to strong controls for the organization.

Determining Potential Risks and Controls

The project timeline allowed five weeks for completion of this review. The review involved looking at financial areas at two different facilities. Therefore, clearly defined objectives and scope were crucial to a successful project. The auditors met with management and reviewed due diligence materials from the acquisition to arrive at the following objectives:

- Obtain an understanding of financial processes and document the key financial processes.

- Identify key risks and controls in those processes.
- Perform limited testing to determine whether the controls are functioning as intended.

In consultation with management, the key financial processes referenced above were determined to be: payroll, cash receipts, billing, materials management, and accounts payable.

Each of the key processes above could easily result in a separate audit. Therefore, it was decided that only the key controls would be tested.

A scope document was developed and buy-in of the CFO was obtained (Exhibit 1). To keep the audit on track a project plan was developed (Exhibit 2). The project timeline allowed 260 hours (five weeks) to review financial operations at two different facilities.

Educating Management and Staff

Education was key to the successful completion of the audit. Since controls in the key financial processes had not been reviewed by an outside organization as far back as anyone could remember, this audit was sure to bring about changes. The individuals in department management and their staffs had already been through changes due to the prior acquisitions. Convincing them that more changes were

needed required showing them how these changes would benefit them. Two tools were used to provide this education: Flowcharts and the "Beat the Crook" game.

Meetings were held with the individuals who perform each step of the processes reviewed, and cross-functional flowcharts showing what steps are taken in the following process areas: payroll, cash receipts, cash posting, purchasing, and accounts payable.

The pictorial representations helped the individuals who perform the work to better understand their jobs, as well as the upstream and downstream step in each process. When individuals understand more about what happens to their work before and after they are finished with it, they tend to understand more about why they do things in a certain way and what might need to change. The flowchart also ensured that we had a solid understanding of what controls were already in place.

Once it was understood what controls were in place, the audit turned to determine which controls were not in place. This was accomplished by means of a "Beat the Crook" game (Exhibits 3 and 4). The games put the auditor in the place of the "crook" and the individuals interviewed played the role of someone returning from vacation during which the "crook" had attempted to steal from

Exhibit 1

GENERAL CONTROLS REVIEW
 Arroyo Grande Community Hospital
 French Hospital Medical Center
Scope Considerations

AreaArea	In	Out
Cash Receipts and Posting	Analytical review Compliance with CHW P&P Cash collection (lockbox, mail, cashier, other) Cash receipting, deposits, and posting Cash drawer reconciliation Petty cash Physical security Unapplied cash	Cash account reconciliation Escheatment Unclaimed property Dietary Gift shop Cash equivalents (e.g., securities) Document retention Information systems
Payroll	Analytical review Compliance with CHW P&P Payroll master Timekeeping Overtime authorization Payroll processing Payroll distribution Check stock Payroll stamp	Wage and hours Tax submission to the IRS W-2 Document retention Information systems
Billing & Collections	Analytical review Compliance with CHW P&P Unbilled A/R Billing/claims processing (overview) Follow-up processing (overview) Credit balances/refunds and approval Bad debt write-offs and approval Administrative adjustments and approval	Pre-admission and authorizations Admitting/registration functions HIM Collection agencies Charge master Denial management Document retention Information systems
Accounts Payable	Analytical review Compliance with CHW P&P Vendor master requests Invoice receipt and approval Invoice coding Invoice entry and matching Check processing Check stock Returned checks	1099 processing Accrual G/L accounts Monthly cut-off Document retention Information systems
Materials Management	Analytical review Compliance with CHW P&P Purchase requisitions and approval Purchase order processing Receiving % Purchase order usage Returned goods	Inventory/Central Stores Volume discounts Consigned goods Sales tax Fixed assets Document retention Information systems

Exhibit 2

**GENERAL CONTROLS REVIEW
Arroyo Grande Community Hospital
French Hospital Medical Center**

Objectives

- To obtain an understanding of key financial processes performed by the above two facilities.
- To document these processes via high-level process maps.
- To identify key risks in these areas and key controls to mitigate those risks.
- To perform limited control testing to determine that controls are functioning as intended.

Scope

- Cash Receipts
- Payroll
- Billing and Collection (B&C)
- Accounts Payable (A/P)
- Materials Management (MM)

Excluded

- Substantive detailed testing will not be performed unless warranted by control testing.

Timing

Objective	Week Performed				
	Cash	Payroll	B & C	A/P	MM
Obtain overall understanding	8/9-8/13	8/2-8/6	8/9-8/13	8/16-8/20	8/16-8/20
Document processes	8/9-8/13	8/2-8/6	8/9-8/13	8/16-8/20	8/16-8/20
Identify key risks and controls	8/9-8/13	8/2-8/6	8/9-8/13	8/16-8/20	8/16-8/20
Limited control testing	8/23-8/27	8/23-8/27	8/23-8/27	8/23-8/27	8/23-8/27

Report writing	Week of 8/30-9/2
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the facility. The games provided a series of scenarios and requested a response from those individuals in different areas of the process (i.e., cash receipts and cash posters, materials management and accounts payable). What made these games effective was:

- Department management suggested scenarios prior to staff interviews. These suggestions helped them buy into the game idea. Meetings were held with department management after completion of each game. These meetings alerted them to potential audit issues.
- The games looked at each process as a whole. For example, if a cashier thought that the cash poster provided a control that was not in place, all participants could see the breakdown.

- The games placed the "blame" on the interviewer, not the interviewee. The person interviewed was assumed to be honest. The interviewer was the crook. As a result, each person interviewed opened up more about their concerns.
- The individuals interviewed not only helped identify problems based on the responses to the scenarios, they also helped identify the solutions.
- When it was time to develop action plans, internal audit experienced virtually no resistance from the individuals responsible for carrying out the changes because they helped develop them.

The games were a hit! Staff talked about it at coffee breaks and in the lunchroom, asking if internal audit had been to their department yet. Department

management decided to keep the game on hand so it could be used to assess risks periodically.

Best Practices

Our audit organization maintains a database of best practices from over 300 facilities nationwide. A best practice is defined as a practice or process that strengthens the client's internal controls, could benefit another client if implemented, and is transferable by way of sharing methodology, tools, and templates. During this project, individuals requested information on how other facilities ensure strong controls in some of the process areas reviewed. However, they also had best practices to share. One of the collection locations had an excellent example of a cash-balancing template. This was recommended for use at both facilities, and it was submitted to CHAN's *Best Practice Committee* for

Exhibit 3

“BEAT THE CROOK” Disbursements Cycle

Hypothetical Scenario: You are on vacation for a month. I have taken your position on a temporary basis. When you return from vacation, I will be no longer be working for this facility and there will be no way to reach me. Consequently, you will be responsible for any actions I take on your behalf while you are away. Listed below are a series of scenarios. Please respond by advising how the process currently in place would detect these situations. For those situations that would not be detected, we will meet together to discuss what changes could be implemented to detect those situations should they occur in the future.

Scenario	Materials Management Response	Accounts Payable Response	Suggestions to Address
I am a buyer			
I created a bogus vendor with the address to my personal post office box. I issued a PO to this bogus vendor and then sent Accounts Payable (A/P) an invoice. Invoice was paid.			•
I issued a Purchase Order (PO) and received the goods. But I took some of the goods and adjusted the PO. Invoiced matched to adjusted PO and receiving report. Invoice was paid.			•
I created a PO with a ship-to address of my home. I input the receiving report. Vendor sent in invoice. Invoice was paid.			•
I entered a new item on the item master and ordered it from a vendor with whom we do not have a contract. Facility paid.			•
I am an Accounts Payable processor			
I entered a new item on the item master, ordered it, received it, and took it for myself. Vendor invoiced the facility and the facility paid.			•
I input a return PO indicating that items were returned to the vendor. Instead, I took these items for myself.			•
I keyed in a patient refund to someone other than a valid patient. This refund check was sent and cashed by my friend or by myself.			•
I keyed a non-PO invoice into the same vendor, same invoice number, but a different date. Invoice was paid.			•
I keyed a non-PO invoice into the same vendor but under a different vendor number. Invoice was paid.			•
I keyed a non-PO invoice to the same vendor, same vendor number, but I input the invoice number without the dashes. Invoice was paid.			•
Someone forged the manager’s signature for a non-PO invoice and took the items or used the service for themselves. I entered it and the invoice was paid.			•
Manager charged the invoice to a revenue account. I keyed this in and the invoice was paid.			•
A recurring invoice has been set up to pay monthly. I paid this recurring invoice, even though the contract had expired (e.g., rent).			•
I paid an invoice for an item that we no longer have (e.g., equipment lease), which was not set up as a recurring invoice.			•
I entered a new line on the PO, or I changed the per-unit \$ amount to force the invoice to match the PO. Invoice was paid.			•
I received a returned check and endorsed it to myself on behalf of the facility.			•

Exhibit 4

“BEAT THE CROOK” Cash Receipts

Hypothetical Scenario: You are on vacation for a month. I have taken your position on a temporary basis. When you return from vacation, I will be no longer be working for this facility and there will be no way to reach me. Consequently, you will be responsible for any actions I take on your behalf while you are away. Listed below are a series of scenarios. Please respond by advising how the process currently in place would detect these situations. For those situations that would not be detected, we will meet together to discuss what changes could be implemented to detect those situations should they occur in the future.

Situation	Cashier Response	Cash Poster Response	Suggestions to Address
I am a cashier			
Patient pays in cash or check and does not need a receipt. I take cash or endorse the check to myself.			•
Patient pays in cash or check. I prepare a receipt for the patient but do not log it on the pegboard. I take cash or endorse the check to myself.			•
Patient pays \$50 cash. I write receipt for \$50, but write it by hand on the pegboard for \$40, or I white out the \$50 on the pegboard and write in \$40. I take the \$10 and go buy lunch with it.			•
I take some of the cash box money and spend it, and put receipted patient cash in the cash box so it balances. I then log this patient cash on pegboard the next day, replacing it with more patient cash so that the cash box balances.			•
I balance the cash box daily and state that the box is in balance. I also take money from cash box and spend it.			•
I am a cash poster			
I pick up the cash and checks from the cashiers. I pocket some of the cash or endorse some of the checks, and run a new tape, entering and depositing the smaller amount.			•
I prepare the deposit and post the batches. I take \$20 cash for myself.			•
I post the batch and take \$20. Deposit is made the next day. However, I take \$20 from the next day’s patient cash so the deposit balances.			•
I prepare and post batches and make the deposit for another cash poster and myself because the other cash poster is sick. I take \$20 from the other poster’s cash, run a tape, enter, and prepare deposit on smaller amount.			•
I receive a refund from a vendor. I endorse the check to myself and do not include it in the deposit.			•

consideration. This cash balancing tool was approved for distribution to the over 300 facilities served! Facility management was delighted that, although a lot of work was required, their first review resulted in identification of something that could be shared with others.

Summary and Conclusion

It is not hard to develop an audit program to address risks and controls in a financial process. To perform this audit

at a facility that has no experience with internal audit, and to get it completed in five weeks, may provide challenges not usually encountered in an audit. It requires that we scope the audit very carefully, provide education at the facilities on how internal audit benefits the facility, and show them the unmitigated risks that need to be addressed. This project was effective because it combined the risk assessment with education, involved individuals at all levels—from senior management to the

individuals actually performing the steps in the process, and shared best practices. The CFO recommended that this type of project be performed at any new facility that CHW acquires in the future. ■

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