FREQUENTLY ASKED QUESTIONS

What Is the Board's Role in Financial Audits?

Members of Enron's Board of Directors claim they were duped: by management and by the energy giant's auditor, Arthur Andersen, so they had no warning of the company's eventual financial collapse. Critics say those directors shirked their responsibility by leaving financial details to management; that they failed to ask the pointed questions that could have revealed Enron's dire straits in time to save the company and its investors.

The debacle has shone a spotlight on the audit committees of boards of all kinds of organizations, including healthcare systems.

Fundamentals of the Audit

Virtually all hospitals and healthcare organizations hire an accounting firm to conduct an annual audit of their financial statements. While management prepares the financial statements and works closely with the auditors, it is the Board of Trustees, through its Audit Committee, that has responsibility for overseeing the relationship with the external auditor.

The auditor's first job is to evaluate the organization's accounting procedures to determine how much it can rely on management's data in conducting its own tests to certify the accuracy of the financial statements.

Auditors make a note of any "material" discrepancies in the financial statements. What is "material" varies depending on the system and the auditor, but usually falls in the range of a 5 percent to 10 percent deviation from what has been reported on financial statements.

Then the auditor gives the Audit Committee its opinion: Are the financial statements a true representation of the organization's financial staus? Is it at risk of failing in the next year? Are there particular risks on which the board and management should focus?

A second audit—one that's less common in healthcare—is the internal audit, during which a staff auditor or outside auditing firm follow a similar process to determine whether internal accounting systems and departmental procedures are in order.

What Experts Advise

Great Boards asked four experts what a board should expect from the external and internal auditors. Our panel includes:

Bob Wilson, an independent consultant who works with financially troubled companies, including hospitals. Wilson worked as an auditor and consultant for Arthur Andersen for 29 years until 2000.

Mike Riley, president of trans-Action Associates in Baltimore, Md., a healthcare management firm providing project management, capital financing and financial turnaround services to hospitals and health systems.

Bob LeFever, a financial and management consultant in Philadelphia for 25 years, and a member of the Temple University Health System board. LeFever also is a former member and chairman of the Jeanes Hospital board.

David LeMoine, CEO of Catholic Healthcare Audit Network in St. Louis, which conducts internal audits for Catholic healthcare systems.

Q. Why is it important for the board, and not management, to oversee the relationship with the auditors?

Wilson: Management is involved in organizing the system's finances, so governance should oversee it. Audit Committee members should not be members of management and should be independent of management.

Q. What is an internal audit?

LeMoine: Internal auditing insures the effectiveness of internal controls in three areas: operational, financial and compliance. We're looking for weaknesses in internal controls, such as lack of proper billing. We audit managed care contracts, for example, to make sure they're properly paid, that the billing goes out properly and that they're receiving proper reimbursement for it.

Q. What kinds of problems can an internal audit uncover?

LeMoine: We've saved a lot of money for hospitals by increasing their reimbursement from managed care contracts because we found out they weren't being properly paid; i.e., they could have billed for items they

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weren't billing for. We've found out that hospital operating rooms and other departments have billed only for some procedures—surgery for instance—but not for others, like anesthesiology.

Q. Do most boards understand the scope of an external or internal audit?

Wilson: No. Most board members think an external audit is a guarantee of the accuracy of financial reports, or that every single financial thing in the hospital was looked at 100 percent, but audits are done on a sampling basis. Board members generally don't realize how limited an audit really is.

Riley: There's a common misconception that the external audit is a fraud audit to find every single accounting error. External audit procedures are designed to test the fairness of the financial statements' presentation, taken as a whole—not the accuracy of every accounting transaction.

LeMoine: Boards don't understand exactly what an internal auditor does. In some cases, the internal auditor will not have the resources to audit nursing homes or home health agencies. Instead, we do all of the big operating departments of the hospital, and we spend about 30 percent of our time auditing compliance with government regulations.

Q. What, specifically, does the board have to do to insure that everything is going well?

Wilson: The board should be satisfied that management-supplied financial information is accurate.

Riley: The Audit Committee should meet with the lead external auditor periodically without hospital management present. Too often, the external auditor comes in once a year, takes questions for 15 minutes and leaves. That doesn't lend itself to developing the kind of rapport and business relationship you want with somebody who can provide you with a lot of information when a sensitive topic comes up.

LeFever: At Jeanes Hospital, the board committee meets with the external auditors to determine what the scope of the audit will be. When we receive a copy of the audit report. we hold an executive session without management for an open discussion with the auditors, which lasts however long it takes, to ask about any concerns they have, large and small.

Q. What are some typical common shortcomings of Audit Committees?

Wilson: Commonly, Audit Committees don't ask their auditors enough tough questions. Members with limited financial backgrounds tend to shy away from asking questions. Others leave the questions up to management.

Riley: A common stumbling block is overreliance on the CFO or CEO because the Audit Committee members either don't have the background or the time to understand hospital operations for them to make independent judgments on issues, particularly for internal audits.

LeMoine: Most Audit Committees think their responsibility is only with the external auditor, but that's only one small piece of it. Internal auditing, financial reporting and risk assessment are also important responsibilities.

Q. Perhaps the Enron board should have asked more questions about off-balance sheet transactions. Do healthcare systems have any off-balance sheet transactions?

Riley: Suppose a hospital leases a medical office building and is liable to pay rent on any unleased space. The terms of the lease should be disclosed in the hospital's audited financial statement as a contingent liability. Such footnotes are often written with a lot of accounting-ese that the reader may not fully understand. The board should ask about any such contingent liabilities and understand the probability that any of them could turn into actual liabilities.

Q. What lessons can healthcare boards learn from Enron?

Wilson: Take your financial oversight responsibility seriously. Do not abrogate it to management. Do not abrogate it solely to external auditors.

Riley: The Audit Committee should always ask, "Why?" Probe. Look at things from a common-sense standpoint. A lot of things Enron was doing would have flunked the test of common sense. – *SO'M* (**Website Extra**: *More FAQs at www.GreatBoards.org.)*

Contact Our Experts

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