

Corporate Governance Challenges: When Auditors Must Push Back

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The auditors can do WHAT?

Health lawyers should anticipate the proper role of external auditors when called upon to respond to allegations of fraud committed *against* a healthcare client. In these situations, external auditors are impressed with specific professional obligations intended to confirm that the board has (a) properly evaluated the fraud allegations; and (b) considered any underlying implications to the organization's internal financial controls. The failure to plan for auditor involvement in any related organizational investigation thus could have serious potential ramifications for the timely delivery of audited financial statements and other auditor-produced documents. As a result, auditor contact should be high on counsel's list of investigative "action items."

Trigger Events

So what kind of "fraud" are we talking about here? *Not* the familiar "anti-kickback," false claims or related types of healthcare-specific fraud committed *by* officers, employees, or agents of the organization. *Nor* are we referring to fraud committed *against* the organization *by an external source* (e.g., an unscrupulous vendor intentionally charging the organization for goods or services that were not provided). Rather, we are talking about traditional acts of *defalcation* committed against the organization *by an internal source* (e.g., an officer, employee, or agent), such as:

- » A chief executive officer manipulates contracts to accelerate revenue recognition.
- » A chief information officer creates a fictitious vendor to funnel "kickbacks" during a large project.
- » The chief financial officer maintains two sets of books, one for state auditors and one for external auditors.
- » The materials management director alters supply contracts to mask theft over multiple years.
- » A chief financial officer falsifies expense reports over a period of time.
- » A key employee absconds with personally identifiable information on patients and uses them for false credit applications.
- » The chief executive officer exaggerates expense account reporting to cover an improper relationship with an organizational vendor.

The common theme of these similar examples is that they implicate the effectiveness of the organization's internal financial controls. *That's what makes it "personal" to the external auditors.*

Why We Care

Unfortunately, recent developments, academic analyses, and media reports all suggest an enormous increase in this type of fraud against nonprofit healthcare organizations.¹ These things can and do happen—with disappointing regularity—in the nonprofit world.² And, when they do, the auditor's professional obligations are implicated; *it's not a matter of discretion—but rather a requirement.* In addition, both federal and state charity regulators monitor closely incidents of fraud against the nonprofit, through disclosures on the Form 990 (Part VI, Section A) and the annual nonprofit corporate filings required by many states. These regulators are vitally interested in how charities (and their boards) acknowledge and respond to events of defalcation. That's why it is *so important* that organizational counsel understand the merits of involving the external auditors at the incipiency of responsive planning to any credible fraud allegations, rather than after the investigation has been completed.

Auditors are charged with exercising professional skepticism. This means that auditors must closely scrutinize the fraud evaluation efforts of the board and management in order to assess both the competence and independence of the individual or firm engaged to investigate the incident. It also means that the auditor ultimately must be satisfied that the investigation was properly pursued by the board. *A lot is at stake.*

What does this mean? The auditor is required to assess the work and qualifications of all experts used by management. For example, the auditor will assess the qualifications of the organization selected to conduct the investigation. The auditor may ask questions like "Has this firm done similar investigations in the past?" and "Do the assigned professionals have health industry experience?" In the worst-case scenario, the delivery of the annual audit may be dependent upon implementation of auditor-suggested control improvements. These situations thus require close collaboration with the board, outside counsel, forensic auditors, and the financial auditors, in order to reduce the risk of delays to the issuance of financial statements and of other potential repercussions if investigations are not handled appropriately from the "get-go".

With increased awareness of these auditor obligations, health lawyers can more effectively advise clients on internal investigations and other fraud evaluation processes that will facilitate collaboration with the financial auditors (and regulatory filings) and prevent problems down the road. Accordingly, the following discussion will review the auditors' specific obligations to evaluate evidence of potential fraud, how that works in the context of the audit process, and how healthcare lawyers can work with their clients and auditors to design an organizational response to fraud that will be compatible with the audit process.

The Core Obligations

In circumstances involving fraud against the organization, the external auditors have clear professional duties. In particular, the auditor response to these and similar types of fraud are based on “Statement on Auditing Standards No. 99: Consideration of Fraud in a Financial Statement Audit,” which was originally issued in 2002.³ This Statement *requires* the auditor to ask management and the board about known or alleged instances of fraud, which is defined as an “intentional act that results in a material misstatement in financial statements that are subject to audit.” The auditor also *must inquire* about the process management and the board have pursued to assess risks of fraud and then to mitigate these risks. This is a critical consideration as corporate leadership and counsel develop a response plan.

It is important for the health lawyer to understand that these are *mandatory*—not discretionary—responses by the auditor. *They don’t have any choice.* Further, these mandatory obligations apply differently, depending on whether fraud has merely been alleged (and an investigation commenced) or whether fraud has actually been determined (and responsive action is necessary).

Step One: Where Fraud Is Alleged

The need for auditor consultation occurs first when fraud has been alleged, and board/senior leadership determines that an internal investigation is appropriate. The investigating health lawyer’s first phone call should go to the organization’s audit partner to explain the matter and the planned response. The audit partner will identify his team members and begin to formulate an investigative plan based on facts. In this circumstance, the auditor’s responsibilities include assessing organizational personnel implicated by the allegation; the initial amount of the fraud and potential insurance coverage for loss (if any); and management and the board’s planned or actual response to the allegation. From that point, the auditor is required to assess the adequacy of the internal response and the independence of the process, as well as the adequacy and independence of third parties hired to investigate the allegation. For example:

- » Is the outside counsel retained for this investigation married to a board member?
- » Is the investigator a friend of the CEO’s with no healthcare fraud experience?
- » Is the firm engaged to handle the investigation experienced and well qualified with these types of investigations?
- » Is the scope of the investigation appropriate under the circumstances?
- » Is the board turning to one of its own—a director who is a lawyer—in order to save on investigation expenses?
- » Has the board allocated a realistic amount of time and budget for the investigation?
- » Have board leaders/senior executives been implicated by the allegations and, if so, have their investigative roles been properly limited?

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If the auditor has concerns that investigation team advisors lack independence or the appropriate qualifications, the auditor may determine that the investigation needs to be conducted (or redone) by another firm, adding time and cost to the process. *This is not a completely uncommon occurrence in the nonprofit sector.*

It is worth noting that there is a degree of auditor judgment involved, but the auditor must be satisfied with the independence and competence of the investigation. This extreme situation is generally rare as long as the organization selects a well-known and reputable firm to conduct the investigation. The organization should expect questions from its auditor if it makes an unusual choice, e.g., a small, boutique firm that carries the same name as a board member. It may seem far-fetched but there have been strange examples; e.g., where an investigation was conducted by a firm owned by a board member’s spouse. In this case, the investigation was not independent given the board member’s connection to the firm selected. Use of the organization’s regular outside counsel is normally acceptable to the auditor absent significant independence or competence concerns.

The message to the health lawyer is clear: the “smart play” is to consult with the auditor *before* finalizing the structure of any responsive internal fraud investigation. This might require somewhat of a “culture change” in the traditional manner in which these internal investigations are structured. Lining up the external auditor is not usually the first task that comes to counsel’s mind—or to that of executive/board leadership, either. Yet, too much is at risk—including the appropriateness of key staffing and process issues critical to the internal investigation. This is not about giving the external auditors “veto power” over the selection of advisors, and of the investigation process. That notwithstanding, the failure to consult with the external auditor at this early point could jeopardize the ultimate credibility of the resulting investigation for audit purposes.

The formal detection of fraud can have a direct impact on the timely issuance of any financial statements, bond covenant letters, management letters, and formal board communications

Analysis

by the audit firm while the auditor assesses the adequacy, scope, and results of the response by the board. If any of these auditor communications/reports are delayed, the finalization of financial reporting may be delayed and organizational compliance with bond covenants may be jeopardized. Furthermore, any such lack of credibility could seriously impact the willingness of any state or federal investigative agency to accept the internal investigation as an effective exercise of board fiduciary responsibility.

Step Two: If Fraud Is Detected

The external auditor has an additional role to play in the event the internal investigation concludes that fraud has occurred. In particular, the auditor must assess the materiality of the fraud, and determine its impact on current and prior financial results. The auditor also will want to review any reports issued by third parties related to the incident, including confidential reports prepared by counsel. This, of course, is a potential “flash point” between investigative counsel and the external auditor. The ability of the auditor to access documents and related items subject to one or more legal privileges (e.g., the investigative report of counsel) and/or to interview the parties conducting the investigation, *are factors to be discussed with investigative counsel in order to properly protect the interests of the mutual client*. If the investigation identifies a significant non-compliance matter, the auditor will expect management to disclose that matter in the financial statements, and the auditor will seek to assess how management determined the potential loss or implications of the non-compliance matter.

If the financial fraud is determined to involve members of the organization’s financial management team, such as the CFO or controller, additional considerations are required of the auditor. For example, the auditor may need to reassess initial risk assessments of the audit. The auditor also may need to conduct testing to quantify the fraud and determine appropriate accounting and disclosure, if appropriate. Depending on the accounting firm’s structure, consultation with national office, technical, and fraud professionals also may be appropriate. If the fraud involves contracts or the purchasing department, the auditor most likely will expand testing by a significant amount. For example, if the fraud involves revenue recognition matters, such as inappropriate acceleration of revenue recognition on contracts, auditor detail testing could approach 100% of contracts. If fraud overlaps multiple years, re-auditing of prior results may occur with the auditor using lower materiality levels. Moreover, the more senior the person involved, e.g., the CFO, the more significant the issues can be. For example, the auditor may in its judgment conclude it could not rely on previous representations by the person involved and that also may impact prior periods. This is a serious potential concern that should be closely monitored.

Any of these scenarios will add substantial time and costs to the auditor’s engagement. These additional auditing costs, of course, are above and beyond the expenses of the investigation—as often a third party forensic accountant is engaged

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through outside counsel—and attorney’s fees (including counsel and forensic accountant fees).

Costs aside, if the board and management do not effectively collaborate with the financial auditor and share information, such as non-privileged documentation related to the incident, the auditor-client situation can deteriorate precipitously. For example, the auditor may consider reporting options such as a scope limitation within the auditors’ report. This condition is rare, as the auditor most likely would decline to issue an opinion in an extreme case and may even resign if the auditor becomes sufficiently concerned about integrity of management or the board. In this rare circumstance, the organization may be hard-pressed to find a new, qualified auditor willing to take on the risk of resuming the audit.

As recent developments suggest, charity regulators are historically sensitive to any suggestion of a significant delay in or other problems with the issuance of a nonprofit’s financial statement. Furthermore, resignation of an external auditor is likely to be considered a seminal organizational event—by both regulators, and by the board.

Does the Fraud Indicate a Material Weakness?

The health lawyer also may need to advise the client of the potential that the results of the fraud investigation may raise accounting “material weakness” concerns. Where material fraud is determined to exist, the fact that it occurred within management’s system of internal controls will cause the auditors to suspect a material weakness in those controls. For example, although the fraud may have been identified through some type of detection control (e.g., like the investigation of unusual unfavorable budget variances), the fact that an effective preventive control was not in place may indicate a significant control breakdown. The auditor may conclude that the situation constitutes a material weakness, especially if material errors are the direct result of the control breakdown, which will guarantee that the auditor will perform additional testing.

For hospitals that expend any federal funds and hence must file an OMB A-133 Single Audit report, internal control issues can cause additional complications. Material weaknesses in internal controls must be reported in the “Schedule

of Findings and Questioned Costs.” Any instance of fraud, unless clearly inconsequential, also would be reported in the “Schedule of Findings and Questioned Costs.” The “Schedule of Findings and Questioned Costs” is made available to federal agencies as part of the OMB A-133 Single Audit report, and if the controls in question impacted the handling of federal dollars, oversight agencies such as the Department of Health and Human Services may begin to get concerned and could reduce future funding.

Conclusion

There’s no getting around it. In any internal investigation of fraud committed against the organization by internal sources, the auditors have an important role to play. Hence, it makes sense to involve the auditors at the earliest possible point. This, despite the fact that auditor involvement will invariably add to the cost and extend the time frame of the investigation. This is not a matter of auditor discretion. Professional audit standards *mandate* that external auditors evaluate leadership’s response to allegations of fraud—and understandably so. Furthermore, there is a significant level of complexity that is involved when fraud affects the organization’s financial reporting issuance and process. So, the key is to involve the external auditors at the incipiency of the investigation. In some situations, this might be facilitated where the Audit Committee is the primary point of contact between the governing board and investigative counsel. The mindset of that Committee is one that historically recognizes the need for auditor/counsel collaboration. The alternative is not appealing . . . the failure to properly coordinate the fraud investigation with the external auditors not only could jeopardize the credibility of organizational response to the fraud allegation, but also could result in significant delays in the issuance of critical financial statements and other auditor-generated reports. This situation can arise if an investigation overlaps the typical end-of-year audit cycle. The auditor will need to be satisfied that investigation is complete and that any amounts that need to be recorded in the financial statements are finalized prior to releasing any reports. *Try explaining that to the client*; i.e., that issuance of the organization’s audited financial statements will be delayed until the auditors “get up to speed” on the fraud investigation.

Tips for structuring the internal investigation

- » Dialogue with the auditor as early as possible about how to structure the investigation to make sure the scope, process, objectives, and selection of third-party experts are appropriate. Proactive communication with the auditors will minimize the risks of surprises in the process.
- » Remember that independence and competence are essential criteria to the auditor when selecting a third-party investigative counsel. Even if a board member (or his/her spouse) could handle the investigation ably and cost-effectively, the auditor may deem this investigation ineffective given that the investigator is not independent of the process.

- » Consider the qualifications of the investigation team. The team should include not only attorneys but professionals with healthcare experience, as well as a certified public accountant or forensic accountant to bring the requisite audit and documentation experience needed.
- » Make sure the board is cognizant of the special audit-related issues involved when members of the financial management team—or the senior executive leaders—are implicated by the allegations.
- » Help the organization budget for (in terms of time and expense) the auditor’s involvement, recognizing that these costs are in addition to, not to be subtracted from, the legal budget.
- » Inquire as to why the matter wasn’t prevented by the hospital’s internal controls.
- » While fraud is certainly unpleasant, it can be a wake-up call to an organization to improve its internal control environment so that future or more serious incidents will be prevented.

Healthcare lawyers and external auditors should work collaboratively to advise their mutual client in situations where the organization has allegedly suffered fraud as a result of the actions of internal sources.

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Endnotes

- 1 Janet Greenlee, Mary Fischer, Teresa Gordon, Elizabeth Keating, *An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents*, *NONPROFIT AND VOLUNTARY SECTOR QUARTERLY*, vol. 36, no. 4 (Dec. 2007).
- 2 See, e.g., Jonathan D. Rockoff, *Two Hospital Officials Charged with Fraud*, *WALL ST. J.*, Apr. 28, 2010; *Former Hospital CFO Charged with Fraud*, *Ethisphere Corpedia Daily GRC Digest*, Aug. 31, 2010, <http://ethisphere.com>.
- 3 Healthcare lawyers are well aware of the widespread changes in auditor practices that arose in the wake of the Enron/Sarbanes/Oxley era, and the rationale for such changes. Of course, the same environment prompted major changes to lawyers’ professional ethical responsibilities, as well.