



**RISK  
MANAGEMENT  
SERIES**

# What Every Health Center Should Know about Internal Controls and Monitoring Systems

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For at least a century and a half, the Federal government has been concerned that its funds be used in the manner for which they are intended. For example, to combat fraudulent profiteering during the Civil War, the government adopted the False Claims Act. Over the years since then, many organizations—both for-profit and nonprofit—have placed an increasing emphasis on safeguarding assets and ensuring accountability to customers, contributors, the public, and government regulators. Such an emphasis in recent years is due, in no small part, to the wide wake left by many heavily-publicized private-sector financial scandals, including those involving Enron, HealthSouth, and WorldCom to name but a few, and similar events in the nonprofit sector.

In this context, health center governing Boards of Directors and managers undoubtedly have been impressed by the importance of internal controls. Indeed, the Office of Management and Budget (OMB) Circular A-133, *Audits of State and Local Governments and Non-Profit Organizations*<sup>1</sup>, which applies to every health center that expends more than \$500,000 in Federal funds in a fiscal year, specifically requires the health center's independent auditor to: 1) report on the health center's internal controls, including the scope of testing of internal controls and the results of the tests; and 2) where applicable, include a statement of reportable conditions of internal controls in the audit report. It may be tempting to think of internal controls as simply another arcane item, mainly of interest to accountants and auditors. However, from a risk management perspective, nothing could be further from the truth. Implementing internal controls and, importantly, monitoring their effectiveness, is essential to effective stewardship of the health center's resources.

<sup>1</sup> See OMB Circular A-133, § \_\_\_\_ .505.

This Information Bulletin is a primer on internal controls theory and practice, highlighting internal control issues for health centers and suggesting strategies to ensure that a health center has adequate and appropriate internal controls. In particular, this Information Bulletin:

- ◆ Defines internal controls;
- ◆ Explains why internal controls are important for health centers;
- ◆ Describes features of appropriate internal controls for health centers;
- ◆ Examines internal controls from an auditing perspective; and
- ◆ Provides a sample internal controls checklist to assist health centers in establishing and monitoring their internal control system.

Please note that the contents of this Information Bulletin are not intended as legal or accounting advice. For specific advice on a particular issue, a health center should contact qualified legal or accounting professionals.

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## WHAT ARE INTERNAL CONTROLS?

Because internal controls refer to a system to achieve a desired outcome, they can be defined in various ways. One good definition, which we believe captures all of the key elements, is as follows:

Internal controls involve an integral process that is affected by an entity's management and personnel and is designed to address risks and to provide reasonable assurance that, in pursuit of the entity's mission, the following general objectives are being achieved:

1. Executing orderly, ethical, economical, efficient and effective operations;
2. Fulfilling accountability obligations;
3. Complying with applicable laws and regulations;
4. Safeguarding resources against loss and damage.<sup>2</sup>

In short, internal controls for health centers are implemented and followed by health center management and other staff, designed to ensure that the health center is:

1. Operating effectively, consistent with the program's objectives as well as Federal and state law and regulations;
2. Protecting its assets; and
3. Assuring the Federal government that its funds are being used properly.

However, while complying with grant requirements, laws, and regulations is critical, Melanie Herman, Executive Director of the Nonprofit Risk Management Association, notes that effective internal controls are more about doing the right thing for the sake of the organization than meeting the requirements or expectations of the accounting profession, industry standards-setting entities, or a regulatory body.<sup>3</sup>

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2 *Guidance for Internal Control Standards for the Public Sector*, International Association of Supreme Audit Institutions. OMB Circular A-133 contains a similar definition.

3 Herman, Internal Controls: Safety Tools That Should Make Cents for Every Nonprofit, Michigan Nonprofit Association, [www.nmaonline.org/rrisk02.asp](http://www.nmaonline.org/rrisk02.asp) (Accessed June 20, 2007)

## THE IMPORTANCE OF INTERNAL CONTROLS

Maintaining effective internal controls is important for the wellbeing of the health center beyond merely obtaining a “clean” audit report. Some of the most important reasons to pay attention to internal controls are:

**Accountability** – Effective internal controls demonstrate that the health center takes its accountability to stakeholders – funding sources, patients, and the community it serves – seriously.

**Board Expectations** – Each health center Board delegates operational matters to the Executive Director/CEO and through the CEO to staff. Maintaining a sound internal controls system is one way to demonstrate that the staff is worthy of the Board’s trust and confidence.

**Care** – An effective internal controls system promotes the Board’s ability to exercise its duty of care to preserve and protect health center assets.

**Efficiency** – A properly structured system of internal controls should reduce the day-to-day burden on staff by reducing careless errors and revealing mistakes early before they

become more serious problems that will take significant time and resources to correct.<sup>4</sup>

## APPROPRIATE INTERNAL CONTROLS FOR HEALTH CENTERS

No set of internal controls over financial reporting and program requirements can be applied universally. Each health center needs to examine its own operations and financial management to determine what works best for its particular circumstances. However, all effective internal controls will have at least the following features:

**Authorization and Approval** – Procedures to sanction expenditures, including written approval policies and a sign-off system.

**Proper Documentation** – A paper or electronic trail for key activities, in particular the health center’s revenue stream and spending.

**Physical Security** – Protective measures that safeguard assets by: 1) preventing theft by insiders and outsiders, and 2) limiting access to accounting systems and assets to those who need access.

**Monitoring and Early Detection** – Internal audits or similar internal reviews and “spot checks” to detect fraud or errors at an early stage, and early intervention to prevent further noncompliance or erosion of assets.<sup>5</sup>

There is, however, specific guidance that health centers would be well advised to follow. Policy Information Notice (PIN) 98-23, *Health Center Program Expectations*, which was issued by the Health Resources and Services Administration (HRSA) in August 1998, states that health centers should have accounting and control systems that are appropriate to the size and complexity of the organization, but minimally a health center should have:

- ◆ An accounting system based on Generally Accepted Accounting Principles (GAAP) that is designed accurately to portray the financial performance of the health center;
- ◆ Within the constraints of the health center size, a separation of the financial functions so that assets of the health center are safeguarded; and
- ◆ A set of routine financial reports – reviewed by appropriate members of the management staff and the Board on a regular basis – that not only show the current financial status, but allow a comparison to past and projected financial position.<sup>6</sup>

More detailed guidance can be found in the Compliance Supplement to OMB Circular A133.<sup>7</sup> The Compliance Supplement is published annually

4 Adapted from Herman, *supra*.

5 Adapted from Herman, *supra*.

6 PIN #98-23, p. 33.

7 [http://www.whitehouse.gov/omb/circulars/a133\\_compliance/07/pt6.pdf](http://www.whitehouse.gov/omb/circulars/a133_compliance/07/pt6.pdf).

to guide auditors performing Circular A-133 audits. Thus, it is a useful reference for health centers to use in evaluating their internal controls, in particular OMB's categorizing of the five key elements of internal controls.

[T]he categorizations reflected in this [section] may not necessarily reflect how an entity considers and implements internal control. Also, this part is not a checklist of required internal control characteristics. Non-Federal entities could have adequate internal control even though some or all of the characteristics included in [this section] are not present. Further, non-Federal entities could have other appropriate internal controls operating effectively that have not been included in this [section]. Non-Federal entities and their auditors will need to exercise judgment in determining the most appropriate and cost effective internal control in a given environment or circumstances to provide reasonable assurance for compliance with Federal program requirements.<sup>8</sup>

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## Five Elements of Internal Controls

(OMB Circular A-133 March 2007 Compliance Supplement)

- ◆ **Control Environment**
- ◆ **Risk Assessment**
- ◆ **Control Activities**
- ◆ **Information and Communication**
- ◆ **Monitoring**

### OMB's Five Elements of Internal Controls

#### Control Environment – Providing Discipline, Structure, and Culture of Compliance

According to the Compliance Supplement, the control environment “sets the tone of an organization influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.”

A health center's control environment can be established through a number of mechanisms, all of which not only establish the structure on which to build an effective system of internal controls, but contribute to the culture of compliance. By creating a culture of compliance, a health center sends the message to employees from the top down and across all departments that adherence to internal standards and external regulations is valued.

The following are examples of how to establish this control environment:

- ◆ **Establish a Code of Conduct** that emphasizes everyone's commitment to ethical practices, especially upper management.
- ◆ **Establish an Audit Committee** of the Board to engage the auditor, receive all reports from the auditor, and make sure the audit findings and recommendations are addressed and implemented, as appropriate. (Further discussion of the role of an Audit Committee follows later in this Information Bulletin).
- ◆ **Create an organization chart** that makes the lines of responsibility clear for managers.
- ◆ **Hire competent and experienced key managers** who have adequate knowledge to discharge their responsibilities.
- ◆ **Train employees** in the culture of compliance and in the man-

<sup>8</sup> A-133 Compliance Supplement, Part 6-1 (March, 2007).

agement of federal funds and program requirements.

- ◆ **Clearly communicate to all staff** that misuse of health center assets and/or fraudulent financial reporting at any level will not be tolerated.
- ◆ **Promote open communication** of policies and procedures and reporting of compliance concerns.

### Risk Assessment – Identifying, Analyzing, Managing Risk

The Compliance Supplement defines risk assessment as “the entity’s identification and analysis of risks relevant to achievement of its objectives, forming a basis for determining how risks should be managed.” Risk assessment should be accomplished utilizing a process of:

- ◆ **Identify the risk** through reporting, claims, investigations, and audits;
- ◆ **Compile and prioritize** the risk issues; and
- ◆ **Create a yearly plan** with timelines for solving each problem and preventing recurrence.<sup>9</sup>

The risk management process can be overseen by a compliance, quality improvement, or finance committee of the Board or of the management staff reporting to the Board. However, it is important that everyone in the organization, as well as contractors, be encouraged to help identify risks. For example, a custodian may identify significant exposure when he notices patient records in the trash.

- ◆ **Periodically report** to senior management and/or to the Board. A report could be produced in the form of a matrix that shows the:
  1. Issue,
  2. Date it was identified,
  3. Proposed solution,
  4. Responsible person, and
  5. Expected date of completing the implementation of the solution.

This reporting format also can be used to track progress in solving problems.

Other key aspects of risk assessment include:

- ◆ **Assure that key managers understand** the policies, procedures, and controls to determine when costs or activities could be erroneously charged to the Federal program.

- ◆ **Identify and monitor** employees who need close supervision;

- ◆ **Examine billing and claims** submission practices for “hot button” items such as:

1. Billing for services not rendered or not provided as claimed.
2. Double billing resulting in duplicate payments.
3. Knowing misuse of provider identification numbers resulting in improper billing.
4. Unbundling (billing for each component of a service instead of billing or using an all-inclusive code).
5. Upcoding (or downcoding) the level of service provided.

- ◆ **Maintain timely, accurate, and complete documentation** of patient diagnosis and treatment.

- ◆ **Review business arrangements** wherein the health center refers business to, or orders services or items from, an outside entity for compliance with Federal and state fraud and abuse laws.<sup>10</sup>

- ◆ **Designate an individual**, such as the compliance officer or a risk manager, to identify issues on an ongoing basis and recommend solutions to management. Ideally, the person should have some familiarity with compliance with federal grant rules on budgeting, cost allocation, and A-133 audits, as well as Section 330 of the Public Health Service Act, health center implementing regulations, and the Health Center Program Expectations and other

9 See also NACHC Risk Management Information Bulletin # 8, *Implementing a Risk Management Program for Your Health Center*.

10 Health centers would be well advised to review the Department of Health and Human Services Office of Inspector General’s *Compliance Program Guidance for Individual and Small Group Physician Practices*, the OIG’s annual work plan, and the OIG’s periodic fraud alerts and other guidance in assessing potential risk areas. All are available on the OIG website [www.oig.hhs.gov](http://www.oig.hhs.gov).

relevant policies issued by HRSA. The health center can also use consultants and legal counsel to advise the Board or a designated committee of the Board and the management team.

### **Control Activities – Establishing Policies to Ensure Directives are Carried Out**

According to the Compliance Supplement, control activities consist of “the policies and procedures that help to ensure that management’s directives are carried out.” As such, the risk management process should be supported by clearly understood policies that are not simply model policies copied from another organization, but actually describe the health center’s particular procedures for implementing the internal controls.

◆ **Establish policies and procedures for internal controls that include:**

1. Conflict of interest standards;

2. Procurement policies and contracting review and approval;
3. Check signing and purchasing levels of authority;
4. Policy on how to draw down Federal grant funds and manage the health center’s operating account (*e.g.*, the length of time the funds may remain in the account; who is responsible for, and who has authority to, access the account; maintaining federal funds in interest-bearing account);
5. Procedure for tracking different funding sources;
6. Authority and responsibility for determining the reasonableness, allocability, and allowability of costs of the health center being charged to the Federal grant;
7. Generating and reviewing, as well as reporting to the Board, the monthly financial reports that show current revenues and expenses, along with a breakdown of: (1) pro-

ductivity; (2) patient encounters; (3) cost center allocations and (4) other measures. Comparisons should be made between the current actual figures and figures from past years, the current year budget, and projections;

8. Physically securing and prohibiting personal use of the assets of the health center, everything from office and medical supplies to large equipment and cash;
9. Detailed process to determine a patient’s eligibility for discounts from charges;
10. HIPAA privacy and security requirements, including:
  - Nondisclosure of protected health information except with authorization or for treatment, payment or operations
  - A description of how protected health information will be secured, stored, and maintained, including encryption of data
  - Backup and recovery of data in the event of a disaster
11. Pre-employment screening, including procedures for verifying that an individual has not been suspended or debarred from participating in federal programs for all employees, not just those who have access to health center assets;
12. Reviews of operating performance, including forecast data and distribution of reports to management.

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- ◆ **Update policies and procedures** to make sure that they are accurate and adequately address risks actually experienced. Some health centers might prefer having all the policies reside with one person to be updated; others might prefer to assign the review and updating of policies according to the department in which it falls. In either case, the policies and procedures should be reviewed and if appropriate, updated, every one to three years and whenever relevant laws, rules, or policies change.

### Information and Communication – Collecting Data and Disseminating

The Compliance Supplement states that information and communication are the “identification, capture, and exchange of information in a form and time frame that enables people to carry out their responsibilities.” It is extremely important that health center employees receive timely information about policies, procedures, and regulations that affect how they do their job. Evidence that good communication procedures exist would include:

- ◆ **Develop and update job duties and responsibilities**, especially control responsibilities, are set forth clearly in job descriptions that are periodically updated.
- ◆ **Maintain an accounting system** that properly tracks Federal and non-Federal activities and the costs allocated to each.
- ◆ **Reconcile and review financial reports** to ensure their accuracy is provided.
- ◆ **Distribute financial reports** to the Board of Directors and appropriate management personnel in a timely fashion for review and appropriate action.
- ◆ **Retain records and necessary billing documentation** for defined amounts of time, consistent with legal requirements.
- ◆ **Communicate to and among management and staff** through e-mail or internal website, staff and/or management meetings, memos, bulletin boards, newsletters, surveys, suggestion box, or telephone hot line, about:
  1. Policies and procedures and any updates;
  2. Internal control issues;
  3. Compliance problems; and
  4. New laws and regulations that affect health center operations.

Communication up and down the health center lines of authority serves to emphasize the importance of internal controls.

  - The information is accurate, timely, and easily accessible.
  - Individuals who raise issues of concern are informed that they have been heard and that some action has been taken, as appropriate.
  - Good communication channels exist with vendors, sub-recipients, and affiliates.

### Monitoring – Assessing Effectiveness

The Compliance Supplement describes monitoring as “a process that assesses the quality of internal control performance over time.” Monitoring of the effectiveness of controls can occur through internal operations, as well as external reviews. For example, the process of supervision of employees and employee turnover, along with management review of reports, creates a monitoring mechanism. Similarly, management meetings and “town” meetings with all staff provide opportunities for feedback to make sure that all systems are operating properly. Because health center services are often provided at multiple sites, monitoring can also occur by means of unannounced site visits by management to determine if procedures are being followed.

Externally, patients and their families can effectively contribute to the monitoring process through patient satisfaction surveys and the patient grievance procedure. For example, if a deaf patient were not offered a sign language interpreter or written materials to assist in communicating during the visit, the patient might complain to the health center. In turn, the risk manager or compliance officer would investigate the complaint to make sure that appropriate policies were in place and that applicable policies were followed. The protocol would assure that any deficiencies detected would be corrected promptly.

## AUDITING AND INTERNAL CONTROLS

The annual audit is an important tool for monitoring and reporting to the Board on the effectiveness of a health center's internal controls. Obviously, an audit, which essentially is a "report card" on the health center's operations, prepared by outside professionals who are independent of the health center's management and Board, will reveal strengths and weaknesses in the health center's internal controls after the fact. Of course, an audit is not a substitute for having effective internal controls in the first place.

In that regard, health centers and, in particular, Board members should be aware that there may well be findings regarding deficiencies in

*... an audit is not a substitute for having effective internal controls in the first place.*

their internal controls for audits of fiscal years ending after December 15, 2006. This is due to a tightening of the reporting of internal control deficiencies required under the American Institute of Certified Public Accountants Statement on Auditing Standards (SAS) 112 which has been incorporated into Government Auditing Standards for financial audits.<sup>11</sup> On June 26, 2007, OMB proposed amendments to Circular A-133 to include SAS 112 reporting terminology regarding internal controls of compliance matters covered by the audit. According to OMB, the terms "reportable condition" and "material weakness" (as defined in previous auditing guidance) should no longer be used when referring to internal controls over compliance matters. Instead, the auditor should use the following terminology and definitions:

**Control Deficiency** – exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect on a timely basis noncompliance with a type of compliance requirement of a Federal program.

**Significant Deficiency** – a control deficiency, or a combination of con-

trol deficiencies, that adversely affects the entity's ability to administer a Federal program such that there is more than a remote likelihood that noncompliance, with a type of compliance requirement of a Federal program that is more than inconsequential, will not be prevented or detected.

**Material Weakness** – a significant deficiency, or a combination of significant deficiencies, that results in more than a remote likelihood that material noncompliance will not be prevented or detected.

According to OMB, this change in terminology and related definitions may result in the reporting of additional internal control matters than had been reported using the previous terminology and definitions.<sup>12</sup> In short, the bar for assuring effective controls has been raised.

It is up to the Board of Directors to ensure that any corrective action that the Board determines to be necessary as a result of an audit taken. Moreover, failure to take appropriate corrective action is likely to result in an internal control deficiency reported in the audit. Each action taken in response to the audit report should be documented in the minutes, and will be reported in the subsequent audit.

<sup>11</sup> *Government Auditing Standards*, also known as the "Yellow Book," must be followed by auditors performing a health center's Circular A-133 audit.

<sup>12</sup> 72 Federal Register 35,081 (June 26, 2007).

## AN INTERNAL CONTROLS CHECKLIST

There are a variety of aids that health centers might use to evaluate their internal controls. One example, adapted from a sample prepared by the American Institute of Certified Public Accountants, follows.

### Sample Internal Control Checklist

#### Ethical Environment

- Do Board members and senior executives set a day-in, day-out example of high integrity and ethical behavior?
- Is there a written code of conduct for the Board and employees addressing acceptable business practice, conflicts of interests, and expected standards of ethical and moral behavior?
- Is it periodically distributed to the Board and staff?
- Is it reinforced by training, top-down communications and periodic written statements of commitment to the culture of compliance from key employees?
- Are dealings with patients, vendors, employees, and other parties based on honesty and fair business practices?
- Is it clear that fraudulent or even inaccurate financial reporting at any level and in any form will not be tolerated?
- Are ethics principles woven into criteria used to evaluate individual, department, and contractor performance?
- Are performance and incentive compensation targets reasonable and realistic, or do they create undue pressure for short-term results at the expense of ethical and compliant business practices?
- Does health center management react appropriately when receiving news of possible compliance problems from subordinates and contractors?
- Does a process exist to resolve close ethical calls?
- Are internal control risks identified and candidly discussed with the Board of Directors?
- Is health center management explicitly prohibited from overriding established controls?

#### Risk Assessment and Monitoring Activities

- Is relevant, reliable internal and external information timely identified, compiled, and communicated to those positioned to act?
- Are risks identified and analyzed and actions taken to mitigate them?
- Are controls in place to ensure management decisions are properly carried out?
- Does management routinely monitor controls in the process of running the organizations operations?
- Is a process in place to collect information from external sources, such as

## AN INTERNAL CONTROLS CHECKLIST

health care industry and regulatory information, which could have an impact on the health center's business or financial and compliance matters?

- Is a process in place to respond to new information needs in a timely basis?
- Are periodic, systematic evaluations of control systems conducted and documented?

### Board Effectiveness

- Does the Board function appropriately independent of management?
- Do Board members possess an appropriate mix of operating and financial control expertise?
- Does the Board receive key information from health center management in sufficient time in advance of meetings to prepare for discussion at the meetings?
- Is the Board informed of significant issues on a timely basis and in a manner conducive to its having a full understanding of the issues and their implications?
- Is the Board informed about turnover in key functions, such as key personnel in finance and accounting?
- Is there an unusual pattern of employee turnover observed in key functions or other indicators of problems?
- Does the Board understand and monitor the broad organizational control environment?
- Does the Board assure the existence of, and compliance with, a code of ethics?
- Does the Board have a meaningful relationship with independent auditors, senior financial control executives and key corporate and business unit operating executives?

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## CONCLUSION

Management of health centers is a complex business. No one person can handle oversight of all the various requirements. Therefore, in order to ensure that federal assets are preserved and that the health center is performing consistent with the program objectives of Section 330 of the Public Health Service Act as well as applicable state and federal laws and regulations, there must be a system of checks and balances, or internal controls in place. In the long run, effective internal controls will improve the quality, efficiency, and effectiveness of the health care services, while demonstrating the health center's commitment to compliance.

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