Risks of material misstatement: Health Care Entities

Note: This practice aid is intended to help auditors identify risks of material misstatement (RMM) in accordance with AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. This publication is an *other auditing publication* as defined in AU-C section 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards* (AICPA, Professional Standards). Other auditing publications have no authoritative status; however, they may help you, as an auditor, understand and apply certain auditing standards.

In applying the auditing guidance included in an *other auditing publication*, the auditor should, exercising professional judgment, assess the relevance and appropriateness of such guidance to the circumstances of the audit. This document has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA.

Instructions

AU-C section 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, requires that the auditor identify and assess the risks of material misstatement (RMM) at the financial statement level and relevant assertion level for classes of transactions, individual account balances, and disclosures to provide a basis for performing further audit procedures. RMM includes both inherent risk and control risk.

To aid auditors in meeting this requirement, this document includes information that could be useful in assessing RMM for health care entities. **These examples do not include all RMM that could apply or be relevant.**

Refer to the AICPA's *Health Care Entities: Audit & Accounting Guide* for further information on auditing clients in the health care industry.

Risks

In many health care entities, assertions for certain significant accounts may have inherent risk assessed as relatively low. Such assertions typically have characteristics such as: (*a*) a low volume of transactions, (*b*) transactions that are not complex, or (*c*) transactions that do not require the use of significant accounting estimates or other judgments. Examples of such relatively low risk assertions may include:

- Completeness, usual nature (not expired or obsolete), and existence of inventories
- valuation of certain marketable securities and assets whose use is limited
- completeness and categorization of short/long-term debt.

Similarly, the auditor may be able to assess the risks of material misstatement for routine, regular course of business property and equipment and supplies as being relatively low because the transactions therein are generally small in number, relatively simple in nature, internal controls may have been tested in prior audits (if not changes), and do not involve the use of complex estimates. However, attention must be given to these transactions due to the prevalence of mergers, acquisitions, and other joint ventures in the current environment. A complete understanding of these routine accounts may need to receive additional scrutiny depending upon the entity activity.

However, assertions for certain other significant accounts may have higher inherent risk due to various factors such as: (*a*) complex transactions, (*b*) transactions involving the use of significant accounting estimates or other judgments, or (*c*) transactions involving the use of experts. Examples of such higher risk assertions may include:

- the valuation of patient accounts receivable, goodwill, certain marketable securities and derivative financial instruments
- proper classification of charity care versus bad debt expense, including IRS Section 501(r) compliance
- federal regulations pertaining to Stark Law compliance
- the completeness, accuracy and valuation of medical malpractice and other self-insured liabilities, pension liabilities, or third-party settlement assets and liabilities.

Additionally, there is a higher inherent risk associated with revenue recognition, including the clinical coding process. As such, the independent auditor may consider obtaining an understanding of:

- internal controls over documentation of the services rendered
- clinical coding, including the use of groupers and supervisory reviews
- entity compliance program self-audit procedures and robust nature of compliance program
- billing procedures (for example, admission, payor verification, and discharge)
- estimating and reporting the fair value of patient accounts receivable and revenues (refer to the *AICPA Audit and Accounting Guide: Revenue Recognition*).

The auditor also may consider the results of:

- the internal compliance program and its effectiveness
- the internal audit function, risk assessment and reports with management's corrective action plans
- entity self-referrals to any payor or government agency
- entity enterprise risk management assessment process, findings, and risk mitigation process
- external reviews (consulting or regulator or payor), including denials.

Additionally, a not-for-profit health care entity that receives a significant amount of grants and contributions may have an increased risk of material misstatement if it does not have proper internal controls established and functioning properly.

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