

Mercy Hospital: A Case Analysis

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Abstract

This is a case study which describes an account (names, other facts changed to preserve anonymity) in which an internal auditor in a hospital setting, due to personal biases and a lack of objectivity, performed a substandard audit of a capital asset acquisition and violated several standards of the International Standards for the Professional Practice of Internal Auditing as well as the Institute of Internal Auditors (IIA) Code of Ethics. Students use the Standards and Code of Ethics to form conclusions regarding shortcomings of this audit. The International IIA Standards and Code of Ethics are online and easily read, with the Standards being twenty one pages in length and the Code of Ethics being two pages. The case is designed to be taught in one class period. Students are exposed to actual standards and required to employ the standards in their analysis of the case.

Case Description

This is a case study involving internal auditing in a hospital setting. It describes an account (names, other facts changed to preserve anonymity) in which an internal auditor, due to personal biases and a lack of objectivity, performed a substandard audit of a capital asset acquisition and violated several standards of the International Standards for the Professional Practice of Internal Auditing as well as the Institute of Internal Auditors (IIA) Code of Ethics. Students make use of the International Standards and Code of Ethics to form conclusions regarding shortcomings of this audit. It is designed to be taught in one class period, with students taking time outside of the classroom to read the Standards and Code of Ethics as a basis for analyzing the information presented. The most recent version of the International Standards for the Professional Practice of Internal Auditing (The Institute of Internal Auditors, 2010) as well as the most recent version of the IIA Code of Ethics (The Institute of Internal Auditors, 2009) are easily read in one evening, with the Standards being twenty one pages in length and the most recent Code of Ethics being two pages. Students are exposed to actual standards and required to employ the standards their analysis of the case.

Mercy Hospital - Background

Mercy Hospital is a leading health-care provider and one of the oldest hospitals in the region. The 300-bed, acute-care facility is known for its quality of care and respected for their expertise and innovation in the delivery of health care. As a leader in cardiac, trauma, surgical, orthopedic, neurologic, vascular and cancer care, Mercy Hospital offers patients the latest treatments by providing its medical staff, comprising more than 600 physicians, with the most advanced technology available. Mercy Hospital is one of eight individual hospitals comprising a hospital network located across seven states ranging from Pennsylvania to Mississippi. The eight hospitals have a network headquarters which provides many of the financial functions including internal audit services. Collectively, the hospitals are members of the Mercy Health Network. Management at each hospital is decentralized except all of the hospitals participate in a consortium to purchase medical supplies for a more competitive price than otherwise would be available.

64-Slice CT Scanner

The 64-Slice CT Scanner is a new imaging medical device that helps physicians diagnose and treat a variety of medical conditions by providing a more anatomically detailed image of the patient's organs. Older CT scanners have been used for years to study internal organs, bones, soft tissue and blood vessels. They are particularly useful in trauma situations to identify injuries to the heart and vessels, liver, kidneys or other internal organs. The scanner is also used to plan for surgery and monitor the treatment of tumors for cancer patients.

Heart related maladies are all too common. The United States Center for Health and Human Services reported that in the USA for the years 2007-2008, over 5 million people arrived in emergency rooms complaining of chest pain (United States National Center for Health Statistics, 2010, p. 2). The new 64-Slice CT Scanner is judged to be faster and more reliable for diagnosing chest pain. It can evaluate a heart patient by capturing thousands of images of the heart in less than 5 seconds or capture images of the whole body in less than 30 seconds. The cost of these machines is generally expected to range from \$1.5 to \$2 million.

Bidding on the 64-Slice CT Scanner can be a very competitive and costly commitment by vendors. They insist that Board approval be granted for the machine before final bids are submitted. The list price and other costs associated with the CT scanner are shown in Table 1.

Table 1 Here

The Audit Process

Mercy Hospital's capital-asset procurement process for any single acquisition over \$100,000 is to have a formal proposal submitted to the board of directors (BOD) who vote on its approval. If the proposal is approved, the funds are transferred to the respective hospital for eventual disbursement. The internal auditors are charged with following up within one year of acquisition to check the propriety of the purchase and disbursement of funds. Recently, a proposal for a new CT Scanner was submitted by Mercy Hospital's controller. The other hospitals were told to "wait and see" until the internal auditors could inspect the documentation of the acquisition and the operating effectiveness and efficiency of the new process before being allowed to submit their own proposals. Mercy's proposal was the one of the larger proposals submitted over the past several years at a total of \$1.625 million dollars plus approximately \$25,000 for the labor and other necessary expenditures to remove the old equipment to permit the installation of the new scanner. The cost of the new scanner by itself was listed in the proposal at \$1.3 million.

The internal auditor assigned to the acquisition was Jack Jones. Jack had been with the network for over three years performing mostly operational audits (on existing processes), reviewing internal controls, payroll and travel expenses. Jack believed that the procedures associated with this capital-asset audit would be simple and routine.

This was not Jack's first visit to Mercy Hospital. In fact, Jack had performed an audit on the hospital's payroll and travel expenditures only a year ago. Jack's recollection of the experience was not a pleasant one. He had several "confrontations" with the controller, mostly as a result of clashing personalities. While all the expense issues were easily resolved, Jack felt there was still an adversarial relationship between them and he was "on guard" for any "preemptive strikes" this time around.

It was a long drive to Mercy Hospital so when Jack arrived a little late the day of his audit he was greeted by the controller with a perceived air of indifference and promptly led to a secluded and windowless office room. The controller calmly explained that he was extremely busy and would answer any questions at the end of the day. Jack merely nodded his head and sat down in front of several tall piles of invoices that the controller had furnished and represented the documentation supporting the purchase, set up, and testing of this new technology. Jack was somewhat surprised, fully expecting to see only a handful of invoices, but did not ask for any explanations. As Jack began looking through the myriad of statements and canceled checks he soon found one particular invoice near the top of the first pile which indicated that the actual price paid for just the machine itself was only \$902,000!

Jack's first reaction was to call the director of auditing. When he found that the director was out for the day and could not be reached, he decided to call the VP of Operations at corporate headquarters. Jack was critical of the controller in describing the seriousness of his suspicions based on this preliminary information. Jack didn't realize that there was a scheduled BOD's

meeting that day and that the news would be passed on to the Board. The Board members were outraged over the alleged misuse of the funds and possible fraud.

Jack was unaware that the controller was soon being lambasted by the chair of the BODs in a private conference call. Seconds after the call, the controller walked up to Jack and had only two words to say—"Get out." Jack was flabbergasted; he called back to Network's Home Office only to receive a rather icy response from the Chair of the BOD's secretary suggesting that he return immediately. As Jack got into his car and drove back to the home office he wondered what he had done so wrong.

Postscript

Three days later Jack was called in to the director of internal audit's office. The director told the story of how he personally visited Mercy Hospital the next day after Jack's visit and performed the capital-asset audit himself. The director found that there were a number of reasonable explanations for the differences in the original proposal and the actual expenditure. To begin with, the companies who sold the machine would not talk about discounting the price until they knew that the funds were available. Once the proposal was approved and the funds were authorized for disbursement, only then did the competing vendors begin slashing their prices because of competition for the sale. This is what drove the cost of the machine down from \$1,300,000 to \$902,000. Other accessories and services provided by the vendor reduced the initial list price even further by some \$57,000. Training and warranty costs were not subject to discounting. However, there were several factors that mitigated some of these savings.

A more accurate summary of the sale price was provided without the renovation and additional hospital personnel costs, and other outside consultants that proved necessary to fully comply with all safety and documentation requirements is shown in Table 2.

Table 2 Here

It would take close to a month before the new machine became operational because no one really knew how difficult it was going to be to remove the old machine which had been embedded in the concrete floor (to minimize vibration). It was decided that to save time and costs, the new machine would be set up in a new room adjacent to the room for the older scanner. The new space would have to be renovated and new electrical connections installed. Since the hospital could not afford to shut down for any extended length of time, the new space had to be renovated before the older machine could be dismantled. Then, while the new equipment was being tested, the old scanner had to be kept running in its temporary location. During the time that both machines were running, machine operators and supporting personnel were asked to work double shifts in order to test and become familiar with the new scanner before closing down the old machine. This took longer than expected because Mercy's technicians were not familiar with the new machine and had some difficulty with even minor start-up problems. Therefore, for the first two weeks, special outside consultants were hired to operate the scanner at the proper specifications. These additional and unexpected outlays were costly and brought the total to just under \$1.4 million (\$1.17 million and \$230,000 for the renovations and other expenditures) which was still lower than the original estimate of \$1.65 million. Even though the list price came in at a reasonable \$902,000 (saving \$398,000 and other discounts provided additional savings of \$57,000), the renovations amounted to \$230,000 and exceeded the original estimated renovation costs of \$25,000. The director went on to explain to Jack that the reason for the abnormally large number of invoices was due to the renovation cost, additional labor cost associated with the new machine, and the cost of running both machines during the transition. As it turns out, Mercy's controller actually did a commendable job in overseeing the project and keeping accurate records of the disbursements. In fact, the controller created a specialized installation

guide that will probably save hundreds of thousands of dollars when the remaining hospitals install more of these machines. When the director was finished, he told Jack that unless he changed his attitude and re-considered what it means to be a professional internal auditor, he was likely to remain a payroll auditor for the rest of his career. The director told Jack to go back and read a basic internal audit text on interviewing techniques, the *Code of Ethics* and the *Standards for Professional Practice*. Jack still didn't understand. What was the director trying to say?

Required

1. Discuss the possible violations Jack may have committed according to the Institute of Internal Auditors (IIA) *International Standards for the Professional Practice of Internal Auditing* and *Code of Ethics*.
2. Comment on Jack's interviewing techniques. What could Jack have done differently? What did Jack forget to do?

How to Present the Case

Students should be asked to read the case and discuss or research the required question(s). Refer them to the Institute of Internal Auditors website and the Standards and Code of Ethics. Ask students to refer to the Standards and Code in answering the first case question. With regard to the second question, refer students to an internal auditing textbook to research audit interview techniques and goals.

Table 1: List Price and Ancillary Costs of 64-Slice CT Scanner

Qty	Description	Warranty Period	List Price
1	64 Fast Whole Body CT Scanner		\$1,300,000
	64 Long Couch		
	CT Accessory Kit, Console		
	Media for DVD-Ram Drive, Cable 5EE		
	Floor Epoxy Kit		
1	PGP Study Split, Worklist Mgt Specs		\$15,000
1	Gating/Fast Rotation- Cardio and Monitor		\$100,000
1	C100 Station & Software Package		\$145,000
1	Voltage Regulator		\$20,000
1	Universal Power Supply		\$10,000
	Rigging/Installation		\$21,000
	Shipping		\$14,000
	Capital Acquisition Costs		\$1,625,000
	CT-Course for TechBioMed Training		\$20,000
	Warranty coverage-13 hour day	12	\$5,000
	Additional 6 months	6	\$60,000
	Site Training and Warranty Costs		\$85,000
	Hospital Price	18	\$1,710,000

Table 2: CT-Scanner and Ancillary Cost, Original List Price and Updated Bid Price

Qty	Description	Warranty Period	List Price	Bid Price
1	64 Fast Whole Body CT Scanner		\$1,300,000	\$902,000
	64 Long Couch			
	CT Accessory Kit, Console			
	Media for DVD-Ram Drive, Cable 5EE			
	Floor Epoxy Kit			
1	PGP Study Split, Worklist Mgt Specs		\$15,000	\$10,000
1	Gating/Fast Rotation- Cardio and Monitor		\$100,000	\$90,000
1	C100 Station & Software Package		\$145,000	\$103,000
1	Voltage Regulator		\$20,000	\$20,000
1	Universal Power Supply		\$10,000	\$10,000
	Rigging/Installation		\$21,000	\$21,000
	Shipping		\$14,000	\$14,000
	Capital Acquisition Costs		\$1,625,000	\$1,170,000
	CT-Course for TechBioMed Training		\$20,000	\$20,000
	Warranty coverage-13 hour day	12	\$5,000	\$5,000
	Additional 6 months	6	\$60,000	\$60,000
	Site Training and Warranty Costs		\$85,000	\$85,000
	Hospital Price	18	\$1,710,000	\$1,255,000
	Note* PO must be received no later than 60 days from the bid date (modified amounts from year 2008)			

References

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