How bullet-proof are my financial and operating procedures; and how can I tell if they aren't?

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Your public reputation is excellent. You've worked hard to keep up-to-date so you know you have the skill set. Your practice is in a good geographical location servicing an ever-growing demographic. You are performing interesting, quality work. Your practice premises has new levels of equipment and the reception layout looks great. You have successfully expanded and integrated more staff including hygienists and employee dentists. In short, you are doing everything right.

You think your personal evaluation might be a little subjective so you check with your practice manager, your bookkeeper and your accountant. Each of them tells you your profit figures and your key ratios are looking good too. This is your objective test satisfied. After all, figures don't lie and so you get back to doing what you do best.

However, you're just not sure that everything is as it seems or should be. You are doing well but you feel you could be getting a little more return for all the hard work and stress of running your own show. You would like to understand some of your accounts and financial ratios and practice business procedures a little better but you don't have the time, inclination or expertise. After all, that is why you have a practice manager, a bookkeeper and an accountant!

However, if your instinct is telling you something is amiss, then you should make the time to act on it and follow through, particularly if you are not 100% sure of what your finance and practice staff are saying and doing or there are some inconsistencies in what you see and hear from those you have involved in your practice's operating and financial affairs.

What could my instincts be telling me?

Over the years of working with clients, both in the course of regular quarterly and annual reviews as well as specifically requested reviews, the following key areas of fraud and shrinkage keep recurring:

Fraudulent financial reporting

- Liabilities/Accounts payable
  - Incorrect accrual of liabilities (e.g. unsupported increases in accruals, invoices received from recognised suppliers but with private PO Box addresses);
  - Duplicate payments to suppliers (e.g. multiple payments of similar amounts, receipt of invoices without supporting documentation);
  - Purchase of inappropriate items after purchase order approval (e.g. purchase order changes after approval); or
  - Suspense account fraud (e.g. amounts hidden in suspense accounts and not reallocated).

- Accounts receivable
  - Embezzlement of old or written-off outstanding account balances (e.g. several aged receivables written off at one time yet cash collected);
  - Excessive discounts to customers (e.g. large credits/discounts to some patients); or
  - Improper posting of credits (e.g. excessive credit memos to some patient accounts).
- Revenue recognition
  - Period - end sales cutoffs (e.g. excessive sales recorded prior to or after quarter or year end to disguise cash takings).

Misappropriation of assets

- Cash
  - Skimming (e.g. cash removed before it enters the books);
  - Unauthorized transfers (e.g. unusual transactions observed in bank reconciliations); or
  - Fictitious refunds (e.g. patient refund to disguise takings).
- Materials/inventory
  - Overstatement of specialist inventory count (e.g. to disguise fictitious purchase orders).
- Payroll
  - Falsification of time records (e.g. excessive hours submitted);
  - Inappropriate wage/commission payments (e.g. poor pay cheque controls, lack of support for calculating employed dentist payments); or
  - Paying employees through expense reimbursement process (e.g. increased expense accounts, payroll tax evasion).
- Material costs
  - Material ordered in excess of requirements (e.g. collusion between buyer and supplier staff).
- Purchasing
  - Split purchases to avoid exceeding delegation of authority (e.g. many purchases just below staff delegation limit); or
  - Product substitution (e.g. cheaper quality and priced product delivered compared with what was ordered).
- Expense reporting
  - Misuse of practice credit card (e.g. appearance of personal expenses); or
  - Reimbursement of expenses not incurred/inappropriate (e.g. $11.00 expense submitted as $111.00).

Note that not all of the above matters were issues revealing outright fraud, collusion or theft. The majority were areas where poor procedure and control issues were identified and subsequently improved. Had those issues been left unresolved, they would most certainly have given rise to an increased likelihood of future fraud, exposure to penalty taxes, mismanagement of the practice through inaccurate reporting as well as potential doubling up of compliance expenses in respect of practice management, bookkeeping and accounting.

How do I act on my instincts?

This article will not provide an exhaustive checklist that you can independently use to flush out the issues. Neither will this article recommend you engage in a costly audit of your practice. It will however show you how you can begin to assess and mediate against the risks in your practice, as well as how you can objectively manage and measure those people you engage to help you do so. *Remember, this isn't a witch hunt. All you want is to establish, and then maintain, bullet-proof financial and operating procedures that eliminate any possibility of creative accounting or fraud.*

In an effort to ensure that our own regular quarterly/annual client reviews were as time and cost efficient as possible, we initially used an *Account Reconciliation checklist.* Interestingly, over time, that checklist changed and developed into an *Account Reconciliation Quality Criteria checklist* which became increasingly used by clients who wished to:

- Improve their own bookkeeping skills;
- Improve their bookkeeper's accounting skills;
- Better integrate their records with our quarterly and annual tax and accounting compliance;
- Identify areas of poor process control and potential fraud; as well as
- Decrease their overall bookkeeping and accounting costs.

The *Quality Criteria checklist* allocates an objective quality score to your practice's chart of accounts, both profit and loss as well as balance sheet items. A review is then undertaken of each individual account based on the following seven criteria:

- Account details (account number, account description);
- Prior period comparative review/reconciliation performed (at least quarterly);
- Reconciliation review performed (with sign off);
- Account balance reconciled to independent source;
- Reconciling items identified and aged;
- Corrective actions identified; and
- Corrective actions resolved in a timely manner.

How does the quality criteria scoring system work?

Each account is individually assessed against each item obtaining either an item "pass" or an item "fail". Each account can receive a possible maximum score of 7/7. If the individual account score drops to less than 4/7 then that entire account is counted as a "fail".

By way of illustration, let's say we are currently reviewing the December 2007 year to date P&L account for materials/consumables. We see that:

- It is accurately titled and numbered - pass;
- The bookkeeper did a December quarter review work paper comparing the material costs against revenue in the quarter, year to date, etc - pass;
- The practitioner, who likes to keep on top of his key cost accounts signed off on the review work paper indicating he had considered it reasonable - pass;
- Material costs were incurred through various suppliers but no attempt has been made to generate a summary report or agree original purchase orders and invoices received - fail;
- No reconciliation has been attempted in respect of materials ordered, delivered, used, invoices received, paid or outstanding, etc - fail;
- The bookkeeper has undertaken reconciliations in prior periods and has left a note on file indicating the December quarter end reconciliations are outstanding due to the Christmas and New Year holidays but will be done as part of January month end - pass; and
- The bookkeeper did both December and January reconciliations together as part of the January month end - pass.

The materials/consumables account was passed with a score of 5/7. The review continues for each other account and the final scores collated together with a summary of all corrective actions identified for follow up. A client with 94 accounts could end up with something like:

- Number of accounts passed: 81
- Number of accounts with defects: 13
- Percentage of accounts defective: 14%

Dependent upon the nature of the defects and the ease with which corrective actions can be effected, this defect rate might be considered acceptable. However it is not uncommon to find that a practice could have a low defective "accounts" percentage (as above) yet still have a relatively high "opportunities" failure rate.

To clarify, in addition to recording which accounts passed or failed, you should also measure the total quality criteria opportunities by which each account is reviewed. In this example, it is 658 opportunities (94 accounts x 7 quality criteria each). If we assume all 94 accounts each received a score of 4/7 the defective accounts percentage would remain as low as 14% (as above). However, that means 282 opportunities have been failed (i.e. 94 accounts x 3 failed opportunities each). Accordingly we would end up with:

- Number of opportunities passed: 376
- Number of opportunities failed: 282
- Percentage of opportunities defective: 43%

This is not considered an acceptable defect rate. If, for example, all the opportunity defects centre around qualitative failures in respect of agreeing quarterly reconciliations to independent source documents (as was the case with the materials account) then significant problems have been identified with the standard of bookkeeping. At worst, there is an increased likelihood of risk of fraud. At the very least, you will be up for corrective accounting compliance costs at quarter or year end when your accountant will be chasing to collate the requisite supporting documentation.

Notwithstanding that some of you may harbour reservations about the quality criteria scoring system, it does provide an objective benchmark against which directional improvements can be measured. In fact, part of the overall scoring system going forward builds in self improvement in the sense that each account holds two opportunities in respect of identifying action plans as well as implementing corrective actions in a timely manner.

So it's really all about more reports and reconciliations?

No, not really because consistent reconciliation to independent data should really be a given. For instance, in our materials/consumables account example, it was noted that the bookkeeper had previously undertaken reconciliations and collation of supporting documentation. Past (or future) action plans may have included the introduction of some agreed procedure changes to enable such reconciliations and reports to be produced. Such process improvements may not have emerged as a consequence of fraud but they are often identified as areas of control and process improvement to avoid it. Once so identified, they will not be forgotten but will be automatically followed up and scored as part of the ongoing review process.

In this regard, the most common area of process improvement involves segregation of duties. Segregation of duties is a fundamental internal check and process control whereby different employees, acting independently, automatically check the efficacy of the other's actions. Whilst several employees can still collude to commit fraud it is less likely where several need to be involved.

In an ideal world, we would have different employees ordering, taking delivery, receiving and paying invoices. However, this is not often viable in a small dental practice where much is delegated to few. Consequently, it is more commonly seen that corrective actions involve changed coding practices rather than strict adherence to segregation of duties. That is, rather than increase practitioner review and sign off of employee actions, etc, it is often more appropriate to focus and ensure that work orders are immediately coded to the appropriate account via purchase order records, which are themselves immediately updated and on-charged on receipt of materials, etc.

Of course, notwithstanding that some segregation of duty trade offs make commercial sense in smaller practices, sometimes the principle is simply not negotiable. This point was made recently in a client review where it was identified that the practitioner had commenced to allow wage cheques to be drawn by employees themselves! Perhaps it was less a question of misplaced trust in a busy successful practice and more a positive reflection on the quality of staff employed by the practitioner; nonetheless the corrective action was implemented forthwith.

So in its simplest form?

The key to assessing the quality of the financial information provided to you and the operating procedures your staff follows is as straightforward as asking yourself:

- *Are my financial information and practice procedures timely, uniform and transparent?*
- *Does everything I see in my accounts have substantiating data or statements which are easily identified and readily available for my follow-up?*
- *Is everything my staff do in accordance with a procedure that should promptly identify anyone that attempts to enhance their own financial position at the cost of my own?*

Perhaps your answers to these questions aren't all affirmative at the present moment. However, they could be and once set up correctly, your financial and operating processes should become self perpetuating and bullet proof.

Disclaimer

This article is designed to provide generic information only and should not be viewed as a recommendation to act. Individuals should seek advice from a qualified advisor to ensure their actions are commensurate with their financial needs and requirements.

About the author

Garry Pammer is a Partner of Clark & Jacobs Accounting and Business Advisers, specialising in providing advice to dentists. Advice includes planning for your financial wellbeing, superannuation, insurance, practice management, computer software and the buying and selling of dental practices. For a free assessment of your financial position and to see how you can achieve your goals, call Garry on (02) 9264-1111.