

***Protecting Your Assets  
Accounting Issues Relating To Factors  
On Internal Control For Clientele***

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**What Is The Definition Of Internal Control?**

Internal controls are the safety features established within an accounting system to safeguard assets and to mitigate liabilities. There are two segments of internal control: control of the asset and control of the liability.

In reviewing a balance sheet, you would note the assets that would be subject to internal control. Cash and cash equivalents can be controlled in a variety of ways, mainly through segregation of duties so that the person who has control of the asset does not have control of the record. For example, the person who opens the mail is not the same person who reports the receipts on an accounts receivable system.

The accounts receivable system should be scrutinized for extraordinary adjustments. Daily banking should occur. Cash should be taken to the bank on a daily basis and a separate person should control and reconcile cash receipts to the daybook. A daybook is used in most businesses but should be used especially in the field of veterinary medicine.

The computer-generated reports should always agree with the daily cash receipts count. If a discrepancy occurs, you may have a severe problem. Even a minor difference can be an indication of a consistent defalcation. On an annual basis, the practice manager should reconcile the beginning accounts receivable balance, and the fees earned throughout the year and total cash receipts. Beginning balance accounts receivable plus fees earned, minus cash received, minus adjustments and other discounts applied, gives the ending accounts receivable balance. Whenever a practice manager performs a year-end closing, the practice manager should sign-off as reconciling this data before forwarding to their CPA. If the practice manager does not provide this information in a timely manner, the hospital director should directly inquire of the practice manager, in writing, as to why the information that he requested has not been forthcoming. A practice manager who cannot reconcile the data may himself become suspect of dishonest activity.

Cash is critical. In the area of petty cash, the practice manager should insist on an imprest petty cash account. (Cash is to be replenished only to the extent of receipts received for reimbursement). Any underage of cash should be posted to the disbursement system at the point the underage is noted. If this is occurring on a frequent basis, there should be an elimination of the person who has custody of the cash and an alternative person situated in their place.

All employees should be required to take vacations. If an employee refuses to take a vacation, that may be prima facie evidence that they may be stealing. If they appear so dedicated that they are unwilling to take a vacation, they may be fearful that they will be found out.

Watch for payroll figures that seem unreasonable. If you see any payroll where the percentage of gross income is lower than those of your colleagues, note that you may be a candidate for embezzlement. The probability is that people who are underpaid are going to steal because they can find moral justification for this dishonesty. They feel they are being wronged and therefore they feel two wrongs make a right.

Watch out if employees drive expensive cars and wear expensive designer clothes, this may be something to follow-up on. There is a possibility that a person is taking unauthorized appropriations from the practice. Keep your honest employees honest by controlling cash.

### **Where Else Can Defalcations Occur In Cash?**

#### **Kiting and Substitution**

Transfers are a fantastic way for people to steal. One way is to assess an amount as a transfer going between two different accounts, alleged as deposits in transit. You unfortunately find out that no deposit in transit exists. Large deposits in transit should be traced to the subsequent year's cash disbursement system so you can see that there is a disbursement and a subsequent receipt going into an alternate source.

#### **Phantom Accounts**

A practice manager with discretion and complete confidence may assign a phantom account for an asset that does not exist. For example, a money market fund may be allegedly established when de facto there is no money market fund. For this reason, a practice owner should insist on copies of the last bank statement, money market fund statement or brokerage statement plus monthly reconciliations from the practice manager. These are the avenues through which people steal.

#### **Analytic Review**

A practice owner can spot defalcation by paying attention to financial percentages of expenses to gross income. When you see percentages get too high, watch out! For example, if drugs and professional supplies, as a percentage of gross, exceed the norms for your type of practice (small animal, large animal or mixed), or your style of practice (bread and butter, diagnostic, or glamour), the possibility exists that people are stealing. You may not know for sure but at least make note of the area in question. If material fluctuations are occurring consistently in inventory, as compared to prior years, this could be a problem sign flashing an alert.

#### **Voided Checks**

Voided checks are checks written on the disbursement sheets but not sent to the right payee. If a reconciliation is not prepared and reviewed by an independent person, this defalcation will not be caught. On a monthly basis, every principal should be signing off on every bank statement reconciliation. We would like to see the initials of every principal on every bank statement to note that the principal has reviewed the bank statement.

### **Forgery**

One simple way of forging is to sign someone else's name and then have the check cashed at a bank. Every principal should contact their banker and let them know who the authorized signatories are. Sometimes the bank does not control signatories appropriately and will not even check. We encourage you to have constant contact with the bank and discuss appropriately authorized signatures.

### **Evaluations**

If you know that you are going to give an employee an unfavorable employee evaluation, you should be alert that your cash could be an entrée to get even. Any employee who will be terminated may feel that this is the appropriate time to start stealing. People normally do this to try and justify something.

### **Hiring Practices**

The best way of reducing theft is through appropriate hiring, but even then you are not guaranteed that your employee will remain honest. When hiring people, follow up on references and try to determine if they have stolen in a prior practice. Try to keep the prior employer talking; they may eventually reveal a problem. If you do spot a defalcation, you must prosecute to the fullest extent of the law. This sets an example and lets people know that you are serious. From state to state, a theft in excess of a specified dollar amount of as little as \$100 may be a felony and subject to a jail term. You must prosecute. Problems with the IRS may result. The IRS may accuse you of making a gift of the money and tax you for both income tax purposes and gift tax purposes.

### **Existence of Duplicate Books**

Do everything possible to find out if there are duplicate records being sent to your CPA. The bookkeeper may be sending one set of records to your accountant and maintaining another set of records for their own use. Your CPA would not have a shot at exposing this ploy without auditing each and every check sent. The audit would be far too expensive for most practice owners to consider. Therefore, we encourage you to initial every disbursement sheet you send to your CPA to let him know that you have at least looked at those disbursement sheets.

Every DVM should be given the opportunity for an internal control review by their accountant. If you say, "We do not want one" every time your CPA mentions this, you may be passing up an opportunity to save tens of thousands of dollars.

REMEMBER -- theft from other than cash can occur.



## **Inventory Control**

Theft can also occur in inventory. Generally, complete inventory control in most small animal practices is not commercially practical. Understanding the economic limitations, let's look at ways to control the risk.

### **Situation #1**

Employees come in when owners/principals are on their lunch hour and purchase a case of dog food. They ring up the transaction but they record an amount that is less than what the actual purchase should be. The difference between what was rung up and what was actually paid goes in the pocket of the defaulting employee. This was a theft.

### **Situation #2**

People come in after hours and take inventory. Sometimes it seems like a semi-truck pulls in at 10:30 p.m. Practice owners can spot this by being aware of excessive ordering in a specific area. Practice managers should question why so much of a product is being used. Practitioners should be encouraged to start looking at their invoices to make sure they are buying appropriate products.

Ever wonder why dietary food is delineated on the chart of accounts? It is an analytic tool but it also spots a problem in a practice over a series of years, especially in the area of dog food, which is one of the major targets of theft.

### **Situation #3**

Controlled drugs are critical to the proper management of veterinary hospitals. Be sure your practice complies with every DEA requirement for controlled substances. Maintain contemporaneous logs. Make periodic inquiry whether your practice is controlling these substances. Be careful that your practice is not one of the growing cases where employees euthanized themselves. Intravenous use of drugs is no longer an unfortunate peculiarity. Unbalanced souls have sought access to easily obtained drugs through the workplace. Veterinary hospitals are prime targets for associate access to drugs. Be diligent and maintain the appropriate level of care in administering access to controlled substances. Put out markers. One type of a marker is the bait and switch tactic. The practice owner will have a friend, unknown to the staff, come in during lunchtime and say, "Can you get me these drugs?"

### **Situation #4**

Theft can occur by people fencing a product. Inventory can be lifted and then sold. Both the primary employee thief and the secondary fence/practitioner may both be prosecuted.

Less obvious, but much more devastating, is theft by employees taking clients. Groomers are prime examples by stealing client names. This is a felony and in some states is a case for prosecution. When practitioners know of a situation where an employee has stolen clientele from them and appropriated fiduciary information, the practitioner may prosecute in some states. The

dollar value of a client could be worth up to \$150, making the theft a possible felony with just one client.

Receptionists can steal by securing employment in another practice and giving client lists away to the new employer. Photocopying client and patient records, and accessing computers to copy data files are thefts. They are unauthorized. Practitioners should be made aware of these situations.

An inefficient staff steals employer funds with down time. In small animal practices, people hide. They go to burrow in certain places, sit down, read, smoke and waste time. Employee theft resulting from these inefficiencies becomes even costlier when multiplied by employees' payroll tax costs and fringe benefit costs (anywhere from 15% to 40%).

Most practitioners won't think about these multi-faceted forms of employee theft until after the fact. Practitioners are completely unaware of problems but soon ask, "Why didn't you tell me that people not working costs me so much money?" "Why didn't you tell me that by stealing petty cash, someone could steal so much?" "Why didn't someone force me to bank daily or reconcile statements monthly?"

The answer is to always be diligent in establishing and enforcing good internal controls. In past years, theft was not as big a concern because there was a certain morality that existed in the work force that is now evaporating. Now, practitioners are forced to act as policemen.

Practitioners must no longer avoid conversations on accounting issues and propriety of disbursements. Appropriating funds without authorization is the most popular way of stealing, but employees can be very creative. By slipping in phony invoices without validation, employees can make unauthorized withdrawals. If an employee cannot give you a reasonable explanation on a disbursement, consider their lack of explanation as a warning sign that there could be a defalcation. Consider adopting purchase orders.

Theft of receivables can occur by a person expunging an account for a friend. Many employees have friends that come to your practice. The dishonest employee has the capacity of making entries in the adjustments, discounts, or returned fees area of the client's account on a pegboard or computer system. As a safeguard, review the returns, allowance, and discount adjustments daily to be sure they are proprietary. Valid reasons for client refunds must be documented. Consider requesting client signatures on all refunds and adjustment entries. Every practitioner should initial the adjustments report summary once per month.

Don't forget the small point-of-purchase items sold in your practice. Watch for leashes, collars, smocks and plastic bags taken home.

## **Office Supplies**

Employees steal office supplies. De minimis pilferage is accepted. If an employee needs an extra pen, he or she may forgetfully put it in their pocket and go home. However, wholesale carting out of items such as reams of paper towels or boxes of pens or pencils must be stopped. If you feel your practice has this problem, then put markers out. Employees steal when services are provided outside of the practice unit. Doctors sometimes moonlight, even though they are engaged full time at the practice. We recommend that you include a clause in doctors' employment agreements not allowing outside employment or gratis service. Not only are you stolen from in terms of income that is put in the employee's pocket but you may be subject to malpractice committed by the moonlighting employee DVM. In the event the employee commits malpractice outside the scope of his employment in the practice, an outside third party may consider the DVM's activity in-scope and may then sue you.

### **How to Protect Against Theft Loss**

Internal control can be safeguarded in a variety of ways. Good systems are one way, but don't forget transfer of risk to an insurer. One way you can do this is through coverage called fidelity insurance. Fidelity is a bonding insurance coverage that transfers part of the risk of loss, in the event someone embezzles money from you, to the insurer. You buy the coverage and the insurance company prosecutes. The insurance company does not know the person who steals and will be very aggressive in the prosecution. It is not uncommon for an insurance company to bring in their own investigators and prefer charges. That cost of coverage is well worth it. Trying to prove a theft is expensive and it causes bad press in the community. Let the insurance company take the heat.

You want all employees to know that if someone has stolen from you, you or the insurance company will prosecute. In the event that someone comes to you voluntarily and confesses, take this into consideration but always consult with your attorney in regard to pronouncing absolution.

### **What To Do**

Here are some steps to take in the event of suspected defalcation:

- 1) Contact OEM, CPA, INC.
- 2) Contact your attorney. Your attorney will give you advice relative to state laws, how to proceed, and what should be said.
- 3) Contact your insurance carrier.
- 4) Possibly talk to your personal banker. They have vast experience.

### **Theft of Equipment**

Always maintain a detailed inventory of equipment. Logging in serial numbers, descriptions, manufacturer, condition of equipment, cost, etc. is very important in proving loss. Theft can occur with furniture or even leasehold improvements. Your job as practice manager is to safeguard the assets. Give your CPA these detailed lists for a secondary credible source in the event of loss. Videotape the hospital assets as an ancillary source.

### **Controlling the Liabilities**

Many times you yourself have granted the authority to an employee to commit the practice. At the point of this authorization, you have given financial responsibility that can eventually be translated into a loss. For example, an employee could be authorized to buy equipment. If that employee buys equipment, on the authority of the employer, the vendor has recourse against you for payment. Judiciously restrict authority to order for the practice. Always monitor your listing of accounts payable. Make sure the vendor's balances are reasonable. Occasionally, talk to the vendors directly. You may be amazed what your practice has been committed to.

Insist that correspondence or inquiries be directed to you on any matter relating to billing deficiencies. Also, make sure correspondence for the practice from accountants, attorneys, insurance agents, etc. be addressed to you. Occasionally pick up the mail yourself.

Open your own bank statement from time to time. Look at your disbursement sheets for misnumbered checks. Look for different colored inks on a one-write disbursement system. When you see multiple inks, compare the payee on the cancelled check to the disbursement sheet.

### **Controlling Risk**

In designing a system for internal control, you as a practitioner must determine the acceptable level of risk. The level of risk will determine the amount of control needed. The risk you are assessing is that the system you have established will not be able to catch the defalcation or theft. The issue becomes materiality. Some risks will be small since the probability of loss will be nil or acceptable at a low level. This controlled risk then becomes an educated risk that balances the commercial realities of policing individuals with the benefits derived from the policing effort.

Even with the best system, there is a risk on internal control. That level of risk is contingent upon a practitioner's willingness to spend the resource dollars to prevent the risk.

As management, you are responsible for internal control. It is not the responsibility of the accountants, attorneys, or the insurance agents. Management engages the assistance of professionals but assumes ultimate responsibility. It is management's responsibility to make sure that the assets used in practice are used for the purpose that they are required.

Occasionally, discrepancies will occur. When they do result, the differences must be analyzed and reconciled.

One of the best ways of controlling the risk is to restrict access to corporate assets. Limit only those who have a business purpose to utilize those corporate assets.

By capital expenditure control, cash, receivables, inventory, and fixed assets can be conserved as corporate resources. Generally, these assets represent the bulk of the assets that are at risk under internal control.

Vague, nondescript, and general descriptions in favorite expense categories are primary indicators of possible problems in internal control. For example, repair expense may seem out of line in a practice. This may be because some items of a capital nature are being expensed. Once these items are expensed, they are lost to the control of the property record. Also, misclassifications are common in drugs and professional supplies as well as office supplies. Once an item is shown on the income statement as an expenditure that demands expensing, the opportunity for management to control that asset through the balance sheet becomes diminished.

An analysis of internal controls and an assessment of the inherent risk for a practice demands an investment of resource dollars by the clinician with the practice's CPA. Many practitioners are unwilling to pay more than a nominal amount for this service. The value for the service is only perceived after the loss has occurred. Generally, internal control studies are offered to clients by CPAs as a separate consultation.

Since every practitioner has a different tolerance for risk, a study for internal control for a practice should not be performed in a cookbook manner by the accountant, but rather should be a joint effort in planning between the practitioner and the CPA. Both should sit down and map out a plan for determination of internal control in the practice.

Even the best plan for internal control cannot warrant against defalcations. They occur based upon practitioner's willingness to invest dollars to determine the inherent risk and also the practitioner's willingness to invest dollars to maintain and monitor the system of internal control to control the risk. The expenditure also means reviewing, on a periodic basis, the internal control to determine if technology or alternate methods for theft have made the existing system less effective.

There are instances where internal control cannot be effective because of collusion. When two people join to defraud or steal, the discovery of that theft becomes very difficult. Collusion normally occurs when two people have control of the asset as well as the record. They can adjust the record to reflect the loss of the asset as a normal occurrence in business.

### **Other Sources of Internal Control**

Generally, a spouse is a wonderful warning sign that internal control may need revamping. The spouse may be mistrusting of other individuals in the practice. Generally, the spouse has a clearer vision of the true worth of employees, since the spouse does not work with the employees on a daily basis. Since the spouse sees the direct result of not bringing home an adequate level of income, the spouse many times is more than willing to check out the disbursements or defalcations.

Of course, the most difficult defalcation to guard against is the defalcation by the principal in the practice. The principal may simply need funds and wish to steal from the government. Also, the principal may be taking funds so that a spouse does not discover that a separate savings arrangement is being established.

### **Provide the Appearance of Review**

A practitioner does not generally deal with bank reconciliations. As we have indicated in prior segments of this article, we strongly recommend that, on an occasional basis, a principal be involved with receiving the mail and opening up the bank statements. On occasion, the principal should at least open the statement and shuffle the checks to let individuals performing the reconciliation know that the bank statements are being reviewed. If the mail is circumvented or opened before the time the practitioner has an opportunity to review the contents, the practitioner will lose the detachment of correspondence between the bank and himself. If a person is stealing from the practitioner, that person will have a first shot at going through the mail and doctoring the required documents to the attention of the practitioner.

Sometimes the control of mail becomes even more of a critical issue when the accountant or attorney is writing to the practitioner attempting to alert him or her of a possible concern regarding internal control. Accountants will, on rare occasion, be able to spot a problem through analytic review and will sometimes make mention to the principal. However, relying upon analytic review for defalcations is an extremely unreliable and foolish way of maintaining internal control. Only the sharpest accountant can spot a real material change in expense and thereby have concern over the issue of internal control.

Some practitioners like the idea of having specific correspondence sent to the practitioner's home.

Since 44% of all employee thefts occur at the cash register, attention to cash receipts is critical. Practices must insist that all clients receive receipts. The client then becomes a form of defense against employees not ringing up a correct transaction. Pre-numbered receipts or computer-generated receipts are also extremely useful in maintaining internal control.

Principals should always be cognizant of the "No Sale" memorandum or "Adjustment" memorandum in a computer system or cash register. Employees may be opening up the register without putting money in and possibly taking it out without authority.

As a sensitive reminder of the recent confirmations in our judicial system, a practitioner should also be aware of the inherent risk in accusing an individual of theft. When a practitioner accuses someone of a misdoing, that same person could make a reverse accusation for a non-provable offense, such as age, racial discrimination or sexual harassment.

With sexual harassment, it is especially difficult to disprove since in America you are assumed guilty until proven innocent. Although male practitioners run the greatest risk of this accusation, the issue has also been levied against female practitioners.

Another area of unauthorized defalcation is through the payroll system. Sometimes individuals prepare payroll checks without an adequate level of supervision. Additional hours are added or alternative rates are utilized either by the individual writing the check or an individual phoning in the results to a payroll service. A practitioner must be extremely careful to make sure the information on payroll is accurate and complete.

### **Conclusion**

In order to maintain a good internal control system in your practice, you must be more resourceful and creative than the person who could possibly be stealing from you. Diligence is essential. Documentation and compliance with established systems is the lifeline for reduced theft. Be always cognizant that it is only honest people that steal from you. Dishonest people never have a chance of getting into your practice. Always look for opportunities to improve and strengthen your system of internal control. Do not be Scottish by hesitating to invest in new technologies. Remember that the risk you assume could be far more costly than the cost of reducing that risk. Consult with your CPA periodically on the systems of internal control. If your CPA is trying to reduce the fees that he or she must charge you, they may not volunteer any information on internal control. They assume you must ask them if you wish to retain their skill in this area. We strongly encourage mutual discussion between your practice and its accounting firm.

After a theft has occurred, the cost of prevention is a minor issue. Have a little forethought and vision and anticipate that loss before it occurs.

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