

ANTIFRAUD PROCEDURES REPORT

INTRODUCTION

We did this work as part of our 2007 Annual Audit Program as approved by the City Council. While the term “fraud” has a specific legal meaning we use the term in this report to mean a variety of wrongdoing. It includes white-collar crime and embezzlement. Fraud in this report includes theft of cash or other assets with active concealment of the theft.

Because of many well-publicized frauds in the corporate world (e.g. Enron, WorldCom), internal and external auditors are under greater pressure to help their organizations and clients avoid such situations. The latest edition of *Sawyer’s Internal Auditing*, the “bible” of internal auditors, says: “Because of the enormous sums involved and the potentially disastrous effects of fraud and associated wrongdoing, internal auditors are being expected to put such unsavory activities under the spotlight of their audit surveillance.”

Not all frauds can be uncovered even by the best auditors. Wrongdoing such as kickbacks, forgery, collusion, and other unrecorded transactions can be difficult to discover without a tip. Neither are auditors expected to be handwriting experts. According to *Sawyer’s Internal Auditing*, “When skillfully prepared false documents are presented to auditors who have no reason to doubt their validity, it is reasonable for the auditors to rely on them.” Nevertheless, internal auditors are expected to be alert to the “red flags” or indicators of possible fraud. According to the International Standards for the Professional Practice of Internal Auditing section 1210.A:

“The internal auditor should have sufficient knowledge to identify the indicators of fraud but is not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud.”

This audit report represents over 100 hours of direct audit time. Most of our direct audit time is being used for the four audits described in our 2007 Annual Audit Program: cash handling, construction projects administration, Washington Pavilion management contract, and purchasing/procurement.

METHODOLOGY

We used computer assisted audit techniques for many of these procedures. This consisted of using *Cognos Impromptu* computer software to extract data from various accounting and payroll database catalogs. The data is then analyzed using various filters and sorting techniques to try and identify unusual transactions or records for more detailed examination. For example, we might access the accounts payable database on the City’s computerized accounting system. This database contains many files of

information such a file of all the vendors the City does business with. Then we used the *Cognos Impromptu* to create a list of all vendors having a certain characteristic such as a mailing address containing a post office box. This filtered list is sometimes called a query. In some cases, we traced items on our query report to the original source document such as an invoice or time sheet. Use of specialized computer software such as *Cognos Impromptu* allows us to examine the entire databases and files of accounts payable and payroll information. We did not have to rely upon taking audit samples. In other situations we looked at various documents such as logs of when sealed bids were received. We also used the internet to search for state/city price lists for various commodities and for vendor addresses.

PURCHASING

Last/low syndrome

The last/low syndrome occurs in contract bidding when the last contractor to turn in a bid is typically the low bidder. If this situation occurs more often than seems likely by the laws of probability it could be an indicator of collusion between contractors or between a contractor and purchasing staff. The Finance department records the date and time when sealed bids are received. We were able to compare when bids were received with the contractor that ended up receiving the City contract as the low bidder. We concluded that there was no evidence that the last contractor to turn in a bid was more likely to win the bid award.

Supplies and materials-price comparison

An indicator of purchasing fraud might be a situation where the City is paying a much higher than average price for various commodities. We looked at materials commonly purchased by most state and local governments. We compared seven road materials such as calcium chloride and asphalt. We compared six chemicals such as carbon dioxide and quicklime. We were able to locate price lists from seven states and two cities including Fargo, ND for many of these commodities. Materials used by the City of Sioux Falls were purchased at a similar or lower price compared to other state and local governments.

ACCOUNTS PAYABLE

Vendor-employee phone comparison

A common audit technique is to search for employees who also are vendors providing services or commodities to their employer. This does not necessarily indicate a fraud situation. However, one fraud scheme involves an employee who sets himself up as a “vendor” to his employer (often using a vague business name like A & B Enterprises) and then submits fraudulent invoices for payment. The fraudster will sometimes use their own phone number as the phone number for their false business. We used CAAT to search the vendor database and the employee database and see if there were any matches with phone numbers. We found 50 matches or “hits”. We did further investigation

including looking at the invoices submitted for payment. We were satisfied that these situations were legitimate and that there was no evidence of employee fraud.

Vendor address search

Government agencies can be vulnerable to a fraud scheme involving an outsider setting up a fraudulent business and billing the agency for services or goods never provided. Such a false business may use a post office box, a “virtual” office, or a mail drop company like the UPS Store or Mailboxes Etc. for a mailing address. Of course, legitimate businesses also use mail drops. Additionally, good controls over the addition of vendors to the master vendor list can make these fraud schemes difficult to pull off. We ran an *Impromptu* query of all vendor addresses. The query was set up to pick out any vendors that had addresses that were the same as the following: Mailboxes Etc., UPS Store, Postnet, Alternative Resources, Virtual Offices, South Dakota Penitentiary, Alliance Business Centers, and Commercial Mail Receiving Agency. We found the addresses for these companies through a check of the phone book and an internet search. We had 23 hits. We then did further investigation by looking at what was being purchased and the original invoices. In some cases we did internet research to establish that these were not fraudulent corporations. We believe these vendors were legitimate.

PAYROLL

“Ghost” or “Phantom” employees

Ghost employees show up on an organization’s payroll but either do not exist at all or are not employees of the organization. Someone with access to the payroll system puts the ghosts into the payroll system to commit fraud against the organization by cashing the payroll disbursements. There are a number of common audit techniques to identify phantom employees. Two of these techniques are an **employee address review** and a **review of duplicate payroll direct deposit accounts**.

Employee address review

We ran an *Impromptu* query of all current employee addresses. Those with home addresses listed as post office boxes, out-of-state, or outside of 75-mile radius of Sioux Falls were isolated. We had 22 hits with this query. The employee files in Human Resources were reviewed to verify that these employees were actual City employees. No deviations were found. We did not include temporary or seasonal employees in this query. We will review these employees as we perform future payroll audits.

Employee duplicate payroll direct deposit accounts

City employees normally receive their pay as a direct deposit to their bank account. We ran an *Impromptu* query of all employees, past and present, with the same financial institution and account numbers. Married couples who both work for the City might have the same bank account. Also, family members such as a parent and child might have the same account. We further filtered the query results to isolate those matches that did not have the same home addresses. These matches were reviewed. We had no evidence these situations were not legitimate.

Overtime

Overtime, if not properly controlled and monitored, can be an area ripe for fraud. Fraud in this area might be unnecessary overtime and falsified overtime. Our audit procedure was not designed to detect unnecessary or falsified overtime. We will look for unnecessary or falsified overtime when we do future payroll audits. We ran a report of the top overtime earners since the beginning of the year. Then we looked at the job titles of these employees to look for reasonableness of overtime. The top 25 overtime wage earners were all from Public Works major organizational unit. Typically they were mechanics and equipment operators. Much of the overtime appeared to be the result of snow removal operations. We correlated overtime with weather archive information from the National Weather Service website.

Accrued vacation balances

One “red flag” of a possible fraud situation involves an employee who never misses work. They rarely use their paid time off and come in early and stay late. Embezzlement schemes often require constant day-to-day attention by the fraudster to maintain the scheme. We used computer assisted audit techniques to run a report of employee accrued vacation balances and sorted the list from most unused to least unused vacation. We also put the employee position title in the report. No one in a position involving the maintenance of financial records or receiving payments from customers appeared to have an unusual amount of unused vacation.

Terminated employees; last payment compared to termination date

One type of payroll fraud involves a supervisor who may delay processing termination papers on employees and then keep the payroll checks for one or two pay periods after the employees have been terminated. Most City employees receive their pay in the form of direct deposit into their bank account; therefore, we do not think this type of fraud is likely. Our audit procedure was not designed to uncover this exact fraud scheme. However, we did run an *Impromptu* query of all terminated employees from the last 12 months. We performed an analysis of the termination date compared to the date of their last pay. Employees receiving their final pay after the pay period in which their employment was terminated were isolated for further review. This query resulted in a list of 24 employees. Our investigation showed many of these employees to be temporary employees that received special pay (bonus) for their service such as swimming pool employees. Other employees either received a Healthy Lifestyle rebate or a payout from their medical reimbursement account. These situations are neither fraud situations nor errors. Two of the employees’ final time sheets were reviewed because the employees were being paid for hours worked from a previous time period. We later learned that these employees were either not turning in their time sheets on-time or they were not recording their hours correctly. Therefore, they were later paid for time worked but not recorded during the proper time period.

CONCLUSION

We found no evidence of fraud in the specific audit procedures we performed. Upon further investigation all suspicious transactions and situations we found were determined to be legitimate or minor errors upon further investigation.

We want to emphasize that not all frauds will be uncovered using audit techniques, even when used by the most experienced auditors. We also performed some additional procedures which we did not put in this report. These procedures were discussed with the Audit Committee. No evidence of fraud was found in these situations either. There are many other specific antifraud procedures we can perform. These will be included in subsequent annual audit programs.