

CITY OF BROWNWOOD

SUPPLEMENTARY FRAUD RISK ASSESSMENT REPORT

NOVEMBER 2007

Prepared by:

Director of Finance

Submitted to:

City of Brownwood Audit Committee
November 21, 2007

Preface

The following Supplementary Fraud Risk Assessment Report has been prepared by the Director of Finance to follow up on the recommendations made in the original Fraud Risk Assessment Report prepared in January, 2006. Its purpose is to determine whether or not the recommendations have been adopted and the reasons, if any, for any non-compliance. It is also to determine if changes are needed to the original study and, if so, what they would be.

The purpose of the original report was to document an administrative understanding of the risks of fraud residing within the City in order to:

- Ensure there are adequate procedures and internal controls in place designed to prevent, detect and deter fraud;
- Identify potential risk areas and develop administrative and departmental action items for minimizing these risks; and,
- Highlight the City's oversight function designed to prevent, detect and deter fraud.

The City's Audit Committee, consisting of the Mayor, one Council member, three citizen members, the City Manager and City Attorney, is responsible for reviewing and approving the procedures and internal controls submitted to them by Senior Management designed to prevent, detect and deter fraud and the continuous monitoring of the effectiveness of those procedures and internal controls.

This report reviews the assessment in the original report of the areas determined to have an element of risk and to determine if those areas have changed.

Throughout the document, the original assessments are reported in normal type face. Corrective actions recommended by the Director of Finance and/or Audit Committee follow in indented paragraphs using italics. Actions actually taken or explanations for non-compliance follow in further indented paragraphs using bolded italics.

CITY OF BROWNWOOD

Fraud Risk Assessment Report

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1.0 Introduction to Fraud

According to a recent publication, Management Anti-Fraud Programs and Controls – Guidance to Help Prevent, Deter, and Detect Fraud¹:

"Fraud can range from minor employee theft and unproductive behavior to misappropriation of assets and fraudulent financial reporting. Material financial statement fraud can have a significant adverse effect on an entity's market value, reputation, and ability to achieve its strategic objectives. A number of highly publicized cases have heightened the awareness of the effects of fraudulent financial reporting and have led many organizations to be more proactive in taking steps to prevent or deter its occurrence. Misappropriation of assets, though often not material to the financial statements, can nonetheless result in substantial losses to an entity if a dishonest employee has the incentive and opportunity to commit fraud.

The risk of fraud can be reduced through a combination of prevention, deterrence, and detection measures. However, fraud can be difficult to detect because it often involves concealment through falsification of documents or collusion among management, employees, or third parties. Therefore, it is important to place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place and fraud deterrence, which could persuade individuals that they should not commit fraud because of the likelihood of detection and punishment. Moreover, prevention and deterrence measures are much less costly than the time and expense required for fraud detection and investigation.

An entity's management has both the responsibility and the means to implement measures to reduce the incidence of fraud. The measures an organization takes to prevent and deter fraud also can help create a positive workplace environment that can enhance the entity's ability to recruit and retain high-quality employees.

Research suggests that the most effective way to implement measures to reduce wrongdoing is to base them on a set of core values that are embraced by the entity. These values provide an overarching message about the key principles guiding all employees' actions. This provides a platform upon which a more detailed code of conduct can be constructed, giving more specific guidance about permitted and prohibited behavior, based on applicable laws and the organization's values. Management needs to clearly articulate that all employees will be held accountable to act within the organization's code of conduct."

¹ Published as an exhibit to SAS No. 99, Consideration of Fraud in a Financial Statement Audit, a joint publication of the American Institute of Certified Public Accountants, Association of Certified Fraud Examiners, Financial Executives International, Information Systems Audit and Control Association, The Institute of Internal Audits, Institute of Management Accountants and Society for Human Resources Management.

2.0 Ethics in the Workplace

2.1 Promoting Ethical Behavior

As a municipality, charged with the responsible use of public funds, the City places a high priority on ethical behavior and actively promotes its value system in the workplace. Ethical behavior is addressed in the City's Personnel Rules and Regulation Manual, but promotion of the City's value system has taken place through verbal instruction and by example.

The City believes that adopting a separate Employee Code of Ethics Policy, which would communicate a zero tolerance for fraud and the disciplinary consequences of violating the policy, would strengthen and emphasize the City's commitment to ethical conduct in the workplace. The policy should be written by Senior Management, with input from all Department Heads, and presented to the Audit Committee for approval. From there, it should go to the City Council for final adoption through resolution. It should be incorporated into the Personnel Rules and Regulation Manual and posted on the City's website. It should be separately distributed to all employees who will be required to sign for their receipt, understanding and acceptance of the Code. Finally, it should be reviewed by the Audit Committee annually for potential revisions. A Code of Ethics should also be adopted by the elected City Council.

A Code of Ethics has been reviewed by Senior Management and will be presented to the Audit Committee for approval. The Audit Committee previously determined that a separate Code for elected officials was not needed due to the existence of numerous state and federal laws that already govern behavior.

2.2 Employee Hiring and Background Checks

The City's general employment policy calls for the employment of qualified persons. The City attempts to screen applicants for suitability for employment by conducting a combination of reference and/or background checks on prospective employees.

The Human Resources office posts all vacant positions to be filled on the City's website, internal bulletin board and in selected publications for advertisement. The Human Resources office receives and processes all applications for staff employment.

The Human Resources office obtains employment reference checks on all full-time prospective employees that are included in the employee's personnel file. Departments are discouraged from hiring prospects with negative or marginal references.

2.3 Employee Concerns and Discipline

Currently, there is not a known process for employees to report concerns of suspected fraud. Also, the employee disciplinary procedures applicable to fraudulent or unethical behavior are not well-defined.

The new Employee Code of Ethics Policy should include a process for employees to report concerns of suspected fraud. The Audit Committee recommends the use of a post office box to receive anonymous written reports. The availability of this mechanism to report fraud will be published in the local newspaper and information distributed to all employees. Any correspondence received will be taken unopened to one of the citizen board members who will open it and consult with the other citizen board members to determine the next course of action. This may include, but is not limited to, calling an immediate meeting of the audit committee or deferring any report until the next meeting of the audit committee.

Post Office Box 1135 has been established for receipt of anonymous reports. This information is included in the Code of Ethics document which will be incorporated into the Employee Personnel Manual.

3.0 Assessment of the City's Operational Fraud Risk

3.1 Introduction of Fraud Awareness

A discussion was held at the department head level of fraud awareness and the requirements of Statement on Auditing Standards 99.

3.2 Initial Assessment

The Director of Finance completed an initial assessment of potential fraud risk on a departmental basis. This initial assessment was provided to Senior Management for their observations. A preliminary assessment was then prepared by the Director of Finance incorporating these observations.

3.3 Interviews

The Director of Finance conducted several interviews with various department heads and staff informing them about the increased national awareness of fraud detection and prevention, the new audit standards, and to develop an understanding of the procedures and internal controls within the respective areas. Strengths and weaknesses were openly discussed and, in closing the interview, the attendees were provided with the preliminary assessment of the fraud risk in their respective departments and given an opportunity to comment.

3.4 Final Assessment

Based on the information provided during interviews, and upon further review by Senior Management, a final assessment of departmental fraud risk was prepared by the Director of Finance.

3.5 Items Requiring Further Discussion

The following items came to light from the Final Assessment Report that will require additional discussion by the Audit Committee for potential action:

3.5.1 Financial Procedures

The Finance/Accounting office has a procedural manual that has been developed over time that incorporates the duties of various staff members along with how those duties are carried out. Due to limitations on manpower, the Director of Finance has deemed it in the best interests of the City that employees within the Accounting and Utility Billings departments be cross trained in department procedures, as well as duties within the Utility Billings department. This has created a potential fraud risk regarding segregation of duties. Personnel in both departments have access to the General Ledger (Accounting) and Cash Collections (Utility Collections) which could lead to potential asset misappropriation and the means to conceal it.

Controls in the form of adjustment report reviews are in place by the Finance Director. With the lack of additional support personnel to provide backup, segregation of duties is a particularly difficult challenge. The Audit Committee agreed that a potential fraud risk regarding segregation of duties exists, however internal controls currently in place mitigate this risk. With the lack of additional personnel to completely segregate duties, it is the recommendation of the Audit Committee that this risk be accepted by the City.

The original assessment has not changed and there are still few options to address the risk. The original recommendations of the Audit Committee will stay in place.

3.5.2 Fueling Procedures at Brownwood Regional Airport

There are currently no controls over the dispensing of regular unleaded and diesel fuel by city employees at the airport.

It is recommended that Senior Management develop control procedures and implement them as soon as possible. Referral to the Audit Committee is not necessary.

Controls have been put in place in the form of written logs being kept as part of the fueling procedure. These are spot checked against the pump numbers to determine that all fuel has been properly accounted for.

3.5.3 Check Signing

There are currently no procedures in place to provide signature access in the event two or more of the three authorized signatory's are absent. Also, one signatory has access to two signature stamps.

It is recommended that Senior Management develop a backup plan and address the custody of two signature stamps by one signatory as soon as possible. Referral to the Audit Committee is not necessary.

Controls have been put in place to be sure no one City employee has access to two signature stamps.

3.5.4 Inventory of Fixed Assets

There is no current inventory of fixed assets owned by the City of Brownwood. Many asset misappropriation concerns identified by surveyed personnel could be addressed by conducting and maintaining a fixed asset inventory for the City.

The City is retaining RCI Technology Inc. from San Antonio to conduct a total inventory of city assets valued over \$500, excluding land. This year's budget includes an amount to cover the cost.

The inventory has taken place and all fixed assets have been bar coded.

4.0 Assessment of City's Financial Reporting Fraud Risk

4.1 Purchasing and Approval System

All requests for purchase orders are initiated by the department making the purchase and are approved by the departmental director or supervisors given authority to do so. Purchase order requisitions are reviewed by the Purchasing department prior to issuing purchase orders, with selected purchase orders also reviewed by the Director of Finance.

Budget account balances are verified for sufficiency by the Director of Finance on a regular basis by reviewing appropriate reports in the accounts payable and general ledger system. Department heads are also given an opportunity to review budget account balances via weekly reports.

There is currently no policy in place to communicate the City's purchase order policy to vendors.

The City recommends that letters be issued to vendors frequently doing business with the City, communicating the City's purchase order policy.

Notifications have been sent to vendors.

4.1.1 Credit Cards

The City participates in the State of Texas purchasing card program administered by JP Morgan/Chase. The City issues a limited number of these credit cards to key personnel, primarily for travel needs, however a broadening of the scope of use of credit cards has been discussed. The State of Texas program allows for additional safeguards in the form of contemporaneous on line review of transactions and immediate adjustments of credit limitation and authorization for each card.

An overall administrative review of credit card policies and procedures should be conducted. Employees should be trained on the use of these cards and documentation requirements adopted in the new policy. The policy should address misuse of credit cards and the potential consequences of misuse.

This has not yet taken place due to the need to incorporate changes in travel and entertainment policies with credit card use, and to determine the new City

Manager's preferences for use of purchasing cards as part of our purchasing policy. This will be addressed in the upcoming year.

4.1.2 Petty Cash Funds

The City maintains petty cash funds throughout selected departments that collect cash payments from customers. Expenditures from the funds are requisitioned on a regular basis. The fraud risk associated with petty cash funds is believed to be low.

4.1.3 Employee Travel Expenditures

Employee travel procedures were reviewed and have been determined to be an area of low risk for fraud. A detailed Travel Policy is in place to regulate approval, advance and reimbursement practices of the City.

4.2 External Financial Reporting

External financial reporting is coordinated through the Director of Finance and the City's financial advisor, First Southwest Company of Dallas. External financial reports are prepared and submitted to fulfill continuing disclosure requirements imposed on the City through bond covenants for its bonded debt and by state law. Other outside governmental agencies also receive reports regularly.

4.3 Internal Budget Reporting

Department heads are provided with electronic budget reports (consolidated and detail) on a monthly basis. They are also presented with electronic departmental expenditure reports detailing the individual transactions charged to their budgets with a running total of budget balances in individual accounts.

The City Manager and Senior Management are presented with electronic consolidated and detail budget reports for all operating funds.

The City Council is presented with a monthly Budgetary Control Report that provides departmental totals to date with budget and last year to date comparisons. These reports are also presented to senior management and all department heads. Quarterly reports are presented on the City's website.

Year end financial statements are prepared on a departmental and city-wide basis for reproduction on an as requested basis and review by all city departments.

The City will be undergoing an upgrade of its accounting system beginning in late March, 2006. The new system will allow online access to all budget information by department heads, directors and senior

management on a day to day basis. Budget data will be reviewed periodically to analyze for potential fraud.

The upgrade has been accomplished.

4.4 Internal Auditing

The City currently has no procedures in place to conduct internal audits of various City departments.

It is recommended that City departments that collect payments from the public or otherwise handle cash be audited by the Finance office periodically throughout the year. Two members of the Accounting staff have already received training on procedures for conducting internal audits. Senior management anticipates being able to conduct these audits beginning in the spring of 2006. A schedule should be established so these audits will take place on a regular basis but the departments chosen for audit will be selected randomly with the approval of the City Manager.

The Audit Team was able to conduct one internal audit during the last year. This report was previously distributed to the Audit Committee.

5.0 Oversight

Senior Management, consisting of the City Manager, City Attorney, City Engineer and Director of Finance, is responsible for the development of procedures and internal controls designed to prevent, detect and deter fraud and the continuous internal monitoring of the effectiveness of those procedures and internal controls.

The Audit Committee, consisting of the Mayor, one Council member, three citizen members, the City Manager and City Attorney, is responsible for reviewing and approving the procedures and internal controls submitted to them by Senior Management. It is also their responsibility to make recommendations to the City Council for changes, additions, deletions and overall improvements to the procedures and internal controls of the City. Finally, they are charged with reviewing and discussing fraud related and other financial matters with the City's independent auditors.

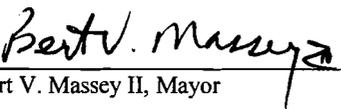
The Mayor and City Council are responsible for appointing the Audit Committee and enforcing those recommendations of the committee that they wish to adopt. They are the final arbiters of setting up procedures and internal controls designed to prevent, detect and deter fraud.

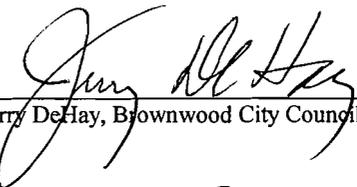
6.0 Summary and follow-up

All recommendations made in the original Fraud Assessment Report have been followed with the exception of revising the credit card policy. This was not done due to the need to incorporate additional policies for travel and entertainment into an overall policy and because guidance from a new City Manager is needed on purchasing policies.

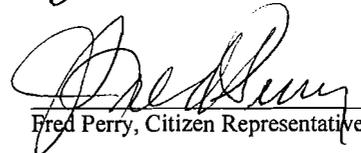
The original departmental assessment of fraud risk was reviewed and it was determined that the findings have not changed. The assessments and recommendations described in the original report are still germane to the City.

7.0 Signatures


Bert V. Massey II, Mayor


Jerry DeHay, Brownwood City Council


Pat Coursey, Citizen Representative


Fred Perry, Citizen Representative


Charles Boland, Citizen Representative


Bobby Rountree, City Manager


Pat Chesser, City Attorney


Walter Middleton, Director of Finance