Performance Audit

Accounts Payable

Durham County Internal Audit Department

March 4, 2011

Performance Audit:

Accounts Payable

Why We Did This Audit

This audit was conducted to determine if the County's accounts payable infrastructure employs effective controls to remit vendors accurately and timely with reasonable assurance that the process is free of fraud and other abuses. Specific questions were:

1. Are adequate controls in place over the process of vendor setup, maintenance, and validation?

2. Are adequate controls in place to secure unissued and blank stock?

3. Are adequate controls in place to prevent duplicate payments?

4. Are adequate controls in place to prevent payments to incorrect vendors?

What Is Recommended

1. Purge the vendor file of erroneous and inactive records and correct inaccurate tax information reported to the IRS.

2. Use a higher level duplicate payment warning available in SAP.

3. Develop a methodology to separate purchasing functions from receiving functions at the department user level.

What we found

The Finance Department's accounts payable processes include controls to mitigate the County's financial risks of incorrect or inappropriate payments to vendors. Practices for making purchases are designed for appropriate approval and review and payment processing include both manual and machine controls. However, (a) the vendor master file includes inactive and erroneous information, (b) the possibility exists for duplicate payments, and (c) the duties of purchasing and receiving should be segregated.

The Finance Director agrees that improvements in these areas would strengthen controls. The Director has begun procedures to implement the report recommendations.

For more information regarding this report, please contract Richard Edwards at 919.560.0042 or rcedwards@durhamcountync.gov.

COUNTY OF DURHAM

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March 4, 2011

Michael M. Ruffin, County Manager:

This audit of the County's Accounts Payable was conducted in accordance with the fiscal year 2010 Audit Plan. The audit fieldwork was conducted between November 9 and February11, 2011.

Three recommendations were made in the audit report to reduce the inherent risk of inappropriate vendor payments and vendor or employee fraud. The recommendations were to (1) purge the vendor file of erroneous and inactive records and correct inaccurate vendor information reported to IRS, (2) use a higher level duplicate payment warning available in SAP, and (3) develop a methodology to separate purchasing functions from receiving functions at the department user level.

We did not find instances of fraud and only one duplicate vendor payment. Based upon our audit design and tests, we do not have reason to believe fraud exists. The recommendations, which are based upon industry best practices, will provide additional assurances through increased risk mitigation designed to prevent errors and fraud.

The Finance Director reviewed the report and agreed with the findings and recommendations. The Director's plan to implement the recommendations is in Appendix 1.

I appreciate the courtesy and cooperation provided by the Finance Director's staff and other departments that contributed to the audit.

Richard C. Edwards

Richard Edwards
Internal Audit Director

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Introduction

This performance audit of Durham County's accounts payable processes was conducted pursuant to the September 12, 2005, Audit Department Charter which established the Audit Oversight Committee and Audit Department and outlines the internal auditor's primary duties. The Audit Committee authorized this audit in July 2010.

A performance audit is an engagement that provides assurance or conclusions based on an evaluation of sufficient, appropriate evidence against stated criteria, such as specific requirements, measures, or defined business practices. Performance audits provide objective analysis so that management and those charged with governance and oversight can use the information to improve program performance and operations, reduce costs, facilitate decision making by parties with responsibility to oversee or initiate corrective action, and contribute to public accountability.[1]

This performance audit was conducted in accordance with generally accepted government auditing standards except for conduct of a peer review. The peer review has been tentatively scheduled for June or July 2011. The audit standards require I plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on the audit objectives. I believe the evidence obtained provides a reasonable basis for the findings and conclusions based upon the audit objectives.

Background

The Finance Department's Accounts Payable (AP) area is responsible for reimbursing vendors for goods and services provided to support County operations. The area is staffed with three employees. In FY2010, AP remitted approximately 26K checks to 3702 vendors for an amount totaling approximately $155 million.

AP's role in reimbursing vendors is only a part of the process to appropriately pay for the goods and services we acquire. Purchasing and receiving functions at the departmental level play an important role as well. Purchasing functions solicit vendors and initiate paperwork AP processes to complete the remittance process. Proper paperwork, including accurate and timely submission of invoices and other information determines to a large degree the appropriateness and timeliness of vendor remittances.

Achievement of accurate and timely vendor payment is the goal of the AP area. However, to achieve this goal, AP as well as operations outside of AP's control,

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[1] Comptroller General of the United States, *Government Auditing Standards*, Washington D.C: U.S. Governmental Accountability Office, 2007, p. 17

must work together as a unit. Below is the most common structure for obtaining goods and services and remitting vendors. The structure is:

- User departments order goods and services from appropriate vendors. This includes insuring that purchases are suitable and priced competitively.

- User departments receive goods. This includes assuring the correct goods and services in the quantities ordered are received in suitable condition.

- User departments prepare paperwork and submit bills and invoices to AP for payment processing.

- AP processes the paperwork and remits vendors for the goods and services.

Although automated systems are used in the remittance process, much of the process is manual although it interfaces with a powerful enterprise resource planning (ERP) system; SAP in this instance. The AP process is time-consuming and repetitive requiring diligence at all processing points. These manual processes require close attention to detail so as not to submit inaccurate data for payment processing. According to experts in accounts payable subject areas, most errors such as incorrect and duplicate payments are the results of manual errors made by employees at the user level.

Inappropriate vendor payment is a large national problem, costing more than a billion dollars annually. Analyst at the Institute of Management and Administration, Inc., our primary source of information on best AP practices, estimates that duplicate vendor payments amount to approximately $1.3 billion annually. An unspecified annual amount is lost in invoice fraud, however, the average instance of vendor fraud it $90k.

The vendor file is the repository of information regarding accounts payable and vendor activity.

Before a vendor is allowed to do business with the County it must be included in the vendor master file. Information in the form of an application and an IRS Form W-9 that provides vendor details is required from the vendor and entered onto the master file. The automated system generates a vendor identification number for reporting and remittance purposes. Purchasers draw upon that file to complete paperwork required to remit vendors.

Audit Objectives

This audit was conducted to determine if the County's accounts payable infrastructure employs effective controls to remit vendors accurately and timely

with reasonable assurance that the process is free of fraud and other abuses. The specific questions were:

1. Are adequate controls over the process of vendor setup, maintenance, and validation in place?
2. Are adequate controls in place to secure unissued and blank stock?
3. Are adequate controls in place to prevent duplicate payments?
4. Are adequate controls in place to prevent payments to incorrect vendors?

Scope and Methodology

Fieldwork was conducted November 9, through February 11, 2010. We reviewed the accounts payable process at the point where remittances are made as well as obtained information at other areas that link to the process. We reviewed a sample of 93 of 2,845 unique non-employee check recipients to determine if (1) vendors were appropriately entered into the master file, (2) application data was on file, (3) documentation such as invoices and bills supported payments, and (4) purchases were authorized. We also reviewed an additional 71 sets of identical payments to determine if they were duplicates. Our sample was drawn from remittances made in fiscal year 2010. Specific steps completed were:

1. Review of accounts payable and purchasing procedures and manuals,
2. Cross-referencing vendor data from the master vendor file with the FY2010 check register to determine if payments were made to vendors on the vendor list,
3. Cross-referencing of the check register with the employee data file,
4. Review of SAP authorizations to determine appropriateness of user access,
5. Discussion of invoice processing with AP staff,
6. Observance of accounts payable processes to determine if Durham's controls are comparable to industry best practices.

Findings and Conclusions

The Finance Department's accounts payable processes include controls to mitigate the County's financial risks of incorrect or inappropriate payments to vendors. Practices for making purchases are designed for appropriate approval and review and payment processing include both manual and machine controls. However, several enhancements would provide a greater level of control and increase assurance that payments are made timely and appropriately.

This report will recommend (1) improved vendor master file maintenance procedures, (2) use of higher level SAP warning alert to prevent duplicate payments, and (2) segregation of duties at the departmental purchasing level. We did not find evidence of fraud, abuse, or other wrongdoing regarding any of these issues. However, implementation of these recommendations will strengthen the goal of reasonable assurance that operations are sound.

Vendor setup controls guard against tampering by unauthorized and inappropriate users. Controls for vendor setup exceed those prescribed by industry best practices. Industry best practices recommend that AP manage the vendor master file. Their research demonstrated that a number of entities allowed purchasers at the departmental or user level to access the vendor file and make changes and additions. The County's vendor file management is restricted to one area in the Purchasing Department.[2] One employee in that department, with backup as needed, sets-up the vendor in the system and makes necessary revisions. AP personnel tasked with processing pay requests, do not have authorization to access vendor setup or change modules. The opportunity for AP check processors to create a vendor and make a remittance without collusion has been eliminated. Additionally, the County's practice provides segregation of duties that reasonably assure security and control over the master file.

Potential exists for user efficiencies if vendor files are purged of inactive or erroneously entered vendors. The vendor master file contained 21,479 vendor records at the time of our review. Of those, 12,199 or 57 percent have not been active over a period of time. This includes some that were recently established and some that have been in the system for more than five years.

There are several reasons inactive vendors are in the file. Some vendors apply but never provide goods or services. Some vendors cannot be identified because the vendor information and invoice information differ resulting in creation of an additional record. Also, because the process is manual, some input errors are made.

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[2] Reference is made throughout the report to "purchasers." That term is reserved for departmental level employees that procure goods and services for their individual departments. The structure within the Finance Department that oversees contracts and major procurements is referred to as the "Purchasing Department."

Best practices encourage keeping the vendor file free from inactive vendors and erroneous entries by regularly purging the file. The theory is that accurate files decrease the opportunity for remittance errors and fraudulent vendor practices. Unnecessary data also affects user efficiency. For example, one keystroke may result in several vendors with the same or similar name coming onto the display screen. The user cannot tell which vendors are erroneous or inactive and must sort through them to identify the appropriate vendor. This is inefficiency that purging is intended to eliminate.

The vendor file has not been purged since October 2005 when SAP became the repository for vendor information. Vendor files including payment information are kept for five years in accordance with Finance Department policy to comply with State of North Carolina information retention statutes. However, those that do not have payment activity do not need to be retained. According to department officials, purging the files have been discussed but due to workload, that task has not been gotten around to it yet.

We recommend purging the file of inactive vendors and erroneous entries and maintaining it in good order by purging unneeded data at least annually. The Finance Director agrees with the recommendation and has begun setting plans into motion to purge the file.

Incorrect vendor provided information should be corrected. Vendors do not always provide correct vendor information such as tax identification numbers. IRS can assess fines of up to $50 for each incorrect 1099 record submitted unless the agency can demonstrate its reports reflect W-9 information provided by the vendor. The County reports about 25 erroneous records per year but has not been fined because the data comes from the W-9 form, a legal document for IRS tax purposes.

We reviewed the erroneous reports list from the IRS for tax years 2007 through 2009. We identified 13 vendors that repeated for two of the years and several repeated in all three years. We recommend that the vendors on IRS' report be contacted and asked to provide correct information. This will help the County in its efforts to maintain its vendor file in good order. The Finance Director agrees with this recommendation and has directed that the vendors on IRS' erroneous list be contacted and asked to provide corrected information.

Adequate controls are in place to secure unissued and blank check stock. Blank check stock is not locked away; it is stored in the general AP area. However, there are mitigating controls that reduce the likelihood of the stock being used inappropriately. The controls are:

1. Stock contains watermarks to prevent possible tampering and duplication attempts.

2. SAP authorizations to print checks are limited to the (a) AP Supervisor, (b) back-up, and (c) Deputy Finance Director. The SAP system requires

each to put in their unique security code or ID before the system allows a payment transaction to be completed.

3. One dedicated printer in the AP Supervisor's office is equipped with Magnetic Ink Character Recognition capabilities which allow the financial institution to validate the printed checks.

4. As checks are printed, SAP assigns a check number, prints the County Manager's and Finance Director's signatures, and retains a log of what checks are printed and who authorized the printing.

Based upon controls in place, it would be difficult for blank check stock to be used inappropriately. Therefore, we are not recommending enhancements to current controls.

Controls to prevent duplicate payments must be vigilantly practiced.
Controls are in place to prevent duplicate vendor payments but they have to be carefully practiced to achieve complete effectiveness. Controls must be vigilantly practiced at the departmental purchasing level where invoices and bills are submitted for payment as well as at the point final payment processing occurs.

We identified approximately 426 vendor remittances of identical amounts made within a one to three month period and reviewed 71 to identify duplicate payments. During the first 25 vendors, we indentified one duplicate payment in the amount of $7.42. During the next 46 we did not identify additional duplicates. Based on that level of frequency we abandoned the review process because we do not believe there are substantial duplicate payments. However, because we identified one instance, we know the potential for duplicate payments exist and recommend the additional control addressed later in this report section.

The overpayment we identified occurred as a result of submitting a duplicate invoice for processing. The purchaser said it was likely the vendor's record did not show a payment and sent the purchaser a duplicate invoice.

The SAP system is designed to provide a warning if a duplicate payment is submitted. The AP processor assumes the warning was overlooked in the instance of the duplicate payment. The system has a higher level control that makes it harder to overlook the warning. We recommend utilization of this higher level warning control. The Finance Director agrees with this recommendation and has begun steps to implement it.

Controls are adequate to prevent payment to incorrect vendors. The correct vendor identification number is the key to this process. The process requires department representatives to submit a document package that includes the vendor's unique vendor identification number. The department representative

obtains the vendor identification number by keying in the vendor name and matching the invoice address with the address in the master file record.

AP remits the vendor identified by the vendor number it received from the purchaser. If the user department inadvertently makes an error in transcribing the identification number on the form, SAP will catch it because the vendor number does not match the address. In such an instance, AP returns the package to the buying department for corrections.

Our opinion is that controls are adequate to prevent payment to incorrect vendors.

Changes are needed at the departmental level. According to best practices, vendor fraud is not as common as errors such as duplicate payments, however fraud is costly. Much of vendor fraud involves opportunities provided by lax controls for purchasing and receiving processes. It has long been established that segregation of duties should be implemented between purchasing and receiving functions. Without proper segregation of these duties, opportunity, a major factor in the commission of fraud, is present.

I discussed this issue with four departments. None of them separated the ordering function with the receiving function. All of them had processes to confirm the receipt of goods but it was generally done by the person that ordered it, a practice that falls short of best practices. Segregation of duties should be encouraged at the departmental purchasing level. We didn't find instances in which we suspected fraud but the opportunity existed in the four departments we discussed the issue with and the opportunity should be mitigated by segregating duties.

The persons I spoke with regarding this issue understood the need for segregation of duties after our discussions. They also knew how to implement a simple process to obtain the level of control required. The reason they had not developed plans previously is because they were unaware of risks associated with combining purchasing and receiving functions.

Recommendations

We did not find evidence of fraud or multiple errors and do not have reason to believe fraud exists. The recommendations address inherent risks of inappropriate vendor payment and vendor or employee fraud in an accounts payable operation. They will improve upon the department's currently existing controls over accounts payable practices and procedures.

1. Purge the vendor file of erroneous and inactive records and correct inaccurate tax information reported to the IRS,

2. Use a higher level duplicate payment warning available in SAP, and

3. Develop a methodology to separate purchasing functions from receiving functions at the department user level.

Appendix 1

Finance Department Response

COUNTY OF DURHAM
FINANCE DEPARTMENT

To: Richard Edwards, Internal Auditor

From: George K. Quick, Finance Director

Subject: Response to A/P Audit

Date: March 3, 2011

This memo is intended to address the recommendations made as the result of the Accounts Payable audit conducted by you dated February 14, 2011.

Recommendations:

1. Purge the vender files of erroneous and inactive records and obtain corrected vendor information reported by the IRS.

   Response:

   We accept this recommendation and are currently in the process of purging all inactive files and those file that have had not had any activity over the past five years. We expect to complete this process prior to FY2011 end.

2. Utilize a higher level duplicate payment warning available in SAP

Response:

We are currently testing this upgrade for implementation. This change
should be in place within the next 60 days.

3. Develop a methodology to separate the purchasing function from the
receiving function at the department user level.

Response:

A memo will be sent out County wide to inform all departments of the
necessary changes in their workplace. While the Finance Department
potential risk associated with the current process and encourage them to
make recognizes the need to separate this function, we understand that
this may not be possible due to limited employees.

I hope that the above changes will help the Accounts Payable area of the
Finance Department to continue to reduce risk to the County and move
closer in line with best practices.