CITY OF
TORRANCE

March 29, 2023

TO: Nao Pabalan, Accounting Manager

FROM: Jason Nishiyama, Deputy Finance Director

SUBJECT: Accounts Payable High-Risk Review

Enclosed is the final audit report for the Accounts Payable High-Risk Review. Internal Audit would like to thank you and your staff for the support and assistance provided to us during the audit.

Should you have any questions, please feel free to contact Fulton Bell or myself.

Thank you.

Enclosure

Cc: Aram Chaparyan, City Manager
    Danny Santana, Assistant City Manager
    Sheila Poisson, Finance Director
    Ian Dailey, Assistant Finance Director

CITY OF TORRANCE

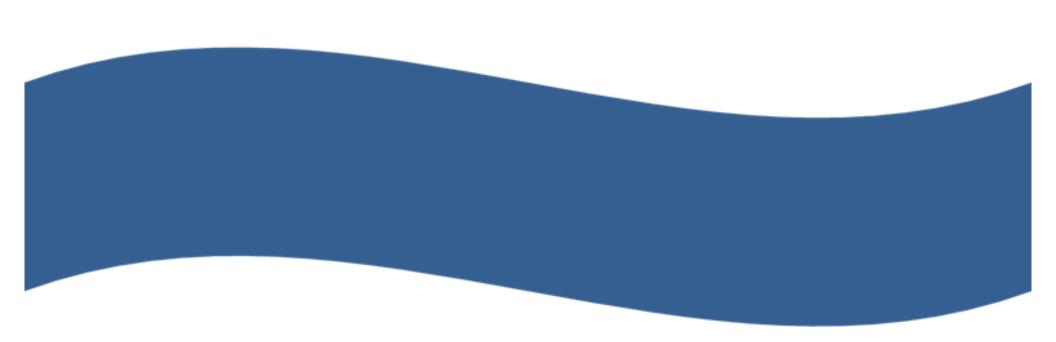## INTERNAL AUDIT SERVICES

Accounts Payable High-Risk Review

June 28, 2022

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Audit Overview

Background

California Government Code section 8546.10 authorizes the State Auditor to establish a high-risk local government agency audit program (local high-risk program) to identify local government agencies that are at high risk for the potential of waste, fraud, abuse, or mismanagement, or that have major challenges associated with their economy, efficiency, or effectiveness. They are currently focusing their efforts on evaluating the risks facing California cities. In fiscal year 2020-21 the City performed better its overall risk of financial distress level to moderate moving from fourth worst to sixth worst. Internal Audit Division within the Finance Department performs reviews of City operations to verify controls are in place to prevent and detect waste, fraud, abuse and or mismanagement.

Audit Objective

The objective of the advisory review was to document internal controls in Accounts Payable currently in place, identify control gaps, and advise on controls to close those gaps.

Scope

The scope of the audit did not include testing of accounts payable transactions to ensure payments were properly approved and verified. The scope of the audit included documenting internal controls for the following activities:

✓	Vendor invoice processing	✓	Batch review
✓	Accounting batch review	✓	Pre-check run review
✓	Three-way match	✓	User access edits and changes
✓	Payments	✓	Authorized payments
✓	Outstanding checks	✓	Payments accurately recorded

Approach

We planned and performed the audit to obtain sufficient and appropriate information to provide a reasonable basis for our findings. In order to achieve the audit objective we performed the following procedures:

- Interviewed key personnel regarding Accounts Payable processing procedures
- Reviewed Accounts Payable policy and procedures
- Researched Accounts Payable best practices

Executive Summary

Finance accounts payable processes can be improved by enhancing existing controls in place. Based on walkthrough of processes we identified three issues for improvement which are summarized by priority rating to the right.

(1) Maintenance and control over the vendor master file is needed. It is important to manage the vendor master file because it is the official record of suppliers and vendors across all departments and basis for issuing purchases orders and processing payments. We found the system feature within New World which forces approval to add and edit vendors is turned off.

(2) We found one accounts payable staff had access to change vendor information and processed invoices for payment. To prevent errors and unauthorized payments, no one individual should have access to control the entire payables process. An appropriate segregation of duties (SOD) should be implemented.

(3) We noted New World allows users to process and pay a vendor invoice without matching it to a purchase order and goods receipt. Without three-way matching there is a risk of paying for services and products that were not authorized and/or received. A three-way match automated within New World prior to processing payment for vendor invoice mitigates risk of fraudulent transactions and inaccurate payments to vendors.
All issues were discussed with Finance management and remedial actions were implemented or in progress.

Priority 1
Critical control weakness that exposes the City to a high degree of combined risks.
(1) Tighter controls are needed over the vendor master file.   (2) Strengthen segregation of duties to help prevent errors and unauthorized payments.

Priority 2
Less than critical control weakness that exposes the City to a moderate degree of combined risks.
(3) Three-way match control helps prevent fraudulent transactions and inaccurate payment to vendors

Priority 3
Opportunity for good or better practice for improved efficiency or reduce exposure to combined risks.
n/a

Summary of Findings

		Finding	Recommendation	Auditee Response & Action Plan Due Date
Priority 1	1	**Tighter controls are needed over the vendor master file.** Based on walkthroughs, discussions and review of documentation improvements are needed for creating, editing and maintaining the vendor master file. We noted the following issues: • The system feature within New World that requires approval to create new vendors is turned off. Best practices for preventing fraudulent vendors and to ensure accuracy is to segregate duties for entering vendor information and approving vendor adds and edits in the system. • We noted that the Senior Account Clerk who has access to add and edit vendor information also has access to enter invoices into the system. This is high risk because there is a potential for one person to create fictitious vendors and invoices without detection. Staff who has access to create or change vendor master file should not have access to enter / pay invoices. • New World allows vendors to be categorized as business interest only (i.e.: contact only) or payment vendor (i.e.: vendors eligible for payment). Contact only means vendors who want to be notified for bids and future opportunities not authorized for payment yet. Contact and pay means vendors who have an active PO and have been approved. Based on inquiry we found that all vendors entered into the system are entered as contact and pay regardless of status. It is better business practice to separate pay authorized vendor's vs non pay because it minimizes the number of vendors to monitor and reduces the risk of fictitious payment.	(1) We recommend Finance Management to turn on the New World control feature requiring approval each time a vendor file is created, or edits made. (2) We recommend Finance Management update New World roles to ensure no one person has access to add/edit vendor information and create/enter invoices. (3) We recommend Finance to code new vendors who request to be considered for future business or bids be flagged in New World as "contact only" and change the status as necessary when vendors are authorized for PO. Best practice is to minimize the size of the vendor master file and limit inputting one-time vendors. (4) We recommend Finance to review the vendor master file periodically and deactivate vendors that have no activity.	(1) Finance is in the process of implementing a workflow in New World to require all vendor files additions, edition or deletion to be initiated by Purchasing staff and approved by the Revenue Manager. Currently, we are performing the testing of this feature in the New World TEST environment, and upon completion, it will be implemented in the PROD environment. This will ensure proper segregation of duties and authorization. (2) Access to add and edit vendor information for the Senior Account Clerk (in the AP Division) was temporarily granted during the year-end Form 1099 reconciliation to expedite the process. This access has since been turned off and will not be granted in the future. Additionally, access to create invoice for the Senior Account Clerk (in the Purchasing Division) is currently being reviewed and updated. Finance has already implemented a new control where all New World security access requests are approved by Accounting Manager and processed by IT Analyst in CIT. (3) Finance obtained and reviewed the list of all vendors with the most recent payment transaction date as well as the list of all vendors with no payment history, generated by CIT. For all vendors identified with no payment history or most recent payment dated prior to July 1, 2020, Finance is in the process of updating the status to "contact only". Going forward, Finance will perform the same review and update vendor status annually (to be completed by the end of February each year). (4) See response to (3) above. Please note that "deactivating" vendor is not a practical option in New World. In order to deactivate a vendor, disbursement checks associated with a vendor cannot be in "not reconciled" status. Since the Finance does not utilize the bank reconciliation module in New World, all of the checks are marked as "not reconciled", which prevents us from deactivating vendors. Alternatively, Finance will update the status to "contact only", which prevents from making any disbursements to the vendor.

Summary of Findings

		Finding	Recommendation	Auditee Response & Action Plan Due Date
	2	**Strengthen segregation of duties to help prevent errors and unauthorized payments.** We discovered through a walkthrough of Accounts Payable's processing of vendor invoices for payment and their role in generating checks, a breach in segregation-of-duties (SOD) occurred. Best practice states individuals responsible for processing vendor invoices for payment should not have access to edit vendor information. We found that Senior Account Clerk responsible for supervising Accounts Payable processing of vendor invoice was given access to edit master vendor files for 1099 updates. This SOD violation occurred because there is no process in place to review and approve access privilege in New World.	We recommend Finance and CIT to institute a control that requires approval from the management team before access privileges are granted within New World.	Access to add and edit vendor information for the Senior Account Clerk (in the AP Division) was temporarily granted during the year-end Form 1099 reconciliation to expedite the process. This access has since been turned off and will not be granted in the future. Additionally, access to create invoice for the Senior Account Clerk (in the Purchasing Division) is currently being reviewed and updated. Finance has already implemented a new control where all New World security access requests are approved by Accounting Manager and processed by IT Analyst in CIT.

Summary of Findings

		Finding	Recommendation	Auditee Response & Action Plan Due Date
Priority 2	1	**Three-way match control helps prevent fraudulent transactions and inaccurate payment to vendors** Based on walkthrough and inquiry we noted New World allows users to process and pay a vendor invoice without matching it to a purchase order and goods receipt (manual three-way matching). Vendor invoices can be processed via purchase order (non-encumbered PO goods receipt not required), goods receipt (encumbered PO), or direct pay (no associated PO). When the user enters the vendor's name New World will determine if there are any purchases order (s) associated with the vendor. If there are purchase orders associated with the vendor a warning will be displayed, however, the warning does not prevent the user from continuing to process the invoice without matching. Based on a limited sample review, we were able to verify invoices can be processed for payment without being matched to a purchase order. Without three-way matching there is a risk of paying for services and products that were not authorized and/or received. A three-way match automated within New World prior to processing payment for vendor invoice mitigates risk of fraudulent transactions and inaccurate payments to vendors. An effectively designed three-way match is automated in the system and verifiable through documentation.	(1) Finance should implement an automated three-way match in New World preventing users from processing payments without confirmation of good receipts, matched to a purchase order and authorized. (2) Finance should work with CIT to create an exception report that lists vendor invoices that were paid without purchase orders. The exception report should be reviewed by management to verify all invoices that were paid are authorized. Authorized payments must be direct pays or authorized by an approved purchase order.	(1) For Encumbered PO, three-way match is performed by responsible department who creates Shipper (Receipt of Goods), which is then matched against PO and Invoice. Accounts Payable only processes invoices for the matched amounts/quantity. For non-encumbered PO, Shipper is not required or used, instead invoice is matched against PO by the responsible department prior to Accounts Payable processing invoices for payment. Staff are exploring the elimination and/or reduction of non-encumbered Purchase Orders as a means of improving the three-way match process as part of a redesigned purchasing project underway. Additionally, all payments require multiple layers of approval prior to disbursements, and Accounting Manager performs final approval for disbursements and verifies that all payments have proper authorization based on the City's threshold rule. (2) Finance will implement a regular review of a report listing all direct payments, which is generated by CIT, to ensure that all direct payments properly fall within the authorized types of purchases for direct payments per the Purchasing Guidelines. The listing of items and qualification for direct payments is being evaluated as part of the previously mentioned redesigned purchasing project that is underway. Estimated completion date is May 31, 2023. - Target completion date: May 31, 2023.