



Internal Audit Report

PURCHASE ORDER INVOICE AND DIRECT PAYMENTS

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I. EXECUTIVE SUMMARY

Internal Audit & Advisory Services (IAS) has completed an audit of direct payments and purchase order invoice payments made through the University's Financial Information System (FIS) to evaluate the adequacy of controls in preventing or detecting inappropriate payments and to test specific transactions for appropriateness.

Overall, limited testing of transactions and controls in place provided reasonable assurance that payments were appropriate. We did not identify any payments that would constitute a misappropriation of university funds. However, in some transactions tested, errors were identified that should have been detected at both the unit level and by FAST prior to payment. In general, a review of payments processed outside of FAST by units processing specialized transactions appeared reasonable and appropriate.

The following issues requiring management corrective action were identified during the review.

- A. Unauthorized Bank Account/Fictitious FIS Vendor:** A campus unit had established a longstanding checking and savings account at a local credit union using the university's tax ID number without proper approval, oversight or detection by campus management. A fictitious vendor had been inappropriately created in FIS and used to fund the account.
- B. Multiple One-time Vendor Payments:** Two vendors were inappropriately paid multiple times using the one-time vendor process.
- C. Payment With Multiple Problems Approved and Paid:** A direct payment reimbursement for \$5,416 to an employee should not have been approved and paid as it included entertainment expenses; payments to a third party that should have been tax reported; and lacked original receipts.
- D. Miscellaneous Services Account Code Used Improperly:** Four of 26 direct payment transactions coded as miscellaneous services were reimbursements for other payments for tangible goods and not services.
- E. Donation Payment Approval:** Direct payments were made for donations without senior officer approval.
- F. Reimbursement Guideline Proposal:** Financial Affairs has proposed guidelines limiting the use of reimbursements using direct payments. These guidelines will need to be balanced with the increase in workload required to approve exceptions.

Management agreed to all corrective actions recommended to address risks identified in these areas.

Observations and related management corrective actions are described in greater detail in section III of this report.

II. INTRODUCTION

Purpose

The purpose of the audit was to review specific purchase order invoices and direct payment transactions and related internal control processes to determine if internal controls were sufficient to prevent or detect any inappropriate payments.

Background

Campus disbursements are made using a purchasing card, a purchase order, or a direct payment request. Purchase order invoice payments and direct payments are processed by the Financial Administrative Services & Transactions office (FAST) and within campus units with specialized needs. This decentralized process is more complex than channeling all payments through a central process, such as FAST, but allows for subject expert oversight and approval for unique processes.

The Banner Financial Information System (FIS) is a financial data management and reporting system. Using fund accounting, FIS tracks monies received from various sources (state, federal, students, public, etc.) and accounts for how those monies are spent. FIS payments are generated by either purchase order related invoices or direct payment requests. Purchase orders are created in the CruzBuy system, which interfaces with FIS to encumber funds until invoices are paid.

The process of creating requisitions and purchase orders using CruzBuy offers controls in that an on-line approval queue is established based on individual buyer's authority for specific FOAPALs¹. Purchase orders that exceed the unit's approval authority are routed through the Procurement and Business Contracts office for further review and approval. This process assures that appropriate contract language is attached to each purchase order, competitive bidding is carried out when required by State law, and the best price for goods is achieved through negotiations and/or existing contracts with preferred vendors.

After purchase orders are created, the supplier invoices the university. Invoices that are within established purchase order tolerances are paid by FAST or the distributed office of record unit. If the invoice amount is more than established tolerances, the originating unit and/or Procurement and Business Contracts is asked to process a change order or obtain a corrected invoice before payment is processed. In FY 2011, 55,940 purchase order invoice payments were processed totaling \$171.7 million.

Direct payments are the modern equivalent of the old check request system and simply produce checks to the desired payee (vendor) from the accounts FOAPAL specified by the unit making the request. Direct payments do not encumber funds and bypass most of the controls and processes

¹ FOAPAL consists of a UCSC Banner FIS chart of accounts (Fund Organization Account Programs Activity Location) assigned either by the Planning and Budget office or by the Accounting office.

involved in creating purchase orders thru CruzBuy. The primary control for assuring direct payments are appropriate and in compliance with university policy lies with the staff and/or faculty who have signature authority on the individual FOAPALS. These individuals approve the direct payment request forms (paper) that are sent to either FAST or to the distributed office of record for processing.

Administrative and academic divisional offices may also review and approve direct payment requests as an additional control, although this process varies from division to division. Senior Officers are ultimately responsible for delegating signature authority and divisional review procedures

The units outside of FAST that process payments include: Physical Plant, Physical Planning & Construction, Payroll Office, Baytree Bookstore, McHenry Library, Fleet Services, UCO Lick, and Student Business Services. These offices are responsible for processing payments and conduct a final review to determine if the transaction has been appropriately authorized and is being paid in the proper manner.

Vendors in FIS are normally set up in the FIS database by FAST using a modified State of California 204 form. This form collects taxpayer ID information for vendors who may receive tax reportable payments and information about women or minority owned businesses required for federal contracts and grants.

FIS allows direct payments to be processed as “one-time” vendors. For one-time vendor direct payments, the payee’s name and address is keyed directly into the payment form, but the information is not stored in the vendor database and no vendor history is preserved that would enable FAST to detect duplicate payments or verify that specific payments have been made. Accordingly, these payments are considered inherently higher risk as there is no vendor history preserved and system controls to prevent duplicate payments are disabled.

UNEX course refunds constituted a large number of one-time vendor payments. Refunds were one of the stated purposes for using one-time vendors. Reconciliation of UNEX one-time vendor refunds was addressed in the UNEX It System Development consultation SC-11-50. In FY 2011, the university made 17,442 direct payments to vendors set up in the vendor database and 1,714 payments to one-time vendors. The dollar totals for these direct payments were \$57.7 million and \$2.3 million, respectively.²

Scope

The scope of our review was to evaluate the adequacy of controls to prevent or detect inappropriate payments. The audit included testing of specific transactions to identify problems

² Student payments originating from an AIS interface are also treated as one-time vendor payments to facilitate processing in FIS, but since they are not manually entered and AIS provides the controls they were removed from the totals and not included in our sample.

and/or provide assurance that controls are functioning as intended. The audit specifically included:

- Interviews with FAST and unit staff responsible for processing payments, reconciling payments to ledgers and/or balance sheet accounts, and interview with staff responsible for requesting refunds and other types of payments.
- High level review of data from all FY 2011, payment transactions.
- Data mining techniques to select judgment samples of potentially high risk transactions for detailed testing.
- Detailed testing of supporting documentation for 50 transactions and detailed review and questioning of 164 transactions.
- Reviewed controls in three of the distributed offices and found them to be sufficient.

III. OBSERVATIONS REQUIRING MANAGEMENT CORRECTIVE ACTION

A. Unauthorized Bank Account/Fictitious FIS Vendor		
<p>A campus unit had established a longstanding checking and savings account at a local credit union using the university's tax ID number without proper approval, oversight, or detection by campus management. A fictitious vendor had been inappropriately created in FIS and used to fund the account.</p>		
Risk Statement/Effect		
<ol style="list-style-type: none"> 1. When a university bank account is created without the knowledge or authorization of university management, the account will not be subject to the controls required of university bank accounts and account funds may be exposed to the risk of misappropriation. 2. When there is no documentation identifying and approving vendors in the FIS vendor database, there is the risk that disbursements could be made to a fraudulent vendor. 		
Agreements		
A.1	CASFS assistant director will assure the bank accounts are closed and CASFS staff are instructed on how to make appropriate payments to support the "Apprenticeship in Ecological Horticulture" program.	Implementation Date
		1/20/2012
		Responsible Manager
		CASFS assistant director
A.2	General accounting manager will spot check the first 10,000 vendors set up in the FIS vendor database to assure that they all appear to be legitimate vendors with appropriate supporting documentation.	Implementation Date
		4/30/2012
		Responsible Manager
		General accounting manager

A. Unauthorized Bank Account/Fictitious FIS Vendor - Detailed Discussion

Controls should be sufficient to prevent the creation of and detect unauthorized bank accounts using the university's tax ID number, as well as fictitious vendor accounts. Whenever identified, these accounts should be immediately closed and fictitious vendors removed from FIS.

In 1995, a FIS vendor was inappropriately created by the Center for Agroecology & Sustainable Food Systems (CASFS) within the Social Sciences division with the name "Apprenticeship in Ecological Horticulture."

Payments from AmeriCorps, a federal financial aid program for “Apprentice Educational Awards” were deposited to a FOAPAL that was used to make direct payments to this vendor. The checks were mailed to the Agroecology campus mail stop and were deposited into a Santa Cruz Community Credit Union check and savings account. The bank confirmed these accounts were created using the university’s tax ID number and that it had existed since the 1980s.

Upon learning of the existence of the bank account, Financial Affairs requested that Social Sciences close out the bank account and the Social Science Division requested bank statements from CASFS. CASFS provided statements dating back to April 2011. A review of these statements indicated that the account was used to both write checks and withdraw cash.

In addition, Financial Affairs indicated that the fictitious vendor was created in 1995, at a time when both General Accounting and Accounts Payable were setting up many vendors within a short period of time to accommodate the implementation of FIS. To search for any other fictitious vendors that may have been set up during that time, we provided a list of the first 10,000 vendors created in the FIS database to General Accounting, who agreed to spot check the list with existing records, including 204 forms and search for other vendors created like this. General Accounting has not identified similar vendors from the list.

While the checking and savings accounts may likely to have been established in good faith to support the program with no intent to misappropriate university funds, campus management was unaware that the account existed, and there was no way to know the appropriateness of transaction activity.

IAS has issued a separate management letter to the Controller and senior Social Science management with greater detail about the checking account and CASFS business practices.

B. Multiple One-time Vendor Payments		
Two vendors were inappropriately paid multiple times using the one-time vendor process.		
Risk Statement/Effect		
There is the risk that duplicate payments to one-time vendors will not be detected, as one-time vendors do not have a vendor history in FIS or system controls to detect and prevent duplicate payments.		
Agreement		
B.1	The FAST accounts payable manager will assure that the NOVA vendor is added to the vendor database before any more payments are processed.	Implementation Date
		2/28/2012
		Responsible Manager
		FAST accounts payable manager

B. Multiple One-time Vendor Payments - Detailed Discussion

One-time vendor payments should not be used without first considering whether or not the payee is or should be included in the vendor database, and processed through the accounts payable process.

UNEX submitted 21 payments to NOVA for student refunds through the one-time vendor process. Student Business Services processed 32 refunds to the US Department of Education as one-time vendor payments. Both units commonly utilized the one-time vendor payment process without considering the appropriateness of using the one-time vendor process.

One-time vendors do not have a vendor history in FIS or system controls to detect and prevent duplicate payments. Researching past payments is much more difficult on a one-time payment than for a vendor within the vendor database.

In the case of the UNEX, the vendor had not been established in the vendor database. UNEX orally agreed to ask this vendor to complete a "Payee Setup Form (204)" to be added to the database, as they are an organization with which UNEX continues to do business.

For the U.S. Department of Education payment, the vendor was already established in the FIS vendor database. The Student Business Services employee processing the U.S. Department of Education payments did not look to see if the vendor was already set up in the vendor database. The director of FAST provided one-on-one training with the Student Business Services employee, and subsequently, multiple one-time vendor payments to this vendor ceased after the training date.

C. Payment with Multiple Problems Approved and Paid		
A direct payment reimbursement for \$5,416 to an employee should not have been approved and paid as it included entertainment expenses; payments to a third party that should have been tax reported; and lacked original receipts.		
Risk Statement/Effect		
<ol style="list-style-type: none"> 1. Entertainment expenditures by the university are exposed to public scrutiny and if inappropriate can affect its public image and reputation. 2. The university could be subject to penalties for not fulfilling 1099 tax reporting requirements. 3. Without original receipts, the inappropriate use of funds could go undetected. 		
Agreement		
C.1	The FAST accounts payable manager will assure staff understand their responsibilities to review and detect noticeable, inappropriate payments and inform the person approving the direct pay request of the problems with the payment.	Implementation Date
		1/3/2012
		Responsible Manager
		FAST accounts payable manager

C. Multiple One-time Vendor Payments - Detailed Discussion

Reimbursements should not be approved and paid unless they are in compliance with UC and campus policies, IRS regulations, and include the appropriate receipts.

One employee reimbursement for a conference totaling \$5,416 included approximately \$800 for 69 bottles of wine and other drinks and food. These items should have been processed and coded as entertainment expenses. There was no host signature or list of guests provided, as required by entertainment policy. The UCSC Entertainment reimbursement form and policy, which should have been used for this transaction which states:

The guest list information is required in order to establish the business relationship to the University of the participants being entertained. If a list is not available, attach invitation list, flyer, newspaper announcement, etc. being entertained. If a list is not available, attach invitation list, flyer, newspaper announcement, etc.

and

I certify that I served as the official University representative at the event or meeting described above and that the event or meeting served a valid, direct University business purpose...

The reimbursement also included a "contractors invoice" for Mariachi music for which the employee paid \$1,000. Other FIS payments made directly to this Mariachi group have been 1099 tax reported.

The reimbursement also included a copy of a check made out to the UC Regents for \$1,000. The check had a description written that said, "UCSC Conference Advance," but no receipt or evidence that the check had been paid and cashed was provided.

D. Miscellaneous Services Account Code Used Improperly		
Four of 26 direct payment transactions coded as miscellaneous services were reimbursements or other payments for tangible goods and not services.		
Risk Statement/Effect		
The misclassification of payments hinders detailed budget monitoring and impacts the accuracy of financial reporting.		
Agreement		
D.1	The FAST accounts payable manager will assure that staff are trained to identify process payments incorrectly coded as services when they are obviously payments or reimbursements for tangible goods.	Implementation Date
		1/3/2012
		Responsible Manager
		FAST accounts payable manager

D. Miscellaneous Services Account Code Used Improperly - Detailed Discussion

Direct payments coded as miscellaneous should more accurately differentiate between services and tangible goods.

Four of 26 direct payments coded with account code 001260, miscellaneous services were reimbursements for tangible goods or other payments not involving provision of services to the University. These four payments totaled \$8,406. The misclassification of goods versus services impacts the accuracy of financial reporting of the campus. In some cases an interpretation is required to determine the best way classify the expense. For example, one of the transactions noted was a reimbursement for brochures. Since the transaction included sales tax, one could conclude it was tangible goods. However, it was pointed out to us that the primary cost in obtaining custom made brochures was the service charges involved in printing. We agree these determinations are not always simple and confirmed that FAST had a process in place to appropriately classify goods vs. services. The director of General Accounting indicated that a recent state audit had the same finding regarding the inappropriate use of account code 001260 and that UCOP was responding to the state audit finding as a system-wide issue.

E. Donation Payment Approval		
Direct payments were made for donations without senior officer approval.		
Risk Statement/Effect		
When the university makes donations it must take extra steps to avoid any appearance of favoritism or a conflict of interest.		
Agreement		
E.1	The FAST accounts payable manager will assure that their staff reviews payment requests for senior officer approval when required.	Implementation Date
		1/6/2012
		Responsible Manager
		FAST accounts payable manager
E. Donation Payment Approval - Detailed Discussion		

Direct payment requests involving donations should be approved by a senior officer when required.

In FY 2011, UCSC made 67 direct payments coded as donations totaling \$39,680. We reviewed five donations in detail and found that senior officer approval was not obtained for three of the five payments. We reviewed the FIS data for all 67 payments and found that 41 appeared to be actual donations to non-profit entities. The remaining 26 payments were mostly for retirement gifts and related reimbursements, and were miscoded as donations.

The campus is currently developing a new policy to govern donations. In the past, the campus had a guideline for donation payment types, but it was not supported by policy and was removed from Financial Affairs policy website. The new direct payment form no longer lists “donations” as one of the payment types; however, for all the donations we reviewed, the old direct payment form was used. The old form specifically stated that donations were a restricted use payment and senior officer approval was required.

Lacking current policy guidance, units making these payments should have followed the instructions on the form they were using and FAST should have verified that senior officer approval had been obtained. We were told that the current donation draft policy requires senior officer approval.

F. Reimbursement Guideline Proposal		
Financial Affairs has proposed guidelines limiting the use of reimbursements using direct payments. These guidelines will need to be balanced with the increase in workload required to approve exceptions.		
Risk Statement/Effect		
Processing necessary exceptions to the guidelines may reduce the efficiencies the guidelines were created to achieve.		
Agreements		
F.1	The FAST accounts payable manager and FAR accounting services director will consider whether requiring detailed explanations for reimbursements over \$500 or for receipts greater than 120 days old be incorporated in the proposed guidelines to limit the number of transactions requiring exceptional approval from the divisions.	Implementation Date
		7/2/2012
		Responsible Manager
		FAST accounts payable manager
F.2	The FAST accounts payable manager and FAR accounting services director will include exceptional approval procedures in any reimbursement guidelines proposed.	Implementation Date
		7/2/2012
		Responsible Manager
		FAST accounts payable manager
F.3	If reimbursement guidelines are implemented, the FAST accounts payable manager and FAR accounting services director will monitor for their effectiveness and assure that any increase in workload is justified by improved controls and/or increased use of CruzBuy and purchasing cards.	Implementation Date
		7/1/2013
		Responsible Manager
		FAST accounts payable manager

F. Reimbursement Guideline Proposal - Detailed Discussion

Generally, processing payments using the purchase order or ProCard mechanism is more efficient and better controlled than using a direct pay reimbursement process. In addition, a timely submission of reimbursement requests and current receipts helps promote accurate and appropriately supported reimbursements.

To reduce the use of the direct pay reimbursement method and to improve controls over the process, FAST and FAR have proposed reimbursement guidelines, which would;

- limit the amount of reimbursements to \$500 for goods or services that could have reasonably been purchased using either CruzBuy or the Pro-card, and
- Impose a deadline for submitting receipts for reimbursement to 120 days.

There is currently no policy limiting reimbursement amounts or the time that receipts can be collected before submission for reimbursement. FAST staff cited concerns that when people saved receipts for things like office supplies for a long time before submitting them it would be difficult to verify they were all business related expenses. We did not find any transactions with old saved receipts in our testing samples but in general, we agree that receipts should be submitted timely so that unit level management can better verify all purchases were business related.

FAST and FAR conducted a survey to determine why employees used the direct pay reimbursement process rather than purchase orders or ProCards. The most common reason cited for purchasing the products and seeking reimbursement was an immediate need for the product, followed by the convenience, the user did not have a purchasing card, the vendor did not accept purchase orders, and the vendor was not in the CruzBuy system.

To understand the impact of implementing a \$500 threshold on direct payments, we quantified the number of direct payments employee reimbursements of \$500 and over and found that there were 478 such payments made during FY 2011. If new guidelines would truly cause more of these purchases to be made via CruzBuy or purchasing cards that would be a positive development for the campus.

However, requiring 478 instances where a reimbursement has to be returned to the department for exceptional approval would create additional workload for both FAST and the divisions. As a result, the \$500 limit on reimbursements may be more difficult to implement and enforce than the benefit gained. There will always be some unavoidable reimbursements for more than \$500 and if the guidelines were implemented, there would have to be a process for employees to obtain exceptional approval for amounts over this limit.

A compromise solution may be that users are required to provide a detailed explanation why CruzBuy or ProCards could not be used for any reimbursements over \$500 or why receipts over 120 days old are being turned in. This would at least force employees to consider alternative purchasing methods. If the explanation was not provided or was not sufficient to justify the reimbursement, they could then require an exceptional approval.

Raising the threshold from \$500 to \$1000 during FY 2011, reduced the number of reimbursements falling under this exception to 188, so FAST and FAR may consider this dollar limit as an optimum balance.
