



AUDIT AND ADVISORY SERVICES

Procurement in the International Environment Audit Project No. 16-668

April 7, 2017

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April 7, 2017

Scott Bidy
Interim Vice Chancellor
Administration and Finance

Vice Chancellor Bidy:

We have completed our audit of Procurement in the International Environment as per our annual service plan in accordance with the Institute of Internal Auditors' *Standards for the Professional Practice of Internal Auditing* and the University of California Internal Audit Charter.

Our observations with management action plans are expounded upon in the accompanying report. Please destroy all copies of draft reports and related documents. Thank you to the staff of Supply Chain Management and the Controller's Office for their cooperative efforts throughout the audit process. Please do not hesitate to call on Audit and Advisory Services if we can be of further assistance in this or other matters.

Respectfully reported,

Wanda Lynn Riley
Chief Audit Executive

cc: Associate Vice Chancellor and Chief Financial Officer Rosemarie Rae
Assistant Vice Chancellor and Controller Delphine Regalia
Acting Chief Procurement Officer Stacey Templeman
Director Joyce Sturm
Interim Senior Vice President and Chief Compliance and Audit Officer John Lohse
Associate Chancellor Khira Griscavage

University of California, Berkeley
Audit and Advisory Services
Procurement in the International Environment

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OVERVIEW

Executive Summary

Audit and Advisory Services (A&AS) completed our audit of procurement in the international environment as part of our annual service plan for FY 2016. The overall objective of our audit was to assess the adequacy of procedures and controls designed to mitigate certain key risks uniquely associated with purchases from foreign vendors or purchases delivered/used in foreign countries.

During FY 2015, campus payments to foreign suppliers totaled approximately \$15 million or 2-3% of total campus procurement activity; this estimate excludes payments made to foreign individuals or entities that would not be considered a procurement action, including, but not limited to, expense reimbursements, stipends, or honoraria. Campus business processes and policies pertaining to foreign purchases are largely the same as for domestic purchases, except for a few additional requirements imposed by external regulatory bodies such as Office of Foreign Assets Control (OFAC), the Internal Revenue Service, and United States Customs and Border Protection.

Our audit procedures were focused on central campus processes and included interviews with campus Supply Chain Management (SCM) and Controller's Office personnel, walkthroughs of procedures and controls, and reviews of related policies and documentation. Our procedures were designed to evaluate the design of current processes to mitigate risks associated with the areas in the scope of our audit, and did not include an assessment of individual transactions or overall campus compliance with relevant laws, regulations, and policies.

We noted that the design of procedures and controls uniquely related to international procurement activities may not be fully aligned with policy and regulatory requirements or may not adequately manage related risks, as follows:

- OFAC restricted party verification is currently performed after the purchase occurs, when a payment obligation to the vendor likely has already been created, instead of at the time of supplier acceptance and/or before the purchase contract is issued, resulting in potential financial and compliance exposure for the campus;
- current procedures/controls to support compliance with foreign supplier tax withholding and reporting requirements do not provide adequate assurance that all supplier information required by federal tax rules is obtained or that all payments are properly evaluated for reporting/withholding treatment;
- changes to the vendor master file made by Accounts Payable (A/P) personnel are not currently monitored such that fraudulent vendors and payments may be created and go undetected; and
- guidelines related to foreign purchase handling have been developed for SCM buyers but have not yet been fully vetted by or communicated to key campus stakeholders, such as requisition creators in Campus Shared Services.

Management agrees with the observations and has developed management action plans to address the related risks.

Source and Purpose of the Audit

A&AS completed our audit of procurement in the international environment as part of our annual service plan for FY 2016. The overall objective of our audit was to assess the adequacy of procedures and controls designed to mitigate certain key risks uniquely associated with international procurement activities.

Scope of the Audit

Our audit included an assessment of procedures and controls related to international procurement activities as of the second quarter of FY 2016. For purposes of our audit, we defined our scope as those purchases covered by University of California Business and Financial Bulletins BUS-34 (*Securing the Services of Independent Consultants*) and BUS-43 (*Materiel Management*) that are either (i) from foreign suppliers (regardless of the performance/end-use location) or (ii) from domestic suppliers performed in/delivered to foreign locations. Procedures related to international sub-awards, real estate transactions, and business contracts related to research, educational, and outreach activities with foreign partners were not included in this audit. Purchases that are made locally in foreign countries and that are not routed through central campus buyers were also not included.

Areas of audit focus included elements of the end-to-end procurement business process that are unique to foreign (versus domestic) suppliers, including

- supplier selection and due diligence procedures, including compliance considerations (e.g., OFAC restrictions) and operational considerations (e.g., compatibility with destination country infrastructure);
- federal and state tax withholding and reporting requirements; and
- foreign supplier contracting and payment considerations (e.g., requirements for non-standard university terms and conditions and monitoring procedures).

Our audit procedures were focused on central campus processes and included interviews with campus SCM and Controller's Office personnel and walkthroughs of procedures and controls. We also reviewed a small sample of foreign purchase transactions and relevant campus procedures and training/guidance materials. Our procedures were designed to evaluate the design (versus the ongoing operating effectiveness) of current processes to mitigate risks associated with the areas in scope of our audit, and did not include a detailed review of specific purchases or an overall assessment of campus compliance with relevant laws, regulations, and policies.

Background Information

During FY 2015, campus payments to foreign suppliers totaled approximately \$15 million or 2-3% of total campus procurement activity; this estimate excludes payments made to foreign individuals or entities that would not be considered a procurement action, including, but not limited to, expense reimbursements, stipends, or honoraria. The largest categories of campus purchases from foreign suppliers, representing approximately 90% of foreign procurement activity, are for laboratory/technical equipment and supplies; software; library books and materials; consulting fees; and miscellaneous expenditures and services. Campus business processes pertaining to foreign purchases are largely the same as for domestic purchases, with low value dollar purchases

(less than \$5,000) processed by individual departments and Campus Shared Services Business and Financial Services (CSS B&FS), and higher value dollar purchases (greater than \$5,000) and/or higher risk purchases (such as controlled substances or explosives) processed by designated campus buyers within SCM or certain campus departments. Accounts Payable staff review all payments to evaluate tax withholding and reporting requirements, and payments to foreign vendors are forwarded for further review and handling by one of three foreign tax analysts in the Controller's Office.

Similarly, there is one set of university policies (BUS-34 and BUS-43) that covers both domestic and foreign purchase activities, with a small number of additional requirements stipulated for foreign purchases (e.g., the requirement that purchase contracts for foreign-made goods incorporate provisions related to forced, convict, or indentured labor). Policies also refer generally to "other governing requirements" under federal and state laws and regulations that might be relevant to foreign purchases. Examples of such requirements include those imposed by external regulatory bodies such as OFAC and United States Customs and Border Protection.

Summary Conclusion

Campus processes pertaining to purchases from foreign suppliers are largely the same as for domestic suppliers; however, foreign purchases do entail additional risk considerations that should be managed. We noted the design of procedures and controls related to certain areas are not currently fully aligned with policy/regulatory requirements or may not adequately manage related risks, as follows:

- OFAC restricted party verification is currently performed after the purchase occurs, when a payment obligation to the vendor likely has already been created, instead of at the time of supplier acceptance and/or before the purchase contract is issued, resulting in potential financial and compliance exposure for the campus;
- current procedures/controls to support compliance with foreign supplier tax withholding and reporting requirements do not provide adequate assurance that all supplier information required by federal tax rules is obtained or that all payments are properly evaluated for reporting/withholding treatment;
- changes to the vendor master file made by A/P personnel are not currently monitored such that fraudulent vendors and payments may be created and go undetected; and
- guidelines related to foreign purchase handling have been developed for SCM buyers, but have not yet been fully vetted by or communicated to key campus stakeholders, such as buyers in Campus Shared Services.

Management agrees with the observations and has developed management action plans to address the related risks.

SUMMARY OF OBSERVATIONS & MANAGEMENT RESPONSE AND ACTION PLAN

Supplier Due Diligence

Observation

Verification that suppliers are not restricted parties under OFAC is performed at the time of payment, but not at supplier set-up. Similarly, there is not a process in place to identify updates to supplier status (i.e., being added to the OFAC list after initial supplier set-up) on an on-going basis. Therefore, the risk of purchasing from a sanctioned country or restricted supplier is not adequately mitigated.

In addition to these compliance verification steps, management may also wish to consider the importance of performing additional supplier due diligence for larger transactions given the potential difficulty of enforcing the standard university terms and conditions in foreign jurisdictions.

Management Response and Action Plan

SCM is currently verifying the OFAC status of existing suppliers whose restricted/debarred status was not previously checked. In addition, by October 1, 2017, SCM management will implement procedures to perform OFAC supplier verifications for all new suppliers prior to supplier acceptance.

Foreign Supplier Tax Requirements

Observation

Under the Foreign Account Tax Compliance Act, the campus (as a withholding agent) is required to collect and report information about its foreign suppliers and related payments. At the time of our audit, the campus was collecting the required data for a subset of foreign suppliers (those with withholdable payments); however, the IRS requirement more broadly requires that these forms be collected for all foreign suppliers regardless of the nature of the transaction. Prior to the audit, SCM and Controller's Office management had identified the need to evaluate and update related processes.

In addition, we noted an opportunity for management to strengthen the process to route foreign supplier payments to the foreign tax analyst for review/assessment. The current process requires manual intervention and there are no back-end reporting/monitoring procedures; therefore, there is a risk that payments may not be properly routed and evaluated for tax withholding or reporting requirements.

Management Response and Action Plan

Supply Chain Management – By October 1, 2017, SCM management, in coordination with the Controller's Office, will develop and implement a process that addresses foreign supplier tax

requirements. Because of the complexity of this undertaking, the roll-out will include a change management/communications plan for campus customers and suppliers.

Accounts Payable – As a result of the audit findings, the Accounts Payable department has provided an additional in depth training session for all staff that handle invoice transactions that may involve foreign tax implications. This training will be repeated on an annual basis. Included with the training was a reinforcement of the importance of adhering to these requirements. A more automated system based solution was evaluated, but it was determined that SciQuest, the system in which the transactions are being entered and routed for review/approval, did not have the capability to identify transactions to foreign entities and, based upon that criteria, automatically route for additional workflow review. In lieu of an automated solution, beginning at the outset of fiscal year 2018, we will be running a BFS query on a periodic basis to identify all transactions that were posted in the prior period that were to vendors with a foreign address and verify that all applicable transactions that should have been routed for tax review were properly routed.

Segregation of Duties

Observation

A/P department team members have access to update the vendor master file to help facilitate necessary changes to tax withholding codes and other payment-related data. However, access is not restricted to specific data elements and there is currently no monitoring to ensure that A/P changes to the vendor master file outside of the tax withholding data are appropriate. Absent such monitoring, data elements of the vendor master file could be changed that would allow for fraudulent suppliers/payments to be created and go undetected.

Management Response and Action Plan

By October 1, 2017, SCM and the Controller's Office will implement procedures to address the segregation of duties risk noted. The preferred solution is for the Controller's Office to create a user role that will allow for restricted access to the master file that aligns with business needs – such a role existed previously and could be restored.

Foreign Purchase Order Handling

Observation

Because there are compliance, financial, and operational considerations that are unique to foreign purchases (such as OFAC sanctions, export control restrictions, Buy American Act regulations, customs requirements, tax handling requirements, and potential limitations on the enforceability of standard university contracts), ensuring buyers and end-users have a reasonable understanding of these issues is warranted. At the time of our audit, guidelines relating to foreign purchases were being developed for SCM buyers. We understand that input from the Risk Services office and the Office of Legal Affairs had been obtained. We further recommend that input from other key offices (e.g., Research Administration and Compliance) also be obtained to ensure the completeness of guidelines, and that the guidelines be provided to the CSS B&FS organization as well as to end-users for their reference and use.

Management Response and Action Plan

A number of actions have already been taken to date, including the delivery of various training sessions and the expansion of documented guidelines to assist buyers in managing foreign purchase risks and requirements. The SCM website has also been updated to provide information to customers about foreign shipping requirements, including export control considerations.

In addition, by October 1, 2017, SCM management will deliver a training session for the CSS staff to increase their knowledge and understanding of issues around export controls and international transactions in general.