



City Wide Charge Account Audit

**Audit Report 12-02
August 2013**

August 5, 2013

Members of the City Council:

The purchasing process is one of the most important government fiscal functions. The Rapid City City Council approved this audit of the City Charge Account Program as part of the COMPASS 2012 Audit Plan.

Purchasing of supplies and materials is decentralized throughout the organization. The amount of purchases made under the charge account program as well as the policies and procedures for making purchases vary greatly throughout the City. The City Charge Account Program and City purchases can be strengthened in a number of ways.

Effective controls over purchasing require the development of written policies and procedures, consistently following those procedures and ensuring that City managers and staff understand the purpose of effective controls. In a decentralized operating environment like Rapid City, strong policies and procedures are especially important.

We have made four recommendations to strengthen purchasing policies, procedures and practices. We provided the Mayor, the Finance Officer, and the director of the Community Resources Department with a draft of this report on June 20, 2013. Management's response is included in this report. We greatly appreciate the cooperation and assistance of City managers and employees with this audit.

We would be happy to discuss our audit conclusions, findings, and recommendations with any member of the City Council, City staff, or citizen.

This audit was conducted by Kelan Kelly and Sarah Kuntz.

Kelan Kelly
Chief Auditor

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Introduction

A charge account program is simply a method of payment for purchases made. A charge account program must have controls specific to the method of payment, but it is necessary to look at the existing controls for the entire purchase process, from the determination of the need for an item to the payment for the item. This audit reviewed the City's current purchasing policies and procedures, as well as specific policies and procedures for administering the charge account program. Purchasing can be especially vulnerable to fraud since it involves cash disbursements, and risks are increased when employees can walk into local merchants and "charge" purchases to the City. Proper purchasing controls will provide for savings; enhance supplier relationships and buying channels; and promote efficient and effective transaction processing.

Purchasing audits assess the adequacy and effectiveness of internal controls throughout City departments. Purchasing audits consist of objective review and evaluation of the practices and procedures used by City employees related to making responsible purchases with City resources, while considering the quality of goods and services desired.

Our review of purchasing operations focused primarily on the following four audit objectives:

1. Determine if internal controls and program requirements are adequate to safeguard against loss and misuse of City resources;
2. Determine if City vendor charge accounts are used by employees consistent with established policies and procedures;
3. Determine if alternative methods of procuring goods and services would result in increased efficiency and effectiveness; and
4. Determine if alternative methods of procuring goods and services would result in cost savings for the City.

Scope and Methodology

This audit focused on written policies and procedures used by departments when making purchases, as well as controls used by vendors when purchases are charged to the City's account. The audit work involved reviews of current practices reportedly used by departments and a cursory review of transactions from selected local vendors for January 2012 through March 2013.

In conducting this audit, staff employed a number of audit methods and techniques. Staff reviewed relevant literature on purchasing from the AICPA, COSO, GAO and GFOA to develop criteria for effective purchasing controls. We also reviewed audit reports from other jurisdictions. We obtained descriptions of current purchasing practices and controls from the Finance Office as well as from individual departments. We requested and reviewed written policies and procedures from all departments as well as four local vendors. Staff analyzed expenditure reports from the City's accounting system. Finally, we interviewed management and staff.

Compliance with Government Auditing Standards

We conducted this audit in accordance with generally accepted government audit standards. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our audit findings and conclusions based on the audit objectives. We believe that the evidence obtained provides a reasonable basis for the conclusions and findings based on the audit objectives.

Background

In the City of Rapid City, departments are responsible for making purchases of goods and services necessary to carry out their functional operations. The City establishes charge accounts with essentially any vendor that will agree to send the City a bill for items purchased. The charge accounts most frequently used are established at a number of local businesses in Rapid City. In total, the Finance Office reports the City has over 30,000 vendors. Payments to vendors in 2012 totaled \$106,206,926¹. Purchases from vendors may range from small purchases such as irrigation supplies at local hardware stores to a large item ordered from out of state by Public Works for a repair to a component of infrastructure.

A few local vendors, such as Office Max, Scheels, and Menards, request a list of employees authorized to make purchases for the City. Sam's Club and Wal-Mart will issue a card to employees authorized to make purchases. At other vendors, anyone may walk into the store and potentially make a charge to the City charge account.

Purchase invoices are entered into IFAS for payment by the departments and then the original invoices are to be sent to the Finance Office. Vendor statements are sent to either the Finance Office or the departments. The Finance Office will reconcile the invoices collected from the departments to the statements they receive.

Purchasing practices reflect both the need to maintain good vendor relationships and the need to be responsible in the use of City resources. Effective controls protect resources from accidental loss and intentional misappropriation.

In general, sound purchasing principles require:

- An organizational structure and staffing resources sufficient to segregate incompatible responsibilities such as purchasing, receiving, and approval of purchases;
- A physical environment conducive to responsible purchasing; and

¹ Data was obtained from IFAS using the GL1002: GL Paid Transactions by Cost Center/Object, showing payments made between 1/1/2012 and 12/31/2012. The number presented does not include personnel (\$59,463,802) and debt service (\$14,346,786) payments. Due to the current coding used in IFAS, and limited reports currently available, we were unable to reasonably exclude other amounts. This amount includes transactions initiated by employees, including through contracts.

- Management oversight and guidance at an appropriate level for the purchasing environment.

For charge account programs, a well-designed system of internal controls is needed to provide reasonable assurance that the program is operating as intended, and is not vulnerable to fraudulent, improper, or abusive activities.

Conclusions

Currently, purchasing responsibilities are spread throughout the City. We found a number of areas where purchasing practices could be improved by implementing best business practices. Controls over purchases could be improved by developing policies and procedures for departments; identifying controls desired from vendors; and providing training for employees and managers with purchasing, receiving and approving duties.

Objective One: Determine if internal controls and program requirements (City and vendor) are adequate to safeguard against loss and misuse of City resources.

The Finance Office is charged with the responsibility for accounts payable under Rapid City Municipal Code 3.04. This responsibility includes the charge account program. During our review of purchasing and charge account policies and procedures, we noted a lack of City wide policies and procedures. Some departments have taken it upon themselves to develop policies and procedures. However, there is considerable inconsistency due to a lack of guidance. The Finance Office has not established purchasing guidelines to provide a framework for policies and procedures for City departments. And further, the Finance Office has not established guidelines to address specific methods of payment.

Objective Two: Determine if City vendor charge accounts used by employees are consistent with established City policies and procedures.

Rapid City does not have established policies and procedures for City vendor charge accounts or purchases. Additionally, Rapid City has no mechanism to require a sufficient level of performance from vendors.

Objective Three: Determine if alternative methods of procuring goods and services would result in increased efficiency and effectiveness.

Objective Four: Determine if alternative methods of procuring goods and services would result in cost savings for the City.

Purchasing Card Program

The purpose of a purchasing card (also known as a procurement card or p-Card) program is to provide organizations the opportunity to streamline their procedures for procuring and paying for goods and services. A p-card program will delegate the authority and capability of purchasing items directly to designated cardholders. It is a method of payment for employees to make purchases for official government business. A p-card program reduces the volume of accounts payable transactions and associated administrative costs by eliminating vendor statements and consolidating multiple vendor payments into one monthly payment.

GFOA recommends as a best practice, that governments explore the use of p-cards to improve the efficiency of their purchasing process. This guidance is based on the following benefits:

Benefits to cardholders:

- Convenience of purchasing without a purchase order;
- Expedited delivery of goods;
- Better pricing on goods;
- Expanded list of merchants from whom purchases can be made; and
- Reduced paperwork.

Benefits to government:

- Simplified purchasing and payment process;
- Lower overall transaction processing costs per purchase;
- Increased management information on purchasing histories;
- Reduced paperwork;
- Decentralized procurement function;
- Ability to set and control purchasing dollar limits;
- Ability to control purchases to specific merchant categories and vendors; and
- Receipt of rebates from the bank based upon dollar volume of total purchases.

Benefits to vendor:

- Expedited payments;
- Reduced paperwork; and
- Lower risk of nonpayment.

Contracted and Cooperative Purchasing

Contracted and cooperative purchasing are strategies used in many forms and varied levels by most governments, in an effort to provide comprehensive purchasing services based on sound procurement practices and principles. Properly administered contracts/agreements have the potential to:

- Provide opportunities to negotiate prices and/or discounts;
- Satisfy recurring requirements;
- Ensure quality of goods and services;
- Reduce administrative costs by eliminating repetitive acquisition efforts;
- Leverage buying power through volume purchasing;
- Streamline ordering procedures; and
- Reduce procurement lead time.

Criteria

Criteria represent standards against which performance is measured. Depending on the audit topic, criteria may include laws, regulations, contracts, grant agreements, expected performance measures, benchmarks and defined business practices. Criteria identify the requirements, or desired state or expectation, with respect to program or operation. Rapid City does not have a formal, written city wide purchasing policy for the purchases of products or services, to include transactions through charge accounts. Therefore, our criteria consisted of guidelines issued by the Committee on Sponsoring Organizations of the Treadway Commission (COSO), recommendations from the American Institute of Certified Public Accountants (AICPA), guidance issued by the United States General Accountability Office (GAO), best practices from the Government Finance Officers Association (GFOA) and industry best practices for governmental purchasing activities. We were also guided in our work by Rapid City Municipal Code 3.04 which charges the Finance Office with the responsibility to manage accounts payable.

Based on this guidance, best practices for purchases include:

- Written policies and procedures;
- Segregation of duties;
- Established and appropriate levels of authorization;
- Controls over goods purchased;
- Controls over payment and approvals;
- Controls over inventory; and
- Determination of legitimate government need.

Findings and Recommendations

Prudence in the management of public funds requires that there be adequate control procedures in place to protect those funds. Controls over purchases, including through charge accounts, should be improved city wide. Open charge accounts may be in excess of 30,000 accounts, payments exceed \$106 million, and controls are lacking, there is significant risk for loss, misuse, and misappropriation of City resources. We have made a number of recommendations to ensure City resources are responsibly used and best practices for purchases are followed by City employees.

Policies and Procedures

Rapid City management and staff do not have adequate policies and procedures to guide them in making purchases to ensure they are obtaining the best quality product and service for the least cost.

City management and elected officials have not recognized the importance of establishing good internal controls. The Finance Office has not established appropriate purchasing guidelines to provide City staff with a framework for developing effective purchasing policies and procedures.

Lack of effective, written policies and procedures for purchasing activities results in the potential for loss and misuse of City resources, including inappropriate purchases.

- Recommendation 1:** We recommend the City Finance Office develop purchasing policies and procedures to provide guidance to City departments. City departments can further develop these purchasing policies and procedures specific to individual department needs. Policies and procedures should include, but are not limited to the following:
- Purchasing goals, tone at the top related to control over purchases;
 - Identify allowable and unallowable purchases;
 - Delegation of purchase and approval authority, to include periodic review;
 - Training requirements for employees with purchase and approval responsibilities (includes initial training and refresher training);

- Procurement and price comparison processes for acquisition of goods and services and required documentation;
- Process for purchase payments and approvals of transactions;
- Segregation of duties;
- Safeguarding of assets and inventory;
- Comparison of actual expenditures to budgeted expenditures;
- Periodic review of various levels of purchase functions; and
- Disciplinary actions.

Management's Response

While I completely disagree with the statement made that City management has not recognized the importance of establishing good internal controls, I agree that additional written policies and procedures need to be developed. The Finance Office will begin to develop additional purchasing guidelines to assist City departments in developing effective written purchasing policies and procedures that address goals, allowable/unallowable purchases, purchasing authority, safeguarding of assets, etc. We currently have some documentation (purchasing guidelines) that is provided to departments when requested. We believe the various departments keep this on hand for new employees. For more complete written policies and procedures, it will likely take 12-18 months for completion, depending on when vacancies can be filled.

Vendor Requirements

The Finance Office reports Rapid City makes purchases from over 30,000 vendors. Currently, no restrictions exist to limit the number of vendors or allow for proper vendor controls to ensure authorized employees are making legitimate and necessary purchases.

The City has allowed departments, divisions, and programs to make purchases from vendors of their choosing as long as they remain in compliance with RCMC 3.04.

The City lacks a mechanism to ensure vendors meet minimum requirements to adequately control City charge accounts, thus increasing the potential for loss, misuse, and misappropriation of City resources.

Recommendation 2: We recommend the City Finance Office seek City Council approval of an ordinance to require vendors to register with the City before allowing purchases to be made on account. This will give the City a mechanism to require a minimum level of performance adequate to minimize risks.

Recommendation 3: We recommend the City Finance Office develop guidelines and requirements, and policies and procedures for vendors, to strengthen controls around purchases and charge accounts for the City of Rapid City. In addition to purchasing controls the following should be included:

- Criteria for establishing and deactivating or cancelling accounts;
 - Application for credit;
 - Statements to be sent to Finance Office for reconciliation; and
 - Compliance with City vendor requirements.
- List of authorized purchasers;
- Require purchasers to show ID at the time of purchase;
- List of allowable and unallowable purchases; and
- Required documentation to receive payment.

Management's Response

The Finance Office will work with the City Attorney's office to prepare an ordinance for Council approval which would require vendors to complete an application/registration process prior to the City allowing purchases to be made on account. We are currently receiving notification of new hires and terminations so that authorized purchaser lists are current with the vendors. This project should take up to six months depending on the work load of the City Attorney's office. Additional controls will be included in the written policies and procedures noted in the first finding, which would likely take 12-18 months for completion.

City Identification

The City of Rapid City does not currently issue identification to all employees upon hire. The City has not recognized the need for employees to have proof of current employment to improve controls over purchasing.

Identification, or proof of employment, is often requested when a tax exempt purchase is made and during travel when governmental rates are desired. Additionally, City employees could be impersonated or employees that have left employment could pose as current employees and incur charges.

Recommendation 4: We recommend City management and Human Resources implement a process to provide City employees with City issued identification.

Management's Response

The Community Resources Department does not disagree with the finding of the Compass Program's charge account audit that City employees could be issued City identification in order to have proof of current employment with the City of Rapid City. The logical time for an employee to be issued City identification would be during their orientation by the Human Resources Division. An attempt should also be made to recover the identification along with other City property upon an employee's separation of employment with the City.

Human Resources can investigate the available equipment and software available to accomplish this process if directed to do so by the Mayor and/or City Council.

Auditor's Concluding Remarks

Expenditure data for 2012 was requested from the Finance Office for inclusion in the audit report, to quantify the significance of the findings. This data was not received prior to the issuance of the draft report on June 20, 2013. The Finance Officer provided 2012 expenditure data on July 16, 2013. The completion of the audit report was delayed so that we could include expenditure data in the report. However, the analytics of the data is limited due to the untimely receipt of the requested information.

The response from the City Finance Officer for Recommendation 1 stated that she disagrees with the statement that the City management has not recognized the importance of implementing good internal controls. During planning and fieldwork of this audit we requested current policies and procedures (from all departments and city wide) for purchasing goods and services. The response received from the Finance Office was "the City Municipal code that governs purchasing is 3.04. Each department may have their own procedures for purchasing; but we are not made aware of those." Since municipal code 3.04 charges the Finance Office with the responsibility to manage accounts payable, it is appropriate that guidance on sufficient internal controls would be established by the Finance Office. If management had recognized the importance of good internal controls, we would have obtained city wide policies and procedures during the course of our audit work.

The responses for recommendations 1, 2, and 3 provide an estimated implementation time of 12-18 months. Information and guidance is readily available through various resources, a 6 month timeline would be more appropriate.