



## **CITY OF KILLEEN**

### **ACCOUNTS PAYABLE AUDIT**

Audit Report #23-03

#### **A Report to the City of Killeen Audit Committee**

Committee Chair  
Committee Members

Ramon Alvarez  
Michael Boyd  
Debbie Nash-King  
Jack Ralston  
Bob Blair

#### **Prepared by**

The Internal Audit Department  
Matthew Grady, City Auditor  
July 2023

# EXECUTIVE SUMMARY



## AUDIT REPORT HIGHLIGHTS

### Why Was This Audit Conducted?

The City Auditor proposed this audit to the Audit Committee as part of an ongoing focus on the City's revenue streams.

The City Auditor appreciates the cooperation of the Finance Department's management and staff on this audit.

## Accounts Payable Audit

Mayor and Council,

I am pleased to present this audit of the Finance Department's Accounts Payable Process.

### Audit Objectives

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The objectives of the audit were to: (1) assess the adequacy of internal controls over the accounts payable process; (2) review the process for managing vendor files; and (3) review a sample of payments for support and authorization. The scope of the audit focused primarily on accounts payable activity for FY 2022.

### Audit Results

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The City Auditor's review of the Finance Department's accounts payable process found that management had established a robust system of internal controls to ensure the integrity of the process. The department issued about 10,000 payments in FY 2022, totaling nearly \$100 million. Best practices noted included the proper separation of duties, limited access to the vendor database, and both internal and external error checks. The internal control system could be further strengthened by fully documenting policies and procedures. Staff have made some efforts to document separate operations within accounts payable process. However, a more comprehensive approach is needed to fully document the process to ensure both consistency and continuity of operations. In addition, the use of foreign vendors, while not prohibited, has sometimes been problematic for staff in getting the information necessary to complete vendor files and process payments. In some instances, orders had to be cancelled, resulting in wasted staff work. Finally, there were about 5,000 long-dormant vendor files still active in the database that needed to be deactivated. This is a legacy issue caused by lack of upkeep in prior decades. Management and staff were aware of the issue and had begun work to resolve it prior to issuance of this report.

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## INTRODUCTION

The City Auditor conducted this performance audit of the City's Accounts Payable process pursuant to Article III, Chapter 40 of the City Charter, as Amended May 11, 2013, and in accordance with the City Auditor's Audit Plan approved by the Audit Committee on June 4, 2020, and amended January 13, 2022.

The objectives of the audit were to: (1) assess the adequacy of internal controls over the accounts payable process; (2) review the process for managing vendor files; and (3) review a sample of payments for support and authorization. The scope of the audit focused primarily on accounts payable activity for FY 2022. The audit did not include payroll transactions.

### Background

The accounts payable process is designed to pay vendors for goods and services purchased by the City. The process carries with it certain inherent risks, including the risk of overpayment to vendors, duplicate payments to vendors, and fraudulent payments to fictitious or unauthorized vendors.

The U.S. Congress' General Accountability Office (GAO) in its report titled "Improper Payments: Fiscal Year 2022 Estimates and Opportunities for Improvement," identified an estimated \$247 billion in payment errors by federal agencies. The GAO attributed the improper payments to the federal government's longstanding deficiencies in its internal controls.

### *Internal Controls*

Internal controls can be generally defined as a system of guardrails designed to minimize an entity's risks, protect their assets, ensure the accuracy of their records, and ensure adherence to policies, rules, regulations, and laws. In 1985, the first conceptual model for an internal control system defined the following five components essential to a well-functioning system of internal controls:



In the decades that followed, the GAO further developed the model, which now includes 17 subprinciples to the original 5 components.



While the conceptual model has become increasingly cumbersome, the purpose of the internal control system is relatively simple and can be summed up by answering the following five questions:

- (1) What is our objective, i.e., what are we trying to accomplish?
- (2) What are the risks that something bad may occur that will prevent us from achieving our objective?
- (3) What steps can we take to minimize those risks?
- (4) How do we ensure our employees understand this internal control process and their respective roles in the process?
- (5) How do we adjust for internal or external changes affecting the internal control process?

The specific features of well-functioning internal control systems will vary depending on the answers to these questions. However, there are certain concepts that are common to most well-functioning internal control systems, including the need for proper separation duties, the establishment of clear, comprehensive written policies and procedures, and the monitoring of the internal control system.

### *Separation of Duties*

One of the key aspects of any internal control system is the proper separation of what are considered "incompatible duties." Specifically, duties involving (1) the custody of assets, (2) authorization for use of assets, (3) recordkeeping, and (4) review should be handled by different individuals. Invariably, the occurrence of fraud or erroneous payments are the result of a breakdown in the system that allows for the consolidation of these duties under too few individuals.

Proper separation of duties in the accounts payable process would require that individuals responsible for ordering and receiving goods or services should not be able to authorize their own request, create a vendor file, enter transactions into the system, review transactions, or issue payments. Each of these activities ideally should be performed by different individuals. Limited staff may sometimes preclude the separation of all incompatible duties. In such instances, additional supervision would be warranted to mitigate the risk of fraudulent or erroneous transactions.

### *Written Policies and Procedures*

The fourth component of the internal control conceptual model refers to *Information and Communication*. Clear, comprehensive written policies and procedures serve several purposes: (1) they ensure the consistency of operations from one department to another; (2) they support continuity of operations in times of significant change; and (3) they provide an effective mechanism for training new staff.

### *Monitoring*

An internal control system can be affected by changes both internal and external to the control environment, and therefore should be monitored to ensure it is functioning as intended during times of change. Internal reorganizations, changes in technology, changes in banking institutions, and changes in accounting systems can all have an impact on the internal control system and management must be attuned to these changes and make appropriate adjustments to the system, as needed.

## **Statement of Compliance with Audit Standards**

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Those standards also require that we, as internal auditors, meet the criteria for independence. We believe that we met those independence standards, and that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.

## FINDINGS AND RECOMMENDATIONS

**The City Auditor’s audit of the Finance Department’s accounts payable process found the process was sound; however, it could be further strengthened by fully documenting policies and procedures, developing a policy on the use of foreign vendors, and deactivating long-dormant vendors still active in the vendor database.**

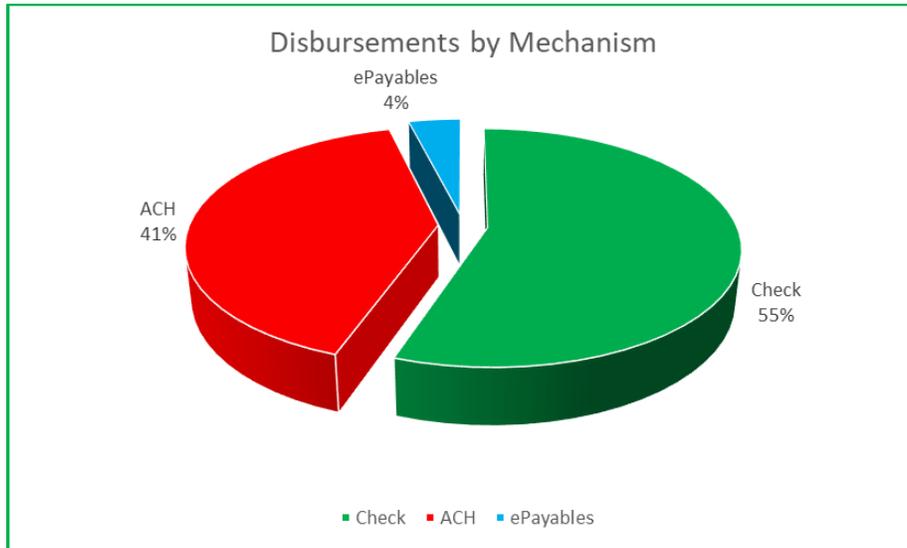
The City Auditor’s review of the Finance Department’s accounts payable process found that management had established a robust system of internal controls to ensure the integrity of the process. There were several best practices noted in the review, including the proper separation of duties, limited access to the vendor database, and both internal and external error checks. That said, the process could be further strengthened by addressing several issues. Both Accounting and Purchasing staff have made some efforts to document separate operations within accounts payable process. However, a more comprehensive approach is needed to fully document policies and procedures in place to ensure consistency of operations between departments and divisions, as well as continuity of operations during times of change. In addition, the use of foreign vendors, while not prohibited, has sometimes been problematic in the getting the information necessary to complete vendor files and process payments. In some instances, orders had to be cancelled, resulting in wasted staff work. Finally, there were about 5,000 long-dormant vendor files still active in the database that needed to be deactivated. This is a legacy issue caused by lack of upkeep in prior decades. Management and staff were aware of the issue and had begun work to resolve it prior to issuance of this report.

### **Accounts Payable by the Numbers**

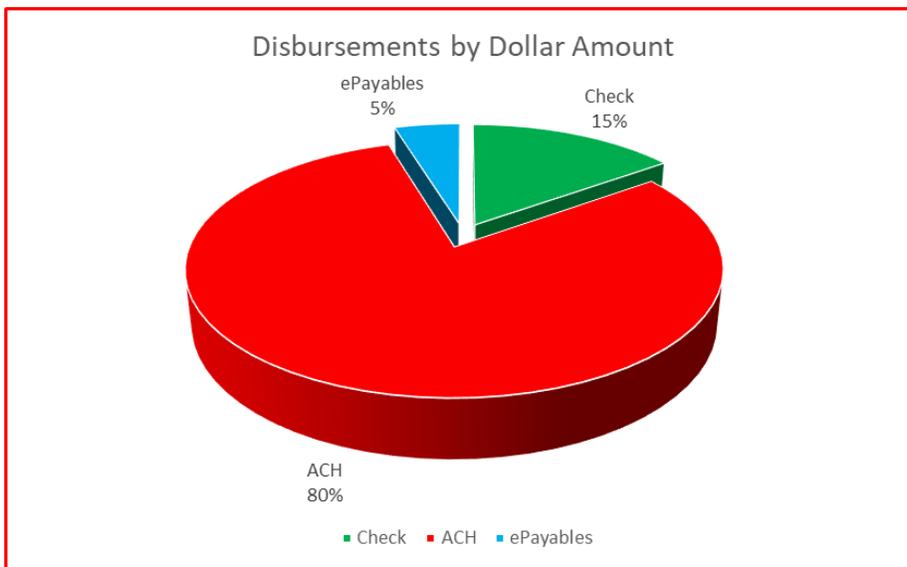
The Finance Department’s Accounts Payable (AP) group processed over 10,000 payments in FY 2022 totaling nearly \$100 million, not including payroll. The majority of payments (55%) were issued via checks. In terms of dollar amounts, however, the vast majority of payments (85%) were conveyed electronically through Automated Clearing House (ACH) payments (80%) or ePayables (5%).<sup>1</sup>

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<sup>1</sup> ePayables are a more streamlined alternative to ACH electronic funds transfers (EFT) and function like a virtual credit card, in which payments are loaded onto the vendor’s virtual card.

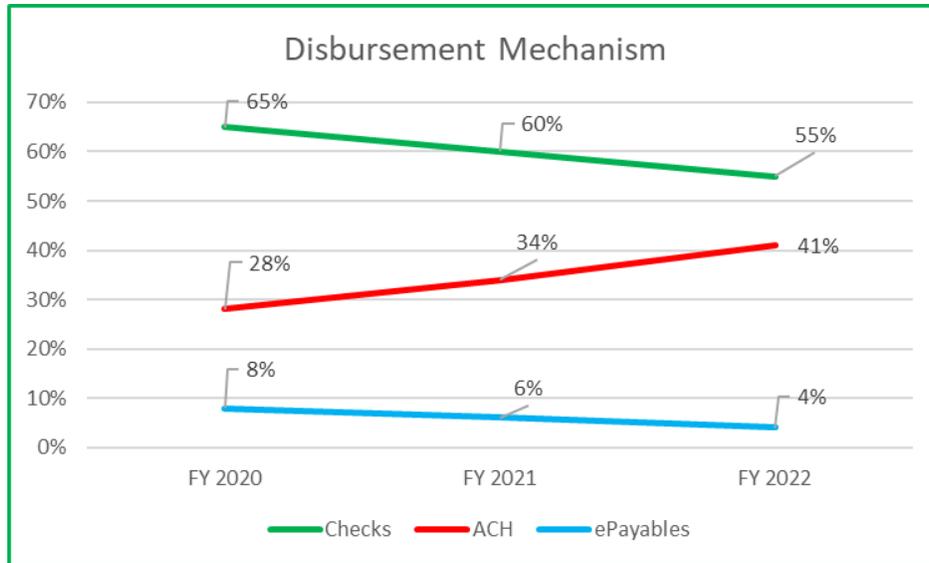


Source: Finance Department

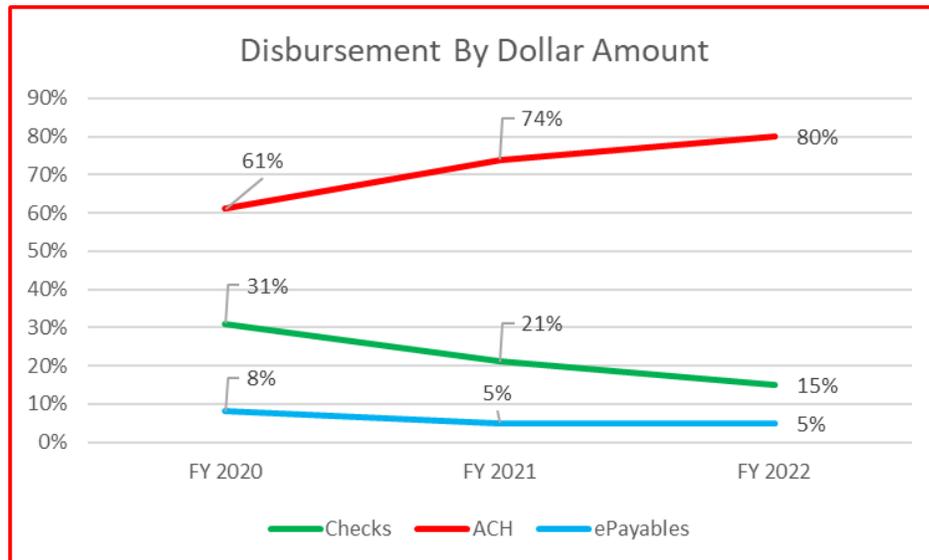


Source: Finance Department

While payments via check represented the majority of payments issued in FY 2022, the trend since the beginning of the decade has been towards electronic funds transfers via ACH transfer. In FY 2020, payments issued via check represented 65% of total payments and 31% of total dollars disbursed. Since then, payments issued via check have declined to 55 percent and the total dollar amount to 15 percent.



Source: Finance Department

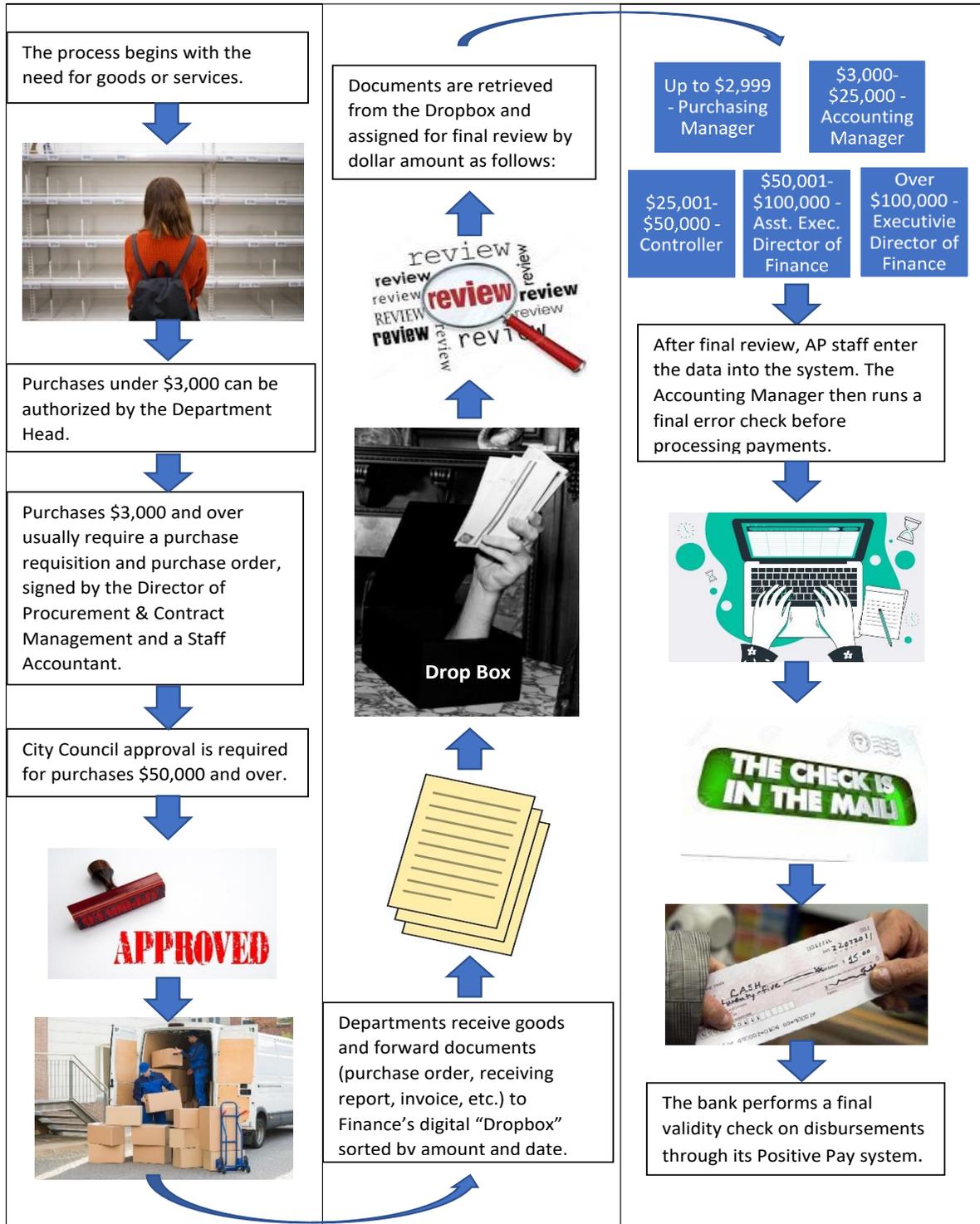


Source: Finance Department

The movement away from checks has been gradual due to small vendors' preference for paper checks. It is nonetheless a positive trend given that payments via electronic funds transfers are less susceptible to fraud than paper checks, which can be altered or stolen. Moreover, payments via ACH are more cost-effective. The Association for Finance Professionals estimates the median cost of a check transaction at \$3.00, as compared to the estimated median cost of an ACH transaction, which can range from \$0.26 to \$0.50.

# The Accounts Payable Process: Overview

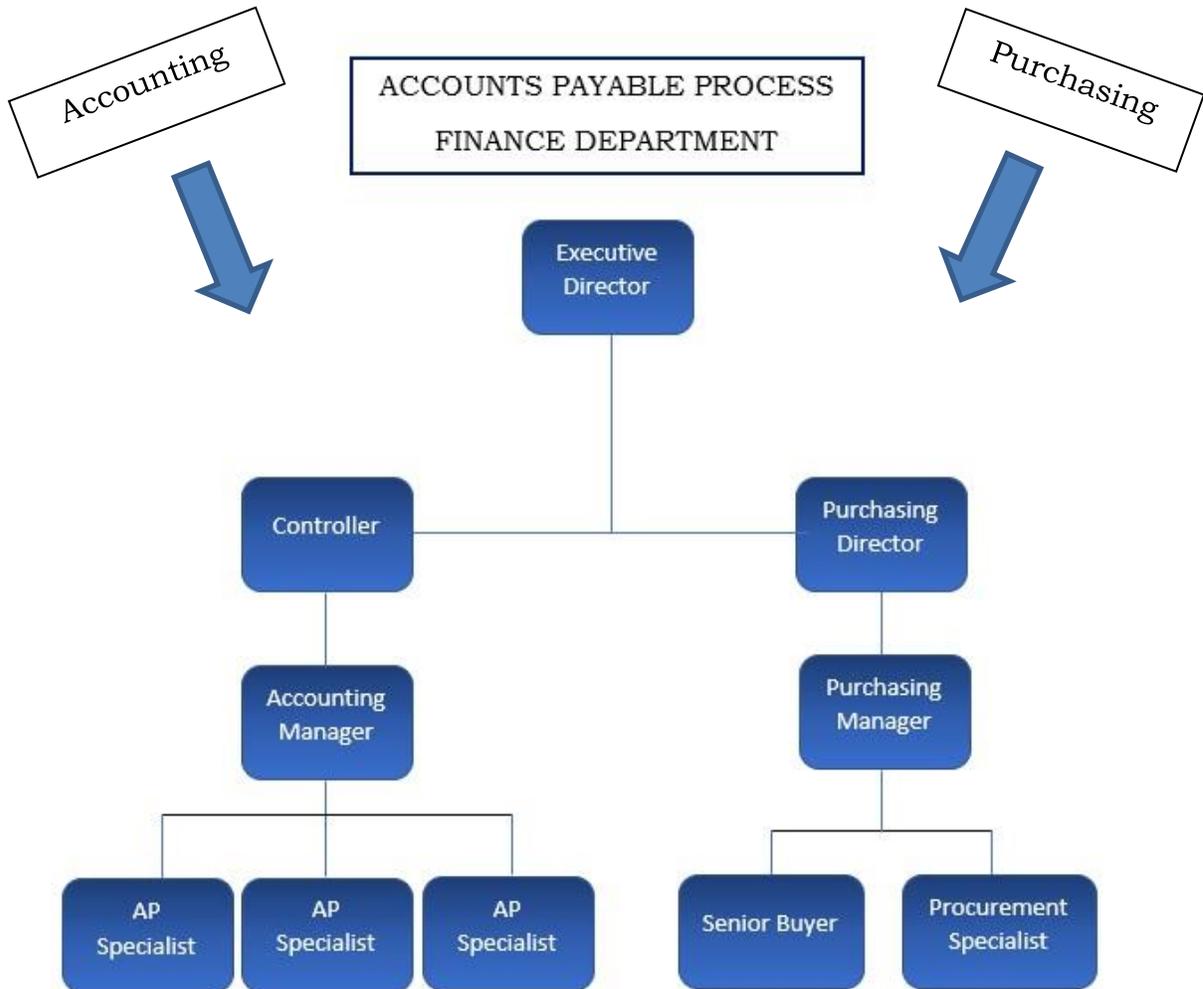
The City's accounts payable process, at a glance is shown below, from end user requests for goods/services to issuance of payments:



## The Accounts Payable Process: Internal Controls

The Finance Department's accounts payable process has a robust system of internal controls built on separation of duties, a multi-tiered system of review, and both internal and external error checks. There were a few areas that could be strengthened, which will be discussed in the following section. However, taken as a whole, the system appears adequate to ensure the integrity of the process.

The Finance Department delegates the various stages in the process between its accounting and purchasing functions, as shown below.



The following is a discussion of internal control best practices noted in the accounts payable process.

### *Separation of Duties*

#### Procurement Specialist

The Procurement Specialist manages the vendor database. This includes creating new vendor files from vendor request forms, deactivating old vendors, and eliminating duplicate entries. Limiting access to the vendor database is a best practice that minimizes the risk of unauthorized users creating fictitious vendors.

#### Purchasing Director

The Purchasing Director authorizes purchases for \$3,000 or more. Isolating the authorization function from the ordering and recordkeeping functions is in keeping with internal control best practices.

#### Purchasing Manager

The Purchasing Manager is responsible for reviewing for accuracy and completeness all purchases under \$3,000, which make up the majority of purchases. Isolating the review function from the ordering/receiving and recordkeeping functions is in keeping with internal control best practices.

#### AP Specialist Group

The AP Specialist Group is responsible for entering AP files into the accounting system once they've been reviewed for accuracy and completeness. Isolating the recordkeeping function from the ordering/receiving, authorization, and review functions is in keeping with internal control best practices.

### *Internal and External Error Checks*



The Finance Department's Accounting Manager runs a final error check on each AP batch to identify and resolve any discrepancies before checks are printed or electronic transfers are initiated.



The Finance Department utilizes the bank's Positive Pay system, which flags items for potential fraud. Staff send the bank an electronic file of checks issued, and the Positive Pay system identifies discrepancies when checks are presented to the bank. Typical hits include stale-dated checks and second attempts to cash checks already cashed. The bank presents flagged items to Finance staff for rejection or approval.

### *Multi-tiered System of Review*

Finally, the Finance Department uses a multi-tiered system of review for purchase requests, where the more high-profile, higher dollar amounts are moved up the chain of command based on dollar thresholds. The purpose of the review is to identify and resolve with the requesting department any deficiencies noted, such as missing documents, missing signatures, failure to exercise tax exempt status, etc.

Purchasing  
Manager

Reviews AP files for accuracy and completeness for purchases up to \$2,999. These comprise the majority of the average 200 purchase requests processed weekly.

Accounting  
Manager

Reviews AP files for accuracy and completeness for purchases ranging from \$3,000 to \$25,000.

Controller

Reviews AP files for accuracy and completeness for purchases ranging from \$25,001 to \$50,000.

Assistant  
Director

Reviews AP files for accuracy and completeness for purchases ranging from \$50,001 to \$100,000

Executive  
Director

Reviews AP files for accuracy and completeness for purchases over \$100,000.

### **The Accounts Payable Process: Opportunities for Improvement**

While the internal controls over the Finance Department's accounts payable process are robust, there is room for improvement in several areas. These include the need to fully document the current procedures in place, the need to address the use of foreign vendors, and the need to address the legacy issue of inactive vendors still active in the vendor database.

### *Written Policies and Procedures*

As mentioned in the introduction, *Information and Communication* is one of the five main components of the internal control conceptual model. Clear, comprehensive policies and procedures help to ensure both the consistency and the continuity of operations. The Finance Department has made some efforts in this area, both on the Accounting side with the AP specialist group, and on the Purchasing side with vendor database management. However, a more comprehensive approach is needed to tie all the interrelated functions together – departments, accounting, and purchasing – to show the accounts payable process in its entirety. This would allow participants in the process to understand not only their individual responsibilities, but also their role, as it relates to the entire process.

It should be noted that the City is in the process of acquiring a new Enterprise Resource Planning (ERP) system.<sup>2</sup> This could have a significant impact on the way in which staff interact with the accounting system. The use of screenshots from the current accounting system, for instance would be useless for anyone trained on the new system. For that reason, management should consider holding off on documenting formal written policies and procedures until after the new ERP system is implemented.

### *Use of Foreign Vendors*

The City has on occasion purchased goods from foreign vendors. While the practice is relatively infrequent, it has been sometimes problematic in getting the information necessary to set up a vendor profile, such as the IRS Tax ID number. In two of the more recent instances the orders ultimately had to be cancelled, which resulted in wasted staff work. There were a total of 62 foreign vendors listed in the vendor database dating back more than two decades. Most of the vendors listed were Canadian, but also included vendors in Germany, the UK, Hong Kong, Australia, and Dubai. Expenditures ranged from \$450 to \$35,000. The Texas State Code does not prohibit the purchase of foreign-produced goods, although it does require that preference should be given to goods produced in Texas or other states over foreign products if the cost and quality are equal. Toward that end, management should consider incorporating into its financial

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<sup>2</sup> Enterprise Resource Planning system refers to software used to manage day-to-day business activities. While the accounting system is a core function of an ERP system, it also includes human resources, procurement, and project management functions.

policies a requirement that departments provide justification for purchases of goods or services from foreign vendors if there are viable options available from local, State or other domestic vendors.

#### *Vendor Database – Inactive Vendors*

The vendor database was well-managed in terms of maintaining the database of active vendors. Active vendors are generally defined as vendors active within the last year, of which there were approximately 1,500 as of May 2023. In addition to verifying the accuracy and completeness of new vendors added to the system, the procurement specialist has worked with Information Technology staff to ensure that unauthorized individuals do not have IT permissions to make changes to the vendor database.

However, there was a legacy issue of long-dormant vendors still active in the system. As of May 2023, there were approximately 5,000 such vendors in the system, some dating back to the late 1990s, as well as some duplicate vendor entries. Ideally, an organization's vendor database should be reviewed every 12-to-18 months and vendors without any activity should be inactivated. Since this was not a practice in prior years, the number of vendors still active in the database has been allowed to accumulate. The presence of so many active vendors in the database runs the risk of old vendors being selected in error, vendors being paid twice in the case of duplicate vendors, or old vendor files being altered and used for fraudulent purposes.

As previously noted, the City is in the process of acquiring and implementing a new Enterprise Resource Planning system. In preparation for the transition, management should devote the resources necessary to bring the active vendor database up to date. Management was aware of this issue and had begun taking action to address it prior to the issuance of this report.

#### **Conclusion:**

Finance Department's accounts payable process is supported by a robust system of internal controls that appear adequate to ensure its integrity. The process could be strengthened further, however, by fully documenting its policies and procedures, establishing guidance on the use of foreign vendors, and deactivating dormant vendors still active in the vendor database.

**Recommendations:**

The City Auditor Recommends that the Executive Director of Finance:

1. Develop clear, comprehensive written policies and procedures to document the accounts payable process in its entirety, in conjunction with the roll out of the new ERP system.
2. Consider incorporating into the City's finance policies, the requirement that justification be provided for purchase requests from foreign vendors.
3. Continue deactivating dormant vendor files in the vendor database and establish procedures going forward to review the database every 12 to 18 months for inactive vendor files.

## **VIEWS OF RESPONSIBLE OFFICIALS**

Copies of the draft report were provided to the Executive Director of Finance, Assistant Director of Finance, and the Controller for review and comment. They agreed with the findings and recommendations. The Controller provided clarifying comments on written procedures in place for the accounts payable process, and the report language was adjusted accordingly.

## **OBJECTIVES, SCOPE AND METHODOLOGY**

### **Objectives**

The objectives of the audit were to: (1) assess the adequacy of internal controls over the accounts payable process; (2) review the process for managing vendor files; and (3) review a sample of payments for support and authorization.

### **Scope and Methodology**

The scope of the audit focused primarily on accounts payable activity for FY 2022, but also included historical data from prior years. The audit did not include payroll transactions.

To address the audit objectives, the City Auditor:

- ▶ Spoke to key personnel, including the Executive Director of Finance, Assistant Director of Finance, Controller, Finance Accounting Manager, Director of Purchasing and Contract Management, Purchasing Manager, Procurement Specialist, and Senior Buyer.
- ▶ Obtained an understanding of the accounts payable process through interviews and review of documents.
- ▶ Conducted research on internal control best practices.
- ▶ Obtained and analyzed data on accounts payable activity for FY 2020 through FY 2022.
- ▶ Obtained and analyzed reports on the vendor database.

## **Statement of Compliance with Audit Standards**

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. Those standards also require that we, as internal auditors, meet the criteria for independence. We believe that we met those independence standards, and that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objective.