CITY AUDITOR'S OFFICE

Use of Purchase Orders

August 17, 2009 **AUDIT REPORT NO. 0912**

CITY COUNCIL
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Robert Littlefield
Vice Mayor Ron McCullagh
Tony Nelssen

August 17, 2009

Honorable Mayor and Members of the City Council:

This audit of the *Use of Purchase Orders*, Audit No. 0912, was included on the City Council-approved fiscal year 2008/09 Audit Plan.

The City has established policies and procedures to ensure that City purchases are procured appropriately and that goods and services are received. However, the City should revise Administrative Regulations to provide requirements for appropriate authorization of purchase requisitions and purchase orders and to clarify the preferred purchasing methods for purchases of less than $2,000.

We would like to thank City staff, particularly those in the Purchasing and Accounting Departments, for their cooperation and assistance during the audit.

If you need additional information or have any questions, please contact me at (480) 312-7867.

Sincerely,

Sharron Walker

Sharron Walker, CPA, CFE
City Auditor

Audit Team:

Lisa Gurtler, Assistant City Auditor
Leo Lew, Senior Auditor
Joanna Munar, Senior Auditor

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EXECUTIVE SUMMARY

This audit of the *Use of Purchase Orders* was included on the City Council-approved fiscal year 2008/09 Audit Plan. The audit evaluated appropriate authorization, purchasing methods and processes, and monitoring of City purchase orders during the period of July 1, 2008 through April 28, 2009. Because the Procurement Code was revised in July 2008, purchase orders prior to this time were not included in the audit.

The City has established policies and control procedures to ensure that purchases are valid, procured in an effective manner, and monitored. Established controls include segregation of duties, procurement specialization, communication between Purchasing and departments, budget monitoring, and confirmation of receipt of goods or services. However, the City's controls over purchase requisitions/orders can be improved through developing, clarifying, and enforcing City policies.

Financial Services management stated there is no specific Citywide guidance in the Administrative Regulations (ARs) for authorization of purchase requisitions and purchase orders although such guidance exists for travel, purchasing cards, and check requisitions. As the City processed more than $178 million in expenditures through purchase orders in fiscal year 2008/09, regulations should be expanded or developed to establish consistent signature authority guidance for these types of purchases.

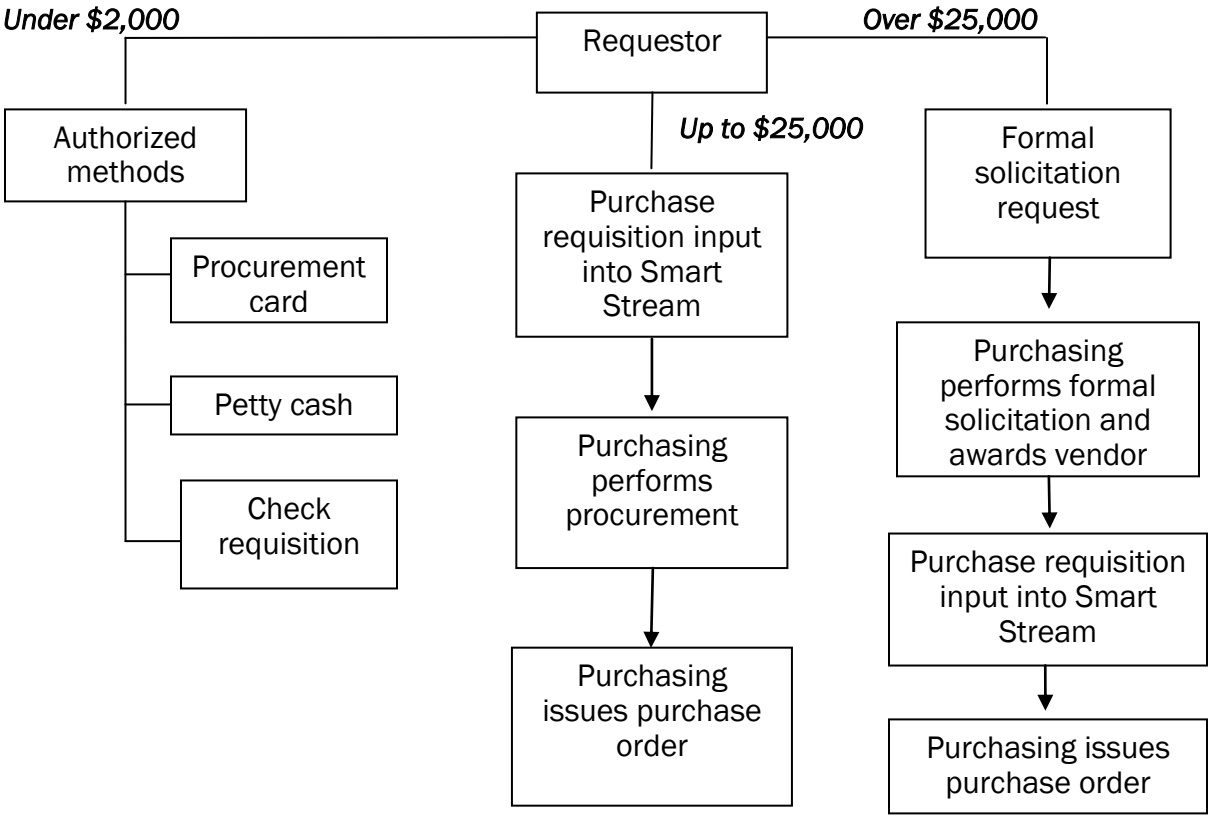
While Administrative Regulations (ARs) state a preferred order of purchasing methods for making small purchases of less than $2,000, Financial Services management does not agree with these ARs and does not require departments to follow them. If the ARs are not consistent with management's objectives and policies, Financial Services should perform analyses of the City's purchasing types and volumes and evaluate the efficiency and cost-effectiveness of different purchasing methods to revise the ARs as appropriate.

BACKGROUND

The City of Scottsdale uses a variety of processes to procure goods and services, with the method used dependent on the purchase type and dollars involved. The City's Procurement Code, Sections 2-180 through 2-216, establishes its centralized Purchasing Division and governs its procurement of materials, services, and construction.

This audit focused on the City's use of Purchase Orders, which are processed by the Purchasing Division for the requesting City department. An authorized staff member in the requesting department submits a purchasing requisition in SmartStream, the City's financial system. A Purchasing Division Buyer or Bid & Contract Specialist selects the appropriate procurement process, selects a vendor, and establishes a purchase order to fulfill the requisition. Either the Warehouse confirms receiving the requested items, which authorizes payment, or the requesting department receives the goods or services and signs the vendor invoice to approve payment. When the purchase order has been completed or is no longer needed, it is closed. Open purchase orders and blanket purchase orders across the entire City are reviewed annually as a part of fiscal year end procedures to determine their status and evaluate the next fiscal year's needs. The following flowchart illustrates the general purchasing processes.

Chart 1. General Purchasing Processes



SOURCES: Auditor summary of Procurement Code and Administrative Regulations 208, 214, 220, and 270

OBJECTIVES, SCOPE, AND METHODOLOGY

The objective of this audit was to evaluate internal controls over the use of purchase orders to ensure:

a) Appropriate authorizations are obtained to initiate purchase orders (including confirmation of appropriate funding) and make payments (including confirmation of receipt of goods and services).

b) Appropriate purchasing methods and procurement processes are applied.

c) Purchase orders and their related purchases are appropriately monitored.

Because the Procurement Code was updated effective July 1, 2008, the scope of the audit was limited to purchase orders created from July 1, 2008 to April 28, 2009. The organizational names used in this report (i.e., Department, Division) are those prior to the City's July 2009 reorganization.

To fulfill the audit objectives, our methodology included:

- Reviewing City Procurement Code Sections 2-180 through 2-203 and 2-214.
- Reviewing Administrative Regulations (ARs): 208–*Check Requisitions*, 214–*Purchasing Requirements, Methods, and Procedures*, 220–*Purchasing Card Usage and Administration*, 270-*Petty Cash*, 285-*Signature Authority*, and 320-*Ethical Standards*.
- Reviewing prior City Auditor audits, including: 9203 *Accounts Payable Control Review*, 9600 *City Procurement Card Pilot Program*, 0140 *Check Requisition Audit*, and 0702 *Procurement Card Program*.
- Reviewing management reports regarding distribution of purchase orders, purchase requisitions, and workload status.
- Reviewing available financial, purchase order, and purchase requisition reports, guidance, and forms available on the City's intranet.
- Reviewing U.S. Government Accountability Office reports related to procurement.
- Interviewing staff in the Financial Services Department, including the Purchasing and Accounting Divisions.
- Selecting a judgmental sample of 40 purchase orders created between July 1, 2008 and April 28, 2009.
- Interviewing staff in the various City departments who had submitted the requests for the selected purchase orders.
- Examining supporting documentation and related invoices for the selected purchase orders to evaluate authorization to initiate purchases, procurement processes, and authorization to make payments.

Our testing found that the Purchasing Division has systems in place to provide reasonable assurance that goods and services are procured in a fair and competitive manner. In addition, test results indicate that the Accounting Division has systems in place to provide reasonable assurance that there is confirmation of goods and services received and that invoices, purchase orders, and receipts are matched prior to making payment. Review of the Purchasing Division structure, processes, and available reports indicate that purchase orders can be monitored (e.g., by vendor, contract, open/closed, cost center, account) by procurement agents and City departments' staff.

However, we did identify two areas for improvement. There is a lack of Citywide guidance for the authorization and approval of purchase requisitions, which initiate purchase orders (see Finding 1 on page 5). In addition, we found that management does not agree with or require compliance with the requirements in ARs 208 and 220 regarding the use of certain purchasing methods (see Finding 2 on page 7).

We conducted this audit in accordance with generally accepted government auditing standards as required by Article III, Scottsdale Revised Code, Section 2-117, et seq. Generally accepted government auditing 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. We believe that the evidence obtained provides a reasonable basis for our observations and conclusions based on our audit objectives. Audit work took place from April 2009 through July 2009, with Leo Lew and Joanna Munar conducting the work.

FINDINGS AND ANALYSIS

Finding 1: Establishing authorization levels for initiating purchases will decrease the risk of inappropriate expenditures.

The City processed 6,248 purchase orders totaling $178.5 million for fiscal year 2008/09. Given the volume of the City's expenditures authorized through purchase orders, it is important to have control processes in place to limit the risk of unauthorized, unnecessary, abusive, or fraudulent purchases.

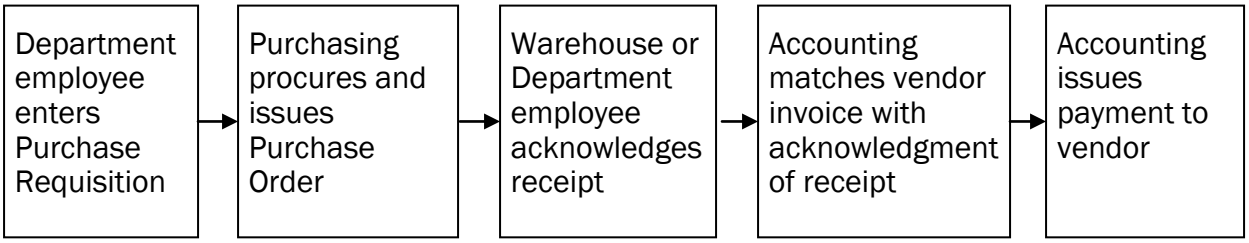
Administrative Regulation (AR) 285–*Signature Authority* states its purpose is "to provide appropriate internal audit control and facilitate processing of expenditure-related documents and administrative forms," and it specifies three levels of signature authority. Level 3 signature authority is designated for expenditures of $2,000 or less; Level 2 authority is for expenditures of $2,001 to $20,000; and Level 1 is authorized for expenditures greater than $20,000. Further, AR 285 specifies that internal controls must include the review and approval of at least one level of management higher than the preparer.

Financial Services management applies AR 285 signature authority requirements to travel expenditures, purchasing card transactions, and check requisitions because they are specifically mentioned in the regulation. However, because AR 285 does not specifically list purchase orders, Financial Services management asserts that such signature requirements do not apply to purchase orders, and there is no specific Citywide policy. AR 214 - *Purchasing Requirements, Methods, and Procedures* requires department managers to develop internal controls to ensure accountability with applicable procurement code, regulations, and procedures. However, given Financial Services management's position, department managers would have no such guidance to follow.

Currently, a person with access to enter a purchase requisition into the City's financial system can submit a requisition without obtaining an independent supervisory approval. Upon receiving the requisition, Purchasing relies on the departmental approval process to have taken place, selects a procurement method, and initiates a purchase order. Purchasing does not require a departmental approval before sending the purchase order to the vendor.

When goods are received in the Warehouse, Accounting matches this receipt with the vendor invoice and processes the vendor payment. Alternatively, when the requesting department notes that goods or services have been received, Accounting processes the vendor payment. There is nothing to prevent this receipt of goods or services from being noted by the same person who generated the purchase requisition. As a result of not having required signature authority levels for purchase requisitions/orders, this particular type of expenditure can be made without any supervisory oversight.

Chart 2. Purchase Request and Payment Process



SOURCE: Auditor summary

Need for Consistently Documented, Authorized Purchase Approval at Initiation

Of the 40 tested, eight purchase orders (or 20 percent) did not have evidence of a second person being involved in the purchase request. Additionally, 24 purchases (or 60 percent) did not have authorization by a level of signature authority comparable to AR 285 requirements:

- 13 of these 24 had a documented approval, but the approver was not of an appropriate level based on AR 285.
- 11 of the 24 did not have evidence of an approver with any signature authority.

The key time to control a City expenditure is prior to placing a purchase order with the vendor. Especially during these challenging economic conditions and tight budget constraints, enhanced expenditure controls can increase accountability and integrity of City purchases.

Recommendation: The City's controls over expenditures should be strengthened by developing and enforcing a policy to require review and approval by a supervisory person of appropriate signature level for purchase requisitions. This may be accomplished by modifying AR 285 to clarify procedures and requirements for authorizing purchase requisitions and/or purchase orders.

Finding 2: Analyzing City purchases and clarifying the related Administrative Regulations can lead to more efficient and cost-effective purchasing.

Financial Services management does not agree with requirements of Administrative Regulations (ARs) 208 and 220 regarding certain purchasing methods and, therefore, does not require departments to comply. AR 208 – *Check Requisitions* requires the most cost-effective methods of purchase to be used, and lists a specific required order to be followed for purchases of less than $2,000. A City purchasing card is to be the first choice for allowable types of purchases, followed by petty cash for transactions of less than $125, then a check requisition, and finally a purchase order. AR 220 - *Purchasing Card Usage and Administration* states the purchasing card, if available, should be selected before other payment types. The ARs indicate this order of preference is based on processing costs for each, as shown in the following table:

Table 1. Purchasing Methods

Method	Limits	Purchased by	Processing Cost
Purchasing card	$2,000 per transaction	Authorized card user/approver	$5
Petty cash	$125, but greater than $50 requires buyer approval	Authorized user/approver	$7
Check requisition	Less than $2,000 or up to $25,000 if on approved check requisition use list	Authorized requestor/approver	*$5, $35
Purchase Orders:			*$65, $85
Formal, competitive	Greater than $25,000	Purchasing Division	Not available
Informal quotes	Greater than $10,000 to $25,000	Purchasing Division	Not available
Informal, price justification	$10,000	Purchasing Division	Not available

*ARs 208 and 220 listed two different amounts for cost

SOURCES: Procurement Code and ARs 208, 214, and 220

We selected 10 purchase orders of less than $2,000 each to review compliance with this requirement. For three of the 10 purchases (30 percent), the applicable preferred methods of purchase were not used. Based on available management reports, purchase orders are often used for purchases of $2,000 or less. As shown in the following table, these small purchases represented 58 percent of the volume of purchase orders, but only totaled approximately one percent of their value.

Table 2. Purchase Orders Distribution

FY 08-09 Purchase Orders	Total Value	Percent of Total Value	Volume	Percent of Total Volume
Up to $2,000	$ 2,482,151	1%	3,615	58%
$2,001 – 5,000	3,544,473	2	1,055	17
$5,001 – 10,000	4,437,655	3	590	9
$10,001 – 25,000	6,977,374	4	411	7
More than $25,000	161,094,318	90	577	9
Total	$178,535,971	100%	7,259	100%

SOURCE: Auditor analysis of SmartStream inquiry report

Based on discussions with employees who made the tested purchases, we found they had varied understanding of purchasing card use. One department's staff noted that they may use a purchasing card for purchases of less than $100. Another department's staff explained that technicians in the field use purchasing cards for immediate needs, but if an item can be received in the future, they will submit a purchase requisition. Other departments' staff commented they primarily use a purchasing card for emergency purchases, purchasing card limits hinder their use, they have received mixed messages about using purchasing cards, and they prefer the audit trail of a purchase order.

Purchasing management has expressed that they do not agree with the ARs' stated transaction processing costs and order of preference for the small purchasing methods. Instead, they would prefer the ARs give guidance on different purchase and payment options and the reasons to use different methods. However, Purchasing management has not yet done formal data analyses, such as documenting the cost of various purchasing methods, evaluating the City's purchase types and volumes, and identifying efficient and cost-effective methods, to support making specific changes to the ARs.

Recommendation: The Financial Services Department should analyze and identify the most efficient and cost-effective and purchasing methods and recommend appropriate revisions to the ARs so that clear guidance is available to City departments.

MANAGEMENT RESPONSE AND ACTION PLAN

Finding 1: Establishing authorization levels for initiating purchases will decrease the risk of inappropriate expenditures.

MANAGEMENT RESPONSE: Agree

Management believes the responsibility for purchase requisition authorization exists at the division level and existing practices provide the intended controls. Per AR 214 – Purchasing Requirements, Methods, and Procedures, the responsibility to ensure accountability with the procurement code, applicable regulations and procedures rests with the division management. Division management is expected to oversee their operations in a fashion that provides proper and adequate processes and controls to address their individual business needs. This is true of many of the aspects of management responsibilities throughout the City aside from purchasing. The City expects division management to properly assess their organization, its functional uniqueness and build procedures accordingly.

As such we feel that AR 214 – Purchasing Requirements, Methods and Procedures which requires each division to "prepare and implement internal management controls that assure City staff are following appropriate procurement procedures" is completely valid and the controls are appropriate.

Additionally, management believes Administrative Regulation (AR) 285 - Signature Authority does not apply to the approval of purchase requisitions. Management informed the auditors during the audit of our opinion. As such, we believe auditing for compliance against AR 285 for purchase requisition authority is inappropriate. Specifically, a signature authority database is maintained related to AR 285 in which authorization for an employee is established for the following activities: check requisitions, travel requisitions, budget transfers, and personnel/payroll actions. Authorization for purchase requisitions is not, and has never been, a component of this database nor AR 285.

PROPOSED RESOLUTION:

AR 285 - Signature Authority will be modified such that it is clear that it does not apply to purchase requisitions. The conflicting reference to purchases within Section 2, bullet 2 – All Major Expenditures will be eliminated.

AR 214 - Purchasing Requirements, Methods and Procedures will be amended to clarify the approval process for purchase requisitions.

RESPONSIBLE PARTY:

Financial Management Division

COMPLETED BY:

January 2010

Finding 2: Analyzing City purchases and clarifying the related Administrative Regulations can lead to more efficient and cost-effective purchasing.

MANAGEMENT RESPONSE: Agree

Management agrees that the four Administrative Regulations (AR) AR 208 – Check Requisitions, AR 270 – Petty Cash, AR 220 Purchasing Card Usage and Administration and AR 214 Purchasing Requirements, Methods and Procedures need to be amended to eliminate all conflicting statements and provide clear and consistent direction and guidance to City Staff on how best to make use of these various payment and purchasing methods.

PROPOSED RESOLUTION:

AR 208 – Check Requisitions, AR 270 - Petty Cash , AR 220 – Purchase Card Usage and Administration and AR 214 – Purchasing Requirements, Methods and Procedures will all be amended to reflect current management practice. In addition, amendments will be made to eliminate any conflicting or confusing information. The amended Administration Regulations will provide consistent and accurate guidance regarding the various payment and purchase alternatives available.

The Purchasing Division will provide appropriate reference material to staff and will address all the changes in the City's Contract Administrator Academy (CAA) training course which is held twice yearly.

RESPONSIBLE PARTY:

Financial Management Division

COMPLETED BY:

January 2010

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