IA- Procurement & Account Payables

INTERNAL AUDIT

| Data →	Information →	Knowledge →	Wisdom →
Hindsight →	Insight →	Foresight →	Smart to Wise →

IIA definition – Internal Auditing

- Independent & objective
- Assurance & consulting
- Adds value
- Improves operations.
- Accomplishes objectives
- Systematic, disciplined approach to evaluate & improve GRC effectiveness.
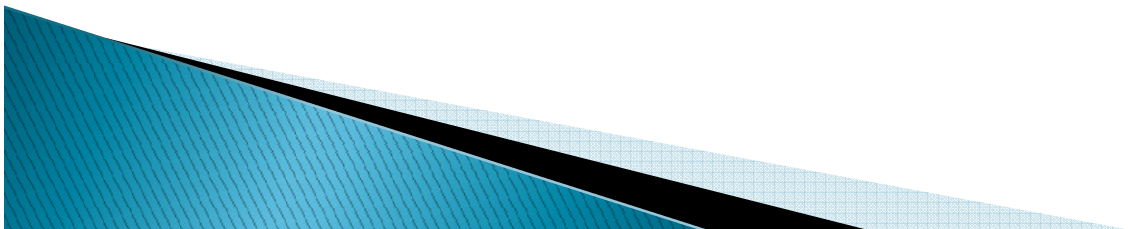
Types of IA

- **Compliance audit –** applicable rules, regulations & laws
- **Operational audit:** efficient & effective conduct of operations
- **Information system audit:** proper functioning throughout.
- **Performance audit:** efficient use of resources
- **Environmental audits:** environmental laws and regulations
- **Special assignments** on fraud investigation, corruption
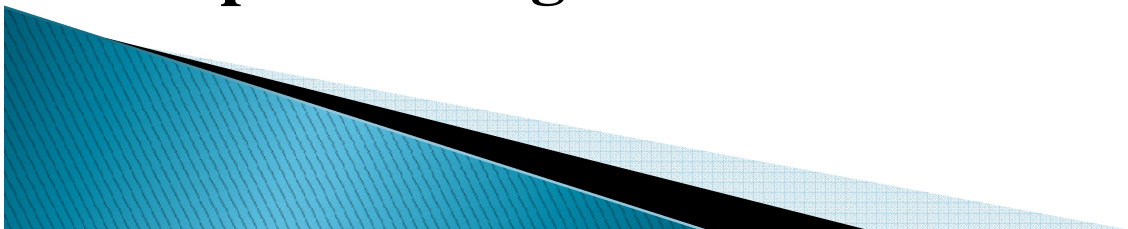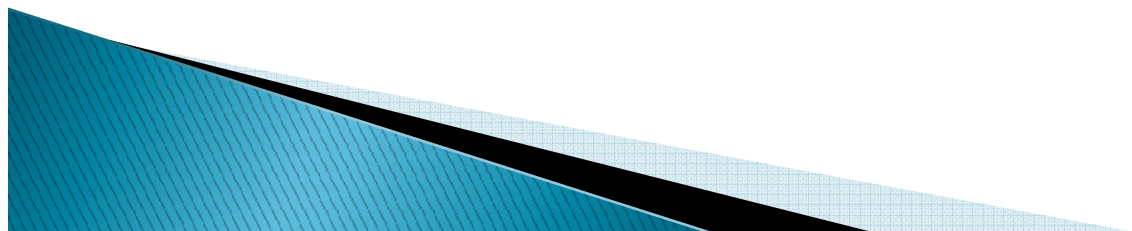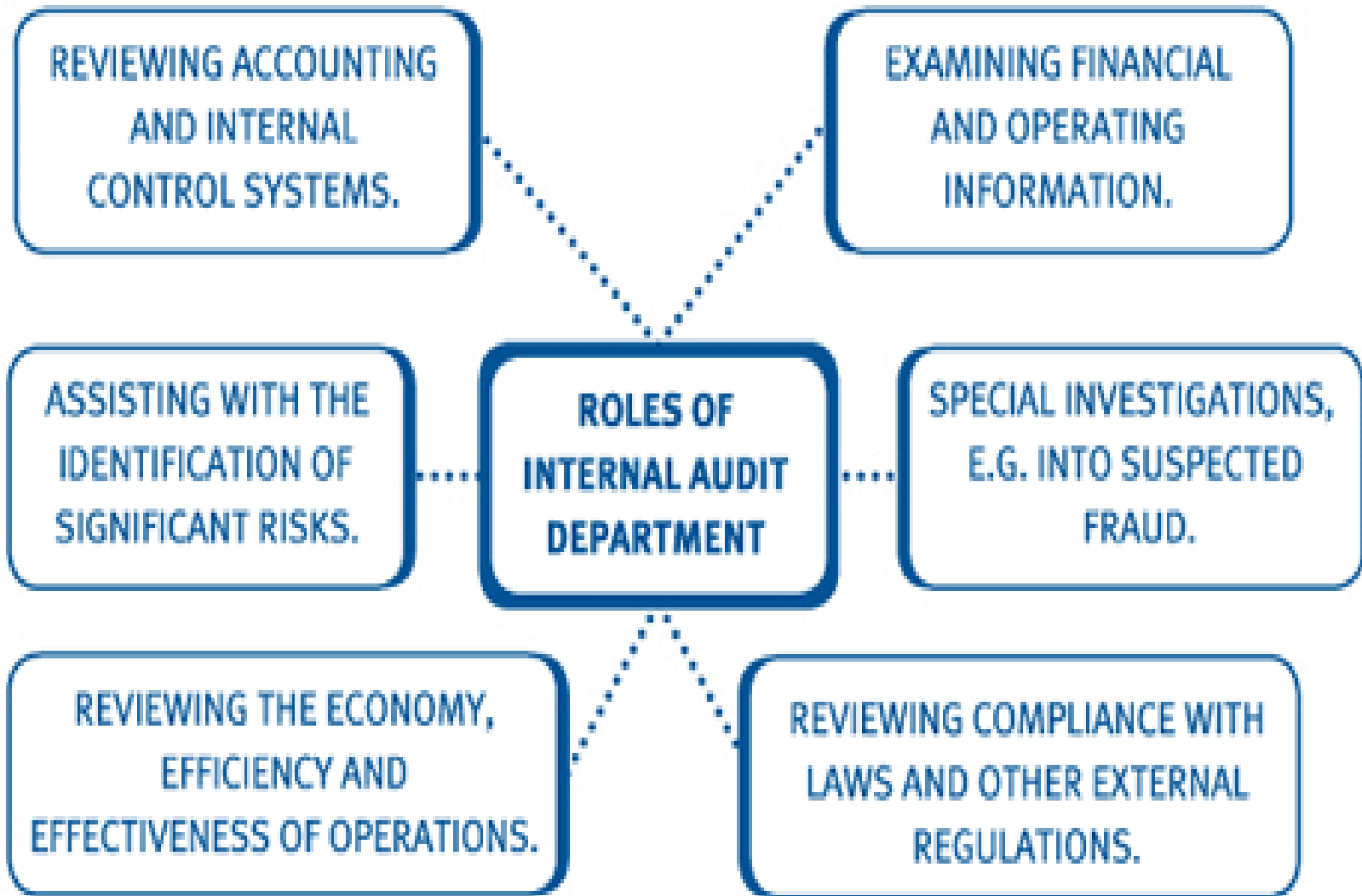
IA SCOPE

▶ <u>IA evaluates & examines</u>-

- ❑ Reliability, integrity of information & means used for identification, measurement, classification & reporting.
- ❑ Systems established to comply with policies, plans, procedures, laws & regulations having significant organizational impact
- ❑ Risk management
- ❑ Verification of existence of assets
- ❑ Means to safeguard assets
- ❑ Effectiveness & efficiency of employment of resources.
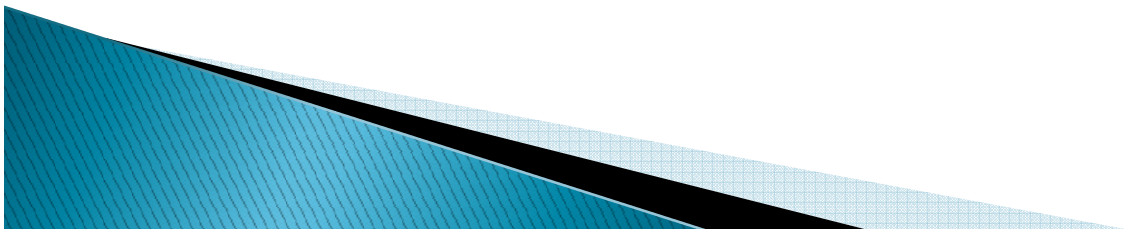
IA Planning steps

- **Evaluate** operations or programs to ensure consistency of results with established objectives & goals & that they are carried out as planned.
- **Monitoring** & evaluating governance processes & effectiveness of organization's risk management processes.
- **Evaluating** quality of performance of external auditors & the coordination required with IA
- **Performing** appropriate consulting and advisory services on governance, risk management & control
- **Reporting** periodically on IA purpose, authority, responsibility & performance relative to plan.
- **Reporting** significant risk exposures & control issues, including fraud risks, governance issues, & other matters as per board request.
- **Evaluating** specific operations as appropriate as per board's / management request.
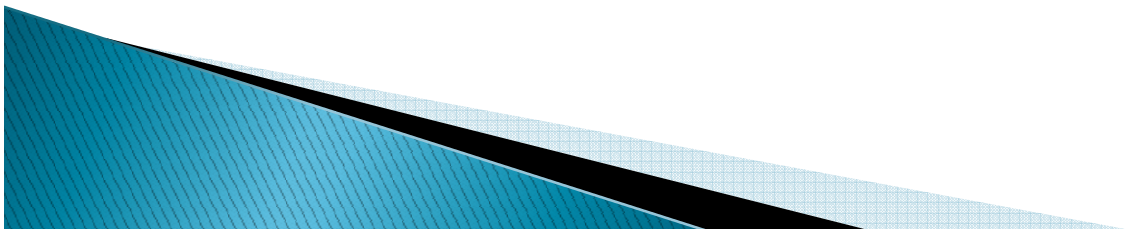
Risks-

- Ability to process invoices on a timely basis.
- Reliance on error-prone manual processes to approve requisitions, scan supplier invoices & issue payments .
- Failure to issue purchase orders for each new order
- Non confirmation if deliveries match contractual terms or cannot easily access vendor contracts
- Lose early payment discounts by over-extending payment cycles or accepting discounts without calculating cost of capital outlay
- Neglect to take advantage of maximum savings on volume rebates or trade spend initiatives
- Incorrectly load supplier and/or contract information into master data files.
- Lack processes & systems to prevent late payments, under- or over-payments, duplicate payments or missed payments.
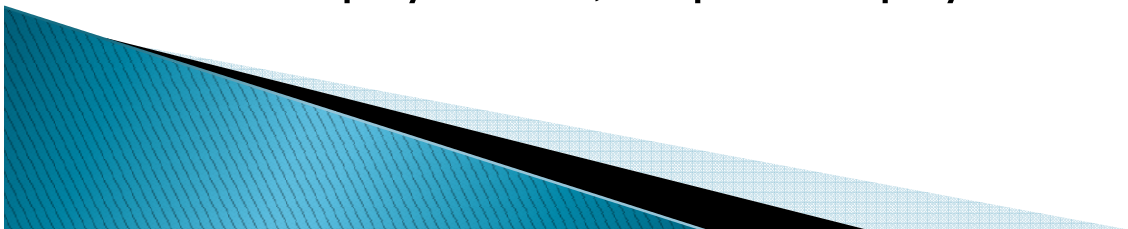
Risk – types

- Credit Risk–including Residual risks
- Credit Concentration Risk
- Market Risk
- Business Risk
- Operational Risk
- Strategic Risk
- Interest Rate Risk in the Banking Book
- Compliance Risk
- Reputation Risk
- Liquidity Risk
- Intraday Risk
- Model Risk
- Technology Risk
- Counterparty Credit Risk

Risk – types

▸ **Risk velocity** – Speed at which risk travels within an organization

▸ Risk vulnerability / Risk threats / Risk registers / Risk informed decision making

▸ Cost of control not to exceed risk impact – Cost benefit analysis.

▸ Economics – optimal allocation of scarce resources

▸ Pareto Principle Key is to prioritize & attack the critical risks – Picking low hanging fruits

▸ Organization to clearly define it's KRI's' **Risk appetite**

Risk – Controls

- Risk – Uncertainty of an event that accomplishes achievement of objectives.

- Probability & Impact / Significance & likelihood.

- Inherent or residual risk – Risk net of current controls.

- Risk to be within tolerance / acceptance levels post corrective actions .

| Risk Identification | → | Risk assessment | → | Risk evaluation | → | Risk management | → | Risk monitoring | → | Risk responses. |
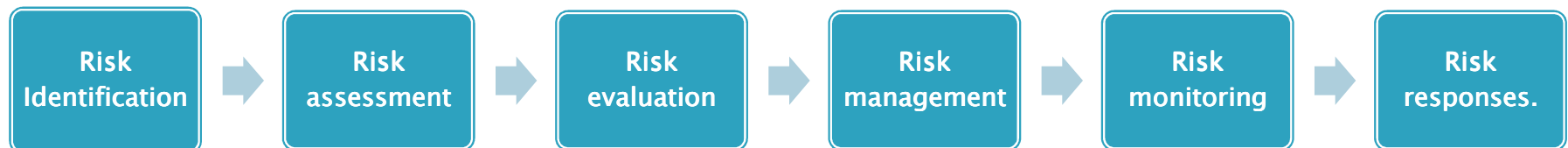
Account payable Frauds

- Occupational fraud is a growing problem.

- The <u>Association of Certified Fraud Examiners (ACFE)</u> estimates that _5% of all revenue_ is lost to occupational fraud every year.

- Fraud is not 100% preventable but there are steps you can take to both prevent & detect fraud on an ongoing basis.

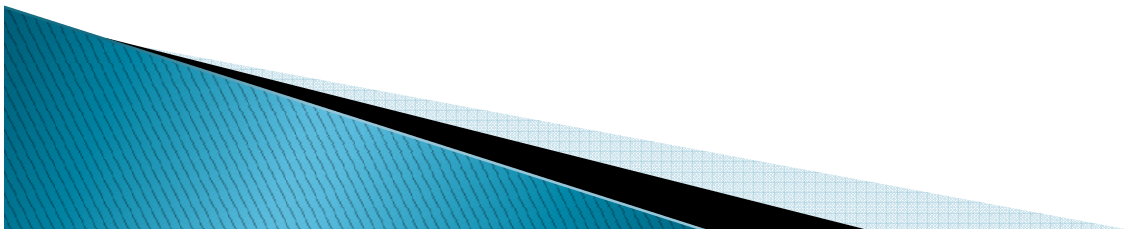- Scan for duplicate payments every 6 months & perform an annual cross-check between your vendor file & employee file.
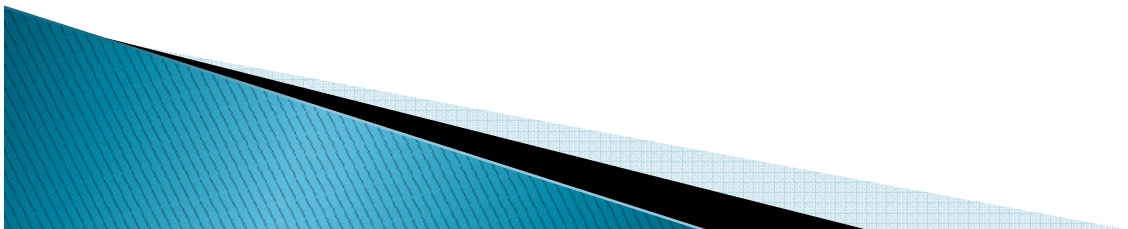
Procurement frauds –

- Leaking of bid information –
- Creation of dummy / fictitious vendors –
- Sourcing from favored vendors for a kickbacks or expensive gifts, free travel or lavish entertainment in return –
- Paying more for low quality goods or product substitution of a product inferior to that specified in the contract –
- Winning a bid at a low price & then increasing price & requests by subsequent price order changes – Misleading by supplying goods / services at a low rate but the goods / services are of a sub standard quality.
- Exclusion of qualified bidders –
- Ambiguous contract specifications followed by change orders increasing scope or contract period –
- Unnecessary purchases.
- Splitting of purchase orders to avoid quotes / tendering process
- Ordering goods or services from vendors with no intention of paying for them
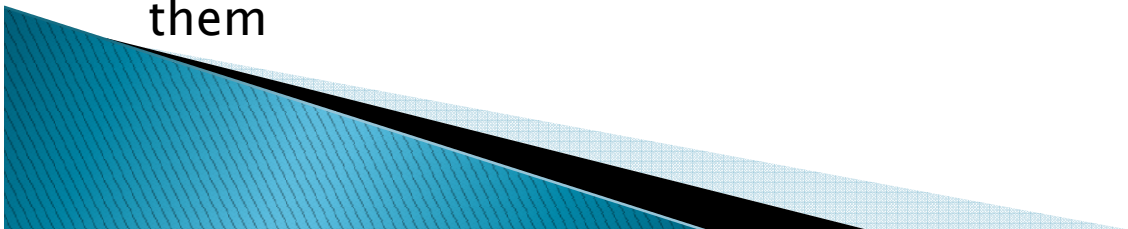
Procurement

- Act of acquiring, buying goods, services or works from an external source.
- Favorable to acquire at best possible cost to meet the needs of the acquirer in terms of quality ,quantity, time, & location.
- Purchasing decisions include–
  - delivery & handling
  - marginal benefit
  - price fluctuations.
- Making buying decisions under conditions of scarcity.
- Use of economic analysis methods viz cost–benefit analysis or cost–utility analysis.
- Risk Assessment
- Where risk is involved in the costs or the benefits, the concept of expected value to be employed.
- Acquisition is a much wider concept than procurement, covering the whole life cycle of acquired systems.

Process of Procurement

Input

- Purchase Order
- Good Received
- Q.C. Inspection
- Purchase Return

Purchase

- Purchase Order
- GRN
- Purchase Return Note
- Edit Reports
- Analysis Reports
- etc

Reports

Inventory

- Stock Out
- Stock In

Accounts Payable

- Vendor Invoice
- Vendor Credit Memo
- Vendor Master

WebViewer

DIRECT VS INDIRECT PROCUREMENT

| Direct procurement and indirect procurement			
		TYPES	
	Direct procurement	Indirect procurement	
	Raw material and production goods	Maintenance, repair, and operating supplies	Capital goods and services
FEATURES Quantity	Large	Low	Low
Frequency	High	Relatively high	Low
Value	Industry specific	Low	High
Nature	Operational	Tactical	Strategic
Examples	Crude oil in petroleum industry	Lubricants, spare parts	Crude oil storage facilities

FUNCTIONS OF PURCHASE DEPARTMENT

- Purchase materials at lowest possible cost while maintaining quality. Maintain good relationship with the suppliers. Take advantage of economies of scale. Maintain records efficiently. Develop highly competent personnel. Co-ordinate with all the departments of the organization.

TYPES OF PURCHASING SYSTEM

- Tender System Stockless Purchase System
- Blanket Order E-Purchasing
- E-Procurement Subcontracting Rate Contract
- Method Petty Cash System
- Capital Equipment Purchase
- Imports
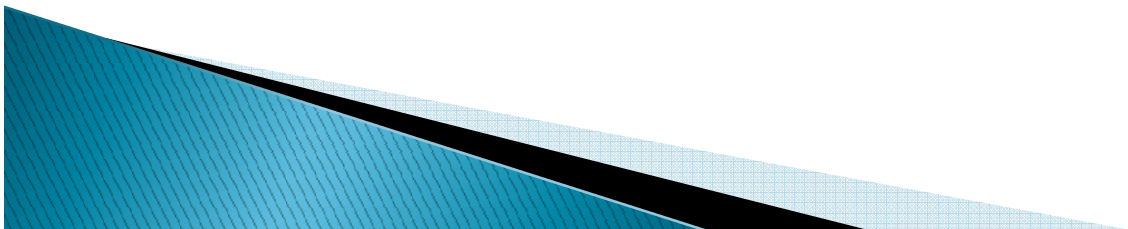
TENDER

- entity invites suppliers to give their quotations. supplier with the lowest quote wins the contract. followed by large organizations and governments when purchases are of large value.

Types of Tender

- Open Tender.
- Restricted Tender
- Negotiated Tender

Advantages / Disadvantages

- Advantages: Competitive Lower Cost Transparent Process
- Disadvantages: Low Price usually Detriment of Quality Time consuming
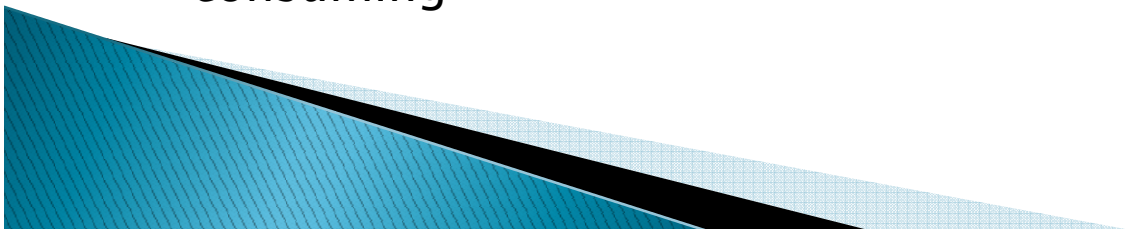
Blanket Order

- Co's purchase many small items regularly on day – day basis & it is difficult to have inventory for all.
- 2 methods: Agreement to supply a Fixed Quantity at a Fixed Price for a Specific Period.
- Agreement to supply for a Specific Period but Quantity is unknown.

Advantages / Disadvantages

- ADVANTAGES: Flexible – Avoid negotiation & placing repetitive new orders – Advantage to supplier to plan work at his place – Reduces clerical activities & Protects against higher future pricing
- DISADVANTAGES – Petty frauds – needs flexible internal control – Poor vendor performances – Difficulty in determining & forecasting quantity
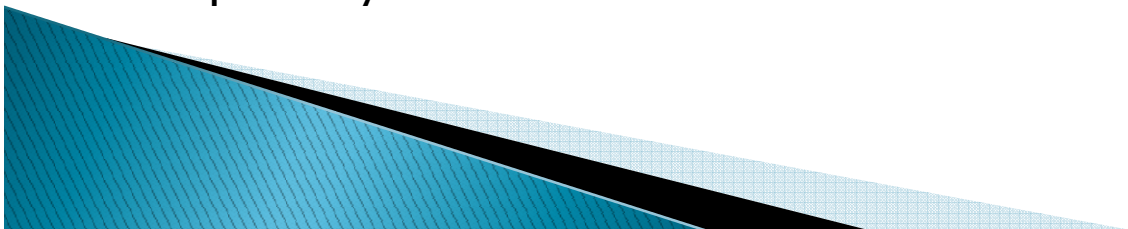
Sub – contracting / Outsourcing

- Process of entering a contractual agreement with an outside person or company to perform a certain amount of work (known as a subcontractor). Many small businesses hire subcontractors to assist in a wide variety of functions. - say Payroll preparation

Advantages / Disadvantages

- Advantages: Cost Saving – Increased Efficiency – Continuity & Risk Management
- Disadvantages: Loss of Managerial Control –Quality Problems Hidden Costs
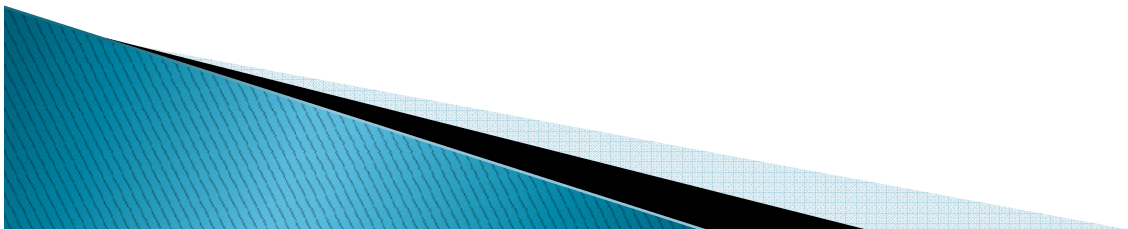
E-Purchasing / E- procurement

- business-to-business or business-to- consumer or business-to-government purchase and sale of supplies, work, and services through the Internet. E-procurement helps to achieve benefits such as increased efficiency and cost reduction.

Advantages – Disadvantages

- ADVANTAGES Reducing Cost Visibility of spend Productivity Control Quicker processing times Better communication
- DISADVANTAGES High Learning curve Human or system errors in orders No hardcopies Training costs System failure

Order on Telephone

- Method used to place orders of small value where purchase department does not prepare a formal PO. Order is placed & Price discussed & finalized on telephone. works well with the captive type of vendors

Rate Contract / Agreement

- cost reduction strategy aimed at standardizing procurement prices for commonly procured, homogenous & price varying inputs. Basic idea is to aid a company in establishing parameters for purchasing goods & services necessary in continual business operations.
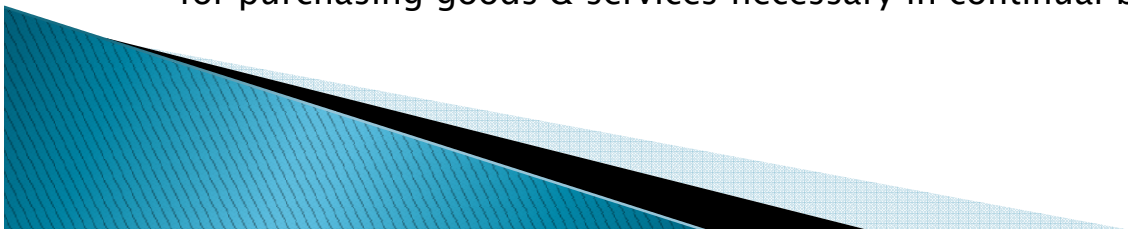
Stockless purchasing

- Arrangement in which a supplier holds items ordered by the customer in his own warehouse & releases them as & when required by the customer. also known as just-in-time purchasing. vendor has a clear idea of the requirements of the buyer & holds stock at a convenient location. seller bears financial responsibility of holding stock.

Examples

- Tyre warehouse near automobile manufacturing units. Petrol pumps in transport undertaking. Aviation fuel pumps at airport.

Advantages / Disadvantages

- Advantages: Reduced warehouse space Eliminate the cost of storing, maintaining and distributing supplies Increased inventory turnover Less manpower
- Disadvantages: High cost Need of complex technology
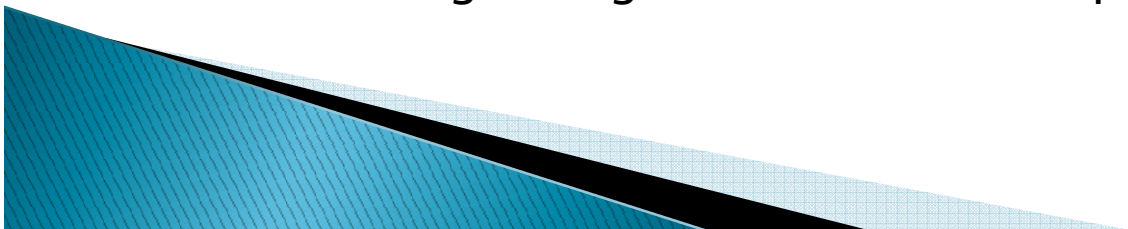
Imports –

- Method to purchase the goods from an area or country outside Indian Territory. Imports are regulated by the Central Government.

Procedure of obtaining Import License-

- Obtaining Foreign Exchange Placing an order Receipt of Shipment Advice Appointing C & F Agents Dispatching letter of credit Receipt of Documents Bill of Entry Delivery of Goods

Advantages / Disadvantages

- Advantages: Stabilizes market fluctuations – Maintains cost competitiveness – Enhances potential for business expansion – Higher quality – More variety -Cheaper goods
- Disadvantages: High Tax - Increased Transportation Cost – FX risk
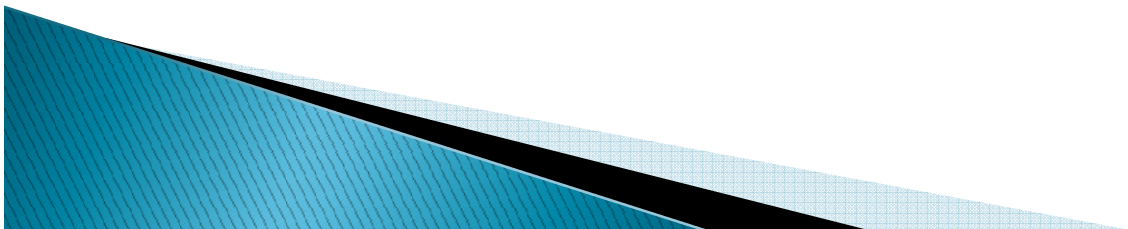
Procurement life cycle-7 steps

- **Identification of Need:**
  - ◦ Internal step of establishing a short term strategy followed by defining technical direction & requirements.
- **Supplier Identification:**
  - ◦ After Make-buy, multiple vs. single suppliers decision identifying who can provide the required **product/service (P/S).**
- **Supplier Communication:**
  - Requests for quotation, proposals, information or requests for tender advertised, or direct contact made with the suppliers.
  - References for product/service quality are consulted, & requirements for follow-up services including installation, maintenance, & warranty are investigated.
  - Samples of the P/S being considered may be examined, trials undertaken.
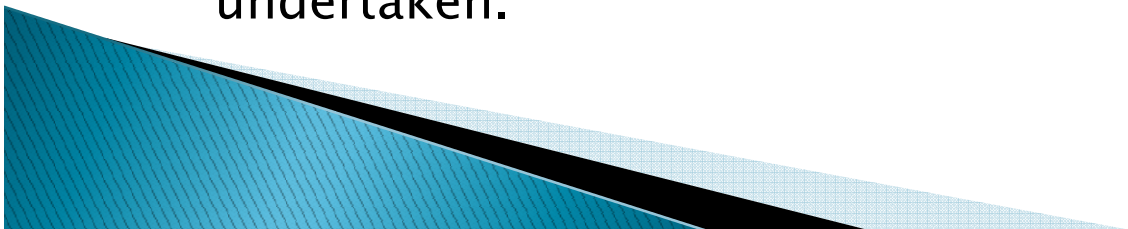
- **Negotiation:**
  - price, availability, & customization possibilities, delivery schedules.
- **Supplier Liaison:**
  - Evaluate the performance of P/S, supplier scorecard is a popular tool for this purpose .
  - After P/S consumption, the contract expires & is to be re-ordered, company experience with the P/S is reviewed.
  - If the P/S is to be re-ordered, consider other suppliers or to continue with the same.
- **Logistics Management:**
  - Supplier preparation, expediting, shipment, delivery, & payment for the P/S are completed, based on contract terms, installation & training.
- **Additional Step – Tender Notification:**
  - Raise the competition for the chosen opportunity direct from their e-tendering software, or as a re-packaged notification.
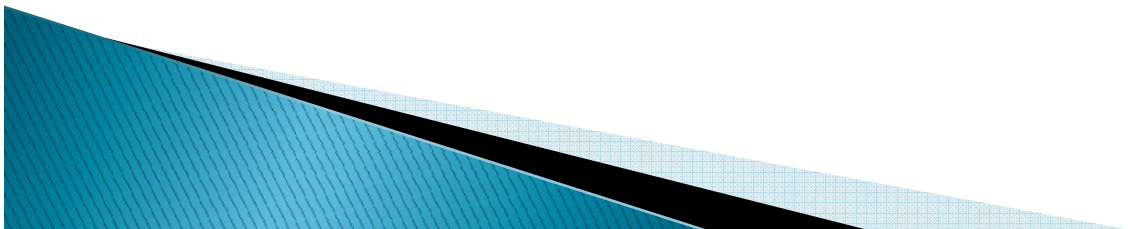
Accounts Payable

- Money owed by a business to its suppliers shown as a liability on a company's balance sheet.
- Responsible for the timely processing & payment of invoices.
- Client & external supplier's expectations shall be met.
- Establish & maintain a supplier database.
- Monitor Purchase Order activity & compliance.

Procurement Software

▸ e-procurement software manages the purchasing processes electronically and/or via cloud computing.

▸ As per Procurement Network's research, there are more than one hundred e-Procurement solutions available today.

▸ Important element of supply chain management systems,

▸ These systems help organizations efficiently manage their purchasing cycle times & maximize profit on every purchase order.

▸ <u>Procurement software</u> : SMART by GEP, a cloud-based, end-to-end procurement platform by GEP, Track8 by Future Purchasing, Puridiom – procure-to-pay software, Fishbowl Inventory – Inventory management, Tradogram - Private Purchasing Portal by PIBCI.
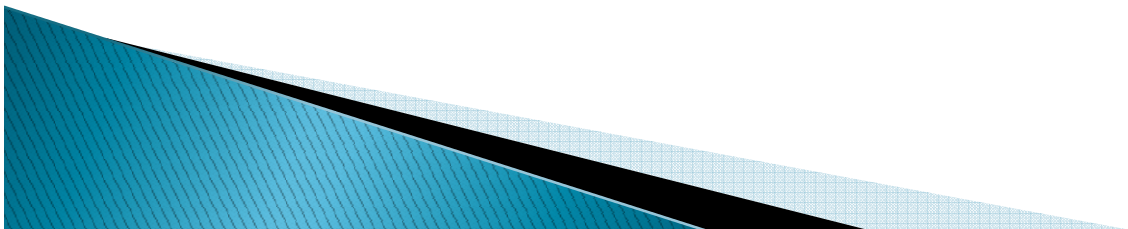
Internal Controls over Procurement & A/c Payables
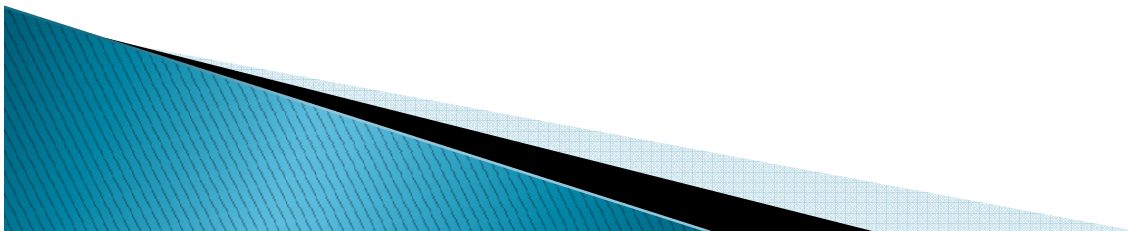
Segregation of duties-

Assign related buying functions to different people. With proper segregation, no single person has complete control over all buying

Best practice is to have different people:

- Approve purchases
- Receive ordered materials
- Approve invoices for payment
- Review and reconcile financial records
- Perform inventory counts

Potential consequences if duties are not separated:

- Unauthorized or unnecessary purchases made
- Improper charges made to department budgets
- Excessive costs incurred
- Goods purchased for personal use

Accountability, Authorization & Approval

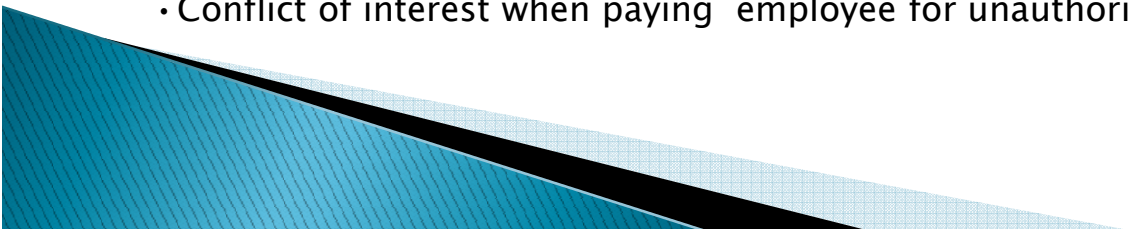You maintain accountability when you authorize, review & approve purchases based on signed agreements, contract terms & purchase orders.

Best practices:

- Comply with ethical buying practices & policy.
- Review and update signature authorizations periodically.
- Obtain pre-approval of consultant agreements by Purchasing.
- Verify receipt of goods and services against contract/ purchase order and invoice information.
- Reconcile ledgers for accuracy of recorded transactions.
- Monitor to ensure that invoices are paid in a timely manner.

Potential consequences if accountability does not exist:

- Unauthorized, unnecessary, or fraudulent purchases
- Unauthorized work performed by suppliers
- Lost supplier discounts due to late payments
- Improper charges to incorrect account/ funds resulting in a misappropriation of funds
- Conflict of interest when paying employee for unauthorized outside work

Security of assets

ensure resources are accounted for, periodic counts of inventory & comparing results with control records.

Best practices:

- Secure goods received in a restricted area & restrict access.
- Lock goods and materials, & provide entry to few known people
- Keep inventory records & periodically calculate opening – closing inventory amounts.

Consequences if assets are not secure:

- Theft of goods & Inventory shortages
- Additional costs incurred for replacement of goods
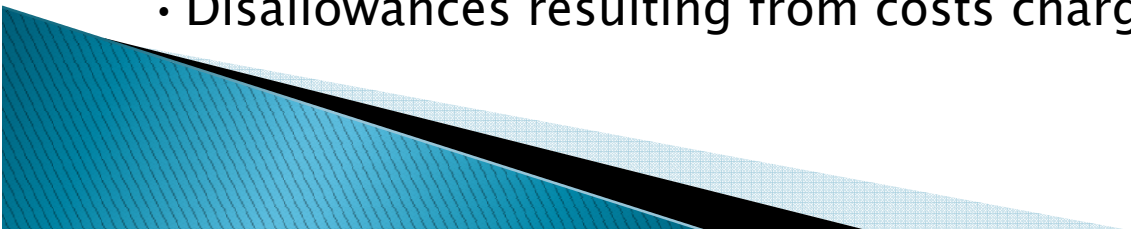
Review and reconciliation

Timely review of supplier's invoice, packing slips & purchase orders. Check accuracy of information for prior payment, correct quantity ordered & price charged. Monthly ledger reconciliation to find improper charges & validate appropriate financial transactions.

Best practices:

- Review supplier invoices for accuracy by comparing charges to purchase orders.
- Verify that goods & services purchased have been received.
- Perform monthly reconciliations of operating ledgers.

consequences if review & reconciliation is not done

- Improper charges to your department budgets
- Disallowances resulting from costs charged to incorrect accounts.

Audit Objectives

- Comprehensive policies & procedures addressing purchasing activities are developed & documented
- Entity complies with established policies & regulatory requirements
- Validating proper segregation of duties within Purchase Dept
- Ensuring adequate internal controls are implemented to limit exposure to unauthorized or inappropriate transactions
- Verifying that transactions are processed in accordance with guidelines policies & procedures
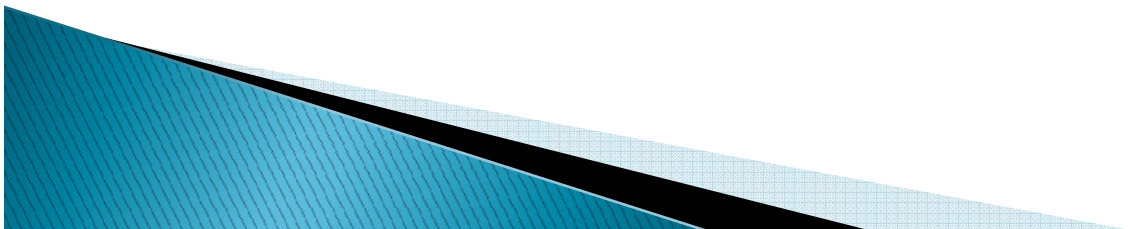
Preliminary work

▸ Obtain an understanding of auditee's operations through research & walkthroughs

▸ Perform a general overview of internal control environment & establish audit scope.

▸ Develop appropriate audit tests to provide assurance that management's objectives are being met & documented in audit work program.
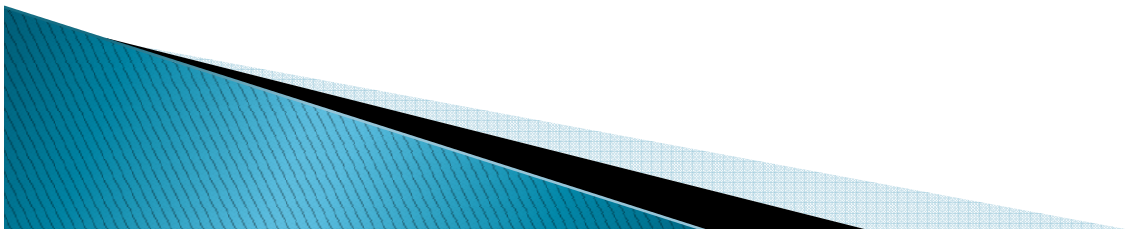
AUDIT PROCEDURES & TESTING

Obtain the following, where applicable:

Policies & Procedures

Organizational Charts

Audit Reports

External Auditor Management Reports

Regulatory Examination Reports

Information Regarding Laws & Regulations

General

Review policies & procedures to determine adequacy. Ensure the policies and procedures have been communicated to appropriate personnel.

Review any prior examination reports to determine whether corrective action has been implemented for noted deficiencies

Techniques-Internal Audit of Account payables

1) Duplicate Payments-

▸ Duplicate vendor numbers for the same vendor is the number one cause of duplicate payments.

▸ Recommendation for developing an accurate and comprehensive duplicate payment report:

Report	Vendor	Invoice	Invoice date	Invoice Amount
EEEE	EXACT	EXACT	EXACT	EXACT
EEED	EXACT	EXACT	EXACT	DIFFERENT
EEDE	EXACT	EXACT	DIFFERENT	EXACT
EDEE	EXACT	DIFFERENT	EXACT	EXACT
DEEE	DIFFERENT	EXACT	EXACT	EXACT

IA-Account Payables

2)Implement some fuzzy-matching:

▸ Implementing "similar" fuzzy-matching instead of exact matching-

▸ Amounts are considered *similar* if they meet one of three criteria:

1. The amounts are 5% +/- the other amount

2. One amount is exactly twice as much as the other, i.e. Rs220.15 and Rs440.30

3. The amounts start with the same first 4 digits, i.e. Rs123.45 & Rs1,234.55

IA-Account Payables

3) Rounded-Amount Invoices:

▸ A way to identify rounded-amount invoices is to use the **MOD function in Excel.**

▸ Eg: your invoice amount is Rs150.17; then MOD(150.17,1) gives you the remainder of dividing 150.17 by 1, which is .17.

▸ Using the MOD function with a divisor of 1 on a non-pennies amount would leave a remainder of 0. Additionally, try to rank your vendors by those with a high percentage of rounded-amount invoices.

▸ To do this, just calculate each vendors' number of rounded-amount invoices & divide it by the total number of invoices for that vendor, obtaining the percentage.

▸ Then rank by descending percentage to review the most suspicious vendors first.

IA-Account Payables

4) Invoices Just Below Approval Amounts:-

▸ People who commit fraud are not always the "sharpest knife in the drawer."

▸ Suppose an A/P clerk knows the different Rupee thresholds for management approval.

▸ For eg, a supervisor may only be allowed to approve invoices of Rs3,000 or less, while a manager may be allowed to approve invoices of Rs10,000 or less, and so on.

▸ If this A/P clerk & a manager decide to skim off some extra Rs together, what is the easiest way to get the most money?

▸ Create an invoice just below the approval level of that manager: Rs9,998 when the approval level is Rs10,000; or Rs2,978 when the approval level is Rs.3,000.

To identify these potentially fraudulent invoices-

▸ Identify invoices that are 3% (or less) LESS THAN the approval amount. Eg, if your approval amount is Rs3,000, then any invoice that is between Rs2,910 & Rs2,999 would be flagged as suspicious.

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5) Cheque Theft Search:-

- Conduct a reconciliation of Accounts Payable with the monthly Bank Statement to identify discrepancies between the two.
- Instrumental in identifying cheque fraud.
- Identify missing cheque numbers or gaps in reconciled checks numbers-this is usually indicated on the bank statement with a '*'" or '#' to indicate the cheque number is not sequential.
- Conduct a reverse Positive Pay electronically - By merging your cheque register, A/P file, & bank statements together, identify stolen cheque.
- If your bank has OCR (Optical Character Recognition) abilities, then you can identify the actual payee on the cheque.
- There are 3 different data bases describing 1 activity. Use the 3 data sources to find any discrepancies in the 1 payment. If your cheque numbers are unique, try merging all 3 data sources by the cheque number and compare each of the following fields:
- **payee-cheque amount-cheque date.**
- Using SQL code or another programming language, identify all of the cheques that are in one data base & not the other.
- Identify all of the cheques that are in all 3 data sources but have different payee names or different amounts & dates.

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6) Abnormal Invoice Volume Activity

▸ A way to alert to abnormal behavior.

▸ Rapid increase in invoice volume indicate a legitimate increase in business, but also may indicate a fraudster becoming more confident in stealing money.

▸ The increase may warrant further investigation.

▸ *Eg: Q)a vendor has 2 invoices one month and 70 the next – you may want to know why?? even if the reason is not a fraudulent one.*

▸ To calculate the % increase in invoice volume from month to next month, find the difference in number of invoices & then divide by the number of invoices in the first month.

▸ In our example, going from 2 invoices to 70, the difference (68) divided by the number of invoices in the first month (2) represents a 3,400% increase.

▸ Setting the threshold percentage is the key

▸ When doing audits, set the threshold percentage appropriately.

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7) Vendors with Cancelled or Returned Cheques:

- Vendor with many cancelled cheques or a regular pattern of cancelled cheques is abnormal.
- They are usually legitimate transactions; however, a cancelled cheque can be returned to the wrong hands and re-written to the fraudster.
- This algorithm is easy to implement. Calculate the number of cancelled or returned cheques for each vendor & divide by the total number of cheques for that vendor. Then, sort this list by descending percent so that your most suspicious vendors are at the top of the report.

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Case Study-

- "An uncashed disbursement cheque was returned to an accounts payable clerk for disposition because she originated the invoice entry.
- The clerk put the cheques in her desk and forgot about it for several months.
- Upon cleaning her desk, she discovered the returned cheques. When she checked the paid history, she realized the supplier had returned the cheques when it was determined to be a duplicate payment of an invoice.
- She also noticed that the payee name had been printed slightly below "Payee" on the cheques. With a bit of effort she managed to align the cheques and insert her name above the original payee in a print similar to the original, along with an "or" designation following her name.
- The fraud was caught by an accounts payable auditor searching for duplicate payments and who was asked by the supplier to furnish proof of duplicate payments by providing copies of both cancelled cheques. "

8) Above Average Payments per Vendor:

▸ This algorithm identifies invoices that are way above average for a particular vendor.

▸ Suppose a vendor normally has invoices ranging from Rs1,000 to Rs3,000; suddenly an invoice shows up for Rs25,000.

▸ You may want to investigate this abnormality by using alert pattern.

▸ For each vendor, calculate the average & standard deviation of the invoice amount. Then, calculate a z-score for each invoice amount:

z-score = (invoice amount – average amount) / standard deviation.

▸ Then, flag all vendors with a z-score above 2.5, indicating the payment is more than 2.5 standard deviations above the mean. If your report is still too large, try increasing the z-score threshold to 3.0 or higher.
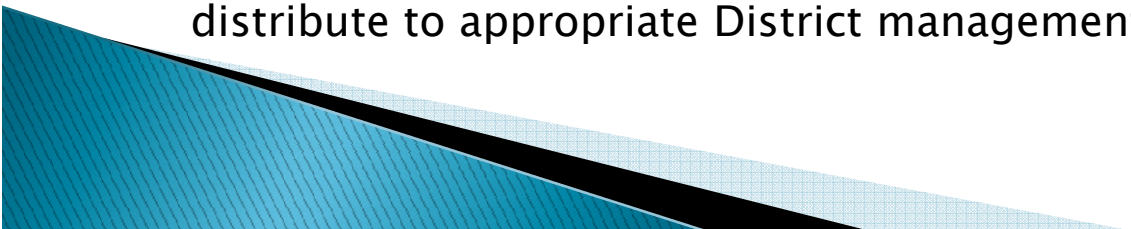
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9) Vendor / Employee Cross-Check:

- "Trust but *verify*".
- Conduct some data mining to make sure Employees are trustworthy.
- Cross-check your vendor & employee files to see if an employee has set up a fictitious vendor.
- Try merging your vendor file & employee file by the following variables:
- Address.
- Tax ID Number.
- Phone Number.
- Bank Routing Number.

IA-Account Payables

WORK PAPERS:

- Organize all relevant work papers in a clear & logical manner with cross reference audit steps to their corresponding work papers.
- Create a final index for the work paper bundle.
- Compile and securely store audit files for reference if needed.
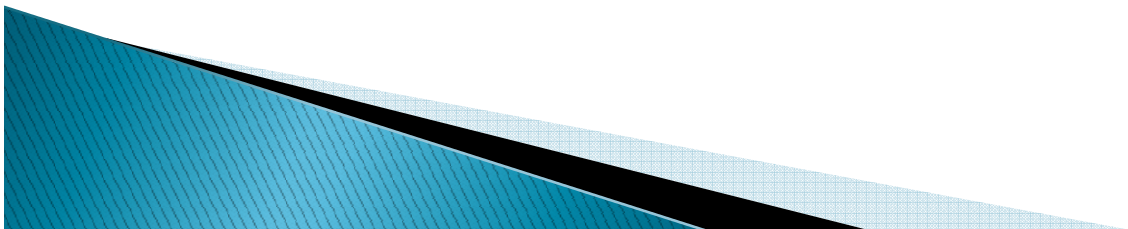
AUDIT FINDINGS & REPORTING:

- Document summaries of all audit findings as soon as exceptions are noted.
- Recommend to auditee any appropriate adjustments, internal control or operational recommendations as a result of the review.
- Determine whether to include each audit finding in final audit report based on the audit disposition, the overall materiality to the audit and the relative risk exposure.
- Prepare the draft audit report for review by auditee.
- Distribute tentative & preliminary audit report to auditee & request responses within two weeks.
- Compile final audit report with auditee's responses, review for errors & distribute to appropriate District management.

Procurement & account payables: Best Practices

- Forecasting & Planning of Requirements.
- Need Clarification/Specification.
- Sourcing Decisions in Emergency/ Non-Emergency Situations .
- Contract Generation for Structured or Unstructured Requirements.
- Receiving of Services, Materials & Documents.
- Settlement & Payment in Accounts Payable.
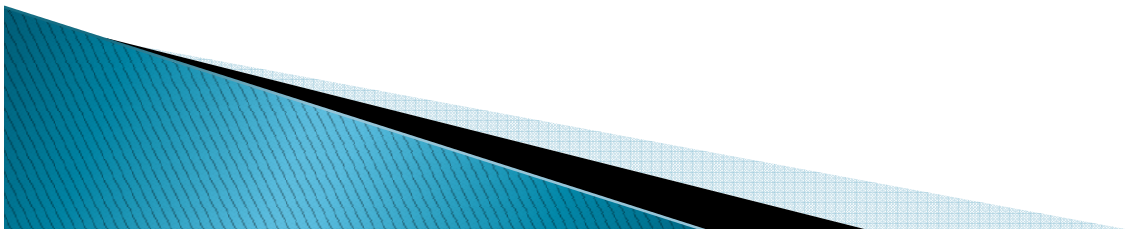
‣ "A dysfunctional finance team cut off from procurement is like a pantomime horse – the back end follows the front, but they're not really sure where or why and the front is blind to whatever chaos is following in its wake. The simple fact is that a team which is connected works better, produces better results, saves money and better overall visibility, which of course also helps in terms of compliance."