
2 Government-Wide: Payments to Vendors

Summary

It is very important that government organizations have a strong system of internal control to protect public funds, as well as the public interest, through the continued and effective operation of important government programs. In July 2008 we completed a government-wide internal controls audit addressing the processes surrounding payments to vendors. The Nova Scotia Government made payments to vendors totaling \$6.6 billion in 2007-08. The objective of this audit was to assess whether controls over payments to vendors are adequate to ensure all transactions are complete, accurate, authorized and provide an adequate management trail.

We concluded that key controls did not operate effectively throughout the year to ensure all payments and related accounting records are complete, accurate, authorized and provide adequate linkages to other relevant accounting documents or records.

We encountered numerous instances where controls did not operate effectively throughout the year. Payment transactions were not always authorized, supported by invoices or other documentation, coded with posting information, and checked for mathematical accuracy. We found no evidence of critical reconciliations occurring in two instances. We found significant numbers of government staff had access to incompatible functions of the government's accounting systems. We also noted that the annual service audit conducted by a public accounting firm on certain of government's general information technology controls resulted in a qualified opinion and the identification of several control deficiencies.

We found that the Government has not adequately documented and assessed its own control systems. Further, there is insufficient communication of the general responsibility of senior management in departments and agencies for controlling their own systems and transactions.

Control deficiencies such as those found by this audit pose a significant risk to the Government of Nova Scotia. They can present opportunities for fraudulent transactions and allow errors to occur and remain undetected. A lack of control system documentation and assessment can lead to an incomplete understanding of critical government systems, as well as a false sense of security about the adequacy of control in government.



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Background

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- 2.1 The Committee of Sponsoring Organizations (COSO) – an organization of professional associations dedicated to providing guidance on organizational governance, business ethics, internal control, enterprise risk management, fraud and financial reporting – defines internal control as:

“...a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- *effectiveness and efficiency of operations*
- *reliability of financial reporting*
- *compliance with applicable laws and Regulations.”*

- 2.2 One of the key components of an internal control framework is control activities. As defined by COSO:

“...these are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity’s objectives. Control activities occur throughout the organization, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.”

- 2.3 A strong system of internal control is crucial to any organization to protect the integrity of the organization, as well as the financial and other interests of its stakeholders (e.g., shareholders, customers, suppliers, and the public). Internal control is important to government organizations as a means of protecting public funds, as well as the public interest through the continued and effective operation of important government programs.

- 2.4 In the Nova Scotia Government, systems having government-wide application are managed centrally, with delegation of certain operational functions to the departments. An example is the government’s corporate financial management system which is managed centrally by the Department of Finance through its Government Accounting Division for accounting and reporting purposes, as well as by its SAP Customer Competency Centre for purposes of system management and control. Many other government



systems are specific to individual departments and are managed by the departments or their Corporate Service Units (CSU's).

- 2.5 In the accounting practices of the Nova Scotia Government, the term “*vendor*” means more than traditional commercial vendors such as companies which sell office supplies and provide telecommunications services. It also includes other receivers of payments such as grant recipients and government employees who have submitted an expense claim.
- 2.6 For the year ended March 31, 2008, the Province’s Consolidated Fund recorded expenditures totaling approximately \$8.1 billion. Of this amount, \$6.3 billion was paid to vendors, as follows:
- Operating goods and services - \$539 million
 - Professional services - \$191 million
 - Grants and subsidies - \$5,543 million
- 2.7 The remainder is comprised of payments for salaries and debt servicing, and journal entries for amortization. Payments for capital assets, which are not classified as expenses under generally accepted accounting principles, totaled approximately \$315 million.
- 2.8 Regardless of their type, vendor payments originate and are authorized within the various government departments and agencies. The process of checking and recording payment transactions is the responsibility of government’s Corporate Service Units. There are eight CSU’s in the Government of Nova Scotia, each serving one or more client departments and other government entities.
- 2.9 There are two forms of payment used by the Province. Many vendors receive payment in the traditional manner – by way of cheque. There is also an option for approved vendors to be paid by electronic funds transfers, whereby the Province transfers money electronically from its bank account to a vendor’s bank account. Approximately 12.5% of total dollars paid in 2007-08 were remitted by cheque, while 87.5% were remitted by way of electronic funds transfer.

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Scope and Approach

- 2.10 In July 2008 we completed a government-wide internal controls audit addressing the processes surrounding payments to vendors. The period covered by the audit was April 1, 2007 to March 31, 2008. The audit was performed in accordance with Section 8 of the Auditor General Act and auditing standards established by the Canadian Institute of Chartered Accountants.



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- 2.11 The objective of this audit was to assess whether controls over payments to vendors are adequate to ensure all transactions are complete, accurate, authorized and provide an adequate management trail.
- 2.12 Our approach included obtaining and documenting a detailed description of vendor payment processes, and performing detailed testing of transactions to determine if adequate controls were in place and operating effectively throughout the period under audit. We focused on payments made by core government departments and agencies, thereby excluding entities such as district health authorities, regional school boards and crown corporations. We examined payments relating to the purchase of operating goods and services, procurement of professional services, and issuing of grants and subsidies. We included payments for capital assets in our testing as these would appropriately be considered payments to vendors.
- 2.13 We also reviewed the results of the annual independent service audit of government's SAP Customer Competency Centre for the year ended March 31, 2008. This audit is conducted by a private sector firm and results in an opinion on the adequacy of general controls over certain of the government's computer operations, including those which process payments to vendors. We considered the results of this audit in arriving at our overall assessment of internal controls relating to payments to vendors.

Significant Audit Observations

- 2.14 *Conclusions and summary of observations* – Our audit sought to assess the adequacy of control over payments to vendors. We concluded that key controls did not operate effectively throughout the year to ensure all payments and related accounting records were complete, accurate, authorized and provide adequate linkages to other relevant accounting documents or records.
- 2.15 We encountered numerous instances where controls did not operate effectively throughout the year. Payment transactions were not always authorized, supported by invoices or other documentation, coded with posting information, and checked for mathematical accuracy. We found no evidence of critical reconciliations occurring in a couple of cases. We noted that the annual service audit conducted by a public accounting firm on certain general information technology controls of government resulted in a qualified opinion and the identification of several control deficiencies.
- 2.16 We also found inadequate segregation of incompatible accounting responsibilities. This is due to significant numbers of government staff with conflicting combinations of access privileges to government financial accounting systems.

2.17 The Government of Nova Scotia has experienced cases of fraud in the past; some of which were due to inadequate segregation of incompatible accounting responsibilities. Past reporting by our Office has highlighted internal control deficiencies in specific entities and across government. The prevalence and types of control weaknesses found by this audit, and the significant funds flowing through payments to vendors indicates that government needs to be very concerned about its state of internal control and address the matter in a prompt and thorough manner.

Segregation of Duties

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2.18 A basic premise of internal control is that no employee should have responsibility for performing two or more of the following incompatible activities:

- authorization of transaction
- custody of assets
- recordkeeping
- reconciliation of accounting records to assets

2.19 Assigning incompatible responsibilities has a negative impact on systems of internal control and subjects the organization to higher risks of fraudulent activities. Accordingly, management must exercise care in assigning job responsibilities to employees.

2.20 In the modern age, segregation of duties is primarily established by which features of computer systems employees are permitted to use. In some instances, employees may be assigned access privileges which enable them to perform functions incompatible with their other responsibilities.

2.21 We performed an analysis of system access privileges related to vendor payment processes, looking for instances where incompatible access privileges have been assigned. We identified the following.

- 114 government employees have system access privileges enabling them to enter invoices for payments and process receipt of goods. This could allow them to approve an invoice for payment when the goods received were deficient, or even non-existent.
- 13 government employees can create or change vendor master records and initiate cheque or electronic payments. This could enable fictitious vendors to be set up in order to misappropriate government funds.

2.22 These findings are similar to those from our 2006 audit that examined application controls relating to the government's financial management



systems. We are concerned that, two years later, our recommendations to address these segregation of duties issues have not been completely addressed.

Recommendation 2.1

The identified instances of incompatible access privileges should be investigated to determine if all or some are necessary. If they are necessary, compensating controls should be put in place to mitigate the higher risk these situations cause.

2.23 Internal control systems should be monitored by management, assisted by processes that assess the adequacy of controls on a regular basis. We found there were no processes to periodically ensure only compatible computer access privileges have been assigned to individual employees.

Recommendation 2.2

The government's SAP Customer Competency Centre should perform periodic analysis to identify where incompatible system access privileges have been assigned to government employees so that these situations can be reviewed for necessity, and compensating controls implemented where appropriate.

Testing of Vendor Payment Transactions

2.24 The primary focus of this audit was to document the processes and controls relative to payments to vendors, identify the key controls, and perform detailed testing of transactions to ensure that key controls existed and operated effectively throughout the audit period. In performing this work we visited each of the eight Corporate Service Units (CSU's), as well as the Government Accounting Division of the Department of Finance.

2.25 We encountered numerous transactions in all CSU's which were not subjected to all of the controls that had been described to us during the systems documentation phase of the audit. We examined 163 transactions and noted the following control deficiencies.

2.26 *Payment authorization* – Only certain employees in departments can authorize payments. Departments are required to provide CSU's with listings of employees who are permitted to perform this function, and are responsible to promptly update the listings as changes occur. The CSU's are required to use these listings to ensure all payment requests submitted by departments are properly approved. We found:

- one payment was processed without any evidence of departmental approval; and
- two payments were processed with approvals by employees who were not on the approved signing authority lists.



2.27 In these instances, there is a risk that unauthorized or fraudulent transactions could occur.

Recommendation 2.3

CSU's should not process payments without evidence of proper departmental approval.

2.28 *Mathematical accuracy* – We found six vendor invoices that contained mathematical errors which were not detected by CSU staff.

2.29 Our concern with these errors was that they indicated that invoices at risk for mathematical errors were not always being checked for accuracy. Failure to check such invoices for mathematical accuracy can result in the loss of funds through excessive payments.

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Recommendation 2.4

CSU's should verify the mathematical accuracy of documents supporting payments if there is a risk of errors occurring in the documentation. CSU employees should provide evidence of this process by signing or initialing the documents checked.

2.30 *Posting information* – Prior to being submitted to a CSU, invoices or other supporting documents are stamped to provide a place to record posting information such as cost centre, account and vendor numbers. This information helps ensure that payment transactions are properly recorded in the accounting records and the intended vendors are paid. We identified:

- 15 documents which were not coded with a cost centre number;
- 13 documents which were not coded with an account number; and
- 3 documents which were not coded with a vendor number.

2.31 If cost centre, account and vendor numbers are not coded by departmental employees on an invoice being submitted to a CSU for payment, there is no guarantee that CSU employees will know the proper account in which to record the payment, or even the proper vendor to be paid.

Recommendation 2.5

Payments should not be processed by CSU's without all required posting and payment information being recorded by departments on the supporting documentation.

2.32 *Monitoring and verification* – There are reports that can be produced by the government's corporate financial system that enable CSU staff to check the accuracy and completeness of payment processing. Although there is



no formal requirement for CSU's to perform this detailed checking, we determined that some CSU's use the reports extensively on a daily basis, while others use it less frequently or not at all. Failure to check payment transactions could result in errors or fraudulent transactions being recorded and not subsequently detected.

Recommendation 2.6

Payment transactions should be checked by CSU's to ensure they were processed and posted correctly.

2.33 *Supporting documentation* – All payment transactions should be supported by appropriate documentation to explain and support the purpose of the payment. Examples of supporting documentation include:

- for office supplies – invoices and evidence of goods received;
- for travel expenses – signed expense claims and travel cost receipts; and
- for grant payments – letters of approval signed by a Minister or senior government official.

2.34 We detected three instances where payments were processed and posted by CSU's with insufficient or no supporting documentation. If payments are not supported by such documentation there is risk that payments will be made for purposes other than intended.

Recommendation 2.7

Payments should not be processed by CSU's unless all relevant supporting documentation is provided.

2.35 *Payment runs* – A key control over the processing of electronic vendor payments is the reconciliation of payment run totals to bank reports of payments processed. It is the responsibility of the Government Accounting Division of the Department of Finance to perform this function. If this balancing process fails to take place on a timely basis there is risk that errors or fraudulent transactions will go undetected before payments are made. We found two instances where there was no evidence of the balancing of batches of electronic payments.

Recommendation 2.8

The balancing of electronic payments to bank records should be performed and documented by the Government Accounting Division of the Department of Finance before payments are made.

2.36 Another common control over electronic payments is to program the responsible computer system with limits on how large a payment it will

process. There are two limits set for government's electronic payments. Individual payments relating to the Department of Community Services' income assistance program are limited to \$25,000 or less. All other government payments are limited to \$25 million or less.

- 2.37 The \$25 million dollar limit was set to accommodate very large loan and grant payments made by government. However, it does not provide much control over the average electronic payment. If someone was able to access and change an electronic payment run file before it was sent to the bank, and other controls were circumvented, it is conceivable that this person could transfer an amount under \$25 million to another bank account, perhaps in another country. We believe there is a need for a series of dollar limits requiring multiple or higher levels of approval to exceed. These may best function at the bank, and require special letters or other signed approvals be sent with payment runs.

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Recommendation 2.9

The Department of Finance should implement lower or multiple levels of electronic payment limits to prevent a very large, unauthorized electronic payment from being processed.

Testing of Control over the Vendor Master File

- 2.38 There is a very important component in all payment systems generally known as the vendor master file. This is a database file that contains all the information pertinent to each approved vendor, such as name, address, assigned vendor number and payment preference (i.e., cheque or electronic payments). It is critical that strong control be exercised over who can approve, create or change vendor information in such files. Without strong control, fictitious vendors could be set up or payments could be redirected to another bank account.
- 2.39 All vendor accounts are approved and created through Government Accounting. When a department deals with a vendor that has not previously done business with the government, it requests the vendor be set up in the payment system by sending a form to Government Accounting. A copy of an invoice must be attached to the request so Government Accounting can be sure it has accurate vendor information and it can check that the vendor is not already approved and in the system.
- 2.40 We examined a sample of 30 entries to create or change vendor information in the master file. We found the following.
- Three entries occurred relating to income assistance payments from the Department of Community Services where no list exists of individuals who are authorized to approve the set up and changing of vendors.



- Four entries occurred where a copy of the invoice was not provided.

Recommendation 2.10

The Department of Community Services should provide Government Accounting with a listing of all employees authorized to approve income assistance payments and ensure that the listing is promptly updated when changes occur.

Recommendation 2.11

Government Accounting should not create or change vendor master file records unless the request is fully supported by required documentation.

Journal Vouchers

- 2.41 Some of the transactions we selected for testing were journal vouchers. These generally represented entries to set up accounts payable, correct errors or reclassify previous entries. Journal vouchers are powerful accounting tools which, if not properly controlled, can provide means to cover up errors or fraudulent activities.
- 2.42 We were unable to trace 16 journal voucher transactions to their related payments because the journal vouchers did not contain sufficient information to enable this. We reviewed these transactions with Government Accounting staff and they were also unable to trace the journal vouchers to the related payments. The risk in these instances is that inappropriate journal vouchers could be posted and not be discovered since there is no way to substantiate them against their related transactions.

Recommendation 2.12

CSU's should ensure there is sufficient information presented with journal vouchers to identify any related transactions.

Service Audit Report on General Information Technology Controls

- 2.43 The government's SAP Customer Competency Centre is responsible for the management, operation and maintenance of the government's corporate financial management systems. These include the government's processes relating to vendor payments. An independent audit focusing on the adequacy of the Centre's general information technology controls is conducted by a public accounting firm each year. This audit examines subjects such as who can access computer systems, adequacy of system back-up and recovery processes, how well the data and physical assets of the systems are protected, and how changes to computer application programs are controlled.



2.44 The most recent audit, for the year ended March 31, 2008, resulted in a qualified opinion based upon non-achievement of two of nine control objectives defined for the audit. We examined the report from this audit and noted several control deficiencies were found that have relevance to the government's vendor payment systems. Based on the auditor's qualified report and specific control deficiencies described, we concluded that general information technology controls are not strong enough to ensure payments to vendors are adequately controlled.

Internal Control System Documentation

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2.45 Roles and responsibilities for specific internal controls are delegated throughout government. While the Provincial Finance Act includes general references to the roles and responsibilities of the Minister and Deputy Minister of Finance in this regard, there is little documentation of overall responsibility for control relating to the various entities which comprise the Government. Additional guidance needs to be developed and effectively communicated. This would include the roles and responsibilities of departmental and crown entity governing bodies and senior management in the design, implementation, operation and maintenance of internal controls.

2.46 A significant part of this audit was dedicated to determining and documenting government's systems of internal control relating to vendor payments. This involved determining the processes and transaction flows relating to vendor payments; identifying key controls which will ensure the payments are accurate, authorized and properly accounted for; and testing to ensure the systems described were indeed the systems in place.

2.47 It is a concern to us that Government has not prepared its own descriptions and evaluations of its control systems. Such documentation is critical to management's ability to design, modify and monitor internal control, and the absence of such may be a contributing factor to the control weaknesses we observed during this and other audits. During our Fall 2007 follow up of Recommendation 2.2 in the December 2005 Report of the Auditor General, it was indicated that the Department of Finance will be working with Service Nova Scotia and Municipal Relations on a pilot basis to develop a framework and methodology for the documentation of internal controls in government.

Recommendation 2.13

The Department of Finance should oversee a project to document and communicate responsibility for internal control throughout government, as well as to have all significant control systems in government documented. Once documented, control systems should be analyzed for weakness, deficiencies corrected, and a system to periodically monitor compliance with government control standards should be implemented.

Response: Department of Finance

The Department of Finance would like to thank the Auditor General for the opportunity to respond to this chapter concerning controls over payment to vendor. The chapter deals with issues of segregation of duties, testing of payment transactions, control of the vendor master file and internal control documentation.

RESPONSE:
FINANCE

Generally speaking, the findings and recommendations concerning segregation of duties, payment transactions and control of the vendor master file, address minimum risk activities and in many cases there are compensatory controls in place to address the weakness identified. However the report does suggest that some fundamental accounting policies and procedures need to be understood. The Department of Finance through the Controllers Office, will ensure that Corporate Services Unit and corporate staff are reminded of accounting policies and processes and, if needed, arrange for appropriate training.

The last section of the chapter deals with internal control responsibilities and documentation of controls. The Department agrees with the recommendation and an initiative is underway which will clearly communicate internal control responsibilities and establish a process to document control in high risk areas.