# Accounts Payable Outsourcing Audit
# April 2014

Craig Terrell, Interim City Auditor
Lee Hagelstein, Internal Auditor

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# Accounts Payable Outsourcing Audit

*Office of the City Auditor*
**Craig Terrell, CPA**
**Interim City Auditor**

*Project # 13-13*                                                          *April 25, 2014*

## Executive Summary

### Outsourcing the AP function is cost effective

### Monthly service is billed accurately and according to the contract

### Compliance with Service Level Agreement requirements

## Opportunities for Improvement

### Ensure all calls for service are answered

### Reduce invoice corrections

### Reinstate users locked-out of the system in a timely manner

### Reduce duplicate vendor records and purge inactive accounts

As part of the Fiscal Year 2013 Annual Audit Plan, the City Auditor's Office conducted an audit of the City of Arlington's Accounts Payable Outsourcing operations. The audit was conducted 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. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

The objectives of the audit were to determine whether:

- the City is achieving the objectives of outsourcing
- the City is being billed in accordance with the contract
- the City is exercising appropriate oversight over the outsourcing agreement

The City Auditor's Office noted that outsourcing the AP function is cost effective. Through the first four years of a five year contract, the City has realized cost savings of approximately $146,000. The City is being billed in accordance with the contracted fees and the vendor is meeting contractual service level requirements on a regular basis.

Although management has generally exercised strong oversight over the AP outsourcing function, the City Auditor's Office did note the following exceptions:

- not all service center calls are being answered by the vendor;
- there are a significant number of invoices processed that require correction by City staff;
- when a user is locked-out of the Catalyst system, sometimes it takes an extended period of time to reinstate the user; and
- the vendor master file contains many duplicate and/or inactive accounts

These findings and recommendations are discussed in the Detailed Audit Findings section of this report.

# *Audit Scope and Methodology*

The audit was conducted in accordance with generally accepted government auditing standards. The following methodology was used in completing the audit.

- Interviewed various City staff and surveyed end-users regarding past and current procedures
- Reviewed the Business Process Outsourcing Services Agreement between the City of Arlington and SourceNet Solutions, Inc. (SourceNet)
- Reviewed invoices within Catalyst to verify expenditures
- Reviewed the vendor master file to identify duplicate and/or inactive vendor records
- Reviewed the vendor maintenance process
- Tested the monthly billings from SourceNet to ensure accuracy
- Tested the monthly performance level requirements to ensure compliance with the contract
- Calculated the cost effectiveness of outsourcing the AP function
- Evaluated the efficiency of the outsourced AP process

# *Background*

On May 20, 2009, the City of Arlington entered into a Business Process Outsourcing Services Agreement with SourceNet. The agreement terminates on the fifth anniversary of the "Conversion Date" of the agreement (the date in which the transition period was deemed to be completed). The conversion (go-live) date was December 12, 2009. The agreement will remain in effect until December 31, 2014, unless terminated sooner based on provisions of the agreement. The contract also includes an automatic renewal for additional successive one-year terms upon completion of the initial term unless either party provides a written notice of termination 180 days prior to the completion of the initial term.

Proposals were received from three nationally recognized business process outsourcing providers. Based on the proposal of the most qualified provider, it was estimated that outsourcing the Accounts Payable process would result in a savings of approximately $90,000 during the initial five-year contract period. Also, future savings were estimated at approximately $60,000 per year.

In addition to the cost savings, the following benefits were also expected from outsourcing the AP function:

- Payment according to vendor terms resulting in better cash management
- Management of vendor discount opportunities resulting in cost savings
- Paperless processing efficiencies for City departments
- Vendor access to on-line invoice status and electronic billing and payments
- Vendor database management to be performed by outsourcing agent
- Form 1099 preparation to be performed by the outsourcing agent
- Procurement card management to be performed by the outsourcing agent (which was later returned to the City and is now being performed by the Purchasing Department)

Outsourcing the Accounts Payable function resulted in a reduction in force of four positions. The chart below shows the initial cost savings analysis prepared by management for outsourcing the accounts payable function. The analysis showed a savings of approximately $150,000 over the 5-year period, offset by an estimated one-time implementation fee of approximately $60,000.

### Accounts Payable Outsourcing Analysis

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Total |
|---|---|---|---|---|---|---|
| **Current accounts payable costs** | | | | | | |
| Salary and benefits - increase 2% per year | $168,878 | $172,256 | $175,701 | $179,215 | $182,799 | $878,848 |
| Other direct costs - increase 2% per year | 6,000 | 6,120 | 6,242 | 6,367 | 6,495 | 31,224 |
| Accounts payable "as is" | $174,878 | $178,376 | $181,943 | $185,582 | $189,294 | $910,072 |
| **SourceNet estimated costs** | | | | | | |
| 36,500 invoices per year | $164,250 | $152,388 | $138,700 | $133,225 | $120,906 | $709,469 |
| 1099 processing | 2,800 | 2,800 | 2,800 | 2,800 | 2,800 | 14,000 |
| P-card administration | 7,280 | 7,280 | 7,280 | 7,280 | 7,280 | 36,400 |
| Total | $174,330 | $162,468 | $148,780 | $143,305 | $130,986 | $759,869 |
| Estimated outsourcing savings | $548 | $15,908 | $33,163 | $42,277 | $58,308 | $150,204 |

Salary and benefits include:
Three accounts payable clerks
One accounting assistant

Yr 2 - 10% invoices billed at electronic rate
Yr 3 - 15% invoices billed at electronic rate
Yr 4 - 20% invoices billed at electronic rate
Yr 5 - 25% invoices billed at electronic rate

**Source:  Financial and Management Resources**

The contract also included a Service Level Agreement that must be met by SourceNet. Those requirements are shown in the table on page 7. Within the contract, SourceNet and the City of Arlington are required to perform certain duties. The responsibilities of SourceNet and the City are shown below:

SourceNet
1) Manage document receipt
2) Verify and process invoices
3) Utility bill processing
4) Payment exception avoidance and reclamation
5) Set-up and monitor the vendor master file
6) Respond to inquiries and e-commerce
7) Provide reporting to external/internal customers
8) 1099 activity

City staff
1) Approve and code items
2) Develop and approve policies and procedures
3) Perform exception resolution
4) Review and approve check runs
5) Print and mail all checks
6) Ensure compliance with AP policy
7) P-card administration

Shared Responsibilities
1) Review input and output for data errors
2) Information systems (hardware and software) support
3) Management action (review of monthly activity and charges)

# *Audit Results*

**1. The Financial Services Department has saved approximately $146,000 over the last four years by outsourcing the AP function.**

The chart below contains the results through the first four years of the contract.

| Accounts Payable Outsourcing Analysis Through 12/31/13 | | | | | |
|---|---|---|---|---|---|
| | Year ended 12/31/2010 | Year ended 12/31/2011 | Year ended 12/31/2012 | Year ended 12/31/2013 | Totals (4 year) |
| **Accounts payable salary savings - 4 FTEs** | | | | | |
| Base salary | $  131,810 | $  131,810 | $  135,764 | $  135,764 | $  535,149 |
| Benefits | 35,075 | 36,968 | 39,289 | 41,264 | 152,596 |
| Stability pay (increases $354 per year) | 3,997 | 4,351 | 4,705 | 5,059 | 18,112 |
| One-time payments | - | 5,273 | - | 2,715 | 7,988 |
| Total savings | $  170,882 | $  178,402 | $  179,759 | $  184,802 | $  713,845 |
| **SourceNet actual costs - for month ended** | | | | | |
| December 2009 | $  4,138 | | | | $  4,138 |
| January | 8,186 | $  10,503 | $  9,735 | $  8,974 | 37,398 |
| February | 9,038 | 9,274 | 9,497 | 8,009 | 35,817 |
| March | 10,834 | 10,754 | 9,642 | 9,283 | 40,513 |
| April | 11,489 | 9,848 | 9,518 | 10,602 | 41,457 |
| May | 10,798 | 9,129 | 11,166 | 10,402 | 41,495 |
| June | 12,391 | 10,384 | 9,385 | 9,809 | 41,969 |
| July | 11,439 | 9,239 | 10,516 | 10,889 | 42,083 |
| August | 11,212 | 11,018 | 10,186 | 10,853 | 43,269 |
| September | 11,247 | 11,341 | 8,790 | 11,211 | 42,588 |
| October | 10,669 | 10,617 | 10,780 | 12,675 | 44,741 |
| November | 11,028 | 11,603 | 10,975 | 11,118 | 44,723 |
| December | 11,221 | 8,966 | 8,944 | 9,268 | 38,398 |
| P.O Box | 900 | 940 | 960 | 1,040 | 3,840 |
| 1099 Fee | | 609 | 609 | 628 | 1,846 |
| Total annual fees | $  134,587 | $  124,224 | $  120,703 | $  124,761 | $  504,275 |
| Savings before implementation | 36,295 | 54,177 | 59,056 | 60,042 | 209,570 |
| Total implementation cost of $79,240 | | | | | |
|   amortizied over 5 year contract | (15,848) | (15,848) | (15,848) | (15,848) | (63,392) |
| Total outsourcing savings | $  20,447 | $  38,329 | $  43,208 | $  44,194 | $  146,178 |

**Source:  Payroll Records and Lawson**

On the initial cost savings analysis, the estimated savings after four years was $91,896; whereas, the actual personnel savings was calculated at $146,178.  The main reason for the variance between the initial analysis and the re-calculation is due to the volume of transactions.  The initial analysis assumed an annual volume of 36,500 invoices; whereas, the actual volume averages only around

27,000 per year. Also, the initial analysis includes other AP direct costs (i.e. computer licenses, office supplies and general service charges) which the re-calculation does not include.

Although there is cost savings from outsourcing the AP function, it should be noted that some of the duties of the four AP positions were distributed to staff (users) throughout the City. Users are required to verify, scan and upload invoices to Catalyst for payment and may also be required to perform some research if errors need to be corrected. In addition, employees within the Accounting and Purchasing Divisions are now more involved with the AP process than before, including two employees in Finance and four employees in Purchasing. These employees are responsible for making changes/corrections to invoice errors/omissions. Even though some of the AP activities were distributed to users (about 180 employees), it was not necessary to hire additional personnel within any of the departments to ensure that these tasks were performed. The City Auditor's Office did not conduct any tests to determine the amount of extra time spent by users in performing AP duties. It is generally believed that any extra time is offset by increased efficiency gained from having electronic access to AP documents.

**2.  Management ensured that the City was billed according to the AP Outsourcing Agreement.**

The Outsourcing Agreement with SourceNet includes billing rates for paper and electronic invoices. For paper invoices, there is a tiered rate schedule during the 5-year term. The rate for the first two years of the contract (Dec 2009 – Nov 2011) was $4.50 per invoice; the rate for the next two years (Dec 2011 – Nov 2013) was $4.25 per invoice; and the rate for the final year of the contract (Dec 2013 – Nov 2014) is $4.00 per invoice. The rate for electronic invoices is $1.25 per invoice throughout the term of the contract. During this audit, it was determined that SourceNet billed the correct rate for both paper and electronic invoices.

In addition, the contract states that, on a monthly basis, a minimum percentage of all transactions will be converted to, or be billed at, the electronic rate. The minimum percentages are as follows: year two – 10%, year three – 15%; year four – 20%; and year five – 25%. If the minimum is not reached during a particular month, SourceNet adjusts for the difference. During the first three years of the contract, the minimum number of electronic invoices processed each month was attained. However, during the fourth year of the contract, the City did not reach the minimum percentage of electronic invoices for the months of June – December 2013. Therefore, SourceNet issued credits or made adjustments to subsequent billings for June – November. The December adjustment has been requested by the Finance Department, but as of the conclusion of the fieldwork, has not been received.

**3.  Management has generally ensured that the vendor has met service level requirements.**

The contract also included a Service Level Agreement that must be met by SourceNet. Those requirements are shown in the following table:

| Metric | Description | Purpose | Service Level | Results (4-month avg.) |
|---|---|---|---|---|
| Document Services | Documents sorted, batched, and routed to Transaction Processing (Imaged or Routed Manually) | Measure the timeliness of receiving invoices or qualified payment documents from vendor or client and routing those invoices to transaction processing | Within two (2) business days of receipt | .04 of a day = approx. 1 hour |
| Transaction Processing - Standard | Items processed to their fullest extent (i.e. Completed, deleted or routed to Support Group, Special Services, Document Services or Client | Measure the timeliness of processing each invoice or qualified payment document to its fullest extent | Within two (2) business days of receipt from Document Services | 1.82 days |
| Transaction Processing - Expedited | Critical Items processed to the fullest extent if received prior to (agreed to daily cut off time) when supported by an Expedited Payment source document | Measure the timeliness of processing items deemed critical to its fullest extent | Same day if received prior to (agreed to daily cut off time) when supported by appropriate source document | 0.00 |
| Quality | Controllable Error Rate | Measure the quality of processing invoices or qualified payment documents in accordance with the client's designated processing rules, policies and procedures | Less than 1% controllable error rate | 0.58% |
| Support Group | Elevation of exceptions to appropriate management personnel within a reasonable period of time | Measure the timeliness of routing transactions which require additional client or third party intervention | Within three (3) business days of given exception status | 1.16 days |
| Customer Service Center | Availability of Phone Inquiries | Measure the availability of SourceNet Customer Service agents for phone inquiries | Average speed to answer (ASA) of 1 minute or less | 30 seconds |

**Source:  SourceNet's Service Level Agreement reports**

The City Auditor's Office verified the accuracy of the monthly Service Level Agreement reports provided by SourceNet.   The results (included in the Results column) indicate that these performance level requirements are being met on a regular basis.  However, as described in the Detailed Audit Findings, the Customer Service Center results (average speed to answer) only included calls that were presented and answered, but does not include calls that were not answered.

# *Detailed Audit Findings*

1.  **Customer Service Center service level requirement is not calculated based on all calls received.**

    General business practices dictate that all calls for service received by a Call Center operation should be answered. A review of the Service Level Agreement (SLA) reports from SourceNet (established within the contract) shows that calls that are answered are being answered in a timely manner and according to stated service level requirements. However, a review of the Key Performance Indicators (KPI) reports shows that not all calls are actually being answered. The KPI reports for October 2013 show the following:

    | Date | # Calls Received | # Calls Answered | Not Answered |
    |------|------------------|------------------|--------------|
    | 9/30/13 – 10/4/13 | 23 | 19 | 17.4% |
    | 10/7/13 – 10/11/13 | 17 | 16 | 5.9% |
    | 10/14/13 – 10/18/13 | 18 | 12 | 33.3% |
    | 10/21/13 – 10/25/13 | 15 | 9 | 40.0% |
    | 10/28/13 – 11/1/13 | 14 | 4 | 71.4% |

    The service level agreement requires that the vendor answer calls for service in an average speed of one minute or less. This calculation does not include the impact of calls not answered. For the time period shown above, 31% of the calls received by the Call Center were not answered (27 of 87 calls). To ensure that the service level agreement accurately portrays the vendor's responsiveness, unanswered calls can be assigned an arbitrary speed of answer so that they may be included in the calculation. Alternatively, the number or percent of unanswered calls could be included in the service level agreement reports. The City Auditor's Office surveyed departmental users and noted that some expressed dissatisfaction with the vendor's responsiveness.

    If a call is not answered the first time an end-user calls, then inefficiency results from the employee having to take time during the day to call back. In addition, survey respondents stated that when making calls to resolve issues, a person cannot usually speak with the same representative. This could require the caller to repeat the scenario multiple times until the issue is resolved, which would result in inefficiency.

    *Recommendation:*

    The Chief Financial Officer should:

    1)  Discuss the Customer Service Center procedures with SourceNet to ensure that all calls for service are answered.

    2)  Ensure that the measurement of the Customer Service Center for the Service Level Agreement report is based on all calls for service, not only those that are answered.

    *Management's Response:*

    *Partially concur. Finance will engage in discussions with SourceNet regarding ensuring all calls for service are answered and that the Service Level Agreement report is based*

*on all calls for service whether answered or not.  However, Finance cannot ensure that SourceNet can change the method they use for measurement of Customer Service Center for the Service Level Agreement report.*

> *Target Date:   August 31, 2014*
> *Responsibility: Sherry Wright, Assistant Director of Financial Operations*

2.  **Sampling indicated that 34 percent of uploaded invoices require correction.**

As stated in the Background section of this report, one of the benefits of outsourcing the AP function was paperless processing efficiencies for City departments.  However, a review of the KPI reports shows that there are a significant number of invoices that are being rejected and sent back to City staff due to some type of change or correction necessary.  Once an invoice is received by SourceNet, if any type of change is necessary (i.e. no PO number, misspelled name, no division number, wrong dollar amount, etc.), the invoice is sent to SourceNet's Special Services Group (SSG) for review.  After the SSG determines what needs to be corrected, they send the item back to the City for correction.  The City then corrects the invoice and sends it back to SourceNet.  Invoices requiring purchase order corrections are sent to Purchasing and all others are sent to Finance.  The KPI reports for October 2013 show the following:

| Date | # Documents Received | # Received in SSG | Sent to SSG |
|------|------|------|------|
| 9/30/13 – 10/4/13 | 445 | 147 | 33.0% |
| 10/7/13 – 10/11/13 | 720 | 161 | 22.4% |
| 10/14/13 – 10/18/13 | 443 | 155 | 35.0% |
| 10/21/13 – 10/25/13 | 516 | 251 | 48.6% |
| 10/28/13 – 11/1/13 | 373 | 146 | 39.1% |

Although invoice correction criteria are not specifically quantified within the contract, the percentage of invoices with errors appears to be excessive.  According to management, a majority of the corrections are from invoices uploaded by vendors directly to SourceNet.  Other corrections are from invoices that are mailed from the vendor to the various City Departments and uploaded by City staff.  Therefore, many of the corrections are not identified until they are actually reviewed by SourceNet.  Management noted that Finance (two staff members) spends around one hour per day and Purchasing (four staff members) spends about two and one-half hours per day correcting invoices.  Finance staff also stated that if the City was still performing this function in-house, a majority of the types of corrections noted would still have to be made before processing a payment.  Staff time required for this purpose could be reduced if the number of corrections were reduced.

The City's agreement with SourceNet states that the vendor is responsible for working with City vendors to encourage the use of electronic invoice tools.  While the vendor has met all contractual requirements, it has not significantly increased the level of automation in the accounts payable process.  Vendors (including SourceNet) have utilized Optical Character Recognition (OCR) and Intelligent Character Recognition (ICR) solutions to capture invoice

data and automate the accounts payable process. In the future, potential vendors may be able to further automate the process by performing real-time data validation, decreasing the number of invoice errors and the amount of human interaction necessary to process payments. The City Auditor's Office was not able to quantify the number of errors in detail or determine if process improvements are possible within the vendor's current operating environment. However, City management indicated that additional training could be provided to users and/or vendors in an attempt to decrease the percentage of invoices requiring corrections.

### *Recommendation:*

The Chief Financial Officer should ensure that staff provides additional training to users and/or vendors outlining the information required on uploaded invoices.

### *Management's Response:*

*Concur. Finance staff will increase the number of training sessions being offered to end users each year and will provide training to vendors at every opportunity.*

> *Target Date:   August 31, 2014*
> *Responsibility: Karen Irwin, Payroll Supervisor*

### *Recommendation:*

The Chief Financial Officer should coordinate with SourceNet to seek ways in which to further automate the accounts payable process, decrease errors and increase efficiency.

### *Management's Response:*

*Concur. Finance will coordinate with SourceNet to seek ways to improve the efficiency of the accounts payable process.*

> *Target Date:   August 31, 2014*
> *Responsibility: Sherry Wright, Assistant Director of Financial Operations*

3.   **The vendor does not reinstate locked out users in a timely manner.**

In order for an end-user to perform his/her duties within the Catalyst system, the end-user must have continuous access to the system. If an end-user does not log-in to the Catalyst system within a specific amount of time, the user gets locked-out of the system. Also, if the end-user enters his/her password wrong, after the third attempt, the user ID is locked-out of the system. Survey respondents indicated that it takes too long to get the user's password re-instated. Once the user gets locked-out and notifies SourceNet, the request is sent to SourceNet's IT department, which is responsible for re-instating user IDs. Finance management agreed that sometimes it could take a few days to get re-instated. Until SourceNet reinstates a user that is locked-out, that employee does not have access to the system and therefore cannot perform necessary job duties.

*Recommendation:*

The Chief Financial Officer should review SourceNet's process by which end-users are reinstated when they are locked-out of the system and request that SourceNet develop a process to ensure end-users are reinstated in a timely manner.

*Management's Response:*

*Concur.  Finance will review SourceNet's processes to ensure locked-out end-users are reinstated in a timely manner.*

   *Target Date:    August 31, 2014*
   *Responsibility: Sherry Wright, Assistant Director of Financial Operations*


**4.  The vendor master file contains duplicate vendor records and inactive accounts.**

Leading business practices dictate that old, outdated records be periodically purged from an organization's records.  In addition, duplicated records should also be deleted from the system.

In order to add a new vendor to the system, an end-user must request that a new vendor be set-up. This requires the end-user to complete a new vendor set-up form and obtain a copy of the vendor's form W-9, "Request for Taxpayer Identification Number (TIN) and Certification".  Once this information is obtained and completed, the request must be approved by a supervisor.  Once the approval is obtained, the information is sent to SourceNet to enter into the Catalyst system.  A review showed that this process appears to be operating effectively.  However, it appears that in some cases, the Lawson accounting system is not being reviewed to ensure that the vendor does not already exist.  This leads to duplicate vendor records within the system.  Tests indicated that the current vendor master file contains several duplicate records.

The current vendor master file contains 37,633 records.  During this review, the City Auditor's Office identified 162 duplicate accounts (by vendor name).  Further review showed that 76 of the duplicate accounts had a different Tax Identification Number (TIN); 63 of the duplicate accounts had the same TIN; and the remaining 23 did not have a TIN associated with the account.

Within the vendor master file, there are 23,569 records (62.6%) that are labeled as inactive.  A cursory review showed that a majority of the records are for individuals and not businesses.  The records reviewed were created between January 2005 and December 2013.  The numbers of records, by creation date, are shown in the following table:

**Vendor Master File**
**Inactive Accounts by Year**

| | |
|---|---:|
| 2005 | 336 |
| 2006 | 2,582 |
| 2007 | 2,735 |
| 2008 | 2,882 |
| 2009 | 3,435 |
| 2010 | 3,473 |
| 2011 | 3,201 |
| 2012 | 2,830 |
| 2013 | 2,095 |
| Total | 23,569 |

**Source:  Vendor Master File**

In addition to three SourceNet employees, two employees in the Purchasing Division and the Assistant Director of Financial Operations also have the ability to reinstate inactive accounts.  In order to adequately protect an organization from fraud and/or misuse within the accounts payable function, records within the vendor master file can be periodically archived and/or purged.  If not, it is possible for inactive accounts to be unknowingly reactivated and used to disburse unauthorized funds.

In addition to vendor records, the City Auditor's Office noted that accounting, payroll and human resources information has not been archived and/or purged since the inception of the Lawson system.  No formal policy, procedure or practice has been established to identify when or how information should be archived and purged.  According to management, Financial Services staff has started to work with the Information Technology Department to identify the most appropriate method by which to archive and purge records in the Lawson Financial System.

> *Recommendation:*
>
> The Chief Financial Officer should ensure that staff reviews the vendor master file and archives or purges duplicate and inactive accounts in accordance with established policies and procedures.
>
> *Management's Response:*
>
> *Concur.  Finance will ensure the vendor master file is reviewed and that duplicate and inactive accounts are archived or purged.*
>
> *Target Date:   August 31, 2014*
> *Responsibility: Deven Mercer, Systems Administrator*