

City of Pasadena
Investigation into Matters Relative to the Underground Utility Program
as of November 11, 2014

RECOMMENDATIONS

Opportunities for Operational Improvements

During the performance of our work, we obtained City policies and procedures related to the scope of our work, focusing on the Finance Department, specifically Purchasing and Accounts Payable divisions, and reviewed the policies and procedures with regards to the design and effectiveness of internal controls and processes. As a result of our procedures, we provide the recommendations set forth below for the City's consideration in improving and strengthening the City's policies, processes and system of internal controls in the areas of the Underground Utility Program and Finance Department.

A. Underground Utility Program

Invoice and payment documents for expenditures charged to the Underground Utility Program, with regards to the Four Vendors, and testimony obtained from employees interviewed, indicate that D. Wooten performed Underground Utility Program activities with limited direct supervision or oversight from supervisory personnel (i.e., principal engineer, city engineer). The lack of effective regular monitoring of program activities and expenditures provided an opportunity for D. Wooten to engage in recurring unauthorized transactions and as a result, misappropriate City funds for a number of years, virtually undetected.

1. **Prepare and establish written desk procedures:** The City should establish clearly delineated processes and procedures specific to the UUP, starting with written and documented desk procedures for the duties and responsibilities of the program manager as well as the designated program supervisor, where applicable. Written processes and procedures should ensure that employees are informed of and understand the specific roles and responsibilities required of them and the appropriate processes and procedures to be followed in the performance of their duties. Due to the long-term, multi-year timeline required to complete the UUP, written and documented processes and procedures, including detailed process narratives, are necessary in the accurate and consistent accounting, reporting, and reconciling of UUP expenditures.
2. **Assign an additional employee to the UUP:** The City should consider assigning an individual (e.g., program analyst), to assist with the performance of UUP financial activities to ensure accuracy in accounting and segregation of duties. Duties would include assisting in monitoring, tracking, and reconciling program expenditures against the progress and completion of actual electrical undergrounding conversion work performed. The monitoring and reconciliation process should ensure that invoice amounts billed by vendors represent actual work performed for services rendered and can be verified – that work can be tracked and identified with a specific property address.
3. **Segregate tasks and duties among employees:** The City should establish procedures to ensure UUP program activities are properly segregated among employees, and not concentrated in any one individual. For example, the program manager should not be allowed to approve vendor invoices, submit invoice payment requests, and pick up the printed checks. These duties should

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be segregated to ensure no employee has the ability to authorize and approve payment of vendor invoices and also have custody of check payments.

4. **Adhere to document chain of custody:** Invoices and other documents submitted for signature authorization should be directly routed to the next level for further approval or processing. There should be adherence to a chain of custody of the documents such as that approved documents are not handed back to the initiator or requestor where the documents may be subject to unauthorized changes or manipulation.
5. **Monitor and reconcile private property reimbursements:** With regards to payment of reimbursement claims submitted by private property owners – the City should have procedures in place to identify all properties within the Underground Utility Program eligible for reimbursement and track property owners who have already received a reimbursement as well as the vendor who performed the work. Ensure that no properties are reimbursed more than once and no “double dipping” occurs where both the vendor and property owner both receive payment from the City.
6. **Discontinue historical practice of submitting invoice payment requests as reimbursements:** Reiterate to Underground Utility Program employees and all Accounts Payable staff that vendors receiving direct payment from the City for work performed on a property are not to be processed as reimbursements, but rather as regular vendors that must go through the regular procurement process and be added to the Master Vendor List prior to receiving payment. Vendors may not bypass the regular procurement process by receiving payments as reimbursements (i.e., a purchase order or contract must be required prior to payment).

B. Special Handling Requests

Invoice and payment documents for the Four Vendors showed that D. Wooten used Special Handling Request Forms to expedite processing of invoice payment requests, when the nature of the services invoiced – electrical undergrounding conversion labor and services – did not appear to warrant expedited payment processing. Use of SHR Forms should be considered on an exception basis, however, D. Wooten’s repeated and unmonitored use of SHR Forms appeared to be the rule, and not the exception. City policies and procedures regarding use of SHR Forms should be revised.

7. **Communicate purpose of Special Handling Request:** Conduct effective city-wide communication to re-emphasize and re-enforce the policy that use of Special Handling Request Forms should be limited to time-sensitive emergency payments and should not be used as the normal process for invoice payment.
8. **Use only original SHR Forms for payment requests:** The City should ensure that invoice payment requests accompanied by an SHR Forms are submitted using only original SHR Forms and bearing original signature authorizations on the Department Head approval line. Payment requests should not be submitted by City department using photocopies or other reproduced documents and Finance should not accept non-original SHR Forms for payment processing.

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9. **Limit review and approval of SHR Forms:** The review and approval of Special Handling Request Forms should be limited to the City Department Head requesting payment and the Director of Finance. Such authority should not be delegated to others under normal circumstances, if possible.
10. **Establish Dollar Amount Thresholds:** Special Handling Requests exceeding certain threshold amounts should be subjected to higher level review and approval before processing. For example, requests for payment of an amount \$25,000 and over should be reviewed and authorized by the Director of Finance; \$50,000 and over requires additional review and authorization by the Deputy Director Finance/Treasury; and \$75,000 and over requires additional review and approval by the City Manager or Assistant City Manager.
11. **Track SHR Forms electronically in the system:** Track the use of Special Handling Requests electronically within the IT system and notate each payment that was processed using a Special Handling Request Form. Record supplemental authorization information such as the employee who submitted the request and the supervisor in the respective department who authorized the request. A reference field should be included in the tracking process to identify the City Department which submitted the SHR Form. Tracking of SHR Forms will help to facilitate future reviews.
12. **Conduct regular reviews:** Finance should conduct periodic regular review of Special Handling Request Forms for any unusual trends such as high volumes from a specific department or employee, high volumes of payments to a specific vendor, repetitive dollar amounts, or spikes in use around certain timeframes. Follow up should be performed on any unusual or excessive activity identified.
13. **Perform operational audit:** In addition to conducting periodic regular reviews of processed SHR Forms. We recommend the City perform an operational compliance audit of the SHR Form process to assess the process, procedures and actual practices. The audit should cover activity in recent fiscal years (i.e. the last 3 to 5 years) to determine unusual patterns or trends that may be indicative of fraudulent activity and to identify areas of potential internal control weaknesses.

C. Vendor Master List

During the performance of our work, we inquired with Finance Department personnel regarding the existence and maintenance of the City's vendor master list. We were informed that the vendor master list represents a historical listing of vendors who have been issued payment by the City, and the listing is not used for any particular purpose nor updated on any regular basis.

A vendor master list, or vendor master file, is considered an integral part of an organization's Procurement and Account Payable processes and contains key information on vendors which facilitates the procurement of goods and services. The effective maintenance of a vendor master list is considered

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a best practice in preventing unauthorized or inappropriate activity, duplicate payments, and inefficiencies. In order to safeguard the City's resources over the procurement of goods or services, adequate preventive internal controls should be in place over vendor validation, setup, modification, and maintenance, resulting in a valid and current master vendor list of approved vendors.

14. **Create a valid Vendor Master List:** The City should create a valid vendor master list based on the vendor data and information maintained in the financial system and sourced during the vendor setup/procurement process. The Vendor Master List should serve as an approved vendor list or database from which the City can cross-reference to. The City's current vendor master list appears to be an accumulation of vendor names that have received payment from the City and would not be considered a reliable or adequate data source to support a vendor master list.
15. **Restrict user access to the Vendor Master List:** Only select members of the Purchasing division should have authority and access to add/change/delete vendor information to/from the Vendor Master List. Additionally, username identifications must be used to uniquely identify the employee who added each vendor or made changes to the existing vendor information.
16. **Require vetting process for new vendors:** The Vendor Master List should include only those vendors who have been vetted and put through the normal procurement process. Vendors may not be added via deviated methods. Vendors should be required to complete and submit a W-9 (Request for Taxpayer Identification Number (TIN)), a Vendor List Questionnaire (Form AA-1), or equivalent vendor application document prior to set-up in the system.
17. **Additional required procedures for new vendor validation:** Vendors providing only a PO Box should be required to provide a physical street address. Procedures should be performed to validate the vendors address and phone number, (e.g., Better Business Bureau, State Contractors License Board, Secretary of State website, etc.). The information gathered to validate the vendor should be documented and maintained in the vendor's data file.
18. **Cross-reference vendors to the Vendor Master List prior to payment:** Vendors should be checked against the Vendor Master List prior to payment processing to ensure the vendor has been set-up in the system and vetted through the procurement process. Payment requests for vendors not found on the Vendor Master List should be followed-up with the requesting City Department for reasons why payment is outside of established vendor procurement policy.
19. **Update and maintain the Vendor Master List:** The Vendor Master List should be continually reviewed, updated, and cleaned-up of inactive suppliers or one-time vendors.

D. Form 1099-MISC ("1099s")

We found the City did not have written or documented procedures over the 1099 vendor identification and reporting process. Based on the City's current practice, the Purchasing division identifies a vendor's 1099 status in the initial vendor set-up phase based on the vendor information provided. When no W-9,

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AA-1 Form, or other equivalent document is submitted by the vendor, the vendor's 1099 status in the financial system defaults to "000" – indicating no 1099 reporting required. This was the case for SCEJ, New Covenant Center, and M. Jenkins, where no W-9 or AA-1 Form was submitted, and the lack of vendor information resulted in a default designation in the system of no 1099 required. Any follow-up or updating of a vendor's 1099 status by Purchasing is limited to those instances when the City has been notified by the vendor that a 1099 is required and none was received.

In accordance with Internal Revenue Service ("IRS") rules and regulations, the City is required to report taxable income to vendors in amounts that exceed \$600. When vendors are setup in the financial system, a mechanism should be in place to determine whether or not each vendor requires a 1099 based upon the vendor's organizational structure (e.g., C-corporation, partnership, sole proprietorship, etc.).

20. **Establish written procedures for 1099 reporting:** Create, maintain, and have readily available process narratives which provide a procedural walk-through of the 1099 process, including vendor identification, evaluation, and reporting. Clearly delineate which processes are the responsibility of the Purchasing division (including 1099 vendor identification) and which process should be handled by Accounts Payable division (including 1099 issuance and reporting).
21. **Ensure 1099s vendors are set up in the system:** Ensure that 1099 vendors are setup correctly in the system to receive 1099 reporting. Care should be taken to properly evaluate the 1099 status for every vendor application at the time of set-up by referencing the applicant's W-9 form, Form AA-1 or vendor application document.
22. **Require W-9 from all vendors:** Require all vendors to submit a W-9 or AA-1 Form with their vendor applications and verify the information submitted is accurate (e.g., using the IRS online verification system, contacting the vendor, etc.). Any vendors who fail to provide the required form or information should not be set-up in the system as an approved vendor. Requiring W-9s before vendor set-up can help to avoid year end 1099 problems.
23. **Update and maintain vendor 1099 reporting status:** Ensure that a mechanism exists to update the vendor information in the system and the vendor's 1099 requirement status is periodically updated and kept current.
24. **Perform reviews prior to annual reporting:** The status of each 1099 vendor should be reviewed every December prior any reporting to the IRS to ensure the completeness and accuracy of the 1099 reporting data.
25. **Perform periodic audits:** Perform periodic audits to ensure the appropriateness and timeliness of 1099 reporting – vendors required to receive a 1099 should have been issued one.

E. Purchase Orders

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The City has written and documented Purchasing policies and procedures regarding vendor procurement in which City departments are required to submit an authorized purchase requisition to request vendor procurement of goods or services. Once approved, a purchase requisition is processed to generate a purchase order contract with the specified vendor. The use of a purchase requisition/order system is considered to be a best practice in providing an audit trail to show the purchase of goods or services were approved. According to the City Accounts Payable Procedures, procurement of goods or services without a purchase order, contract, or other agreement is not in conformance with City policy.

However, invoice documents for expenditures charged to the Underground Utility Program, with regards to the Four Vendors, and testimony obtained from employees interviewed, indicate that D. Wooten routinely submitted vendor invoices for payment which were not supported by a purchase order contract, or other agreement, yet the invoices were processed by Accounts Payable and the check payments issued. We found that the Finance Department followed a historical practice of processing UUP invoice payment requests as reimbursements (i.e. refunds) – although the invoice document was more consistent with vendor procurement than a refund claim. We strongly recommend this historical practice be discontinued.

26. **Invoices should be matched to purchase orders:** The City should ensure that invoices are properly matched to the correct purchase orders and invoices that do not meet the City's policy requirements should not be processed for payment. Invoices over \$100 without purchase orders are in violation of the City's policies and procedures and may not be paid without a memo containing proper authorization.
27. **Vendor must be processed through the purchasing function:** All vendors receiving payments from the City must go through the regular procurement process and comply with all purchasing policies and procedures, including expenditure thresholds and purchase requisition specifications. Specific to the Underground Utility Program, vendors may not bypass the procurement process by receiving payments as reimbursements.
28. **Procurement through competitive process:** Whenever possible, procurement of goods or services should be made by a competitive bidding/lowest quote process, even when not expressly required, to ensure the most efficient use of City funds.
29. **Segregation of duties:** The City should ensure that no employee should have complete control over the entire purchasing function. The responsibilities for purchasing, receiving, and approving payments for goods or services should be segregated and assigned among different employees. Currently, the Finance Department's Purchasing Administrator is head of the Purchasing and Accounts Payable divisions. In smaller organizations, it may not be feasible to separate Purchasing from Accounts Payable. However, as a best practice, Purchasing and Accounts Payable functions should operate separately from one another to ensure no one employee has conflicting duties and responsibilities.

F. Accounts Payable Function

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Strong internal controls are essential to an effective Accounts Payable function. Internal controls which are poorly designed or easily circumvented creates an environment where fraud is easier to commit, duplicate payments increase, and the overall function is not cost-effective.

While the City has written and documented policy, procedures and controls for the Accounts Payable function, we found that the Accounts Payable staff supplemented established policy and procedures by following unwritten and informal historical practices which were inconsistent with current policy. Specially, Accounts Payable staff followed a historical practice of processing vendor invoices for Underground Utility Program charges as reimbursement claims, when documentation did not appear to support a reimbursement claim. In addition, Accounts Payable staff rely heavily on the City departments to provide properly completed and authorized invoice and payment request documents. We recommend Accounts Payable perform a more robust and diligent review of invoice payment requests submitted by City departments.

30. **Validate payment request information prior to payment:** Accounts Payable staff should validate information on invoices prior to payment; such information includes purchase order numbers and amounts, service/item description, and vendor name, number, and address. Requests not properly completed or missing information should not be processed, but followed up on with the requesting City Departments.
31. **Document review and approval of payment requests:** Accounts Payable staff should provide evidence indicating formal review and approval processes have been performed on submitted payment requests via proper documentation such as memos, e-mail, and signatures. If exceptional circumstances arise that are outside the normal policies and procedures, documentation of approval from proper authorities must be attached. Verbal or oral agreements, authorizations, and understandings should not be accepted under normal circumstances.
32. **Adhere to a chain of custody for invoice payment documents:** Accounts Payable should develop a closed-loop disbursement process within its own division. Invoices submitted for necessary Finance approval and signatures must subsequently be directly routed to Accounts Payable staff for processing without looping documents back to the City departments. Specifically, individuals submitting invoices may not have access to the invoices they submit until after disbursements have been processed and checks have been cut.
33. **Accept only original documents with original signature authorizations:** Only invoices with documentation containing original wet signatures should be processed for payment. Invoice payment requests may not be processed based off of photocopies of originals nor should documentation containing white out be processed. Accounts Payable should strive to be diligent in examining invoice supporting documentation by checking for authorization signatures.

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34. **Implement additional internal controls over invoice process:** The City should develop embedded internal controls to ensure all invoices processed for payment are legitimate transactions. Examples of internal controls include:
- Multi-levels of review to ensure adequate supervision of work performed in-house quality control group that conducts testing on random sampling of processed payments
 - Technology-assisted automated functions that prevents payments of invoices with mismatched, exhausted, and/or expired Purchase Orders, mismatched vendor names and IDs, unauthorized amount thresholds, etc.
 - Proper segregation of duties between Purchasing and Accounts Payable functions
 - Glaring discrepancies or suspicious activity with one invoice will trigger in-depth further review of all invoices submitted by the same employee or for the same vendor
 - Maintain active list of vendors or employees involved with suspicious activities and take extra care when processing invoices related to these parties
 - Employees should disclose, on an ongoing basis, any personal or financial relationships leading to potential conflicts of interest
 - Internal audit function should maintain independence and ensure relationships with colleagues do not deter or inhibit them from performing their job duties

G. Internal Audit Function

In previous years, the City maintained a Finance Department, Internal Audit Unit. Currently, there is no city-wide Internal Audit Department or internal audit personnel on staff who perform internal audit functions in-house. As a cost-effective mechanism, the City contracts with outside accounting and auditing vendors to provide internal audit services on an as needed basis for its City departments. We recommend the role, responsibility, and authority of a city-wide Internal Audit Department be reevaluated to ensure identified high risk areas are addressed and covered appropriately by audit and results reported timely to the City Manager's office.

35. **Re-establish an Internal Audit Department:** The City should consider re-establishing an internal audit function, whether it is a complete internal audit department or a senior internal audit director who can provide oversight in coordinating and outsourcing audits to independent third party contractors. We were advised by the Human Resources Department that recent efforts have been underway to hire a senior internal audit director or equivalent.
36. **Conduct surprise audits:** Department Heads should implement a process of surprise operational compliance audits in connection with the Internal Audit function. Surprise audits can be an important fraud prevention mechanism in deterring potential fraudulent employee behavior. Areas of focus in a surprise should include:

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- Accounts Payable: Audit for fictitious vendors, vendors should be researched to ensure that they exist and represent legitimate organization. Red flags include PO Box addresses, missing required vendor set-up documents, or missing vendor data in the system.
 - Payroll: Audit for ghost employees on City payroll by reviewing payroll report or W-2s for any unfamiliar names to ensure individuals are actual employees.
37. **Establish system of internal audit record keeping:** The City should establish a formal internal audit records keeping system and follow-up process. Departments found to be deficient in any areas or processes should be required to submit corrective action plans and additional internal audits may be scheduled as necessary.
38. **Perform fraud risk assessments:** The City should perform periodic reviews to identify instances where circumvention of standard procedures could occur and evaluate whether mitigating controls exist and are effective. Key components to this step include mapping existing controls to prioritized fraud risks, assessing the degree to which particular fraud risks are mitigated by existing controls, and identifying what potential remediating controls are necessary, if any.
39. **Establish investigation protocols and procedures:** In addition to the current HR Department function which investigates administrative matters, the City should consider designing and implementing an investigative process, specific to Internal Audit, to respond to allegations of fraud that includes the following elements:
- Protocols for responding to initial allegations (e.g., decisions on internal and external notifications, selecting an unbiased and qualified internal or external investigation team, etc.);
 - Standard investigative procedures exist for those conducting the investigation (e.g., steps required to preserve attorney-client privilege, interviewing and other investigative techniques, documentation requirements, etc.); and
 - Protocols for reporting findings from the investigation.

H. Personnel and Training Considerations

40. Additional employee evaluations: In addition to the annual performance review, consider conducting informal employee evaluations on a more frequent basis to evaluate employee responsibilities, background and qualifications relative to their job description. Determine if the employee is qualified to perform the job duties assigned and if the level of responsibilities is appropriate for the job description.
41. Enhance employee supervision and oversight requirements: Establish effective employee supervision by maintaining adequate oversight of employees' tasks. Supervisors and managers should conduct independent and adequate review of employees' work and note regular deficiencies.

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42. Conduct regular annual training programs: Departments should conduct regular annual training programs for all employees to emphasize and communicate adherence to the City's policies and procedures. Employees should be required to sign an acknowledgment accepting compliance of their jobs' roles and responsibilities with documentation maintained by the Human Resources department. Failure to comply will/may result in disciplinary actions up to and including termination.

43. Endeavor to provide new hiring training and refresher training: Provide new hire training programs to newly hired employees and refresher training programs to current employees on a periodic basis to communicate appropriate job responsibilities and process protocols according to the City's policies and procedures. Although training often times is conducted as on-the-job training, at no point should training be taught based on unwritten historical practices of the department which are inconsistent with the City's own policies and procedures.