



**CITY OF COLORADO SPRINGS
OFFICE OF THE CITY AUDITOR**

**09-08 – MEMORIAL HEALTH SYSTEM
MATERIALS MANAGEMENT**

PUBLIC REPORT

MARCH 12, 2009

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Office of the City Auditor Public Report

Date: March 12, 2009

To: Honorable Mayor and Members of City Council
Members of the Memorial Health System Audit Committee
Members of the Memorial Health System Board of Trustees

Re: 09-08 – Memorial Health System Materials Management Report

We performed an audit of Memorial Health System (MHS) Materials Management for the period January 1, 2007 to December 31, 2007. In 2007, the Materials Management processed 32,831 purchase orders and 188 contracts totaling \$124 million dollars.

The purpose of our audit was to evaluate whether Materials Management was efficiently acquiring, receiving, and inventorying goods and services, while adequately safeguarding resources. We also evaluated whether MHS, as an entity, was abiding by the internal policies and procedures established for these processes. Our scope included a review of electronic system access to Materials Management and related financial data.

We concluded that overall, goods and services were being acquired in an efficient manner, assets were adequately safeguarded, and the policies and procedures established for acquiring and safeguarding of resources were being followed. The attached report contains findings and recommendations for areas where we believe internal controls could be strengthened.

As always, feel free to contact me if you have any questions.

Sincerely,

A handwritten signature in blue ink that reads "Jeff Litchfield".

Jeff Litchfield
City Auditor

cc: Dr. Larry McEvoy, II, Chief Executive Officer
Michael Scialdone, Chief Financial Officer
Tom Kerwin, Chief Information Officer
Jason Fahrlander, Chief Operating Officer
Tom Smith, Director Materials Management
Kristi Speiser, Purchasing Manager
John Wyckoff, Compliance Officer
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Introduction

09-08 – Memorial Health System Materials Management

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Abbreviations and Acronyms used in this Report

CER	Capital Expenditure Request
MHS	Memorial Health System

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GPO	Group Purchasing Organization
GSA	Global Spending Analysis
IS	Information Services
PR	Purchase Requisition
PO	Purchase Order
RFP	Request for Proposal
RMA	Returned Material Authorization

Introduction

AUTHORIZATION

We performed an audit of Memorial Health System (MHS) Materials Management for the period January 1, 2007 to December 31, 2007. We conducted this audit under the authority of Chapter 1, Article 2, Part 7 of the City Code, and more specifically parts 703, 705, 706, and Part 709 (B) and (C) of the Code, which state:

1.2.703: ENSURE PUBLIC ACCOUNTABILITY:

The City Auditor shall ensure that administrative officials are held publicly accountable for their use of public funds and the other resources at their disposal. The City Auditor shall investigate whether or not laws are being administered in the public interest, determine if there have been abuses of discretion, arbitrary actions or errors of judgment, and shall encourage diligence on the part of administrative officials.

1.2.705: DETERMINE EFFECTIVENESS AND EFFICIENCY OF PROGRAMS:

The City Auditor shall determine the extent to which legislative policies are being efficiently and effectively implemented by administrative officials. The City Auditor shall determine whether City programs are achieving desired objectives. The City Auditor shall review the administrative control systems established by the enterprises, department or group managers and by the City Manager, Utilities Executive Director and Memorial Hospital Executive Director and determine whether these control systems are adequate and effective in accomplishing their objectives.

1.2.706: EXAMINE BOOKS, RECORDS:

The City Auditor shall examine and inspect all books, records, files, papers, documents and information stored on computer records or in other files or records relating to all financial affairs of every office, department, group, enterprise, political subdivision and organization which receives funds from the City or under the direct or indirect control of the City Council. The Auditor may require any person to appear at any time upon proper notice and to produce any accounts, books, records, files and other papers pertaining to the receipt or expenditure of City funds, whether general or special. If that person fails to produce the papers, then the Auditor may request Council approval to search for and take any book, paper or record in the custody of that person or public official.

1.2.709: MAKE PERIODIC REPORTS TO COUNCIL:

The City Auditor shall make periodic reports to Council which shall include the following:

- B. Information of proposals deemed expedient in support of the City's credit, and recommendations for lessening expenditures, for promoting frugality and economy in City affairs and for an improved level of fiscal management;
- C. Matters concerning the effectiveness and efficiency of the programs and operation of the City;

Introduction

ORGANIZATIONAL PLACEMENT

The Office of the City Auditor is structured in a manner to provide organizational independence from the entities it audits. This independence is accomplished by the City Auditor being appointed by and reporting directly to City Council. The audited entity in this audit, MHS, an Enterprise of the City of Colorado Springs is governed by a Board of Trustees (a 15-member board also appointed by City Council).

SCOPE AND METHODOLOGY

We performed an audit of Memorial Health System (MHS) Materials Management for the period January 1, 2007 to December 31, 2007. The purpose of our audit was to evaluate whether Materials Management was efficiently acquiring, receiving and inventorying goods and services while adequately safeguarding resources. We also evaluated whether MHS, as an entity, was abiding by the internal policies and procedures established for these processes. Our scope included review of system access to the Materials Management and related financial data.

The audit was conducted in accordance with the *International Standards for the Professional Practice of Internal Auditing*, a part of the Professional Practices Framework promulgated by the Institute of Internal Auditors. The audit included interviews with appropriate personnel and included such tests of records and other supporting documentation as deemed necessary in the circumstances. We reviewed the internal control structure and compliance tests were performed. Sufficient competent evidential matter was gathered to support our conclusions.

It should be noted that although the focus of our audit was Materials Management (the Purchasing and Warehousing functions), for items in our testing sample, we reviewed invoices and payments for proper matching and approvals. Accounts Payable is a Finance function and is not a Materials Management responsibility.

This audit combined the 08-323 Purchasing – Full System Review with 08-361 Receiving and Inventory Review. The 08-361 Receiving and Inventory Review did not include Pharmacy Inventory, which was completed separately under 08-363 Pharmacy Inventory Audit. The Purchasing audit was combined with Inventory and Receiving when we recognized the opportunity to utilize the audit resources available in a more efficient manner as the audited areas overlapped.

BACKGROUND

For calendar year 2007, the following volume of Purchase Orders and Contracts was processed by Materials Management:

Purchase Orders	32,831	\$108,618,630
Contracts	188	\$15,594,074

During our audit period, MHS opened the new North Hospital, and completed a significant expansion to the Central Hospital. This required significant involvement from Materials

Introduction

Management personnel. Materials Management staffing levels did not increase during construction.

The Materials Management organization, overseen by the Materials Management Director, was comprised of both Purchasing/Contracting and the Receiving and Inventory functions. The Purchasing group includes 16 employees with two sections, Purchasing and Contracts. The Purchasing Manager and the Contracts Manager reported to the Materials Management Director. Seven buyers, five analysts and an administrative assistant in turn reported to the Purchasing Manager. There were no positions reporting to the Contracts Manager. Additionally, a Clinical Products Analyst reported directly to the Materials Management Director. (This position was open during our fieldwork.)

The Receiving and Inventory functions include Central Warehouse, Distribution and Receiving personnel who report to the Materials Management Director under the responsibility of the Operations Manager. This group was also responsible to inventory and re-stock supply rooms in clinical areas. There were approximately 45 employees in the Operations group.

Central Distribution inventory balance on December 31, 2007 was approximately \$1.2 million. An additional \$1.25 million in inventories was held in the clinical patient areas, and restocked from Central Inventory.

MHS was a member of the Novation/VHA Group Purchasing Organization (GPO), which negotiates pricing contracts with vendors and suppliers on behalf of its members. Over 60% of goods and supplies for the Health System were procured under this contract. MHS was not required to purchase all supplies under the contract, and could negotiate separately with the supplier.

Generally, competitive bids were required by MHS policy for single items over \$50,000. Competitive bids were not required in instances where equipment was standardized, a clinical preference existed, or the item was available from a Novation supplier under the GPO contract. Materials Management referred to an industry study that indicated that, on average, approximately 60% of Hospital supply and materials costs were dictated by Physician preference. As such, competitive bids were not required for MHS in the majority of purchasing decisions, with the exception of construction projects.

COMMENDABLE PRACTICES

During our fieldwork, a number of improvements were in progress or had been implemented that will improve efficiency of processes or reduce health system costs. These include the following:

At the time of our review, Materials Management was working on an initiative to reduce vendor pricing on orthopedic implants. We understand this new pricing took effect the beginning of 2009. Based on last year's volume, Materials Management anticipates savings of approximately \$3 million annually. We commend Materials Management for their efforts to obtain more favorable pricing on these high cost items. Additionally, Materials Management had identified approximately \$850,000 in potential savings from product conversions and new technology. This was in addition to the annual savings realized from participation in the Novation Group Purchasing contract.

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Materials Management participates in a Global Spending Analysis (GSA). MHS submits annual purchasing data to Novation for analysis to determine if opportunities exist for cost savings (e.g. to convert to similar products.) They plan quarterly participation in the near term to help identify potential savings. We understand the third quarter 2008 GSA analysis was in progress.

Several improvements were made to the procurement process. Materials Management had been working to automate the requisition process in Central Supply, which was previously a manual process. This will allow MHS to better determine desirable inventory levels and allow for cycle counts. Additionally, the Capital item approval limit was increased from under \$2,500 to under \$5,000 effective June 1, 2008. Given the cost of equipment and construction, we agree this was reasonable and cost-effective.

Partnerships between business units were in progress during our review to identify areas of potential savings. For example, we noted that Cardiology Service was implementing technology that interfaces to Lawson and would allow more accurate inventory levels to be set. The Business Manager was working with Materials Management to standardize vendors used by several different groups in the hospital and negotiate more favorable pricing. This required coordination with health care providers in several departments to gain their support. Initiatives of this kind have the potential to save MHS significant dollars, especially in areas with high cost supplies. We commend this practice.

OVERALL OPINION

We conclude that overall, goods and services were being acquired in an efficient manner, assets were adequately safeguarded, and the policies and procedures established for acquiring and safeguarding of resources were being followed. However, during the course of our audit, we did identify areas where we believe internal controls can be strengthened. These areas are listed on the pages that follow.

We have made no determination as to which findings are more important than others. Therefore, the findings are not necessarily listed in order of importance.

Findings, Recommendations, and Responses

1. All Purchase Order invoices for goods should have approvals and evidence of receipt prior to payment.

Under normal circumstances, a Purchase Order related invoice was agreed to the receiving department and PO data in the system as a three way match for authorization to pay. However, not all equipment was delivered to the warehouse for receiving and no system receiving data existed for authorization. For example, many 2007 purchases for the MHS North Hospital were delivered directly to a separate warehouse during construction rather than to the receiving warehouse. In these instances, no receiving data was entered in the system for evidence of receipt. Policy indicated that a signed packing slip or a signature by the Purchasing Manager or designee should be obtained by Accounts Payable as evidence of receipt and approval to pay. We performed a sample review of POs from creation to payment. We identified two equipment purchases in our test that did not have evidence of receipt or Purchasing Department approval for payment in Accounts Payable files.

We identified one disbursement for implants that did not have supporting documentation to independently verify the implant was placed into the patient. The implant cost was \$27,000. We understand that subsequent to our review a process was put in place in which requisitions are created by the requesting department and routed to billing and Purchasing. We agree this will ensure confirmation of use of the item prior to payment on implant purchases.

Auditor's Recommendation:

We recommend processes be implemented to ensure all disbursements are authorized for payment per policy. A Finance employee reviewed checks to invoices after they were printed and before they were mailed. This employee should verify all invoices have been approved in accordance with policy during this review process.

Additionally, evidence of receipt should be required to be submitted to Accounts Payable prior to authorizing payment versus Purchasing approval only, to ensure segregation of duties.

MHS Response:

MHS agrees with the recommendations. Policy 5.24 will be changed to reflect these recommendations no later than July 1, 2009.

Findings, Recommendations, and Responses

2. Segregation of duties and administration of user access over requisitions, purchase orders, vendors and payment was not adequate.

We noted multiple concerns with access to the Lawson application, including access to Purchasing screens by employees outside Materials Management and Finance. Segregation of duties concerns included seven employees having access to both the vendor master and invoice entry, buyers with access to set up purchase requisitions (PR) and approve PRs, and an employee who could both create contract purchase orders and set up vendors in the master file. We noted that programmers had user ids for access to all major transaction screens.

The quarterly report of changes to the vendor master file included only new vendors, not changes to existing vendors. Those with access to the vendor master file could change names or addresses without independent oversight to prevent irregularities.

We noted security permissions set up in error, and that security changes were not logged, and not reviewed regularly by cost center managers.

There were 26 employees set up as both requisitioners and approvers, which means it was possible they could enter and approve their own requisitions.

Three employees had requisition limits of \$100,000,000 with no approval needed. We understand that for two of these individuals have been revised to \$100,000, which provides some limits, but exceeds the \$50,000 limit for this department that was prescribed by policy. MHS indicated that the third employee's access had been removed.

Auditor's Recommendation:

We recommend:

- Reports of current accesses should be distributed to cost center managers regularly. We understand that subsequent to our review, the Purchasing Manager began generating access reports for Approver and Requisitioner for user department management review. Purchasing now also reviews these access requests for reasonableness prior to setup by Information Systems (IS).
- Finance and Materials Management Managers should review access profiles to ensure no permissions are allowed which violate segregation of duties. Good business practice dictates that the receipting, purchasing, vendor master maintenance, and accounts payable functions are separate.
- Finance and Materials Management should also ensure the process does not allow for granting individuals permission to approve their own requisitions. We understand that subsequent to our review, the user access process has been changed to ensure requisitioners are not set up as approvers.

Findings, Recommendations, and Responses

- Employee requisition levels that exceed policy should not be updated to the Lawson System and all existing requisition levels should be brought into agreement with policy, including the \$100,000 requisition levels noted above. If the \$100,000 levels are a business necessity, then the policy needs to be updated to reflect the necessity.

MHS Response:

MHS agrees with the recommendations. We are currently in the process of gathering the approver/requestor data to send to all departments for their review. This will be completed by July 1, 2009.

I.S. will generate the user access for Materials Management manager's review by April 30, 2009. Materials will review these reports monthly.

The requisition approval level policy will be updated once the approver/requestor data has been approved by the departments to ensure all requests are accounted for.

Findings, Recommendations, and Responses

3. Returns to vendors should be tracked and logged in the Lawson system to ensure credits were received.

MHS has a Returned Material Authorization (RMA) process in place for returning material to vendors. We noted a significant number of credits received without a RMA. In these cases, the user departments were returning goods to the vendor directly, without using the RMA and involvement from Receiving or Purchasing. There was also no process in place to review outstanding returns in Lawson to ensure credit was received.

Auditor's Recommendation:

MHS Purchasing should work with Accounts Payable and user departments to ensure returns are tracked and logged in the Lawson system. Outstanding credits in the Lawson system should be reviewed regularly to ensure credit was received. We understand that an on-line RMA process was implemented subsequent to our review, which should allow user departments to more efficiently utilize the RMA process required by MHS procedures.

MHS Response:

MHS agrees with the recommendation. Purchasing will work with Accounts Payable to ensure returns are tracked and proper credit is received. A process will be implemented by July 1, 2009.

Findings, Recommendations, and Responses

4. Segregation of duties in the Receiving function and over the exceptions for receipt of goods by the Warehouse was not adequate.

MHS policy allowed for receiving by the user department for Information Systems (IS) items or items received by Clinical Engineering. The user department notified Receiving via email that the item was received by IS personnel or picked up at the vendor's facility by IS personnel. The MHS Receiving Department then entered the item as received without evidence of receipt in the form of a packing slip or equivalent. Additionally, a receiving report could be entered by Receiving upon notice from Purchasing. Segregation of duties were not sufficient to prevent Purchasing or IS personnel from ordering materials for invalid use. This was especially true for items having personal use or resale value (IS purchases.)

Receiving personnel should not be able to requisition items (other than to generate a requisition through the handheld PAR scanner) because this would violate segregation of duties. Requisition and approval levels in place for user departments could be circumvented or Receiving personnel could requisition and receive goods for their own use. At the time of our review, six individuals in Operations (Central Receiving) were authorized requisitioners. The number and dollars in requisitions was reported monthly to Materials Management, but reasons for requisitions were not researched in detail.

Manual issues (issuance of inventory without requisitions as support) versus issues entered by authorized requisitioners through the system should be minimal. We noted there could be as many as 200-400 manual issues in a given month. Many of these manual issues did not have reason codes, i.e., the reason for manual issue was not documented. Possible reasons for manual issues would be to correct an error or fill an order received by phone without a requisition. Manual issues could allow requisition and approval levels in place for user departments to be circumvented or Receiving personnel could issue items for personal use.

Auditor's Recommendation:

We recommend:

- The user department be required to provide evidence of receipt such as packing slips prior to receiving data being entered for receipt in Lawson.
- Instances where items are received by the ordering department should be reviewed to determine if this practice is necessary. For example, except for emergency items, we question if items should be received or picked up by IS.
- The ability to requisition by Receiving personnel should be eliminated or limited and monitored by the Purchasing personnel via reports. Circumstances causing requisitions to be entered by Receiving personnel, instead of user departments, should be researched and resolved wherever possible. Circumstances causing orders to be filled manually should also be researched as manual issues should be minimal.

Findings, Recommendations, and Responses

MHS Response:

We agree with the recommendation and the IS Department will review the ordering and receiving process with Receiving to determine if the practice of non-emergent items should continue. Proposed review of process completion date shall be April 30, 2009.

We agree with the recommendation and the IS Department will revise its process with Receiving to ensure that packing slips are forwarded to Receiving prior to data being entered into Lawson. Proposed revision of process completion date shall be April 30, 2009.

Purchasing will monitor requisitions submitted by receiving personnel on a monthly basis. This process will begin July 1, 2009.

Except in instances where the MMIS is down and not functioning, we agree that manual issues should be minimal. Materials Management will enforce a cessation of this practice and require a monthly report of manual issues that are processed except during times when the MMIS is not functioning.

Findings, Recommendations, and Responses

5. **“Received But Not Invoiced” and “Matched, Not Received” related purchase orders should be reviewed and investigated.**

Accounting identified \$1.3 million of “Received But Not Invoiced” PO’s that were six months old or older and these purchase related items were not reviewed or investigated. The system automatically wrote off the old items by debiting the expense or asset account and crediting the Receipt Error (expense) account. Accounting reversed the write off each month. The rationale was that they do not believe the department’s expenses should be charged with something they believe was an error.

Similarly but with the opposite impact, the “Matched, Not Received” Report was run each month for ‘not received’ POs older than 2 months. The system automatically recorded the items appearing on this report by debiting the Receipt Error account and crediting the department expense or asset account. Accounting reversed this entry each month indicating the department should be charged as the invoice was paid. The 2007 total impacting this account was \$754,000.

Neither Purchasing nor Accounting was reviewing the report and could explain the outstanding items. Some invoices (PO related) were mailed directly to departments and forwarded to accounting to pay as a check request. In some cases, the department may receive their purchases directly, instead of going through the warehouse receiving. This could result in an open PO and a received but not invoiced item.

Auditor’s Recommendation:

We recommend these reports be reviewed to understand the underlying causes and possible correction for items not clearing timely. Once the cause of items hitting this report is understood, we recommend establishing a dollar threshold for which items should be researched and corrected on a monthly basis.

MHS Response:

MHS agrees with the recommendation. Purchasing, Accounts Payable and Operations will meet within 90 days to formulate a plan to review and investigate why these items are hitting the report. A process for review and correction will be established by July 1, 2009.

Opportunities for Improvements

During our review, we noted the following areas where there were opportunities for improvements that would benefit the systems and internal controls in place at MHS.

6. Controls over the contract requisition, Request for Proposal, and reporting process should be improved.

MHS Policy does not define contract request and approval limits. A standard form or software with system access and dollar limits was not used for contracts.

As part of our compliance testing, we reviewed to determine that contracts in our test were in the contracts database. MHS does not include time and materials contracts in the contracts database and was not reviewing for contracts issued in previous years to identify those with payments in future years to which MHS was committed. We noted two contracts entered into after the creation of the contracts database that were not found in the contracts database.

The Contracts Manager indicated he does not participate in user department committee Request for Proposal (RFP) development and evaluation process in most cases. The exception was when contracts or services were of a general non-technical nature. MHS Contracts issued the RFP's in accordance with policy and ensured the evaluation of RFP's submitted by the operations committee was adequately documented.

Auditor's Recommendation:

We Recommend:

- MHS Policy should be revised to state authorized contract requestors, approvers, and dollar amounts to ensure that only authorized requisitioners initiate the contracting process. The request should be submitted and approved through the contracts database.
- MHS compare Lawson reports of contract payments to the contract database in order to evaluate the completeness of the contract database. Control reports, including deleted contracts, should be reviewed by someone independent of the setup in Lawson.
- MHS Contracts should participate in the RFP committee and document evaluation and approval of the vendor selection. We believe that increased participation on the part of the Contracts group would add significant value to the procurement process and ensure that all vendors are given adequate consideration.

MHS Response:

MHS agrees with this recommendation. As part of the new executive team role clarity the initiation and authorization of all contracts and capital purchases is under review. It is expected that this review and subsequent policy and practice changes outlining who is authorized and at what dollar amounts will occur by the end of June, 2009.

MHS agrees in spirit but disagrees in practical terms with comparing Lawson to the Contract Database. The desired state would be to have all contracts that predate the database scanned

Opportunities for Improvements

into the system but economic realities make this impractical. Since December 2007 the practice has been that all new contracts are entered into the database. Additionally, a hardcopy may be kept if desired. Since a general rule of thumb exist that contracts may not exceed 3 years in length the number of hardcopy contracts will soon be exhausted and everything will reside on the database.

MHS agrees full participation in the RFP process should occur. This practice will begin immediately. MHS also agrees that better documentation should be provided in the contract database related to those contracts that are the direct result of an RFP. This practice has already been adapted moving forward.

Opportunities for Improvements

7. Vendor selection decisions, including waiving the bidding selection process, should be documented.

Purchasing policy did not require bids when sole source procurement was justified or when a single item purchased was under \$50,000. Reasons for sole source justifications included cases in which equipment was standardized, clinical preference, or if the item was available from a Novation supplier. If no bids were required because of the above exceptions per policy, the reason for vendor selection was not documented and business reasons for selection were not included in the files.

In our review of a sample of Purchase Orders there were three instances noted in which the Capital Expenditure Request (CER) files did not document the reason for vendor selection. These were not exceptions under the current policy because no single item was over \$50,000 or because a sole source condition existed. In our sample review of Contracts, unless bids were solicited, there was no documentation for vendor selection. Valid business reasons for selection were provided to the auditor, but this was not documented in the contracts database or purchasing files.

We also could not identify in every case Materials Management Director's approval documentation of the of sole source vendor selection as per policy 5.0301-32. This would only be documented if the Director negotiated or signed the contract.

For one construction contract reviewed, documentation of sealed bids was not found in the file and vendor selection evaluation was not documented. It appeared the Purchasing employee was not involved in the vendor evaluations. Vendor evaluation documentation was from a project architect regarding the technical aspect of the agreement. The role of the professional purchasing point of view was not noted in the file documentation.

We understand that subsequent to our review, documentation of reason for selection, including exceptions allowed by policy (e.g. equipment standardization), was implemented as a requirement for purchases over \$20,000.

Auditor's Recommendation:

Decisions over vendor selection or sole source selection should be documented and maintained in Purchasing files in accordance with the above policy. We suggest MHS require user departments to prepare and submit a sole source justification for single items over \$50,000 to be reviewed and approved by Materials Management and retained in the CER, Contracts, or Purchasing databases/files. This would ensure that vendor selection and approval is documented in such a way that someone unfamiliar with the purchase could clearly determine the business reasons for selecting a particular vendor.

We understand that much of the routine supply purchases are tied to Novation contracts. Purchases made from a Novation supplier and low dollar item purchases (to be defined by Materials Management) would be exempt from documentation requirements. Once total volume of purchases of low dollar items reach a certain dollar threshold to be determined by Materials Management, documentation of best value for source should be prepared.

Opportunities for Improvements

MHS Response:

MHS agrees with the recommendation. Capital purchases through the CER and RFP process will be documented in the contracts database as well as any sole source selection made without the benefit of an RFP.

MHS will document in the item master product selection when product unit dollar amount exceeds \$100.00 or aggregate purchases exceed \$50,000 annually. This will begin no later than July 1, 2009.