

# State Bar of California

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Review of Internal Controls:

Budget

**June 30, 2010**



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# State Bar of California

## Review of Internal Controls

### Budget

Like many public agencies, the State Bar provides a multitude of services to a specific body of constituents—individuals admitted to the bar and those wishing to be admitted to the bar. Through regulating and providing services to its constituents, it also serves the public by assuring that only qualified individuals become attorneys and affording a disciplinary process for those not following the rules of practice.

The State Bar currently has spread its varying responsibilities among eight Executives and an Executive Director. Each of the Executives administer programs and services—some services are purely regulatory and protect the public such as the Chief Trial Counsel and the Office of the State Bar Court that work together to investigate, discipline, and adjudicate member actions. Other programs and services work with and for constituent groups such as Admissions that serves potential members by developing, administering, and grading examinations in addition to the number of administrative processes involved in the many application and admission processes including moral character determinations. Still other departments provide internal services supporting the program initiatives—information technology, finance, and general counsel are individual service departments each managed by an Executive, while the remaining business operational units such as human resources and operations are managed by the Deputy Executive Director.

The budget—the formal plan for revenues and expenditures for the year—is a fundamental element in the State Bar’s enterprise risk environment. Annually, the State Bar Executives develop this plan and, following a schedule of events, vets and submits the budget for Board of Governors approval. The Office of Finance is the lead department on budget development and management with the department managers responsible for contributing to the budget development and for monitoring spending to ensure that line-items and programs remain within acceptable and approved levels.

We conducted an internal audit of controls related to the various activities involved in developing and monitoring the State Bar’s budget. Our goal was to evaluate the strength of the controls in place, assess the control environment, and provide recommendations for improving these operations.

## Scope and Methodology

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The State Bar of California (the State Bar) contracted with Sjoberg Evashenk Consulting, Inc. (SEC) to conduct three separate reviews evaluating the internal controls pertaining to procurement and accounts payable, payroll, and budgetary control business processes. The objectives of each review were to:

- (1) Evaluate and test the existing internal controls pertaining to the business process;
- (2) Identify significant risks and internal controls weaknesses pertaining to the business process; and,
- (3) Recommend improvements to the internal controls and procedures pertaining to the business process to mitigate any significant risks or weaknesses identified.

This report addresses the State Bar's internal control environment related to its budget processes—results, findings and recommendations for the other two areas, payroll and procurement and accounts payable, are issued under separate covers.

To meet the audit objectives, we conducted interviews, reviewed and tested documents and records to understand and evaluate the control environment related to the budgetary business cycle as follows:

- ✓ Interviewed key officials to obtain an understanding of how the organization's goals, objectives, current projects, and future initiatives drive budgetary decisions.
- ✓ Determined the level of involvement and input garnered by the State Bar during the process, assess how final budget decisions are made.

To address these two objectives we:

- Interviewed key managers to obtain views and understanding of their roles, responsibilities, and accountability in developing and managing budgets. Specifically, SEC team members conducted numerous interviews with Executives and key managers to obtain an understanding of the environment that they operate within in terms of budget development and planning, monitoring, and spending.
  - Obtained information available and used for ongoing budget oversight and inquired how the information is used during the year.
  - Inquired about perceived and actual challenges managers face in conducting these duties.
- ✓ Identified through interviews and documentation reviews, the State Bar's budget preparation and monitoring processes, including methods employed to develop annual budgets, monitor budget-to-actual revenues and expenditures, control budget transfers, and forecast revenue and expenditures. To meet this objective we conducted numerous interviews and gathered and developed data to:
    - Understand the various roles of control functions in monitoring and assisting managers in terms of spending and managing budgets.
    - Assessed the processes related to addressing and investigating material variances between budget and actual.

- Identified the key reports, the users of the reports, the frequency that reports were provided/received, and the usefulness of reports.
- Tracked how historical patterns are used for budget planning and development.
- ✓ Assessed controls related to line-item budgets and spending including budget transfers between key budget categories.
  - Reviewed written policies, procedures, or protocols related to line item budgeting including overspending/underspending a particular expense line item and the transfer of spending authority from one line-item to another.
  - Discussed with the department executives and budget managers their practices related to monitoring and tracking line-item spending and the processes followed to move spending authority.
  - Assessed Finance’s role and processes for monitoring department spending on an ongoing basis.
- ✓ Evaluated the controls in place to track and manage cash flow particularly as it relates to the various funding sources to assure compliance with laws, rules and regulations related to such funds.
  - Obtained a listing of all funds and definitions of the funds from the Office of Finance.
  - Developed a worksheet to break down each department/business unit into funds—showing funding by source and expenditure by fund.
  - Discussed the flow of funds at the department levels.
  - Determined the accounting coding and monitoring for ensuring that funds are expended from the appropriate fund and source.
- ✓ Reviewed the fiscal system security permissions and operational roles and responsibilities relative to the JD Edwards system to ascertain the strength of the controls over system access, separation of duties, and oversight and management. We met with the CFO, finance staff, and information technology staff and:
  - Considered the system access permissions and determined the strength of those permissions and the process for granting and removing access authorities.
  - Assessed the roles and responsibilities of Finance staff and determined whether adequate separation of duties exists.
- ✓ Determined the role and reporting relationships between the State Bar personnel, management, and board members. Considered the intended and actual reporting and communication between the State Bar staff, its departments and divisions, and the board in terms of budget and budget management.
- ✓ Reviewed the methods used to report the initial budget, on-going status to State Bar management, and the Board. Inquired of key users whether information provided to the budget users (departments) is sufficient, timely, and useful.
- ✓ Assessed the processes used to monitor and prevent budget line-item spending by department and by fund.

- Reviewed operating statements for selected departments as well as the new monthly monitoring reports.
- Assessed the formal and informal processes used to approve, track and execute changes in line item budgets.
- ✓ Discussed the requirements for semi-annual forecasts and assessed compliance with Board Book Policies and Procedures.
- ✓ Tested the periodic financial reporting to the BOG.
- ✓ Obtained an understanding of the processes applied for indirect cost allocation.
- ✓ Interviewed key members of the Planning, Program Development and Budget Committee representatives to ascertain their needs and perception of the budget information provided by the State Bar.
- ✓ Followed-up on the written policies and procedures over budgetary internal controls to assess needs for updates or changes.

## Review Results

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The California State Bar has faced many challenges over the past few years including servicing over 225,000 members with increased budgetary constraints, high public and legislative scrutiny, and significant turnovers in key Executive positions. Yet, despite these challenges, State Bar Executives and management continue to strive to deliver high-quality services for constituents and to fulfill its mission to protect the public and have taken a pro-active approach strengthen the control environment and embraced the tenets of accountability and transparency. For example, over the past few years the State Bar has adopted a popular budget reporting approach, one that is supported by the Government Finance Officers Association, and includes an expanded format, more budget detail by department and program, and has begun to develop service-related goals and objectives with associated performance measures and activity results. Moreover, as of the first part of calendar year 2010, Finance has developed and rolled-out more timely, succinct, and user-friendly monthly budget monitoring report that provides each department Executive with a meaningful snapshot of the prior month's activities, year to date spending, and a comparison of the same period in the prior year. The initial response to these reports is very positive.

### Budget Planning Internal Controls are Adequate

Budget planning processes followed by the State Bar include a number of important internal controls. Guiding the effort is the State Bar Board of Governors whose oversight provides a key component in the control structure over the annual budget. Another important control is the defined policies and procedures for development of the annual budget that includes a general calendar and milestones. The annual planning process involves guidance and oversight from the BOG's Planning, Program Development and Budget Committee requiring on-going communication between the Executive and the BOG with the goal to ensure that the State Bar executes its organizational and spending strategy effectively and efficiently. While the annual budget is comprised of individual revenue and spending plans developed by each operating department, the BOG is involved in setting long range strategies, approving initiatives, and representing the needs of the constituent groups in determining priorities and initiatives.

Each year, Finance notifies the Board of Governors and its Planning, Program Development and Budget Committee (Planning Committee) of the formal State Bar Budget process and the calendar of dates set for the year's budget cycle in order to meet the BOG's timeframe for approval. The annual budget is considered and adopted by the full Board of Governors, usually at the last business meeting of the Board year (July - August). Specifically, the CFO prepares a staff report around mid-year to the Planning Committee that sets forth tentative dates for each major step in the budget process. In subsequent weeks, Bar Executives meet with either the Planning Committee or a budget subcommittee to discuss budget assumptions, financial forecasts, and other factors that will affect the budget. This meeting results in a document that represents the Committee's guidance that is used by State Bar staff in preparing budget instructions that are sent to departmental budget liaisons.

Key Planning Committee members stated that they are more comfortable with budget information now than ever. The Committee has established a budget subcommittee that meets

with Finance on a monthly basis. We are told that communication between the Committee and the State Bar executives is cooperative, frequent, and informative. This on-going collaborative relationship between the BOG and the organization is an important component of the control environment.

Finance also will provide budget process educational briefings to the BOG when process changes occur or to provide background information to the changing BOG membership. These briefings are intended to describe the internal budget processes, explain the structure and contents of the budget document that will be presented for approval, and to ensure understanding between the governing board and State Bar operations.

The BOG approval of the State Bar's budget is the final step in the budget planning process; as the primary fiduciary over the State Bar, the BOG must ensure that the budget is sound. Yet, the BOG's responsibilities are directly tied to the external controls exerted by the State Legislature and the Governor that annually approve the fee bill which determines the level of revenues that will be generated for General Fund spending purposes.

Finance holds the primary responsibility for ensuring the timely and accurate completion of the budget plan. To facilitate the process it issues guidance for budget preparation to department budget managers and sets the milestones for the preparation schedule. The guidance includes budget assumptions and goals, any anticipated legislative action needed, and a time frame for completing key steps. Finance leads the process, gathers the departmental input, and once approved by the Executive Director and Deputy Executive Director prepares the final document for submission and approval by the BOG. The CFO also provides educational briefings to department Executives and budget managers to facilitate the efficient and effective development of the revenue and spending plans and to provide any updates on using the JD Edwards system for accessing financial information.

State Bar department Executives also provide essential controls over the budget planning process. As discussed in more depth later in this report, State Bar Executives have access to operating results monthly and are provided baseline budget documents during the budget development process. These individuals are closely involved in financial decisions of their respective departments and are aware of resources available, program and service costs, spikes in activities, and future needs and demands, and they add input into the planning process from the program expert level.

The State Bar has an up-to-date policies and procedures manual that includes the process to be followed in the development of an annual budget including a general calendar and milestones. The manual also includes fund descriptions and a Chart of Accounts to be used for budgetary and financial recording and reporting purposes and processes to be followed in accomplishing mid-year reallocation of budget line items.

However, we found that while the *Budget Policies and Procedures Manual* establishes the general guidelines for budgeting and the budget process, it does not include provisions reflecting the Executive Director's or other department executives' fiduciary responsibilities to ensure that

receipts and spending are within the approved budgetary line items and for the prudent use and safeguarding of funds paid by Bar members. Further, were unable to find within the manual provisions or sanctions that address any overspending or actions related to spending that are not in compliance with the BOG approved budget. Adding specific accountability to the budget process could further strengthen the control environment.

## The Control Environment Related to Budget Development Appear Adequate But Opportunities to More Closely Manage Costs Exist

While the presentation and detail of the budget document have changed and improved over the past few years, the basis of the State Bar's budget has not changed. The State Bar applies a "build upon" method of budgeting that generally begins with prior year spending and adjusts these expenditures for significant initiatives or decisions. Although this is a common methodology, it applies a "status quo" presumption and does not require or provoke examinations of spending patterns or linking activities to outcomes or results. Thus, if spending authority was granted in the past this methodology allows that level in the future. Moreover, even though dozens of "accounts" comprise the expenditures reflected in the *Strategic Planning Budget*, the Board of Governor's approve the spending plan at a very high-level—primarily five spending line items—affording State Bar management significant flexibility in spending within these categories. As a result, Executives can incur considerable costs within the approved plan without BOG knowledge or approval.

In recent changes to the budget planning and development approach, the State Bar has broken out several "operating divisions" or subdepartments for budgetary purposes. For example, Chief Trial Counsel's Office (department) now includes separate budgets for Investigation, Audit and Review, and Abandoned and Unauthorized Practices which previously were included in other budgets of the Office. These efforts will allow greater visibility and transparency to the BOG, stakeholders, and the public while also affording greater control and oversight by Bar Executives and managers.

During the budget development process, generally, Finance develops the base-line budget from data retrieved from the JD Edwards financial system. Using the prior two years' line-item spending as the foundation, Finance adjusts certain factors for the baseline budgets for each operating division within departments. While Finance examines all line items its primary focus for budget planning are on personnel costs and indirect cost charges. Personnel costs comprise a significant portion of the State Bar's expenses—over 60 percent of its operating budget for 2010. Budgeted amounts for personnel costs (salaries and benefits) are driven by authorized positions designated to each operating division regardless of whether the position is filled or vacant. Working with Human Resources, Executive Director and others, an escalation factor is built to accommodate merit salary increases, cost of living increases, cost changes due to parity adjustments, provisions included in collective bargaining agreements, insurance premium increases, retirement plan contributions, or other relevant elements. This factor is applied to the personnel costs calculated for the prior year.

Indirect costs are also a significant cost included in departmental budgets--\$25.8 million or 23 percent of the 2010 operating budget. Twelve categories of costs are included in the indirect cost allocation pool. As reflected in Table 1, costs related to the administrative center are accumulated and allocated based upon several factors. Many methodologies exist for the capturing and allocation of overhead or indirect costs and the State Bar appears to apply acceptable approaches.

**Table 1. Indirect Cost Allocation Elements and Allocation Basis**

Administrative Area	Allocation Basis
Membership Billing	Revenues
Board of Governors	Actual costs as a percentage of total State Bar direct costs
Appointments	Number of appointments per committee to total appointments
Property Related Costs	Costs of all State Bar facilities allocated by square foot
General Counsel	Hours relevant to operating departments
Executive Director	Actual costs as a percentage of total State Bar direct costs
Library	By number of attorneys
Human Resources/Payroll Depts.	Per FTE in division
Information Technology	Per FTE in division
Finance	Actual costs as a percentage of total State Bar direct costs
Communications	Actual costs as a percentage of total State Bar total direct costs
Administration & Support Overhead	Actual ED costs as a percent of total State Bar direct costs

Recently, occupancy costs have been added to the indirect cost pools whereas in prior years, occupancy costs were budgeted as separate line items using a different method. Specifically, as reported to the Board of Governors in October 2009, in prior years the Los Angeles facility was a separate expense and charged to direct service departments using the facility. In the 2010 budget, this approach changed, the new approach adds the costs of the Los Angeles to the pool of all building and facilities costs and the total pools is allocated by square foot occupied, creating a standard “per square foot” charge State Bar-wide regardless of the department’s physical location. This factor combined with the changes in budgeting separating out several divisions within departments makes comparing results between years difficult in the short term but provides additional fiscal management information going forward.

The *Strategic Planning Budget* document presents the budgets for each “Operating Service Area” that captures the program-based activities of the State Bar and “Support Service Areas” that are administrative activities undertaken by the State Bar to support its programs and services. Each operating or support area (department) is presented in total as a Financial Overview that reflects three years actual and the budget year proposed “Sources of Revenue” in

high level terms and expenditures using five broad categories: Personnel, Goods and Services, Buildings and Equipment, Indirect Costs, and Other Expenditures.

In addition, included in the Financial Overview is a summary of expenditures for the same four year periods by “service area” or subdivision of the department illustrating the costs related to those specific programs or activities. This data is accompanied by brief descriptions of programs or services of the subdivision and individual budgets for each using the 5 expenditure categories listed above. Thus, although the budget presentation used for BOG approval in the most recent years provides more detail than previous budget documents, the high-level categories allow Department Executives great latitude in spending in three of the five categories—they have no control over Personnel or Indirect Costs spending. Policy is clear that budgets as approved cannot be overspent and the Executives we spoke with clearly understood the rules and the internal control over total costs is in place. Although Finance and Executives monitor expenditures during the year at a much more detailed level, technically they are held to the constraints included in the BOG-approved document. Should the BOG or the Executive Director decide that greater accountability, tighter expenditure constraints, or more transparency is desired, rules or parameters could be set that would require certain types or levels of expenditure to be either reported and/or pre-approved by the Executive Director or the BOG.

During the budget development process, Finance provides detailed line-item expense data to the departments by subdivision (service area), known as baseline budgets. These costs are presented with two prior years actual, the budget year, and the projected baseline year with the adjustments made to the personnel and indirect costs items. According to the CFO, most expenditure line items are carried forward year to year and may have an inflation factor or not, depending upon the fiscal circumstances related to the department or the State Bar overall. These carried forward expenditure categories include contracts, temporary help, and other costs and continue at historical rates unless they are clearly one-time costs such as moving or recruiting expenses which would be budgeted at zero but reflected on the three year projection until the line item “drops off”. It is stated and widely understood that personal services and indirect cost charges are set when the baselines arrive at the departments and are not to be adjusted. The departments review the other expense categories and adjust line items to meet the expected needs as long as the expense total for non-personnel program costs are not increased. If the department deems a need for expense category augmentation, a “decision package” is prepared requesting additional funds and setting forth the rationale for such an increase for consideration by State Bar Executives.

Up until the last year most departments carried vacant positions and the salary savings provided a cushion from overspending, although State Bar policy, affirmed by department directors, is that these savings could not be transferred to other aspects of their programs but provided a cushion against overspending within the department budget. All executives voiced that with the elimination of vacant positions and no increase in the Fee Bill that they would be watching their budgets more closely than they had to in the past. Departments have recently begun including brief discussions of “accomplishments” and initiatives and in some cases have established “activity measures”.

In total, the budget planning process is formal and deliberate and includes adequate controls. However, as the budget is presented in very high level spending categories it appears to afford the Executive Director and the department executives a great deal of spending flexibility within the provisions approved by the BOG, with potentially limited transparency and accountability.

## Budget Change Controls are In Place but Rarely Applied

The BOG approves the budget annually and according to the Board Book Tab 17, Policies and Procedures, “upon adoption, the annual budget for the State Bar shall remain static” but allows changes in the “implementation of a new program or an internal reorganization that materially changes the scope of one or more programs” with the approval of the Board committee on Planning, Program Development and Budget and adopted by the BOG. Given that the BOG approves spending using five expenditure categories and two are devoted to personnel costs and indirect costs, the remaining activity within a department is covered under the remaining three umbrella categories—goods and services, buildings and equipment, and other expenditures. In the past, few occasions have required that funds be formally moved among these three categories. Although department expenditures are maintained in much greater detail, budgets are not closely restricted within the detailed line items. In the event that spending authority be transferred, the following rules from the Office of Budget and Planning *Budget Policies and Procedures Manual* apply:

- *Service area managers may transfer budget amounts between detailed objects of expenditure within the same major object group and service area upon request.*
- *Department directors may transfer budget amounts between detailed objects of expenditure within the same major object group and department (and specifically between services areas of the same department) with the approval of the deputy Executive Director or the Executive Director.*
- *The Executive Director may authorize the transfer of budget amounts between detailed objects of expenditures and between departments.*

The manual further requires that “budgeted funds from one object pool to another, either within the same cost center or between two different costs centers within the same fund” requires the completion of a form, “Request for Budget Transfer,” that includes a brief justification for the change and sets the onus of ensuring the sufficiency of monies available within the affected fund on the requestor. The form must be approved by the department head prior to submission to Finance.

Executives and budget managers at the department level that we spoke with indicated that the need to move money between line items is infrequent. Only one manager described a need to formally move funds between line items and recently learned about the process that requires the submission of a form to accomplish such transfer. Most of these individuals stated that they were not too concerned with modestly overspending a line item as long as the department’s budget remained in balance. Nevertheless, the State Bar’s high level budget management approach is acceptable from a control environment perspective.

## Accounting Processes Appear Adequate to Ensure Appropriate Fund Usage

Our review revealed that Finance and department Executives and budget managers are keenly aware of where revenues (if any) are posted—fund, revenue classification, etc., and against which cost center, account and fund an expense is to draw upon. The funds are clearly segregated and the structure protects the integrity of the source and uses of the many funds collected and expended by the State Bar.

Currently, the State Bar utilizes some 22 funds to account for the many activities and programs it administers. Of these 22 funds, three can be considered “unrestricted” with usage at the full discretion of the State Bar and BOG with another three funds allowing some level of discretion and flexibility in the use of the monies. The General Fund is the chief operating account where funds may be used at the direction of the State Bar and the BOG to meet the mission, goals and objectives of the organization overall and is funded for the most part with member dues, fees, and interest income. For the 2010 budget, the General Fund comprises about \$66 million of the total \$140.8 million (including grants and claims) of the State Bar budget and generally supports:

- Office of the Chief Trial Counsel
- Mandatory Fee Arbitration
- Media & Information Services
- Executive Office
- Probation
- State Bar Court
- Other programs and activities in part

Approximately 60 percent of personnel costs are funded with General Funds with programs having dedicated funds supporting the positions in those programs, for example Sections and Admissions. Each employee position is tied to a program and funding source and expenses related to those positions are charged to those funds. Similarly, operating costs are coded and tracked to the department and fund.

The State Bar uses a JD Edwards system for its financial and budgetary processes. This system allows very detailed reporting and recording of budget and financial information using a variety of codes and accounts to budget and record revenues and expenses to the appropriate department, business unit, fund, and account. *Budget Policies and Procedures Manual* includes the State Bar “Chart of Accounts” by object groups/object codes. Line item budgets and financial recording of transactions follow these codes.

As costs are incurred during the year, and invoices, contracts and other payments pass through the departments for approval they are coded for recording to the appropriate place and fund. During the budget process and throughout the year when the operating statements are reviewed, any transaction that does not appear to be appropriate is questioned by the department or by Finance. Most all interviewees noted that occasions arise where something is incorrectly coded or recorded and the issue is raised for resolution.

Our testing of position control documents as compared to the payroll rosters and our analytical review of budget documents and operating reports showed that financial information were consistent and accurate and suggest that the controls are working as intended.

## Monitoring of On-Going Financial Activity Appears Strong

Unlike many government and quasi-government organizations, the State Bar actively uses available management information and monitors spending on a monthly basis. This attention to monitoring and commitment of department Executives and budget managers to program fiscal integrity establishes a robust budget control. In prior years departments relied primarily on the voluminous operating statements to check transactions and monitor expenditure results. With the new streamlined monthly monitoring reports, Executives have a snapshot of key information to go along with the detail already available. While our review occurred during the rollout of these new reports, the reception is very positive and will add an additional component to not only the control environment but also to the Executive's decision and management toolbox.

Monthly, Finance notifies each of the departments that the month end JD Edward's operating statements reflecting the expenditures posted during the month by expense categories are available for review. According to the executives and budget managers we spoke with these reports were available usually around 1 to 2 months after the end of the reporting period. The CFO noted that the goal is to have the month end closed by mid-month the following month and the reports available 5 days afterwards but we are told that Finance is not always successful in meeting those goals.

The department Executives and budget managers that we spoke with all either reviewed these reports personally or have designated a manager to monitor spending. Most conveyed little concern about overspending line item budgets but rather monitored these reports to ensure that expenses were posted into the proper categories and that no unexpected expenses appeared.

Overall, the Executives and managers interviewed were generally satisfied with the annual budget information as well as the detailed monthly data provided in the operating statements. Our interviews disclosed that while it appears that for those departments with fairly stable expenses and revenue sources, the newer annual budget protocol to take the year's budget as a whole for the department and line item and divide the amounts by 12 months is sufficient for their management and monitoring purposes. Alternatively, those managers with peaks and valleys and significant activity fluctuations stated that the 1/12 approach was not effective or particularly helpful for their management purposes and the former approach where data was input into the budget on a month by month basis and reflected in the reports as such worked better for them—even if it was more work in the beginning.

While some executives and managers noted that these reports met their needs for monitoring ongoing expense and funding activity, others noted:

- Reports (operating statements) were sometimes too late to be the most useful.
- The operating statements were too voluminous and detailed to be useful.

- Reports were not configured in a usable manner. So meet the information requirements of certain departments the data from the operating statements were manually loaded into excel spreadsheets formatted to suit the needs of department managers

During our fieldwork, Finance began issuing a new report targeted to the department Executives. This report, “Monitoring Report” is by department, service area, and object group. The intent of the report is to provide Executives an easy to read, snapshot of their department activities without the detail or bulk of the operating statement. The Monitoring Report identifies the current year budget in total, year to date costs incurred by major cost line items, a calculation of the percentage of costs incurred to date to the total year budget, and a calculation reflecting the prior year’s percentage of costs incurred for the same period for that line item. In addition, the report reflects the prior year costs—actual year to date, actual annual, and total budget. Currently, Finance emails these reports to the Executives each month directly—unlike the JD Edwards operating statements whereby the Executive is notified of the report being available on the system and the data had to be retrieved by the department. The early reactions to these reports are positive.

In addition to the department Executives and budget managers using the monitoring reports, they are also provide concise, timely, and useful financial information to the Executive Director, Deputy Executive Director, and the CFO.

Periodic reporting to the BOG is in place and provides another control facet in the overall budget control environment. Although policy requires quarterly financial reports to the BOG, in practice Finance provides financial reports at every BOG meeting. We found evidence of this reporting on the agendas for the BOG meetings. Further, the BOG requires that the State Bar provide a semi-annual report forecasting revenues and expenditures based upon the actual experience at that point in the year. Finance does provide a year-to-date budget to actual report at the last Board Meeting before the State Bar Annual Meeting; even though it does not typically include projections, data are sufficient to assist the BOG in assessing the outlook for the remainder of the year and to provide a foundation for the following year’s budget deliberation.

## System Security and Segregation of Duties

Another essential component of the budget control environment are security controls related to access to the fiscal system and the related separation of duties of the individuals conducting the various related activities. We found that the segregation of duties among these individuals is adequate and that the system is appropriately configured and access permissions in place to protect the integrity of the environment.

We obtained from Finance a matrix developed by Finance and Information Technology that sets forth all the functions included in the JD Edwards system and the related roles and permissions across the various departments including Human Resources, Finance, Information Technology, and Procurement. We evaluated these roles, permissions, tasks, documents, and application processes related to budget as well as the other related activities and determined that strong controls exist over the automated systems.

Similarly, we conducted a review of the separation of duties across finance and found that with the automated permissions and controls and s appropriately defined positions and responsibilities that appropriate separation of duties exist in finance and as those duties relate to budget.

## Conclusions and Recommendations

Our review finds that the State Bar has an adequate set of internal controls for its budget control environment. During our review we did not identify areas of potential control weaknesses but we did note a few opportunities to improve these activities for Board of Governors and State Bar Executive Director consideration.

1. The *Budget Policies and Procedures Manual* establishes only general guidelines for budgeting and the budget process and does not include provisions reflecting the Executive Director's or other department executives' fiduciary responsibilities and roles to ensure that receipts and spending are within the approved budgetary line items and for the prudent use and safeguarding of funds paid by Bar members. Further, the manual does not specify provisions or sanctions that address overspending or actions related to expenditures not in compliance with approved budgets.

Therefore, the State Bar and BOG may wish to consider including in the *Budget Policies and Procedures Manual* specific language relative to the fiduciary responsibilities and roles of Executive Director and/or other department executives as well as stating expectations, provisions and perhaps sanctions for overspending or expenditures not in compliance with the budget or policies, procedures, rules, regulations or protocols and their accountability to the BOG, constituency, and public.

2. Although we found that the budget planning process is formal and deliberate and includes adequate internal controls, the budget is presented in very high level spending categories and affords a great deal of spending flexibility within the provisions approved by the BOG with potentially limited transparency and accountability.

To add more control, transparency and accountability over spending activities, the State Bar or BOG may choose to adopt limitations or constraints that require spending over a certain level and/or for particular types of expenditures to be either defined in the budget, require certain type of pre-approval, or other control that would elevate such expenses to the view of the senior Executives and the BOG.

# State Bar of California's Response to the Audit Report

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# THE STATE BAR OF CALIFORNIA

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Judy Johnson  
Executive Director/Secretary

180 Howard Street, San Francisco, CA 94105-1639

Tel: (415) 538-2358  
E-mail: [judy.johnson@calbar.ca.gov](mailto:judy.johnson@calbar.ca.gov)

July 12, 2010

Kurt Sjoberg and Marianne Evashenk  
Sjoberg Evashenk Consulting, Inc.  
455 Capitol Mall  
Suite 700  
Sacramento, CA 95814

Dear Mr. Sjoberg and Ms. Evashenk:

State Bar Management appreciates this opportunity to respond to the recommendations contained in your recent audits of Budget, Payroll, and Procurement/Accounts Payable. We have reviewed the reports and agree with the recommendations you have identified to improve our control environment. Accompanying this letter are our specific responses and the steps we will take to implement the recommendations.

Management wishes to express its appreciation for the manner in which these audits were conducted and reported. In addition to providing us with recommendations for improvement, the audits also highlight areas in which the Bar's controls are strong and functioning as intended. The inclusion of this type of information in the reports is especially helpful to readers in understanding the entirety of the Bar's controls in these three fiscal-related business processes and the commitment of staff in constantly maintaining and improving them.

We look forward to continuing our collaborative relationship with your firm as our internal auditors. Please let us know if we can provide you with additional information or if you have questions regarding our responses.

Sincerely,

July Johnson  
Executive Director

Attachment/s

## Audit of Budget Controls

### State Bar Response to Audit Recommendations

#### Recommendation:

- 1. The Budget Policies and Procedures Manual establishes only general guidelines for budgeting and the budget process and does not include provisions reflecting the Executive Director's or other department executives' fiduciary responsibilities and roles to ensure that receipts and spending are within the approved budgetary line items and for the prudent use and safeguarding of funds paid by Bar members. Further, the manual does not specify provisions or sanctions that address overspending or actions related to expenditures not in compliance with approved budgets.*

*Therefore, the State Bar and BOG may wish to consider including in the Budget Policies and Procedures Manual specific language relative to the fiduciary responsibilities and roles of Executive Director and/or other department executives as well as stating expectations, provisions and perhaps sanctions for overspending or expenditures not in compliance with the budget or policies, procedures, rules, regulations or protocols and their accountability to the BOG, constituency, and public.*

#### Management Response:

Management agrees with this recommendation. The Office of Finance has prepared a budget monitoring policies/procedures document to accompany the *Budget Policies and Procedures Manual*. This document spells out the responsibility of management to ensure that receipts and spending are within the approved budgetary authority and for the prudent use and safeguarding of funds paid by the membership. The document further outlines examples of corrective action that must be taken to address budgetary overspending and the ramifications on annual performance evaluations of department budget managers who allow overspending to occur.

A copy of the budget monitoring policies/procedures document is attached for review.

#### Recommendation:

- 1. Although we found that the budget planning process is formal and deliberate and includes adequate internal controls, the budget is presented in very high level spending categories and affords a great deal of spending flexibility within the provisions approved by the BOG with potentially limited transparency and accountability.*

*To add more control, transparency and accountability over spending activities, the State Bar or BOG may choose to adopt limitations or constraints that require spending over a certain level and/or for particular types of expenditures to be either*

*defined in the budget, require certain types of pre-approval, or other control that would elevate such expenses to the view of the senior Executives and the BOG.*

**Management Response:**

Management will provide further detail regarding expense categories in the 2011 budget. Categories presented in past budgets included:

1. Personnel
2. Goods & Services
3. Indirect Costs
4. Client Security Fund Claims
5. Grant Distributions
6. Interfund Transfers
7. Building & Equipment
8. Other Expenditures
9. Reimbursements.

In 2011, the expense categories will be further broken down to include:

1. Salary and Benefits
2. Temporary Outside Help
3. Supplies and Postage
4. Professional Services
5. Other Outside Services
6. Occupancy
7. Travel & Training
8. Client Security Fund Claims
9. Grant Disbursements
10. Computers & Software
11. Buildings & Equipment
12. Other Expenditures
13. Interfund Transfers
14. Indirect Costs
15. Reimbursements

Beginning in August, staff will work with the budget subcommittee regarding any further controls it would like to propose to the Board of Governors in conjunction with the 2011 budget adoption.

**The State Bar of California**  
**Budget Monitoring Policies and Procedures**  
**Attachment to Management Response**

**Introduction**

The State Bar's expenditures are formally governed at the fund level through the annual budget resolution adopted by the Board of Governors. The budget allocates spending authority within the fund across operating departments.

Departmental operations are expected to be managed within budgets and, when projected variances arise, these are brought to the immediate attention of the Executive Director and the Office of Finance. Each manager who has budget monitoring duties is responsible for ensuring that receipts and spending are within the approved budgetary authority and for the prudent use and safeguarding of funds paid by the membership.

Corrective action is necessarily taken on a case-by-case basis, depending on the extent to which projected departmental variances impact overall expenditure authority at the department level. Examples of typical corrective action will include:

1. Requiring vacant positions to go unfilled
2. Deferring discretionary operating expenditures
3. Transferring budget amounts between service areas of the same department (requires approval of the Executive Director or Deputy Executive Director)
4. Transferring budget amounts between departments (requires approval of Executive Director)

In addition, budget management becomes a factor in annual performance evaluations under the current evaluation category of financial accountability. This rating category requires that operations be managed within budgets and financial resources be used efficiently.

**Monthly Financial Report/Budget Monitoring Procedures** – A report of current year revenues and expenditures is provided on a monthly basis to assist department liaisons in monitoring their budgets. Operating Statement Reports for each business unit (cost center) are available through the Oracle/JD Edwards financial system after each month end close. After the closing of the books, the Office of Finance will send an email to each designated budget liaison announcing that the operating reports are ready for review. This report provides the following information:

- Budget for the current month
- Actual revenues/expenditures for the current month
- Current month budget to actual variance
- Budget year-to-date
- Actual year-to-date revenues/expenditures
- Year-to-date variance
- Annual Budget

The Office of Finance will also provide each Senior Executive with a Department Year to Date Expenditure Report. This report provides the following information:

- Year to date actual expenditures by department and service area
- Current year adopted budget
- Percentage of adopted budget spent year to date
- Budget benchmark based on prior year actual expenditures
- Year to date expenditures for the prior year
- Prior year adopted budget

Significant variances at the departmental level should be reviewed for accuracy and for potential impact upon cumulative year-end outcomes. Each departmental budget liaison should also review the monthly operating statements to identify any unusual trends. Variances are important in determining potential budget shortfalls and the need for corrective actions, i.e., additional expenditures, processing a budget transfer, or need for contingency funding. Significant year-to-date variances need to be explained to the Office of Finance as soon as possible after the month end close. The definition of “significant” varies depending on the departmental budget size and nearness to year-end; generally, all deficits or any variances in that may result in the over expenditure of a departmental budget as a whole should be investigated and explained.

Detailed transactions resulting in any significant variances may be viewed by using the “account ledger inquiry” feature of the Oracle/JD Edwards system.

**Budget Authority vs. Cash Revenues** – staff must remember the difference between adopted budget and current cash resources. The adopted budget represents the legal authority to spend. However, the Bar can only use available resources. Therefore, with the exception of grant funded programs, no expenditures should be allowed unless: 1) budget for the expenditure has been adopted, and 2) resources to pay for the expenditure have been secured.

If unexpected resources or revenues in excess of projections are secured after budget adoption, departments must check with the Office of Finance for direction prior to making any expenditure of funds. Likewise, no expenditure should take place unless cash flow meets budget forecasts and/or other financing has been secured. For grant programs such as IOLTA, Equal Access, and Client Security Fund, the annual budget serves as an estimate of revenues/expenditures; however, it doesn’t restrict the amount of funds to be distributed in the event that annual grant revenues exceed the amount projected or in the event that grant distributions relating to the previous year are delayed for payment until the current year.

**Request for Budget Transfer** – The budget is an estimate of anticipated expenditures. Careful management of approved budget amounts is required to fund current planned service requirements, unforeseen emergencies and/or increased service demands. Every effort should be made to absorb these unforeseen expenditures via prudent spending, savings acquired from more efficient work methods, and quality improvement projects.

Should a budget transfer become necessary, it may be initiated as follows:

- Request a transfer of funds within a business unit or department by initiating a budget transfer form. This form is available on the Finance intranet site. Under the section “Increase”, provide the business unit, object code, amount, and a detailed description of the budget to be increased. Under the “Decrease” section, enter the business unit, object code, description, and amount from where the budget is being transferred. The total “Increase” and “Decrease” amounts must be equal. Budget transfers within a business unit or department require the signature of the requestor and the approver.
- When an intradepartmental transfer is not adequate to cover the forecasted deficit, a request for an interdepartmental transfer or budget transfer from contingency funds may be requested. Transfers of this nature require the approval of the Executive Director and the Chief Financial Officer. Contact the Office of Finance for instructions on a transfer of this nature.

Failure to initiate a budget transfer may cause purchase orders and requisitions to be held until the budget shortfall is addressed. Also, no formal purchasing solicitation may take place until contingency funds are authorized.

**Continuing Appropriations** – Appropriations typically expire at the end of a budget year. In certain cases, a continuing appropriation may be authorized. Continuing appropriations are usually restricted to large technology or building improvement projects. The Office of Finance will determine the need for a continuing appropriation and will budget accordingly.