

State Bar of California

Review of Internal Controls:
Procurement & Accounts Payable

June 30, 2010



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State Bar of California

Review of Internal Controls

Procurement & Accounts Payable

Procurement is the acquisition of goods and services at the best possible cost, in the right quality and quantity, at the right time, in the right place and from the right source. These related activities utilize a number of processes that include requisitions, purchase orders, contracts and other agreements. Accounts payable is the non-payroll disbursement business activity that ensures the appropriate delivery, receipt, pricing and approval of a procured good or service, the availability of funding, and the proper payment of the obligation.

Controls over the procurement and payables function are intended to safeguard assets, assure the accurate and timely reporting of relevant information, provide strength of the enterprise risk environment, assure the fulfillment of management directives, and protect the best interests of the State Bar. Our review of the procurement and accounts payables cycles revealed that the State Bar has established and generally follows a comprehensive set of procurement and accounts payable policies and procedure. These procedures are based on the California Business & Professions Code Section 6008.6 which includes provisions requiring the State Bar to “establish a request for proposal procedure.” Although we found generally adequate controls in place, we noted instances where controls related to high dollar P-Card transactions could be strengthened, security services provided under a long-term contract should be re-procured, and processes related to temporary professional services agreements be improved.

Scope and Methodology

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 our observations surrounding the State Bar’s procurement and accounts payable processes—findings and recommendations for the payroll and budget reviews are issued under separate covers.

To meet the audit objectives, we conducted interviews, reviewed and tested documents and records to obtain an overall understanding of the control environment related to the accounts payable and procurement business cycles as follows:

- ✓ Identified through interviews and documentation reviews all existing procurement practices and processes from the identification of the need to procure a good/service to the selection of the vendor utilizing the following primary procurement tools:
 - Purchase Requisitions for standard and custom contracts
 - Purchasing Card
- ✓ Conducted limited testing on a cross-section of large and small standard purchase orders, custom contracts, and amendments (where applicable) to determine compliance with Procurement Manual provisions related to competitive bidding, approval, and oversight and that contracts not extend beyond 36 months without specific approval.
- ✓ Contracts include required elements, scope, milestones, and costs.
- ✓ Contract amendments comply with all aspects of Section 9.12 of the State Bar's General Procurement Manual, including competitive bidding rules and sole source justification, if applicable.
- ✓ Temporary agency contracts and independent contractor agreements comply with Sections 9.11 and 11.00 of the State Bar's General Procurement Manual.
- ✓ Reviewed management, oversight, and controls over purchase requisitions, standard purchase orders, custom contracts, and amendments was sufficient to ensure that the State Bar received the goods and services procured/intended and the costs were within budget.
- ✓ For all procurement types tested, ensured that each complied with Section 4.00 of the State Bar's General Procurement Manual involving competitive bidding rules.
 - Competitive bidding processes solicited sufficient qualified vendors and RFP documents included adequately developed project goals, objectives, and scope that fully address the State Bar's specific needs.
 - Procurements did not inappropriately circumvent competitive processes, such as:
 - Appropriate use of sole source procurement.
 - Proper use of temporary agency contracts and independent contractors.
 - Purchases were not artificially "split."
- ✓ Assessed the State Bar's exemptions to competitive bidding and determine if allowable exceptions are reasonable and do not inappropriately impact the State Bar's ability to competitively procure goods and services.
- ✓ Tested P-card purchases to determine whether purchases complied with Section 6 of the State Bar's general procurement manual related to purchasing cards, including whether:
 - Purchases complied with allowable usage and, if they did not, steps taken by the State Bar to seek reimbursement.
 - Using the P-Card was the appropriate method to procure the goods/services and identify if purchases appeared to be artificially "split."

- P-Card expense packages contain the signatures of appropriate level State Bar staff approving the purchases, approvers appear to have scrutinized purchases, and sufficient supporting receipts or other purchase documentation.
- ✓ Identified existing processes designed to guard against potential conflicts of interest between employees and the roles that they serve in the State Bar's official business, particularly as it pertains to private sector businesses seeking to do business with the State Bar. This includes determining the applicability of California Government Code §87300 to the State Bar as a public non-profit corporation, and evaluating whether the State Bar has adopted and promulgated a Conflict of Interest Code to ensure that employees that are likely to benefit financially do not participate in key decisions.
- ✓ Gained an understanding of the process and controls employed over the entire accounts payable/expenditure processing/vendor payment functions, including the existing practices and individuals involved with the following:
 - Receiving shipments of supplies and goods.
 - Reviewing/scrutinizing invoices, including acknowledging goods and services were received and authorizing payments.
 - Reviewing invoices for accuracy of quantities received, prices charged, services received, and mathematical correctness.
 - Reviewing, approving, and preparing disbursements, including level of supporting documentation required, criteria used for establishing allowability of costs, and review/approval process utilized.
 - Recording the disbursement in the fiscal system, including ensuring expenditure coded properly and recorded into correct account and fund.
 - Utilizing, securing, and accessing check stock or signature stamps.
 - Testing the State Bar's compliance with processes and controls by selecting a sample of general ledger accounts based on, but not limited to account expense amount, transaction volume, and description for transaction level testing.
 - For each of the payments, verified that the invoice, travel claim, or P-Card statement was authorized by the appropriate level staff as required by the State Bar's "Expense Policy & Procedures."
- ✓ Reviewed the segregation of duties among personnel to assess the adequacy of the State Bar's assignment of conflicting procurement, receiving, and accounting activities, and ascertain the adequacy of mitigating controls over potential system weaknesses.

Review Results

The California State Bar has faced many challenges over the past few years including servicing over 225,000 members with increased budgetary constraints, facing staff turnovers in key positions, and trying to restore trust after an embezzlement of State Bar funds. Yet, increased public scrutiny has allowed State Bar management to take a pro-active approach in identifying and mitigating internal control risks and embrace opportunities to strengthen its existing policies and procedures. For instance, the State Bar has implemented stronger controls over lease payments it receives from tenants at the San Francisco office. Specifically, tenant invoicing and payment processing is no longer centralized at the Operations department. Instead, invoices are generated by the Finance department based on a pre-established rent schedule that is reviewed and approved by Operations, General Counsel, and Finance. Rent checks are also received by Finance who scan the check and save a copy on a shared drive only accessible by Operations, Finance, General Counsel, and the Executive Director's office. In another example, in response to a high-level risk scan internal control assessment conducted by Kevin Harper, CPA & Associates in early 2009, the State Bar has either already implemented or is in the process of taking corrective actions on issues identified as recommended by the external financial auditor, Macias, Gini and O'Connell. For instance, we learned that the State Bar has designated its Director of Operations to act as Risk Management Officer and identify risk areas to communicate to the State Bar's senior executive team on a regular basis.

Overall, during the course of our review, we have found staff to be dedicated and resolute in the importance of segregation of duties over accounts payables and in ensuring a competitive and fair atmosphere in its procurement processes. The control environment relative to procurement and accounts payable is generally adequate; however, our review identified a few weaknesses in these areas that should be relatively easy to correct.

Internal Controls over Accounts Payable Were Adequate

The State Bar's accounts payable processes are centralized at its Finance department in San Francisco wherein all invoices, regardless of whether they are received at the State Bar's offices in Los Angeles, Sacramento or San Francisco are forwarded to Finance for payment processing. Our review of the State Bar's accounts payable processes did not reveal internal control weaknesses with the currently employed procedures.

Generally, there are two types of invoices—Purchase Orders, "PO" based invoices and direct invoices (without PO).

- *Invoice with PO*: These invoices are the result of goods or services received by the State Bar based on a fully executed purchase/sales agreement for goods or services contracts including professional and technical services. For these invoices, the receiving department or buyer attests to the satisfactory delivery of goods or services by approving (annotating an ok-to-pay) on the invoice. Depending on the dollar amount, the invoice has to be approved by an appropriate level management staff. The receiving department is also responsible for referencing the underlying PO number and assigning the General Ledger account(s) against which the invoice is to be expended.

Once Finance receives the original approved invoice, accounting staff will match the PO number noted on the invoice against the PO recorded in its Oracle ERP system, and verify that there is sufficient funding left on the PO to pay for the invoiced goods or services. However, both the Procurement and Finance Managers indicated that a 10 percent allowance/contingency is built into each PO by the system to allow for instances where actual invoiced costs are higher than the PO costs (e.g. actual shipping rate, tax, variances, etc). If the invoice exceeds the PO by more than 10 percent, then Finance would return the invoice to the department to re-negotiate the payment or work towards a PO amendment to obtain additional funding, which may require re-bidding the contract if certain dollar thresholds are exceeded.

- *Invoice without PO*: Invoices that do not have an underlying PO that was issued through the Oracle system have to be approved and are processed in the same fashion as the ones with a PO except that Finance is not matching the invoice to the PO. Examples of invoices without a PO represent a variety of expenses that are generally exempt from the PO process as outlined in the Procurement Manual Section 2.03 including routine monthly billings for such things as utilities, telephones, gas, electric; professional membership and union dues, subscriptions, sponsorships; transit reimbursements, fire/elevator inspections; direct mailing postage; litigation costs; outside legal counsel, and other payroll or trust related payments.

Based on our review of the State Bar's accounts payable processes and discussion with State Bar staff, we did not find any internal control weaknesses with the currently employed procedures. Specifically, the various responsibilities such as entering and approving payments in the system, preparing/printing and signing checks, and reconciling check register to payable batches are appropriately segregated amongst finance staff. In addition, the check stock is secured in a locked file cabinet, checks are sequentially pre-numbered by the system, and the positive pay online-banking requires the matching of each check to the check register before the check can be cashed (e.g. the check has to be "released" by the State Bar before it can be cashed). Moreover, the State Bar's financial auditors also tested the State Bar's disbursement/accounts payable processes and did not note any exceptions or areas of risk.

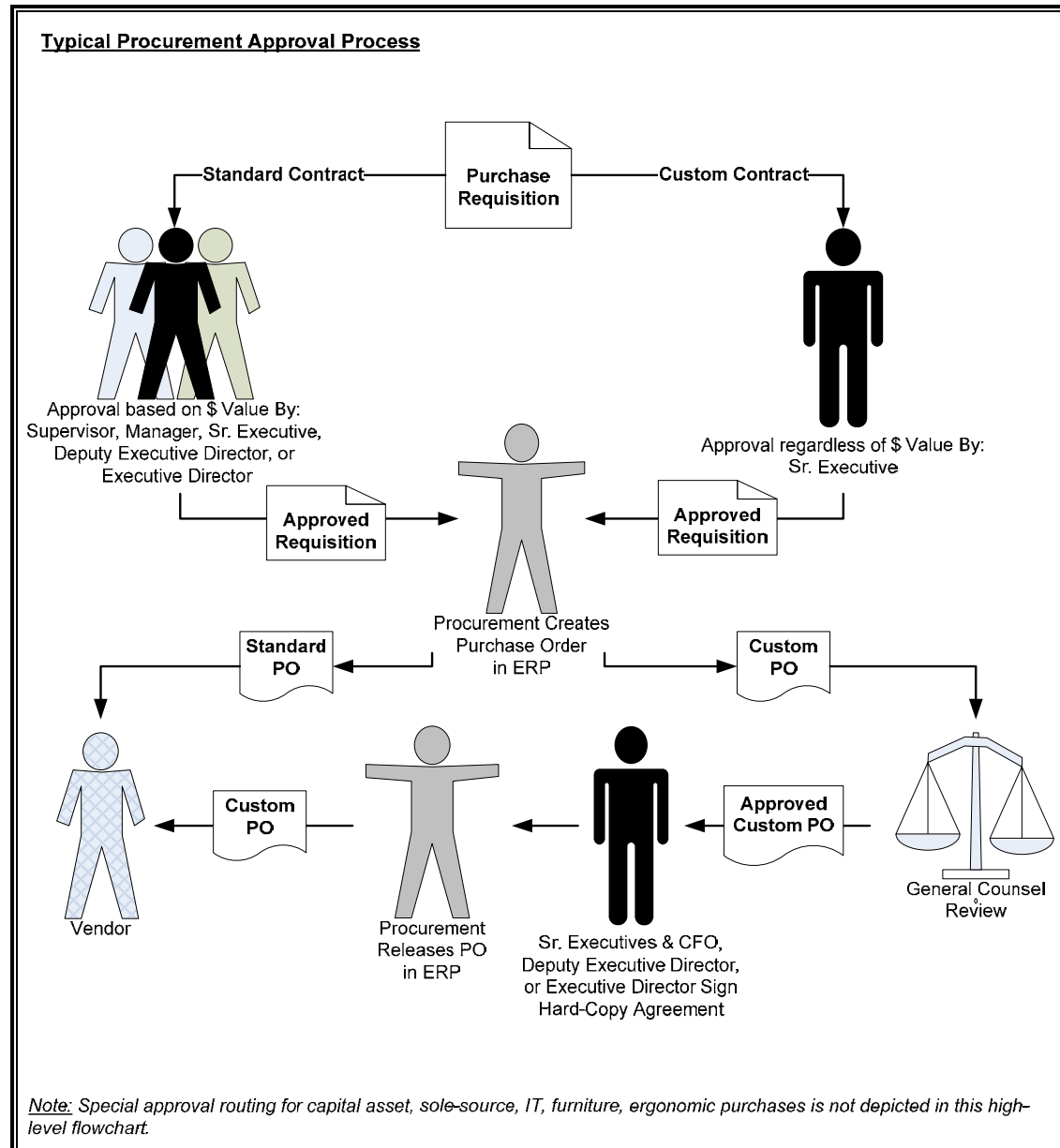
While Controls Were Generally Adequate, Certain Procurement Processes Warrant Attention

We reviewed the State Bar's procurement manual, conducted interviews with procurement staff, and tested existing State Bar contracts and found that generally controls related to these processes were adequate. However, we identified a few practices where opportunities for improvement exist related to P-Card expenditure approvals, long-term agreements, and the use of temporary professional services.

Between January 1, 2007 and December 31, 2009, the State Bar's Oracle ERP system listed a total of 3255 active contracts categorized into 11 areas including standard, sole-source, standard telecom, custom sole-source and others. In addition, the State Bar's system also contained 16 contracts categorized as "OI" which represents the contracts executed prior to the implementation of Oracle in 2002. While there is no standard procurement process as different contract types (e.g. standard or custom), nature of goods or services procured (e.g. IT, sole

source), and purchasing values, the State Bar has developed a comprehensive Procurement Manual that guides the users through the various procurement steps as required by State Bar policies and procedures. Further, depending on the contract type, varying levels of procurement approvals are required before a purchase is made. For example, all sole-source procurements have to be approved by the Deputy Executive Director, while all IT related purchases have to go through the Chief Information Officer. The flowchart in Figure 1 is a high-level representation of a typical procurement approval process.

Figure 1: Typical Procurement Approval Process



Therefore, we generally did not note any significant weaknesses in the State Bar's procurement process and found Procurement staff to be knowledgeable about sound procurement practices

and diligent in ensuring the organization follows competitive procurement guidelines when purchasing goods or services. However, we identified a few practices where opportunities for improvement exist.

P-Card Expenditure Approvals Were Inconsistent

Our review of a sample of expenditures paid in 2008 and 2009 generally revealed no issues with the payment of those invoices and claims. For instance, out-of-state travel claims were adequately approved by Senior Executive staff and the claims were supported by underlying hotel and airfare receipts. Additionally, invoiced services were given the “ok-to-pay” by appropriate level staff who were familiar with the services received. However, while “regular” expenditure transactions such as travel claims and vendor invoices were adequately supported by underlying receipts, purchase orders, and goods receipts documentation, we found that payments made via P-Card lacked some of the required additional levels of review. Given the nature of purchasing cards where cardholders are given more purchasing flexibility, it is critical that a framework is in place to minimize opportunities for cardholders to inadequately spend State Bar funds.

Our testing revealed some inconsistencies with required additional approval levels for P-Card transactions that exceeded the \$5,000 threshold. Specifically, while the State Bar’s authorization matrix requires the approval of a Senior Executive for all expenditures exceeding \$5,000, we found instances where the Senior Executive did not sign-off on the P-Card purchases even though they were over \$5,000. Although the P-Card statements were approved by the cardholder’s immediate supervisor, the supervisor should have forwarded the P-Card envelope to the Senior Executive over that area for secondary or additional approval since some of the transactions exceeded the supervisor’s approval threshold.

Certain Long-Term Agreements Need to Be Re-Evaluated

Majority of the State Bar’s contracts have terms that do not exceed the 36 months limit set by the Procurement Manual Section 9.02. Some exceptions to that rule include long-term lease agreements that can extend up to 10 years. However, our review identified one long-term, sole-sourced contract with Universal Protection Services (UPS) to provide security for the State Bar’s Los Angeles office that has been in place since approximately 1993. Although records were missing for the initial 1993 contract, the 1997 contract renewal provided for an open-ended contract term and as such the State Bar has continued to operate with a purchase order (PO) from 1997.

While UPS might have been the most suitable security provider in the early 1990s and appeared to meet all the State Bar’s needs and expectations for the safety of its Los Angeles staff and visitors, any contract that has been in place for nearly 20 years should be re-evaluated. State Bar Executives recognized this need and a memo from the Director of Operations to the Deputy Executive Director from December 2009 demonstrated that the State Bar is aware of the prolonged term of the UPS contract. We are told that a multitude of challenges including a reorganization in the Operations Department has delayed efforts to re-procure the services. Instead, the Director of Operations indicated that the UPS contract will be revisited as part of a greater real estate plan for the State Bar, which had a target implementation date of sometime in

2010. In fact, at the conclusion of our fieldwork, we were told that not only the security contract for the State Bar's Los Angeles office but also the one for San Francisco building is slated to be re-bid. A request for proposal (RFP) is currently in preparation and the State Bar expects to award the contract later this year, with an anticipated new service start date in January 2011.

With the recent progress with the UPS contract, we encourage the State Bar to further its initiative and revisit all contracts that have been in place for over four years and work with the Procurement Department to re-procure those services.

More Favorable Pricing Could Have Been Negotiated For Temporary IT Staff

During our review of State Bar's contracts, one custom IT contract stood out as it had 8 work orders for 2 projects issued over a one year period worth \$225,400. Specifically, in October 2007, the CIO approved a purchase requisition (PR) to hire a Senior Developer from Magenic Technologies to provide "expert advise and professional services" for the State Bar's Microsoft-based applications. While the initial PR designated \$25,600 for the period from October 20, 2007 to October 28, 2008 for one consultant, the agreement also called for individually negotiated and priced work orders to be issued under the umbrella of the master agreement.

While issuing work orders to a consultant under a master services agreement is a general practice followed by many private and public entities, the services provided by Magenic could have been procured with a more defined project cost schedule. Specifically, since the State Bar knew the full scope of services and anticipated the consultant would be working full-time on the project over several months, the State Bar could have negotiated a contract with a concrete deliverable and price instead of issuing multiple work orders for the same scope. For instance, the State Bar could have required the consultant to create a fully functional "Find an Attorney Website" for a pre-determined price and final delivery date. Moreover, since the State Bar hired a temporary agency to staff the project, it might not have received the best value for its money since temporary staff services are not competitively procured but rather are negotiated based on the agency's rates for that position. Also, by competitively bidding the project, the State Bar would have had more pricing and deliverable options to choose from, which all could have lead to possible cost savings.

Opportunities Exist for Greater Oversight of High Dollar Contracts

Aside from the issues discussed in this report, we also identified an opportunity where the State Bar should consider changing its practices to afford greater transparency over its contracts. Specifically, while the majority of the State Bar's contracts are standard purchase order-based contracts valued at less than \$50,000 each, there are a number of contracts that require a separate agreement specifying the terms and conditions, and typically have greater contract values. These "custom" contracts are mainly used for consulting services and often demand more deliberation from the requestor in terms of defining a project scope, estimating costs, and setting schedules.

While our review of several custom contracts found no irregularities with the vendor selection or contract approval processes, we noted an unusual contractor relationship for services provided by a consultant, P.L. Short, LLC that spanned three separate agreements since 2007. Specifically,

the three agreements were worth a combined \$678,999 and related to providing on-going support services, system upgrade and implementation services for the State Bar's Oracle ERP system. From a procurement perspective, all three contracts with P.L. Short were procured using standard procurement methods and were in accordance with the State Bar's Procurement policies and procedures. Moreover, although the first two contracts were valued at less than \$50,000 and therefore were not required to be formally bid, the requesting department advertised for the services on the State Bar's website. In fact, the Human Resources (HR) department was looking to hire a "Systems Analyst" as a temporary contract position to assist HR staff in utilizing and troubleshooting the State Bar's new ERP system during year-end closing processes. The year-end closing related services were completed by January 1, 2008 and the State Bar had paid the consultant approximately \$18,000 under the first contract. Five months later in May 2008, the HR department again advertised for a "HR Systems Contractor/Consultant" position on its website. The desired qualifications for this position included extensive experience with the ERP system as the State Bar was encountering problems with upgrading the system. The third and last contract worth \$280,000 was executed in August 2008 and was competitively procured using the RFP (request for proposal) solicitation method. The contract was increased by \$300,000 one year later to allow for a continuation of the services but due to the fee bill veto earlier this year, the contract was put on hold.

Altogether, we are told that a "business decision" was made that was believed to be in the best interest of the State Bar and while the same consultant was hired for the entire project, we found no evidence of the competitive procurement process being intentionally circumvented. In fact, HR indicated that the consultant's hourly rate of \$150 or average of \$190 including travel, was a great value since hiring a local consultant would have cost the Bar nearly \$207 per hour.

Many of these questions and concerns could have been avoided if certain limitations were set by the Board or in Policies and Procedures requiring contracts of certain type or value needing further review or oversight, particularly when such a follow-on or contract amendment brings the agreement total beyond a set level. Currently, the Board is not involved in the procurement process and as such, typically is not notified of contracts unless there is specific matter or concern arises. Although the State Bar's Procurement Manual stipulates that "no contract may be entered into, by or on behalf of the State Bar unless authorized by the Board of Governors", the same section also defines 'authorization' as "approval of a budget or agenda item." By approving the State Bar's annual budget and embedded expenditure line items, the Board essentially agrees with all contracts that result from that expenditure authorization without actually knowing the vendors selected and the terms of the contract.

However, with many custom contracts obligating State Bar funds in the \$100,000 dollar range; transparency and control over such significant obligations should be in the best interests of the State Bar and its constituents. Further, as fiduciaries of the Bar, the BOG and the Executive Director should ensure that the appropriate oversight and approval of significant expenditures occur. To add greater accountability as well as oversight, the Board may wish to consider requirements for notification or some level of approval either prior to or during the contracting process for certain contract types or levels of spending.

The practice of keeping boards informed about the entity's intended contractual obligations is not uncommon and provides for additional oversight without significant effort needed by staff or Board members. In fact, many larger California trial courts have implemented policies where contracts exceeding \$100,000 have to be authorized by a budget or executive committee typically consisting of the presiding judge, court executive officer, and a selection of judges depending on the court's size. One county trial court even required the approval of the full bench for all contracts over \$100,000. In following the trial court model, the State Bar could establish a contracting threshold that if exceeded would require Board review and approval prior to the contract being executed with the vendor. While the actual contract signing authority would still remain the same pursuant to Section 3.01 of the Procurement Manual, by keeping the Board informed throughout the contracting process, questions and ambiguity about high dollar value contracts could be immediately addressed and possibly eliminate public concerns "after the fact."

Conclusions and Recommendations

With an already strong internal control framework in place over accounts payable and procurement, the recommendations we have made here should be relatively easy to implement. As such, we encourage the State Bar to consider our recommendations to further strengthen its existing procurement policies, procedures, and practices. Specifically, the State Bar should:

1. Emphasize the importance of additional reviews needed by senior executive staff for P-Card purchases exceeding \$5,000;
2. Continue its efforts to re-procure the security services contracts and work towards researching and renegotiating other long-term contracts.
3. Evaluate the costs and benefits of using a temporary agency to staff a deliverable based project versus competitively bidding the work.
4. Consider incorporating steps to inform its Board about high value custom contracts to increase oversight and transparency over its contracting processes.

State Bar of California's Response to the Audit Report



THE STATE BAR OF CALIFORNIA

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July 12, 2010

Kurt Sjoberg and Marianne Evashenk
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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,

Judy Johnson
Executive Director

Attachment/s

Procurement Audit

State Bar Response to Audit Recommendations

Recommendation:

1. *Emphasize the importance of additional reviews needed by senior executive staff for P-Card purchases exceeding \$5,000.*

Response:

Management agrees with this recommendation. By way of background, a limited number of cardholders are granted higher transaction limits by their Senior Executives, in most cases to facilitate payments in the field for Section Education and Program Development functions and Bar Examinations. Most of these higher-level transactions are authorized by both the respective Senior Executive and the CFO in advance by the governing custom contract in place. After early discussions with the auditors, we began to further monitor each of these transactions as they post to the cardholders' account and to document the appropriate Senior Executive's approval in writing on the face of the Pcard monthly statement.

Recommendation:

2. *Continue its efforts to re-procure the security services contracts and work towards researching and renegotiating other long-term contracts.*

Response:

Management agrees with this recommendation. The Office of Operations currently plans to have a request for proposal for security services developed and advertised by September 2010 and have a board-approved agreement in place by the start of 2011 for both our Los Angeles and San Francisco operations. Other long-term contracts that contain auto-renewal clauses will be evaluated individually prior to their renewal dates and slated for renegotiation and/or opened for formal competitive bidding.

Recommendation:

3. *Evaluate the costs and benefits of using a temporary agency to staff a deliverable based project versus competitively bidding the work.*

Response:

Management agrees with this recommendation: Procurement staff will work with Human Resources to identify future contracts that can be appropriately defined in measurable deliverables and to identify candidates for the formal competitive bidding process.

Recommendation:

4. *Consider incorporating steps to inform its Board about high value custom contracts to increase oversight and transparency over its contracting processes.*

Response:

Management agrees with this recommendation: Effective March 2010, custom contracts for consulting services, capital equipment, or technology purchases exceeding, or amended to exceed \$75,000 require specific full board approval, except in cases of emergency where the immediate preservation of the public health, welfare or safety, or protection of State Bar employees and property does not allow time for full board approval prior to execution.