



THE STATE BAR OF CALIFORNIA

180 Howard Street
San Francisco, Ca 94105
(415) 538-2000

Date: July 13, 2010
To: Audit Committee
From: Office of Finance
Subject: Presentation of Sjoberg Evashenk Audits

Item IV A.

Background:

In November 2009, the Audit Committee engaged the services of Sjoberg Evashenk Consulting, Inc. to perform three separate audits to evaluate the internal controls pertaining to the payroll, accounts payable/procurement, and budget business processes. The audits are now complete and are attached to this agenda item for your review. Contained within the reports are management's responses to the six recommendations made by the auditors.

Discussion:

The audit reports are quite comprehensive, describing both the existing control environment within each business process function and highlighting the controls and processes that work well along with areas where controls could be enhanced. 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 the Board of Governors and staff to constantly maintaining and improving them.

There are a total of 45 pages of detailed information in the reports. Each begins with an overview of the scope and methodology of the audit along with a list of the specific procedures performed during the course of the examinations. This agenda item provides a staff summary of the highlights of the major sections of the reports. Auditor recommendations and staff responses are included in the Conclusion, Recommendations and Management Responses section of this agenda item.

Payroll Audit

The discussion of payroll processes begins on page 4 of the report. The Review Results section states:

Our review of the various activities and transactional testing of the Bar's payroll processes and procedures revealed they are closely followed as written and

intended. Additionally, we found no discrepancies between amounts reflected on approved timesheets, DTS forms, final payroll registers, and general ledger accounts. We also found appropriate Human Resources approvals were in place authorizing hires and promotions, payroll signatures were present acknowledging personnel changes, salaries paid complied with MOU agreements and agreed with amounts reflected on payroll registers. Moreover, the Bar's external financial auditors provide additional oversight of payroll processing each year as the Bar undergoes a financial statement audit that includes tests by these auditors. These tests cover payroll processes and transactions and check for accuracy of pay and approval of timesheets. For Fiscal Years 2008 and 2009, the external financial auditors did not find any exceptions or significant issues related to the Bar's internal controls over payroll processing. As a result of our work and that of the external auditor, we found that the control environment over payroll functions and activities is strong.

Accounts Payable/Procurement

The discussion of the procure-to-pay controls begins on page 4 of the report. The Review Results section states:

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.

The audit found no internal control weaknesses in accounts payable and there are no recommendations. The report further notes that the State Bar's financial auditors tested the Bar's disbursement/accounts payable processes and did not note any exceptions or areas of risk.

In the area of procurement, the auditors 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.*" These opportunities relate to P-Card expenditure approvals, long term agreements, and the use of temporary professional services.

Budget Audit

The audit of the Bar's budget controls is the most lengthy of the three audits. It provides exhaustive detail about the budget development and monitoring processes and recommends two improvements to strengthen the control environment. The audit report is divided into seven categories. Each is summarized below.

Review Results (page 5)

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 to 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 (page 5)

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.

This section of the report calls attention to two specific controls, one of which was instituted earlier this year by Planning Committee Chair, Patti White. Beginning on page 5, these controls are explained as follows:

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.

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 Control Environment Related to Budget Development Appear Adequate But Opportunities to More Closely Manage Costs Exist (Page 7)

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 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 (page 10)

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 (Page 11)

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 sources and uses of the many funds collected and expended by the State Bar.

Monitoring of On-Going Financial Activity Appears Strong (page 12)

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.

System Security and Segregation of Duties (page 13)

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.

Conclusions, Recommendations and Management Responses

The conclusion and recommendations for accounts payable/procurement are:

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;*

Management Response: We agree 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.

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

Management Response: We agree 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.

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

Management Response: We agree 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.

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

Management Response: We agree 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.

The conclusion and recommendations for Budget are:

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 executive's 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: We agree 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.

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.

Management Response: We agree with this recommendation. We will provide further detail regarding expense categories in the 2011 budget. The nine expense categories presented in past budgets included:

Personnel	Goods & Services
Indirect Costs	Client Security Fund Claims
Grant Distributions	Interfund Transfers
Building & Equipment	Other Expenditures
Reimbursements	

In 2011, the budget will be expanded to include the following 15 expense categories:

Salary and Benefits	Temporary Outside Help
Supplies and Postage	Professional Services
Other Outside Services	Occupancy
Travel & Training	Client Security Fund Claims
Grant Disbursements	Computers & Software
Buildings & Equipment	Other Expenditures
Interfund Transfers	Indirect Costs
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.

Staff Comments

We wish to express our appreciation for the manner in which these audits were conducted. The conclusions and recommendations will enhance the existing control environment and assist us in maintaining a strong system of internal controls.